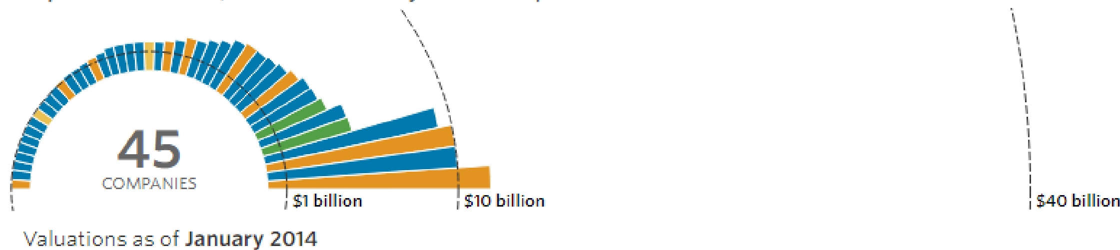
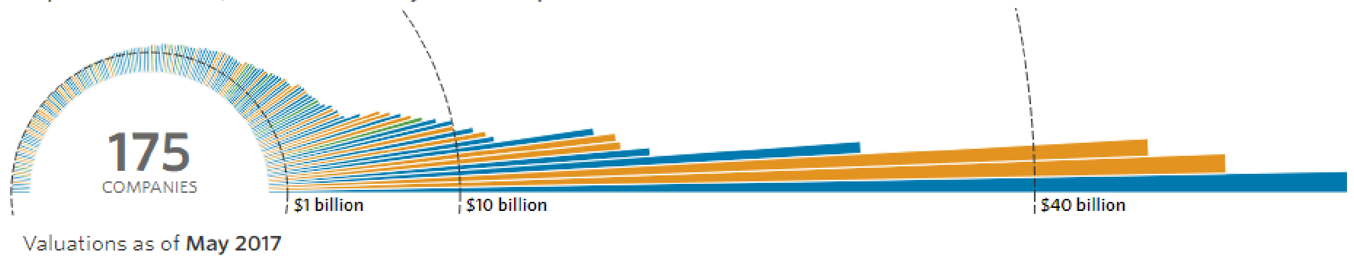
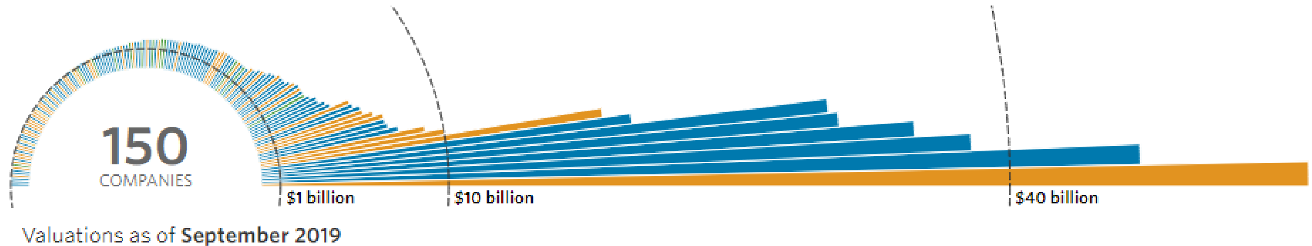
Understanding Valuations of Unicorns

When venture capitalist Aileen Lee coined the term "unicorn" in the fall of 2013 to describe a VC-backed company valued at $1 billion or more, it was a fitting description of an exceptionally rare phenomenon, with around 40 companies in the world holding such title. While unicorn status is still rare, the tech market boom of 2014 - 2017 made unicorn companies more commonplace. The infographics below – the first as of January 2014, the second as of May 2017, and third as of September 2019 – show how the number of VC-backed private companies valued at $1 billion or more increased dramatically over 40 months from January 2014 to May 2017.[1]







The number of unicorns nearly quadrupled to an all-time high of 175, and despite a more tepid tech market in the months and years since the boom, today the number of billion-dollar start-ups remains near the record high at 150 thanks to many of the companies choosing to delay initial public offerings. One byproduct of this state of affairs has been prolonged periods during which many funds have been unsure of how to mark their holdings of unicorn securities. It is inherently difficult to value an early-stage company, especially when that company derives its value from unique and disruptive technologies. Unfortunately, the difficulty is not an abstract issue,

1 Source: The Wall Street Journal and Dow Jones VentureSource. Includes companies that are privately held, have raised money in the past four years and have at least one venture-capital firm as an investor. Excludes companies that were majority-controlled by an institutional investment firm at one point. Only valuations confirmed by VentureSource or The Journal are included, based on direct investments, not secondary deals. Colors denote region.

