

Valuation Vantage[®]

Insights and Perspectives on Leading Corporate Finance Valuation Issues[®]

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Valuing Start-Up Companies

Valuing early stage and start-up companies is complex, as many do not have a product or service that has reached feasibility or completed beta testing.

The first step in valuing start-up companies is to identify the standard of value. For most early stage and start-up companies, Fair Value is the standard of value, but that standard depends on the purpose of the engagement. Fair Value is “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” (ASC 820-10-35-2). Most early stage and start-up companies issue stock options, and must comply with ASC 718 for financial reporting purposes, which requires Fair Value and IRC 409(A) for tax purposes, which in turn requires Fair Market Value. As noted in paragraph C50 of SFAS 157, which is now superseded by ASC 820, it is assumed that Fair Value is consistent with Fair Market Value for US GAAP purposes. For purposes of this article, Fair Value is the assumed standard of value.

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The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Service Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

How to Value an Earnout

An earnout is a form of contingent consideration that is often included as part of the purchase price of a company in which there is a valuation gap between the buyer and seller. The earnout serves to bridge this gap by rewarding the seller upon achievement of performance metrics, milestones, etc.

In accordance with GAAP, the acquirer must value the earnout, include it as part of the purchase price, and record the value of the earnout as a contingent liability on the balance sheet. This liability needs to be revalued every period until the earnout period has ended and all changes in the value flow through the income statement. This new requirement, effective as of December 15, 2008, has increased the complexity of the purchase price allocation process.

So how do you value an earnout? Typically, earnouts are structured based on achievement of revenue, gross profit, or EBITDA targets. Therefore, a natural starting point is to look at the acquired company's forecasted financial metric(s) and compare it to the earnout

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Fair Value is measured with a preference towards observable market inputs, as opposed to unobservable assumptions. US GAAP’s Fair Value hierarchy prioritizes the inputs to the valuation techniques used to measure Fair Value:

- Level 1 Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 Inputs include quoted prices for similar assets or liabilities in active markets.
- Level 3 Inputs are unobservable and are developed based upon the best information available under the circumstances, which might include a company’s own data. Such inputs should reflect the assumptions from the perspective of an active market participant. This level is intended for use when there is little, or no market activity for the asset or liability at the measurement date.

With the established Fair Value hierarchy, the valuation techniques of valuing early stage and start-up companies are discussed in the following approaches:

- Recent Round of Financing (Level 1 Input) – The round of financing can be an indication of Fair Value. However, the round of financing can be less of an indication of Fair Value, especially if the subject company receives a new round of financing from existing investors or if it receives a down round (price per share is lower than the previous round of financing). This round of financing is input into an option-pricing model (discussed later in this article in more detail) to obtain the implied equity value of the subject company. This method is referred to as the reverse option-pricing method (“reverse OPM”) or “solve for” method.
- Recent Offer to Acquire the Business (Level 1 Input) – An offer for an early stage company rarely happens, but if the subject company has a product or service that is not easily replicated by other companies or has a workforce that is difficult to recreate in an industry where recruiting new employees is difficult, it may encourage a potential acquirer to make an offer.
- Asset Approach (Level 2 & 3 Inputs) – This approach requires using a cost-to-recreate methodology (Level 3 Input) if the start-up has no history of revenues, but already has developed technology and/or has in-process research & development. Discussions with the chief technology officer or other technology-related staff are required to understand the inputs required to recreate developed technology and/or in-process research & development. These inputs include materials, obsolescence factor, man hours, and employee wage rates and specific skill sets.
- Market Approach (Level 2 Inputs) – If the start-up already has a history of revenues, a trailing revenue multiple from the guideline public company approach or comparable company transaction analysis can be applied. A forecasted multiple from the guideline public company analysis can also be applied to the forecasted revenue. The selection of guideline public companies is extremely important. Some of the criteria to consider in selecting guideline public companies include the following:
 - o Size
 - o Business Activities
 - o Growth
 - o Leverage
 - o Liquidity
 - o Profitability
- Income Approach (Level 3 Inputs) – The most appropriate income-based methodology typically is a discounted cash flow analysis rather than a capitalized cash flow analysis, especially if the company has no history of revenues. Using this approach can be difficult, due to the speculation related to the forecast. Industry growth rate analysis may be used to benchmark the reasonableness of the subject company’s forecasted revenue growth rates. This can be obtained through various sources, including:
 - o Forecasts of guideline public companies
 - o Equity research reports for guideline public companies
 - o Industry benchmark reports

