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Consistent & Transparent Valuation of 'Unicorns'

WEBINAR | 23RD MARCH 2017 | 10AM EST

Agenda

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Welcome	Ian Blance | Voltaire Advisors
1010 - 1020	The SEC Unicorn Sweep Letter and Unicorn Valuation | Jamie Lynn Walter, Kirkland & Ellis LLP
1020 - 1030	Accounting, Auditing, and Internal Control Considerations for Investment Valuations| Rajan Chari, Partner, Deloitte & Touche LLP
1030 - 1040	Methodologies for Early Stage Private Equity Valuation | Jon Tang, Senior Manager, Empire Valuation Consultants
1040 - 1055	Audience Q&A
1055 - 1100	Summing Up
1100	Close of Webinar

Introduction

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- What is a 'Unicorn'? Unicorns are private (usually tech) companies without much of a performance record who have an estimated valuation of $1bn or more.
- Fortune lists 174 unicorns as of January 2016 including such widely held investments as Uber, Airbnb and Spotify. Notably, many of them are Chinese companies.
- Concern has been brewing at the SEC about valuation of these interests for a couple of years, and this was thrown into much sharper focus with the 'sweep' letter to investment companies in late 2016. It has been widely reported that valuations for these types of private investments vary significantly between different fund groups and even between different funds within the same group.
- Valuations of investments of this kind can be influenced by highly subjective assumptions in key variables and calibrations. The key to ensuring a robust and defensible value is to have a clear and transparent policy and procedure in place to produce this.
- The issue is complicated further by there being a number of different approaches to valuing these companies. The choice of approach and the methodologies deployed here are often subject to a high degree of judgment and subjectivity.

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The SEC Unicorn Sweep Letter and Private Equity Valuation

Jamie Lynn Walter
Partner
Kirkland & Ellis LLP

KIRKLAND & ELLIS LLP

Consistent & Transparent Valuation of "Unicorns"

March 23, 2017

Jamie Lynn Walter

What is the SEC looking for?

- Sweep letters sent to registered investment company advisers requesting information about policies and procedures for valuing large private tech companies
- Consistent with SEC's broad effort understand how funds value unlisted securities
- SEC sees connections between valuation and other priorities
  - Liquidity
  - Suitability

Why Unicorn Tech Startups?

- SEC Chair Mary Jo White laid out concerns in March 2016 speech at Stanford
  - Crowding of VC and PE assets into hot companies; willingness of investors to sacrifice disclosure for access
  - Cultural pressure to grow quickly, increase valuation at each financing round, achieve “prestige associated with reaching a sky high valuation fast”
  - Boards tend to be overweight founders and VC, underweight public company governance experience
- Significant valuation differences between funds
  - WSJ reported Airbnb shares valued anywhere from $73 to $119

Lessons for Private Equity

- Private funds remain a focus in 2017 OCIE Examination Priorities
- Reasons to expect tech startup valuation may come up
  - Increased RIC ownership of late-state tech startups means early-stage PE investment is more likely to impact retail investors
  - PE funds, as early-stage participants, may have information to uncover overpricing before it can have widespread impacts

Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative

Chair Mary Jo White | March 31, 2016

"[I]f [VC and PE investors] choose – with eyes wide open – to invest in private companies at valuations that may be ethereal or overinflated, who loses when the truth behind inflated valuations is revealed? I think we all do. Not just the VC and private equity funds, but also smaller retail investors..."

Offices

Beijing
Kirkland & Ellis International LLP
29th Floor, China World Office 2
No. 1 Jian Guo Men Wai Avenue
Beijing 100004
P.R. China
+8610 5737 9300
+8610 5737 9301 fax

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
United States
+1 312 862 2000
+1 312 862 2200 fax

Hong Kong
Kirkland & Ellis
26th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852 3761 3300
+852 3761 3301 fax

Houston
Kirkland & Ellis LLP
600 Travis Street
Suite 3300
Houston, TX 77002
United States
+1 713 835 3600
+1 713 835 3601 fax

London
Kirkland & Ellis International LLP
30 St Mary Axe
London EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
Los Angeles, CA 90071
United States
+1 213 680 8400
+1 213 680 8500 fax

Munich
Kirkland & Ellis International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
United States
+1 212 446 4800
+1 212 446 4900 fax

Palo Alto
Kirkland & Ellis LLP
3330 Hillview Avenue
Palo Alto, CA 94304
United States
+1 650 859 7000
+1 650 859 7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
United States
+1 415 439 1400
+1 415 439 1500 fax

Shanghai
Kirkland & Ellis International LLP
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
United States
+1 202 879 5000
+1 202 879 5200 fax

