



Assisting Corporate Executives with Their Equity Compensation

Presented by:

Bill Dillhoefer

VP Net Worth Strategies, Inc.

Session Overview...

Provide advisors with what you need to know to engage and assist individuals who receive equity compensation (grants of company stock or options).

Section Topics

- Equity Comp. Industry Overview
- Definitions, Key Concepts and Taxation
- Case Study Illustrating a Framework for Providing Guidance
- Programs and Services for Assisting Executives
- Equity Comp. Resources & Summary

EQUITY COMPENSATION INDUSTRY OVERVIEW

Equity Compensation

- Aligns the Interests of Shareholders with the Interests of Plan Participants by:
 - Building wealth
 - Motivating and retaining key employees
- Statistics:
 - 11k+ public companies offer equity compensation
 - 9+ million individuals hold employee stock options
 - 500k+ top executives get company stock & options accounting for 80% of their compensation
 - Market value of outstanding grants varies, but in the current market many options are in-the-money!

Equity Compensation Trends

- Regulatory change (FAS-123) mandated option expensing and resulted in:
 - Widespread program changes (but equity compensation is not going away)
 - Reduction of shares issued & recipients
 - Changes in grant types issued (e.g. options, SARs, restricted stock/units, performance awards, etc.)
 - Increased program complexity

Common Misconceptions

- Getting assistance or creating an equity comp. strategy is unnecessary
- One should exercise / sell when:
 - At option expiration or when employment is terminated
 - Money is needed
 - Stock price target is met
- Taxation can be avoided
- If one receives Restricted Stock Shares/Units they don't need to worry about their Options

Equity Comp. Truths

- Careful planning and professional assistance facilitates better decisions & reduces costly mistakes
- Exercise / sell decisions should be based on:
 - Remaining time value / leverage not stock price alone
 - Financial goals not cash flow requirements
 - Level of concentration in company stock and options
- Taxes are unavoidable but they can be managed
- Outstanding Stock Option Grants still require timely action

DEFINITIONS, KEY CONCEPTS AND TAX CONSEQUENCES

Stock Options 101

- Definition:
 - A grant of the right to purchase company stock in the future at a fixed (grant) price
- Grant Price: (aka – exercise, strike or option price)
 - It is the price at which an employee can exercise the stock option, once vested
- Vesting Date:
 - The date when a tranch of options can be exercised

Stock Options 101

- Bargain Element: (aka: Spread)
 - The difference between the option exercise price & the market price of the stock at exercise
- Exercise:
 - The process of **purchasing** the option shares at the grant price
- Selling:
 - Selling the purchased stock shares of an exercised option (the option itself is not sold)

Restricted Stock 101

- Restricted Stock Shares/Units
 - A Grant of employer stock at no cost that is subject to restrictions
 - The terms for RSAs and RSUs differ slightly
- Types of Restrictions
 - Time Vesting (i.e. Future Date)
 - Performance Vesting (i.e. Revenue Target)
- Restricted Stock Valuation = Shares*Price

Taxation

- Unavoidable! Even gifting retains tax liability.
- Occurs when the client takes ownership by exercising stock options or when RSAs vest
- Incentive Stock Options (ISOs):
 - ISO's trigger Alternative Minimum Tax (AMT)
- Non Qualified Stock Options (NQSOs), Stock Appreciation Rights (SARs), & RSAs:
 - Gain taxed at ordinary income rates (compensation)
 - Cashless Exercise: sale proceeds used to pay exercise price and withheld for taxes