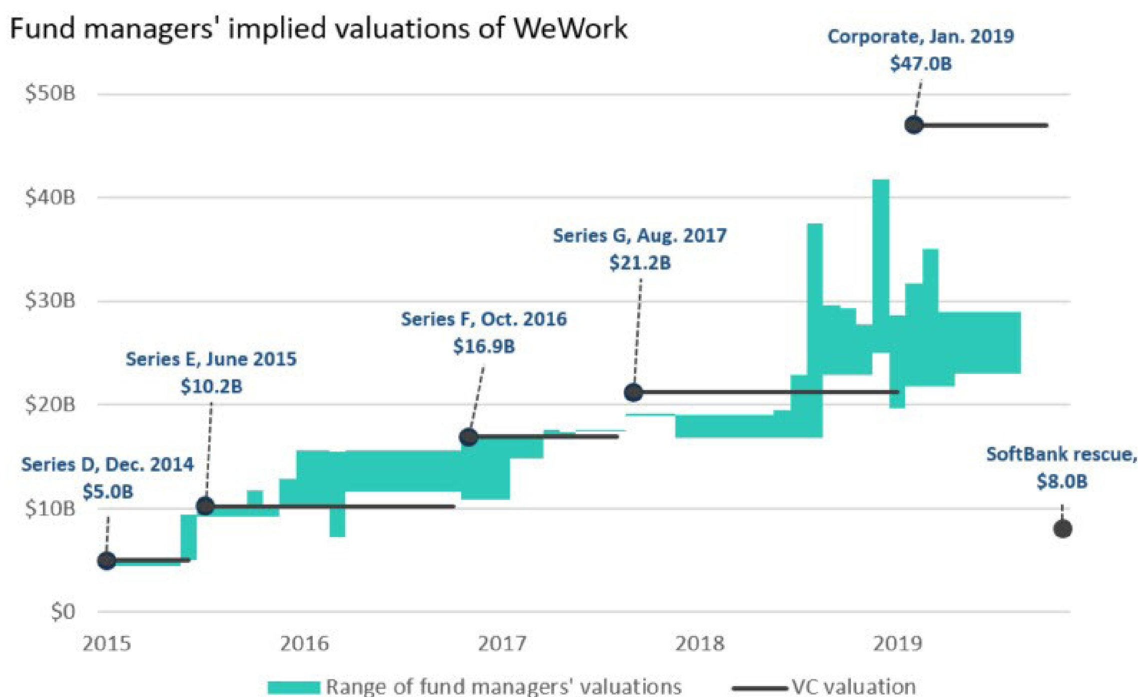
because when the number of unicorns has increased, determining their values correctly became commensurately more important, particularly to the Securities and Exchange Commission ("SEC").

The SEC's increased interest in this area clearly derives from unicorns' newfound relevance to retail investors, as shares of private companies like Airbnb and SpaceX now represent a material percentage of portfolio value for some brand-name mutual funds.

Houlihan Capital has learned from industry insiders and public sources that SEC examiners are asking more questions of mutual fund managers and board members about the valuation of these hard-to-value assets. Of note, the SEC reportedly contacted T. Rowe Price and Fidelity Investments in late 2016 to request details on the ways portfolio managers value these private companies. Then, in May of 2017, Wellington Management confirmed that the SEC had opened an investigation into aspects of its private company investment activities, with a focus on valuation practices.

One phenomenon surely piquing the interest if not yet the ire of the SEC, is the many instances of the same security being assigned different prices by more than one mutual fund on the same date. An analysis conducted in 2015 by The Wall Street Journal of closely held technology start-ups worth at least $1 billion found 12 such occurrences. Most conspicuously, as of June 30, 2015, the T. Rowe Price Global Technology Fund valued Cloudera Inc. at $27.83 per share, while the Hartford Growth Opportunities Fund reported identical shares at $13.10.

