



What's your business worth?

A primer on the venture capital valuation

Nashua High Tech Expo

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Agenda

- About
- Investors and their process
- Background and definitions
- Valuing risk
- Structure vs. price

About this presentation

Why value?

- Selling your business
- Seeking investors or strategic partners



This presentation will focus on taking investment partners

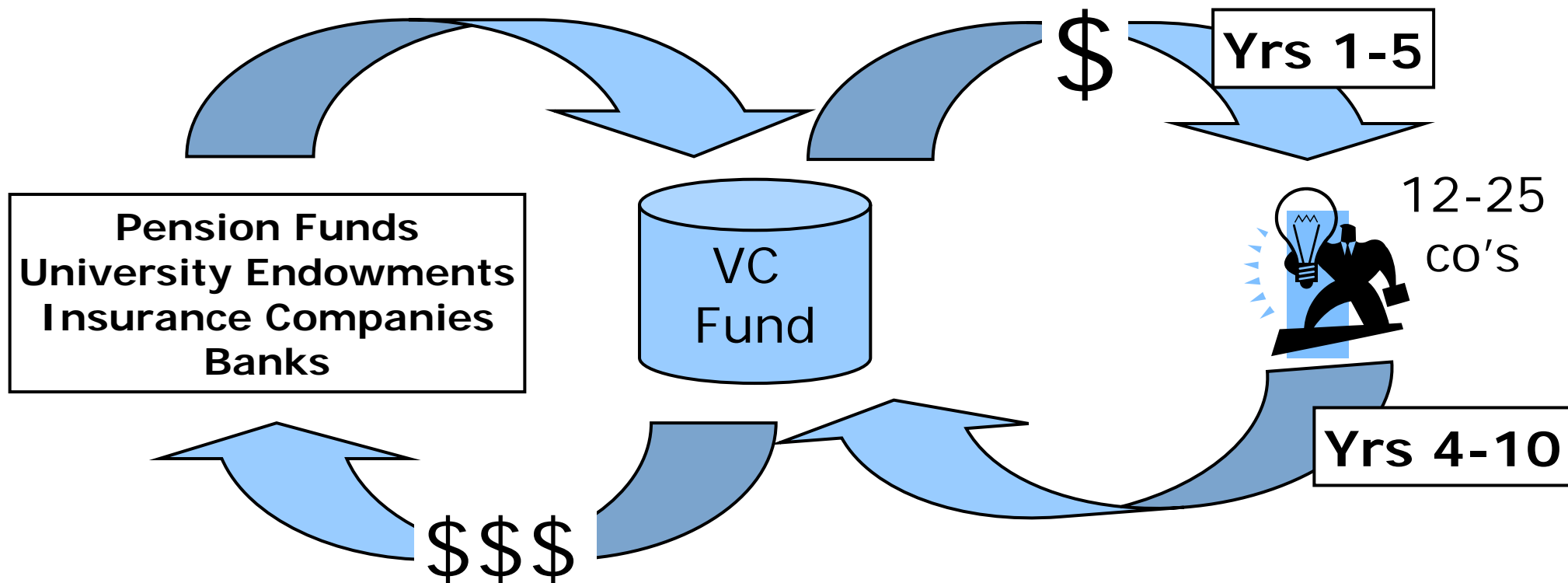
Types of investment partners?

- Individuals or “angel” investors
- Venture capital funds
- Strategic partners



Today's focus: venture capital funds

Investors support VC funds that can consistently manage high risk capital



Venture capital managers must plan for losses as well as gains

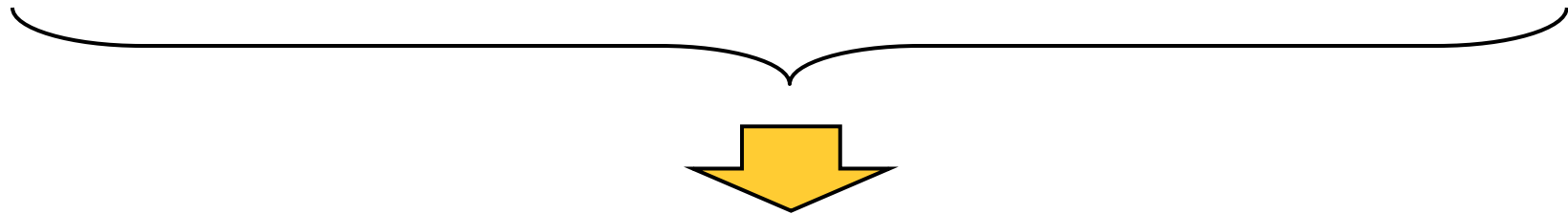


12-25
Investments

1/3 = 100% loss

1/3 = return of cap.

