The Evolution of Valuation Issues Through a Company's Lifecycle -- From Inception to Liquidity and Beyond

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Josette Ferrer, Managing Director
Clairent Advisors LLC

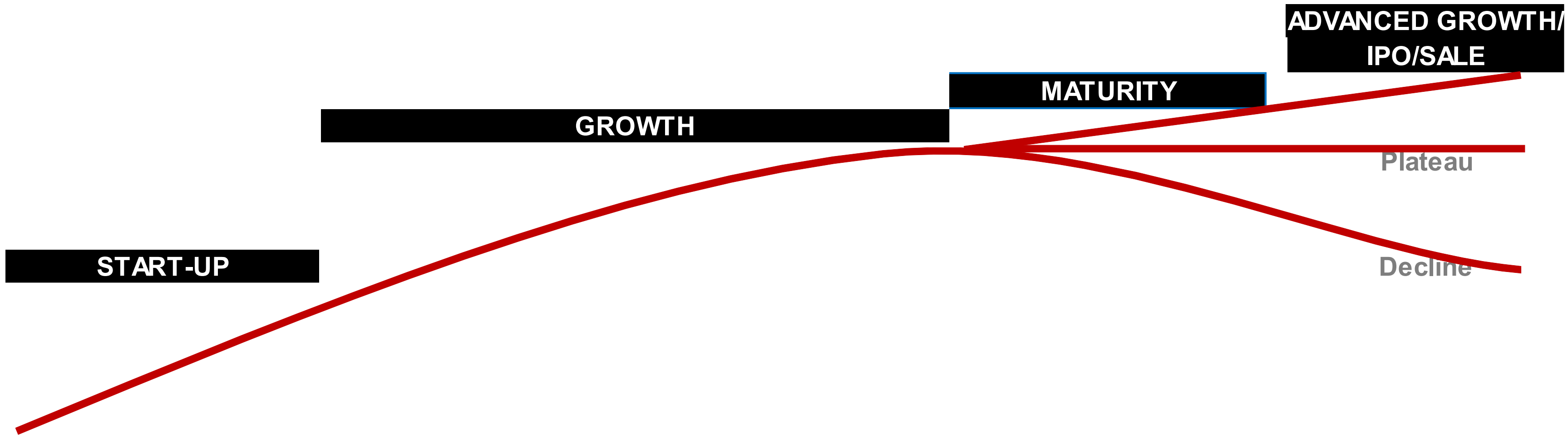
Agenda

- **Background**
  - Stages of Development and Valuation Needs
  - Valuation Approaches and Considerations
- **Start-Up/Early Stage Companies**
- **Growth/Mature Companies**
  - Focus on Purchase Price Allocations

Per Mike's Request!

- **Mature/Public Companies**
- ***Appendices:***
  - *Speaker Background/Contact Information*
  - *Bibliography*

Stages of Development and Valuation Needs



Focus	- Proof of concept - Establish demand	*Rapid Expansion* - Revenue growth	*High Growth* - Quality of growth - Breakeven	- Infrastructure -- processes, productivity, efficiency, profitability
Risks	- Business failure	- Competition	- Lack of/low quality growth - Lagging profit margins	- Status quo management/transition; stagnation

Valuation Needs

- **Negotiating with investors** (Start-up → Maturity)
- **409A/ASC 718** (Start-up → end of Maturity)
- **Acquisitions -- Business Combinations/ Purchase Price Allocations** (Growth through Maturity →)
- **Impairment** (Growth through Maturity →)

Valuation-Specific Considerations

"Big Four" audit requirements/SEC considerations (Maturity →)

Valuation Needs At All Stages

- **Disputes/Litigation**
- **Estate and Gift Tax**

Background: Valuation Approaches & Considerations

INCOME APPROACH

- Present value of future economic benefits
- Discount cash flows to present value at a rate of return that incorporates risks associated with the particular investment

MARKET APPROACH

- Comparison of subject property to recently priced property (sale, license, transactions, etc.) that is similar and for which price information is available
- Two methodologies for a business:
  - Public company market multiples method
  - Similar transactions method

