

## Equity Monetization

*During the high-tech boom of the 1990s, countless investors were sitting on large concentrated positions of stock with significant gains. Given the opportunity to sell or hedge that position, most investors chose to do neither and suffered through the collapse of the high-tech market. Recently, given the strong performance of the Canadian equity markets, many investors are faced with a similar decision. “I own a large position in one oil and gas stock and I am sitting on a significant gain. Do I ride the momentum of the market, or do I take some money off the table by hedging a portion of my position?” If the answer to the question is the latter, then RBC Capital Markets can help, through Equity Monetization.*

## What is Equity Monetization?

Some investors have a portfolio whose value is concentrated in a single equity security. Typically, these investors are “asset rich and cash poor”. In most cases, these clients are:

- ∅ Individuals or corporations who have sold assets or companies to an acquirer, and have received public company shares as payment;
- ∅ Employees who have acquired shares in their employer through stock or option grants;
- ∅ Founders, or other long-time shareholders, of a company;

A client in this situation seeking to diversify their portfolio, or liquidate the portfolio, may face a significant tax liability if the adjusted cost base of the security is low. In this situation, an Equity Monetization Strategy (EMS) may be beneficial to the client.

## How is it implemented?

The EMS is implemented in three steps:

1. The client delivers the securities to a collateral account at Royal Bank of Canada (RBC) and pledges the subject securities to RBC.
2. The client hedges the value of the subject securities for an agreed-upon term—typically three to five years—by entering into a hedge transaction with RBC. The contract takes one of two forms:

- ∅ A non-participating forward

establishes a single value for the subject securities, at the end of the term of the contract.

- ∅ A participating forward.

establishes a range of values for the subject securities, at the end of the term of the contract. Essentially, the client accepts some downside risk (typically 5% to 15%) on their position, in order to potentially participate in further upside of the security.

3. The client borrows against the pledged and hedged securities via a term loan advanced by RBC. The term of the loan matches the term of the hedge, and the loan is structured on a discount basis so that no interest is paid prior to maturity.

### **An EMS Example**

A client owns securities worth \$10 million, and wishes to implement an EMS for a term of five years. The client selects a non-participating forward.

1. RBC determines that, for a five-year hedge contract, the applicable fixed value is \$12 million. (All values are purely illustrative.)
2. RBC determines the applicable loan rate, discounts this \$12 million future value back to the present, and determines that the loan advance is \$9 million.

In five years' time, principal and interest due on the loan equals \$12 million. For the hedge, the client elects one of two forms of settlement:

- ∅ Physical settlement: the client sells the securities to RBC for a payment of \$12 million, which is applied to repay the loan.
- ∅ Cash settlement: the client retains the securities, and settles the value of the contract via a single net payment. (If the market value of the securities exceeds \$12 million, the client pays this excess to RBC; if this market value is less than \$12 million, RBC pays this difference to the client.) The client also repays the loan in full.

### **The Advantages of an EMS**

Through the loan, the client is able to raise nearly 100 per cent of the value of the securities in cash. Through the hedge, the client sheds some or all (depending on the form of hedge) of the price risk of the securities, while retaining all voting rights and regular dividend entitlements.

Where the adjusted cost base of the securities is low, a further attraction of an EMS is that it may enable a client to defer any tax liability associated with the disposition of the subject securities. Furthermore, interest on the loan may be tax deductible to the client, if the loan proceeds are used to earn income from a business or property.

## **Who Can Use EMS?**

Clients who hold positions in a single security with a market value of \$2,000,000 or more can potentially participate in an equity monetization strategy. The securities should be traded on a North American stock exchange.

## **Can I Use EMS with Employee Stock Options?**

In practice, it is impossible to carry out an equity monetization strategy with unexercised employee stock options.

However, under current Federal income tax rules, Canadian residents do not recognize a tax liability on the exercise of employee stock options if certain criteria and thresholds are met. Instead, the taxable stock option benefit (difference between the fair market value at exercise and the strike price) can be deferred to the year when the shares that are acquired upon exercise are disposed.

Therefore, a client whose stock options meet the tax deferral criteria set out in the Income Tax Act rules, may exercise the employee stock options and then enter into an equity monetization on the shares acquired.

In additions to elections that need to be filed, the two main criteria to be eligible for deferring the taxable stock option benefit deferral until disposition are:

- i. the strike price must be equal to or greater than the fair market value of the stock at the time the options were granted; and
- ii. for options vesting in a given year, an employee will be able to defer taxation upon exercise for those shares acquired having a total fair market value (determined at the time the options were granted) not exceeding \$100,000 Cdn. Therefore, the fair market value of the shares at the time the options are exercised is not relevant for purposes of the \$100,000 per year calculation.

The \$100,000 annual vesting limit is best illustrated by an example.

An executive is granted 40,000 options in each of years 2000, 2001 and 2002. The employer does not grant any further options after 2002. The options granted vest 25% each year starting in the year following the grant year. The strike price is equal to the fair market value of the shares at the time of grant, which is \$2 per share for the 2000 options, \$3 per share for the 2001 options and \$4 per share for the 2002 options.

The share price has appreciated substantially over the past few years and each share is now worth \$30.

So the total strike price for all the options is \$360,000 [40,000 x \$2 + 40,000 x \$3 + 40,000 x \$4] and the current market value for all the shares is \$3,600,000 [120,000 x \$30]. The potential taxable stock option benefit is \$3,240,000 [\$3,600,000 - \$360,000].

The executive decides he wants to exercise all the options and then enter into an equity monetization strategy with the acquired shares to diversify and hedge his position. Upon exercise, how much of the \$3,240,000 stock option benefit can be deferred for tax purposes until disposition? The following table illustrates the amount that vests each year for each series of options to help us calculate the deferral amount.

	Year of Vesting					
	2001	2002	2003	2004	2005	2006
<b>2000 options</b>	\$20,000	\$20,000	\$20,000	\$20,000		
<b>2001 options</b>	\$30,000	\$30,000	\$30,000	\$30,000		
<b>2002 options</b>	\$40,000	\$40,000	\$40,000	\$40,000		
<b>Total</b>	\$20,000	\$50,000	\$90,000	\$90,000	\$70,000	\$40,000

Since the total value of the options in each year of vesting does not exceed \$100,000, then all the options can be exercised and the full taxable stock option benefit of \$3,240,000 can be deferred until disposition. As a result, there may now be an incentive for this executive to exercise the options and enter into an equity monetization strategy.

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