Venture Capital Valuation: Case Studies and Methodology
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CHAPTER 8

Don't Hate the Appraiser (Blame the Auditor Instead)

". . . it may be inappropriate to use discounted cash flows for valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows."

—Auditing Fair Value Measurements and Disclosures,
Statement on Auditing Standards No. 101

I've had the pleasure of working with a wide variety of appraisers almost exclusively with respect to the work they do valuing venture-backed companies to fulfill either financial reporting or tax compliance requirements. In this field, one often hears that "valuation is more of an art than a science." In fact, I have a memory peg for that, which is included in this chapter. But despite the saying, if you've spent time with any of these valuation professionals, you realize that they are truly dedicated to what they do, take the opinions they issue very personally, and are constantly making an effort to remain current in the latest technology and techniques to reach more meaningful and appropriate value conclusions.

This chapter offers a candid interview with Jeff Faust, an Accredited Valuation Analyst whose practice expertise has focused on 409A valuations. Following the interview with Jeff in this chapter, Chapter 9 then offers a group discussion including two other valuation professionals who have focused primarily on 409A and Topic 820 valuations for venture-backed companies and venture funds since the regulations became effective. However, unlike this chapter, which leans more toward the experiences of a single analyst with respect to 409A valuations, Chapter 9 is focused on linking the interactions with valuation professionals, auditors, and the rules they follow

with the needs of company founders, CFOs of portfolio companies, and CFOs of venture funds.

INTERVIEW WITH JEFF FAUST, AVA

The first interview is Jeff Faust, AVA, Senior Manager of Business Valuations for Berger Lewis in San Jose, CA. I met Jeff through my National Association of Certified Valuation Professionals course titled "Five Mistakes Your Auditor Made," which was partially on some of the topics we discuss in the interview. In addition to being a valuation professional, Jeff was also a co-founder of a Bay Area technology company that makes online option tracking and accounting solutions used by some of the most popular publicly traded technology companies.

Be Flexible With VCs (Partners) and Valuators

LORENZO: Jeff, could you give a background on how you got into valuation?

JEFF: Sure. I've been doing valuation for over 15 years. I got into valuations when I was hired by an ESOP consulting firm to learn the overall product from an installation and implementation perspective. Once I had that down, I got moved over to the valuation group and kind of learned valuations from the ground up through employee stock ownership plan design and valuation.

I got into valuations for venture-backed companies because I rolled one of my valuation practices into a CPA firm in 2006, and the CPA firm I'm at now focuses heavily on venture-funded companies and entrepreneurs working through complicated tax situations. Because of that I do a lot of venture-funded company valuations now.

LORENZO: In your experience in dealing with venture-backed, early-stage companies, is there one thing that sticks out as so important that you would want people running those companies or CFOs of those companies to know about valuation?

JEFF: I think the biggest focus is to be flexible. Valuations are determined in a lot of different ways and incorporate a variety of measurements. So I think that being flexible and being open to other views is the biggest message I would want to get across. I believe that's the biggest thing, to be flexible. I think too many CFOs or owners of companies have a preconceived notion of value when they go into negotiations with VCs. But they might be better off if they threw those preconceptions out the window and were open for discussions. The same should apply to third-party valuations.

Another thing I would say along those lines is don't expect too much [of the company], be willing to give up a big chunk of it, understanding that venture firms can bring a lot more than the dollar amount they invest. I think that's another thing founders and management don't always take into perspective. VCs have typically invested in lots of companies and have access to a lot of networking opportunities. So if an owner thinks, "Wow, I'm giving up 40% of my company" as opposed to thinking, "I'm gaining a partner." The owner is adding a partner, not just someone delivering the funds. So that power they bring, if you get the right VC, overwhelmingly exceeds the 40% ownership founders give up (see Chapter 5).

