Financial Parity Planning

Comparing Current and Prospective Career Offers; Making the Leaving Worthwhile

Stop. Think critically and analytically before you leap. Have you considered what would have to be offered beyond a jump in salary and bonus to achieve parity with your current situation? What kind of offer would put you on par or, better yet, ahead of your current wealth trajectory? That is the essence of financial parity.

At its best, your career is pulsing with intellectual and social engagement, physical commitment and financial satisfaction, providing you with a stimulating environment that is constantly changing and leveraging your professional skills and gifts. From working on groundbreaking initiatives, to being surrounded by bright colleagues who are among the best in their fields, the corporate environment keeps the journey challenging and the rewards relatively lucrative. When one or more of these cylinders is no longer firing, you may be more or less receptive to the inevitable calls from recruiters and search firms. That is when the age-old question surfaces, prompted by a recruiter's inquiry or from a nagging desire for the unmet challenge: do I stay, or do I go?

You also may be seeking more: more nights at home with the family, greater financial rewards or more opportunity to run your own division or business line. Whatever the reason, including a desire to spend your life differently, almost everyone considers a career change at one time or another. You are looking to a return on life.

Leaving a company role that has been a consuming passion for many years may be spurred by the push or the pull, it may seem wrenching or long overdue, difficult or simple – or some combination of all. Surveys cite a range of reasons executives leave. Discontent mounts when an executive does not like what she is working on or who he is working for. The growth opportunities are capped, or the resources are not available to get the job done.

Your questions are valid; your reasons are your own.

Before you make a decision, it is important to secure a complete review of your individual compensation to assess financial parity. As much as 80% or 100% of an executive's compensation is in long-term rewards. Too often, executives do not view long-term compensation as "real money", because it may be on paper, unvested, subject to variables beyond their control. A lot of money can be lost by walking away from unvested grants and options. The prospect of leaving behind a wealth of short- and long-term compensation when you move on can be concerning, limiting and possibly incalculable without sophisticated modeling tools. How can you ensure that you and your family will come out ahead financially in a career change?

This white paper is to guide awareness of the financial parity concept in considering financial offers in a career change. Here we explore how financial parity planning is performed, what types of compensation may be more negotiable than others, and how to include financial parity in decision making. Finally, you will gain an understanding of how different stakeholders view compensation types.

SFG Wealth Planning
Executive Equity Guidance for Life

Georgetown Crossing Offices
3655 Route 202, Suite 140
Doylestown PA, 18902
215.345.5601
888.864.8588
www.sfgadvisors.com

Alignment with Executive's Own Financial Interests

As you know, most public companies invest a considerable sum in advisors who attend to the needs of management, their boards and compensation committees. These advisors help to ensure their compensation programs are aligned with company peers and are designed to attract, retain and motivate its employees. The right balance between short- and long-term incentives grounds management decision-making. "The primary focus of the company's compensation policies is not to build wealth for individual executives, but to create rewards that inspire company performance and incentives that help build shareholder value," said Chuck Steege, CFP® founder of SFG Wealth Planning and a Certified Equity Professional (CEP), a mark of the equity compensation industry. "Who is looking out for the personal interests of the executive?"

Few financial advisors conduct the analytical work behind an executive's compensation. It requires a considerable focus on studying company stock plan documents, managing the triggers for vesting, exercise and expiration, to understand the timing and considerations involved. Many financial advisors are interested in liquidity events, lacking the background or interest in executive compensation plans to advise on the big picture of financial parity of offers.

Executive service providers of financial planning and accounting are working for the corporation, not for the individual executive, Chuck explains. In serving a wide range of wealth levels and executive ranks in the company, they often merely take a modeled approach, following templated methods and simplified formulas that allow them to leverage their time and provide consistency in their service and delivery.

Only independent fiduciaries, hired and compensated individually by the executive, are able to mitigate conflict risk advising an executive on pay parity. Very few independent financial advisors have the expertise and inclination to dig deep into the executive's compensation plan documents to understand the pay structure, the terms, performance metrics and timing. The devil is in the details when it comes to quantifying future value of long-term rewards.

Financial Parity Planning

Financial Parity Planning is the evaluation of total compensation – current and prospective – to compare the financial rewards of each in pursuit of long-term wealth creation. Financial parity planning is an intricate process completed by advisors skilled in employer stock plans, financial planning and tax consequences who compare the complexities of current grants with potential financial offers for the senior executive to meet or exceed financial goals. Comparing total rewards can be tough when there are structural characteristics of various forms of long-term incentives, including different tax treatments, timing, market fluctuations and other uncertainties baked into an apples-to-apples comparison of financial offers. These variables define the art and the science of financial parity planning.

