Dynamic Synthetic Equity:

A HIGH PERFORMANCE ROUTE TO GROWTH AND SUCCESSION

By Mark C. Bronfman – Sagemark Consulting

Long-term growth and succession is the holy grail of many private companies. Owners and boards often grant significant long-term equity awards to attract and retain top talent to achieve this end. Get it right and the owner group gains the financial freedom to pick their succession path: stay active, go passive, sell, merge, transfer to family, etc. Get it wrong and the company can stall and may never recover.

Unfortunately too many companies do get it wrong. These companies can waste millions on long-term equity incentive awards that are static, ineffective and unfair and, more importantly, often fail to deliver high performance growth and succession. A tailored value sharing structure can solve many of these problems. This article highlights the common pitfalls as well as the evolving best practices for equity-based incentives in two main sections.

Public company pay practices like employee stock options and restricted stock can generate distorted outcomes for private companies. Dynamic synthetic equity designs are often better.

As one of a company's single largest investments, equity-based reward plans must drive critical results and enable a differentiated competitive advantage. Explore these robust designs to help deliver the essential outcomes of high performance growth and succession.

Dynamic Synthetic Equity:

Section 1 explains why traditional public company equity awards often don't work for many private companies. Section 1 introduces the FAIR Principles for equity incentives including Fair Value, Fair Share, Fair Deal and Fair Team with special emphasis on dynamic synthetic equity.

Section 2 is a more concrete "how-to" guide. Leveraging the FAIR Principles, this section presents robust equity-based plan examples that many boards, CEOs, owners and industry practitioners may have never seen or considered such as Enterprise Value Plans, Value Band Plans, Deferred Participation Plans, and Incentive Unit Bonus Plans.

DESIGN PRINCIPLES: EQUITY-BASED INCENTIVES FOR PRIVATELY HELD COMPANIES

Fair Value Minimize the plan distortion common to fair market value plans

Fair Share Promote graduated rewards consistent with owners' objectives

Fair Deal Encourage owner-like behavior from key executives

Fair Team Reallocate rewards to top performers over time

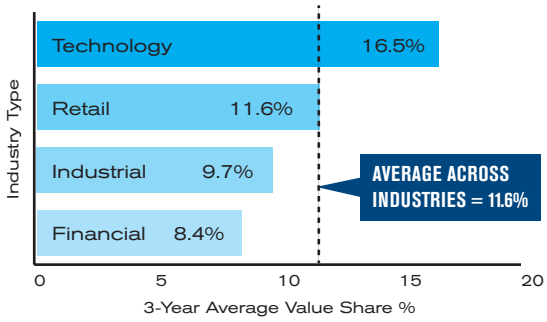
SECTION 1

Problem Statement | Principles-Based Solution | Applications and Examples | Implementation Considerations

WHY TRADITIONAL EQUITY DOESN'T WORK FOR MANY PRIVATE COMPANIES

Equity-based incentives for the core executive team are one of the most important "big-big" investments a company will ever make (big financial cost and big strategic impact). Per Frederick W. Cook and our own study,[1] owners and boards of growing middle market private companies[2] often expend 11% of company value on equity-based incentives to attract, motivate and retain the senior management team over the long-term (see figure 1). These value sharing programs are sometimes the single largest "investment" a company will ever make for any purpose.

FIG. 1: % OF TOTAL EQUITY VALUE AWARDED AND RESERVED FOR EQUITY-BASED PLAN



Granted and available-for grant shares over all outstanding and issuable shares.
Source: Frederick W. Cook & Co., based on public company data, 2011

Most equity-based rewards such as restricted stock and employee stock options have been "purpose-built" to meet the needs of *public* company executive compensation. Investors and boards use equity-based awards to motivate executives to take prudent risks (a/k/a, "agency theory"). Design priorities typically focus on *who* (levels of management) gets *how much* (tied to industry benchmarks) *when* certain performance triggers are met (grant and vesting triggers). Securities analysts that track public companies expect only true equity awards, consistent with public companies' focus on earnings, less on cash flow.

In theory, a similar equity strategy should work for privately-held companies. However, public company long-term pay practices can generate distorted outcomes for private companies. Where do the solutions break down for privately held companies? Executives are exposed to share price gyrations resulting from ownership succession and capital structure issues no one expected. Upside-only plans, like stock options, can catalyze excessive risk taking, especially when owners go passive. Fair market value (FMV) plans limit reallocation of value to recent high performers as new stars emerge in the company. Given limited daily liquidity for private company shareholders, some plans unintentionally encourage future leaders to cash out and exit the company as a way to lock in value, the exact opposite of a "retention plan".

DESIGN NOTE: Serving in the role of financial advisor, we have helped implement each of the designs presented in this paper. Because these designs are subject to evolving tax law and accounting convention, check with your advisors prior to putting these plans into action.

