1. ENTERPRISE MANAGEMENT INCENTIVES EXAMPLE VALUATIONS

This guidance is aimed at assisting smaller companies in the preparation of their own valuations for EMI purposes.

For background to the EMI options see the Employee Share Schemes User Guide Manual at ESSUM50000.

The valuation of unquoted shares can be complex and this guidance is aimed at those with the most straightforward circumstances in low tax risk situations. The following are examples of valuation methods in a number of commonly encountered circumstances. They should not necessarily be regarded as authoritative, exhaustive or definitive, merely as illustrations of what might be acceptable to SAV for the purpose of agreeing EMI valuations.

The overriding principle remains that no two companies are the same and each valuation must be considered on its merits and the relevant facts.

1.1 Start up companies

a) The valuation concerns a technology based, first year start up company, with no trading history.

The Issued Share Capital (ISC) consists of 2 million shares, 200,000 1p ‘A’ ordinary shares and 1,800,000 1p ordinary shares.

The two classes of shares rank pari passu apart from the ‘A’ shares having the right (under the Company’s Articles of Association) to appoint 2 directors to the Board and rank before the ordinary shares on a return of capital.

The ordinary shares are also subject to risk of forfeiture and pre-emption provisions.

All the 200k ‘A’ ords are owned by an external investor, who recently paid £2m for their 10% minority shareholding, equating to £10 per share.

The company is now looking to grant EMI options over a pool of 10% of as yet unissued shares to its employees.

There is currently no sale or flotation in prospect but the company has plans for such an eventuality within the next 3 to 5 years.

Valuations are needed for the Actual Market Value (AMV) and the Unrestricted Market Value (UMV) of the ordinary shares, at the date the EMI options are granted. See the Shares and Assets Valuation Manual at SVM110050.

The company has no trading record and the assets largely consist of the balance of the cash from the investment and some intangible assets.

To value the ordinary shares, it may be reasonable to look to the price paid by the investor for their 10% shareholding, as it provides a tangible starting point.

To allow for the lesser share rights of ordinary class of shares (to the ‘A’ ords) a discount of around 30% or more (from the £10 per share paid for ‘A’ shares) might be reasonable depending on the exact fact pattern – indicating an Actual Market Value (AMV) of £7 per ordinary share.

For the Unrestricted Market Value (UMV) the risk of forfeiture and pre-emption provisions are to be ignored and so a 10% premium might be reasonable, indicating a UMV of £7.70 per ordinary share.

b) An alternative start up company scenario might, unlike the above example, involve no external investment, with all the initial capital being provided by the founder shareholders.

For instance, 2 individuals may set up a company with each subscribing £50,000 of their own money and having 50,000 £1 shares issued to them in return. The ISC would then be a total 100,000 £1 ordinary shares.

The two founders may wish to recruit some key staff to build the business but, as the company could not at that stage afford commercial salaries for the new employees, they may wish to give them EMI options over a pool of 10,000 shares in total.

As in the example above, the company has no trading history and little in the way of assets. In view of this, it might be reasonable to value the minority holdings over which the new employees will hold EMI options, by reference merely to the par value of £1 per share paid by the founders. It might be reasonable to discount the par value if the founders have some preferential rights over and above those of the employees, by virtue of the terms of the Articles of Association.

Your attention is drawn to the caveats at the start of this section.

1.2 Established trading company

A company has been trading for around 10 years and wishes to incentivise its employees by granting them a pool of up to 5% of the company's enlarged share capital. The company is not currently in the process of a sale or flotation.

The company's most recent performance is:

	Full audited accounts to Nov 2010	**Full audited accounts to Nov 2011**	**Management accounts to Nov 2012**
Turnover	£6.5m	7m	7.5m
Post tax profit	£525k	£600k	£600k
Dividends paid	£1 per share	£1 ps	£1 ps
Dividend cover	2.62	3	3

The fully diluted share capital would be 200,000 £1 ordinary shares.

The management accounts for 2012 have been utilised as it is considered that the last published accounts (to Nov 2011) are now stale at the valuation and it is reasonable to take into account more up to date information.

Based on this record of profits, maintainable earnings are taken as £600k per annum, which equates to earnings per share (eps) of £3, on the basis of the fully diluted share capital.

