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THOUGHT LEADERSHIP

Value is in the Eye of the Beholder: Transition from Private to Public

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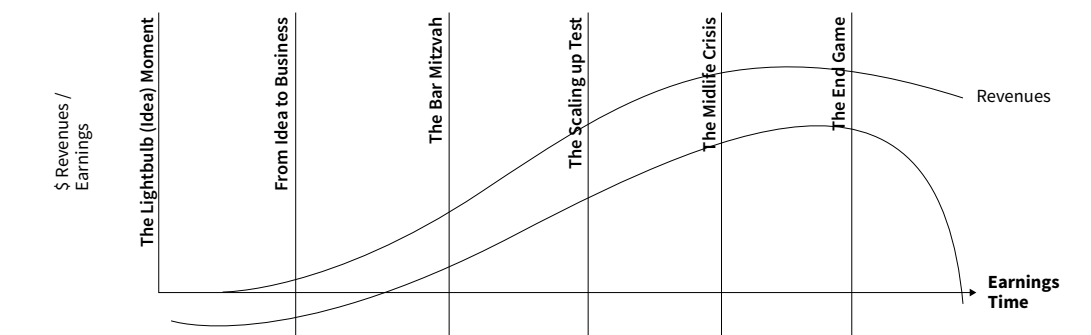
When you think about charting the lifecycle of a company, what image comes to mind? Does the trajectory start low, then shoot up steeply? Perhaps it shows exponential growth, which then plateaus? Does it always plateau or does it continue to show high growth?

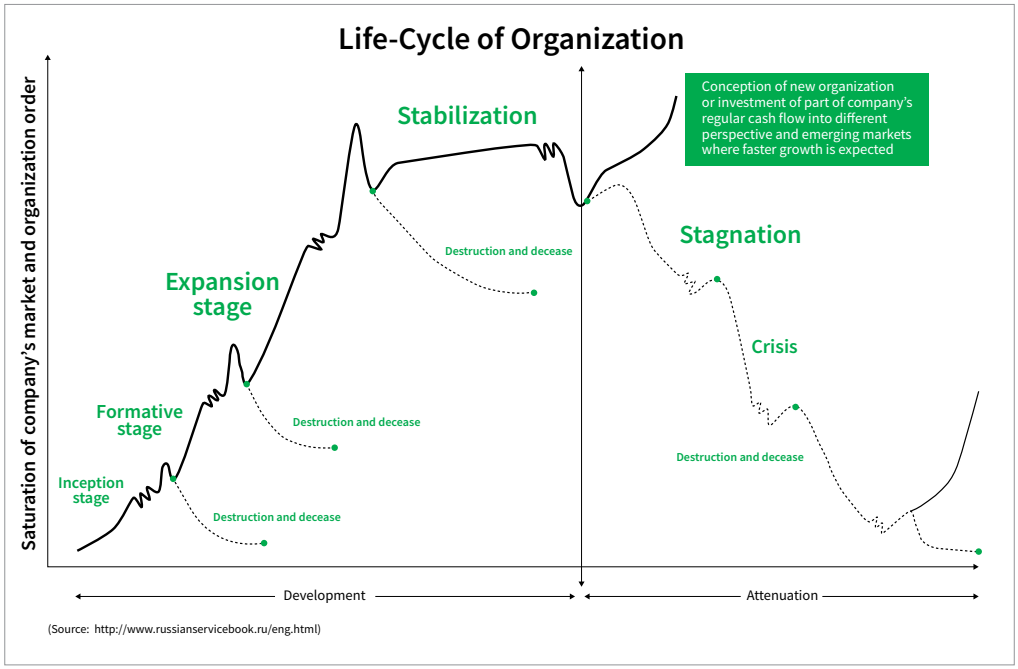
Does it look something like this?



