Appraisal Economics Inc.
Valuation and Economic Consulting Services

HOW TO VALUE A STARTUP BUSINESS

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INTRODUCTION

The business world is filled with prime examples of startup firms who famously went from small teams set up in a garage or mom's basement to burgeoning companies now employing the world's top thinkers and making waves in the economy. While these top-rated companies may have started from next-to-nothing, they made a very important move in their growth – they managed to properly value their companies from the beginning, using that foundation as the basis for exponential gains. This whitepaper seeks to present the process of providing a proper valuation for a startup firm, reinforcing the need for accuracy with famous upstarts as case studies.

WHAT IS "MARKET VALUE", ANYWAY?

Simply put, market value is the price an asset would fetch if sold in the marketplace.

In terms of business and economics, market value most often refers to the market capitalization of a publicly traded company. The quick-and-dirty way of determining that valuation comes from multiplying the number of its outstanding shares by the current share price.[1]

Market valuation is an important concept to understand and critical number to know – and not just for publicly traded companies. In fact, in the startup world, market valuation is paramount to spawning growth. However, for a startup, defined by cofounder of Warby Parker's Neil Blumenthal as "a company working to solve a problem where the solution is not obvious and success is not guaranteed", business valuation can seem somewhat elusive.[2]

Without publicly-traded shares, though, proper market valuation is still possible – and important, often dictating how well a company does in a.) an initial public offering (IPO); or b.) when put up for sale. The companies examined toward the end of this whitepaper did one thing supremely well prior to going to market for an IPO or sale – they valued their companies fairly, and because of that, their IPOs and/or sales were wildly successful and set them on prolific paths.

Understanding what makes up a startup's valuation is important, but where does one begin? The answers lie in key intangibles that must be developed over the beginning of a startup's life.

These intangibles, in place of years' worth of financial performance and history, will eventually drive the market valuation. But first, let's examine the traditional methods of business valuation.

1 "Market Value." Investopedia, n.d. Web. 11 July 2014.
2 Robehmed, Natalie. "What Is A Startup?" Forbes. Forbes Magazine, 16 Dec. 2013. Web.

VALUATION METHODS

There are two popular approaches taken when valuing a business. While each has many layers, the basic concepts of each approach are outlined below.

THE INCOME APPROACH

This first approach estimates valuation by converting projected earnings to a current value. Projections are based on a capitalization rate (an expected rate of return)[3], a discount rate (converting future income and expenses to a single current amount)[4], or a multiplier. No matter the method of conversion, the goal is to determine a fair value measurement of market expectations to reflect the current value of the company. Meticulous estimating of the proper level of earnings to combine with the conversion factor – after-tax, pretax, discretionary, or cash flow – is key to coming up with a reasonable value.

THE MARKET APPROACH

The market approach is just that – it uses prices and other relevant information generated by identical or comparable market transactions. Simply put, it sets the value based on what other comparable businesses have been sold for in the startup's geographic area. While this approach seems straightforward, implementing it can prove difficult if similar business transactions don't yet exist.

3 "Capitalization Rate." Investopedia, n.d. Web. 11 July 2014.
4 "Discount Rate." Investopedia, n.d. Web. 11 July 2014.

MAXIMIZING INTANGIBLE ASSETS

In either method for valuation, intangibles will be the underlying assets that truly boost a company's net worth. For a private startup that has not yet seen major income growth, intangibles rank with even more importance. Therefore, time prior to the sale should be spent cultivating those intangibles. The International Business Brokers Association recommends focusing development efforts on the following intangible assets when looking to increase the value of a startup[5]:

DEVELOP KEY EMPLOYEES

A startup must be more than its founder or CEO. When it comes to an IPO, buyers generally aren't interested in paying a premium if the business relies on a single person, or pair of people, for its success. In order to avoid this situation, it's important that leaders remember to delegate responsibilities and focus on a learning atmosphere where key employees and staff members have the opportunity to grow and demonstrate pertinent skills in key functions. A company who's success is reliant on a team of capable, well-trained employees who collectively carry a valuable amount of intellectual property – not just a single brain – will see a significant impact on its valuation at the time of sale.

WRITE IT DOWN

Document everything. There can never be too much organization or detail. Job descriptions, operations processes, and strategic plans will become pertinent information in valuation. Succinctly documented records and plans leave little room for guesswork when it comes to a potential buyer emulating the startup's practices and growth. Other important records to retain include sales and expense reports, internal profit and loss statements, balance sheets, and tax returns.

5 "Valuing Your Business." International Business Brokers Association, n.d. Web. 11 July 2014.

