

HOW DO INVESTORS PLACE A VALUE UPON YOUR BUSINESS?

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February, 2002

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Any small business entrepreneurs expecting to find equity financing from angel or venture capital investors should be aware of the many ways sophisticated investors use to value a candidate business, and should be prepared to supply information to the investor to help in that process.

Valuations are down considerably from the highs of 1998-2000. Many entrepreneurs tend to expect higher valuations than the market will support in today's environment, making understanding the process of fair valuation even that more important.

Financial History and Projections

The importance of accurate current financial statements cannot be overstated. An entrepreneur should “know his numbers and be able to defend them” during early meetings with candidate investors. At the least, historical numbers must include the latest income statement and balance sheet, showing activity through the latest period. If the business is not a startup, expect to supply income statements for the past several years as well, to emphasize trends in revenue and costs.

Detailed projections for the next 12 months are a must. Beyond that, projections should be made for two additional years, but need not be in account-by-account detailed format. Sophisticated businesses will also create a cash flow projection for the same period, showing cash used and remaining at the end of each period.

How Much Money Can I Get?

Here is a question with a circular answer. To grow your business to a size that will be attractive to a VC or angel making an investment now, you've got to show that the business will be large enough at the time of the investor's liquidity event (cashing out) to make the investment attractive at all.

Most VC's look for a 10x opportunity – that is – a ten times increase in the valuation from investment to liquidity event. Later stage investors sometimes look for less, since the business has already proven its capability to stay in the

game and has already completed its product development cycle, eliminating more risk for the investor.

So you've got to play with the numbers to determine your level of comfort. The more you ask for – the more equity you give up. Completing this exercise often leads an entrepreneur to lower his expectations about the amount of money to be raised. Try this example:

You want to raise \$2,000,000 today. Your projections and the analysis we'll undertake below lead to a possible valuation of \$20,000,000 in five years, assuming that you meet your plan, and allowing for a 50% discount to the plan numbers during the investor's evaluation. That means – using the 10x expectation for return – that the business is worth \$2,000,000 today at best (\$20,000,000 divided by 10). To raise \$2,000,000, you must give up 50% of the post-investment equity (the current value of \$2,000,000 plus the investment of \$2,000,000).

Remember that the investor will include the full number of shares reserved for your present or future option plan – usually 15-20% of total equity – making your personal equity 20% less when calculated as “fully diluted” or including reserve for options. Therefore, in the example above, you would control less than 50% of the company at funding if you received \$2,000,000.

Given the strong desire by entrepreneurs to keep controlling interest in the early stages of growth, the amount that can be raised must be lower than \$2,000,000 in order to accomplish this goal.

So the circular reasoning exercise returns. Raise the projections (and sell the investor on the increased projections as a result) or lower the amount of capital to be raised in this round. Future rounds should be at higher valuations if you meet your plan, making dilution of your equity less onerous at that time.

With this in mind, let's explore a number of methods to value your business. Many investors use a combination of methods, throwing out those that do not fit the form of business.

Corporate Valuations Using Various Methods

There are ten recognized ways to value a business. Some are inappropriate for young businesses or those engaged in certain enterprises such as software development, where fixed assets are not usually important enough to use for purposes of valuation. Here they are, with short explanations of each.

1. Sales Multiple:

The usual limits for use of a sales multiple for valuation are from .5 to 4 times gross revenues for similar businesses. There is some latitude based upon the growth of the Company, using trailing (last 12 months), actual (fiscal year projections) and forecast (next twelve months or next fiscal year). For some businesses, when purchases of goods for resale are a large component of cost, the value is determined after first deducting all cost of goods purchased from third party sources. (A \$3,000,000 business engaged in resale of hardware costing \$1,700,000 would be valued as if it were a \$1,300,000 business for this purpose.)

