



Insights on Providing **Equity Comp. Guidance** (T3 CFP CE Credit)

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Equity Compensation (EC)

- **Aligns the Interests** of Shareholders with the Interests of Plan Participants by:
 - Building Wealth
 - Attracting, Motivating and Retaining Key Employees
- **Market Size:**
 - **11k+ Public +#? Private Companies** Offer Equity Compensation
 - **8-9 Million** Employees Receive Company Stock & Option Grants
 - **500k+ Top Executives** Get Company Grants Accounting for **80%** of Their Compensation
 - Companies Grant More Than **\$110 Billion in Company Equity** to Key Employees Annually

EC Opportunity and Risk

S&P 500 Index Over the Past Decade



Equity Comp Planning Issues

- EC Recipients get ***education NOT guidance*** from their employers
 - Website lets them exercise & sell (no analytics)
 - Surveys indicate recipients are afraid of making mistakes
- Recipients may have advisors, but getting **guidance from the watercooler**
- **EC Planning is Different from Financial Planning**
 - FP: Determines if the client is on track to retire? (Strategic)
 - ECP: Identifies when, why & how to diversify? (Tactical)

Keys to EC Planning Niche Success

- **Access to Stock Plan Participants**
 - Start w/ current clients or friends. Easy to get referrals after assisting initial EC recipients.
- **Provide Proactive Guidance**
 - Don't wait for clients to ask for help because it's often too late. Periodic updates are important.
- **Process for Managing/Analyzing Holdings**
 - More concrete than EC knowledge
 - Important to track holdings & provide unique insights

Stock Option Fundamentals

- **Stock Option 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 tranche of options can be exercised

Stock Option Fundamentals

- **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 Fundamentals

- **Restricted Stock Shares/Units**
 - A Grant of employer stock at no cost that is subject to restrictions.
- **Types of Restrictions**
 - **Time Vesting** (i.e., Future Date)
 - **Performance Vesting** (i.e., Revenue Target)
 - **Double Triggers** (i.e., Vesting + Liquidity Event)
- **Restricted Stock Valuation = Shares*Price**

EC Taxation Basics

- **Unavoidable!** Even gifting retains tax liability.
- Occurs when the client takes ownership by **exercising** stock **options** or when **RSA/Us vest**
- Incentive Stock Options (**ISOs**):
 - ISO's trigger **Alternative Minimum Tax (AMT)**
 - Taxed as **LT Cap Gains** if held for qualifying periods
- Non-Qualified Stock Options (**NQSOs**), Stock Appreciation Rights (**SARs**), & **RSA/Us**:
 - Gain taxed as **ordinary income** at exercise (NQSOs & SARs) and at Vesting (RSA/Us)
 - Shares held after purchase and then sold are taxed (less cost basis) as **Long-Term Cap Gains if held for 1 year**

Comparison: NQSOs versus ISOs

Option type	Eligibility	Event that triggers taxes	Taxes	Withholding ?	Tax at sale
<i>NQSOs</i>	Company employees, executives, directors, contractors, consultants	Exercise	Ordinary income tax, Social Security, Medicare on exercise spread	Yes, at exercise	Capital gains tax for amount over cost basis
<i>ISOs</i>	Only company employees and executives	Sale, unless AMT incurred at exercise	Ordinary income tax, AMT, or none*	No	Capital gains tax*

*ISO taxation depends on when shares are sold and on the sale price relative to the exercise/purchase price and the market price at exercise

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Exercising & Holding NQSOs

NOT a good planning strategy because...

