



# 2006 Employee Ownership Conference



## Getting the Most Out of Your Private Company Equity Plan

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Minneapolis/St. Paul

Naomi Derner, Vice President



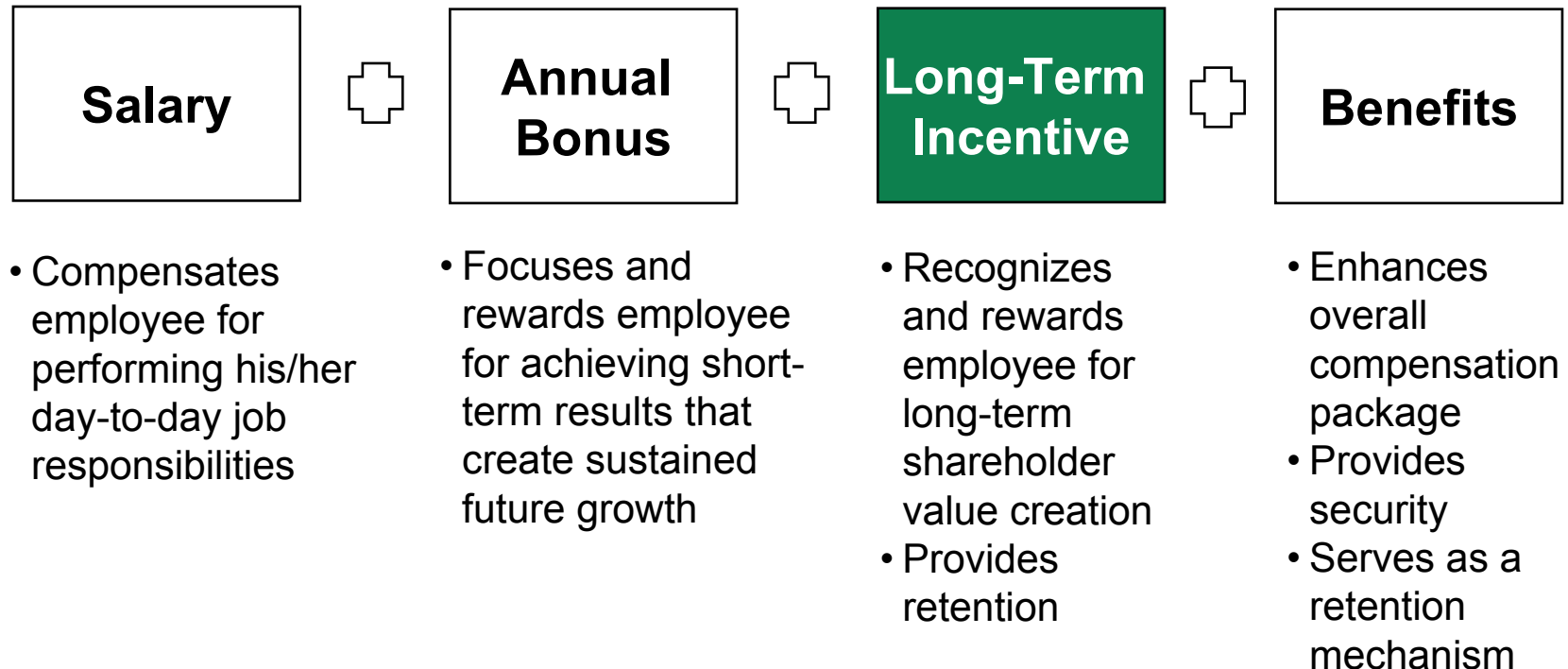
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# Distinct Role of Long-Term Incentive Compensation

## Compensation Components



## Pay Positioning By Business Life Cycle Phase

	Start-Up	Growth	Mature	Renewal
<b>Base Salary</b>	• Below-market	• Near-market	• At-market	• At or above market
<b>Bonus</b>	• Low (conserve cash, focus on long term)	• Moderate	• Competitive	• Depends on business objectives
<b>Long-term incentives</b>	• Founder's equity/stock options, above average	• Stock options at or above average	• Combination of stock options, restricted stock, performance plans at market	• Combination of stock options, performance shares/plans at or above market
<b>Benefits</b>	• Low	• Moderate	• Average or above average	• Average or above average