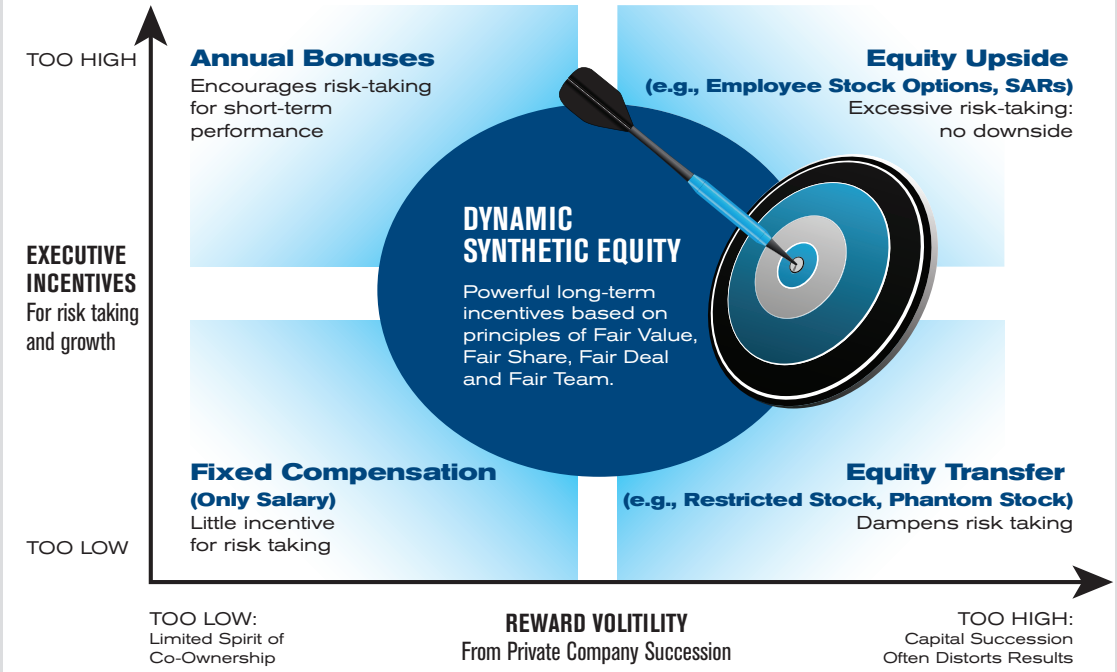
Equity-Based Value Sharing Options

Equity-based rewards fall into three primary categories: (a) traditional true equity; (b) traditional synthetic equity; and (c) dynamic synthetic equity. Each of these three are described later in this section. Equity-based awards are further refined into equity *upside* awards (e.g., employee stock options) and equity *transfer* awards (e.g., phantom stock). Dynamic synthetic equity plans can pivot towards either equity upside or equity transfer.

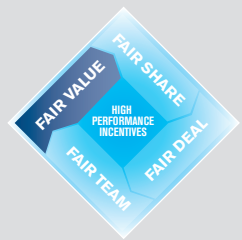
Figure 2 presents a simplified framework to facilitate plan shaping across these myriad of options. The framework considers two primary dimensions: growth and succession. The Growth Dimension considers how much "risk and return" the company/owners are willing to take to encourage growth. The Succession Dimension considers how much reward volatility the company/owners are willing to take relative to plausible succession pathways (e.g., bring on more owners, sell, redeem, go-passive, merge, family transfer, etc.) Dynamic synthetic equity can often best balance the shifting realities across growth, capital structure, succession and strategy.

DESIGN NOTE: Those interested in a basic primer on the use of synthetic equity in private companies are encouraged to read "Synthetic Equity," available on the BOLDValue.com website.

FIG. 2: DESIGNING EQUITY-BASED AWARDS FOR PRIVATELY HELD COMPANIES

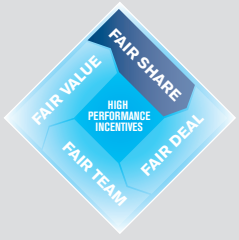


Dynamic Synthetic Equity Examples:



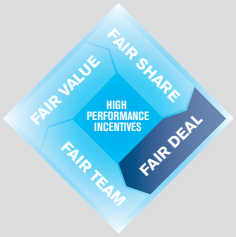
Enterprise Value Plan

These plans base rewards on growth in enterprise value, not FMV, since FMV is easily distorted by succession capital flows.



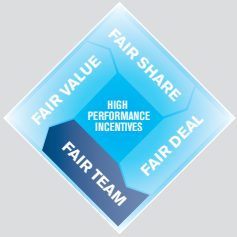
Value Band Plan

These plans offer graduated value sharing (akin to a tax table) rather than linear value sharing, since typical owners are more willing to share upside.



Deferred Participation Plan

In these plans, key executives choose to defer salary and bonus which is then indexed to the value of synthetic equity, creating true "skin in the game".



Incentive Bonus Unit Plan

A broad cross-section of the team can be included in these plans, with value that can be reallocated based on relative contribution per executive over time.

Dynamic synthetic equity-based plans create a value sharing structure capable of adapting to dramatic company changes resulting from the shift in growth, capital structure, succession and strategy. These can be, by far, the most resilient plans for growth and succession.

Conversely, traditional (or "static") plans are often grounded in fair market value (FMV) and offer fewer safeguards and shock-absorbers if the company or ownership structure evolves differently than anticipated.

Each of the three types of equity-based sharing options is described below, along with some key advantages and disadvantages of each.

A. TRUE EQUITY incentives, like restricted stock and employee stock options, are well understood and the typical default for long-term incentive compensation. In short, the company provides a grant of equity (restricted stock) or the right to acquire equity at a specific price within a certain time period (employee stock option). These grants are typically subject to a time and/or performance vesting schedule. Once the executive has fully acquired the equity and has "tax basis", the executives shares in true equity gains or losses – often at preferred capital gains rates.

For better or worse, true equity solutions conform to the rules of "property." Transactions are tracked using FMV. There is a cost drag (tax cost or acquisition cost) to create basis. Valuations are often required. Transactions below FMV may trigger tax consequences. Values only go up or down linearly (more on this later). Grants have a "first-in" bias: those that come in early to an organization typically get the greatest value and it can be difficult to reallocate value to the higher performers at a later date. Securities and legal constraints limit who can be offered equity. Tax and accounting requirements dictate the costs of equity transfer. Design freedom is often greatly limited.

B. SYNTHETIC EQUITY is the second major type of equity-based award; it includes phantom stock and stock appreciation rights (SARs). One share of phantom stock is typically equivalent to one additional notional share of stock in the company. Assuming there are a total of 9 true equity shares and one phantom stock share, the phantom share grantee has 10% notional ownership (1 share divided by a total of 10 true and notional shares). SARs share the upside value of a share with no requirement of a buy-in and are similar to stock options. (All references in this paper refer to synthetic equity SARs.)

Synthetic equity generally provides the economic characteristics of equity without the legal and tax limitations of true equity. Synthetic equity solutions follow the tax and accounting rules of compensation (not property). Annual formal valuations are not required. Executives generally escape a buy-in or tax obligation until they are paid out. Owners do not cede equity control. No second class of S corp. stock is triggered, so different rights and privileges can be offered as part of the plan. Synthetic equity can track division values without requiring creation of new legal entities.

As an added benefit, synthetic equity typically has a materially lower after-tax cost to the company since all payments are treated as tax-deductible compensation, whereas true equity may only offer a single up-front tax deduction. With these and other advantages, it is no surprise that Vivient and WorldatWork report that synthetic equity is now the number one equity-based compensation technique used in privately held U.S. companies.[3]

DESIGN NOTE: The succession planning issues discussed here are often much less relevant to private equity portfolio companies since these portfolio companies often have a time-specific exit path, institutional owners and limited expectation of changes to capital structure prior to a change in control. Accordingly, PE firms typically use traditional equity plans.

Collectively, these traditional true equity and synthetic equity incentives are very simple, broadly understood and follow decades of value sharing convention. Tell someone they have restricted stock and/or phantom stock and they (or their advisor) may say they somewhat understand what they are getting.

