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A valuation challenge: Development stage technology companies

Few assignments present more challenging issues for a valuation consultant than a development stage technology company (DSTC). Instead of an extensive operating history, a DSTC's history consists of brainstorming, planning, startup and fundraising activities.

Unlike a company offering an established service or product, a technology company typically offers a new or emerging service or product in a rapidly evolving industry. For the valuation expert, this means the valuation will be based less on fact and more on assumptions about the future. And in cross-examining the expert, opposing counsel certainly won't hesitate to challenge these assumptions.

Let's look at some of the issues that might be raised and how valuators can address them.

Foretelling the future

Section 3.03 of Revenue Ruling 59-60 provides guidance in valuing a DSTC. The section reads, "Valuation of securities is, in essence, a prophesy as to the future...." Is there any better word than "prophesy" to describe the valuation of a company that has little or no meaningful history and untested projections?

Particularly for litigation purposes, the valuator needs to reconcile what appears to be prophesying with economic reality. If the valuation consultant fails to reconcile projections with reality, opposing counsel can be expected to highlight the incongruity.

Unlike a company offering an established service or product, a technology company typically offers a new or emerging service or product in a rapidly evolving industry.

But what is the reality that sets a DSTC apart from an operating company? The guidelines set forth in the Financial Accounting Standards Board's Statement No. 7 describe the development stage enterprise as one for which "planned principal operations have not commenced," or one that has not realized "significant revenues" and devotes "most of its efforts to activities such as financial planning; raising capital ... research and development ... starting up production ..." and other related activities.

Using the right method

In valuing a DSTC, traditional, historically based valuation methods are often inappropriate. Methods that rely on capitalization or multiples of representative earnings levels are of little use when the company has not yet realized revenues but has incurred a steady, and perhaps increasing, stream of losses. And methods that are a function of historical cash flows are not helpful when the company has operated as a cash sponge.

In addition, methods that rely on guideline companies are not useful as historical benchmarks if the subject company has nothing to compare. In addition, the newness of the specific technology combined with the subject company's development stage may mean the company has no comparable peers.

A valuation consultant needs to recognize that a DSTC's value lies in the future. Everything that has happened in the company's past was intended to create a foundation for the future. For instance, the company needed to:

- Set up the research and development teams,
- Recruit the scientific, technical and management teams,
- Select production methods,
- Outsource vendors,
- Identify markets and distribution channels, and
- Procure financing.

All of these activities incur a substantial — perhaps enormous — cost, justified by the expectation of future earnings and cash flow. So a valuation expert evaluates the past qualitatively, focusing on future-directed numbers in his or her quantitative analysis.

Projecting the financials

Fortunately, for most DSTCs, financial projections abound. These projections are typically prepared at critical points in the company's development.

Although projections present the valuation expert with management's best predictions of what the future will bring, the valuator needs to recognize that multiple projections may reveal that management's expectations have been changing.

Given the magnitude of the future unknowns, a valuator typically uses management's projections, with perhaps a few adjustments, in the projection underlying a discounted cash flow model. Of course, he or she may want to temper the projection with adjustments to control unrealistic growth rates, cost/revenue relationships and financing requirements.

After the adjusted/modified projection is in place, the valuator selects a discount rate that incorporates the venture's risk, the projection's inherent risk and the capital costs. The high level of risk inherent in a DSTC would suggest that a reasonable rate of return would be that associated with venture capital funding.

Various studies have indicated that this rate would range from 50% to 70%. Venture capital rates also incorporate a lack of marketability component, because venture capitalists recognize that their investments may be illiquid for some time.

Staying aware

In the context of litigation, valuation consultants need to stay aware of the peculiarities of DSTCs and take into account the additional factors to consider in valuing them. Awareness and careful preparation can go a long way to ensuring the valuation expert withstands cross-examination and makes the case for his or her numbers. ❑

The inquiry process

When examining a development stage technology company (DSTC), a valuation consultant needs to review and analyze each of management's projections sufficiently to gain an understanding of its assumptions and expectations — as well as any events that caused management to change those assumptions and expectations.