Stock Option Valuation

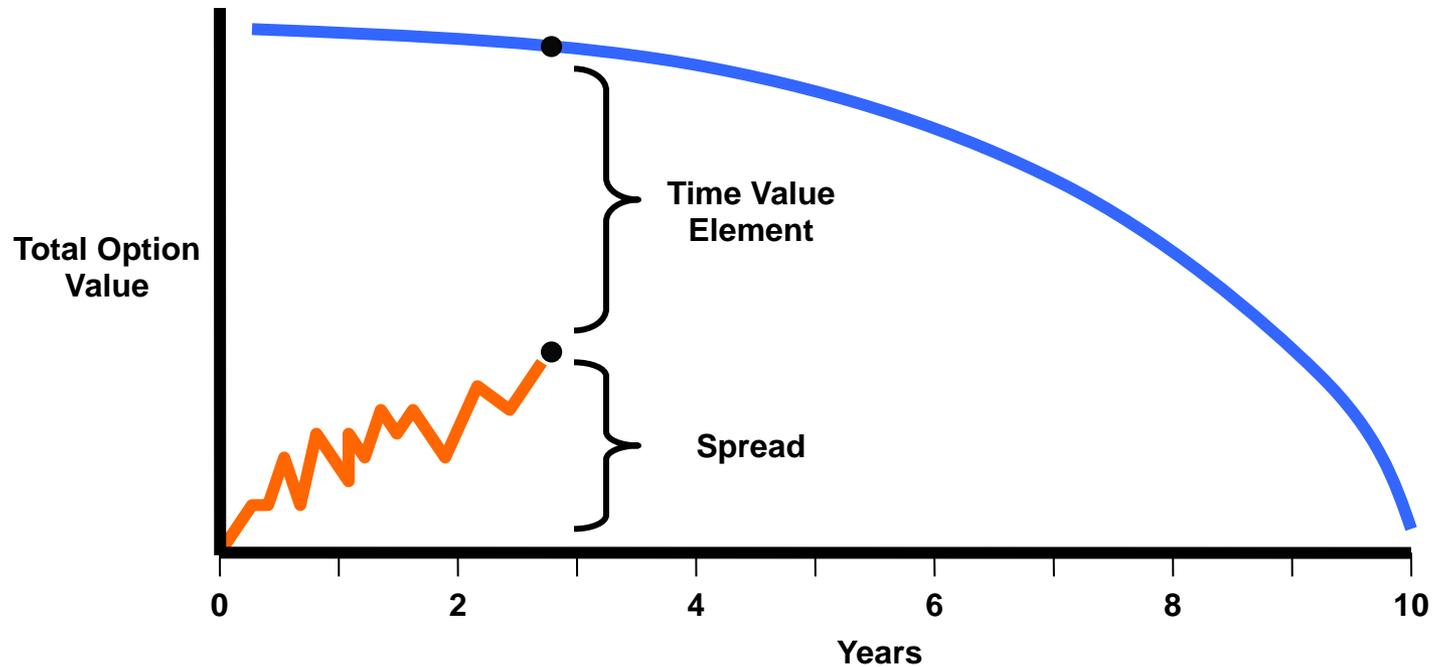
- In-the-Money Value (ITMV):
 - Fair Market Value (FMV) – Grant Price x Shares
 - Under Water: stock price is below grant price
- Option Value (aka: Full / Black-Scholes Value [BSV]):
 - Made up of two components:
 - In-the-Money Value + Time Value (TV)
 - Time Value is estimated using the Black-Scholes methodology
 - $BSV = TV + ITMV$

Estimating Time Value

The Black Scholes formula calculates the Time Value of a stock option using the following assumptions:

1. Time until expiration
2. Volatility of the stock price
3. The In-the-money value / Leverage
4. Risk free rate of return (RFR)
5. Per share dividend

Time Until Expiration



Time Value decreases as the expiration date approaches.

