



# Share Valuation: The Wisdom On Price-Setting For Your Employee Share Schemes

**Webinar**

Tuesday 21 July 2020





# A Word From The Chairman



**Ian Harris, BA (Hons)  
FCA FBCS FIBC CMC**

Managing Director

Z/Yen Group



# Agenda



- 11:00 – 11:05 Chairman's Introduction
- 11:05 – 11:25 Keynote address
- 11:25 – 11:30 Final thoughts
- 11:30 – 11:45 Questions & Answers



# FS Club

Platinum Sponsors



Gold Sponsors



Silver Sponsors



Bronze Sponsors



Personal Sponsors



# EsopCentre

Tier One  
Sponsors



Baker  
McKenzie.

Bird & Bird

CLIFFORD  
CHANCE

C/M/S/  
Law. Tax.

Computershare

Deloitte.

DOYLE CLAYTON  
Workplace Lawyers

Global Shares

howells

ING

KKR

Intertrust

KLEINWORT  
HAMBROS  
SOCIETE GENERALE GROUP

LEWIS SILKIN

Linklaters

LINK Market  
Services

mm&k

Ogier

OCORIAN

Pinsent Masons

pwc

SANNE

Shareworks  
by Morgan Stanley

TRIVERS  
SMITH

VG

YBS  
SHARE PLANS

ZEDRA  
DO MORE. ACHIEVE MORE.

Rm2

BT

EQ

RBC

WHITE & CASE

WillisTowersWatson

Tier Two  
Sponsors



cytec solutions

fieldfisher

Investec

LGL Group  
Experience Excellence

MACFARLANES

PETTFRANKLIN  
HELPING SHARE GROWTH

Tier Three  
Sponsors



ABBISS  
CADRES  
YOU AND YOUR PEOPLE

bms.

David  
Craddock  
Consultancy  
Services

GANNONS  
Solicitors

GORE

TTP Group

Vestrata

WRIGLEYS  
— SOLICITORS —



## Share Valuation: The Wisdom On Price-Setting For Your Employee Share Schemes



**David Craddock**

Founder and  
Director

David Craddock  
Consultancy  
Services



# DAVID CRADDOCK CONSULTANCY SERVICES

Specialist in Employee Share Ownership and Reward Management,  
Management Buyouts, Share Valuation  
and Investment Education



# Share Valuation for Employee Share Schemes

---

## Meaning of Market Value through Statute and Case Law: The Statute Law – The Underlying Principle (Slide 1)

### Statutory Open Market Value

The basis of valuation in relation to any assets is established by statute in Section 272(1) TCGA 1992 as: “the price which those assets might reasonably be expected to fetch on a sale in the open market”

Section 272(1) TCGA 1992 represents, therefore, the definition of Market Value that is applied for tax purposes.

The terms Market Value and Statutory Open Market Value are interchangeable for these definitional purposes. In application, the same representation is also found in Actual Market Value.

Always remember that Section 272(1) TCGA 1992 is the foundation for Market Value: “in relation to any assets”, where TCGA 1992 applies.

For all practical purposes, Market Value or Actual Market Value or Statutory Open Market Value is the best price that could be expected for the asset (shares or otherwise) on a sale in the open market between a hypothetical willing seller and a hypothetical willing buyer on the basis that both are equally informed about the company, its activities and the market within which it operates and that both the willing seller and the willing buyer are acting for self-interest and gain.

The Restricted Market Value is the Actual Market Value whereas the Unrestricted Market Value typically has an uplift of 15% to 20% to account for the enhancement to value through the absence of restrictions.



## Share Valuation for Employee Share Schemes

---

### Meaning of Market Value through Statute and Case Law: The Statute Law – The Underlying Principle (Slide 2)

#### What is the specific treatment for the shares of SMEs?

The treatment of unquoted shares and securities that are not listed on a recognised stock exchange is addressed in [Section 273 TCGA 1992](#).

In the first instance, for the treatment as prescribed in [Section 273 TCGA 1992](#) to apply, the requirement must arise under [Section 272\(1\) TCGA 1992](#) to determine the price which the asset might reasonably be expected to fetch on a sale in the open market.

