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Meeting the demands of a new valuation era

Surprises are great on birthdays, but terrible during year-end audits.

With today's ever-changing regulations regarding valuations, it's all too common to confront the unexpected during the valuation process. Year after year, the audit community revises some element that affects the foundation or framework of valuation practices. Valuations can no longer be calculated on the back of an envelope or based solely on transactions or single data points. They are now one of the most integral and most heavily scrutinized elements in the reporting process. In fact, a recent survey by Prequin showed that 70% of LPs and 40% of GPs surveyed believe valuations to be the biggest challenge facing the industry in 2016.[1]

If you're not in line with audit expectations or up to speed with accepted practices, you're playing a high-stakes game that could end up in year-end write-downs or—even worse—a loss of credibility with your co-investment partners and LPs.

This guide provides five easy steps for a surprise-free valuation audit. By being proactively aware of these five best practices, you can gain a clear understanding of today's complex reporting requirements and sidestep unpleasant surprises at year-end.

1 Understand acceptable valuation approaches

Post money values are still one of the most commonly referred-to metrics in deal making. However, since the application of Topic 820, the audit community has stopped accepting post money as the de facto value of companies and has started requiring more comprehensive models. The main reason behind this shift is that post money assumes the most optimistic outcomes and ignores the differences among the various classes of equity. Auditors needed a better way of establishing the overall valuation of investor holdings so they could arrive at the value of the individual share-class holdings.

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When equity investors view the overall valuation in terms of post money, this does not account for the terms and preferences of individual classes of stock. This is a problem because it doesn't make sense to equate the highest preferred stock values with common stock values. This would be acceptable if a company were performing extremely well and all investors were able to convert their shares at the same time. But even in the best-case scenario, not all stock classes are guaranteed conversion at the time of the exit.

While it's true that prices in a post money calculation are considered arm's length between a willing buyer and seller, it's important to remember that the entire company did not change hands in the transaction. Only a small percentage of the overall ownership was exchanged.

Therefore, it's more advisable to assign that transaction price to only the current round of preferred stockholders. This number becomes the first data point for determining the valuation of the remainder of the stock classes. This approach is very much in line with the 409A requirements of portfolio companies, which need to assess stock in accordance with the terms and conditions of the equity waterfall before determining the current value of stock options for tax reporting. Although 409A methodologies vary, they're all based on the premise that preferred classes of stock may carry a higher value based on liquidation preferences and seniority.

[1] 2016 Preqin Global Private Equity & Venture Capital Report (http://bit.ly/2fb0aWb)

Because of these factors, it's essential to emphasize to your co-investing partners that post money values should not be the sole input in determining the valuation of your investment, but should be viewed as one of many data points that help corroborate the final value and investment thesis.

Other valuation methods that could be used to corroborate value include:

- Option Pricing Model
- Market Approach (Guideline Public Companies)
- Market Approach (Guideline Transactions)
- Income Approach (Discounted Cash Flows)
- Probability Weighted Expected Returns Method (PWERM)

2 Corroborate to strengthen your case

To give your valuation output added strength and acceptance, it's important to consider whether all or some of the valuation approaches mentioned above may be applicable to valuing your portfolio company.

While technically it's acceptable, per Topic 820, to rely on only one reliable valuation approach that's reasonably applied, it's far preferable to use a second method as well. If a company has normalized revenues when backsolving to a recent round, the value derived should be supported by a market or income approach—whichever is more applicable. When disparity between approaches is greater than commonly acceptable, conduct a subjective analysis to determine the best approach. Use appropriate reasoning based upon deal terms and the facts and circumstances of the investment.

Disparities between the methods can be prevalent when companies offer preferential deal terms to provide downside protection to those participating in later rounds. These preferential terms can greatly impact the allocation of proceeds in your models, which—if not taken into account—can result in serious adjustments to your carrying values during your year-end process.

3 Know your deals - inside and out

To understand how to value your company, you need to understand the deal terms as well as how the company is performing against its respective plans. There are many key provisions that go into a term sheet besides price per share, post money value, and total amount raised. Understanding key terms and their impact on your valuation model—including why the terms were agreed upon in the first place—is critical.

When defending your valuation position and approach to your auditors, know how the deal was negotiated and what the investing partner's main motivation for investing was. This will help your internal finance team determine if a round can be defined as arm's length and provide a good data point for the valuation work. It will also make the auditors more comfortable with the way you carry value.

Digging deeper into deal terms

In today's valuation world, deal terms are more important than the overall post money or issue price. To align with model-based valuation approaches under the Topic 820 framework, make sure you know your key terms and conditions as well as their impact on liquidation payouts and valuation models. There are many consistent terms across deals, but sometimes these vary from investment to investment. Not identifying these terms on in-house valuations can lead to inaccurate valuations on interim financial statements and

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year-end write-downs. In the worst cases, deals may fall apart because of a disagreement about the terms that the investing partners and portfolio companies spent months negotiating.

Liquidation preferences

It's imperative to pay attention to negotiated payout preferences when performing valuations. Given the risk of investing capital in early-stage companies, venture investors typically negotiate the right to have their investments return prior and in preference to other investors and option holders. These preferences are commonly associated with a multiple; for example, "1x" means "one times the original issue price."

For the majority of portfolio companies, classes of preferred stock carry a 1x liquidation preference. This means that if there is a liquidity event involving the portfolio company, the holders of the preferred stock are entitled to receive a payout equal to the original issue price of the security, after debt is paid out but before other classes of equity are paid out.

