

IRC Section 409A And The Conundrum Of Valuing The Common Stock Of A Privately Held, Venture-backed Company

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Since the enactment of Internal Revenue Code ("IRC") Section 409A, one question we are frequently asked is: how do you value a privately held, venture-backed company? Moreover, once you've valued the early-stage company, how do you determine what portion of that company's value should accrue to the common stock holders (often company management and employees – those most affected by IRC Section 409A) versus the company's preferred stock holders (often venture capital firms or other investors)?

It is worth reviewing IRC Section 409A. In April 2007, the Treasury Department issued final regulations under IRC Section 409A, which addresses the treatment of nonqualified deferred compensation plans. The code section addresses many topics outside the scope of this article (and best left to a compensation specialist to discuss) but says that an option granted with an exercise price less than the *fair market value* of its common stock as of the date of grant (an "in-the-money" option) is a deferred compensation arrangement. Furthermore the recipient of an in-the-money option may be subject to serious adverse tax consequences including (1) taxation at the compensation income rate at the time of vesting (as opposed to the time of exercise) and (2) a 20 percent tax penalty, including interest related to underpayment. Suffice it to say, a company would be wise not issue options to its employees at an exercise price less than fair market value of the company's common stock unless it wants serious trouble with its employees. The regulations under IRC Section 409A suggest several Safe-Harbor methods that a company may employ to determine the fair market value of its common stock; however, in practice, given the complexity of the valuation process, most companies have sought the assistance of an independent appraiser. Generally, the appraiser will value the common stock of a company in two steps: First he will determine the overall value, or *business enterprise value* ("BEV") of the subject firm; and, second, (assuming the subject firm has a complex capital structure, which includes one or more rounds of preferred investment) he will allocate the BEV to the company's capital components, or share classes.

There is no universal formula to determine the appropriate fair market value for a company's BEV. However, the methods commonly used to value interests in closely held businesses are the income, market, and cost approaches.

The *Income Approach* focuses on the income-producing capability of an asset. The income approach estimates value

based on the expectation of future cash flows that the asset will generate – such as cash earnings, cost savings, tax deductions, and the proceeds from disposition. These cash flows are discounted to the present using a rate of return that incorporates the risk-free rate for the use of funds, the expected rate of inflation, and risks associated with the particular investment. The selected discount rate is generally based on rates of return available from alternative investments of similar type, quality, and risk.

The *Market Approach* measures the value of an asset through an analysis of recent sales or offerings of comparable investments or assets. When applied to the valuation of a business enterprise, consideration is given to the financial condition and operating performance of the entity being appraised relative to those of publicly traded entities operating in the same or similar lines of business, potentially subject to corresponding economic, environmental, and political factors, and considered to be reasonable investment alternatives. The market approach can be applied by utilizing one or both of the following methods:

The *Public Company Market Multiple Method* focuses on comparing the subject entity to guideline publicly traded entities. In applying this method, valuation multiples are: (i) derived from historical operating data of selected guideline entities; (ii) evaluated and / or adjusted based on the strengths and weaknesses of the subject entity relative to the selected guideline entities; and (iii) applied to the appropriate operating data of the subject entity to arrive at a value indication.

The *Similar Transactions Method* utilizes valuation multiples based on actual transactions that have occurred in the subject entity's industry or related industries to arrive at an indication of value. These derived multiples are then adjusted and applied to the appropriate operating data of the subject entity to arrive at an indication of value.

The *Cost Approach* measures the value of an asset by the cost to reconstruct or replace it with another of like utility. When applied to the valuation of a business enterprise, value is based on the net aggregate fair market value of the entity's underlying individual assets. This approach is frequently used in valuing holding companies or capital-intensive firms. It is not necessarily an appropriate valuation approach for companies having significant intangible value or those with little liquidation value (i.e., early-stage companies).

In practice, if the subject company has recently undergone a round of preferred financing, the appraiser will often use that round (which was presumably negotiated between unrelated willing buyers acting with equal knowledge of the company's operations) to infer a



Kenneth J. Pantoga

value of the entire enterprise. Under certain circumstances this step can save a significant amount of the appraiser's and the company's time (and money), as a formal appraisal (incorporating the three traditional approaches) of the company's BEV would *not* be needed.

