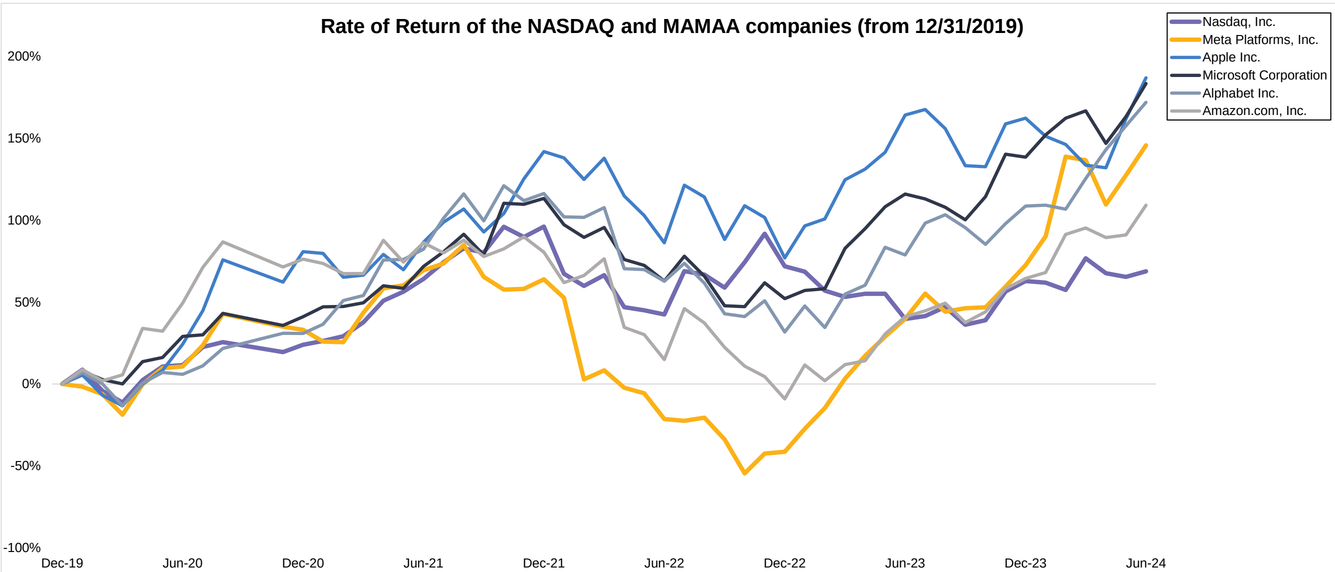
# Equity Compensation in the Tech Sector: Managing Spend in a Period of Uncertainty by Kartik Balaram

The 2020s have been a roller coaster for technology companies. Within a pandemic, we saw share prices plummet and then skyrocket due to a combination of low interest rates and demand for the technology that supported a remote working environment. Competition for product, engineering and design talent spiked, as did new hire equity award offers, right before a market correction triggered cost reduction initiatives, with layoff announcements getting released weekly that read as though crafted by chatbots.




However, the need for competitive and differentiated equity compensation programs has remained throughout this period of instability. While hiring is not as aggressive as it was in 2021, companies are still laser focused on ensuring their equity strategy is compelling to employees with technical skills and experience scaling and going to market in the age of cloud and artificial intelligence – *especially at the executive level*.

Many compensation committees at leading technology firms are emphasizing discipline in the broader equity compensation strategy. While authority to issue equity to non-Section 16 officers and other employees is typically delegated to the CEO, compensation committees retain oversight of aggregate equity budgets for a given year and expect to be informed on equity utilization relative to the approved plan at each quarterly meeting. Boards want to stay competitive and offer compelling equity incentives, but within reason.

Board members are acutely aware of the role equity has within a company's compensation and business strategies. Previewing the broader equity framework and overall strategy with the compensation committee allows for quick transitions from outlining big picture challenges and opportunities for more tailored recommendations informed by Committee feedback.

As technology companies prepare for the annual pay setting cycle, it is important to consider the following areas specific to the overall equity framework:

- **Equity Pool Usage**: The shares a company delivers on an annual basis measured as a percent of the common shares outstanding. This is a metric widely used among companies to determine the overall equity budget/pool for the year. (Not to be confused with the ISS burn rate definition of Value-Adjusted Burn Rate (VABR) which is used in their equity plan scorecard analyses for reviewing equity plan amendments.)[1]

Conducting a market review of burn rates provides guideposts of equity utilization and helps management teams determine the appropriate pool of shares needed to hire, reward and retain employees for the year. This is critical to share with the Committee when seeking approval on the equity budget each year.

