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## Retain & Reward Your Employees: The Synthetic Equity Club

By Tom DeSimone

Locating, hiring and retaining the best employees is an ongoing and often arduous task for owners of closely held businesses. As a company owner, you might be looking for ways to incentivize and reward your key management to encourage and boost loyalty and morale. Consider a Synthetic Equity Club. With a Synthetic Equity Club you can incentivize and reward key employees based upon your company's performance without diluting your company ownership. A Synthetic Equity Club does not require the transfer of real equity, so true ownership does not change but key management and employees can still benefit from company performance excellence.

### Maintain Control of Your Company

Employees can reap the same economic value they would if they actually owned shares of stock but the company does not dilute its ownership mix. Synthetic Equity is something that walks and talks and looks like real equity, but isn't. Often business owners turn to Synthetic Equity Clubs when they

want to implement strategies for employee attraction and retention but do not want to relinquish business ownership or control. With a Synthetic Equity Club, no actual purchase or grant of stock occurs. Instead, the equivalent value of company shares is distributed at a specific point in the future. Synthetic Equity Clubs function more like an employee bonus or incentive program and they require no employee cash investment. Synthetic Equity Clubs can be structured two ways – as Phantom Stock or Stock Appreciation Rights (SARS). Phantom Stock represents the equivalent value of a designated percentage of company stock based on the price at the time the Phantom Stock is issued. Its value will mimic the value of real stock shares but employees do not have to pay taxes annually on the investment and companies do not have to generate and issue them tax documentation each year. However, when the Phantom Stock is liquidated, employees will have to pay ordinary income tax on the investment rather than the more advantageous capital gains tax.

SARS mimic an appreciation model similar to Real Equity Stock Options. Employees are granted the value of a stock increase from a specific date through a maturity date. An attractive feature to many business owners is that if the stock value does not increase, then the company is not obligated to pay the holder of SAR units. Let's take a look at a simple example. A manager is awarded 300 SAR units with a strike price (base price) of \$10.00 per unit. Five years later, the price per share of the company is equal to \$35.00. The SAR holder is ready to exercise, or liquidate, their units. The SAR units hold a value of the difference between the exercise price of \$35.00 and the strike price of \$10.00, or \$25.00 per unit. The SAR holder, therefore, has \$7,500 of value. With SARS, employees work to help the business owner increase the value of the company and the employees stand to gain economically through their stock only when the company does well. SARS provides management teams with strong economic motivation to increase the value of the company.

The lack of initial out of pocket investment can make Synthetic Equity Clubs very attractive to both owners and employees. However, at some point in the future a company is obligated to create a market for synthetic stock. And there are strong downstream implications that owners need to understand completely before they talk to their management teams about granting Synthetic Equity in their companies.

## Build Value for Employees

A Synthetic Equity Club offers many benefits to business owners. However, the challenge is ensuring that a Synthetic Equity Club is also of value to employees. Employee perception might vary since Synthetic Equity is not 'real' stock. To make the stock valuable to the employees, business owners have to cash it out.

Legally, companies must ultimately create a market for the synthetic stocks so the employees can receive a return. If your business is sold, employees will receive the value of their Synthetic Equity from the transaction. Or the purchasing party might offer employees stock in the new company.

Otherwise, at some point, you will be obligated to create a liquidation event.

If you implement SARS, employees might see no return on investment and that knowledge can affect how they view the Synthetic Equity Club. Some companies replace a portion of employee compensation to put the SARS plan in place. Employees often perceive that tactic as a loss of real income. Prairie Capital Advisors recommends companies instead use SARS to enhance their compensation package. SARS is really just icing on the cake. But many companies might try to treat it as long-term compensation and salary and bonuses as short-term compensation. Understanding the ultimate objective of Synthetic Equity is critical. Is the intention to provide a short-term or long-term incentive? The beauty of Synthetic Equity Clubs is that the right combination of Synthetic Equity plans can meet either one, or both, of these intentions.

With all the ins-and-outs of ownership transition and Synthetic Equity Clubs, business owners are wise to turn to a trusted advisor to ensure all goes smoothly. The earlier business owners learn their options the better the chance they have of protecting their long-term interests and developing effective employee incentive and retention strategies. With the proper planning and guidance, Synthetic Equity Clubs can be win-win situations for both employees and business owners.

[For more information, contact:](#)

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