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Once the value of a start-up company is determined, the valuation of the common stock is made more complicated if the Company has received venture-backed, preferred equity financing. As a result, the equity value of the subject company must be allocated between the preferred and common equity classes. Traditionally, this is done by subtracting the liquidation preference of the preferred equity class from the total equity value to determine the common equity value. In 2004, the AICPA released its Practice Aid entitled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, which suggests the following methods to allocate equity value between preferred equity and common equity:

- **Current Value Method (“CVM”)** – The CVM has practical limitations on its use. Specifically, it should be used in two cases: (1) when a liquidity event is imminent and (2) when the business is at such an early stage of development that there is no material progress on the company’s business plan and there is no reasonable basis to estimate value beyond the preferred preference.
- **Probability Weighted Expected Return Method (“PWERM”)** – The PWERM is a methodology used to estimate the value of common stock by analyzing future potential scenarios of the subject company. Typical scenarios that are taken into account often include an IPO, merger or sale, dissolution, or continued operations as a private enterprise. Based on the specific terms of the equity structure, the value attributable to common shares are estimated under each scenario. The probability of various exit scenarios and the value of the business at such exit events are very difficult to support.
- **Option-Pricing Method (“OPM”)** – The OPM is a commonly used method for allocating equity value between common and preferred shares when the range of possible outcomes is difficult to predict. The OPM is more quantitative as it relies on the Black-Scholes-Merton option pricing model.

Valuing early stage and start-up companies requires the use of various and complex business valuation methodologies. Complex capital structures add another degree of difficulty to value start-ups. Several valuation methods are available, but determining a specific value remains difficult due to the amount of uncertainty surrounding early stage companies. ♦

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target(s). In the example of an earnout based on achieving an EBITDA target, if the forecasted EBITDA is above the target for the earnout, it is likely that the earnout will be paid. There may be an inclination to value the earnout by simply discounting the earnout payment using a present value technique. However, this may potentially overstate or understate the value of the earnout because it’s not taking into account the various potential scenarios for EBITDA. It is often more appropriate to use a scenario analysis in which multiple EBITDA scenarios are developed and then probability-weighted. This is especially useful when the earnout is based on different tranches. For example: \$5MM would be paid if EBITDA is between \$1MM - \$3MM, \$7.5MM would be paid if EBITDA is between \$3MM - \$5MM, and \$10MM would be paid if EBITDA is above \$5MM. In this example, if EBITDA was forecasted to be \$4.5MM, simply taking the \$7.5MM payment for that EBITDA tranche and present valuing it would understate the value of the earnout. The scenario analysis would be more appropriate in this example because the earnout payment would be \$10MM if the acquired firm exceeds its forecasted EBITDA by only \$500K.

In addition, there are other valuation techniques such as option pricing models and simulations which can be particularly helpful when dealing with more complex earnout structures. One such option pricing model is a binomial (or lattice) model. A binomial model is depicted in a tree in which there are two movements (up and down) from a starting point. Its advantages include its flexibility and ease of interpretation. A Monte Carlo simulation uses stochastic techniques that allow even greater flexibility. However, the Monte Carlo simulation is complex and requires high level statistical analysis and often is difficult to understand and interpret.

Prior to the new accounting standards, earnouts were not included in the purchase price and any subsequent cash payment would simply increase the goodwill account. In the new fair value world, the manner in which earnouts are valued and initially recorded will have a direct effect on a company’s income statement. Therefore, it’s important for all involved to have an understanding of how earnouts are valued. ♦

Spotlight on Court Cases

In re Global Technovations, Inc., 2010 WL 2671706 (Bkrctcy. E.D. Mich.) (July 2, 2010)

In this Michigan bankruptcy case, the plaintiff, a debtor of Global Technovations, Inc. (“GTI”) sought to avoid a \$25 million acquisition payment under the premise that the transfer was fraudulent. At the center of the case was the acquisition of the defendants’ US operating division, Onkoyo America, Inc.

