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START UP VALUATIONS

THE DILEMMA OF FREE CASH FLOWS

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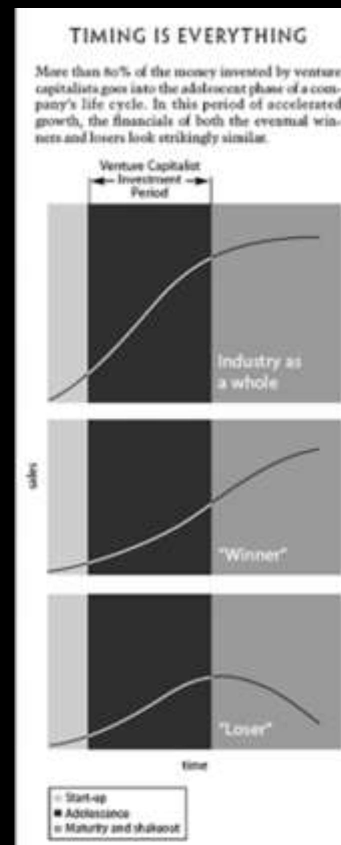
BACKGROUND

The valuation of the Start Ups has been one of the most discussed topic for investment professionals in 2020 and in 2021 with several billion dollar worth IPO's planned by Indian Technology Start-ups the discussion is further gaining steam. Generally, Price of Recent Investment (PORI) is considered to be a fair indicator of the value of the start-up. Under PORI, if the last investor has come at say $100 million valuation, this becomes the benchmark for the next investor coming in. Considering that the recent investment satisfies the level 1 input of valuation as per accounting guidelines and also satisfies market approach application criteria, PORI definitely holds significant weight as an indicator of fair value. The big challenge however is that many times the initial investors would have got something more than an equity shareholder (in form of certain controls or covenants) and equating that to ordinary equity share value could be misleading. Also in an IPO the focus will shift from last Investment Price to multiples of comparable globally listed peers (as Indian peers may not be listed). Additionally with high volatility in the values of start-ups, the date of valuation is an important parameter for the analyst to consider.

Broadly, the main difference between early stage start up and mature publicly listed business is that the listed company will have more concrete facts and figures to work upon. A steady stream of revenue and profitability makes it easier to estimate the Free Cash Flows which are non-existent for early stage start-ups. **This is the great dilemma for Valuer as how reliable are the future projections and free cash flow estimates provided by the management and the approach to take.** In the subsequent section, we have touched upon the basic checks which the Valuer can consider while applying the Income approach for Start-up Valuations.

Also, one additional parameters which one shall consider while evaluating start-ups is the probability of success/failure. As per HBR, on an average - good plans, people, and businesses succeed only one in ten times. The valuer can therefore use an acceptable matrix which can estimate the probability of success or failure of the start- up based on management expertise, demand, pricing and moat around the business.



Source: Harvard Business Review

Discount Rate Estimates

Stage & Target Return	
Start Up	50-70%
Stage I	40-60%
Stage II	35-50%
Bridge/ IPO	25-35%

**Source: Prof Aswath Damodaran*

We are our choices. Build yourself a great story. - **Jeff Bezos**

START UP CLASSIFICATION AND APPROACH

Start Ups can be broadly classified into two categories:

1) **Revenue Generating Start Ups**
2) **Pre Revenue Start Ups**

For Revenue Generating Start-ups there is a proof of concept and of the product's ability to generate revenue. These start-ups may not be profit making however their ability to generate revenue makes them less riskier than the pre revenue stage companies.

DCF is an acceptable valuation method for revenue generating start-ups, however some key points shall be kept in mind are:

- The start-ups may take long to turn profitable, so the explicit forecast period should be longer in duration.
- Growth is a product of Return on Capital (ROC) and Reinvestment Rate (RIR) so make sure that requisite reinvestment which commensurate with projected Growth is done by the company.
- PV of Terminal Value may range from 60-80% of the total value of the start up
- Discount Rate shall reflect the Target Return to an Investor

Apart from Income approach, one can corroborate the findings using the market approach by making necessary adjustments.

For Pre Revenue Start-ups it becomes more complex as actual revenue numbers are not available and thus proof of concept is not established. The additional factors thus to consider in such cases are:

a) **Traction** which can be objectively quantified through number of users, quality of customers etc.
b) **Strength of Founding Team** highlighted through their relevant experience, skill and commitment to the business
c) **Prototype** of working model of your product
d) The **Supply and Demand** framework and the **Moat** around the business
e) **Margins** of the business

ADD-ON VALUATION METHODS FOR PRE REVENUE

Apart from traditional valuation methods, some of the other commonly used Valuation methods by Investors to value pre revenue start-ups are:

Method 1: Berkus Method

Investor Dave Berkus came up with a simple formula of breaking the company into 5 parameters giving each a rating upto $50,000 each:

a) Idea or the Basic Concept
b) Prototype and Technology involved
c) Quality of the Management Team
d) Strategic Relationships / Connections
e) Product Rollout or Launch Plan

However the matrix does not take market into consideration and the maximum value is capped at $2.50 million per start up.

Method 2: Venture Capital (VC) Method

Harvard Professor Bill Sahlman devised the Venture Capital method which is popular amongst the Investors. It has 2 stages:

1. First the Terminal Value of the business in the harvest year is calculated.
   Terminal Value = Revenue (Proj) x Margin (Proj) x Industry P/E
2. Second the Terminal Value is tracked back with the expected ROI and Investment amount to calculate the pre-money value

Method 3: Cost to Duplicate (CTD) Method

In this method, physical assets of the startup is assessed and then estimate how much it would take to duplicate the startup elsewhere. For example, a tech startup could consider the expenses in developing the prototype, IPR costs and other R&D expenses. The flip side is that this is not a forward looking valuation exercise.

Concluding Thoughts

India has created over 44 unicorns with $106 bn in last 10 years. India's market regulator SEBI is also easing norms to facilitate start-up IPOs in the country. Multiple Indian start-up cum unicorns like Zomato, Delhivery, PolicyBazaar, Freshworks, Flipkart, Nykaa are reportedly eyeing the public markets in 2021. Right Pricing (sans unjustifiable market exuberance) would set the tone for long lived success of Start-up ecosystem in India.

zomato

Indicative Valuation: $5.4 Bn
Key Investors: Info Edge, Tiger Global, Kora, Fidelity

DELHIVERY

Indicative Valuation: $3.2 Bn
Key Investors: Soft Bank, Nexus, Multiples, CPPIB

pb

Indicative Valuation: $2 Bn
Key Investors: Soft Bank, Tiger Global, Tencent

Flipkart

Indicative Valuation: $25 Bn
Key Investors: Soft Bank, Tiger Global, Tencent

About the Author** - The author is a practicing Registered Valuer (S&FA), with over 15 years of experience and also holds High Honors in Advanced Valuation Programme by NYU Stern University. These are his personal views. For any query you can reach him directly at **kapil.maheshwari@k-zen.in