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# VALUATION OF IT SERVICES STARTUP VENTURES

**Dr. S K Gupta**
*Managing Director*
*ICMAI Registered Valuers Organization*

## The Perspective

Business valuation is never straightforward - for any company. For startups with little or no revenue or profits and less-than-certain futures, the job of assigning a valuation is particularly tricky. For mature, publicly listed businesses with steady revenues and earnings, normally it's a matter of valuing them as a multiple of their earnings before interest, taxes, depreciation, and amortization (EBITDA) or based on other industry specific multiples. But it's a lot harder to value a new venture that's not publicly-listed and may be years away from sales.

## What Is a Startup

A startup company is a new business that is potentially fast growing and aims to fill a hole in the marketplace by developing and offering a new and unique product, process, or service but is still overcoming problems. Most countries of the world consider the development and implementation of innovative technologies as a necessary thing for the economic growth. So, to make the country a leader in innovation and, as a result, to make the country a competitive one, it is necessary to develop and commercialize new products and technologies or, in other words, to develop the startup business sphere. It may be a cliché that the entrepreneurs provide the energy for economic growth, but it is also true that vibrant economies have a large number of young, idea businesses, striving to get a foothold in markets. Young ventures have seized control of billions of lives providing solutions to everyday problems that seemed to be non-existent before

A startup is equivalent to a unique idea which can have an immense value. A startup is typically a venture that aims to bring a new and innovative service, product or process into the marketplace. The founder is generally the entrepreneur who runs with the idea. The founder often starts small and looks for angel / venture funding. There are a number of avenues that can be utilized to secure funding and get momentum. The founder is often a passionate new entrepreneur from a venerable B-school who does not want to limit the potential of the idea, a group of young and fired up management and technology majors can be instrumental in initiating a dynamic platform. The risk here is not huge as the founders still have the option to go back to the drawing board if the venture faces problems. In the other scenario the founders could be experienced veterans of the technology or corporate world who have given up humongous salaries to set up their dream project. This is more fraught with risks as the capital and labor in the initial stages is often the life savings of the entrepreneur.

## Characteristics of startups

As we noted in the last section, young companies are diverse, but they share some common characteristics. In this section, we will consider these shared attributes, with an eye on the valuation problems/issues that they create.

**1. No history:** At the risk of stating the obvious, young companies have very limited histories. Many of them have only one or two years of data available on operations and financing and some have financials for only a portion of a year, for instance.

**2. Small or no revenues, operating losses:** The limited history that is available for young companies is rendered even less useful by the fact that there is little operating detail in them. Revenues are small or non-existent for idea companies and the expenses often are associated with getting the business established, rather than generating revenues. In combination, they result in significant operating losses.

**3. Dependent on private equity:** While there are a few exceptions, young businesses are dependent upon equity from private sources, rather than public markets. At the earlier stages, the equity is provided almost entirely by the founder (and friends and family). As the promise of future success increases, and with it the need for more capital, venture capitalists become a source of equity capital, in return for a share of the ownership in the firm.

**4. Many don't survive**: Most young companies don't survive the test of commercial success and fail.

**5. Multiple claims on equity:** The repeated forays made by young companies to raise equity does expose equity investors, who invested earlier in the process, to the possibility that their value can be reduced by deals offered to subsequent equity investor

**6. Investments are illiquid:** Since equity investments in young firms tend to be privately held and in non-standardized units, they are also much more illiquid than investments in their publicly traded counterparts.

## Difference Between Startup Valuation and Mature Business Valuation

Startup businesses will usually have little or no revenue or profits and are

still in a stage of instability. It is likely their product, procedure, or service has reached the market yet. Because of this it can be difficult to place a valuation on the company. With mature publicly listed businesses that receive steady revenue and earnings it is a lot easier. All you have to do is value the company as a multiple of their earnings before interest, taxes, depreciation, and amortization (EBITDA). Valuing a startup is more of an art than science, what we meant is that the most scientific methods of valuation Discounted Cash Flows (DCF), Net Asset Value (NAV), Comparable Method, etc. seem to fall apart when it comes to startup as most of the startups are pre-revenue and focuses on growth more than positive cash flows, some are creating their own niche and thus, no comparable exists, some are just an idea which has yet to be fully accepted by the end users

Startup valuation essentially points out the worth of your business—its idea, the product or service and so on. Start-up valuation is different from valuing any running business due to many reasons. Start-ups may not have :

- Business experience
- Operational skill set
- Brand name for their products/ services
- Strong R&D base
- Dedicated execution team
- Experience of affording sudden economic shocks
- A required amount of fund etc.

