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How to Use Phantom Stock to Assist With Ownership Transition and Retention

By Sal DiFonzo

Exploring phantom stock issuance as a viable ownership transfer strategy.

The Engineering and Construction (E&C) industry is comprised predominantly of privately held and family-run companies. Because of this, owners may not have an interest in selling actual shares to nonfamily members, or they may not have identified the next generation of ownership yet. And while FMI's industry research indicates that the majority of owners over age 50 plan to retire in the next 10 years, fewer than half of those owners have taken any action to prepare for the inevitable transition. Owners should allow 10 years for a comfortable transition period; but for those who wait too long, death becomes the mandatory and inevitable ownership transition plan.

In this article, we'll explore the use of "phantom stock" as an effective tool to fill the gap or provide a retention vehicle for those who will not become true equity partners. In a previous article, "Looking to the Future: How E&C Firms Can Leverage Long–Term Incentive Plans," we provided an overview of this strategy. But now we'll delve into more detail on how to use phantom stock to assist with ownership transition and retention.

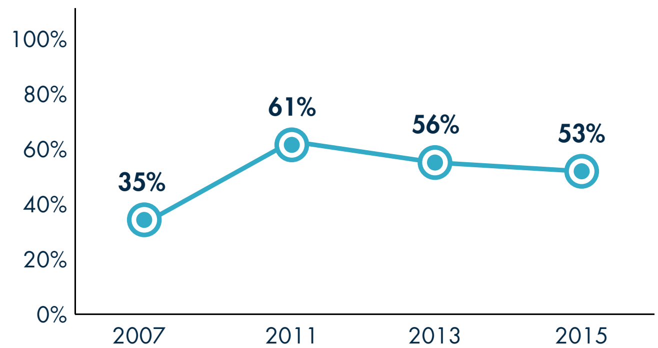
What Is Phantom Stock?

Phantom stock is not real stock in the official sense. Its price can link to an actual share price, and the company may pay discretionary dividends on the shares; but phantom shares are not voting shares. Some of FMI's Canadian clients call it "ghost stock," while compensation professionals refer to it as synthetic equity or phantom stock units. Broadly, phantom stock is a form of long-term incentive compensation plan also known as a non-qualified deferred compensation plan. Such plans may be subject to the Employee Retirement and Income Security Act of 1974 (ERISA) if they include sufficient income deferral provisions so as to constitute a "pension plan" under that statute.

Privately held companies of all industry types utilize long-term incentive plans 53% of the time (see Exhibit 1) whereas only 28% of E&C companies utilize long-term incentive plans, according to FMI's Incentive Compensation Effectiveness Study. Among all privately held companies, phantom equity plans represent 19% of long-term incentive plans (see Exhibit 1). Family-owned companies utilize phantom equity at a higher rate of 29% when they have long-term incentive plans (see Exhibit 2). FMI's compensation surveys show that E&C companies utilize phantom stock plans less than 20% of the time.

EXHIBIT 1

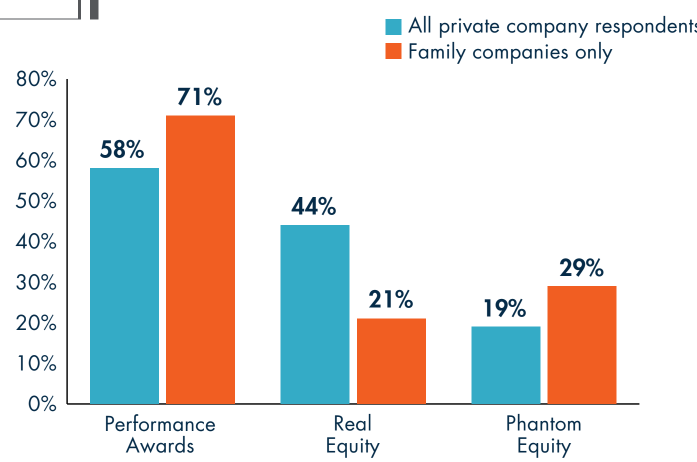
Private Companies With Long-Term Incentive Plans (LTIPS)



