SBIC TechNotes

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SBIC TechNote 12: Guidelines Concerning Valuation Issues

Introduction

This TechNote provides guidance on the following issues related to the valuation of SBICs' investments in portfolio companies:

1. Differences between "Reported Value" of Investments on the Form 468 and other SBA filings and "Fair Value" defined in Statement of Financial Accounting Standards No. 157.
2. Treatment of liquidation preferences held by SBICs and other investors;
3. Clarification of the terms "self-financing" and "positive cash flow from operations" as used in SBA's model valuation policy;
4. SBA's use of a valuation contractor to perform independent valuations of selected SBIC portfolio assets, and procedures to be followed by SBICs seeking to rebut the contractor's valuation of an asset; and
5. Factors that SBA will consider in determining the acceptability of a third party valuation professional retained by an SBIC pursuant to 13 CFR §107.503(c).

1. Differences between "Reported Value" of Investments on the Form 468 and other SBA filings and "Fair Value" as defined in Statement of Financial Accounting Standards No. 157.

The "Reported Value" of the Form 468 Schedule of Loans and Investments (also known as "SBA Guideline Value") must be determined in accordance with a Licensee's Valuation Policy and is reported by the SBIC as of a measurement date in accordance with 13 CFR 107.503. Reported Value will differ in certain instances from "Fair Value", which is the measurement of value that would comply with generally accepted accounting principles (GAAP). In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("FAS 157"), which defined Fair Value in accordance with GAAP as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". The primary differences between the two measurements are that (i) an increase in value above investment cost may be reflected in Reported Value only if it has a specific permitted basis under the Licensee's Valuation Policy; (ii) liquidity (or "blockage") discounts, which are prohibited under GAAP, must be considered for inclusion in Reported Value; (iii) the Reported Value of interest-bearing securities is not adjusted for changes in interest rates. It is expected that Reported Value will not exceed, but may be less than, Fair Value.

SBA recognizes that the differences between Reported Values and GAAP-compliant Fair Values may be significant. There may also be other differences between SBA Form 468 and GAAP financial statements (including, but not limited to, the treatment of unrealized gain/loss, presentation of financial highlights, and treatment of Participating Securities, prioritized payments and SBA profit participation).

As a result, the financial statement presentation on Form 468 may be considered an other comprehensive Basis of Accounting ("OCBOA") and auditors may elect to provide SBA with an OCBOA opinion rather than a GAAP opinion, with the auditor's report stating that the financial statements have been prepared in accordance with accounting practices prescribed or permitted by the US Small Business Administration. SBA has no objection to this practice provided there is appropriate footnote description of the SBA-GAAP differences.

2. Treatment of Liquidation Preferences

Although SBA's current model valuation policy does not discuss liquidation preferences, SBICs should account for liquidation preferences as follows:

- If other investors obtain liquidation preferences and these preferences cause the value of an SBIC's investment to decline, then the SBIC must recognize that decline per Model Valuation Policy paragraph C.4.

- If the SBIC's investment provides for liquidation preferences, the SBIC's valuation should take into account the downside protection afforded by the preferences, up to the cost of the investment, in the event that the value of the underlying company deteriorates. When considering the protective impact of its own preferences, the SBIC must also consider the potential unfavorable impact of preferences held by other investors.

- If a company receives a new round of financing with a meaningful portion of the financing provided by a sophisticated, unrelated new investor which results in a higher valuation of the company as a whole and consequently of the Licensee's previous investments in that company, the valuation of those previous investments should consider all existing liquidation preferences, regardless of whether their effect on value is positive or negative. However, the adjusted value that may be given to the Licensee's investment in either the latest round of financing or any previous round may not exceed the price of the latest round.

3. Clarification of the term "Self-Financing" and "Positive Cash Flow from Operations" in Model Valuation Policy

Paragraph C.6 of SBA's model valuation policy allows an SBIC to increase the value of portfolio assets based on cash flow multiples or other appropriate financial measures of similar publicly-traded companies, discounted for illiquidity. For an investment to be eligible for a write-up on this basis, the portfolio company must have been "self-financing" and must have had "positive cash flow from operations" for at least the past two fiscal years.

