MERCER CAPITAL
www.mercercapital.com

How to Value an Early-Stage FinTech Company

Mercer Capital
August 2018

Stay Updated on How Current Events Are Affecting the Value of Your FinTech Company

Value Focus: FinTech Newsletter

Mercer Capital's FinTech team produces a complimentary quarterly newsletter. Each quarterly issue contains metrics including public market indicators, an update on IPOs, M&A, and venture capital deals in the space, and the performance of public guideline companies. To view the current issue and the archives or to subscribe to receive future issues, visit **https://mer.cr/FinTechNL**.

FinTech companies are the emerging and hyped sector of the financial services industry. Looking at FinTech's recent activity, many of these companies began as start-ups looking to raise millions of dollars in hopes of becoming the next "unicorn" – an industry term describing a tech company valued at a billion dollars or more. While this business trajectory may seem simple and attractive, FinTech companies usually have a highly complex structure made up of many investors of different origins, including venture, corporate, and/or private equity, all with different preferences and capital structures.

Valuing a FinTech company can be a very complicated and difficult task; however, it carries significance for employees, investors, and stakeholders of the company. While FinTech companies have large differences, including niche (payments, solutions, technologies, etc.) and stage of development, understanding the value of a FinTech company is crucial to everyone with an interest in the company.

Market Considerations

FinTech companies usually operate within a certain market niche, and understanding a FinTech company's performance in a particular niche is imperative to determining its value. Analysis of market dynamics is critical for this valuation, which includes factors such as market size, potential market available, and growth prospects. Among other relevant metrics, companies must consider the absolute market value, existing competitors, and potential income to be derived for their particular technology. Early-stage FinTech companies require additional considerations, including a potential new market created by greater innovators.

Another important consideration for valuing a FinTech company is the regulatory and compliance environment. Financial services, such as banks, are heavily regulated, so understanding the rules and regulations is difficult, but highly impactful. FinTech companies are usually at the forefront of innovation, so rules are still taking shape. Regulations and a need to become compliant at an early stage can either complicate or ease growth. In other words, they can either limit the ability of a company to offer its product or protect the company's intellectual property. Finally, the stability of the regulation can also impact a company's valuation, especially as regulatory institutions are just beginning to examine newer technology. Ultimately, understanding whether or not the regulatory environment helps or hinders a FinTech company's growth is key to providing an accurate valuation.

Company Considerations

Quantitative data such as financial and operating metrics have significant weight in estimating a FinTech company's enterprise value. Key performance indicators such as revenue, expenses, profitability, growth, customer acquisition costs, and customer lifetime value have a key role in the company's value estimation. However, especially with startups, quantitative and peer benchmarking information is often limited. As a result, qualitative information becomes more important in determining company value. For example, one factor is the quality and experience of the management team, which includes qualities such as knowledge of the competitive landscape. Significant management experience of a company can enhance the FinTech's value compared to a company with minimal financial services experience.

A FinTech's intellectual property and the ownership of intellectual property and other intangible assets, like strategic partnerships, can also add to a company's value over competitors. These intangibles may increase the value of a FinTech startup to a potential acquirer or investor. When in place and demonstrated, intangibles are an important qualitative consideration for documenting value.

The stage of development of a FinTech company can also impact its value, and a FinTech's company's valuation can change sharply as milestones are achieved (or missed). Some of these milestones include initial round financing, proof of concept, regulatory approval, obtaining a significant partner, reaching a breakeven level of profitability, acquiring a certain level of customers, and more. Milestones are important to set and track; as the more milestones a startup meets, the less uncertainty exists and the more value is created.

Valuation Approaches

There are three common approaches to determining business value: asset approach, income approach, and market approach.

The Asset Approach

The asset approach determines the value of a business by examining the cost that would be incurred by the relevant party to reassemble the company's assets and liabilities. This approach is generally inappropriate for technology startups as they are not capital intensive businesses until the company has completed funding rounds.

The Market Approach

The market approach determines the value of a company by utilizing valuation metrics from transactions in comparable FinTech companies or historical transactions in the company. Consideration of valuation metrics can provide meaningful indications for startups that have completed multiple funding rounds. Although there might be complications from different preferences and rights with several share classes,

valuations and pricing metrics from comparable FinTech companies can provide helpful valuation anchors to test the valuation range. Market data of publicly traded FinTech companies and acquisitions can also be helpful for determining which deal pricing and multiples are available as key valuation inputs.