COST APPROACH

- Values an asset by the cost to reconstruct or replace it
- For a business – measures the value of a company through an appraisal of individual assets of the business (current, fixed, and intangible)

- **Best Practices – Common for All Valuations (Regardless of Company Stage)**
  - Importance of understanding, incorporating, and documenting the "story behind the numbers"
  - Playing devil's advocate – from the outset of an engagement
  - Consideration of as many approaches/methodologies/benchmarks as possible

Start-Up/Early Stage Companies

Start-Up/Early Stage Companies

- **Valuation is challenging**
  - No financial history (revenue/profits)
  - Product/service in development; difficult to gauge market potential

- **Potential Frameworks for Valuation**

  ***Comments below assume the company has not had a recent funding round*

  - **Cost Approach**
    - Technology: Cost to recreate or historical costs; value based on cost multiples
    - Employee value ("acqui-hires")
    - Limited usage (very early stage companies)

  - **Market Approach**
    - Forward revenue multiples
    - Pre-money valuations related to similar transactions
    - ***Different considerations if the company has had a recent funding round (e.g., preferred stock)***

  - **Income Approach**
    - Discounted cash flow calculations considering:
      - Probability-weighted scenario approach (considering failure probabilities) and/or
      - Venture capital discount rates

Background

- **IRC Section 409A ("409A")**
  - Tax requirement that stock options must be priced at or above the fair market value of the underlying security (i.e., the security into which the options are exercisable – usually common stock)

- **Accounting Standards Codification ("ASC") Topic 718, *Compensation – Stock Compensation***
  - Formerly SFAS 123R
  - Compensation for stock options is calculated under GAAP for inclusion in financial statements
  - Considers fair value standard (different from 409A fair market value; differences are generally considered to be immaterial)

- **Focus on GAAP Compliance (Audit Reviews)**
  - So far there has been nominal IRS enforcement activity around 409A; most companies have had ASC 718 valuations reviewed by their auditors
  - Key reference guide: AICPA's Practice Aid – "Valuation of Privately Held Company Securities Issued as Compensation", 2013

- **Strategic consideration -- issues beyond just valuation/compliance**
  - Employee incentives

    ☞ *Client Examples: CEO option grant; grant delays for many employees*

  - Documentation (poor documentation can come back to haunt companies in audit review or for a potential acquisition)

- **Valuation considerations**
  - "Old" rules of thumb don't apply (preferred/common value benchmarks)
  - Different valuation framework applies depending on the situation
    - Recent round of financing –> "Backsolve" Method
      - Derives the implied equity value for one type of security (e.g., common stock) from a transaction involving another type of security (e.g., preferred stock)
    - No round of financing –> "Traditional" valuation methodologies

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Growth/Mature Companies

- **Primary Standards References**
  - **ASC 805, *Business Combinations* (formerly SFAS 141R)**
  - ASC 820, *Fair Value Measurements and Disclosures* (formerly SFAS 157)

- **Other Published Guidance**
  - Appraisal Foundation Monographs
    - *Identification of Contributory Assets and Calculation of Economic Rents* (issued in 2010)
    - *Valuation of Customer-Related Assets* (draft issued in 6/12)
  - AICPA IPR&D Practice Aid (update issued in 2013)
  - Big Four Guidebooks

- **Private Company Council ("PCC") Alternative**
  - ASU 2014-18 – *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (A Consensus of the Private Company Council)*
  - ASU 2014-02 – *Intangibles – Goodwill and Other (Topic 350): Accounting for Goodwill (A Consensus of the Private Company Council)*

Purchase Price Allocations

Sample Opening Balance Sheet Framework

Sample accounts and adjustments relate to two client examples (combined for illustration purposes) -- an agricultural products company and SaaS company

