ClearBridge

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CLEAR*thinking*

2023 Share Requests

ClearBridge
Compensation Group

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Overview

Given equity compensation is critical to attracting, retaining, and motivating key employees, gaining shareholder approval of a share pool is an area where companies cannot afford to miss the mark. To provide companies with guidance for future share requests, this CLEAR*thinking* article analyzes key takeaways from the 2023 proxy voting season, including burn rate/dilution, ISS recommendations, vote results, and considerations for companies planning an upcoming share request.

ClearBridge analyzed 140 of the 610 companies who requested shares so far in 2023, a subset that mirrors the size and industry makeup of the total sample. A summary of the share request and dilution data for this subset is presented below:

	Revenue (LTM)	Market Cap as of Request Date	Current Dilution	Shares Available (% of CSO)	Share Request (% of CSO)	Total Potential Dilution
75th Percentile	$3,536	$4,820	4.8%	4.1%	6.4%	13.2%
50th Percentile	$1,136	$1,570	3.1%	2.3%	3.9%	9.4%
25th Percentile	$363	$685	1.4%	1.0%	2.4%	6.4%

Key Takeaways from Analysis:

- In 2023, there was a 13% increase in share requests over 2022, driven in part by declining stock prices in 2022 which resulted in higher share usage and a greater need for additional shares
- Share requests ranged from 2.4% of Common Shares Outstanding (“CSO”) at the 25th percentile to 6.4% of CSO at the 75th percentile
- A company’s total potential dilution (including share request) has a strong influence on voting outcomes
- Proposals rejected by shareholders tripled in 2023 vs. 2022 (from 2 to 6), although still reflected a very minor percentage of outcomes (<1% of 610 proposals so far in 2023)
- The widening vote margin between companies receiving "For" recommendations by ISS versus those with "Against" recommendations highlights ISS's increasing impact on shareholder voting outcomes

Definitions:

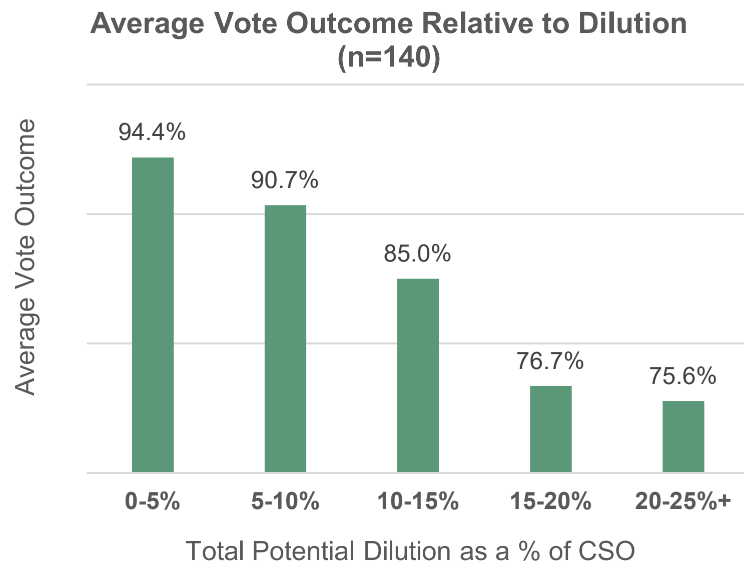
- **Total Current Dilution**: Measures the amount by which shareholder ownership would be reduced if all outstanding but unexercised equity (i.e., full value shares + 40% of options) was converted to common shares outstanding
- **Total Potential Dilution**: Measures the amount by which shareholder ownership would be reduced if all outstanding but unexercised equity (i.e., full value shares + 40% of options) and authorized but unissued equity (including any new share request) was converted to common shares outstanding
- **Burn Rate:** Calculated by dividing the total full value shares and 40% of options granted by the weighted-average diluted common shares outstanding
- Note: Options are valued at 40% of full value shares in calculations given options are generally less dilutive than full value shares, as they only impact dilution when the stock price exceeds the exercise price. The ability to net exercise can also lessen their dilutive effect.

