Valuing, Protecting and Treatment of an Owner's Dilutable Interest in a Rapidly Growing Business

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Agenda

- A Quick Pass Through Some Key Fundamental Concepts
- The Challenges of Valuing a Start Up Enterprise
- **Dynamic Media Partners - a fictional case set to drill into some particulars**
- Hybrid securities and complex capital nuances
- Using Secondary Market Transactions

Acknowledgments

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A Few Fundamental Concepts

Understanding Value

'Value" as a mathematical formula:

$$\text{Value} = \frac{I}{R-G}$$

I = Income

R = Risk

G = Growth

or

$$\text{Value} = \frac{\text{Free cash flow (FCF)}}{\text{Cost of capital (CofC)} - \text{Growth in FCF}}$$

It is quite simple, but estimating the inputs is where the game gets played.

A View From 50,000 Feet Above….

- ***The biggest determinants of a startup's value are:***
  - **the market forces of the industry & sector in which it plays, which include the balance (or imbalance) between demand and supply of money**
  - **the frequency and size of recent exits**
  - **the willingness for an investor to pay a premium to get into a deal, and**
  - **the level of desperation of the entrepreneur looking for money.**

A Few Thoughts on the Value Proposition in This Space

An investor is willing to pay more for an opportunity if:

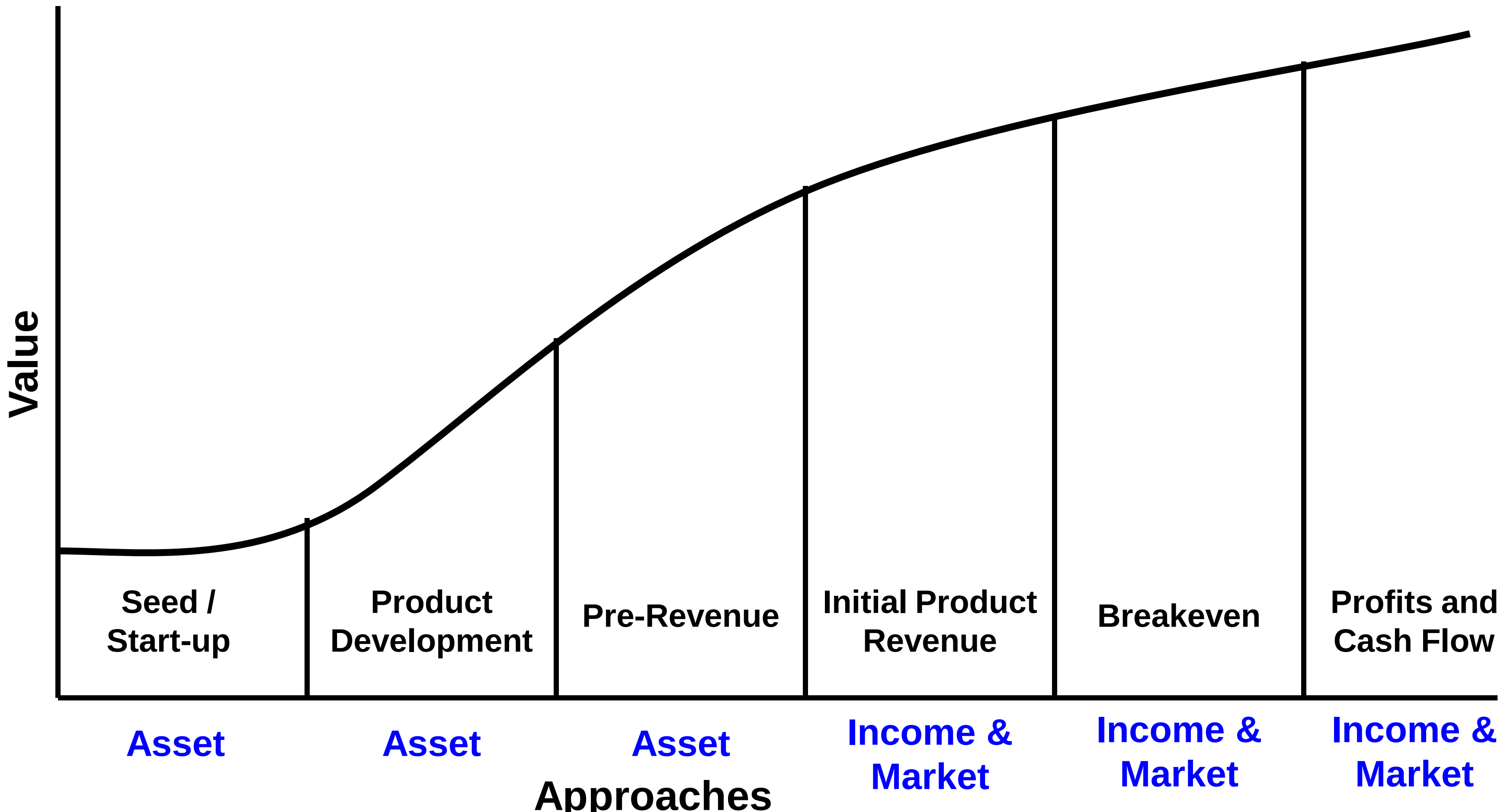
- **<u>It is in a hot sector</u>: Investors that come late into a sector may also be willing to pay more as one sees in public stock markets of later entrants into a hot stock.**
- **<u>If the management team is perceived to be hot</u>: serial entrepreneurs can command premiums. A good team gives investors faith that they can execute.**
- **<u>There is a legitimate prospect for a functioning product</u> (more for early stage companies)**
- **<u>There is some early traction</u>: nothing shows value like customers (or other lenders/investors!) telling the investor there is perceived value.**