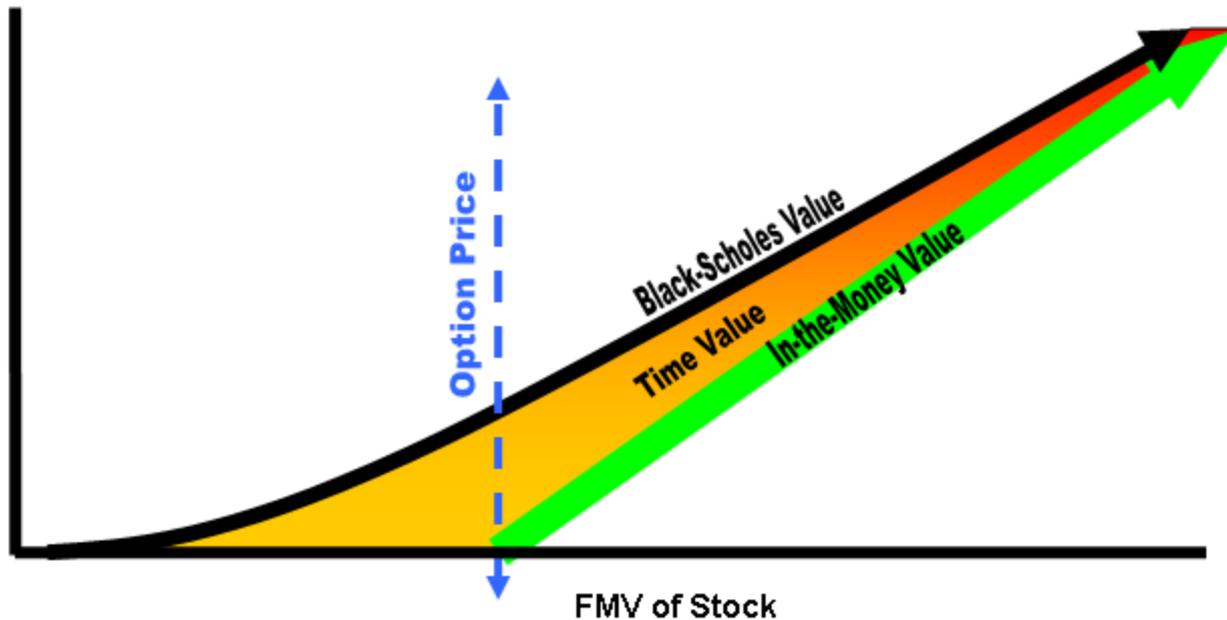
Stock Price Volatility

- The annualized standard deviation of the stock's changes in price
 - Expressed as a percentage (i.e. a Standard Deviation of 0.3 is volatility of 30%)
 - Volatility is a Statistical method to provide range of possible stock prices over the option life
- Types of Volatility:
 - **Historical**: the actual volatility that occurred to the underlying stock during some look back time period
 - **Implied**: the market's estimate of future volatility derived from a market traded option's bid/ask mid price

Volatility Selection

- Depends on the application:
 - Valuing Employee Stock Options for decision support
 - Expensing Stock Options on Financial Statements
 - Analyzing Market Traded Options
- Consequently, selection is “art” not science
- Compare a variety of sources to validate:
 - Company Annual Report (SEC Filings)
 - Market Traded Options: www.ivolatility.com
 - Peer Comparisons (use for private companies)

In-the-Money Value



As the FMV of the stock increase, the ITM value increases and TV decreases because upside leverage is less.

Stock Option Leverage

High Leverage/TV: stock price is close to the option price...

	Stock	Option	ITMV	
	\$ 11.00	\$10.00	\$1.00	
10% Increase	\$ 12.10	\$10.00	\$2.10	110%

Low Leverage/TV: option has significant ITM value...

	Stock	Option	ITMV	
	\$ 100.00	\$10.00	\$90.00	
10% Increase	\$ 110.00	\$10.00	\$100.00	11%

The higher the current stock price is relative to the strike price, the less time value or upside leverage remains in the option.

Risk Free Rate of Return

- An option's value is enhanced by the ability to use the capital that would otherwise be invested in the stock for some other investment...
- The Risk Free Rate represents the return on this other investment...

The higher the Risk Free Rate of Return, the higher the Time Value of the option.

- The Risk Free Rate can be derived from the yield on US Treasury bills or similar investments
- This value can also be found in the company's annual report for the purpose of option expensing

Per Share Dividend

- Decreases an option's Time Value because the holder is forgoing the dividend until the time of exercise
- A dividend can produce negative Time Value depending on the other BSV factors
- The inclusion of a dividend is not relevant if you intend to exercise and sell immediately for diversification purposes

The Time Value of an option is lower when the dividend is factored in.