1/3 = profit



**VC pricing/evaluation must
accommodate expectations of
portfolio loss**

Breaking down business risk

- Management
- Market
- Product
- Technology
- Financial
- Legal



**Focal points
of due
diligence**

VCS assess your business' risks against an "ideal"

Management

- Made money for investors
- Successful startup, ideally in same sector/space
- Complete team in core areas (sales, marketing, finance, etc)

Market

- Large, fast growing with few competitors

Product/ Tech.

- One-tenth cost or 10X performance of nearest competitors
- Proprietary position (barrier to entry such as established market position and/or intellectual property, patents)

Business Model

- Scalable: make once, sell many times
- Appropriate for venture capital financing--no \$400M new plants

Financial

- Sustainable gross margins > 50%
- Limited financing risk (future rounds likely)
- No financial liabilities that affect value or equity position

Legal

- No legal contracts that affect value or equity position
- No outstanding litigation around intellectual property or other assets

Stage risk overlays weighted business risk: Early = highest risk



**Ideal = Low Risk = Highest Valuation
(for business owner)**

Not every risk carries equal weight

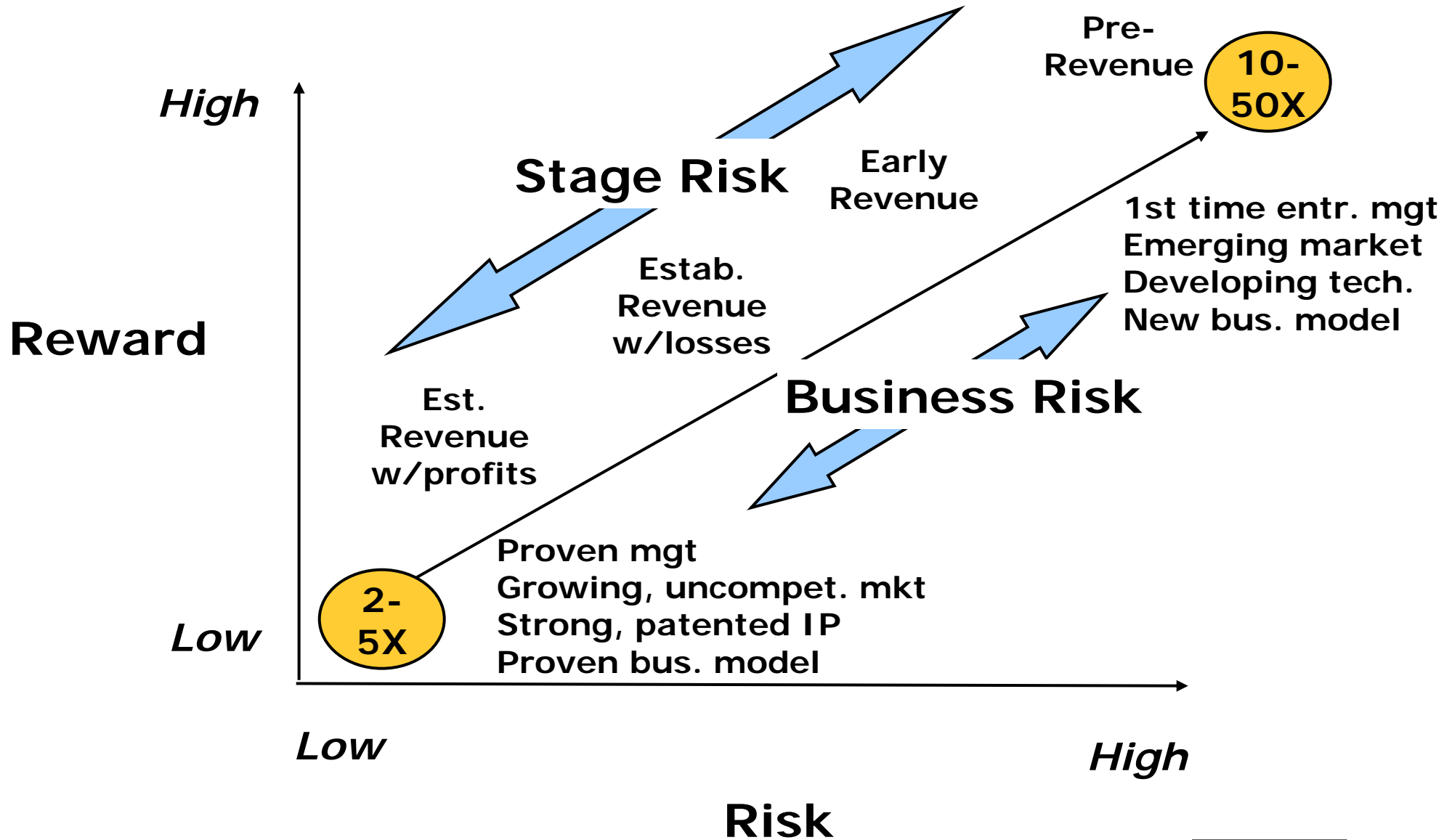
	Risk rating (1=low; 5=high)	Risk weighting	Weighted risk rating
Management	• 3	• 40%	• 1.2
Market	• 2	• 30%	• 0.8
Product/ Barrier to entry	• 3		
Business model	• 2	• 30%	• 0.8
Financial	• 3		
Legal	• <u>1</u>	• 0%	• =
Average	• 2.3		• 2.7

