



CVCA Guidelines & GAAP

CVCA Professional Development Series

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International & Canadian Valuation Guidelines

IPEVCVG

- International Private Equity & Venture Capital Valuation Guidelines
- Developed by EVCA (European Venture Capital Association) & BVCA (British Venture Capital Association)
 - Adopted by 32 other countries/associations, including the CVCA
- To ensure greater consistency & promote best practice
- What if conflict exists between guidelines and:
 - GAAP
 - Laws or regulations
 - Fund agreement
 - Guidelines would take a back seat

Concept of Fair Value

- Guidelines are based on Fair Value
- CVCA
 - Amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction
- GAAP: CICA Handbook subsection 1581.06(b)
 - The amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties under no compulsion to act
- Fair Value does not equal Price
 - Notional concept

Price vs. Fair Value

- Potential differences between fair value and price:
 - Negotiating positions and motivations of the parties to an actual transaction
 - Extent to which a business is actually exposed in the open market and the number of potential purchasers solicited
 - The number of interested bidders
 - The unique circumstances of each potential purchaser, including such factors as economies of scale and/or strategic benefits created by the acquisition

Enterprise Value & Allocation of Value

- Value generally realized through a sale or flotation of entire business, rather than a sale of an individual interest.
- Initial determination of enterprise value (EV), followed by allocation of EV amongst securities
 - Minority discounts rarely applied
 - Marketability discounts are typically considered

Valuation Approaches

- Primary Valuation Approaches
 - Cost/Latest Round of Financing
 - Earnings multiples
 - Other market approaches
 - Net assets
 - DCF (underlying business)
 - DCF (investment)
 - Industry valuation benchmarks
- Review each approach
 - Applicability
 - Application & issues
 - Valuation review
 - “Audit” testing
 - Preparation for review

Cost: Initial Year

- Fair value assumed to approximate cost in initial year, unless circumstances indicate otherwise
- Valuation Review
 - Ensure that cost is still representative of fair value as at the financial statement date
 - Follow-on investment at different value (or expected)
 - Performance significantly above or below initial expectations
 - Significant improvement or deterioration in market, economic or company-specific conditions

Price of Recent Transaction

- Actual transactions involving the subject company or (more often) follow-on financing rounds
- Company is valued based on the post-money value of the financing round
 - Any existing holdings would be re-valued on this basis
- Valuation Review
 - Ensure the transaction provides an appropriate basis for the valuation
 - See next slide
 - Verify that recorded fair value is in accordance with the value established by the transaction
 - Ensure that the recent transaction value is still representative of fair value at the financial statement date

Price of Recent Transaction

- Ensure the transaction provides an appropriate basis for the valuation
 - New investor participation vs. internal funding round
 - Change in original interests in the case of an internal funding round
 - Comparison of rights attached to the new and existing investments
 - The new investment represents a forced sale or a “rescue package”
 - The absolute amount of the new investment is relatively insignificant
 - A new investor is motivated by strategic considerations

Price of Recent Transaction

- Importance of New Third-Party Investors

	\$000's	# of Shares			\$ Per Share
		A	B	C	
Pre-money equity value	15,000	1,250	1,250	-	6.00
New equity financing	9,000	500	500	500	6.00
Post-money equity value	24,000	1,750	1,750	500	6.00
Percentage interest		43.8%	43.8%	12.5%	

	\$000's	# of Shares			\$ Per Share
		A	B	C	
Pre-money equity value	45,000	1,250	1,250	-	18.00
New equity financing	9,000	167	167	167	18.00
Post-money equity value	54,000	1,417	1,417	167	18.00
Percentage interest		47.2%	47.2%	5.6%	

Price of Recent Transaction

- Internal Funding Round
 - No new investors and no change in existing interests

	\$000's	# of Shares		\$ Per Share
		A	B	
Pre-money equity value	15,000	1,250	1,250	6.00
New equity financing	9,000	750	750	6.00
Post-money equity value	24,000	2,000	2,000	6.00
Percentage interest		50.0%	50.0%	

	\$000's	# of Shares		\$ Per Share
		A	B	
Pre-money equity value	45,000	1,250	1,250	18.00
New equity financing	9,000	250	250	18.00
Post-money equity value	54,000	1,500	1,500	18.00
Percentage interest		50.0%	50.0%	

Price of Recent Transaction

- Internal Funding Round with change in original interests

	\$000's	# of Shares		\$ Per Share
		A	B	
Pre-money equity value (50/50)	15,000	1,250	1,250	6.00
New equity financing (20/80)	9,000	300	1,200	6.00
Post-money equity value		1,550	2,450	
Percentage interest (post-money)		39%	61%	

	\$000's	# of Shares		\$ Per Share
		A	B	
Pre-money equity value (50/50)	45,000	1,250	1,250	18.00
New equity financing (20/80)	9,000	100	400	18.00
Post-money equity value		1,350	1,650	
Percentage interest (post-money)		45%	55%	

Offers

- Third-party offers for all or a portion of the business
- Pricing indications for financing rounds
- Consider motivations of the parties
 - Unduly high in order to gain access, open negotiations
 - Unduly low if potential for forced sale or other stakeholders are less liquid
 - May be made on basis of insufficient detailed information
- Consider response of investee Board
- Actual deals expected to close in the future
 - Risk-to-close discount