A Few Thoughts on the Value Proposition in This Space

An investor is less likely to pay a premium for the opportunity (or will totally pass on the investment) if:

- It is in a sector that has <u>shown poor performance</u>.
- It is in a <u>sector that is highly commoditized</u>, with little margins to be made.
- It is in a sector that has a <u>large set of competitors and with little differentiation</u> between them (picking the winners is hard).
- The management team has <u>no track record and/or may be missing key people</u> to execute the plan
- The product is not working and there is <u>no customer validation</u>
- **The cash burn rate is not looking good**

The Evolution of Value in a Fast Growing Enterprise



CHARACTERISTICS OF A START-UP COMPANY

START-UP COMPANIES

STAGE 1 – Companies are characterized by no product or service revenue and a limited expense history. The company typically does not have a product, although development is underway. The management team is incomplete, and the company is funded by seed capital, consisting of the founder's investment and capital from friends, family, and/or angel investors.

STAGE 2 – At this stage, the company has no revenue, but has a more extensive expense history as management has made investments required to establish the company, further develop the product, and identify target markets. Companies at this stage of development have often completed their 2nd or 3rd round of financing, typically provided by venture capital firms.

Along with these infusions of capital, the VC lenders will be seeking more input and control with respect to possibly expanded management rights, rights to future revenues and profits, together with definitive terms on the rights to future offerings of stock, anti dilution provisions and collateral in current shares.

