VALUATION NEWS

NEWS FROM QUIST VALUATION
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Welcome

This issue of Quist Valuation News is devoted to the current equity compensation concerns of private and public companies. Our first article examines the consequences associated with IRC 409A that extend beyond the well defined tax penalties. The second article provides an overview of the key factors considered in an IRC 409A valuation engagement for emerging companies. Our third article offers some additional insights into SFAS 123R. As always, we hope that you find value in this edition of Quist Valuation News.

Sincerely,
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IRC 409A: Beyond the Tax Consequences

Expensing stock options has received a considerable amount of attention in the financial press. While its impact on earnings and a company's ability to properly report returns has affected many well-known publicly traded companies such as Intel, Microsoft and Cisco Systems, a recent regulation by the Internal Revenue Service, Section 409A ("IRC 409A"), may actually have a broader and more direct impact on a far greater number of companies issuing stock options.

Thousands of privately-held companies have turned to equity compensation, (e.g., "stock options" and "stock appreciation rights") as a primary incentive tool for employees in the past twenty years. While the public market is beginning to struggle with expensing, the private market faces an equally daunting challenge of effectively establishing the price at which to grant incentive equity awards. Private companies do not have an established market for their shares, and are therefore subject to, and now at risk of, considerable scrutiny when pricing equity compensation plans.

Historically, privately-held companies have generally relied on the expertise of board members and management in establishing the price at which stock options are granted to employees. While shareholders, board members and management often have competing objectives relative to pricing stock option plans, the market has established and relied on general rules of thumb for pricing evidence. Whether the price was based on a multiple of earnings, a discount from the prior round of funding or a comparable transaction in the marketplace, the analysis was generally limited to a few simple calculations for most private companies. With the recently-issued proposed regulations under IRC 409A, the landscape has changed.

IRC 409A, creates a significant potential tax liability for recipients of equity compensation if the price at which the compensation was granted is below fair market value at the time of the grant. These tax consequences directly impact the individual and can include a 20% tax in addition to employment and income taxes, taxation at the time of vesting rather than the date of exercise, and potential interest charges. While the rules associated with IRC 409A are complicated and require the advice of a legal tax expert, the pressure to appropriately price equity compensation for privately-held companies extends beyond the tax liability facing recipients.

While IRC 409A creates significant personal tax liabilities for recipients, its impact is also felt by other shareholders and prospective buyers of the stock. IRC 409A has cascading consequences on companies considering a possible sale. Acquisition agreements may well include special representations and warranties from the target company with respect to

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compliance with IRC 409A. Acquirers, whether public or private, will want the additional assurance that equity compensation plans are appropriately priced.

Other equity investors (e.g. venture capital, private equity) that generally hold securities with different preferences ("preferred equity investors") are also being impacted. IRC 409A amplifies the often competing objectives faced by preferred equity investors and management. Preferred equity investors are often cautious about writing up investments and generally take a conservative posture on valuation. In turn, they do not want to dilute their position by either raising additional capital or granting stock options below fair market value. They are also cognizant about under reporting the performance of their fund.

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Recent rounds of funding are often used as indication of value for a preferred position until a significant event or transaction occurs at which point the carrying value of their investment is adjusted either up or down. However, the pending tax consequences found under IRC 409A are pressuring some companies into expanding the frequency and sophistication of their valuation process. In the end, this establishes additional evidence of value. Recognizing that preferred equity investors use proprietary valuation metrics and assumptions and generally carry stock with rights that are significantly different from the common, the fact remains that IRC 409A may lead to a more closely monitored valuation track record. Whether this track record has any effect on future rounds of funding, preferred equity reporting or a possible sale of the company is uncertain. However, the fact that emerging companies are being forced to establish a clearly discernable track record is causing preferred equity groups to carefully consider IRC 409A and its impact on their business.

For financial reporting purposes, audit groups are increasing the level of scrutiny associated for both expensing, as well as pricing equity compensation plans. With the implementation requirements of Statement of Financial Accounting Standards (revised 2004) "Share-Based Payment" ("SFAS 123R"), the pressure will mount on privately-held companies as they struggle to comply with the expensing requirements. In fact, some audit firms may be unwilling to accept new clients that rely heavily on equity compensation unless they have a well documented history for both pricing and expensing. While the expensing requirements under SFAS 123R effects private companies as of the first annual reporting period after December 15, 2005, audit partners are increasingly questioning the pricing metrics used for IRC 409A and whether companies have appropriately managed the process.

