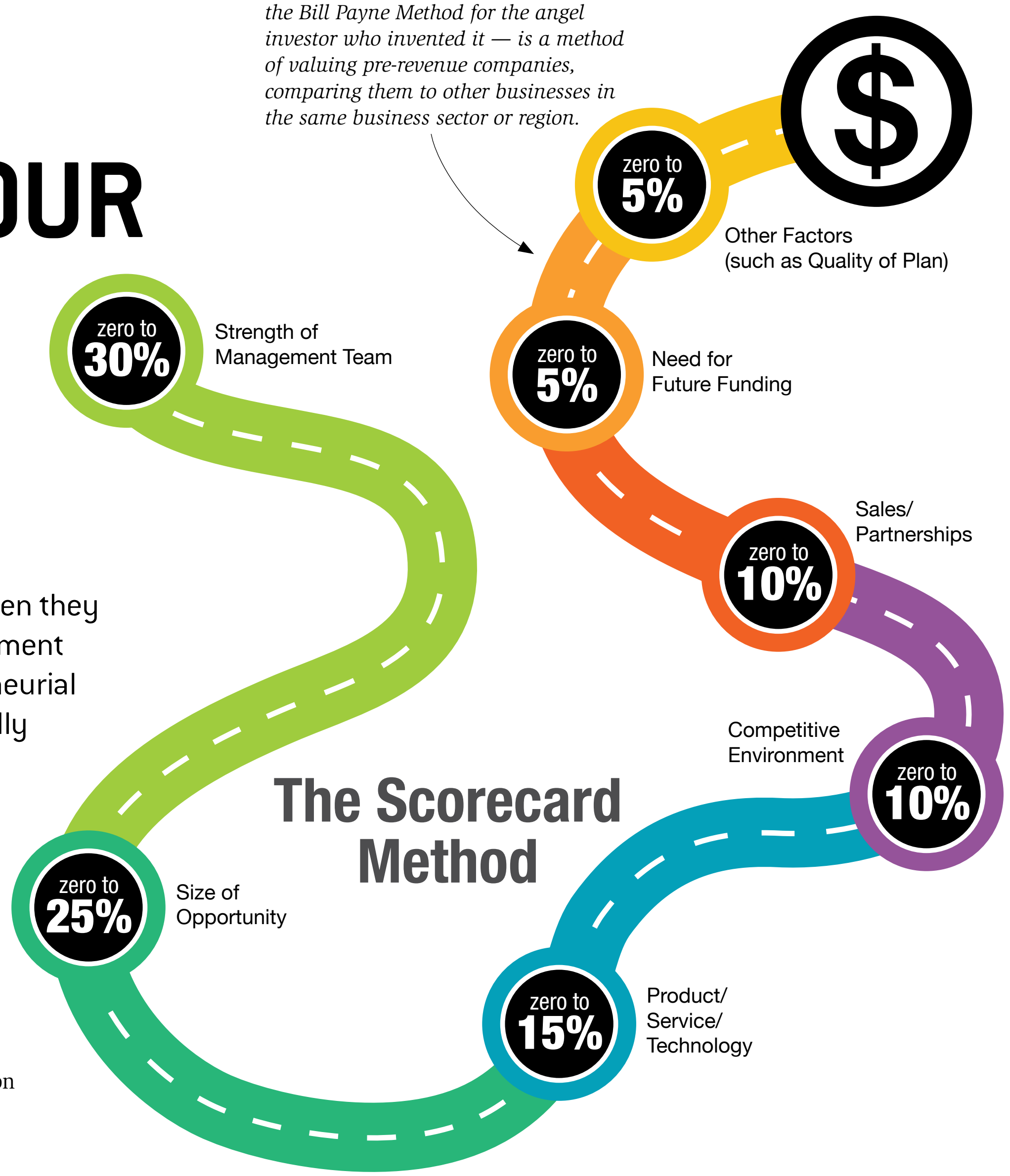
WHAT'S YOUR STARTUP REALLY WORTH?

What potential investors see when they consider your startup for investment might not reflect your entrepreneurial high hopes. Here's how they really assign a value to your fledgling company.