Financial Parity Example:

To illustrate financial parity planning at work, meet Artie, a rising star and 39-year-old marketing executive.

***Current:** Artie is currently head of product development for a big pharma company, who is considering a move to a newly listed biotech company. His current compensation is 70% in salary and bonus; 30% on long-term incentives. The stock has returned 12% annually for each of the last five years. Analysis of 3- and 5-year long-term incentives with current vs. new organization.*

***New:** Company is newly listed and offers no stock history. Stock trajectory unknown. Salary bonus offer is 10% higher than current compensation.*

What could those shares be worth? Only a side-by-side comparison based on likely assumptions as to stock performance prospects, volatility, and other variables, can help us to reveal or quantify true financial parity before making a financial decision or sealing a financial offer with the new company.

Executive Compensation and Equity Rewards

There are three forms of equity compensation to consider: time-based restricted stock, stock options and performance shares. Each has its role in quantifying the current and new company conversation. In our podcast, **Equity Granted: An Executive Chat**, BDO's Compensation Practice Leader Terry Adamson explains that financial parity assumes three potential value points, creating a low, middle and high value paradigm for each form of compensation.

Restricted Stock is the most straightforward, because unvested restricted stock is like any other type of shares. The value of the low, fair and maximum valuation is all the same.

Stock options – Unvested stock options may be thought of as the low value, which is the value of the stock price, less the strike price times the number of shares outstanding. That is the fair value. What is easily missed there is the time value. You may have five or more years left; the future value of the unvested shares can be estimated using a Black-Scholes model to determine the maximum value.

Performance Shares – there is a risk associated with performance shares. What if you would not achieve the target underlying the reward? In this case, the low value could be zero. On the other hand, performance shares offer significant upside if targets are met, resulting in the maximum value. The outcome can be modeled based on an average of potential outcomes.

How Does a Rising Star Break Out Financially?

A rising star who is outperforming her peers finds she is stuck in a narrow pay band for a long time. One female executive was an influential high performer who, based on our assessment of tenure, level and responsibilities, was surprisingly underpaid. After a recent promotion, she was advised to focus less on the paltry salary bump and more on the augmented long-term incentive package. Finally, the result is taking hold.

One way to leap ahead is through performance shares. Once you are participating in retention plans, such as options and restricted stock, the way to accelerate wealth accumulation is with performance awards. Performance awards may be available only within a preset band of vice presidents; it is often the case that to break out financially, you may need to make a career move.

SFG sees the compensation structure of many public companies, and has developed the ability to informally benchmark when executives ask the question, "how does my compensation stack up?"

Beyond culture mix, title change and greater appeal of a work-life balance, a typical executive being pursued by other organizations is being lured by the opportunity to have a greater impact, or to encounter less bureaucracy or be involved in the launch of a new product or service. These levers are what often encourage an executive to entertain the conversation about moving.

Performance shares

Performance shares are granted as compensation for meeting specific targets outlined in advance. Target metrics may include revenue or sales, net margins, return on cash flow, EBITDA or return on investment. The shares either are not granted or vest unless the metric is achieved.

Compensation Favors the Stakeholder

Understanding compensation from the varied perspectives of company, board and shareholders is an important first step to negotiation, when it comes to financial parity. Certain forms of long-term compensation can have more room for negotiation than others, either at your current company or at a new employer. Armed with this knowledge, you may know how best to propose a more favorable long-term compensation structure in your pay package.

Let us take a closer look at how each of three stakeholder groups view equity compensation types. Three major stakeholders include you, the executive; the company; and its institutional shareholders. Without question, stakeholders have divergent interests in short- and long-term incentives:

a. Executive/Employee – The executive's salary or base pay aligns best with the executive's interest. There are no strings attached to current year income; it is tangible and immediate. The bonus is a type of short-term incentive, a profit sharing between the employee and the company that links short term results to compensation.

b. The Company – Tying rewards to performance is in the company's interest. Compensation forms that tie to performance metrics -- Revenue/EPS/ROI and other company performance metrics -- are in the company's interest. There are other metrics that LTI may be tied to as well. You might have stock bonuses, performance shares and performance stock units based on financial or nonfinancial metrics, e.g., operational performance targets, customer satisfaction, etc. These pay-for-performance forms maintain skin in the game for executives and company alike.

c. Institutional investors – Institutional investors favor long-term incentive compensation that pays for performance alignment. Performance shares and performance stock units are pay-for-performance vehicles that respond to greater-than-ever pressures by investors about performance alignment. Companies often maintain metrics around granting/vesting of PSUs with part or all the vesting based on targets such as shareholder return. In that way, PSUs are directly tied to the interest of institutional investors. Total shareholder return is largely measured by stock appreciation.
The performance targets may be expressed in absolute or relative performance basis:

Absolute performance – a measurement based on company performance alone, regardless of peer group, e.g., the stock must appreciate 6% per year over three years to vest after three years.

