Art'o'val Advisors

True Art of Valuation

Valuation Series

5 – Valuation of Startups

May 2023

Introduction to Start-ups

Start-up Overview

- A Start-up is a new business venture providing services or products to an existing and growing market
- A start-up is in the first stage of operations and comprises one or more entrepreneurs
- The primary aim is to respond to market demand by creating new and innovative products or services
- While most small businesses might intend to stay small, a start-up focuses on fast growth in a designated market. Usually, such companies start as an idea and gradually grow into a viable product, service, or platform

Recent Developments

1. In 2016, the Government of India announced its flagship initiative for building start-ups ('Start-Up Scheme') and nurturing innovation with the main objective to boost entrepreneurship, economic growth and employment across India
2. Under the Start-Up Scheme, several benefits were granted to start-ups from legal perspective, funding support, fast tracking of patent applications at lower costs, benefits under Income-tax Act, 1961 etc.
3. As of April 30, 2022, 98,208 start-ups are recognized under Start-Up Scheme and around 1,163 start-ups have been granted income tax related exemptions
4. As per data available on Start-Up India website more than 3,465 start-ups have been funded by SIDBI Funds of funds. India currently houses 3rd largest start-up ecosystem in the world after US and China
5. As per media reports, as at December 2022 India had 108 start-ups with valuation of over $1 billion or having the coveted 'Unicorn' status

Eligibility under Indian Laws

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Indian Acts	Description	Eligibility Criteria
Ministry Of Commerce and Industry	Under the Start-up India Action Plan, start-ups that meet the definition as prescribed under G.S.R. notification 127 (E) are eligible to apply for recognition under the program.	• Should be incorporated as a pvt ltd co. or as a partnership firm or as a LLP • Turnover should be less than INR 100 Crores in any of the previous financial years • Considered as a start-up up to 10 years from the date of its incorporation • Should be working towards innovation/ improvement of existing products, services and processes and should have the potential to generate employment/ create wealth • An entity formed by splitting up or reconstruction of an existing business shall not be considered a "Start-up"
Companies Act, 2013	An entity is considered a "Start-up" only if it is incorporated as a Private Limited company (under the Companies Act, 2013), or registered as a Partnership Firm (under the Partnership Act) or a Limited Liability partnership (under the Limited Liability Partnership Act) in India.	• Not more than 7 years have elapsed from its incorporation/ registration (for an entity in the biotechnology sector, this period is 10 years) • Turnover in any financial year since incorporation/ registration should not exceed INR 250 mn • Working towards innovation, development or improvement of products or processes or services, or is a scalable business model with a high potential of employment generation or wealth creation • Start-ups that are private companies or LLP formed on or after 01 April 2016 • Holds a certificate of eligible business from Inter-Ministerial Board of Certification • Plant & machinery should be new and have never been used in India before
Income Tax Act, 1961	Post getting recognition a Start-up may apply for Angel Tax Exemption Shall be eligible for notification under clause (ii) of the proviso to clause (viib) of sub-section (2) of section 56 of the Act	• Should be recognised by DPIIT under para 2(iii)(a) or as per any earlier notification • The aggregate amount of paid-up share capital and share premium of the Start-up after the proposed issue of share, if any, does not exceed INR 25 Crore

Types of Start-ups

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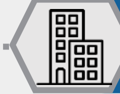
Scalable Start-ups

- Often, companies working in the technology domain belong to the scalable start-up group and these companies work hard to rapidly grow and achieve a high return on investment (ROI)



Large Company Start-ups

- A large company or offshoot start-up includes large companies that have been in operation for a long time
- Companies that fit into this category start with revolutionary products and quickly become famous

Small Business Start-ups

- The purpose of a small business start-up is longevity rather than scalability
- While these businesses have an interest in growth, they grow at their own pace
- Business owners usually bootstrap and self-finance these start-ups

Lifestyle Start-ups

- People who have hobbies and want to pursue their passion can build a lifestyle start-up
- Often, these business owners desire independence and spend their energy, money and time building a start-up
- These business owners earn money by pursuing their favourite hobby or activity

Social Entrepreneurship Start-ups

- Social entrepreneurship start-up focuses on building business to change the environment and society positively
- Some examples of these companies include charities and non-profit organizations

Buyable Start-ups

- Unlike other start-ups on this list, buyable start-ups do not aim to become large and successful
- A business owner builds such a company from scratch to sell it to a big company
- Usually, you are likely to find such companies in the technology and software industry