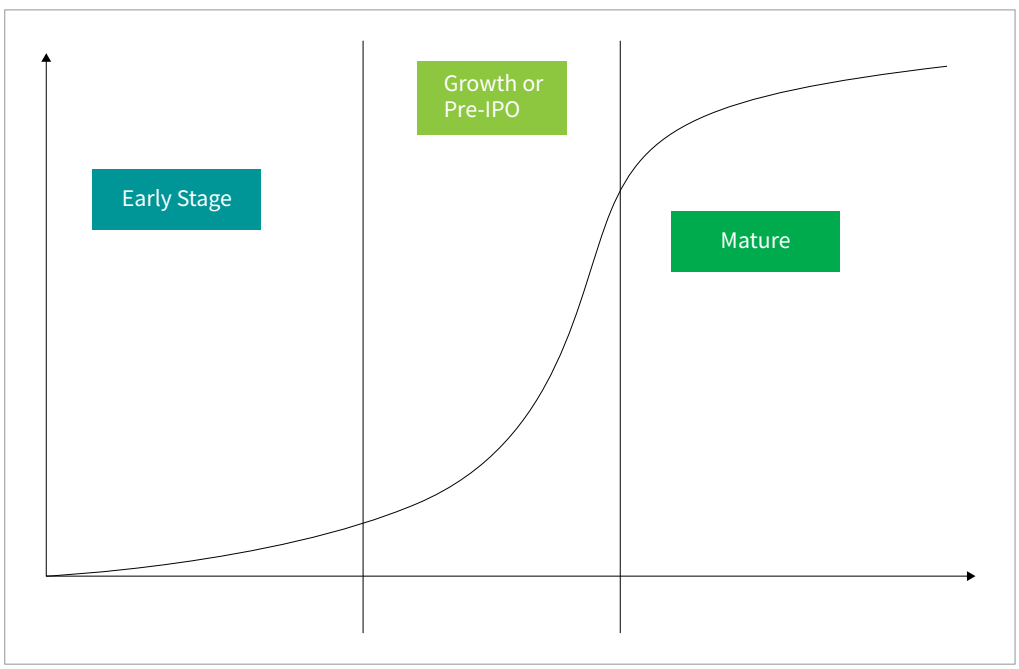
	Stage 1 Start-up	Stage 2 Young Growth	Stage 3 High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
Growth Stage						
All Narrative						→ **All Numbers**
The Top Management's Job	Tell a compelling and plausible story with potential for huge profits	Stay consistent in word & actions with your story	Start delivering numbers to back up the story	Keep your narrative in sync with your numbers	Adjust your narrative to reflect where you are in the life cycle	Act your age (in terms of narrative & choices)

(Source: Dr. Aswath Damodaran, Blog, Dec 18, 2015)

The above is theory. I am sure the 'real' historic growth curve of normal companies looks more like this:



Maybe the above chart is a little too real. A stereotypical company growth curve would be a simple, three-stage lifecycle that looks something like this:

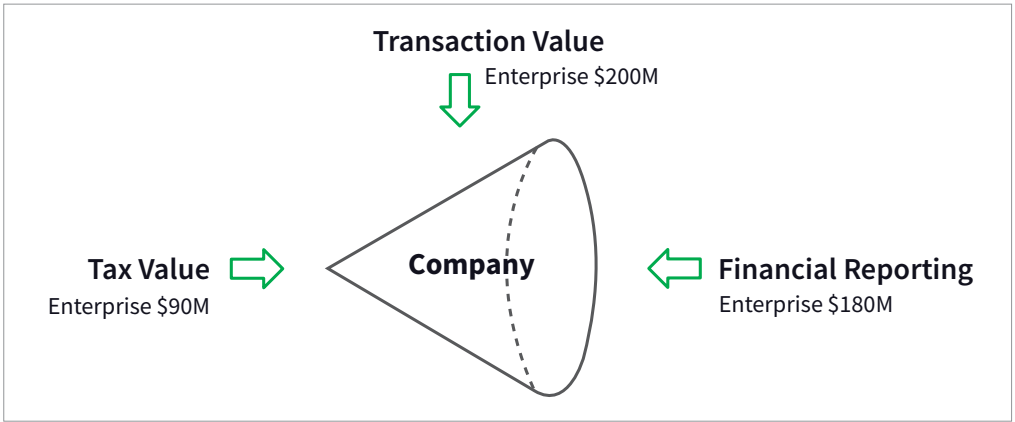


What if we thought of this lifecycle from the investor's perspective? In general, what kind of investors do early stage companies attract? Or how much capital would a mature company require for its pre-IPO round?

Answers to the above may depend on several factors, including the type of investor, the type of fund—venture, PE or CVC—the structure and lifecycle of the fund(s) and many others.

