

Factsheet

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A guide to valuation of shares in unquoted companies

General Features

Where share schemes are established in a unquoted company, the value of those shares may need to be agreed in advance with the Inland Revenue and will need to be communicated to employees if the share scheme is to incentivise staff as intended.

How are my shares valued?

There are a variety of methods to value unquoted companies

- Generally a company is valued on a multiple of its profits after tax. A view on maintainable post tax profits will need to be taken in the light of historic, current and anticipated performance of the company, the competitive environment, the effect of the economic cycle on the business and other factors. The final earnings figure is then multiplied by a suitable multiple, or a price to earnings (p/e) ratio, which is generally taken from the quoted sector or from private company transactions and typically adjusted for limited marketability, control premiums and differences in size.
- Small shareholdings can be valued on the basis of the company's dividend stream. The process is similar to an earnings based valuation in that a view of maintainable dividends is taken by looking at past dividends paid and the ability of the company to continue to pay dividends in the future. The dividend per share is then "grossed up" by looking at the dividend yields of comparable quoted company shares.
- Alternatively an asset based valuation is a good "floor" to a company's value. They are particularly useful for companies with low earnings and/or large asset portfolios.
- Often valuations for the purposes of share schemes are done on the basis of tax legislation.

For example, for the purposes of Capital Gains Tax, Section 272 Taxation of Chargeable Gains Act 1992 defines market value. There is a substantial body of case law on how to value shares on the principles of open market value. The main points are that shares are valued from the point of view of a hypothetical purchaser and seller.

The individual circumstances of, say, an ESOP will not necessarily be taken into account. In addition, there is no need to assume that the secrets of the board room should be disclosed - so the fact that the board may well know that next years profits are due to slump/soar will not necessarily be taken into account. The courts are becoming increasingly sophisticated in considering share valuation issues.

Recent legal cases take into account the actual monetary value being paid as a substantial investor would want to undertake sufficient due diligence regardless of the size of the shareholding to be acquired.

What happens if only a minority of the company's share capital is to be used?

Once a value for a company as a whole has been determined, there may still be a discount if the shares to be used for the share scheme form a minority shareholding. Fiscal valuations in particular will take into account the size of shareholdings and as will be expected, the larger the shareholding the higher the value because larger shareholdings are:

- assumed to have more influence over the board
- assumed to have more and better quality information

- assumed to be more marketable
- hence are worth more than smaller shareholdings

Minority discounts can be a problem if an existing shareholder wants to maximise the value of shares he is selling and it may be important to seek a more modest discount. However, if the scheme is unapproved and it is hoped to minimise any tax liability on participants then large discounts in the value of the shares may be welcome.

Valuation is not a science but an art and in all cases it is important both to know the purpose of the valuation and to understand your objective.

What other issues do I need to consider?

The trustees of an ESOP may want to receive independent valuation advice that they are not overpaying for their shares. In particular, trustees of a QUEST who have a statutory duty not to buy shares at above market value may want such comfort.

Some companies prefer to have a valuation formula which can be contained in the Articles for transparency or in a board policy which is more flexible. A formula can lead to less volatility in the valuation of shares but can be less flexible.

How do I run an internal market?

Unquoted companies with employee share schemes often establish internal market mechanisms to allow employees the opportunity to buy and sell shares and to oblige employees who leave the company to sell shares they have received. In order for the internal market to be meaningful, companies should have regular valuations of their shares and communicate the value to employees. Most companies value their shares annually but it can be done as often as required.

How do I actually get my shares valued?

Most companies have their shares valued at regular intervals for their internal market by their auditors but any valuation expert can be used.

Inland Revenue Shares Valuation

This department of the Inland Revenue is involved with the valuation of unquoted shares. For the three approved share schemes (CSOP, SAYE and SIP) the value of the shares must be agreed in advance with the SVD. The advance clearance will generally be valid for 28 days (but up to six months for a SIP) and options must be granted or shares appropriated within that timescale. The SVD will not however confirm the value of shares to be bought by a QUEST. It is not compulsory, but it is advisable, to agree a valuation with the Inland Revenue before granting EMI options.

Shares Valuation will not normally agree the value of shares in relation to unapproved option schemes in advance of option grant. The SVD will usually only get involved if the market value of the shares, and hence the tax liability arising from such unapproved schemes is disputed after the event. However if the exercise period is greater than ten years, and income tax liability may arise on grant, in which case Shares Valuation will consider valuation prior to grant. Where an employee is to receive shares under an unapproved arrangement - where a PAYE liability will arise, Shares Valuation should agree a valuation to ensure the correct payment to be made.

The information required by the SVD is not excessive, but will generally include the most recent accounts, Articles of Association, details of recent transactions in shares, the purpose of the valuation and the proposed figure together with a description of how that figure was arrived at.

In some cases, Shares Valuation will require more detailed information such as management accounts and forecasts and a more detailed valuation report.

If you are seeking to agree a valuation in relation to a SIP or EMI you need to submit form [Val 230](#) or [Val 231](#) as the case may be.