SORBUS
VALUATION ADVISORY SERVICES

Sorbus Advisors LLC

Portfolio Valuation under ASC 820 for Venture Capital and Private Equity firms

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Sorbus Advisors LLC is an independent provider of valuation advisory services for financial accounting, tax reporting, and portfolio management purposes. Its mission is to help clients navigate a complex regulatory environment as it relates to Fair Value and mark-to-market requirements. Sorbus specialties include valuations related to ASC 820, ASC 480, ASC 815, ASC 718, ASC 805, ASC 350, IRC §409A, transaction advisory, portfolio valuation, estate and gift tax.

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Historical Background

1989 – 1990:	One of the first guidelines were created by a group of investors and managers
2003:	Private Equity Industry Guidelines Groups (PEIGG) was formed, in part, to create portfolio company valuation guidelines. The first version was issued in December 2003. National Venture Capital Association (NVCA) and Institutional Limited Partners Association (ILPA) issued formal support for the guidelines.
2004:	PEIGG issues guidance that allows for non-round write-ups under select set of circumstances. GPs prepare for the audits where, for the first time, Fair Value claim has to be supported.
2006:	Three European VC associations released guidelines (IPEV Guidelines), claim compliance with IASB rules. The guidelines are more detailed than those from PEIGG and partially compliant with US GAAP.
Sep 2006:	FAS 157 is issued. Auditors began selective compliance prior to the standard's effective data.
Mar 2007:	PEIGG issued updated guidelines adapted to FAS 157. Later that year, NVCA confirms its support for the guidelines.
2008/2009:	FASB issues additional guidelines under ASC 820-10-35 and ASC 820-10-65.
2009:	Updated IPEV guidelines are released with stronger set of requirements.

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Valuation Standards - Business Case

- More Transparency = Less Risk = More Funds
- Because investments are correlated, LPs' portfolios require less rebalancing
- Significant opportunity to differentiate from competition by providing LPs with better information
- Provide basis for incentive compensation decisions at the investor level
- Interim performance in the context of exercising the investor's fiduciary duty.
- Most LPs are required by GAAP to report their investments at Fair Value
- Despite their subjectivity, Fair Value estimates provide better information than historical cost basis
- An arbitrary reporting basis such as cost does not allow comparability

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Part I:

Guidance from ASC 820

Definition of Fair Value

US GAAP

- The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
  - Exit Price
  - Market Participant
  - Most Advantageous Market
  - Orderly Transaction

IFRS *(currently, to be updated)*

- Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction
  - *To be amended to incorporate "orderly transaction" & "market participant"*

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Market Participant View

- Market Participants are hypothetical buyers or sellers in the principal or most advantageous market
- Market participants
  - Independent
  - Knowledgeable
  - Willing and able to transact
  - Broadly defined as paying the highest price
- Transaction venue
  - Principal market (highest volume)
  - Most advantageous market

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Highest and Best Use

- A fair value measurement assumes highest and best use from the perspective of market participants, regardless of how reporting entity intends to use the asset
- In-use valuation premise
  - market participant synergies
- In-exchange valuation premise
  - no market participant synergies
  - financial instruments

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Valuation Considerations

- Initial recognition Fair Value may not equal transaction price
  - Related parties, fire sale, unit of account, not principal market
- Valuation techniques
  - Observable over unobservable inputs
  - Consistent methodologies
  - Market approach
  - Income and cost approach

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Three Levels in Value Hierarchy

- Level 1
  - Prices of identical assets in active markets
- Level 2
  - Prices of identical assets in inactive markets
  - Prices of comparable assets in active markets
- Level 3
  - Measurement includes significant unobservable inputs

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International Private Equity Valuation (IPEV) Guidance

General Overview

- IPEV guidelines were introduced in 2005 by AFIC (Association Francaise des Investisseurs en Capital), BVCA (British Venture Capital Association), and the EVCA (European Private Equity and Venture Capital Association).
  - 37 regional VC associations joined by endorsing the guidelines.
  - Updated guidance was published in 2009.
- The goal is provide greater comparability of returns among funds as well as consistency with IFRS and FASB.
- Two main sections of the Guidelines included:
  - Determining Fair Value
  - Application Guidance

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General Overview (cont'd)

- Recognize the difference between hypothetical valuation and transaction price.
- Uncertainties inherent in Fair Value estimates are recognized, but "the Valuer should be wary of applying excessive caution."
- "Whilst it might be difficult in these situations to determine Fair Value, it should in most cases be possible to estimate the amount a Market Participant would pay for the investment in question."
- While difficult, "the Valuer must still come to a conclusion as to their best estimate of the hypothetical exchange prices between willing Market Participants."
  - The range of reasonable Fair Values is significant,
  - Probabilities of various estimates within the range cannot be reasonable estimated,
  - Probabilities and financial impact of achieving milestones cannot be reasonably estimated,
  - No recent investments in the business

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General Overview (cont'd)

- In some situations in it possible to come to the conclusion that the value has not changed from the prior Reporting Date.
- Enterprise value should be apportion each type of financial instrument appropriately.
  - Ratchets, share options, liquidation preferences
  - To take into account the probabilities of triggering variable payouts
  - Significant option or warrant positions may have to be valued using Option Pricing Models (common in early stage companies)

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Valuation Methodologies

- First step is to estimate Enterprise Value
- Three valuation methods are market, cost, and income with strong preference towards market approach
- Market approach is preferred for early stage companies:
  - Recent round
  - Adjusted last round
- Fair Value is Underlying Business Value + Adjustments
  - Surplus assets, excess liabilities
- Suggested Methodologies:
  - Price of Recent Investment
  - Multiples
  - Net Assets (fund of funds)
  - DCF (to entire business or to financial investment)
  - Industry Valuation Benchmarks

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Price of Recent Investment (PRI)

- Expected to be commonly used in seed and start-up situations
- Value indication will be applicable for limited time only
- Additional consideration to be given to:
  - Financial, marketing, development milestones, and general market conditions
  - Third party interest to be taken into account (not conclusive)
  - Nature of financing (factors where price is not representative)
- Adjustments to PRI may be needed if milestones are achieved

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Multiples

- Appropriate for valuing established businesses
- Implies certain level of sustainability in earnings
- Basis for selecting comparable companies:
  - Business activities, markets served, size, geography
- Focus on earnings multiples (revenue multiples secondary)
- Comparable multiples to be adjusted
- Implied Enterprise value to be further adjusted for:
  - Surplus assets and excess liabilities,
  - Deduction of debt,
  - Relative economic value between financial instruments
- Transaction multiples vs. stock price multiples

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DCF, Industry Benchmarks, and NAV

- DCF – cash flows to business:
  - Flexible, but speculative, sensitive to unobservable inputs
  - Financial forecast, terminal value, discount rate
- DCF – cash flows to a financial instrument:
  - Appropriate where transaction is imminent
  - Valuation of non-equity investments
- Industry valuation benchmarks are viewed as reliable in limited number of situations:
  - Price/bed (nursing homes), price/subscriber (cable company)
- NAV is more common for holding companies
  - LP to value their interests, NAV can be used only to the extent there is evidence NAV was derived appropriately

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Valuation Methodology Conclusions

- Enterprise value as an initial step
- Observable (market) over unobservable inputs (DCF)
- Market approach
  - Price of recent round – VC
  - Market multiples – PE
- Enterprise value attribution to various equity based instruments (OPM)
- Marketability and Control discounts
- Optimization of portfolio valuation analysis

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