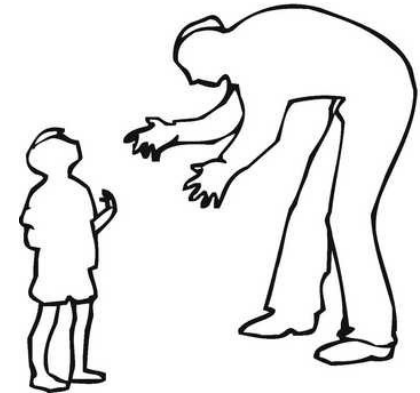


# Determining LTI Objectives

- What are the owners' objectives?



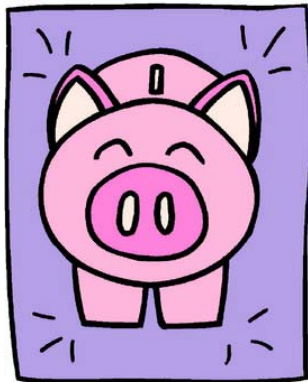
Dress for Sale



Succession Planning



Grow the Business



Maintain financial soundness



Preserve the Culture

## Determining LTI Objectives – cont'd

- What are the typical objectives of the LTI program?



Motivate Desired Behavior



Attract key Talent



Ensure Retention



Provide Wealth  
Accumulation Opportunity

# Key LTI Design Issues

- Determining the acceptable level of dilution
- Selecting the appropriate vehicle: real vs. phantom equity
- Determining the valuation mechanism
- Other key design parameters:
  - Liquidity
  - Other financial, legal (securities law) considerations
- Communicating the LTI program



# Real vs. Phantom Equity

- Usually owners have a specific preference



	<b>Real Equity</b>	<b>Phantom Equity (or Deferral)</b>	<b>Long-Term Cash</b>
<b>Focus</b>	<ul style="list-style-type: none"> <li>• Company value</li> </ul>		<ul style="list-style-type: none"> <li>• Specific goals</li> </ul>
<b>Participation</b>	<ul style="list-style-type: none"> <li>• Generally limited (except ESOPs)</li> </ul>		<ul style="list-style-type: none"> <li>• Broader</li> </ul>
<b>Opportunity</b>	<ul style="list-style-type: none"> <li>• Sharing ratio (uncapped)</li> </ul>		<ul style="list-style-type: none"> <li>• Capped</li> </ul>
<b>Administration</b>	<ul style="list-style-type: none"> <li>• Legal/securities issues</li> </ul>		<ul style="list-style-type: none"> <li>• Fewer complications</li> </ul>
<b>Common Situations</b>	<ul style="list-style-type: none"> <li>• Succession planning</li> <li>• Pulling off a liquidity event</li> </ul>		<ul style="list-style-type: none"> <li>• Difficult corporate structures (e.g., LLCs)</li> </ul>



