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YEAR-END PORTFOLIO COMPANY VALUATION CONSIDERATIONS: SUGGESTED BEST PRACTICES FOR VENTURE CAPITAL FUNDS

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For any audit firm attempting to assess management's year-end valuations for venture capital fund portfolio investments, the challenge can be daunting.

In contrast to private equity, the typical venture capital portfolio investment does not generate cash flow and often lacks any viable revenue transparency. Furthermore, it has few, if any, viable comparable companies or precedent M&A transactions upon which to benchmark fair value. With a lack of any other sufficient and relevant information, the last round of financing is typically the anchor from which most venture funds base their portfolio valuations. Often, this financing is questionable because of the varied rights and preferences the investor has.

Consequently, General Partners (GP), Chief Financial Officers (CFO) and their auditors struggle at year-end to agree on fair value of portfolio investments. From an auditor's perspective, the inherent lack of transparency and other considerations, such as the stage of portfolio company development and lack of true comparables, often pit auditors against management, underscoring insufficient information or documentation around the fund portfolio. During the interim, most auditors will attempt to prevent late season discussions by gaining an in-depth understanding of management's valuation process and identifying problematic and difficult-to-value portfolio companies. In other words, auditors attempt to build consensus with management to avoid last minute fire drills, which often include information requests from the portfolio company and GPs. However, even with clear communication and transparent information, many unanswered questions surface that venture capital funds and their auditors still cannot find uniformity on.

Below are key takeaways and best practices around the valuation review and related audit processes that venture capital firms and their CFOs should take into consideration when approaching year-end valuations.

Do I have a robust and comprehensive valuation policy that reflects the nature of my investment portfolio?

Every valuation begins with a sound underlying valuation policy. The valuation policy should provide the framework of how the fund management is approaching valuation of underlying portfolio company investments. It should be broad, yet specific, and flexible, yet firm, to deal with a dynamic portfolio and encourage the use of appropriate benchmarks when available.

To expedite the audit review process, a valuation framework should attempt to stratify the portfolio investments into "buckets" based on considerations such as the investment's stage of development, age of last financing round, access to information, complexity of capital structure and anticipated time to exit. By stratifying the portfolio into buckets, different valuation approaches and methodologies can be applied based primarily on the financing history, complexity of the capital structure and life cycle of the portfolio company.

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Unfortunately, many valuation policies are static, having little flexibility to accommodate the dynamic nature of the portfolio. In certain valuation situations, CFOs may find their valuation policy is rigid and out of date when evaluating current market situations and their portfolio. These type of situations, when not addressed early, can lead to last-minute surprises, which can often delay the audit process.

SUGGESTED BEST PRACTICE:
First, CFOs and their GPs should sit down and review their valuation policy at least once a year (in conjunction with their investment portfolio) to ensure that the policy is broad enough to incorporate all investments given their current stage of development and composition. Next, fund management should use their valuation policy and attempt to "bucket" each portfolio investment, leveraging a valuation framework that considers: a) stage of developments within the company's lifecycle, b) capital structure complexity and c) other factors. The bucket that a portfolio investment resides in should correlate with the fund's valuation policy and methodology for determining and evaluating enterprise value and the allocation of that value. In addition, immediately following an audit, CFOs should reflect upon any "outliers" that caused the audit to be delayed or added unnecessary hours to the review process. The valuation policy should be reviewed and updated for any possible adjustments that may not have addressed these situations. Finally, portfolio companies on the verge of certain milestones (i.e., new financing, revenue threshold, potential exit) should be reviewed at least quarterly for possible changes in valuation methodology. The valuation policy should also clearly state predefined, but general, "tipping points" that indicate a portfolio company is transcending into a new bucket.

What are some of the more difficult valuation scenarios, and how do those cases change year over year?

Often, venture CFOs are confronted with situations whereby their auditor requires additional valuation support due to lack of transparency. These situations, or "outliers," can cause lengthy delays in the audit review process and, in some cases, result in the late issuance of the audited financial statements. The following are some common situations that venture CFOs face that warrant additional support:

- Early-stage companies raising significant funding at a much higher valuation without a proven product and financial metrics to support post-money values.
- Portfolio investment companies that have not raised outside capital for an extended period of time, yet current valuation is based on the last round of financing without sufficient additional triangulation.
- Portfolio companies whose valuation is uncertain due to the lack of financing visibility and complexity in capital structure.
- Companies with multiple milestone payments can also often present challenges because the auditor will need to evaluate the fund's estimated probabilities for success to adequately account for the risks unique to each milestone. The fund management often applies same probabilities to each of the milestones without giving consideration to conditional probabilities.