As used in the model valuation policy, "self-financing" means that the company is able to meet its day-to-day operational needs without borrowing. Use of a short-term line of credit to handle seasonal or other peak-period business fluctuations may be acceptable, but the SBIC must be able to demonstrate that these borrowings are not indicative of an ongoing cash shortfall. Borrowing to finance one-time activities such as a significant capital expenditure, expansion initiative, or acquisition of another business does not preclude a business from being considered "self-financing".

In determining whether a company has "positive cash flow from operations", the SBIC should use cash flow from operations, as presented on the company's cash flow statement, as a starting point. If the SBIC is aware of other information that suggests that this figure alone gives an incomplete or misleading picture of the company's performance, the SBIC must consider this information in determining whether it is appropriate to treat the company as having positive cash flow from operations.

For example, a company might have positive cash flow from operations because it is delaying payments to vendors or depleting its inventory; these are indicators of deteriorating performance that would indicate that the company should not be considered to have positive cash flow from operations.

Conversely, a company might have negative cash flow because its accounts receivable are growing rapidly. This could be an indicator of negative performance, e.g., if the company was having difficulty collecting its receivables. However, if the quality of receivables is not declining and the growth in receivables is accompanied by strong growth in revenues and operating profitability, it may be appropriate to consider a write-up of the investment based on financial measures. In any case where the SBIC, after consideration of the impact of this additional information, decides that the company should be treated as having positive cash flow from operations and therefore eligible for a write-up based on positive cash flow from operations, the increased valuation must be supported by a thorough, fully-documented analysis that is available for SBA's review upon request.

The requirement in paragraph C.6 for "the past 2 fiscal years" of positive cash flow from operations means that an SBIC must have held its investment in the portfolio company for at least that length of time before it can consider a write-up based on financial measures. If an SBIC's original portfolio company acquires or is acquired by another company, the SBIC must derive the pro forma cash flow from operations of the consolidated entity for the past two fiscal years in determining whether its current investment may be written up.

4. SBA's Use of Valuations Performed by Contractor and Procedures for Response by SBICs

In September 2005, SBA contracted with a professional valuation firm to perform valuations on selected assets of SBICs. Under the contract, SBA can request the contractor to perform valuations of:

a) the portfolio of an SBIC in Restricted Operations and Liquidation.

b) key portfolio assets that concern SBA, based on factors such as:

- Financial deterioration of the company;
- Sustained market deterioration for the industry in which the company operates; or
- Significant round of investment with preferences in which the SBIC did not participate.

c) an SBIC's portfolio or investment(s) where the value is critical to a request by the SBIC for SBA approval on a particular matter or issue.

SBA may request either a "spot check" or an "exit value". An "exit value" gives the value of an investment based upon a projected price at which the portfolio company would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts, considering such aspects as type and time of exit, future portfolio company projections, additional required investment, comparable transactions and financial multiples. A "spot check" provides a current Fair Value, as defined in Section 1 of this TechNote. The contractor will also provide its conclusion as to Reported Value and reasons for any differences between the two values.

SBICs with assets selected for valuation will be asked by either the contractor or SBA to provide the information identified in Attachment 1. Using the information provided by the SBIC and its portfolio company, the contractor will prepare a valuation report which reflects either a "spot check" or an "exit value" and submit the report to SBA. SBA will review the report and determine whether it is acceptable. If accepted by SBA, a copy of the report will be sent to the SBIC along with a letter identifying any discrepancies between the contractor's Reported Value and the SBIC's Reported Value as shown on the Form 468.

If the contractor's Reported Value for an asset is more than the SBIC's Reported Value as identified on the Form 468, the SBIC may, at its option, write up the asset if it concurs that the write-up remains in accordance with its approved Valuation Policy. If the contractor's Reported Value for an asset is less than the SBIC's Reported Value as identified on its Form 468, the SBIC must either write down or write off the asset, as appropriate, or provide sufficient evidence to support its reported valuation. The SBIC may also engage, at its own expense, an independent third party acceptable to SBA to substantiate the Form 468 Reported Value in accordance with the SBIC's approved Valuation Policy, as provided under 13 CFR §107.503(c).

If the SBIC chooses to obtain a third party valuation of one or more assets cited in SBA's letter, the SBIC has 60 days from the date of the letter to choose an independent valuation expert, obtain SBA's approval of the selected individual or firm, have the valuation performed, and submit the expert's written report to SBA. If these steps are not completed within the established time frame, or if SBA determines that the valuation expert's report does not substantiate the SBIC's Reported Value, the SBIC will be required to reduce the value of the asset to the contractor's Reported Value, adjust its Capital Impairment Percentage ("CIP") accordingly, and provide an updated copy of its Form 468 and CIP to SBA.