	Closing Balance Sheet	Adjusted Balance Sheet	
Assets			
Current Assets			
Cash and equivalents	$762,000	$762,000	
Accounts receivable	4,915,000	4,915,000	
Inventory	13,869,000	**16,100,000**	Pre-deal balance replaced by new fair values
Prepaid expenses	2,657,000	2,657,000	
Subtotal, current assets	22,203,000	24,434,000	
Non-Current Assets			
Property and equipment	4,046,000	**4,206,000**	Pre-deal balance replaced by new fair values
Intangible assets	7,472,000	**37,300,000**	Pre-deal balance replaced by new fair values New values considered customer relationships, trade names, and patents
Goodwill	0	**34,055,000**	New balance falls out of purchase price allocation
Subtotal, non-current assets	11,518,000	75,561,000	
Total assets	$33,721,000	$99,995,000	
Liabilities and Equity			
Current Liabilities			
Accounts payable	$1,789,000	$1,789,000	
Deferred revenue	3,396,000	**1,800,000**	Pre-deal balance replaced by new fair values **Usually results in a significant "haircut"**
Accrued expenses and other current liabilities	6,247,000	6,247,000	
Subtotal, current liabilities	11,432,000	9,836,000	
Non-Current Liabilities	395,000	395,000	
Total liabilities	11,827,000	10,231,000	
Total shareholders' equity	21,894,000	89,764,000	
Total liabilities + shareholders' equity	$33,721,000	$99,995,000	

Excerpt from Summary Pages for a Recent Finished Goods Valuation:

Valuation Analysis

Estimated selling price	$4,102,469
Less: Remaining costs	415,375
Less: Reasonable profit to buyer	57,435
Indicated value	$3,629,660
Rounded	**$3,629,700**
Comparison to book value	*$2,912,753*
Implied write-up (write-down)	*$716,947*
Write-up (write-down) percentage	*24.6%*

Analysis of Relative Returns (Reasonableness Check)

Return to Seller	
Proceeds from sale of inventory (fair value conclusion)	$3,629,700
Less: Cost of goods sold incurred	2,912,753
Less: Selling expenses incurred	27,692
Less: G&A incurred	8,205
Less: Depreciation incurred	164,099
Pretax income	$516,952
Seller margin	*14.2%*
Return to Buyer	
Sales price	$4,102,469
Less: Cost of inventory (fair value conclusion)	3,629,700
Less: Cost of goods sold remaining	0
Less: Selling expenses remaining	156,919
Less: G&A remaining	12,307
Less: Depreciation remaining	246,148
Pretax income	$57,394
Buyer margin	*1.4%*

