Valuing Startups - Expert Tips for Every Angel

ANGEL CAPITAL ASSOCIATION

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The Art Of Valuing A Startup

By: Marianne Hudson, ACA Executive Director and Angel Investor

Before investing in a startup, the first question many angels ask is: what is the company worth? Determining the valuation of a company before it has revenues is actually pretty difficult. Unlike valuing companies with revenues, assets and longer track records there is no agreed upon standards for startups.

Valuation of a pre-revenue company is often one of the first points of contention that must be negotiated between angels and entrepreneurs. Entrepreneurs want the value to be as high as possible and angels want a value low enough so that they own a reasonable portion of the company for the amount they invest.

"How To" Tips From Experts

As I brush up on my startup valuation skills, I tap experts like Bill Payne. He is a founding member of four angel groups, an investor in more than 50 companies and a long-time instructor of angel investing courses. While there are dozens of valuation methodologies, he suggests these four that work for angels and startups. These offer an excellent starting point:

- Venture Capital Method calculates valuation based on expected rates of return at exit.
- Berkus Method attributes a range of dollar values to the progress startup entrepreneurs have made in their commercialization activities.
- Scorecard Valuation Method adjusts the median pre-money valuation for seed/startup deals in a particular region and in the business vertical of the target based on seven characteristics of the company.
- Risk Factor Summation Method compares 12 characteristics of the target company to what might be expected in a fundable seed/startup company.

Don't stop with one approach. Sophisticated angels and entrepreneurs will want to use several methods to value a startup because no single method is useful every time. Multiple methods also help in the negotiation process because an average can be determined from among them.

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Since most startups have little-to-no history, revenue and earnings, there isn't much information to analyze or plug into a spreadsheet. To close this gap, angels can look for clues from similar startup deals in the same region and industry. Like real estate, valuations will go up and down depending on market forces. Expect lower valuations during a recession and higher in boom times when there is more competition for investment. Startup valuations may also be adjusted up or down based on the strength of the management team, location of the business, industry or market.

Like Payne says, "It really is an art. Entrepreneurs and professors would love for it to be something that we just throw an Excel spreadsheet at. But there is no perfect methodology to establish the pre-money valuation of pre-revenue ventures, making it even more important for investors and entrepreneurs to know how the number is derived."

Valuation Trends for Angel-Backed Companies

While many media stories hype wild valuations for startups these days, studies and national datasets show a different story for companies receiving angel investment. The real story is that these valuations have been relatively steady for more than three years and that the pre-money valuations are in the $2.5 to $3 million range rather than $10 million plus.

National reports such as the Halo Report, analysis by the Center for Venture Research at the University of New Hampshire, member surveys by the Angel Capital Association, and Payne's informal surveys over the past few years pegged the national median pre-money value of companies funded by angel groups at $2.5 million in 2012 and 2013, jumping to $3 million in mid-2014. Behind the medians are differences by geography and industry. The valuations are higher in Silicon Valley, for instance, and life science startups generally have higher valuations than tech startups.

The 2014 increase to $3 million in the Halo Report is important and time will tell if it is a harbinger of bigger changes. A worrisome trend is the increase in the upper range of valuations, which ticked up from $6.7 million in 2012 to $10 million in 2014. It appears the 2014 increases are from Silicon Valley, which may be headed toward a tech bubble. The question is whether that trend might trickle to other parts of the country as more entrepreneurs access data on these deals and ask for similar prices in their home towns. Many angels across the country are standing pat with lower valuations, but I've heard from several angels that there is pressure to pay more.

One last trend in startup deals is having no valuation at all – through convertible debt deals. In these cases, angels provide loans to startups that are then converted into equity in the next investment round, often at an agreed upon maximum valuation and/or a discount on that valuation for the angels who support the convertible note. This is a topic for a future article, but it is worth pointing out that these deals are increasingly common for tech company deals in Silicon Valley.

Valuation is an important topic for angel investors. It helps to get as much information as possible to make good early-stage investments. There are a variety of resources to start. The Angel Capital Association offers best practices and Investor tools on its website and the Angel Resource Institute conducts several courses on the subject, including one called Valuation of Early-Stage Companies.

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Startup Valuations: Why Location Matters

By: Marianne Hudson, ACA Executive Director and Angel Investor

We've seen many headlines: Investors fund Silicon Valley startup at $10 million pre-money valuation. That's why it takes some entrepreneurs by surprise when they learn that investors in Little Rock won't invest in a similar local startup at Silicon Valley prices.

Should the valuation of startup companies be impacted by location? Those Little Rock angels are on to something. We all know a newly-constructed 3,500 square foot home with a pool near New York City is priced well above a similar home in Fargo, right? The same differentials are true for startup companies. In fact, the issues that influence residential real estate pricing are quite analogous to those which determine the price investors will pay for ownership in startups.

