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Know Your Worth: Startup Valuations (Part 1)

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The most basic question any founder[1] must answer when raising money is: how much is my company worth? Here we are only looking at investment valuations, not 409A valuations used for things like determining the exercise price of your option grants.

Spoiler alert, there's no real answer. As discussed below, valuing early stage companies is an art, not a science, and typical valuation methods don't really work for most startups. But at some point, you have to determine your company's valuation, and there are some general principles that can help.

Valuation Mechanics

First, a bit of basic plumbing. When a founder thinks about valuation, she should think about **pre-money valuation**, the value of her company prior to the new investment. The **post-money valuation** is the pre-money valuation plus the investment amount.

A quick example: if a startup raises $1 million at a $4 million pre-money valuation, the investors will own 20% of the company (i.e., $1 million of new money divided by the $4 million pre-money valuation plus the $1 million investment) and the founder will own 80%. In terms of shares, if the founder has 1 million shares prior to the financing, the per share price paid by the investors will be $4 per share (i.e., $4 million divided by 1 million shares). The investors will have 250,000 shares and the founder will have 1 million shares.[2]

But remember that most startups will put in place (if it doesn't exist already) an option pool at the time of the financing, which often comes out of the founder's side of this calculation. Let's imagine that the founder wants to put in place a 10% option pool.[3] In that case, after the financing, the investors will still own 20%, but the founder will own 70% and there will be a 10% option pool.

Valuation Science and Valuation Art

Now that we understand the mechanics, how do we determine a company's valuation? There is no hard-and-fast rule, and anyone who tells you otherwise is wrong.

Valuing a traditional business is a science. The most common valuation method is called a "discounted cash flow analysis," where you create a forecast of future cash flows for a business and then discount it to the present day. This doesn't really work for an early stage company whose future cash flow projections are highly speculative. Traditional businesses can also be valued using revenue or EBITDA[4] multiples (that vary from industry to industry), or by comparing them to peer companies. It's not easy to do this for #disruptive companies with few data points or clearly comparable companies.[5]

Valuing a startup is an art. Industry data shows that it's largely arbitrary, although there are trend lines. Valuations correlate with investment amounts (the larger the dollars invested, the larger the valuation) and ownership percentages (founders in early rounds usually sell somewhere between 20-40% of their business). It's a balancing act between ownership levels, exit potential, current market trends and future financing requirements.

Some investors have proposed specific valuation methods:

- The "Berkus" method assigns a value of up to $500k for each of a startup's idea, prototype, team, board and sales, with a maximum value of $2.5 million.

- The "Scorecard" method uses a regional comparison (West Coast companies generally have higher valuations) and multiplies it by factors related to team, opportunity, market size, product, competition, need for additional investment and other factors to achieve a valuation.

- The VC "required return" method determines the valuation required to return a specific amount to the fund based on accepted revenue multiples for comparable companies at exit.

- The "First Chicago Method" looks at worst-case, mid-case and best case scenarios, models them and then assigns a probability weight.

These might be helpful starting points, but they aren't tailored to specific companies, and most of the factors are nebulous at best. What's the difference between an idea worth $500k and one worth $350k? How did Amazon or Uber calculate its market size at its start? This is art not science.

Practical Considerations

The bad news is that there's no easy way to value an early stage company, but the good news is that you don't *really* have to. A founder raising money needs to do some price signaling for investors, but you don't always have to set a specific number. You should have a target in mind, of course, but you can signal that to investors without writing down a number and sliding it across the table. Investors will look at how much money you've raised, how long it's been since your last financing and how much progress you've made. Your answers to these questions, together with the amount you're trying to raise (which should be specific) signal your valuation.

If you get a low valuation, the best way to get it higher is to create competition. Investors bidding against each other will lead to higher valuations. Anything that shows traction (including revenue!) will also bump it up.

If you get a great valuation, that's fantastic. But remember that headline valuations can also cause problems. Higher valuations usually come with more deal "structure" to compensate, including features that grant additional economic or control rights to the investor. An investor might give you a great valuation, but only in exchange for a lot of downside protection. And although a high valuation can look great, if you're not able to raise future rounds at increasing valuations,[6] it can look like your business is out of momentum. Investors don't like companies that look like they're treading water, and employees don't like it either. So don't just take the biggest number. Be thoughtful about your financing, and choose investors that will help you grow.

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[1] This article is intended for founders; venture investors already have their own methods for valuing early stage companies.

[2] The TV show Shark Tank has a lot of flaws (I mean, a lot of flaws!) but it does a good job of showing this valuation dance live in the back-and-forth between the entrepreneurs and the "sharks."

[3] The size of the option pool varies depending on the company's needs, but is usually around 10-20%.

[4] Earnings before interest, taxes, depreciation and amortization.

[5] The technical term for this is "garbage in, garbage out."

[6] A "flat round" or even a dreaded "down round."

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