AICPA PE/VC Task Force Update for NVCA Strategic Operations and Policy Summit

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DISCUSSION OUTLINE

- Overview of Task Force Activities and Draft AICPA Guide Planned for Initial Release for Comment 2Q 2018
- Review of 2 VC Portfolio Company Case Studies Planned to be Presented in the Guide
  - Workforce Diagnostics (Case Study #11)
    - Background of Facts
    - Valuation Approaches and Challenges Illustrated in Example
    - Key Take-aways
  - TKO Technologies (Case Study #9)
    - Background of Facts
    - Valuation Approaches and Challenges Illustrated in Example
    - Key Take-aways
- Conclusion

AICPA Task Force Objectives

- Task Force objectives are:
  - Harmonize the diverse views of industry participants, auditors and valuation specialists
  - Produce a more user friendly guide with case studies that can be used to reason through real situations faced by investment fund managers, valuation specialists and auditors
- Working title:
  - *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*

Task Force Members and Observers

Co-Chairs

- Amanda Miller, EY
- Sean McKee, KPMG

Industry Participants

- Timothy Curt (Warburg Pincus)
- Quintin Kevin (Adams Street)
- David Larsen (IPEV, Duff & Phelps)

Valuation Specialists

- Chad Arcinue (EY, Observer)
- Travis Chamberlain (Clifton Larsen)
- Shaan Elbaum (PwC, Observer)
- John Ferro (Grant Thornton)
- Ray Rath (Globalview Advisors)
- Dave Dufendach (Alvarez & Marsal, Observer)

Auditors

- Belanne Ungarelli (PwC)
- Scott Burger (KPMG, Observer)*
- Adrian Mills (Deloitte)

AICPA

- Yelena Mishkevich
- Mark Smith

* - Formerly an industry participant as the Chief Accounting Officer of Kleiner Perkins but has moved to KPMG via Rothstein Kass

AICPA expects to publish the working draft of the PE/VC Guide after busy season in 2018

- Task Force develops consensus, writes draft
  - June 2017 – Completed the first draft of the guide, including 14 chapters, two reference appendices, and around 200 pages of case studies
  - FinREC is currently reviewing the draft
- Current timeline (allowing time for review)
  - June 2017 – have the whole guide written
  - July 2017 – FinREC blessing
  - August 2016 to September 2017 – industry executive review, in parallel
  - Fall 2017 – Fatal flaw reviews
  - Winter 2017 – FinREC approves working draft
  - **May 2018 – release working draft**
  - August/September 2018 – process comments on working draft, get through FinREC (Winter 2018) and final fatal flaw reviews
  - May 2019 – publish the final version

Nature of AICPA Guidance

- Non-authoritative (like other valuation guides issued)
- Must clear FinREC
  - Financial Reporting Executive Committee (FinREC) – the board for the AICPA
  - Mission - determine the Institute's technical policies regarding financial reporting standards and to be the Institute's spokesbody on those matters, with the ultimate purpose of serving the public interest by improving financial reporting.
  - Sixteen members from accounting firms, preparers of financial statements and other professionals including a valuation observer from the FVS Executive Committee.
- Reflects consensus, captures comments by offering review period on working draft
- No transition period – best practices, not standard-setting

- PE/VC guide focuses on specific challenges for this industry:
  - Example rich, covering many investment types over the investment life-cycle
  - Significant discussion on the concept and use of calibration
  - Not rules based

The PE/VC Guide was designed to address many challenging issues for this industry

- Introduction
- Chapter 1, Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies
- Chapter 2, Fair Value and Related Concepts
- Chapter 3, Market Participant Assumptions
- Chapter 4, Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments
- Chapter 5, Overview of Valuation Approaches
- Chapter 6, Valuation of Debt Securities
- Chapter 7, Valuation of Equity Securities in Simple Capital Structures
- Chapter 8, Valuation of Equity Securities in Complex Capital Structures
- Chapter 9, Control and Marketability
- Chapter 10, Calibration
- Chapter 11, Backtesting
- Chapter 12, Factors to Consider At or Near a Transaction Date

