Valuation of Startups

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 loose 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

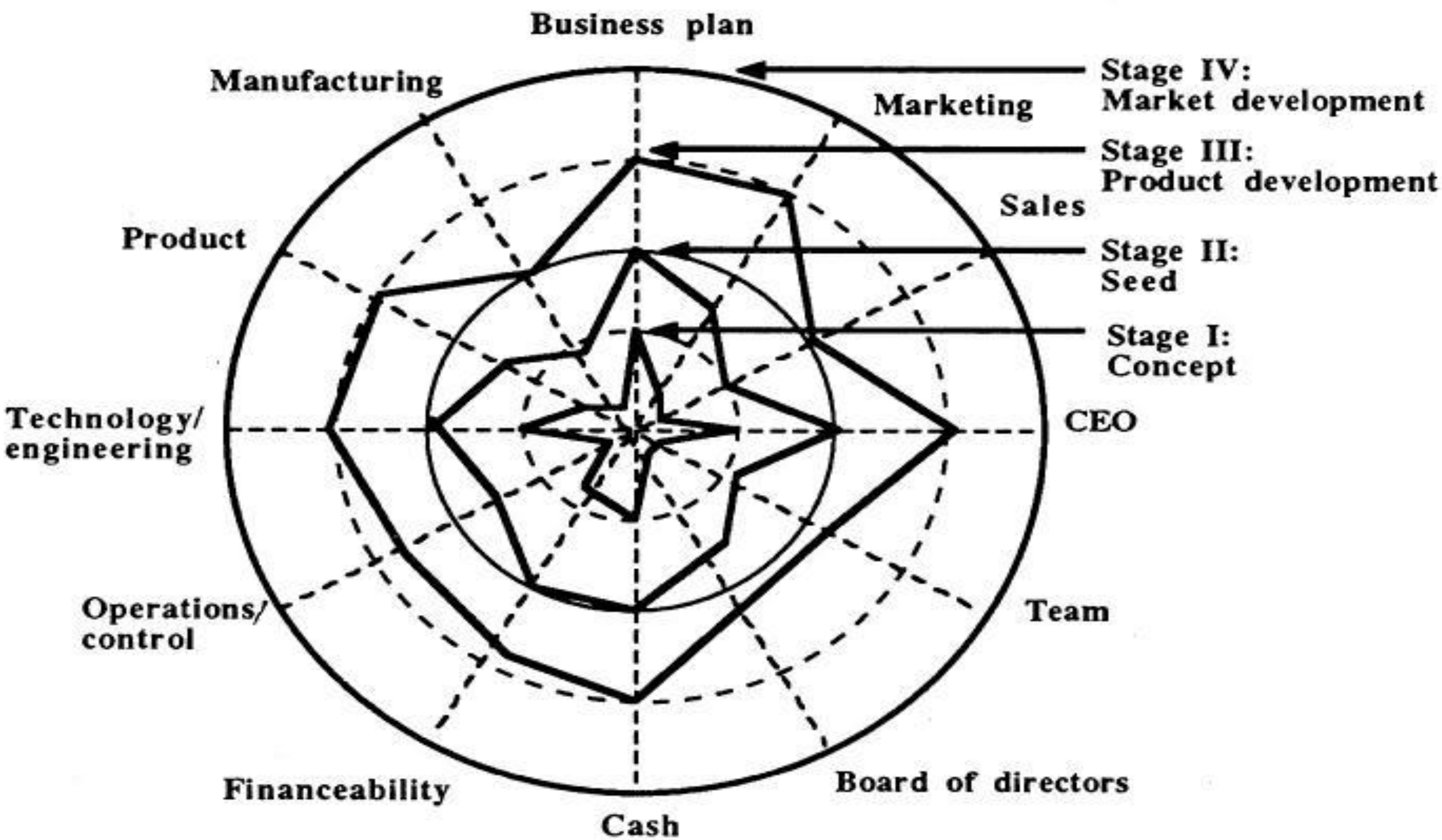
The four major elements of the Bell-Mason Diagnostic include:

