

THE ROUNDTABLE

FACE VALUE

A group of venture capital CFOs sat down with *The Drawdown* to discuss challenges of valuing pre-revenue companies and implications of the new IPEV guidelines

AT THE TABLE

Raxita Kapashi
CFO
Dawn Capital

John Horton
Finance director
DN Capital

Ben Prince
Fund accountant
Amadeus Capital

Alex Goodway
CFO
Kindred VC

Richard Dana
CFO
Founders Factory

Kevin Pearl
CEO & founder
VCM Software

In a discussion led by VCM Software founder Kevin Pearl, who specialises in supporting venture houses in determining portfolio Fair Value

valuations under new IPEV guidelines, the participants revealed challenges they're facing in this field.

Asked about current approaches to valuations, the participants were unanimous in their use of latest funding round and costs. If there was no funding round for 12-18 months, they look to see if it needs to be written down. However, the new guidelines no longer approve of this method.

The Drawdown (TDD): Agreeing a valuation method and regularly reporting portfolio valuations are key

aspects of the CFO role. How is the GP-LP dynamic changing as investor demands increase?

Alex Goodway: There's a high level of granularity and the reporting burden on CFOs or finance teams is increasing. I don't think LPs realise the impact it has on the finance function of the fund.

Raxita Kapashi: As a VC we own a minority stake in portfolio companies and do not want to burden the CFOs with additional reporting requirements when their focus should be to support the CEO and grow the business. There needs to be a balance of how much information is the right information to satisfy the valuation process as well as to satisfy LP requirements.

Alex Goodway: When I worked as an LP investing across PE and VC we looked for the tangible driver behind the increase or decrease of the valuation. If there's a sudden increase in value, we would typically look to the



accompanying investment report to find the source of the increase in valuation. The more obscure the inputs into the valuation methodology, the more difficult it is for LPs to understand what is driving the change in valuation, and the more difficult it becomes for the GP to explain it.

John Horton: We are in a business where the top 20% of the investments deliver most of the returns. The majority of information we collect from smaller and lesser performing companies is irrelevant because their returns won't move the dial on the fund. Investors should be asking for the ones that matter, but those companies are a lot more sensitive. In many cases they're making ground-breaking steps



and don't want any financial information on their performance released into the wider domain. Particularly if they're in the US, they're used to a much lower level of disclosure than is found in the UK.

Raxita Kapashi: When we invest in a portfolio company we're likely not the only VC fund. Therefore, LPs may receive different valuations for the same portfolio company. It would make sense for CFOs to collaborate in certain instances - LPs would then receive consistent information prepared on the same basis.

Richard Dana: In the venture world, when exiting, there's a huge variance in the offers. One could be double another for the same business at the same time. It can be a

nightmare to value the businesses internally if there's a big difference in terms of what the market thinks it's worth. There doesn't seem to be any methodology. I think external market valuations vary hugely at the very early stage.

TDD: Being open and transparent with LPs is a key objective of the IPEV guidelines; what's your take on the framework and what do your investors expect of you?

Alex Goodway: In the past we used the 2015 IPEV guidelines, and we will be adhering to the 2018 guidelines going forward. The main driver for us is we're audited on an annual basis. We don't want our valuations to change having



VALUATION METHODOLOGIES IPEV

The following valuation techniques may be helpful in estimating Fair Value:

Scenario-based methods

A forward-looking method that considers one or more possible future scenarios. These methods include simplified scenario analysis and relative value scenario analysis, which tie to the fully-diluted ("post-money") equity value, as well as full scenario analysis, also known as the probability-weighted expected return method (PWERM)

Option pricing method (OPM)

A forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios

Current value method (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

Hybrid method

A hybrid of scenario-based methods and OPM



Ravita Kapashi



John Horton



Richard Dana

been audited and auditors asking why we haven't considered the new guidelines, then having to adjust those new valuations. It's clear investors care about this, which is why we use auditors alongside our advisory committee to provide accountability.

Kevin Pearl: I think if your accountant is going to sign on your NAV they're going to have to go in this direction.

John Horton: I think accountants want a clearly defined basis that can be consistently applied. If the basis becomes needing to follow OPM, then there may be a shift in that direction.

