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Valuation Report

Business Valuation Trends and Strategies

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Technical Topics

How to Value Startups and Pre-Revenue Companies

Startups are hot again. According to Bloomberg, investors have shown particular interest in the online security and fraud sectors, artificial intelligence and self-driving/mapping technologies. A recent Bloomberg U.S. Startups Barometer was up 12 percent over last year.

From a valuation perspective, startups — or pre-revenue companies — present particular challenges. Unlike well-established businesses with records of performance, cash flow and management success, startups often have very little to assess. With a startup, revenues and profit margins are hypothetical, and the valuation comes down to assessing potential.

Four Questions

When valuing a pre-revenue company, valuation analysts are essentially trying to answer four questions:

1. What is a reasonable revenue growth rate?
2. What is a reasonable profit margin?
3. How much capital will be required?
4. What is a reasonable multiple?

To answer these questions, the analyst makes assumptions about the factors that will drive value. Among the value drivers are elements such as the competitive environment, leadership and management team, intellectual property (including patents and trademarks) and other factors that make the company stand out in the marketplace.

Several Approaches

There are many valuation methodologies, but startups and early stage companies often demand unique approaches, including these popular options:

Berkus Method: Originally developed by Dave Berkus in the

1990s and refined over the years, this method involves assessing four "risk-reduction elements" in the target company.

The Berkus Method adds a fixed amount (for instance, $500,000) in value for each of the following: a sound idea, a prototype, quality management team, strategic relationships, and a product rollout or sales. This method allows for a pre-revenue valuation of up to $2 million or $2.5 million after rollout or launch.

Scorecard Method: Also known as the Benchmark Method, this approach compares the value drivers of the target company to those of other pre-revenue valuations in the industry section and geographic region. The value drivers include the strength of the management team, the size of the opportunity, the product/technology involved, the competitive environment, marketing/sales/partnerships, additional investment needs, and other elements.

These elements are scored on the strengths and weaknesses of the target company relative to the performance of other companies. The scores are used to determine a weighted average value.

Risk Factor Summation Method: Like other methods, this approach assesses risk factors, but it includes a longer, broader list of them. For example, this method includes legislation, litigation and reputation risks, and the likelihood of a "lucrative exit." The factors are then scored on a positive-neutral-negative basis and the average value is adjusted up by a fixed amount for each positive and down by that amount for each negative.

Venture Capital Method: The idea behind this method is to assess expected rates of return at exit. The calculation involves estimating revenues in the year of sale and, based on that number, estimating earnings

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Word to the Wise

The Importance of Storytelling in Valuation

Conventional wisdom says that people are either "left brained" or "right brained" based on which hemisphere of the brain is more dominant. The left brainers lean toward math, science and other logic-driven pursuits, while the right brainers tend to be more creative and imaginative.

For many in the valuation arena, the left brain is where they tend to be most comfortable when receiving and sharing information. But a new book by valuation expert Aswath Damodaran stresses the importance of right-brain thinking as a complement to the numbers.

In his book, "Narrative and Numbers: The Value of Stories in Business," Damodaran suggests that good valuations need to tell a story. Too much emphasis on numbers doesn't give valuation users the big picture they deserve, he writes. Damodaran says that the numbers should be "bound together by a coherent narrative, and storytelling … kept grounded by numbers."

A Five-Step Process

Damodaran recommends melding numbers and narrative using a five-step process:

1. Develop a narrative for the business. What is the story of this business? The founders will likely have a version they tell, but the valuation team must create their own narrative, which may or may not jibe with that of the founders.

Damodaran, the analyst behind the Uber valuation, described the car service company succinctly in two sentences that captured the nature of its current model and his thoughts on where the company would go in the future (hint: logistics).

2. Do a reality check. Damodaran recommends testing your narrative relative to history, experience and common sense. In terms of history, have there been other companies that have "lived the narrative" you claim?

With regard to experience, are there similar narratives you are aware of? If so, what were the road bumps and barriers attached to those companies? And drawing on principles of economics and math, does your narrative make sense?

3. Connect the narrative to value drivers. Here's where the words and numbers start to come together. For example, if the company is committed to networking and has a winner-take-all attitude, those qualities will translate to a large market share. If the company has a strong competitive edge, that will likely connect with a combination of large market share and high operating margin.

4. Connect value drivers to the valuation. Damodaran and other valuation analysts typically use a discounted cash flow (DCF) method to arrive at a valuation, but he acknowledges that some may prefer another model.

5. Keep an open mind. Sometimes the story changes, and Damodaran says it's important to "keep the feedback loop open." The narrative may need to shift based on how things go with the company and whether there are any dramatic changes in the market, regulatory environment or other areas that would impact the value of the company.

Think Shark Tank

Due to their nature, many valuation analysts will rely more heavily on the numbers than the narrative. However, Damodaran suggests that the narrative can have a big impact on how the numbers are interpreted.