Key Metrics of Start-ups

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Metric	Description
Gross Assets Value (GAV)	• Gross assets value is the sum of the value of tangible assets owned by the company
Gross Merchandise Value (GMV)	• Gross merchandise value refers to the value of goods sold through your platform
Customer Acquisition Cost (CAC)	• Customer acquisition cost is the total cost of acquiring a new customer. CAC is calculated as acquisition costs divided by the number of customers acquired.
Retention Rate	• Customer retention rate measures the number of customers a company retains over a given period of time
Annual Run Rate (ARR)	• Annual run rate is the amount of money that you can expect to generate from your customers on an annual basis
Monthly Recurring Revenue (MRR)	• Monthly recurring revenue is the amount of money that you can expect to generate from your customers on a monthly basis
Average Order Size	• The average order size is the average amount of money that your customers spend when they make a purchase from your business
Cash Runway	• Cash runway is the amount of time that you have to achieve profitability before your start-up runs out of money

Key Metrics of Start-ups

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Metric	Description
Burn Rate	• Burn rate is the rate at which your start-up is spending money
K - Factor	• k-factor is the rate at which your start-up is growing organically by word of mouth
Monthly Active User	• Monthly active users is the number of people who use your product or service on a monthly basis
Return on Advertising Spend (RoAS)	• Return on advertising spend refers to the number of sales came from the advertising spending over a period of time
Customer Life Time Value (LTV)	• Customer lift time value is the amount of money that you can expect from your customer over the duration of their relationship with the business
Net Promoter Score (NPS)	• NPS (Net Promoter Score) is a measure of how likely your customers are to recommend your product or service to their friends or family
Lead Velocity Rate	• Lead velocity rate measures the growth in the number of leads generated by your business per month
Average Sales Cycle Length	• Average sales cycle length indicates the time lag between initiating sales contract and closing the deal

Income, Market and Cost Approach

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Following are the start-up valuation methodologies:

Valuation Methods	Income Approach	Market Approach	Cost Approach
Venture Capital Method	✓		
Scorecard Valuation Method	✓		
Comparable Transactions Method		✓	
Cost-to-Duplicate Approach			✓
Risk Factor Summation Method	✓		
Discounted Cash Flow Method	✓		
The Berkus Method	✓		

Valuation Methodologies

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A Venture Capital Method

- As the name suggests, this method is a go-to for venture capital firms, and it's another option to consider if you need a pre-revenue valuation.
- It also reflects the mindset of investors who are looking to exit a business within several years.
- Following are the two formulas to work toward the valuation:

Anticipated Return on Investment (ROI)* = *Terminal Value* ÷ *Post-Money Valuation

Post-Money Valuation* = *Terminal Value* ÷ *Anticipated Return on Investment (ROI)

First, you'll calculate your start-up's terminal value, or the expected selling price after the VC firm has invested.

You can find this using estimated revenue multiples for your industry or the price-to-earnings ratio.

Determine the anticipated ROI, such as 10x, and plug everything in to find your post-money valuation. From there, subtract the investment amount you're asking for to get your pre-money valuation.

Valuation Methodologies

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B Scorecard Valuation Method

- The Scorecard Method is another approach for pre-revenue businesses. It also works by comparing the subject start-up to others that are already funded but with added criteria.
- First, determine the average pre-money valuation of comparable companies. Consider how subject business stacks up according to the qualities.

Qualities	Score
Strength of the team	0 – 30%
Size of the opportunity	0 – 25%
Product or service	0 – 15%
Competitive environment	0 – 10%
Marketing, sales channels, and partnerships	0 – 10%
Need for additional investment	0 – 5%
Other	0 – 5%

Following are the steps:

Assign Quality Percentage

- Assign each quality a comparison percentage.
- Essentially, you can be on par (100%), below average (<100%), or above average (>100%) for each quality compared to your competitors.

Factoring

- For example, you give your ecommerce team a 150% score because it's complete, fully trained, and has experienced developers and marketers, some from rival businesses.
- You'd multiply 30% by 150% to get a factor of .45.
- Do this for each start-up quality and find the sum of all factors.

Valuation

- Multiply that sum by the average valuation in your business sector to get your pre-revenue valuation.

Valuation Methodologies

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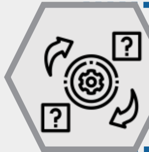
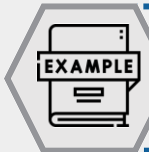
Comparable Transactions Method

The Comparable Transactions Method is one the most popular start-up valuation techniques because it's built on precedent.

This approach answers the question "How much were similar start-ups acquired for?"



With any comparison model, you need to factor in ratios or multipliers for anything that's dramatically different between your two businesses.



