Valuation of a Startup Considering its Tangible and Intangible Assets

Dr. Amartya Kumar Bhattacharya
BCE (Hons.) (Jadavpur), MTech (Civil) (IIT Kharagpur), PhD (Civil) (IIT Kharagpur), Cert.MTERM (AIT Bangkok), CEng(I), FIE, FACCE(I), FISH, FIWRS, FIPHE, FIAH, FAE, MIGS, MIGS – Kolkata Chapter, MIGS – Chennai Chapter, MISTE, MAHI, MISCA, MIAHS, MISTAM, MNSFMFP, MIIBE, MICI, MIEES, MCITP, MISRS, MISRMTT, MAGGS, MCSI, MIAENG, MMBSI, MBMSM
Chairman and Managing Director,
MultiSpectra Consultants,
23, Biplabi Ambika Chakraborty Sarani,
Kolkata – 700029, West Bengal, INDIA.
E-mail: dramartyakumar@gmail.com
Website: https://multispectraconsultants.com

Business valuation is never straightforward - for any company. For startups with little or no revenue or profits and less-than-certain futures, the job of assigning a valuation is particularly tricky. For mature, publicly listed businesses with steady revenues and earnings, normally it is a matter of valuing them as a multiple of their earnings before interest, taxes, depreciation and amortisation (EBITDA) or based on other industry specific multiples. But it is a lot harder to value a new venture that is not publicly-listed and may be years away from sales. If you are trying to raise capital for your startup company, or you are thinking of putting money into one, it is important to determine the company's worth. It is also important to look at the intangible assets of a company, such as its brand equity.

Cost-to-Duplicate

As the name implies, this approach involves calculating how much it would cost to build another company just like it from scratch. The idea is that a smart investor would not pay more than it would cost to duplicate. This approach will often look at the physical assets to determine their fair market value.

The cost-to-duplicate a software business, for instance, might be figured as the total cost of programming time that is gone into designing its software. For a high-technology startup, it could be the costs to date of research and development, patent protection, prototype development. The cost-to-duplicate approach is often seen as a starting point for valuing startups, since it is fairly objective. After all, it is based on verifiable, historic expense records.

One big problem with this approach – and company founders will certainly agree here – is that it does not reflect the company's future potential for generating sales, profits and return on investment. What is more, the cost-to-duplicate approach does not capture intangible assets, like brand value – and that is another big problem with this approach, that the venture might possess even at an early stage of development. Because it generally underestimates what the venture is worth, it is often used as a "lowball" estimate of company value. The

company's physical infrastructure and equipment may be only a small component of the actual net worth when relationships and intellectual capital form the basis of the firm.

To get a better estimate of the value of a startup using this approach, the brand equity will have to be factored-in. Brand equity is an intangible that is worth real money. Brand equity is the value premium that a company realises from a product or service with a recognisable name as compared to its generic equivalent.

Market Multiple

Venture capital investors like this approach, as it gives them a pretty good indication of what the market is willing to pay for a company. Basically, the market multiple approach values the company against recent acquisitions of similar companies in the market.

Let us say mobile application software firms are selling for five-times sales. Knowing what real investors are willing to pay for mobile software, you could use a five-times multiple as the basis for valuing your mobile apps venture while adjusting the multiple up or down to factor for different characteristics. If your mobile software company, say, were at an earlier stage of development than other comparable businesses, it would probably fetch a lower multiple than five, given that investors are taking on more risk.

In order to value a firm at the infancy stages, extensive forecasts must be determined to assess what the sales or earnings of the business will be once it is in the mature stages of operation. Providers of capital will often provide funds to businesses when they believe in the product and business model of the firm, even before it is generating earnings. While many established corporations are valued based on earnings, the value of startups often has to be determined based on revenue multiples.

The market multiple approach, arguably, delivers value estimates that come closes to what investors are willing to pay. Unfortunately, there is a hitch: comparable market transactions can be very hard to find. It is not always easy to find companies that are close comparisons, especially in the startup market. Deal terms are often kept under wraps by early-stage, unlisted companies – the ones that probably represent the closest comparisons.

What is the role of brand equity in this approach? Significant. Because the comparison in question is tenable only when comparison is made between startups having similar brand equity. That is, the comparison would not hold good if made between two startups having identical physical assets but with one having a strong brand equity and the other, to take an extreme case, having no brand equity at all.

Discounted Cash Flow (DCF)

For most startups – especially those that have yet to start generating earnings – the bulk of the value rests on future potential. Discounted cash flow analysis then represents an important valuation approach. DCF involves forecasting how much cash flow the company will produce in the future and then, using an expected rate of investment return, calculating

how much that cash flow is worth. A higher discount rate is typically applied to startups, as there is a high risk that the company will inevitably fail to generate sustainable cash flows.

The trouble with DCF is the quality of the DCF depends on the analyst's ability to forecast future market conditions and make good assumptions about long-term growth rates. In many cases, projecting sales and earnings beyond a few years becomes a guessing game. Moreover, the value that DCF models generate is highly sensitive to the expected rate of return used for discounting cash flows. So, DCF needs to be used with much care.

Brand equity is implicitly taken into account in this approach because the potential cash flow of a company is linked to its brand equity.

Valuation by Stage

Finally, there is the development stage valuation approach, often used by angel investors and venture capital firms to quickly come up with a rough-and-ready range of company value. Such "rule of thumb" values are typically set by the investors, depending on the venture's stage of commercial development. The further the company has progressed along the development pathway, the lower the company's risk and the higher its value. A valuation-by-stage model might look something like this:

Estimated Company Value	Stage of Development
$250,000 - $500,000	Has an exciting business idea or business plan.
$500,000 - $1 million	Has a strong management team in place to execute on the plan.
$1 million – $2 million	Has a final product or technology prototype.
$2 million – $5 million	Has strategic alliances or partners, or signs of a customer base.
$5 million and up	Has clear signs of revenue growth and obvious pathway to profitability.

Again, the particular value ranges will vary, depending on the company and, of course, the investor. But in all likelihood, startups that have nothing more than a business plan will likely get the lowest valuations from all investors. As the company succeeds in meeting development milestones, investors will be willing to put assign a higher value. Brand equity is again a factor in the development of a company and thus in its valuation.

Many private equity firms will utilise an approach whereby they provide additional funding when the firm reaches a given milestone. For example, the initial round of financing may be targeted toward providing wages for employees to develop a product. Once the product has been proved to be successful, a subsequent round of funding is provided to mass produce and market the invention.

Conclusion

It is extremely hard to determine the accurate value of a company - inclusive of taking into account its brand equity - while it is in its infancy stages as its success or failure remains uncertain. There is a saying that startup valuation is more of an art than a science. There is a

lot of truth to that. However, the approaches we have seen help to make the art a little more scientific.

© MultiSpectra Consultants, 2020.