

WING TIPS

Valuation of Unquoted Shares Enterprise Management Incentive Scheme

Readers will no doubt recall the recent article entitled “Tax effective reward mechanisms for SMEs – Enterprise Management Incentive Scheme” in Wing Tips 4 last, which set out the benefits and conditions attaching to these arrangements. The taxation benefits are undoubtedly well worth having, but the object of the exercise is after all to provide an incentive to key employees by getting company shares into their hands and enabling them to realise a healthy profit at some future date. If that fails to happen, the tax advantages pale into insignificance. The key to achieving this is to ensure that they are able to exercise those all important options at the lowest possible price.

HMRC, despite having made these EMI structures available as part of the enterprise culture, bizarrely then does its best to reduce the employees’ profits by trying to maximise the option price. What is that price?

That price is “market value”, the value at which options have to be granted, which is broadly the price at which the shares could be sold in an open market. However, most unquoted company shares are subject to restrictions on transfer and pre-emption rights which prevent a true open market sale, except where the entire company is sold. In most cases, such a sale is not in prospect, and there is at best a very restricted market for the shares, so, as a leading case stated, “.a feat of imagination has to be performed” in order to arrive at open market value.

How is the lowest possible price achieved, given the HMRC mindset? The preferred valuation methodology by HMRC is similar to some of those adopted in the real world. These tax valuations tend to be earnings or dividend based, usually by reference to a Price/Earnings ratio or dividend yield, although they will not normally embrace such things as EBIT, EBITDA or similar models. The starting point will often be a similar listed company, or a basket of such companies, which will provide the P/E or yield for the industry. This is similar to the approach often adopted by Corporate Financiers or Advisers to an IPO.

However, we are dealing with an illiquid asset, there is no market in the shares, the shareholders are bound by sometimes severe restrictions or pre-emption rights, there is no apparent exit route and perhaps no likelihood of dividends as the company reinvests its profits in order to grow. These factors and other disadvantages mean that whilst a listed company may offer a suitable starting P/E ratio, we have to make many adjustments to it to reflect all these differences. We are thus likely to finish with a discounted P/E far removed from the original starting point. The more experienced and persuasive the advocate in the negotiations with the HMRC valuers, the greater the discount is likely to be, with a beneficial effect upon the share value.

Another area sometimes offering room for manoeuvre is that of information. EMI schemes can deal only with minority holdings of shares – no larger than 30%. The information requirement for such holdings is in most cases published information only. That will include published accounts, anything in the press or on the company’s website, and similar information. It will specifically not include management information, board minutes, or any other information that is confidential to the boardroom or to the directors. The reason for this is that the supposed parties to this open market sale are anonymous. The only characteristic that can be attached to the vendor is that of owning the shares in question, and that person cannot be assumed to be a director, even if the recipient of the options is actually on the board.

For the typical company likely to be considering implementing an EMI scheme – a growing one – this is often good news. The last published accounts may paint one picture, but current management accounts might show the company to be trading well ahead of that year, and were that to be factored into the valuation, very different figures might emerge. However, in such circumstances there is no requirement to disclose this information, with a consequential effect upon value. If the company was actually now doing less well currently than the published accounts showed, that might be disadvantageous, but there are ways of dealing with that position too.

Share and business valuation is a specialised subject and is an art not a science. The above merely scratches the surface of what can be done to achieve the required objectives. With good tactics, and a well presented, researched and well argued case, it is often possible to obtain excellent results in negotiations and achieve the low option values that both the company and the employees are seeking, despite resistance from HMRC.

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