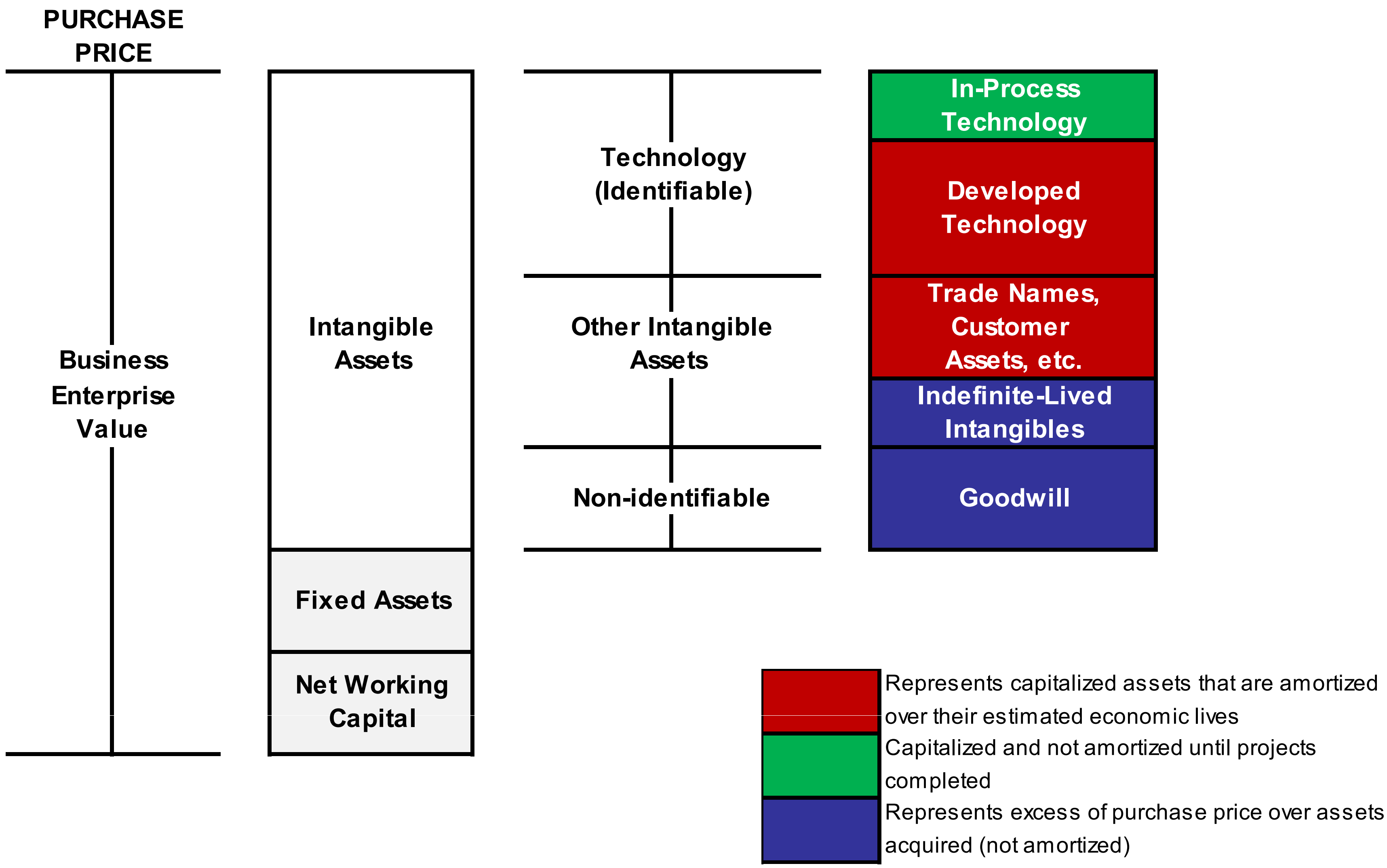
- **Fixed Assets/PP&E**
  - Fair value analysis often results in a step-up in value vs. book value if historical depreciation lives are lower than asset economic useful lives
  - **Valuation Methodology**
    - Replacement cost less adjustments for asset age and obsolescence (functional and/or economic if applicable)

- **Deferred Revenue**
  - Typically represents a performance obligation to provide a product or service in the future where payment has already been made
  - The fair value process associated with PPAs often results in a **significant downward adjustment/haircut** to the book value of deferred revenue – revenue associated with the haircut is not recognized by the acquirer post-transaction
  - **Valuation Methodology**
    - Considers nature of activities to be performed and related costs to be incurred to fulfill the product/service obligation
    - **Costs to full obligation + appropriate profit margin**

Valuation Analysis -- Summary Section of Recent Project ($000's)		
Costs to fulfill deferred revenue obligation	$1,250	**("A")**
Concluded applicable margin	30.0%	**("B")**
Cost + mark-up based on margin	$1,786	Costs / (1 - margin) ("A") / [1-("B")]
Rounded	**$1,800**	
Compares to deferred revenue balance	$3,396	
Fair value / book value	*55.9%*	

Purchase Price Allocations

Overview of Intangible Asset Framework – ASC 805



Typically Recognized Intangible Assets

Technology-Based Intangible Assets
- Patented Technology
- Unpatented Technology

(Patented and Unpatented Technology: *Developed Technology*)

- In-Process Research and Development
- Databases

Customer-Related Intangible Assets
- Backlog
- Customer Contracts
- Customer Relationships (Non-Contractual)
- Customer Lists