SUGGESTED BEST PRACTICE:
Early identification of these investments is key to an efficient audit. It is highly recommended that CFOs and GPs sit down with their auditors after completing their internal third quarter valuation analysis or during their audit planning meetings to go through the portfolio and identify any potentially challenging year-end investments. By performing this task well in advance of year-end, any "outliers" with unique circumstances and fact patterns can be singled out and addressed. The CFO can then begin the process of either substantiating the investment's valuation internally or seeking external assistance. For the selected investments for year-end testing, funds should ensure that all of the required valuation documentation is ready for their auditor to review. Steps that a fund's finance group might take as part of its documentation process include conducting interviews with GPs for specific inputs or assumptions, identifying milestones and significant events that can influence value, analyzing monthly financial information and cash flows, considering past events, and reviewing contemporaneous budgets and forecasts as of the valuation date.

Sampling: What determines whether a certain valuation would be selected for review by the auditor's valuation specialist group?

Most, if not all, auditors will send a certain number of investments to their internal valuation specialists group for review. While different auditors have different considerations in selecting investments for valuation group review, the following represents some of the more common selection criteria:

- Investments that constitute a significant percentage of the overall portfolio balance.
- Portfolio companies with significant increase in valuation over a shorter time span.
- Whether the enterprise value and allocation methodology utilized by the fund is consistent given where the portfolio company is in its lifecycle.
- An investment in an industry or company that is outside the fund's general investment strategy.
- Complexity of the valuation model(s) used, including complex tax structuring, and external factors like credit risk, market risk, regulatory risk, etc.
- Complex capital structure or recent recapitalization/reorganization of the capital structure.
- Situations where the entity holds a minority position and therefore has limited information rights.
- The number of classes of securities with significantly varying and complex rights and preferences (e.g., significant differences in preferences and participation caps, etc.).

SUGGESTED BEST PRACTICE:
Work with your auditor to make the investment portfolio as transparent as possible by stratifying the portfolio investments into different buckets. This will assist the auditor in the sample selection process and help put into perspective each investment's contribution to the overall risk of the portfolio. It will also help cut down on

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follow-up requests and questions, which can lead to a delay.

What are some of the most common valuation misconceptions?

One of the biggest misconceptions CFOs are confronted with when approaching valuation is the notion that "one size fits all." One such example is the application of the Option Pricing Model (OPM). When CFOs are faced with an extremely challenging capital structure with participation caps and varying levels of preference, the OPM can prove invaluable in bifurcating different levels of value across the capital structure. However, generally speaking, the OPM is not the tool explicitly used by market participants to price transactions. Further, the use of OPM as a one-size-fits-all method is not required by accounting standards. The key takeaway from the accounting literature is that market participant assumptions and judgments must be used in estimating fair value.

SUGGESTED BEST PRACTICE:

It is critical for venture CFOs to maintain a degree of flexibility in approach so that the "one-size-fits-all" mentality does not prevail and result in unrealistic or flawed valuation outcomes. Deploying a mechanical approach to all portfolio valuations can backfire and have the exact opposite impact for the end user. This is important to remember in an industry where valuation visibility is anything but clear. The CFO should have a solid and well-documented understanding of each portfolio investment.

How do you address and manage events that impact year-end valuations?

For events that provide additional evidence with respect to conditions that existed as of the balance sheet date and affect the estimates inherent in the process of preparing the financial statements, all the information that becomes available prior to the issuance of the financial statements should be used by the management in its evaluation of the conditions on which the estimates were based. Therefore, the financial statements should be adjusted for any changes in estimates triggered by such evidence.

In reality, there are significant events that often do change the value of portfolio companies even after CFOs and their auditors sit down during the interim. These events can occur after year-end and catch CFOs "flat-footed" because they have flown under the radar and are only becoming evident at the 11th hour, sometimes just weeks away from issuance.

