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presents

Valuing Stock Compensation Under Sect. 409A

Reaching the Best Decisions in Allocating Value to Stock Options and Stock Appreciation Rights

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Robert Webb, Partner, Manager of Labor, Employment and Benefits Group, **Nutter McClennen & Fish**, Boston

Jeffery Banish, Partner, Compensation and Employee Benefits Group, **Troutman Sanders**, Atlanta

Michael Frank, Partner, **Morrison & Foerster**, Palo Alto, Calif.

Jeff Faust, Director of Business Valuations, **Greenstein Rogoff Olsen & Co.,** Fremont, Calif.

Tuesday, November 24, 2009

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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Valuing Stock Compensation Under Section 409A Webinar
Nov. 24, 2009
Background Concepts

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Overview Of 409A Valuation Rules

Significance of valuation under Sect. 409A

Non-qualified deferred compensation arrangements subject to 409A do <u>not</u> include:

- ISOs
- ESPPs, and
- Non-statutory options (and related equity-based compensation, *e.g*. SARs), provided the exercise price is not below FMV

Overview Of 409A Valuation Rules (Cont.)

Permissible 409A valuation methodologies

- Readily tradable securities
  - LSB/FSA: Last sale before *or* first sale after grant
  - Closing price on grant date (or prior trading day)
  - Mean of high/low trading prices on grant date (or prior trading day), and
  - Average selling price during specified period within 30 days before or after applicable valuation date

Overview Of 409A Valuation Rules (Cont.)

Permissible 409A valuation methodologies (Cont.)

- General rule for non-readily tradable securities (NRTS)
  - FMV equals “a value determined by the reasonable application of a reasonable valuation method” (Treas. Reg. Sect. 1.409A-1(b)(5)(iv)(B))
  - The determination of whether a valuation method is reasonable, or whether an application of a method is reasonable, is made based on the facts and circumstances as of the valuation date

NRTS Valuation - Relevant Factors

Factors to be considered under a reasonable valuation method for NRTS include, as applicable:

- The value of tangible and intangible assets of the issuer of the shares
- The present value of future cash-flows of the issuer of the shares
- “Other relevant factors” such as (1) control premiums or discounts for lack of marketability. and (2) whether the valuation method is used for other purposes that have a material economic effect on the issuer, its stockholders or its creditors; and

NRTS Valuation - Relevant Factors (Cont.)

Factors to be considered for NRTS (Cont.)

- The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the issuer, the value of which can be readily determined through non-discretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction); for example, recent arm's length transactions involving the sale or transfer of such stock or equity interests

NRTS Valuation - Relevant Factors (Cont.)

- Methodology must consider all information available. All available information material to the value of the issuer must not take into consideration in applying its methodology

- Use of prior valuations. The use of a value previously calculated under a valuation method will not be deemed reasonable as of a later date *if* (i) the calculation fails to reflect information available after the date of the valuation that may materially affect the issuer's value, *or* (ii) the value was calculated with respect to a date more than 12 months earlier than the date for which the valuation is being used

NRTS Valuation - Relevant Factors (Cont.)

- Consistency. The issuer's consistent use of a valuation method to determine the value of shares or its assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of the valuation method

Valuation Methods Presumed To Be Reasonable

1. *Current Appraisal*

A valuation of a class of stock determined by an *independent appraisal* that meets the requirements of Sect. 401(a)(28)(C) of the Code, and the Treasury Regulations thereunder, as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the grant date of a stock option)

Valuation Methods Presumed To Be Reasonable (Cont.)

2. *Start-up companies*

With respect to *illiquid stock* of a *start-up corporation*, a valuation made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described previously

Presumption Of Reasonableness – Start-Up Companies

- Illiquid stock. Stock of a corporation that has no material trade or business that it (or any predecessor to it) has conducted for a period of 10 years or more *and* has no class of equity securities that are traded on an established securities market, *where* such stock is not subject to any put or call right or obligation of the corporation or other person to purchase such stock other than (i) a right of first refusal upon an offer to purchase by a third party and (ii) a right or obligation that constitutes a lapse restriction.

Presumption Of Reasonableness – Start-Up Companies (Cont.)

