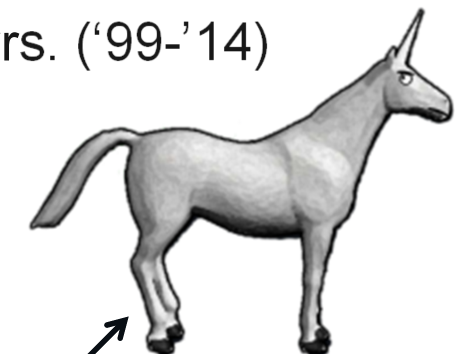
How to Value Your Company:
From Day One to IPO

Will Karnasiewicz, CFA
Manager – Valuation Services
Andersen Tax LLC

william.karnasiewicz@andersentax.com 646-213-5101
1177 Avenue of the Americas, 18th Fl., New York, NY 10036

Valuation In the News – Unicorns

- As of Nov. 2015: 131 private companies valued in excess of $1 billion by VC-firms per WSJ
- Companies choosing to stay private longer
  - Avg. age of companies at IPO went from 4 to 11 yrs. (‘99-’14)
  - Pricing/valuation issues
  - Less liquidity for founders, employees, investors
- Increased scrutiny by SEC and IRS
  - Variance in fair value marks by mutual funds
  - Cheap Stock Issues



Not that (sorry Charlie)

UBER airbnb BuzzFeed ZocDoc VOX MEDIA

These

Valuation: Why Should I care?

- Part 1: Raising Capital
  - What am I giving away?

- Part 2: Incentivizing Employees
  - Issuances of Stock Options, SARs, etc.
  - Compliance with IRC Section 409A

- Part 3: Accounting Issues
  - Scrutiny by auditors and regulators on Fair Value

Starting with Basics: Definitions

- Different Meanings in Different Contexts
- Investing & Fundraising (Negotiated)
  - Pre-Money vs. Post-Money Valuations (Pre + $invested = Post)
- Fair Market Value (IRS)
  - The price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.
- Fair Value (GAAP)
  - Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Part 1: Capital Raising

- VC-backed rounds in the news are eye popping
  - "Uber Raises $2.1 Billion at $62.5 Billion Valuation" (Re/code Dec. 6)
  - "Airbnb Officially Confirms Gargantuan $1.5 Billion Funding Round in SEC Filing" (Re/code Dec. 7)
  - "ZocDoc Valued at $1.8 Billion in New Funding Round" (WSJ Aug. 20)
  - "Vox Media Raises $200M From NBCUniversal" (Techcrunch Aug 12)
  - "Hot new salad chain Sweetgreen just raised a fresh $35 million" (Business Insider Jul. 1)
- A lot of $$$ floating around
- What are the real takeaways (for common shareholders)?

Part 1: Capital Raising – Features of Preferred Stock

- Rights and Protections given to Investors' Stock
  - Preferred liquidation preferences
  - Dividends (5-10%)
  - Conversion Features
  - Participation Rights
  - Ratchet Provisions
  - Board Seats

Participating Preferred – An Example

- Participation – shares in the upside beyond liquidation preference, can be capped
- Structure 1:
  - 2 classes of stock: Common, Series A
  - Series A – Convertible at $1, Non-Participating, 1x Preference ($20mm)
  - 20mm shares Series A, 80mm shares Common
  - $100mm post-money valuation
- Structure 2:
  - 2 classes of stock: Common, Series A
  - Series A – Convertible at $1, Participating, 1x Preference ($20mm)
  - 20mm shares Series A, 80mm shares Common
  - $100mm post-money valuation

Participating Preferred – An Example

- Scenarios at Liquidation (perhaps 3-5 years later?)

Equity = $10 million	Equity = $1 billion	Equity = $100 million
<u>For Structure 1 & 2</u> Common = $0 Series A = $10mm Due to $20mm Liquidation Preference	<u>For Structure 1 & 2</u> Common = $800mm Series A = $200mm Due to Conversion Features, Pro-rata %	<u>Structure 1</u>: Common = $80mm Series A = $20mm <u>Structure 2</u>: Common = $64mm Series A = $36mm Due to Participation

Preferred Features – Takeaway

- Know what you're giving away…
  - Liquidation Preferences and Seniority (downside protection)
  - Dividend Rights (additional "base" return over preference)
  - Participation Features (upside above preference)
  - Pro-rata % acquired by investors (ultimate upside)
  - Conversion Features (ultimate upside)
  - Ratchet Provisions (more downside protection)
  - Board Seats (influence / control over governance)
- Wildly successful exits can cure all …
- But be careful with expectations ("Valuation" vs. Exit Proceeds)

