HOW TO VALUE A START-UP BUSINESS?

Source: PwC

Start-ups usually have negative but growing cash flows, and limited or no historical financial data and forecasts. For that reason, the traditional approaches such as income approach, market approach or net assets approach, which are used in determining the start-up business value, are not helpful because the start-ups and most of the early-stage companies do not have the financial performance indicators necessary for those approaches.

Valuation of a start-up brings various challenges, which require the potential investors to approach the process differently. As historical information is unavailable/limited and forecasts are uncertain, qualitative elements (such as management experience, first customers and revenue) play a significant role in the valuation process.

Start-up valuation methods

There are six different methods, which are often used in practice and applied to different stages of a start-up. The list is infinite, and valuation practitioners will often use a combination of the methods as per the table in the next slide.

Characteristics	1 Idea / Seed	2 Seed / Start-up	3 Early growth	4 Expansion	5 Sustainable growth
Cash flows	NA	Only negative	Negative (but increasing)	Positive (growing at a decreasing rate)	Stable
Proof of concept	×	×	✓	✓	✓
Historical data	×	×	Limited	✓	✓
Forecast data	×	Limited	Limited	✓	✓

Valuation methods

The selected valuation method depends on the maturity stage of the company being valued (target entity).

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#1. For early-stage companies, the fixed ranges approach, the cost approach, and the scorecard valuation method might be used for valuation.

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When using the **fixed ranges approach**, investors propose a ‘take or leave’ investment, which is based on the fixed ranges of capital offered in exchange for a share of equity.

The **cost approach** sets the idea that an investor is willing to cover the costs that have already been incurred to get the target entity to its current stage.

In order to assess the value of the target entity using the **scorecard valuation method**, the potential investors have a list of criteria based on which the target entity and its peers are evaluated.

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#2. Valuation of companies in Early Growth and Expansion stages might be based on the venture capital (VC) and discounted cash flows (DCF) methods.

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Using the **VC method**, the value of the target entity is estimated as the value after a few years (the so called 'exit-value'). That value is then discounted to the present value using a discount rate.

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The **DCF method** is used for companies where cash flows can be reasonably estimated. The DCF approach is a valuation method used to estimate the value of the target entity based on its expected future free cash flows. Those cash flows are then discounted to the present value using an appropriate discount rate, being the weighted average cost of capital (WACC).

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#3. The companies that have reached the Sustainable Growth stage could be evaluated using the DCF or market multiples methods.

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Using the **market multiples approach**, the potential investors could consider either the current market price of publicly traded peer companies or the previous comparable transactions with disclosed multiples. In start-up valuation, the most often used multiples are: enterprise value-to-revenue (EV/R), enterprise value-to-EBITDA (EV/EBITDA), enterprise value-to-EBIT (EV/EBIT), and enterprise value-to-free cash flows (EV/FCF).

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