Qualitative Analysis of High-Growth Companies

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Abstract: Investing in high-growth companies carries substantial risks. This has been experienced by many investors in the past several years. Despite these negative experiences, however, there are numerous examples of companies that grew from small start-ups to established, cash-flow positive companies. The assessment of a company based on qualitative factors (soft factors) provides a good basis to identify and choose potential winners. The assessment is also used for the financial valuation of a high-growth company.

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Do not underestimate the importance of getting a proper financial valuation for a high growth enterprise. To obtain seed funding or later-stage venture capital, expand a business, or for a merger/acquisition, a company needs to be valued.

The value of a company directly determines the size of the portion of equity a particular investment sum will purchase. It is crucial for company management as well as investors or collaborative partners with an equity stake, to have a good understanding of what a company is worth.

Venture Valuation has been exclusively conducting independent, third party valuations of start-up high-growth technology and biotechnology companies for over five years now. The approach utilized by Venture Valuation is different from the methods generally used by accounting and auditing companies which primarily use past performance to determine current value. For high-growth companies there is often not a long history to help determine that value. Also, asset valuation or a value based on past and current earnings does not make sense as there are usually few tangible assets in the company and no earnings. Nevertheless, these knowledge-driven companies are generally worth more than zero.

The Venture Valuation approach determines current value based on future potential. To truly understand the potential of a given company, it is crucial to carefully analyze the underlying business model of a company. It is the ‘soft’ (as opposed to hard financial) factors, such as strength of management, innovative technology, favorable market environment, that ultimately determine a company’s success in the future and that form the basis for a solid valuation. In the following we try to provide a framework – the Fig. gives an overview of this model – to conduct such an analysis.

One has to make sure to analyze and understand these soft factors and use them to determine the risk factor associated with each company with regard to its future earning potential. Ultimately the determined risk factor directly influences the discount rate, which is used for the valuation of an individual company.

This forward-looking assessment of a company’s earnings potential is based on 1) management, 2) market environment and 3) sciences and technology. Furthermore, the stage of the company also has a direct influence on the risk profile of the company.

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Fig. Assessment and valuation framework