Under [Section 273\(1\) TCGA 1992](#), in relation to the information that is available to the parties in a sale for UK tax purposes, the requirement is that:

“there is available to any prospective purchaser of the asset in question all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm’s length”.



## Share Valuation for Employee Share Schemes

---

### Meaning of Market Value through Statute and Case Law:

#### The Leading Case Law

##### Re Lynall Deceased [1968 to 1971] 115 Sol Jo 872, HL

“..... a hypothetical sale ..... between a hypothetical willing vendor (who would not necessarily be a director) and a hypothetical willing purchaser, on the hypothesis that no one is excluded from buying and that the purchaser would be registered as the holder of his shares but would then hold them subject to the Articles of Association of the company, including restriction on transfer.”

#### Commentary

The parties who are available for entering into the transaction must be assumed to be wide and, furthermore, the restrictions contained within the Articles of Association must be taken into account in the formulation of the judgement.

The application of this case to **Section 272(1) TCGA 1992** determines the tax value for purposes of the capital gains tax treatment. Typically there is a need for a market in the shares to facilitate the position, a factor which appears to be the start point for HMRC’s deliberations on this matter. However, for a tax value to prevail, as opposed to simply a contractual value, the capital gains tax treatment requires a transaction position that applies to any anonymous person with no special attributes other than:

(1) wanting to buy, (2) having the resources to buy and (3) being a prudent person.

By properly applying this criteria, the transaction cannot apply specifically to a category of person, say for example to employees only or to directors only.

# Share Valuation for Employee Share Schemes

---

## Meaning of Market Value through Statute and Case Law: The Leading Case Law

[IRC v Gray \(Executor of Lady Fox\) \[1994\] STC 360, RVR 129, CA](#)

“..... although the sale is hypothetical, there is nothing hypothetical about the open market in which it is supposed to have taken place.”

### Commentary

The determination of value must assume a transaction in the real world that accounts for the real facts of the economic parameters that prevail at the time rather than any form of hypothetical assessment of the economic situation. The real assessment of the economic situation must be distinguished from the hypothetical sale. In this context, the actual vendor must be assumed to be a prudent man of action.

[Holt v IRC \[1953\] 2 All ER 1499, \[1953\] 1 WLR 1488](#)

“I must enter into a dim view peopled by the indeterminate spirits of fictitious or unborn sales. It is necessary to assume the prophetic wisdom of a prospective purchaser ..... and firmly to reject the wisdom which might be provided by the knowledge of subsequent events.”

### Commentary

The valuation must be determined without the benefit of any aspect of hindsight or judgement in the light of subsequent events. Even more strictly, the valuation represents a photographic position at a point in time. That point in time will never be replicated, i.e. it is a point in time that existed at that point in time that is now superseded by subsequent points in time.



# Share Valuation for Employee Share Schemes

---

## Meaning of Market Value through Statute and Case Law:

### The Case Law

The summary of the key assumptions that emerge from the case law are as follows:

1. The parties to the transaction, the seller and the buyer, although they are both assumed to be hypothetical, are also assumed to be willing.
2. In essence, it must be assumed that anybody from anywhere in the world can offer themselves as a potential buyer and make a bid for the asset.
3. The application of the principles is predicated on the assumption that all the preparations for the sale have been made in advance.
4. The best price must be assumed to be the best price that the buyer would be prepared to pay rather than the price that the seller would ask.
5. The valuation must always give due recognition to market comparisons and, within that analysis, any special purchaser arrangements of significance.
6. The sale is hypothetical even though the economic situation that prevails in the open market at the time is real.
7. The valuation must be determined as at the valuation date.

## Share Valuation for Employee Share Schemes

---

### Meaning of Market Value through Statute and Case Law: Further Statute Law – The Information Standards (Slide 1)

The requirement to address the Information Standards arises from Section 273(1) TCGA 1992, in relation to the information that is available to the parties in a sale for UK tax purposes, expressed as follows:

“there is available to any prospective purchaser of the asset in question all the information which a prudent prospective purchaser of the asset might reasonably require if he were proposing to purchase it from a willing vendor by private treaty and at arm’s length”.

It is interesting to note that the position taken by the judge in the case of Re Lynall is more prescriptive than the statute.