- Unlike ISOs: **No tax benefit for NQSOs.** Taxed as ordinary income on spread at exercise.
 - NQSO recipients **defer paying taxes** prior to expiration by not exercising
- Exercising NQSOs & holding the shares **eliminates the remaining option leverage**
 - Leverage can have a greater impact on option value than the tax savings
- Taxes must be **paid out-of-pocket** instead of with share proceeds (no cashless exercise)
- The client's level of **concentration risk isn't reduced**

Stock Option Valuation

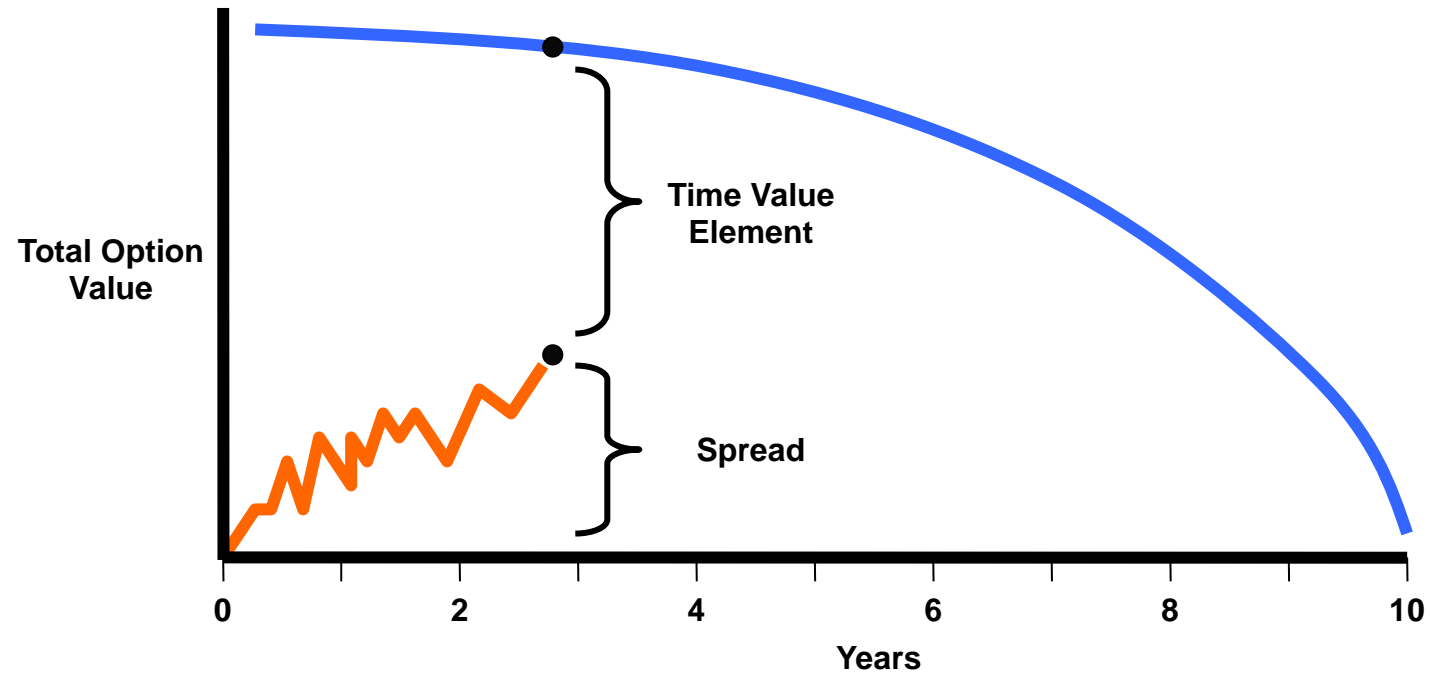
- **Intrinsic** or In-the-Money Value:
 - Fair Market Value (FMV) – Grant Price x Shares
- **Full Option Value (FOV)**
 - AKA: Black-Scholes Value (BSV)
 - $FOV = \text{Intrinsic Value} + \text{Time Value (TV)}$
- **Time Value**
 - Calculated using an option valuation methodology (e.g. Black-Scholes or Baroni-Adesi) and 5 assumptions

Estimating Time Value

The option valuation methodologies calculate 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 different sources** to validate:
 - Company **Annual Report** (SEC Filings)
 - Market Traded Options: **www.ivolatility.com**
 - **Peer Comparisons** (use for private companies)