Time Value Factor Summary

- TV **decreases** as the expiration date approaches.
- TV **decreases** as the in-the-money amount increases.
- TV is **higher** for stocks with higher volatility.
- TV is **higher** when the risk free rate of return is higher.
- TV **decreases** if a dividend is included

CASE STUDY AND FRAMEWORK FOR GUIDANCE

James Deere (case data)

- Financial Goal: **\$3,000,000**
- Current Diversified Portfolio Value: **\$500,000**
- Company: **DE** (Deere & Company, Inc.)
- Assumed Stock Price: **\$91.00**
- Stock Volatility: **33.6%** Risk Free Rate: **2.0%**
- Income Tax Rate: **40%** Cap Gains: **20%** (Fed+State)
- Stock Options:
 - **8 NQSOs**: 24,500 vested & 18,000 unvested
- Shares:
 - **5,000 shares owned** (cost basis: \$300,000)
 - **4,600 RSUs** (cost basis: \$0)

In-the-Money Valuation

StockOpter®		In-the-Money Values							
Grant ID	Grant Type	Expire Date	Exercise Price	Vested Options	Vested ITMV \$	Unvested Options	Unvested ITMV \$	Total Options	Total ITMV \$
NQ2005	NQSO	12/7/2015	\$34.4400	4,000	226,240	0	0	4,000	226,240
NQ2006	NQSO	12/6/2016	\$48.3750	5,000	213,125	0	0	5,000	213,125
NQ2007	NQSO	12/5/2017	\$88.8200	4,000	8,720	0	0	4,000	8,720
NQ2008	NQSO	12/17/2018	\$39.6650	7,000	359,345	0	0	7,000	359,345
NQ2009	NQSO	12/9/2019	\$52.2500	3,000	116,250	1,500	58,125	4,500	174,375
NQ2010	NQSO	12/8/2020	\$80.6100	1,500	15,585	3,000	31,170	4,500	46,755
NQ2011	NQSO	12/14/2021	\$74.2400	0	0	6,000	100,560	6,000	100,560
NQ2012	NQSO	12/12/2022	\$85.5000	0	0	7,500	41,250	7,500	41,250
Total				24,500	939,265	18,000	231,105	42,500	1,170,370

ITM Value = Current Value (\$91) – Exercise Price x Shares

After Tax Valuation

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Cash-Out Values

Grant ID	Grant Type	Expire Date	Exercise Price	Vested Options	Vested ITMV \$	Potential Tax \$	After Tax Value \$
NQ2005	NQSO	12/7/2015	\$34.4400	4,000	226,240	90,496	135,744
NQ2006	NQSO	12/6/2016	\$48.3750	5,000	213,125	85,250	127,875
NQ2007	NQSO	12/5/2017	\$88.8200	4,000	8,720	3,488	5,232
NQ2008	NQSO	12/17/2018	\$39.6650	7,000	359,345	143,738	215,607
NQ2009	NQSO	12/9/2019	\$52.2500	3,000	116,250	46,500	69,750
NQ2010	NQSO	12/8/2020	\$80.6100	1,500	15,585	6,234	9,351
NQ2011	NQSO	12/14/2021	\$74.2400	0	0	0	0
NQ2012	NQSO	12/12/2022	\$85.5000	0	0	0	0
Total				24,500	939,265	375,706	563,559

**Cash Out Value = ITM Value – Potential Tax
(calculated by applying a 40% income tax rate)**

Black Scholes Valuation

StockOpter® Time & Black-Scholes Values

Grant ID	Grant Type	Expire Date	Exercise Price	Vested TV \$	Vested BSV \$	Unvested TV \$	Unvested BSV \$	Total TV \$	Total BSV \$
NQ2005	NQSO	12/7/2015	\$34.4400	9,426	235,666	0	0	9,426	235,666
NQ2006	NQSO	12/6/2016	\$48.3750	32,886	246,011	0	0	32,886	246,011
NQ2007	NQSO	12/5/2017	\$88.8200	112,777	121,497	0	0	112,777	121,497
NQ2008	NQSO	12/17/2018	\$39.6650	49,595	408,940	0	0	49,595	408,940
NQ2009	NQSO	12/9/2019	\$52.2500	40,041	156,291	20,021	78,146	60,062	234,437
NQ2010	NQSO	12/8/2020	\$80.6100	46,299	61,884	92,597	123,767	138,896	185,651
NQ2011	NQSO	12/14/2021	\$74.2400	0	0	173,877	274,437	173,877	274,437
NQ2012	NQSO	12/12/2022	\$85.5000	0	0	287,145	328,395	287,145	328,395
Total				291,023	1,230,288	573,639	804,744	864,662	2,035,032

