Introduction to Valuation
Unit 3: Other considerations when valuing your company
Lesson 1: Use of comparables

Comparing your company to another is not a formal, structured model for valuation, but that doesn't make it any less meaningful and defensible an approach. We apply a comparison approach to value to many things we buy and sell during our lives—like cars, houses or boats.

The establishment of market value—what a buyer is prepared to pay a seller—for *any* asset becomes a bit of a proxy for value.

For both early and late-stage companies, comparables provide an accurate and reasonable approach to valuation, either used alone or in conjunction with other valuation methods.

It's important to note, however, that debate regarding the merits of comparables usually centres around what criteria or measures are adopted for comparison. In its most simplistic form, a "comparison approach" requires us to do some research on valuations of similar companies who have raised equity capital at the same stage and geographic region. At MaRS, we advocate using platforms like PitchBook in order to conduct this comparison research.

PitchBook is a subscription-based database that captures and aggregates financial transactions, especially angel/venture investments, and company acquisition data. Just remember, regional "pricing" applies. So valuations in Canada, for example, are frequently different from those in Silicon Valley.

In the absence of the aforementioned transactional data, we can use a variety of key performance indicators that define value. This is not dissimilar to the Scorecard Method. We can use quantifiable measures such as gross revenue, EBITDA, annual recurring revenue and monthly recurring revenue, as well as the patents filed and/or granted, the number of software engineers employed, the number of channel and reseller partnerships under contract. There are a whole host of metrics that help define value.

It's important to also recognize that different technology verticals have industry-specific metrics and performance indicators that are important milestones to mark value accretion.

For example, in software, the number of monthly or annual subscribers might be incorporated into the valuation framework. For a therapeutic company, the achievement of various clinical trial phases will assuredly increase the relative value of the company. And for cleantech energy companies, the fulfilment of regulatory requirements, confirmation of government subsidies, and future cash flows play a role in defining value.

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Lesson 2: Negotiation

We can't talk about valuation methods and models without addressing the critical role that negotiation plays in achieving a consensus. Remember, valuation at its core is *what a willing buyer is prepared to pay a willing seller.* If you can't get a deal done, your knowledge and practical application of any or all of these models will be for naught.

The most practical advice we can offer to help in future negotiations is to enter the process with a clear head. Check emotion at the door and be prepared. Having a sound understanding of how investors look at and value companies at various stages in their growth is important.

Try to also speak with other entrepreneurs who have engaged in valuation negotiations before, because their insider knowledge might prove helpful in your own preparations.

For example, if you're negotiating with an investor from a VC firm, talk to other company founders and CEOs in their portfolio about their experience in the valuation and term sheet negotiation process. Find out how this VC handles valuation and form a strategy based upon that insight.

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Lesson 3: Can a high valuation hurt your company?

You may be wondering if a high valuation can hurt your company. While we can't do the subject justice in this brief summary, we do want to provide some insight into this topic.

It's important for entrepreneurs to define the *right* value for their company at every stage in its growth. Sometimes, entrepreneurs feel as though the primary goal in negotiating investment terms is to achieve the *highest* possible value for their company, as well as minimize equity dilution to the founders or existing shareholders.

We want to stress, however, that you shouldn't dwell on the valuation, and more importantly, you should be aware that overpricing your company can actually hurt your venture.

It may sound like we're serving the interest of investors by saying that, but if a valuation is not aligned with current, measurable achievements and value metrics, a company will get *ahead* of its value.

If a company secures a commitment of capital at an inflated value, it will then be forced to *catch up* to that unrealistic valuation. That scenario can prove disastrous for a young, growing company. If they don't catch up to that valuation, the company will have a difficult or impossible time finding investors in a subsequent round that will support a higher valuation, or even the post-money from the previous round.

The other alternative is that they do raise capital, but do so at a lower valuation. That's called a *down-round*. This hurts all shareholders and is frequently dilutive to the founding shareholders. A down-round hurts investors less, however, because they frequently build anti-dilution provisions into their deal structures.

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