Pearl Meyer

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Managing Your Equity Burn Rate

Brett A. Herand
MANAGING DIRECTOR

This is the seventh in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

Equity is not free. Burn rate—also referred to as annual dilution rate, run rate, or share usage rate—measures the pace of equity usage for compensation and drives talent decisions, affects management credibility, and impacts shareholder value. It is the direct transfer of shareholder wealth to employees through equity grants as part of a company's long-term incentives (LTI).

This installment of our Executive Compensation Essentials series covers what burn rate measures, how to calculate it, why investors care, and how companies should manage, track, and report it.

What Burn Rate Measures

Companies grant equity to align with shareholders, retain key talent, and drive performance-aligned pay outcomes. Burn rate measures the pace of equity granted as compensation over a period of time, frequently tracked annually and as a 3-year average.

Burn rate can be measured on both a share basis and a value basis:

- Share basis: Shares granted as equity compensation divided by weighted average shares outstanding for the period.
- Value basis: Grant date fair value of equity awards divided by average market capitalization for the period.

Everything else being equal, a company granting 1,000 stock options will have the same share-based burn rate as a company granting 1,000 restricted shares. However, because a stock option is worth less than a restricted share, the company granting stock options will have a lower value-based burn rate.

How to Calculate Burn Rate

- Share-based burn rate: Calculated as total shares and options granted during the period, divided by weighted average common shares outstanding (same denominator used for earnings per share).
- Value-based burn rate: Calculated as total grant date fair value of all equity awards divided by average market capitalization for the period (a quarterly average or the average of the beginning and end of year is typically sufficient).

Using averages in the denominator smooths volatility in share count and market capitalization and acknowledges that awards are granted throughout the course of the fiscal year.

Two common modifications may be considered when the context calls for it:

1. Performance awards: Instead of counting performance share units (PSUs) at target at grant, some companies count actual PSUs in the year they vest.
2. Net of forfeitures: Instead of counting gross grants, some companies subtract forfeitures that occur during the period.

Both adjustments functionally convert the burn rate basis from "as granted" to "what actually occurred." Most burn rate calculations focus on the "as granted" model which is more akin to an assessment of the target LTI opportunity.

Many companies look to offset equity compensation dilution through share buybacks, with some explicitly discussing this as an objective under an authorized share repurchase program. This strategy has no impact on burn rate calculations, stock-based compensation expense, or dilution but may be part of the narrative.

A Quick Example

Here is a quick example set of burn rate calculations on an "as granted" basis.

	Number Granted	Per Share Fair Value at Grant	Aggregate Grant Value
Stock Options	50,000	$10.00	$500,000
PSUs	125,000	$28.00	$3,500,000
Restricted Stock	125,000	$25.00	$3,125,000
Total Granted	300,000		$7,125,000
Weighted Average Common Shares Outstanding (M) 15.0			

Average Market Capitalization ($M)	$750.0

Share-based burn rate: 300,000 / 15,000,000 = 2.0%

Value-based burn rate: $7,125,000 / $750,000,000 = 0.95%

Burn Rate Versus Total Dilution

Burn rate analyzes equity compensation activity over a period of time. Total dilution (also called overhang) is a point-in-time view of all outstanding and unexercised equity awards and can be presented on a share basis or value basis. The view can include or exclude authorized but not yet granted shares. Both views can be used in committee discussions.

Why Companies and Investors Care about Burn Rates

Just as investors want to ensure that management acts as responsible stewards of their investment capital, investors also want to ensure their ownership interests are not excessively diluted through use of equity compensation. More specifically:

- Ownership math: Equity grants dilute existing shareholders and reduce each share's claim on value and voting power.
- Per-share economics: Higher burn rates create drags on earnings per share, free cash flow per share, and other per-share metrics.
- Capital allocation signal: Equity grants are part of the capital budget. A steady and reasonable burn rate signals control and discipline.
- Investor decision-making: Burn rates influence valuation work, forward multiples, and votes on equity compensation plans.
- Governance and alignment: The burn rate is a visible measure of governance quality and is viewed favorably by institutional investors when kept within market norms.
- Strategic flexibility: Elevated burn rates limit room for acquisition grants or targeted retention awards.
- Cost of capital: Perceived dilution risk increases the equity risk premium and can squeeze valuations.

How Companies Should Calibrate and Manage Their Burn Rates

A company's burn rate is essentially an output calculation, and the variables that drive the burn rate include LTI eligibility, participation, grant magnitude, vehicle mix, and stock prices. Everything else being equal, as stock prices increase, fewer shares are necessary to deliver a competitive LTI award.

As the company implements its LTI strategy, it should first build a bottom up share usage model that aggregates expected grants for all eligible employees, based on salaries, eligibility, target LTI rates, and program design. The implied dilution and burn rate from this bottom-up view should then be reconciled to a top-down perspective that tests results against market-based dilution benchmarks and investor expectations.

Market benchmark data can be compiled from analysis of peer company 10-K filings, with care taken to ensure consistent comparisons on the different burn rate definitions.

Tracking and Reporting

Most companies report burn rate and dilution to the compensation committee at least annually. A practical approach is to include a one-page exhibit with each committee consent package. The one-page exhibit should show:

1. Current year and prior three years, share basis and value basis, both “as granted” and “as occurred.
2. The current equity plan share reserve, how many years the current reserve should last, when a new share reserve will be requested, and a simple forward view given planned grant values and assumed stock prices.
3. Peer benchmarks, updated once per year.

Equity Burn Rate is a Valuable Indicator

Burn rate is the pacing metric for equity compensation; it translates directly into dilution and impacts the per-share economics. Credibility rests on clear definitions, consistent methodology, and a normal reporting cadence. The most informative view pairs share-based and value-based measures, shown on both an “as granted” and “as occurred” basis. Disciplined governance protects ownership, preserves strategic flexibility, and aligns talent investment with long-term value.

About the Author

Brett advises boards and management on executive compensation, including performance measurement, incentive design, and technical matters spanning tax, accounting, and SEC requirements.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the

Fortune 500.