
# Value Matters™

THE COMPLIMENTARY NEWSLETTER FOR ATTORNEYS AND OTHER PROFESSIONAL ADVISORS TO BUSINESSES

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### Focus on IRS Section 409a

## Not All Classes of Equity Were Created Equal

IRS Section 409A requires that companies issuing stock options (or stock appreciation rights) determine the fair market value of the underlying shares at each grant date. Compliance with Section 409A may be particularly troublesome for start-up companies in various stages of corporate development. Such companies frequently grant options, and are often capitalized with several classes of preferred and common equity securities with differing associated economic and control rights. While the presence of several classes of equity can prove vexing when valuing the individual securities, valuation professionals have developed methods to tackle these problems, three of which are discussed in the *AICPA Practice Aid: Valuation of Privately-Held-Company Equity Securities Issued as Compensation.*

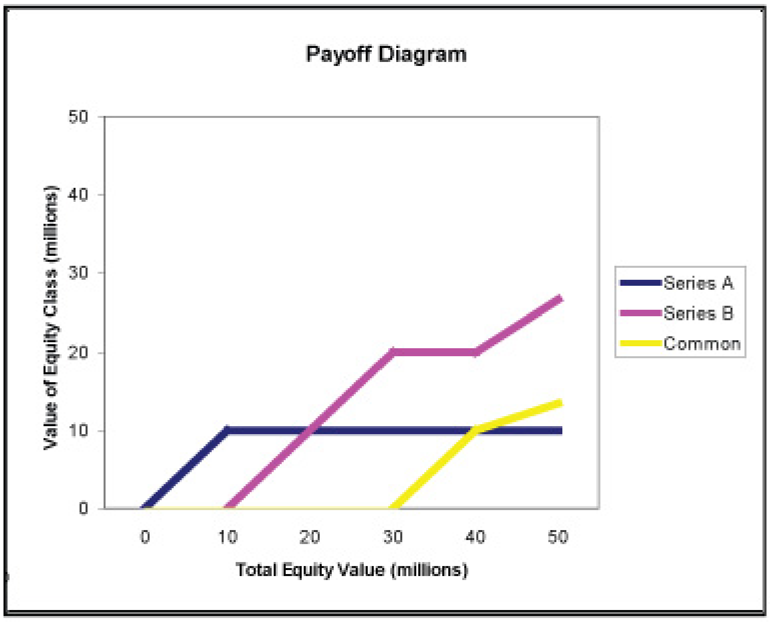
Due to the substantial risk that is often involved in investing in early-stage startup companies, investors often demand higher returns and greater corporate influence. As a startup company matures, capital needs tend to increase while the perceived risk often decreases, leading to multiple rounds of financing (generally structured as preferred equity). A thorough understanding of the different rights associated with the various classes of equity is necessary to properly allocate a company's value between the different equity securities.

The rights pertaining to different classes of preferred or common equity can be generally categorized as *economic rights* or *control rights*. Basically, economic rights are intended to provide economic protections and preferences relative to lower classes of equity, while control rights are designed to provide discretion and influence with respect to significant corporate decisions. Typical economic rights include preferred dividends, liquidation preferences, mandatory redemption rights, and conversion rights, among others. Typical control rights include voting rights, veto rights, board composition, and first refusal rights, among others.

To illustrate, consider an equity capital structure with three classes of equity: common stock (10 million shares), Preferred Series A (10 million shares), and Preferred Series B (20 million shares). Assume that Series A is senior to Series B, both carry a $1 liquidation preference, and Series B carries conversion rights at $1 per share. As shown in the payoff diagram below (which describes the liquidation value of

**INSIDE**

each equity class based on total equity value), Series A, being senior to both common stock and Series B, increases in value up until total equity value reaches the total liquidation preference of $10 million (10 million shares at $1 / share). Series B, being senior to only common stock, increases in value until total equity value reaches $30 million (the combined total liquidation preference of both series of preferred stock). It is not until the total liquidation preference of all preferred stock is met that common stock would receive any payout at the time of a liquidation event. When the common stock value reaches $1 per share (total equity value of $40 million), Series B would exercise its conversion rights and share in further appreciation on a *pro rata* basis with the common shareholders.