Marketing-Related Intangible Assets
- Trademarks, Trade Names
- Trade Dress (Unique Color, Shape, Package Design)
- Internet Domain Names
- Non-Competition Agreements

Contract-Based Intangible Assets
- Licensing, Royalty Agreements
- Franchise Agreements
- Operating and Broadcast Rights

Artistic-Related Intangible Assets
- Pictures, Photographs
- Video and Audiovisual Material (Motion Pictures, TV Programs)
- Musical Works (Compositions, Song Lyrics)

Guidance in ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination*

- Companies are not required to recognize and value:
  - **Customer relationships**
    - Exceptions: Customer-related intangible assets that can be separately sold or licensed independently from other assets of the business (e.g., mortgage servicing rights, customer information lists)
  - **Non-compete agreements**

- If a private company elects ASU 2014-18, it must also elect (or have already elected) to adopt ASU 2014-02, *Accounting for Goodwill*
  - Companies can elect to amortize goodwill on a straight-line basis over a maximum period of 10 years
  - An amortization period less than 10 years can be used if it can demonstrated that another useful life is more appropriate based on facts and circumstances
  - Simplified goodwill impairment testing procedures (see page 21)

Purchase Price Allocations

Case Study – Wireless Telecom Acquisition

$000's	Fair Values
Wireless Licenses	**$200,000**
Subscriber Base	**150,000**
Trade Names	**10,000**
Goodwill	600,000
Fixed Assets	110,000
Working Capital	4,000
Other LT Assets	3,000
	$1,077,000

"Squishy" Assets

Purchase price premium $960,000

89.1% of purchase price

Identified intangibles
37.5% of purchase price premium

Goodwill
62.5% of purchase price premium

Qualitative Factors and Impact on Intangible Asset Values

Comparison of Intangible Assets by Industry

Intangible Asset	Software Company	Services Company	Telecom Service Provider
Technology	High	Low / None	Low / None
Customer Assets	Depends (Low to High)	High	Low / Medium
Trade Name, Trademarks	Low	Depends (Low to High)	Depends (Usually Low)
Licenses	NA	NA	High

Purchase Price Allocations

Qualitative Factors and Impact on Intangible Asset Values (continued)

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill		Notes
General Business and Deal Factors			
- Long company history	↑ IIA	↓ Goodwill	
- High profitability in recent historical periods	↑ IIA	↓ Goodwill	
- High revenue growth and profitability projected in the next several years	↑ IIA	↓ Goodwill	Both aspects add more value to identified intangible assets since these increase economics in early years when present value factors are higher.
- Higher deal multiples paid for the acquired business	↓ IIA	↑ Goodwill	Likely translates into more value in the terminal period (which does not impact the intangible asset valuation models).
- Acquirer plans to make significant changes to the acquired business as part of its integration plans	↓ IIA	↑ Goodwill	Assumes acquirer plans would be similar to market participant likely plans
- Acquirer rationale for the acquisition (e.g., detailed in the deal press release) explicitly references identified intangible assets (like customers or technology)	↑ IIA	↓ Goodwill	

Qualitative Factors and Impact on Intangible Asset Values *(continued)*

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill		Notes
Intangible Asset-Specific Considerations			
Contracts / Customers			
- Significant / material long-term contracts and backlog acquired	↑ IIA	↓ Goodwill	
- High customer retention / contract renewal anticipated	↑ IIA	↓ Goodwill	
- Ability and high expectations to sign new contracts / sell additional products to current customers	↑ IIA	↓ Goodwill	
Developed Technology			
- Significant changes to products expected over the next several years	↓ IIA	↑ Goodwill	
- Company spends significant R&D on new development (vs. maintenance)	↓ IIA	↑ Goodwill	
- Long product / technology lifecycle anticipated	↑ IIA	↓ Goodwill	
- Company has significant patents which are key to its business	↑ IIA	↓ Goodwill	
- Few alternatives exist to the company's technology	↑ IIA	↓ Goodwill	

