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Decoding Pre- and Post-IPO Equity Overhang Rates

By Radford Consulting

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Starting in 2010, Radford's compensation consulting team began tracking US-listed initial public offerings (IPOs) in the technology and life sciences sectors to examine key shifts in compensation strategy occurring just before and after IPO events. Such shifts include the adoption of new, more flexible equity incentive plans, changes to pre- and post-IPO equity overhang rates, the creation of broad-based employee stock purchase plans (ESPPs), and adjustments to executive officer compensation.

Today, Radford's database of recently public companies includes information for a total of 243 organizations that went public between January 1, 2010 and December 31, 2013. During this four year period, technology and life sciences companies raised a median of $75 million by virtue of selling shares to the public, while having a median pre-IPO headcount of 289 employees and median pre-IPO annual revenues of $63 million.

The following research excerpt from Radford's four-year study, produced with data collected from public Securities and Exchange Commission (SEC) filings, explores pre- and post-IPO equity overhang rates, and their importance for judging the overall health of equity compensation programs at recently public companies.

Overhang Under the Microscope

In today's environment of increased investor scrutiny, managing equity overhang rates while on the road to becoming a public company is vital. While private firms tend to have more flexibility to establish and fund equity compensation plans with the blessing of a small group of investors, public companies must obtain the approval of a much broader base of shareholders with diverse standards for equity compensation programs.

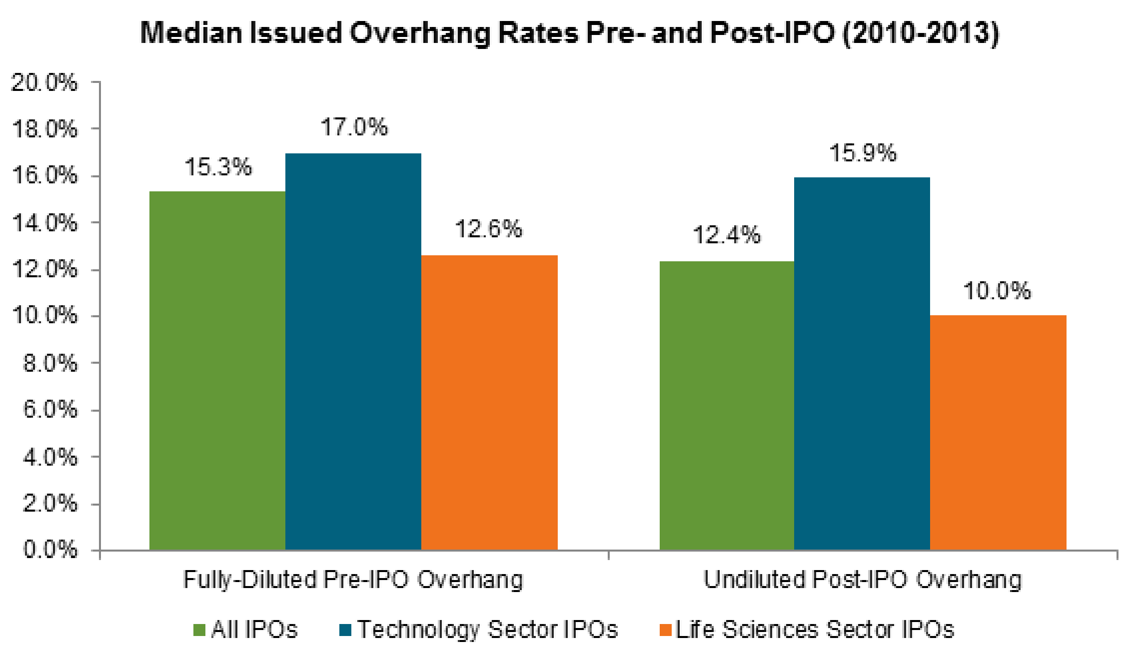
As result, when handling the transition from private to public environments, companies are typically under intense pressure to quickly moderate their use of equity compensation. Monitoring "equity overhang rates" at recen lic companies can provide critical insights into what is an acceptable rate of equity usage as an organization matures and prepares to go public.

Issued Overhang

Overhang rates can be measured in several ways. One measure commonly used by Radford is "issued overhang." It shows the potential dilutive effect of outstanding employee stock options and restricted shares on existing shareholders. Outstanding employee awards are those that have been granted to employees, but have not yet been settled (e.g., unexercised options or unvested restricted stock).

At private, venture-backed organizations it is common to express equity overhang rates as a percentage of "fully-diluted" common shares outstanding, which includes the employee equity awards in the denominator of the calculation even though they are not yet settled (i.e., the outstanding employee awards are in the numerator and the denominator). The convention for public companies is to use an "undiluted" measure, with only common shares outstanding in the denominator.