Characteristics of a Start-up Company

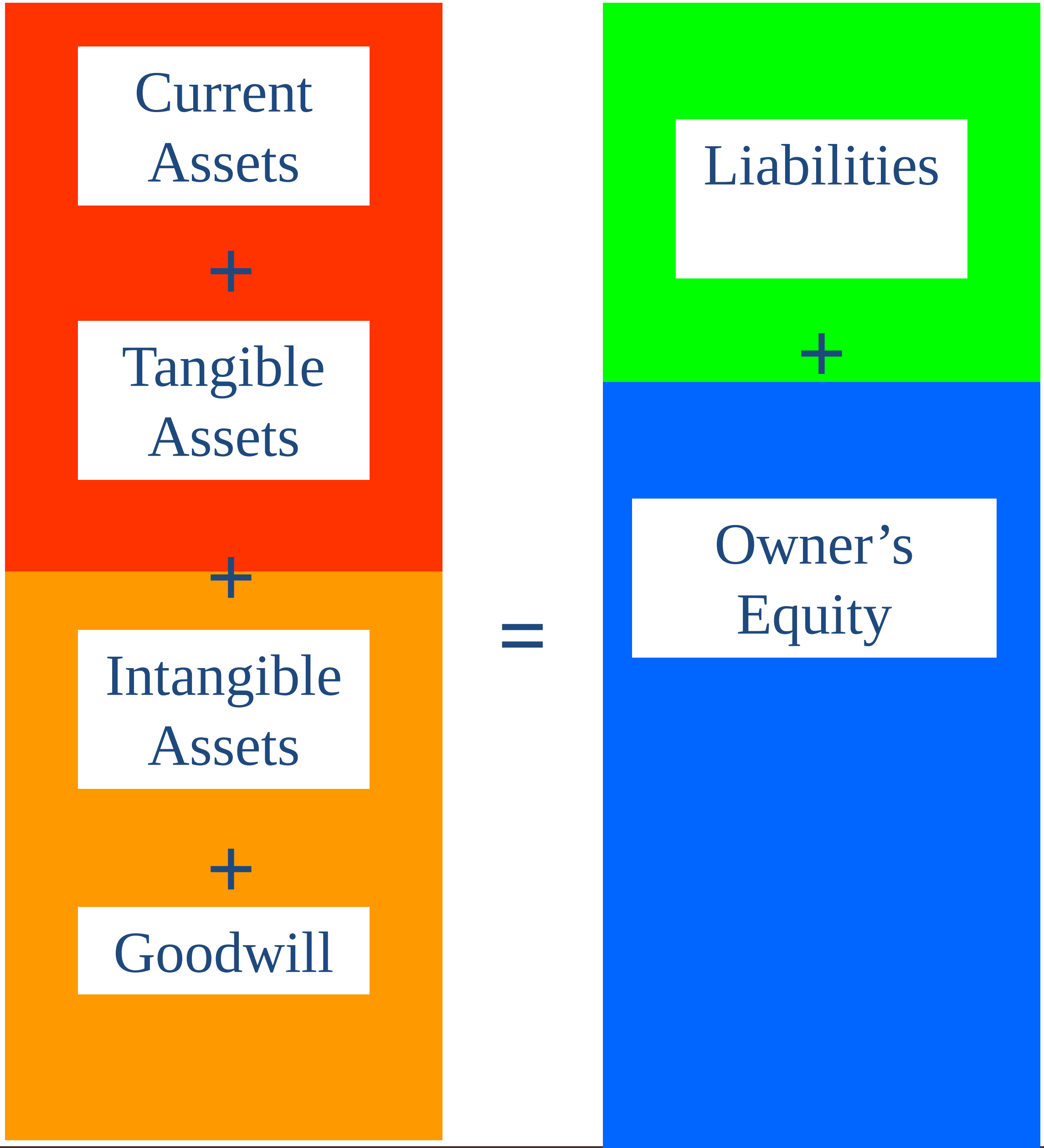
REACHING MATURITY

STAGE 3 – Management has hired additional employees to round out the team and product development is nearing completion – the alpha or beta version of the product is often released at this stage. Typically, the company is not generating revenue from its products. Venture capital firms and strategic investors often participate in the company's financing rounds at this stage, subject to the same provisos as outlined in STAGE 2.

STAGE 4 – Although the company has started to ship products to customers, it is still operating at a loss. Management may enter into preliminary discussions with investment banks regarding an IPO and may complete a mezzanine round of financing to cover any capital requirements until the IPO is completed.

This is where metrics such as click throughs, inquiries made, etc. can begin to be helpful in measuring value, prior to sufficient revenues and cash flows materializing.

STAGES 5 & 6 – The company has an established operating history, generates product revenue and has attained profitability. A liquidity event in the form of an IPO could occur at this stage.


Current Assets
+
Tangible Assets
+
Intangible Assets
+
Goodwill
=
Liabilities
+
Owner's Equity

Current Assets

\+

Tangible Assets

\+

Intangible Assets

\+

Goodwill

=

Liabilities

\+

Convertible Debt, Preferred Stock, Options, Warrants, Restricted Stock

\+

Owner's Equity

Valuing a Start Up Enterprise

Case example – Dynamic Media Partners (DMP)
Now in Year 4 of existence

- Started by entrepreneur Dan Dynamic 3 years ago
- Year 1 initial investment $405,000
- 3,000,000 shares common stock issued to Dan
- Year 2 angel investment of $737,500 by Arnold Angel
- Year 2 bank debt of $750,000 guaranteed by Dan
- Year 3 Series A preferred convertible stock
- Year 4 (current) Series B preferred convertible stock

