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VIEWPOINT

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VALUING COMMON STOCK: MEETING IRC 409A REQUIREMENTS

By Bas van der Brugge, CFA

Our January 2006 Viewpoint discussed how the IRS's new Section 409A regulations significantly changed the rules for a wide array of non-qualified deferred compensation arrangements, including stock options. In fact, the scope of 409A is so broad that it has been described as "the ERISA of employee and executive compensation." Stock options are just one type of deferred compensation, albeit a very common one, that is affected by 409A.

In January, we were concerned that many CEOs and CFOs were not yet fully aware of the potential impact of these new regulations. Now, 10 months later, we find that private company leaders are busy deciding how they can best meet these more stringent standards for determining the fair market value (FMV) of stock options and other forms of deferred compensation[1].

Many executives are quickly learning that there is more to 409A valuations than meets the eye. And the guidance provided by the IRS, unfortunately, is not all that helpful because it doesn't address many of the issues that often arise in doing such valuations.

GUIDANCE FROM THE IRS

As stated in Section 409A, the FMV of a company's stock must be determined by the use of "a reasonable application of a reasonable valuation method." Some more

WHY THIS MATTERS:

- *Knowing what issues can arise in a 409A valuation helps you decide whether to do the valuation in-house or use an outside service provider.*
- *If you decide to do the 409A valuation in-house, you'll want to know in advance the specific challenges entailed.*
- *When choosing an outside service provider, knowing what questions to ask in your selection process is extremely helpful.*

[1] *The 409A valuation issue is largely moot for (regularly traded) public companies, who can rely on market stock pricing data.*

specific details are included about the valuation methods that are supposed to be used. In particular, the regulation talks about the need to consider:

- The value of tangible and intangible assets of the corporation.
- The present value of future cash-flows of the corporation.
- The market value of stock or equity interests in similar corporations and other entities engaged in businesses substantially similar to those engaged by the corporation.
- Other relevant factors, such as control premiums or lack of marketability.

These are all terms and guidelines that most valuation practitioners are familiar with, so at first blush it seems like a pretty helpful starting point. However, the reality is that a typical 409A valuation introduces complexities that are not covered by this high level guidance from the IRS.

In particular, it's important to understand that a 409A valuation is aimed at deriving a value for the common stock and, therefore, it involves a number of challenges that you do not find in a typical enterprise valuation. More specifically, doing a valuation for the common stock involves three steps, as shown in Exhibit I.

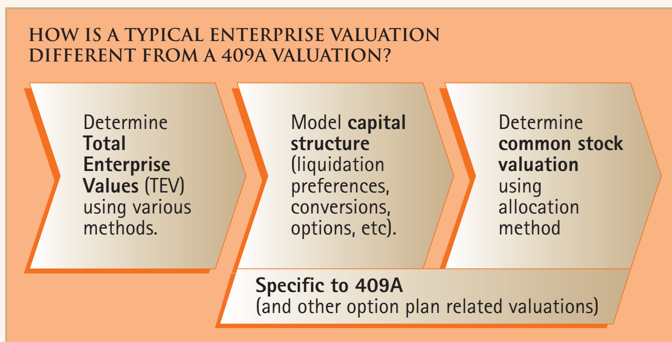

Exhibit I

Step one consists of performing an enterprise valuation, in line with the high-level IRS guidance and standard valuation practices. The next two steps are specific to 409A valuations, or more generally to valuations where you have to look at a particular class of equity. The second step involves looking at the capital structure of the corporation and understanding all the interactions between the different tiers of equity. The third step uses the capital structure to determine how to allocate the total enterprise value across the different classes of equity.

This three-step process is an important framework to understand. Even if you decide to hire outside assistance to do your valuation, understanding this framework will help you know what questions you should ask the valuation professionals you're considering hiring.

STEP 1: VALUING THE ENTERPRISE

For the first step, a range of tools and approaches can be used to determine the total enterprise value. These include:

- **The market approach,** which entails looking at public markets, M&A transactions and private placements to find what valuations are being put on companies that are similar to yours.
- **The asset approach,** which estimates the liquidation value or replacement cost of the company's assets.
- **The income approach,** which looks at the value derived from future cash flows of the business under various scenarios.
- **Company specific valuations,** which consider prior equity pricing events and other relevant valuation data specific to your company. For a lot of privately held, venture-backed companies, this is a particularly relevant approach because many such companies have already had a valuation put on them as part of the financing process.

Determining which of these approaches is applicable to your situation requires looking at a number of considerations. In particular, the stage of the development of the company is an important driver that makes some approaches more applicable than others. Other factors to consider in choosing and weighting the different enterprise valuation methods include the availability of data for a particular industry, the nature of the assets (e.g., are there a lot of intangible assets that are driving the value of the business), and the availability of specific data points for the company.