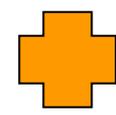
**Black Scholes Value =
Time Value + ITM Value
Volatility: 33.6%, RFR: 2%**

**Compare to ITM
Value of \$1,170,370**

Option Forfeit Valuation

StockOpter®		Time & Black-Scholes Values							
Grant ID	Grant Type	Expire Date	Exercise Price	Vested TV \$	Vested BSV \$	Unvested TV \$	Unvested BSV \$	Total TV \$	Total BSV \$
NQ2005	NQSO	12/7/2015	\$34.4400	9,426	235,666	0	0	9,426	235,666
NQ2006	NQSO	12/6/2016	\$48.3750	32,886	246,011	0	0	32,886	246,011
NQ2007	NQSO	12/5/2017	\$88.8200	112,777	121,497	0	0	112,777	121,497
NQ2008	NQSO	12/17/2018	\$39.6650	49,595	408,940	0	0	49,595	408,940
NQ2009	NQSO	12/9/2019	\$52.2500	40,041	156,291	20,021	78,146	60,062	234,437
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NQ2012	NQSO	12/12/2022	\$85.5000	0	0	287,145	328,395	287,145	328,395
Total				291,023	1,230,288	573,639	804,744	864,662	2,035,032

**Forfeit Value =
Time Value of
Vested + BSV of
Unvested**



Forfeit Value®

\$1,095,767

**Vs. ITM
Value of
Unvested:
\$231,105**

Restricted Share Values

StockOpter® Restricted Stock Values

Grant ID	Grant Type	Shares	Gross Value \$	Potential Tax \$	After Tax Value \$
RSU2011	RSU	2,100	191,100	76,440	114,660
RSU2012	RSU	2,500	227,500	91,000	136,500
Total		4,600	418,600	167,440	251,160

**Gross RSA Value =
Shares * Current Value**

StockOpter® RSA Tax Liabilities

Year	Shares Vesting	Tax Liability at: 58.24	Tax Liability at: 72.80	Tax Liability at: 91.00	Tax Liability at: 109.20	Tax Liability at: 131.04	Shares Required	Net Shares
2013	600	13,978	17,472	21,840	26,208	31,450	240	360
2014	1,500	34,944	43,680	54,600	65,520	78,624	600	900
2015	1,600	37,274	46,592	58,240	69,888	83,866	640	960
2016	900	20,966	26,208	32,760	39,312	47,174	360	540

Shows estimated tax liabilities at 20% price increments and net shares at vesting

Owned Share Valuation

DE Stock Price: \$91.00

StockOpter® Owned Shares Value	
Description	Amount
Number of Shares	5,000
Gross Value	455,000
Cost Basis	300,000
Taxable Gain	155,000
Potential Tax	31,000
After Tax Value	424,000

