

On Market-Based Valuations

BY PETER J. LEITNER

Market-based valuations provide an edge to life science firms, especially those seeking funding, acquisitions or joint ventures, by optimizing key decisions by the CFO, CEO and the board. How can you better recognize a good – or not so good – deal without an independent, objective and robust analysis by seasoned experts?

This approach to valuation echoes the trend of using decision markets to make complex forecasts, from predicting election outcomes to finding submarines lost at sea to selecting strategic vendors, all with surprisingly accurate results. A decision market links multiple participants, whose independent assessments merge into one conclusion, using the same dynamics that set the prices of publicly traded stocks, bonds and commodities. Like all open markets, they allow information to flow freely among many participants who compete in a transparent environment.

Traditionally, the firm seeking a valuation hires one provider, like an investment banker, appraiser or financial advisor. Many of these consultants work as sole practitioners, while others are employed by, or subcontract to, larger companies that contract with clients. Some become employees of those companies that actively pursue acquisitions. In any case, the firm relies on one source that studies the situation and then prepares and delivers a written report.

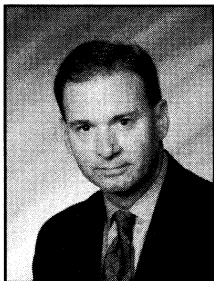
In a market-based valuation, multiple sources participate simultaneously, all preparing independent reports and learning from each other's assumptions and conclusions. Initial disagreements are common, and the participants' valuations evolve – changing whenever new information affects their pricing decisions – while the errors cancel each other out. This pooled expertise yields enormous advantages to firms that are negotiating deals or making strategic decisions. But they also help emerging and growing life science ventures avoid two very common and expensive traps.

The first is so-called "cheap stock", which refers to issuing stock options at a strike price below the stock's fair value. This problem usually lies dormant until IPO planning begins and management learns that the Securities & Exchange Commission considers the discount to fair value a form of employee compensation that needs to be expensed. This charge can be large enough to erase all profits the firm has earned to date, which can damage the confidence of underwriters and investors. It may also prompt option holders to seek tax counsel about the compensation they received, but did not report.

Given the SEC's hot-button attention to this problem, and the Financial Accounting Standard Board's growing preference for fair value financial statements, market-based valuations offer an appropriate solution.

The second trap is in relying on one source for a valuation – be it the company's internal staff or an outside advisor – and then making a major decision based on the conclusion. There is simply too much information, too many variables, and too many opportunities for bias for a single source to do it in an independent, objective and robust way. But an expensive error can be avoided, as the following example of a market-based valuation shows.

The CFO of Buyerco is considering the acquisition of Targetco, and he decides to use a market-based valuation before negotiations begin. The initial assessments, prepared by multiple independent analysts, range from \$21



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million to \$53 million, average \$37 million and have a standard deviation of \$10 million. Stunned, the CFO realizes that the standard deviation is the likely error he would have made – paying too much or walking away too soon – had he relied on a valuation from just one source (including his own staff) in his recommendation to the board and in the negotiations with Targetco. He dodged an expensive error by using a decision market as a hedge.

A key attribute to look for in market-based valuations is the ability for analysts' true sentiments to be known. This seems obvious, but it is difficult to achieve anywhere but in a true market. And, while many CFOs and CEOs will say publicly that their firms are in the 99th percentile, the wise ones will seek a discreet reality check before signing a deal. Another attribute is confidentiality, which should be ensured through the market's contractual influence over participants, its secure environment, and its protocols that should be comparable to those used in sensitive corporate transactions.

Perhaps the greatest and least expected benefit from a market-based valuation is the insight company management gains about their own firm. By hearing the spirited dialogue among market participants and seeing the effect of new information on the firm's valuation, management learns of strengths and weaknesses they either didn't know or didn't fully appreciate, and in any case wouldn't hear from investors who simply say, "No, thanks" during a pre-funding road show. These insights translate into action items that enhance corporate value.

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5 Good Reasons for a Market-Based Valuation

1. Gain an edge in deal negotiations
2. Get multiple valuations for the price of one
3. Avoid issuing cheap stock options
4. Hedge against one, inaccurate valuation
5. Learn what the market really thinks about your firm