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Insights Into Share Valuation for Employee Share Schemes, Revealed Through Dynamic Case Studies

Webinar

Tuesday 17 November 2020

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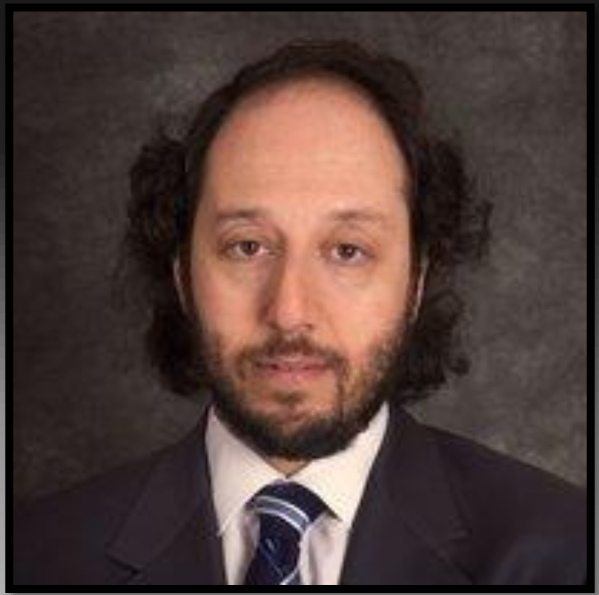
A Word From The Chairman



Ian Harris, BA (Hons) FCA FBCS FIBC CMC

Managing Director

Z/Yen Group

Agenda

15:00 – 15:05	Chairman's Introduction
15:05 – 15:30	Keynote address
15:30 – 15:45	Questions & Comments

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Insights Into Share Valuation for Employee Share Schemes, Revealed Through Dynamic Case Studies

David Craddock

Founder and Director

David Craddock Consultancy Services

David Craddock Consultancy Services

David Craddock Consultancy Services

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

Founder, Principal and Director: David Craddock, MA(Oxon)
Consultant and Lecturer
Author of "Tolley's Guide to Employee Share Schemes"

Share Valuation for Employee Share Schemes

Meaning of Market Value through Statute and Case Law:
The Statute Law – The Underlying Principle

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

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 Factors that are Derived from 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

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**.

As a general rule of thumb, 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

Case Study 1: The Earnings Basis for Whole Company Value – Prepared on 6th May, 2020

The Sustainable Profit Position
Financial year to 31st March, 2017: £350,000 Actual
Financial year to 31st March, 2018: £260,000 Actual
Financial year to 31st March, 2019: £275,000 Actual
Financial year to 31st March, 2020: £330,000 Latest Estimate
Average Sustainable Post-Tax Profits: **£330,000** **Based on the last completed financial year**

The Value Multiple
Quoted Company A: 20.31; Quoted Company B: 13.00; Quoted Company C: 9.63
Average Price-Earnings of the Quoted Comparators: 14.31
Apply a Discount of 50% for lack of marketability of the company to produce Sub-Total: 7.2
Add Bid Premium of 20% to produce the Derived Price-Earnings Ratio: **8.59**

The Whole Company Value on an Earnings Basis
Average Sustainable Post-Tax Profits (based on the last completed financial year: **£330,000**
Derived Price-Earnings Ratio: **8.59**
Whole Company Value: **£2,834,700**

The Whole Company Value on an Assets Basis
Balance Sheet Value as at 31st March, 2020: **£1,560,000**

Apply the Minority Interest Discounts to the Whole Company Value on an Earnings Basis

Share Valuation for Employee Share Schemes

Case Study 2: The Assets Basis for Whole Company Value – Prepared on 29th July, 2020

The Sustainable Profit Position

Financial year to 31st March, 2017: £415,000 Actual
Financial year to 31st March, 2018: £635,000 Actual
Financial year to 31st March, 2019: £425,000 Actual
Financial year to 31st March, 2020: £450,000 Actual
Financial year to 31st March, 2021: £ 0 Budget
Average Sustainable Post-Tax Profits: **£291,666** **Based on 3 years, i.e. 2 years historical and the current year**

