



Share and share alike?

Jon Moulton weighs up the benefits – and otherwise – of the UK's Enterprise Management Incentive

Getting employees across a business to share the same ambition is what every company wants. It makes management that bit easier. The UK's Enterprise Management Incentive (EMI) scheme is a very attractive way of giving employees in smaller businesses substantial incentives, with decent tax breaks and relatively low complexity. Although there can be substantial tax deductions for the company, the more dominant motivation for using EMI is that individuals can realise large amounts. Tax is paid at the 10% capital gains tax rate rather than the potential 45% income tax that would apply on other option schemes. The scheme has been running in some form or other since 2000.

I've been digging around in some data, using actual rather than artificial intelligence. About 14,000 companies have schemes, 4,500 of which issue options each year to 40,000 employees, with an aggregate option value of more than £500m. The average recipient gets shares with an option value of around £14,000 – the median is a lot less as some souls get the full £250,000 limit. HMRC claims the scheme's cost to the Exchequer in income tax and national insurance is around £360m a year.

Having mugged up on the stats, I was rather distressed to find out that somewhere between three-quarters and two-thirds of option holders never exercise their options over their 10-year life. That isn't encouraging. And it's fair to say there's no strong case that the EMI scheme is worthwhile to the country. There simply isn't enough information to work that out.

Pricing problem

One part of the EMI process that is aggravating to external investors is the need to price the options. The tax authorities appear to be really quite relaxed about the valuation approach taken. An 'unrestricted market value' for the shares needs to be submitted to HMRC. This is rather speculative in a private company, but given that this valuation has no economic effect, a fairly light-hearted approach to this number is harmless.

Then, an 'actual market value' must be submitted – the exercise price for the EMI option. If I've

invested in a private company at £10 a share, fully cognisant of pre-emption and minority rights of others and possibly disproportionate voting rights, wouldn't £10 be the 'actual market value'? Perhaps, given it's an option, there may be a case for a higher exercise price.

It's not general practice to use £10, but instead to claim deductions for illiquidity, voting rights and pre-emption, even though these are largely priced in. Clearly, if there are vesting provisions or other relevant issues, some modest further valuation reduction might be appropriate. It beggars belief (to me), but some of the groups organising schemes claim they can get the £10 reduced to £1.

The effect is that if shortly after issuance of the options the company is sold, management does incredibly well. I readily accept that contributing staff should be given part of the future upside they can help to generate, but I'd insist on 'last round' pricing for the exercise price. Rewards for past performance have already been given. Refunds for poor past performance simply never happen.

Unattractive option

Given these frequent large initial discounts, it's not surprising that the average gain on the point of exercise on EMI options is something like 10 times exercise cost. That's a lot better than the average venture capitalist gets.

There can be a very unattractive thing that happens, though – management appears at a board meeting, looking to reprice options (downwards of course). It is often supported in this lower valuation by a tax accountant. The rationale will emphasise personal tax and liquidity, but it's usually accompanied by one of two lines: in underperformance, "We need more incentive"; or in overperformance, "We deserve more". I hate such late renegotiation – for that's what it is.

Depending on the strength and structure of the parties, all outcomes are possible, but it always rankles. Despite all the issues outlined above, I do like the relative simplicity of EMI and its flexibility is often useful. So, I'll continue to put up with having to battle its downsides.

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