

The right price

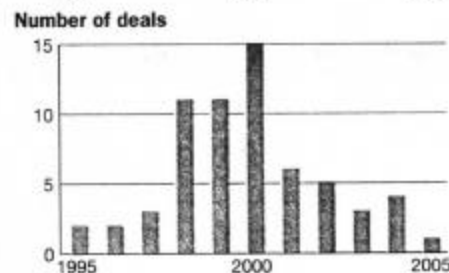
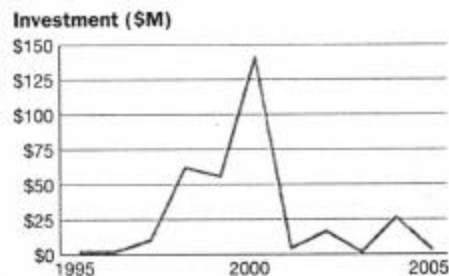
Understanding the most sensitive aspect of the VC process: valuation

BY MICHAEL GURAU

Entrepreneurs tend to shop for capital based on the best price. In the case of a venture capital investment, the best price means the highest valuation for the company, which results in the lowest dilution of the entrepreneur's ownership. Although we believe this approach is often penny wise and pound foolish, it is high on the agenda for most growth-oriented business owners. Let me give you an example from my work at CEI Community Ventures.

We once spent six months with a local entrepreneur, building a level of trust, respect and a desire to find a way to work together. When it

Venture capital investment in Maine companies, 1995-2005



Source: PricewaterhouseCoopers/Venture Economics/NVCA

came time to make an investment offer, we, and other equity investors, said we would commit \$1 million to \$2 million for what we saw as a company with a \$2 million valuation before investment — effectively buying about a third of the company (\$2 million existing valuation + \$1 million VC investment = \$3 million post-money valuation). Then the relationship took a turn.

The entrepreneur saw the offer as something of a litmus test for our support of him. Feeling hurt and “devalued” by an offer he found too low, he walked (more like stalked) from the room, seemingly vowing silently to show us how wrong we were. To my knowledge, he has not raised meaningful capital at his expected value and is in slow-growth mode with limited capital resources.

Whether we were right or wrong about the valuation in that scenario, this individual could have used some coaching on how valuation works, so the situation didn't become a “my

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way or the highway" exchange. I'd like to walk you through the valuation process to help you in any potential engagement with a venture capital investor.

I've often described the venture capital process as a two-sided sell. Initially, VCs are "selling" themselves, their fund and their value-add — i.e., industry contacts, business-development assistance, strategic and financial guidance — to entrepreneurs who may have the luxury of choosing from several investors. Once a company and a potential investor agree to work together, the "sell" shifts to the entrepreneur, who must provide a convincing story to get the venture investor to write that check.

Then comes talk about valuation — often a bucket of cold water in a budding

development, the greater the risk the VC firm is taking for its investment — and the greater the return it expects.

Business risk involves an assessment of the company's key internal components or market factors, such as the management team, the product, the company's business model and its potential competition. Some of these categories are more important than others. For example, a company's management experience often trumps other factors, and many investors would rather take a chance on an experienced management team with an average product than an inexperienced team with a great product.

By analyzing stage and business risk, VCs set a target for their expected return on investment. For example, a company

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relationship. From the demeanor of an ardent suitor, the venture investor now assumes the demeanor of a tough, skeptical investor in order to determine the company's value.

Part science, part art

Venture capital valuations are one part science (analysis, math) and one part art (the VC's judgment and experience). The science relates to assessing risk with as much clarity as possible, and the risks VCs look at when determining valuation fall into two broad categories: stage risk and business risk.

Stage risk refers to the company's stage of development: Early-stage companies with little or no revenue have high failure rates. So the earlier the company's stage of

just going to market with a mix of business risks — incomplete team, uncertain market and competitive dynamics — likely needs to show a potential return to investors north of 10 times invested capital over a four- to seven-year period.

At the other end of the spectrum, an established company with a couple dozen happy customers and a complete management team does not warrant as high a return premium as the early-stage company. In this case, an investor could expect returns ranging from three to seven times his or her invested capital.

The math goes like this: If I'm investing \$1 million and expect to make 10 times my cost, I need to collect \$10 million at the end of the investment cycle (I'll describe the duration and exit strategy for VC investments in the next installment of this

Understanding operating risk

RISK ELEMENT	IDEAL SCENARIO
Management	<ul style="list-style-type: none">• Company has a complete team in all functional roles• Team has made money together before• Is operating in the same industry as prior success
Market	<ul style="list-style-type: none">• Large and fast growing• Favorable competitive environment
Product/technology	<ul style="list-style-type: none">• Has dramatic performance advantages over competition (1/10th the cost, 10 times the performance)• Strong intellectual property protection (patent, copyright, etc.)
Financial	<ul style="list-style-type: none">• Low/no debt• Low risk of later financing difficulty (being in an attractive investment sector)• High gross profit margins (north of 50%)
Business model/plan	<ul style="list-style-type: none">• Scalable: Make once, sell many times• Not exceedingly capital intensive• Realistic and experience-based business model
Legal	<ul style="list-style-type: none">• No outstanding lawsuits• Strong intellectual property position

series). If I project that the company will be worth \$50 million at exit and I need to collect \$10 million of that, then I need to own 20% of the company at exit. Given this scenario, my \$1 million will need to buy 20% today, implying a company valuation of \$4 million "pre-money" (i.e. before new money comes in) and \$5 million "post-money" (value after new money is in).

If there's a disconnect between investors and entrepreneurs at this stage of the game, there are usually a few common causes. First, entrepreneurs are very optimistic about their ability to grow their business. They typically over-project revenue and under-project cost, and therefore argue for a high pre-money valuation. Second, entrepreneurs — especially first-timers — almost always underestimate financing requirements. Third, entrepreneurs just don't want to give up what they see as significant percentages of their companies — even for much needed investment capital — for fear of losing control of their business.

Hopefully, you now understand something of the math and mystery that sur-

rounds the valuation dance. But even if you find yourself on the wrong side of the risk curve in any given area, you can act to mitigate those risks.

If it's an issue of management, you might rethink roles in your company and seek out an experienced professional to complement your team. If you can't afford to hire a new person, try getting a seasoned professional to join an advisory board or your board of directors. This move will help venture investors see that you recognize the gap.

If it's an issue of stage risk — you're too early-stage to justify a high valuation — then your choices are to find a way to mature by bootstrapping (see "The venture equation," Feb. 20) or by accessing other forms of capital (federal or state grant money, friends and family, etcetera). The more mature your business, the less risk for the investor and the better value you can achieve.

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