The Value Multiple

Derived Price-Earnings Ratio: **11.78**

The Whole Company Value on an Earnings Basis

Average Sustainable Post-Tax Profits (based on the last completed financial year: **£291.666**
Derived Price-Earnings Ratio: **11.78**
Whole Company Value: **£3,435,825**

The Whole Company Value on an Assets Basis

Balance Sheet Value as at 30th June, 2020: £3,989,972
Less: Reduction for Estimated Revaluation of Property: £192,000
Net Assets as at 31st May, 2020: **£3,797,972**

Apply the Minority Interest Discounts to the Whole Company Value on an Assets Basis

Share Valuation for Employee Share Schemes

Case Study 3: The Share Trading Assets Basis for the Minority Interest Price where Significant Intellectual Property

The Annual Losses
Financial year to 31st July, 2011: -£1,031,041 Actual
Financial year to 31st July, 2012: -£2,071,064 Actual
Average Sustainable Post-Tax Profits: **£0**

The Whole Company Value on an Assets Basis
Net Assets as per the Balance Sheet Value as at 31st July, 2012: £1,273,627 (cash injections from numerous investors)
Total Number of Shares is Issue over three classes of ordinary shares: 3,079,658
Value per Ordinary Share: **£0.0041**

The Share Valuation on a Share Trading Basis
The company has issued shares consistently throughout 2012 at the price: **£0.0354**
The value of the intellectual property is assessed based on projected profit flows: **£10,901,989**
Total nominal value of all shares: **£3,079,658**
Apply the factor of 100 to convert all shares to £0.01 shares for the calculation: **100** (some have £1.00 nominal value)
Total number of shares as though all shares are of £0.01 nominal value: **307,965,785**
The Calculation of the Value of the £0.01 Ordinary A Share
The value of the intellectual property: £10,901,989
Total number of shares as though all shares are of £0.01 nominal value: **307,965,785**
The Value of the £0.01 Ordinary A Share (the share class for the grant of options): £0.0354

Conclusion
The value of an Ordinary A Share is based on the Share Trading Basis: **£0.0354**

Share Valuation for Employee Share Schemes

Case Study 4: The Growth Shares Model using a Reclassification linked to a Value Freeze

The Sustainable Profit Position

Average Sustainable Post-Tax Profits: **£50,000**

The Value Multiple

Derived Price-Earnings Ratio: **8**

The Whole Company Value on an Earnings Basis

Average Sustainable Post-Tax Profits: **£500,000**
Derived Price-Earnings Ratio: **8**
Whole Company Value: **£4,000,000**

The Share Capital

Before the Reclassification of the Share Capital and Before the Value Freeze

Ordinary Shares: **50,000** – Valued at Whole Company Value of **£4,000,000**

After the Reclassification of the Share Capital and After the Value Freeze

New Preference Shares: **50,000** – Valued at Whole Company Value of **£4,000,000**
New A Ordinary Shares, the Growth Shares for Existing Shareholders: **500,000** – Valued at a low value
New B Ordinary Shares, the Growth Shares for New Employee Shareholders: **100,000** – Valued at a low value
Both the hypothetical willing seller and the hypothetical willing buyer must be recognised; therefore, some value must be attributed to the Growth Shares at the date of the reclassification.

The Attribution of the Growth Value

The new preference shares maintain going forward the value attributed at the reclassification.
The new ordinary shares as the growth shares attract all future increase in value.