Back to Example

Part 2: Incentivizing Employees – IRC Sec. 409A

- Internal Revenue Code 409A deals with **nonqualified deferred compensation (NQDC) plans.**
  - Created as part of the American Jobs Creation Act of 2004
  - Passed by Congress and signed into law on October 22, 2004
  - IRC Section 409A rules are effective for NQDC that is either earned or vested after 2004
  - Initial guidance was provided in Notice 2005-1, issued December 20, 2004
  - Final regulations under Section 409A were issued on April 10, 2007

Part 2: Incentivizing Employees – NQDC Definition

- Nonqualified deferred compensation (“NQDC”) generally defined as...
  - Compensation that has been earned by an employee, but not yet received from the employer. Because the ownership of the compensation -- which may be monetary or otherwise -- has not been transferred to the employee, it is not yet part of the employee's earned income and is not counted as taxable income.
- NQDC is defined by the IRS as...
  - “A legally binding right” during a given tax year to compensation that (i) had not been actually or constructively received and included in gross income and (ii) that is payable in a later tax year.

Part 2: Incentivizing Employees – NQDC Examples

- What falls under NQDC?
  - Salary / bonus deferrals
  - Stock appreciation rights ("SARs") with below-market exercise prices
  - Some employment, severance, and change in control agreements; supplemental executive retirement plans ("SERPs"); or excess benefit plans
  - Options with **below-market** exercise prices

- What is <u>NOT</u> NQDC?
  - Tax-qualified plans
  - Vacation, sick leave, death, and disability benefits
  - Restricted stock
  - Employee stock purchase plans ("ESPPs")
  - Most options and SARs with **FMV** exercise prices

So….<u>what is the FMV</u>? This drives a need for a valuation.

409A Valuation – Why is it necessary?

- To reiterate: valuation needed to determine fair market value of security underlying option/SAR (common)
  - Options then issued with a strike price >= FMV
- If stock issued with below market strike prices what are the consequences?
  - Stiff penalties levied on taxpayer (employee)
  - Current taxation, 20.0% additional income tax, and potentially interest payments

409A Valuations – IRS Guidelines

- A valuation needs to be performed by someone qualified to perform such a valuation, based on her knowledge, training, experience, etc.
  - In most cases, companies choose to hire outside appraisal firms to meet this requirement.
- The valuation needs to be updated at least every 12 months, or more frequently if significant changes occur in the business between grant dates (e.g., new rounds of financing, new product launches, new major customers, etc.)
- The fair market value must be determined using "reasonable application of a reasonable valuation method"

409A Valuations - Methodologies

- Two Steps
  - Step 1: Value the Overall Enterprise or Equity
  - Step 2: Allocation Value from Step 1 to Each Class
- Step 1:
  - Traditional Valuation Techniques
    - Income Approach (Discounted Cash Flow)
    - Market Approaches
    - Cost Approach
  - Backsolve / Infer based on Recent Rounds of Financing
    - Used in combination with models of Step 2
    - Limitations? When is recent round not a good indication of value?

