# The Details Behind Our $105,000 Investment

One of the perks of joining the executive team at the company I work for is either being granted options or the opportunity to get equity (i.e stock) in the company. Not everyone gets a choice, but I am fortunate to be in a position where I get to choose. There are pros and cons to each, which I plan to walk through in this post. My hope is that by the end of this post I will have made a decision. As you can imagine there is a risk/reward trade off between the two options.

For those not familiar with options, an option is a derivative of stock, meaning the option derives it's value from the underlying asset (i.e the companies stock price). Options have a strike price, and as an option holder you make money when the price of the companies stock is greater than the strike price. For example, if the strike price of your options were $50 and the company's stock price was worth $75, then you would have a $25 profit for one option (or a 50% gain).

Unlike options that trade on public exchanges, with each option representing 100 shares of stock, these types of stock option grants represent one for one. This means if you have 1,000 options, then you essentially have control of 1,000 shares.

Equity on the other hand is no different than equity in the public markets (except it is illiquid until a liquidity event happens). Equity is just fancy way to refer to company stock.

## The Lay of The Land – Options or Equity?

I am currently being presented with the choice of either 6,000 options or 6,000 shares of stock. From a gross return perspective (before taxes and risk considerations) they have the same potential. Unlike other companies, the one I work for grants options with a strike price equal to the current stock price. Many other companies will grant options with a strike price that is higher than the current stock price.

This is a great feature of the option grants at my company. You get to participate in any future gains from day 1!

The expected holding period before a liquidity event is 4-5 years. We are partnered with a new private equity group, and the normal investment horizon for private equity is 3-5 years. The last private equity group that partnered with us, was in for 10 years, but that was only because they invested in 2006 right before the great financial crisis. They had to extend their duration in order to achieve the returns they were after. It may have taken a little longer, but they still ended up with compounded returns of 15% over 10 years (before considering leverage).

All of that to say that this will be illiquid until our next liquidity event.

**Choosing the Options**

If I choose to take the options, there is no financial risk, because unlike taking the equity option there is no financial investment required by me. And like I mentioned above, the gross earning potential is the same. Meaning if the stock is up $200/share in 5 years, the gross gain on 6,000 shares would be $1,200,000 (regardless of my choice). This is pretty much a free lunch, where I get something for nothing. Well it's not really nothing, I am basically committed for at least another 5 years, and the options vest over 5 years (20% a year).

Then again, 5 years is something I had already committed too internally, before I knew this.

**Pros**

1. No out of pocket investment, therefore no financial risk.
2. Same gross return profile as equity.
3. Gives me a stake in the outcome.
4. Strike price is set at parity to company stock price based on date issued.

**Cons**

1. Gains on options are taxed are ordinary income tax rates.

The only con I can think of is the fact that the taxes are significantly higher going the options route. Especially when you consider the fact that I live in California. Let's assume that these shares in 5 years are worth $200 more than the strike price and that we are looking at a gain of $1,200,000 as described above. We would be looking at a tax rate of about 55.25% (see this post and the comments). Oh, and by the way this gain would be on top of our earned income, so it will for sure be taxed at our marginal tax rate.

If you decide not to click over to the post linked above, let me quickly breakdown the marginal tax rate:

- Federal Top Tax Bracket = 39.6% (on income >$457,601 if **married filing jointly**)
- CA State Top Tax Bracket = 12.3% (on income >$508,501)
- CA State Millionaire Tax = 1% (a surcharge on taxable income exceeding $1M – which this gain will trigger)
- Medicare Tax = 2.35% (It’s 1.45% for the first $200K in income, then jumps to 2.35% over $200K)

**EQUALS 55.25%**

*Note: it should be noted that I am estimating that our income will be in excess of $600K by 2021, which would be when we would be looking to cash out through a liquidity event. Therefore our marginal tax rate would be as stated above (assuming tax rates don’t change between now and then). I should also point out that I think that a $200 rise in stock price over the next 5 years is a high probability event, so these are my actual expectations.*

Based on a tax rate of 55.25%, our **net proceeds** from cashing in the options would be **$537,000 or 44.75%** ($1.2M x 44.75%).

That means **we would be giving up $663,000 to the state and federal government in the form of taxes**. The sad part is the government will get to keep more of the gain then we will. That is a lot of money to give up.