The Scorecard Method — also called the Bill Payne Method for the angel investor who invented it — is a method of valuing pre-revenue companies, comparing them to other businesses in the same business sector or region.



So many startup entrepreneurs, often spurred on by out-of-date education or bad advice, tend to overvalue the worth of their companies and ask for the moon from investors. And then they wonder why their requests for investment are turned down.

I spend much of my time meeting with entrepreneurs. Our conversation usually starts off with "I want a lot of money for very little of my idea or company." At this point, I ask myself a very simple question: "Is this person worth investing time into — and are they able to absorb an accelerated education?"

In some cases, the answer is yes. However, much of the time I (and most other investors) will try to discourage them from looking for investment until they have better educated themselves and allowed us to help with the learning process, just as someone helped us.

I say this because we often hear about entrepreneurs who regret having received investment early on. Over-inflating valuations doesn't help anyone — sometimes it means they can't raise money again because they can't justify their past valuation.

Seeking investment is often a trade-off between what you want *and* what you are willing to give up. For example, the other day someone mentioned talking to an entrepreneur who wanted "venture capital without giving up any equity." I sure hope they were kidding!

ASSIGNING A VALUE

So, what is your company's worth? This is a critical dollar value to understand when you're seeking investment, not only in terms of the investment itself, but also in showing investors just how much business acumen you have.

Before you start adding up your personal investment, sweat equity, brand and goodwill, or trying to figure out what you need to retire on, let's look at some methods investors typically use to create fair valuations.

There are pros and cons to every method, so it's part art and part science. Stephanie Andrew of Espresso Capital Partners says having robust financial forecasting is a great place to start, as the valuation is only as reliable as the forecast. Mark Grey-Dreaper, chartered business valuator and founder of XPS Group and M&A advisors, points to three commonly used business valuation approaches: earnings-based, asset-based and market-based.

The trouble is, these methods don't work well with pre-revenue companies, so we have to apply more art than science.

For startups, we generally look at: entrepreneur credibility, team experience, board and advisor pedigree, scalability, competitive advantage, quality of executable plan, market opportunity and demand, partnership opportunities, comparable companies, products in the pipeline, regulatory risk and the size of the investment round.

There are a number of specific valuation methods that investors may rely on for startups. Two commonly used ones are:

The Risk Factor Summation Method is based on the premise that the greater the number of risk factors, the greater the overall risk. Essentially, this method encourages (some would say forces) investors to think about the kinds of risks a startup must manage in order to achieve a lucrative exit. It focuses on 12 areas to assess for risk factors, including management, sales and marketing, competition and the potential lucrative exit. Each risk is assessed and assigned a value from -2 (very negative) to +2 (very positive for growing the company and executing a lucrative exit).

The Scorecard Method compares the startup to other typical investor-funded startups and adjusts the average valuation of recently funded companies in the geographic area to establish a pre-money valuation of the target.

Of course, there's far more to these methods than we have space to discuss here, so I encourage you to look for business and startup valuation education in your community and search online for The Risk Summation Method and The Scorecard Method. Two good websites are *nacocanada.com* and *kauffman.org*. Try these methods out on your own business or startup ideas and see what your scores reveal.

THE VALUE OF BEING REALISTIC

The key for any investor (and hopefully for any entrepreneur seeking investment) is to avoid an unrealistic valuation for pre-revenue startups as it may trigger a down-round later on. A down-round is a round of financing where investors purchase stock from a company at a lower valuation than the valuation placed upon the company by earlier investors resulting in dilution of ownership for existing investors.

There is a saying: "The value of a business is only what someone is willing to pay for it." In other words, your ability to attract investors and negotiate with them is essential, and having a defendable valuation is a good place to begin for any entrepreneur. ■

Why Startups Should Welcome Fair Valuations

While valuations can be intimidating, they are important. How many times have you heard entrepreneurs say, "I had everything invested in my business and ended up losing my house"?

In my experience, this is usually preventable. When early-stage entrepreneurs understand how valuations work, it can deter them from entering into businesses that aren't financially sustainable. And that can prevent them from losing their personal net worth when they have to claim bankruptcy or have a fire sale before they even have a fighting chance.