Financial Immunities
DEALING ROOM

Section 409A and 409A Valuation Explained

Companies that offer stock options as an employee incentive need to be familiar with section 409A of the Internal Revenue Code (“**IRC**”). Before 2005, companies would issue options and set the strike price for those options without any third party interference. Since the implementation of section 409A, if specific regulations set forth in the IRC are not followed during this process, the options can be deemed a taxable event for your employee; not the incentive you or your employee may have been looking for. So what is section 409A?

Section 409A is a section of the IRC issued in 2005 that regulates the treatment of nonqualified deferred compensation for income tax purposes by generally imposing a 20% excise tax when certain design or operational rules contained in the section are violated.

The IRS did create an exemption for stock options and stock appreciation rights in an effort to help some companies avoid the harsh restrictions imposed by section 409A. For an option to be considered exempt from section 409A, the following criteria must be met:

1) The option or right must be for company common stock.
2) The exercise price must be equal or greater than the Fair Market Value ("**FMV**") of the underlying stock on the grant date.
3) For stock that is not readily traded on an established securities market, FMV must be determined by the “reasonable application” of a “reasonable valuation method”.

A “reasonable” valuation method must generally take into account such factors as:

i. The value of tangible and intangible assets of the corporation;
ii. The present value of anticipated future cash-flows of the corporation;

iii. The market value of stock or equity interests in similar corporations or other entities engaged in substantially similar trades or businesses;
iv. Recent arm's length transactions involving the sale of such stock or equity interests; and
v. Factors such as control premiums and discounts for lack of marketability.

409A Valuation

There is no universal formula to determine an appropriate value for an illiquid, non-controlling interest in a closely held company. Determination of value is a matter of judgment, which takes into consideration economic and market conditions, as well as investment opportunities that would be considered as alternatives to the interest being valued.

The three approaches for determining fair value at the enterprise level are the market, income, and asset-based approaches. Although many valuation methods are used in practice, all such methods may be classified as variations of one or more of the three approaches.

A brief discussion of each methodology is outlined below.

Income Approach

The income approach obtains its conceptual support from its basic assumption that value emanates from expectations of future income and cash flows. The income approach simulates, in the absence of observable market transactions, how market participants would formulate their decisions to buy or sell securities. The income approach seeks to convert future economic benefits into a present value and has strong conceptual support from many sources.

The Income Approach utilizes a procedure generally known as the discounted cash flow method of valuation. Currently widely used to quantitatively analyze capital stocks, acquisition candidates and capital projects, the DCF method measures value by reference to an enterprise's expected future debt-free cash flows from a company's operations. This typically involves a projection of income and expenses and other sources and uses of cash, the assignment of a terminal (or residual) value at the end of the projection period that is reasonably consistent with the key assumptions and long-term growth potential of the company, and a determination of an appropriate discount rate that reflects the risk of achieving the projections .

Market Approach

The Market Approach is a generally accepted valuation technique used in evaluating a privately held entity, a division or subsidiary of a publicly traded corporation and securities. This approach compares the subject to similar businesses, business ownership interests or securities that have been sold or are being traded in an active market. This approach examines either publicly traded companies or acquisitions of privately held companies within the same industry as the subject entity. Market-derived multiples based on measures such as earnings, book value, cash flow and revenues are typically applied to the appropriate financial indicators of the subject entity to determine a range of total capital values for an entity .

Asset Based Approach (Cost Approach)

The underlying premise when using the cost approach is that the book value or cost of an asset is equal to its fair market value. Certain adjustments are made to assets on a case-by-case basis if this premise does not hold true. For example, in determining the value of a company's assets, appreciated land held for investment purposes would be carried at its fair market value and not its cost basis. This approach is an important tool for determining the fair market value of property, particularly when reliable data relating to sales of comparable companies is not available and when the subject company has not been historically profitable and future profitability is highly uncertain.

In cases where an investment in one of the company's equity interest occurs on or close to the valuation date, the valuation of the company's share price will be performed using the Market Approach (i.e. based on that transaction).

When a start-up company raises capital, it is usually selling preferred shares, which provide a certain level of security for professional investors (such as VC). The valuations you read about in the media are the post-money value based on the preferred price, <u>not the common price</u> .

