

AN ALERT FROM THE BDO FINANCIAL SERVICES PRACTICE

ASSET MANAGEMENT **INSIGHTS**



BDO KNOWS: VALUATION OF PORTFOLIO COMPANY INVESTMENTS – IMPORTANT REMINDERS

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BACKGROUND

The AICPA's Financial Reporting Executive Committee ("FinREC") released a working draft of an accounting and valuation guide (the "Guide") in May 2018, titled "Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies."¹

The Guide provides nonauthoritative valuation guidance and case studies for investment companies within the scope of ASC 946, *Financial Services – Investment Companies*, (which include private equity funds, venture capital funds, hedge funds, business development companies and other investment companies) and their advisors, valuation specialists, and independent auditors related to portfolio company investments. The objective is to provide an overview and understanding of the valuation process and best practice recommendations, as promulgated by ASC 820, *Fair Value Measurement*, for industry

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¹ <https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/working-drafts-of-2-new-case-studies-from-the-pe-vc-guide.html>

participants, valuation specialists and independent auditors, as it pertains to Level 3 investments. The Guide highlights practice issues related to estimating the fair value of illiquid equity and debt instruments of portfolio companies. The Guide also addresses fair value concepts (including market participant assumptions and unit of account) and provides numerous examples illustrating valuation approaches and techniques used to determine the fair value of many investment types at each measurement date over the investment life-cycle.

On December 17, 2018, the AICPA released two new case studies in response to feedback received on the Guide related to Value Fluctuations in a Real Estate Investment Financed with Debt and Investment in Non-Performing Distressed Debt.

Below are considerations and important reminders for all parties involved with the valuing of portfolio company investments during the 2018 year-end financial reporting process.

KEY CONCEPTS ADDRESSED, RELATED CHALLENGES AND BEST PRACTICES:

Unit of account and assumed transactions

The Guide presents a framework for evaluating the unit of account in a manner consistent with how a market participant would approach/view value for the investment held by the reporting entity. When determining the unit of account and the fair value of investment holdings, the Guide emphasizes on the concept of maximizing “economic best interest”.

BEST PRACTICE: The determination of unit of account is an important concept to be considered if a fund holds both equity and debt investments, or multiple classes of equity or a combination of both, in a single portfolio company. The fund should consider how a market participant would likely sell its investments in the portfolio company in order to maximize its overall return on its investments, or its economic best interest. For example, the fund would likely sell its entire position in the portfolio company (e.g. both of its debt and equity investments in one portfolio company) rather than liquidating individual securities. In that case, the fund may determine that the unit of account for determining fair value is the group of investments collectively. If each investment type is a unit of account, then each is valued separately. For example, when debt is the unit of account, the Guide suggests to consider the yield method to fair value the debt instrument when a traded price is not available or is deemed to not be indicative of fair value as of the measurement date.

Calibration

Calibration is the process of using observed transactions in the portfolio company's own instruments, especially the initial (or subsequent) transaction in which the fund entered the position, to ensure that the valuation techniques that will be employed to value the portfolio company investment on subsequent measurement dates begin with assumptions that are consistent with the original transaction assumptions and observed market data, as well as any more recent observed transactions in the instruments issued by the portfolio company.

BEST PRACTICE: To ensure that a valuation model reflects the best available information, begin by calibrating the selected valuation model to any recent transactions and then updating these assumptions for changes between the transaction date and the measurement date.

For example, when using a market approach, the transaction multiple (e.g. revenue multiple) is compared against the multiples of comparable companies. At subsequent measurement dates, based on facts and circumstances, determine if the difference between the multiple being used and those observed for comparable companies at inception should remain the same, increase or decrease in determining the multiple to be used in determining fair value at a subsequent date.

