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Understanding Equity Burn Rates

By Bimal Patel, Senior Analyst, U.S. Research, and Christian Ryther, Senior Analyst, Custom Research

Institutional investors are increasingly interested in equity "burn" or "run" rates, which measure a company's annual cost of granting equity to executives and employees. This concern has grown even as companies are issuing fewer stock options, in part because of market conditions and a shift by some firms to full-value awards. Between fiscal 2001 and 2003, the average option burn rate at both S&P 500 and Russell 3000 companies declined 24 percent, according to ISS data.

While these developments may seem paradoxical, they actually reflect the need for greater sophistication in measuring equity outflows as part of a holistic approach to executive compensation and equity plans. In a trend reinforced by academic studies, some institutional investors and public companies have come to recognize that burn rates constitute one of the most critical measurements of the impact of equity plans. With option grants falling, institutional investors still need to identify outliers with excessive burn rates. Investors also may wish to enhance their approach to compensation by refining or adding measurements of burn rates.

To calculate a company's burn rate, some compensation experts and investors suggest looking beyond stock options to consider restricted stock grants, which have become more prevalent, and weighing a company's market cap, price volatility and industry practices. Although option burn rates have declined, investors may wish to develop policies to identify those companies that lag behind their industry peers in managing equity outflows.

Growing Investor Interest

Investors have become more attentive to equity burn rates, according to a client survey conducted by ISS last fall. Seventy-five percent of survey respondents said burn rate was a "very important" factor, while the other 25 percent agreed it was "somewhat important."

This high level of interest also is reflected in some proxy voting guidelines. The **Council of Institutional Investors** has recommended that compensation committees provide disclosure on "specific targets for annual awards." Some institutional investors have incorporated burn rate guidelines into their proxy voting policies. **TIAA-CREF**, which has had a burn-rate policy for four years, considers voting against equity compensation proposals where "in the most recent three year, potential dilution from stock and stock option grants averaged in excess of 2 percent per year." Other institutional investors, such as **Vanguard** and **Ethical Funds**, also incorporate burn rates into their proxy voting guidelines. Still other investors may wish to upgrade their policies.

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For investors like TIAA-CREF, the burn rate is a starting point for analyzing a company's overall compensation practices.

"If there are 'red flags' raised by the level of burn rate, [we] will look at compensation plans more closely," Linda Scott of TIAA-CREF explained. "Generally, more than 2 percent burn rate level for most companies or 3 percent for human-capital intensive, and tech industries raises a red flag. If a red flag is raised, [we] will look at other factors like trend in burn rate, company performance, market cap, industry comparison, etc."

"High burn rate is one of the factors incorporated into [TIAA-CREF's] governance rating system, which will be used to determine potential withholding votes from the whole board," Scott noted. "High burn rate correlates with high dilution, which is a significant factor in [our] governance rating system."

Why Is Excessive Burn Rate Bad for Shareholders?

The higher the burn rate, the more likely the company is to dilute the value of shares held by existing investors. Also, companies with high burn rates risk depleting their authorized shares quickly.

But an excessive burn rate can also be a warning about a company's future behavior. Academic studies that have shown a correlation between the level of company grants and financial performance. These studies show that burn rates may be useful as a performance indicator in addition to measuring the cost of compensation plans.

In an August 2004 paper, "Corporate Governance and Firm Performance," Lawrence D. Brown and Marcus L. Caylor found that: "Firms with high option burn rates are less profitable . . . , more risky . . . , have more share price volatility, lower price-to-earnings ratios and pay out less to shareholders."

Other academic studies show empirical evidence associated with excessive compensation and equity grants. In a May 2004 paper, Jap Efendi, Anup Srivastava and Edward Swanson at Texas A&M University studied 100 companies that issued accounting restatements in 2001 and 2002 and found a "strong" link between the incidence of restatements and CEOs holding in-the-money options. On average, CEOs at those restatement companies received options worth twice (based on Black-Scholes values) as much as their counterparts at a control group of 100 firms that did not restate financial results. In addition, the average value of options exercised at the restatement companies were 10 times those at the control firms.

Firms that grant an excessive number of options also are more likely to face shareholder lawsuits, according to an April 2004 paper by Lin Peng of Baruch College and Ailsa Roell of Princeton University. They found that investor lawsuits were more common at companies with higher option burn rates and shorter option vesting schedules.

