



INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

WHY INVESTORS SHOULD CAREFULLY EVALUATE NEW VALUATION METRICS

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When Japanese venture fund SoftBank began investing in the coworking space startup WeWork in 2017, many skeptics were perplexed by the company's sky-high valuation.

At \$20 billion, the deal made WeWork the fourth most valuable startup in the United States—and the company had yet to turn a profit. By the end of 2017, WeWork posted a pretax loss of \$939 million, a figure more than double the loss the company reported a year earlier. Spectators began to question whether WeWork's new business model would prove viable in the long term.

But SoftBank continues to ignore such criticisms. Recently, the venture fund revealed that it is in discussions to acquire a majority stake in WeWork, this time investing at an even higher valuation. The deal, which is said to potentially value the eight-year-old startup between \$35-\$40 billion, would bump WeWork up to the second most valuable startup in the U.S., ahead of both Airbnb and SpaceX, and behind only Uber.

So, what metrics were considered for this high valuation? The short answer: community-adjusted EBITDA. Despite its name, "community-adjusted" EBITDA (earnings before interest, tax,

depreciation, and amortization) is a significant departure from a traditional EBITDA calculation. As described by *The Wall Street Journal*, WeWork's ambiguous new metric subtracts "not only interest, taxes, depreciation, and amortization, but also basic expenses like marketing, general and administrative, and development and design costs." Essentially, WeWork is employing a metric which eliminates corporate overhead costs and expenses from its valuation—fees which have played a part in keeping the company from turning a profit—in order to demonstrate the value it could hold down the line, given continued revenue growth and management of costs associated with its rapid expansion.

SoftBank's willingness to place such a significant bet on a startup valued through speculation can possibly be attributed to several factors: record dry powder from private equity and venture capital funds, increased competition for new deals, and an economy marked by high consumer confidence.

THE RISE OF NON-TRADITIONAL VALUATION METRICS?

Given the impact of new technologies and the surge in startups operating under reinvented business models, it's not outlandish

to assume that investors are rethinking the ways in which they conduct valuations. However, “community-adjusted” EBITDA calculations are fundamentally limited, in that they do not offer investors an “apples to apples” comparison to other companies operating in the same space. To make such a metric viable, investors would need to apply competitors to the same financial adjustment model to successfully compare operations and trading multiples. In addition, an adjustment to the weighted cost of capital (WACC) would need to be quantified since market-based WACC’s are based on traditional cashflow calculations.

What’s more, according to research on adjusted EBITDA from S&P Global Ratings, analysts concluded that often “both EBITDA growth and deleveraging efforts fell materially short of the issuer’s projections for the two years that [S&P] tracked companies’ performance after transaction origination compared to projections made by the management at deal inception.”

So, if these companies are regularly falling short of meeting their adjusted projections, why do non-traditional valuation metrics continue to hold weight with private investors? For one, the current environment for both sourcing and winning deals is particularly rigorous. At the end of 2017, dry powder hit a record peak of \$1.7 trillion—but deal flow has remained largely flat. With private equity and venture capital funds eager to put these funds to use, modest deal flow reflects a shortage of attractive investment targets.

As such, when an attractive target presents itself, competition is stiff. Bidders, especially those in venture capital, are often willing to place traditional valuation methods on the backburner if it means winning a deal with a hot target, such as a company that is a major industry disruptor. Certainly, WeWork is an example of a disruptor within the commercial real estate sector.

BACK TO THE BASICS

Amid a strong economy and rapid advancement of new business models, it is important that PE and VC funds do not allow projections to supersede calculated investment. Because of market conditions, valuations have remained high for several years, but some believe an impending market correction could cause valuations to soften.

Thus, in a market defined by such high valuations, buy-side due diligence should stand top of mind for PE and VC investors. This means conducting operational analyses to determine a business’ growth drivers and ensuring that return assumptions will hold up over time. Because competition for new deals remains stiff, it may be required that due diligence be completed pre-bid, or even pre-letter of intent (LOI). Conducting thorough buy-side due diligence grants investors a much deeper picture of a company’s operations, allowing them to make more calculated investment decisions and become less vulnerable to market shifts.

What PE and VC investors are experiencing in the market today is nothing new. Adjusted, speculative metrics have been utilized in the valuation of startups since the dot-com bubble, long before the community-adjusted EBITDA metric was ever conceived. Increased competition, driven by record dry powder and a shortage of attractive investment targets, means that funds are once again paying higher multiples to invest in new business models like WeWork.

But, just because a business model is new or unique doesn’t mean its valuation methods need to be equally creative. Traditional valuation metrics, central to buy-side due diligence, grant investors the ability to look beyond the new business model hype and ensure sound investment decisions are being made.

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