Case example – Dynamic Media Partners
(Angel Investment – Arnold Angel)

- Angel Investment of $737,500
- Made in Year 2
  - 5 Year Term Loan
  - 6% annual interest
  - Includes covenant limiting Dan's annual draws and distributions to $350,000 net of taxes
  - Carries option for Arnold to purchase 8% of Dan's shares (240,000 shares) at any time during 5 year term
  - Option price is $1,200,000
  - "Values" stock at $5.00 per share

Case example – Dynamic Media Partners
(Bank Debt)

- Traditional bank financing
- Made in Year 2
- Loan is to Dynamic Media Partners
- Personally guaranteed by Dan Dynamic but not his Wife Janet Dynamic
- 5 year term loan
- 4% annual interest
- No covenants regarding income or distributions

Case example – Dynamic Media Partners
Preferred Convertible Stock

- Year 3 Series A preferred convertible stock
  - 500,000 shares paying 4% dividend
  - $2,435,000 raised
  - Conversion ratio 5.0 (2,500,000 of common stock)
  - 2 year conversion date (exercisable in Year 5)
- Year 4 Series B preferred convertible stock
  - 500,000 shares paying 4% dividend
  - $2,785,000 raised
  - Conversion ratio 2.0 (1,000,000 of common stock)
  - 2 year conversion date (exercisable in Year 6)

Dynamic Media Partners

	Year -3	Year -2	Year -1	Current Year	Year +1	Year +2	Year +3	Year +4
Revenues	$ -	$ -	$ -	$ 120,000	$ 3,800,000	$ 24,500,000	$ 58,000,000	$ 62,500,000
Development related costs	250,000	1,240,000	2,200,000	1,600,000	2,450,000	1,550,000	1,650,000	245,000
Cummulative devel costs	*$ 250,000*	*$ 1,490,000*	*$ 3,690,000*	*$ 5,290,000*	*$ 7,740,000*	*$ 9,290,000*	*$ 10,940,000*	*$ 11,185,000*
General & administrative	155,000	247,500	185,000	345,000	650,000	2,500,000	3,400,000	3,650,000
Net cash flow	$ (405,000)	$ (1,487,500)	$ (2,385,000)	$ (1,825,000)	$ 700,000	$ 20,450,000	$ 52,950,000	$ 58,605,000
Cummulative cash flow	*$ (405,000)*	*$ (1,892,500)*	*$ (4,277,500)*	*$ (6,102,500)*	*$ (5,402,500)*	*$ 15,047,500*	*$ 67,997,500*	*$ 126,602,500*
Sources of funds								
Initial Owner funding	$ 405,000	$ 737,500	$ 200,000	$ 125,000				
Bank debt secured by owner		750,000						
Series A preferred, convertible stock			2,435,000					
Series B preferred, convertible stock				2,785,000				
Cummulative funding	*$ 405,000*	*$ 1,892,500*	*$ 4,527,500*	*$ 7,437,500*				
Ownership of Dan Dynamic	**100%**	**100%**	??	??	??	??	??	??

Effect of Preferred Stock Conversions

- Initial Stock 3,000,000 common shares to Dan
- At time of divorce, Dan “owns” 100% of common stock, yet…..
- Series A Preferred can be converted to 2,500,000 common shares in Year +1
  - Dan - 3,000,000 shares (54.6%)
  - Irving - 2,500,000 shares (45.4%)
- Series B Preferred can be converted to 1,000,000 common shares in Year +3
  - Dan - 3,000,000 shares (46.15%)
  - Irving - 3,500,000 shares (53.85%)

Now Add Angel Investor's Option

- Dan's % can be further reduced by Arnold Angel
- Option to purchase 240,000 shares from Dan any time through Year +3
  - Dan's 100% can be reduced to 54.6% by Preferred Series A conversion
  - Dan's 54.6% can be further reduced to 46.15% by Preferred Series B conversion
  - Arnold's purchase of 240,000 shares from Dan would reduce his ownership from 3,000,000 common shares to 2,760,000 shares, or 42.46%

