Minicase: "FreshBites Inc. – A 409A Valuation Example"

John M Barrios

Yale SOM

Background:

FreshBites Inc., founded by entrepreneurs Alex and Jamie, is a two-year-old private startup producing sustainable, plant-based snack products. The company recently completed a Series A financing round, raising $4 million at a post-money valuation of $20 million. Preferred stock was issued to venture investors at $4.00 per share. FreshBites now needs a formal 409A valuation to establish the fair market value (FMV) of its common stock for issuing employee stock options.

Step 1: Gather Information

- **Preferred Stock Price:** $4.00 per share.
- **Capitalization Structure Post-Series A:**
  - Preferred Stock: 1,000,000 shares outstanding
  - Common Stock: 4,000,000 shares outstanding
- **Total Valuation (post-money):** $20 million
- **Liquidation Preference:** Investors have a 1x liquidation preference.
- **No Participation Rights** (non-participating preferred).

Step 2: Selecting Valuation Methods

The external valuation firm decides to use two approaches:

1. **Market Approach**: Comparable company analysis (market multiples)
2. **Income Approach**: Discounted Cash Flow (DCF) method

Step 3: Valuation Calculation (Simplified Example)

Market Approach:

- Comparable plant-based snack companies trade at an average valuation multiple of 5x projected annual revenue.
- FreshBites' current annual revenue projection: $3 million
- Implied market value of company = $3M revenue × 5 = **$15 million**

Income Approach (DCF):

- Projected Free Cash Flows (FCFs) next 5 years (simplified): Year 1: ($0.5M), Year 2: $0.5M, Year 3: $1.5M, Year 4: $2M, Year 5: $3M.
- Terminal value at end of Year 5: 6x Year 5 FCF = $18M
- Discount Rate (WACC): 25%
- Calculated Present Value (PV) of future cash flows & terminal value = **$12 million** (simplified calculation)

Step 4: Reconciling Methods

- Average of the two methods:
  - Market Approach: $15M
  - Income Approach (DCF): $12M
- **Average Enterprise Valuation = $13.5M**

Given recent financing at $20M post-money valuation (due to strategic premium and negotiation factors), the valuation firm applies a discount for lack of marketability (DLOM) and control (minority discount):

- Valuation for Preferred Stock (no discount): close to recent financing at $20M valuation.
- Valuation for Common Stock: Apply a total discount of 40% to account for lack of marketability, control rights, and liquidation preference of preferred stockholders.
  - Common Stock valuation = $13.5M × (1 - 0.40) = **$8.1M**
  - Common Stock FMV per share = $8.1M ÷ 4,000,000 shares = **$2.025 per share**

Step 5: Final 409A Valuation Report

- **Preferred Stock:** $4.00 per share
- **Common Stock (FMV, 409A valuation): $2.03 per share**

Step 6: Issuing Stock Options

FreshBites Inc. now sets the strike price for newly issued employee stock options at or above the $2.03 per share valuation to remain compliant under IRS Section 409A.

Discussion Questions:

1. **Why is the common stock valuation lower than the preferred stock price?**

The common stock valuation is lower primarily because of the liquidation preferences held by preferred shareholders. Preferred shareholders are guaranteed priority in repayment during a liquidation event. Additionally, common stock generally lacks voting control, marketability, and certain protective provisions. These factors, combined, lead to a significant discount relative to the preferred stock price.

2. **How did the valuation firm reconcile differences between market-based and income-based approaches?**

The valuation firm reconciled differences by calculating the valuations separately through each method and then averaging the results to reach a blended valuation. This approach considers the market valuation from similar companies (market method) and the intrinsic value based on projected future cash flows (income method). By combining these two perspectives, the firm achieves a balanced and justifiable valuation.

3. **What risks might FreshBites face if they issue stock options below the established 409A valuation?**

Issuing stock options below the established 409A valuation exposes FreshBites and its employees to substantial risks, including severe tax penalties. Employees would owe immediate ordinary income taxes on the spread between the strike price and the true FMV, plus an additional 20% penalty tax under IRS Section 409A. The company would also face potential regulatory scrutiny, damage to investor relationships, and complications during future fundraising rounds or liquidity events.