The relevance of the Information Standards is in relation to determining the type and the amount of information that is submitted to HMRC for purposes of agreeing the valuation. Information should not be given to HMRC over and above that which is required by the Information Standards. In essence, the entitlement to the information is determined by the voting rights that are attached to the shares and by the value of the shares.



## Share Valuation for Employee Share Schemes

### Meaning of Market Value through Statute and Case Law: Further Statute Law – The Information Standards (Slide 2)

As a general rule of thumb, although there will always be exceptions, the type and the amount of the information that is submitted is determined by the following:

1. If the percentage shareholding is 25% or less, treated in effect as an uninfluential minority shareholding, then audited accounts should be submitted together with other published information. In these circumstances, it would not be expected to submit management accounts.
2. If the percentage shareholding is more than 25%, with the capacity, therefore, to block special resolutions at shareholders' meetings, then audited accounts should be submitted together with other published information and possibly any information about later performance that has been prepared at a later date, typically the latest management accounts.
3. If the percentage shareholding is 50% or more, with the capacity, therefore, to block ordinary resolutions, then audited accounts should be submitted together with other published information and possibly any information about later performance that has been prepared at a later date, typically the latest management accounts, and possibly also including confidential information that is relevant to the valuation.
4. Remember that it is always possible to reject unreasonable requests that may be made by HMRC for information. In recent years, HMRC has adopted a position to always ask if there is an exit route. The defence to this request is that under [Section 272 TCGA 1992](#) the determination of the valuation is based on a hypothetical transaction only, which, by definition, excludes any discussion over the exit position.

## Share Valuation for Employee Share Schemes

---

### Application of Recognised Bases of Valuation to the SME: Establishing the Surrogate Position

The relevance of determining the appropriate basis of valuation arises from the requirement to establish a surrogate position for purposes of giving a practical application to the principles set out in Section 272 TCGA 1992.

Whichever basis produces the highest value will prevail for purposes of the company valuation:

1. The Earnings Basis
2. The Net Assets Basis
3. The Trading Basis
4. The Dividend Basis

Subject to the circumstances, The Offer Basis will typically trump all bases, whether lower or higher than the other bases.

## Share Valuation for Employee Share Schemes

---

### Application of Recognised Bases of Valuation to the SME:

#### The Earnings Basis

The Earnings Basis will always be the first port of call for purposes of establishing a value in circumstances where the company has an earnings flow. It is important to recognise, though, that the result arising from The Earnings Basis could be modified by the result from The Offer Basis, depending upon the credibility of the offer and the extent to which due diligence has been performed and the results of the due diligence announced either in their interim form or in their final form.

The Earnings Basis is predicated upon the key assumption that the interest of the purchaser is primarily in the capacity of the company to generate profits from which dividends can be paid and from which any undistributed profits can be reinvested in the company with a view to enhancing the company's capacity to grow in order to generate future profits.

The normal method for valuing the shares of a company that is trading profitably is to apply a price-earnings multiple, derived from the quoted sector, to the average sustainable post-tax profits of the company. There are, therefore, two elements in this calculation as follows:

1. The Average Sustainable Post-Tax Profits
2. The Price-Earnings Ratio



# Share Valuation for Employee Share Schemes

---

## Application of Recognised Bases of Valuation to the SME: The Earnings Basis – The Average Sustainable Post-Tax Profits

### The Rule of Thumb Guideline

The average sustainable post-tax profits are assumed to be the level of profits below which the company's profits are not expected to fall over the course of the next twelve months from the date of the valuation.

### The Assumption of Commercial Trading

The actual trading information from which the average sustainable post-tax profits figure is derived must be tested to ensure that it emanates from commercial trading that has been conducted at arm's length.

### The Normalised Position

The average sustainable post-tax profits figure must be established as a normalised position, appropriately adjusted for any non-recurring or exceptional items, and for any adjustment that is required to reflect wages and salaries, particularly those of the directors, at levels that are consistent with commercial market levels.

### The Identification of Trends

If there is a steady increase in profits year-on-year, then typically the average sustainable post-tax profits figure is best represented in the last reported profit position. If the recent trend is more uneven then some averaging, potentially combined with some weighting, may be applied, over profits from a number of financial years.