Effect of anticipated CIC on presumption

- The presumption of reasonableness for start-ups is lost if the issuer (or grant recipient) may reasonably anticipate, as of the time the valuation is applied, that (i) the issuer will undergo a change-in-control event within the 90 days following the action to which the valuation is applied, or (ii) make a public offering of securities within the 180 days following the event to which the valuation is applied (*e.g.*, the grant of an option or exercise of a stock appreciation right)

Presumption of Reasonableness – Start-Up Companies (Cont.)

<u>Need for qualified valuation provider</u>

- A valuation will <u>not</u> be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the issuer reasonably determines to be qualified to perform the valuation based on his or her significant knowledge, experience (*e.g.*, at least five years of relevant experience), education or training

Valuation Methods Presumed To Be Reasonable (Cont.)

3. *Formula pricing*

- A valuation based upon a formula that, if used as part of a non-lapse restriction (for purposes of Treasury Regulations Sect. 1.83-3(h)) with respect to the stock, would be considered to be the FMV of the stock under Treasury Regulations Sect. 1.83-5

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Valuing Stock Compensation Under Sect. 409A Webinar

Nov. 24, 2009

Evaluating The Need For A Valuation

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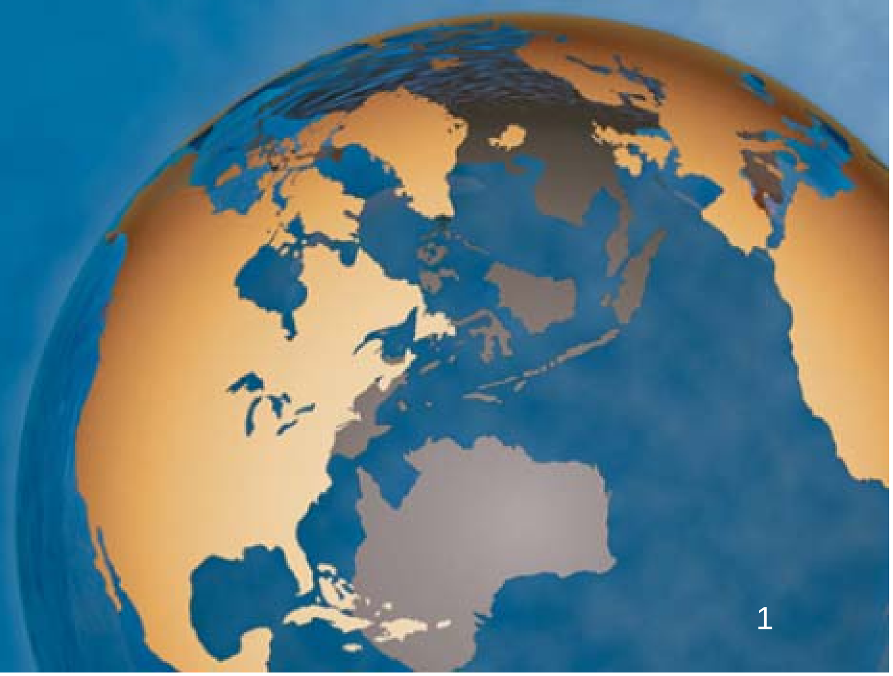

409A Dramatically Alters Way Private Companies Value Their Common Stock

- Previous practice of valuing common stock based on rule-of-thumb discounts is no longer appropriate, e.g., valuing common stock by reference to the value of the preferred stock, such as the old 10-to-1 ratio

- Cursory board resolutions stating that the board has determined the fair market value of the common stock are no longer sufficient

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Third-Party Appraisals Are Not Required

- Choice between in-house valuation or outside appraisal is driven by many factors
- One key factor is whether to adopt a "presumptive" valuation method so as to shift the burden to the IRS to have to prove that (i) the valuation is below fair market value, and (ii) the valuation method or the application of the valuation method was "grossly unreasonable"
- Any valuation method other than one of the "presumptive" valuation methods places the burden on the company to support that the valuation is not below fair market value

General Rule Is Fair Market Value Must Be Determined By "Reasonable Application Of A Reasonable Valuation Method"

- Statement is not controversial but is not particularly helpful either
- Applies to common stock that is not readily tradable on an established securities market
- Two-part test: Reasonable method and reasonable application of the method based upon the facts and circumstances
- Valuation should consider the value of tangible and intangible assets, present value of cash flows, market value of similar interests, recent arm's length transactions, and other relevant factors

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General Rule Is Fair Market Value Must Be Determined By "Reasonable Application Of A Reasonable Valuation Method" (Cont.)