Purchase Price Allocations
Qualitative Factors and Impact on Intangible Asset Values *(continued)*

Factors and Considerations	Impact of Factor on Identified Intangible Assets ("IIA") or Goodwill		Notes
Intangible Asset-Specific Considerations (continued)			
Trade Names			
- Business / product trade names are expected to be retained after the acquisition	⬆ IIA	⬇ Goodwill	
- Strong strength of the trade names in the market / high customer recognition	⬆ IIA	⬇ Goodwill	
- Trade names attract customers and offer strong pricing or other advantages	⬆ IIA	⬇ Goodwill	

	Long-Lived Assets Tangibles & Intangibles	Indefinite-Lived Intangibles	Goodwill
Primary Guidance	**ASC 360** Accounting for the Impairment or Disposal of Long-Lived Assets Formerly SFAS 144 ASC 350-30 (primarily -35)	**ASC 350** Goodwill and Other Intangible Assets Formerly SFAS 142 **ASU 2012-02 (issued 7/12)** **Qualitative Testing**	**ASC 350** Goodwill and Other Intangible Assets Formerly SFAS 142 **ASU 2011-08 (issued 9/11)** **Qualitative Testing**
Focus	Test **recoverability** of long-lived assets; determine impairment if needed	**Fair value test** Indefinite-lived intangibles carried at lower of fair value or carrying value	**Fair value test** Goodwill carried at lower of fair value or carrying value
Testing	Event based	At least annually; event based if triggered	At least annually; event based if triggered

Private Company Alternative

- ASU 2014-02, *Accounting for Goodwill*
  - Companies required to test goodwill for impairment only when a triggering event occurs (vs. having to perform the test annually)
  - Impairment can be assessed at the entity level (vs. at the reporting unit level)
  - Eliminates Step 2 of the goodwill impairment test –> Impairment = Excess of Carrying Amount over Fair Value

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Mature/Public Company Considerations

Public Companies
Increasing PCAOB Scrutiny on Fair Value Issues

- Fair value deficiencies remain high for audit firms
- As cited in a CFO.com article (9/30/14)[1]:
  - Over 40% of all audits inspected by the PCAOB in 2012 had deficiencies
  - Of the 80 available PCAOB inspection reports from 2008 to 2012 **for the top 25 audit firms, 63.7% had fair value and / or impairment audit deficiencies**
  - 2012 deficiencies declined from their peak in 2010 but are still significant
- Tighter requirements = greater documentation continuing to be needed.
  - A quote from an early 2013 WSJ article related to fair value audit deficiencies has come to pass:

    "Auditors are going to be asking a lot more questions about how values were determined ... The work is exponential."

[1] *"Fair Value Continues to Trip Up Auditors"* , CFO.com, September 30, 2014 (references the third annual *"Survey of Fair Value Audit Deficiencies"*, Acuitas, Inc., August 31, 2014).

Public Companies

Increasing SEC Scrutiny on Fair Value Issues

- Continued SEC focus on fair value and related issues in comment letters

- As cited in *SEC Comments and Trends*, published by EY in 9/14:
  - Fair value measurements comprised **25% of comments** for registrants that received comment letters in 2013 and 2014; #2 category ranking associated with comments for both years
  - If other valuation-related comment categories are considered (specifically intangible assets and goodwill; acquisitions and business combinations) the **% of comments involving valuation issues <u>increases to over 50%</u>**

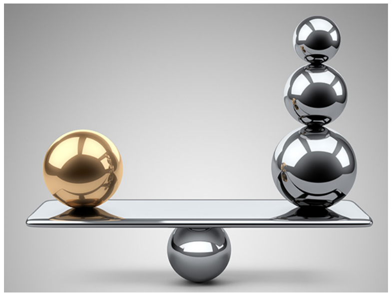
Audit Process Related to Fair Value Reporting

- **3rd party / independent valuation provider** or company management prepares a fair value analysis

- Audit review team (including both valuation and accounting / audit team members) reviews the fair value analysis
  - Valuation-specific and accounting/audit-specific questions