However, familiarity alone does not make these traditional equity designs a best fit for many private companies. The traditional designs are often *static* – failing to respond to the impacts of owner and leader succession such as changes in capital structure. The traditional designs are often *ineffective* – failing to strike the right balance of risk taking, especially as the founders go passive. Most importantly, the traditional designs are often just *unfair* – rewarding the "first-in" executives rather than cultivating a true meritocracy. Dynamic equity-based designs are often better.

"Dynamic synthetic equity is now at a tipping point for equity-based incentive designs for privately held companies."

C. DYNAMIC SYNTHETIC EQUITY

solutions are the third type of equity-based awards. These solutions are often best at enabling competitive advantage and foster high performance succession because they are robust and adapt to inevitable changes to capital structure, owner objectives, governance and strategic intent. Unlike "plain vanilla" synthetic equity that closely mimics the economics of restricted stock and employee stock options, dynamic synthetic equity solutions can self-correct along the changing realities of privately held companies.

Dynamic synthetic equity is now at a tipping point for equity-based incentive designs for privately held companies. Four regulatory developments over the last decade have spurred significant market maturity. First, accounting standard FAS 123R (2004) requires that employee stock options be accounted for as an accrued cost, no longer making options "free of charge". Suddenly, synthetic equity was a "competitively priced" alternative. Second, Sarbanes Oxley (2002) raised the cost of going and staying public, thereby increasing the number of more sophisticated middle market companies using advanced synthetic equity solutions. Third, IRS 409A final regulations (2007) consolidated the rules and tax consequences of deferred compensation, thereby providing greater clarity and confidence for drafting and administration of advanced synthetic plans. Fourth, recent trust and estate laws (2013) provided the first permanent estate gifting exemptions in a decade and permit more sophisticated integration of capital structure, estate planning and exit planning solutions. As a result of these developments, a cottage industry has sprouted up dealing specifically with design and administration of these synthetic plans. Costs have fallen and best practices have evolved. Dynamic synthetic equity has come of age.

DESIGN NOTE:
A profits interest in an LLC as well as Equity SARs are powerful non-traditional equity designs beyond the scope of this paper. By the very nature of multiple classes of ownership and management of capital accounts, LLCs taxed as a partnership permit significantly more equity design freedom than S Corps. There are many derivatives of a profit interest in an LLC that can meet many of the FAIR Principles outlined later in this paper. Still, profits interests can be materially more complicated and even costlier than synthetic plans, so the proper plan selection is very contextual.

Problem Statement | **Principles-Based Solution** | Applications and Examples | Implementation Considerations

THE FOUR FAIR PRINCIPLES: FAIR VALUES, FAIR SHARE, FAIR DEAL & FAIR TEAM

For all of the reasons outlined above, our planning team had a major revelation relative to equity-based plans: traditional equity-based compensation designs often do not provide private companies with effective solutions to promote *both* high performance growth *and* high performance succession. At 11% of the value of the company, these compensation solutions are just not bringing enough enduring value. In short: traditional equity-based plans are too static, costly, ineffective and unfair. Harking back to the words of strategist Michael Porter: Structure is NOT Strategy. Rather, equity-based design is strategic when based on customized, robust and enduring principles.

In response, we crafted a set of FAIR Principles reflecting intended strategic outcomes from these sizeable investments. We considered issues such as business economics, behavior, owner transition, volatility and company structure in private companies. We tested the principles across many of our client situations. And we considered the issues of fairness, agility, resiliency and affordability, which we typically test for as part of equity-based modeling.

While straightforward, these principles can greatly improve equity-based design fit and thereby preserve the succession advantage and avoid wasting millions on ill-designed awards. Plan designs addressing each of these principles in detail are discussed in Section 2.

The Four FAIR Principles:

FAIR VALUE: **Minimize plan distortion common to FMV plans.**

The Fair Value principle recognizes that private companies are subject to dramatic changes in capital structure, given the periodic and often unplanned entry and exit of owners or debt-holders. If not addressed, changes in capital structure can unjustly enrich or penalize key executives with equity-based awards. To minimize distortion from changes in capital structure, the Fair Value principle suggests basing awards on Enterprise Value or formulaic value, not necessarily FMV.

FAIR SHARE: **Promote graduated rewards consistent with owners' objectives.**

Fair Share reflects the value sharing wants and needs of the majority owners of privately held entities, who are often very willing to share on a graduated basis as company values increase. This non-linear approach, in our experience, best reflects how most owners and executives prefer to address value sharing (the better we do, the better you do).

FAIR DEAL: **Encourage owner-like behavior from key executives (including entry cost for equity-based plan).**

Fair Deal refers to the nature of the grant. Many owners find that traditional equity, phantom stock or SARs grants fail to strike the right balance for strategic risk taking – especially when owners go passive. Fair deal strategies incorporate a combination of "skin in the game" techniques to encourage executives to behave more like owners.

FAIR TEAM: **Reallocate rewards to top performers over time and minimize the "first-in" bias.**

The Fair Team principle seeks to ensure that the right top performers participate in the value sharing with minimal impact of the "first-in" bias. Goal: Improve the company's strategic agility and foster a true meritocracy. This is often achieved via the use of unit plans and incentive bonus plans rather than "top-hat" plans and similar design features.

SECTION 2

Applying the FAIR Principles to Equity-Based Rewards

This section illustrates tailored design examples through the lens of each of the Four FAIR Principles including Enterprise Value Plans, Value Band Plans, Deferred Participation Plans, Unit Plans, Incentive Bonus Plans and so on. Please do not limit the thinking to the half-dozen specific solutions presented here. Rather, use these Four FAIR Principles as *building blocks* to craft many powerful designs most relevant to a specific situation.

Problem Statement | Principles-Based Solution | **Applications and Examples** | Implementation Considerations

PRINCIPLE 1: FAIR VALUE (MINIMIZE PLAN DISTORTION COMMON TO FAIR MARKET VALUE PLANS)

Related Example: ENTERPRISE VALUE PLAN

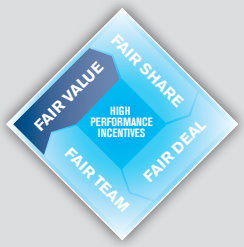
THE CHALLENGE: Privately held companies often experience dramatic changes to capital structure as majority and minority owners enter and exit the company over time. As "succession capital" is infused into or extracted from a privately-held company, the FMV of the company can gyrate. As a result, the value sharing "goalposts" based on FMV can move wildly, frustrating stakeholders involved in the plans.