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



Bell Mason Stages Flowchart

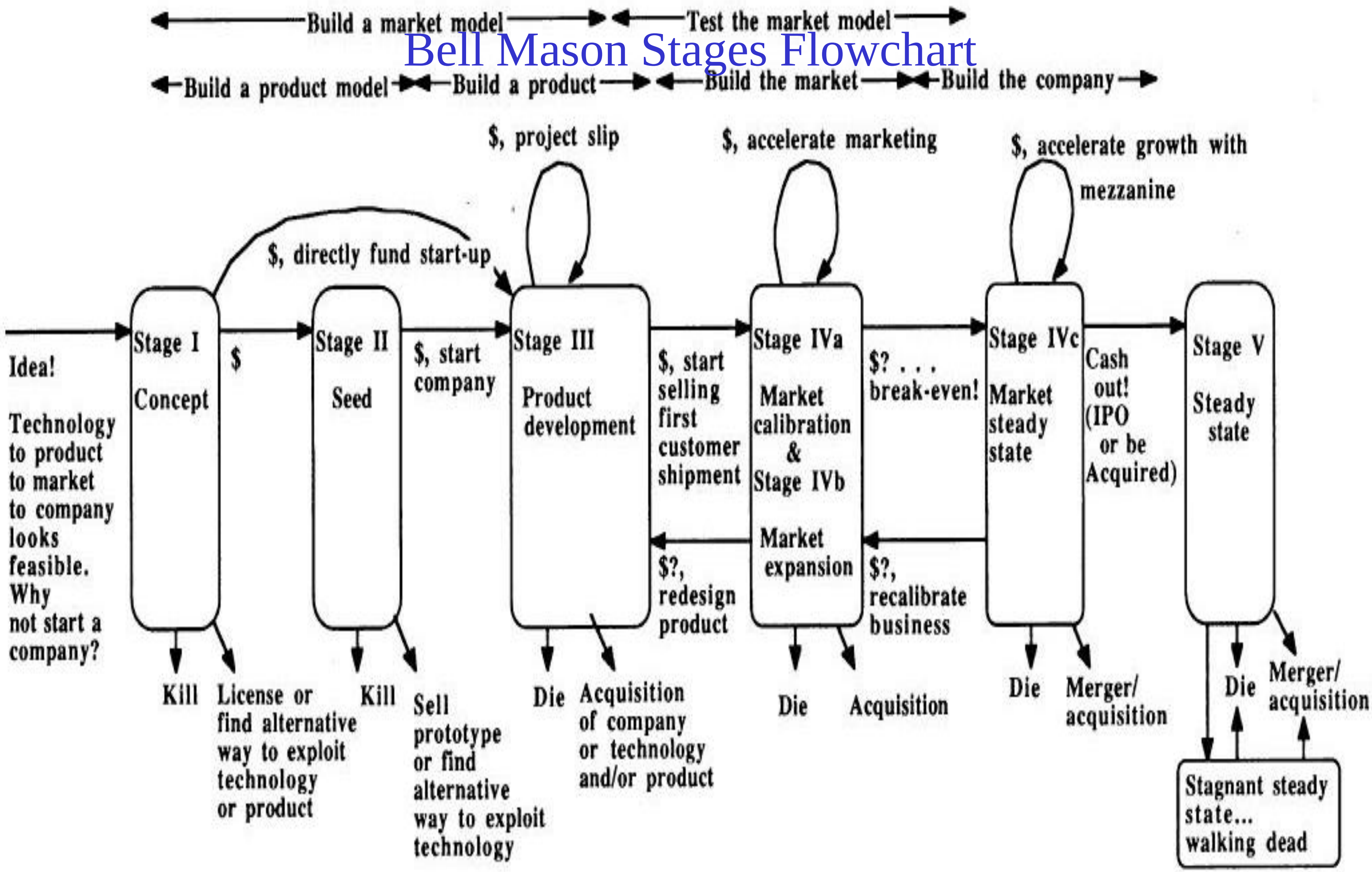


Figure 10-3. Flowchart of the Stages of Growth for a Start-up, Including the Criteria for Moving Among the Stages.

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^{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