- Typical review process –> the audit review team:
  - Reviews analysis to identify key assumptions, assess reasonableness of methodologies, check calculations, etc.
  - Prepares a list of questions for valuation provider and management to address; responses typically prepared in writing
  - Documents responses to questions and whether items were resolved satisfactorily
  - Documents other procedures performed (e.g., shadow calculations for items not satisfactorily resolved; sensitivity analyses)

- **Challenges Faced by Accounting / Audit and Valuation Review Teams**
  - Reviewers must balance scope and depth of review with audit materiality considerations.
  - Review timing.
  - Challenges with auditing assumptions (e.g., projections).
  - Issues not satisfactorily resolved:
    - “Shadow calculations.”
    - Research and identification of supporting market and other data.



Mature and Public Companies

Audit Process Related to Fair Value Reporting (continued)

- **Best Practice Suggestions**

Collaboration and consensus among **management, auditors** (both accounting / audit and valuation teams), **and external valuation specialists** is key

Engage in planning discussions as early as possible

- Key when a valuation has unusual or atypical considerations; also when certain specific circumstances exist (e.g., earnouts).
- Firm and reviewer-specific considerations.
- Consensus between local audit team vs. “National” standards.
- Well reasoned approaches + high quality documentation needed.

☞ *Project Example: Marketing services company*

Mature and Public Companies
Other Valuation Issues

- **Executive compensation**
  - ***Example: Performance share units***
    - ✓ Compensation packages tied to relative performance of a company's stock price to peer group stock price movements
    - ✓ Fair value of market conditions must be assessed – requires use of techniques such as Monte Carlo simulations to model both company and peer stock price movements for multi-year periods
- **Derivatives**
  - ***Example: warrants with typical anti-dilution provisions***
    - ✓ SEC guidance on the Black-Scholes model not being an appropriate framework for fair value purposes – Lattice Models/Monte Carlo simulations often required

☞ *Project Example: SaaS company*

Valuation Issues Relevant at All Company Stages

- **Disputes**
  - **Most common issue – shareholder buy-outs**
    - ✓ Be aware of buy-sell agreement provisions – may impact the starting value point for negotiation purposes

> ☞ *Project Example: Buy-out of investors/management company in a successful restaurant business*

  - **Marital dissolution**
    - ✓ Premise of value? Generally impacted/determined by jurisdiction where a matter is filed
    - ✓ Big question → inclusion or exclusion of discounts for lack of control and marketability

- **Tax Planning/Reporting**
  - **Estate/gift tax**
    - Court cases

Q & A

www.clairent.com

Speaker Background / Contact Information

Josette Ferrer
Managing Director

jferrer@clairent.com
Direct: 415 658 5589
Mobile: 415 272 5191

201 Spear Street, Suite 1100
San Francisco, CA 94105

www.clairent.com

Current Responsibilities

Josette Ferrer is the founder and a Managing Director of Clairent Advisors. Since 1993, Josette has been assisting clients with the valuation of closely held businesses and business interests, intangible assets, intellectual property, stock options, debt instruments, capital equipment / fixed assets, and other assets.