Additional Assumed Facts – Dynamic Media

- Dynamic Media has a Buy-Sell Agreement in place covering all shares issued that gives the company a right of first refusal to purchase shares
- Dan Dynamic has an employment agreement and has assigned all individual rights to IP developed to DMP
- Dan has had a couple big winners in the past but has also re-invested a large portion of those gains back into dead end projects and concepts

Additional Assumed Facts – Dynamic Media (continued)

- Dan has assembled a team at Dynamic Media which is generally well respected and has a positive track record
- Dynamic Media is functioning in the current year in a generally positive economic environment
- Dan’s horizon for monetizing Dynamic Media is longer term; the investors’ horizon is shorter term
- In the context of the divorce, Dynamic Media by any measure is the most valuable asset of the marriage

Challenges for the Financial Expert

- **Typical timing issues are magnified**
  - Availability of current financial and related operational data
  - Timing of due date for report versus date of permanent orders
  - Degree of obsolescence and relevance can change over night!
- **Inability to utilize Discounted Future Benefits methods**
- **Evolving and elusive ownership rights of Dan Dynamic**
  - When and how will conversion rights kick in?
  - When does Dan lose "control"?
- **Are we valuing DMP or the IP rights or both?**

Challenges for Legal Counsel

- **Counsel's challenges if representing Dan:**
  - Avoiding a valuation of $5.00 per share based on Angel investment
  - Avoiding a valuation in excess of $5.00 per share based on revenue projections and economic outlook
  - Convincing the judge that the dilutions and % reductions will occur
  - Introducing discounts for lack of control and lack of market ability based on potential dilutions
  - Dealing with the compensation limitations imposed on Dan and the effect that will have on Dan's ability to pay alimony – which will lead the fact finder back to Dan's interest in Dynamic Media as a source of equitable distribution

Challenges for Legal Counsel

- **Counsel's challenges if representing Janet (the non-propertied spouse):**
  - Restrictions on transferability of Dynamic Media stock
  - Convincing the judge that the dilutions and % reductions may not occur
  - Avoiding discounts for lack of control and lack of marketability based on potential dilutions and % reductions
  - Dealing with the compensation limitations imposed on Dan and the effect that will have on Dan's ability to pay alimony
  - Lack of other assets from which to seek offsetting equitable distribution award
  - Creating a system of reporting that ensures an ongoing understanding of DMP's finances

Possible Solutions/Treatment of DMP Interests

- **Of course, we have "if, as and when" – Janet goes for the ride**
  - Is Janet willing to take a chance that Dan can make DMP into a success and monetize her awarded interest within a timeframe that is acceptable? If so, negotiate for such a result
  - Require payments from any further sale, any loans to Dan or in the case of any future diluting event
  - Track a metric such as tangible book value and allow Dan to take distributions within a certain window as long as the reported metric is at or above a minimum requirement
  - Negotiate for Janet to have the right to "put" portions of her award to Dan at certain times, in order to provide her with liquidity

Possible Solutions/Treatment of DMP Interests

- **If Janet is not willing to take a chance on the future**
  - Establish a value for DMP and negotiate a % of that value to be awarded to Janet
  - Create incentive for Dan to pay by opening up distributions or increased comp to him, as long as tangible book value doesn't fall
  - Require payments against the amount due from any distributions above a certain amount
  - Provide a discount of the amount due if Dan pays on an accelerated schedule

