Valuation of a Start-up

What Are Startup Valuation Methods?

- Startup valuation methods are the ways in which a startup business owner can work out the value of their company.
- These methods are important because more often than not startups are at a pre-revenue stage in their life-span so there aren't any hard facts or revenue figures to base the value of the business on.
- Because of this guesswork, an estimation has be to be used, which is why several startup valuation method frameworks have been invented to help a startup business more accurately guess their valuation.

What determines a startup value?

Positive Factors:

- **Traction** – One of the biggest factors of proving a valuation is to show that your company has customers. If you have 100,000 customers you have a good shot at raising $1 million.
- **Reputation** – If a startup owner has a track record of coming up with good ideas or running successful businesses, or the product, procedure or service already has a good reputation a startup is more likely to get a higher valuation, even if there isn't traction.
- **Prototype** – Any prototype that a business may have that displays the product/service will help.
- **Supply and Demand** – If there are more business owners seeking money than investors willing to invest, this could affect your business valuation. This also includes a business owner's desperation to secure an investment, and an investors willingness to pay a premium.
- **Distribution Channel** – Where a startup sells its product is important, if you get a good distribution channel the value of a startup will be more likely to be higher.
- **Industry** – If a particular industry is booming or popular (like mobile gaming) investors are more likely to pay a premium, meaning your startup will be worth more if it falls in the right industry.

What determines a startup value?

Negative Factors:

- **Poor Industry** – If a startup is in an industry that has recently shown poor performance, or may be dying off.
- **Low Margins** – Some startups will be in industries, or sell products that have low-margins, making an investment less desirable.
- **Competition** – Some industry sectors have a lot of competition, or other business that have cornered the market. A startup that might be competing in this situation is likely to put off investors.
- **Management Not Up To Scratch** – If the management team of a startup has no track record or reputation, or key positions are missing.
- **Product** – If the product doesn't work, or has no traction and doesn't seem to be popular or a good idea.
- **Desperation** – If the business owner is seeking investment because they are close to running out of cash.

Why are Startup Valuation Methods Important?

- When an early stage investor is trying to decide if they should make an investment into a startup he will guess what the likely exit size will be for that startup of a type, and in a specific industry. If a business owner has used methods to show their startup is worth a high amount that investor is likely to invest more into the company.
- Using these methods or frameworks is also important because startup companies lack reliable past performance and predictable future performance that most established businesses use to estimate their value so having a way to guess a valuation is useful, even if it is all guesswork and predictions.
- Ideally, a business owner should use several startup valuation methods to get the most accurate valuation possible. A business owner will want all of the valuations they come to from each of the methods to be within a sensible average.
- For example a startup trying to secure 'seed' investment will offer **10 percent of the company for $100,000**. This values the company at **$1,000,000** but that doesn't necessarily mean it is actually worth $1,000,000 but the startup is suggesting to the investor that there is a potential for the company to be worth that figure after growth and investment.

The Most Popular Startup Valuation Methods

There are many different methods used in deciding on a startup's valuation, while all of them differ in some way, they are all good to use.

- Venture Capital Method
- Berkus Method
- Scorecard Valuation Method
- Risk Factor Summation Method
- Cost-to-Duplicate Method
- Discounted Cash Flow Method
- Valuation By Stage Method
- Comparable Method
- The Book Value Method
- First Chicago Method

Venture Capital Method

- The Venture Capital Method (VC Method) is one of the methods for showing the pre-money valuation of pre-revenue startups. The concept was first described by Professor Bill Sahlman at Harvard Business School in 1987.
- **It uses the following formulas:**
  - Return on Investment (ROI) = Terminal (or Harvest) Value ÷ Post-money Valuation
  - Post-money Valuation = Terminal Value ÷ Anticipated ROI
  - Terminal (or Harvest) value is the startup's anticipated selling price in the future, estimated by using reasonable expectation for revenues in the year of sale and estimating earnings.