Dilution and Burn Rate

When examining share requests, both shareholders and shareholder advisory firms focus on the overall dilutive impact.

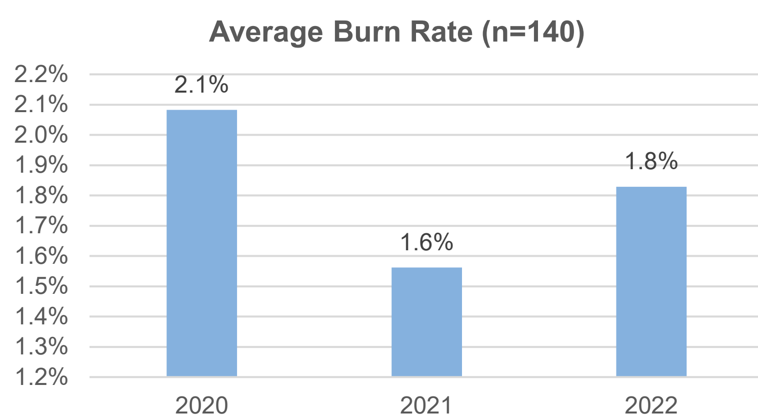
Our findings show that as dilution increases, share support decreases, emphasizing the importance of understanding dilution levels when requesting more shares.

To address dilution concerns, it is crucial to understand your shareholder base and offer detailed disclosure concerning the expected dilution and lifespan of the share authorization, and why the authorization is in the best interest of shareholders.



Did You Know? Many institutional shareholders publicize their proxy voting guidelines, which can be helpful when assessing the likelihood of a share request's success. For example, Vanguard tends to oppose share requests leading to more than 20% total potential dilution.

The average total shareholder return ("TSR") for the companies analyzed fell by around 125 percentage points from 2021 to 2022, correlating with an increase in the average burn rate in 2022, as more shares were required to grant the same equity value at reduced stock prices. Subsequently, share requests increased 13% from 2022 to 2023.



Fungible Ratios: Fungible Ratios are the ratio by which full value shares reduce the pool (e.g., 2:1 fungible ratio means that each full value share granted reduces the pool by 2 shares, while each option granted reduces the pool by 1 share). Fungible ratios are adopted by 6.5% of the companies analyzed. Fungible ratios are set ranging from **1.3:1 to 3.3:1**, with the most common ratio being **2:1**.