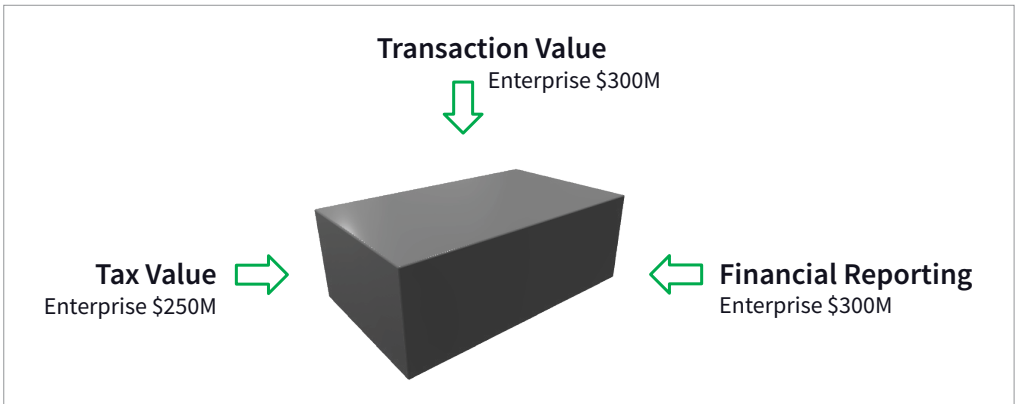
However, in most structures, the early-stage to growth companies —where the cash flows are limited yet the outlook has exponential potential—are most likely to attract venture investors. On the other hand, growth-mature companies— where the cash flows are more predictable—attract private equity investors. For simplicity, let's say that firms investing in early stage companies are venture, firms investing in maturity-stage companies are private equity, and the growth or pre-IPO stage could include both types of investors who value growth and projected cash flow.

Now, picking up from the first article in this series (Value is in the Eye of the Beholder: Private versus Public Company Valuations), let's take another look at the valuation diagram below:

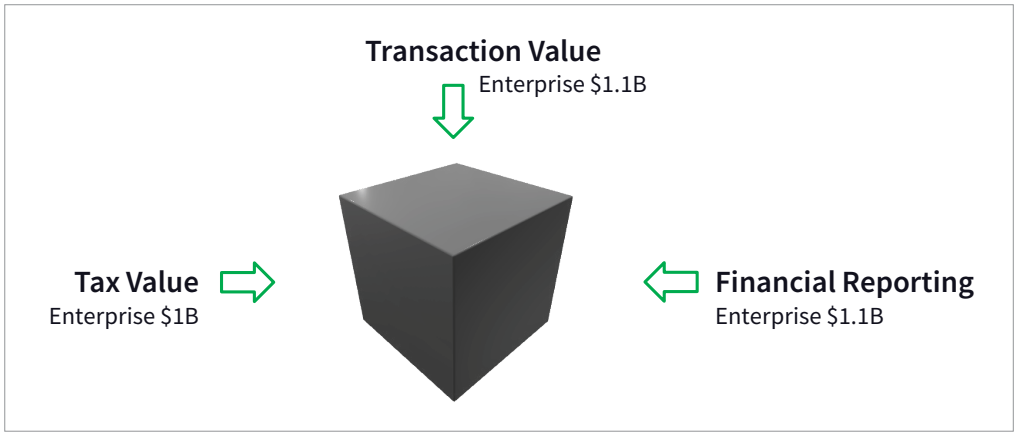


In this diagram, the conical shape represents a private company. Looking at it from three directions gives us three different values—tax, transaction or deal and financial reporting. In an ideal world, where the object has a more regular shape (such as a cylinder or cube), the three values (or views) will be similar. But since not all the processes and perspectives are defined in an early stage company, the irregularly shaped object more accurately supports the hypothesis that, for a growth stage company, the values can be divergent. In the diagram above, for example, the values range between $90M and $200M.

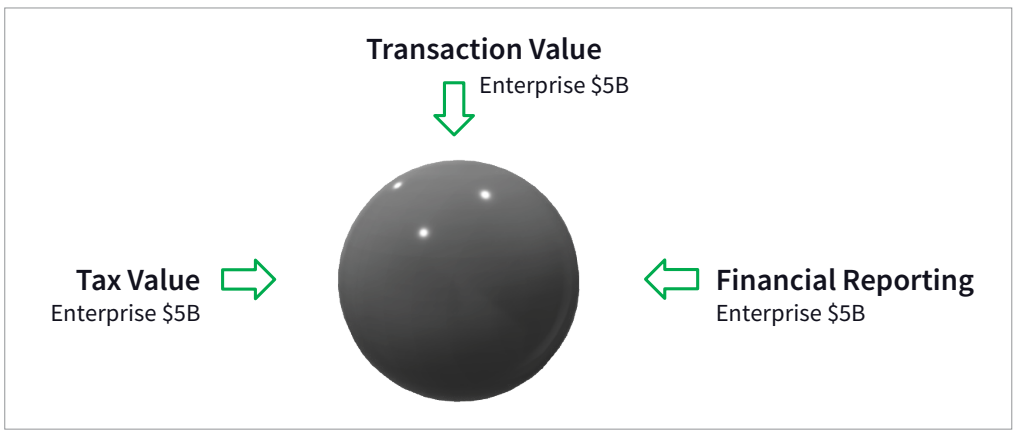
As the company progresses, however, and as more internal and external processes, perspectives and parameters are defined, the shape of the company would start to look more regular, like the diagram below.