For example, if another SaaS company has proprietary technology and you don't, you may want to use the multiplier on the lower end of the range.

This method is similar to the Market Multiples Approach.

Valuation Methodologies

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D Cost-to-Duplicate Approach

- The cost-to-duplicate approach involves taking into account all costs and expenses associated with the start-up and the development of its product, including the purchase of physical assets.
- All such expenses are taken into account in order to determine the start-up's fair market value.

Following are the drawbacks of the method

Companies Projected Financials are not Considered

- The cost-to-duplicate approach, not considering the company's future potential by projecting financial statements of its future sales and growth.

Non-Current Assets are not Considered

- Intangible assets and physical assets are not taking into consideration.
- The argument here is that even at a start-up stage, the company's intangibles may have a lot to offer to its valuation, i.e., brand value, goodwill, patent rights (if any), and so on.

Valuation Methodologies

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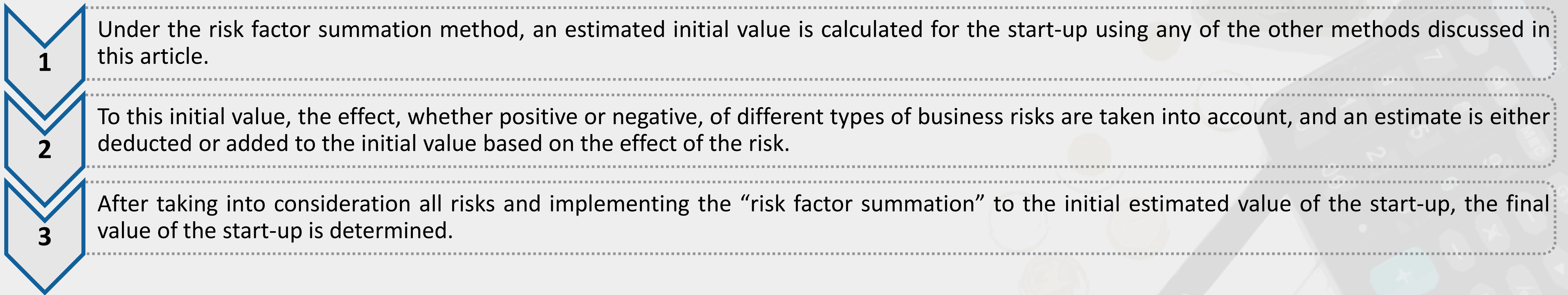
E Risk Factor Summation Method

- The risk factor summation approach values a start-up by taking into quantitative consideration all risks associated with the business that can affect the return on investment.
- Following are the steps for risk factor summation method:

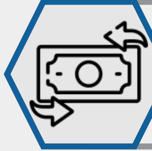


Following are 12 common risk categories:

Management	Stage of the business	Legislation/political risk	Manufacturing risk
Sales and marketing risk	Funding/capital rising risk	Competition risk	Technology risk
Litigation risk	International risk	Reputation risk	Potential lucrative exit

Valuation Methodologies

F Discounted Cash Flow Method


The discounted cash flow (DCF) method focuses on projecting the start-up's future free cash flow.

A rate of return on investment, called the discount rate, is then estimated.

Since start-ups are new companies and there is a high risk associated with investing in them, a high discount rate is generally applied.

The future free cash flows are then discounted back to present value.

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The Berkus Method

- The Berkus approach, was created by American venture capitalist and angel investor Dave Berkus. The method looks at valuing a pre-revenue start-up based on a detailed assessment of the following five key success factors:

Basic Value

Technology

Execution

Strategic relationships in the core market

Production and consequent sales

Key Highlights of the Method

Key Factor Assessment

A detailed assessment is carried out evaluating how much monetary value is assigned to the five key success factors. The start-up valuation is the summation of those monetary values.

Drawback

This approach doesn't take other market factors into account, the limited scope is useful for businesses looking for an uncomplicated tool.

Value Allocation

This approach normally allocates up to $500,000 per success factor for a theoretical maximum pre-money valuation of $2.5 million.

Stage Development Method

The Berkus approach may sometimes also be referred to as the stage development method or the development stage valuation approach.

Selection of Valuation Method

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- Following are the some examples of methods used in different stage start-up valuation but not limit to this, however there is no right or wrong method.

Start-ups Stages	Idea	Seed	Early Growth	Expansion	Sustainable Growth
Fixed Range	✓	✓			
Comparable Method					✓
Scorecard Valuation	✓	✓			
Cost-to-Duplicate	✓	✓			
DCF			✓	✓	✓
VC Method			✓	✓	

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Thank You

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