Source: Vivien Consulting/WorldatWork Study, February 2016

EXHIBIT 2

Prevalence of Long-Term Incentive Vehicles



Source: Vivien Consulting/WorldatWork Study, February 2016

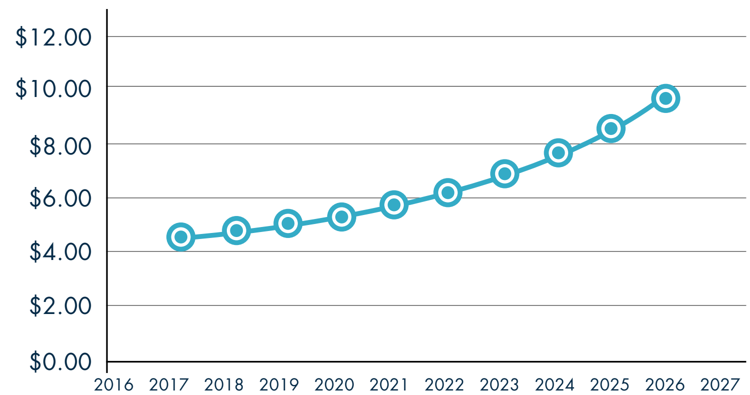
How Does Phantom Stock Work?

In its simplest form, phantom stock finds a company granting a senior manager or key employee a number of shares at a given value. The value on the day that the stock is granted could be based on one of these valuation methods:

- **Book value divided by the number of shares.** This method works best for contractors that retain earnings and grow book value for the purpose of assuming larger jobs in the future.
- **Multiple of company cash flow.** The cash flow method is typically a multiple of EBITDA plus cash on hand multiplied by an assumed market multiple (e.g., EBITDA x 4). Contractors who strip all cash out of the business at the end of the year in the form of distributions or capital expenditures use this method.
- **Outside valuation.** Ordering an outside business appraisal every year is the most expensive option, but ESOP (Employee Stock Ownership Program) companies must do this, so the overlap for valuing phantom shares is convenient.

Once the grant date value is determined, the benefit of a phantom share award is that the value will hopefully grow over time along with the company's book value or cash flow. For example, a senior manager may receive 1,000 shares valued at \$50 per share for a total award of \$50,000 in 2017. After five years, those shares may be worth \$75 each for a total appreciated award of \$75,000. See Exhibit 3 for another illustration of phantom share appreciation over time.

EXHIBIT 3 Phantom Stock Pricing Model



Vesting

Phantom shareholders "vest" or become full owners of the phantom shares at some point in the future, pursuant to the terms of a formal plan document or award agreement. A typical time frame is three to five years, but any time frame is possible. There are variations on the vesting and payout structure where shares could vest in five years but could not be liquidated or cashed out until a certain age after vesting or a specified time frame after vesting. Either the plan document or the participant could specify the liquidation period after vesting. In many cases, participants will hold phantom shares for longer time periods when the return on equity is high.

After a plan participant's phantom shares vest, the plan document often will define when the shares may be converted to cash. Internal Revenue Service (IRS) rules also allow for participants to choose when they receive funds as long as they are in compliance with Internal Revenue Code Section 409A. These regulations require a participant to make an election for cash-out either before December 31 in advance of the plan year for which an award may be granted (cash-out can occur at vest or any time after) or 12 months prior to the vesting of the shares (minimum of five-year wait period from vest).

Accounting Treatment

Phantom stock generally follows the same accounting rules as all non-qualified deferred compensation plans in that companies must take a book expense as the award accrues. For example, a \$50,000 award would result in an expense charge divided evenly over the vesting period. In year one of five, the expense would be \$10,000. Year two would be \$10,000, adjusted by the increase or decrease in the share price.