He points to one of his favorite TV shows, "Shark Tank," as an example of narrative meeting numbers in an engaging way. Damodaran reminds owners that they need to be clear on their narratives, convert the story to value drivers, and set measures for how the narrative unfolds as the company progresses.

Investors need to do the same: Convert narratives into value, make sure the price is reasonable, and be open to how the story might change.

What's your company's story? Our valuation team can help you create a compelling narrative.

What's It Worth?

Different Standards Apply to Different Circumstances

Every business valuation has a purpose. Maybe a company is up for sale. Perhaps a business interest is being given as a gift or is part of an estate plan. Or it could be that a business is bankrupt and on the verge of liquidation.

In each of these circumstances, the valuation analyst and the client must agree on the purpose of the valuation and the standard of value to be used to support that purpose. Some standards are mandated and others simply make sense given the situation. In every case, the valuation analyst must use the standard that applies best to the particular engagement.

Here's a look at several common standards as outlined by the AICPA:

Fair Market Value — This is the most common standard and the one most familiar to business sellers and buyers. It is defined by the AICPA as "the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell, and when both have reasonable knowledge of the relevant facts."

Investment Value — This standard is defined as the value to a particular investor based on individual investment requirements and expectations. It assumes that certain synergies exist between the buyer and seller.

For example, a buyer may be willing to pay more if the purchase will increase the buyer's market potential, provide trademarks or patents of interest, fill a niche in a supply chain, or provide a competitive edge.

Fair Value — Used for financial reporting, fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Fair value is also the standard generally used in cases of dissenting stockholders' disputes. Many states define fair value with respect to the dissenters' shares as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects."

Intrinsic Value — Also known as fundamental value, this is the value that an investor considers "on the basis of an evaluation or available facts, to be the 'true' or 'real' value that will become the market value when other investors reach the same conclusion."

When used in the context of options, it's the difference between the option's strike price and the market value of the underlying security.

Liquidation Value — As its name implies, this is the amount that would be realized if the company ceased operations and its assets were sold. Liquidation can be "orderly," in which case assets are sold for maximum profit, or "forced," in which case assets are sold as quickly as possible, often at auction.

Net Book Value — This is simply the difference between total assets and total liabilities as they appear on the balance sheet. Net book value sometimes serves as the low-end "floor" for a valuation.

While most of these standards sound straightforward, there are nuances involved in calculating value to meet each standard. Your valuation professional will work closely with you to determine which one is best for your needs.

Call us today to learn more about standards of value and which one best applies to your engagement.

Valuing Startup Businesses

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in the year of sale based on industry measures. These figures can then be used to determine "terminal value" for investors.

A Starting Point

These methodologies are often a starting point for valuation analysts, and there are other options as well. To check their numbers, most analysts use a combination of methods to assess a startup, both for investment and employee compensation purposes.

Remember that valuation is always a combination of science and art, which is especially true when it comes to startups. The key to a successful startup valuation is working with an experienced valuation analyst to develop a compelling narrative that convincingly explains the numbers.

Interested in valuation of a startup? Call on our team for their knowledge and experience.

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Streamlined Goodwill Impairment Rule Now in Effect

In January, the Financial Account-ing Standards Board (FASB) issued a new guidance streamlining the process for testing for goodwill impairment.

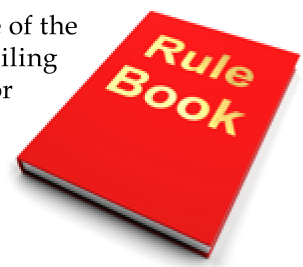
Accounting Standards Update (ASU) 2017-04, "Intangibles — Goodwill and Other (Topic 350), Simplifying the Test for Goodwill Impairment," establishes a one-step test for a drop in goodwill. The guidance eliminates Step 2, which required a hypothetical purchase price allocation measuring the difference between the implied value of a reporting unit's goodwill and the goodwill's carrying amount.

A goodwill impairment loss will now be measured as the amount by which the reporting unit's carrying amount exceeds its fair value.

This new rule was motivated by a similar guidance applicable to private companies that was issued in 2014. That rule gave private companies the option of using a simplified impairment model, which was designed to reduce the cost and complexity of compliance. Some private companies chose not to elect that model because if they were subsequently acquired by a public company, they would have to undo the election and restate their financial statements.

Because public companies can now use the same type of calculation, private companies will no longer face restatement upon acquisition.

The new guidance will result in more impairment in some circumstances and less in others, depending on the nature of the entity's assets. Failing Step 1 under prior rules didn't always result in a goodwill impairment, but it will now.



ASU 2017-04 is effective in 2020 for calendar year-end SEC filers while other public-business entities have an additional year to comply. All other entities that plan to adopt the new rules, including not-for-profits, must do so starting in 2022. Early adoption is permitted for any impairment tests performed starting this year.

If you have more questions about the new FASB guidance, please give us a call.