- Not reasonable if valuation does not consider all available material information, e.g. cannot ignore third-part offer that is likely to be accepted
- Cannot rely on valuation that is more than 12 months old
- Cannot rely on an earlier valuation if the earlier valuation does not consider information that becomes available after the earlier valuation, and the information is material to the determination of the value of the common stock
- Consistent use of method is a factor supporting its reasonableness

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409A Provides Three Presumptive "Safe Harbor" Valuation Methods

- Independent ESOP appraisal method
- Illiquid start-up company method
- Binding formula valuation method

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Independent ESOP Appraisal Safe Harbor Is Valuation Performed By Qualified Independent Appraiser, Using Traditional Appraisal Methodologies

- Presumed reasonable if the valuation satisfies the rules for ESOP valuations and is no more than 12 months old

- Must be performed by an independent appraiser

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Illiquid Start-Up Presumption Applies To Private Companies Less Than 10 Years Old

- Valuation must be in writing
- Must be performed by person that company reasonably believes is qualified to perform valuations and has significant knowledge, experience (at least 5 years), education or training in performing similar valuations
- Stock must not be subject to a put, call or other right (other than a right of first refusal)
- Company must not be anticipating a change in control within the next 90 days or an IPO within the next 180 days
- Valuation must take into account the value of tangible and intangible company assets, the present value of cash flows, and control premiums and discounts for lack of marketability, among other factors
- Valuation may not be more than 12 months old

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Binding Formula Presumption Is Valuation Based On Consistent Application Of Single Formula Used In All Stock Transfers

- Formula must apply for all stock transfers to the company and over-10% shareholders

- Formula must apply regardless of whether transfers are compensatory in nature; reasonable if the formula is used for valuing stock for purposes of the company's regulatory filings, loan covenants and sales to third parties.
- Exception is that formula need not apply to an arm's length transaction involving the sale of all or substantially all of the company's stock

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Do You Need A Valuation? Should You Do It In-House Or Hire Independent Appraiser?

- Must do some type of valuation, e.g., rule-of-thumb discounts and cursory reviews are no longer sufficient
- 409A expectation is for a more rigorous and defined valuation analysis to determine the value of the common stock
- Company can retain outside appraisal firm, or the valuation can be performed in-house or by a related party with the credentials and expertise to perform valuations
- If company wants to shift the burden to the IRS and get the protection of the presumption, then it must satisfy one of the three safe harbor methods
- Otherwise, the burden will be on the company to prove that the value determined for the common stock was not less than fair market value

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Factors To Consider

- Does in-house person or other related party have significant knowledge, experience (at least 5 years), education or training in performing valuations?
- Would a reasonable person rely upon the advice of such in-house person or related party with respect to value, if the reasonable person was buying or selling stock of the company?
- Does the company anticipate a change in control in the next 90 days or an IPO in the next 180 days?
- Lack of qualified in-house person or related party with sufficient knowledge and training to perform valuation may lead to hiring an outside appraiser

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Factors To Consider (Cont.)

- Is one of the safe harbor methods available? The IRS has stated that it will evaluate the company's application of the method, not necessarily if the "number" is correct, so what the company did may outweigh the accuracy of the final valuation if the company complies with the safe harbor method
- The illiquid start-up presumption favors the company. The IRS has said that, if the company does not satisfy the presumption, the general rule still applies – "the reasonable application of a reasonable valuation method"
- So, company could still satisfy the general test, and the closer the valuation method is to the illiquid start-up method, the more likely it will satisfy the general test (even for companies that have been in operation for more than 10 years)

Factors To Consider (Cont.)

- Cost is always a factor; outside appraisal can be expensive
- Discounted valuations by inexperienced appraisers may not be respected by the IRS or others
- Complexity of the company’s capital structure must be considered in determining the qualifications of the person who is to perform the valuation
- 409A valuations are much more involved, because first the enterprise value of the company must be determined, second the relative values of the different classes of equity of the company (with their different voting and dividend rights) must be determined, and third value then must be assigned to the company’s common stock

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Factors To Consider (Cont.)

