EA GP Fund Valuation Policy

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1 Background

EA GP adopts IPEV valuation guidelines to determine portfolio valuations.

Typically, EA GP will adopt "Price of recent investment" techniques. However, in some cases, this is not suitable. The EA GP Investment Committee will consider the valuation of all investee companies at each capital raising round and following the receipt of quarterly reports. The Manager (EA) should provide to the EA GP Investment Committee:

- updates on portfolio companies so that this information can be used to test the valuations which are based upon the last capital raise round.
- information on the degree of 3rd party participation in the last capital raise round to strengthen that valuation method.

Further to recommendations submitted by the IC, valuation determinations must be subsequently agreed by the EA GP Board.

To assist in this process, it is proposed that EA GP adopts a series of more specific criteria to assist in investee company valuations. These are detailed below. The IPEV Guidelines can be found here.

2 Process

2.1 Step 1 - Estimation of fair value

Fair value is the price of which an orderly transaction would take place between market participants at the reporting date. It is in essence an estimate of the market value of an asset at a point in time (specifically at the reporting date).

In estimating fair value of an investment, the valuer should apply a methodology that is appropriate in the context of the investment. In private equity transactions value is primarily crystallised at a sale or floatation of the asset in question, rather than a sale of an individual stake. Accordingly, the fair value of an asset is based on its total enterprise value (EV). In determining the EV of a business, a range of standard valuation techniques is available. These include:

- The price of the most recent investment
- Earnings multiples
- Net assets
- Discounted cash flows
- Industry valuation benchmarks

Given the uncertainties of private equity investing some caution on estimating EV is required. In many instances the fair value of a business cannot be reasonably measured. This may be because the ranges of fair value estimations are wide, the probability of a financial impact for achieving a key milestone cannot be reached or there has been no recent investment into the business. In these situations, the investment should be reported at a carrying value as at the previous reporting date subject to any amendments to that fair value that the valuer regards as being appropriate (e.g. impairments per below).

2.2 Step 2 – Adjustments to Fair Value

Where there is evidence that the fair value of an investment has changed since the last reported valuation, the fair value of the investment should be adjusted to reflect this change.

By its very nature such adjustment will be subjective. This estimation is likely to be based on objective data from the company, and the experience of the investment professionals and other investors.
However, the necessity and magnitude of the adjustments are relatively subjective and require a large amount of judgment on the part of the valuer. Where deterioration in value has occurred, the valuer should reduce the carrying value of the investment reported at the previous reporting date to reflect the estimated decrease, refer to impairments' guideline below.

In determining whether an impairment has occurred there are a number of factors which should be taken into account.

- The performance / prospects of the underlying business are significantly under expectations for the business. Indicators of this include significant failure to meet milestones, service debt, breaches of covenants or a deterioration of budgeted or forecast performance.
- There has been a significant adverse change in either the company's business or technological, market, economic or regulatory environment in which the business operates.
- Key people have left the business.
- Market conditions have deteriorated.
    - Consider whether this is short or long term.
- The business is raising money and there are indications that capital will not be made available or at significantly different terms and conditions than the current investment.

2.3 Step 3 – Review of other factors

Frequently the structuring of investments is complex with differing stakeholders holding different rights which may either enhance or diminish the value of an interest. These may include stock options and warrants, anti-dilution and ratchet clauses, convertible debt instruments and liquidation preferences. At each reporting date the valuer should take into account whether these rights are likely to be exercised and what effect they may have on the Fair Value.

3 Other notes

3.1 Impairment

In order to ensure consistency in valuing the portfolio, where there is limited information in valuing the company and impairment is required, impairment will be applied in percentages as follows:

- Permanent, critical impairment - -100% (i.e. value down to a nominal $1)
- Permanent, major impairment - -75% (i.e. value down to 25% of previous reporting period valuation)
- Permanent, minor impairment - -50%
- Temporary, critical impairment - -50%
- Temporary, major impairment - - -25%
- Temporary, minor impairment - -10%

Terminology:

- Critical – is something that affects all parts of the business.
- Major – is something that affects 25%-75% of the business.
- Minor – is something that affects less than 25% of the business.
- Permanent – is something that won't change, e.g. a founder/key person leaving.
- Temporary– is something that will change within 12-24 months, e.g. an economic situation, negotiations.

3.2 “Price of recent investment”

3.2.1 Age of Portfolio investment

All investments will be reviewed, irrespective of whether there has been a recent investment round or not.

3.2.2 Size of the recent investment

In order to contemplate a revaluation using a recent investment round, the size of the investment round should typically be at least $0.5m, of which at least 50% is from new investors. If the investment round meets this criteria, then the following must also be met:

a) Evidence of operational performance to substantiate this value.
b) Evidence that the new investors, or a proportion of them, are commercial investors.

3.3 Different share classes

Typically different share classes in the same company will all be priced the same, i.e. at the latest fair value price. Since the different classes refer to different preferences in the shares and would only cause a difference in return of capital if the company exits at a lower valuation than the valuation at investment. If the company is distressed, any liquidation preference should be considered and ordinary shares discounted to 0-20% of the preferred share value.

3.4 Companies valued in foreign currency

Where a company issues shares in another currency and EA Funds invest in NZD, the valuation will convert the NZD cost into the foreign currency value using the reporting date FX.

4 Recommendation

That the IPEV valuation guidelines found here alongside the additional valuation criteria noted in this paper be adopted as the EA GP Portfolio Valuation Policy. The Valuation Policy will remain under review as the EA Fund portfolios mature.