STARTUP NV

Women Dreamers & Believers Conference

Presents:

Business Valuation for Early Stage Companies

Who sets valuation?

The valuation put on the business is a critical issue for both the founder and the investor.

Question: Who sets the valuation during negotiations between the company and investors?

Answer:

- The long answer is valuation is a product of negotiations between the company and the investors and there is not one right formula or methodology to rely upon.
- The short answer is that its usually the investors, especially in a more difficult environment.
- But savvy CEOs of companies in hot industries may have negotiating leverage.

Question: So if the VCs are usually the ones to set the valuation, why do they bother to ask the founder about valuation?

Answer:

They want to find out

1) if you've done your **homework**; and,
2) if you can be reasonable.

Homework Lesson: Valuation

Rule #1 of early stage company valuation:

Your company is worth what someone else will pay for it

By arming yourself with both **qualitative** and **quantitative** support, you will have better success negotiating a higher value for your company with potential investors..

How do early stage **investors** think about valuation?

Key factors considered when determining value include:

- Founders
- Company fundamentals
- Size of market opportunity
- Initial traction by the company
- Proprietary technology already developed by the company
- The recurring revenue opportunity of the business model
- The capital efficiency of the business model
- Whether the company is “hot” and being pursued by other investors
- Valuations of comparable companies
- Current economic climate
- **Expected return on investment**

It is important to understand and be able to communicate to potential investors a **realistic path to liquidity for your company**.

VC Expected Return on Investment

The nature of venture funds require VCs to pay close attention to an investment's **expected return**.

- VCs need their **entire portfolio** to return **3.0 x – 5.0 x** over its life...but assume most investments will be losers.

- VCs will generally invest only in those opportunities that will return at least **10.0 x** over a time horizon of 3 to 7 years. They will want to pay only a small percentage of the expected exit value when they invest in a startup.

- Individual angels might accept a lower return or a longer time horizon, particularly if they have a personal interest in or connection to the company.

Estimating Valuation – Expected Return Method

To determine your valuation using an Expected Return Method:

1. Estimate **Exit Value**: how much your company will be worth when you sell the company (exit value).

2. Estimate **Time to Liquidity**: the number of years until the company will be sold.

3. **Discount to PV**: discount the exit value back to the present at an appropriate discount rate to get to the post- money valuation.

4. **Assess Reasonableness** of Potential Investment: Does this valuation make sense?

$$PV = \text{Exit Value} * (1/(1+DR)^{\wedge}t)$$

Where:

PV = present value

DR = discount rate, likely 50% - 100%, to reflect the extremely high level of risk of this investment and the annual return required by the investors

t = time to liquidity

1. Estimate the Exit Value of your Company

- ✓ It is important to understand and be able to communicate to potential investors a **realistic path to liquidity for your company**.
- ✓ Research recent **M&A** in your industry to determine what an acquired company "looks like". Startups may become most attractive to acquirers when they reach a certain size by revenues, profitability, users, or some other metric.
- ✓ Talk to **industry insiders** (CEOs, CFOs, investors, attorneys, bankers, etc.) for clues as to how recent transactions were priced, i.e. EV/revenues.
- ✓ Create a supportable model of projected revenue and profitability over the next 5 years.
- ✓ Apply these metrics to your company's forecast in the exit year to estimate an exit value.

Common ways to calculate exit value are:

= Revenue Multiple x Exit Year Revenues

- OR -

= Profit Multiple x Exit Year Profit

1. Estimate the Exit Value of your Company

Revenue Multiple Range: 0.25 x to 12.0 x Median: 6.0 x

- Dying companies are at the low end, high-flyers at the high end, what's the realistic range?
- Don't depend on medians/averages or very high outliers, unless they are directly relevant.
- After research and analysis, we selected **4.0 x**

Exit Year Revenues: **$25.0 million**

- Supported by business plan and market analysis

Where can I obtain revenue or profit multiples:

- *Free Trial of Capital IQ or Pitchbook*
- *Hire advisor on hourly consulting basis*
- *Calculate the old fashioned way – with market data and 10Ks and 10Qs*

Exit Value = Revenue Multiple x Exit Year Revenues

= 4.0 x * $25.0 million = $100.0 million

Remember, your company is more likely to get a higher multiple with higher revenues, and more likely to get a lower multiple with lower revenues.

2. Estimate the Time to Liquidity

- It should fit in with the investor’s investment horizon, typically 3-7 years.

- Should allow enough time to grow enough to be an attractive candidate for exit.

3. Discount to Present Value

Discount the exit value back to the present value at an appropriate discount rate over the selected time horizon to liquidity.

