Transcription

Valuation

Decoding Valuation

As a layman I understand that valuation really means the value of the company at any point of time. But I think things become complicated especially when I read so many articles which say that a company has been valued at $500 Million somebody has received this funding of $50000 in exchange of certain percentage of equity. It always confuses me. And I start wondering there is a science in terms of how investors estimate the value of a particular company. What are the various factors that you take into consideration? And how really us the valuation of a company decided?

So let's start talking about valuation, what is valuation? Valuation is essentially the value of the company that you have created. Valuation, hopefully your valuation will keep on increasing as the business becomes bigger and bigger, that's the idea right. That's how investors and you will make money. Now typically valuation is more of an art than a science and let me explain that.

So when you start off the business, when you are very early stage, when you are at seed stage and you just thought of an idea and you are going to leave your job and start doing this and you go to an investor or an angel investor for financing how does he value your company because you don't have revenues, you don't have customers so what does he do? So at that point in time valuation could simply be looked at, he could look at and say hey you know this is a good team, good idea, good product, big market, let me give it some value. So that is one way of thinking about it. Second stage is when you get to early stage or series A or series B funding at that point it's all about traction.

How much traction have you got, you got some money to prove your idea on the part, have you build out a good business, have you build out a good team or not essentially and that's where you will get your A or B cheque for. That's where people will look at has this person been able to define MVP and some sort of product market fit and that's where valuation come into play and then the third stage is the growth stage, you have built out a decent product, you have built out a decent team and you start to get revenues to flow in, you have some sort of profitability which can be observed, which can be at least projected out and that's where you know valuations are based on those principles.

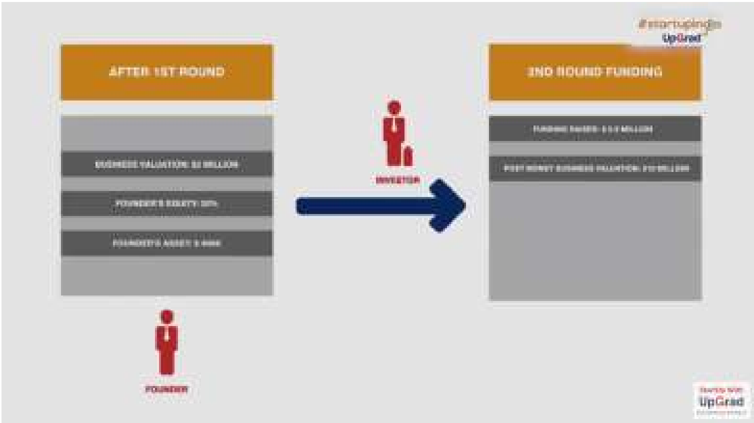
Keep in mind the seed and early stages the company might not necessarily be making too of revenue or any profits. So it's very difficult to really ascribe a positive value to the company in an accounting sense or financial sense. So it's more of a give and take, it's more of a negotiation between the investors and the startup founder. In the growth stage there are still little bit more science. There is discounted cash flow or DCF is the methodology which is used by most investors to understand how to value a particular company. But then again even in a DCF what assumptions to make, how the company will grow, what the terminal growth rate of the company will be all of those are more art than science. You can't really argue about it.

Decoding Valuation

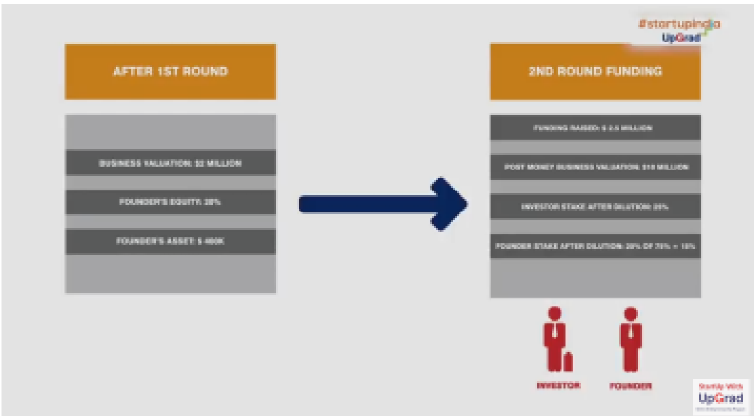
To understand valuations, let's talk about four terms. One is funding, two is pre money valuation, and three is post money valuation and forth is dilution. Essentially funding is amount of money which you have gone to raise to the investor so you say for example you say I want to raise a million dollars and that's the amount of funding you are negotiating with the investor. He might or might not agree to give you that money or at least that's the money which you want to raise. So that is funding so let's say million dollars is what I want, million dollars is the funding is what I am looking for. Next comes pre money valuation. Pre money valuation essentially the value you have created to this point of time before the funding goes into your bank account, that's the pre money valuation and this is where the whole discussion with the investor is. So the investor might say you have got a team, you got a good product but you have no customers. So your valuation let's say for example should be only 5 million dollars, pre money.

