PRAIRIE

VALUATION OF SYNTHETIC EQUITY IN PRIVATE COMPANY COMPENSATION AND FINANCING STRUCTURE

The Use of Synthetic Equity as an Ongoing Compensation Strategy

The term synthetic equity is a catch-all term for a variety of economic interests in a company that don't also include the legal ownership of an equity interest. For anything that is labeled synthetic equity, the potential economic claim/benefit granted to the holder uses the Company's stock price to determine the economic return, but the economic return is paid in cash instead of shares. Accordingly, the payments may dilute (i.e. reduce) value of the business because cash leaves the Company, but they don't dilute percentage ownership because no additional shares are issued.

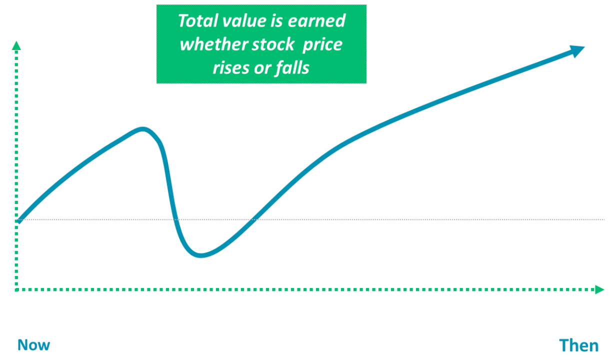
The easiest way to understand this to compare and contrast two of the simplest and most commonly used examples of synthetic equity; Phantom Stock and Stock Appreciation Rights ("SARs"). Phantom Stock and SARs are intended to mimic the actual ownership vehicles of direct share ownership and stock options, respectively as shown below.

Some Common Nomenclature		
	Direct Stock Ownership Concept	**Stock Option Concept**
Real	**"Restricted Stock" Grants**	**"NSOs" or "ISOs"**
Synthetic	**"Phantom Stock" Grants**	**"SARs"**

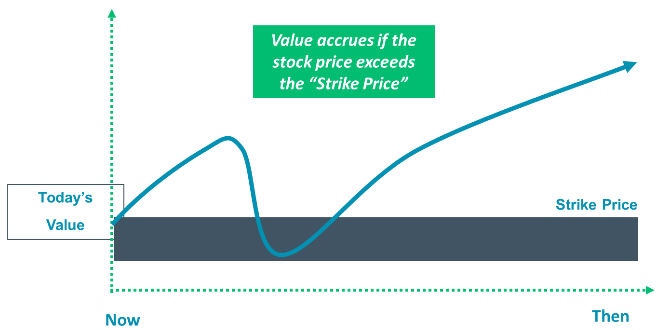
Let's take a look at each of the two dimensions in this table. First, we distinguish between holding whole shares versus holding a stock option. In cases of ***Whole Share Ownership***, the recipient will ultimately get value for the stock at its then-current value, whether value goes up, down or stays the same. Under the ***Stock Option*** concept the benefit to the holder is measured as the appreciation in the stock since the date of the grant. Thus, if the stock price goes down or stays the same, there will be no value earned by or accruing to the holder. So, both cases do reward the holder for appreciation, but the Stock Option idea is more acutely driven by appreciation. Thus, the Stock Option concept is more often used as an incentive to the holder to increase company value possible as a component of management compensation.

The selection between these two choices is driven by the intent of the Company and, possibly, its shareholders. Companies have a lot of discretion in designing how they want their equity-based incentive plans to change. The delivery of the economic benefit can be a factor, as can vesting. So, there is a combination of elements that can be considered to impact how, when and under what conditions the ultimate benefit can be earned and paid. In general, however, they tend to follow the patterns described below.

Whole stock models tend to be used in situations where a reward or 'thank you' is contemplated.



The stock option concept, on the other hand, is typically a forward-thinking reward mechanism granted to people who can influence share price growth and should be rewarded for that on a forward-thinking basis.



Both of these models have their place in situations calling for equity-based compensation, and there are quite a few companies that employ both because different needs that arise.

THE USES OF SYNTHETIC EQUITY IN ACQUISITIONS AND FINANCING

Apart from using synthetic equity as an element of compensation and ownership transition planning, there are also many applications in acquisition settings.

Among others, some examples include (1) the financing of the transaction using warrants, (2) use of synthetic equity as a form on consideration paid to the seller, and (3) the use of synthetic equity to help assure the retention of selling company management through the transition.

Acquisitions of private companies are typically defined by who the buyer is. Phrases such as these tend to define the span of situations:

- Strategic buyer purchase
- Financial buyer purchase
- Equity group Leveraged buyout ("LBO")
- Management Buyout ("MBO")
- Internal Recapitalization
- Employee Stock Ownership Plan

With the possible exception of the first case, where a strategic buyer acquires a business for cash or their stock, the other forms frequently involve some measure of financing. With the ebb and flow of the financing markets, there can be a greater or lesser amount of the purchase price that is financed. To the extent that financing is intended to be maximized, then there will likely be a gradation of the financing involved ranging from fairly low-risk senior bank financing to some form of subordinated financing provided either by the seller or by a third-party high-yield lender. Depending on the circumstances, the cost of the subordinated portion of the purchase consideration may be high enough to where a current cash interest payment is not feasible. In such cases, lenders typically seek to fill the gap using warrants to enhance their overall yield on the loan they are making.