### The Proximity of the Financial Year-End

The further into the financial year that the snapshot of value is being established the more relevant it will be to examine the management accounts for the current financial year and determine a latest profit estimate for the current financial year.

# Share Valuation for Employee Share Schemes

---

## Application of Recognised Bases of Valuation to the SME: The Earnings Basis – The Price-Earnings Multiple

### The Concept

The price-earnings multiple is the ratio of market value (as represented in the price) to profits (as represented in earnings). By multiplying the average sustainable post-tax profits figure, therefore, by the price-earnings multiple, the market value is established.

### The Benchmark

The price-earnings ratio for the unquoted private company is derived from a basket of quoted company price-earnings ratios that have been extracted from the data relating to the quotations on the recognised stock exchanges. The basket will normally consist of at least three quoted companies that are involved in the same or similar trade as the unquoted private company. The basket will be averaged and, in certain cases, weighted accordingly.

### The Discounts to Establish Whole Company Value for the SME

A discount is applied to the averaged (and potentially weighted) position of the quoted price-earnings ratios in order to account for the following: the unquoted company is (a) significantly smaller in size; (b) significantly less diversified in its trading profile; (c) has a lower asset backing; (d) has less marketability in its shares; (e) has a dependence on a small group of managers for its trading success.

### The Bid Premium

In order to value the company as a whole, it is necessary to adjust upwards for a bid premium to reflect the fact that it is the whole company that is being valued and not just small quantities of shares. The adjustment is for the reason that it is assumed that trading on the recognised stock exchanges is at minority interest prices.



## Share Valuation for Employee Share Schemes

---

### Application of Recognised Bases of Valuation to the SME: The Application of the Discounts – The Order of Events

1. Apply the company discounts to the quoted price-earnings ratios and add back the bid premium to establish the Value Multiple.
2. Establish the Whole Company Value of the SME through multiplying the Average Sustainable Post-Tax Profits by the derived Value Multiple.
3. Apply discounts to the Whole Company Value of the SME to determine the value of the percentage shareholding.
4. Issue the shares on the basis of the derived percentage shareholding.

## Share Valuation for Employee Share Schemes

### Influence of the Percentage Stake and the Minority Interest: The Control that Is Attached to the Shareholding

<u>The Percentage Shareholding</u>	<u>The Level of Control and Influence</u>
90% to 100%	Ability to affect the compulsory purchase of all remaining shares
75% to 100%	Full control over the decisions of the shareholders' meetings including any alteration to the Articles of Association and the power to wind up the company
50% exactly	Expectation of some influence over the running of the company's activities and some influence in the decisions of the shareholders' meetings through the ability to block ordinary resolutions
25% to 50%	Significant influence over the decisions of the shareholders' meetings through the ability to block special resolutions
10% to 25%	Potential influence, subject to whatever other shareholdings may be alliance
1% to 10%	No control and little influence over the company

## Share Valuation for Employee Share Schemes

### Influence of the Percentage Stake and the Minority Interest: The Level of Discounts Applied to a 100% Value

<u>The Percentage Shareholding</u>	<u>The Level of Discount</u>
75% to 100%	0% to 5%
51% to 74%	10% to 15%
50%	20% to 30%
25% to 49%	35% to 40%
Less than 25%	50% to 75%

## Share Valuation for Employee Share Schemes

---

### Impact of Funding Prices and Subscription Prices on Valuation: The Leading Case

IRC v Stenhouse's Trustees [1992] STC 103, (Court of Session in Scotland) should be considered-

In this case, there were empirically-verifiable transactions in the form of sale of the shares, involving members of the same family and companies and trusts in which the families were interested parties. Additionally, certain agreements had been obtained from HMRC over the years, specifically on value.

In this case, it was held that the evidence of the sales, and that of the agreements, was admissible before the Special Commissioners for the purposes of an appeal before the Special Commissioners on the question of share values.

**The following statement was made in this case:-**

“The evidence of market sales is only evidence of value, and cannot be regarded as, in themselves, conclusive ..... the question whether any weight, and if so how much, is to be attached to evidence of transactions seems to me to be a question of fact and opinion. Some of the transactions ..... may be of no use: but there may be others which took place between parties who were genuinely trying to strike an open market value, and I do not see why such cases should simply be ignored .....