The cumulative expense is carried on the balance sheet as a liability for the entire award. The liability is "marked to market" or changes each year, depending on the value of the phantom shares. It is important to note that this is an unfunded liability, with future obligations paid out of operating income in the year that the participant receives the cashed-out award. At award payout, the company takes its tax deduction, and the liability on the balance sheet is reduced. Participants are taxed at ordinary income tax rates at time of vesting (not at award payout). Unfortunately, there is no reduced capital gains tax rate on the appreciation of phantom shares; it is all considered earned income.

Why Use Phantom Stock?

Nothing aligns the senior management team's interest with owner interests better than real stock. Building a long-term incentive plan based on performance shares, where the number of shares earned is tied to performance outcomes, is usually the preferred design approach. However, there are several situations that may prevent an owner from utilizing real stock as an ownership transition or retention tool, such as:

- The family owns all the shares, there are heirs who are already working in the business, and there is no interest in widening ownership outside of the family.
- The family owns all the shares, and the sole person working in the business owns all the shares. There are no heirs, but due to prior decisions that previous generations made, family members with no working interest in the business own the balance of shares and will not relinquish ownership. FMI recommends that only individuals with a working interest in the business be shareholders. Siblings, spouses, ex-spouses and other noninterested parties certainly enjoy collecting annual distributions, but their ownership is purely from a capital perspective. A good buy-sell agreement would state that only employee-owners receive shares and that there is a mandatory sell age (at which time the shares must be sold either to employees or back to the company treasury).
- The owner has not identified a successor. The owner needs time to assess whether existing management team members are qualified to become the next generation of owner. Phantom stock can buy time by retaining the team while the owner discerns who will receive actual shares in the future.
- Private equity owns the company. The number of shares that the private equity enterprise gives the management team may be limited, or shares may only be in the form of stock options.

Advantages and Disadvantages of Phantom Stock

Here are several reasons to use phantom stock:

- Aligns interest of management team with owners to increase the share price.
- Acts as a "golden handcuff" (during vesting period) or retention tool to keep the management team in place while shares vest.
- Can pay a distribution or dividend, and not necessarily at the same rate as real shares.
- Is a performance measure for determining award and can directly relate to strategy (e.g., increase book value, return on assets) or directly tie to owner interests (e.g., return on equity).
- Has flexible design rules around award amount, vesting period, vesting age, vesting tenure, payout period and eligibility.
- Nonvoting phantom shares do not affect the owners' decision-making authority.
- Plan designs often include a "fail-safe" or minimum level of profit requirement in order for the company to make awards.

Here are several reasons not to use phantom stock:

- Real equity is available, and owner(s) are willing to sell some of their shares or otherwise dilute their ownership.
- A deferred cash program is less complex.
- The company's current ownership does not anticipate growing the value of the business or does not think it will be profitable in future years.
- Participants may be responsible for income taxes at time of vesting.
- The stock price may decrease, thus magnifying issues within the business.

Concerning the last reason, even a decreased value phantom share still has retention value. Contrast this with stock appreciation rights (SARs), where only the increase in share value is available to the participant. Share prices below the strike price essentially make stock appreciation rights worthless, and, therefore, they would have no retention value versus phantom shares.

Conclusion: Aligning Management Interests With Ownership Interests

Phantom stock is a highly effective retention tool in that it aligns management interest with ownership interests. This tool supports the ownership transition process by giving the owner time to execute a plan to select, retain and evaluate candidates. For non-owner recipients, phantom shares send a message that the participant is still a valued contributor to the company.

Great flexibility in program design also makes phantom stock attractive. For example, the program could allow a five-year vesting period whereby the owner could issue real shares to future owners and phantom shares to management team members that they would like to retain. During this period, the owner would establish management team performance measures that align with both the business strategy and with the owner's best interests in growing the profitability, value or size of the business.

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