How to Value an Early Stage Company

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It is a truism in the venture finance industry that valuing early-stage companies is more of an art than a science, especially when it comes to those at the very beginning of their journey. But, of course, for all the difficulty it involves, company valuation forms a crucial part of any startup's or scale-up's life, from the perspective of both the entrepreneur and the investor.

The valuation of a company determines the percentage ownership an investor receives in return for their investment. For example, for an investment of £500,000, a pre-money valuation of £2m would give the investor a 20% stake in the business; that is reduced to about 14% using a pre-money valuation of £3m.

In turn, the size of the equity stake will determine the size of the return an investor could make further down the line in the case of an exit, such as a trade sale or, more rarely, an IPO. More equity sold equals greater return. The incentive for the investor is therefore to maximise their ownership in exchange for cash; for the entrepreneur, it's to minimise it.

How, then, do savvy investors go about valuing early-stage deals? The difficulty lies in the fact that relatively little or even no hard historical data exists with which an investor could make an informed decision about the company's future prospects. Quantitative modelling runs into serious obstacles here; past successes are not necessarily an indication of future performance

Cash flow analysis

A popular method for valuing the stock of well-established or publicly listed companies is through discounted cash flow analysis (DCF). While there are a number of fairly complex DCF models, which vary depending on the exact type of cash flow used, the basic underlying principle remains the same in all of them. In essence, the company's current valuation is determined by the money it is expected to make further down the line – or, more precisely, by the present value of the cash flow to be received by shareholders in the future. It is 'discounted' cash flow because a discount rate is used to work out how much future cash is worth today.

In the early-stage context, however, predicting future cash flows is a stab in the dark, more so when the company is still in the pre-revenue phase of its development. Entrepreneurs are ever optimistic, and no analyst at SyndicateRoom has ever seen a company revenue or EBITDA projection graph whose line doesn't start at the bottom left and ends up at the top right.

Future performance projections

Nevertheless, quantitative methods using historical evidence and projections of future performance still has a place in early-stage valuation, becoming increasingly important as a business generates more hard data. Approaches based on market and transactions multiples, the Venture Capital Method and the First Chicago Method are commonly applied by investors.

The multiples method compares the company targeted for investment to a range of similar ones in terms of stage of development and sector. Value is often expressed as a multiple of some cash flow measure, e.g. enterprise value in relation to EBITDA (EV/EBITDA), or share price relative to per-share earnings (P/E ratio). Let's say that the average comparable company has an enterprise value of five times its EBITDA; since target company x has an EBITDA of £10m, its enterprise value is £50m. A weakness of this approach is that it could mirror the under- or overvaluation of an entire sector.

The Venture Capital Method uses multiples in respect of future earnings to work back to a valuation in the present. In simplified terms, you forecast after-tax earnings for the expected year of the company's sale, then use an industry specific P/E ratio to determine the company's anticipated selling price. Using the selling price and your hoped-for return, expressed as a multiple of initial investment (ROI), we can work out the current post-money valuation (which equals sale price divided by return on investment). Subtract the amount of investment the entrepreneur is currently looking for, and you have the pre-money valuation for the round.

The First Chicago Method is somewhat more complex. By combining elements of multiples-based valuation and DCF, it posits three possible valuation scenarios (upside, base, downside). Each scenario is assigned a probability deemed appropriate by the investor, and the final valuation is the probability-weighted sum of the three scenarios.

Pre-revenue startups

Other methods aim to avoid the uncertainty of financial forecasts, and are thus typically applied to pre-revenue startups. The Berkus Method works by assigning monetary value, within certain parameters, to critical elements of a business (e.g. management team, prototype, etc). The valuation grows as the strength of these factors grows.

The Scorecard Method is a comparative tool that allows investors to gauge how the target company measures up to others at a similar stage in its sector and region. Akin to the Berkus Method, the investor can adjust the valuation relative to the average deal, according to their judgement about how the target company performs in certain key areas compared to the other companies.

The Risk Factor Summation Method allows the investor to assign risk points to certain elements of the business, and then increase or decrease the average pre-money valuation of analogous deals according to the company's risk profile.

These methods rely on the investor's personal judgement, or in other words, on their instincts and gut feeling, formed by their experience as an investor and their knowledge of the relevant industry. Savvy investors will use a cross-section of techniques to arrive at a reasonable valuation. As the target company matures, instinctual methods will increasingly give way to more sophisticated quantitative modelling.

Common factors

In any case, there are a number of common factors that will influence an investor's decision. Some of these relate to the company itself, ranging from the quality of the management team, to product traction, to USP, to the desperation of the entrepreneur for funds. Others relate to the broader market: the size of comparable deals, the size of previous exits in the sector, an investor's analysis of future trends and the likelihood of an exit (its potential size), the balance between demand and supply in the early-stage equities market, etc.

Broadly speaking, investors approach the valuation of a company from two directions.

An investor can start from the top, and think about the size of a potential exit and desired ROI. As we have seen above when discussing the Venture Capital Method, it is possible to work back from there to a pre-money valuation. Alternatively, an investor could start by looking at the valuation of comparable deals and modify their valuation accordingly. This latter approach, however, tacitly rests on the assumptions of those investors who start from the top, since existing valuations will have come about by investors pondering how to achieve a decent return in the sector under consideration.