

THIS JUST
IN.....

Recently, the Private Equity and Venture Capital Taskforce of the AICPA published an Accounting and Valuation Guide entitled,

'Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies'.

PURPOSE OF THE GUIDE

The Guide was developed specifically for investment fund and venture capital fund managers, auditors, and valuation specialists. It addresses a variety of investment types, across different stages of investment and related life cycles of portfolio companies.

Objectives of the Guide include identifying certain requirements under financial reporting standard ASC 820, and providing best practices guidance for financial reporting issues not put forth by the FASB under ASC 820

PURPOSE OF THE GUIDE

Provides **practical examples** for **preparers of financial statements, independent auditors, and valuation specialists** regarding the accounting for and valuation of portfolio company investments held by investment companies **within the scope of FASB ASC 946, *Financial Services—Investment Companies*** (including private equity funds, venture capital funds, hedge funds, and business development companies).

ACCESSING THE GUIDE

The Guide is published and copyrighted by the AICPA.

It's available at:

www.aicpastore.com

STRUCTURE OF THE GUIDE

The Guide's Fourteen Chapters cover a *broad range of industry specific valuation topics* and examples; Chapter 14 contains Frequently Asked Questions covering a broad range of investments and valuation issues

Its *Appendix C* also provides Case Studies of practical applications for best practices.

Appendix c: valuation case studies

The examples in *Appendix C* illustrate a broad spectrum of situations, covering different investment strategies (e.g. LBO, early-stage venture capital investments and BDCs) and industries (e.g. real estate, biotech, software, cleantech, oil & gas, medical devices, among others; including capital intensive and low capital growth businesses). The introduction to the appendix provides a summary to assist practitioners in quickly identifying those examples that are most relevant for a specific valuation need.

Some COMMON Valuation issues Addressed in the Guide's Case Studies include:

If there is a recent financing round, when is it considered reasonable to price all equity classes at the same price per share?



If a portfolio company is not yet generating revenue, is it reasonable to leave the fair value indication at cost, since there is no indication as to how the next round will price?



What valuation methodologies should management consider when there has not been a recent financing round, relative to the valuation date?

CHAPTER 2 – FAIR VALUE AND RELATED CONCEPTS

Fair Value is defined by:

- FASB ASC Topic 820 (fka SFAS 157),
- IFRS 13, and
- GASB (US Government Accounting Standards Board) Statement 72

as:

*... the 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.

CHAPTER 3 – MARKET PARTICIPANT ASSUMPTIONS

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- They are independent of each other
- They have a reasonable understanding about the asset or liability and the transaction
- They can enter into a transaction involving the asset or liability

For the purposes of this discussion, relevant market participants are other investors willing and able to transact in the investment being valued, at the reporting date

CHAPTER 3 – MARKET PARTICIPANT ASSUMPTIONS

Market participants and the information they would evaluate will depend on the characteristics of:

- **The portfolio company**

- Industry, stage of development, product pipeline, market opportunities, management depth

- **The specific position being valued**

- Economic Rights including: downside protection, dividends, upside protection

- Non-economic Rights including: information rights, debt covenants, board seats

- **The industry and overall market conditions**

- Expected growth and profitability, level of competition, required rates or return or multiples

CHAPTER 4 – UNIT OF ACCOUNT

FASB 820 and FASB ASC 946 do not provide specific guidance regarding the determination of the unit of account for the instruments held by funds. *The unit of account is best represented by how a market participant would transact in the security – either as an individual security or grouping of assets – to realize the economic best interest, given the investment strategy.*

Similarly, the task force believes that the assumed transaction for purposes *of valuing the investments may consider a grouping of assets in a given portfolio company held within the fund (e.g. the debt and equity together) to the extent that is how market participants would transact.*

CHAPTER 4 – UNIT OF ACCOUNT

- Market participants generally consider cash flows received from the measurement date through the liquidity event, factoring in the market participant's required rate of return
- Assumptions used to determine fair value should be consistent with the expected time horizon a market participant would expect for the investment– Impact on value of a controlling versus minority interest upon change of control
- Calibrating the valuation analysis to the transaction price will account for the impact of the probability and timing of a change in control, giving consideration to the market participant's required rate of return

CHAPTER 10 - CALIBRATION

CALIBRATION IS REQUIRED BY GAAP/ASC 820

- Calibration of input assumptions to an observed transaction
- Update of calibrated inputs at subsequent measurement dates

- **When is a transaction a reliable indication of fair value?**
- **How to apply calibration in valuing a debt or equity investment in a business using the income approach and market approach**
- **Inferring value from other transactions in the portfolio company's instruments or secondary market activity in a company's stock**
- **Consideration of other valuations performed for a portfolio company**

CHAPTER 5 – OVERVIEW OF VALUATION APPROACHES

What Valuation Approach is Appropriate from a Market Participant Perspective?

