# VALUING START-UPS

## A SUMMARY GUIDE BY BDO CORPORATE FINANCE

This summary guide is intended for entrepreneurs, investors, valuation professionals and anyone who might be interested. The universe of start-ups is rich and diversified. Yet start-ups share some characteristics that may make a valuation exercise tricky and traditional valuation approaches hardly relevant. In any case, most start-ups need private capital, and despite increasing legal financial mechanisms to bypass valuation issues, a valuation exercise remains crucial for objective negotiations and later venture monitoring. A proper valuation exercise should rely on a set of methods (rather than on a single approach), selected on the basis of the start-up's maturity stage and available information, as well as on a solid business plan and a good understanding of the success factors. Let's embrace the vibrant world of start-ups!

### 5 characteristics of start-ups

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| 1 | **Little or no revenue**. Given their maturity stage, start-ups generate little to no revenue. Some do not yet even have a product or service to offer. The value rests entirely on future growth potential. |
| 2 | **Negative earnings**. Most start-ups are associated with negative cash flows and earnings, expenses being related to research and development rather than sales. Hence, conventional scaling measures and capitalisation of earnings are of little use. |
| 3 | **Limited historical data**. Start-ups have little to no track record (usually no more than 2 years). Absence of revenue, profits and history reveals the crucial role of business forecasts when it comes to valuation. |
| 4 | **High risk**. Start-ups are typically associated with high uncertainty and risk of failure, boosting expected rates of return. |
| 5 | **Few comparables**. Start-ups are often the first players in their industry/segment. Accordingly, finding a peer group that shares the same risk, growth characteristics and business model is much more complex than for listed or mature companies. |

### 10 valuation methods

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| 1 | **Sweat Equity Method**. Valuation based on the combined value of all costs, including non-monetary contributions, expensed to date to develop the venture. |
| 2 | **Discounted Cash Flow Method (DCF)**. Valuation based on the sum of all future cash flows generated, with particular attention to discount rate (usually ranging from 20% to 60%) and terminal value (reflecting growth potential). Alternatively, the First Chicago Method calculates a separate DCF (or uses valuation results from other methods) based on three scenarios (best, mid and worst) and their respective likelihood. |
| 3 | **Multiples Method**. Valuation based on a rule of three with a KPI from a comparable company (typically sales or operational metrics specific to the venture's industry). |
| 4 | **Venture Capital Method**. Valuation from the investor's perspective, based on the estimated value of the venture at exit date (usually computed via the Multiples Method) and the rate of return required by this investor. |
| 5 | **Berkus Method**. Valuation based on the assessment of 5 key success factors for which a range of dollar values is assigned (maximum added value per factor set at $500k for a company forecasting over $20M revenue within 5 years). |

## 10 valuation methods

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| 6 | **Five 'million dollar points' Method (Dave McClure).** Valuation based on the assessment of 5 key points (maximum added value per point set at $1M). |
| 7 | **Scorecard Method (Bill Payne).** Valuation based on a base value (median value for similar start-ups) adjusted considering a weighted set of criteria. |
| 8 | **Risk Factor Summation Method.** Valuation based on an initial value (median value for similar start-ups), adjusted considering 12 risk factors where each leads to a positive, neutral or negative change of value (ranging from $500k for very low risk to -$500k for very high risk). |
| 9 | **Funding Round Multiple Method.** Valuation based on a multiple of funds to be raised and the percentage of dilution accepted (usually ranging from 1.5 for massive dilution of 40% to 4 for low dilution of 20%). |
| 10 | **Real Options Method.** Valuation based on option pricing model (e.g. Black-Scholes Model), with specific attention to interest rates, investment time horizons and volatility. |

## 5 steps for a business plan

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| 1 | **Start from the future.** Unlike the usual approach for mature companies, begin with thinking about what the venture might look like in the future, in a sustainable and moderate-growth state. |
| 2 | **Set revenue targets.** Estimate market size, penetration rate and average revenue per client in order to determine the company's target revenue at the future date. |
| 3 | **Estimate achievable performance.** Define sustainable economics, operating margins and return on capital at the future date, using business model's fundamentals and benchmarks. |
| 4 | **Work backwards.** Determine the speed of transition and necessary timeframe to reach that desired future state and how. |
| 5 | **Incorporate uncertainty.** Consider multiple scenarios. Assess a future set of financials for a full range of potential outcomes, from optimistic to pessimistic, and their respective weight. |

## 10 key success factors

(for the attention of entrepreneurs)

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| 1 | **Idea.** Be a pioneer, innovate with a game-changing technology and keep a realistic vision of the new idea's true market potential. |
| 2 | **Timing.** Be in the right place at the right moment, when technologies can be understood, used and readily adopted by a broad audience. |
| 3 | **Product.** Offer cutting-edge technology and create a memorable, appealing and unique brand. Welcome early users and feedback as opportunities for enhancement, future development and, in some cases, radical reorientation. |
| 4 | **Leadership.** Set the vision, make decisions, inspire and motivate the team, display tenacity and diplomacy. |
| 5 | **Team.** Look for skillful, committed and flexible team members, from various backgrounds but sharing the same vision and passion. |
| 6 | **Advisory board.** Do not overlook the importance of external business mentors or advisory partners sharing priceless experiences and insights. |
| 7 | **Monetisation strategy.** Build a strong, scalable, adaptable business model ensuring profit-making and monitor cash flows very closely. |
| 8 | **Funding strategy.** Assess the level of funds required, plan out ideal funding process, identify the right investors, get to know them and build a healthy relationship. |
| 9 | **Growth strategy.** Treat growth carefully, finding the right balance between expansion and market observation. |
| 10 | **Customers.** Keep in mind that converting a promising idea into a commercial success begins with users. Make customers the ultimate goal. |

**HUNGRY FOR MORE?**
If you would like to receive more information on start-ups or if you would like to discuss what is possible for you, please do not hesitate to contact our Corporate Finance experts:
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