The "Pre-Money Myth" Revisited

LORENZO: That's a great point. I actually have something along those lines that we've been working on for a while for descriptive purposes. On this whole concept of the definition of pre-money value and how that's different than actual company value (see Chapter 1), I think it would be helpful for both entrepreneurs and investing partners to understand the limits of the current definition. So this is one of the most popular versions of the definition you'll see, which is "Pre-money value equals the company value prior to financing." So the problem is that when a financing round closes, people think, "Well, that means my company is worth the pre-money value plus the amount of cash we raised and my percentage ownership times that amount is what my stake is worth."

- VCs invest $5 million at $5 million pre money (50%)
- Entrepreneur/Founders own 30%
- Option pool reserve is 20%
  - Founder (Board) grants 1% of shares to key hire

Founder perceives value of grant on common stock as 1% X $10 million ($100,000), despite having far fewer rights and protections than if the 1% was granted in shares of the preferred stock purchased by VCs.

That, of course, is not the case, since they (the founders) got something different than these people (the VCs) have. So really what pre-money and post-money "value" are describing, or reconciling, is the fully diluted percentage of the company that's been sold in the most recent round of financing. As a result, I think it would be beneficial to revise the part of the definition that refers "pre-money value" as the "value of the company immediately before the next round of financing." Do you have any thoughts on that?

JEFF: That's correct and I would agree. Your suggestion hits on the whole issue of share dilution and preferences not being taken into

consideration with respect to true pricing. At the end of the day, either the math has to agree or you have to change the definition as you've suggested. So conceptually and practically I understand that there has to be a way to test the math for share prices paid in a new round. But to call that a valuation of the entire company is problematic, because it does not take into account the preferences and priorities. So your classic Boolean logic doesn't quite get factored in here if you consider the rights.

The problem you have that this relates to is the whole standards of value (see Chapter 1) and definitions of value (see Chapter 5). I mean is it fair market value or is it investment value? Technically speaking, all of this is investment value, but then you have to flip over the coin for compliance and treat it as if it's a fair market value transaction and it's not. Also, allocation that is so critical to fair market value concepts for venture-backed companies (see Chapters 3 and 5) is not in the traditional formula or definition for pre-money value or post-money value.

So as long as people realize that these concepts are disconnected, they can continue to use the formula. Modifying the definition could help to make it clear to people that they are not the same concept. Investment value is not fair market value. It's kind of an interesting thing when you roll it over and start doing 409A valuations and after-the-fact concepts where you're using these post-money valuations as a guideline and see people crisscrossing standards of value. In that case, your investment value and your fair market value will be split, and people who have invested in these rounds could be looking at that as a measurement of their investment and saying, "Wait a minute, I got ripped off" and that's not the case.

For that reason I think it's very critical to establish a definition of what those are [pre-money value, post-money value, investment value, and fair market value]. The limitations of what this implies and the ramifications represent a gap that needs to be bridged in the definition of pre-money value.

LORENZO: That's similar to what I've heard from some active investing partners when discussing adjusting the definition of pre-money value as I've suggested here. They said, yes, I agree with that completely but when we are negotiating with founders they can be motivated by getting a certain "valuation" based on the existing definition. In reality, the numbers would stay the same; the terminology (pre-money value, post-money value) would stay the same. The only change would be in the definition.

Also, when you look at some of the companies that got financing in late 2008, at the height of uncertainty with respect to financial crisis, there were fair amounts of up rounds for promising venture-backed companies. In those deal transactions were no aggressive (lopsided) deal terms because funds wanted to get in on the transactions. With a substantial up round

and founder-friendly deal terms, pre-money value according to the existing definition and company fair market value start to come together. But of course, some of that depends on industry also.

JEFF: Yes, absolutely.

LORENZO: So if you're dealing with a biotech deal, there tend to be much longer term bets than an Internet company, and the deal terms reflect that added risk, with things like cumulative dividends and more complex redemption provisions for instance. If you're dealing with a hardware company it might depend on whether the deal's on the East Coast or Bay Area.

