Valuation of startups and the uncertainty involved in the valuation process

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Foreword

A key focus of Vision 2030 is in creating a robust environment for businesses to develop and grow. It aims to broaden the economic base and creates job opportunities. Saudi Vision 2030 has caused significant foreign investment to come in KSA along with several international businesses and investors for the purpose to establish ventures in the country.

The Kingdom of Saudi Arabia's venture capital market is quickly expanding as a result of numerous government initiatives aimed at achieving the Saudi Vision 2030. More of such initiatives to promote entrepreneurship are being observed than ever before.

Venture Capital – Key Highlights:

- Startups in Saudi Arabia increased by 270% while deals increased by 54% by 2021 compared to 2020.
- H2 2021 was a record half year with most VC deals closed and funding was collected more than half the year before.
- A remarkable number of investors and non-MENA investors have funded Saudi-based initiatives in 2021

From a bird’s eye view, the total rate of startup activity in Saudi Arabia rose significantly. In addition, Saudi Arabia recorded the highest level of market confidence, with 80 percent of people perceiving the outbreak as an opportunity to start a business.

Valuation of startups and the uncertainty involved in the valuation process

Uncertainty and limitations involved in valuing a startup

Startup valuation remains subjective to the assumptions based on the qualitative and quantitative prospects considered in keeping the valuator's judgment. Traditional valuation methods fail to value the company and the effort have been done to come with the contemporary valuation methods to resolve the issue. Some of the Uncertainty and limitations involved in valuing a startup are stated below:

Small or no revenue: Valuing a business is never an easy and straightforward task for any company. Especially for startups with a very little or no revenue or profits and no certain future, the task of valuation becomes particularly tricky.

Negative Earnings: Startups usually experience negative earning in their initial years foillowed by J curve earning increase in the later. Thus, the negative earning limits the use of traditional valuation methods i.e. DCF and Multiples Valuation Method.

Survival & Uncertainty for future: Most of the start-ups fail within 3 years' time whereas, some transform into billion-dollar companies. Here are few examples of successful and unsuccessful start-ups:

- **AirBnB:** It's three owners used to rent mattresses till 2017. There was a design conference that was held in San Francisco that resulted in fully booked hotels in the city. So, they got the idea of renting out their three airbeds of their living-room and making breakfast for their guests. Eventually, they developed a website and started to assist the travelers. As per now, AirBnB has been developed to be a $10 billion company.
- **PepperTap:** The startup was founded in 2014 on the idea to develop a marketplace for buying groceries online but the most lucrative part of the idea was to deliver them within 2 hours to customers. The startup was successful in raising a massive funding of $51 million over four rounds. Regrettably, PepperTap announced to close all of its operations in April 2016 because they entered the online grocery business without sufficient preparation. It failed to acknowledge the need for deep pockets, large assortment, competitive prices and inventory management.

No History: For established, private and public listed companies with stable revenues and earnings, we can establish trends, growth history and margins. Startups do not have a long-standing history or extensive financial statements or controls.

Market Sizing: While determination of the revenue remains subjective the market sizing/ demand supply of the prototype product offering of the startups. Therefore, scenarios may be considered for the determination of the market sizing and range of valuation may deemed with the probabilistic assumptions taken in account.

- So, the basic concept here is that startups have a very uncertain future totally depending on the market response.
- Therefore, the discount rate is very subjective even within the same industry.
- Moreover, the financial numbers and margins can change significantly from one month to another. Startups start from point zero and passes through several phases of growth. This is very challenging to determine in numbers.

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Traditional methods of valuation are not suitable for startup valuation

- Generally, Income Statement and Statement of Financial Position is used to estimate future cash flows where multiple valuation method or industry specific multiple method is applied. But startups are focused on building and growing their operations in-order to survive.
- The lack of typical information required to implement traditional valuation methods makes traditional valuation methods incapable of valuing startups.
- Since the company has not operated over a prolonged period, there is a scarcity of information on past revenue or cash flow.
- There is no market data in the absence of comparable enterprises and the assets of tech startups company are intangible and difficult to assess objectively.

Non- Applicability of Discounted Cashflow Method

- Traditional approaches, such as the Discounted Cashflow Method are ineffective to value a startup company, since it calculates the discount rate based on the sector and the company's history. Furthermore, traditional models assume constant market risk over time, whereas risk fluctuates with time, particularly in context of newly established business. Traditional discount rate approach focuses on market risk, whereas the major risk for startups is the firm's specific risk.
- Another issue is The Terminal Value, the Terminal Value forecast is usually included in the DCF, which sometimes account for a substantial portion of value of the company. The definition of the TV for a new firm, on the other hand, is significantly more complicated because it is complex to predict the company's growth pattern, say when and how shall it grow.

