



Portfolio Valuation and Fund Advisory Services

Growth Equity Valuation European Snapshot

MARKET UPDATE **SPRING 2023**



Houlihan Lokey's Growth Equity Valuation Snapshot

Spring 2023

Houlihan Lokey is pleased to present a summary of European growth equity observations from its valuation professionals based on real-time market and valuation insights.

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1 Frozen exit markets for IPO and M&A with large bid/ask spreads

2 Limited LP distributions over past year

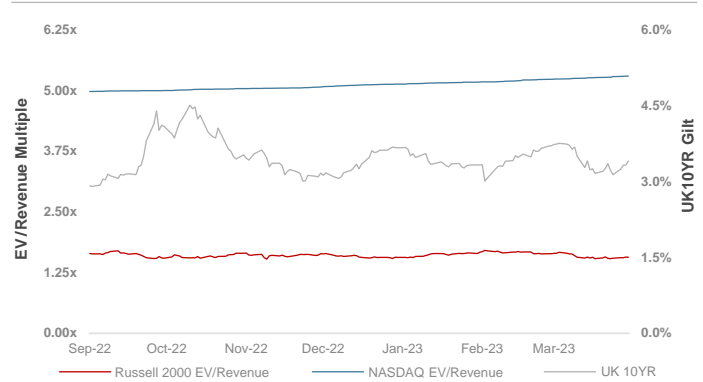
3 Reduction in LP allocations as a result of denominator effect

4 Higher rate environment and regional bank failures

5 Portfolio companies facing liquidity issues

↓
DEPRESSED VALUATIONS

Past Six Months: EV/Revenue vs. UK 10YR Gilt



Note: EV refers to Enterprise Value.
Source: S&P Capital IQ.

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Funding and Valuation Environment in Spring 2023

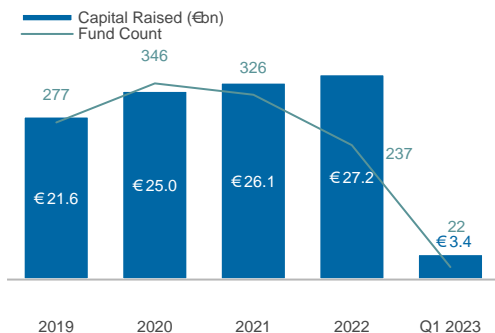
With the IPO market effectively frozen in 2022 and early 2023, fundraising in Q1 2023 fell dramatically as investors were unable to recycle their capital into new funds. Per PitchBook, in Q1 2023, VC raised €3.4 billion of capital, the lowest figure since 2015.

- Per PitchBook, we also note that from 2022 through Q1 2023, European M&A levels have scaled back slightly but remain in line with pre-pandemic levels. Q1 2023 saw an estimated 4,555 M&A deals, down 4.3% Q-o-Q while M&A deal value dropped to \$383.6 billion, down 10.7% Q-o-Q.
- After the Silicon Valley Bank (SVB) and Signature Bank crises, the Fed stepped in with a number of policy decisions to bolster liquidity and confidence in the depository institutions to prevent additional bank runs. These policy decisions in part helped the market in posting a recovery in Q1 2023. While the market has seen a recovery, liquidity has declined as SVB has been a central player in the venture lending space. Additionally, given these banks were major providers of capital call credit lines, difficulty in getting these loans could make it challenging for funds to invest in additional financing rounds. As such, fund managers are increasingly turning to NAV loans as a substitute to buoy capital needs for their portfolio companies.
- With the capital demand-supply ratio at an all-time high, investors have more leverage over deal terms and valuations, which contributes to the valuation decline. As the cash runway becomes tight, companies underperforming and seeking capital from outside their existing investor base can expect less favorable terms and, in some cases, structured downside protection for the investors, cramdowns, or pay-to-play financings in more distressed situations.
- Inflation has also led to higher costs of goods and labor, which directly decreases the companies' profitability. Higher base interest rates have also resulted in reduced cash flow for borrowers financed with floating-rate debt.

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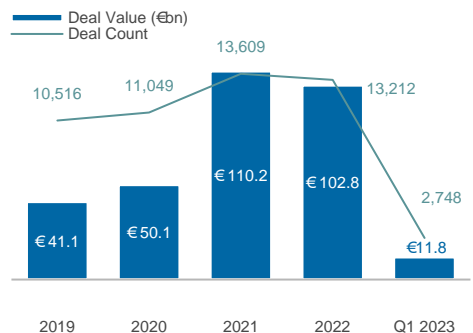
Funding Reports

European VC Fundraising Activity



Source: PitchBook.

European VC Deal Activity



Source: PitchBook.

4 Valuation Considerations in a Down Market

■ Preferred Equity Liquidation Preference as a Valuation Floor?