JEFF: Yes, and that's the other thing that I don't think people understand is the whole hype cycle in pre-money valuations where people say, "Well, Facebook got an X amount valuation," and founders ask, "How do I get that hype on my valuation?" But there may be something to that from a portfolio valuation perspective. If you have a VC that's invested in a ton of social media companies, it may not have a need in its portfolio for another, whereas if you're talking to a VC that was late to that game, you might end up giving up a little less of the company.

LORENZO: Now we've talked a bit about valuations from the new round of financing perspective, and you've done a lot of work around 409A valuations and tax compliance work.

JEFF: That's correct.

LORENZO: A lot of the valuation practices are now being applied for financial reporting purposes are actually from the tax world, correct?

JEFF: Yes.

LORENZO: So I'm kind of curious, in that space, when you do the 409A valuations, and you come up with a fair market value for the common stock, it seems like you have to balance the requirements for tax compliance with the demands of auditors that will be reviewing your work from a financial reporting perspective.

JEFF: Right.

Why Don't Users Read the 409A Valuations?

LORENZO: What percentage of the management teams when they get that report actually understand what's in it?

JEFF: VERY LITTLE, and that's the sad part.

There's an e-mail I recently got that said that price is still the major factor for decision making for 409A analysis. But there are so many 409A valuations that are done wrong, auditors are so picky on them that they throw them out frequently, that I'm surprised quality is still not in their minds (see Chapter 5).

Cost is still the primary issue. So my experience plus that drives to me that these people they don't understand at all what they're getting. That's troubling to me because it's important for management to understand the disconnect between the investment value stated in financing transaction, the fair market value of their common stock, and more important, what's a buyer going to consider down the road? Perhaps more important to them as founders, what happens to them when they get acquired. I mean I literally had to walk a CFO through why the company had to sell for $50 million before any of the management team was entitled to a penny. He had no idea and got real angry and was furious with me, because he didn't know what he was getting into when he got his funding.

LORENZO: Right.

JEFF: That's so critical, and that of course is an extreme case. But all along the way they have to understand valuation. IPOs can be a different situation, but even some of those have thresholds that should be considered and the 409A valuation gives a good glimpse into that.

LORENZO: Applying more rigorous valuation methods to venture-backed companies started with 409A for portfolio companies but quickly started to follow, in theory anyway, to venture funds as a result of FAS 157, which became Topic 820. When discussing Black-Scholes and OPM models with venture-fund CFOs and analysts, one of the questions we would often get asked at Liquid Scenarios is "Where do we get the variables from to input into the model?" My response was you just paid, indirectly, for a thoroughly researched set of risk-free rates matched to time, volatilities, and comparables in the 409A valuations for your companies. Those are really artful and time-consuming processes, so grabbing a template that may be six- to nine-months old can still quickly get you up to speed. Depending on your ownership percentage and shareholder rights agreements, most companies will send you a copy if you ask nicely.

JEFF: Absolutely.

LORENZO: But the answer we generally get is, well, we sometimes might take it into consideration, but we don't want to be forced to base our valuations on it. My reply has generally been that the standards of value are different, so an auditor can't really hold you to what's in the 409A valuation. However, to take it into consideration, you might want to look at the variables that apply both to the fair market value and the value to you as an investor. With volatility, risk-free rates and comps right at your fingertips, that's going to save you time and get you indications of value quicker regardless of what the standard of value is.

JEFF: Yes, exactly, that is a lot of work. Also, auditors are super picky about consistency and you know sometimes if you arrive at odd conclusions but use consistent methodology they are more likely to work with you.

Deriving Discounts for Lack of Marketability

LORENZO: Along those same lines, one of the other things I want to address is on the various types of discounts applied to arrive at fair market value for a minority interest. This is something that I believe will become more important as parties getting these reports or relying on them start to ask how was that arrived at, what are you really doing with those discounts, are you just trying to get to a certain number?

Perhaps briefly you could just share some of your experience in terms of when you apply a marketability discount and what percentage of the time you use a quantitative model versus some of the other methodologies.

