

carta

Secondary transactions and 409a valuations

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When shares of a private company are sold by existing shareholder(s) to new or existing shareholder(s)...

...whether one-off or facilitated with or without the company's involvement...

...or when a private company repurchases share(s) from existing shareholder(s).

How could a secondary transaction affect a 409a valuation?

Step 1: Carta Valuations conducts an independent appraisal using a acceptable valuation methodology to determine the fair market value (“FMV”) of the company’s common stock.

Step 2: Carta Valuations selects an appropriate weighting to be assigned to the secondary transaction price alongside the FMV determined by Step 1.

An appropriate secondary weighting is based on professional judgement, and there is no quantitative model that outputs a precise secondary transaction weighting.

However, there are several factors that can directionally influence a higher or lower weighting.

Factors that influence the secondary transaction weighting

1) Which share classes were transacted?

Question	Lower weighting*	Higher weighting	Context
Which share classe(s) were transacted in the secondary transaction?	Preferred stock	Common stock	The 409a valuation concludes on the fair market value ("FMV") of common stock, not preferred stock.

*Carta Valuations would not place weighting on the price of preferred stock transacted in a secondary transaction. However, depending on the context associated with the secondary transaction, Carta Valuations may need to review the transaction in some capacity.

2) What is the company's history and plan for future secondary transactions?

Question	Lower weighting	Higher weighting	Context
<p>Was the secondary transaction negotiated alongside a primary transaction of preferred stock?</p>	<p>Yes</p>	<p>No</p>	<p>If the motivation of the buyers to conduct the secondary transaction was limited to their need to invest an amount that would satisfy internal investment mandates, this may cause the transaction to lean towards being defined as non-arm's length. However, Carta Valuations may view the primary transaction and secondary transaction as one combined transaction.</p> <p>Note that if the shares transacted in the secondary transaction were immediately converted into preferred stock, this means that buyers were pricing preferred stock, not common stock.</p>

Question	Lower weighting	Higher weighting	Context
Have any material event(s) occurred following the secondary transaction?	Yes	No	If material event(s) have occurred following the secondary transaction, the transaction may no longer be a relevant indication of value. Repeatable or “programmatic” secondary transactions signal an active and liquid market for a company’s shares.
Was this the company’s first secondary transaction?	Yes	No	
Does the company expect secondary transactions to continue?	No	Yes	
Does the company offer (or intend to offer) recurring, company-sponsored liquidity events?	No	Yes	

3) How was the secondary
transaction price
determined?

Question	Lower weighting	Higher weighting	Context
Was the secondary transaction arm's length?	No	Yes	<p>An arm's-length transaction satisfies multiple, if not all of the following conditions:</p> <ul style="list-style-type: none"> • Term sheets for the transaction were shopped around and / or negotiated. • Buyers had access to financials and other company information and performed due diligence. • The financing was led by sophisticated and / or institutional buyers. • The terms of the transaction did not include either a premium or discount based on strategic initiatives between the buyers and the company.

Question	Lower weighting	Higher weighting	Context
Was the company involved in the secondary transaction?	No	Yes	The company's involvement in the transaction improves the quality of the information provided to buyers and sellers.
Were there multiple secondary transactions with inconsistent prices?	Yes	No	Inconsistent prices indicate a lack of market equilibrium. However, depending on other factors of the secondary transaction(s), a volume-weighted transaction price may be considered.

Question	Lower weighting	Higher weighting	Context
Was the price determined by a prior 409a valuation?	Yes	No	A 409A valuation is a compliance document that determines the fair market value (“FMV”) of a company’s common stock, and is utilized by a company to issue stock options.
Was the price set equal to the price of preferred stock in the company’s recent primary financing?	Yes	No	Preferred stock have rights and preferences not afforded to common stock. Accordingly, the price of preferred stock may not be indicative of the value for common stock.
Was the price based on the company’s recent convertible debt financing?	Yes	No	The valuation associated with a convertible debt financing may not be indicative of the valuation associated with common stock.

4) What are the details of the buyers?

Question	Lower weighting	Higher weighting	Context
Were there any new investors?	No	Yes	New investors provide a fresh perspective on the company, thereby causing the transaction to lean towards being defined as arm's length.
Were the buyers primarily current employees and / or board members at the company?	Yes	No	Employees and board members have a vested interest in the company, thereby causing the transaction to lean towards being defined as non-arm's length.
Was there a concentrated majority of buyers?	Yes	No	A concentration of buyers signals a lack of market competition and shopping around for the best terms, thereby causing the transaction to lean towards being defined as non-arm's length.

