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Exceptions to Standard Valuation Assumptions: Coloring Outside the Lines

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The ever-changing and sometimes disruptive nature of a venture-stage company requires a thorough analysis of its moving parts when completing a report. While some standard assumptions can be made when considering transactions and financial performance, these are not always going to be a one-size-fits-all solution.

Ideally, your assumptions will be tailored to the latest information available and dynamic to adjust for the changes in the management team's outlook period to period. For example, you may be looking at a potential exit event that has taken longer than expected to prepare, or a new direction that will ramp up operations based on additional partnerships. These sorts of variables should be considered when making notes around various exceptions, such as extending an exit time frame instead of rolling forward the 3-year exit period considered in the last report.

Ultimately, it's acceptable to 'color outside the lines' in order to communicate the bigger picture. In this article, we'll look at some of the areas where a non-traditional approach may help you enhance the clarity and accuracy of your valuation.

Historical versus projected performance

When looking at financial history and deciding how to properly weight historical versus projected performance for the same subject company that is being examined over time, the best indication is whether or not the company met its milestones in the year prior.

EXAMPLE:

If the company projects to deliver a substantial increase in revenue but never seems to reach that value, it is time to reduce the weight of projected performance. With proper documentation, straying from the traditional 25% / 75% on historical/projected figures is perfectly acceptable.

A traditional weighting for historical versus projected financials in the Guideline Public Company market approach is 25% placed on historical and 75% placed on future performance. The logic behind this assumption is that these venture-stage companies place more value on where they expect to be in the next twelve months than where they have been for the last twelve months. This is acceptable given the rapid expansion of operations and accelerated growth during the early stages of a business. It is up to the preparer to determine just how much weight should be placed on the historical versus forward-looking financials received. Any deviation from the 25/75 weighting application is best footnoted to prevent confusion or misrepresentation.

EBITDA and positive cash flows

Another example of an exception to a traditionally accepted rule involves EBITDA and the length of time that positive cash flows have been realized.

Although a company may have started to recognize positive cash flows, it still might not be time to actually consider this as a part of the indication of value. Many times, there are fluctuations with positive EBITDA as early profitability recognized is somewhat unstable and the company can reach this through different avenues. However, the sustainability of historical EBITDA figures can only be confirmed by speaking with the management team and adjusting accordingly.

This aligns with the practice of drafting footnotes for a possible omission of EBITDA multiples, despite showing positive EBITDA in the report. This issue is fairly standard when this scenario is presented in the analysis, especially if the company's value was not derived from EBITDA indications in the past.

Revenue fluctuations

In some instances, a subject company being valued has begun to generate revenue, but the most recent transaction is still the best indication of value. This could be due to specific pricing inputs that drove negotiations, or a situation in which the significant revenue generated is still not quite considered stable or significant in the eyes of the management team (or the preparer, for that matter).

On the other side of the coin, the company may recognize steady revenue for a longer period of time, and raises a new round of financing in the near term in relation to a report date. There are instances when revenue is still the best indication of value, and the terms set in the new round are not reflective of the company's performance. Significant revenue can be reached at different levels based on the subject's operating sector and overall stage of development. While it is a subjective term, with thresholds that vary from industry to industry, a good rule of thumb is to define it around the $7.5 - $10 million mark. Again, it is important to take these considerations on a case by case basis, and not apply a blanketed approach to all reports since each entity will exhibit different attributes.

External estimates

Other indications of value from external sources can be brought into the fold as well, where they may take priority over the main tried and true methods. These indications can come in the form of letters of intent to acquire the entity (whether partial or full) where terms ideally have been discussed and presented to the target's management team. In order for this to be considered as a reasonable indication, a formal discussion needs to have taken place, with both parties including a proposed value for the investment.

Keep in mind that an LOI, post money or recap proposal may be well above the market and/or backsolve indications derived from the company's underlying information. In some instances, a market approach or backsolve may help to corroborate the external appraisal of the company's value given the merger or acquisition pricing. In these instances, more background should be included to support the weight assigned to each separate indication. As long as meaningful commentary can be recorded and reflected within the report surrounding a proposal and the information is known or knowable as of the report date, these more unique circumstances are still acceptable to include in a report to drive the final value.

Documentation is key

The main point to keep in mind when making changes to traditional assumptions is that this will usually draw some attention with questions behind deviation from standard reporting guidance. At the end of the day, it's still acceptable to color outside the lines where inputs and assumptions should be applied that enhance an opinion to best reflect the subject's growth, risk and profitability. So, as it has been stressed before, add a footnote! This will give the reader a clear window into the thought process behind the exception and help them understand why it was contemplated and warranted.

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