Many angels will invest in hot startups run by celebrity serial entrepreneurs at much higher pricing than for similar startups with first-time entrepreneurs. And, we've heard that life science startups are often priced well-above software startups. What factors impact startup valuation?

To answer that question I turned to long time active angel investor William H. Payne, who has successfully founded and invested in over 50 startup companies. Payne, a member of Frontier Angel Funds, is an Angel Resource Institute trustee, lead instructor and program developer, and advises entrepreneurs all over the world. Bill helped me understand the role the economy, real estate and bubbles have on regional variations in startup valuations.

Economy

We've all witnessed how the real estate market fluctuates wildly with the economic cycle. Homes in Las Vegas that sold for $1 million in 2006 only commanded $400-500,000 in 2010, but by 2015, many of those homes had regained much of their value from the peak in the economic cycle in 2006. According to Bill the same is true for software/Internet companies. Investors who funded companies for $1 million pre-money valuation in 2010 saw pricing for similar ventures soar to $4 million by 2015. Both markets are impacted by the economy.

Bill explained, "Buyers are scarce for residential real estate at the bottom of the economic cycle and the same is true for startups. Investor sources dry up in poor economic times. In down markets, entrepreneurs seeking capital must sell larger percentages of ownership in their startup companies to raise capital."

Location, location, location….

Residences located in competitive regions like New York City versus less competitive markets like Missoula, command higher pricing for similar homes. Likewise, within regions, residences in the best neighborhoods and near highest quality schools are priced higher than elsewhere in the same region.

The analogy works for startups in Palo Alto versus my home town of Kansas City. Pricing and demand will be higher where larger numbers of investors are chasing interesting deals than in markets with limited capital sources. "In fact", Bill says, "within a region, capital intensive startups often command higher pricing that others which require less capital to achieve first revenues, because investors recognize that more resources may be required for capital intensive ventures to meet sufficient milestones to become fundable."

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Size and Maturity

Bill laid out the analogy in the table below, where his research compares the size of a residence (both square footage of the home and lot size) to the maturity of the venture. Larger houses are priced higher than similar but smaller homes located nearby. Likewise, startups without a proven track record are priced below those with companies with revenues and earnings in similar markets. Bill's analysis shows that other factors being similar, later stage companies are priced well above those with little customer validation and no earnings history.

Analogy: Comparing Factors Impacting Values of Residential Real Estate to Startup Companies*

Residential Real Estate	Startup Companies
Economy	*Economy*
Location • Region • Proximity to schools, etc.	*Location* • Physical • Business sector
Size • House • Lot	*Maturity* • Stage of development • Cash, revenues, earnings
Amenities • Pool, landscaping • Marble countertops	*Business plan* • Team, IP • Size of opportunity

**Research provided by William H. Payne*

The Business Plan

The fourth comparison Bill added is of the amenities of a residence to those of a startup company. Homes with pools, dramatic décor and gorgeous landscaping sell at higher prices per square foot than their not-so-attractive, yet nearby neighbors. His analysis shows that the same is true for new companies. Startups with an awesome, experienced team, quality intellectual property and a fractured yet huge marketplace are priced above those with less experienced teams with some IP and smaller opportunities.

Bubbles

Bill found one more similarity between residential real estate and startup pricing: irrational exuberance. In 2006, real estate buyers in Las Vegas somehow believed that skyrocketing pricing would continue indefinitely, prompting senseless speculation. Pricing promptly dropped as much as 50 percent in following years. Historically, real estate price inflation has reoccurred regularly.

There are analogous bubble pricing in startups. For example, investors drove pricing sky high in 1999-2000, again in 2006-7 and perhaps again in 2015? When pricing is too high, entrepreneurs often raise too much money and lose their sense of lean operations, spending money unnecessarily. Inflated startup investment leads to down rounds, excessive dilution of entrepreneurs and investors and reduced returns to both. Have we entered another of bloated pricing of startups? Only time will tell.

Entrepreneurs are often told that the team, the product and the plan are the only significant considerations in determining the pre-money valuation of their startup company. Yes, these are important considerations, but only within a range of pricing which is determined by the economy, their location in this country and the maturity of their venture. We need to consider these influences and others. The high tech press, mostly located in Silicon Valley, reports on venture pricing for deals financed in Silicon Valley, which cannot be assumed to be consistent across the country.

So what does this mean for angels in Little Rock vs. Boston? A startup venture can only be priced with a good understanding of the financial cycle and the competitiveness for startup financing in the region of the venture. As with real estate, location…location…location is the abiding factor in defining the range of pre-money valuations for startup companies. The message is clear: pay close attention to the pricing of similar startup ventures in your neighborhood. And, if you sense we have entered another bubble of inflated pricing, perhaps it is time for investors to be more selective in their angel investing.

Scorecard Helps Angels Value Early-Stage Companies

By: Marianne Hudson, ACA Executive Director and Angel Investor

Scorecards are ubiquitous in baseball, helping coaches, players and fans understand the factors that led to a victory or defeat. It turns out that scorecards come in pretty handy for startup business investing, too.