## Real Equity Example: Financed Stock Purchase

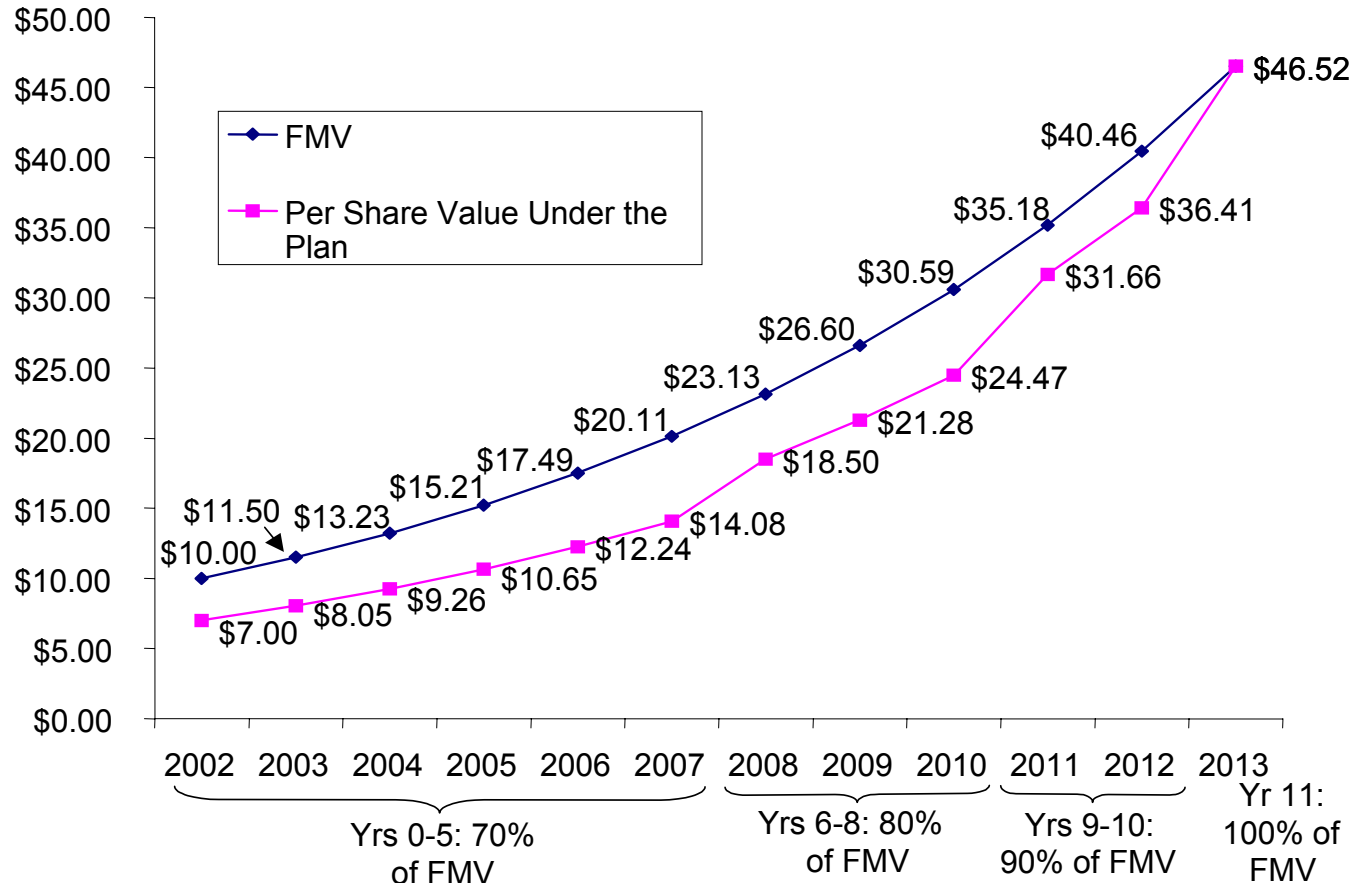
- **Objective:** Ensure management succession
- **Issuance:** Discretionarily issued to management
- **Purchase Price:** 70% of fair value (FV)
- **Financing:** Finance 90% of the purchase price
- **IRC 83(b) Election:** Allowed to make election upon award
- **Shareholder redemption:**  
Years 1 to 5 – 70% of FV    Years 6 to 8 – 80% of FV  
Years 9 to 10 – 90% of FV    After Year 10 – 100% of fair value
- **Repurchase of Stock :** Shareholder may offer the stock for repurchase at any time subject to certain redemption provisions



# Real Equity Example – cont'd

- Company financed stock purchase

**Unrestricted Fair Value vs. Stock Purchase Value  
(assumes 15% growth rate)**



## Phantom Example: Stock Appreciation Rights

- **Objective:** Fast-growing private company
- **Sharing Ratio:** Up to 10% (CEO: 4%, VP: 1.5%)
- **Vesting:** Over 4 years (10%, 20%, 30%, 40% per year)
- **Trigger:** None – employee can exercise vested PSARs at pre-determined exercise windows
- **Valuation:** Multiple of revenue & EBIT, net of investments