..... I can see difficulties in dealing with evidence concerning previous agreements if the Revenue are not prepared to reveal the approach which they themselves took in arriving at the value in question, but that is a problem which requires to be dealt with as the evidence is heard.”

# Share Valuation for Employee Share Schemes

---

## Impact of Funding Prices and Subscription Prices on Valuation: The Key Principles

The key principles to recognise on funding and subscriptions are as follows:

### The Pre-eminence of the True Trading Basis

Even where the company is generating consistent losses in its trading profile and has accumulated significant losses with its balance sheet showing significant net liabilities, the actual subscription for the shares has the potential to establish The Trading Basis for the shares and set a precedent for Market Value for employee share schemes.

### The Arm's Length Principle

The subscription or funding may not be from an arm's length source or, even if it is, the subscription or funding may not be based on an arm's length transaction. The investor may be a friend or family member.

### The Recognised Share Valuation Principles

The value through the subscription or funding mechanism may be difficult to substantiate through the application of recognised share valuation principles. In these circumstances, again without any recognised basis for validation, it should not be the prime source of the valuation opinion.

### The Influence of Protective Investment Decisions

It is conceivable that the existing investors have invested additional funds simply to avoid dilution of their existing shareholdings and that this may explain why there is an absence of strong economic reasoning for the price that has provided the basis for additional funding.



# Employee Share Schemes

**All Best Wishes for Your Business Initiative  
from David Craddock  
Consultant, Lecturer, Author  
and Specialist in Employee Share Schemes and  
Reward Management,  
Management Buyouts, Share Valuation &  
Investment Education**

---

**David Craddock Consultancy Services  
Telephone: 01782 519925  
Mobile Phone: 07831 572615  
E-mail: [d.craddock@dcconsultancyservices.com](mailto:d.craddock@dcconsultancyservices.com)  
[www.DavidCraddock.com](http://www.DavidCraddock.com)**





# Questions & Comments



# EsopCentre

Tier One Sponsors



Tier Two Sponsors



Tier Three Sponsors



## FS Club

Platinum Sponsors



Gold Sponsors



Silver Sponsors



Bronze Sponsors



Personal Sponsors



# Resources – “It’s Our Business”



Home » newspad

## newspad

The Esop Centre’s *newspad*, edited by Fred Hackworth, is a monthly publication providing in-depth coverage of the main international news in the employee share ownership field.

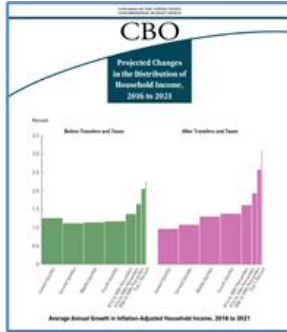
### July 2020

In this month’s edition:

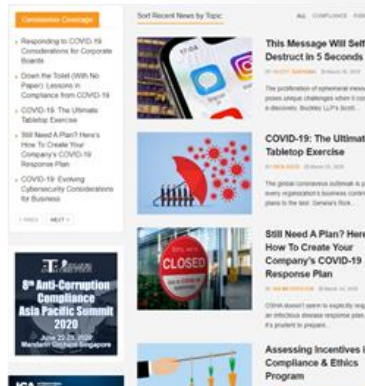
- EMI soars in popularity and in cost to taxpayers
- Limited Covid Sharesave disruption
- Sharesave triumph for Smiths
- No extension to reporting deadline
- Jersey conference for trustees September 25
- Share plans symposium rescheduled for March 24
- Pandemic furlough and tax risk to EMI
- Employee shareholder stake crucial to Royal Mail future
- Coping with Covid – members’ reactions
- State should invest in SMEs, urges report



# Resources – Bulletins



From 43,000 curated sources, you get a machine summary of the key point(s) from forward-looking articles, not just article titles:



## (LF.10) Reduced Inequalities

In September 2015, 193 world leaders agreed to 17 Global Goals for Sustainable Development. If these Goals are completed, it would mean an end to extreme poverty, inequality and climate change by 2030.  
Goal 10: Reduce inequality within and among countries.



