Startup Founders Embrace 409A Cuts to Gain Recruiting Edge



Art by Mike Sullivan



By Mark Matousek

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Jul 7, 2022, 6:00am PDT

Comments by Jud Valeski and Kenneth Goldman

Between 2016 and 2021, investors boosted the valuation of Sendbird, a communications software startup, to $1.1 billion, from $6.5 million.

This June, a different kind of evaluator gave Sendbird what might have sounded like frightening news: It had determined the startup was worth around 50% less than it had been a year ago. But that conclusion didn't bother John Kim, Sendbird's CEO and a co-founder. If anything, he saw it as positive, he told The Information.

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That's because the harsh opinion came from a company that conducts 409A valuations, appraisals that shape the price at which private companies issue stock options to their employees. Like many founders, Kim prefers a conservative 409A valuation, though one that still represents his company's worth accurately.

The Takeaway

- 409A valuation cuts emerge as a recruiting tool amid tech downturn
- Appraisers expect more off-cycle reviews in second half of 2022
- Next round of regular 409A assessments will see more cuts

The less a 409A provider thinks a startup is worth, the lower the price at which the startup will issue options and the greater the potential profits for employees. While a bullish valuation from venture capitalists sends a powerful signal to potential employees, customers and investors—and makes the startup's founders wealthier on paper—a higher 409A doesn't have the same impact.

409A cuts are likely to spread throughout the tech industry as a recession looms and public stock prices plunge. With venture capitalists becoming more conservative, founders more inclined to conserve cash, and initial public offering prospects less viable, startup employees could see the value of their equity compensation fall, and they may find it harder to negotiate higher salaries.

One high-profile example of a dramatic markdown has ignited the conversation about how 409A valuations are changing and what it means for employees. Instacart, which notched a $39 billion valuation in its most recent fundraise in March 2021, saw its 409A valuation fall 38%, to $24 billion, in March. The Wall Street Journal reported at the time that the grocery-delivery firm told employees they would receive more shares in their annual equity grants as a result of the valuation cut. An Instacart spokesperson declined to comment on when the company plans to go public.

With fewer ways to make their employees' compensation more attractive, other startup CEOs could find lower 409A valuations a valuable tool for recruiting and retention in the second half of this year. Though a new 409A won't cut the price of options they've already issued, it will make future option grants less expensive. It also isn't likely to upset investors, as some told The Information they don't consider the 409A valuation at all when deciding how much they're willing to pay for a startup's shares.

"The 409A is not really a data point that investors use, but what it does help with is retention and attraction of employees," said Kevin Swan, co-head of global private markets for Morgan Stanley at Work, which offers stock plan services including 409A valuations.

The appeal of a lower 409A valuation can be particularly strong for executives. Those who are well versed in the details of equity compensation tend to feel strongly about the price they have to pay to

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convert their options into shares, said Jana Rich, CEO of executive recruiting firm Rich Talent Group. “Our candidates are pretty savvy, and it matters a great deal [to them] because a pretty significant part of their compensation is tied to equity,” Rich said.

That isn’t necessarily the case for all employees, though. While some pay a great deal of attention to the strike price on their options, others don’t, according to founders, venture capitalists and a recruiter who spoke to The Information.

Conservative numbers

Startups tend to receive a 409A assessment from a third-party provider at least once per year, or more often if they experience a significant event like a new funding round. While startups can calculate the fair market value of their shares on their own, many outsource that task to an independent appraiser to reduce the risk that their employees will get hit with tax penalties, said Wendy Moore, a partner at law firm Perkins Coie who works with tech startups. If the Internal Revenue Service determines a company has issued stock options at a price that’s too low, it will make employees pay extra taxes on those options, Moore said.

Still, there are ways for founders to try to get their desired outcome when it comes to 409A valuations. When Paul Canetti, an adjunct assistant professor at Columbia Business School who has founded multiple tech companies, used to ask venture capitalists for money, he would reduce the width of the graphs he showed them to make upward-sloping lines look steeper. But Canetti gave a different kind of pitch to 409A-valuation firms. Where venture capitalists saw Canetti’s hopes and dreams, 409A providers heard everything that could go wrong.

“We would give the 409A folks our more conservative numbers, and we’d give the VCs our most optimistic numbers,” he said, referring to financial projections.

Daniel Eyman—managing director of asset valuation firm Meld Valuation, which performed 409A valuations until early 2021—encountered a number of executives with a mindset similar to Canetti’s. At the beginning of the 409A process, a company will send the valuation provider a variety of documents, including a breakdown of how its equity is distributed, its current finances and its financial projections. To Eyman, it often felt like companies weren’t giving him their most optimistic forecasts.

“When the file’s called ‘Projections for 409A,’ you know they’ve been sandbagged,” he said.

Those efforts to nudge 409A providers toward a lower valuation carry risks, as some employees may interpret a declining 409A as a sign their company is headed in the wrong direction, said Dana Etra, a managing director at compensation consulting firm FW Cook.

Ultimately, it's timing and what's happening with comparable firms that most strongly influence how new valuations shake out. In some cases, companies will pay a 409A firm for a new valuation that isn't tied to their annual schedule or to a major event, but reflects how broader market conditions have impacted them. Eyman said he saw a number of tech firms do this at the beginning of the Covid-19 pandemic.

So far, there hasn't been a wave of companies asking for new 409As outside their normal schedule, valuation providers told The Information, though some, like Morgan Stanley's Swan, have noticed a few startups considering such a move. Swan said he expects to see more off-schedule 409As in the second half of this year.

While public tech stocks have plunged this year amid rising interest rates and slowing growth expectations, the 409A providers said they haven't seen a broad decline in valuations yet. In fact, in May, the median 409A valuation Carta, which offers 409A valuations and other stock plan services, gave among companies that last received an assessment 12 months prior rose 6%, according to data Carta shared with The Information.

Some founders who have recently completed the 409A process, though, have watched their valuations shrink. Kim, the Sendbird CEO and co-founder, said the startup CEOs he has spoken to who have received 409A valuations in the last two months saw their valuations drop 25% to 80%.

"If anyone's up, I would be surprised," Kim said.

—Additional reporting by Sylvia Varnham O'Regan

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Conversation 2 comments

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Jud Valeski
Executive

Such a shame that 409a became standard use. I have yet to meet an analyst/evaluator that can get within 50% of a "startups'" real value. But... everyone

loves a standard. I'd love to see boards buck the trend and stop using 409a's and go back to determining their own value. Yup... there's a lot of risk in doing so, but, I'd bet a dollar everything would pan out just fine.

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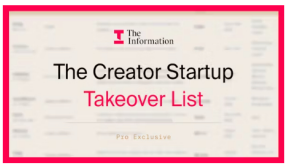
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