Relative performance – a measurement of average annual return or relative to peers. For example, the performance target may be a percentage return relative to its peer group, e.g., shareholder return must equal 100% or 120% of peer group performance.

Trends in Performance Metrics

Adamson notes that plan design is headed toward rewarding performance based on multiple dimensions aimed at company performance. He points to several dimensions of performance metrics. The trend in plan design is for a company to have a broad portfolio of performance metrics in each of these dimensions:

1. *Top line metrics – increased revenue or sales, which a sales executive can impact directly.*
2. *Two-dimensional performance measures, both top line and bottom line (cash flow, net margin, EPS, EBITDA). An executive running a line of business can have direct impact on these metrics.*
3. *In addition to top line and two-dimensional performance, a three-dimensional measure could include funding (investments of the company, return on invested capital or ROI). These more advanced metrics tend to be utilized with named executive officers and Section 16 officers, who directly impact these areas.*
4. *Four-dimensional measure would take in the future (target based on shareholder value)*
5. *Strategic goal (target based on drug approval, D&I target or other strategic goal)*

This list of dimensions of executive pay illuminates the moving target of performance pay structures. "A company that is operating under two-dimensional measure in their short-term incentive plan, is paying out on operating income. Then you probably want to move on your long-term incentives in the direction of 3D or 4D measurement that considers investments or stock price," Adamson says.

Impacts for the Executive

As you can see, the particulars of compensation plan design descend into complexity quickly. It is instructive to understand the trend toward pay-for-performance when delving into financial parity planning. The reason this matters to an up-and-comer is that massive returns can be derived from equity rewards.

Restricted stock may be an attractive way to enhance pay if the executive is moving to a new organization with exciting prospects for growth. Stock options may be favored by those with low tolerance for risk and the ability to wait them out over long vesting periods. Performance awards can offer significant upside and a bet on your own ability to impact company performance. However, they can lead to disappointment and financial setback if the targets are not reached.

Negotiating with a New Employer

When negotiating with a potential employer, it is essential to look beyond a sizable boost in salary and bonus as the desired result. The employer may be constrained by salary bands that offer very little room to increase a salary and bonus offer. Instead, look at the compensation on a total rewards basis: salary, bonus and long-term incentives.

Top talent being pursued by a new organization can be enticed by inducement or sign-on grants. There is more latitude for inducement grants that are carved out of the existing company share plans. The prospective new employer will be careful to avoid a grant that conflicts with grant size formulas already in place with incumbent executives. Inducement grants may be awarded in restricted stock awards and stock options – they are the simplest to negotiate upfront. They will likely be unvested, with a long vesting schedule. If you consider your stock awards as long-term incentives, the wealth-building prospects may help you to overcome the lack of immediate liquidity. You may earn more awards later as the stock appreciates.

The value of stock options has one variable that can make or break the executive's reward. The date the grant is issued can present a bit of a wild card. The strike price is established on the day of the grant. Two incoming executives arriving three months apart can experience different strike prices based on where the stock is trading that day. It is our best counsel not to time the market but to rely on time in the market to build wealth in company stock options. With that said, stock options can be awarded as inducement grants.

Performance awards are less commonly awarded as inducement grants. Companies will not want to discriminate in favor of their new vs. current executives in awarding performance shares in a recruiting situation.

Conclusion

Who will you call when you are entertaining the financial impact of a career change? Many times, the large financial institutions employed by your company to handle executive services are constrained in tailoring any personalized advice for you.

As large providers, they often follow certain procedures in advice-giving, rather than shouldering the risk of having the executive making a bad move based on their direction. “In our experience, these large companies offer support for liquidity events rather than personalized financial parity planning,” Steege says. It is hard to predict whether they would want to put their corporate relationship at risk by advising an executive to leave the company or move to a competitor.

Corporations hire CPA firms for tax equalization. An expat may ask simply, “which offer is in my best interest?” The company’s accounting firm may experience conflict if they advise against the interests of their corporate client. Who is advocating for the individual executive?

We invite you to learn more about financial parity planning by joining our podcast on this topic with Chuck Steege and Terry Adamson.

You can find Equity Granted: An Executive Chat, wherever you access your podcasts or on our website at www.sfgadvisors.com

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