- If the distributions of **income**, means-tested transfers, and federal taxes follow CBO's projections, **income inequality** will be greater in 2021 than it was in 2016.
- **High growth** over the past decade has been based on unsustainable resource exploitation; addressing the **resulting growth in inequality** and environmental cost will be critical to ensure social stability and to ensure **strong sustainable growth** in the coming decade.
- The increase in **inequality** observed in the last 30 years is a serious threat to France's social contract.
- America's proto-populist president is peddling a tax plan that will further increase **economic inequality** at a time when **income** and wealth gaps are already widening.
- A failure to give the **world's poorest women control** over their bodies could widen **inequality in developing countries** and thwart progress towards global goals aimed at ending poverty by 2030.
- Under French leadership the G7 group of the 7 largest advanced economies plus the European Union will focus in 2019 on fighting **inequality**, including **poverty** induced by **climate change**.
- Leadership might require companies to take positions and advocate for **change on global inequality** - including **in-work poverty**.
- Achieving the 17 **Sustainable Development Goals** - which include clean water, clean energy, sustainable cities, climate action, responsible consumption, **reduced inequality** and more - could open a market opportunity of \$12 trillion by 2030.
- The next decades offer an opportunity to address **African urban poverty** and **inequality** and shape development priorities to ensure that urbanisation helps foster well-functioning, livable and sustainable cities.
- In Africa and in the LDCs, eradicating poverty by 2030 will require both **double-digit GDP growth** and dramatic declines in **inequality**, illustrating the scale of the current challenges faced.
- The economic catch-up of Asia with the West will continue in the coming decades - thereby reducing **global inequality** among countries and among world citizens.

## (FS.3.05) Employee Share Ownership

- Considering 75 percent of the 2025 global workplace will be Millennials and Generation Z, it's critical that **organizations keep a pulse on employee engagement** and in a way that's consistent with how the emerging generations communicate.
- 2019 will see a continued evolution in designers' understanding of workplace optimisation with design that boosts office morale and **employee wellness** while facilitating a creative work environment.
- By 2018, Gartner Predicts Twice as Many Employee-Owned Devices Used for Work than Enterprise-Owned Devices. With proposed revisions to the UK Corporate Governance Code, from 2020, companies will be required to report on **employee engagement**, as announced earlier this year by Financial Reporting Council.
- For HR leaders looking to better determine the attitudes that drive employee turnover and increase retention, using AI to provide insights into **employee engagement** will be crucial.
- By 2021, Artificial Intelligence (AI) will allow the rate of innovation in New Zealand to double. **Employee productivity gains** are expected to increase 1.3 times.
- Artificial Intelligence will double the rate of innovation improvements and improve **employee productivity gains** by 1.5 times in New Zealand by 2021.
- US health benefit costs per **employee** will increase 4.1% next year - slightly higher than inflation and less than the double-digit increases seen in years past.
- With a tight labour pool, small businesses will find 2019 is the year to focus on **employee engagement** and happiness.
- Nearly 50 percent of companies also expect that automation will lead to some reduction in their **full-time workforce** by 2022, based on the job profiles of their **employee base** today.
- **Employee wellness** has been on trend for years, but expect to see some high-tech changes in 2019.
- By 2020, automation and artificial intelligence will reduce **employee requirements in business shared-service centers** by 63 percent, which says the RPA market will top \$1 billion by 2020.
- This year, many **organizations** will look to employee scheduling software to solve problems around creating, publishing and managing employee schedules that include options to open shifts to select groups and integrate data on sales to help identify customer traffic patterns to optimize worker ratios.



To subscribe:

<https://fsclub.zyen.com>

[#Subscribe](#)

# Thank You



## Forthcoming Webinars

- 24 July 2020 (10:00)**     **Getting Back Its Mojo? Uncertain Times For UK Financial Services**
- 27 July 2020 (11:00)**     **Debunking the 'Conventional Wisdom' In Financial Markets: AI-Powered Financial Forecasting In Action**
- 28 July 2020 (12:00)**     **Unfit For Purpose: What Has Gone Wrong With Our Pension System And How We Will Fix It?**

**Visit** <https://fsclub.zyen.com/events/webinars/>

**More added every day...**