How To Blend:

A Discussion On The Impact Of Blending Valuations

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The ultimate purpose of a private company valuation is to arrive at the value of its underlying securities and more explicitly, the value of the securities one holds in the company. Today, there are two blending theories on how best to combine multiple valuation approaches into a single private company value: blending at the entity level and blending at the share level. The application of discounts and valuation approach weightings at the entity level has been common practice among valuation specialists for years, but more recently, when valuing private company investments, it has become more common to apply these at the security level. The biggest difference between the two blending approaches is theoretical; exactly, at what point in the valuation process is it appropriate to apply any discounts or weightings? This philosophical difference leads to technical variances between the two methodologies, especially when combining multiple valuation approaches together to reach a single fair value.

As seen in the diagrams below, the first step in either blending technique is to conduct all valuation approaches. If only a single valuation approach is considered, there will be no blending; however, after calculating the company value, the methodologies still diverge in the appropriate next steps. The entity blending technique is a top-down approach while the share level is a bottom-up approach.

Figure 1: Entity Level Valuation

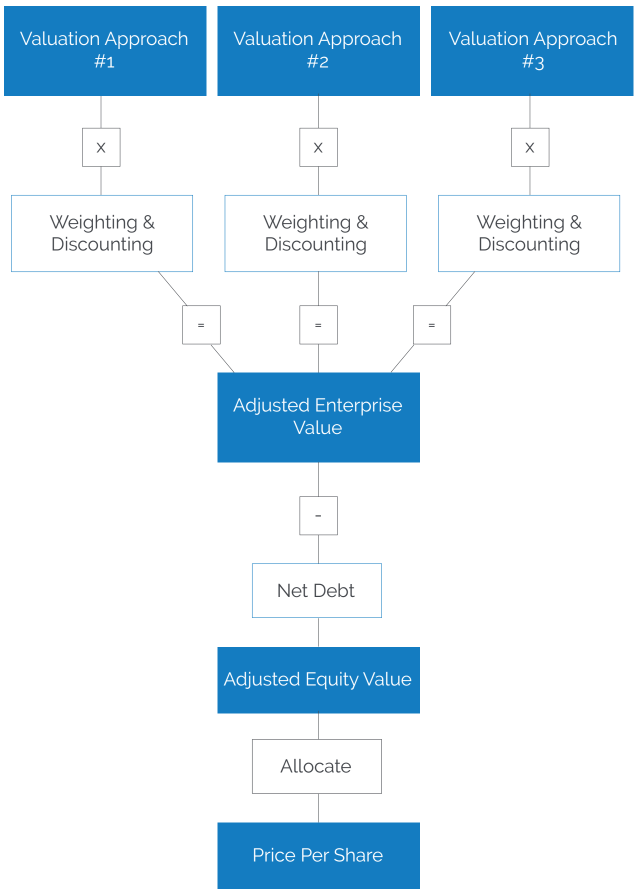
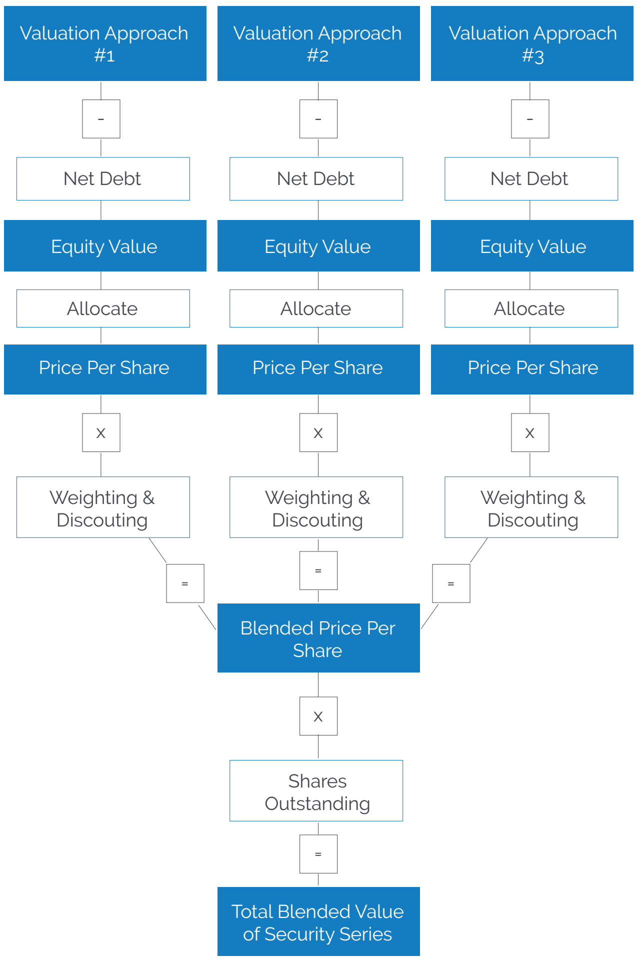


Figure 2: Share Level Valuation



For entity level blending, the weightings and discounts are applied to the enterprise value calculated by each valuation approach. These values are then combined into one adjusted enterprise value and allocated to each security based upon each security's terms and conditions. Depending on the number of shares held across various security series, one can determine the value of their holdings by summing the price per share of each series times the number of shares held across all security series.

The share level blending approach requires subtracting out net debt from the enterprise value to reach the equity value available to the equity securities. This must be done for all the chosen valuation approaches. The next step is to select an appropriate allocation method for each valuation approach and allocate the equity value from each valuation methodology to the individual security series based on the selected allocation method. If security holdings require any additional discounts, it is appropriate to apply those at the share level. The sum of the weighted and discounted results from each valuation equals a single blended price per share per security series. As in entity level blending, an investor determines their holdings by taking the sum of the blended price per share times the number of shares held for each of the security series. To build up to the enterprise value, take the blended price per share times the number of shares outstanding for a series to calculate the fair value of that series. Summing the total blended value of each security series will lead to a final blended equity value and adding net debt will provide the company, or enterprise value.

Due to different points of blending values together between the valuation methods, the equity value allocated to the securities for the two approaches will be different, unless it is a single valuation approach with the same allocation method and no discount applied. Even if a single valuation methodology is used and the allocation approach used is the same, the price per share of each security series could be different. If blending at the entity level, the equity value available to allocate will already include the discount, meaning that a smaller value will be allocated as share level blending takes the discount after allocation. This means that the value available to the equity holders will be different based upon the blending technique chosen. Since each blending technique is allocating a unique value, the value of the securities at each of the breakpoints may be different between the two practices; for example, a conversion of a convertible preferred security may be triggered with one approach but not the other. In the end, this may lead to different prices per share for the security series of the same company as a result of the chosen blending technique.

If multiple valuation approaches are selected, the resulting values to allocate will also differ based on the blending techniques. First, the value available to allocate will be different as the weightings are applied at the same time as the discount for each respective blending technique. In addition, when blending values together at the share level, a user can assign different allocation methods for each valuation approach to calculate share prices for each. On the other hand, blending value at the enterprise level allows for only one allocation method because the multiple valuations are combined into just a single adjusted enterprise value. While the differences between the calculated enterprise value may not be extremely large, the price per share of the same security may be different between the two blending approaches.

Ultimately, valuations are just as much an art as a science, but it is important to understand how the chosen methodologies or assumptions impact the fair value of holdings. Deciding when to apply weightings and discounts in a valuation must be considered before performing a valuation as they could have a material impact on the final per share values.

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