Present Value = **Exit Value** * (1/(1+**DR**)^**t**)

Where:

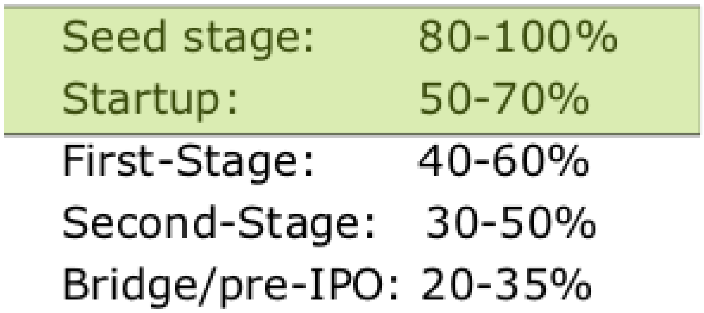
PV = present value

DR = discount rate, likely 50% - 100%, to reflect the extremely high level of risk of this investment and the annual return required by the investors

t = time to liquidity

VC Rates of Return

General guidelines for discount rates based on studies of VC rates of return:



Seed stage:	80-100%
Startup:	50-70%
First-Stage:	40-60%
Second-Stage:	30-50%
Bridge/pre-IPO:	20-35%

1. Based on three studies. These studies are old, yet the results generally seem to hold today.
Plummer, James L., QED Report on Venture Capital Financial Analysis, Palo Alto: QED Research, Inc., 1987.
Scherlis, Daniel R. and William A. Sahlman, "A Method for Valuing High-Risk, Long Term, Investments: The Venture Capital Method," Harvard Business School Teaching Note 9-288-006, Boston: Harvard Business School Publishing, 1989. 17 Sahlman, William A. and Howard H. Stevenson, Amar V. Bhide, et al...., “Financing Entrepreneurial Ventures,” Business Fundamental Series, Boston: Harvard Business School publishing, 1998.

- A seed stage company has no or minimal revenues.
- A start-up company has a product and has begun generating revenues.
- A first-stage company has gained some traction.
- A second-stage company has solid traction, loyal customers, and more predictable year-over-year or recurring revenues.
- A bridge/pre-IPO company is planning an exit.

Pulling It All Together

1. **Estimated Exit Value = $100 million**
2. **Time to Liquidity = 5 years**
3. **Discount Rate** = **60%** (first stage)

Present Value = **Exit Value** * (1/(1+**DR**)^**t**)

= ($100 mm)*(1/(1+.60)^5)

≈ $9.5 million

Post-Money Value = $9.5 million

Investment (Raise) = $3.0 million

(Implied) Pre-Money Value = $6.5 million

□ **Each of the above assumptions must be realistic!**

□ **Be prepared to justify your time to liquidity and exit value assumptions to potential investors.**

Can this valuation work?

Post-Money Value = $9.5 million
Investment (Raise) = $3.0 million
(Implied) Pre-Money Value = $6.5 million

Investor Stake (%) = Raise / Post-money value

= $3.0M / $9.5M

≈ **31%** = reasonable √

If it doesn't work, revisit your original assumptions:

- ✓ Is your **exit value** too high?
- ✓ Did you choose a high enough **discount rate** for your company's current stage of development?
- ✓ Is your **time to liquidity** assumption realistic?
- ✓ Are you trying to raise the right amount of money?

Summing It Up

For early stage companies, qualitative factors are very important.

However, when you **do your homework** and combine qualitative with **quantitative analysis and market research**, you will strengthen your position for negotiating with potential investors.

PROFESSIONAL BIOGRAPHY

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Kristin Fox serves as Director of Business Development for Vantage Point Advisors. As Director of Business Development, Ms. Fox is responsible for leading the firm's business development efforts and nurturing client relationships.

Ms. Fox has spent over 20 years in the financial services industry and has significant expertise in performing valuations of businesses and business interests for a variety of purposes including transactions, financial reporting, tax restructuring, corporate planning, litigation support, and gift and estate tax purposes. She is well versed in numerous industries including business and consumer services, consumer products, food and beverage, restaurants, chemicals, automotive, industrial machinery, hospitality, and healthcare.

Prior to joining Vantage Point Advisors, Ms. Fox served as a Director for Cabrillo Advisors, Inc., consulting with middle-market companies, emerging growth businesses and high net worth individuals. She has also held senior-level positions with BDO USA, LLP as well as American Appraisal Associates, Inc. (acquired by Duff & Phelps.) She holds the Accredited Senior Appraiser (ASA) designation and USPAP Certified Appraiser as awarded by the American Society of Appraisers. Ms. Fox is a graduate of DePaul University in Chicago, IL with a Bachelor of Science in Commerce (Major in Finance).

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Resources

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