The *AICPA Practice Aid* discusses three methods of allocating enterprise value across various equity classes in a company: the probability-weighted expected return method ("PWERM"), the option-pricing method ("OPM"), and the current-value method ("CVM"). The Practice Aid also clearly states that "no single enterprise value allocation method appears to be superior in all respects and in all circumstances over the others."

Under the PWERM, the company's enterprise value is estimated at the date of various assumed potential future outcomes (which could include an IPO, liquidation, continued private operation, etc.). Each enterprise value is allocated across the different classes of equity based on the rights and characteristics of each equity class assuming the equity-holders maximize the value of investments (i.e. holders of convertible preferred stock convert when appropriate, etc.). Each estimated scenario value is then discounted to the present at an appropriate rate and probability weighted to determine the fair market value of each class of securities. This method is conceptually appealing in its forward-looking consideration of different liquidity events; however, at the same time, it is heavily reliant on assumptions (indications of value are only as good as the assumptions on which they stand) and certain circumstances can require very complex probability modeling.

The OPM considers the various classes of equity as a group of call options on the company's total enterprise value. Under this method, exercise prices reflect the respective liquidation preferences and conversion rights of each class of preferred stock. In the case of the example capital structure we discussed previously, Series A would be modeled as a call option with an exercise price of zero, Series B with an exercise price of $10 million. Common stock is modeled as a call option with an exercise price equal to the enterprise value of the company remaining after each class of preferred stock has been liquidated (or $30 million in the case of the example above). Conversion features, such as those accruing to Series A, may also be modeled in an option-pricing method. Although somewhat less intuitive, the OPM is attractive in that it does not require as many assumptions as the PWERM, while still considering differences in equity classes from a forward-looking perspective. On the other hand, the method requires an assumption of volatility which can be difficult to accurately estimate for a private company.

The CVM values each equity class based on the greater of conversion value or liquidation preference in the context of the company's current enterprise value (as determined through an appropriate application of traditional valuation approaches). The simplicity and clarity of the CVM can make it an appealing method to use in certain circumstances; however, this method does not consider value from a forward-looking perspective. Despite this shortcoming, this method can be useful in situations where a liquidity event appears imminent or where the company is at an early stage of development such that predictions of future performance are highly speculative.

Even in relatively simple circumstances where a company is capitalized by only two or three classes of equity, judgment related to the appropriate method and assumptions must be exercised based on the subject company's stage of development, industry, expectational factors, and any other material factor that could impact value. In cases where the capital structure is not so simple as only two or three classes of equity, the valuation models can become substantially more complex. Given the high stakes of IRS Section 409A compliance, it is important to choose a valuation professional with industry knowledge, familiarity with IRS and FASB standards, and experience tackling complex valuation issues through a variety of methods. The professionals at Mercer Capital have this experience and expertise, and are available to talk with you about any valuation issues related to equity securities in complex capital structures.

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## OTHER SECTION 409A RESOURCES

"IRS Code Section 409A & Valuation," Z. Christopher Mercer, ASA, CFA, *Value Matters™*, August 28, 2006

"Section 409A of the Internal Revenue Service Code," Z. Christopher Mercer, ASA, CFA, Mercer on Value, June 20, 2006

"8 Things You Should Know about 409A," Travis W. Harms, CPA /ABV, CFA, *Value Matters™*, June 8, 2006

"Pricing Stock Options – IRS Code Section 409A," Z. Christopher Mercer, ASA, CFA, Mercer on Value, May 16, 2006

"Watch Out for 409A," Eden A. Gipson, *Value Matters™*, February 16, 2006

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**October 19-20, 2006**
"Today's Word on Lack of Marketability"
CICBV/ASA Annual Conference
Toronto, Canada
**Z. Christopher Mercer, ASA, CFA**

**November 6, 2006**
"Marketing with the Newest Technology Tools"
IGAF Conference
Las Vegas, Nevada
**Barbara Walters Price**

**November 8, 2006**
"Discount & Capitalization Rates Revisited"
BV Resources Teleconference
*For more information, visit www.bvresources.com*
**Z. Christopher Mercer, ASA, CFA, panelist**

**November 30 - December 1, 2006**
Topic TBD
Arkansas AICPA Meeting
Little Rock, Arkansas
**Timothy R. Lee, ASA**

**December 3-4, 2006**
"Buy - Sell Agreements: Ticking Time-Bomb or Reasonable Resolution?"
"Ask the Experts Panel"
AICPA Business Valuation Conference
Austin, Texas
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