Share Valuation for Employee Share Schemes

Case Study 5: The Growth Shares Model using a Discounted Profit Flow Analysis

The Calculations that precede the preparation of the Discounted Profit Flow Model

1. Value Multiple

Determine a Derived Price-Earnings Ratio: **10**

2. Discount Factor

The composite elements:

- The risk-free rate or return: **1.4%**, based on the researched money markets
- The risk premium for private equity investment: **5.6%**, based on published premium positions
- The risk premium for the small and non-diversified company: **8.0%**, maybe based on a start-up company
- The risk premium for the share illiquidity of the company: **5.0%**, based on researched sources

The result is the Discount Factor of **20%**

Discounted Profit Flow Model

To generate a Whole Company Value using an Earnings Basis:

- Project forward to, say, five forward years for Profit After Tax, assuming a realistic Growth Rate
- Apply the Valuer Multiple of **10** to the Profit After Tax figure projected for Year 5
- The resultant figure is a Whole Company Value projected for Year 5
- Discount back the projected Whole Company Value to Year 0 using the Discount Factor of **20%**

The result is to produce a Discounted Whole Company Value at Year 0: **£8,000,000**

Apply the Minority Interest Discounts to the Whole Company Value

The result is to produce the minority interest share price for purposes of the employee share scheme.

Share Valuation for Employee Share Schemes

Case Study 6: The Emergence of a Special Purchaser in the Market to Influence Value

Suppose the company has been valued by an expert share valuer at £20million, and then suddenly a potential purchaser emerges offering £60million. What is the company's value?

The International Valuation Standards

The definition of a Special Purchaser is: "A particular buyer for whom a particular asset has special value because of advantages arising from its ownership that would not be available to other buyers in the market." The definition of Special Value is: "An amount that reflects particular attributes of an asset that are only of value to a special purchaser." A special purchaser will be prepared to pay, therefore, a premium over and above the otherwise open market value to achieve his objective.

The Application of the Hypothetical Transaction

The principle of the hypothetical transaction must be applied. The assumption will be that the hypothetical purchaser will have to increase his offer for the asset to better the price that the special purchaser is prepared to pay. If that is true, then the premium price that the special purchaser is prepared to pay becomes an element in the determination of the Statutory Open Market Value which is the Actual Market Value for purposes of the share valuation analysis.

Re Lynall Deceased CA [1969] 3 WLR 984

The position of HMRC is to rely upon the decision in Re Lynall, that the open market is influenced by the existence of a special purchaser only where it can be clearly established by cogent evidence that at the date of valuation, the special purchaser as a matter of fact meets the following criteria:

- The special purchaser is offering to buy the shares.
- The special purchaser is financially able to buy the shares at the enhanced price.
- This fact is known to the open market.

The courts will require clear proof of this situation before weight can be given to it as the basis for the decision.

Share Valuation for Employee Share Schemes

Case Study 7: The Distinction between Equity Value and Enterprise Value

The Equity Value and the Enterprise Value, each offers a different viewpoint on the valuation. The Equity Value focuses on the share value while the Enterprise Value focuses on the overall value of the business. The Equity Value is used by stock market investors and potential buyers of the controlling interest while the Enterprise Value reveals how the business is funded.

Expressed through the Balance Sheet Approach

Equity Value		**Enterprise Value**	
Gross Assets	100	**Gross Assets**	**100**
Add: Cash	20		
Less: Liabilities	(50)		
Net Assets	**70**		
Share Capital	**70**	Share Capital	70
		Add: Liabilities	50
		Less: Cash	(20)
Equity Value	**70**	**Enterprise Value**	**100**

The Equity Value is the Market Capitalization as represented in the Earnings Basis calculation as follows:

Equity Value = Sustainable Post-Tax Profits x Value Multiple (Remember Case Study 1)

The excess of the Whole Company Value derived from the Earnings Basis compared with the Whole Company Value derived from the Assets Basis is Goodwill as follows:

Equity Value = Net Assets + Goodwill

But: Net Assets = Gross Assets - Liabilities

Therefore: Equity Value = Gross Assets – Liabilities + Goodwill

Therefore: Equity Value + Liabilities = Gross Assets + Goodwill

Therefore: Equity Value + Debt Value = Gross Assets + Goodwill

Equity Value + Debt Value = Enterprise Value = The Source of Funds

Gross Assets + Goodwill = The Application of Funds

Share Valuation for Employee Share Schemes

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

The Percentage Shareholding	The Level of Control and Influence
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

The Percentage Shareholding	The Level of Discount
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

Final Tips for Share Valuation

1. The Predominance of Share Trading

HMRC will always give emphasis to any trading in the shares although that can, in certain circumstances, be overridden if any basis, say typically the Earnings Basis, can demonstrate a higher value.

