

# Ten Top Techniques for Startup Valuation

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Once you have a potential investor excited about your team, your product, and your company, the investor will inevitably ask “What is your company’s valuation?” Many entrepreneurs stumble at this point, losing the deal or most of their ownership, by having no answer, or quoting an exorbitant and indefensible number that convinces the investor that you don’t understand basic economics.

This is a particularly difficult challenge for early-stage companies, looking for their first Angel funding round, since they are likely to have very few assets, very few customers, and only a trickle of revenue. The founders need money, but aren’t ready to give up majority ownership, yet the investor needs to have ownership quantified to rationalize a traditionally high risk investment.

Let’s consider a hypothetical example. Two founders of a new health-care web site company named NewCo have spent \$200K of personal and family funds over a one year period to start the company, get a prototype site up and running, and have already generated some “buzz” in the Internet community. The founders now need a \$1M Angel investment to do the marketing for a national NewCo rollout, build a team to manage blogs and other resources, and maybe even pay themselves a salary.

How much is NewCo worth to investors at this point (pre-money valuation)? What percentage of NewCo does the investor own after the \$1M infusion (post-money ownership percentage)? Well, if the parties agree to a pre-money valuation of \$1M, then the post-money investor ownership is 50% (founders give up half interest, and lose control). On the other hand, if the pre-money valuation is \$4M, the founders ownership remains at a healthy 80% level.

So what magic can the founders use to justify a \$4M valuation (or even the \$1M valuation) at this early stage? Here are a list of tips and techniques that I recommend to every startup:

1. Place a fair market value on all physical assets (asset approach)

This is the most straightforward valuation element, often called the asset approach. New businesses normally have fewer assets, but it pays to look hard and count everything you have. Sometimes founders forget to include all the computer equipment they bought or upgraded to get the business started. Be sure to include office space, office equipment, furniture, tools, and the value of inventory or prototype products, including development costs. From this point forward the valuation gets more subjective.

2. Assign real value to intellectual property

The value of patents and trademarks is not certifiable, especially if you are only at the provisional stage. Yet the fact that you have filed is very positive, and puts you many steps ahead of others who may be stepping into the same area. A “rule of thumb” often used by investors is that each patent filed can justify \$1M increase in valuation.

If you are incorporated, then your company name is also protected. If you have acquired a marketing-oriented Internet domain name, and some trademarks, these also give you a competitive head start. You should make the case that these together are also worth as much as the real assets in the valuation process.

3. All principals and employees add value

Assign value to all paid professionals, as their skills, training, and knowledge of your business technology is very valuable. Back in the “heyday of the dot.com startups,” it was not uncommon to see a valuation incremented by \$1M or every paid full-time professional programmer, engineer, or designer.

Don't forget to include the “sweat equity” for unpaid efforts of founders and executives. If NewCo's two founders have been working for a year each on this company, that fact could be factored in as if they had been paid a conservative salary of \$100K each per year.

If the management team has successfully built a company like this before, and has deep domain knowledge, a sizeable premium for “strength of the management team” should be added.

4. Early customers and contracts in progress add value

Monetize the value of existing customer relationships and contracts, even contracts which haven't yet been signed. Assign probabilities to active customer sales efforts, just as sales managers do in quantifying a salesman's forecast. Highlight any recurring revenues, like subscription fees, that don't have to be sold from scratch each time.

5. Use discounted cash flow (DCF) on revenue projections (income approach)

In finance, the discounted cash flow (DCF) or income approach describes a method of valuing a company using the concepts of the time value of money. All future cash flows are estimated and discounted to give them a present value. The discount rate used is the appropriate cost of capital, and incorporates judgments of the uncertainty (riskiness) of the future cash flows. The discount rate typically applied to startups may vary anywhere from 30% to 60%, depending on maturity and the level of credibility you can garner for the financial estimates.

Without getting into all the mathematics, what you are looking for is the net present value (NPV) of your ability to produce future revenues as projected, factored by the risk in your plan. There are several of these interactive calculators available via the Internet to explore the concept without hiring a CPA.

For example, if NewCo is projecting revenues of \$25M in five years, even with a 40% discount rate, your NPV or current valuation comes out to about \$3M.

6. Multiple of discretionary earnings (earnings multiple approach)

This approach is usually applied to a more mature startup – one that has at least a couple of years of full operation, and has already passed the breakeven point. If you are still losing money, skip ahead to the cost approach.