In certain circumstances, the purchasers of preferred securities may negotiate a higher multiple for the liquidation preference. With a higher multiple (most commonly 2x or 3x), the preferred class of stock would be paid out based on that multiple of the original issue price for every share held (in an attempt to lock in a positive return, despite a range of negative outcomes). These favorable preferences increase the intrinsic value of the preferred security while being punitive to the valuation of other share classes.

Pari passu versus ranked preference

The seniority of preferred securities can greatly affect payouts when the exit price is below a level at which all stock converts to common.

When a preference is pari passu, the classes of preferred stock are paid out together, with each class returning their liquidation amounts simultaneously. If Series A and Series B are pari passu, for example, they will be paid together prior to any value being distributed to holders of common stock. If proceeds are not enough for each to return its entire liquidation preference, Series A and Series B investors will share the proceeds owed to them pro rata, with common shareholders left out of the money.

With ranked preferences, Series B would typically be senior to Series A and would therefore return its entire preference amount prior to the Series A or common shareholders receiving any proceeds.

When performing valuations, understanding how modeling these preferences impacts the waterfall distribution will help you determine the fair value of your holdings.

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Participating preferred stock

"Participating preferred" is an investor-favorable term that means it both limits the downside and enhances the upside of the investment. It's also one more reason why share classes need to be considered carefully when valuing a company. When this method is used, investors may receive the benefit of preferred stock to be paid first, as well as the right to share in payouts with common holders.

The amount of sharing in common stock can be either "capped" (most commonly at 2x or 3x the securities' original issue price) or "uncapped." When the participation is uncapped, the preferred security is not incentivized to convert to common stock since it achieves the best of both worlds: receiving its full preference in seniority to common shareholders and receiving its full pro rata as if it converted to common.

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4 Engage stakeholders early

As you define your valuation process, keeping both internal and external stakeholders involved in the process will help pave the way to a smooth year-end audit.

When discussing and documenting the reasons behind nonstandard terms with your GPs or deal teams, you can easily build a case during your year-end audit to support your decision to rely on certain aspects of a deal term while discounting others. These internal discussions also assist in aligning the expectation of the GP in terms of how these deals will affect carrying values, and why the post money valuation may not be presented on your audited financial statements.

When deals with high valuations and/or nonstandard deal terms close during the year, reach out to your auditors early. The earlier you engage them, the earlier you can both work together to adopt a strategy for valuation with which all parties can be comfortable. These discussions are much easier in August than in December or January, especially if the discussions involve a reduction in carrying value compared to what was published in the preceding quarterly financials.

Don't limit stakeholder engagement to nonstandard deals alone. Work with your auditors to create a comprehensive valuation policy that defines the situations and thresholds that guide your application of the various valuation approaches. By taking the initiative and communicating early, often, and consistently, you can gain buy-in from all stakeholders long before year-end and ensure that valuations hold no surprises for them.

5 Define and document consistently

As more attention and scrutiny is placed on portfolio-company valuations, firms are forced to be proactive in gaining a greater understanding of the details of their investments. A lack of insight into deal details can severely elongate the audit cycle and cause uncomfortable valuation adjustments at year-end. By implementing some best practices around documentation, you can reduce the stress and surprises that can accompany the audit cycle and continue to build relationships of trust with your LPs, co-investors, and audit teams.

A smooth year-end begins with a comprehensive valuation policy. Review your policy with your audit team and agree on ways to group your companies based on their similarities. Profitability and the timing of the most recent financing events create good initial grouping categories that can then be further classified by industry, size, and growth rates. Include as much detail in your policy as possible, including approaches to selecting market multiples, volatilities, and exit times.

Once your portfolio has been bucketed into workable groups, your valuation policy should address the standard approach that your accounting team will use for these classifications of portfolio companies. Again, include your auditors and gain agreement on these standards along with the minimum documentation requirements for companies that fall cleanly into these classifications. From there, during your valuation work, you can rely on your standard approaches and document any deviations from the valuation policy.

Although a robust valuation policy can be instrumental during the audit process, best practices are not just limited to the year-end work that is done for audit. Avoid manual models and develop a systemized approach to recording the transactions and refreshing valuations as events occur. That way, you won't be faced with a backlog of catchup work as year-end approaches. Proactively reach out to your deal teams to understand the investment thesis and thought processes behind how the deal was priced, along with any details about how and why nonstandard terms, if any, were negotiated into the round. Understanding all these elements will enable you to write a clear valuation narrative that explains your outlook on the investment and supports your valuation decisions. Providing these narratives to your auditors along with your valuation models will enable them to efficiently perform their work and document their conclusions with minimal need for time-consuming question-and-answer sessions to explain the reasoning behind your selections and conclusions.

Proactively reach out to your deal teams to understand the investment thesis.

Enhanced oversight for a new era

Regulators and LPs are demanding greater consistency, accuracy, and transparency regarding portfolio company valuations. To fulfill their requirements, you need to not only use accepted valuation formulas, but also document the thought processes you used to make key decisions during the valuation work.

In this new era of increased oversight, understanding the terms of your deals and having a clear, consistent, systemized valuation approach in place will help you meet the requirements of regulators, auditors, and investors; eliminate hours of extra work during the valuation audit cycle; and avoid unexpected valuation adjustments and delays that can harm your reputation.

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