Valuing early stage firms*

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This week Patrik Frei of Venture Valuation explains how his firm evaluates a startup company. Zürich-based Venture Valuation utilizes a systematic approach to consider all the important aspects in evaluating high growth companies. It specializes in the valuation of IT and e-commerce companies, working with the likes of NCiCube Zurich, and corporate venture capitalists in the biotech field, such as Novartis Venture Fund.
The value of a company directly determines the size of the portion of equity a particular investment sum will purchase. It is crucial for both, company management as well as for investors or collaborative partners with an equity stake, to have a good understanding of what a company is worth.

Don't underestimate the importance of getting right the valuation for a high growth enterprise. It's a necessary step to obtain seed funding or capital, expand a business, or find funds for a merger/acquisition. Most startups need to be valued based on expectations of future financial performance.

Venture Valuation has been exclusively conducting independent, third party valuations of start-up high growth technology and biotechnology companies for over two years now. Our approach is different from the methods generally used by accounting and auditing companies where past performance primarily determines the value.

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 analyse the underlying business model of a company. It is the "soft" (as opposed to hard financial) factors, such as management, technology, market environment, that ultimately determine a company's success in the future and that form the basis for a solid valuation.

Venture Valuation makes sure to analyse and understand these soft factors and uses them to determine the risk factor associated with each company with regard to its future earnings. Ultimately the risk factor determined, directly influences the discount rate, which is used for the valuation of an individual company.

Venture Valuation's forward-looking assessment of a company's earnings potential is based on 1) management, 2) market environment and 3) technology and intellectual property.

Management A face to face evaluation of the core management team is essential. Every company sooner or later faces crises and challenges. An excellent management team can get a company over almost any hurdle or difficulty it may face.

Similarly, no matter how good a business plan or how elaborate financial projections of a company, a management team that lacks vision or ultimate commitment will not succeed. A good management team is not always evident in a business plan. We had a company that offered a very short and unsophisticated business plan. But when the management team turned up, it was clear that they were very focused on bringing the product to the market and that they had made the decision to not spend a lot of time working on a business plan, rather to invest their time in rolling out of their product. In this case the founders had an exact vision where they wanted to go and how they wanted to reach their goals. It was just not that well communicated in the business plan.

When evaluating a management we look for complementary teams and skills as well as the track record of the team as a whole and the individual team members and how this can help to achieve the challenges of the future. It is also important how the employees are involved in the company, whether they are thinking like owners or simply follow orders. A generous employee stock option plan, for example, usually is a good sign that the company is committed to attracting and retaining top talent. Another important factor we consider, is the degree of commitment and expertise the board of directors brings to a company.

Market If there is no market for a product then even outstanding technology will not guarantee success. Therefore we systematically analyse the environment the product or service is positioned in. In our experience, the five forces concept by Michael Porter is a good methodology for the market assessment. The first step is to check what kind of substitute could satisfy the same market need.

Next the competition is analysed. We consider the intensity of rivalry among existing players and also determine the barriers of entry for new competitors. We believe it to be very important to get a feeling for the current and future market environment to determine the likelihood of success. Additionally the bargaining power of suppliers and buyers are taken into consideration. Further criteria consist of market and growth potential.

Technology On the technology side we most importantly assess the competitive advantages the company has with its technology and how sustainable it is. One important part is the assessment of intellectual property rights and the depth of coverage the patents provide. Depending on the nature of the business, technology can be very important (i.e. biotechnology), but it can also be a very small part of the whole business idea. Furthermore the strategic alliances and partnerships a company has been able to build, can play a very important part in the whole evaluation as well.

Based on the analysis of the underlying business model and the "soft" factors mentioned earlier, Venture Valuation then perform the financial valuation of the company. Since the valuation for high growth technology companies depends on multiple factors and really cannot be pinned down to one single method, we use up to four different methods for the calculation. This gives us a broad approach to the company's value and ensures that we consider all important factor influencing the company. Our view of valuation is not what has happened in the past but rather what the future could bring.

An invited paper by Patrik Frei of Venture Valuation for Venturix News.

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