Your Guide to the Wild West of Startup Investing

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Today, it's all about startups. I hope you like the recent focus on this exciting investment category. If you're ready to take a step up, and learn more about how to invest wisely in this potentially confusing field, then you should join my forthcoming private call. Hopefully, that will help you make sense of the opportunities.

One problem with appraising firms like these is working out whether the valuations offered are sensible. At a presentation a few months ago, I was asked by an investor in the audience how to value private companies. I said that it's a little bit like guessing the heights of school children. When they enter primary school, they're all about hip-high; when they enter middle school, they're about chest-high; and when they enter secondary school, they usually come up to your shoulders. This simple heuristic (rule of thumb) allows you to work out whether children are far outside the normal height for their age – giving you a crude measure of their health.

Similarly, firms go through several stages of development: idea stage; "minimum viable product" (MVP); commercial launch; break-even; and internationalisation. Using a similar approximation, you can usually guess the valuation of firms at various stages. This helps you to spot any that are overvalued or undervalued, for their stage in development. However, it makes less sense than many people assume to finely divide individual companies on this crude basis.

Valuing specific firms against their peers can make the difference between a good investor and a great investor. Most growth investors would say you should pick the company first, and the price second. However, when faced with a choice between two good companies – one realistically priced, and one that's too high or low – you're better off picking the realistically priced firm.

Why is valuing a firm too low a problem for investors?

If you're buying shares from another investor, you'll normally want to buy as cheaply as possible. This makes perfect sense, and it's the way most dividend stocks are exchanged. Nevertheless, a lack of buyers can of course indicate that a firm's in trouble – so be careful, if you spot a "bargain".

With growth firms, you may buy newly issued stock directly from the company. Here, particularly, undervaluation can hurt investors just as much as overvaluation. Undervaluation means the firm is starved of growth capital – and may have difficulty raising further funds in later rounds. This is due to over-dilution of the founding team. No wants to put money into a firm, if the management team has too little stake in its future to resist hunters' approaches.

Another risk with undervalued growth companies is that there's always the temptation to use hocus-pocus to "correct" the shareholding of the management team. This almost invariably means that earlier investors get washed out – and later backers go home with all the winnings. That's a brand of skulduggery I've personally been a victim of – and it's very costly indeed. You *can* fix it – but doing so requires an uncertain and costly legal process.

Accordingly, it's critically important to make sure any growth company you're investing in is correctly valued, and any shares you're buying from other investors are priced in a manner that suggests you're not the only buyer around.

To help you raise your game, we're having a brief chat with one of the firms working in the company valuation space.

You can easily get opinions, analysis, and reports on public companies – but there are very few equivalent services for private companies. EQUITY X is one of these – and, in a moment, I'll hand you over to the founder, Akio Kurata, to explain how its service helps private company investors.

However, before you hear from Akio, I'd like to tell you about our *"Early Stage Investor"* product. It's something I've been working on personally, with Nick O'Connor – and it's all about how to invest successfully in high-growth firms. These are often tech stocks, and are often found on crowdfunding sites. It's a rich new seam of opportunities, for those seeking high-growth firms – and it's where I'm currently investing most of my money personally. You can check it out, here.

AL: Akio, why is your service needed?

AK: Mark-to-market equity valuation work is numerical and repetitive. EQUITY X works as junior bankers do – and this helps financial institutions, corporate investors, fund administrators and accounting firms to make existing operation more efficient, by hiring fewer well-paid professionals.

AL: What firms can you analyse?

AK: EQUITY X can analyse private companies based in UK – in the telecommunication, media and technology sectors.

AL: What do you discover?

AK: Users can get business plans, future cash flows, enterprise values, and equity values. If you click on a button, you will have a PDF report.

AL: Why did you set this up?

AK: Equity valuation is expensive and time consuming – as no knows the future. Finance professionals have to consider assumptions. Why do they analyse numbers? Their clients would like to know normalised future cash flows – a true guide to a target company's ability to generate cash flows.

AL: Can machines conduct such fundamental analysis?

AK: Yes, artificial intelligence can analyse raw data, normalise financials, and generate free cash flows. I am not sure why professionals still spend a lot of time working on Excel spreadsheets. Our new solution facilitates a mix of art and science – machines analyse and humans discuss.

AL: How can people be sure the information is reliable?

AK: If you request, we can show you our database in a face-to-face meeting. You can compare raw data with the results, and understand how EQUITY X works in an intuitive way.

AL: How are you planning to expand the service?

AK: Our expansion plans are mainly based around gathering data. With databases in each country, users can analyse private companies in one place in an efficient way at an affordable price. If any of your readers have access to massive databases of public and private companies, EQUITY X would be happy to discuss a strategic partnership to deliver better customer experiences in the digital age.

I hope you enjoyed that insight from Akio. Don't forget to sign up for the forthcoming call, where you'll learn much more about private company investing.

How do you value private company shares? Let me know: **andrew@southbankresearch.com.**

Best,

Andrew Lockley
Exponential Investor