**After Tax Value of Owned Shares =
Shares * Price – Basis * Cap Gains Rate (20%)**

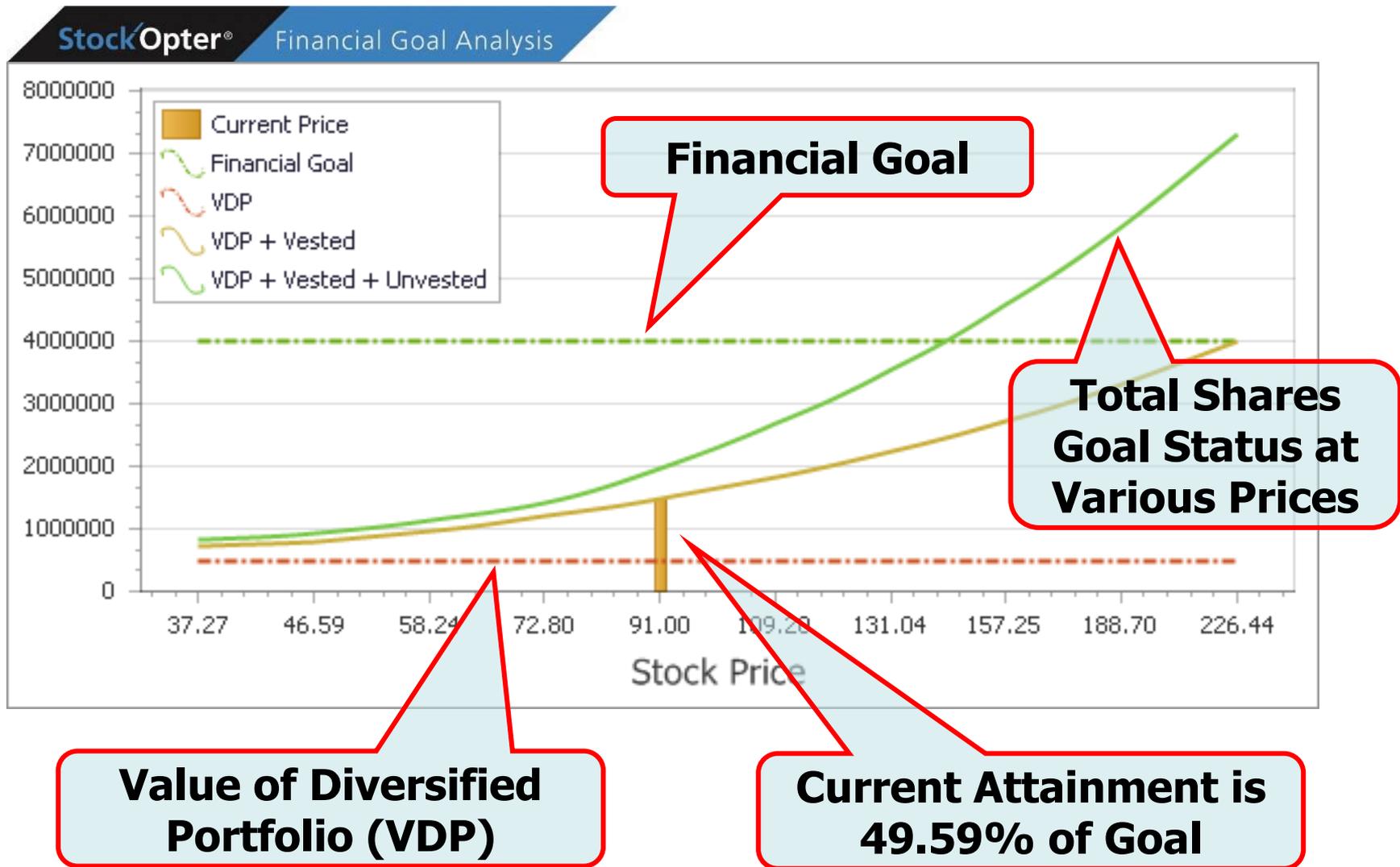
Leverage Analysis

StockOpter®		Leverage Analysis					
Potential Stock Price	Increment Change	Option Value \$	Option Value Change	RSA & Owned Shares \$	RSA & Owned Change	Option, RSA & Owned \$	Option, RSA & Owned
\$37.27	-20.00 %	11,320	-88.34 %	357,792	-20.00 %	369,112	-32.19 %
\$46.59	-20.00 %	97,075	-67.80 %	447,264	-20.00 %	544,339	-36.75 %
\$58.24	-20.00 %	301,505	-49.75 %	559,104	-20.00 %	860,609	-33.74 %
\$72.80	-20.00 %	599,985	-48.74 %	698,880	-20.00 %	1,298,865	-36.45 %
\$91.00	0.00 %	1,170,370	0.00 %	873,600	0.00 %	2,043,970	0.00 %
\$109.20	20.00 %	1,943,870	66.09 %	1,148,320	20.00 %	2,992,190	46.39 %
\$131.04	20.00 %	2,872,070	47.75 %	1,250,984	20.00 %	4,130,054	38.03 %
\$157.25	20.00 %	3,985,995	38.78 %	1,509,000	20.00 %	5,495,595	33.06 %
\$188.70	20.00 %	5,322,600	33.53 %	1,811,520	20.00 %	7,134,140	29.82 %
\$226.44	20.00 %	6,926,000	30.13 %	2,173,824	20.00 %	9,100,394	27.56 %