JEFF: Sure, we run quantitative models on all of our companies. They don't always produce numbers that are relevant necessarily, so in those cases we have to switch over to more qualitative models. We run a lot of them, so we do the protective put, the QMDM, and we've implemented the Rand Curtiss, where you answer a bunch of questions and it recalculates based on your starting point, which is your classic Mandelbaum criteria (see Chapter 1, "Court Rulings"). So we'll run a bunch of models, get a gut feel, cross-check them, and see which is most applicable to the company.

It's kind of like the trend of running both the Duffs & Phelps and the Ibbotson Buildup method for the required rate of return. You do them both to see how they compare and end up with a more defensible argument. The challenge that we have in all of that is that the competition, primarily firms relying on overseas analysts, is getting fierce. There are foreign competitors coming in, undercutting everyone, and for us to do all of that and still remain competitive for a Series A or B company is almost impossible for us here in the Bay Area. That's the difficulty, auditors keep requiring more and more and clients want to pay less and less. If someone goes down the road and shops your rate, they may face problems a year later but by then there's no benefit to our firm.

Still, we try to use as many methods as possible because we know the auditors are not going to like the one we choose. So if we do all of them, we can just present the ones they feel are better quickly.

LORENZO: [Laughing] Yes, that appears to be the consensus approach.

The Auditor versus the Valuation Professional

JEFF: And it's funny because before we do a valuation we meet with every company's auditors, especially if they are Big 4 auditors, and discuss what are you looking for, are we heading down the right path with our plan, by the way there's judgments, and are you OK with that? But then when we're done with all of the work, we still have to go through this process

where they ask for something that's not in our report. Then we say, well you told us that was OK when we started, and they say well we want to see a fact-based judgment. Our position is, isn't all of this a fact-based judgment or opinion? Don't misunderstand me, I understand that they want to see an audit trail for why various comps may have been rejected, for instance, so using judgment based on something statistical. I get that; that's what we do as valuation professionals, but at the end of the day it's a judgment call.

So I think the key thing for me is that rather than noting it as a judgment, we say, here's what we did to get to that answer. That can allow us to walk the auditors through our logic and that gets them to a place where they can say, OK we're good.

LORENZO: And they have to ask a lot of those questions to satisfy their SAS101 requirements, so providing a logical flow they can test is helpful.

JEFF: Exactly. But in order to keep your fees down, you have to not only do the best work, but also have an idea of what to expect from an auditor during a given season. At this point we have to prepare clients for the auditors and we simply have to charge for auditors who keep asking questions that don't relate to the work we've done. To address that, we've gone through the process of discussing with clients what to expect from the auditors, and that's something they tend to be grateful for.

We had one set of auditors telling us that each scenario in a PWERM had to contain the same specific individual risk. The next auditors were, like, no they all have to be the same. So we changed it so that they all had the same risk. The next year, we get another auditor saying, no they all have to be the same. But then, I realized, they don't have their valuation person consulting on this engagement, because there's been times when auditors have gotten together without understanding the impact of things. They need to get the perspective from the valuation community. So I really think there needs to be the valuation community and the audit community in a room talking about these things.

What are we allowed to do, according to the auditor's perspective, what are the variations? What's logical and figure it out. Otherwise we're all getting frustrated as one auditor bashes you and you make an adjustment, only to get a completely conflicting demand from another auditor. That's the most challenging for us valuation folks. But you may have hit it early on in suggesting that some smaller clients feel they are trapped in a billing machine. The 409A valuation is viewed as a having a fixed price range, within reason, whereas the audit simply has to get done so if extra work is spent, that's going to be reflected in the audit bill at some point.

I've spent an agonizing amount of time with an auditor discussing a client's valuation and going, wow, that was tough, but at least next year

we can give them exactly what they want. We give them exactly what they want and now it's a whole other set of problems and you are like "why?"