2. Price Earnings Ratio:

This traditional method of valuation has been applied to companies in all industries, and is the most often quoted method of valuation for public companies. A P/E multiple of between 5 and 30 is common, with growth of company and growth of industry directing the selection of the number. The market sector in which the company works usually has a narrow range of price earnings multiples. You can find that average number in the quarterly Business Week Magazine report of public company earnings, among other resources.

Earnings for this and other valuation methods below are usually based upon net income after taxes (or reserve for tax), but sometimes are calculated before deducting interest and tax, with the assumption that borrowing is a function of capitalization, not earning power, and tax is a reflection of a company's current status within a multiyear tax planning horizon, perhaps with previous losses shielding present tax liability.

3. Free Cash Flow Model:

This method is often used to value privately held companies with a range of five to eight times the cash available to spend after operating expenses are paid. Free cash flow is important when the buyer intends to finance the purchase using the revenue from the purchased company itself.

4. Book Value Method:

This is the basic net worth of the Company on the balance sheet. It is not relevant for early stage companies, since the value of the intellectual capital and future growth are discounted entirely using this method. This value is often multiplied by two or three times in growth environments, then used as one sanity check against other methods.

5. Liquidation / Salvage Value:

This value is only used as a minimum floor below which no offer should ever fall. It represents the amount the company or a secured lender would realize in a distressed sale, and is never high unless the company owns significant undervalued real estate or fully depreciated working assets.

6. Replacement Value:

This is one of the best ways to create some minimum value, especially for young companies, or where the investment in technology has been heavy and the life span of the technology is long. Replacement value goes up where there is a high barrier to entry due to proprietary tools or patents. The problem with using either liquidation value or replacement value is that usually an appraiser is required to determine the value. The cost for the appraisal is often a barrier to small company's use of this method.

7. Similar Company Transaction:

A very logical way to examine the value of a company is to base the value upon what someone else is willing to pay for a like company. This is often done with public companies. Unfortunately, using public companies for comparison greatly overstates the value of private enterprises.

Private statistics are rarely available, except when public companies purchase privately held firms and must reveal the amount paid in their 10-Q and 10-K forms for public scrutiny.

8. Recent Same-Company Transaction Price:

This value often sets the basic minimum if there has been such a transaction in a relevant time period. Qualifying transactions would include actual company share sales prices, qualified stock options granted (which are taxable if below market value), valuations by independent appraisers if used for Employee Stock Option Plans under ERISA rules, or internal buy-sell transactions between partners. There is flexibility here, as in any valuation, by the negotiation of how the payment is to be made and over what time period.

9. Internal Rate of Return Method:

Internal rate of return is a classic financial methodology used in valuations, where projected profits are discounted back to the current period. The problem with early stage companies is that most of them do not have a stable enough history to rely upon the numbers. In more stable environments, the calculation might use up to ten years of projected cash flow, discounted back to present value and discounted a further thirty percent for risk. Technology companies would never use more than five years, and would employ a higher discount factor of forty

percent or more. Sometimes, the period is reduced to three years for such high risk technology companies. To find the valuation using this method, use your projected net income after tax for each of the next three years. Calculate the present value of each of the two future years by deducting seven percent per year from the net number (fourteen percent for year three). Multiply each of the three results by 70% as a risk reduction. Add the three resulting numbers, and you have the three year internal rate of return. If the value of your business is so high that it would take ten or more years of cash flow to pay the purchase price for your shares, the company is too highly valued for most investors, unless strategically “buying” technology not cash flow.

10. Comparable Public Company Valuations Method:

One way to find the value of your enterprise is to compare it to similar companies already on the public market. Usually, an investor making such a comparison will deduct about 20% of the value of a comparable public entity in calculating your value, just to account for the intrinsic value of being a public company. This sanity check may surprise you – as many small public companies are now valued at less than their cash reserves, a sign that the market does not expect such a business to be able to become profitable in time to protect its cash on hand. To find the “market capitalization” (enterprise value) of a public business, visit *MSN Money* or *Yahoo Finance* and look for “market capitalization” within the summary of financial information.