Berkus Method

- The Berkus Method assigns a range of values to the progress startup business owners have made in their attempts to get the startup off of the ground. The following table is the up to date Berkus Method:

If Exists:	**Add to Company Value up to:**
Sound Idea *(basic value)*	$1/2 million
Prototype *(reducing technology risk)*	$1/2 million
Quality Management Team *(reducing execution risk)*	$1/2 million
Strategic relationships *(reducing market risk)*	$1/2 million
Product Rollout or Sales *(reducing production risk)*	$1/2 million

Scorecard Valuation Method

- The Scorecard Valuation Method uses the average pre-money valuation of other seed/startup businesses in the area, and then judges the startup that needs valuing against them using a scorecard in order to get an accurate valuation
- The first step is to find out the average pre-money valuation of pre-revenue companies in the region and business sector of the target startup
- The next step is to find out the pre-money valuation of pre-revenue companies using the Scorecard Method to compare.
- The final step is to assign a factor to each of the above qualities based on the target startup and then to multiply the sum of factors by the average pre-money valuation of pre-revenue companies

Risk Factor Summation Method

The Risk Factor Summation Method compares 12 elements of the target startup to what could be expected in a fundable and possibly profitable seed/startup using the same average pre-money valuation of pre-revenue startups in the area as the Scorecard method.

The 12 elements are,

- Management
- Stage of the business
- Legislation/Political risk
- Manufacturing risk
- Sales and marketing risk
- Funding/capital raising risk
- Competition risk
- Technology risk
- Litigation risk
- International risk
- Reputation risk
- Potential lucrative exit

Cost-to-Duplicate Method

- This approach involves looking at the hard assets of a startup and working out how much it would cost to replicate the same startup business somewhere else. The idea is that an investor wouldn't invest more than it would cost to duplicate the business.
- For example if you wanted to find the cost-to-duplicate a software business, you would look at the labour cost for programmers and the amount of programming time that has been used to design the software.
- The big problem with this method is that it doesn't include the future potential of the startup or intangible assets like brand value, reputation or hotness of the market.
- With this is in mind, the cash-to-duplicate method is often used as a 'lowball' estimate of company value

Discounted Cash Flow (DCF) Method

- This method involves predicting how much cash flow the company will produce, and then calculating how much that cash flow is worth against an expected rate of investment return. A higher discount rate is then applied to startups to show the high risk that the company will fail as it's just starting out.
- This method relies on a market analyst's ability to make good assumptions about long term growth which for many startups becomes a guessing game after a couple of years.

Valuation by Stage

- The valuation by stage method is often used by angel investors and venture capital firms to come up with a quick range of startup valuation.
- This method uses the various stages of funding to decide how much risk is still present with investing in a startup. The further along a business is along the stages of funding the less the present risk. A valuation-by-stage model might look something like this:
- Estimated Company Value Stage of Development $250,000 - $500,000
- Has an exciting business idea or business plan $500,000 - $1 million
- Has a strong management team in place to execute on the plan $1 million – $2 million
- Has a final product or technology prototype $2 million – $5 million
- Has strategic alliances or partners, or signs of a customer base $5 million and up
- Startups with just a business plan will receive a small valuation, but that will increase as they meet developmental milestones.

Comparable Method

- This method is to literally look at the implied valuations of other similar startups, factoring in other ratios and multipliers for things that may not be similar between the two businesses.
- For example, if Startup A is acquired for $7,500,000, and its website had 250,000 active users, you can estimate a valuation between the price of the startup and the number of users, which is $30/user.
- Startup B might have 125,000 users which would then allow it to use the same multiple of $30/user to reach a valuation of $3,750,000

The Book Value Method

This method is based solely on the net worth of the company. i.e. the tangible assets of the company. This doesn't take into account any form of growth or revenue, and is usually only applied when a startup is going out of business.

First Chicago Method

- This method factors in the possibility of a startup really taking off, or really going badly. To do this it gives a business owner three different valuations
- Worst case scenario
- Normal case scenario
- Best case scenario