Protecting Growth

Equity monetization can help clients rein in the risk of large equity positions

BY CHRISTOPHER KRUCZYNSKI

Stock options, deferred profit sharing plans, restricted share units and other equity-based incentive packages have become an important part of many clients' total compensation plans. These and other forms of equity-based compensation can create tremendous upside for many executives, senior level managers and employees who receive stock as part of their bonus or earning structure.

However, with the potential for upside comes the risk of downside. As an advisor it is crucially import to understand how equity from an employer fits into your clients' overall financial plan and how to manage the risk associated with a concentrated equity position.

More and more employers are using equity as economic incentive for their employees. Many advisors frequently encounter public company employees who have assembled a significant number of shares as part of a compensation plan over the years. In most cases, selling the shares will attract a large tax bill. In even more cases, clients don't want to sell the shares even if it is the prudent step to take to reduce investment risk.

As the market has been hot for the last few years, many clients with large equity positions are hesitant to scale back their position. Given the recent volatility we've seen in the stock market you will need a strategy to protect your clients' wealth and reduce portfolio risk.

Consider the following scenarios. You have a client who is a senior level executive of a large, publicly traded company. She has amassed a substantial equity holding in the company she works for as part of her compensation plan over the years. Delighted at current stock prices, she is doing very well, but given the volatility of securities in her industry you need a strategy to protect this investment and her wealth.

In the second scenario, your client owns a private company, but supplies a public company. He owns a large block of shares received when he converted stock options as part of a bonus package. He wants to improve his liquidity, but feels his investment options are limited because he doesn't want to sell his stock and offend his customer. You need a strategy to help him monetize his stock position while still allowing him ownership.

In each case, the investor wishes to eliminate the market-price exposure, but isn't able or willing to sell the stock outright. It is important for professional financial advisors with high-net-worth or business owners as clients to understand options for hedging and monetizing stock positions. Whether you have these types of clients or not, undoubtedly you will come across these situations at some point in your career so you should have an understanding of how to help these unique clients and demonstrate your skill and expertise.

We've all had clients who have had a significant run on a single position and now find themselves with an elephant in their portfolios. Or they find their holdings are too concentrated, but can't sell the security outright without triggering a tax liability. The clients want to (a) lock in gains they've enjoyed on paper (b) defer tax on the sale of a stock by deferring the actual disposition and (c) diversify their portfolio through use of a loan and (d) avoid any margin calls that might otherwise apply when borrowing. An effective solution for all of these situations is equity monetization.

WHAT IS EQUITY MONETIZATION?

Equity monetization is a transaction or series of transactions that provides a security holder with a cash amount approaching the amount they'd receive on an outright sale, but shifts all or part of the economic risk associated with the security to a third party while preserving the ownership with your client. Equity monetization strategies have been employed in the United States for a decade, but are becoming more popular in Canada.

THE ADVANTAGES OF EQUITY MONETIZATION

The main advantage of equity monetization is the elimination of the stock market risk in your client's equity holdings without the usual drawbacks associated with selling the securities outright. And since they retain legal title of the stock, they maintain voting rights and may continue to receive potential future dividends from their securities. They are also able to obtain cash proceeds from their stock today while deferring taxes until maturity of the hedge, at which time the strategy can be rolled over for further deferral.

THE DISADVANTAGES OF EQUITY MONETIZATION

The disadvantage of equity monetization is the erosion of upside potential in the security the client holds. In addition, clients with very small or illiquid stocks (as can be the case when your client is an entrepreneur) will find it difficult to monetize their position, unless you can match the client with a third party that specializes on taking on that type of risk.

Likewise, thinly traded stocks can pose a problem even when the company in question has a reasonable market capitalization. If trading volume on a stock is lower than the number of shares the holder desires to hedge, it will be difficult to find a lender willing to enable a monetization strategy because the banker on the other side of the transition must move in and out of the market to hedge his exposure. There are definitely risks in equity monetization and they aren't for everyone, but when used effectively for the right client, equity monetization strategies are powerful tools.

STRUCTURING EQUITY MONETIZATION TRANSACTIONS

Equity monetization can be structured in several different ways.

