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Don't Let the Markets Get You Down

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In recent months, the question most frequently asked by clients of our valuation group is, "If I redo my valuation, how far will it have dropped?" The answer is, of course, that it depends. The valuation will most likely have fallen, but the question of how much is more difficult to discern without some analysis.

When we say that the market is down 50 percent, that doesn't always tell the story for an individual company. Below are examples of median stock price changes in industry sectors from 9/30/2008 to 3/15/2009, based on public company comparable sets we've used in recent valuations.

Sector	Median Stock Price Change 9/30/08 - 3/15/09
Solar	-67.2%
Mobile Gaming	-45.4%
SaaS	-43.8%
Medical Device	-43.9%
Security Software	-7.4%

Source: SVB Analytics and Capital IQ

It's Not All Scorched Earth

One thing that has surprised us is the number of companies that have been able to raise funds during this period of (to

be kind) uncertainty. These financings are evidence that: 1) innovation doesn't stop; and 2) investors do not sit on capital indefinitely. In terms of SVB Analytics' valuation work, a new round closing provides the best marker of value for that company, overwhelming anything related to market conditions. Thus, if a company received a truly flat round, its common stock value may not drop in lockstep with the public or M&A markets. It's hard to ignore the fact that smart people wrote checks at a particular valuation.

Flat is in the Eye of the Beholder

In the current environment, as companies raise money the interplay between valuation and terms has become more interesting. There is an understandably strong desire to maintain a reasonable valuation, at least optically, and that leads to terms that can mask the "down-ness" of the round. In addition to larger liquidation preferences, we have seen situations in which, for example, the price per share may be the same for the new round, but the conversion ratio is now more than 1:1. Or the price may be the same, but the investors are now also taking warrants with a \$0.01 strike price. Or capped participation is now uncapped. All of these terms change the allocation of value between classes of stock and can drive down the value of common more than one would think based on the price per share.

On the other end of the spectrum, the most difficult valuation projects right now are those for companies that haven't raised money within the last six months (anything before October can be irrelevant) in which the company is doing better than market conditions would suggest. An

example would be a drug development company that at the end of 2007 was four years away from revenue and at the end of 2008 is three years away from revenue. If the company made exactly the progress it and its investors expected to make over the last year, should the value have dropped more than 50 percent just because that's what happened to the public markets?

Anecdotally (at least until more data is in), most rounds closed in the fourth quarter of 2008 and the first quarter of 2009 have been inside rounds with no new investor to set the valuation and thus ensure a “market” transaction. Differing needs of the investors within the syndicate due to fundraising schedules, reserve allocations and mark to market accounting can cause divergence among previously aligned investors. As we gather more information about those rounds and whether or not they constitute true market transactions, companies and valuation firms will be better able to incorporate them into the overall valuation of the company and its common stock.

What's a Company to Do?

Many companies are getting new valuations to take advantage of reduced values and to lower the strike price of options for their employees, which can make a lot of sense. However, getting a new valuation is not always a straightforward decision. Talking with the company's board of directors and its valuation provider can give some insight as to how others are handling this question. For example, if a round closed in early February and the company has a 409A valuation, but now it's mid-March and the markets dropped another 15 percent, that round is probably still going to be the driving force of the valuation. On the other hand, if during that time, the company lost two marquee customers and management has provided new forecasts to the board which are materially different from those used to raise the money, one could argue that the investors would not have put their money in at the

terms from six weeks before, and thus a change in value is warranted.

What Companies are Doing

We see boards of companies that receive a new valuation be very deliberate about setting a new strike price for options. For example, if the previous strike price was \$0.50 and the new valuation is coming at \$0.44 per share, some companies keep the strike price at \$0.50. The two perspectives we frequently hear are: 1) it is not worth the impact to employee morale to lower the strike price when the value is relatively close, particularly if management and the board believe that the longer-term prospects are good; and 2) lowering the strike price can be advantageous to new employees who receive the lower strike price, potentially to the detriment of long-time employees who have options with the higher strike price. If the difference in value is starker — say, for example, the value has moved from \$0.50 to \$0.29 per share — companies appear more likely to change the strike price of their options and look for ways to compensate employees with significantly out-of-the-money options.

The strike price of stock options is the board's decision. Any valuation from an independent provider establishes an important foundation for the board in demonstrating that their decision was informed with reference to an appropriate methodology with reasonable assumptions. Understanding the backdrop of those assumptions and the sensitivity of the outcome to them can help management and the board make better decisions, and can help other users of the valuation (including the company's audit firm, the SEC and/or the IRS) gain comfort with the result.

In a time of volatile markets, it's easy to become paralyzed. However, business goes on, employees must be hired and retained and financial statements have to be prepared and audited. Though a common stock valuation is a relatively

small piece of these activities, it can take on increased importance, particularly when timing becomes an issue. In the end, choosing a valuation date that makes sense (rather than trying to find the nadir of the public markets), working with a valuation firm that can provide an established and reasoned methodology within a reasonable timeframe and ending up with a common stock value that makes sense given internal and external factors will contribute, at least in part, to the smooth management of a company.

About SVB Analytics

SVB Analytics offers valuation and corporate equity administration services to SVB Financial Group's core constituencies of private, venture capital-backed companies and venture capital firms. SVB Analytics' services offerings include fair market IRC409A/FAS123R valuations and corporate equity tracking and administrative services. SVB Analytics is a member of global financial services firm SVB Financial Group, with Silicon Valley Bank, SVB Capital, SVB Global and SVB Private Client Services, which serve the unique needs of technology, life sciences and private equity firms. More information on the company can be found at www.svb.com.

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