



PRE- AND POST-MONEY CALCULATION THE USE OF COMMON STOCK EQUIVALENTS IN PORTFOLIO VALUATIONS

In May of 2018, the American Institute of Certified Public Accountants (AICPA) released its first working draft for the valuation of portfolio company investments. The guide, officially known as ***Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*** (unofficially known as the VC/PE Guide) provides much needed guidance and standards as they relate to the investments made by institutional investors. Despite being in draft form, much of the theory and guidance provided is highly relevant to the valuation industry, and many key points are addressed by auditors and incorporated into engagements throughout the community. One topic in particular pertains to the use of common stock equivalents (CSE) in valuations.



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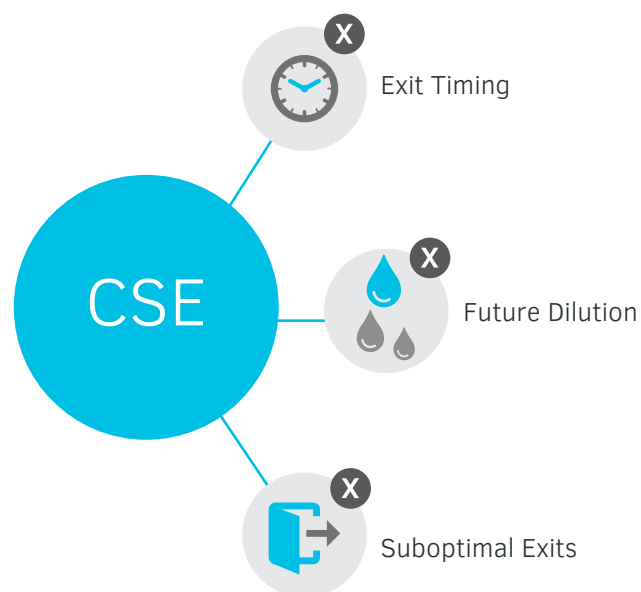
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A CSE is a quick method of determining equity share value by assuming all outstanding shares are equal in terms of rights, preferences, and protections. In essence, this method considers all shares to be common on a fully diluted basis. This is most often employed or considered when a new transaction has occurred for the subject company. In a situation in which a new investment round occurs, and, for example, a price per share of \$5.00 was paid for this new more-senior round (again, for example, let's assume this is a Series C), the CSE price now for all outstanding shares (including Series B, Series A, and common on a fully diluted basis) would then be adjusted to \$5.00. In practice, this is the implication behind a pre- or post-money calculation.

The advantages of considering the CSE in an analysis relate to the nature of the venture capital and private equity industries. The VC/PE Guide acknowledges that many transactions are negotiated using pre- or post-money calculations. This makes the use of a CSE a market participant assumption and an important input and consideration. Chapter 8 of the VC/PE Guide discusses the use of CSE in scenario-based approaches for modeling out company exits. This is particularly relevant when the exit outcome of the company is considered binary in nature; with an exit being at such a high value that all equity would essentially convert to common, an IPO exit that forces conversion to common, or the other exit resulting in the subordinate classes of equity falling to a near-zero value. This is perhaps best exemplified in the pharmaceutical/biotech industries, in which the pass-or-fail results of FDA trials may create a binary outcome for the company.



There are, however, shortcomings to the CSE method. In its simplified form and application, the CSE does not necessarily account for exit timing, future dilution, or suboptimal exits. To account for these factors, more-complicated assumptions may be made in scenario-based approaches. These assumptions may include, for example, merger or acquisition sale scenarios in which the junior preferred securities may not receive their full liquidation preference. Another option would be the use of an option pricing model (OPM), such as the Black-Scholes Model, to determine the allocated value of the junior preferred securities. The use of an OPM may help to capture differences in preference and seniority, but valuation specialists should use prudence and caution, as even the much-venerated OPM may overly skew results for the junior preferred securities.



In addition to the above disadvantages, transactions involving warrant coverage or a conversion ratio greater than 1x would often result in a CSE price per share lower than the stated nominal price for the round.

Clearly, there can be a great deal of nuance in valuing portfolio positions. As this new guidance gains wider acceptance and adoption, greater scrutiny and rigor surrounding the methods used in valuing private company portfolios is expected to occur. For this reason, qualified and competent valuation specialists should be sought out to help navigate the complexities of portfolio valuations.