As the chart below illustrates, issued overhang rates typically drop after an IPO. This occurs because the total number of shares outstanding at the company rises once shares are sold through the offering. The drop-off effect is most noticeable at life sciences companies, where a greater percentage of the company is typically offered in the IPO. In sector vs. sector comparison, issued overhang rates are higher at technology companies, where equity compensation is often used more broadly and aggressively.



The issued overhang measures described above are calculated as follows:

Fully-Diluted Pre-IPO Issued Overhang is calculated as unexercised options plus unvested restricted sto s outstanding warrants divided by total common share equivalents outstanding pre-IPO plus unexercised options, unvested restricted stock and outstanding warrants

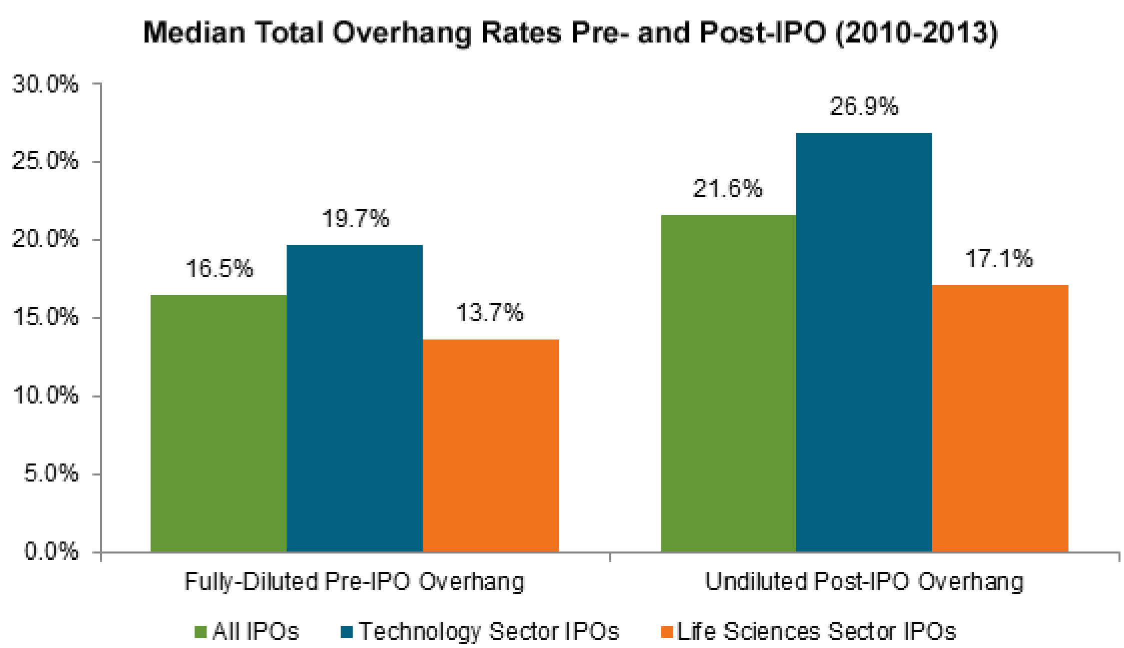
Undiluted Post-IPO Issued Overhang is calculated as unexercised options plus unvested restricted stock plus any stock awards granted as of the offering divided by total common shares outstanding post-IPO

Readers should note that employee stock purchase plan (ESPP) shares are excluded from all overhang calculations in this analysis.

Total Overhang

Another overhang measure frequently used by Radford is called "total overhang." Total overhang provides a more comprehensive view of potential shareholder dilution by taking into account the entirety of employee equity programs. This is done by including shares available for future grants, along with outstanding employee stock options and restricted shares, in overhang calculations. As was discussed above, the same issues with respect to "fully-diluted" and "undiluted" measures remain when considering total overhang rates at pre- and post-IPO companies.

Unlike issued overhang, total overhang rates typically increase at the time of an IPO. This occurs because companies often introduce new equity compensation plans with fresh funding at the time of an IPO. Again, like issued overhang, total overhang rates at technology sector companies tend to be higher when compared to life sciences companies.



The total overhang measures described above are calculated as follows:

Fully-Diluted Pre-IPO Total Overhang is calculated as unexercised options plus unvested restricted stock outstanding warrants plus shares available for future grants pre-IPO (excluding new EIP funding) divided by total common shares equivalents outstanding pre-IPO plus unexercised options, unvested restricted stock, outstanding warrants and shares available for future grants pre-IPO

Undiluted Post-IPO Total Overhang is calculated as unexercised options plus unvested restricted stock plus shares available for future grants post-IPO (including new EIP funding) divided by total common shares outstanding post-IPO

Readers should note that employee stock purchase plan (ESPP) shares are excluded from all overhang calculations in this analysis.

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