Kevin Pearl: Within the framework of the new IPEV regulations there are two distinct areas: Enterprise Value (EV) and Fair Value (FV) of the specific security.

When it comes to EV, the guidelines state market makers value companies. VCs, as market players, can usually calculate that themselves.

For non-revenue investments IPEV describes using, amongst other parameters, Milestone indicators including financial and technical development measures. (*2018 IPEV Guidelines, page 35*).

IPEV: EXTRACT

Generally, for Private Capital Investments, Market Participants determine the price they will pay for individual equity instruments using Enterprise Value estimated from a hypothetical sale of the equity as follows:

- Determine the Enterprise Value of the Investee Company;
- Adjust the Enterprise Value for factors that a Market Participant would take into account;
- Deduct from this amount the value, from a Market Participant's perspective, of any financial instruments ranking ahead of the highest-ranking instrument of the Fund in a sale of the Investee Company.
- Take into account the effect of any instrument that may dilute the Fund's Investment to derive the Attributable Enterprise Value

TDD: Once you've worked out the EV, what is the next step to the process?

Kevin Pearl: Calculating the Fair Value of VC's investment in the company. According to IPEV, there are four Fair Value methodologies (*see Valuation Methodologies boxout*).

IPEV recommends guidelines in the appropriate methodology for determining FV (*see IPEV boxout on left*).

When calculating FV, you have to understand that different securities (Preferred A, B, Common, Warrants, etc) have unique rights which need to be considered. In addition, we can't ignore Junior security types i.e. instruments not in the money. Hence using either 'the last PPS multiplied by the number of shares' (which ignores liquidation preferences) or waterfall valuations (which ignores junior security types) is not complying with the new regulations.

As an example of a junior security, take a Warrant not in the money. Someone is better off holding an out-of-the-money Warrant than not holding it because in the future it may be worth in-the-money. So it shouldn't be ignored in FV calculations.



Alex Goodway

Ben Prince

John Horton: If management has control over the commons.

Kevin Pearl: Yes their control doesn't negate either that the senior securities have additional rights or that the junior securities need to be given value.

Richard Dana: Yes, but you don't necessarily have to, you have four options and you can still plug this through the waterfall of the EV.

Kevin Pearl: The guidelines acknowledge it is very complex. If you're doing it simply, you've probably ignored something. What I hope to do is remove some of the mystique and show that software can manage the complexities of calculating waterfall and OPM values.

TDD: Of the different methodologies for FV, which do you think is the most relevant?

Kevin Pearl: With all the subjective variables in PWERM, defending FV through it may prove a challenge. CVM is really only relevant if an IPO or M&A is imminent. This leaves OPM.

TDD: What is needed for OPM?

Kevin Pearl: There are four stages that need to be carried out. Systems like ours handle this process in a professional and timely manner.

The first stage is populating the cap table, which most VCs have. The second, which is complicated, is gathering each security's rights by thoroughly reading all the investment documents, which most VCs don't have in their entirety. Thirdly, adding the variables for OPM, the EV, volatility, risk free interest rates and years to event. Lastly, with all that data run the OPM calculations.

As gathering preferences is such a challenge, firms like ours offer a service to ensure that the data inputted is correct and complete.

John Horton: I like the concept of OPM. I understand the logic to it, but it won't cover all circumstances. For example, it is difficult to deal with the rights held by the management team who can influence whether a business is sold or not and look to negotiate better terms for themselves than implied by the waterfall.

Kevin Pearl: Management theoretically safeguards the interest of shareholders, and though at a later stage if the 'exit' isn't large enough they may renegotiate, for FV purposes, we discount this.

TDD: How do you think increasing adoption of the IPEV guidelines and the willingness of your accountants to sign off on valuations will change the way you calculate valuations going forward?

Ben Prince: I've seen the OPM method in the guidelines, but I've not looked into the pricing model at all. I've never had a question from an LP on it nor from auditors. But I think if we shifted to this tomorrow, the question would be why is there now value in ordinary shares when they're out of money?

Kevin Pearl: Auditors aren't yet requiring FV through the new regulations. We think they will soon. It's important VCs understand ahead of time what the implications will be for them.

Alex Goodway: The best thing is having an honest, open conversation with your accountant or auditor and understand what they're seeing from their other clients as well.

This roundtable was made possible thanks to VCM Software. ♦