The Special Topics and FAQ chapters cover a variety of additional considerations

- Chapter 13, Special Topics
  - A. Enterprise has traded securities
    1. P*Q rule
    2. Underwriter lockups and SEC Rule 144A
    3. Similar vs. identical securities
    4. Significant decrease in volume or activity or distressed transactions
  - B. Pricing services / broker and dealer quotes
  - C. Indicative offers
  - D. Insider financing rounds
  - E. Early stage companies with no recent financing rounds
  - F. Rights and privileges not enforced
  - G. Commitments to portfolio companies (loans, equity)
- Chapter 13, Special Topics *(cont'd)*
  - H. Guarantees
  - I. Dilution
    1. Existing capital structure – preferred and common units
    2. Future rounds
    3. Management securities
    4. Investor warrants
  - J. Options and warrants, convertible notes and related securities
  - K. Contractual rights (also known as "contingent considerations")
  - L. Private fund interests
- Chapter 14, Frequently Asked Questions

The PE/VC Guide also includes a range of case studies to demonstrate the approaches

- Appendix A, Valuation process and documentation – best practices
- Appendix B, Valuation reference guide
- Appendix C, Example investment summaries

1. Leveraged Buy-Out (LBO) – Value of debt for valuing equity
2. Benefits of Adding Leverage – day 2 gain vs. day 360 gain
3. Downside of Leverage – roll-up, backtesting at exit
4. Real-estate development project – value accretion as project progresses
5. Oil & gas development project – value accretion given new information
6. Oil & Gas Bond – significant decrease in volume or activity
7. Joint venture – agency effect when control rests with junior securities
8. Emerging market investment – reliability of financial statements
9. **Start-up with a strategic exit – "last man standing" ("TKO TECHNOLOGIES")**
10. Biotech startup – down-round to strategic sale with earnout
11. **Software as a service startup – quick ramp but lots of competition ("WORKFORCE DIAGNOSTICS")**
12. Clean-tech startup – changes in value due to changes in regulations and government support
13. Emerging market startup – opportunities and risks in China
14. BDC debt – straight debt, debt with prepayment penalties, convertible debt, warrants
15. Restricted stock investment (PIPE) – direct investment in traded public company stock
16. Investments in related securities when the enterprise has traded stock

Purpose and content for case studies

- Illustrate a wide variety of situations
- Each case study includes:
  - Background on subject entity and securities
  - Initial transaction and calibration
  - Valuations at various measurement dates across time until exit
    - Changes at subject entity
    - Changes in industry / market
    - Valuation at each measurement date
    - Calibration to prior measurements
  - Description of the exit transaction, showing how value was ultimately realized

Key areas of focus where the PE/VC Guide may clarify best practices:

- Consider the time horizon of the investment when estimating the value of debt for the purpose of valuing equity and the value of any NOLs, even when valuing a controlling position
- For debt investments with warrant coverage, allocate value between the debt and warrants to report the fair value as separate line items on the schedule of investments
- Estimate the value of the enterprise for the purpose of valuing equity interests in the enterprise without consideration of premia or discounts
- Estimate the fair value of debt and the value of debt for the purpose of valuing equity consistent with the cash flows, the market yield, and the remaining expected term
- For equity investments in portfolio companies with complex capital structures, consider alternative methodologies or apply appropriate adjustments when using the option pricing method (OPM) to allocate value between classes of equity
- Estimate value by calibrating the selected valuation model to any recent transactions and then update these assumptions for changes between the transaction date and the measurement date
- Perform backtesting to improve the fund's valuation processes
- Exclude transaction costs from the fair value of investments on day 2; that is, the fair value immediately after the transaction close may be less than the capitalized cost

Workforce Diagnostics Case Study

Background on Portfolio Company

- Pre-revenue SaaS software company focused on data analysis regarding employee productivity.
- Fund invested in Series A & B, but decline to participate in Series C.

	Price Per Share	Fund Investment	Total $ Raised
Series A	$3.00	$3.6 million	$10.8 million
Series B	$4.00	$4.0 million	$18.0 million
Series C	$2.00	-0-	$6.0 million

- Fund was one of three VC's initially invested in WD and its highest fully diluted ownership was 13.3%.