Since the vast majority of equity plans and plain vanilla synthetic equity plans are premised on FMV per share, succession capital can, in turn, materially distort equity value year to year. This is especially true when cash related to succession and capital structure does not stay inside the privately-held company. Rather, cash exits to redeem and retire shares of owners - perhaps as part of an MBO, an ESOP, life insurance settlement, large distributions to shareholders and other types of recapitalization. As a result, a company with a share price of $50 today may be valued at $90 or $10 per share tomorrow.

Here is an example.[4] One of the three founders of an electronics manufacturer dies and the company uses life insurance proceeds to redeem and retire the shares from the founder's estate. The company now has the same company value with 33% less shares. As a result the price per share jolts up approximately 50%. The CEO with a major block of SARs now finds her grants to be worth twice as much – even though she did nothing to propel the share price. As this example illustrates, FMV per share plans can result in significant distortion between the intended operational targets and the actual measurement used for rewards. This inevitability leads to undue enrichment or undue penalty. How can these designs be improved upon?

THE FAIR APPROACH: To improve the situation, use "Fair Value" rather than FMV. As illustrated in figure 3 below, self-correcting Fair Value plans can come in many different flavors. These plans can track formulaic value based on the success of business operations (examples include multiple of sales, profit, backlog, etc.). Fair Value plans can track the value of total equity, often a better measure than equity value per share. These plans can also be based on equity value with adjustment for succession capital debt. Company context should drive the definition of appropriate company value for the purposes of long-term value sharing. The time spent selecting and defining these values across a variety of scenarios is a worthwhile investment.

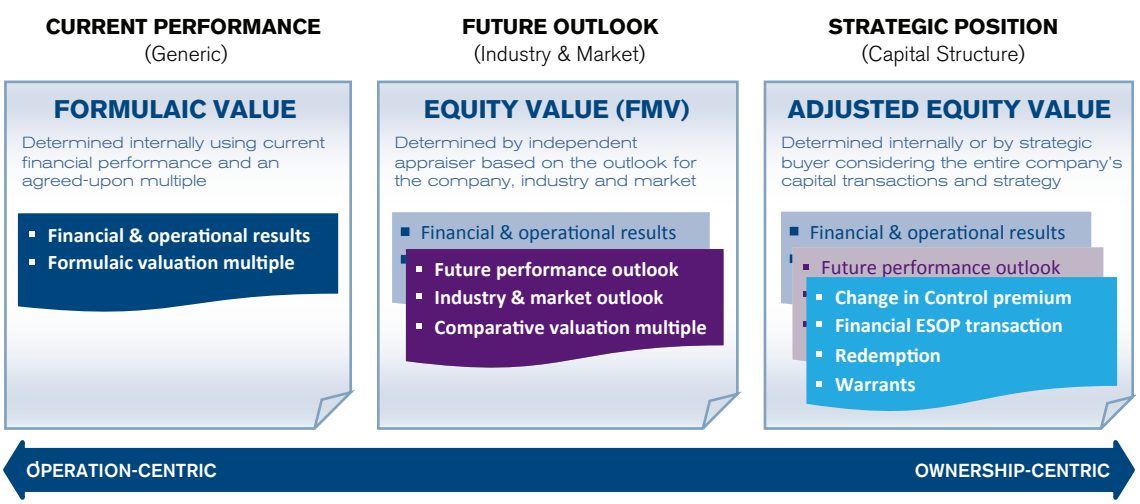
THE EXAMPLE: A research company with $500M in annual revenues completes a partial leveraged ESOP by bringing on material debt. Before the transaction, the equity value was $300M. After the transaction, the equity value shrank to $100M. Assume the company planned



Enterprise Value Plan

These plans base rewards on growth in enterprise value, not FMV, since FMV is easily distorted by succession capital flows.

FIG. 3: ELEMENTS OF "FAIR VALUE" PRIVATE COMPANY VALUATION Getting the Right Value Sharing Framework



to retire the succession debt over six years, so the company FMV would likely increase dramatically each year simply based on debt payoff. What kind of value sharing plan can a company with a debt-suppressed equity price consider?

The client asked us to design a suitable SARs plan. We pointed out that a SARs plan could provide major rewards to the executives unlinked to true performance improvement (i.e., unjust enrichment) since simply paying off the debt raises the equity value even though the company is not necessarily growing either the top line or bottom line.

Instead, we fashioned an "enterprise value unit" plan that was based on overall company value excluding the ESOP debt. Executives are now rewarded for operational performance independent of the changing capital structure, which is out of their hands. Overall, this advanced design is much more responsive to changes in capital structure than a plain vanilla synthetic equity plan.

Value Band Plan

These plans offer graduated value sharing (akin to a tax table) rather than linear value sharing, since typical owners are more willing to share upside.

PRINCIPLE 2: FAIR SHARE (PROMOTE GRADUATED REWARDS CONSISTENT WITH OWNERS' OBJECTIVES)

Related Example: VALUE BAND PLAN

THE CHALLENGE: Equity plans and most synthetic equity plans are measured based on linear value sharing – while the utility gained by the majority owner is typically anything but linear. Owners are often more willing to share large portions of value once they have crossed certain value thresholds; and often key executives prefer to participate in larger amounts over time. Traditional linear plans negate the objectives of both the owner and the key executives. Dynamic synthetic equity performs much better.

Consider this: a business owner typically has a flattening value or "utility" from every additional $5M value created by the business. The increase from zero to $5M may be truly transformational for the owner and her family. The increase from $5M to $10M will be greatly appreciated as well, although it's not as "valuable". Moving forward, few business owners will notice the value appreciation from $100M to $105M. (For more on this topic, see

Nobel Prize winning Daniel Kahneman's work on prospect theory and endowment effect).