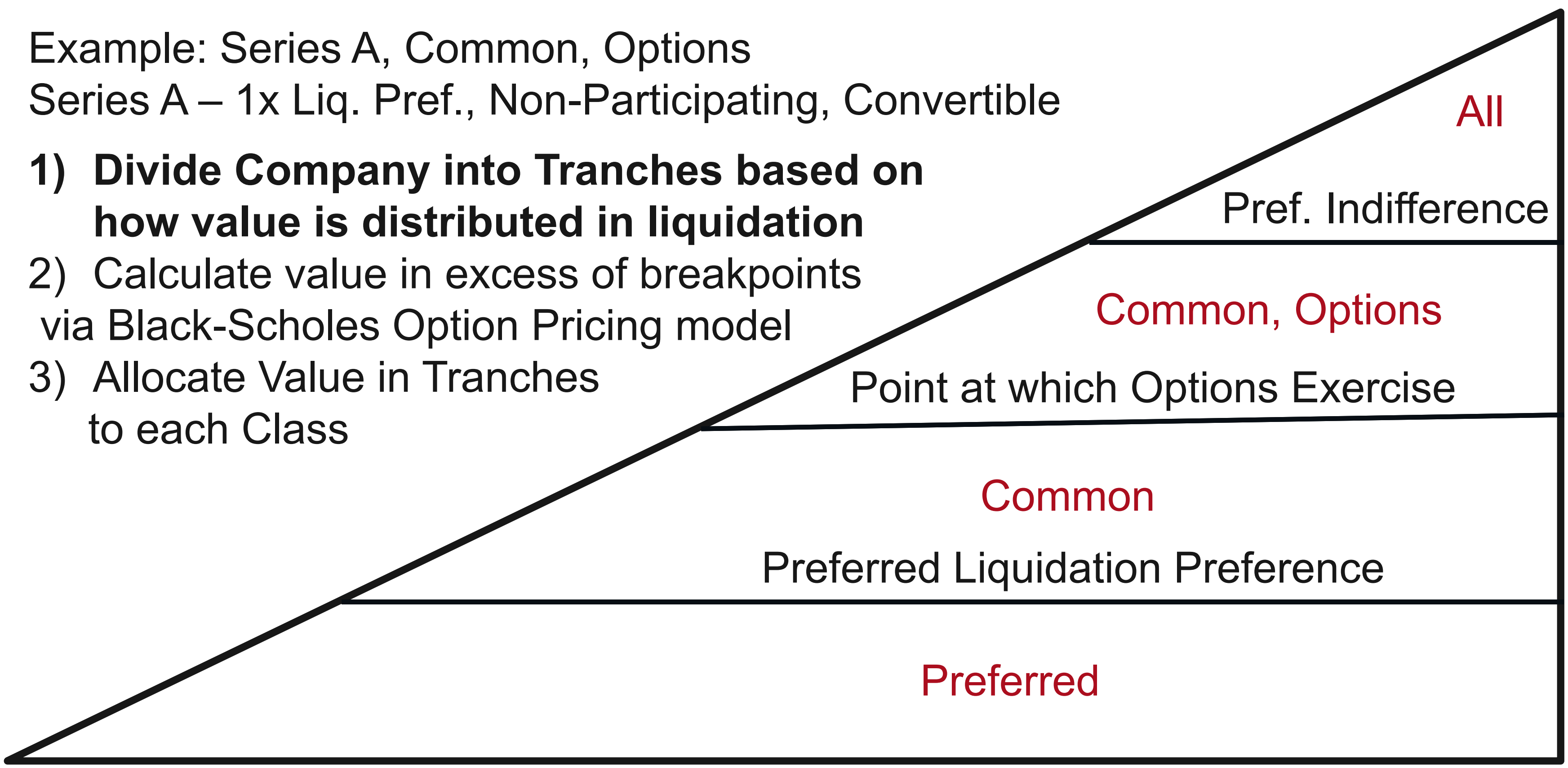
409A Valuations - Methodologies

- Step 2: Allocation of Value to Different Share Classes
- Current Value Method
  - Value of each class if liquidated today
  - Only appropriate in limited circumstances (i.e. if exit imminent)
- Probability Weighted Expected Return Model (PWERM)
  - Analysis based on various exit scenarios
  - Highly dependent on various management assumptions
  - Can also be used with Option Pricing Method as Hybrid Approach
- Option Pricing Method (OPM)
  - Typically Black-Scholes, could use Binomial or Monte Carlo
  - Most common methodology

409A Methodologies – OPM Walkthrough

Example: Series A, Common, Options
Series A – 1x Liq. Pref., Non-Participating, Convertible

1) **Divide Company into Tranches based on how value is distributed in liquidation**
2) Calculate value in excess of breakpoints via Black-Scholes Option Pricing model
3) Allocate Value in Tranches to each Class