The valuation process should include in-depth inquiry into five factors:

1. The reasons that management prepared the projections,
2. Management's background and mindset,
3. Reasons for possible inconsistencies in the various sets of projections,
4. Whether anticipated milestones were achieved, and
5. Whether the company accomplished its financing targets.

This inquiry process should enable the expert to select the projection most appropriate for valuation purposes. It should also give him or her some feel for the likelihood that the DSTC will achieve the projections.

Be prepared

Key valuation provisions in buy-sell agreements

In a volatile and uncertain business climate, a well-planned buy-sell agreement can cut off potential problems at the start — before they have a chance to bring down a company or partnership.

Future imperfect

In writing an agreement, a closely held business owner and his or her attorney must incorporate provisions that determine what will happen to the company in the event of death, disability, voluntary or involuntary withdrawal, divorce, bankruptcy or insolvency. More specifically, they need to resolve several significant issues, including:

- Whether to use a repurchase agreement or a cross-purchase agreement,
- What triggering events to include,
- How to facilitate future tax planning, and
- How to fund the agreement.

In the process of dealing with these questions, though, they may lose sight of key valuation-related provisions that can strengthen the agreement and greatly ease transition pains.

For many attorneys and business owners, the best way to ensure a buy-sell agreement addresses the pertinent valuation issues is to use an outside valuation professional. Whether you decide to hire one, two or more valuators, make sure they are independent and have the appropriate professional credentials and experience.

In addition, you'll have to decide who will pay the valuators' fees and how to resolve potential disagreements between valuators regarding the company's value. You may also want the agreement to include specific valuator or firm names to avoid having to search for these later.

Defined value

A clearly defined value premise is an important component of the buy-sell agreement. Attorneys and valuators typically refer to Revenue Ruling 59-60's definition of "fair market value," which is what shareholders usually expect to receive for their interests.

But the value premise may vary depending on the company's characteristics and circumstances — and the triggering event. Some buy-sell agreement provisions give a shareholder less than fair market value if he or she leaves because of misconduct or voluntarily decides to exit the company.

Valuation discounts

After defining the value premise, the agreement needs to address the issue of valuation discounts. For instance, the valuator needs to ask:

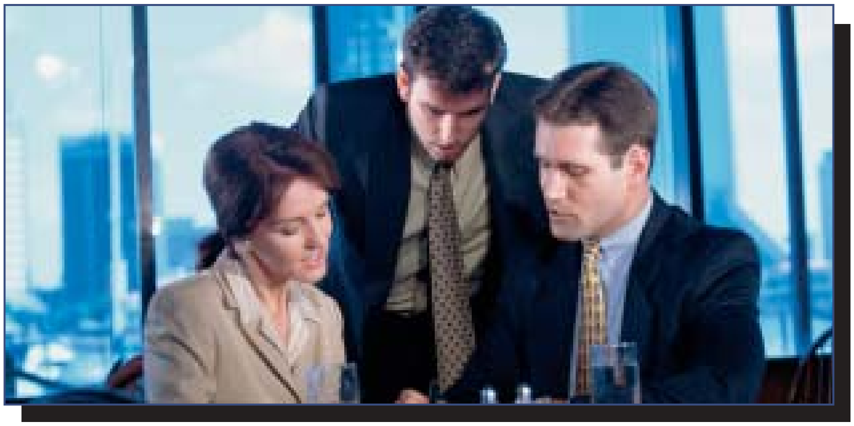
- Are controlling interests subject to a discount for lack of marketability?
- Are minority interests subject to both a discount for lack of marketability and a discount for lack of control?
- Should a key-person discount be taken if the triggering event was an important shareholder's death or departure?

In addition to deciding which discounts (if any) are appropriate, you may want to request that shareholders agree to specific percentages at the outset to avoid future disagreements.

Valuation formulas

How will value be determined when the unexpected happens? Some agreements incorporate a formula or industry "rule of thumb." For instance, simply looking at the book value on a specific date or using an earnings before interest, taxes, depreciation and amortization (EBITDA) multiple might be a quick way of coming up with a value number.