Fund Investment Amount	$7.60 million
Fund's Highest Carrying Value (1.16x @ $4.00/share)	$8.80 million
Fund's Lowest Carrying Value (0.73x after Series C round)	$5.56 million
Fund's Ultimate Exit Proceeds (1.0x - liquidation preference)	$7.60 million

Workforce Diagnostics Case Study
Valuation Approaches Illustrated

- Valuations at subsequent measurement dates are *calibrated* to last round of financing.
- Judgments made at interim measurements are informed by a *scenario analysis* like the following (based upon subjective factors):

Table 7: WD Valuation as of September 30, 2X12				
Scenario		Future Proceeds	Scenario Probability	Probability Weighted Proceeds
Liquidation			85.0%	
Exit (3 years)		$ 600,000,000	15.0%	$ 90,000,000
Total			100.0%	$ 90,000,000
			After Dilution Adjustment	$ 72,000,000
	Discounted at 20% Venture Capital Portfolio Return			$41,700,000

- For later rounds/lower valuations, where liquidation preferences matter, the analysis includes assessing how each series of preferred would share in the assumed results.

Workforce Diagnostics Case Study
Take-aways

- Calibration to the latest round is a commonly used approach that is required by GAAP.
- The calibration needs to be reevaluated at each measurement date based upon objective <u>*and subjective*</u> factors that have changed in the interim.
- For pre-revenue companies, since market participant assumptions are mostly driven by expectations about future events (including, for example, IPO timing and value expectations), assumptions those future events are relevant in many cases.
- Liquidation preferences generally don't matter unless they matter. Generally only a factor in evaluating downside and sideways scenarios.

TKO Technologies Case Study
Background on Portfolio Company

- SaaS software provider focused on enterprise collaboration.
- Established leader in category at the time the fund invested $10 million for a 10% stake, but limited revenues and significant cash burn.
- Quantitative metrics provide little relevant insight the first several measurement dates.
- Key focus is evaluating the company's achievement relative to milestones and the impact on exit prospects.
- The fund's judgment is heavily influenced by external factors as the competitive landscape changes rapidly.

Fund Investment Amount	$10.0 million
Fund's Highest Carrying Value (2.55x)	$25.5 million
Fund's Ultimate Exit Proceeds	

TKO Technologies Case Study

Valuation Approaches Illustrated

- Initial investment based upon the belief that company could achieve $1 billion valuation using 4.0x revenue multiple, ramping from very modest bookings (<$5 million) to >$250 million at a future exit date.
- Subsequent observed M&A transactions seemed to validate market participants' enthusiasm and expected valuation range.
- Lack of subsequent rounds for calibrating makes the valuation process subjective.
  - Factors considered included:
    - Cash burn relative to subjective and changing milestones.
    - Bookings and customer acceptance relative to subjective and changing milestones.
    - Market share and continuous evaluation of the competitive landscape.
- Assessing the relative weighting to place on various company-specific and market-oriented factors requires judgment.

TKO Technologies Case Study
Take-aways

- With early stage companies entering a *niche market*, it can be just as important (and perhaps more important) to evaluate the competitive landscape as it is to evaluate company-specific progress and achievements.
  - This can apply as easily in software as with a biotech company pursuing targeted therapies impacting small populations.
- Second and third order consequences of market developments can impact prospects for the future.
  - For example, a major cash infusion for a competitor can accelerate their time to market.
  - Be sure to identifying potential acquirers, their interest and ability to pay the valuation sought can be quite relevant.
    - In this case, the two largest enterprise software companies acquired two other competitors and left no room in the market for TKO to survive as an independent company.
- Many early stage investments fail, even if they start out strong.

CONCLUSION

- Fair value accounting is here to stay so let’s make sure everyone knows how to apply it to our industry.
- Emphasis on judgment in evaluating relevant factors, *consistent with market participant assumptions*.
  - Diversity of case studies and valuation approaches intended to show the breadth of relevant issues and challenges.
  - Many case studies show multiple valuation approaches at each measurement date and changes to approaches as the investment changes of matures.
- The guide intentionally is silent on documentation requirements and includes tables and calculations only where they are essential to communicating the facts.
- Establishes some common terminology and constructs that will help auditors to speak to investors and vice versa.