If the SBIC chooses to submit justification for its Form 468 Reported Value without engaging an independent third party, it has 15 days from the date of the SBA's letter to provide the supporting evidence. If the SBA determines that the evidence is insufficient to support the Form 468 Reported Value, the SBIC must either write down or write off the asset, as appropriate, or, within 45 days after notification by SBA, submit to SBA written substantiation for the Form 468 Reported Value of the asset from an independent third party, acceptable to SBA, at its expense as discussed in the preceding two paragraphs.

5. Third Party Valuation Retained by SBIC

This section provides guidance on the factors considered by SBA in approving "an independent third party acceptable to SBA" under 13 CFR §107.503(c).

In determining whether a third party valuation professional is acceptable, SBA will consider the following factors:

- ***The third party must be independent from the SBIC, its affiliates and the portfolio company being evaluated***. The SBIC must disclose in writing any prior, current or prospective arrangement or relationship that the valuation expert or its affiliates will or have had with the SBIC, its affiliates, and/or its portfolio companies. The third party's compensation for performing the valuation must not be contingent in any way upon the result and the SBIC must submit a written certification to this effect.

- ***The third party must be qualified***. The SBIC must submit information acceptable to SBA regarding the third party's professional background and experience, including:

    - All professional accreditations maintained by the third party.
    - List of similar engagements performed within the previous twelve months.
    - List of at least 3 client/customer references, including customer names, organizations, and phone numbers for which the third party has performed valuation services on similar assets being valued.
    - Sample valuation report.
    - Name, email address, and phone number of third party.

- ***The SBIC must provide the proposed third party with a copy of its SBA-approved Valuation Policy***. The SBA will contact the third party to ascertain the third party's familiarity with the SBA Valuation Guidelines, experience with similar assets being valued, and the approach the third party intends to take for the asset(s) being valued.

- ***The third party valuation report must meet accepted professional standards.*** SBA considers the standards from any of the following societies to be acceptable: American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA). If the third party proposes to use a different set of standards, the SBIC must submit a copy of these standards to the SBA for consideration and approval.

- ***The third party valuation report must:***

    - Be signed by the third party and include a certification signed by the third party that the third party has no ownership or economic interest in the asset(s) appraised, or other conflict that could raise issues as to the appraiser's independence or objectivity
    - Describe all assumptions and limiting conditions.
    - Describe the asset(s) being valued, including, as applicable, type of security, number of shares, cost, and the effective date of the valuation.
    - Include a comprehensive business description associated with the asset being valued.
    - Include a detailed financial analysis, including discussion of the financials of the underlying business, adjustments made and reasons for adjustments, projections used in the valuation and key assumptions, and comparison to the industry within which the business operates.
    - Explain the valuation methodology used, reasons for why the method was selected, all appropriate variables used in the valuation method and supporting rationale.
    - Include the Enterprise Value and Fair Value of the portfolio company associated with the asset being valued. (The Enterprise Value is defined as the value of financial instruments representing ownership interests in an entity plus net financial debt of entity. Net financial debt is the sum of short-term debt, current maturities of long-term debt and long-term debt, less cash and cash equivalents and marketable securities.)
    - Include a waterfall of how the Fair Value of the portfolio company would be distributed if the portfolio company were to exit at the identified Fair Value considering all liquidation preferences.
    - Include the current Fair Value of the asset(s) being valued.
    - Include the Reported Value of the asset(s) being valued, along with an explanation of how the Reported Value was determined in accordance with the SBIC's approved

Valuation Policy.

Attachment 1 – Information Needed from SBICs for SBA Contractor Valuations

1. Annual financial statements (balance sheet and income statement) for prior three years
2. Most recent month's interim financials
3. Current financial forecasts for remainder of current year and next year if available. If less than 3 months left in current year, the following year's forecast is very important.
4. Preferred stock investment document (liquidation preference)
5. Capitalization table
6. Investment history
7. Most recent Form 468
8. Business plan (if available)
9. Company brochure or web site
10. Phone number and e-mail address for CEO and CFO
11. Recent management reports/Board presentations

If an exit valuation is being performed, the SBIC's exit valuation estimates are also required.