- Application of informed professional judgement
- Consideration of facts and circumstances of the portfolio company and securities being valued
 - Business operations
 - Stage of development
 - Customers and Competition
 - Exit strategies
 - Characteristics of the subject securities

CHAPTER 5 – OVERVIEW OF VALUATION APPROACHES

The Guide addresses selection of valuation methodologies at both the portfolio company level, and at the level of the subject investment unit of account

– **Market Approach**

- » Guideline Companies Method
- » Similar Transactions Method
- » Transactions in Subject Security

– **Income Approach**

- » Discounted Cash Flow
- » Discount rate adjustment technique
- » Expected present value technique

– **Asset Approach**

CHAPTER 6 – VALUATION OF DEBT INVESTMENTS

Fair Value of Debt Instruments (when Debt is the Unit of Account)

- Change of control provisions
- Synthetic credit ratings
- Prepayment features (call or put rights)

• Value of Debt for the Purpose of Valuing Equity

- Proxies for measurement of debt
- Change of control provisions

• Decline in the fair value of debt and effects on enterprise and equity value

CHAPTER 9 – CONTROL AND MARKETABILITY

• Control Premium

- Definition of a controlling interest
- Relationship between control premium and transaction price
- Task force's view on the inclusion of a control premium in the enterprise value used in valuing a fund's interest in a portfolio company
- Situations where a control premium or discount may be appropriate

• Marketability

- Definition of marketable versus nonmarketable investments
- Task force's view on the application of a marketability discount to the enterprise value of the portfolio company as a whole
- Task force's review on the application of a marketability discount to various equity interests within the portfolio company

• Assessing Discounts or Premia via Calibration

CHAPTER 11 - BACKTESTING

The PE/VC Task Force (task force) believes that it is a best practice for investment companies whose financial statements are based upon fair value estimates to perform periodic (for example, quarterly) backtesting on investments which have had subsequent realizations, liquidity or other significant events, comparing the implied value from the transaction to the fair value estimate from the most recent analysis as well as valuations from other prior periods that may be deemed relevant.

CHAPTER 7 – VALUATION OF EQUITY INTERESTS IN SIMPLE CAPITAL STRUCTURES (ONE CLASS OF PREFERRED EQUITY OR ONE CLASS OF COMMON EQUITY)

- Assumes sale of investment in the enterprise on the valuation date
- Market participant would be other private equity or venture capital investors, unless it would be optimal for the fund to be actively marketing the position in a different market
- Considers the enterprise value consistent with
 - cash flows and capital structure that market participants buying an interest in the enterprise would expect considering the post-transaction ownership(through the expected liquidity event, if any). Specifically, market participants transacting in the equity interest would consider the portfolio company's plans given the investors who in the aggregate have control of the business and the expected time horizon for the investment.

CHAPTER 8 – VALUATION OF EQUITY INTERESTS IN COMPLEX CAPITAL STRUCTURES (MORE THAN ONE CLASS OF PREFERRED AND COMMON EQUITY)

- **Scenario-based methods**

- Simplified Scenario Analysis
- Relative Value Scenario Analysis
- Full Scenario Analysis

- **The OPM**

- Senior and junior preferred classes of equity
- Limitations of the OPM

- **The Current Value Method ('Waterfall Method')**

- Liquidity event by acquisition or dissolution
- Equity being valued has seniority over other classes of equity

- **The Hybrid Method**

- A hybrid of scenario-based methods and OPM

CHAPTER 13

– special topics

- **Enterprise has traded securities**

- P*Q Rule
- Underwriter lockups and SEC Rule 144A
- Similar vs. identical securities
- Significant decrease in volume or activity or distressed transactions

- ***Pricing services, broker and dealer quotes***

- Background*
- Management responsibilities*

- **Indicative Offers**

- **Insider financing rounds**

- ***Early stage companies with no recent financing rounds***

- **Rights and privileges not enforced**

- **Commitments to portfolio companies**

- Loan commitments
- Equity commitments

CHAPTER 13

– special topics

- **Guarantees**

- **Dilution**

- Anticipated future dilution
- Changes to anticipated future dilution
- Impact of share-based awards
- Current dilution
- Summary