- Consider if valuation is needed for other purposes, such as to determine the expenses to recognize for accounting purposes
- Will valuation take into account the AICPA guidelines for valuing the stock?
- Likely that valuation that satisfies the AICPA guidelines will satisfy the general test for the reasonable application of a reasonable valuation method (but a valuation sufficient for 409A may not work for the accountants)
- The IRS has said that it will not use hindsight to judge the valuation. So, in theory, later SEC or accounting problems should not be fatal to valuation for purposes of 409A (although I would not want to rely on the IRS' statement in these types of circumstances)

Practical Implications

- Type of valuation may differ depending on the stage of the private company’s life cycle
- Different considerations at different stages: Start-up/founders stage, venture capital and angel financing stage prior to expectations of a change in control or IPO and after the company anticipates a change in control or IPO stage

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Start-Up Stage

- Not likely to see formal appraisals in typical start-ups prior to the time the company has assets and begins operations
- May not need valuation if company makes initial equity awards in outright grants of stock or restricted stock or restricted stock units
- Still may be necessary to value company stock to determine income to be recognized by management and accounting expenses to be booked
- Performing precise valuation at this stage will be difficult due to the company's lack of assets and financial history and relative inability to project future earnings and cash flow from operations

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Post-Funding And Prior To Change In Control Or IPO

- The company might consider an independent appraisal of the value of its common stock once assets are acquired and operations begin
- No clear time when, or if ever, the company reaches the stage of needing an independent appraisal
- Initial or subsequent venture capital or angel financing rounds could result in investors' requiring an independent appraisal
- Company board will need to determine, with the assistance of counsel, whether an outside valuation is advisable
- At this stage, complex capital structure of the company with different financing layers may dictate going outside the company for advice

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Post-Funding And Prior To Change In Control Or IPO (Cont.)

- Board will need to weigh desire to satisfy a safe harbor method (to get the protection of the presumption) against the cost of an outside appraisal and the availability of in-house expertise to perform the valuation
- Events, such as subsequent rounds of financing, third-party offers or other events, may invalidate prior appraisals
- May be costly to have regular valuations throughout the year, which could drive the company to consider annual grants at set times so as to minimize the times valuations are needed
- May be able to rely on illiquid start-up presumption being satisfied by a written report prepared by the company’s internal financial personnel or a board member with experience or training in stock valuations
- Not unusual for board member appointed by venture capital investor to assist with the valuation
- Not unusual to use independent appraiser to set annual valuation and rely on qualified in-house person to update the valuation during the year

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After Expectation Of Change In Control Or IPO

- Once the company reasonably anticipates a change in control in the next 90 days or an IPO in the next 180 days, it may not rely on the illiquid start-up presumption. However, the company could still follow the same rules to satisfy the general valuation test

- Companies at this stage may want to consider using an independent appraiser, especially if needed to avoid “cheap stock” issues with the SEC

- Auditors and accountants at this stage may require independent appraisals for financial accounting purposes

- Buyers may be concerned about compliance with 409A and want assurances that the company has not granted discounted options or stock appreciation rights that are not exempt from 409A

General Conclusions

- 409A will require more rigorous valuations than in the past
- No longer have the leeway previously permitted in prior valuations such as when valuing common stock for purposes of issuing incentive stock options
- Investors or accountants may require independent valuations for various reasons
- Company must weigh cost of outside appraisal firm against its ability to perform the valuation in-house with internal people or other related parties who have the appropriate experience, education or expertise
- Valuation in any event must be performed by someone with the credentials and expertise to do so
- No easy answer

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General Conclusions (Cont.)

- Company should be able to protect itself by performing the valuation in a way consistent with the illiquid start-up presumption, even if it is not technically available (if not using an independent appraiser)

- Safest choice would be to obtain an independent, third-party valuation contemporaneously with the time of the proposed equity grants

- If obtaining an independent valuation, hire an appraiser with experience (i) in the company's industry and (ii) with other companies in the same life cycle stage as the company

General Conclusions (Cont.)