Using Secondary Market Transactions

Private Equity Secondary Market

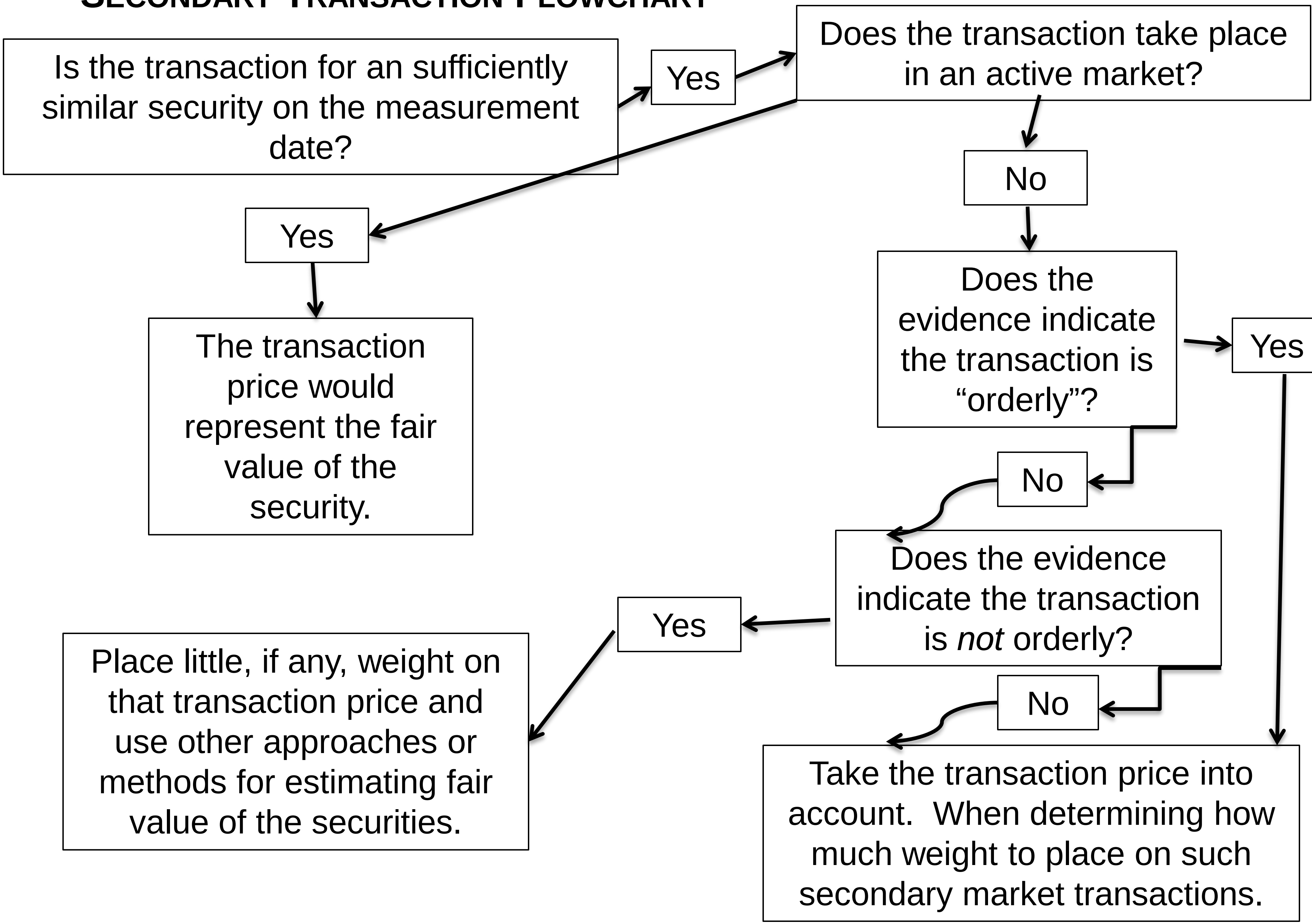
The private equity secondary market (also often called private equity secondaries or secondaries) refers to the buying and selling of pre-existing investor commitments to private equity and other alternative investment funds.

Sellers of private equity investments sell not only the investments in the fund but also their remaining unfunded commitments to the funds. By its nature, the private equity asset class is illiquid, intended to be a long-term investment for buy-and-hold investors. For the vast majority of private equity investments, there is no listed public market; however, there is a robust and maturing secondary market available for sellers of private equity assets.

Driven by strong demand for private equity exposure, a significant amount of capital has been committed to dedicated secondary market funds from investors looking to increase and diversify their private equity exposure.

www.wikipedia.com

SECONDARY TRANSACTION FLOWCHART



Secondary Market Transactions

Arguments against using	Arguments in favor of using
Exchanges are not regulated.	Exchanges have FINRA and SEC oversight.
Due to lack of regulation, there is no mechanism for willing buyers and sellers to get consistent information about the investment’s risk and return. Companies control information flow.	There is plenty of knowledge available on these exchanges and other places in order for the buyers and sellers to make informed decisions.
Due to lack of regulation, the potential for large asymmetric knowledge differences between a buyer and seller is significant.	The same argument could be made for public exchanges where buyers and sellers have equal access to the same knowledge.
Buyers and sellers are different then in public markets. Companies control who the buyers and sellers are. This does not meet market participant definitions.	Buyers are accredited investors, therefore, they are knowledgeable about what they are purchasing.