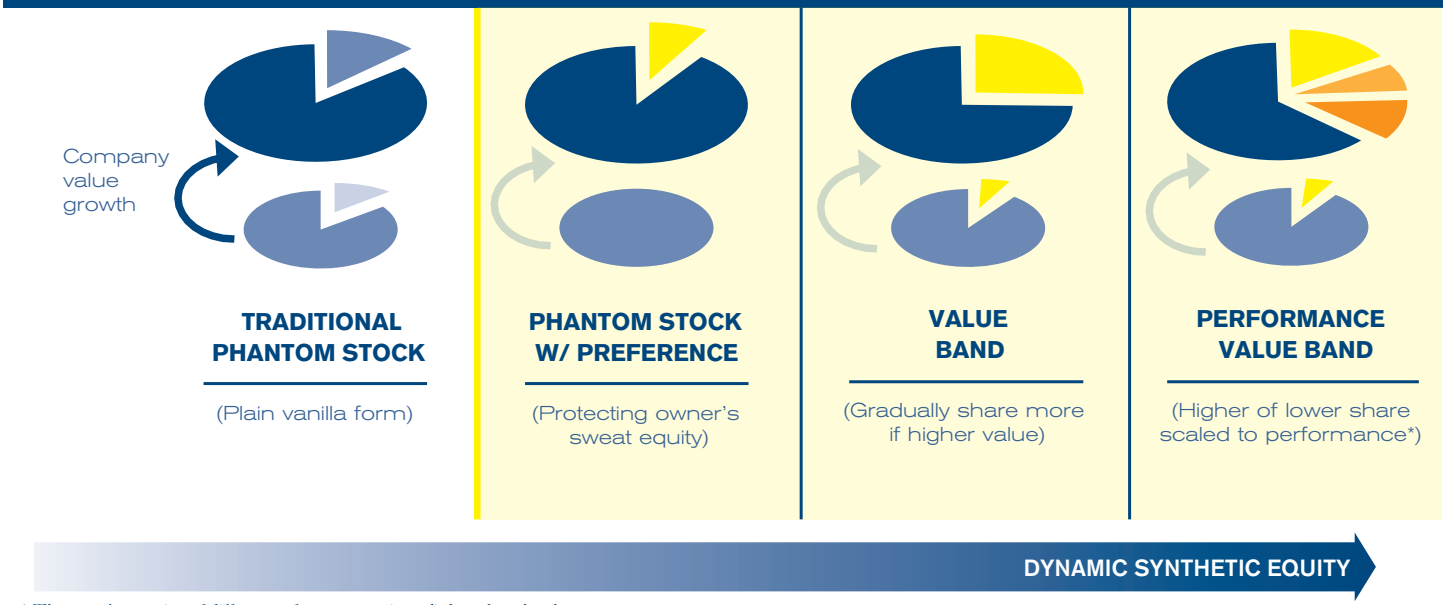
Similarly, the utility value to key executives is not straight line. A far out-of-the-money value sharing program (a/k/a, a "lottery ticket") has much more value to plan participants than one might expect. Would a key executive rather have a 1% linear phantom stock value, or start with no value, with the upside chance to have 10% of enterprise value if the company is a rocket? Having received this lottery ticket, few executives will be willing to go back to a small amount. Furthermore, we find that key executives are *more* engaged in value share plans when they understand that the value share equation is grounded in the true objectives of the owner.

THE FAIR APPROACH: What we call value-band plans (or "the better we do, the better you do" plans) fall into three major categories. We find that a large portion of clients show extreme interest in these types of "non-linear" plans. (See figure 4.)

a. ***Phantom stock with a preference*** (share value only after business achieves a certain value).
b. ***Value band*** (share value on a graduated basis, similar to a federal tax table: share 0% below $30M, 5% between $30M and $50M, 10% between $50M and $100M, etc.)
c. ***Performance value band*** (share value based both on the firm's lagging economic value and leading business health metrics such as revenue diversification and percentage of new products).

THE EXAMPLE: In a recent case study illustrating this Fair Share design, a $100M medical training company is 100% owned by the non-active founder in his mid-70s positioning the company for a business exit via an eventual sale of the company.

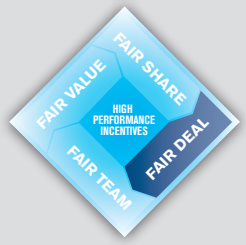
FIG. 4: "FAIR SHARE" OPTIONS BEYOND TRADITIONAL PHANTOM STOCK PLAN DESIGNS



** There can be a variety of different performance metrics to link to the value share.*

The passive owner offered his top people a total of about 6% of the company using phantom stock. The executives believed they could grow the company materially and the 6% cut was nice, but insufficient for the value they were creating – especially since the passive owner was now primarily a financial investor only. The executives asked us to serve as a neutral third party and craft a design that may work for all parties. The passive owner agreed to the planning exercise and, along the way, also came on as a personal planning client, which helped us fully understand his objectives.

We designed a "Value Band Plan" to provide a graduated value share to the management team in the event of a change in control. Instead of providing linear 6% phantom stock, we designed a graduated value band plan with value sharing intervals up to a full 20% of the company if the company deal valuation exceeded $160M. (This design appears, in practice, like a progressive tax table with increasing share at higher values.) Further, we structured the plan as a "unit plan" to encourage reallocation of value to the individual team members who created the greatest value over time (see "fair team" section for more on unit plans). Four years after we introduced the plan, the company sold for close to $200M and the executive team reaped a full $40M value share. This was viewed by all parties as fair, based on merit and truly rewarding.



Deferred Participation Plan

In these plans, key executives choose to defer salary and bonus which is then indexed to the value of synthetic equity, creating true "skin in the game".

PRINCIPLE 3: FAIR DEAL (ENCOURAGE OWNER-LIKE BEHAVIOR FROM KEY EXECUTIVES)

Related Example: DEFERRED PARTICIPATION RIGHTS PLAN

THE CHALLENGE: The governance of value share plans changes dramatically when the founders or owners are no longer active in the business. Once the "governor" (i.e., owner) is no longer involved in the business, the key executives are more likely to "swing for the fences", especially when stock options are involved – often destroying value along the way. (For more on this, see Penn State Professor Don Hambrick's article "Swinging for the Fences: the Effect of CEO Stock Options on Company Risk-Taking and Performance").

What does one do when the "fox is in the henhouse," meaning that the new CEO, who is covered under the executive compensation plan, can increase or decrease strategic risk to suit herself and the management team? See figure 5, which indicates that the mix of equity-based compensation has significant impact on an organization's propensity to take classically defined strategic risk expressed as big investments, M&A activity, key acquisition of new talent, etc. Specifically, often neither of the two traditional equity-based plans is acceptable to the fiduciaries and owners. Option 1: employee stock options only offer share in upside and therefore *exacerbate* risk. Option 2: restricted shares endow right of share ownership and therefore *dampen* strategic risk. Employee stock options provide a "freebie" ticket to upside whereas restricted shares come with the tax cost entry. While there are derivatives of these programs (e.g., 83(b) tax election for restricted stock), the typical true equity-based rewards encourage too much or too little risk taking.