A 20% increase in stock price yields a **66.09%** increase in ITM value

A 20% decrease in stock price yields a **48.74%** decrease in ITM value

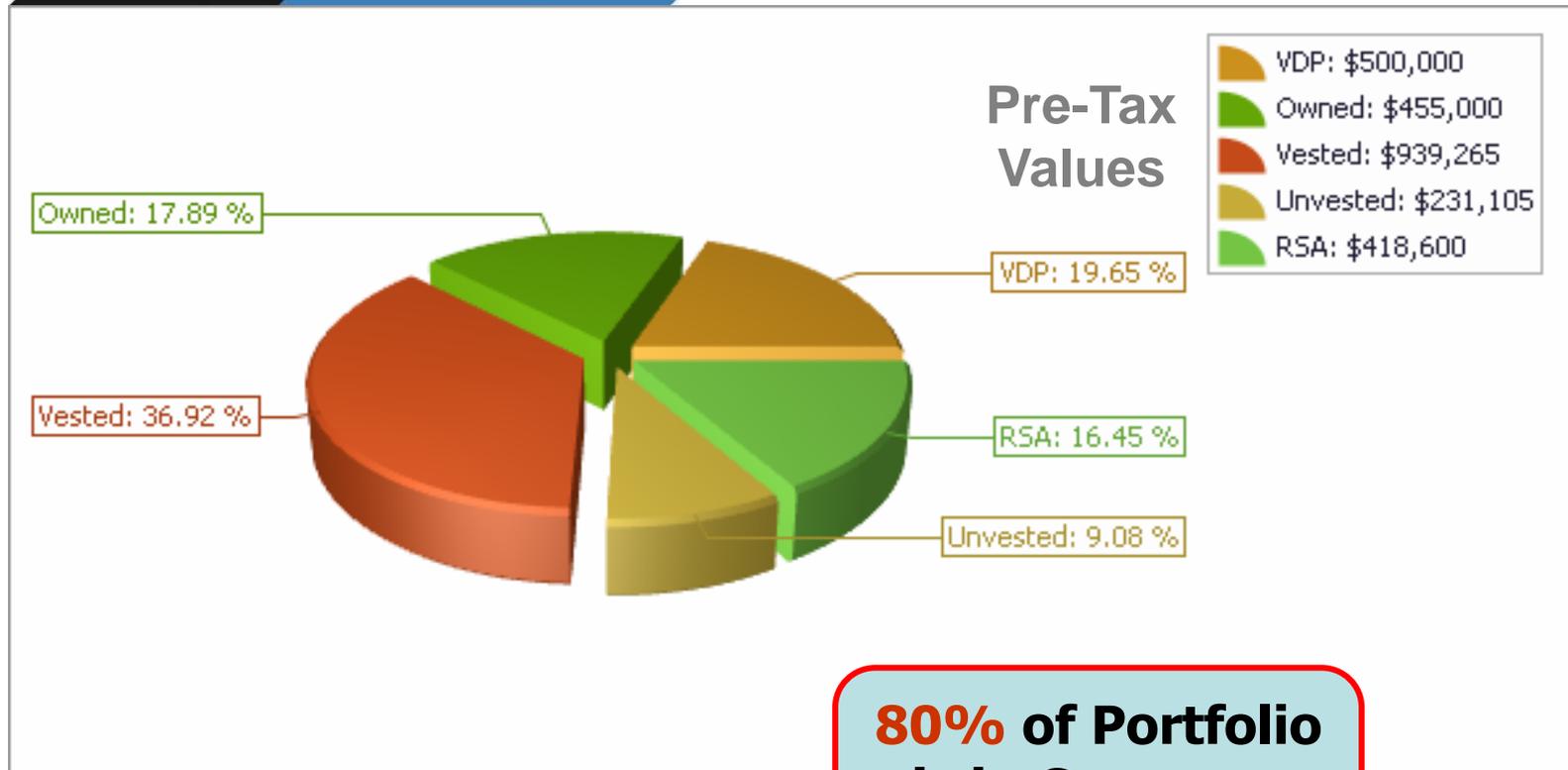
Financial Goal Attainment



Concentration

StockOpter®

Concentration Analysis



**80% of Portfolio
is in Company
Stock or Options**

Option Exercise Ratio

- The **Insight Ratio** is **TV divided by BSV**
 - Represents the remaining theoretical potential
 - 10% means 90% of theoretical potential has been achieved
- Provides a framework for exercising based on **risk v. reward**
- Planning horizon and risk profile are key considerations

Insight Ratio Example

This grant's "Insight Ratio" means 96% of its full value is ITM Value and at risk if the stock price drops from \$91

StockOpter®		Insight Ratios							
Grant ID	Grant Type	Expire Date	Exercise Price	Vested ITMV \$	Vested TV \$	VaR Value	VaR Ratio	Vested BSV \$	Insight Ratio
NQ2005	NQSO	12/7/2015	\$34.4400	226,240	9,426	54,775	17.21 %	235,666	4.00 %
NQ2006	NQSO	12/6/2016	\$48.3750	213,125	32,886	68,469	48.03 %	246,011	13.37 %
NQ2007	NQSO	12/5/2017	\$88.8200	8,720	112,777	8,720	1,000.00 %	121,497	92.82 %
NQ2008	NQSO	12/17/2018	\$39.6650	359,345	49,595	95,857	51.74 %	408,940	12.13 %
NQ2009	NQSO	12/9/2019	\$52.2500	116,250	40,041	41,081	97.47 %	156,291	25.62 %
NQ2010	NQSO	12/8/2020	\$80.6100	15,585	46,299	15,585	297.07 %	61,884	74.82 %
NQ2011	NQSO	12/14/2021	\$74.2400	0	0	0	1,000.00 %	0	100.00 %
NQ2012	NQSO	12/12/2022	\$85.5000	0	0	0	1,000.00 %	0	100.00 %
Total				939,265	291,023	284,487		1,230,288	

Volatility: 33.6%, RFR: 2%

Insight Ratio Factors

- Proximity to retirement?
- Bullish on company growth prospects?
- Concerned with negative leverage?
- Close to achieving a financial goal?