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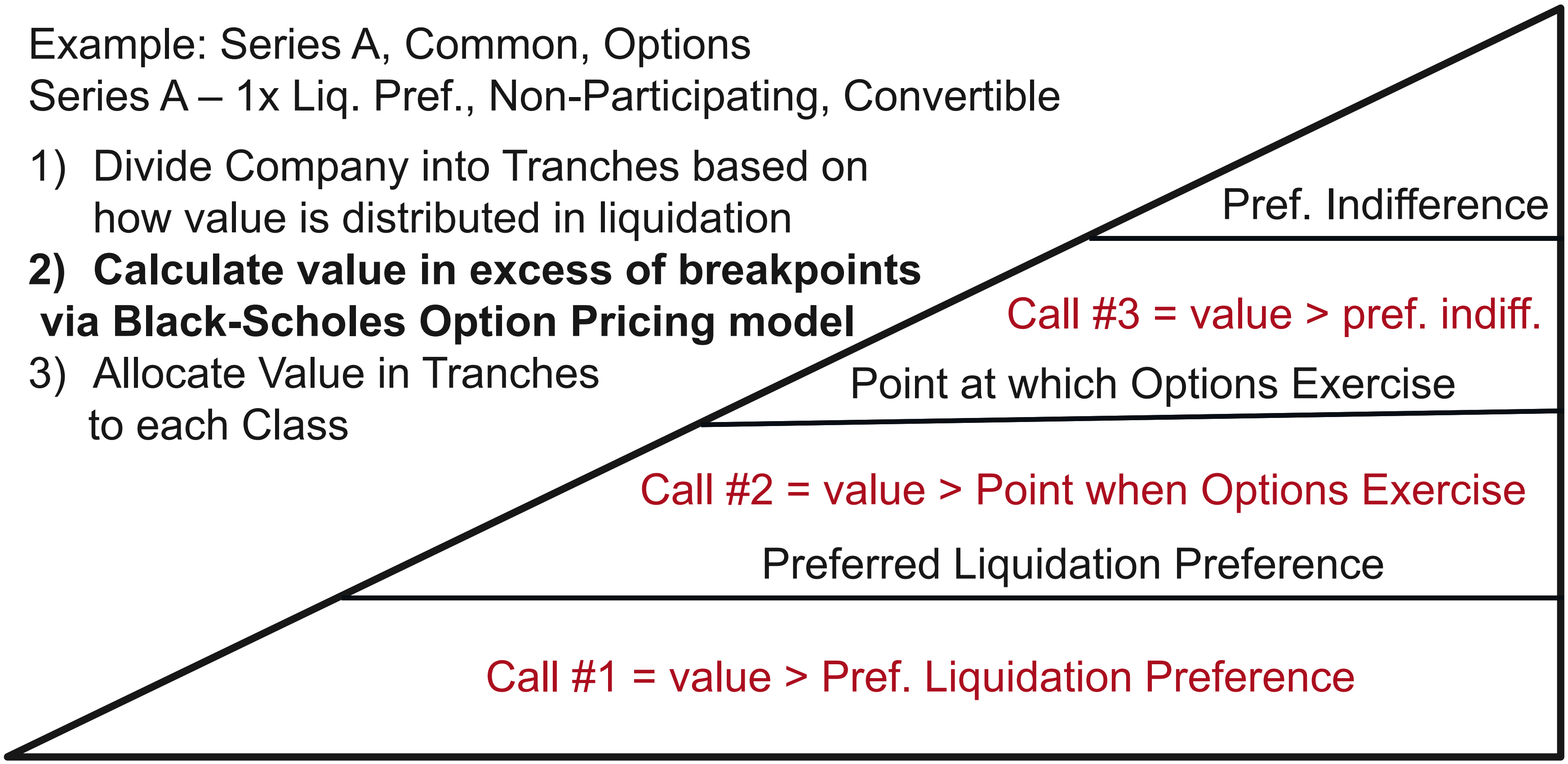