- In the current environment, where valuations for many companies have declined significantly from the time of prior financing rounds, a common question that is often asked by investment professionals is how a preferred investment can be marked lower than its liquidation preference when the underlying company's equity value exceeds the investment's respective liquidation preference.
- Given fair value is defined as "the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date," one way to answer the question is to think about how a new investor would underwrite the same security today. Assuming the value of the company has declined, perhaps due to underperformance or declines in their sector, a new investor investing in the same security today would require a higher dividend rate or lower price per share to compensate for the decline in company value.
- You can also make an analogy to bonds with below-market coupons. There are five-year U.S. Treasuries currently trading around 90. This isn't because people are ascribing a significant default risk; rather, it's because of the below-market yield on these bonds. Similarly, growth equity assets are long-duration assets (or growth-oriented businesses with long-term cash flow potential) that are sensitive to increasing interest rates, as profitability may be years away.

■ Value Dispersion Among Security Valuation Methods

- Commonly used private company valuation methods include valuing securities on (i) a common stock equivalent (CSE), or as-converted basis, the typical post-money headline valuation observed in public press releases; (ii) a waterfall basis, which assumes the company is immediately sold or liquidated; and (iii) an option pricing methodology (OPM), which treats equity securities as call options on the company's equity value.
- Understanding the various rights and privileges attached to each security class in a company's capital structure is essential to security valuation. Seniority, liquidation preferences, dividends, ratchets, conversion ratios, and other variables are highly impactful economic features that provide downside protection. Generally, the stronger and more senior these various rights and privileges, the higher the value per share of that class relative to other classes. The reverse is also true—the weaker and more junior the rights and privileges, the lower the relative value per share of that class relative to other classes. Typically, the most recent round of financing is likely to have the strongest rights and privileges and will come at the top of the food chain in the capital structure.
- Let's use Chime Financial, Inc. (Chime) as an example. Chime raised \$1.1 billion in a Series G financing at a \$25 billion valuation (on a CSE basis), or \$69.07 per share in September 2021. However, recently, Chime was valued at around \$8 billion based on publicly available information. The table below presents the per-share value dispersion reflected in the different classes among the different security valuation methods: OPM, CSE, and waterfall.


Chime Implied Per-Share Values: \$8bn Total Equity Valuation			
Class	OPM Method	CSE Method	Waterfall Method
Series G	\$62.60	\$22.00	\$69.07
Series F	\$38.89	\$22.00	\$40.92
Series B	\$19.96	\$22.00	\$20.56
Common Stock	\$19.93	\$22.00	\$20.56


*Note: OPM method reflects a time to liquidity of two years and volatility of 45.0%.
Source: Capitalization table data per PitchBook.*

- In the OPM and waterfall methods, the enhanced rights and privileges of the senior securities generally make them more valuable than more junior securities. However, the CSE method reflects the company's securities converted into common stock; thus, any differences in rights and privileges in a company's different classes of equity are ignored. While this assumption may be appropriate if a company sells or IPOs at a sufficiently high value, it may fall apart if the value of the company declines and is then sold or liquidated as shown below.
- Notice how the Series G is under the original issue price of \$69.07 from the September 2021 financing for both the OPM and CSE methods. This is due to the equity value deterioration from roughly \$25 billion at the last round valuation (on a CSE basis) down to \$8 billion today.
- Method weighting is also important in security valuation. This can be based on a number of factors, such as business stage, growth profile, company performance, and ultimate progress toward an exit event. Has the board of directors set a plan for IPO or M&A? Have investment bankers been hired? Ultimately, this is based on expectations at the given valuation date.


Houlihan Lokey's Growth Equity Expertise

Houlihan Lokey has a successful track record and robust experience in assisting its clients—including private equity, venture capital, hedge fund, sovereign wealth fund, and family office—with ongoing portfolio valuation work and fund-related transactions.


 We have deep **valuation expertise** in investment, NAV reporting, and fund-related transaction matters.


 We advise **boards of directors and valuation committees** as they navigate audit review, regulatory challenges, and new fund formations, including valuation policy and procedures.

 We value large portfolios of **highly structured, venture-backed “unicorn”** investments for various investors across the globe.

 Our industry-leading Fund Opinions practice provides valuation and fairness opinions to many **financial sponsors** annually in connection with cross-fund, spin-out, and other conflict-of-interest transactions.

 Our Capital Markets team has **substantive private placement experience in structuring and raising capital** with leading industry participants in growth and structured equity.

 Our valuation practice has deep technical expertise and a market presence across various industries and asset classes. This is further enhanced with access to **the firm's dedicated industry groups**, which provide an unmatched level of expertise and transaction experience to inform the valuation process.

 It is critical to engage advisors early when starting the IPO process. Our **Accounting, Financial Reporting, and Public Equity** teams advise portfolio companies on the best practices for going public, managing the IPO timeline, navigating auditor review, and crafting the equity story.



Webinar Replay—Unicorns Unveiled: Exploring the Venture Market, Valuation Approaches, and Index Methodology

Houlihan Lokey, in partnership with Morningstar Indexes and PitchBook, recently hosted a webinar called **Unicorns Unveiled: Exploring the Venture Market, Valuation Approaches, and Index Methodology**, discussing the current venture/growth equity environment, the framework for and challenges of valuing unicorns, and the newly created Morningstar PitchBook Global Unicorn Indexes. If you are interested in obtaining the presentation or a recording of this webinar, please contact us.



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