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Why Private Company Valuations Matter

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High flying venture backed companies are a casual occurrence in today's market with firms like Airbnb, Snapchat, Uber and Spotify not only leading the news but also becoming a part of everyday lives. We almost forget that they aren't publicly traded but 'know' they are worth billions. In fact, this scenario is so common that the market coined the phrase 'unicorns' for privately-held venture backed companies worth over a $1 billion and 'decacorns' for venture backed companies over $10 billion. Yet flashy news articles aside, given that there are a handful of investors and owners in each business and they aren't subject to the ebbs and flows of the often fickle public company markets are they really worth billions? Is Uber worth more than Ford?

In order to truly answer this question, it is important to understand how a privately-held venture backed company can actually have a publicly-known value. Generally the only indication of value that is released to the market is the amount and percentage of the company that investors purchased (aka the last round). The media will then calculate a value of the company known as post money. Post money value is the last round issue price times the total number of shares issued. For example:

Type of Security	Seniority	Issue Date	Issue Price	Preference	Shares	Participation
Series A	1	June 2010	$1.00	1x	1,000,000	Yes
Series B	2	August 2011	$2.50	1x	5,800,000	Yes
Series C	3	November 2013	$6.20	1x	11,500,000	Yes
Series D	3	March 2016	$21.50	1x	23,000,000	Yes
Common	4	NA	NA	NA	10,000,000	Yes

If we were to calculate the post money value of the above company upon issuance of Series D -

- Issue price of Series D * Total no. of fully diluted shares in the company = post money for Series D as of March 2016
- $21.50 * (1,000,000 + 5,800,000 + 11,500,000 +23,000,000 + 10,000,000) shares
- $21.50 * 51,300,000 share = $1,102,000,000
- $1.1B

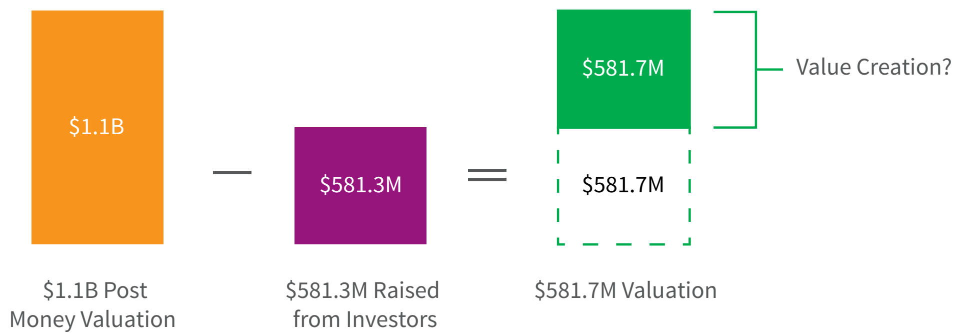
Yes, that's billion with a capital B. Now that is a lot of money!

But how much money has the company raised from investors? Let's see...

Type of Security	Issue Date	Issue Price	Shares	Capital Raised
Series A	June 2010	$1.00	1,000,000	$1M
Series B	August 2011	$2.50	5,800,000	$14.5M
Series C	November 2013	$6.20	11,500,000	$71.3M
Series D	March 2016	$21.50	23,000,000	$494.5M
			Total:	$581.3M

So we are comparing $581.3M as amount raised to post money (aka 'valuation') of $1.1B, basically implying that company has created value worth $1.1B - $581.3M = $518.7M

Is that really true? Are post money or amount raised true benchmarks of value or value creation?



Sometimes. They are definitely the most commonly used ones.

Most readers of social media or blog posts do not understand the terms and conditions the preferred money comes with. If you review the columns in Table 1, notice the T&Cs of seniority, liquidation preference and participation. These are just a few for illustration. There are other strings investors can attach to their money including: dividends, participation caps, management carve outs and sliding preferences to name a few. For the most part such terms take value away from the overall distribution on exit because the preferred shareholders will pull monies away per such terms.

The underlying question to all the above is, "why are private company valuations important"?

Well, let's consider a statement from Mary Jo White, Chair of the SEC, from March 31, 2016 in Silicon Valley.

> "And beyond any specific regulatory requirements, some of the principles that characterize public companies – transparency with investors, controls on financial reporting, strong corporate governance – have applicability and relevance to private companies, especially those pre-IPO companies that aspire to go public, and should not be overlooked or avoided, whether or not mandated by federal law or an SEC regulation."

This indicates that the regulators now too are starting to pay attention to private company valuations.

So when we hear of another private company's billion dollar valuation, let's "look before we leap" and recognize that unless the buyer bought the entire company it doesn't always translate.

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