Write-ups & Write-Downs

Early Stage

- Difficulties of accurately assessing value
- Write-downs in tranches of 25% (CVCA)
- Write-ups should not be taken unless able to reasonably establish value

Later Stage

- More traditional valuation approaches

Earnings Multiples

- Typically EBITDA or EBIT multiples used
 - To remove impact of leverage
- Revenue multiples in the case of early-stage companies
- Trading multiples
 - Private-company discounts
- Transaction multiples
 - Potential synergistic premiums
- Other multiples
 - Original transaction multiple, if relevant
 - Financing multiples (or transaction value)
 - Put option formulas

Earnings Multiples

- Earnings (EBITDA, EBIT, etc.)
 - Historical
 - Trailing
 - Forecast
 - Should be consistent with multiple (or adjustment to multiple considered)
- Per CVCA, financial data should be based on expected maintainable EBITDA, EBIT, etc.

Earnings Multiples

- Valuation Review
 - Level of EBITDA, EBIT or revenue used in calculation
 - Appropriateness of any normalization adjustments
 - Selected multiple
 - Trading and/or transaction analysis
 - Accuracy, relevance and completeness
 - Discounts applied
 - Other adjustments (redundant assets, etc.)
 - Net debt and allocation of EV

Net Assets

- Value derived mainly from value of underlying assets, rather than earnings
 - Property holding companies
 - Investment businesses
- Liquidation approach
 - Typically only applied if company is in process of being liquidated, or liquidation is highly likely / imminent
- Valuation Review
 - Appropriateness of approach
 - Assessment of asset/liability values used

Discounted Cash Flow

- Used infrequently
- Both CVCA and PEIGG “warn” against DCF approach
 - Subjectivity and sensitivity to assumptions
 - Vs. traditional valuations
 - Considered a “last resort” or as a secondary check
- In practice, most often encountered in the following situations
 - Later-stage P/E (vs. VC) investments
 - Resemble traditional valuations
 - Contractual arrangements establish milestone payments
- Valuation Review
 - Appropriateness of approach and assessment of assumptions and analysis

Industry Valuation Benchmarks

- Rules of thumb for specific industries
 - Price per subscriber
 - Price per bed
- Multiple of revenue approach might also be considered an industry benchmark or “rule of thumb” approach
- Useful in specific industries, but otherwise relegated to a cross-check

Valuation Review

- Prepare valuation memo for each material investment in the fund
- Memo should address
 - Brief description of the company and the investment
 - Significant events in the year (if any) and performance relative to expectations
 - Financial overview and discussion
 - Key statistics (Revenue, EBITDA, cash on hand and burn rate)
 - Comparisons to prior years and budget
 - Valuation approach and calculations
 - Rationale for approach
 - Rationale for assumptions (multiples, earnings levels, etc.)

Debt Instruments

- Typically valued at cost
 - Assess whether write-down required
 - Based on EV analysis
- Rarely valued using an NPV approach
 - Difficulty in assessing appropriate interest rate
 - Unless stated rate is clearly not at market
- Valuation Review
 - Covenant status and ability to service
 - EV coverage

Debt Instruments

- Debt issued with equity instruments (common shares, warrants, etc.)
 - Segregation between debt and equity components
 - Equity instrument revalued periodically
 - Debt discount amortized over term
 - Effective interest approach

Warrants & Options

- Valuation approaches not specifically addressed in the guidelines
- In practice, typically valued at intrinsic value
 - As opposed to a Black-Scholes valuation
 - Black-Scholes might be more acceptable if options related to publicly-traded shares

Convertible Securities

- Should be valued as either
 - Straight debt or preferred shares, or
 - On an as-converted basis
 - Depending on likelihood of exercise
- Issue needs to be considered if:
 - Fund owns convertible debt
 - Fund owns securities junior to convertible debt – that is, consider the potential dilutive effect of the convertible securities

Liquidation Preferences

- Fund acquires preferred shares at a cost of \$10 million and a 2 times liquidation preference upon a liquidity event
- Whether, when and how to recognize the liquidation preference
 - Immediately, when liquidity event is imminent, over time
- Fund owns shares with liquidation preferences
- Fund owns shares that are affected by the liquidation preference rights of other securities
- At times liquidation preferences are revised or removed in subsequent financing rounds

Accrued (or PIK) Dividends

- Similar to liquidation preferences, dividends are only payable upon exit or other liquidity event
 - Also might be removed or revised in subsequent financing rounds
- Whether, when and how to recognize the dividends
 - When liquidity event is imminent
 - As they accrue
- On shares held by Fund or shares held by others
- Consider ability to pay (EV coverage)

Public Investments: Trading Restrictions

- Formal Restrictions on Trading (escrowed shares, lock-up periods, etc)
- Valuation Guidelines
 - Recommend marketability discount
- CVCA
 - 20% discount recommended for 6-month lock-up period
 - Other periods not addressed

Public Investments: Liquidity Discounts

- Shares owned by Fund are high relative to normal trading volumes (in excess of 20 days)
- GAAP
 - US & IFRS – no not allow marketability / liquidity discounts
 - Canada – such discounts are allowed, but not mandated
- CVCA
 - Provides table showing discounts for various holdings
 - Soon to be changed to no discounts
- Industry practice in Canada
 - No liquidity discounts