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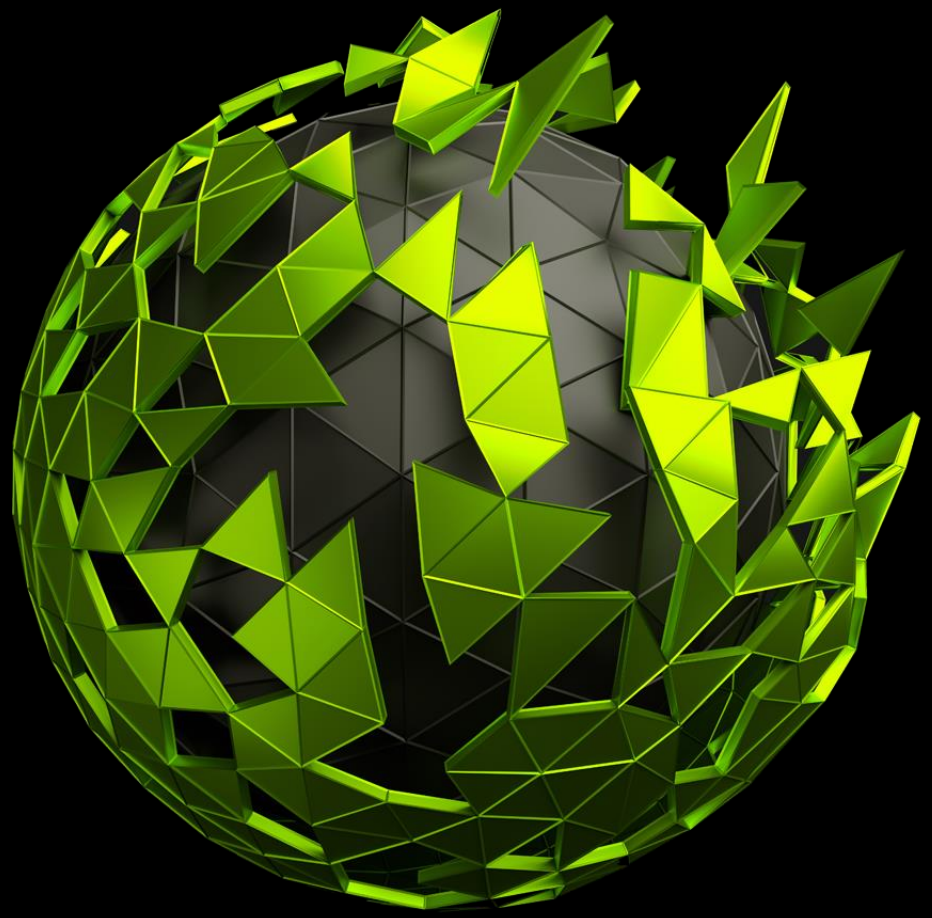
Best Practices in Private Equity Valuation & Audit

Rajan Chari
Partner
Deloitte & Touche LLP

Deloitte.



Accounting, Auditing, and Internal Control Considerations for Investment Valuations

Rajan Chari
rchari@deloitte.com

Accounting Considerations

Key Fair Value accounting concepts:

Fair Value - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [FASB Accounting Standards Codification (ASC) Master Glossary]

Market Participants Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

c. They are able to enter into a transaction for the asset or liability

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so. FAS 157, paragraph 10 [FASB ASC 820-Glossary]

When a price for an identical asset or liability is not observable, a reporting entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk [FASB ASC 820-05-1C]

Accounting Considerations

Key Fair Value accounting concepts:

A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest.

In developing those assumptions, a reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally, considering factors specific to all of the following…..

c. Market participants with whom the reporting entity would enter into a transaction in that market. [FASB ASC 820-35-9]

If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. [FASB ASC 820-35-24c]

Valuation techniques used to measure fair value shall be applied consistently.

However, a change in a valuation technique or its application (for example, a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. [FASB ASC 820-35-25]

Audit Considerations

Key questions that an auditor considers:

- What are the valuation policies and procedures?
- Do the valuation policies and procedures conform with the basis of accounting?
- Have the investments been valued in accordance with the valuation policies and procedures?
- Are there investments for which the valuation assertion is of a greater risk?
- Are there adequate internal controls in place? Are those performing the internal controls sufficiently competent relative to investment valuation and the basis of accounting?
- Does the documentation provided by the client demonstrate how the valuation was performed?
- Are the valuations in accordance with the basis of accounting?
- Is the unit of account appropriate? Have the investment's rights and preferences been appropriately considered?
- Can key inputs be reasonably corroborated?
- What do back-testing results and retrospective analyses show?
- Taking a step back, does the valuation make sense?

Valuation Methodologies and Inputs

Key questions those in an oversight role may ask include the following:

- Is there a benefit of using more than one methodology?
- What should be made "standard" versus what should be based solely on circumstances? How much judgment should be allowed?
- Who makes the choices of what is used?
- What internal controls do we have over the valuation methodologies and inputs? How do we prevent bias/manipulation in the valuation process?
- Are we consistent in what we do?
- Do we perform our valuations in a manner that is consistent with what we have told investors?
- Have we considered how others may be valuing the portfolio company?

