Venture Capital Perspective

When valuing early-stage investment propositions, venture capital firms typically apply steep discount rates to accommodate the high risk associated with startups. Considering all aspects, this approach raises several issues, though.

Applying standard valuation approaches on startups do not work well, or at all: Book values, to begin with, seem meaningless, as the principle value of a startup is the new idea and its intended implementation, aspects that won´t be found on a firm´s balance sheet. - Neither does applying a liquidation value make much sense, because in a startup there is not much to be liquidated, as the idea and its implementation are all linked to the individuals driving the venture. Once they leave, most of the value in a startup vanishes.

Applying the Discounted Cash Flow (DCF) valuation approach may theoretically work, as a startup could be assessed on the basis of future expected cash flows, like any other investment opportunity. Having said this, the ultimate challenge in applying this approach is how to deal with the high failure rate and – hence – risk profile of early-stage corporates: The most common answer to address this aspect is a (substantial) increase of the applied discount factor by adding a sort of early-stage risk premium. This typically results in excessively high discount factors, often doubling, tripling the level of cost of equity commonly applied in valuing mature firms.

This (excessively) steep discount factor should – as is assumed – fairly represent the high return expectations of early-stage investors, such as angel investors or venture capital funds. These commonly justify such yields with the exposure to the high business risk assumed for investing in a largely untested product, market environment and, not least, management team. - Whilst this approach seems widely accepted, its rationale could be challenged, though:

It appears that in valuing startups the steep discount factor applied seems to serve as some sort of last resort "dumping ground" for risks not further analyzed, assessed or broken down.

Instead, one could consider alternative valuation strategies, whereby (at least some of the) risk is

shifted from the discount factor towards the stream of future expected cash flows: In essence, that can be achieved by creating a set of alternative cash flow scenarios, illustrating a (more or less wide) variety of possible outcomes. Of course, the ultimate challenge in this approach is that these scenarios will need to be weighted, whereby attaching probabilities to the outcome of each scenario is certainly a tedious task.
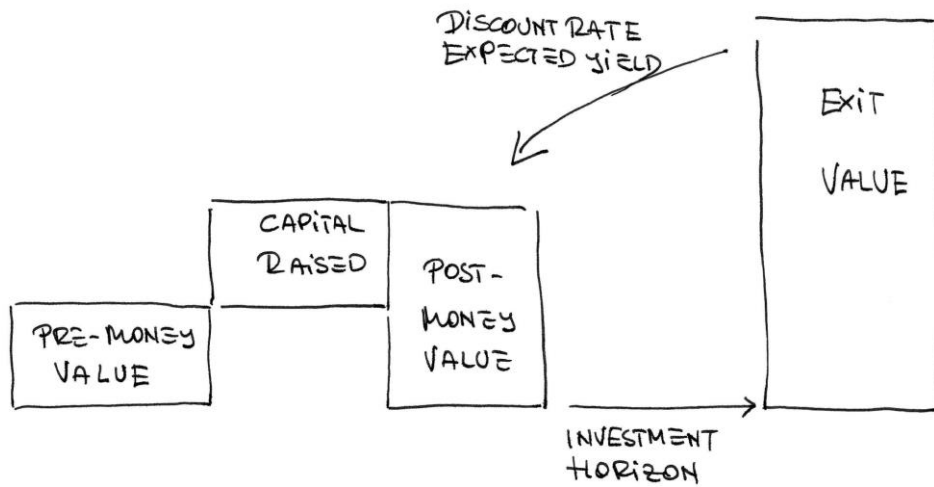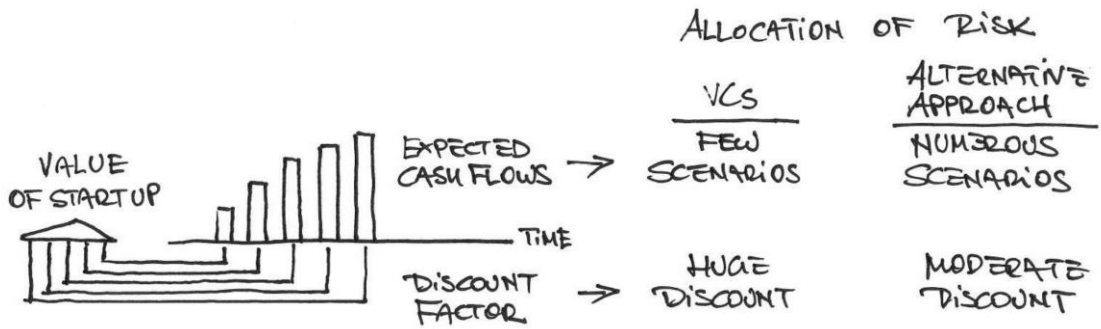
In another alternative approach, anticipated future expected cash flows could be combined with a startup´s estimated annual survival rate: Starting at a very low level (high infancy mortality), such rate should actually increase dramatically over time.

Both these alternative approaches could help transferring risk away from the discount factor, thereby bringing latter back to more reasonable levels. – Nevertheless, the difficulty in applying the DCF approach in regards to startups is – alas: its inherent weakness – that the bulk of a firm´s value is derived from the residual or terminal value.

In practice, the venture capital method is widely applied: Thereby, the investor assumes a selling price for a full sale of the company (with the terminal value derived on the basis of an assumed exit multiple). This selling price is referred to as the target´s post-money valuation. Upon this, an anticipated return on investment for the investor is applied – usually in a yield corridor of between 20-40 per cent - and discounted back to derive the asset´s current value. Deducting from that amount the cash investment made by the investor gives the investment´s pre-money valuation. – As many startups are financed through subsequent funding rounds, also a factor accounting for the anticipated dilution of an investor has to be applied. That may range from anywhere of between 80-20 per cent.

Less popular (and equally cumbersome to implement) valuation approaches for startups are among others: Berkus Method (attributing values to the progress a startup has made in commercializing activities), score card valuation method (as an adjustment of pre-value valuations along certain characteristics of a firm), or risk factor summation method.

Various multiples-based approaches are also typically applied, using as benchmarks previous, similar, comparable transactions completed.

ALLOCATION OF RISK

	VCS	ALTERNATIVE APPROACH
EXPECTED CASH FLOWS →	FEW SCENARIOS	NUMEROUS SCENARIOS
DISCOUNT FACTOR →	HUGE DISCOUNT	MODERATE DISCOUNT

VALUE OF STARTUP

TIME

DISCOUNT RATE
EXPECTED YIELD

EXIT VALUE

CAPITAL RAISED

POST-MONEY VALUE

PRE-MONEY VALUE

INVESTMENT HORIZON

For more concepts click on:

Corporate Finance Concepts

Christian Schopper

www.christianschopper.com