Stage risk overlays weighted business risk

- **Early stage:** Pre-revenue; early revenue with losses
- **Development stage:** Established revenue with losses
- **Later stage:** Established revenue with profits

Stage	Risk	Return multiple
• Early	• Highest	• 7 + X
• Development	• Medium	• 4-7X
• Later	• Lowest	• 2.5-4X

Reward follows risk



Look to the future, discount to the present

- **Review** management projection to exit year
 - Analyze future revenue, costs, and financing expectations
- **Project** the form of exit (sale/merger, IPO) and value-basis (multiple of sales/earnings) to arrive at future company value
 - Comparable company analysis: public companies, M&A
- **Discount** back using risk adjusted rate, expressed as IRR % or multiple of cost (X)

Example 1: Development stage consumer products manufacturer

- Established revenue stream (\$4M) with losses
- 50% gross margins
- \$25M revenue target by year 5
- Seeking \$2M of capital
 - Stage and business risks: Moderate
 - Exit valuation: Moderate (comparables trade at 1-1.5X sales)

(\$M)	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Sales	4	8	12	15	20	25
Pre-tax profit	-1					3.75
Exit value						37.5

Investment (\$M)	2	
Required mult. of cost (#)	7	
Cash return (\$M)	14	
Valuation at exit (\$M)	37.5	
Ownership (Ser. A) at exit	37%	
Pre-money valuation	3.4	63%
Post-money valuation	5.4	
Internal Rate of Return (IRR)	48%	

7X with no interim financing equates to 37% ownership

Example 2: Early stage technology company

- Very early revenue with losses
- 95% gross margins
- \$15M revenue target of by year 5
- Seeking \$2M of capital
 - Stage risk: High; Business risk: Moderate
 - Exit valuation: High (comparables trade at 3-5X sales)

(\$M)	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Sales	0.1	1	3	6	10	15
Pre-tax profit	-0.5	-2	0			2
Exit value						60

Investment (\$M)	2	
Required mult. of cost (#)	15	
Cash return (\$M)	30	
Valuation at exit (\$M)	60	
Ownership (Ser. A) at exit	50%	
Pre-money valuation	2.0	50%
Post-money valuation	4.0	
Internal Rate of Return (IRR)	72%	

15X with no interim financing equates to 50% ownership

Structure can mean more than price: Participating vs. Convertible Preferred

- Venture capital investors require preferred stock with unique rights, among them the right to redeem (debt-like feature) the stock by year 4 or 5
- Traditional preferred stock is “convertible preferred”
 - At exit, investor has right to choose between redemption of the preferred stock as if debt (repay plus nominal interest) OR conversion to equity (common stock).
- “Participating preferred” stock is often proposed when parties cannot agree on valuation
 - At exit, investor receives both return of capital (potentially multiples of cost) AND common stock participation

Participating preferred protects investors in low valuation scenarios...

Dev. Capital scenario: Year 5

		<u>Exit Value</u>		
	<u>\$M</u>	<u>Low</u>	<u>Medium</u>	<u>High</u>
	<u>2</u>	<u>5</u>	<u>15</u>	<u>40</u>

Investment basis

Traditional Convertible Preferred (6%)

- Unconverted value of investment
- Converted value of investment
- Multiple of investor cost
- Total proceeds to others (mgt)

Mgt makes Money...	2.7			
Investors don't...		1.9	5.6	14.9
		0.9	2.8	7.5
		3.1	9.4	25.1

Participating 6% Preferred (1X)

- Total proceeds to investor
- Multiple of investor cost
- Total proceeds to others (mgt)

Low value protection		3.5	7.3	16.6
		1.8	3.6	8.3
		1.5	7.7	23.4

At high end, extra participation layer less meaningful

Influencers of valuation

- **How attractive are your investment options?**
 - Strong:** Attract multiple investment suitors can improve your negotiating position
 - Weak:** Less than six months of cash to support losses hurts your position
- **Buyers vs. investors:** apples and oranges
 - Majority interest vs. minority interest
 - VCs won't compete with strategic buyer (but may partner/co-invest with a strategic investor)
- **Stage matters:** Moving up stage/maturity curve—reducing risk for investors--will always improve your position
 - Bootstrap with low/no cost capital (friends, family, fools)
 - Leverage supplier/customers for capital (receivables, payables)
 - Consider alternatives to equity (near-equity, bank)

Thank you