Non- Applicability of Multiple Valuation Method:

- Another method deployed by companies to value is market multiples when pursuing the market approach. Since multiples are typically based on earnings or revenues, this technique is difficult to adopt with newly established businesses. This is because new startups have recorded losses, no profits, and are at the initial stage, revenues are insignificant.
- High burn rates is also an important factor. Even if we manage to get some financial data on few months or even a year, startups burn through capital to grow, resultantly earnings and cashflows are likely to be negative. A startup also needs to expand their assets to cope with its expanding operations. The project future CAPEX, working capital and return on capital becomes very hard to determine.

Non- Applicability of Net Asset Method:

- The Asset-Based Valuation (cost approach) is based on an analytic valuation of the company's present assets and liabilities, however, it is a rigid approach, since it does not account for the company's future expansion. It is the least appropriate method for evaluating the economic capital of startups because they typically have few tangible assets and are undercapitalized.

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Need for valuation for raising funds and attracting investment

Startup Company Valuation aids in calculating the appropriate amount of equity to give an investor in exchange for funding. Factors like related risk and return on investment are vital to an investor, therefore as a result, determining the fair value of a company is critical for all stakeholders involved.

Factors that are accounted for in valuation of startups are:

01 **Startup reputation :** For an entrepreneur to survive and flourish in the market, he or she must project a positive image of the company, since it is one of most important aspect investors seeks before investing.

02 **Traction :** It relates to how far a startup progressed till date or how much momentum it has gained through time, bearing in mind its potential customers.

03 **Prototype :** A prototype is critical to the business since it has potential to influence an investor's decision. Before evaluating any startup, one must have a prototype or a minimal viable product available.

04 **Industry :** The industry in which a startup plays a determining role in a reasonable company valuation. Other factors such as pre-valuation revenues, market size, distribution methods, competitors, etc., all contribute significantly in determining a startup's fair valuation.

Applicability of Valuation Method as per stage of growth of companies

For entities that are startup or idea-based company, and those that are experiencing rapid expansion in its early stages, the appropriate method to value such enterprises are those of pre revenue valuation methods such as score cards, reproduction cost, and scenario assessment. For entities that are experiencing high growth, the appropriate method would constitute venture capital method, comparable transaction method and DCF for corroborative purposes. Finally for entities that experience mature growth or decline, the suitable valuation method would constitute: DCF valuation and comparable companies' method.

New Valuation Methods for Startups

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New Valuation Methods for Startups

1. Berkus Method

Dave Berkus, a venture capitalist, devised the Berkus Method to determine valuations for pre-revenue startups, or companies that have yet to sell their goods at scale. The goal is to assign monetary amounts to five critical early-stage startup performance measures. The simple method is nowadays aiding founders and investors in avoiding erroneous valuations based on projected revenues, which few new enterprises achieve in the time allotted. The five performance measures include: sound idea (the basic value), prototype (to mitigate technology risk), quality management team (to mitigate execution risk), strategic relationship (to mitigate market risk), and product rollout or sales (to mitigate production risk).

Advantages

- The Berkus method is a very simple model that is based solely on qualitative aspects. This makes it a popular method to value pre-revenue startups.
- The model can easily be modified (geography, sector, currency) to fit your circumstances.

Disadvantages

- The model's simplicity is its greatest strength, but also its greatest weakness. Founders and investors need to realize that startup valuations are the result of negotiations. Moreover, founders and investors have conflicting interests while discussing a potential investment deal.
- The method ignores one of the most common pitfalls for startups: financial risk.

Valuation of Abhi – Startup (Tentative)

	Weights	Comparision %	Factor
Strength of the team:	40%	125%	0.50
Size of the Opportunity:	25%	150%	0.38
Strength and protection of the product/service:	10%	100%	0.10
Competitive Environment:	10%	75%	0.08
Strategic relationships with partners:	5%	80%	0.04
Funding required:	10%	100%	0.10
Sum of Factor	100%		1.19
Average Company Valuation in Market (USD)			75,630,252
Target Company Valuation using Factor (USD)			90,000,000

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New Valuation Methods for Startups

2. Scorecard valuation method

Another option for pre-revenue enterprises is the Scorecard Method. It compares the startup against companies that have already received funding, but with additional criteria. Usually, the average pre-money valuation of similar companies is sought and then comparison is made that how the business stands up against them in terms of the following characteristics:

- Strength of the team
- Size of the opportunity
- Product or service
- Competitive environment
- Marketing, sales channels, and partnerships
- Need for additional investment

Advantages

- Considers qualitative aspects along with focusing on financial inputs from comparable companies.
- Flexible method as it enables a valuer to increase the total adjustment to a qualitative factor by making comparison with peers.