LORENZO: Is there a continuity in audit personnel, though, because often they represent very small jobs and staff are of course transitioning?

JEFF: In this particular case [details taken out] there was, in a lot of cases there's not continuity, and that's what causes the problem. Of course, as appraisers, we completely understand that they [the auditors] have to remain skeptical. It's a big part of their job. So we shouldn't get offended. But they need to be reasonable with their requests as opposed to saying, "Well, we asked these 10 questions last year, so let's just find 10 other questions to ask this year." Or, if there's a reason for asking totally different questions, then explain that in the context of the engagement, and we can all get further more successfully to serve the client, as opposed to creating work just to be that way. I think there's got to be a fine line; understanding that we appreciate it's their job to question our work, within reason.

LORENZO: I think one of the things along those lines that some of the valuation professionals we worked with when 409A was expected to become effective is that a lot of the audit personnel assisting with developing tests were from Big 4, at the time accounting firms were valuation teams focused on Wall Street–type analysis for publicly trading firms with earnings or at least some revenue. Obviously, in those cases someone has already solved for "S" the value of the stock and that someone has been the market of buyers and sellers. So anything after that is a very different type of analysis that comes up with a value for a security that no third party has ever paid cash for in an arms-length transaction.

The issues aren't the same. There's many acceptable ways to approach some of the variables, but with so many other variables that are unique to each particular situation, there's a different type of expertise that has to be applied.

JEFF: Yes, yes, that's absolutely right. Also, it's worth noting that with respect to actually doing the valuations, the audit firms could never afford to actually perform them because no startup could pay 30 grand for a 409A valuation. Period. So I've asked time and time again to auditors, "Have you ever done a 409A valuation?" and I'm told, "No, but we look at a lot of them" To which I respond, well, understand that in order for me to do all of the additional analysis you are requesting, that's 30 grand. I can't charge a client that. I can only charge 20% to 30% of that. In that scope, I'm going to have to choose the most important elements.

Even the practice aid talks about the cost-benefit relationship of these analyses; there's a whole paragraph that talks about it. They [auditors] love to quote that whole book as a bible to them except that one page, "Oh, I

don't want to talk about that." You can spend 800 hours on a brand new Series A venture-funded startup and be no better off than grabbing a percent of its recent round and being done. Was it really worth spending thousands of dollars? Absolutely not. So there's a fine line for startups where it's very hypothetical. You can apply a lot of science to a hypothetical situation. At the end of the day it's still hypothetical.

So that's all a valid point I don't think auditors always consider and that's a valuable lesson for owners to understand that this is going to go on. That may give owners and founders better perspective when they are raising a new round of funding as to some of the factors at play.

LORENZO: That's interesting what you mention about the practice aid, about the cost-benefit analysis, because prior to 409A there used to be another practice aid on valuing private companies, and it more or less explicitly states that for most early-stage companies, their resources are better spent creating value than measuring it. So if it wasn't for the tax law and then the revisions to FAS123 for financial reporting, then none of this would really be getting done. But there's always been a recognition that for early-stage companies there's a cost benefit to be considered. This is very similar to how auditors approach control procedures for these companies. How many people should a startup hire to put financial controls in place? Well, in most cases it should not hire anyone just for that, and auditors are used to just assuming that control risk is at its maximum and test appropriately to make sure that things have been properly.

What 409A Valuation Professionals Actually Do

LORENZO: Along those same lines, this is kind of an attempt to simplify what valuation professionals do in a manner that anyone can understand. I'd just like to get your opinion if you think this is fair. It's kind of consistent I think with what we've discussed . . .

> You basically gather some data
>
> You apply some kind of a formula
>
> And then you make a judgment
>
> So based on where that all lines up you may start all over again.

JEFF: Yes, I think that's exactly what it is. I'd probably put the arrows back in the other direction. Sometimes you teeter between the three all along the way. It's kind of like putting a plane on autopilot or making small corrections all along the way. The more you learn, the more you make adjustments and you start pinpointing and then when you realize no

additional information is going to change your opinion you realize, "OK, it's done." So that's a great way to describe valuation absolutely.