Dividends are maintainable at £1 per share and are well covered.

A quoted company (on full London Stock Exchange) that operates in the same market as this company, shows a price earnings (p/e) ratio of 12.03. Applying a discount of around 60% to 65% to the quoted p/e – to reflect the differences between a minority holding in this company and the quoted company – indicates a final p/e ratio of 4.5*

Applying a p/e of 4.5 to eps of £3 then indicates an AMV of £13.50 per share for a minority holding in this company.

Looking at the dividends, the same quoted company had a dividend yield of 3.40%. Increasing this by a multiple of say 2 – once again to reflect the differences between the quoted company and this company – indicates a revised yield % of 7.4%.

Applying this yield to the maintainable dividend of £1 per share (equal to 100%) then indicates an AMV of £13.50 per share, ie the same as the valuation on an earnings basis.

The UMV can then be taken at around a 20% premium to the AMV, ie at £16.20 per share, to reflect the fact that the Articles of Association for the company give the Board full veto on any share transfers and this and other restrictions are to be ignored when considering the UMV.

* A suitable multiple (of profits) may also be arrived at by reference to data on the sales of companies – both private and quoted – in similar markets to the company under consideration. Careful research of the terms of such company sales should be undertaken by the valuer before such transactional multiples are utilised, to ensure that the implied multiples are, so far as possible, reliable and comparable.

If the company has a high level of debt on its balance sheet, which reduces any post tax profits substantially, the value of its shares can be arrived at by reference to an Enterprise Valuation (EV) looking at its maintainable Earnings Before Interest Depreciation and Amortisation (EBITDA). It is then possible to apply an EBITDA multiple from a comparable quoted company. Deducting the company's debt from the resulting EV will then leave the Equity Value, from which the minority share value can then be assessed, utilising appropriate discounts

Whilst EBITDA multiples for quoted companies are not available in publications such as the Financial Times, these can be calculated by the valuer, usually by adding a particular quoted company's Market Capitalisation to its long term debt, to arrive at its EV. The EBITDA for the quoted company can then be calculated by reference to its accounts and dividing the EV by the EBITDA, to give the multiple. It can then be appropriate to discount the quoted company's EBITDA multiple to reflect the differences between the quoted company and the unquoted company which is being valued.

Your attention is drawn to the caveats at the start of this section

1.3 Company with imminent AIM flotation

A previously private Computer Software company is scheduled to float on AIM in the next two weeks but wishes to grant EMI options to employees beforehand.

The price that investors are invited to subscribe for shares, which will also constitute the opening price on AIM, will be £2.50 per ordinary share.

The employees will be granted EMI options over the same ordinary class of share as will be floated on AIM but there will be individual performance targets in their option agreements that will determine when they can exercise their options.

A small discount may be appropriate, depending on the facts, to reflect any risk that the float may not go ahead in the scheduled time frame.

It may therefore be reasonable to use the price of £2.50 per share or - subject to the above factor - very close to this, as both AMV and UMV for the purpose of granting the EMI options.

No adjustment/discount is required (for a valuation for option purposes) to reflect the performance conditions restricting the employees' freedom to exercise their options, as these conditions are personal to the employee only.

Your attention is drawn to the caveats at the start of this section

1.4 Company in talks over a sale

A component production company is in talks with a competitor business for a sale of the company. The sale price, subject to due diligence, will likely be comprised of cash and a small earn-out element.

In anticipation of a sale, the company wishes to grant EMI options over 10% of the (fully diluted) share capital to its employees.

The likely sale proceeds are not known but the range equates to £20 to £22 per share – on a pro rata basis.

In the light of the impending sale, it is reasonable to value the shares over which options will be granted to the employees by reference to the possible sale proceeds per share.

Depending on the level of risk, uncertainty over the final amounts payable and also the timing, it might be reasonable to apply a discount in the range of 15% to 30% indicating a share value of around £14 to £18 per share for the EMI options. It will depend on the specific circumstances of the company as to whether a differential is required between the AMV and UMV.

Your attention is drawn to the caveats at the start of this section

Note. A sale may affect a company's qualifying status for EMI under Sch. 5 Para 9(3) ITEPA 2003. For further guidance see the Employee Share Schemes User Guide Manual at ESSUM52100.