## Deferred Compensation as a LTI Vehicle

- Allows key employees to defer compensation pretax
- Receives tax deferred investment growth
- Balances ownership rewards and investment/retirement planning opportunity for key employees
- Flexibility to match owner objectives, financial measures and tax planning
- No government limits on amounts contributed by company or deferred by employee
- Can structure contributions in many different ways
- Funds are subject to claims of creditors





# Independent Appraisal - Factors Affecting Valuation

## External

- Supply and demand for venture capital deals
- Perceived or actual attractiveness of industry sector
- Prospects for IPOs
- Risk tolerance of VC's
- Current public market valuations
- Other current economic conditions

## Company Specific

- Industry or sector
- Stage of development/Stage of financing
- Historic track record of company and/or management
- Company-specific prospect and timing for IPO
- Other company specific factors



# Independent Appraisal - General Valuation Approaches

- Comparable transactions
  - Venture financings
  - Corporate (strategic investor) financings
  - Merger & acquisition transactions
- Market multiples
- Discounted cash flow analysis (traditional)



# Comparable Transaction Approach

- Comparable private company transactions (implied valuations in financing deals and M&A) are highly relevant in valuing early stage technology companies
- In some instances, private company transactions may yield multiples of revenues, earnings, etc., which are applicable in the market multiple approach.
  - In most instances, financial data for comparable company transactions are not available. Even if it is available, it may be hard to properly interpret without inside knowledge.
- Assuming that implied revenues and earnings multiples are not available from comparable transactions, the most relevant piece of information is the actual transaction or pre-money financing valuation itself



## Comparable Transaction Approach – cont'd

Transactions should be selected based on:

- Comparability of the industry;
- Comparability of the specific business model; and
- Timing of the comparable transactions
  - Is especially important because valuations can change dramatically depending on “external” factors such as the state of the public equity markets and the economy, supply and demand for venture funding, and the perceived or actual attractiveness of the industry sector.
  - Case in point: you would not want to rely today on early stage valuations of Internet portals or business-to-business e-commerce deals of 3 years ago without significant adjustments to reflect changes in market pricing



## Comparable Transaction Approach – cont'd

- Establishing comparability:
  - Very few transactions will be truly comparable
  - Rather than throwing out the data, a comparison with the subject company can add meaningful valuation insight
- Criteria for comparison may include:
  - Stage of corporate development/round of financing
    - ♦ Generating revenues? Profitable?
  - Stage of product development
    - ♦ Initial development vs. prototype vs. alpha test vs. beta test vs. initial ship vs. volume ramp
  - Number of employees
  - Management recruitment
  - Sales/distribution channel
- Estimating subject company value based on comparable transactions will typically involve a subjective assessment of the subject company vs. the comparable transactions involving these and other criteria



# Market Multiple Approach

- Based on market multiples of measures of company performance, such as revenues, earnings, cash flow, or other measures
- Multiples of revenues are most common for early stage companies
- The relative level of multiples can be determined using public company comparables or private company valuations



## Market Multiple Approach – cont'd

Establishing true comparability can be problematic

- Public companies are generally much larger and less risky, are likely to be more profitable, but may exhibit lower growth rates.
  - Although the absolute level of public company valuations may not directly translate into early-stage valuations, changes in public valuations may be reflective of similar changes in early stage company valuations. These are some of the “external factors” mentioned previously.