The actual value of a business is often determined as a blended average of the ten above, subjectively placing more or less weight upon one or several of these.

Then There's The Rule Of Thumb Method:

There is an eleventh method – but it is one I use only as a rule of thumb to size up the first ten. For early stage companies, I use the “*Berkus Method*” approach. I give \$500,000 valuation credit for the attractiveness of the core idea upon which the company is founded (assuming that I am attracted to it). I add another \$500,000 if I believe good management is already in place to execute to the plan in the early stages of rapid growth. Then I add \$500,000 if the company has struck impressive strategic alliances with either vendors or customers, adding to barriers of entry for other businesses. Finally I add \$500,000 if the company has completed its product or prototype and demonstrated its attractiveness before an appreciative customer candidate, which all goes to further reduce the risk of investment, adding to value. Using this method for early stage companies, I can quickly assess the starting valuation against which to measure all others.

Valuing an early stage company is not a precise exercise, even if the above methods lead you to believe that there is some precision in doing so. Yet the value of the business is most important to determine at each stage of equity financing to strike a careful and fair balance between the needs of the

entrepreneur to retain control at the early stage and of the investor to find opportunity for reward to offset his risk of investment.

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Founder and President of Berkus Technology Ventures, LLC, Dave Berkus is a venture capitalist with a hands-on background in technology-based businesses. An entrepreneur for over forty years, he has formed and managed successful businesses in the entertainment and software arenas, and has become known as a respected technology industry leader and spokesperson. Mr. Berkus has performed appraisals upon numerous technology companies over the years, with many of his appraisals used as the basis for acquisition negotiations.

Listed in Marquis' *"Who's Who in America"* and *"Who's Who in the World"*, Mr. Berkus is current or recent board chairman or board member for numerous public and private technology-based companies. In recognition of his accomplishments serving as Board member or Chairman and adding significant shareholder value for thirty-two emerging technology companies over the years, he was named *"Director of the Year – 1999"* by the *Forum for Corporate Directors* of Orange County, California. Mr. Berkus is co-author of *"Better Than Money!"* - a book for technology companies addressing the issues resulting from rapid growth. In the investment community, he is the Managing Partner of *Berkus Technology Ventures, LLC* and of *Kodiak Ventures, LP*, both early stage investment funds, and an active Board member of the *TechCoast Angels* group of early stage venture investors.

Mr. Berkus serves as Board Member and Vice President of the Western Region, *Boy Scouts Of America*, and is Chairman of the Advisory Board of *ABL/TECHNOLOGY*, a networking organization of CEO's in high tech businesses.

As founder of Computerized Lodging Systems, Inc., Mr. Berkus was an early pioneer in the mini-computer industry, innovating numerous technology "firsts", and guiding CLS through a decade of spectacular growth, including two consecutive years on the *Inc.500* list of America's fastest growing companies. For his accomplishments in advancing technology in the hospitality industry, in 1998 he was inducted into the *Hospitality (HFTP) "International Hall of Fame"*, one of only twenty so honored worldwide over the years.

A graduate of Occidental College, Mr. Berkus currently serves as a Trustee of the College. He is a commercial pilot with instrument and multi-engine ratings, and holds Flight Safety International's coveted "Pro Card" for airline transport pilot proficiency.

Current or recent boards: Apogee Broadcasting Corporation, AuriQ Systems, Inc., GlobalLink Access, Inc. (Chairman), Enhanced Simulation Technologies, Inc. (Chairman), EPC International, Inc. (Chairman), GameSpy Industries, Inc. (Past Chairman), Hotelware Corporation (Chairman), Kodiak Ventures, L.P. (Managing Partner), Word-Of-Net, Inc., Sulcus Hospitality Technologies Corp. (AMEX:SUL), Occidental College Board of Trustees, Boy Scouts Of America Western Region Executive Committee. In addition, Mr. Berkus serves on four advisory boards.