- **Options and Warrants, Convertible Notes and Related Instruments**

- **Contractual rights (*Contingent Consideration*)**

- **Private Fund Interests**

- NAV Practical Expedient
- Alternatives to the NAV Practical Expedient
- Secondary Transactions in an Interest in a Private Fund
- Discounted Cash Flows

CHAPTER 14

FAQ:

CARRYING VALUE AT COST

Q: Is there a rule of thumb for a timeframe during which it is permissible to carry our investments at cost from the date of our initial investment (e.g., a one year safe harbor?).

A: No. Although in some cases, value may not change significantly over a short period of time, in other cases, value can change dramatically overnight. The objective of the fair value measurement is to reflect the exit price for the investment at the measurement date.

CHAPTER 14

FAQ: HOLDING VALUE AT COST

Q: My portfolio company isn't generating revenue yet. Can't I just leave it at cost since I don't know how the next round is going to price?

A: The objective of the fair value measurement is to reflect the exit price for the investment at the measurement date; thus, holding investments at cost would generally not be appropriate.

Calibration may be used to assess the inputs to the valuation model that are consistent with the entry price, provided that the transaction price reflects fair value at initial recognition, and then at later measurement dates, these inputs would then be updated to reflect company-specific progress and current market conditions

Early stage companies with no recent financing rounds

The best choice will very likely involve a technique that “rolls forward” the value obtained from a previous (now stale) financing round that reflected fair value at initial recognition.

CALIBRATION:

Performing an analysis as of the most recent financing date to ensure that the starting assumptions used in the model are consistent with market participant assumptions for the transaction.

- Is the entity performing in accordance with its business plan?*
- Have any significant value events (internal or external) occurred since the previous financing round?*
- Does the entity need additional financing to survive to a successful exit event?*
- Is the entity attempting to raise additional financing as of the measurement date?*

Unless the circumstances suggest that nothing of significance has occurred since the most recent transaction, the updated value should be carefully tested for reasonableness, and supplemented with additional scenarios as necessary. The selection of additional analyses and scenarios is, as always, a matter of professional judgment.

CHAPTER 14 FAQ: TREATMENT OF EQUITY INTERESTS WITH DIFFERENT LIQUIDATION PREFERENCES

Q: How should the valuation appropriately capture the fair value of higher ranking (senior) and lower ranking (junior) classes of equity?

A: As examples in the guide illustrate, in some situations, seniority (or lack thereof) will have a significant impact on the value of an equity interest, while in other situations, seniority may have little or no effect on value. **At very early stages, the expected outcomes may be “bimodal,” such that all equity interests are expected to have similar values if the enterprise achieves success, and similar (\$0) values if the enterprise fails. At the other end of the spectrum, as some successful enterprises approach an exit event, market participants may assume with near certainty that the enterprise will exit at a high value in which all classes of equity will convert and share equally.**

CHAPTER 14

FAQ: ALLOCATION METHODS WHEN USING POST-MONEY VALUE

Q: I just completed a Series C financing for one of my portfolio companies, where the pre-money value was \$80 million with 16 million shares outstanding, and the financing raised \$20 million in primary capital for 4 million shares at a price of \$5 per share. If I'm using the post-money value of \$100 million to support my fair value estimate, does it matter how I allocate that value to my Series A and Series B shares?

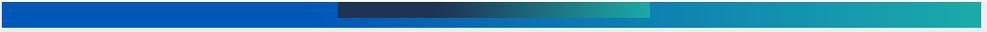
A: The post-money value assumes that the various classes of equity have the same value, and therefore, it is most commonly used with a simplified scenario analysis where market participants would assume that the liquidation preferences have little to no value. As discussed previously, sometimes liquidation preferences matter, and the values of different classes of equity may vary significantly. In such cases, it would be appropriate to apply an allocation method that captures such differences.

CHAPTER 14

FAQ: different values for earlier and later round investments

Q: Would you expect all investors to measure the value of a previous investment in a venture portfolio company which has a recent round of financing involving third-party investors at the value resulting from that round of financing?