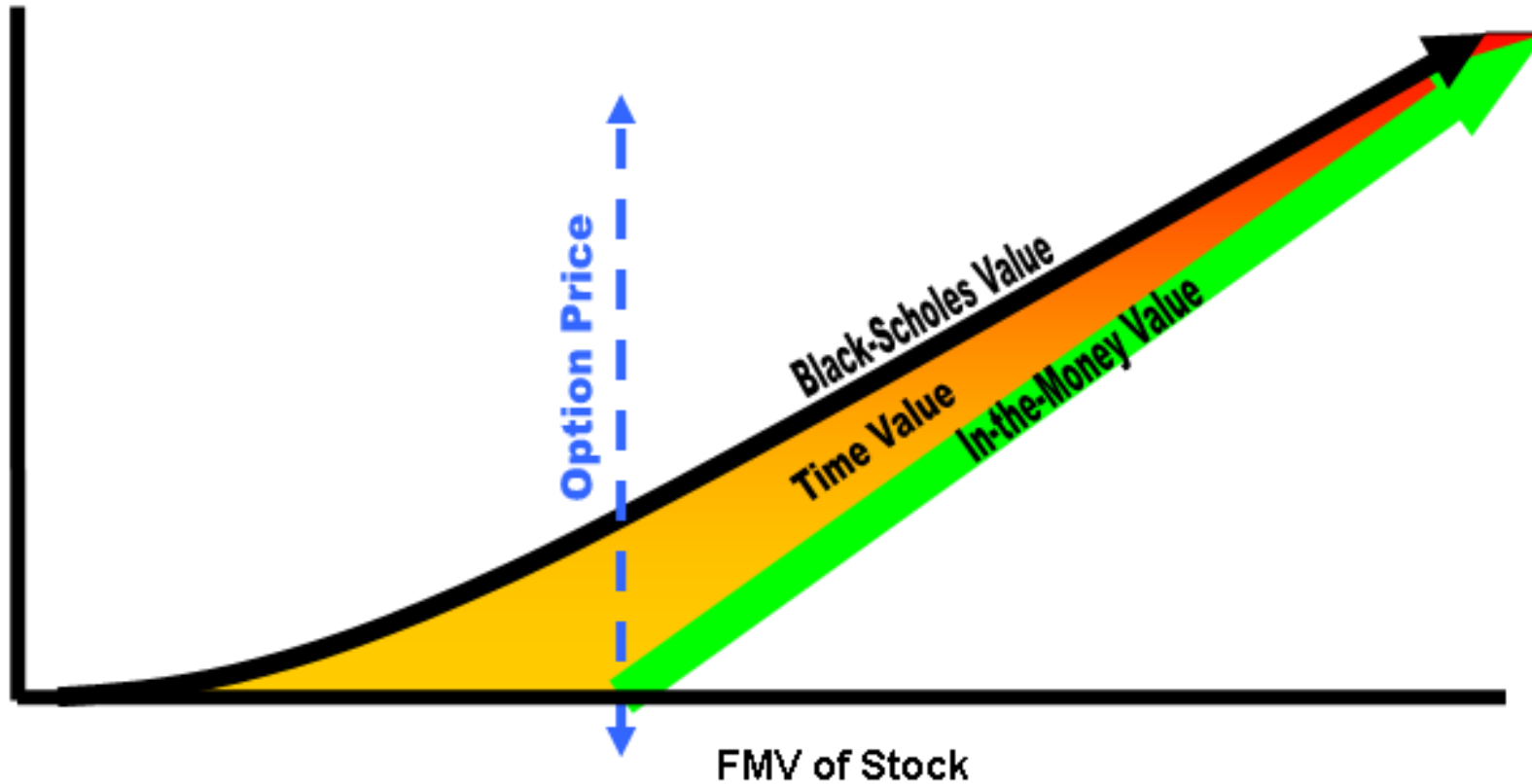
Volatility: NDAQ, Nasdaq Inc.

