

FOCUS

Valuing your business: Formulas offer just a starting point

When it's time to sell a portion of their businesses, entrepreneurs often get confused by valuation. Although there are plenty of calculations that rely on a combination of investor mind-reading, MBA-type research and dart-throwing, they're complex and don't take into account all factors that affect valuation. Determining valuation is a blend of quantitative factors heavily dominated by qualitative factors that entrepreneurs and investors evaluate through different lenses (the entrepreneurs' lenses generally being rosier).



GUEST COLUMN

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Fortunately, there's a relatively simple calculation to get you started. You need to know two things: How much of your company you're selling, and how much you need to raise. In Portland you should expect to sell 30 to 40 percent of your company in a Series A and set aside 20 percent of the total post-close shares for a stock option plan.

To get a starting-point range, use the following calculations:

Post-money valuation = amount raised divided by percentage of company sold.

Pre-money valuation = post-money minus amount raised.

To illustrate: You want to raise \$1,500,000 in your Series A.

Your starting-point valuation range is between \$2,250,000 and \$3,500,000. Qualitative factors move that higher or lower.

Raise	Percentage Sold	PostMoney*	PreMoney**
\$1,500,000	30	\$5,000,000	\$3,350,000
\$1,500,000	40	\$3,750,000	\$2,250,000

*=Raise/Percentage Sold
**=PostMoney-Raise

You can manipulate these numbers to derive a range with which you're comfortable. For example, you could raise \$2 million:

Raise	Percentage Sold	PostMoney*	PreMoney**
\$2,000,000	30	\$6,666,667	\$4,666,667
\$2,000,000	40	\$5,000,000	\$3,000,000

*=Raise/Percentage Sold
**=PostMoney-Raise

Or, you only want to sell 35 percent of your company:

Raise	Percentage Sold	PostMoney*	PreMoney**
\$1,500,000	35	\$4,285,714	\$2,785,714

*=Raise/Percentage Sold
**=PostMoney-Raise

You may be curious to know what sort of price per share your valuation creates. Price per share is determined by dividing your pre-money valuation by the number of your outstanding, fully diluted shares before the Series A investment. "Fully diluted" means all issued and outstanding common stock, plus outstanding, unexercised options and warrants, as well as all the unissued shares set aside for the incentive plan. Using the 30 percent example above, if your fully diluted shares amounted to 3,500,000, it would seem your price per share would be \$1.

If only it was that easy!

Most frequently, your Series A investors, especially if they're angel or institutional investors, will require a post-close pool equal to 20 percent of the post-close fully diluted shares, and then include that pool in the calculation of pre-close fully diluted shares. More shares divided by the same price results in a lower price per share. Here's how it works. Effectively, you're selling 55 percent of your company (35 percent Series A, 20 percent stock incentive pool) or 4,277,778 shares, of which 2,722,222 are Series A Preferred and of which 1,555,556 will be allocated to your stock incentive pool and added to your pre-close fully diluted shares. Your Series A price per share is then roughly equal to \$0.55 (\$3,500,000 / 5,055,556). To be clear, this assumes 100 percent of the shares originally allocated to your stock incentive plan are outstanding prior to your Series A negotiation. If you have shares remaining in the plan, the total

number you would add to the pre-close fully diluted shares is something less, and the Series A price per share falls somewhere between \$0.55 and \$0.85.

You also want to keep in mind that Series A investors generally want a tenfold return on their investment in three to five years. If you want to sell 40 percent of your company for \$2 million, you're stating a valuation of \$5 million and implying that in three to five years you'll be worth \$50 million. You should have solid data to support such a prediction, but whether you can support it also depends on how your investors view the qualitative factors they use.

Among the qualitative factors considered, the management team is cited as the most important in early-stage investments. Because Series A investments tend to be in pre-revenue companies (often pre product) and the company hasn't demonstrated proof of their business plan assumptions, investors invest heavily in people. Those people should be right for the company now, but should also honestly be willing to step aside when they're no longer right. Following closely on the heels of the oft-cited team criteria are size of market, product, and competitive landscape.

Your valuation also should look similar to recent investments in like-kinds of companies. According to a May 2006 survey of valuation methods published by a Cornell MBA student, "comparable transactions" or "comparable multiples" were the two most frequently used valuation methods. Nonetheless, data about private early-stage investments, tend to be elusive, forcing investors to rely on word-of-mouth or comparables that may be limited or narrow in scope.

Valuation — and deciding whether to invest — is more art than science. Sure, there are specific factors investors care about deeply. In reviewing those factors, however, investors rely primarily on intuition with some quantitative analysis sprinkled in. The resulting "formula" heavily is weighted by gut instinct.

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