The use of warrants, which pay off based on stock price growth in the future, enhances the yield to the lender by, theoretically, the required incremental 10 percent; that is, if everyone's math and assumptions are correct. The all-in return (the combination of the periodic interest payments, the principal repayments plus the expected future warrant proceeds) feed into a calculation of what finance people refer to as an Internal Rate of Return (or "IRR"). A lender might propose a loan based on a targeted IRR of 15 percent, for example, but there can be a great deal of negotiation involved in setting and agreeing to the terms that achieve that IRR.

SYNTHETIC EQUITY/ WARRANT VALUATION CONCEPTS

Regardless of its form or use, Synthetic Equity represents a claim on the equity of the Company and therefore reduces the value that accrues to all other stakeholders and. It is important to properly measure the reduction, which is often referred to as ‘dilution’. Generally, the value dilution caused by any form of Synthetic Equity is dependent on the form of the interest conveyed. If a ‘Whole Share’ concept is being used (i.e. Phantom Stock), then the value is the whole share stock price. The trickier component is when a ‘Stock Option’ concept is being used (i.e. SARs and Synthetic warrants).

In these cases, any value is generated by the ability to hold the interest until such point in time as there becomes an economic spread between the then-current market value of the underlying common stock and the contractual strike price or base value. Of course, if no such spread ever occurs, Stock Option based Synthetic Equity will not generate any intrinsic value to the holder.

The key comes down to how long the holder can wait for a spread to be realized. In private companies, various forms of Synthetic Equity frequently have longer-term exercise windows ranging up to ten years in some cases, during which value can change dramatically. *The basic concept is: The longer the timeframe a Synthetic Equity interest can be held, the more chances there are for a price movement that triggers an in-the-money position that can be acted upon.*

Option Pricing Models In public markets, analysts routinely determine the value of synthetic (and real) equity positions in order to determine how expensive and dilutive they are to the issuing Companies. With readily ascertainable stock prices, the job is simplified a bit, but there still needs to be a way to capture the benefit of being able to hold the interest until price changes result in a spread and yield a value. Financial analysts have created mathematical models to do this, and they are generally referred to as *option pricing models*. While there are others, a widely-used option pricing model is the Black-Scholes Option Pricing Model. Since private company valuation methods ‘mimic’ the public markets, this approach is frequently used in private company settings, as well.

The application of the Black-Scholes model requires a variety of assumptions and the reflection of certain underlying concepts that can impact value. These assumptions included the current value of the underlying securities, the historical and expected price volatility for the underlying securities, the risk-free rate of return of return, the expected holding period of the warrant, and others. These assumptions are based on information extracted from the market, however the duration of the subject warrants, and their specific terms, are generally not found in warrants that are actively tradable on established exchanges or over-the-counter markets. Thus, judgment is required in completing a valuation of warrants of this type.

Value Premise to be Used An important factor in the calculation of the value of Synthetic Equity is the current market value of the underlying securities, particularly in the case of private companies where no active market exists. One of the delicate issues in private companies regards the value premise that should be used in the valuation needed as an input in an option pricing model. There may be times where it is appropriate to use a non-marketable minority interest premise in estimating that input into the Black-Scholes model, since the economic interest being granted to the Synthetic Equity holder regards a minority interest in the Company's securities. Alternatively, there may be a coincident valuation being undertaken in support on the administration of an Employee Stock Ownership Plan at the Company, and that price gets used for the valuation of both the ESOP and for any Synthetic Equity outstanding that needs to be valued. This is done oftentimes for no other reason than to simplify communications and administration of the various equity plans that exist.

Regardless of the situation, it is important to fully discuss and understand the value premise issue at the time any synthetic equity plan is established, or when financing using synthetic equity is being structured. This will lead to (1) clarity in how relevant documents are drafted, (2) consistent expectations of the stakeholders and (3) an appropriate reflection of how dilutive such interests are to other Company stakeholders.

SUMMARY AND CONCLUSION

To be sure, there are complicating factors when companies choose to structure Synthetic Equity plans as compensation or use Synthetic Equity in structured financing, but their use can be very instrumental in successfully attaining critical company objectives. The proper structuring of either application requires careful planning and an understanding of the longer-term implications of the issuance of Synthetic Equity.

Those implications ***drive, and are driven by*** estimates of current value and value trajectory, both of which require specialized expertise. In fact, the analysis that underlies the best decision-making allows for iterative 'what-ifs' that demonstrate the tradeoffs between alternative structures. These two examples will help clarify the point:

- Assume that a management SAR plan is being structured for 10 key employees with a given set of terms. Being able to estimate what the income will be to the recipients in, say, year 8 will result in a reaction of whether that income is appropriate, and will therefore dictate whether the size of the grant today is too large or too small. The same set of assumptions will also help estimate the value dilution today to other stakeholders.

- Assume that the Company wants to borrow funds to complete an acquisition, and that the yield on the financing needs to be enhanced with warrants structured with a given set of terms. Being able to estimate that amount of value of the value of the warrant spread to the lender in, say, year 8 will allow a calculation of the all-in yield on the loan (the "IRR"). Knowing that will help determine whether the warrant grant structured today is too large or too small.

Regardless of the intended use, companies need to be properly advised on Synthetic Equity structures and their implications to all stakeholders.

Robert Gross
Senior Managing Director
Prairie Capital Advisors, Inc.
630.413.5585
rgross@prairiecap.com

Robert Gross is a Senior Managing Director in the Chicago office of Prairie Capital Advisors, Inc. an employee owned company that offers investment banking, ESOP advisory and valuation services to support the growth and ownership transition strategies of middle-market companies. With over three decades of experience engaged solely in valuation ownership transition, capital management and financial transactions, Mr. Gross is one of the most trusted and well respected financial advisory experts in the industry.