Ivolatility.com shows the historical & implied volatility over the past 12 months



In their **2021 10-K NDAQ** used an expected volatility of 30.3% to expense their employee stock options

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** when calculated by Black Scholes
- The inclusion of a **dividend is not relevant** if the client intends 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

Time Value Applications

- **Insight Ratio:**
 - **Option Time Value / Full Option Value**
 - Represents the % of **theoretical potential compared to intrinsic value**
 - Effective at indicating option exercise **order & urgency**
 - **5% Insight Ratio = 95% of the option's value is at risk**
- **Option Forfeit Value:**
 - The current **pre-tax option value lost** if the client left the company (prior to retirement)
 - Includes the **time value of the vested options + the full option value of the unvested options**

EC Planning Framework

Step 1: Gather and Organize Info

Step 2: Calculate Values and Risks

Step 3: Identify & Track Diversification Criteria

Step 4: Model Strategies for Taxes & Cash Flow

Gathering & Organizing EC Info

Biggest Challenge & Barrier to Opportunity...

- **Good Info:**
 - **Grant documents** (terms & vesting schedule)
- **Unreliable Info:**
 - **Client spreadsheets**
- **Other Required Info:**
 - **Owned Share Lots** (acquisition date & cost)
 - **Value of Other Investments** (concentration%)

Key Values & Risks

- **Equity Comp Values:**

- **Intrinsic Value:** $FMV - Exercise\ Price * Shares$
- **After-Tax Value:** $Intrinsic\ Value * (1 - Tax\ Rate)$
- **Full Option / Time Value:** $Intrinsic + Time\ Value$
- **Forfeit Value:** $TV\ Vested + FOV\ Unvested + RSA\ Value$

- **Equity Comp Risks:**

- **Concentration:** % of equity comp. to other investments
- **Leverage:** % change of option value on X% price change
- **Insight Ratios:** % of FOV representing TV

Diversification Criteria & Monitoring

Establishes “When” to Take Action

- **Ideally Determined by Risk & Not Wishful Thinking**
 - High Concentration (>50%) in Company Holdings
 - Low Insight Ratios (<10%)
- **Setting Price Targets**
 - Insight Ratios Can be Used to Determine Future Stock Prices of Stock Options
 - For Owned Shares Utilize Reasonable Annual Growth Rates (+/- 5-8%)
- **Monitoring Alternatives**
 - Nightly Using Closing Stock Price for Insight Ratios and Concentration%
 - 10b5-1 Plans Using Market Stock Price for Automatic Trades

Strategy Modeling (As Needed)

- Provides Detailed **Taxes & Cash Flow** Calculations
- Answers Specific **Client Questions**:
 - Estimating **AMT** Liability for ISO Exercises
 - Comparing Exercising ISOs as **Qualified v. Disqualifying**
 - How Many **ISOs Can be Exercised Up to AMT limit**
- Illustrating **Exit Strategies** Using
 - Different Annual **Stock Price Growth Rates**
 - Various **Rates of Diversification** Based on **Risk Profile**

Case Study: Sam & Sally Sample

- **NDAQ Stock Price:** \$157 (down from \$210 [25%] on January 1st)
- **Stock Volatility:** 30% **Risk Free Rate:** 1.7%
- **Income Tax Rate:** 50% **Cap Gains:** 20% (Fed+State)
- **Stock Options:**
 - **2 ISOs, 2 NQSOs:** 33,500 vested & 9,500 unvested
- **Shares:**
 - **3 RSUs:** 9,000 shares vesting 2022 - 2025
 - **7 Owned Share Lots:** 1 exercised ISO, vested RSUs and ESPP shares
- **Other Investment Value:** \$1,400,000
- **Financial Goal:** \$12,000,000
- **Client Goals:** Diversify Regularly, Avoid AMT, Compare QvD Strategies

CASE STUDY ANALYSIS DETAILS & CALCULATIONS

StockOpter.com Sample

Equity Comp Planning Resources

- Kitces Article on [Equity Comp Niche](#)
- [StockOpter University](#)
- [StockOpter.com](#)
 - Equity Compensation Valuation & Risk Analysis
 - Multi-Year Tax & Cash Flow Modeling (New)
 - Customizable Client Deliverables
 - Decision Criteria Monitoring and 10b5-1 Plans
- **myStockOptions.com**
 - Articles
 - Webinars

Q & A

Insights on Providing Equity Comp. Guidance

Thanks for Attending!

For Additional Information

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