For early-stage companies, market metrics can provide valuable insight for potential valuations and financial performance as well as pricing metrics for when the FinTech company matures. For already mature FinTech companies, recent financial performance can be compiled and compared to public FinTech companies to serve as a valuable benchmarking tool. Investors can discern how the market might value a private FinTech company at an IPO based on pricing information from comparable public FinTech companies.

The Income Approach

The income approach can also provide a meaningful indication of value for a FinTech company. This relies on considerations for the FinTech companies' market potential, expected cash flows, risk, and growth prospects. The most common income approach method is the discount cash flow (DCF) method, which determines value based upon the present value of the expected cash flows for the enterprise. The DCF method projects the expected profitability of a company over a discrete period and pricing the profitability using an expected rate of return, or a discount rate. The combination of present values of forecasted cash flows provides the indication of value for a specific set of assumptions. For FinTech startups, cash flow forecasts are often characterized by a period of operating losses, capital need, and expected payoff as profitability improves or some exit event, like an IPO, occurs. Additionally, the income approach may require the consideration of different scenarios for future financial performance (such as high growth/profitability, average growth/profitability, and low growth/profitability) and potential exit scenarios (sale to strategic, sale to financial, IPO, downside sale/liquidation).

Putting it Together

Multiple valuation approaches are considered to provide lenses through which to assess value and generate tests of reasonableness against which different indications of value can be evaluated. Different methods are not expected to align perfectly. Value indicators from the market approach can be volatile, and investors typically think longer-term. More enduring indications of value can often come from income approaches, such as DCF models or probability weighted expected return models. Valuation of a FinTech is vital to measure realistic growth, to plan progression, and to secure employee and investor interests. Given the complexities in valuing private FinTech companies and the ability for the market/regulatory environment to shift quickly, it is important to have a valuation expert who can adequately assess the value of the company and understand the prevalent market trends.

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

About Mercer Capital

We provide valuations for a variety of purposes including: corporate/strategic planning, transactions (fairness opinion and M&A), equity compensation (409A compliance, ESOPs, and stock option programs), and financial statement reporting (purchase price allocations, impairment testing, equity compensation). Additionally, Mercer Capital provides related financial advisory and consulting services for companies across the corporate lifecycle — from start-ups to more mature companies.

Our financial technology practice provides services to a number of FinTech niches, including payments, technology, and solutions.

- **Payments**. Those FinTech companies that facilitate and/or support the transfer of money, particularly non-cash transactions, including processors, merchant acquirers, and hardware/software companies.
- **Technology**. Those FinTech companies providing software and technology services to other financial services companies, such as banks/thrifts/credit unions, investment companies, and healthcare/insurance companies.
- **Solutions**. Those FinTech companies that assist businesses and consumers (including non-financial companies) with financial services solutions, including general outsourced solutions, payroll/administrative, and financial media/content.

Mercer Capital also has experience providing valuation services to specialty finance companies and alternative lenders.

See our recent book, ***Creating Strategic Value Through Financial Technology*** (Wiley, 2017) by Jay D. Wilson, Jr., CFA, ASA, CBA.

Mercer Capital's FinTech Team

Jay D. Wilson, CFA, ASA, CBA
901.322.9725
wilsonj@mercercapital.com

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Rohan Bose
214.206.3796
boser@mercercapital.com

Daniel P. McLeod
901.322.9716
mcleodd@mercercapital.com

Copyright © 2018 Mercer Capital Management, Inc. All rights reserved. It is illegal under Federal law to reproduce this publication or any portion of its contents without the publisher's permission. Media quotations with source attribution are encouraged. Reporters requesting additional information or editorial comment should contact Barbara Walters Price at 901.685.2120. Mercer Capital's article does not constitute legal or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal or accounting matters should seek competent professional advice. Inquiries to discuss specific valuation matters are welcomed. To add your name to our mailing list to receive additional complimentary publications, visit our web site at www.mercercapital.com.