But though they may appear to save time and money, valuation formulas are not as simple as they seem. Two different people are likely to interpret the term "book value" or calculate the earnings base differently. Depending on how they approach it, their value estimates could vary widely even if they use the same formula.



And valuation formulas tend to be inflexible, failing to account for subjective factors. For instance, just using the EBITDA-multiple formula without adjusting it for discretionary or unusual items, such as excess officers' compensation or nonrecurring income, is likely to result in an inaccurate number.

A fair agreement

Many buy-sell agreements list consensus between parties as the first way of estimating a company's value and turn to other methods if the shareholders can't agree. This can be one of the fairest methods — but there *is* a catch: The parties have to agree to agree.

Agreement between parties probably shouldn't be the only method for determining value listed in a buy-sell agreement. Why? If an adversarial situation arises among the company's shareholders, litigation is likely to ensue.

Another option is to require shareholders to agree on the company's value once a year. This agreed-on value then becomes the one used for the buy-sell agreement until the parties update it again the following year. But busy shareholders and attorneys may be tempted to procrastinate on the yearly agreement, leaving the parties vulnerable to problems when a triggering event occurs.

Unconventional alternative

A rather unconventional but interesting way to convince shareholders to agree on a company's value is to use the "Texas shoot-out" method. No guns are required. Using this method, a shareholder who offers to buy another shareholder's interest also has to sell his or her own interest for the same price.

This may not be the best option if death is the triggering event, thus favoring shareholders with better access to financing. But it may help keep shareholders from low-balling each other.

Predictable result

Unexpected events can cause unpredictable behavior. To reduce the possibility of an upset and ensure smooth transitions in difficult circumstances, business owners and their attorneys must try to predict and plan for every eventuality. No one buy-sell agreement is right for every situation. But regardless of the situation, choosing the right valuation provisions is key. ❏

Brushing up on dental practice valuations

To determine the value of any type of professional practice, a valuation consultant needs to understand its characteristics as well as the specific valuation issues involved. Take dental practices: Recent changes in the health care industry have caused many dentists to more carefully consider how their decisions may affect their practices' values.

Value in transition

For dentists, knowing their practices' values is as important as knowing their cash flows, accounts receivable or any of the other "numbers." They need to position their practices for possible sale, whether of part or all of the practice. A dentist should have a strategic plan: "positioning for transitioning."

After the dentist's practice is in position, he or she can then take advantage of any transition opportunities that may come along. This will also serve to build a foundation in the event of death, disability or other urgent situation that might demand a quick transition.

Tangible vs. intangible assets

A practice valuation helps determine the terms necessary to make the purchase an economically viable investment. It then becomes part of the overall practice-sale marketing package, showing the true value of the practice and not just the price. Prospective buyers, their tax and legal advisors, and any lending institutions that may be involved in the purchase financing will then be able to easily review this package.

A practice valuation typically includes the following two components in varying capacities:

1 ***Tangible (hard) assets.*** This comprises assets that can actually be touched and clearly identified. Tangible assets include equipment, furniture and fixtures, supplies, and leasehold improvements. This category also includes any of the practice's cash assets that the seller might be transferring to the buyer when the sale takes place, such as cash-on-hand at the time of sale, as well as any collectible accounts receivable.

2 ***Intangible (cash flow) assets.*** This category represents a practice's goodwill or "going concern" and is usually calculated by measuring the income the practice has generated over the past three or more years. The cash-flow value in some dental practices may now be worth significantly more than that of the tangible assets. This relative value scenario is a total reversal of what existed in years past.

Unlike the tangible assets' value (which is relatively stable), the intangible assets' value is very unstable. Thus, this value component can rapidly disintegrate in cases of death, disability or loosely structured associateships. This is why it is crucial for dentists to plan ahead for the eventual transfer of this perishable asset to a successor.

No simple formula

Valuation consultants can draw on numerous theories and methodologies to determine a practice's value. The choice of valuation method as well as the terms of the purchase structure can dramatically affect a practice's final selling price.

