Exploratory Note 29

Startup Valuation Techniques:

The Berkus and Risk Factor Summation Methods

**INTRODUCTION**

Comparables and discounted cash flow (DCF) analysis can be used for companies at all different stages of development; however, in the absence of certainty, it is important for you to understand that the outputs of such models are going to be (at least) somewhat unreliable—and this is especially true when it comes to early-stage firms. This note expands on our discussion of valuation by presenting two alternative approaches that are designed especially for very early-stage firms: the Berkus and Risk Factor Summation Methods. These models do not provide us with greater accuracy or precision in practice; however, as they are widely utilized in the early-stage community, especially by non-institutional investors, they are worthy of consideration.

**THE BERKUS METHOD**

The so-called Berkus Method was designed by David Berkus about twenty years ago and has received limited academic attention since the early 2000s (it was first addressed in *Winning Angels*—a practical review of early-stage angel performancewritten by a couple of Harvard professors). Instead of looking forwards a number of years and attempting to project financial performance—through relative or absolute efforts—and working backwards to an appropriate valuation, the Berkus Method looks at five factors and attributes up to half a million dollars of value for each: soundness of the idea, prototype existence, quality of the management team, strategic relationships, and existing sales. Each is considered in the below sub-sections.

***Soundness of the Idea***

The first matter of concern for the Berkus Method is the conceptual soundness of the idea. This has nothing to do with current performance, only potential. What factors would likely justify a half million dollar partial valuation?

Is a niche market necessarily underserving of a full half million dollar partial valuation?

***Prototype Existence***

Is there a prototype in existence? If so, is this a good thing? Why?

If not, does this necessarily warrant a less than half million dollar partial valuation? Why?

***Quality of Management Team***

It is interesting that traditional valuation metrics do not directly address managerial quality; although, it can be indirectly addressed through the subjective adjustment of inputs or selection of multiples. How?

The Berkus Method addresses this issue directly. First, why is management critical? What constitutes good management?

Does a poor management team necessarily warrant a less than half million dollar partial valuation? Why?

***Strategic Relationships***

The Berkus Method puts a premium on strategic relationships. Why are they important?

***Existing Sales***

Finally, existing sales are considered. Why are existing sales a good thing?

The existence of sales helps to minimize production risk. What is production risk and why is it a concern for early-stage firms?

***Putting All Five Together***

The Berkus Method culminates in the aggregation of the partial valuations derived from the five areas considered above. If a firm scores excellent in the first four categories, but does not currently have sales, then the Berkus Method would support a valuation of, perhaps, no more than two million dollars.

What do you think of this approach? Is it reasonable? Is it perfect? If it is less than perfect, what are its flaws?

**RISK FACTOR SUMMATION METHOD**

The Risk Factor Summation Method is similar to the Berkus Method, but starts with a median valuation and proceeds to make set adjustments based off of an analysis of twelve risk factors. Each risk factor is assessed as follows:

+2 Very positive for growing the company and executing a successful exit

+1 Positive

0 Neutral

-1 Negative

-2 Very negative for growing the company and executing a successful exit

Every point is worth either plus or minus $250,000 when it comes to the final valuation (which starts at an appropriate geographic median).

The risk factors:

Management

Stage of the Business

Legislation and Political Risk

Manufacturing Risk

Sales and Marketing Risk

Funding and Capital Raising Risk

Competition Risk

Technology Risk

Litigation Risk

International Risk

Reputation Risk

Potential for a Lucrative Exit

**OTHER NON-QUANTIFIABLE VALUATION FACTORS**

The lists above are by no means exhaustive when it comes to matters of importance to early-stage valuation. Consider, for instance, the following:

Board Seats – if an institutional investor wants two board seats and the founder is only willing to give up one, what will likely be demanded by the institutional investor in exchange for such a concession (if it does not kill the deal entirely)?

Founder Vesting - might the vesting period requirements of a founder lead to different demanded valuations by the capitalists? Why?

Anti-Dilution Requirements – anti-dilution is a negotiable matter. Why might it lead to different valuations?

**CONCLUSIONS**

What can we take away from all of this? If nothing else, recognize that valuation is an inherently imprecise science—so imprecise, in fact, that it might be more appropriate to refer to it as an art form with scientific characteristics.