GUIDE TO EARLY STAGE COMPANY VALUATIONS

AN ENTREPRENEUR'S REFERENCE

The Valuation of Early Stage Companies

Tips for Avoiding Classic Entrepreneur's Mistakes

By Mike Pellegrino

A classic mistake entrepreneurs make is to overlook the valuation of their company. However, when an entrepreneur requires external capital, the valuation issue is paramount. It is simple. Investors fund entrepreneurs that have a credible valuation. I will discuss in this article three basic ways to value a company. They are the cost approach, the market approach, and the income approach.

Cost Approach

If you value your company using the cost approach, you look at what it cost you to get your company to its current state. These costs include things like labor, materials, applied overhead, and capital charges. Once you accumulate all costs, you adjust the final tally for obsolescence to arrive at a company valuation. The problem is that the cost approach rarely provides a credible valuation for an early stage company, because the company's value is in what future income it will generate. Consider this: rumors are that Nike spent $35 in the 1970's to purchase rights to the "swoosh" emblem on all their products. That swoosh is worth substantially more than what it cost Nike to purchase it. Given that future income is what is important to potential investors, you generally will not use the cost approach to value your company.

Market Approach

When you value a company using the market approach, you look for comparable companies in the same industry of the same relative size that recently sold in the open market. The reasoning is logical: if the market paid $X for that company once, then one would expect that the market would reasonably pay a similar amount again. The way that you value a company using this method is to use a gross multiplier such as a cash flow factor to arrive at a value. Your company generates $1M of cash flow in year 5, and you use a cash flow multiplier of eight, so your company is worth $8M. There are other multiplier ratios commonly used as well such as price to earnings (P/E) or price to sales (P/S). Once you determine the value of the company using this multiplier, you then adjust the resulting value to account for identifiable differences.

The problem is that the market approach does not work well for early stage companies. First, comparable circumstances do not exist. The comparable had a proven management team, existing customers, available working capital, and a host of other factors that dictate why the company sold for the price it did. Second, the market is not rational. Investors enter the market with imperfect information and

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Pellegrino & Associates LLC specializes in the valuation of early-stage technology for investment purposes.

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drive prices sky-high. That is why a company like Sonic Wall could have a P/E ratio of 8675 in the dot-com bubble and a market valuation of $1.2B on earnings of $147,000. That is beyond irrational—it is insane. Third, much of the comparable companies an entrepreneur uses are publicly traded entities. However, the price action of public companies does not apply for private companies. Again, the new company lacks cash flow, a proven product, the effects of market timing, etc. Fourth, the market multiples ignore the portfolio income that a comparable company may generate. If the comparable company sells a comparable product to yours, but 50% of their revenues are from other sources such as services, then these multipliers do not account properly for the income mix.

Despite the issues with market valuation techniques, entrepreneurs continue to look to these market techniques, usually with public companies, to value theirs. It is easy to understand why—the calculation is simple. Do not fall into this trap. Most investors will not consider a company valued using the market approach, particularly one that is early stage.

Income Approach

The income approach is the last method that one uses to value a company. This method is the most principled, requires the most discipline and insight into your company to complete, and is what investors typically expect. Using this method, you project what the sales will be over a discrete period (3-5 years typically) and then some horizon value. You then project the direct costs (labor, materials) and indirect costs (e.g., rent, sales & marketing, etc.), and required capital investment attributable to generating those sales.

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With this information, you can determine the company's free cash flows, which at the end of the day, are what investors care about because free cash flows are the greatest indicator of economic benefit that the investors may receive. Once you determine free cash flows for each discrete year and the horizon, you discount these cash flows using an appropriate cost of capital to the present value to determine what they are worth today. You must discount the cash flows because you are asking your investors to trade spending money today on other things to invest in you. Your investors will want to know what trading a spending dollar today gets them in the future. If it gets them only break even after 5 years, they generally will not fund you because there are other deals that provide superior risk adjusted returns.

The discount factor and the entrepreneur's cost of capital is again another area where entrepreneurs typically get into trouble. If you are looking for investment capital, you should expect to have a cost of capital of at least 30%. You are high risk, and you must compensate your investor accordingly for this risk. So, do not look to public companies for guidance for a cost of capital. Public companies have substantially lower risk than your company does. To use their cost of capital would not compensate properly your investors for the additional risk of your investment.

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Valuation Discounts

Once you have determined a value for your company, there are generally two other discount factors that you should apply to your company's value: a minority interest discount, and a lack of marketability discount. These discounts are cumulative. The minority discount applies when you sell an investor a minority share of your company. Unless you provide them 51% ownership, they do not have the power to change the board, set policies, etc. Therefore, those with majority control have more power to effect company change. Their stock is worth more. Minority shares are generally worth only 65-80% of a majority owner's shares. The next discount to apply is one for the lack of marketability. Unlike public companies, where it is easy to sell a share of stock on the open market, you are offering a share of a company that is very difficult to unload, particularly if it is a minority interest share. This discount compensates the investor for purchasing an interest that is hard to sell to another party when the investor no longer wants it. An illiquid share is generally worth only 50-65% of a liquid share's value.

Let us apply these concepts. You have a company that generates revenues worth $84 million over its life. You are in the biotech industry and you require FDA approval. You are thus high risk. Using a risk-adjusted cost of capital of 46%, your company is worth $4.7M. However, you are selling a minority interest and the minority interest discount is 21%. Your company is now worth $3.7M. In addition, you are selling a private, illiquid issue and the discount for lack of marketability is 43%. Your company is now worth $2.1M. If you are asking your investor for $1.4M, it is quite reasonable that the investor expect about 40% ownership in your company. Do not be dejected with this example. You will own 60% of a company that, if you execute properly, will likely make you very wealthy. Contrast that with 100% ownership of a company that may be worth nothing without investor funds.

I have scratched the surface of valuation issues with this piece and an in-depth discussion can easily fill a book. While I have glossed over many technical details, remember that entrepreneurs that provide a credible valuation, who present credible sales projections, who discount them appropriately, and who consider additional value discounts will find themselves closer to funding their company than those that do not.