If you are doing well, you can estimate your company's valuation by multiplying earnings before interest, taxes, depreciation and amortization (EBITDA) by some multiple. A target multiple can be taken from industry average tables, or derived from scoring key factors of the business, and averaging the results, with the final average called the “multiple”. The industry tables, factors to

assess, and the scoring process are available via several web sites, and software products are available to do the work if you like.

A variation on this theme is to look at future earnings, rather than current earnings, and apply a “backward multiplier.” Investors want successful deals to return at least ten times their original investment. Roughly speaking, if a deal looks promising, they will try to estimate what the company will be worth in five years and then divide that figure by ten to arrive at the current valuation.

7. Calculate replacement cost for key assets (cost approach)

The cost approach is employed to great effect on difficult or unprofitable businesses. It attempts to measure the net value of the business today by calculating how much it could cost for a new effort to replace key assets. Most investors track the investment funds and measure the profit making potential of that investment. Under the umbrella of the cost approach, it makes sense to use the replacement value to estimate the current market value of the enterprise.

If NewCo has developed 10 online tools and a fabulous web site over the past two years, how much would it cost another company to create similar quality tools and web interfaces with a conventional software team? \$2M might be a low estimate.

8. Find “comparables” who have received financing (market approach)

Another popular method to establish valuation for any company is to search for similar companies that have recently received funding. This is often called the market approach, and is similar to the common real estate appraisal concept that values your house for sale by comparing it to similar homes recently sold in your area.

Usually you can find online investor sites with the relevant information on recent funding activity. If you can't find the relevant information in the public domain, you may need to ask your business advisors to query their investor friends. There are also professional valuation consultants who can certainly help you in this regard, for a price.

Don't forget the old real estate adage of “location, location, location”. If you and your business are physically located in just the right place at the right time (nothing like being next door to a major supplier or customer), then be sure to include this factor into your valuation estimate.

9. Look at the size of the market, and the growth projections for your sector

The bigger the market, and the higher the growth projections are from analysts, the more your startup is worth. For this to be a premium factor for you, your target market should be at least \$500 million in potential sales if the company is asset-light, and \$1 billion if it requires plenty of property, plants and equipment.

In the investment community, this premium factor is called “goodwill” (also applied for a premium management team, few competitors, high barriers to entry, etc.), and goodwill can easily account for a couple of million in valuation.

10. Assess the number of direct competitors and barriers to entry

Competitive market forces also can have a large impact on what valuation this company will garner from investors. If you can show a big lead on competitors, you should claim the “first mover” advantage. Investors look for a big enough window of opportunity for a company to generate profits before competitors swoop in and crimp margins. On the other hand, if there are more than three similar competitors, that's a bad sign, and will hurt your valuation.

If you can show that your competitors have large “barriers to entry”, this also may qualify you for a premium valuation. Barriers to entry represent unique circumstances that thwart competitors’ attempts from entering the target market and capturing a major market share. Such barriers include unique people skills, government regulations, market share, partnerships, recognized brand name, economic and market conditions, existing customer relationships, and many others.

In summary, you can see that startup valuations always start with real financial data which you should be ready to provide. The analysis then extends into many subjective areas, so be prepared with own your assessment already summarized in your Financial Model. Be aware that most investors follow a set of pragmatic solutions, more art than science, and only the experienced investor will even understand or appreciate some of the approaches discussed above.

Even if a given investor excludes some of the above components of value from consideration in your case, your credibility will be bolstered by the fact that you understand his business as well as yours. In any case, the analysis will prepare you for the heavy negotiation to follow. Remember that precision is not the issue here – the task for the entrepreneur is to build a company that is worth at least \$50M before thinking about an exit -- so no investor wants to spend more than five minutes arguing the fine points of the last valuation dollar.

In any case, flexibility is the key message you want to convey -- along with the fact that your primary interest is launching the startup about which you are passionate, and while changing the world through this startup you also intend to make a great deal of money for yourself and for the investor. The ideal scenario is that both parties exit the negotiation believing that the deal is fair, although they would have both liked to have received more value on their side of the deal. At the outset it is important to remember that it will be much better to own a smaller percentage of a large success than a large percent of a startup that doesn't get off the ground.

So what is a reasonable valuation for a company like NewCo? My advice for early-stage companies like this one is to target their valuation somewhere between \$1.5M and \$5M. A lower number suggests that the founders are giving away the company, while a much higher number may suggest hubris or lack of reality on the part of the owners. Of course, we have all read about the “new” company with \$100M valuation, but I haven't met one yet.

### **About the author**

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