STEP 2: MODELING THE CAPITAL STRUCTURE

Step two of the process involves analyzing the interactions between the different tiers of equity in your company. Exhibit II shows a typical capital structure for a venture-backed company.

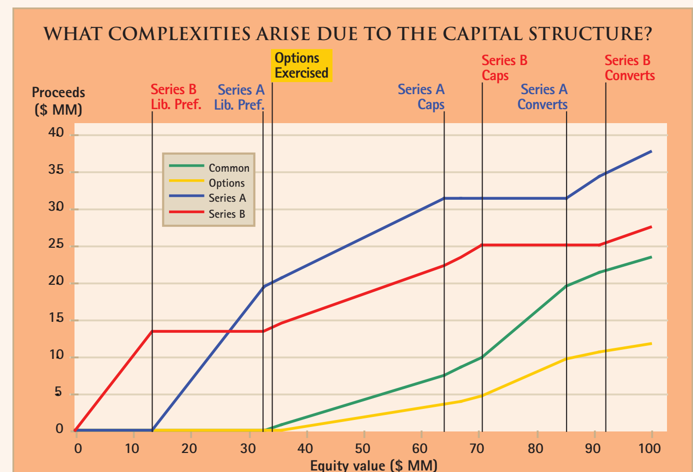

Exhibit II

The company in this example has two tiers of preferred stock, Series A and B. It has one option pool with one strike price and it has a tier of common stock. This example shows that the payoff structures for the different types of equity quickly become complex, even with such a fairly simple capital structure. Going from left to right in this exhibit, the first two breakpoints correspond to the liquidation preferences getting filled out for the preferred stock. Next, the options get exercised fairly shortly after the common stock is in the money, followed by break points where the Series A and

Series B participation rights cap. Later on, there are trigger points where it becomes attractive for the preferred stock holders to convert the preferred stock into common stock and participate above the caps.

STEP 3: ALLOCATING VALUE TO THE COMMON STOCK

The capital structure analysis is important to understand as you go into the third step of the 409A valuation, which is determining how the overall enterprise value that has been calculated in the first step accrues to the different tiers of shareholders. There are three allocation methods for making this determination:

- **The Current Method:** This method involves putting a value on the common stock as if a liquidity event were occurring today. This method is fairly widely used, but has a number of drawbacks. One key problem of the Current Method is that in many situations the liquidation preferences exceed the enterprise valuation. This would imply a negative value for the common stock, which clearly is not an acceptable answer. However, the common stock is not worthless in such a situation, because in most cases there is an opportunity to create significant additional value in the future. In other words, the common stock has significant "option value." Another problem of the Current Method is that in most cases shareholders have to wait for several years before they can cash out, yet the Current Method ignores the associated time value of money.

  As a result, this method's applicability is limited for most practical situations.

- **The Option Method:** This approach uses established corporate finance techniques to estimate the option value and time value of money components that are not captured by the Current Method. It captures the upside of the common stock more accurately and enables you to put a value on a common stock that is underwater with respect to the liquidation preferences. Typical implementations use Black and Scholes option pricing formulas or binomial trees, which require inputs such as volatility and exit horizon.

  In practice, we find that the Option Method is often an appropriate allocation method that generates robust results, but requires some sophistication around its implementation.

- **The Probability-Weighted Expected Return Method:** This is actually a hybrid between a valuation method and an allocation method. It boils down to a scenario analysis in which you look at a several exit scenarios for your business several years out from today, and the corresponding proceeds for the common shareholders

DOING IT IN-HOUSE - IN THE 409A TRENCHES

Mark Attarian is a partner in the Financial Leadership practice of Tatum, LLC, a national executive services and consulting firm; he works from Tatum's Newton, Massachusetts office. He recently shared with us his experience managing an IRC Section 409A valuation exercise at one of his clients that was expecting a near-term liquidity event. "At the enterprise valuation level, the mechanics were relatively straightforward," Attarian said. "But we looked to our investment bank and accountants for guidance on process and methodology - picking up the phone and saying 'I want to make sure we're approaching this properly'".

"Our main concerns were making sure that we were looking at all of the right comparables, key trends in the markets and the prospects of the business going forward. We looked at how similar companies traded in the public markets and scoured data bases for relevant transactions.

"For the discounted cash flow, we developed three thoughtful scenarios for where we thought we could take the businesses. We developed base, upside and downside cases, all supported by reasonable assumptions. We avoided overly aggressive assertions for organic growth and assumed no meaningful future M&A activity. We focused on the core businesses for which we had high visibility, and included products and services in advance stages of development.