Policies and Procedures

Key questions those in an oversight role may ask include the following:

- Do the policies and procedures encompass the actual policies and procedures disclosed to investors?
- Are the actual valuations performed for each investment consistent with what is written in the policies and procedures?
- Do the policies and procedures encompass concepts/expectations made to the manager or in the public domain by regulators in the last year?
- Are there newly acquired investments that may necessitate augmentation of the policies and procedures?
- Are the policies and procedures written in sufficient detail so that a new person entering the valuation function could understand the overall valuation process and carry out his/her duties accordingly?
- Are the policies and procedures written in sufficient detail so that someone performing oversight over the valuations could use them as a guide to explain the valuation process to an outside party?
- Do the policies and procedures address how changes to the valuation process should be made?
- Do the policies and procedures allow for some level of standardization?

Preparers and Reviewers

Key questions those in an oversight role may ask include the following:

- Each firm has the ability to evaluate what will work best; there is no “right” model.
- Key questions to consider about the parties involved in preparing the valuations:
  - Does the party understand common valuation practices?
  - Does the party understand the relevant accounting standards, and has the party been educated on any changes required or suggested by accounting bodies or regulatory agencies?
  - Does the party have access to portfolio company management and all of the relevant inputs required?
  - Is the party objective, and are any perceived conflicts of interest mitigated by internal controls?
- Several of these questions are applicable for those performing internal controls as well.

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Methodologies for Early Stage Private Equity Valuation

Jon Tang

Senior Manager

Empire Valuation Consultants

Early Stage Private Equity Valuation

Jonathan Tang, CFA
Senior Manager
Empire Valuation Consultants LLC
New York, New York

March 2017

Experience Excellence

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Early Stage Private Equity

- Perform Company Valuation
- Calculate Security Value
- Control and Marketability
- Transparency and Consistency
- AICPA Guide coming…

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Company Valuation

- Income Approach
  - **Discounted Cash Flow (DCF)**
  - **Cash Flow Projections**
  - **Appropriate Discount Rate**
- Market Approach
  - **Publicly Traded Companies/Transactions**
  - **Arms-Length? Attached Securities?**
  - **Pre/Post-money Value vs. Fair Value**
- Cost Approach
  - **Generally not applicable for early stage companies**

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Security Value

- Current Value Method
  - **Calculates the value of the security if the company is sold today (Current Value)**
  - **Most useful when value of the company significantly above liquidation preference**
- Option Pricing Method
  - **Takes into consideration future increases in value and how that may affect various securities**
  - **Most useful when value of the company is close to or below liquidation preference**

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Control & Marketability

- Difference in level of control of security holders
- Lack of (efficient) market for private equity
- Cash flow levels
- Discount rate levels
- Can be estimated using option models

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Transparency & Consistency

- Source for model inputs
- How cash flows are derived
- Consistency in methodology
- Consistency in assumptions
- Back testing
- Stories and numbers

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AICPA Guide

- New guide being written
- *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*
- First public release of working draft expected July/August 2017

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Jonathan J. Tang, CFA

212.714.0122
jtang@empireval.com

350 Fifth Avenue
Suite 6115
New York, NY 10118

Jonathan is a Senior Manager at Empire Valuation Consultants' New York City office. He is a Chartered Financial Analyst (CFA).

Jonathan joined Empire Valuation in January of 2007. Since then, he has developed extensive expertise in valuations related to complex securities, intangible assets, mergers and acquisitions, and estate planning. He has led numerous engagements for financial reporting purposes, including ASC 820 (Fair Value Measurements), ASC 805 (Business Combination), ASC 718 (Stock Compensation), and Impairment Testing related to ASC 350 (Goodwill and Other Intangible Assets) and ASC 360 (Property, Plant and Equipment). He has also performed many valuations for tax reporting, acquisition and divestiture, transfer pricing, ESOP, and general corporate planning purposes.

Jonathan has presented on various valuation topics, including discount for lack of marketability (DLOM), option pricing models and early stage company valuations at industry conferences, and is involved with the development of The Appraisal Foundation's valuation advisories. He is a member of Empire's Technical and Standards Committee.

EDUCATION

M.B.A. in Finance and Strategy – New York University, Stern School of Business

M.S. in Electronics and Telecommunications Engineering – Georgia Institute of Technology

B.S. in Electrical and Computer Engineering – St. Cloud State University

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Audience Q&A

Thank You!

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- Participants will receive a copy of the slide deck and a recording of the Webinar tomorrow.

- This Webinar is part of our VIVA program of fund valuation initiatives throughout 2017 – more details can be found here:

http://www.voltaireadvisors.com/viva.html

- The next event is our Webinar on Private Loan and Debt Valuation on April 20th

Voltaire ADVISORS

Contact Us

Voltaire Advisors LLP

14 Wall Street
New York
NY 10002
USA

No.1 Poultry
London
EC2R 8JR
UK

+44 800 677 1694
info@voltaireadvisors.com
www.voltaireadvisors.com