

THE VALUATION GAME AND LEGAL VEHICLES



We got used to the idea that most entrepreneurs set up companies with the aim of solving a problem and making profit while at it. Business growth and sustainability are some of the buzz words when such discussions come up. However, in recent times, the business world has come to accept a new model, the motive being to set up a business with a predetermined exit point for the founder, who monetizes his/her equity once the triggers are activated.

One of the basic things this model does, is to include entrepreneurs/ founders in the conversations around exit strategies. Such conversations were usually within the confines of the likes of Venture Capitalists, Private Equity and other kinds of investors. However, with the advent of this new business model, it has become an all-inclusive conversation, with founders at the driving seat. We are not out to test the viability of this model, therefore, we will not delve much into its pros and cons.

We also won't weigh in on how some have used it to lay the foundation for globally impactful organizations, while others have gone ahead to abuse it. We will focus on highlighting the interplay between valuation (finance) and vehicles (legal) that are usually seen in this model.

Valuation which is the focal point when a company is looking to monetize equity or engage in any financial activity – goes beyond the current assets and liability of the organisation. Factors such as preceding transactions, projected earnings, peer group analysis & market conditions (amongst others) are also considered. However, as important as the valuation is, the vehicle housing/ hosting the business is also important in preparation for the valuation game. When speaking about vehicles, the two fundamental questions are 'What' and 'Where'.

What kind of vehicle should you set up?

This leads to deeper enquiries such as:

- Is a company the best fit for the founders' purpose or would an organized cooperative or other vehicles be more suitable?
- How should the entity be structured?
- Where the entity is affiliated with other entities, how should its relationship with these affiliates be defined?

These questions may sound very basic but are vital in creating the structures for the Founder who's end goal is to exit the business.

The next question is where the vehicle should be

set-up considering tax, regulations affecting money and other related things.

These are the blurry lines where valuation and legal vehicles meet in the valuation game. Understanding the suitable vehicle and structures from the onset are fundamental to valuation at the exit point. It helps the easy movements of assets and debts between entities, making it effortless to activate an exit strategy within a short term and get the books as neat as possible. This is easily achieved by passing down the debts and plausible liabilities to another entity within the same structure (then cutting the affiliation cord between the entities for the purpose of Valuation), which ultimately plays a vital role in valuing the cleaned entity up for immediate grabs. May we also state that the fact that debts and liabilities are left in another entity does not mean the ultimate downfall of such entity.

Let's look at it this way:

The founders of Jack Ltd had a target to exit the company at year 5. At incorporation, they also set up a Jordan Ltd, which they have over time used to play in the same space but with a different business vertical. At year 4, depending on the model that is more acceptable in the market, transaction records, projections and other factors that affect valuation (including public relations), and the relationship/equity structure between the two entities (which is where your legal and financial advisers are key), the founders can take two routes:

- Move the debt of the more viable entity to the lesser one, which will further increase its valuation, and immediately monetize their exit from the viable one; or
- Accumulate the debts of both entities into the valuable entity (if the other factors affecting the valuation makes the debt inconsequential in the scheme of things) and still trade it off. This would clean up the books of the less viable entity and by ripple effect, increase its valuation as well and open it up to other financing opportunities.

Although the notion is that this business model hinged on valuation negates the principle of 'starting a business one doesn't believe in', the impact of this model cannot be disregarded. Therefore, founders who opt for this model should ensure they get it right from the onset. The vehicles and structures are as important as the finances, and like many other simple but technical aspects of business, it is also best accounted for at the beginning or in the early stages. Structures generally get more complicated and resistant to regulations as the company gets older.



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