

## ***A Missing Piece of the Valuation Puzzle***

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There has been a good deal of elegant work done on the valuation of private equity securities and the issuers thereof - chiefly securities issued by early stage firms. The challenges are significant since the usual indicia of value are often not in place (e.g. revenues and net after tax earnings), particularly on a historical basis. Valuation is key to the pricing of various rounds of financing of an emerging growth company. The [pre-money valuation](#), given the amount of the financing, yields the [post-money valuation](#) and, based thereon, the percentage of the company the investors in the round wind up owning. Thus, a [pre-money valuation](#) of \$3 million and a \$1 million investment equals a [post-money valuation](#) of \$4 million, with the investors owning 25% ( $\$1 \text{ million} \div \$4 \text{ million}$ ) of the company. The issue is how to arrive at the \$3 million [pre-money valuation](#).

The "venture capital method" entails ignoring the negative start-up cash flows, and estimating a hypothetical future terminal value for the company as of several (usually five) years in the future and discounting backwards, using a significant discount factor to take into account the unusual risks involved in early stage finance. The trick is to derive reliable projections based on some currently ascertainable indicia and evidence. The process aims to minimize the pure guesswork as much as possible, but is very difficult, given the lack of information. There is also future guesswork involved when one factors in the dilutive effect of future financings and speculates on the amount of dilution those financings will entail.

There are also other methods that VCs use to value early stage companies. The Discounted Cash Flow ("DCF") method improves on the venture capital method by including all relevant cash flows for the company, and estimating a true cost of capital for the company. Comparators are often used, but perfectly comparable companies are hard to find, as are detailed financials, in the private equity space. A somewhat more sophisticated model involves the "option method". The idea is that an early stage financing represents, in effect, payment for a call on future values. If the company fails (as many do), then the call is worthless, similar to a publicly traded option that expires out of the money. On the other hand the profit from a successful investment can be spectacularly well beyond anything a DCF analysis would suggest.

This article seeks to illustrate and highlight a significant oversight, in all the current methods - a piece of the equation that is routinely left out of conventional valuation discussions.

Take a typical conversation at the outset of the negotiation of a Series A Round financing. The discussion starts out with the issue of valuation. The entrepreneur and his or her advisors lay on the table a number, based on art as much as science, and suggest that the venture capitalist agree with it as the basis for further discussions. There may be, depending on the investment climate, a certain amount of discipline applied to the pricing of the deal if there is more than one potential investor. In such a case, the market sets the price of the security... *i.e.*, the pre-money valuation. The fact is, however, that there is not much of an auction market for Series A Round securities. In fact, if a knowledgeable venture capitalist smells an auction, he or she

will ordinarily pass and go on to the next opportunity, or team up with the competitor and make a consolidated bid.

The price, in other words, is usually left to naked negotiations between the buy and the sell side. The negotiation starts with the entrepreneur's number, a different number comes from the VC, and the price settles somewhere in the middle. The final result is usually closest to the VC's number since most VCs have a relatively good handle on what is going on in the marketplace, what other firms are paying for investment opportunities. Moreover, ordinarily, there are fewer buyers than there are sellers and more deals than money. The parties agree on a price and then the negotiation segues to a discussion of deal terms. When the deal is finalized, the entrepreneur reports to his or her current shareholders that a pre-money valuation of X dollars has been secured.

My point is that this process, as described, puts the cart before the horse. The entrepreneur and the angels cannot understand the valuation number until they fully understand deal terms. Thus, the term sheet may recite a pre-money valuation of \$10 million and, from the entrepreneur's standpoint that may appear to be favorable. However, the \$10 million stands up only if the new investors are buying common stock with their \$1 million and standing *pari passu* with the existing shareholders. And, that is hardly ever the case.

Let us assume that the new investment is a convertible preferred stock. The new investors get their money back plus accrued dividends before the common shareholders *i.e.*, the entrepreneur *et al.*, get anything. And, let us assume there is at least a fifty-fifty chance the company will be sold for less than its post-money valuation ...*i.e.*, \$2 million vs. \$4 million. Without doing the precise math, it is clear that the valuation, given that scenario, is not \$3 million pre-money. Further, let us say that accrued but unpaid dividends are tacked on to the liquidation preference for purposes of the conversion calculation. If that dividend is 10% and the liquidation event is assumed to be four years away, the common shareholders are being diluted (even under a favorable scenario) automatically by 2.5% a year (the 10% dividend times the 25% interest with which the VCs start out).

Assume the VCs impose restrictions on the transfer of the entrepreneur's shares, perhaps even reverse vesting. Under classic valuation theory, those restrictions eat into the current value of the [common shares](#). Also assume the convertible preferred is in fact a convertible participating preferred, meaning that the VCs get their money back first and then they share in the proceeds as if they had converted. In most scenarios, *i.e.*, those not involving a terminal value in the stratosphere, the participating preferred deal term negatively impacts the entrepreneur's value significantly.

All this, of course, is well known. [Savage Deal Terms](#) in favor of the VCs have an individual and cumulative negative impact on both the pre- and post-money valuation of the company. What is remarkable is how little quantification work has been done on the impact of deal terms on notional valuations. It is true that the outcome of the valuation negotiation in a Series A Round gets underway does not *ipso facto* determine the outcomes of the parties. The parties do not see their investment posted on the score sheet until the liquidity event occurs, the price of that event matched with each participant's percentage and, if applicable, the effect of various deal terms factored in. All relevant items determine the ultimate return on

investment. If the company is sold or goes public, for instance, at a valuation of \$500 million, the fact that the Series A investors get their \$1 million back first is not a major factor one way or the other; if the terminal value is \$5 million, on the other hand, the reverse is true.

In the above sense, the question of pre-money valuation has no definitive significance. However, since valuation determines the parties' relative percentages, it is a critical number. And there is no reason why, under a variety of likely scenarios, the players should not have all the material information at their fingertips when the negotiations go forward.

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