BUILD RELATIONSHIPS

Businesses the world over have been developed simply by creating meaningful, strategic, and rewarding relationships. Hard assets aside, relationships are key, and provide a reason for focusing on general principles such as name recognition, customer awareness and positive reputation building. Each relationship established becomes a part of a business' value. This extends beyond company partners – consider diversifying both supplier and customer accounts, as well.

IMPROVE CASH FLOW

It's been said before, and proved many times over in the business world: cash is king. Many financial analysts consider a company's cash flow to be the most important indicator of a startup's financial health, so it comes as no surprise that a potential buyer will be very interested in seeing the "true cash flow." Where cash flows are weak, it requires much more than a quick financial fix – startups should be thoroughly analyzing the company's practices in supply chain, pricing relationships, and flow of funds from customers in order to take a holistic approach to consistently improving cash flows.[6]

DETERMINE (AND STICK TO) A NICHE

One of the greatest fallacies of a startup is the attempt to be "all things to all people." Because of the inherent unsustainability of this business model, it's likely to drive buyers away. However, potential buyers are much more likely to pay a premium for a startup successfully operating in a niche with limited competition and identifiable barriers to entry.

6 Bernabucci, Bob. "Improving Your Cash Flow Problems." Entrepreneur.com. N.p., 02 Aug. 2005. Web.

TRUTHS BEHIND VALUING A STARTUP

Startup valuation, with its reliance on intangibles, can truly be more of an art than a science. Still, there are a few concepts to keep in mind during valuation, described by Asheesh Advani for Entrepreneur Magazine[7]:

YOU ARE WHAT THE MARKET SAYS YOU ARE

Investors will be the ultimate drivers of valuation. After all, it all comes down to what the people with the pocketbooks are willing to pay. Oftentimes, a startup's estimation of market value will be above what investors declare it to be worth – this is normal. However, there's hope. Keep reading.

YOU CAN TELL THE MARKET WHAT YOU'RE WORTH

Investors will base their valuation off of information you've provided. If all the previous intangibles are entered into a fair market value of the startup alongside the hard assets, it will likely be a well-backed, reasonable estimation. Without a wealth of tangible assets or a long history of financial performance to base a valuation on, investors will rely heavily on what the startup broadcasts – and in case it hasn't been said enough, intangibles play heavily into that valuation.

ASK FOR HELP

Valuation cannot happen in a silo. And because of the weight that a reasonable projection carries, it's important that a startup brings the right people with the right skills on board. Valuation firms specialize in determining market rates, and are often staffed by teams of diverse expertise – industry specialists, certified appraisers, financial consultants, lawyers, and more.

7 Advani, Asheesh. "How to Value Your Startup." Entrepreneur.com, n.d. Web. 11 July 2014.

TIPS FOR VALUING A STARTUP: THE DO'S AND DON'TS

DO

Value the intangibles. Determining what sets the business apart is key to valuation, but in a startup atmosphere, differentiation is difficult without maturity. Instead, focus on identifying and broadcasting the intangibles that make the startup a unique competitor in its niche. As described above, this includes intellectual knowledge, goodwill and relationships, thorough documentation, and more.

DON'T

Over- or under-estimate future income. Easier said than done, yes; that's why consulting a valuation firm can be the best move a startup makes. Speaking to an advisor or a team of advisors who understand the industry, market, and existing history of the startup will speed the valuation process up significantly, and guarantee its accuracy.

DO

Play the comparison game. Use similar businesses in the startup's sector as benchmarks. What are they valued at? What have they sold for? In addition, consider what it would cost to set up a similar startup from scratch at this moment. What's the current entry cost in this market? Current market conditions should be taken into account when coming up with this estimate.

DON'T

Be disappointed if potential buyers value the startup differently. It's important to remember that every analyst will differ in valuation techniques. As such, buyers most often come in at a lower valuation than a startup originally intended. This goes back to sharing the right information to influence the number in buyers' heads.

SUCCESS STORIES

It's time to take a quick glimpse at some of the most famous startups that made astronomical strides from meager beginnings – in fact, the selection here all saw their starts in garages of various sizes[8] – by making the right moves in valuing their companies from the start.

AMAZON

It seems hard to believe, but Jeff Bezos founded Amazon.com in 1994. Initially started as an online bookstore, he ran it entirely out of his garage in Bellevue, Washington. It was July of 1995 when he sold his first book, and his IPO came just two years after in 1997. Underwriters valued the firm at $18 per share, and with that modest introduction, investors pushed the price 30% higher. Amazon ended the day $54 million richer.[9] And, there's no secret that Amazon.com is now the world's largest online retailer, with a 2013 valuation of $157.5 billion.[10]

APPLE

The "Steves": the late Steve Jobs and his counterpart, Steve Wozniak, at ages 21 and 26 respectively, gave Apple Computers its start in 1976 in a garage in Cupertino, California. The company's initial public offering went out on December 12, 1980 at a modest price of $22 per share, but generated more capital than any IPO since Ford's infamous 1956 debut. The stock closed 32% higher that day.[11] In 2013, Apple was valued at $483.1 billion, with shares trading over $90 in mid-2014.