2. The Offer Basis

A genuine offer trumps any other basis, whether that other basis is higher or lower than the offer basis, although care should be taken to determine the status of the due diligence as an influencing factor.

3. The One Value for the Same Transaction

There has to be only one value for both the seller and the purchaser, i.e. there cannot be different values for the same transaction undertaken by the same parties.

4. The Rights and Restrictions of the Seller/Transferor

When setting a value, always examine the rights and restrictions of the shares in the hands of the seller/transferor before the sale/transfer, i.e. where the shares have come from.

5. The Already Determined Values

If there is a value already established for a transaction that has already taken place in the company's shares, then HMRC will seek to apply that value on subsequent transactions, even if relating to a different class of shares.

6. The Purchase of Shares by the Majority Shareholder

A majority shareholder will normally not buy additional shares at a minority price.

Share Valuation for Employee Share Schemes

Final Tips for Share Valuation (Continued)

7. The Articles of Association

The provisions of the Articles form part of the hypothetical transaction as envisaged by Section 272, TCGA 1992 and provide the basis for a tax value where the hardwiring into the Articles applies to anybody anywhere in the world. Furthermore, the integrity of the Articles should be respected as the constitution of the company and the basis for order in its activities and undertakings.

8. The Influence of Voting Rights and Different Classes of Shares

Although voting rights for minority shareholders do not attract value, HMRC seems to take the view that if the employees have voting rights in a separate class, even when all other rights compared with other classes are the same, the shares will have an enhanced value.

9. The Treatment of Excess Cash

Given that the company should be valued on the basis of adequate working capital to service the business, any excess cash should be added to the value determined on an Earnings Basis.

10. The Internal Market

The last trading price for sales to the employee share trust provides the starting point for the price-setting for the next transaction although the time-lapse since the last transaction should be accounted for. As a general rule of thumb, there should be congruence between the selling prices and the purchase prices for the trust's transactions and congruence between the bases for determining those prices. From a trust law perspective, the trust should not buy above market value, otherwise there is breach of trust.

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 &
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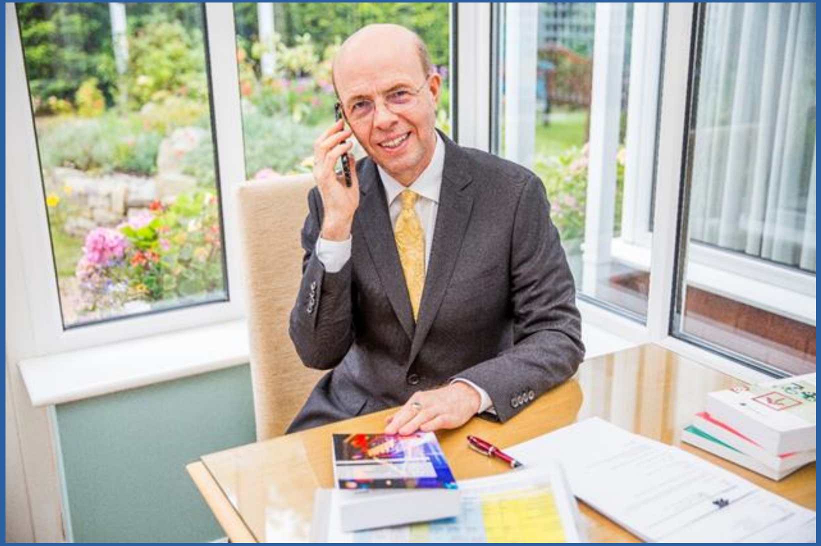

David Craddock Consultancy Services
Telephone: 01782 519925
Mobile Phone: 07831 572615
E-mail: d.craddock@dcconsultancyservices.com
www.DavidCraddock.com