A popular method is the forward sale, which involves a derivative contract to "lock in" a selling price at a maturity date in the future. The contract typically has a maturity date at two, three, five or seven years in the future. To initiate this process, an investor will pledge the shares in question via a special agreement and the shares are held in a collateral account in the investor's name.

A contractual agreement determines the term of pledged shares and the forward value (or lock-in price) at the end of the term. The lending institution determines a guaranteed sale price based on the current value of the stock, current interest rates and loan rates. The lending institution will then provide a loan of 90% or more of the lock-in price. The result is the elimination of any exposure to a large block of shares on a tax-deferred basis.

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Many times the interest payments for the loan are built into the contract itself so clients don't have to find outside funds to finance the transaction. Another benefit is that these interest payments are tax-deductible. As well, up to 90% of the current price of the security have been monetized and can now be used to diversify the investor's portfolio.

A variation of this strategy is the costless collar. Instead of using a single lock-in price, a costless collar involves simultaneous offsetting forward contracts. The first is the purchase of a put (which gives the buyer the option to sell the security) at a strike price slightly lower than the current trading price.

The second transaction is the sale of a call (which gives the buyer the option to sell the security) at a price slightly higher than the stock's current price to establish a floor and ceilings and lock in the future purchase/sale price of equity within a range. The premium received for selling the call is used to pay for the put – which creates the zero-premium or "costless" component of the transaction and the fact that the put and call surrounding the transaction are the origin of the "collar."

There are some real costs to this strategy – your client gives up the ability to profit from large increases in the stock's value – but when used primarily to protect against downsides as equity monetization is designed, they are quite effective.

INSIDERS AND EQUITY MONETIZATION

Company insiders are not restricted by securities laws from participating in equity monetization structures. While securities law requires insiders to report equity monetizations and other derivatives-based transactions, it does not restrict an insider from entering into such transactions. The CSA recognize that insiders may legitimately rely on equity monetization transactions to achieve tax-planning goals, to enable portfolio diversification, and to retain voting and dividend rights. It always makes sense to get legal counsel on particularly complicated situations.

EDUCATING CLIENTS

At the end of the day, monetization strategies can be effective tools in managing client expectations or an emotional connection to a position as in managing a portfolio. Those with large positions in a single security, particularly ones they've held for a long time, can be dangerously optimistic or take risks they shouldn't. Equity monetization can be an easier "compromise" than an outright sale.

Ultimately it's your client's risk tolerance that determines whether or not an equity monetization strategy will be employed. But many clients may not be aware of options for diversifying or monetizing a large position and will appreciate being gradually introduced to the concept. That is until you tell them how! ■

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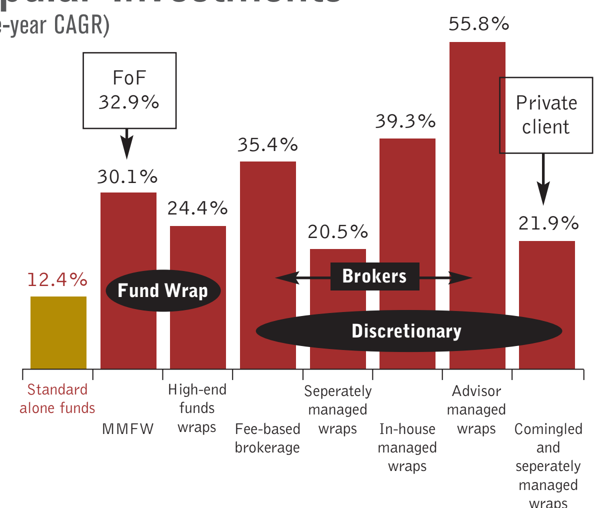
1▸ Wealth Trends

taking, if we assume the world is going be to be one of low inflation and low interest rates." That will drive the provision of advice – 60% of all wealth goes through the advice channel, and Bederman expects that to rise to 70% – but it also means the regulators will focus less on products and more on the quality and transparency of advice.

While risk-protected products are on the rise, so too are vehicles aimed at higher net worth individuals such as managed assets, which include various wrap solutions (*see Popular investments, below*). Managed assets are expected to expand by 16% a year, compared to a growth rate of only 5% for stand-alone mutual funds. They current stand at $126 billion in assets. The trend is most prevalent among full-service brokers where assets grew 12%, managed assets grew 33% and discretionary assets 35% in the past year. ■



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