- Is best to involve accountants early in the process to avoid costly mistakes such as where the 409A valuation does not take into account AICPA valuation guidelines and is rejected by the accountants

- The company should draft its equity awards with appropriate language to protect itself, if the IRS challenges the valuation, by including a provision that says the company is not liable if the award becomes subject to 409A and fails to comply with the 409A requirements

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Valuing Stock Compensation Under Sect. 409A Webinar

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Evaluating Total Exposure

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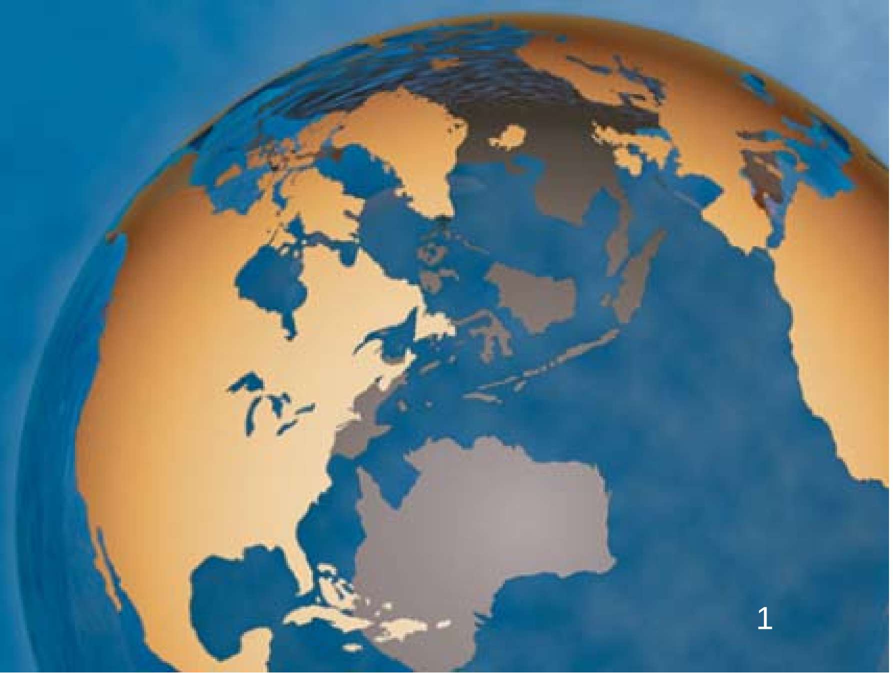

Downside Of Getting The Valuation Wrong

- Option or stock appreciation right likely subject to 409A
- Non-compliance could result in recognition of income from the award at the time of vesting, plus additional 20% tax
- Company required to remit applicable tax withholdings at the time of income recognition (not including the additional 20% tax); failure to do so results in payment of interest and tax penalties
- Incentive stock options may be disqualified and treated as non-qualified options
- Cheap stock problem on IPO that could require additional financial accounting expenses to be recognized

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Downside Of Getting The Valuation Wrong (Cont.)

- 409A problems likely to result in disgruntled management
- Could result in violation of the company's financing arrangements, loan covenants and other agreements
- Risk of lawsuits for improper certifications that no 409A problems existed or that stock options or stock appreciation rights were not issued "in-the-money"
- Management and shareholders could be personally liable
- Additional costs to then obtain valuation that auditors will accept

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Nov. 24, 2009

How Much To Reveal To An Outside Valuation Specialist

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What Should We Share With Our Outside Valuation Experts?

- Regulations say a valuation method will *not* be considered reasonable if it does not take into account *all* information *material to the company's valuation*
- Factors to be considered include:
  - The value of the company's tangible and intangible assets
  - The present value of the company's future cash flows
  - The market value of equity interests in substantially similar businesses that can be determined readily by objective means
  - The effects of any control premiums and/or marketability discounts
  - Recent arm's length transactions involving the sale or transfer of the stock or equity interests
  - Whether the proposed valuation method is used for other purposes that materially affect the company, its shareholders, or creditors; and
  - *Other relevant factors*

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What Should We Share With Our Outside Valuation Experts? (Cont.)

- The IRS will *not* consider a valuation method to be reasonable if it fails to take into account all information that is material to the company's valuation
- A value that was previously determined under an otherwise reasonable method will not be considered to be reasonable for purposes of Code Sect. 409A if *either* the determined value does not reflect after-acquired information with material effects on the company's current value, or the value was determined as of a date more than 12 months before the date for which the valuation is being used
- Examples from regulations
  - Resolution of material litigation
  - Issuance of a patent
- Does it matter if the new information is negative rather than positive?

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Practical Interworkings With Outside Valuation Firm

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409A Valuation Vs. FAS Calculations

- What to do if there is a discrepancy
- Minority discounts
- IPO run-up “cheap stock” issue
  - SEC linear approach
  - 409A “facts at the time” approach

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What If You Are Approaching The 12-Month Anniversary Of Your Last Valuation?