Question	Lower weighting	Higher weighting	Context
<p>Was the motivation of the buyers to invest an amount that would satisfy their internal investment mandates? In this situation, the secondary transaction is usually conducted alongside a primary transaction of preferred stock.</p>	<p>Yes</p>	<p>No</p>	<p>If the motivation of the buyers to conduct the secondary transaction was limited to their need to invest an amount that would satisfy internal investment mandates, this may cause the transaction to lean towards being defined as non-arm's length.</p>

Question	Lower weighting	Higher weighting	Context
<p>Was the motivation of the secondary transaction to compensate employees? In this situation, the secondary transaction is oftentimes a repurchase made by the company.</p>	<p>Yes</p>	<p>No</p>	<p>If the company's intention for the secondary transaction was to compensate employee shareholders (for example, to provide liquidity at a favorable price to assist with recruiting or retention or in connection with a severance agreement), then the transaction price may not represent a negotiated price that reflects fair value.* In this situation, the company typically withholds employee taxes that were created as a result of the secondary transaction.</p>

*If the company concludes that the fair value of the shares is lower than the price that the company or its investors paid to purchase shares from an employee, the difference between the transaction price and the fair value of the shares would typically be considered to be additional compensation cost for financial reporting purposes, unless there was another pre-existing relationship between the buyer and the seller that provides a rationale for the excess payment. Please see FASB ASC 718-20-35-7 and FASB ASC 718-10-15-4 for additional discussion.

5) What are the details of the sellers?

Question	Lower weighting	Higher weighting	Context
Were all employees eligible to sell?	No	Yes	A 409A valuation determines the fair market value (“FMV”) of a company’s common stock for “rank-and-file” employees. If all employees were eligible to participate in the secondary transaction, the secondary transaction price becomes a more applicable indication of value.

6) What restriction(s) were imposed on the buyers and sellers?

Question	Lower weighting	Higher weighting	Context
Was the seller supply distributed to buyers pro rata, or with preferential access to a subset of buyer(s).	Preferential access	Pro rata	A concentration of buyers signals a lack of market competition and shopping around, thereby causing the transaction to lean towards being defined as non-arm's length.

Question	Lower weighting	Higher weighting	Context
Were there restrictions on the sellers?	Yes	No	<p>The greater the seller restrictions, the lower the weighting.</p> <p>Seller restrictions for a structured secondary transaction often include the following:</p> <ol style="list-style-type: none"> 1. Share cap based percentage of vested shares. 2. Dollar cap based on intended offering size. 3. Minimum tenure requirements. 4. Minimum job level requirements (e.g. "Director" level and above). 5. Allowing only former or only current employees to participate.

7) What was the size of the transaction?

Question	Lower weighting	Higher weighting	Context
<p>Was the size of the transaction small relative to the company's value, the company's total fully diluted share count, and / or relative to the size of a corresponding primary transaction of preferred stock?*</p>	<p>Yes</p>	<p>No</p>	<p>A small transaction may be relatively one-off, but could still be considered in determining the fair market value ("FMV") of a company's common stock. For example, a small amount of shares are transacted on public markets relative to all public shareholdings, and those trading prices are accepted as market values, given that they are based on a market equilibrium.</p>

*A "small" secondary transaction is generally considered to represent < 1% of the company's value, < 1% of the company's total fully diluted share count, and / or < 1% of the corresponding primary transaction of preferred stock.

Summary

Factor	Question	Lower weighting	Higher weighting
1) Which share classes were transacted?	Which share classe(s) were transacted in the secondary transaction?	<input type="radio"/> Preferred stock	<input type="radio"/> Common stock
2) What is the company's history and plan for future secondary transactions?	Was the secondary transaction negotiated alongside a primary transaction of preferred stock?	<input type="radio"/> Yes	<input type="radio"/> No
	Have any material event(s) occurred following the secondary transaction?	<input type="radio"/> Yes	<input type="radio"/> No
	Was this the company's first secondary transaction?	<input type="radio"/> Yes	<input type="radio"/> No
	Does the company expect secondary transactions to continue?	<input type="radio"/> No	<input type="radio"/> Yes
	Does the company offer (or intend to offer) recurring, company-sponsored liquidity events?	<input type="radio"/> No	<input type="radio"/> Yes

Factor	Question	Lower weighting	Higher weighting
3) How was the secondary transaction price determined?	Was the secondary transaction arm's length?	<input type="radio"/> No	<input type="radio"/> Yes
	Was the company involved in the secondary transaction?	<input type="radio"/> No	<input type="radio"/> Yes
	Were there multiple secondary transactions with inconsistent prices?	<input type="radio"/> Yes	<input type="radio"/> No
	Was the price determined by a prior 409a valuation?	<input type="radio"/> Yes	<input type="radio"/> No
	Was the price set equal to the price of preferred stock in the company's recent primary financing?	<input type="radio"/> Yes	<input type="radio"/> No
	Was the price based on the company's recent convertible debt financing?	<input type="radio"/> Yes	<input type="radio"/> No

Factor	Question	Lower weighting	Higher weighting
4) What are the details of the buyers?	Were there any new investors?	<input type="radio"/> No	<input type="radio"/> Yes
	Were the buyers primarily current employees and / or board members at the company?	<input type="radio"/> Yes	<input type="radio"/> No
	Was there a concentrated majority of buyers?	<input type="radio"/> Yes	<input type="radio"/> No
	Was the motivation of the buyers to invest an amount that would satisfy their internal investment mandates? In this situation, the secondary transaction is usually conducted alongside a primary transaction of preferred stock.	<input type="radio"/> Yes	<input type="radio"/> No
	Was the motivation of the secondary transaction to compensate employees? In this situation, the secondary transaction is oftentimes a repurchase made by the company.	<input type="radio"/> Yes	<input type="radio"/> No