LORENZO: Great. So this then would be the qualifiers of where you go through the different stages. Is there anything you would add to these with respect to valuation standards or would you say that this covers it? My intention was to create a mnemonic to assist CEOs, CFOs, founders, and venture-capital investing professionals in remembering it, since it's said that valuation tends to be more art than science, so we have "art": accuracy, relevance, and timeliness.

JEFF: Absolutely. That's a perfect way to describe it because so much of the data we get is all about transactions. But then we have to ask how many are recent—are the older ones actually more relevant—and none of these factors is ever set in stone. For instance, another appraiser called to confirm that I never use transactions that are over five years old and I said yes, unless there's one that's a primary competitor, the only deal that's gone on in the same space forever and appears to be a perfect match. So like you say, it's an issue of relevance.

LORENZO: Before I wrap up, is there anything you'd like to point out to a CFO or your fellow valuation professionals to increase the quality of understanding or the quality of the profession?

JEFF: I guess the biggest thing I would say is just share information. I'm surprised by appraisers that when they figure something out, they don't want to share it as if they've discovered this huge thing that's going to make them competitively better than the rest. The challenge is that because of that behavior not a lot of people are going to embrace sharing new ideas or discoveries. If it's of use, it still won't benefit them or the profession if they are so secretive about it that no one gets a chance to convince the auditors that it's sound. I think there needs to be a certain amount of collaboration among the appraisal community. I think we can be more powerful in delivering our message. That could be a function of too many appraisal societies or because people get so guarded about their work. When the practice aid came, we figured it out quickly at one of my firms, and they were very guarded about it. I thought that was kind of silly because I know other appraisers that are doing it wrong. They're talking to auditors, and we need to start sharing.

I personally started collaborating with fellow appraisers proactively and I believe it's improved all of our services. I've learned from them and when I started sharing, someone would modify my model to make it better.

Reviewing the Carver Deal Term Test

LORENZO: Oh, thanks for reminding me. I wanted to share a technique I've been recommending to some valuation professionals, as well as

venture-fund CFOs and some angel investors for the past few years. I call it the Carver Deal Term Test.

The basic idea is that you take each security that a company has and you assume that it's possible to do a secondary purchase of each of those securities for the same price per share, let's say $1. So, for example, you could buy 100,000 Series A for $100,000, 100,000 Series B for $100,000, 100,000 Series C for $100,000, 100,000 Common Shares for $100,000, just as an example. This is basically leveling out the amount paid across rounds. Next, across the breakpoints you show what the multiple would have been, or the price per share, or the percentage of proceeds would be for each of the securities you purchased side by side.

JEFF: So you do that after you've built in all the preferences, right?

LORENZO: Yes, absolutely. I've found this to be much more effective in getting across the relative value of securities, especially when speaking to venture-capital fund finance teams and certain founders that have more than a couple of rounds of financing behind their venture. Instead of diving right into the Black-Scholes model and sorting through why the Series A got allocated more of the company value than the Series C, they can easily grasp the relative rights to sale or exit proceeds assuming each investment was made for the exact same price.

Well, Jeff, thanks a lot for taking the time to share some of your insights for founders, CFOs, CEOs, angels, auditors, VCs, and other valuation professionals.

JEFF: Thank you, Lorenzo.

SUMMARY

The interview in this chapter shows how some of the methods and cases discussed previously in this book relate directly to every venture-backed company that either intends to get another round of financing or plans to comply with 409A.

In Chapter 9, I combine snippets from one of a series of interviews I did with some of these valuation professionals who were willing to go on the record with their opinions, despite the frankness with which they express their positions, with some of the illustrations used in the book to convey the context of practitioners in this particular area. Auditors, company CFOs, fund CFOs, and perhaps others can certainly get a better idea of what goes into some of the analysis explained, and challenged, within this book.