THE FAIR APPROACH: Dynamic synthetic equity designs provide options that can "thread the needle" and provide a more acceptable balance of risk and return for the executive and a better outcome for the enterprise experiencing an unexpected change in governance. While typical synthetic equity like phantom stock may appear "free" and without buy-in cost or tax cost, it does not have to be that way. Rather, one can craft almost any type of dynamic synthetic equity arrangement to achieve

a risk/return balance that should perform well for the likely governance scenarios. These designs are not complicated; they are simply unfamiliar.

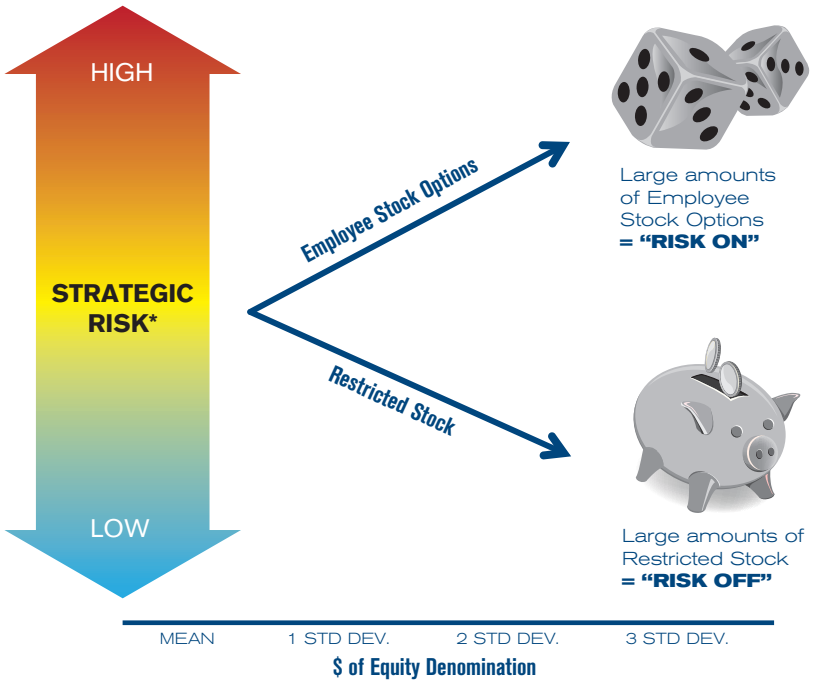
Want an executive to "buy-in" at 10 cents on the dollar for synthetic equity? That can be done (see example below). Want the management team to all receive SARs that are 25% in the money at grant to simulate part endowment and part upside without bargain purchase taxation? That can be done. Want to incorporate a "double-trigger" of grant followed by performance unlocks based on key business outcomes? Also doable. A creative answer can be crafted to meet almost any business context.

THE EXAMPLE: In a recent case study illustrating this Fair Deal design, an economic consultancy with an FMV of $120M is owned by a serial entrepreneur seeking to put 15% of company equity in the hands of his three key people so they are motivated to grow the business and act as "co-owners." The owner is unsure of his forthcoming succession pathways: he may stay in the business, take on minority investors or sell the business. Furthermore, the owner wishes to grant the most senior executive, Zelda, the right to acquire shares for a deep discount since she is almost a co-founder. The key executives, including Zelda, do not have the resources to acquire the shares. The owner does not want to simply grant them a phantom stock award. Rather, his goal is to have the executives pay something and have a degree of "skin in the game" so they truly feel like co-owners.

To address this situation, we set up a simulated buy-in using a nonqualified deferred compensation platform we call a Deferred Participation Plan. Since this is not an FMV platform, different "buy-in" prices can be set for each executive: Zelda comes in at $400k per 1% whereas the other key executives come in at $900K per 1%. The executives defer their salary and bonus on a pre-tax basis over a period of years and the values are indexed to a formulaic valuation of the company each year. The plan provides the executives with a pro-rata share of any change in control value, value at separation of service incorporating stepladder discounts and a partial payout in year 10 of the plan, thereby encouraging all of them to achieve key milestones by that year. We also crafted a program to help groom these executives and reward the next level of management.

The company continued to grow and the owner eventually did go passive, leaving the three key executives to drive the business on a daily basis. They are synthetic owners, have funds at risk and operate like fiduciaries to balance the growth and sustainability of the organization.

FIG. 5: EQUITY-BASED INCENTIVES HAVE SIGNIFICANT IMPACT ON PROPENSITY TO TAKE STRATEGIC RISKS



**Definition of Strategic Risk: R&D spending, capital expenditure, long term debt, etc.*
NOTE: The chart is a simplified rendering based on a study by Cynthia Devers, et al., using data from 794 firms with an average of 6.5 years of data per firm (based on 10-K filings).
Source: Devers, University of Wisconsin-Madison in Organization Science-Examining Compensation Design Effects on Firm Risk

Incentive Bonus Unit Plan

A broad cross-section of the team can be included in these plans, with value that can be reallocated based on relative contribution per executive over time.

PRINCIPLE 4: FAIR TEAM (REALLOCATE REWARDS TO TOP PERFORMERS OVER TIME)

Related Example: INCENTIVE BONUS PLAN

THE CHALLENGE: Given rapidly changing business models in many industries as described in the recently released book *Big Bang Disruption*, many companies continually reevaluate their strategic and succession pathways (see figure 6). Inevitably, the talent at the next juncture will be different than the key management group that brought the company to the opportunity line. However, long-term executive compensation plans have a "first-in" bias, such that those who helped to initially grow the company reap the rewards even if they are no longer playing a critical role in the company. This means that there may be insufficient reward capital going to the new executives, creating an uncomfortable mismatch between those creating value and those reaping value.

Regulatory limitations may also restrict a company's ability to provide grants to lower level executives who create the most value. Some synthetic plans may be viewed by the Department of Labor ("DOL") as a "shadow" retirement plan - and under the Employee Retirement Income Security Act ("ERISA"), certain groups can participate in these plans only as long as the total group is limited in number to a "select group of management or highly compensated employees," a term which has never been defined by the DOL. Here's the common rule of thumb: typically no more than 10% of the employee base can be eligible for this type of "top-hat" plan. Still, it's a good idea to have an experienced ERISA attorney review the proposed plan population in light of the company context. Furthermore, many of these plans are also subject to Section 409A of the Internal Revenue Code. 409A rules can restrict a company's ability to alter payment and other select plan provisions once the plan is established and grants are made. Collectively, the first-in bias and the regulatory rules can just get in the way of fostering a pay-for-performance approach and culture. Unchecked, regulations can create a Gordian knot.

