MERCER CAPITAL

UNDERSTANDING THE VALUE OF A

START-UP COMPANY

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July 2013

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Valuation for start-up enterprises can be a tricky proposition. Regardless of industry, start-ups generally share a common set of operational characteristics and valuation needs that are distinct from mature firms. Because both the subject enterprise and valuation purpose are misfits within the context of typical valuation work, typical valuation practices are generally not applicable for start-up companies.

In recent years, valuation issues have become increasingly important due to changing IRS and accounting rules, as well as increasing regulatory and shareholder scrutiny, which together compound potential troubles for start-up companies. In the past, industry specific start-up "rules of thumb" may have been sufficient to serve as reasonable basis for any valuation concern. While the simplicity of such rules can be appealing, the scrutiny of the IRS, SEC, and your auditors in combination with the potential liability associated with misreporting make it critical that value be determined and articulated in a credible fashion. Below, we will discuss common circumstances that give rise to the need for a valuation, basic valuation concepts, and specific valuation considerations relevant to start-up companies.

THE WHEN AND THE WHY OF BUSINESS VALUATION

The day-to-day activities of start-up companies, being in a formative phase, require significantly more attention from senior management than mature firms. As a result, many start-up company founder/managers overlook pending valuation issues for more immediate operational concerns.

For start-ups, valuations are most often needed for employee stock option or equity compensation compliance purposes. For financial reporting purposes, SFAS 123R requires that employee stock option compensation be recorded as an expense at the fair value of the option grant as of the grant date. The issuance of IRS 409A created tax implications for non-qualified deferred compensation plans, which includes the issuance of stock options and stock appreciation rights to employees at a discount. Given the severity of the tax implications, the rule effectively requires non-public companies that issue stock options or other forms of equity as compensation to obtain an independent, contemporaneous valuation of the relevant securities.

Other common valuation circumstances for start-ups involve advisory services and fairness opinions related to additional fundraising or exit events on behalf of company management for both planning purposes and to fulfill a fiduciary duty to shareholders.

Mercer Capital provides valuation and transaction advisory services to start-up companies in energy, healthcare, media, technology, and other industries.

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DEFINING THE "VALUE" OF A BUSINESS OWNERSHIP INTEREST

Through casual observation, the value of an enterprise seems like an easy concept with a single definition. In reality, the appropriate definition of value varies depending on the circumstances surrounding each valuation engagement. The actual analytical framework for determining value is only developed once these aspects are defined. The following concepts are vital to understanding what is meant by "value" and are essential in defining an engagement with a valuation specialist.

STANDARD OF VALUE

The standard of value is the identification of the particular definition of value used in a specific engagement. Identification of the appropriate standard of value is the first step of every valuation. So, what are the most common standards of value for start-up companies?

Fair Market Value

Fair Market Value is the most common standard of value used in business appraisals and is the standard used for 409A compliance related to equity compensation. Fair market value is defined by the American Society of Appraisers as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." A significant body of application guidance has been generated over the years through a variety of professional standards, government regulations, and court cases.

Fair Value

Depending on the situation, fair value can have one of two distinct meanings. For start-up company valuation, fair value most commonly refers to the standard defined by FASB in SFAS 157 for financial statement reporting purposes. Here, fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This definition of fair value is the relevant standard of value for valuations involved in SFAS 123R compliance for employee stock option compensation reporting.

In other circumstances, fair value can refer to the statutory standard of value applicable to cases involving dissenting minority shareholders with respect to corporate reorganizations or recapitalizations covered by the various state statutes. It may also have a specific meaning for divorce or under the securities laws for a given state. These statutory definitions of fair value (which are completely unrelated to the definition of fair value for financial statement reporting), however, are not commonly relevant in start-up company valuation.

Many business owners often pragmatically observe that fair market value and fair value are different than the real world where buyers and sellers are very specific people who are individually motivated, uniquely informed, and are using something other than 100% cash to transact.

Investment Value

Investment value is the value to a specific investor based on their particular investment requirements and opportunities. This value reflects the knowledge, expectations, synergies, and economies of scale of the particular investor. Investment value is generally used when valuation or investment banking professionals are advising their clients as to the merits of executing a specific transaction such as raising additional equity capital, selling the business, or completing an IPO. Investment value answers the questions – what's it worth to them? Or what's it worth to me?

A word of advice concerning who you choose to value your start-up: associated with nearly every industry are niche consultants who sometimes practice valuation without the requisite command of how value is defined for a given circumstance and correspondingly how such value should be developed. Given the incremental valuation complexities particular to start-up enterprises, it is important to remember that industry knowledge and valuation knowledge are not synonymous.

APPROACHES TO VALUE

There are three general approaches to determining business value – asset, income, and market. Under each approach there are specific ways to determine value that are commonly referred to as methods. As a general rule every valuation should consider each of these approaches. Ultimately, the conclusion of value will reflect consideration of one or more of these approaches (and perhaps various underlying methods) as being most indicative of value for the subject ownership interest.

The Asset Approach

This approach determines the value of the assets and liabilities based on the cost that would be incurred by the relevant party to reassemble them. For start-up companies, the asset approach is generally inappropriate to apply unless the start-up is in a very early stage of operational development such that there has been no intellectual property or other intangible value developed internally.

The Income Approach

The income approach is based on the idea that the value for a given enterprise is created by the expectation of future cash flows and thus focuses on the capacity of a start-up company to generate future economic benefits. The mechanics of an income method require an estimate of future cash flows and an appropriate discount rate with which to determine the present value of future cash flows.