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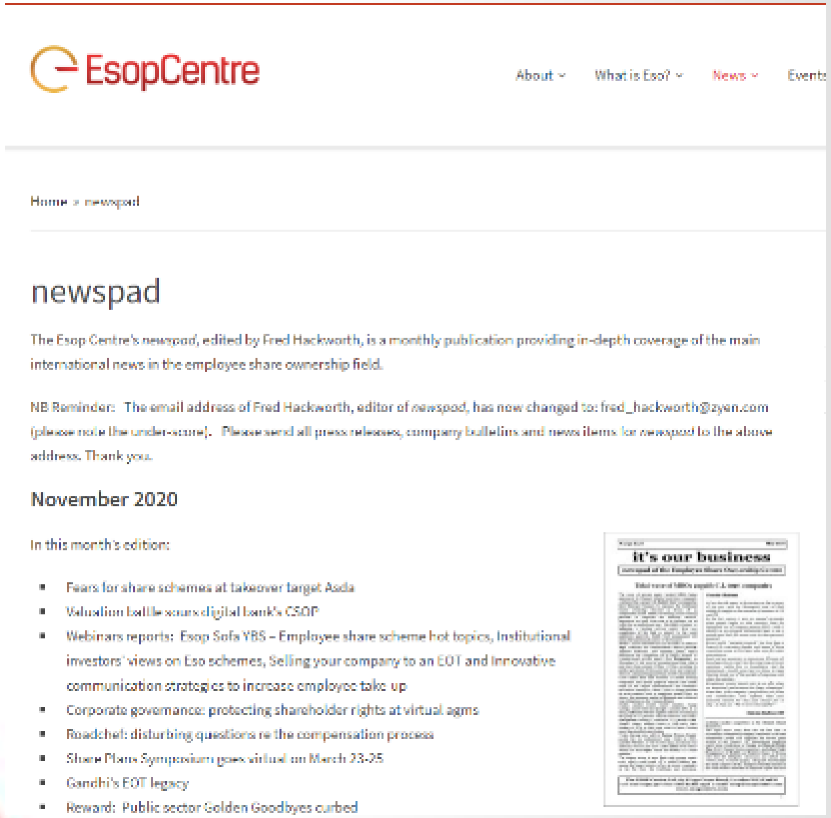
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- Corporate governance: protecting shareholder rights at virtual agms
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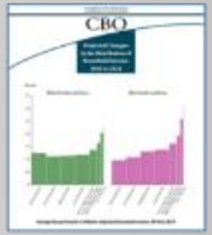

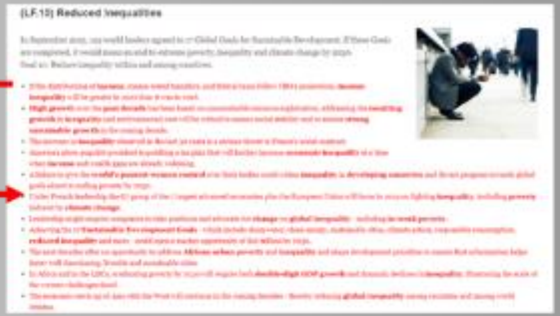

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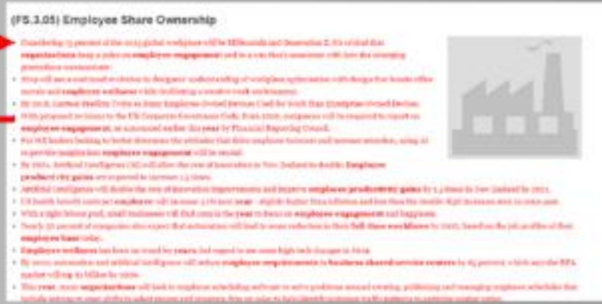

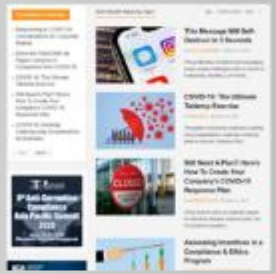

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