It is also challenging to perform calibration specifically for early stage, pre-revenue and life science companies. Some matters to consider for calibration in these circumstances are:

- ▶ The investment thesis by fund's management is key in setting up calibration upon entry to a transaction – why was it a good investment, what is the potential of the company to grow, are there comparable companies that management will be tracking the performance against, what is the exit strategy with respect to the timing and estimated value
- ▶ Qualitative assessment may include milestone, probability associated with clinical trials, collaboration agreement, market size and product penetration, etc. – changes in these qualitative factors may be sufficient support to the current fair value
- ▶ Tracking of internal progress and benchmark with similar company/product development – what was the growth expectation against guideline companies, how is actual growth at calibration impacting the enterprise value at a measurement date

- ▶ Consider recent updates from the portfolio company:
 - Is the company operating in line with business plan?
 - Any change to time horizon? Accelerating time line from previous plan would lead to a higher value
 - Occurrence of significant value events (e.g. new financing)
 - Internal – assembly of key members of management, proof of concept, regulatory approval, strategic partners or executing with key customers
 - Cash burn and cash runway
 - Timing of next round financing
- ▶ Weight may be given to negotiated prices for a transaction that has not yet closed while taking into account appropriate adjustments for uncertainty

Complex capital structure and allocation methods – valuation of equity positions

Regarding the valuation of equity interests in a portfolio company with simple and complex capital structures, the Guide provides guidance and a flowchart with an overview of what valuation methods are appropriate to use giving considerations of the following:

- ▶ capital structure (simple vs. complex)
- ▶ type of security (preferred vs. common/option/warrant)
- ▶ exit strategy (IPO, bimodal/multiple outcomes)
- ▶ investment time horizon
- ▶ ownership % (control vs. minority)

The Guide describes four possible methods for valuing equity interests within complex capital structures, including the Scenario-based approach, Current Value Method (“CVM”), Option Pricing Method (“OPM”), and Hybrid Method. Each method has its merits and challenges, and different methods may be more or less appropriate in different circumstances.

Regardless of the valuation approach selected, the Guide recommends developing a calibration model at investment date using the post-money value based on anticipated investment return, exit strategy and timing, and future dilution; consideration of market participants' assumptions at the measurement date —e.g., whether the liquidation preferences would be relevant to market participants (to determine which valuation method to use, OPM or Scenario-based); and application of internally consistent valuation assumptions between investment date and measurement date.

A Scenario-based approach may be appropriate depending on the portfolio company's stage of development, for example when the time to a liquidity event is short, making the range of possible future outcomes relatively easy to predict. For early stage company with binary expected outcomes of either success or failure scenarios, the simplified Scenario-based analysis may be more appropriate than OPM since downside protection or preferred liquidation preference is not expected. Although the Scenario-based method is intuitive, forward looking, and appears easier to implement compared to OPM, it requires a number of highly subjective assumptions and inputs in the valuation model that are difficult to estimate and support objectively such as:

- ▶ estimation of future exit price
- ▶ anticipated exit timing
- ▶ anticipated future dilution at the time of exit
- ▶ discount rate
- ▶ scenario probabilities

The OPM may be more appropriate to use if liquidation preferences would be considered by market participants and the investment holding includes option-like securities (i.e. common, option, and warrant). The OPM can also be used as a reasonableness check against the result from the Scenario-based method.

The CVM allocates the equity value to the various equity interests in a business as though the business were to be sold on the measurement date. CVM is typically used when a liquidity in the form of an acquisition or dissolution of the portfolio company is imminent or when the fund's position has seniority over the other classes of equity and have control over the timing of exit.

The Hybrid Method is a hybrid of scenario-based methods and OPM. Hybrid Method is useful when transparency exists into one or more likely near-term outcomes but has uncertainty as to what will occur if that outcome falls through.

BEST PRACTICE: For equity investments in portfolio companies with complex capital structures, consider alternative methodologies or apply appropriate adjustments if using OPM is used to allocate value between senior and junior preferred classes of equity.

Valuation of Debt

The Guide provides guidance regarding the valuation of debt instruments, including the valuation of debt for the purpose of valuing equity.