Where as you might say hey I got a good team, I got a good product and I have customers in trial, I might not have paying customers so I should evaluate at 9 million dollars and that's where the whole give and take and negotiation starts happening. So at some point in time you will negotiate a particular value and the investor will negotiate down to a particular value and that's where we come to a pre money valuation. So let's say you both come down to 7 million dollars of pre money for your company. That's the negotiated pre money for your company. Pre money valuation plus the amount of funding that you are raising gives you the post money valuation essentially. So if you said 7 million dollars and you are raising a million dollars so that's 7 + 1 = 8 million dollars and that's where we have ended up with your post money valuation. Finally with all this maths comes down to dilution.

Dilution is essentially the percentage of a company that you are giving away for that funding to the investors. So essentially for one million dollars at a 7 million pre money, you have given away close to 12 .3 or 12.4 percentage of the company to the investor and that's your dilution. The thing to keep in mind when you are negotiating with the investor all the time is yes you want higher pre money or you want to lower your dilution but the investors might not be attracted to your business if you try to push them a lot because as investors they also want to own a certain percentage of the business that they can feel they are responsible for the business or they can spend ample time and give enough attention to the particular business. And this dilution varies from investor to investor. The other thing to keep in mind as a founder is, among all of this how you make money or why valuation is important to you as a founder is you win a percentage of the business. Let's assume you own 20% of the business at some valuation. Now depending on how that valuation is post money that defines how much tapered money you have in the bank account.



So let's take an example, let's say in your first round of funding you own 20% of a 2 million dollar business which basically mean that you as an entrepreneur your stake was worth 400,000 which is 20% of 2 million dollars. Now you have another round of funding at much higher valuation. Let's say you raised 2.5 million dollars at a pre money valuation of7.5 million which is essentially post money of 10 million.



So what you have diluted is 2.5, you took 2.5 million dollars on a 10 million, so the investor essentially took 25% of your company fundamentally that. Now if you take that maths and you look at your own stake, so you own 20% and you diluted 25%. So which is basically you are left with 15% of the company at valuation of 10 million dollars, so your stake now is 1.5 million dollars. So even though you own lesser of the company, only 15% of the company but your stake has grown from 400,000 dollars to 1.5 million dollars.

Cap Tables

So, let's talk about cap table. Cap table is essentially short form for capital tables or capital structure table which basically tells about, which essentially you can think of as an excel sheet or a table which shows all the numbers or percentage ownership or shares of the various participants of the company. The founders, the investors, the employee stock option and anybody else who has a certain stake in that particular company. So let's discuss this with an example.

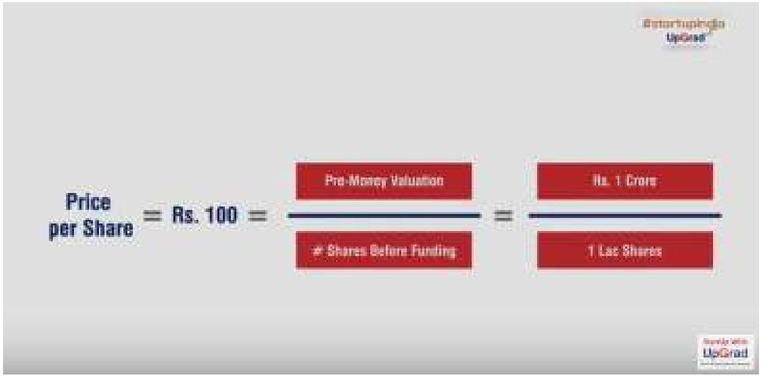
In this case, we are talking about 3 guys - Navin, Yogi and Jitendra, who are fresh out of a college and have a business idea and a product named TOWERS. They started in 2012 and decided to allocate 40% each between Navin and Yogi who are the brains of this idea and have also worked on the technology and since Jitendra joined them later on his responsibility was for getting the commercial job(s) done they allocated him 20% of the shares.