"The Company had a complicated capital structure, including four rounds of preferred stock, each with different preferences, redemption obligations and liquidation rights. Reading the articles of incorporation and modeling the payouts to the different classes of shareholders was a fun and challenging exercise by itself.

"Since we were close to a liquidity event, we did not have to deal with certain specific allocation issues. The good news was that the common stock was always in-the-money with respect to the liquidation preferences, which made our analysis more straightforward.

"My advice to anyone faced with doing this: if you have the right in-house expertise, then hire a valuation expert. Even if you decide to do the valuation in-house, you should have a qualified expert review your work. We knew our valuation would be scrutinized by lenders, tax authorities, institutional investors and potential option grantees. We made sure our lawyers, outside auditors, executive team and senior advisors understood and were comfortable.

"Although I understand no one to date has been tested on this yet, the obligations of the company and the potential liabilities that both the company and its employees may incur can be substantial. You'll sleep better at night if you get this done right."

at those end points. We find this approach is sometimes useful for early stage companies, where going through the full valuation tool kit is not justified in terms of the resources that would be required. However, we also find that this method is very heavily dependent on assumptions that may be more difficult to analytically substantiate.

THE EVOLUTION OF VALUE

When we talk to CEOs and CFOs about 409A valuations, one practical question we're often asked is about the evolution of value over time. One approach we take to tackle this issue is to implement a scenario analysis as part of our Income Approach analysis. Exhibit III shows how this works.

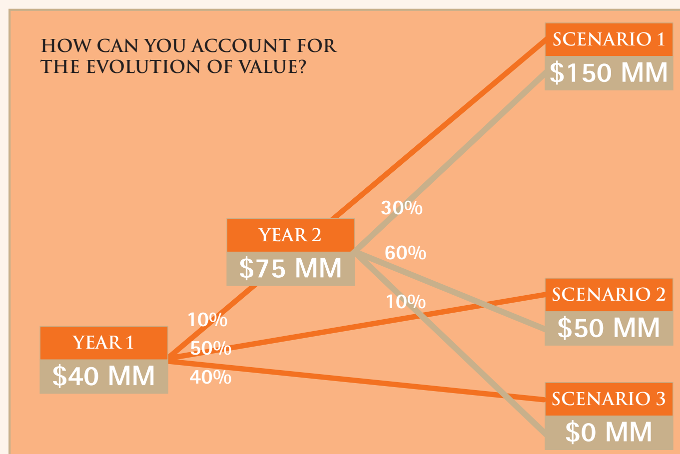

Exhibit III

In this example, in year one, we have looked at three scenarios: Scenario 1 results in an enterprise value of $150 million, Scenario 2 produces a value of $50 million, and in Scenario 3 the company faces some major complications and has negligible value. We weight those scenarios as shown in the exhibit and come up with a $40 million enterprise value for the company at this point in time.

Now, let's assume we revisit this analysis one year from now. The company will have learned a lot about its performance and will have a much better sense of where things are headed. Perhaps the company will have successfully executed on its plans and achieved some major milestones. The valuation end points may be still in line with what we originally thought, but the likelihood of ending up in the best case scenario has increased and the likelihood of major complications has decreased. As a result of that change in expectations of how the future might pan out, the value has moved from $40 million to $75 million.

The benefit of this approach is that it enables you to explain retroactively why the value has changed, because it gives you a clearly documented path around the evolution of value. Additionally, it mitigates one of the main drawbacks of the Discounted Cash Flow approach, which is the dependence on a specific set of financial projections.

WHAT TO ASK A SERVICE PROVIDER

With this primer on Section 409A valuations, you should be better prepared to make your decision on whether to undertake the process in-house or engage with outside valuation professionals. If you decide to go with an outside provider, here are some questions to keep in mind:

- Which enterprise valuation methodologies do you typically use? How do you think about the appropriateness of the various methodologies for my business?
- Which allocation methods are you familiar with implementing? Which one do you expect to use for my company, and why?
- How do you typically account for the evolution of value over time?
- How many 409A valuations have you worked on? Do you have references?
- How much does the initial valuation cost? How much for an update?
- What is the typical time frame? How much of my company's time will this require? What end products can I expect?

As we stressed in our first Viewpoint on this topic, companies that fail to take the new standards set by IRC Section 409A seriously face significant exposure. Make sure you understand all the implication of these regulations thoroughly by seeking advice from your legal, financial and other advisors. If you don't, the people who can become unhappy with you will include your employees, your investors and the Internal Revenue Service... now there's an unpleasant scenario to contemplate.

Bas van der Brugge, CFA *is an associate at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.*

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