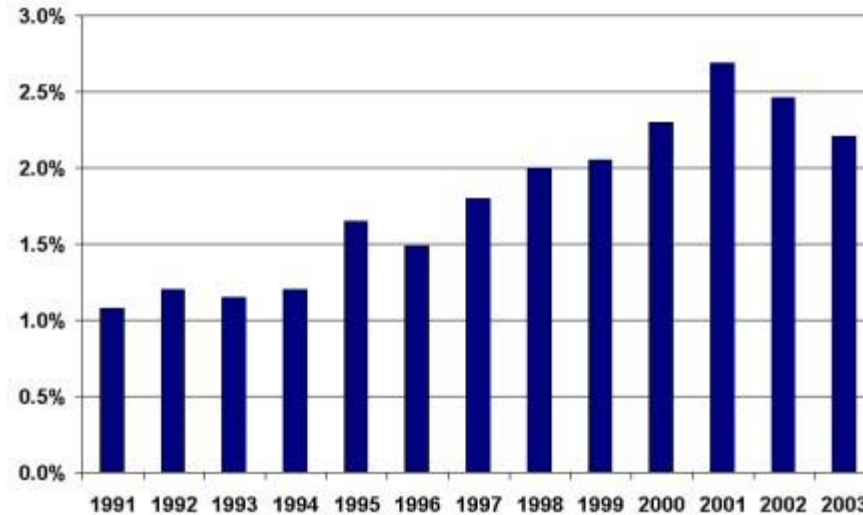
Even though such studies may not examine burn rates in particular, the evidence presented shows the importance of exercising extra caution in reviewing companies with excessive burn rates.

Burn Rate Trends

Option burn rates have declined significantly at U.S. companies since 2001, thanks in part to governance reforms and pressure from shareholders. One major reason has been anticipation of a regulatory requirement to expense options. After years of opposition from technology companies,

the Financial Accounting Standards Board (FASB) approved a final rule in December that is slated to take effect for large U.S. companies after June 15, unless Congress intervenes.

Burn Rate of Top 200 Companies



Source: Pearl Meyer & Partners. Data is for the 200 largest public U.S. industrial and service corporations, excluding mutual companies, regulated utilities and companies with dominant insider ownership.

The decline in equity grants is part of a broader shift in how companies are addressing executive and equity compensation. The future cost of option expensing is driving companies to consider alternatives to stock options. In addition, shareholders--particularly state and union pension funds--have become increasingly vocal in opposing what they consider excessive option grants and executive compensation.

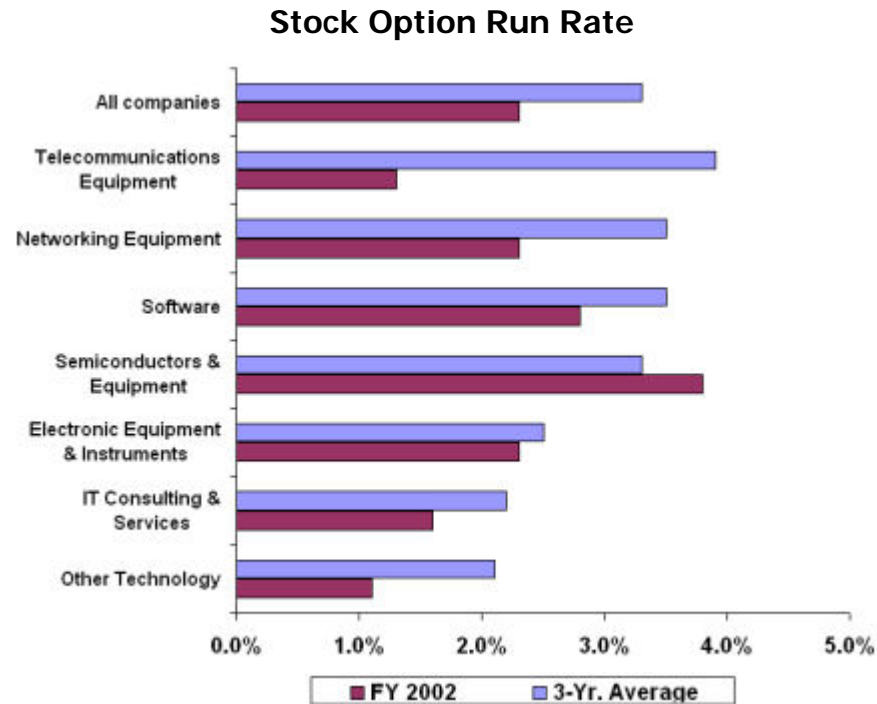
Rather than rely exclusively on options, more companies are recognizing that a balanced compensation mix that includes stock grants may better align management interests with shareholders' interests. [ISS does not oppose the use of stock options as part of a balanced set of incentives, provided they are administered properly and expensed as required by new FASB rules.]

A 2003 **Pearl Meyer & Associates** study showed that average annual burn rate among the largest 200 U.S. companies decreased from a record high of 2.69 percent in 2001 to 2.46 percent in 2002 to 2.21 percent in 2003. [See the above chart for burn rate figures since 1991.] "While rates remain above those in the early 1990s, it is the first time in more than a decade that annual grants have dropped in two successive years", the study found. That study examined other equity grants besides options, considering shares granted annually for management and employee equity incentives as a percent of weighted average shares outstanding on a diluted basis.