## Market Multiple Approach – cont'd

Early-stage private companies are more comparable, but:

- Valuation and operating data may be hard to obtain. Even if they are available, a lack of understanding of all of the nuances of scant financial data on private company comparables may distort the valuation
- Public information sources such as Venture Source are invaluable tools; “insider” knowledge of comparable deals is also helpful
- Due to lack of available detailed information on the comparables, direct comparisons with the subject company may be difficult



## Market Multiple Approach – cont'd

- Infrastructure and High-Growth Software Companies

(Dollars in millions, valuation as of 7/1/05)

	Ticker Symbol	EV / Revenue			LTM Margins		Q Rev.	Growth			LTM
		LTM	CY05	CY06	GP	EBITDA	Y-o-Y	1-Yr Hist.	1-Yr Proj.	5-Yr EPS	Rev.
<b>Positive EBITDA Companies</b>											
Progress Software	PRGS	2.67x	2.55x	2.36x	84.0%	19.9%	10.4%	17.3%	10.5%	15.0%	\$383.4
BEA Systems	BEAS	2.40x	2.26x	2.12x	78.5%	22.7%	7.3%	6.7%	8.0%	10.4%	1,099.2
Tibco Software	TIBX	2.31x	2.38x	2.13x	73.2%	20.7%	24.8%	46.6%	9.5%	21.3%	437.1
<b>Small, Growing Companies</b>											
Vertical Commun.	ASFT	3.49x	NA	NA	83.9%	-58.1%	67.7%	36.1%	NA	NA	14.3
Intellisync	SYNC	3.34x	2.86x	NA	74.8%	2.3%	38.4%	70.2%	57.8%	NA	57.1
Tumbleweed Commun.	TMWD	2.38x	2.07x	1.69x	80.7%	-3.5%	18.1%	42.0%	19.5%	23.3%	45.3
Agile Software	AGIL	1.42x	1.23x	1.09x	66.3%	2.7%	17.7%	21.5%	15.3%	15.0%	117.0
<b>Small Companies with Negative Margins or Negative (or Low) Historic Growth</b>											
webMethods	WEBM	0.79x	0.74x	0.69x	69.8%	-1.2%	0.2%	5.8%	7.0%	13.8%	200.6
Iona Technologies	IONA	0.72x	0.68x	0.63x	82.6%	9.3%	-3.2%	-8.3%	5.3%	15.0%	67.5
Vitria Technology	VITR	0.67x	0.57x	0.42x	62.9%	-14.7%	16.1%	-23.3%	21.2%	20.0%	64.2



# Traditional Discounted Cash Flow

- Based on:
  - Detailed financial projections
  - Weighted average cost of capital for the subject company
- Not based on:
  - Current market multiples for the company (except as it relates to predicting future value)
  - Timing and amount of future required investment and resultant dilution to current shareholders' ownership stake



## Traditional Discounted Cash Flow – cont'd

- Extremely sensitive to projections, terminal valuation multiples and discount rate
- Relevance of approach may be limited for early stage companies
- For financial reporting purposes, the discounted cash flow approach needs to be considered



## Traditional Discounted Cash Flow – cont'd

- Discount Cash Flow (Traditional)

(Dollars in Millions)

	Projected Fiscal Year Ending November 30,				
	2005 Stub	2006	2007	2008	2009
Revenue	\$11.313	\$35.700	\$50.500	\$70.600	\$92.800
% Growth			41.5%	39.8%	31.4%
EBIT	(\$6.602)	(\$10.475)	(\$0.700)	\$8.000	\$16.500
% of Revenue	-58.4%	-29.3%	-1.4%	11.3%	17.8%
Less: Taxes	(1.981)	(3.143)	(0.210)	2.400	4.950
<b>Debt-Free Earnings</b>	<b>(\$4.621)</b>	<b>(\$7.333)</b>	<b>(\$0.490)</b>	<b>\$5.600</b>	<b>\$11.550</b>
Less: Capital Expenditures	(0.250)	(0.700)	(0.800)	(1.000)	(1.200)
Less: Working Capital Changes	(0.150)	(0.214)	(0.675)	(0.443)	(0.326)
Add: Depreciation and Amortization	0.249	0.653	0.742	0.875	1.035
<b>Total Net Investment</b>	<b>(\$0.151)</b>	<b>(\$0.261)</b>	<b>(\$0.733)</b>	<b>(\$0.568)</b>	<b>(\$0.491)</b>
<b>Net Debt-Free Cash Flows:</b>	<b>(\$4.773)</b>	<b>(\$7.594)</b>	<b>(\$1.223)</b>	<b>\$5.032</b>	<b>\$11.059</b>
Discount Period	0.21	0.92	1.92	2.92	3.92
Discount Factor @ 27.5%	0.95	0.80	0.63	0.49	0.39
<b>Present Value of Net Debt-Free Cash</b>	<b>(\$4.537)</b>	<b>(\$6.077)</b>	<b>(\$0.768)</b>	<b>\$2.477</b>	<b>\$4.270</b>
Present Value of Cash Flows:	(\$4.635)				
Terminal Value	\$59.966				
<b>Concluded Enterprise Value</b>	<b>\$55.331</b>				

