



## **Valuing Seed- and Early-Stage Businesses: Experience Required**

How does one determine the value of a business with a high degree of risk, little history, no operating profits and marginal revenue? This is the challenge faced by CPAs working with seed-stage or early-stage businesses. With so few answers and so many questions, the valuator must rely on a variety of techniques, many of which are outside traditional valuation methods.

Valuing a fledgling company is vastly different than placing a value on an established enterprise. Traditional assessments use standard methods of valuation, while seed- to early-stage companies usually are valued using non-traditional methods. Start-ups are counting on significant growth, which is dependent on highly uncertain future events. This uncertainty may be heightened when the top company manager is the original “idea” person, who may or may not be particularly skilled at running a business. Furthermore, if the product or service is new, market acceptance and competition can be extremely difficult to assess.

For these reasons, expertise in valuing seed- and early-stage businesses is an absolute must. Relying on textbook methods alone can result in substantial misrepresentation of the value of the business.

### **Why Now?**

Some entrepreneurs wonder why a valuation is even necessary at such an early stage. The most obvious reason is to justify the investment. If the company is looking for financing, an independent valuation helps fine-tune the financing or investment request and adds credibility to the

pitch and substance to the business plan. Here are other reasons you may wish to seek early valuation:

- The IRS requires a valuation in connection with the gifting of shares, even in a start-up.
- Stock options require a determination of fair-market value at the date of issue.
- Shareholder or intellectual property disputes often come down to conflicts over perceived value.
- A valuation may be helpful for purposes of estate planning.

Beyond these specific reasons is another one of fundamental importance to business owners:

Periodic independent business valuations can serve as a fundamental component in the strategic planning process, helping to guide decisions to position the company for its intended future, whether that's IPO, sale, merger or simply steady growth. Knowing the value of the company — and the thinking behind that valuation — provides a benchmark from which future performance and value can be assessed. Note that the company itself may not be the party requesting the valuation. Potential investors often require a valuation to help determine the viability of a deal and potential return.

### **Essential Truths**

A valuation is based on expectations of performance, and increased risks mean decreased value. Consider just a few of the uncertainties and potential barriers to success that impact the value of a seed- to early-stage business:

- *Management team risks*: Can the management team perform and execute key deliverables? This is an absolutely critical factor and a common reason for failure.
- *Market risks*: Will demand increase or decrease? What degree of competition is the company facing? What share of the market can realistically be won?
- *Product/service risks*: Can the company meet schedules and customer expectations while keeping costs on track? Are prices, volume, costs and capital investments forecasted properly?
- *Financial risks*: Will the company run out of money before it hits its stride?

The key is figuring out how to assess the company fairly while acknowledging that new companies rarely perform at

peak efficiency in all areas. A thorough competitive study is a natural starting point, accompanied with exhaustive internal and external risk analysis.

### **Multiple Methods**

Once the external and internal factors are assessed, a valuation analysis is performed. For obvious reasons, typical valuation methods such as price-to-earnings ratio and single-period capitalization aren't viable options when valuing a new or young company. In a start-up, there is no track record for income and cash flow.

Business valuers often consider the discounted cash flow (DCF) method — which takes into account present value, future value, interest and periods of time — and various market-approach methods, including the guideline transactional method. Angel investment rules of thumb should also be considered. When using the DCF method, valuers must be certain they are comfortable with the reliability of the forecasted amounts utilized.

Some companies in the early stages of development have not reported revenues. In addition, some companies report research and development as revenue. How does the valuator analyze a company with no revenue? In this case, the valuator uses the Discounted Earnings Method or the DCF method, usually in conjunction with a probability analysis.

What about a company with negative earnings and no projected profitability in the near future? Multiple of Revenue is the most common method used to estimate value, with the DCF method as a good alternative.

### **Art or Science?**

Whatever the reason for the valuation of a young company, the process is likely to involve a fair amount of interpretation — interpretation of fact and of more subjective measures. When choosing a business valuator, it's important to look for one who is familiar with the process and who knows what questions to ask, where to look for answers and how to assess the many unknowns. These sound information-gathering skills combined with solid methodology will result in a valuation that's fair and accurate — one that a business or investor can rely on to make informed decisions about the future.

*For more information about the valuation of seed- and early-stage companies, please call our office.*