Other studies, such as those by **Hewitt Associates** and **Executive Compensation Resources**, have documented similar trends. According to ECR's study of Fortune 250 companies, the average run rate declined from 2.3 percent in fiscal 2001 to 2.0 percent in 2002 to 1.8 percent in 2003.

The technology industry has traditionally been a major user of options. But there, too, usage has fallen in recent years, as shown by recent two studies. In July 2004, **Mellon Financial Corp.**'s Human Resources & Investor Solutions found that the industry decreased its use of broad-based stock option grants by approximately 15 percent to 20 percent, with annual burn rates declining 30 percent in a one-year period.

A survey by **Presidio Pay Advisors Inc.** showed that the annual option run rate in fiscal 2002 was 30 percent below the three-year average due to layoffs and reduced competitive grant levels. The study covered 118 information technology companies in the S&P Small Cap 600 Index. That study defined the run rate as the number of options granted in a fiscal year minus any cancellations or forfeitures divided by the total outstanding shares. The study also showed the breakdown of option burn rates across different segments within the IT industry. [For more on this study, see the chart below.]



Source: Presidio Pay Advisors, Inc.

Companies Take Action

As the studies illustrate, many companies have reduced their use of stock options since 2001 in response to investor concerns. Exxon Mobil Corp., Altria Group Inc., **MCI** Communications, **Microsoft** Corp, and Goldman Sachs Group are among the companies that have moved from

options toward restricted stock grants.

Some companies are also adopting policies targeted specifically at burn rates. **General Mills Inc.**, **Intel Corp.** and **Sysco Corp.** recently implemented run-rate commitments as part of their compensation plans. In its 2003 proxy statement, General Mills agreed to reduce its run rate from 4.2 percent in fiscal 2002 to 1.6 percent. Likewise, Intel pledged in 2004 to maintain the company's long-term average annual dilution at less than 2 percent of total shares outstanding. And Sysco has set a burn-rate goal of 1.5 percent.

Other companies, however, appear to have relatively high burn rates compared to their industry peers. **Lehman Brothers Holdings Inc.**, for example, has a three-year average burn rate of 25.04 percent, according to ISS data. That rate is more than four times the rates at most of its industry peers, as defined by the Global Industry Classification Standard (GICS). Lehman Brothers argues that its stock plan, which has significant vesting and forfeiture provisions, helps retain high-performing employees.

Implications

Consideration of burn rates suggests several implications for this proxy season and beyond. First, companies can expect greater scrutiny of burn rates in evaluation of compensation and equity plan practices. Second, more academic study is warranted to help corporations and their owners better understand the implications of equity burn rates. In particular, more research is needed the relationship between burn rates and total shareholder return.

Third, investors may wish to refine their compensation and equity plan policies to consider burn rates. Even though option grants are falling, investors will want to flag outliers with excessive burn rates. In addition, the policies should take into account the value of restricted stock. While some investors may welcome a reduction in options, a company should not be able to reduce its equity burn rate simply by switching to stock grants because there is still a cost to shareholders. There is no clear consensus among investors about how to value these grants. For instance, TIAA-CREF uses a 3:1 ratio for restricted stock in the definition of burn rate and is working to clarify this policy, Scott said.

As investors review their own policies, they may wish to consider the new guidelines that ISS adopted for this proxy season.

Policy

ISS has sought to develop a policy that takes a holistic approach and considers other aspects of a company's executive compensation plan, such as deferred compensation, low-interest loans, use of company aircraft and other perks.

ISS is applying the new policy to those companies with a meeting date after Feb. 15. Specifically, ISS will recommend voting against equity plans that have excessive burn rates over three years.

According to the ISS burn rate policy: "Burn rate is calculated as the total number of equity awards (in the form of stock awards and stock options) granted in any given year divided by the number of common shares outstanding. The gross number of equity awards is considered in the burn rate calculation and is not discounted by cancelled or forfeited shares." Thus if a company has granted 100 equity awards in the past year, and there are 10,000 shares outstanding, the burn rate for the past year is equal to one percent. For companies that grant both full value awards and stock options to their employees, ISS shall apply a premium on full value awards for the past three fiscal

years.

ISS will consider a company' s average three-year burn rate to be excessive where it exceeds both:

- the mean burn rate plus one standard deviation of its Global Industry Classification Standard (GICS) peer group, segmented by Russell 3000 Index and non-Russell 3000 Index
- and two percent of the company' s common shares outstanding

A company with high three-year average burn rates may avoid triggering the policy by committing to meet the industry average over the next years.

ISS expects to further refine its burn-rate policy this year as it receives more input from companies and investors. In addition, ISS will encourage shareholders to express their views on equity outflows and what rates they consider to be excessive.

Valerie Ho and Sandra Sussman of ISS' Global Research division also contributed to this article.