Avoiding Gray Areas Part 1: Valuation Assumptions

David Mesner, Valuation Analyst | Ipreo Private Capital Markets

Documenting entries and selections is crucial to develop a blueprint of the thought process that is used to complete reports year over year.

When a report is drafted, there may be some inputs that are not available, despite efforts to retrieve specific data points from the subject's management team. In those circumstances, it is reasonable to make assumptions in some areas. When applied properly, assumptions can reduce the overall report process time without compromising the integrity of the findings.

However, the details and thought processes that went into those assumptions need to be documented properly within the report in order to avoid confusion.

Some standard assumptions across all types of investments may include:

- Time to exit
- Volatility
- Interest rate on outstanding debt
- Weight placed on financial performance

Let's take a closer look at the documentation that should accompany each of these assumptions.

Time to exit

If no specific exit timeframe is targeted or indicated, there are three different means by which an assumption can be made:

01 A time to exit may be assigned based on the company's position/maturity as of the report date. This examination to determine a reasonable time to exit would incorporate the company's historical performance (specifically revenue growth or decline), cash-flow position as of the report date, and the cash and debt balances as of the report date. The subject's amount of leverage is important to consider when compared to positive or negative cash flows.

02 The time to exit can be estimated by the means of exit. Based on discussions and steps taken with external parties such as bankers or potential buyers for IPO or M&A participants, this can help to whittle down and conclude a good exit timeframe as well.

03 Additionally, a time to exit may be assumed simply from examining the capital structure if no apparent exit has been outlined.

For example: If the subject company has only closed one or two rounds of preferred equity, it is reasonable to assume a 4- to 5-year window of time before an exit event is pursued. The logic here is that the company is still in a stage of expansion and development, usually taking more time to reach an exit-stage of maturity. Conversely, if the subject company has issued 3 or more preferred rounds of equity over the course of its life, then it is reasonable to assume a 2- to 3-year exit timeframe.

The rationale for these considerations are just trends followed within the venture space, as a more mature company with additional funding secured would normally pursue an exit sooner, given product development and financial growth. This should be applied if no other indications are present, and act more as a last resort.

As a general rule of thumb, when preparing a roll-forward from a prior period, it's best to maintain the exit date used in the older report if no new information has been gathered.

Volatility

In the majority of venture stage companies, the subject is going to have a certain level of instability but also potential to grow at a more rapid rate with more emphasis placed on future performance versus historical data.

On the Qval platform, the financial information entered serves as a basis for calculating a volatility correlation using regression between the subject company and public companies within the sector list selected. This allows the platform to select volatility based on the regression results and trends in the market.

If financial performance is unavailable to better determine the level of volatility when compared to a sector list, it's reasonable to assume the 90th percentile selection based on the investment's higher potential for fluctuation in value over time compared to a group of publicly traded companies. Within the Qval platform, volatility is calculated using an industry sector list of companies through a five-year period.

The list of guideline public companies from a market approach or a specific set of 5-10 companies is typically too narrow a range to properly reflect the market's volatility over time as of a set valuation date. Also, guideline public companies used in a market approach may not always conduct business in the same sector as the subject company, since a venture subject company is disruptive in nature and may not have ideal comparable companies. Therefore, the entire sector in which the subject company operates should be used to determine volatility.

Interest rate on outstanding debt

In some instances, a debt balance is provided on the balance sheet, but no further information is available. If debt is present, the report should include a debt provision within the allocation to account for future interest to accrue based on the exit timeframe selected. Since the interest rate will not always be provided, an assumed rate can be applied. Typically, a mid-tier, high-yield rate such as S&P's BBB or Merrill Lynch US High Yield BB rate is acceptable.

Weight placed on financial performance

When looking at the company's performance in the twelve months leading up to the valuation date (Last Twelve Months) and also the twelve months after the valuation date (Next Twelve Months), a common weighting assumed is 25% LTM and 75% NTM.

The reasoning behind this lies with the early-stage nature of venture backed companies. There is a surge of development runway and operational expansion to reach greater adoption rates and increase probability of success, no matter the industry. Therefore, greater weight is traditionally placed where the company is expected to be over the next twelve months as opposed to where the company was previously. (This applies to the Guideline Public Company market approach for revenue, EBITDA, or a combination of both metrics.)

Finding a good balance between these options is key to developing a sound opinion in the report, and in the next segment of this article series, we will touch on the commentary that should be added around market approach inputs further.

More context is better

Running through items such as the company's leverage details, volatility, financial performance, and exit-time horizon are some of the most common assumptions that can be made within a report, but assumptions are not necessarily limited to these data points alone when compiling a new report or roll forward from a prior period.

It is always best to consider the available information from the subject company's management team along with market trends and other applicable external factors when making these assumptions. Documenting the thought process behind assumptions like these will always keep the reporting process running smoothly. Just remember: when in doubt, add a footnote!

In the next segment, we will discuss subjective inputs in different scenarios and a good method for keeping your thoughts organized for those entries that require some extra attention and decision-making.

For more information contact Ipreo Private Capital Markets at PCM-info@ipreo.com