Experience

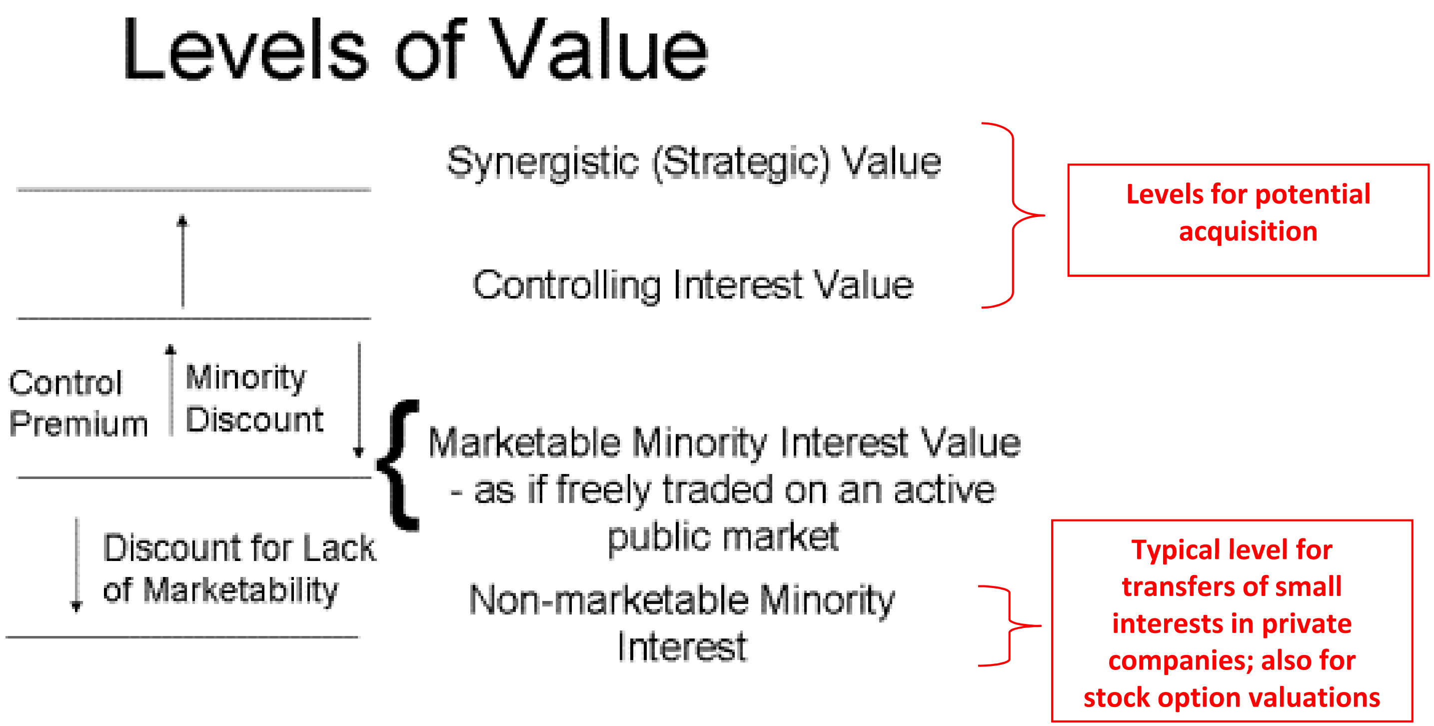
Prior to founding Clairent Advisors in 2010, Josette was the U.S. Practice Leader of Marsh's Valuation Services Group (formerly Kroll's Valuation Services Practice). Her career includes serving as the Managing Director in charge of the San Francisco Valuation Services Group of WTAS, Inc. ("WTAS“, now operating as Andersen Tax), a former subsidiary of HSBC Group. At WTAS, Josette's responsibilities included developing and overseeing all technical, operational, marketing functions for the SF valuation team. Prior to WTAS, Josette was a director with Huron Consulting Group and a senior manager at Arthur Andersen LLP.

While Josette has extensive experience serving clients in many industries, areas of specialty include telecommunications, high technology, service companies, consumer products, manufacturing, and financial services. Her clients have ranged from small, emerging businesses to Fortune 500 companies. Josette has been a guest speaker for a wide variety of forums, including Financial Executives International/FEI, the Institute of Management Accountants/IMA, the Practicing Law Institute /PLI, CalCPA, the San Francisco and Contra Costa Bar Associations, Santa Clara University, BIOCOM, and various venture capital roundtables.

Education and Affiliations

- B.S. in Business Administration, University of California, Berkeley
- Member, Fair Value Forum
- Board Member, SF Chapter, Financial Executives International
- Corporate Affiliate, Finance Scholars Group
- Strategic Partner, Strategic Alliances Resources Network
- Executive Committee Member, ProVisors SF3 Group

Appendix: Background / Reference Slide



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