Essentially, if a liquidation event occurs (such as IPO or merger), investors who hold preferred shares are first in line to get back their investments. Preferred shares also typically afford the investor some say in the company strategy. Common shareholders don't have those privileges.

The 409A valuation recognizes that certain benefits simply wouldn't be recognized by a common shareholder, particularly minority common shareholders. It takes into account all the various rights and privileges that don't exist with common shares and puts that into a valuation framework.

<u>For an early stage startup especially, there could be a significant difference in value between preferred-share and the common-share for which options are being granted out to employees</u>.

Our experience performing 409A valuations indicates that on average the common share value ranges between 1/3 to 2/3 of the price per share of the most recent investment round of preferred shares.

There are three (3) generally accepted methods for allocating the value of a company among debt and various equity classes:

<u>Probability-Weighted Expected Return Method ("**PWERM**")</u>

Under the PWERM, the value of a company's common stock is estimated based upon an analysis of future equity values assuming various liquidity events, such as an IPO or sale. Share value is based upon the probability-weighted present value of expected future cash flows, considering each of the possible future events, as well as the rights and preferences of each share class.

Option-Pricing Method ("**OPM**")

The OPM treats common and preferred shares as call options on the company's equity value, with exercise prices based on the liquidation preference of the preferred share . Just as an out-of-the-money option may have value, common stock may have value even when the value of the company's equity is less than the liquidation preference on its preferred shares.

Current-Value Method ("**CVM**")

The CVM is based on the allocation of the current value of the company to the different classes of shares based on the rights and priorities of each layer shares. The main assumption of this method is that the shareholders will act to maximize their profits based on the present value of the company, and not based on a valuation of a particular scenario in the future. The assumption is that if a preferred share is in the money (i.e. the value if converted to common is greater than its liquidation rights), the shareholder shall exercise the rights and converts it to a common share.

After one allocates the company's total value among the various capital owners, one also has to consider several adjustments to the value of the company's common share such as Discount for Lack Of Marketability ("**DLOM**") and Discount for Lack of Control ("**DLOC**").

Discount for Lack Of Marketability

Much empirical evidence exists to support the notion that controlling interests in private companies should have a Discount for Lack of Marketability (DLOM). The underlying fact corroborating the existence of such a discount is the lower valuation multiples private companies are being acquired for compared to their otherwise comparable public companies.

There are several possible explanations for the existence of the private company discount, but perhaps the two most important ones are:

- Private companies lack the access to an active public market for their shares and thus, common shareholders cannot force registration to create marketability. Moreover, this lack of access to an active market impairs the ability of private company common shareholders to minimize the risks associated with their inability to control the timing of potential gains and/or losses.
- Public companies enjoy greater exposure to the market compare to their comparable private firms. All public companies have exposure to the market through quotation systems, SEC filings, and various reporting services. Buyers interested in making acquisitions can screen available databases in search of a company with the criteria they are looking for. Moreover, few private companies enjoy similar media exposure such as the one the public companies do.

Control Premium/Discount for Lack of Control

Control premium is defined as the excess price paid on shares containing control / differential voting rights, in comparison to the traded market price.

The importance of control and its value may be expressed in three main aspects:

1. *The ability to navigate the company, to determine business strategy, and manage efficiently*.

   Stockholders holding a controlling interest in a company can determine the nature of the business; select management; enter into contracts; buy, sell, and pledge assets; borrow money; issue and repurchase stock; register stock for public offering; and liquidate, sell, or merge the company. Investors, buying a controlling interest associate positive value to the ability to determine business strategy as they see fit. As the potential to change the business strategy and improve its management increases, the economic value of control increases as well.

2. *Private benefits of control.*

Controlling parties hold the ability to appoint management and key personal in the company and to determine their salaries and benefit packages. Thus, they can consume salaries and other benefits beyond what is considered reasonable based on their qualifications. In this instance, the controlling party enjoys from consuming company resources on the expense of other shareholders. Another aspect of private benefits of control is managerial empire building. Empire building occurs when managers or executives are more concerned with expanding their business units, their staffing levels and the dollar value of assets under their control than they are with developing and implementing ways to benefit shareholders. This type of behavior decreases operating performance and reduces firm value.

3. *Synergy with other businesses.*

Another source for the control premium is the existence of potential synergy with other businesses under the control of the controlling party.