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Phantom Stock Valuation

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Phantom stock plans have become very popular among private companies as a way to engage senior management, generally those who don't have any actual equity ownership, in the value proposition of the business. Designing phantom stock plans can be tricky. One of the key considerations is the valuation of the business. This article will review and discuss the valuation issues common in designing a successful phantom stock plan.

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Phantom Units

The amount of compensation delivered to a phantom stock plan participant is based on the number of units he or she holds and the "phantom unit value" or "unit value." In most plan designs, a maximum number of phantom units will be established in the plan. The units will represent a percentage of the total value of the company. For example, the plan may create 100 units of which 10 (10 percent) may be granted to phantom participants and 90 (90 percent) represent the interests of the real shares. Thus, each phantom unit is equivalent to one percent of the value of the company. Unitizing the plan in this manner makes the math simpler.

Phantom Unit Valuation

There are three basic approaches to establishing the value of phantom units, which are also common methods to value actual shares, for example, subject to buy/sell agreements:

1. Appraised value
2. Book value
3. Earnings formula

Appraised Value

This approach requires the company to retain the services of an independent appraiser or firm. The appraiser provides an opinion as to the valuation of the business, which is then used to determine the value of the phantom units. Appraisers will often use a number of methods to determine value and may include both intrinsic and extrinsic factors in the determination of value.

This is a plus, as the value rendered should most certainly reflect a fair value; however, extrinsic factors are often not under the control of the executives in the plan and may reward or penalize the executives in the value of the phantom stock compensation. Examples of extrinsic factors that may impact the valuation include interest rates, competitor consolidations, and shortages of natural resources. Appraisals can be expensive and using an outside appraisal may delay closing the books at the end of the year, since the current updated values are needed to adjust the company's phantom stock liability each year.

Book Value

Book value relies on stockholders' equity set forth in the company's financial statements to represent the value of the company. Generally accepted accounting principles (GAAP) are the standard for determining value. Book value may or may not be representative of a true fair value for the company, but it is easy to measure and does a good job of sharing profitability with the phantom shareholders. Book value does not necessarily reward for growth in value, however. For example, a steadily performing company with no growth in earnings may show nice growth in book value with little or no growth in actual shareholder value.

The calculation of book value generally requires the use of a "circular" equation to solve for the book value of the units, which is treated as a liability (expense) under GAAP.

Earnings Value

Earnings value formulas generally use earnings before interest, income taxes, depreciation and amortization (“EBITDA”) as a proxy for the operating cash flows of the business multiplied by a factor to determine enterprise value. The factor, referred to as a “multiple”, will typically range from four to ten times EBITDA depending on the industry, the interest rate environment, the expected growth rate for the business, and other factors. Enterprise value is then reduced by bank debt and increased by cash balances to determine equity value. In private company situations, equity value may be further reduced to reflect discounts for lack of marketability and/or control.

EBITDA formulas are common valuation formulas used to determine values for buying and selling company stock and can be effective in a phantom stock plan if a few design techniques are used:

- Calculate EBITDA before the phantom stock plan expense. The objective is to determine the total enterprise value, which is then shared or allocated between the phantom shares and the real shares.
- Average the EBITDA over a number of years, generally three, to reduce the volatility of the values produced. The averaging may be weighted on most recent earnings or a simple average may be used.
- Reserve the right for the Board to make adjustments for extraordinary gains or losses in determining EBITDA. There is no perfect formula to identify all unusual items and how they should be treated. The Board needs the flexibility to make adjustments in unusual situations.
- Lock in or fix the multiple to be used to calculate enterprise value. It generally makes sense to use a conservative multiple that does not change over time. This ensures the appreciation in value is resulting from earnings growth, not changes in the environment over which the executives have no control.
- Keep the balance sheet adjustments for debt and cash straightforward. In some cases, it makes sense to limit the addition of cash balances to situations where the company has adequate working capital. Alternatively, an excess working capital adjustment may be used.
- Provide for a substitution of actual value (rather than formula value) if the company is sold. This provides the upside opportunity to the management team, which is enjoyed by the shareholders in a liquidation event. Only in an event like this does the actual value of the company become known.
- Carefully consider how to address delivering value to the phantom shareholders when actual dividends are paid to the equity shareholders. When dividends are paid, the company has less cash to pay down debt or reinvest in the business, which may impact the valuation. It is important that the plan treat the phantom shareholders fairly. The most common approach is to pay the phantom shareholders “dividend equivalent” bonuses or deferred bonuses. If the shareholders desire not to share dividends with phantom shareholders, the plan can be designed to share growth in enterprise value rather than equity value. In this case, special adjustments must be made to offset the value of significant capital investments made by the company since there are no debt offsets.

Once equity value for the company is determined, there are two possible approaches to calculate the actual unit value of the phantom stock units as illustrated below. For purposes of the following illustrations, assume there are 90 units, which represent 90 actual shares of stock outstanding, and 10 phantom units that are available for grant under the phantom plan.

A. **Equity Method** – Phantom share value determined before plan liability (the simplest approach).

Average EBITDA	100 (before phantom plan expense)
Multiple	6
Enterprise value	600
Less bank debit	-50
Add cash	10
Equity value	560
Total share equivalents	100
Value per unit	5.6

- This approach is simplest and treats the phantom units on par with the real shares.

- This approach is used when there is no desire to keep the value of the real shares equal to the value of the phantom shares (although they will be close).
- Since the total share equivalents (100 in this example) are used from inception, the allocation or grant of additional phantom units does not dilute the current unit holders.

B. **Liability Method** – Phantom share value determined after plan liability (requires a circular equation).

Average EBITDA	100 (before phantom plan expense)
Multiple	6
Enterprise value	600
Bank debit	-50
Plan liability	-40 based on unit value resulting from calculation
Add cash	10
Equity value	520
Total share equivalents representing real shares	90
Value per unit	5.78

- The formula above solves for value of actual equity and assumes the phantom plan is a liability of the company that reduces equity value.
- The unit value for the phantom plan is set equal to the unit value of the real shares.
- This approach is used when the company desires to keep the value of real shares and phantom shares equal (using the same formula). For example, when buy/sell agreements use the same formula used for the phantom plan.
- This approach requires a circular equation and, thus, it is more complex.

Designed properly, phantom stock plans share the value growth of the business with the phantom stock plan participants in much the same manner as the equity shareholders share the growth. Although there are important tax differences—phantom stock plans pay compensation, which are taxable as wages, while equity shareholders enjoy dividends and capital gains—the value proposition can be very much the same.