Factor	Question	Lower weighting	Higher weighting
5) What are the details of the sellers?	Were all employees eligible to sell?	<input type="radio"/> No	<input type="radio"/> Yes
6) What restriction(s) were imposed on the buyers and sellers?	Was the seller supply distributed to buyers pro rata, or with preferential access to a subset of buyer(s).	<input type="radio"/> Preferential access	<input type="radio"/> Pro rata
	Were there restrictions on the sellers?	<input type="radio"/> Yes	<input type="radio"/> No
7) What was the size of the transaction?	Was the size of the transaction small relative to the company's value, the company's total fully diluted share count, and / or relative to the size of a corresponding primary transaction of preferred stock?	<input type="radio"/> Yes	<input type="radio"/> No

Examples

Structure “W”

First secondary transaction of Founder stock

The company’s CEO / Founder is planning to sell 20% of their interest in the company to an existing investor. The purchase price is based on the company’s last primary transaction of preferred stock – which occurred six months prior to the anticipated secondary transaction – with no adjustments made for the company’s performance and macroeconomic events. The shares expected to be transacted represent about 1% of the company’s fully diluted capitalization. This will be the company’s first secondary transaction.

Weighting

This secondary transaction is limited to the company’s CEO / Founder and one existing investor, will be the company’s first secondary transaction, and will be priced based on a historical primary transaction of preferred stock with no adjustments. Accordingly, this transaction would likely receive low to no weighting. However, the non-insignificant size relative to the company’s fully diluted share count may justify movement upwards on the weighting.

Structure “X”

Company-facilitated secondary transaction

The company is planning to facilitate a \$200M tender transaction. All current and former employees are eligible to sell common stock up to the lesser of a) 15% of their vested holdings or b) \$1M. The buyers include existing investors and one new investor. The new investor will purchase the first \$50M, with the remaining \$150M split pro rata between existing investors and the new investor. The purchase price is based on the company’s last primary transaction of preferred stock, at an implied post-money of \$1.2B, with adjustments made for the company’s performance and macroeconomic events.

Weighting

This secondary transaction is large in size relative to the company’s value, open to all employees with customary restrictions, and involved a new investor with negotiation conducted to determine the purchase price. Accordingly, this transaction would likely receive a higher weighting. However, the measurable restrictions, concentration of buyers, and having the purchase price based on a primary transaction of preferred stock may justify movement downwards on the weighting.

Structure “Y”

Secondary transaction alongside a primary transaction of preferred stock

The company expects to sell \$150M of preferred stock in a primary transaction, and will allow a subset of investors to purchase up to \$50M of common stock from employees at the same price as preferred. All employees with a minimum tenure of one year are eligible to sell up to \$5M of their vested holdings. The secondary transaction will be facilitated pro rata across eligible buyers and sellers. The motivation of the buyers was predicated on their desire to own a greater equity stake in the company with the intent to maximize their potential upside. All common shares transacted in the secondary transaction may immediately be converted into preferred stock following the transaction, but that has yet to be determined.

Weighting

This secondary transaction is large in size relative to the corresponding primary transaction of preferred stock, open to a large group of employees, will be facilitated pro rata across eligible buyers and sellers, and the motivation of the buyers was not to invest an amount that would satisfy their internal investment mandates. Accordingly, assuming that the common shares transacted were not immediately converted into preferred stock, this transaction would likely receive a higher weighting. However, the measurable restrictions, and having the purchase price based on a primary transaction of preferred stock, may justify movement downwards on the weighting. **Furthermore, if the common shares transacted were immediately converted into preferred stock, this transaction would likely receive low to no weighting. If the shares transacted in the secondary transaction were immediately converted into preferred stock, this means that buyers were pricing preferred stock, not common stock.**

Structure “Z”

Secondary transaction(s) without the company’s involvement

A group of former employees have been approached by multiple buyers, and over the past six months, ten former employees have sold their shares of common stock to four different buyers at various prices. Each buyer is a savvy, institutional investor, acting independently and without the company’s involvement. The company is unsure of how these prices were determined, but each transaction price appears to approximate the price of the company’s last primary transaction of preferred stock with adjustments made for macroeconomic events. The aggregate share count of the secondary transactions represented about 2% of the company’s fully diluted capitalization.

Weighting

These secondary transactions were limited to a group of the company’s former employees, were conducted without the company’s involvement, and were transacted at various prices approximating the price of the company’s last primary transaction of preferred stock. Accordingly, these transactions would likely receive a lower weighting. However, the multiple buyers, frequency of transactions, adjustments for macroeconomic events, and the the non-insignificant size relative to the company’s fully diluted share count may justify movement upwards on the weighting.

Additional questions?
Contact val-operations@carta.com

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