The impact and pressure to appropriately price equity grants has just begun. While many private companies will continue to price stock options using their own internal expertise, the proposed IRC 409A rules have created a significant demand for independent valuations. Numerous law firms have concluded that the Independent Appraisal Presumption, which is a valuation performed by a qualified independent appraiser is the clearest presumption available under the regulations and provides the best protection against the consequences of IRC 409A. However, the consequences extend beyond IRC 409A and may potentially have far reaching effects on privately-held companies.

IRC 409A Practical Valuation Issues For Emerging Companies

What are some of the key factors considered in the valuation process for companies complying with IRC 409A?

In preparing a valuation under IRC 409A, there are several factors that play a critical role

in the process. These factors add or subtract from the complexity of the valuation process and the certainty of the result. While all companies have unique inputs that affect their valuation process in general, the most critical include the capital structure, financial reporting, projections, market data and industry characteristics.

The complexity of the capital structure of the subject company is quite possibly the most important factor in determining the scope of an engagement under IRC 409A and a critical component to determining the value of common stock. Companies with a single class of stock can generally be valued using traditional valuation methods (e.g. market multiples, discounted cash flow). However, companies with multiple rounds of preferred funding require a thorough understanding of the rights and powers, including; liquidation preferences, conversion rights and clawback features held by each class of stock. Even though these rights and powers might not be exercised as of the valuation date, they impact the expected value for each class of stock and therefore must be considered. The more complicated the capital structure the more complicated the valuation.

The quality of the financial reporting of the subject company is an often overlooked factor that is critical to the valuation

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Understanding the Valuation Process

We are often asked by companies that have yet to engage an independent valuation expert to detail the process required to complete an engagement. The following details a typical engagement process with Quist Valuation and the involvement generally required by our clients.

- **Stage 1: Document Collection**
  - Quist will provide a detailed list of questions and documents required for the valuation process, which will include the client's recent financial statements (audited statements are preferred, but not required) and details of the equity compensation plan among others
  - Clients will be given forms and documents to complete and return for Quist's review
  - Electronic format is preferred
- **Stage 2: Management Interviews**
  - Quist will engage management in an interview process that generally requires 2 to 6 hours of the senior management team's time and is focused primarily on three main areas
    - History of the company and its development milestones including operations/competition/customer relationships, etc.
    - Financial discussion of historical performance and projections
    - Outlook for the business, including a detailed assessment of risk factors and opportunities
  - Quist interviews are conducted through either face-to-face meetings or via live video conference meetings that are facilitated and coordinated by Quist using Quist supplied equipment
  - Quist's interviews are generally limited to C-Level executives
  - Interviews are conducted by senior members of the Quist management team
- **Stage 3: Valuation Process and Valuation Meetings**
  - Quist will complete the valuation process internally, which may include a few additional clarifications and requests from management
  - A draft report will be prepared and delivered to the client for review and verification of facts and assumptions and limiting conditions found in the report
- **Stage 4: Final Report Prepared**
  - Quist will make changes to the final report based on management/counsel/auditor review of our draft report

Engagements generally require between four to six weeks depending on the availability of data and each respective clients' timing needs. Shorter turnaround times may be available depending on client needs.

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process. Audited financial statements prepared by a reputable accounting firm will not only simplify the valuation process, but also reduce the perception of risk for an investor. Internal or interim financial statements and management's ability to tie them to the audited statements will further reduce the complexity of the valuation process.

Understanding both a range of possible outcomes, as well as the expected projected results is a key component to the valuation process. Whether this is evidenced in a single year budget or a seven-year projection depends greatly on the company and ability of the management team to forecast results. Companies that can clearly detail and justify projections evidenced both by a track record of meeting and/or exceeding projections, as well as an understanding of the inputs used in the forecast process, often reflects the strength of management. Additionally, the capital requirements of the business, the company's market share relative to competitors and margins as they relate to the industry are key components of the valuation process.

The availability of data on comparable market participant data affects which valuation approach is most evidentiary. Emerging companies in a relatively new market space may not have truly comparable publicly traded companies. Conversely, emerging companies in established industries often have multiple transactions that may provide evidence of value. Comparable data includes evidence from the publicly traded markets and transaction data that is often available on acquisitions of private entities. Market trends and data quality are also often important factors to consider. Whether they include publicly traded entities or recently acquired businesses, both can be critical to the end result.

The final factor, which can sharply affect the valuation process, is the industry in which the company competes. Obscure industries can often pose a difficult challenge to clearly determine the appropriate value drivers. Some industries have multiple types of companies competing for the same dollar, such as restaurants or retail, while others are dependent on evolving technological advances such as software or consumer electronics. The fit of a subject company within a broad industry category or its unique positioning can impact both the complexity and relevance of industry research.