DCF Assumptions	
Discount Rate	27.5%
Tax Rate	30.0%

Terminal Value Assumptions	
Terminal EBITDA (2009)	\$17.535
Terminal Multiple	10.0 x
<b>Terminal Value</b>	<b>\$175.350</b>
Discount Period	4.42
Discount Factor @ 27.5%	0.34
<b>PV of Terminal Value</b>	<b>\$59.966</b>



# General Valuation Approaches

- Rates of Return – Per AICPA Practice Aid

<u>Stage of Development</u>	<u>Plummer<sup>1</sup></u>	<u>Scherlis and Sahlman<sup>2</sup></u>
Start-Up	50% - 70%	50% - 70%
First Stage or “Early Development”	40% - 60%	40% - 60%
Second Stage or “Expansion”	35% - 50%	30% - 50%
Bridge/IPO	25% - 35%	20% - 35%

1. Plummer, James L., *QED Report on Venture Capital Financial Analysis*, Palo Alto: QED Research, Inc., 1987.

2. Scherlis, Daniel R. and William A. Sahlman, “A Method for Valuing High-Risk, Long Term, Investments: The Venture Capital Method,” *Harvard Business School Teaching Note 9-288-006*, Boston: Harvard Business School Publishing, 1989.



# General Valuation Approaches - Strengths & Weaknesses

	<u>Strengths</u>	<u>Weaknesses</u>
<b>Comparable Transactions</b>	<ul style="list-style-type: none"><li>• Most accurate indicator of private market valuation at the time of the original transaction</li></ul>	<ul style="list-style-type: none"><li>• Valuations today may have changed dramatically since the transaction occurred</li><li>• True comparability hard to establish</li></ul>
<b>Market Multiples (Public Company)</b>	<ul style="list-style-type: none"><li>• Up-to-date indicator of current valuations</li><li>• Available comparable information</li><li>• Active trading volume a positive</li><li>• Useful to predict future IPO value</li></ul>	<ul style="list-style-type: none"><li>• Public companies generally less similar to early-stage private companies</li></ul>
<b>Discounted Cash Flow (Traditional)</b>	<ul style="list-style-type: none"><li>• Theoretically the most “correct” approach</li></ul>	<ul style="list-style-type: none"><li>• Far fetched projections or inaccurate details</li><li>• Sensitive to changes in discount rate</li></ul>



## Private Company Valuation Under 409A

- Must be determined by a “reasonable application” of a “reasonable valuation method”
- The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date



# Private Company Valuation Under 409A – Reasonable Method

A reasonable method should look at the following factors if applicable:

- The value of the company's assets, both tangible and intangible
- The present value of the company's future cash flows
- The fair market value of similar companies in substantially similar types of businesses the value of which can be reasonably determined through objective criteria or other relevant factors
- Whether the method is used for other valuation purposes
- Other relevant factors such as control premiums and lack of transferability



## Private Company Valuation Under 409A – Reasonable Application

In order to constitute a reasonable application, the valuation must:

- Take into account all available information material to the value of the corporation
- Reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent)
- The valuation must not be more than 12 months old



## Private Company Valuation Under 409A – Independent Valuation

- The valuation must be performed by an independent appraiser who regularly holds himself out to the public as an appraiser and is qualified to make a valuation appraisal of the issuer's stock
- The valuation must be no more than 12 months old.
- Fees for the initial report currently range from \$10K to \$40K.
- Updates are required at least once per year, and more often if there have been material new developments. Fees for updates should be lower than the fee for the initial report.