8 Dunlop, Michael. "10 World Famous Companies That Started in Garages." Retire @ 21, n.d. Web. 11 July 2014.
9 Galante, Suzanne, and Dawn Kawamoto. "Amazon.com IPO Skyrockets."CNET News. CBS Interactive, 15 May 1997. Web.
10 "The World's Biggest Public Companies." Forbes. Forbes Magazine, n.d. Web. 11 July 2014.
11 Deffree, Suzanne. "Apple IPO Makes Instant Millionaires." EDN Network, 12 Dec. 1980. Web.

DISNEY

It might seem tough to think of a time when Disney was a startup, but at a small house just 45 minutes from Disneyland in Anaheim, California, The Walt Disney Company launched in a small garage out back. The year was 1923, and Walt and his brother, Roy, set up "The First Disney Studio" with their uncle, Robert Disney, where the first Alice Comedies (later, Alice in Wonderland) were born. In December of 1957, Walt and Ron took the company public, setting the price at $13.88 per share.[12] At the close of 2013, America's largest media conglomerate was valued at $142.9 billion.

GOOGLE

A startup that eventually turns its name into a verb might be the epitome of success. But much like the other startups described here, Google saw modest beginnings as Larry Page and Sergey Brin gave birth to Google in Susan Wojcicki's garage in September of 1998. When the project began interfering with their studies as Stanford graduate students, the pair attempted to sell it to Excite for a mere $1 million. Facing rejection, they kept the firm running, growing it to an IPO valuation of $85 per share on August 19, 2004. The IPO turned an estimated 1,000 Google employees into millionaires, on paper.[13] As of 2013, the world's most trafficked site was valued at $382.5 billion.

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12 Kennon, Joshua. "Walt Disney IPO Case Study – A Look at 56 Years of Investment Returns." JoshuaKennon.com, 20 June 2013.

13 Edmonston, Peter. "Google's I.P.O., Five Years Later." DealBook. NYTimes.com, 19 Aug. 2009. Web.

HARLEY DAVIDSON

In 1901, William S. Harley paired with his childhood friend, Arthur Davidson, to create a small engine to power a bicycle in – you guessed it – a garage in Milwaukee. In 1903, they officially founded Harley-Davidson, one of the most well known companies for its supreme brand loyalty. The company's IPO didn't come until 1986, and debuted at a humble $11 per share.[14] At the end of 2013, the firm was valued at $15 billion.

HEWLETT-PACKARD

Bill Hewlett and Dave Packard used an initial private investment of just $538 to build their first product, an audio oscillator, in Packard's garage in 1939. Oddly enough, one of their first customers was Walt Disney himself, who used the oscillators in Fantasia. The HP Garage has since become an icon – fondly referred to as the "birthplace" of Silicon Valley.[15] After an IPO set at $16 per share on November 6, 1957, HP closed 2013 valued at $62.9 billion.

MATTEL

Today's highest-grossing toy company in the world[16], Mattel began as a picture frame company run by Harold "Matt" Matson and Elliot Handler in a garage in Southern California. To utilize raw materials to their full extent, the friends began using picture frame scraps to create dollhouses. It led to impressive growth and public ownership beginning in 1960. As of 2013, Mattel was valued at $13.6 billion.

14 Fahey, Jonathan. "Love Into Money." Forbes Magazine, 07 Jan. 2002. Web.
15 "The Birthplace of Silicon Valley." The HP Garage. N.p., n.d. Web. 11 July 2014.
16 Sicoli, Carlo. "Fun For Profit: The World's Nine Biggest Toy Companies." The Richest, 21 Jan. 2014. Web.

VALUING A STARTUP FOR LONG-TERM RETURNS

Despite the strange coincidence of each of the above firms getting started in a garage, the success of these companies wasn't necessarily determined by location, but in the fact that their owners recognized the importance of intangibles, learned how to successfully grow their market share, and were thorough in their valuation of the companies to guarantee enormously successful returns when the time came.

For a startup, valuation can be an extremely daunting task. A worthy reminder: valuation cannot happen in a silo. When it comes to properly valuing something as near and dear to you as your startup firm, it's best to consult with the professionals who manage valuations on a daily basis. Appraisal Economics proudly staffs a unique blend of experts known for thorough, accurate valuations. Contact Appraisal Economics today to get started.