Disadvantages

- The scorecard elicits high-level of subjectivity as weights assigned to qualitative factors may significantly differ from case-to-case.
- High-level of judgment to assess the differentiating factor – that is, the level at which the target start-up is at an advantage/disadvantage to its peers.

Valuation of Abhi – Startup (Tentative)

	Criteria maximum valuations
Quality of the core team	25,000,000
Quality of the Idea:	30,000,000
Product roll-out and IP protection	15,000,000
Strategic Relationships	12,000,000
Operating Stage	8,000,000
Target Company Valuation (USD)	90,000,000

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New Valuation Methods for Startups

3. Risk Factor Summation Approach

The Risk Factor Summation Approach evaluates a startup by quantifying all risks associated with the company that could affect the return on investment. Using any of the other approaches as mentioned, an estimated initial value for the startup is derived using the risk factor summation method. The influence of various sorts of business risks, whether positive or negative, is factored into this starting value, and an estimate is removed or added to the beginning value based on the risk's effect. The ultimate value of the startup is established after taking into account all types of risk and applying the "Risk Factor Summation" to the initial estimated value of the startup. Management risk, political risk, manufacturing risk, market competitiveness risk, investment and capital accumulation risk, technology risk, and legal environment risk are some of the sorts of company risks that are considered.

Advantages

- Considers qualitative aspects along with focusing on financial input from comparable companies.
- Holistic evaluation of risk factors vis-a-vis comparable companies, making it much more informative than scorecard evaluation method.

Disadvantages

- High-level of subjectivity as allocation of weights (+1 or -1) assigned to risk factors may significantly differ from case to case.
- Attribution of +1 point to different risk factors may not be contributing the same amount of value to the business.

Valuation of Abhi – Startup (Tentative)

Average Company Valuation in Market (USD)		75,630,252
Risk Factors	**Score**	
Management	2	151,260,504
Stage of the business	1	75,630,252
Legislation/Political risk	-1	(75,630,252)
Manufacturing risk	-1	(75,630,252)
Sales and marketing risk	1	75,630,252
Funding/capital raising risk	1	75,630,252
Competition risk	-1	(61,260,504)
Technology risk	-1	(75,630,252)
Litigation risk	-1	(75,630,252)
International risk	-1	(75,630,252)
Reputation risk	1	75,630,252
Potential lucrative exit	1	75,630,252
Target Company Valuation (USD)		90,000,000

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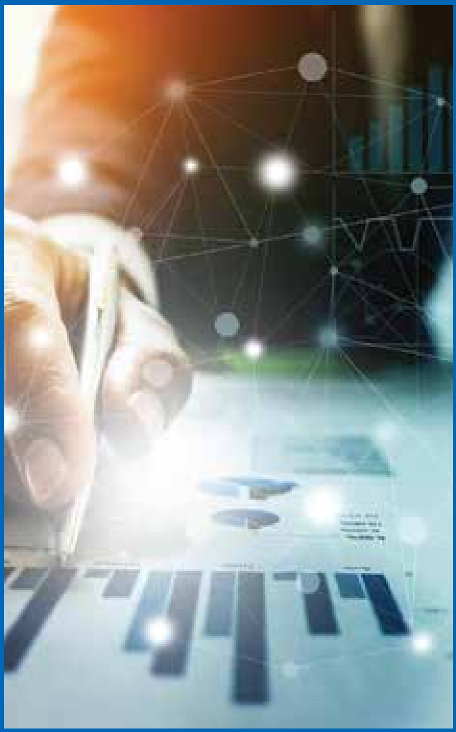
New Valuation Methods for Startups



4. Venture capitalist method

It depicts the thinking of investors who want to exit out of a company in a few years. We utilize predicted revenue multiples for relevant industries or the price-to-earnings ratio to compute the startup's terminal value, or the expected selling price after the VC firm has invested. Formulae for Post money valuation:

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

Advantages

- Suitable for start-ups where key financial variables can be reasonably estimated

Disadvantages

- Fails to consider qualitative aspects of the business (management team, product/service, competition).
- Value is highly influenced by subjective assumptions on projected revenue/EBITDA and investor's required rate of return.

5. Gross profit X competitor's multiple method

This strategy is essentially a product of the gross profit of startup and a multiple obtained from comparable firms, as the name implies. Product market acceptance, company health, and market penetration are all indicators of gross profit. It's especially important for start-ups because the majority of them aren't profit-maximizing and continually invest back into their businesses.