THE FAIR APPROACH: Careful design can overcome many of these challenges. Dynamic and advanced synthetic equity plans are often set up as "unit plans," enabling a reallocation of the plan value to those who are most deserving. Unit plans offer significant advantages over true equity FMV plans, or even simple synthetic equity plans. Furthermore, many incentive bonus plans can be crafted to stay within the short-term deferral limitations and thus be exempt from Section 409A and even be exempt from ERISA altogether. The "playing field" here is quite technical and is not for the novice; we have seen a number of plan designs where the plans hit tripwires that limited the degrees of freedom in the plan. In the hands of a good cross-disciplinary advisory team of accountant, attorney and financial advisor, many of these plans can be very flexible, strategic and supportive of a merit-based culture.

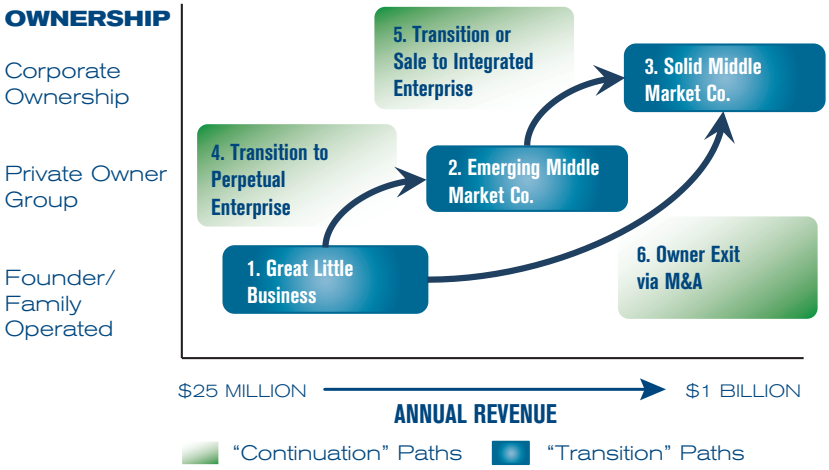
THE EXAMPLE: Here is a case study illustrating this Fair Team design. There are three owners of a telecommunications product and services business recently valued in the range of $400M. Given the volatility of the industry, however, their equity value has spiked as high as $1B and fallen as low as $150M. Its leaders believe the company may follow one of three growth trajectories: grow perpetually over the long-term, merge with a competitor or pursue an outright sale for family liquidity.

The company's existing stock option plan did not fit the business, since company volatility created dramatic distortion in annual value. As a result, there was a low correlation between the executives reaping value from the stock options and those who were driving the greatest value. The company instead moved to a non-409A and non-top-hat cascading value band unit plan based on a target maturity date.

This design permits the company to have an unlimited number of employees in the plan, while the sizes of the grants are periodically reallocated based on the company's performance evaluation system. For this client we used a "career unit" model in which the number of units granted is tied to the annual performance reviews.

The company effectively uses the plan as an enticing recruiting tool. During the past few years, over 50% of the growth of the business has emerged from a unit that did not even exist five years ago. This plan fits the client's needs and reallocates value to the high performers, creating a healthy culture of competition and performance consistent with the company's strategic growth and future opportunities.

FIG. 6: SIX SUCCESSION PATHWAYS



These are hypothetical numbers. Individual companies' revenue growth may vary.

CONSIDERATIONS PRIOR TO IMPLEMENTING DYNAMIC SYNTHETIC EQUITY

These FAIR Principles shape the tailoring of modern synthetic equity-based value sharing plans. Still, there are a vast array of considerations for synthetic equity planning – much more than can be covered herein. This section only touches on a very few selected implementation considerations.

- Like any other strategic process, these plans take time to evaluate, test, socialize and design. Owners may want to consider a "strawman" design phase to fully incorporate the combinations of desired plan features prior to starting detailed plan design and implementation phases. Once put into place, these plans deserve an annual review (just like the underlying company strategy is periodically reviewed).

- While dynamic synthetic equity fits many situations, it does not fit all situations. Consider true equity plans, bonus plans and qualified plan alternatives as well. If a private company is a reasonable candidate to go public via an IPO, traditional equity plans may deserve special attention.

- Ongoing participant education relating to plan mechanics, economics and payout is critical for any plan. Educate participants often and coordinate closely with payroll and benefits. Since many of these plans are subject to provisions of 409A, implementation at payout is especially important. Expect that any plan put in place (including simple traditional equity plans) will require continued participant education.

- The end to end costs to put a dynamic synthetic plan into place vary widely depending on the experience of the advisors, the hierarchy of decision makers, integration with other plans, breadth of financial modeling, consideration of personal planning and business succession planning. We have seen the full team cost range from under $10,000 to dramatically more – over a planning period of several weeks to several months.

DESIGN NOTE:
A Unit Plan is essentially a value sharing "pool" set up in advance where a participant's value is based on her units in the overall pool. This differs from the traditional direct grant where the denominator is typically the fully diluted shares of the company including synthetic. Direct grants can be very difficult to reallocate.

MAKING DYNAMIC SYNTHETIC EQUITY THE COMPETITIVE ADVANTAGE:

DESIGN NOTE:
Consider responding to the questionnaire on the next page to gage the extent to which your equity-based plans fully support essential growth and succession strategies.

Too many private companies are wasting millions on traditional equity incentive programs like restricted stock, stock options and phantom stock that are too often ineffective, static and unfair. Dynamic synthetic equity often does a much better job at laying the foundation for high performance growth and high performance succession.

The first step to designing better equity based plans starts with the use of the Four FAIR Principles of Fair Value, Fair Share, Fair Deal and Fair Team. As these principles are applied, companies will see the value in:

- Reducing plan distortion common to fair market value plans;
- Promoting graduated awards consistent with owners objectives;
- Encouraging owner-like behavior from key executives; and
- Reallocating rewards to top performers over time.

Private company owners and boards should start applying private company equity-based solutions such as dynamic synthetic equity to achieve meaningful private company competitive advantage. Equity-based programs are just too big and important to simply mimic the plans of others.

ABOUT THE AUTHOR
Mark C. Bronfman is a private wealth advisor with Sagemark Consulting in Vienna, Virginia. Mark founded the BOLD Value service line, which is dedicated to the issues of executive compensation, corporate benefits, capital structure, business succession and personal/legacy planning for middle market businesses.

Prior to his affiliation with Sagemark, Mark served as an equity partner with Accenture with a specialty in Strategy and Business Architecture. He earned his MBA from the University of Virginia (Darden) and his B.S. in Accounting from Penn State. Mark is a frequent writer and speaker at industry events and is a non-practicing CPA.