In this example, a growth-stage company has divergent values, but the spread is narrower, shrinking from $90M - $200M (a 120% variance) to $250M - $300M (a 20% variance). Similarly, as the company transitions towards maturity, and as internal and external processes, perspectives, and parameters are established, we can expect the values to continue converging, and the company will start to look even more regular:



In the example above, the spread now is $1.0B - $1.1B (a 10% variance, or a difference of $100M, which is much narrower than it was in the early stage). If we take the trend to its logical conclusion, we can see that if the same spread was charted for a public company, it would look like the diagram below, which represents a 0% variance.



How else are early-stage or venture companies different than pre-IPO or PE-backed companies? Let's look at some key differentiators:

- **Different Asset and Investor Profiles** – The finance teams for PE and venture portfolio companies have different types of experience, and their valuation expertise is different. The valuation methods, allocation methods and analytics around valuations are different. The investment thesis, holding periods and holding structures are different. The availability of data—both historic and pro forma—are also different.
- **Evolution of Best Practices** – PE as an investment option has been in existence for many decades, and the valuation methods are more traditional, and require traditional valuation approaches, such as DCF, guideline public companies and guideline transactions. Venture, on the other hand, has only evolved over the last 20 years. The first official guide on valuation methodology—a cheap stock guide—was only issued in 2013. Globally, valuation methodologies for venture are relatively new, and not fully accepted. Most jurisdictions outside US are still struggling in identifying best practices for venture and early-stage companies.
- **Audit/Compliance Expectations** – The audit teams and audit review process for venture and PE are also different, and most non-VC focused audit teams do not know how to value or review venture companies. Our valuation team witnesses this every year. If a PE auditor reviews venture reports, clients have to provide guidance in order to familiarize them with the dynamics of early-stage companies.

The table below outlines the parameters that affect the overall structure and processes for a company in each stage of growth.

	Early Stage	Growth or Pre-IPO	Mature
Investor Type	Angel, Seed or early venture	Venture, Corporate VC, strategic, early stage PE	Strategic, PE, Corporate VC, LPs
Valuation Methods	Backsolve, Post Money	Market Approach, Backsolve, Post Money	Market Approach, Transaction Approach, Post Money, DCF
Allocation Methods	Option Pricing Model OPM), Waterfall	OPM, Waterfall, Common Stock Equivalent (CSE)	Waterfall, CSE
Audit Scrutiny	Low	Medium-High	High
Tax Exposure	Low	Medium	High
GP Involvement	Low-Medium	Medium-High	High
LP Attention	Low	Medium-High	High
SEC Scrutiny	None	Low-Medium	High
Dispersion in Values	High	High-Medium	Low

And wait—it gets more complex.

Within the venture capital bucket, there are two categories – traditional VCs and corporate venture capital.

Let's discuss corporate venture capital (CVC), which are the investment arms of public companies. CVCs function like traditional VCs, except for one difference: they have only one LP—the parent public company. And historically, they, too, were marking their valuations per the guidelines supplied by the authorities and capturing those valuations as "other comprehensive income." With the introduction of ASU-2016-01, they now must run their unrealized gains or loss through net income and then run that exposure through earnings per share (EPS).

For example, if a CVC invests in an early-stage company, we would expect a divergence in value as highlighted in the chart depicting an early company. Which value should they mark to? If the post money value is $200M and financial reporting value is $180M, how would they justify the write down?

Why does that even matter? It does. In a BIG way.

As you can see, private-company valuation is an incredibly complex area, and the choice of methodology will be impacted by many variables. In our next article—the third and last of the series—we will look at some of the nuances within venture capital that can significantly impact valuation calculations. Stay tuned...

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