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# HYDE Valuations, Inc.

**We Value Both Real Estate and Businesses**
**Including Machinery & Equipment**


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## *Stock Options for Private Companies*

The dot.com boom era was certainly exciting and it created a number of things that continue to exist today despite the bad feelings associated with this phenomenon that linger on even now. One of these remaining items is stock options issued by privately held companies that hope and plan to go public.

The problems arose by the dot.com companies prior to the peak and the bubble bursting, granted some stock options to reward individuals for risking their careers, their houses, and often their personal relationships. These options were supposed to be granted at “fair market value”, however, many companies began granting them like coupons at a grocery store and when they were cashed in, usually as a result of an initial public offering (IPO), a lot of very wealthy individuals were created over night.

This very fast and incredibly large creation of wealth was noticed by both the Securities and Exchange Commission (SEC) and by the IRS. The SEC was concerned that these companies were taking advantage of unknowing investors by diluting their investments with low priced options (called “cheap stocks”) granted before the IPO. In the late 1990s, near the peak of the dot.com boom, the SEC began levying penalties for what they perceived as cheap stock option grants and then required the offending company to restate its financial statements assuming that the option grants were issued at prices closer to the IPO price. The IRS got involved as well issuing IRC §409A covering deferred compensation which includes stock options. This caused lots of problems and resulted in some new rules governing how these options should be valued and priced.

While the volume of these typically young, but growing companies, has greatly diminished, they still exist and often need to grant stock options to key individuals as an enticement to get them to stay with the company, but yet they don’t want to create income tax problems for these individuals without being able to give them the cash to pay the income taxes associated with the grant. The companies that typically desire to issue stock options to key employees are those that were started with venture capital funds and/or have received one or more investments from venture capitalists usually structured as preferred stock offerings or as debt that is convertible to common stock. The complex capital structures make for interesting valuation problems for the appraiser as the value of the equity in the company must be allocated among the various types of securities to arrive at the fair market value of one share of common stock.

Initially, companies got away with using some rules of thumb and other very simple techniques to state the fair market value of their common stock for stock option purposes. However, now it is required to have an independent valuation professional perform a business appraisal to support the fair market value in order for a privately held company to grant stock options.

As described and detailed by the AICPA in the Valuation of Privately Held Company Securities Issued as Compensation Practice Aid, there are four generally accepted methods of allocating the enterprise value of a company to its various classes of securities: a) the Probability Weighted Expected Return Method; b) the Option Pricing Method; c) the Current Value Method, and d) hybrid methods. Each method has its own strengths and weaknesses.

Under the Probability Weighted Expected Return Method, the value of an enterprise’s common and preferred stock is based upon an analysis of future value of the company assuming various possible future liquidity events. The typical four possible future events (or non liquidity events) considered are:

- Initial Public Offering
- Strategic Sale or Merger
- Dissolution

- Private Enterprise (No Liquidity Event)

Share value is based upon the probability weighted present value of expected future net cash flows to shareholders, considering each of the possible future events and considering the rights and preferences of each share class.

Under the option-pricing method (OPM), each class of stock is modeled as a call option with a distinct claim on the enterprise value of the Company. The enterprise value is defined as the value of equity and interest-bearing debt, i.e. the market value of invested capital (MVIC).

The option's exercise price is based on a comparison with the enterprise value (versus regular call options that typically involve a comparison with a per share stock price). Both the common stock and preferred stock have, at the time of a liquidity event, payoff diagrams that are similar to the payoff diagrams of regular call options. The characteristics of each class of stock, including the conversion ratio and any liquidation preference of the preferred stock, determine the class of stock's claim on the enterprise value.

The current value method is based upon the determination of the enterprise value conclusion as developed by the income and market approaches and then allocating that value to the preferred stock based upon the liquidation value of the preferred stock or conversion values, whichever is higher. The underlying assumption is that a preferred shareholder will, at the valuation date, exercise (or not exercise) its conversion rights in the manner most beneficial to the preferred shareholder. This method is generally considered appropriate in the following circumstances:

- companies with an imminent liquidation or acquisition event
- when an enterprise is at an early stage of development such that no material progress has been made on a company's business plan and
- no significant common equity value has been created in the business above the liquidation preference on the preferred shares and
- there is no reasonable basis for estimating the amount and timing of any such common equity value above the liquidation preference that might be created in the future.

In some circumstances, it may be appropriate to use a hybrid of the Option Pricing Method and the Probability-Weighted Expected Return Method. For example, if a firm anticipates a high probability that an IPO may occur in a short time frame, however, should it not occur, the firm is expected to remain private for three years, a hybrid method might be appropriate.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value both real estate and businesses including machinery & equipment.**

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
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