

Cash Protection

Advanced strategies in equity monetization

BY CHRISTOPHER KRUCZYNSKI

PART ONE: AN EM PRIMER

For most advisors, having a client with a large, concentrated position in a security is a relatively common occurrence and one of the many reasons to use a strategy to mitigate risk, improve diversification or realize liquidity. Portfolios heavy in a single stock must often be addressed while observing concurrent needs with regard to proxy or voting rights, tax impact or portfolio objectives. There is, without question, a need for tools to address this situation to preserve capital and wealth.

Employees of public companies are often compensated through stocks, warrants and options or participation in employee share ownership programs (ESOPs). In other cases, clients can build or inherit large positions in a single security and find themselves unable or unwilling to sell or reduce the size of their holdings.

A strategy that is becoming increasingly common in Canada to deal with such situations is equity monetization (EM). EM has been used by European investors for more than two decades and in the U.S. for over 10 years.

WHAT IS EM?

EM is a derivative strategy that limits or reduces price risk in a security by transferring it to a third party while allowing an investor to maintain ownership (and rights and benefits associated with ownership) of the underlying security. EM is a transaction or series of transactions that provide an individual with an equity position with liquidity approaching the price they'd realize in an outright sale.

RELUCTANT TO SELL

Many times investors are resistant to a sale purely for psychological reasons. For example, some investors who have realized significant gains with a top-performing stock are committed (even irrational) champions of the stock and/or the underlying company, particularly those who have realized gains on multiple investment rounds! These individuals can become keen to mitigate portfolio risk from a concentrated position but wouldn't dream of selling or reducing their positions.

Other individuals have or did have a relationship with a com-

pany where a portion of their compensation was delivered in equity or equity options (which were at some point exercised). They may have strategic reasons or "optics" to maintain ownership of the securities, but again would like to reduce their risk to price decreases.

Another situation typical to Canadian advisors involves a requirement for liquidity which may or may not be motivated by a desire to reduce or transfer risk. Clients needing to monetize assets or fund managers having to meet redemption commitments or similar situations can create an urgent need for liquidity.

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Underlying motives for using EM created by those situations identified include (a) locking in "paper" gains (b) avoiding a tax liability by deferring actual disposition (c) diversifying a portfolio by monetizing a "loan" from within the portfolio without exposure to "margin" calls. In each situation, EM can be a powerful ally and one an advisor must feel comfortable deploying.

CHALLENGES TO EM

Like any hedging tool, there are challenges associated with EM. Firstly, EM involves buying or selling options, which can increase trading, monitoring and associated costs. Secondly, mitigating risk can also cap or limit returns. Finally, there are challenges to monetizing positions in illiquid stocks, typically in finding a counterparty for the option instruments and/or the inability to properly price the option. While options aren't for all clients, in the right situation, EM is a powerful ally for investment advisors.

THE TYPICAL EM TRANSACTION

A typical EM transaction traces the following path:

1. A client with a large, concentrated position and his or her investment advisor determine that an EM strategy is an ideal tool to realize their objective, given their specific situation (i.e. liquidity requirement and timing, characteristics of the stock which they hold, etc.).

2. The investment advisor structures a forward sale to lock in a future selling price at a maturity date, typically two, three, five or seven years forward.

3. To initiate the contract, the client pledges his or her shares to a collateral account in his or her name via a special agreement.

4. A contractual agreement determines the term of the pledged shares and the exercise price. The counterparty (typically a lending institution) determines a guaranteed sale price, based on the current price of the stock and current rates.

5. The institution then provides 90% to 100% of the exercise price by the number of shares covered by the agreement. The actual loan amount can vary determined by whether or not interest payments are built into the contract itself so clients or investment advisors don't have to worry about monitoring carrying costs. Depending on structure, these payments can be tax-deductible.

6. At the end of the contract, the client transfers ownership of the security to the institution. If the shares have appreciated beyond the exercise price, the client has forgone "upside" return and the institution benefitted. If the share prices have depreciated below the exercise price, the client has benefitted at the expense of the institution.

