CHAPTER 16

Determining the Valuation of Your Business for VC Funding

"If you really do put a small value upon yourself, rest assured that the world will not raise your price."
Anonymous

What is My Business Worth?

"Value, like beauty, lies in the eyes of the beholder," is a cliché but it aptly sums up the essence of value. The beholder in this case is the VC who evaluates you, your organisation, and your business plan to judge its value. Based on this value he invests in your business and gets ownership of a portion of your company.

Understanding the valuation from the VC's perspective is extremely important if you are to succeed in raising venture capital. Hence, before you start meeting the VCs you must have an understanding both of the valuation methodologies which are in use and the mechanics of the venture capital valuation method. Using this knowledge you will be able to:

- Decide on the valuation methods relevant to value your business.
- Develop a range of valuations for your business.

- Develop realistic expectations regarding the value of your business which, in turn, will improve your chances of closing the deal with the VC.

General Methods of Valuation

There is no universal method of valuation. As in the case of sartorial styles, one size does not fit all. Different situations call for different methods of valuations and usually a combination of methods is used to arrive at a valuation range. The final valuation is then arrived at after considering the soft metrics, that is, subjective factors or the intangibles.

There are many methods of valuation and all of these subscribe to the basic principle of valuation theory which states that the value of any asset is the present value of all the expected benefits to the owner of that asset. Also, valuation is often regarded as both a science and an art. The word art here incorporates the element of subjectivity, the assessment of soft factors that have a bearing on the final valuation of any assets or business.

VCs typically use three methods while valuing businesses. Each of these methods provides a different valuation and together provide a range of valuations that the business can justify. The final valuation is always arrived at through negotiations between a willing buyer and a willing seller. The point to note here is that you may arrive at certain valuations for your business using these methods but the final valuation that you are able to get from the VC will be based on negotiations with the VC.

The Cost or Assets Method

This method values a business as a sum total of the cost of its assets less its liabilities. The underlying assumption is that the price of an assets reflects its economic value. There are a number of definitions of cost in use to value the assets, namely:

- Liquidation or break-up value, mostly used for businesses that are closing down;

- Historical cost, i.e. the cost at which the assets are carried in the balance sheet; and
- Replacement cost, i.e. the current market cost of the assets.

This method may be suitable for businesses that have substantial tangible assets, such as manufacturing companies. It is also suitable where the business is in distress and there is little value attributed to the business itself as a going concern.

The main disadvantage of this method is that there is no correlation of cost with value. Also, as it deals with tangible assets it is not relevant for valuing a business the assets of which are chiefly intangibles such as IPRs (patents, proprietary designs, trade secrets and trademarks).

This method suffers in its applicability to new age businesses, which compete in the marketplace on the basis of human creativity and innovation. By not incorporating this aspect in its valuation metrics, the method becomes limited in its scope and universality.

The Income or Discounted Cash Flow (DCF) Method

This method uses the present value of future cash flows to arrive at the value of a business. It uses the DCF methodology to factor in the risk, time and cost of money to value the business.

DCF uses a reverse compound interest technique to convert the future expected cash flows of a business to its present value. A discount factor, which reflects the risk and cost of money for the buyer, is applied to the forecasted cash flows to arrive at the value of business.

Theoretically, the DCF method is sound as it arrives at a value by equating the present value of future benefits. In practice, however, forecasting cash flows and determining the discount factor to be applied inject elements of subjectivity in the methodology which can become points of debates between the entrepreneur and the VC. In spite of this limitation, it is a most useful method of valuing businesses. It is particularly useful when either no comparative transactions can be found or when the revenues and earnings of a business are largely predictable, making determination of expected future cash flow an easy task.