Secondary Market Transactions, Cont.

Arguments against using	Arguments in favor of using
Business risks can more easily be kept from the investors leading to financial models that incorporate this risk being significantly different from traded prices on these markets. Open markets better inform investors of these risks.	As long as both the buyer and seller have the same knowledge of the relevant facts, it should not matter. Does this ever happen on secondary markets?
Prices on these markets do not reflect market participant assumptions due to asymmetric knowledge and does not include information available through usual and customary due diligence efforts.	As long as both parties have a reasonable understanding of the asset and the transaction is based on all available information, it meets the market participant definition. Tall order?

SECONDARY MARKET TRANSACTIONS, CONT.

Arguments against using	Arguments in favor of using
There are too few transactions to consider this an "active market."	How many transactions make an active market?
In instances where there are few transactions, the motivations of the buyer and seller may not be known.	The company understands the facts around the transactions and therefore can help determine the arms-length nature of the transactions.
Due to the limited number of transactions, the sites act more like an auction where the last prices on the auction more heavily influence the future exchange prices than company and economic fundamentals. This may lead to an upward bias in the pricing.	Knowledge of past transactions does not influence this marketplace any differently then it would on a public exchange.

Dealing with Complex Capital Structures

What makes it complex?

Complexity is a function of

- Desired Flexibility in attracting investors
  - Rights and preferences
  - Hierarchy of claims
  - Bundling of classes of capital
- Broader range of financial instruments
- Appropriate alignment of risk and return
- Utilize instruments that are neither straight debt or straight equity

Identifying the Layers of Complexity

- Voting and non-voting classes of common
- Preferred stock
- Convertible preferred
- Options and warrants
- Hybrids
- Debt with special features
- Dilution privileges and protections

Preferred stock – typical characteristics

- **Right to dividends**
  - Cumulative/ Non-cumulative
- **Liquidation preference**
  - Participating/ Non-participating
- **Redemption rights**
- **Conversion rights**
  - Fixed or variable ratio
- **Voting, veto, Board seats**
- **Registration rights**
- **Anti-dilution provisions**

Preferred Stock – valuation

- **Two step process**
  - Estimate overall equity or enterprise value
  - Allocate to asset classes, preferred, options, warrants, common
- **Current allocation methods**
  - PWERM – Probability Weighted Equity Return Method
  - OPM – Option Pricing Method
  - CVM – Current Value Method
- **Each of these allocation models have strengths and weaknesses <u>and require a high degree of subjective judgment</u>**
- **AICPA Practice Guide, 2013 – Cheap Stock Practice Aid**

Options and warrants

Options and warrants overview

- **Employee stock option and warrants impact the fair value of equity in two ways**
    1. **Increase cash flow to the company from exercise proceeds and any related income tax benefits triggered on exercise**
    2. **Dilutive impact on existing shareholders as new shares are issued**

- **Impact on both can be mitigated if the firm repurchases the share**

Options and warrants – dilution example

- Case 1
  - Value of a firm with no dilutive options and warrants

    - $50 share price, 10 million shares O/S – market cap of $500 million
- Case 2
  - Identical firm issued options an d warrants with a market value of $20 million

    - Results in a reduced stock price (due to anticipated dilution)

      of $48 per share

    - Total value is still $500 million

    - Of that amount, $20 million is allocated to options and

      warrants

Employee stock options

- These instruments take on the feel of warrants from an economic standpoint
- When exercised, these instruments impact the value of a firm by
  - Increase future cash flows, and
  - Increase the number of shares outstanding
    - As opposed to traded stock options
    - These are private transactions among investors

Hybrid Securities

Hybrid securities

- Not straight debt or straight equity
- May consider preferred stock a type of hybrid due status between common shareholders and debt holders
- Most common in practice
  - Convertible debt
  - Debt with detachable warrants
  - Convertible preferred stock

