

Valuing an Early Stage Venture

For those of us who've invested in early stage companies, especially technology startups, we have confronted a universal problem. There are many ways to project the value of a company for purposes of pricing an investment, but all rely upon the revenue and profit projections of the entrepreneur as a starting point. Many formulas then discount those projections according to some set percentage or by assigning weight to elements of the enterprise.

And in my opinion, all fail to take into account the universal truth – that fewer than one in a thousand startups meet or exceed their projected revenues in the periods planned.

Years ago, confronted with the same conundrum, in the middle 1990's I came up with a method of assessing the value of critical elements of a startup without having to analyze the projected financials, except to the extent that the investor believes in the potential of a company to reach over \$20 million in revenues by the fifth year of business.

First published widely in the book, *Winning Angels* by Harvard's Amis and Stevenson with my permission in 2001, the method has undergone a number of refinements over the years, particularly in the maximum assigned to each element of enterprise value, reducing those amounts as the investment market adjusted from the craziness of the bubble to more logical values in the years that followed. Because the Internet has such a long memory and documents from the distant past can be found with ease will yield a number of conflicting valuations culled from the many subsequent publications of the method over the ensuing years.

Here is the latest fine-tuning of the method. You should be able to adopt it to most any kind of business enterprise, if your aim is to establish an early, most often pre-revenue valuation to a start-up that has potential of reaching over \$20 million in revenues within five years:

If Exists :Add to Company Value up to :

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| 1. Sound Idea (basic value, product risk) | \$1/2 million |
| 2. Prototype (reducing technology risk) | \$1/2 million |
| 3. Quality Management Team (reducing execution risk) | \$1/2 million |
| 4. Strategic relationships (reducing market risk and competitive risk) | \$1/2 million |
| 5. Product Rollout or Sales (reducing financial or production risk) | \$1/2 million |

Note that these numbers are maximums that can be “earned” to form a valuation, allowing for a pre-revenue valuation of up to \$2 million (or a post rollout value of up to \$2.5 million), but certainly also allowing the investor to put much lower values into each test, resulting in valuations well below that amount.

There is no question that startup valuations must be kept at a low enough amount to allow for the extreme risk taken by the investor and to provide some opportunity for the investment to achieve a ten times increase in value over its life.

Once a company is making revenues for any period of time, this method is no longer applicable, as most everyone will use actual revenues to project value over time.