### What determines a startup value?

A startup is like a box. A very special box. The box has a value. Its value increases as you put more things in the box The valuation of startup companies is determined by a cohort of positive and negative factors

### Positive Factors

- **Traction** – One of the biggest factors of proving a valuation is to show that your company has customers
- **Reputation** – If a startup owner has a track record of coming up with good ideas or running successful businesses, or the product, procedure or service already has a good reputation a startup is more likely to get a higher valuation, even if there isn't traction.
- **Prototype** – Any prototype that a business may have that displays the product/service will help.
- **Revenues** – More important to business to business startups rather than consumer startups but revenue streams like charging users will make a company easier to value
- **Supply and Demand** – If there are more business owners seeking money than investors willing to invest, this could affect your business valuation. This also includes a business owner's desperation to secure an investment, and an investors willingness to pay a premium.
- **Distribution Channel** – Where a startup sells its product is important, if you get a good distribution channel the value of a startup will be more likely to be higher.
- **Hotness of Industry** – If a particular industry is booming or popular (like mobile gaming) investors are more likely to pay a premium, meaning your startup will be worth more if it falls in the right industry.

### Negative Factors

- **Poor Industry** – If a startup is in an industry that has recently shown poor performance, or may be dying off.
- **Low Margins** – Some startups will be in industries, or sell products that have low-margins, making an investment less desirable.
- **Competition** – Some industry sectors have a lot of competition, or other business that have cornered the market
- **Management Not Up To Scratch** – If the management team of a startup has no track record or reputation, or key positions are missing.
- **Product** – If the product doesn't work, or has no traction and doesn't seem to be popular or a good idea.
- **Desperation** – If the business owner is seeking investment because they are close to running out of cash.

### What is an IT Services Startup ?

An IT Services startup would be a company or business venture of Information Technology that provides IT based services or products. Defining an actual IT service company is a common and major challenge, particularly if IT and the customer are not aligned around what is expected from both parties. One reason for this challenge is one of perspective: IT sees the service from the basis of applications and infrastructure. Customers see the service from outcomes and usage. For companies to fully support the customer in meeting their objectives, both IT employees and customers must make a concerted effort to reach a definition of the IT services being provided. Customers who purchase and/or use IT services do so with the intention to accomplish a certain objective. According to ITIL4, a service is any means of enabling **value co-creation** by facilitating **outcomes** that customers want to achieve, without the customer having to manage specific **costs** and **risks**.

### Service offerings and service packages of IT Service Ventures

IT as a service (ITaaS) is an operational model where the information technology (IT) service provider delivers an information technology service to a business. A service offering, also known as a service package, can include one or more services, designed to address the needs of a target consumer group. For example, an IT service provider can talk with a customer to understand the customers needs and objectives. With this

understanding, the service provider can deploy their relevant services to create a service offering specific to that customer's needs. Such a service offering may include any combination of:

- Goods or physical products
- Access to resources, such as subscription to a timed usage based on certain terms and conditions
- Service actions, such as maintenance, processing, or support activities

IT services refers to the application of business and technical expertise to enable organizations in the creation, management and optimization of or access to information and business processes.

- The IT services market can be segmented by the type of skills that are employed to deliver the service (design, build, run). There are also different categories of service: business process services, application services and infrastructure services.
- If these services are outsourced, they are referred to as business process outsourcing (BPO), applications outsourcing (AO) and infrastructure outsourcing.

### Few common features of IT Services startups include:

a. Lack of tangible physical assets
b. Dependency on key management team
c. Lesser upfront capex
d. Lack of strictly comparable peers
e. Dependencies on a platform or a technology
f. Enhanced subjectivity in valuation assessment
g. Fast changing and evolving
h. Certain industry specific issues encountered while doing valuation in service industries

### Valuation of IT Services Startups

Information Technology or Information Technology-enabled services company valuations is challenging because most companies have some services, some technology, some partners, some clients and some vision.

- **Start from the future :** When valuing high-growth companies, start by thinking about what the industry and company might look like as the company evolves from its current high-growth, uncertain condition to a sustainable, moderate-growth state in the future. Then interpolate back to current performance. The future state should be defined and bounded by measures of operating performance, such as customer-penetration rates, average revenue per customer, sustainable margins, and return on invested capital. Next, determine how long hyper growth will continue before growth stabilizes to normal levels. Since most high-growth companies are start-ups, stable economics probably lie at least 10 to 15 years in the future.
- **Work backward to current performance :** Having completed a forecast for total market size, market share, operating margin, and capital intensity, it is time to reconnect the long-term forecast to current performance. To do this, you have to assess the speed of transition from current performance to future long-term performance. Estimates must be consistent with economic principles and industry characteristics. For instance, from the perspective of operating margin, how long will fixed costs dominate variable costs, resulting in low margins? Concerning capital turnover, what scale is required before revenues rise faster than capital? As scale is reached, will competition drive down prices?
- **Develop weighted scenarios :** simple and straightforward way to deal with uncertainty associated with high-growth companies is to use probability-weighted scenarios. Even developing just a few scenarios makes the critical assumptions and interactions more transparent than other modelling approaches, such as real options and Monte Carlo simulation. To develop probability-weighted scenarios, estimate a future set of financials for a full range of outcomes, some optimistic and some pessimistic

No single startup valuation method is accurate all the time. More than likely, you'll work through multiple methods and combine techniques to find a fair value.

