Introduction to Valuation
Unit 1: Background to valuing companies
Lesson 1: Introduction

Welcome to our course on valuation. This course is a direct response to your demands to better understand the valuation process and its real-life, practical application for scale and growth companies.

Entrepreneurs who have never engaged in the valuation process are frequently intimidated by the methods or models involved. We often hear “it’s too complex,” or “I can’t do the math or spreadsheet modelling.”

But valuing early-stage companies is not rocket science.

This course will take the mystery out of valuation and give you the tools to understand and apply it throughout the evolution and growth of your venture.

Before investing in a startup, the first question many entrepreneurs and investors ask is, “What is the company worth?”

Valuation defines how much equity, or share ownership, an investor acquires for his or her monetary investment. Therefore, determining the valuation of a company *before* it has revenue can be a little tricky.

Valuation of a pre-revenue company is often one of the first points of contention—and by that I mean heated debate—that must be negotiated between investors and entrepreneurial founders, and amongst existing shareholders.

Entrepreneurs often want the value to be as high as possible in order to *minimize* the dilution to their ownership. On the other hand, investors want the value to be low enough so that they can own a reasonable portion of the company for the amount they invest.

Either way, there are pitfalls at both ends of the spectrum—really high or really low. We’ll learn more about this later.

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Lesson 2: What valuation method is the best to use?

What valuation method is the best to use?

The short answer is: it depends. And one approach is rarely sufficient to achieve your goal. Experienced investors and entrepreneurs often use *several* different methods to value a startup because no single method is best.

Using multiple valuation methods can also help in the negotiation process, because an average can be determined among them.

Since most startups have little-to-no history of revenue or earnings, there isn't much information to analyze or plug into a spreadsheet. In order to close this gap, angels can look for clues from similar startup deals in the same region and industry.

Like we see in real estate, valuations will go up and down, depending on market forces. You can expect lower valuations during a recession and higher ones in boom times when there is more capital available in the ecosystem.

Startup valuations may also be adjusted up or down based on the strength of the management team, as well as the location of the business, industry or market. Valuations of startups in Ontario, for example, may differ greatly from valuations comparable companies might achieve in Silicon Valley. We call that a "market differential."

It applies to company valuations the same way it applies to real estate. Similar homes may differ in price wildly depending upon the location.

Valuation at the startup phase **is** more art than science.

Accountants, chartered business valuators and professors love quantifiable models and Excel spreadsheets, but they're just not useful, or appropriate, at these early stages. There is no *perfect* methodology to establish the pre-money value of pre-revenue ventures. Therefore, it is even more important for investors and entrepreneurs alike to know and understand *how* the number is calculated—even if there is a healthy dose of subjective measure employed.

At an early stage, valuation models are mostly subjective, because they largely use qualitative metrics. As such, one can always argue or debate the merit of them.

In later stages of growth, approaches based on income are most often used. We will touch on those methods in later units of the course.

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Lesson 3: Reasons to value a company: Negotiating with investors

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There are many reasons why you might want to know the estimated value of your company.

The one that probably springs to mind first among entrepreneurs relates to raising equity capital—be it from angels, VCs or strategic corporate investors. When founders sell shares in their company to raise capital for company expenses, they need to define and/or negotiate a price for those shares. That price will define how much of the company is sold to investors in exchange for their capital commitment.

It's similar to buying or selling a home. Before buying or selling, you want to have a good understanding of the market value when defining the price. That same principle applies to raising equity capital for your startup or growth company.

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Lesson 4: Other reasons to value a company

There are also less obvious reasons why you should ascertain the value of your company at various stages in its evolution.

1. Founders frequently seek out co-founders to join them in their entrepreneurial venture and sometimes those co-ownership relationships come to an end. In that case, valuing the share price of a company for founder and/or partner *buy-in* and *buy-out* scenarios, which happens more often than you might think, becomes necessary.

2. Valuing a company, and its share price, is also quite useful when establishing an employee stock option plan, known as an ESOP. ESOPs are an important tool for attracting, incenting and retaining high-quality talent in the knowledge-based sector. Before issuing and distributing options to new recruits, managers or board directors, you need to be able to define the current fair market value of the company and its shares so you can translate that into the option price. This is typically aligned with the share price.

3. Unfortunately, entrepreneurs tend to also face marital dissolution because of the toll entrepreneurship takes on personal relationships. Like any other asset, share ownership in your company is deemed a marital asset by the courts and subject to potential distribution. No matter what decision about treatment of that asset is exercised, the value will have to be ascertained.

4. Last, but certainly not least, is the exit plan. Namely, a liquidity event that might be the payday for shareholders. Entrepreneurs and investors are often aligned in their objective to scale and build value in a company to ultimately sell it for a profit. The ability to apply valuation methods and models is essential in defining and defending a valuation range when negotiating third-party offers and acquisitions.

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