SUGGESTED BEST PRACTICE:

In line with keeping highly detailed and transparent data, we recommend that CFOs maintain a "contingency bucket" for those portfolio companies they consider "in limbo" at the interim. If there are instances where the CFO believes an event is imminent or highly possible, those companies should be identified and closely monitored. It is incumbent on the auditor to highlight the importance and potential impact these events can have on fair value. The CFO should convey in real time any new information that will cause a material impact on fair value so the auditor is aware that additional adjustments may be forthcoming. When subsequent events impact the year-end valuations, the ability for the auditor to point to a transparent and well-documented valuation makes a follow-on adjustment that much easier.

What are appropriate revenue multiples and discounts for a venture CFO?

Even if significant revenue warrants an attempt at a public company comparison, the representative set of comparables for most venture-backed portfolio companies is often so far removed from the target portfolio company that the analysis becomes meaningless. In addition, CFOs struggle to find appropriate levels of discounts to place the portfolio company on equal footing with its publicly traded comparables. When venture CFOs attempt to rely on a revenue multiple for publicly traded companies in similar or like industry verticals, a few obvious problems immediately emerge:

1. The public companies that the target is being compared to are involved in so many other businesses that the relevance of the revenue reflection is questionable.
2. The question of whether to employ multiples based on forward 12 months' or last 12 months' revenues is often called into question.
3. If the CFO applies a multiple followed by various discounts, most notably a discount for lack of marketability, in order to put the target company back on a private company footing.
4. The CFO may apply other "subjective" discounts without significant numerical support.

All of the above can and does lead to additional time spent on agreeing to the appropriate comparable set, valuation metrics and discounts.

SUGGESTED BEST PRACTICE:

First, the fund should clearly delineate in its valuation policies all scenarios that warrant a public company multiple or precedent transaction multiple. When deriving a comparable set of companies to benchmark the target investment against, there should be careful consideration taken to ensure those companies truly represents the similarities of the target portfolio company. In too many instances, selected comparables represent companies that are significantly larger than the portfolio company being evaluated (e.g., large behemoths such as Apple or Netflix are used as comparables while only a fraction of their revenue is representative of the target's business model). CFOs and GPs should be cognizant of this and map out realistic and truly representative comparables in advance.

CFOs should also avoid using "subjective" discounts in their valuations. Without substantial support (i.e., comparison of size, growth prospects, profitability, financial conditions, etc.), their auditors are likely to cast doubt on these discounts, which could significantly hold up the audit.

Finally, with regard to discounts for lack of marketability (DLOM), CFOs should view them in the context of the portfolio company's growth stage and exit timing. The DLOM, measured by costs both in terms of time and money, would have to be incurred for the investor to locate a willing buyer. Theoretically, the closer the company is to

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exit, the lower the DLOM should be. CFOs should clearly convey in their valuation policy their approach and application in using specific discounts and avoid subjective discounts.

Conclusion:

Since valuation is more art than science, CFOs are confronted with a level of subjectivity as they attempt to triangulate value with the most readily available and most relevant reference points possible. In accordance with suggested "best practices," venture CFOs should maintain a flexible, robust and current valuation policy at all times to address and reflect the majority of circumstances in their investment portfolio. In addition, ongoing communication with their audit firm is paramount. It is important to reiterate that a well-planned interim discussion can avoid many of the late season discussions that are often inherent in venture valuations.

In terms of a specific valuation approach, given the opaqueness of venture capital, it is often incumbent on the CFO to consider a variety of valuation metrics, including the last round price in an effort to arrive at fair value marks.

For purposes of facilitating year-end audits, CFOs must also attempt to provide as much meaningful and verifiable support using widely accepted databases (e.g., Bloomberg, Capital IQ) wherever possible. However, from an auditor's perspective, it is extremely important to avoid employing "subjective" data (i.e., premiums and discounts) that have no grounding and cannot be defended. More time will be spent analyzing and validating the assumptions, both of which could lead to a delay in the release of the audit opinion.

By taking into consideration some of these basic and upfront "best practices," venture CFOs can save significant time and avoid unwarranted and often costly late season discussions with their auditors.

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