Another issue surely becoming more conspicuous with each additional IPO of a unicorn is the often-significant difference between the realized or contemplated IPO price and the immediately preceding per-share value assigned by the company's venture investors. WeWork's disastrous attempt at going public is the latest and most dramatic data point yet for widely held mutual fund companies like Fidelity, Vanguard and John Hancock that tagged lofty valuations on their shares in the co-working space provider – valuations now poised for a massive downward adjustment.



One explanation for differing opinions of value is simply a lack of understanding of how to properly appraise unicorns. There are three generally accepted approaches to valuation that should be considered: the cost approach, the income approach, and the market approach.

The cost approach estimates the fair value for an asset based upon the capital necessary to create an equivalent asset. This valuation approach is most appropriate for highly capital-intensive businesses like real estate holding companies or petroleum refiners, firms whose value has an upper bound closely related to the explicit costs to construct a substitute. A start-up might be valued using the cost approach if it was struggling to remain solvent and was a candidate for liquidation. Since a unicorn is by definition a going concern, the cost approach should not be relied upon.

Nearly as unsuitable is the income approach. The income approach is based on the premise that the fair value of an asset is equal to the present value of the future earnings capacity that is available for distribution to investors in the asset. A commonly applied valuation methodology within the income approach is the discounted cash flow ("DCF") method. Using a DCF analysis, expected future cash flows attributable to the asset are estimated and then discounted to present value at an appropriate required rate of return.

While the DCF method is fundamentally sound, it becomes suspect upon application to unicorns. How does one forecast discrete cash flows for a business that has no history of earnings and perhaps even no history of revenue? Furthermore, how does one determine a discount rate for such an embryonic company? Depending on the investor's information rights, a company-generated budget may not even be available to assist in answering these questions. If relied upon at all, the DCF method should be used with extreme caution.

Among limited choices, that leaves the market approach as the best valuation indicator. The market approach provides market-based evidence of actual transactions and comparable businesses that are traded in public equity markets. Third-party investments in the equity of an enterprise generally represent the best estimate of fair value if they are completed at arm's length between willing parties, which is why some mutual funds are reluctant to report a change in value of a unicorn for multiple quarters. For example, Fidelity reported the same price for Dropbox throughout 2013. This tactic is misguided, however, because, even if new company-specific information is unavailable, material changes are happening in the economy and relevant industry all the time. Moreover, a stationary value may be a red flag to the SEC indicating insufficiently proactive valuation procedures. The board of directors should incorporate all material changes (e.g., interest rates, economic indicators, regulatory reform, and the emergence of new competitors) into the valuation of illiquid securities.

The guideline public company ("GPC") method is another valuation method within the market approach. The GPC method involves identifying and selecting public companies with financial and operating characteristics comparable to the enterprise being valued. Once a publicly traded peer group is identified, valuation multiples can be derived from the ratio of enterprise values or stock prices to respective business metrics. Then, those multiples can be adjusted for growth and risk and multiplied by the same metrics of the subject enterprise to estimate the fair value of the subject enterprise's equity or invested capital.

Typically, analysts use company revenues, earnings, EBITDA, or book value as the denominator in a valuation multiple. Unicorns usually demand more creativity because book value and income measures for the subject may be de minimus, negative or otherwise not serviceable for the approach. Houlihan Capital often uses revenue multiples or sector-specific multiples as alternatives.

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Revenue multiples and sector-specific multiples offer a number of advantages in the valuation of unicorns. First and foremost, the sector-specific metrics and revenue of a unicorn are often better predictors of its future profit stream than traditional metrics. Moreover, revenue multiples remove some of the potential for bias created by eliminating firms in a sample, are less volatile than earnings multiples, and are harder to distort with accounting decisions. Sector-specific multiples go one step further: they can be estimated for firms where accounting statements are nonexistent. For instance, an investor in a unicorn social network company may only receive periodic updates on the company's number of members. Still, a value may be imputed by looking to public data on, say, Facebook and using the ratio of enterprise value to members.

When valuing a unicorn, the truth of the matter is that there is no formulaic solution. It takes expert knowledge and experience to arrive at informed conclusions. To comply with best practices, mutual fund managers have been forming internal valuation committees to evaluate their illiquid investments, to ensure a well thought out process, and to provide a level of independence to support their valuations. Further, even if a board of directors of a mutual fund holding illiquid securities has an expert in-house valuation team, best practice is to enlist an independent third-party valuation firm like Houlihan Capital.

Value. Added.

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