***OutReach***

Reid Zuerlein, Jacob Baron, Lucas Lantis, Ben Hoffman

Accurate and consistent valuation is the biggest challenge that financial analysts face. Valuation models and forecasts are highly dependent on their estimates of future growth and earnings, which are notoriously hard to predict for even the oldest, largest firms. This effect is amplified when trying to value an early-stage company. Most start-ups will not have an established history of results that analysts can use as a starting point, which makes estimating growth even more challenging. Unlike established companies, startups also do not generally have deep balance sheets or large amounts of capital to survive a downturn for long periods of time. This means that investors will demand a higher rate of return compared to safer investments in exchange for the increased risk of an early-stage investment. The key challenge surrounding early-stage startups is the uncertainty of their growth and success, and how to justify this in exchange for an investment.

OutReach has unique attributes which makes you stand out in the crowded startup space. For starters, OutReach has been profitable from a very early stage. Most startups begin with an idea and need outside capital in order to scale up to profitable operations. Your experiences at Qualcomm revealed an untapped market niche that your idea promises to fill. However, by employing an indirect sales method, keeping lean operations of only 100 on staff, and outsourcing manufacturing to third parties, OutReach eliminated many costs that aren’t essential to their business or brand. OutReach was able to avoid VC funding at their earliest stage because of this atypical profitability. Like most startups, OutReach has run into a situation where investment from the VC world offers for a higher rate of return at a quicker pace. The following analysis was compiled to weigh all options and determine your best course of action. Under the venture capital valuation method, we calculated a pre-money valuation of $178 million and a post-money valuation of $208 million using a 50% annualized return (VC industry average).

Using the discounted cash flow method (DCF), we calculated a pre-money valuation of $282.86 million and a post-money valuation of $312.86. The first step in coming to these results was determining the cost of equity for ORN. We used the CAPM approach by adding the risk-free rate to the market premium times the industry average beta and found the cost of equity to be 14%. We then used this cost of capital to find the present values of the free cash flows and terminal value. The value of the company resulting from this calculation was $625.71 million. Considering that many startups die in the early stages, we multiplied this number by a 50% probability of failure to achieve a post-money value of $312.86 million. Subtracting the $30 million investment leads to the pre-money valuation of $282.86 million. Divide the $30 million investment by the post-money valuation and find the ownership value to be 9.59% of the company. This number is well below the venture capital’s request and lower than Mr. Perez’s 15% estimate.

Everest Partners is asking for a 30% stake in your organization, which in our opinion, is too high. When valuing ORN, Everest likely used a P/E ratio of approximately 10 (the P/E of one public comparable company, Cisco Systems). Using this ratio, the post-money valuation of ORN would be $98 million with a required ownership percentage of 30.5%. We believe that this estimate is overly conservative based on ORN’s past performance. We completed our own venture capital valuation using numbers that we found were more in line with ORN’s performance and risk. If Everest would have instead used the industry average P/E of 21.85 they would have calculated a post money valuation of $208.2 million and a required equity stake of 14.4%, which is much more in line with Mr. Perez’s own calculation. While startups are generally valued using lower P/Es due to their illiquidity compared to a large public firm, we believe that ORN’s proven performance and profitability at such an early stage warrants the use of an industry average P/E at the least. This analysis suggests a required equity stake of 14.4% for the same $30 million investment, which is far less than the 30% that Everest Partner’s is pushing for.

In conclusion, Pete Perez should decline the offer from Everest Partner’s based on the conservative valuation model they chose to utilize, and the atypical characteristics of ORN. While a $30 million-dollar investment would help ORN grow at an even faster pace, it is too large of a stake in the company to make financial sense. ORN is in a unique position being highly profitable and lean in organizational structure. Their low costs combined with software advantage will allow them to grow rapidly and efficiently without giving up a large part of the organization. ORN does not require this VC infusion to continue to survive, like many startups with shallow balance sheets do. Considering all of these factors, we suggest that ORN should negotiate with Everest to accept a smaller percentage of the company, in the 15% - 20% range. If this is impossible, ORN should reject the deal.

Grade 38/40

Report: still lacks format. - Divide into sections. As it stands its a single block of text, hard to navigate, read, and retain information. - I would also recommend at least one table with summary of many results, as it is hard to navigate the text with numbers embedded. VC valuation: - One single calculation? This is NOT what I described as the required analysis in class. You were supposed to set up a model, then try different combinations of data to find out what motivates the 30% offer, then see if that changes in Perez's favor with more reasonable numbers. What you present shows the barest minimum of effort. DCF valuation: - Forgot to include Terminal Value of the firm, which adds considerably to the value of the company. This is even after I sent everyone a message containing the growth rate required... - Given the NPV you obtain, what is the equity stake Perez should offer Evert Partners?

Roberto Stein , Feb 11 at 3:14pm

Professor, We did test different scenarios in our model. We describe how we got our 14% required equity stake, and also demonstrated how Everest could have gotten their 30% by using more conservative estimates. While we didn’t copy and paste the same table with different numbers in the excel sheet, I felt that we did quantify these results into our report. I was responsible for the VC valuation for our team and I don’t think the barest minimum of effort is a fair analysis, considering we did test multiple scenarios and even got one to match the numbers presented by Everest. - Jake Baron

Jacob Baron , Feb 11 at 3:22pm

Professor, To add to what Jake said, the terminal value is listed on the excel as TV and referenced in the paper and powerpoint. Although the number itself is not included in the word or powerpoint it is included in the present value of the firm before accounting for the probability of failure. Had the terminal value not been included the value, it would be far lower than it is. The equity stake Perez should offer is listed as 9.59% for the $30 million investment in all 3 of the files as ownership equity.

Benjamin Hoffman , Feb 11 at 3:55pm

1. Thank you for sending me your comments. Canvas should probably alert me if someone has left a comment on a graded assignment, but since I received no such alert, I would not have checked on my own. 2. Going through your calculations again I can see that I did indeed miss a few things. Specifically, the TV of the DCF valuation is there, I didn’t see it before. Also, I can see in your report that you cite more than one VC valuation result. Looking back on it, it seems I took only what I saw on the Excel file, which shows only one calculation. Of course, you can change the parameters and obtain other results, but that would not leave a trace on the Excel itself. Given this additional information, I am changing your grade.

Roberto Stein , Feb 13 at 1:11pm