Once a company's BEV is determined, the appraiser then allocates that value to the company's various classes of securities (e.g., Preferred A, Preferred B, Preferred C, and so on, and Common). The American Institute of Certified Public Accountants ("AICPA") has issued a Practice Aid, titled *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the "Practice Aid"), which offers guidance on what methods can be followed to perform this allocation. According to the Practice Aid, there are three widely used methods for allocating a BEV to various security classes. These methods include the *Probability-Weighted Expected Return Method* ("P-WERM"), the *Option Pricing Method*, and the *Current Value Method*.

P-WERM

The Practice Aid describes the *P-WERM* (pronounced PEA-WORM) as follows:

Under a probability-weighted expected return method, the value of [a company's] common stock is based upon an analysis of future values for the enterprise assuming various future outcomes. Share value is based upon the probability-weighted present value of expected future investment returns, considering each of the possible future outcomes [which]...might include an IPO, merger or sale, dissolution, or continued operation as a viable private enterprise.¹

The advantage of the *P-WERM* is that it can be used to model the value of the common stock under exit scenarios reflective of what could realistically occur in the company's future. The downside of this approach is that it requires the appraiser and management to make multiple layered assumptions about future events as well as the probability of those future events occurring, and those assumptions may not be easily corroborated.

Option-Pricing Method

The Practice Aid describes the *Option-Pricing Method* as follows:

The option-pricing method treats common stock and preferred stock as call options on the enterprises value, with exercise prices based on the liquidation preference of the preferred stock. Under this method, the common stock has value only if the funds available for distribution to shareholders exceed the value of the liquidation preference [of the preferred stock] at the time of the liquidity event.²

The advantage of the *Option-Pricing Method* is that it considers the future likelihood of future scenarios without relying on as many subjective assump-

tions as the *P-WERM*, and for that reason some find the *Option Pricing Method* a more objective valuation approach. However, results of this method are highly sensitive to certain key assumptions, namely the expected volatility of the company's common stock, and time to an exit event, such as an IPO.

Current-Value Method

The Practice Aid describes the *Current-Value Method* as follows:

The current-value method of allocation is based on first determining enterprise value using one of the three approaches (market, income, or asset-based), then allocating that value to the various series of preferred stock based on their liquidation preferences or conversion value, whichever would be greater.³

The advantage of the *Current-Value Method* is that it is easy to use and understand. As a result, historically it has been the most common method used to price a venture-backed company's common stock. However the most significant disadvantage, and some would argue fatal flaw, of this approach is that it does not consider the likely future appreciation of a company. For example, Company A which is comprised of preferred and common securities may be worth \$100 today. Let's say the liquidation preference of its preferred securities is also equal to \$100. Does this mean the value of the company's common stock is \$0? Under the *Current-Value Method* the answer is yes, the common shares are worthless. But unless Company A is planning to liquidate, we know this is not likely true; the common stock should be worth more than \$0, because at some future date the value of the company could be greater than \$100. Say, for example, at some future date, Company A is worth \$210. Given that the liquidation preference of the preferred securities is \$100, the common could then be worth \$110 (\$210 minus the \$100 liquidation preference), or certainly more than \$0. Given the shortcomings of the *Current-Value Method*, in most circumstances, the AICPA recommends using the *P-WERM* and *Option-Pricing Method* to determine the fair market value of a privately held company's common stock.

In summary, to value the common stock of an early-stage, privately held company, the appraiser can value the company's BEV using traditional valuation methodologies including the cost, market, and income approaches. But then he must allocate the BEV amongst the company's various classes of securities, and although this may appear to be a complex task, it can be accomplished by a competent appraiser following the guidance of the AICPA.

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¹ From AICPA Audit and Accounting Practice Aid Series, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, paragraph 141.

² *Ibid.*, paragraph 146.

³ *Ibid.*, paragraph 150.

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