Now from the cap table perspective, these guys will have to infuse capital in this decided proportion such that the cap table states the same. So let's say Navin, Yogi and Jitendra subscribe to a total of 1 Lakh shares divided in a ratio of 40 to 40 to 20 between the three of them.

They devoted their final year of college in creating a product and have just approached an angel investor to help them kick start their operations with some investment. Mr. Ritesh is an hotelier and as an angel investor agrees to fund them an angel investment of 25 lakhs INR for around 20 % stake in their company.

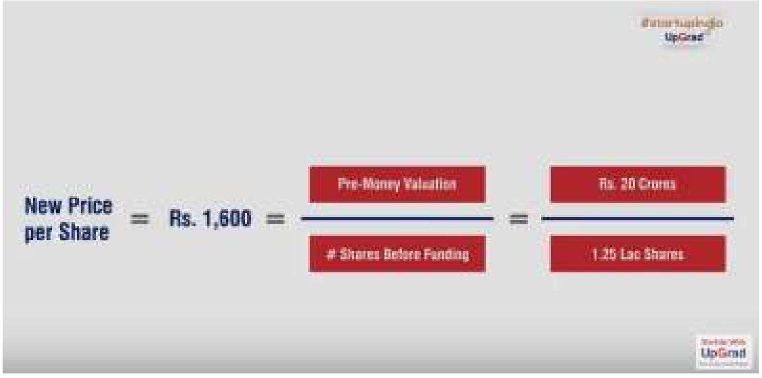
Now an important point to note here is that whenever an investor is roped in, he may come in as a Preferred Shareholder which means that he gets paid first in case of a sell out and only then, the remaining portions goes to common shareholders. We will look deeper into this in the upcoming sessions.

Here for the exchange of 25 lacs investment, the company will issue fresh shares to the investor. Hence the overall pool of shares will go up in order to accommodate the incoming investor.



The price per share for Ritesh, the angel investor would be Rs. 100 per share and he would get 25,000 shares. You would get the price per share by dividing the pre money valuation with the number of shares existing before the transaction.

Now after the first seed investment has been made and the funds have been received and used, say 6 months later the idea gets traction. It appears as if their efforts and investments of marketing, SEO and sales have paid off and investors have started valuing the idea. So now the first investors, say TETRIS VENTURES have decided to invest in towers. They are willing to pool in 5 crores for the 20% stake. So hence there would be a 20% dilution to the existing shareholders. Now the net worth of the company at this stage would be 25 crores post money.



The share price would be 1600 per share which is 16 times the previous round. Now Mr. Ritesh the Angel Investor does not participate in this round. That means he will also be diluted along with the founders. Although the percentage of the holding of founders have diluted from where they started their overall valuation has increased significantly. For instance, Naveen who had put 4 lakhs for 40 percent stake is now standing at 6.4 crores although his ownership has been diluted to 25.6 percent.

Summary – Valuation

In this session we spent some time understanding the various funding phases and more importantly we spent a lot of time to understand in detail how companies are valued. We also looked at the various factors that investors look at while deciding the valuation of the company and that various significantly across the different rounds like angel and seed investing, Series A and Series B round and the Series C and Series D rounds. We then also moved ahead to understand some of the critical terms when it comes to evaluation when it comes to evaluation as an entrepreneur. These include pre and post money evaluation and dilution. Then we also looked at understanding employee stock options or ESOPS and the cap table which gives you a good idea of the equity distribution in a company. It was great meeting you for this session and I look forward to seeing you soon