### The Dark Side of Valuation

With the estimation challenges that analysts face in valuing young companies, it should come as no surprise that they look for solutions that seem to, at least on the surface, offer them a way out. Many of these solutions, though, are the source of the valuation errors we see in young company valuations. The biggest determinant of your startup's value are the market forces of the industry & sector in which it plays, which include the balance (or imbalance) between demand and supply of money, the recency and size of recent exits, the willingness for an investor to pay a premium to get into a deal, and the level of desperation of the entrepreneur looking for money. *You need to pay attention to elements that influence growth*. The most common things to look at include things such as: The hotness of the industry, The capabilities of the startup team, product or service and its competitive advantage.

### Relevant Factors / Approaches to value an IT Startup

Unfortunately, there is no single formula that can be used to precisely value your business. There are, however, a number of tried and trusted techniques which can be used to determine an indicative value for

your business. Of course, the seller will want to drive the price up and potential buyers will want to drive the price down, so the final value will be down to negotiation between both parties. Which approach / formula is most appropriate for your business will depend on several factors:

- **What are the circumstances of the valuation?** A healthy ongoing business? An approach from your main competitor? A business prepared to maximize value? A forced sale?
- **How tangible are the business assets?** Most technology companies will have no real tangible assets beyond an office whereas a semiconductor fabrication plant will have significant tangible assets.
- **What is the age of the business?** Is it a young, innovative and scaling business or a mature company with an established and dependable revenue flow?
- **Which technology sub-sector is the business in?** IoT? Big data? Biotechnology? SaaS? Renewables technology? Values in each sub-sector will vary widely. The Barriers to entry in some sub-sectors are low, enabling competitors to quickly get a foothold thereby potentially reducing your business' value.
- **How valuable are your intangible assets?** Some of the most valuable parts of the business may not appear on the balance sheet, for example, trademarks, reputation, branding, key people, size and quality of the customer base while others such as patents and IP may not be recorded on the balance sheet at actual perceived market value.
- **Is the business dependent on the owner?** Owner dependence is one of the most important factors in valuing (and marketing) a business and different buyers will have a different perception of the risk – much of the value in an owner-dependent business is destroyed if the owner leaves abruptly.
- **What is the current economic climate?** This has always been a 'buyer's market' but Brexit, for example, has introduced an increasing degree of uncertainty which has led to delayed decision making on some transactions.

When valuing a business, it is usual to use at least two methods and arrive at a value range rather than one definitive figure.

- **Multiple of profits (or Price/Earnings ratio) :** This is a good technique for companies with a solid track record of profitability but ratios vary widely. a small unquoted business is usually valued at between 5 and 10 times its annual post-tax profit and a quoted company with excellent prospects may reach 20. For certain innovative and high growth technology firms, the P/E ratio has risen dramatically, such as Facebook which had a P/E ratio of 114 at the time of its IPO. While such companies are seen as the exception rather than the norm there has been a trend towards normalization of P/E ratios within the technology space and most growing technology companies are now commonly valued in the 10-25 P/E multiplier range, but again every company and sector will be slightly different.
- **Asset valuation :** This method is used for asset-rich businesses, and is generally not so relevant to the technology industry, although a biotechnology or life science company would probably be an exception to this rule. To calculate your asset valuation, take the value of your assets and subtract your liabilities. This method of valuation usually produces the lowest valuation because it does not take into account the potential for future earnings.
- **Entry valuation :** What would it cost to start a similar business from scratch? Tricky figure to come up with this one. You'll need to calculate the cost of employing people, delivering training, developing products and services, building assets and a client base.

## Conclusion

A start-up is characterised by having little or no revenue, negative cash flows, being mostly lossmaking, having short histories, a binary business model and being dependent on equity financing. It is extremely hard to determine the accurate value of a company while it is in its infancy stages as its success or failure remains uncertain. Valuing a business at any stage of it's lifecycle is difficult, but early stage is particularly problematic. Remember that valuations are nothing but formalized guesstimates. For an established business, knowing the valuation is rather straightforward. The market value of the business can be calculated using tangible metrics and assets, such as revenue, profits and customers. Just as beauty lies in the eyes of the beholder, value too is based upon the outlook of the person who is valuing the company. *Value is therefore a relative concept.*

There's a saying that startup valuation is more of an art than a science. Startup valuation, as frustrating as this may be for anyone looking for a definitive answer, is, in fact, a relative science, and not an exact one. Valuing a start-up comprises throws up many problems, the first one of them being that it is extremely hard to tell what the future of the company will be, or more precisely if it will survive at all in the coming years. Because of this an estimation has be to be used, which is why several startup valuation method frameworks have been invented to arrive at reasonable acceptable valuation of startups.