GTI was approached by the president of Onkoyo America who presented the US operating division as a profitable, stable company with \$6.9 million in annual cash flows. With limited cash on hand and a desire to enter the automotive market, GTI signed a letter of intent in 2000 to purchase Onkoyo America for \$28 million in cash and \$12 million in earnout. After performing due diligence and undergoing rounds of negotiation, GTI and Onkoyo Corporation eventually agreed on a transaction price of \$13 million in cash and \$12 million in notes.

Shortly after the transaction, numerous irregularities involving Onkoyo America came to light. The major inconsistencies included: 1) an inventory overstatement of \$649,000; 2) additional accounting adjustments of \$2 million; 3) “dramatically” overstated forecast targets; and 4) failure to disclose a possible conflict of interest – the President of the US division was entitled to receive \$100,000 for closing the transaction.

The implications of the items listed above ultimately resulted in GTI and Onkoyo America going bankrupt by 2010, as the target company realized actual EBITDA of \$4 million, which fell short of projected EBITDA of \$6.8 million. In addition, the accounting adjustments also resulted in GTI being in violation of its loan agreement. Onkoyo America was then liquidated and the plaintiff sought to avoid the transaction payment under grounds it was a fraudulent transfer.

In an effort to calculate the Fair Market Value of the Company, both the plaintiff and defendant applied generally accepted valuation approaches, including: 1) a discounted cash flow analysis (“DCF”); 2) guideline public company method; and 3) comparable transactions method. In addition, the plaintiff also applied a capitalization of trailing earnings method.

The court found the capitalization of earnings method, which resulted in an Enterprise Value of \$6.7 million to be the most appropriate, as it claimed it was “the most reliable and least speculative basis for analyzing and evaluating [the target company’s] reasonably expected future performance.”

The court ruled out the results of both the plaintiff’s and defendant’s discounted cash flow analysis, primarily because of the inclusion of faulty projections and that “neither expert’s explanation [...] for his chosen WACC was persuasive.” The court found that the defense’s projections indicated “no rational relationship to the [target’s] historical results” and that Onkoyo America “had demonstrated a historical inability to create accurate projections [...] and] to grow its sales even when the industry and its peers were realizing significant growth.” It is also important that the defendant’s DCF was still considered “unreasonable and unreliable” despite discounting the forecasted performance at “nominal percentages.”

The defendant’s use of faulty projections also extended to the market-based approaches (guideline public company and comparable transaction analyses). More specifically, the defendant still utilized the unsubstantiated forecast to arrive at Enterprise Values of \$38.5 million and \$45 million for the guideline public company and comparable transaction methodologies, respectively. The court ultimately rejected both, as they were based on unreasonable projections.

The plaintiff’s market-based results, which utilized trailing 12 months EBITDA, resulted in Enterprise Values of \$2 million and \$6.9 million under the guideline public company and comparable company transaction approaches, respectively. The court, after taking into account the results of the capitalization of earnings approach (\$6.7 million), adopted a Fair Market Value minimum of \$6.9 million for Onkoyo America as of the valuation date.

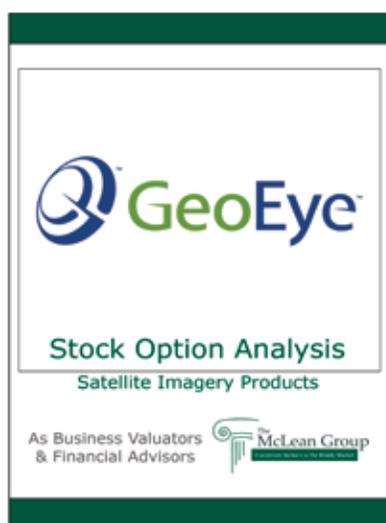
The court’s ultimate decision concluded that the debtor was rendered insolvent as an immediate result of the acquisition and voided the payments as fraudulent transfers.



Practice Highlights

SmartCPAs

The McLean Valuation Services Group's Andy Smith recently was recognized as one of 2010's top CPAs in the greater Washington, DC metropolitan region by *SmartCEO* magazine, a regional publication including features, interviews, case studies and columns catered to CEOs and business owners. *SmartCEO* is read by more than 50,000 business owners in the Baltimore, Philadelphia and Washington, DC metro markets.



The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services in more than 30 offices in the US and Canada. Its affiliate, The McLean Valuation Services Group, performs business valuation services for transaction, financial reporting and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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