While there are other factors which may influence the valuation process, these five reflect some of the primary ones that emerging companies completing an IRC 409A valuation project will need to consider.

123R – Insights

A year has now passed since the Financial Accounting Standards Board (FASB) released SFAS 123R, which "requires that the cost resulting from all share-based payment transactions be recognized in the financial statements." Much has been written in the mainstream press about the pros and cons of expensing stock options. In fact, USA Today published a lengthy exposé on January 16, 2006 titled "**Fears subside over accounting for stock options.**" Yet, the "fears" the article discusses are the potential impact on share price and earnings, which Wall Street is clearly managing. The underlying "fear" for most of the readers of Quist Valuation News, is based on accounting/audit/SEC compliance and how board members, audit committees, and management should appropriately determine the expense.

Best practices are still evolving relative to 123R, as company specific issues are being brought to auditors and advisors. Regardless, annual

Quist Valuation has additional information regarding IRC 409A on www.quistvaluation.com

report season is upon us and many public companies are releasing earnings adjusted for share-based payment transactions for the first time. Numerous companies have avoided the problem altogether by accelerating the vesting schedule of their plans and/or eliminating their share-based incentive programs altogether. For those who have stayed the course and maintained their share-based plans, the road remains uncertain. Despite the available guidance there are few obvious paths to follow.

From a valuation perspective, many issues appear relatively straightforward. Yet, we find that many companies are missing the nuances of binomial models and closed-end models (e.g. Black-Scholes). As with any valuation process, whether it be discount rates, transaction multiples (see our last newsletter), or pricing stock options, there are a number of common misperceptions that exist. Misconceptions and misinformation can often lead to critical mistakes.

The most common misconception we encounter is that by using the binomial versus a closed-end model, companies can ensure a lower result. The truth is that, when correctly applied, the resulting expense from the two models should converge with minimal differences. A second and obvious truth is that inappropriate inputs into either model will lead to an inappropriate result. This is especially true with expected term and volatility, both of which are critical inputs to all option valuation models and difficult to correctly apply. A closed-end model, such as the Black-Scholes model, is based on European options, which can only be exercised on the day the option expires. Therefore, Black-Scholes is at a disadvantage to a binomial model in accounting for early exercise. The binomial model can be developed to account for sub-optimal exercise behavior or check for exercise behavior at every point in the life of the option. The point is that both models need appropriate adjustments to take into account exercise behavior.

In terms of volatility, historic volatility is the first place most companies will and should turn. However, historic volatility is often an insufficient input. Implied volatility is derived by traded options in the marketplace and provides an indication of near-term volatility (as few options are traded beyond a few months). Considering the merits of each, as well as giving consideration to the matching principle (matching the historic period to the expected term of the option) should improve the volatility input regardless of the model selected. In the end, volatility requires judgment based on the expected performance of the company and may even require a benchmark analysis to determine a meaningful estimate of volatility. As is true with any valuation methodology, the 'devil is in the details'.

Hot Valuation Issues:

- **Have the rules changed for Fairness Opinions?**
  In an opinion issued on December 21, 2005, the Delaware Court of Chancery called into question numerous long held practices common in mergers and acquisitions. Although the decision issued in In re TeleCommunications, Inc. Shareholders Litigation, No. 16470, is not a definitive ruling that will govern future cases, the Court's actions illustrate a possible change in how common M&A practices are viewed. Specifically, the impact of differential consideration, contingent fee arrangements for fairness opinion providers, the independence of advisors, selection of comparable transactions and several issues specific to the Special Committee, including its composition, compensation, mandate and responsibilities were all called into question. While the ultimate outcome of the case is not yet known, it would behoove M&A practitioners to review their best practices to ensure the highest standards of "fairness" are maintained.

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- IRC 409A Practical Valuation Issues For Emerging Companies
- 123R – Insights
- Understanding the Valuation Process

IN THE NEWS:

- Quist Valuation is proud to announce the promotion of Tara Hume, CFA, FRM to Team Leader. In her new role, Tara will be responsible for leading one of Quist's analyst teams and will rely on her extensive analytical and management skills to ensure that our clients receive superior business valuation support. Congratulations Tara!

In our next issue:

- Rules of Thumb and Transaction Multiples Part II
- Waterfall, waterfall, waterfall...409A
- Performance Based Restricted Stock Plans and the Binomial Model