Valuation of Startups

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*It has yet to be proven that intelligence has any survival value.*

Arthur C. Clarke

*2 is not equal to 3, not even for large values of 2.*

Grabel's Law
On True Entrepreneurs

• A true entrepreneur does not need capital:
  • HP started with $538 in 1938, Microsoft & Apple capital was $5000 in the 1970s
  • DEC-Gen Doriot $70K 1957-> $350m 1971
• All you need is a customer
  – Paul Allen on Microsoft – IBM
  – Mail Order – UPS in the USA
No Investor – No Value

• Liquidation value = net assets – full liabilities
• Most companies have net nil or negative value. Assets are realized at a fraction but liabilities have to be paid out in full.
• Build your value by:
  – Get investment – prove yourself to investors
  – Build a track record of financial performance
  – Exit by Private Trade Sale or Public Listing
  – The real company value only known at exit
Progression of Investors

- Founders: keep records & ensure legal separation
- Family, Friends & Fools
- Doctors & Dentists
- Angels
- Lead Venture Capitalist
- Other VCs → due diligence by referral
- Government Funding
- Warning: syndicate to keep no of shareholders < 10
Stage Definition

- Seed
- Startup
- Early Stage
- Expansion
- Management Buy-Out/Mature/Exit
Exit Strategy @ Silicon Valley

• 20,000 enterprises
• 15,000 – 16,000 fail (75%-80% failure rate)
• 3,000 – 4,000 trade sales (15%-20%)
• 300 NASDAQ IPOs (<2% make it to IPO)
• IPO strategies
  – Immediately – founders known in industry
  – After proven financial performance
Approaches to Valuation

1. The **market approach** – comparative – suitable when value yet another dot.com;

2. the **income approach** - recognizes future earnings by calculating the present value of projected cash flows at a reasonable present value discount rate.

3. and the **asset-based** approach – results in the lowest valuation based on expenditure.
Valuation Jargon

1. **Financing Round**: Seed, First, Second, Third, Mezzanine and IPO

2. **Pre-Money Valuation**: post-money valuation of a company at a financing round minus the amount raised at that round.

3. **Step-Up in Value**: increase in pre-money valuation between two financing rounds e.g. $10m/$2m = x5

4. **Return on Capitalization (ROC)**: annualized change, or growth, in pre-money market capitalization between two rounds.
Valuation Dilemma

• Economic Profit = Invested Capital x (ROIC – Opportunity Cost of Capital)
• How do you forecast ROIC when a startup has no revenue, next to nil physical assets, good will as premium on valuation and IP?
• Partial answer: V&V measurable milestones
• Minimum ROIC for startups: 40% (30% risk of having to write-off investment altogether)
Myths v Reality

- Ideas are worth millions – ideas are an unpaid prerequisite – VCs invest in implemented ideas
- NASDAQ is about dot.coms
- Granted clusters of patents in key markets may be worth millions
- 90% of NASDAQ is about true blue chips with 15+ to 100 years of proven financial performance, years of high profitability and massive protected intellectual property: IBM, AT&T, Cisco, Microsoft, HP, Sun ..
Insight into Patents

• Cost: Provisional $2K → International Search $20K → National Granted $30K → Global $400K → global cluster of patents $multi-million

• IP protection is a major business function

• Patents are a CSF for many Australian success stories: Cochlear, ResMed, Orbital Engine and Metal Storm

• Utility required but no $value is necessary

• Watch: IP assignment to company & no sharing

• 5+ years provisional → intntl search → pending national → granted national → global cluster
What’s behind VC’s 20%+ IRR?