A: It is each fund's responsibility to make its own fair value determination for its investment, given the interests it holds. If the rights of the interests are similar or the expected distribution of outcomes is bimodal, it is common practice for venture capital investors to estimate that the fair value of early rounds of financing would equal the transaction price for the latest round. However, as time passes and more rounds of financing are completed, the rights associated with newer rounds of financing may begin to deviate more from the earlier rounds, and the likelihood of a mid-value exit may increase. In those cases it would be common for the investors to have different perspectives on value based on differences in assumptions relating to the distribution of future exits, the associated payoffs to each class of equity, and risk.



WHAT BEST PRACTICES DOES THE GUIDE PUT FORTH RELATED TO ALLOCATING THE TOTAL EQUITY VALUE OF A PORTFOLIO COMPANY ACROSS BOTH SIMPLE & COMPLEX CAPITAL STRUCTURES?

The valuation methods in the AICPA Guide focus on estimating the fair value of the different classes of equity based on the future payoffs at the time of an expected exit/liquidity event.

The Guide identifies best practice valuation considerations when selecting a valuation methodology; Please see Appendix C , case Study #9 & #10 & Case Study #11 for detailed examples of methodologies/equity allocation, and Chapter 14 (highlighted items) for frequently asked questions related to equity and debt valuation

Overview of Valuation Methodologies / Equity Allocation for Complex Capital Structures

-Calibration: across the different potential valuation methodologies, the determination of fair value should consider calibration to a recent financing round and/or to a prior valuation analysis/model upon which the prior fair value indication was based; Calibration to the price paid at various financing points is the best way to ensure that the quantitative support for the fund's fair value measurements is consistent with market participant pricing. ***Note: The Guide considers this a best practice for valuation, please see Appendix C, Case Studies #9 and #10 & #11 for detailed examples;***

-Criteria for Selection of Valuation Methodology: (See Chapter 8, Begin at 8.14) :

- The **subject company's stage and nature of its operations**; as well as the remaining risks of achieving expected performance milestones and a successful exit/liquidity event
- The **expected time until an exit/liquidity event** and the amount of **future financing rounds required until exit**
- The **economic and control-based rights associated with the shares which comprise the subject investment**; and whether the rights of the subject shares are aligned with the class of shares which controls the timing of the portfolio company's sale/liquidity event

-Criteria for Selection of Valuation Methodology: (See Chapter 8, Begin at 8.14) :

Understanding Control & Economic Rights of Each Share Class: If the preferred classes have differing seniority, it is important to consider why the seniority was negotiated and who controls the decision about the nature and timing of the ultimate liquidity event

If new investors negotiated for seniority or greater than a 1x liquidation preference, the negotiations themselves may provide an indication that the liquidation preferences matter, so assuming a de minimis value for the liquidation preferences may not be reasonable.

-Criteria for Selection of Valuation Methodology: (See Chapter 8, Begin at 8.14) :

-Typical Liquidation/Exit Strategies: 1. *The portfolio company succeeds and either IPOs or has some other high value sale, in which case all interests in the portfolio company are converted in accordance with the conversion rights of each type of instrument so converted;* 2. *The portfolio company achieves some, but perhaps not all, of its target outcomes, in which case it is “liquidated” typically by a merger / acquisition transaction) and the proceeds from the “liquidation” are allocated according to a negotiated liquidation formula; or* 3. *The portfolio company fails, meaning investors lose their money.*

The Guide describes several methods for valuing equity interests in complex capital structures, including: 1. Scenario-based methods, and 2. the Current Value method (CVM), *These methods are illustrated by case studies See especially in Case Study #9, & Case Study #10 & Case Study #11*

Valuation Methodology #1: Scenario-Based Methods- Scenario-based methods focus on either (a) the current post-money value, or (b) a range of future exit values allocated to the various equity interests and then discounted to present value at the current valuation/ measurement date.

A .Simplified Scenario Analysis(See Chapter 8, Begin at 8.20): in this approach, value of the various equity interests are estimated based on their pro-rata share of the “post-money” value for the company, considering the maximum number of common-stock equivalents. The pro-rata share of the post-money value is also known as the fully-diluted value of equity.

The simplified scenario analysis approach may be appropriate if the distribution of outcomes for the portfolio company is expected to be bimodal, with immaterial value on the downside for any liquidation preferences on preferred shares; that is, if the portfolio company is either expected to succeed, exiting at a value that is high enough that all classes of equity will monetize at the same price, or the company will fail, exiting at a low value that would provide no payoff to the existing classes of preferred; or , in instances where the later equity rounds have additional preferences but the earlier rounds have control over the timing of the portfolio company’s exit.