Endnotes:

1 See "The Average Share of Change in Control Value for the Core Executive Team", Mark Bronfman, at Boldvalue.com.
2 "Middle market" is defined as companies with revenues of $25M to $1B consistent with The National Center for Middle-Market at the Ohio State University.
3 Based on "Private Company Incentive Pay Practices Survey" by WorldatWork and Vivient Consulting, Jan., 2012.
4 All examples presented in this paper are hypothetical, yet broadly based on similar cases on which our team has worked or been consulted.

Do You Have a Robust Value Sharing Design?

Most companies spend around 11% of total company value on equity-based value sharing plans – yet surprisingly few understand if these plans are truly supportive of long-term strategic goals.

Consider the following statements to gauge the extent to which your plans and practices support your strategic intent and likely succession pathways of the owners.

	YES	NO	
1.	❑	❑	We seek a high performance culture - and the leading and lagging performance metrics are embedded in our equity-based incentive plans.
2.	❑	❑	Our company has stress-tested our long-term compensation plan to ensure that the plan embraces strategic change across people, capital, ownership and leadership.
3.	❑	❑	The sizing and structure of our equity-based value sharing plan reflects our true strategic objectives and aims to give us a competitive advantage in the "war for talent".
4.	❑	❑	Our plan adjusts to reward top performers and minimizes the "first-in" bias.
5.	❑	❑	The equity-based plan encourages and rewards new leaders and owners so that they enter and exit the company with minimal friction.
6.	❑	❑	The key executives understand the plan and view it as FAIR – especially in respect to changes in capital structure, unique value sharing needs of the majority owner, plausible changes in governance and company strategy.
7.	❑	❑	Our reward practices strike the right balance between simplicity and agility – especially in respect to succession.

Please consult your advisors if you are concerned that your value sharing practices do not align with the company's growth strategies or the owners' succession pathways.

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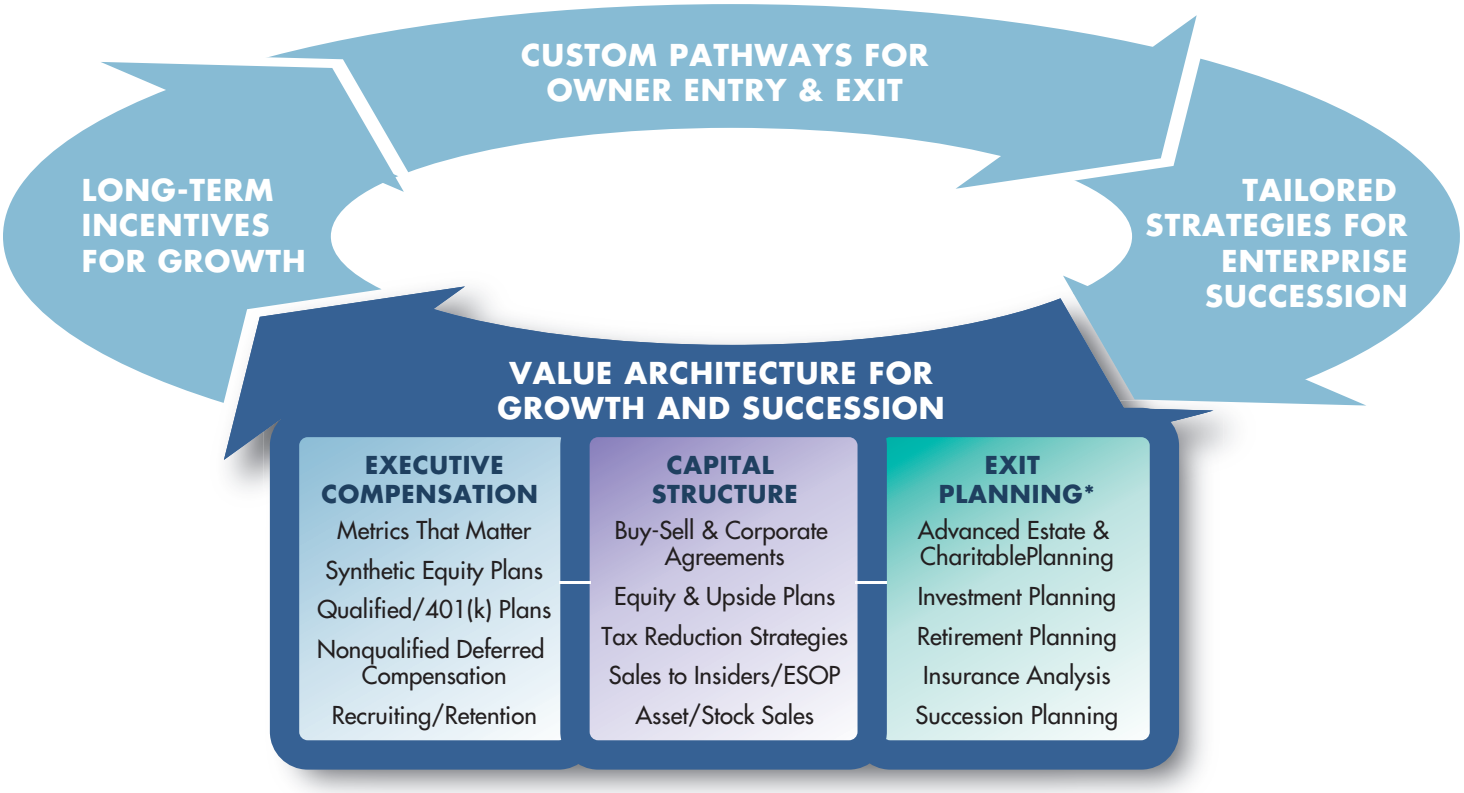

Our team of recognized financial planners and professionals has helped over 100 local businesses with Succession Pathways planning. We are strategic in helping clients achieve long term objectives via Leadership, Capital and Business Succession. We are equally tactical and practical in helping clients overcome the everyday scarcities of cash, talent, and confidence that can jeopardize a company's succession pathways journey. Our process is best tailored for companies having from $25 million to $1 billion in sales. Let our process work for you.

MARK C. BRONFMAN, MBA, CPA**

Sagemark Consulting
8219 Leesburg Pike,
Suite 200
Vienna, VA 22182

OFFICE: 703-749-5064
MOBILE: 301-526-3483
EMAIL: Mark.Bronfman@LFG.com
WEB: www.BOLDValue.com

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