• Vast differences in VC performance:
  – A quarter of VCs lose their funds
  – A quarter of VCs barely maintain funds
  – A quarter of VCs gain commercial bank interest
  – A quarter of VCs have 30%+ IRRs

• For each ten investments: 3 Dogs , 4 Walking Dead, 2 Cash Cows and 1 Home Run = the reason why you are a VC
Bell Mason Diagnostics

By Gordon Bell DEC & Heidi Mason Regis McKenna

When you can measure what you are speaking about, and express it in numbers, you know something about it: but when you cannot express it in numbers, your knowledge is of a meagre and unsatisfactory kind: it may be the beginning of knowledge, but you have scarcely, in your thoughts, advanced to the stage of science.

-William Thompson, Lord Kelvin 1882-1907)  
*Popular Lectures and Addresses, 1891-94*
The 4 Elements of Bell-Mason

The four major elements of the Bell-Mason Diagnostic include:

1. The five stages of company growth
2. The twelve dimensions that are measured to assess a start-up
3. The rules used to evaluate each dimension
4. A relational graph plotted against the ideal model for success
The Twelve Dimensions

• The twelve dimensions are grouped into 4:
  – Technology/Engineering, Manufacturing and Product
  – Business plan, Marketing and Sales
  – CEO, Team and Board of Directors
  – Cash, Finance-ability and Operations/Control
Bell-Mason Dimensions - Stages
Figure 10-3. Flowchart of the Stages of Growth for a Start-up, Including the Criteria for Moving Among the Stages.
Process

1. Approach
2. Offer
3. Need
4. Claims
5. Due Diligence
6. Key Terms
7. Negotiation and Deal
Approach

– Best startups are approached
– Passive 2nd Board Advertising: ASX e.m .. IPO.com
– Conferences as pickups for date
– Well promoted sophisticated web-sites
– Universal Law of <= 6 Degrees of Separation
– Do your homework: no unsolicited approaches
– More than 90% of proposals rejected on approach and many due to primitive approach
– Thorough analysis of your investor(s) is critical before you make your 1st move
Offer

• Presentations – meet the key people
• NDA+schedule, business plan & financials
• Quality and timeliness of obtaining an up-to-date Information Memorandum
• VC’s level of good will is very high at the beginning and decreases exponentially over time. Be prepared. You cannot buy time lost
• VCs spend >80% waiting for startups to act.
Need

• Be specific about the need for investment
• Needs are not questioned at the beginning
• Need determines investment
• Equity = Investment/Valuation
• Lead VC equity =>25% and <=50%
• If $1m need, valuation =>$2m and <=$4m
• If justified, AusIndustry can match $ for $
Claims

• Self-critique & integrity are priceless and the only way to build a successful business
• Never refer to a party without naming it
• VCs detest name droppers
• Never make claims that cannot be verified
• Measurable milestones -> payment schedule
• Be careful about forecasting revenue
Due Diligence

• Referential due diligence strongly preferred
• 1\textsuperscript{st} due diligence is costly & takes time
• Sloppy cooperation is a big warning sign
• DD is about people: key management and advisory group will get reference checked
• Books are usually a no-brainer except for the color of money spent
• Expert opinion: 1 & 2 pass
Key Terms

• Board seats, minority protection e.g. veto
• Rights on future capital raisings
• Terms on future finance e.g. anti-dilution
• Payments driven by verifiable milestones
• Handling of undeclared liabilities
• Service contracts
• Exit mechanism
Negotiation & Deal

• VC’s 1st offer is always the best offer and probably the last offer as well based on 20+ years of experience as an employee and small business

• Negotiation must be less 3 weeks – goodwill decreases exponentially over time

• VCs are for a WIN-WIN and have every incentive to offer you a good deal
Warning Signs

• Everything centers around the CEO
• Wife & husband .. Bros .. business
• No hurt money – just personal time
• 70% of investment spent in 3 months
• J curve or “hockey stick” revenue forecast
• Percent of market without milestones
• No competition, no research, no disclosure
Ideal Startup

- True partnership of 3-4 founders. CEO is only the first among equals
- Coal face paid >75% of expenses
- World class advisory group
- Hurt money – extra mortgages & give up secure jobs. Startup is not a hobby.
- True achievements e.g. US patent granted