Start-up Valuation Methodologies at Early and Exit Stages

1.RESEARCH TOPIC:

The research topic will cover the valuation techniques for start-up companies, mainly the technology and social media / social network "SocNet" companies. It will examine how start-ups are valued during early stages (for financing and fundraising) and at exit stages (for acquisition, merger, or IPO).

There is an increased interest in start-ups from analysts, consumers, and investors alike, due to their impact on how we go about doing our day-to-day activities and how they are changing our lives. As they provide disruptive, innovative, convenient ways of doing business compared to the traditional big corporates. The change can be felt in how we connect and interact with friends and family and the impact on our social life. Or how we as consumers interact with companies and order or book a service via applications and websites available.

It will be interesting to understand how the Silicon Valley Firms - the so-called "Unicorns" with $1 Billion valuation, are valued with a price tag worth millions and billions of dollars despite having low number of employees or low profit business model. And how accurate are these valuations when the business is few years old and is going to be acquired or going to IPO.

Company valuation is a complex task and even more difficult when it comes to a start-up that has no historic financial performance to assess the business on or has generated any revenue yet. The traditional valuation techniques used for corporate companies doesn't always apply for these start-ups, as they may not generate high revenue but have high number of subscribers and growth potential.

Thus, there is a risk that these firms can be overvalued and so when it comes to closing an acquisition deal or IPO they are bought for a lower price or the share price is lower than initial valuation.

2.RESEARCH OBJECTIVE

The research will study the valuation methods used to value a start-up business, and how the valuation works at early stages (seeding and growth phase) for fundraising and investment purposes and how the valuation is calculated at exit stage for merger, acquisition and IPO purposes. At the funding stage the valuation can offer investors a high share price but during the pre-IPO phase it can be valued at lower price. This raises a question about the accuracy of the valuation and assumptions used when valuing a new business.

The research will aim to answer the question "what are the methods used to value a company as a start-up and during exist process, and are there any links, differences, and / or similarities between the different valuations?".
Answering the question will help to understand if the initial valuation for a new start-up is correct and if the business value today is the same as the valuation that was predicted earlier.

From the literature review in the next section, we will notice there are no studies or researches that link or talk about the connection between the different valuations, thus making the research objective is to understand if there is a relationship between the valuation methods used at early stage and at late stage.

3.LITERATURE REVIEW

The literature review will cover the research reports, articles, and publications that have been done on the valuation techniques for a start-up from early stages and the valuation during an IPO or M&A.

One of the resources used for this research and review on start-up valuation is a study done by Miloud, Aspelund and Cabrol (2012), where they examined how venture capitalists value a new venture for financing. They developed a theoretical framework that examines the factors venture capitals consider in valuing a firm, which is based on analysing 184 rounds of early-stage venture capital investments in 102 new ventures. The results of the study identify that there are different factors that need to be considered when valuing a start-up which are as important as the company performance. These factors include the attractiveness of the industry, the founders and management team, and the external relationships of the new venture. They conclude that with young firms the valuation methods are different from the traditional valuation of well-established and public capital market companies. As with new firms rather than valuing them on their output (e.g. future cash flow) they can be valued based on their input (e.g. entrepreneur, industry attractiveness...etc.).

Another article that reviews tech companies and networks valuation is by Weinman (2007) which outlines the argument as to why some networks may some of the time experience growth in value that is only linearly proportional to the growth in nodes. And that there is no exact quantitative analytical process that can be used for determining the value of a network - i.e. there is no universal law. But different variables such as number of subscribers, number of website users...etc. should be taken into consideration to value a new business. Weinman (2007) also asks some important such as if the network grows in size, does its value increase? If so, in what proportion relative to its size? The article looks at recent acquisitions and that valuing a business through subscribers, users, or growth is complex. And there can be value creation synergies through consolidation, marketing synergies or scale economies which makes the business value and acquisition deal viable and sensible.

In chapter 3 of their book "Masterminding the Deal" Clark and Mills (2013) review the methods used for merger valuation (MV) which determines if the M&A deal is successful or not. And in chapter 6 they view the Facebook IPO and the acquisition of Instagram as marking the beginning of the second phase of the fourth M&A wave (the second dot com merger wave) that's led by tech companies. And how Facebook value evolved since it was founded in 2004 until its IPO in May 2012. The book provides analysis and implementation approaches to increase merger success. And highlights the risks with the current merger wave mainly in the technology related sector and social media firms and what they call the “vapour numbers”. This is because with some of the recent social network IPOs the share price post-IPO is a small fraction of the pre-IPO price guesses which were mistakenly referred to as ‘valuation’ by the financial press and the IPOs arrangers before the launch.

An article that was published in the Finance Times dated 11 Nov 2015 by Murad, Hook and Waters (2015) closely examines some of the most recent valuation of Silicon Valley companies that are being exposed as mere 'marketing numbers' when they reach the harder reality of an IPO, causing fears of a bubble and an imminent correction. The article talks about how things changed for some companies on the way to IPO, where the preliminary prices are far below what the investors who funded the companies were anticipating. And the projected valuation to go public is lower than that promised to the investors a year earlier. This disappointing reality of the share prices at IPO has been a rude awakening for investors and entrepreneurs.

There are other resources that will be considered and included in the literature review of the main research report, but the important point to highlight from the literature review above is that they all consider the valuation at each stage separately and talk about each one individually without linking them. Hence the research objective aims to study the valuation approaches for start-ups during the different business lifecycles, and identify if there is a link between them. And how the valuation can change or differ from what initially thought.

4.RESEARCH DESIGN AND DATA COLLECTION

The research approach will be to collect and analyse *secondary data* that already exist, using academic researches, business reports, journals and official publications. And will be a mixed *qualitative* and *quantitative* approach using numeric data as well as narrative data. Collecting primary data or conducting surveys and questionnaires will not be relevant for this project.

The research type will be a *descriptive study* as it will produce an accurate presentation on the valuation methods based on the data collected and analysed, and an *explanatory study* as it will focus on studying the valuation at different stages of the business and explains if there is a relationship between them.

The research strategy will be a mixed strategy of *archival research* by using and analysing documents and publications as the principal source of data, and *case study* by referring to real-life examples. The population and sample of the research will focus on the tech and social media companies, using most recent examples of these companies’ valuation, acquisition, and IPO. The source of data will be publicly available reports and figures that are disclosed.

REFERENCES – All these resources I have them available in PDF

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