- "Refresh" valuation?
  - Will this permit an additional 12 months of reliance?
- New valuation?
- What if the interim information is negative?
  - Can a company safely revise downward from an outside valuation?

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Decisions forced by in-house execs, outside advisors

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Decisions Forced By Others

- Actions by internal executives and investors can affect the process and outcome of the 409A valuation

- This includes:
  - Outside stock transactions
  - Stock sales between executives and board
  - Stock purchased from departing executives
  - Follow-on rounds that have different terms (and a different pre-money valuation)

Decisions Forced By Others (Cont.)

- Depending on how much "weight" is put on the outside transaction, the valuation could dramatically change

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (#1)

METHODS UTILIZED	APPRAISED VALUE OF TOTAL EQUITY	WEIGHT	WEIGHTED VALUE OF TOTAL EQUITY
Income Approaches			
Discounted Net Cash Flow to Equity (DCF)	6,318,697	100%	6,318,697
Capitalized Net Cash Flow to Equity	6,763,605		
Discounted Future Earnings (DFE)	5,385,929		
Capitalized Earnings	5,461,612		
Market Approaches			
Guideline Company Method	6,986,451		
Comparative Transaction Method	6,161,407		
Venture Capital Method	6,339,571		
Others			
Company Specific Transaction	10,181,040		
		100%	6,318,697

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (#2)

METHODS UTILIZED		APPRAISED VALUE OF TOTAL EQUITY	WEIGHT	WEIGHTED VALUE OF TOTAL EQUITY
Income Approaches				
	Discounted Net Cash Flow to Equity (DCF)	6,318,697	75%	4,739,023
	Capitalized Net Cash Flow to Equity	6,763,605		
	Discounted Future Earnings (DFE)	5,385,929		
	Capitalized Earnings	5,461,612		
Market Approaches				
	Guideline Company Method	6,986,451		
	Comparative Transaction Method	6,161,407		
	Venture Capital Method	6,339,571		
Others				
	Company Specific Transaction	10,181,040	25%	2,545,260
			100%	7,284,283

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (#3)

METHODS UTILIZED	APPRAISED VALUE OF TOTAL EQUITY	WEIGHT	WEIGHTED VALUE OF TOTAL EQUITY
Income Approaches			
Discounted Net Cash Flow to Equity (DCF)	6,318,697	50%	3,159,349
Capitalized Net Cash Flow to Equity	6,763,605		
Discounted Future Earnings (DFE)	5,385,929		
Capitalized Earnings	5,461,612		
Market Approaches			
Guideline Company Method	6,986,451		
Comparative Transaction Method	6,161,407		
Venture Capital Method	6,339,571		
Others			
Company Specific Transaction	10,181,040	50%	5,090,520
		100%	8,249,869

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (#4)

METHODS UTILIZED	APPRAISED VALUE OF TOTAL EQUITY	WEIGHT	WEIGHTED VALUE OF TOTAL EQUITY
Income Approaches			
Discounted Net Cash Flow to Equity (DCF)	6,318,697	25%	1,579,674
Capitalized Net Cash Flow to Equity	6,763,605		
Discounted Future Earnings (DFE)	5,385,929		
Capitalized Earnings	5,461,612		
Market Approaches			
Guideline Company Method	6,986,451		
Comparative Transaction Method	6,161,407		
Venture Capital Method	6,339,571		
Others			
Company Specific Transaction	10,181,040	75%	7,635,780
		100%	9,215,454

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (#5)

METHODS UTILIZED	APPRAISED VALUE OF TOTAL EQUITY	WEIGHT	WEIGHTED VALUE OF TOTAL EQUITY
Income Approaches			
Discounted Net Cash Flow to Equity (DCF)	6,318,697		
Capitalized Net Cash Flow to Equity	6,763,605		
Discounted Future Earnings (DFE)	5,385,929		
Capitalized Earnings	5,461,612		
Market Approaches			
Guideline Company Method	6,986,451		
Comparative Transaction Method	6,161,407		
Venture Capital Method	6,339,571		
Others			
Company Specific Transaction	10,181,040	100%	10,181,040
		100%	10,181,040

Decisions Forced By Others (Cont.)

- Sample of how these actions affect the valuation (summary)

100/0	6,318,697		
		15%	
75/25	7,284,283		
		13%	
50/50	8,249,869		61%
		12%	
25/75	9,215,454		
		10%	
0/100	10,181,040		

Decisions Forced By Others (Cont.)