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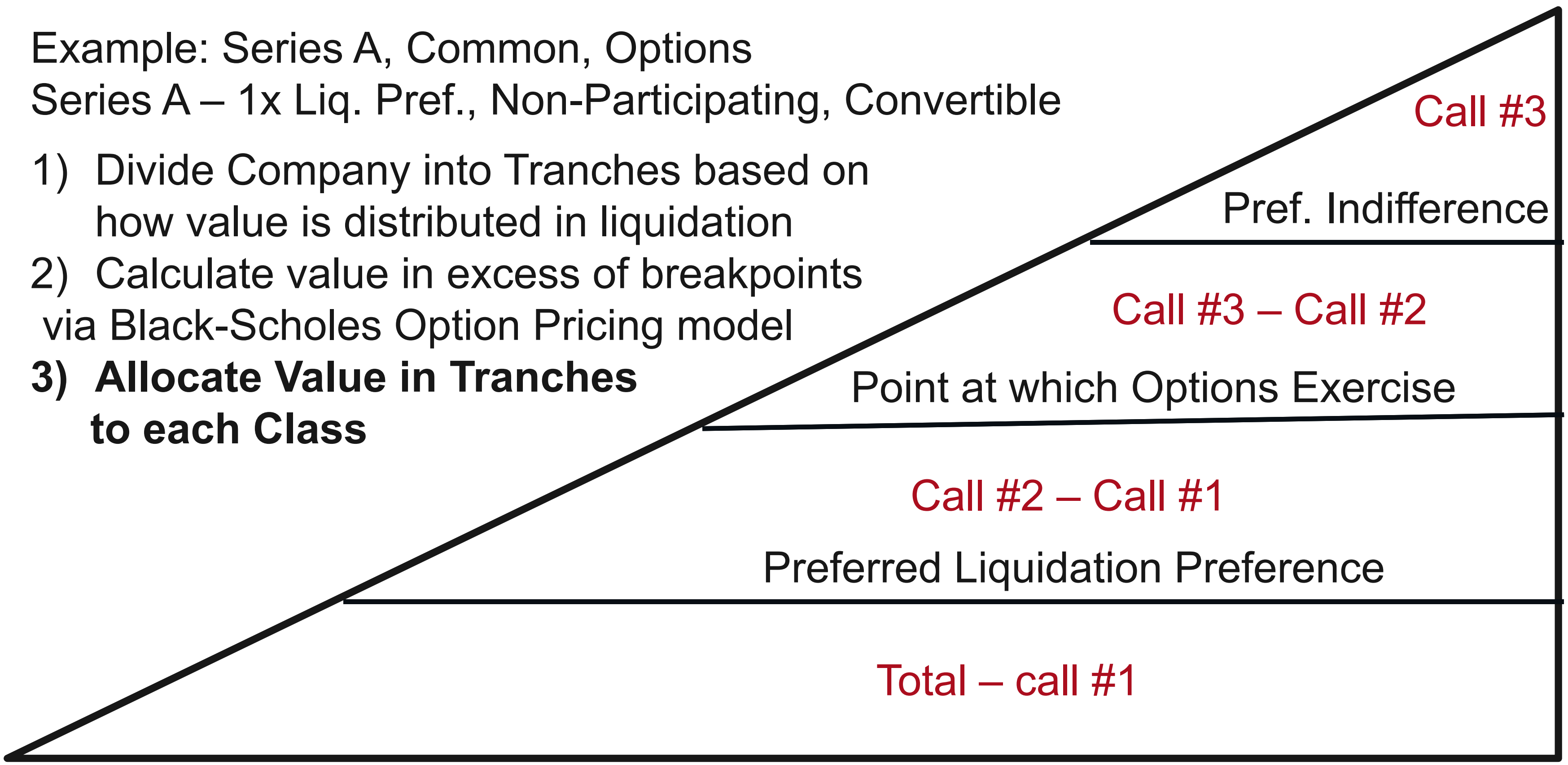

Startup Life Cycle – Valuation Techniques

Scenario	Step 1 Methodology	Step 2 Methodology
Pre-Revenue Startup, no funding to-date	Income or Cost Approach	OPM if multiple classes, otherwise N/A
Early-Stage with Recent Round of Financing	Backsolve based on recent round	OPM
> 1 yr. since last round, Exit Uncertain	Income and/or Market Approach	OPM
Potential Sale / Exit, Clearly Defined Scenarios	Market Approach and/or Backsolve	Hybrid PWERM
Sale Imminent	N/A if LOI, Otherwise Income & Market Approaches	Current Value Method

Part 3: Accounting / Fair Value Issues

- Investments need to be recorded at fair value on financial statements of investment fund (PE, VC, mutual)
- "Mutual Funds Flail at Valuing Hot Startups Like Uber" (WSJ 10/29/15)
- Challenges arise further away company gets from last round of financing
- As more companies go public, more data points for valuators, but still imprecise

Fair Value Quandary – An Example

- **Dropbox, Inc.**
- Perhaps the best known cloud storage company, especially consumer facing
- One of the top "Unicorns"
- Last round of financing was $350mm at $10b valuation in January 2014
- 2014 revenue rumored to be $400mm, implying approximately 25x rev. multiple

- **Box, Inc. (NYSE: BOX)**
- Raised approx. $550mm between 2005-2014
- July 2014 round was for $150mm at $2.4b valuation
- Went public 1/23/15
- 1st day pop up 66% to $2.7b
- Currently at $1.65b market cap
- TTM Rev multiple has fallen from around 11x to 5x

No one single "right" answer!

Key Takeaways

- Know the differences between (investor) preferred and (employee) common
- Consider when a valuation should be performed and what to look for in a 3rd party specialist
  - Compliance with IRS/FASB regulations
  - Other Disputes?
- Valuation is both an art and a science
  - As shown with mutual funds, different firms will reach different conclusions but each valuation can be valid if well supported and use consistent, appropriate methodologies

Q&A

Thank you for listening!