

Asset Rich/Cash Poor

Source: Jason Jones, Senior Investment Manager, Deutsche Bank Offshore, March 2001

Are entrepreneurs and the new millionaires created by the technology boom of the last ten years really an attractive client base for Trustees, or is the typical tax efficient structure in which their wealth is held a major cause for concern when potential liabilities to future beneficiaries are considered?

When asked from where they expect their future growth to emerge, most private client organisations, be they Trust Companies, Stockbrokers or Private Banks, cite the 'new-economy'. Most believe their businesses will attract a more entrepreneurial client base, where wealth has been built over a relatively short period of time, and is increasingly tied towards equity-based, rather than monetary reward.

This creates the ever-more common occurrence of what used to be known as the 'paper-millionaire', now more usually referred to as the 'Asset Rich / Cash Poor'.

The major concern facing fiduciary businesses, particularly where a company or trust structure is the legal owner of the assets, is how to unlock the wealth of these clients in order to reduce risk through diversification, provide a regular income for the client and beneficiaries, or to enable the client to participate in other market opportunities.

Each of these aims may now be achievable, with the owner of the stock retaining control of the original source of the wealth, through the concept of monetization. Put simply, this is the process of partly turning assets into cash for use in other purposes.

Most banks will typically lend a holder between 10% and 20% of the value of a single, blue-chip, equity position. However in today's increasingly volatile equity climate, the threat of margin calls, should the value of the asset fall below a certain level, is a very real concern.

Through the use of basic option strategies, this risk can be negated, to the extent that a financial institution might lend up to 90% of the asset value, safe in the knowledge that a minimum value for the shares can be guaranteed over a set period of time.

Other than a straight asset sale (which may involve breaching ESCROW covenants, lock in periods, stock exchange commitments or creating capital gains tax liabilities), the most basic form of monetization occurs when a put option is purchased to provide a minimum guaranteed sale value for an asset against which bank lending can take place. A put option simply provides the client with the right, but not the obligation, to sell a set number of shares at a pre-prescribed price, at a set date in the future.

This process is best illustrated through an example:

A client holds 100,000 shares in Company A, against which he wishes to borrow the maximum sum available, for use in diversifying risk.

Company A's shares presently trade in the market at USD\$ 5.00. A put option to sell lots of 100 shares at USD\$ 5.00 in January 2003 is available at 20 cents per share.

In order to provide sufficient coverage for the bank, the client would be required to purchase 1000 options at a cost of USD\$ 20 each. (100 shares X \$ 0.20 X 1000)

This gives a total cost to the client of USD\$ 20,000, to guarantee a value of USD\$ 500,000. (100,000 shares X USD\$ 5.00)

With this put option in place, a conservative bank would usually be willing to lend 80% of the value of the asset (USD\$ 400,000), against an estimated 10% (USD\$ 50,000) were the position un-hedged. The bank is in the position of knowing that the value of their collateral will not fall below USD\$ 500,000 at the expiry date of the option in January 2003. (Even if the share price has dipped below this level, the option can be sold at a profit equal to any theoretical loss on the shares, or can be extended and re-financed out of the interest or dividend earnings on the USD\$ 400,000)

This process provides numerous benefits:

- ❑ The client retains participation in any rise in price of his stock holding above the level of USD\$ 5.00, whilst guaranteeing a minimum value
- ❑ The client continues to benefit from all shareholder rights. (Entitlement to dividends, voting etc..)
- ❑ The cash sum raised can be deployed to provide 80% diversification of the value of the original asset. (Negating one of the trustees major liabilities)
- ❑ Cash has been raised without the need for accruing a potential capital gains liability on the original asset. (Dependent upon the client's underlying tax regime, however a liability may arise on any option profit).

A further enhancement of this strategy can be implemented where the client is willing to accept a limited upside potential in the stock over a set period of time. In addition to purchasing the put option, a simultaneous sale of a call option is undertaken, generating revenue to defray the cost of the put option purchase.

A call option confers the opposite right to a put option, i.e. the right to purchase a set number of shares, at a set cost, at a set date in the future.

Continuing the initial example, Company A also has a Call option to buy lots of 100 shares at a price of USD\$ 5.30 in January 2003, which presently trades at 20 cents per share.

Through the simultaneous purchase of the initial 1000 put options at 20 cents per share, and the sale of 1000 call options at 20 cents per share, both of which expire on the same date, the client is able to enjoy all the benefits of the original put option strategy, but at zero initial cost.

The only risk inherent in this strategy is that the maximum rise in the value of the shares held by the client is USD\$ 5.30, above which a call option must be purchased to net off the sale of the original call. (And thus avoid the call being exercised).

These are the two most basic option strategies available to secure significant levels of bank lending, however the question of how the borrowed funds are utilised is equally important.

For clients, the greatest risk of holding the bulk of their wealth in one company's shares is the risk that the price of those shares decline. There are, however, other considerations which should be taken into account, such as the lack of liquidity due to the size of the position or the company, or the inability to exploit other market opportunities.

Perhaps the most sobering thought for professional trustees however is where the asset is held in a trust structure. Not only do the Trustees, as legal owners, place themselves in the clients' position with regard to the previously identified risks, but also present themselves as potential victims of legal recourse from the Trust's latter beneficiaries, if prudent action is not taken to

protect the value of the Trust's assets. Through the use of basic monetization strategies, these risks can be reduced or eliminated, to both the Trustees' and underlying clients' benefit.

If, as Trustees, you believe that there is significant risk in any positions held within any Trust structures administered by yourselves, or would like to take the opportunity to discuss monetization strategies with Deutsche Bank Offshore in Jersey, please call Jason Jones on (01534) 889000

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