- What factors are looked at to determine how much weight to put on the outside transaction?
  - Size of the transaction
  - Date of the transaction
  - Parties involved (arms-length negotiation vs. insider deal)
  - Anything else relevant

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Making Decisions With Limited Guidance

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Correction Methods

Availability of relief

Applies if, during a grant recipient's taxable year:

- A covered failure occurs, and
- The correction requirements are satisfied

Effect of relief

- The stock right is treated from the date of grant as not providing for a deferral of compensation for purposes of 409A

Correction Methods (Cont.)

Covered operational failure

- A failure eligible for correction under the Treasury guidance consists of a stock right that satisfies all requirements to be excluded from coverage under 409A, *except* that the exercise price of the stock right is erroneously established at less than the fair market value of the underlying stock on the date of grant

Correction Methods (Cont.)

Required corrective action

- Before the stock right is exercised and not later than the last day of the grant recipient's taxable year immediately following the taxable year in which the issuer granted the stock right to the recipient, the exercise price must be reset to an amount not less than the fair market value of the underlying stock on the date of grant

Correction Methods - Example

- On Jan. 1, 2009, employer grants employee a stock option to purchase 100 shares of stock, and the stock option qualifies for exemption from 409A except that, due to an error, the exercise price is set at an amount below the fair market value of the stock on Jan. 1, 2009
- On July 1, 2010, employee partially exercises the stock option and purchases 40 shares, but retains a stock option to purchase 60 shares

Correction Methods – Example (Cont.)

- If, before the later of Jan. 1, 2011 or the exercise of the remaining stock option to purchase 60 shares, the exercise price of the remaining stock option is reset to a price at or above the fair market value of the underlying stock on Jan. 1, 2009, then the stock option to purchase 60 shares may qualify for the relief provided under Treasury Notice 2008-113

- Because the exercise price was not reset before the exercise on July 1, 2009, the portion of the stock option that was exercised to purchase 40 shares is not eligible for the relief provided in Notice 2008-113

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Valuing Stock Compensation Under Section 409A Webinar

Nov. 24, 2009

Stock Grants During An Effort To Sell The Company

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Selling The Company

- Cannot use the "start-up" company internal valuation safe harbor if M&A activity is reasonably expected within 90 days (or IPO within 180 days)
- Stages of a deal
  - Unsolicited offer vs. shopping the company
  - Term sheet
  - LOI/NDA
  - Talking terms
  - Binding agreement
- Is 20/20 hindsight required?
- Acquiror sensitivities

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Valuing Stock Compensation Under Section 409A Webinar

Nov. 24, 2009

Deciding on an allocation approach

Jeff Faust, jfaust@groco.com

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Which Allocation Approach Should Be Used?

- The three allocation approaches outlined in the 2004 AICPA Practice Aid, "*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*":
  - Current-value method (CVM)
  - Option-pricing method (OPM)
  - Probability-weighted expected return method (PWERM)

If your valuation analyst is not following these allocation methods and is not intimately familiar with this practice aid, the valuation will be thrown out by your auditor!

Which Allocation Approach Should Be Used? (Cont.)

- General overview of each allocation method
  - Current-value method (CVM)
    Like a waterfall analysis
  - Option-pricing method (OPM)
    Uses Black-Scholes
  - Probability-weighted expected return method (PWERM)
    Estimates value under various scenarios (IPO, sale, dissolution, no exit) and assigns probabilities to each

Which Allocation Approach Should Be Used? (Cont.)

- The method used will greatly depend on the company's stage of development

  - Current-value method (CVM)
    Very early (pre-revenue/Series A) or when a transaction is imminent (waterfall analysis)

  - Option-pricing method (OPM)
    Middle stage (generating revenue, progress on model, Series B)

  - Probability-weighted expected return method (PWERM)
    Latter stage (an exit is within 3-5 years)

Which Allocation Approach Should Be Used? (Cont.)

- All things being equal, if you ran all three methods, the result will be along these lines, i.e. CVM the lowest, PWERM the highest

  - Current-value method (CVM) = $.04
  - Option-pricing method (OPM) = $0.10
  - Probability-weighted expected return method (PWERM) = $0.18

If it doesn't look something like this, you have done something wrong!
(This is why auditors will often run an OPM against a PWERM, even if the valuation analyst selected and only illustrated a PWERM)