When the debt or debt-like investment is the unit of account, the Guide suggests the following best practices for traded and non-traded debt instruments:

- ▶ Traded debt instrument – the traded price as of the measurement date may be the best estimate of fair value, assuming the transaction is determined to be orderly.
- ▶ Non-traded debt instrument – when a traded price as of the measurement date is not available or is deemed to not be determinative of fair value, the typical valuation technique is the yield method, i.e. expected cash flows over the contractual term of the debt is converted to present value using a market yield (i.e. discount rate) considering the risk of the instrument and market condition current as of the valuation date.

BEST PRACTICE: Develop a calibration model at the transaction date to estimate fair value using contractual terms (coupon rate, maturity, amortization, pre-payment, etc.), establish the implied yield/discount rate based on the credit quality portfolio company and where the debt is stacked in the portfolio company's capital structure, and credit spread for comparable traded debt or similar credit quality and term. At subsequent measurement dates, estimate market yield considering changes, if any, in the portfolio company's/debt credit quality and credit spread in the market.

When the debt or debt-like investment is held by an investor and its value is considered as an input in valuing the equity interest, the valuation technique is to estimate the enterprise value then subtract the value of debt (commonly referred to as a waterfall approach). In this instance, the amount that is ascribed to the debt reflects the value that market participants holding equity interests would assign to the debt given the market interest rate and principal payments over the expected time horizon for the debt. Funds may use the par, face, book value, or payoff amount as a proxy for measuring fair value of debt for the purpose of valuing equity in a waterfall approach, as those amounts better reflect market participant assumptions of cash flows associated with the debt over the time horizon of the investment. As a result, the value of debt for purposes of valuing equity may be different than the fair value of the debt considered independently.

FREQUENTLY ASKED QUESTIONS (FAQS)

Based on recent discussions with our clients and other participants in the industry, we have identified the following FAQs:

How to best use the Guide to get up to speed on the issues that are most critical to valuing our portfolio?

Fund advisors may want to refresh themselves and, therefore, might first review chapters that cover broad industry issues: i) Chapter 1, "Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies"; ii) Chapter 3, "Market Participant Assumptions"; iii) Chapter 4 "Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments"; and iv) Chapter 10, "Calibration". These chapters will be particularly beneficial in developing an overall understanding of the valuation process. In addition, preparers are encouraged to review Chapter 8: "Valuation of Equity Interests in Complex Capital Structures", Chapter 11, "Backtesting," and Chapter 12, "Factors to Consider At or Near a Transaction Date," as well as Case studies 8-12 in Appendix C are particularly beneficial for venture capital fund managers.

Where in the bid – ask range should we mark our investments? Would it be appropriate to use the bid (low), ask (high), midpoint, or some other point?

The fund should choose its best estimate within the range that is most representative of fair value under current market conditions, that is, the exit price at which the investment would transact in an orderly transaction between market participants on the measurement date.

How are the transaction costs considered at or near a transaction date?

Transaction costs are excluded from the fair value of investments on day 1; that is, the fair value immediately after the transaction closes may be less than the total capitalized cost of investment.

What are practical ways in developing a calibration model for early stage companies?

Challenges such as developing a calibration model will be encountered especially for early stage companies. However, consideration of the original investment thesis, relevant qualitative inputs and assumptions should be documented to support fair value at the transaction date and updated to reflect internal and external value events at subsequent measurement dates.

Is it appropriate to apply a discount to measure the fair value of a restricted security?

A restriction to sell securities (e.g. a contractual lock-up period) is a characteristic of the instrument which would be transferred to market participants. Therefore discounting is allowed. The

adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period.

FINAL THOUGHTS

Although the Guide is nonauthoritative and is not yet finalized, we believe that valuation firms and management teams responsible for valuation should begin to align the best practices illustrated in the Guide for the 2018 year-end valuation process for any significant gaps between current practices and the best practices highlighted in the Guide. As the Guide is expected to be finalized in May 2019, auditors (and the SEC in its examinations) will continue to expect further enhancements to valuation documentation for the methods used, the inputs and assumptions applied and the results of the calibration processes during 2019.

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