

## Financial Facts & Money Matters: *Protecting clients from a large stock position* *An equity monetization strategy can help protect client wealth*



By Thane Stenner, CIM, FCSI – featured in *Beyond Numbers* magazine January, 2004

Imagine you have a client who's accumulated a large block of company stock serving as an executive for XYZ Inc. Now that he's retired from the company, his position is worth several million dollars. Understandably, your client is on top of the world. He's made it. He's rich.

You, however, see things a little differently. The lack of diversification in your client's portfolio makes you a little anxious. Should anything go wrong at XYZ, your client's net worth could suffer. On the other hand, an outright sale of XYZ stock could generate a significant tax bill, to say nothing of unwanted publicity. Not what either of you want.

There is a solution to this dilemma. Specialized equity monetization strategies can help your high net worth (HNW) clients secure wealth, diversify their portfolios, and defer taxes all at the same time. For you, the financial professional, such structures offer a way to add tremendous value to client relationships. Even if it is beyond the scope of your practice to facilitate such transactions, simply explaining them to clients can strengthen your bond with clients and cement your role as a trusted professional advisor.

### **What is equity monetization?**

An equity monetization strategy allows a client to receive cash for a large block of publicly-traded stock without officially selling the stock. That cash can then be used to build a well-diversified portfolio of equities, a portfolio inherently more secure than a portfolio based on a single stock position. Because the transaction is structured as a loan, it does not trigger any tax.

According to André Barrett, CA, CFA, executive director of equity structured products at CIBC World Markets, it's a strategy that is well-known in the United States, and is quickly gaining in popularity here. Barrett attributes the increased interest to the stock market volatility of the past few years. "We get a lot of calls from clients we spoke to several years ago," Barrett admits. "After suffering through the bear market of the last couple of years, these same clients are now looking to protect themselves."

As Barrett points out, equity monetization is as much about managing a client's emotions as it is about managing the portfolio. Simply put, a concentrated stock position can tempt investors to take risks they shouldn't. "They become married to the position," Barrett says bluntly. Barrett admits that it can be difficult to persuade some HNW individuals to divest themselves of the stock that has made them rich. Often, it takes careful persuasion to convince them to do something differently. "I often say to people, you're right, the way to gain extreme wealth is by taking extreme risks. But for everyone who succeeds, there are hundreds who fail. It's not worth the risk."

### The structure of equity monetization

Equity monetization can be structured in a number of different ways. One popular method is the forward sale. This strategy uses a customized derivative contract to “lock in” a selling price on a maturity date three, five, or seven years in the future. Once the lock in price is agreed to, the lending institution provides a loan of 90 percent or more of the lock-in price. As Barrett explains, the net result is the elimination of any economic exposure to a large block of shares on a tax deferred basis. As an added benefit, interest payments are built into the contract itself, meaning clients don’t have to find payments from outside sources to fund the loan.

A variation of this strategy is the range forward sale. Instead of a single lock-in price, the lender sets a price range with a floor and ceiling. If upon maturity the stock is trading within the agreed-upon range, the client will receive the market price for the shares. If on the other hand the stock is trading above the ceiling or below the floor, there will be a cash payment required by either the lender or the client. (Under either structure, the client can settle their obligations under the loan and forward contract by a cash payment or a delivery of shares.) Barrett says such deals are very popular with HNW clients who remain bullish on their stock, even though they recognize the need for protection.

### An equity monetization example

Real-life examples make the benefits of equity monetization clear. Several months ago, Barrett met with a senior executive at a Canadian company looking to divest a large block of company stock. Barrett provided two possible structures for the client to consider, the first of which was a simple five-year forward sale.

<b>Five-year forward sale</b>	
<b>Number of shares:</b>	40,000
<b>Current stock price:</b>	\$65 per share
<b>Current value of holding:</b>	\$2.6-million
<b>Term:</b>	5 years
<b>Forward price sale:</b>	\$75.72 (116.5% of current stock price)
<b>Loan advance:</b>	\$59.28 per share (91.20% of current price)
<b>Proceeds:</b>	\$2.37-million
<b>Annual interest rate:</b>	5.01% (zero coupon structure – no interest payments for the term of the contract)

Because the client was comfortable taking on more risk, Barrett also proposed a range forward sale structure:

<b>Range forward sale (equity collar)</b>	
<b>Number of shares:</b>	100,000
<b>Current stock price:</b>	\$65 per share
<b>Current value of holding:</b>	\$6.5-million
<b>Term:</b>	5 years
<b>Floor price:</b>	\$58.50 (90% of current stock price)
<b>Ceiling price:</b>	\$89.70 (138% of current stock price)
<b>Loan advance:</b>	\$46.44 per share (71.40% of current price)
<b>Proceeds:</b>	\$4.64-million
<b>Annual interest rate:</b>	5.01% (zero coupon structure – no interest payments for the term of the contract)

Barrett’s client eventually opted for the latter strategy. “This structure allowed the client to retain precisely as much exposure to the stock position as he wanted,” Barrett says.

**Freedom to choose**

At the end of the day, the question of how much risk is enough is ultimately up the client. Barrett for one has seen more than his fair share of horror stories: clients walking away from equity monetization structures only to see their wealth go up in smoke some months down the road. Barrett admits there is little the professional can do to prevent this from happening. Even so, Barrett believes there is value in bringing the subject up. “Even for those clients who decide not to do these structures, I’ve never had a negative response to the concept,” he says. “Every client who’s been introduced has found it beneficial.” And as Barrett points out, that can only be good for business.

For those clients who do take Barrett up on the offer to protect themselves, the benefits are clear to both client and professional. Barrett for one feels a sense of satisfaction knowing the client is better off as a result of your work. “Some of the deals we’ve done in the past, they’ve have turned out to be so beneficial to clients,” he says. “That’s satisfying, because you’ve helped people who may have otherwise seen tremendous damage done to their net worth.”

In this way, Barrett is performing the greatest duty to his clients – to be stewards of client wealth – on their ability to protect and preserve client wealth. Ultimately, that’s not just good for business, it’s good for the heart too.

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