7. As the underlying tool used in EM strategies are forward agreements enabling customization, in the case of large positions and/or highly liquid and desirable stocks, an almost infinite number of options and features within agreements can be structured depending on interest rate environment, option premiums, market volatility and liquidity of the issues. Provided these features can be priced and a counterparty found, the agreements can be completely geared to a client's needs.

PART TWO:

MAKING THE MOST OF EM

Like most aspects of managing one's practice (and life) the key to success in EM is a combination of education/experience and expectation management.

I. STRUCTURE RIGHT

When reviewing the structure, it is critical to be familiar and briefed on best practices. The "costless collar," for example,

is rarely used in current market conditions because of the cost of doing the option, where the forward equity option (with a bank as counterparty) is the vehicle of choice.

II. STAY INFORMED

There are institutions and brokers who specialize in EM, so it's important to maintain ongoing contact with them to advise clients on concurrent strategies and tactics.

III. HAVE THE HARD TALK

Sometimes the hard thing to do and the right thing to do are one and the same. Too often it is the toughest conversation that would provide the most benefit to your client. When there is "an elephant in the room," the best course of action in almost all cases is "introduce it." If your client's portfolio needs to be more diversified and needs to be moved from a concentrated position to mitigate risks, an EM can be a conversation starter.

HANDLING OBJECTIVES

There are a number of common objectives to deployment of an EM strategy put forward by prospective clients. Some of the more common, along with guidance in addressing them are:

1. Does a client, who's an insider, have to disclose taking an EM position?

Yes, the reporting requirements for EM strategies are similar to insider trading filing requirements on SEDI (The System for Electronic Disclosure by Insiders).

2. Will the public/analysts look at taking an EM position in a similar light to a sale by an insider?

For a moment, let's separate your needs as a holder of a concentrated position of a security from that of an insider (management, executive, board member, major shareholder of a public company). Let's also assume that if we're forthright and straight and pay heed to management of the stock as well as the company, any short-term market discomfort won't affect long-term value or share price.

3. How are analysts/the public likely to react?

This question can't be answered in isolation; the reaction of shareholders, investors and analysts to any announcement is a function and barometer of their trust in management. In our experience, press-releasing use of an EM strategy explaining the benefit to the

executive, details of the transaction and benefit to shareholder (if any) is the most desired option. Being forthcoming and open is a good policy in all communication with investors. It does, however, benefit management to pay attention to timing and "management of the stock" to ensure that EM doesn't pressure the stock price downward.

4. Is there anything different about reporting in this situation?

There can be a tendency for managers to hold reporting on those factors affecting them personally, to a different (typically higher) standard. We've had several clients who experience discomfort at even the thought of releasing use of an EM strategy the same way they might report on the sale of a security. Our approach has always been that as a senior executive of a public company in a transparent, efficient market, you are by definition a component of what's newsworthy. We advise them to toughen up and stand strong (but most of all to stay off stock discussion boards)! When you develop a reputation for fair reporting, the long-term value of your security shouldn't be affected by your need to mitigate risk or monetize.

5. What if the stock goes up beyond the forward strike price?

Most deals are now being written with an extendible feature. The client is now in a position to have greater flexibility with the contract. Using a renewal or extendible feature allows the executive to revise the terms if the stock has appreciated in value above the upside set by the forward strike price. It can be useful to work through "what if" scenarios with your client to assess their comfort threshold and determine appropriate safeguards.

PARTING THOUGHTS

In the past decade, we have worked with numerous clients and their advisors to structure EM strategies. In many situations they are a critical component to a well-functioning portfolio and certainly an area where top advisors should develop effective strategies and networks to provide their clients with top service. ■

Christopher Kruczynski is a senior wealth advisor with the Marchand-Kruczynski Group of ScotiaMcLeod and specializes in Equity Monetization Strategies for advisors and their clients. For more information visit www.mkgscotiacleod.com. ScotiaMcLeod is a division of Scotia Capital Inc., a member of the Scotiabank Group, Member CIPF. This article is for information purposes only. It is recommended that individuals consult with a financial or tax advisor before acting on any information contained in this article. The opinions stated are not necessarily those of Scotia Capital or The Bank of Nova Scotia.

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