Hybrid securities – valuation issues

- Is any portion of the payment tax deductible?
- Do the cash flows on the securities have high priority if the firm is in financial trouble?
- Do the securities have a fixed life?
- Does the owner of the security share control of the entity

Hybrid securities – debt with detachable warrants

- Lower the interest rate of the debt
- Can be detached from the debt and either exercised or sold to other investors
- ROI to the investor consists of the yield on the debt plus the equity yield on the warrants
- Investors will price the instrument based on these two components

Hybrid securities – convertible debt

- Similar to debt with detachable warrants
  - In each case, an investor trades interest yield for potentially more favorable return on equity on the upside

- Equity component of this security is not detachable; this decision is usually made at maturity whether they are better off converting to common shares or not

AICPA Practice Aid

- ***AICPA <u>Valuation of Privately-Held-Company Equity Securities Issued as Compensation</u>*, details the application of the three identified methods of allocating value between preferred and common equity:**
  - **Current Value Method (“CVM”)**
  - **Probability Weighted Expected Return Method (“PWERM”)**
  - **Option-Pricing Method (“OPM”)**

General Overview of Allocation Methods

- **In general**
  - No one method is superior to another
  - Inputs and empirical data is hard to obtain
  - Facts and circumstances will drive appropriate model selection
  - Possible to reflect rights and preferences of shareholder agreement or indentures

- **Selection of method depends on**
  - Does it reflect a going concern expectation of each class?
  - Does it ascribe some value to the common, if not liquidation?
  - Can results be independently replicated?
  - Do the benefits of applying the method exceed its costs?

Allocation methods – strengths

PWERM	OPM	CVM
• Explicitly considers rights and preferences of each security class at some date in the future where those rights would either be exercised or abandoned	• Treats each class as a call option on the enterprise or equity value	• Simple to apply assumes current date allocation to all classes of securities irrespective of future events or outcomes
• Forward looking, incorporating future economic events of outcomes	• Use of BSM or binomial model aids in application of this method	
• Sensitivity testing is available	• Useful for securities with a high level of uncertainty	

Allocation methods - weaknesses

PWERM	OPM	CVM
• Relies on a number of assumption concerning the future which are unknown at the measurement date	• Very sensitive to inputs such as volatility and horizon life	• Failure to recognize future events or circumstances limits its application to a narrow set of facts and circumstances
• Requires management inputs which may not be objective	• Won’t pick up radical spikes that are available in a PWERM	• Does not reflect the underlying achievement of the investment objective
• Divergence in modeling could lead to lack of consistency or comparability		• May not yield a result consistent with the measurement objective

Option Pricing Method ("OPM")

Strengths	Weaknesses
• Produces wide range of potential outcomes	• Requires specification of single exit date
• Assigns probabilities objectively, based on a risk neutral framework	• Difficult to capture dilutive impact of future pre-event financing rounds
• Can capture dilutive impact of current and anticipated future awards of stock and stock options	• Does not capture milestone (non-normal) changes in value
• Relative ease of application, auditing and pervasive application in practice	

Using the Discounted Future Benefits Method

What does the word ***Value*** mean?

"All values are anticipations of the future" ◘ **Justice Oliver Wendell Holmes, 1904.**

Without consensus as to the standard of value, the resulting valuation conclusion is without meaning.

One of the Biggest Conundrums in Business Appraisal

- The “Great Recession” has wreaked havoc on many industries and closely held businesses
- Using historical data to project future operating potential (e.g. cash flows) is dicey at best in many situations
- Family law courts frown on using future economic benefits as a driver to value a business enterprise under the presumption that these benefits are the future income of the propertied spouse
- Yet, they allow the use of a single period capitalization model!

Taking the Double Dip Out of the DCF

- If the projected future economic benefit stream (e.g. cash flows) are normalized to remove a reasonable provision for the owner's (e.g. propertied spouse) compensation for actual services rendered, shouldn't the remaining cash flow, properly discounted to the date of divorce, be a better indication of entity value, as compared to other available methods?
- Capitalized cash flows does the same thing with the assumption of constant perpetual growth!

Other Issues

Other Related Issues

- Tiered entity issues

- Impact of the Great Recession and related recovery
  - Milton Freidman's Plucking Theory
  - Timing is everything