Methods under the income approach are wide ranging but typically fall into one of two categories: 1) single period capitalization of income; or 2) discounted future benefits. By nature, income expectations for start-up companies are characterized by high non-linear growth expectations, and thus single-period capitalization of income methods are rarely appropriate to use.

The Market Approach

The market approach compares the subject to similar businesses, business ownership interests, or other assets that have been recently transacted. Market methods include comparison of the subject interest with valuation metrics implied by investments in publicly traded companies and those implied by transactions involving controlling interests in similar companies. Consideration of prior completed financing rounds or other transactions in interests of a start-up is also a method under the market approach.

Guidance in SFAS 157 suggests that the market approach is the preferred approach when appropriate data is available in sufficient quantity and quality. Most start-ups are not near IPO or acquisition, however, so there is generally not sufficient information to implement the market approach to determine the enterprise value for start-up enterprises with the exception of the occasional very late stage start-up.

Prior financing rounds can provide meaningful indications of value for a particular equity class in a start-up, but rarely provide meaningful indications of enterprise value. Generally, start-ups funded by one or more financing rounds subsequent to the company's initial formation are capitalized by several classes of equity which complicates the determination of enterprise value based on a given share value. However, such per share information is often helpful in providing upper or lower boundaries for enterprise value, and can credibly substantiate the reasonableness of valuation conclusions.

START-UP VALUATION CONSIDERATIONS

Valuation considerations unique to start-up enterprises generally include the operational development of the start-up, the passing of certain milestones, the quality of the management team, and economic ownership of intellectual property or other intangible assets, among others.

Operational Development

The value of a given start-up is largely related to its level of operational development. Despite differences in industry characteristics, most start-ups tend to follow similar patterns in operational development. We have found that the specification of six developmental stages found in the AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* describes this pattern pretty well:

1. "The enterprise has no product revenue to date, a limited expense history, and, typically, an incomplete management team with an idea, plan, and possibly some initial product development....

2. "The enterprise has no product revenue but substantive expense history, as product development is under way, and business challenges are thought to be understood. Typically, a second or third round of financing occurs during this stage....

3. "The enterprise has made significant progress in product development; key development milestones have been met... and development is near completion (for example, alpha and beta testing), but generally there is no product revenue. Typically, later rounds of financing occur during this stage....

4. “The enterprise has met additional key development milestones (for example, first customer orders, first revenue shipments) and has some product revenue, but is still operating at a loss. Typically, mezzanine rounds of financing occur at this stage. Also, it is frequently in this stage that discussions would start with investment banks for an IPO.

5. “The enterprise has product revenue and has recently achieved break-through measures of financial success such as operating profitability or breakeven or positive cash flows. A liquidity event of some sort, such as an IPO or sales of the enterprise, could occur at this stage....

6. “The enterprise has an extablished financial history of profitable operations or generation of positive cash flows....”

The operational development stage of a start-up impacts value primarily in relation to the overall level of uncertainty associated with each stage of development. Compared to a later-stage start-up, a seed stage start-up with only an idea and incomplete management team and plan has essentially no relevant information to substantiate any future earnings expectations, and accordingly is characterized by a significantly higher degree of uncertainty. In the context of an income approach to valuation, this uncertainty would increase the appropriate discount rate to apply to expected cash flows, and thus decrease the value of the enterprise.

Milestones

Since the development of start-up enterprises is measured by the passing of various milestones, the meeting of milestones (or the lack thereof) contributes significantly to the valuation of a start-up. Passing certain milestones create a bigger impact on value than others; examples of such milestones include the completion of the initial round of financing, proof of concept, regulatory approval, delivery of product to customers, profitability, and others.

With the passing of each milestone, the level of uncertainty associated with the start-up decreases and thus drives value upwards. Generally, meeting later-stage milestones generates greater increases in value than that of earlier-stage milestones.

Management Team

Compared to mature enterprises, financial information for start-up companies (even later-stage start-ups, but to less of a degree) is less frequently available and typically of lower quality. Due to this relative lack of information, qualitative factors such as the quality of the management team in place become an important consideration, especially in the valuation of early-stage start-ups.

Intellectual Property

Economic ownership of intellectual property and other intangible assets such as an assembled workforce, key customer or other strategic relationships, etc. all represent the existence of some competitive advantage over future or existing competitors. Similar to the importance of the quality of the management team, qualitative consideration of intellectual property and other intangible assets is important to the value of a start-up enterprise.

FINAL THOUGHTS

Mercer Capital has valued start-up enterprises across a number of industries over the years and we have witnessed many of the hardships and successes of such companies. We hope this information, which only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics. We encourage you to extend your business dialogue to include valuation – sooner or later circumstances requiring independent valuation will arise, and early awareness will minimize the likelihood of potentially unpleasant surprises.

MERCER CAPITAL'S FINANCIAL REPORTING VALUATION SERVICES

In an environment of increasingly complex fair value reporting standards and burgeoning regulatory scrutiny, Mercer Capital helps clients resolve fair value reporting issues successfully.

We have the capability to serve the full range of fair value valuation needs, providing valuation opinions that satisfy the scrutiny of auditors, the SEC, and other regulatory bodies.

We also have broad experience with fair value issues related to public and private companies, financial institutions, private equity firms, start-up enterprises, and other closely held businesses. National audit firms consistently refer financial reporting valuation assignments to Mercer Capital.

Our professionals are nationally recognized as leaders in the valuation industry, and hold the most rigorous credentialing designations including the CFA, ASA, and CPA, among others, which are representative of the highest standards in the valuation and accounting industries. Mercer Capital has the institutional capability to tackle even the most uncommon or complex fair value issues. We understand the sensitivity of financial reporting timing needs and meet your deadline on time, every time.

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