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Valuation of Pre-Revenue Technology Companies

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With high levels of investment liquidity from the current strong economy, public technology company share valuations are at six-year highs. Based on these values, we are seeing some pre-revenue tech companies seeking angel funding at excessive valuations of \$10 to \$20 million usually because they have sold shares in \$20,000 increments at these values to family, friends and fools. Unfortunately these companies to raise further funds will need angel investors who follow the buy low, sell high rule and only invest at lower realistic values. So existing small investor may see their 10% shareholding being diluted or "crammed down" to a 1% shareholding if new money is invested. Or nobody invests new money and the company collapses.

The traditional methods of valuating companies that has been based upon discounted cash flow and multiplier methodology, has worked well for companies with revenues. However for pre-revenue companies, successful angel investors have either used quick and easy rules of thumb or put off the valuation until subsequent funding occurs. Statistics on pre-revenue companies are that 50% of pre-revenue companies fail, 40% limp along and only 10% are successful. So angel investors are looking to earn at least 10 times their investment in a pre-revenue company, to make up for their losses in the other nine companies they invested in.

Quick and Easy:

1. The modified Berkus Method values an early stage deal in \$500k increments for a sound idea, a prototype, a quality management team, a quality board and any sales. The resulting value ranges between \$500k and \$2.5 million. So a company with a pain killer concept, a completed prototype, but an in-complete quality management team, no sales and a weak board, may have a maximum value of \$1 million.
2. The traditional VC method is to try to project what the exit value of the company will be in say five years using traditional valuation methodology such as comparables and discounted cash flows. A savvy investor will initially try to invest at an entry valuation of 10% of the exit value to ensure they can earn 10x their money. Because it is much easier to build a company up to a \$20 million exit valuation than it is to \$200 million exit value, the investor playing the odds, can more likely earn 10x on an entry value of \$2 million than an entry value of \$20 million
3. \$1 million is the average valuation for university technology spin-off companies with interesting patentable science and the scientist.
4. An investor using the reverse engineering approach asks how much do you need for the next 12-18 months and that equates to roughly 30%-40% of the company. Used by both seed venture capital firms and angel investors.
5. Rule of Thirds is a common VC rule where at the early-stage round, 1/3 should go to founders, 1/3 to capital providers and 1/3 to management. If \$500k is raised, then 1/3 of the equity goes to the investors and the post money valuation is \$1.5 million.

6. \$2.5 million Angel Maximum Standard Valuation is based upon the experience of successful angel investors who have said that this is the maximum value for start-ups that have a reasonable chance of making it and where the angel does not play a controlling role. Values above this are for either quite advanced companies that are ready for VC firms or quite unrealistic.

Value Later:

An angel invests funds today on the understanding that the valuation will be set later usually by a subsequent incoming VC round, but the angel's investment will be at a 20-40% discount to the second. The initial agreement takes the form of loan debenture payable in 12 months and convertible into shares at the agreed upon discounted price. The entrepreneur doesn't have to worry about valuation, knowing that a professional will later put an appropriate valuation on the business.

Bob Chaworth-Musters in 1997 initiated the BC Angel Forum™ (www.ANGELforum.org) where emerging companies present to private equity investors. BC director of Canada's National Angel Organization. Valuation workshop on Sept 24 and 22nd Angel Forum on Nov. 1, 2007, both in Vancouver.

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