## Private Company Valuation Under 409A – Illiquid Start Up Exemption

- With respect to an *illiquid start-up corporation*, the valuation is made reasonably and in good faith by a person or persons with significant knowledge and experience or training in performing similar valuations and is evidenced by a written report that takes into account all relevant factors
- The presumption for illiquid start-up corporations is not available if the issuer reasonably anticipates, at the time of valuation, that it will be acquired by another entity or participate in an IPO within the next 12 months. In such a case a professional appraiser must be used.



## Private Company Valuation Under 409A – Definition of “Illiquid Start Up Corporation”

“Illiquid Start-Up Corporation” Definition. A corporation that has:

- No trade or business that it or any predecessor to it has conducted for a period of 10 years or more,
- No class of equity securities that are traded on an established securities market, and
- Stock that is not subject to any put or call right or obligation of the issuer or other person to purchase such stock



## Private Company Valuation Under 409A – Report Preparation

Who can write the report for the illiquid start up?

- Individual that has “significant knowledge and experience or training in performing similar valuations”
- Appears to include the board of directors or venture capital investors
  - But possible additional legal risk
  - One solution – have disclaimers and limitations of liability in option documentation
- Unclear whether report must be by a Board committee, a single Board member, the Company’s CFO or an outside consultant.
- Does not seem to require a professional appraiser



## IRC 409A: What should your company do?

### Equity Securities Issued as Compensation

	<b>Early Stage</b>	<b>Mid-Stage</b>	<b>Late Stage</b>
Stage	Seed and A-B Rounds	C-D Rounds	D+ Rounds and Pre-IPO
Focus Area	409A	409A 123(R)	409A 123(R) S-1
Audience	IRS	IRS Auditors	IRS Auditors SEC



## IRC 409A: What should your company do?

	Early Stage	Mid-Stage	Late Stage
<b>Risk of Exposure</b>	Lower	Higher	Very High
<b>Situation</b>	Cash constrained May not have a qualified CFO	<p>→</p> <p>→</p> <p>If audited, then may need appraisal for 123R</p>	Less cash constrained More likely to have qualified CFO Auditors advise outside appraisal for 123R
<b>Exit Strategy</b>		Far from liquidity, but strategizing exit Unanticipated sales	May consider IPO next 12 - 36 mos More frequent sale opportunities
<b>Alternatives</b>	Use restricted stock instead of options Hire "mom & pop" shop  Ask qualified board member or VC to assist	Prepare report internally, if qualified Beef up internal valuations qualifications If <3 years from liquidity, hire reputable firm	Independent appraisal by a reputable firm
<b>Pitfalls</b>	Earlier sale could result in acquirer demanding reps or asset sale structure	Earlier than anticipated opportunity/window for liquidity event Pushback from auditors Inconsistency with later independent appraisals	Internally or "mom & pop" shop prepared reports may not be acceptable



# Models for Available Liquidity

- IPO or bust
- Acquisition by Public/Bigger Company
- Corporate Redemption Programs
- Internal Markets
- Insurance Funded
- Buy-Sell and Right of Refusal Models
- Tag-Along/Drag-Along Protections



# Incentive Plan Communication

- Many Private Companies struggle with how much financial information to share with employees
  - Strike the balance between confidentiality and openness
- Articulating key drivers of performance is a must
- Vital performance factors can be articulated without fully disclosing financials
  - Value creation and payout factors should be the focus
- Regularly scheduled performance updates are the key
  - Plan features
  - Key drivers
  - Financial updates



## In Summary

- Long term incentive programs offer many creative opportunities for private companies
- It is important during design process to understand:
  - Key owner objectives
  - Valuation mechanism
  - Tax/accounting/legal issues
  - Financial ramifications – Projections
  - Communication and ongoing plan measurement strategy
- Ongoing communication and reporting is key to plan's overall success



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