This past October, I enjoyed watching my hometown Kansas City Royals become the World Champions of baseball. Their scorecard was easy to understand, what with runs, hits, and great pitching stats. Those stats were the factors that led to their World Series win.

Angel investors are using a similar concept for determining the value of the startups that approach them for financing. They look at the factors that make a new business more or less valuable in a valuation scorecard. The factors are just different, like industry sector, market size and quality of the management team.

Before we jump into the details of the scorecard, it's important to understand first why company valuation is so important to angels and entrepreneurs. The bottom-line is that it part of the critical calculation of determining how much of the company the investor owns for their investment. Marcia Dawood, an experienced investor and board member of the Angel Capital Association, walked new investors through the important calculations in a recent webinar.

Dawood explains there are two types of valuation – "pre-money" is the company's value before an investment and "post-money" is after the investment. And an investor's percent of ownership equals the size of the investment divided by the post-money valuation. We use both to determine percentage of ownership.

For example, if a company has a pre-money valuation of \$2 million and raises \$500,000, then the post-money valuation is \$2.5 million. The investors own 20 percent of the company (by dividing the \$500,000 by \$2.5 million).

Sometimes entrepreneurs back into a valuation when they know how much they want to raise and how much of their company they are willing to give up. Investors can do this too. Dawood says, "Think about Shark Tank. Mr. Wonderful says 'I'll give you $200,000 for a 10 percent stake in your company.' Divide the $200,000 by .10 and you get a $2 million post-money valuation and after subtracting the $200,000 investment, you get a $1.8 million pre-money valuation."

The numbers in the calculation can have a huge impact on your success in an investment, so it is important to be comfortable with the final pre-money valuation and the elements that get you to that number. You don't want to buy company stock for too high of a price. So how do you do that?

Keeping Score

Criteria	Weighting	Comparison	Adjusted Weighting
Entrepreneur, Team, Board	30%	120%	0.36
Size of Opportunity	25%	100%	0.25
Product/Technology	15%	140%	0.21
Competitive Environment	10%	90%	0.09
Sales/Marketing	10%	60%	0.06
Need for More Financing	5%	100%	0.05
Other	5%	80%	0.04
Total			1.06

There are several ways to value startups, but the most popular method used by angels to determine a pre-money valuation is the Scorecard Method. Bill Payne, a long-time angel who also led the webinar, uses a real estate analogy to explain the method: it appraises startups using comps.

The Scorecard Method is used for comparing target companies to similar startups, such as business sector, stage of development and geographic location. You compare your target company to the norm for several factors and then adjust the median by your appraisal of the target. These days it is easier to find data on investments and valuations of entrepreneurial firms on the Internet.

The main parameters, or criteria, of the Scorecard Method, in order of importance, along with their respective weights, are: entrepreneur, team, board (30%), size of opportunity (25%), product/technology (15%), sales/marketing (10%), need for more financing (5%) and other (5%). You can change the percentages according to your own preferences about what is important to a startup's potential. Put them into a column.

Next, approximate how the company you're trying to determine a valuation for stacks up in each of those parameters against similar startups. If you think the management of the target startup is 20 percent stronger than the other similar companies, for example, then use the number 120 percent in the comparison column for the parameter. Do the same for the other criteria. When you are finished, multiply the two numbers in the

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row and post that number in an adjusted weighting column.

Tally the numbers in the adjusted weighting column and multiply that sum by the pre-money valuation for similar startups. You end up with a chart with a final valuation scorecard like this:

This should be fairly accurate as long as you have a good starting value and use a similar stage of development, a comparable business sector and a like location.

Obviously, you want to keep in mind that if the seed stage valuation is too low, entrepreneurs are going to eventually be diluted after multiple rounds. As a result, their interest in driving the company is going to be diminished. If the seed stage valuation is too high, the entrepreneurs and the investors have undervalued the financial contribution.

Other Options

The Scorecard Method, along with the Venture Capital Method and the Dave Berkus Method, are only three of the many methods used by angels in appraising a pre money valuation of a startup company. It is best to use multiple methods, then make a decision from there as to what you think is appropriate for your company and the company you are investing in.

Besides these methods, the Angel Resource Institute offers other ways to learn valuation. There are also some ACA webinars which are chock-full of good information.

Payne recommends that angels try multiple valuation methods for each investment opportunity. Essentially, establishing benchmarks helps make something that is very subjective more objective.

These posts originally appeared on [Forbes.com]

Marianne Hudson writes about angel investing – trends, ideas and how to succeed.

She is an angel investor and Executive Director of the Angel Capital Association (ACA), the world's leading professional association for angel investors. ACA is focused on fueling the success of accredited angel investors who support high-growth, early-stage ventures, and has more than 13,000 member angels across North America.