Some of the more common practice valuation methods are capitalization, discounted future earnings, excess earnings and asset summation. These methods should be balanced with real market knowledge. What are practices consistently selling for in a given area under similar circumstances?

Finally, rules of thumb became popular years ago when dentists were seeking simple methods for determining their practices' values. But each rule of thumb presents its own challenges, so one needs to be extremely careful when using these methods without consulting a professional valuator.

A viable investment

In the final analysis, buyers and their advisors inevitably will base their purchase decision on the present and (to a certain degree) the potential net income that the practice could generate.

To consider the practice a viable investment, the buyer must feel certain the practice will generate enough net income to first pay the existing overhead. The practice must then create enough remaining net income to cover the purchase price's debt service. This includes the total of all payments on the practice, including any loan for down payment financing.

The remaining net income must support a reasonable lifestyle for the buyer, while paying off the debt. With the average debt service payout period at between seven and 10 years, it would be unreasonable to expect the buyer to live the lifestyle of a pauper until the time the practice is paid off.

Important decisions

Dentists have been experiencing the effects of limited dental insurance benefits, patients' fee concerns and rising overhead costs. They are now coming to grips with the reality that managed care is having a major impact on dentistry. Decisions made today in relation to managed care may greatly affect a practice's ongoing profitability and future value. Therefore, it's critical for any dentist to stay apprised of the value of his or her practice and know how that value could affect a future sale. ❏

Can the "reasonably foreseeable" rule be broken?

It is accepted valuation practice not to consider in a valuation subsequent events that were unforeseeable at the time of the valuation's effective (or "as of") date. Typically, valuators are trained to disregard subsequent events in a valuation report. But it's important to note that they can't always disregard unforeseen subsequent sales.

For instance, what if a sale was "reasonably foreseeable" on the valuation's as of date? Perhaps the company was already negotiating with a buyer. If so, the valuator needs to address this in the report.

Asking reasonable questions

To ascertain whether a company's sale was reasonably foreseeable, valuators interview management at the valuation date, reminding managers to answer the questions as if the interview were taking place on the valuation's as of date.

First, the valuator needs to ask whether the company is currently marketing itself for sale. In addition, it's important to determine whether management plans to market the company for sale in the near future or is currently considering any offers to buy the company.

If the company is considering offers, how far have they taken the proposed sale's negotiations? The valuator would also need to look into whether the company's industry is experiencing a high degree of mergers and acquisitions.

A valuator may also need to address a company's subsequent sale when preparing a valuation for tax purposes. In *Jung* and *Cidulka (Estate of Jung* and *Estate of Joseph Cidulka)*, the subject companies' subsequent sales turned out to be important evidence of the companies' values.

But as in *Jung*, a valuator who uses the company's subsequent sales information needs to adjust appropriately to account for differences between the valuation date and the dates of the later-occurring events. These adjustments include changes in general inflation, investors' expectations, business performance and tax laws.

The courts' rulings in *Jung* and *Cidulka* have raised questions. Some have suggested the rulings are merely increasing the likelihood that valuations for tax purposes will become even more subjective. For instance, how far into the future should valuators be expected to project before sales data becomes irrelevant? And how should valuators adjust these transactions for changes in company, industry and general market conditions?

Shades of gray

Using subsequent events in a valuation may be a clear no-no or may be more ambiguous — depending on the situation. Because valuators and the IRS don't always see eye-to-eye, it's important to understand the exceptions to the rule.

J.L. PIERSON & CO. LLC

BUSINESS VALUATION AND APPRAISAL

J.L. Pierson is an Accredited Senior Appraiser designated by the American Society of Appraisers (ASA) in the Business Valuation discipline. He specializes in business valuation for closely held businesses, family limited partnerships (FLPs), Limited Liability Companies (LLCs) and professional corporations. Valuations are performed for investment, estate planning, financial reporting, corporate insolvency, gift/estate tax and income tax purposes. This type of valuation work often involves discounts that must be based on reasoned and well-documented judgment — not a formula or software package — that is fully consistent with case law.

J.L. Pierson specializes in Business Valuation and appraisal only, including such projects as:

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