START-UP VALUATION

"Price is what you pay. Value is what you get." - Warren Buffet, Berkshire Hathaway Chairman

Start-ups require fundraising to develop, test ideas, products and services, and to hire and build teams. Before fundraising, start-ups have to to go through valuation, which is a complex process due to the following challenges:

- **no revenue** - revenues in case of stat-ups are small or non-existent, while expenses are present and related to setting-up business.
- **illiquidity** - as equity investments in young companies are privately held, thus they are less liquid, comparing to publicly traded companies.
- **multiple claims on equity** - repeated attempts to raise equity brings in a possibility that a value of an investor (who invested earlier) might be reduced by deals offered to subsequent investors.

The valuation method itself depends on a funding round and specific investors' requirements. The first round of funding usually comes from the founders themselves. In many cases, it takes a form of work with no salary for a significant period of time, and is called a “sweat equity”. At this very early-stage, company's valuation tend to be determined by how experienced founders are, and by a perception of business opportunity. Here, the **Cost-to-Duplicate** approach can be applied.

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The **Cost-to-Duplicate** approach takes into account all costs and expenses associated with establishing a new business, including a product and services development, and purchase of physical assets. These expenses determine a start-up fair market value.

The **Cost-to-Duplicate** approach, however, has two major drawbacks. First, it does not take into account a company's future potential, thus valuation can be underestimated, and secondly, it does not account for intangible and physical assets. Even at this start-up stage, the company's intangibles may add significantly to its valuation, for instance, thanks to a brand value, goodwill, patent rights, to name a few.

At a later stage, however, when angel investors and VCs are engaged, a proper valuation is a must. Series A is the most important financing round for any start-up and typically it is done by a professional venture capital fund (VC). VCs normally get involved in building an organisational structure, join the board and set up regular meetings. A valuation that founders and VCs agree upon determines what percentage of the company a founder will sell, and consequently, how much of a dilution they will take in financing. After a successful series A, subsequent rounds including B, C, D, E, F and mezzanine follow, and all of them require performing a proper valuation.

5 Valuation Methods

In general, there are two ways to approach a start-up valuation i.e., pre-money and post-money. Pre-money means an investor's value assigned to the company prior to the investment. Post-money equals a pre-money valuation plus an investment. This method requires to divide money invested in a company by post-money valuation to get an "equity stake" that investors receive. It is also called a "founder's dilution" percentage.
The pre-money and post-money approach is an integral part of remaining valuation methods. Here are 5 methods, most commonly used for start-ups' valuation:

1. **Market Company Valuation** – this method looks at comparable start-ups in the industry which are already valued. Several websites offer such data, i.e. CrunchBase, Gust, AngelList. It further adjusts a valuation to a start-up individual characteristics through comparing its profile to a comparable company's profile (defined by the industry, niche, founder experience, location, customer traction, B2B or B2C, stage of development, funding level, team) and adjusting for larger and obvious differences.

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2. **Step Up Valuation** – offers valuation based on the monetary value assigned to milestones a start-up achieved. Start-up founders usually measure the progress they make and plan next steps. This valuation approach offers a more structured approach to look at achieving goals and milestones.

3. **Venture Capital Quick Valuation** – in this method one estimates how much money founders need in order to survive for the next 18 months.

4. **Venture Capital Valuation** – the "exit values" are estimated. Based on ROI (return on investment) expected by the VC one can arrive at the pre- and post-money valuations.

5. **DCF Valuation Method** – future cash flow is discounted to find its current value. Then a rate of return on investment, called the "discount rate" is estimated. Based on this, it is further determined how much projected cash flows are worth. As start-ups are associated with high investment risks, a high discount rate is generally applied.

All methods listed above can be used to estimate a value of a start-up. However, it is important to note that those methods may lead to different results. Given that it is essential for founders to be transparent as to which valuation method they used and why, and be able to provide all required information in front of investors in order to gain trust.

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