- Concentrated position?
- Upcoming cash-flow requirements?

Key Ratio Considerations*

Risk Profile	Insight Ratio (TV/BSV)
Short/Conservative	30%-50%
Medium/Moderate	11%-29%
Long/Aggressive	<10%

*** General guidelines for establishing individual decision criteria**

PROGRAMS & SERVICES FOR ASSISTING EXECUTIVES

Executive Service Programs

- Types of Programs:
 - 1-on-1 Assistance
 - Group Workshops
- Programs Generate Referrals
- Services can include:
 - Analysis Reports (see sample)
 - What if Analysis
 - Portfolio Monitoring and Management

RESOURCES & SUMMARY

Equity Comp. Resources

- Decision Support & Practice Building Videos, Resource Links and Articles:
 - <http://blog.stockopter.com> (Free)
- Equity Compensation Education & Content:
 - www.myStockOptions.com (Fee Subscription)
- Application for Creating Reports, Monitoring Positions & Conducting Workshops:
 - www.stockopter.com (Fee Subscription)
- LinkedIn Groups:
 - Equity Comp. Recipient Decision Support
 - The Stock Option Connection

Summary

- Assisting executives with equity compensation is a large, underserved and lucrative opportunity for advisors
- Professional assistance facilitates better exercise / diversification decisions & reduces costly mistakes
- Taxation is unavoidable and shouldn't drive exercise or diversification decisions.
- An equity compensation decision framework based on Time Value concepts facilitates client engagement
- An executive services program will efficiently & effectively drive business via clients with equity compensation
- Visit www.StockOpter.com and the [StockOpter University](#) for detailed information on the material in this presentation



Questions & Contact Info

Bill Dillhoefer

bdillhoefer@networthstrategies.com

541-383-3899