- **Equity Philosophy**: The position relative to market that a company targets when establishing equity values both on a refresh and new hire basis. Equity in the technology sector continues to have – relative to other sectors – an outsized role in compensation packages. Executives consistently advocate for above median market positions on equity compensation, producing a remarkable dynamic where far more than 50% of companies will state without irony that their equity offerings are at or above market median.

  Many high growth technology companies have particular angst about competing with established players for new hires. Historically, new hire awards at publicly traded companies have averaged 1.5x to 2x the value of an annual award, to help entice employees to join the company and replace the value of any unvested equity awards left on the table at their former employer. Over the past five years, the high demand for qualified "been there, done that" candidates drove these premiums as high as 3x to 5x annual awards, requiring special approvals from compensation committees (when internal equity grant frameworks used for budgeting purposes are set at more modest premiums).

  Equity philosophy is point of pride within HR and management teams, and they are reluctant to upset the apple cart on this topic. In general, exceptions on new hire premiums are (and should be) limited to truly exceptional candidates. Committees and management teams acknowledge that an aggressive philosophy may not be sustainable in the long-term, so it is important to monitor success rates in hiring and retaining talent to validate the appropriate pace and quantum of adjustments to internal equity grant frameworks.

- **Equity Eligibility**: This is where the tech sector attempts to find balance between the competing principles of individualism and solidarity. Companies celebrate the former via differentiating rewards based on performance but foster the latter through universal eligibility for equity awards. It is generally accepted that broad eligibility for equity awards cultivates a culture of teamwork towards a common goal. Leadership generally wants their team members to financially participate in the value appreciation of the company.

  However, as companies grow and mature, they tend to face greater scrutiny of equity spend. The common trend is to dial back eligibility and be more targeted with equity delivery. The shift away from a "spread the peanut butter evenly" approach usually starts with reducing eligibility across lower levels in the company.

  When there is heightened focus on cost reductions across a sector, this evolution from universal to targeted eligibility tends to accelerate. As we write this, newly public companies still embrace near-universal eligibility to tenured employees but are more apt to establish new frameworks for their first annual award cycle as a public company that exclude employees at lower levels.

- **Functional/Regional Differentiation**: Differentiation by functional role or geographic location allows for a greater emphasis on specific labor market competitiveness, allocation of a limited pool towards roles that have greater impact in the organization and can help reduce the overall cost of the program.

  Traditionally, higher equity awards have been provided to engineering vs. G&A functions. Some companies conduct a deeper dive to hone in on premium roles within engineering (such roles may include artificial intelligence, machine learning, cloud engineering or data analytics).

[1] Calculated as ((# of options * option's dollar value using a Black-Scholes model) + (# of full-value awards * stock price)) / (Weighted average common shares * stock price)

When equity is analyzed regionally, it may uncover discounts in certain regions across the U.S. (as is the case internationally) akin to the way salary is differentiated in different U.S. locations. This is another way to get further savings and more "bang for the buck" but can also add further complexity in terms of administration. We also note that the degree to which a company or the broader market embraces work-from-home structures influences relative premiums and discounts vs. traditional high- and low-cost-of-labor locales. We suspect the differences will decrease over time.

- **Vesting**: The rate of equity delivery over time is receiving renewed interest. Standard RSU vesting schedules have been four years with ratable vesting occurring equally on an annual basis (i.e., 25% on each anniversary of date of grant). Many companies are modifying their approach to better attract prospects and reinforce medium-term (e.g., 1- to-2 year) retention of current employees. The trend is towards more employee-friendly vesting periods and schedules.

  Many leading technology companies have shifted towards a vesting period of *three years* and/or a *quarterly* vesting cadence. Recent client experience suggests a quarterly vesting schedule while keeping the four-year vesting period is the preferred approach. The three-year vesting approach is becoming increasingly popular among companies who are trying to get more "bang-for-the-buck" from a limited equity budget, since in the short-term these companies can reduce the number of shares out the door while maintaining a consistent dollar value-vesting-per year approach they would have received under the four-year schedule.

A regular annual review of the broader equity strategy and approach helps management teams understand the effectiveness of their programs and allows Committees to gain better insight into what drives the requested equity budget for the year. The fluidity of the technology market can and should be reflected in these budget requests.

Talent acquisition and retention must be balanced with affordability. Previewing management's perspective on the key parameters outlined above with Board members allows for a quick transition away from broad market reviews and towards the important discussions and refinements that truly tailor a company's approach to specific challenges and opportunities. It is easier to reach consensus and Board approval when management comes to the table with clarity on these items.