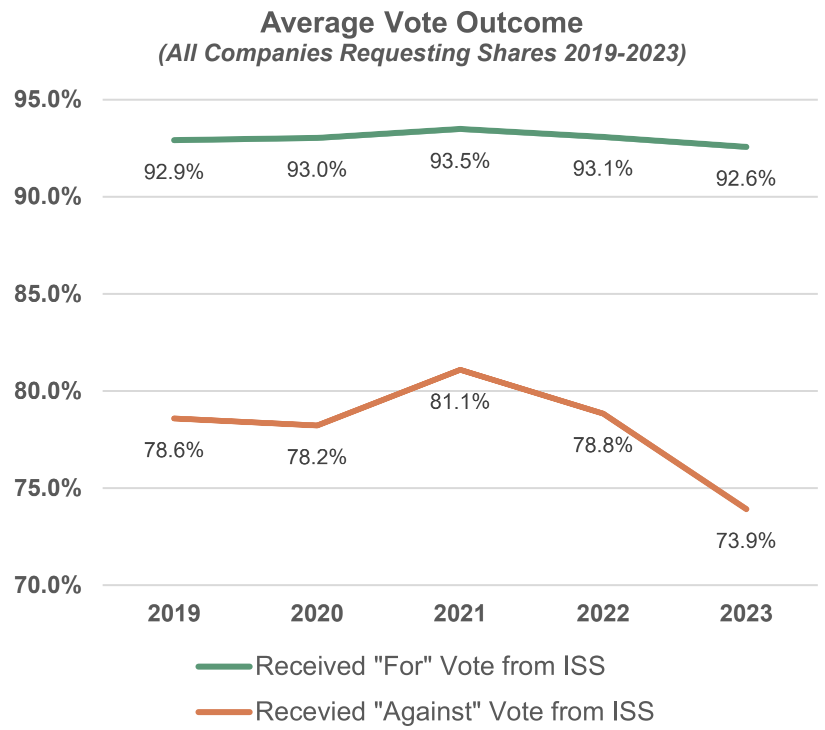
Impact of ISS on Voting Outcomes

Provided below is a summary of the sample statistics, broken out based on ISS recommendations:

	Revenue (LTM)	Market Cap as of Request Date	Current Dilution	Shares Available (% of CSO)	Share Request (% of CSO)	Total Potential Dilution
Companies in Sample with 'For' vote (n=97)						
75th Percentile	$3,869	$6,248	3.9%	3.8%	5.0%	11.0%
50th Percentile	$1,593	$2,289	2.2%	2.0%	3.2%	8.1%
25th Percentile	$497	$863	1.3%	0.8%	2.3%	5.9%
Companies in Sample with 'Against' vote (n=43)						
75th Percentile	$2,355	$2,440	7.2%	5.6%	8.0%	16.3%
50th Percentile	$669	$893	4.9%	2.5%	6.3%	12.9%
25th Percentile	$158	$311	3.1%	1.2%	3.9%	10.0%

Key Takeaways:

- Total potential dilution is higher for companies receiving “Against” votes (12.9% at median, compared to 8.1% for companies receiving “For” votes)
- The difference in average vote outcomes between proposals with a "For" and "Against" vote from ISS is over 18 percentage points in 2023, demonstrating the influence of ISS recommendations on voting outcomes
- At median, companies receiving a “For” vote from ISS are ~2.5x larger than companies receiving an “Against” vote
  - Higher equity values typically enable companies to deplete share reserves at a slower rate, even when factoring in increased compensation levels



***Did You Know**?* While ISS typically votes “Against” **~30%** of companies requesting shares each year, less than **1%** of companies ultimately fail to receive shareholder approval. 6 companies failed to receive shareholder approval of their share request in 2023, up from only 2 in 2022.

Ready, Set, Request: Preparing for an Upcoming Share Request

Contemplating a share request in 2024? Consider the following:

- **Evaluate Current Share Pool / Stock Price Impact**: Assess the estimated duration of your current share pool, and understand the influence of market volatility on share value and pool utilization by modeling various stock price scenarios to ensure equity grant decisions account for all future potential stock price environments

- **Compensation Strategy:** Assess if changes in equity design, like introducing performance shares ("PSUs") or options, will impact your share usage and burn rate for the upcoming year
  - Note: It is best practice to account for PSUs out of your share pool at maximum payout to ensure sufficient shares are available in case of maximum performance achievement

- **Assess Plan Features:** Assess whether any of your plans include elements like evergreen provisions, liberal share recycling, reload options, and vesting schedules that could negatively influence voting outcomes

- **Engage Shareholders:** Consider preemptively discussing the share request with key shareholders to gauge their support and incorporate their feedback as necessary

- **Prepare for ISS and Glass Lewis Recommendations**: Understand ISS and Glass Lewis voting policies on equity-based compensation and align your proposal. For example, could consider conducting a preliminary estimation of the ISS Equity Plan Scorecard ("EPSC") to determine share request limits for a "For" recommendation

How ISS and Glass Lewis Evaluate Equity Plan Share Requests:

ISS and Glass Lewis evaluate share requests by assessing factors like potential dilution to existing shareholders, historical burn rate, and specific plan features such as performance metrics and vesting schedules. They will also consider the company's financial and stock performance relative to industry peers. Governance structure and practices are also taken into consideration.

Contact Us

This report was authored by Ken Foulks and Xanthe Coffman. For questions specific to this CLEAR*thinking article,* or for more information on ClearBridge Compensation Group or any of our services, please visit our website or call us at 212-886-1022.