EMW

GETTING READY FOR INVESTMENT

VALUATION

If your business is in its infancy, and any potential exit seems in the distant future, the importance of a valuation may appear relatively insignificant. However, obtaining and, more importantly, understanding the value of your company can help you improve its real or perceived value and is crucial when pursuing third party investment.

Often, any primary third party investment will be in exchange for equity (ie. shares) in your company. Without an accurate valuation you may either struggle to attract investors if the price is too high, or you may end up giving away too much of your company if the price is too low.

With various methods and formulas used to value companies, here are some of the main methods:

- **Asset Valuations**: This method essentially prices a company on its net asset value: the value of its assets minus the value of its liabilities. Often used for valuing property companies and companies based around tangible assets, but would severely undervalue any company whose value resides in IP or other intangible assets.
- **Earnings Multipliers**: This method multiplies average annual profits (adjusted so as not to include one-off factors like exceptional costs or one-off purchases) by a given figure depending on the sector, typically a multiple of between three and five. Companies with recent years' financial success will find this method most advantageous, but this method may underestimate any start-up or early stage business which has yet to turn successive years of significant profit.
- **Entry Cost:** This method considers the estimated cost of getting a new business to the same point as your company, taking into account factors such as how much it would cost to build up a customer base and assets, train people and develop products or services. Accordingly, this method will only be appropriate for certain companies; if for example your business is IP heavy with low setup costs, it would almost certainly be undervalued when using this method.
- **Industry Rules of Thumb:** Some industries have formulas that are used almost universally to get a valuation (eg. retail companies are generally valued as a multiple of turnover, number of customers or number of outlets). Whilst this method will be useful if your business falls entirely within the usually parameters its sector, it will prove less so if your business has some particularly unique features as they are unlikely to be accounted for.

There are also various factors that will affect the value of your company – the biggest being a potential investor's perception of your company and of its value: the more risks any potential investor perceives, the lower the value will be. Some of the common factors that affect valuation are:

- **The Economy:** You will need to assess the current position of the market and consider financial forecasts for the future. Often timing is everything. If your business is in the same position as property businesses were in 2009, now may not be the appropriate time for external investment.
- **Industry Market Forces:** You should consider whether the sector in which you operate is mirroring the wider economy or experiencing contrary conditions. For example, should your company's sector enjoy a period of growth despite harsh economic conditions it may increase the chance of any potential investor paying a premium, whilst your company may struggle for any investment should the adverse be the case.
- **Supply and Demand:** Who is more desperate for the investment; your company or the investor? If your company is in desperate need of the investment and potential investors have a healthy supply of similar companies to choose from, the valuation of your company may have to be reduced to some extent to attract investment. Adversely, should your company have a particularly unique selling point then any potential investor may be willing to pay a premium.
- **Revenue:** The current state of your company's revenue will often dictate how investors view their level of risk and thus the level of equity they will require to offset some of that risk. For example, if your company is still pre-revenue the investor will more likely require substantial equity, which may be more than you are willing to give. It may therefore be advisable to be patient and only seek investment once your company has begun to generate some sales.

Additional considerations such as how well you control costs and whether there is likely to be any need for capital expenditure in the near future will also play a part.

The Competition and Recent Exits: You should also consider companies that have similar profiles to yours and those to which your company aspires to be like (and has a realistic chance of reaching or bettering). Consider their current values in the market and the price at which any of them recently exited. Such comparables may prove significant in convincing any potential investors that your valuation is appropriate.

People: The old cliché of people do business with people is particularly true in relation to start-ups. The founder(s) and management team's record of success, experience in your company's sector, and commitment to the company will be of interest to potential investors.

Valuing your company is very subjective and is more of an art than a science. Valuing a start-up or early stage business is particularly difficult due to the small sample size of data accumulated in comparison to well-established companies.

Whilst any pre-investment valuation should ideally be ascertained by a corporate financier, it is not a one-off process but rather the value of your company is something you should regularly evaluate so you can plot its value over a sustained period of time. Such information will aid you in making the hard decisions about when the right time for investment in your company may be.

Get in touch

If you would like assistance in sourcing funding, please contact us so that we can help introduce you to the right experts.