Advantages

- Suitable for start-ups where financial data is difficult to forecast.
- Suitable to value start-ups incurring losses at the EBITDA / PAT level or the companies that can at least cover their variable costs.

Disadvantages

- Inconsistent method, as gross profit as an income belongs not only to the equity stakeholders, but also debt and preference stakeholders.
- This method can become misleading when costs are not appropriately categorized as cost of sale.
- Not suitable for start-ups operating in the services industry.

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New Valuation Methods for Startups

6. Comparable transaction method

It is one of the most often used startup valuation approaches today as it is based on the assumption that comparable firms have similar acquisition prices. Another option is to utilize revenue multiples for similar firms in the same industry, however modifications should be made, say if the comparable company has a technology that the startup company does not.

Advantages

- Highly relevant in cases where the target has comparable start-ups operating in the market (with similar growth and margins).
- Traditionally backed method with lowest subjectivity..

Disadvantages

- Not relevant in cases where a start-up is operating in altogether different market (with no comparable companies or transactions).

7. Cost-to-Duplicate Approach

This method stands on the premise that how much would it cost to start your company all over again, excluding any intangible assets such as brand or goodwill. We normally sum up the fair market worth of physical assets in this manner, which may also include costs for research and development, product prototypes and patents, among other things. This is far more simplest method being used in this changing era.

Advantages

- Considers a realistic approach of pooling all the resources needed to start a similar business.
- Factors the fair values instead of historical values.
- Suitable for start-ups where financial data is difficult to forecast or the ones in the pre-revenue phase.

Disadvantages

- Not forward looking as it does not factor the potential value increase due to milestones to be achieved.
- Fails to factor intangible assets like brand value, reputation in the market.

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8. First Chicago Method

This technique is a hybrid methodology that uses multiples to calculate a terminal value and then discounts future cash flows to arrive at a valuation. This technique entails a comparison of three different value situations:

- The "best case" scenario is predicated on exceeding expectations.
- The "base case" is what the majority expects the company's future performance will be.
- The "worst case" scenario predicts how the firm will fare if numerous scenarios go wrong.

This method may be broken down into the following steps:

- In each of the three scenarios above, future cash flows are projected. In the best-case scenario, strong top-line growth is combined with an EBITDA margin that is greater than average. In the worst-case scenario, the cognitive process would be reversed.
- To predict a terminal valuation for each scenario, the final year's cash flows are multiplied by a comparable firm multiple. Under each scenario, discount the cash flows using the needed return to arrive at the valuation.
- Each possibility should be given a probability weight. To arrive at the final valuation, multiply the individual values by their corresponding likelihood weights.

Advantages

- By evaluating a range of outcomes, this method extensively accounts for the uncertainty involved in case of a start-up.
- High level of flexibility in terms of selection of method to compute values under each scenario.

Disadvantages

- High- level of judgement involved in assigning probability to different scenarios.
- To compute multiple scenarios, the valuer needs to have good level of industry knowledge and understanding of key value drivers.

How Insights Assist the client in valuing a startup

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How Insights Assist the client in valuing a startup

The valuation of startup is increasingly complex, therefore, we have designed and developed such valuation methods that enable to value your business at any phase of its lifecycle. We have a diversified team of consultants who have performed many startup valuations within KSA and globally. With Saudi Vision 2030 and increased diversification within the Kingdom, the opportunities to develop are increasing.

Our professional consultants work with the leaders of the business in-order to understand their strategic objectives before building workable and sustainable solutions which create impact, whilst supporting a business to achieve an exceptional performance and above average returns.

We imply the following valuation methods for valuation of startups in Insights:

1. The Berkus Method.
2. Scorecard Valuation Method.
3. Risk Factor Summation Method
4. Venture capitalist method
5. Gross profit X competitor's multiple method
6. Cost-to-Duplicate Approach
7. Comparable transaction method
8. First Chicago Method

We are helping the clients to value their businesses at each stage of the business lifecycle.

Let Insights be your business partner in growth!

Contact Us

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About Insights:
We are a fully serviced advisory firm offering our clients a wide range of professional services to support tactical as well as strategic decision making. We are fully committed to sharing our wealth of knowledge on the challenges which the companies are currently facing and how they can best address and overcome them in order to become more prosperous. To that end, we are offering a variety of services including Corporate Finance & Deal Advisory, Tax Advisory, Financial & Risk Advisory along with Accounting Support Services and Research services which provide timely insights to our clients.

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