A .Simplified Scenario Analysis(See Chapter 8, Begin at 8.20): In these situations, the liquidation preferences for the preferred stock would be expected to have no impact on the ultimate payoff realized, and thus, **the future payoffs would be consistent with a fully-diluted approach for measuring the value of the equity interests on the valuation/measurement date.** The post-money value used as an input to a simplified scenario analysis would be calibrated to the company's latest financing round, and then updated for each measurement date considering the changes in the company and the changes in the markets. *See Appendix C Case Study #9 and #10 & Case Study #11 for examples*

B. Relative Scenario Analysis (See Chapter 8, Begin at 8.24) - As time passes and more rounds of financing are completed, the economic and control rights associated with newer rounds of financing may begin to deviate more from the earlier rounds, and the likelihood of a mid-value exit may increase. In those cases, it would be common for the investors to have different perspectives on value based on differences in assumptions relating to the distribution of future exits, the associated payoffs to each class of equity, and risk. Under a relative value scenario analysis, the value of the various equity interests are estimated based on their pro-rata share of the post-money value for the company calibrated to the most recent round, considering the common stock equivalents, and then adjusted to consider the differences in expected cash flows and difference in risk for the earlier rounds of financing.

B. Relative Scenario Analysis The post-money value used as an input to this analysis would be calibrated to the most recent round of financing considering the range of future exit scenarios, and then updated for each measurement date considering the changes in the company and in the markets, evaluating the changes in the expected future exit values in all success and mid-value exit scenarios and on market participants' required rate of return for the equity interests. *See Appendix C, Case Study 9, Case Study #10, and Case Study #11 for examples*

B. Relative Scenario Analysis Typically, a simplified scenario analysis or relative-value scenario analysis is calibrated to the most recent financing transaction date, and then updated to reflect the changes in the post-money value through the measurement date. If the post-money value considering common-stock equivalents is estimated by considering a future exit value, then these methods should incorporate an estimate of the dilution from future rounds of financing required to reach that exit. **Estimated dilution would be incorporated as discussed in paragraphs 13.65–.76, “Dilution.”**

C. Full Scenario Analysis(PWERM) (See Chapter 8, Begin at 8.29). Share value is based upon the probability-weighted present value of expected future investment returns, considering each of the possible future outcomes available to the portfolio company, as well as the rights of each share class. The future exit scenarios and required rate of return would be calibrated to the most recent round of financing.

C. Full Scenario Analysis(PWERM) (See Chapter 8, Begin at 8.29). The required rate of return for other classes of equity would be assessed considering the relative risk of each class. Typically, a full scenario analysis approach is used when the company is close to exit and does not plan on raising additional capital. ***See Appendix C Case Study #9 and #10 & Case Study #11 for examples***

Valuation Methodology #2 : The Current Value /Waterfall Method (CVM) (See *Chapter 8, Begin at 8.54*) of allocation is based on first estimating equity value on a controlling basis, assuming an immediate sale of the portfolio company, and then allocating that value to the various series of preferred stock based on the series' liquidation preferences or conversion values, whichever would be greater. ***CVM focuses on the present and is not forward looking, the task force believes its usefulness is limited primarily to two types of circumstances. One, when a liquidity event in the form of an acquisition or a dissolution of the portfolio company is imminent, and expectations about the future of the portfolio company as a going concern are virtually irrelevant and the investors who hold this class of equity have control over the timing of exit***

Valuation Methodology #2 : The Current Value /Waterfall Method (CVM) *In this case, the investors could sell the portfolio company on the measurement date and their position would realize the allocated value from the CVM .* A limitation of the method is that it is **not forward looking and fails to consider the option-like payoffs of the share classes and, therefore, may not appropriately reflect the way that market participants would realize value from the interest.** That is, absent an imminent liquidity event, the method fails to consider the possibility that the value of the portfolio company will increase or decrease between the valuation date and the date at which common stockholders will receive their return on investment, if any.

CHAPTER 14

FAQ: USE OF THE CURRENT VALUE METHOD

Q: My fund has control of the portfolio company and could sell the company if we wanted. Should I use Current Value(‘Waterfall’) Method to value my interests?

A: It depends. If the fund’s interests have seniority over the other interests in the capital structure, and the fund has the right to choose to sell the company on the measurement date, then the value that could be realized in a current sale of the company would be a lower bound on the value of the fund’s investment.



QUESTIONS?



Presenter

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