Let’s take a look at the Equity route.

**Choosing Equity**

There are a few additional factors that need to be considered when going the equity route. If I choose to take the 6,000 shares in the form of equity, I am required to come up with at least 35% of the value. Based on a $50 share price, the 6,000 shares are worth $300,000, which means I will need to bring $105,000 to the table. That is a lot of money and it would represent our single largest investment to date. And as I have previously discussed, I already have a lot of concentration risk with respect to where our income is generated.

**Pros**

1. Gains on equity will be taxed at capital gains rates, so we would keep more of the gains.
2. Gives me a stake in the outcome.
3. The company will provide up to a 65% non-recourse loan for the remaining purchase of the shares. The interest rate is 1% and it doesn't require any payments, the accumulated interest will be deducted from the proceeds in a liquidity event.

**Cons**

1. I have to put up risk capital of $105,000. The company has just completed a leveraged recapitalization, which means there is a debt to service.

Option #2 requires a significant amount of skin in the game. I wouldn't have to contribute this until Q1 of 2017, which by that time I estimate we will have about $165,000 in the bank, so that won't be a problem. It will be tied up for a minimum of 5 years and maybe longer depending on how the economy is by then. It also would put yet another delay in our plan to acquire property #3 in our real estate portfolio.

On the flipside it comes with a much lower tax bill. The gains would be taxed at long term capital gains rates. Sticking with the scenario in which the gain is $1,200,00, the tax rate would be 33.3%, let met break this down below:

- Federal Capital gains Rate 20% (based on income)
- CA State Tax Rate 12.30%
- CA State Millionaire Tax = 1% (a surcharge on taxable income exceeding $1M – which this gain will trigger)

**EQUALS 33.3%**

Based on a tax rate of 33.3%, our net proceeds from cashing in the stock would be **$800,400 or 66.7%** ($1.2M x 66.7%). This is an additional $263,400 in our pocket. Well, that is before paying the 1% interest rate on the $195,000 loan from the company. Over 5 years the accumulated interest will be approximately $10,000. So, it is still an additional $253,400 in our pocket.

The government would only get $399,600 in this scenario. Still a lot of money, but much easier to stomach (especially since in this scenario we get to keep more than the government gets in taxes).

## The Decision to Be Made

The decision we have to decide is if the potential for an additional $253,400 is worth putting up $105,000 in risk capital. The compounded return, should this scenario play out, would be about 28% per year. In a dooms day scenario the company could go bankrupt due to unforeseen risks on the horizon. It was leveraged up similarly going into the great recession, but it weathered that storm and emerged stronger than ever. But as we all know, history is not and indication of future performance.

The company has a long record (like 20 years) of robust double digit growth. In order to achieve the stock price target (appreciation of $200/share) used in this post, we will need to continue that growth profile over the next 5 years. I honestly don’t think the company is at risk of going bankrupt. To me the biggest risk is another event like the Great Recession happens and the money is tied up for longer than 5 years.

I also feel really confident about the management team and the prospects going forward.

The hardest thing I am having trouble coming to grips with is the concentration of risk…putting too many eggs in one basket. I was hoping that by the end of this post I would have come to a final decision. However, this is not the case, my wife and I are going to have to discuss this further before we make our decision. Luckily we have some time.

**Update 11-6-16:** I originally wrote this back in September of 2016 when I first was presented with this decision. My wife and talked it over and after thoughtful consideration we decided that going the equity route was the right decision for us. Although it is a lot of concentration risk, I feel very confident about this decision. I really think the risk is assymetrical, meaning that the reward is much greater than the potential risk (10:1 risk/reward or better). It reminds me of a quote from Warren Buffett:

> ***Keep all your eggs in one basket, but watch that basket closely.***

That said, we will be cutting a check for $105,000 in January of 2017. We have already been granted the stock, but were given until January 31, 2017 to come up with the funds.

*What would you do if you were in my shoes? Is there anything else I should be thinking about? Anyone else ever have to make this kind of decision?*

-Gen Y Finance Guy

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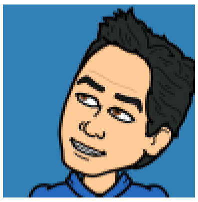

### Gen Y Finance Guy

**Hey, I'm Dom** - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More