



Business Valuation Theory and the Early Stage Company

By Glenn P. Cato

If you are asking yourself, why should any early stage company entrepreneur be concerned about business valuation theory given their most immediate pressures are meeting payrolls, getting a product to market or achieving revenue traction? There are some good reasons to understand the fundamentals.

Before talking about reasons favoring the importance of understanding business valuations, let me address one often asked question. How important is an independent business valuation when raising a private round of equity? If the round of equity being raised is a Seed Stage or Series A round, there is little if any value to obtaining an outside valuation. Most accredited investors make their own assessment of the risk and return and the valuation becomes a negotiated amount. These investors already know the return on investment they want or need to justify the risk of a particular investment. Most early stage companies at the Seed Stage or Series A round have very little leverage to negotiate a higher valuation. Companies at this stage of development can expect the “Golden Rule of Business” to apply. “He who has the gold makes the rule.” Thus, the time and money allocated to an independent valuation can be redeployed in a more effective manner.

While the independent study of an early stage company is of suspect value, understanding the principal drivers of valuation is important for an early stage company. Perhaps the most compelling reason is benchmarking a company’s performance against your industry segment’s premier companies. Identifying the drivers of value within your industry segment provides an entrepreneur with the targets or standards that will eventually be used to compare his/her company against the best in the industry. These benchmarks are much easier and quicker to establish at the outset versus making changes to an entrenched cost structure or operating strategy. Identifying specific benchmarking targets helps entrepreneurs focus on a specific course of action versus meandering around, unsure of how to measure developmental progress. To illustrate, let’s assume an entrepreneur is developing the next generation software company and decides to resell computer hardware, as a convenience, to customers. Reselling computer hardware typically results in lower margins and when blended with the higher margin software, the overall impact on gross margins will be lower than companies selling only software. In this circumstance, an entrepreneur might decide upon an alternative strategy that provides the desired customer convenience, but does not impact negatively on gross margins. When this decision is made at the outset the company shows a more consistent gross margin history comparable to similar companies in its industry.

Understanding valuation fundamentals can turn qualitative operational strategies into quantifiable valuation creation. For example, an entrepreneur’s ability to understand that a 10% increase in manufacturing efficiency translates into a several million dollar increase in enterprise value can properly prioritize that strategy against other value creating strategies. An entrepreneur focused on value building strategies will maximize cash flow and maximize value creation.

Let's start by examining the definitions of value. In business there are four standards of value:

- **Fair Market Value.** FMV is likely the most common standard of value. The IRS in Revenue Ruling 59-60 defines FMV "as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.
- **Fair Value.** The definition of fair value focuses on an equitable or equivalent value of the property in question. The definition of fair value differs from state to state and is mainly derived from court cases and therefore is constantly evolving. In these situations it is hard to find a willing seller, thus a fundamental difference between fair value and fair market value. The Financial Accounting Standards Board in FAS 157 *Fair Value Measurements* weighs in with this definition as it relates to financial reporting. "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."
- **Investment Value.** The definition of Investment Value is the value to a particular investor rather than a hypothetical buyer as defined in FMV. The investment value is that value required to meet an individual's requirements or expectations. An example of Investment Value is noted in our earlier discussion about negotiated valuation of early stage companies. The valuation at which an investor is willing to invest in an early stage company most likely fits the Investment Value standard. Most early stage entrepreneurs are under some type of compulsion to complete a deal and fund their future operations and therefore do not meet the definition of Fair Market Value.
- **Intrinsic Value.** Shannon Pratt *Valuing a Business* states, "Intrinsic value (sometimes called fundamental value) differs from investment value in that it represents an analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor, but rather tempered by how these perceived characteristics are interpreted by one analyst versus another." For example, if an analyst believes, after an analysis, that the business fundamentals for a particular company warrant a price higher than the stock is currently trading, the analyst will conclude there is intrinsic value in the stock that the market has not recognized.

Gary Trugman, author of the AICPA's *Understanding Business Valuations* identifies how the purpose of a valuation drives the applicable standard of value.

<u>Valuation Purpose</u>	<u>Applicable Standard of Value</u>
• Estate and gift taxes	Fair Market Value
• Inheritance taxes	Fair Market Value
• Ad valorem taxes	Fair Market Value
• ESOP's	Fair Market Value
• Financial acquisitions	Fair Market Value
• Stockholder disputes	Fair Value (most states)
• Corporate or partnership dissolutions	Fair Value (most states)
• Going Private	Fair Value (most states)
• Strategic Acquisitions	Investment Value
• Buy-Sell Agreements	Both parties must agree
• Marital Dissolutions (divorce)	State case law determines

In summary, applying a working knowledge of valuation fundamentals to qualitative operational strategies will translate into a quantitative impact on enterprise value. The ability to prioritize a large

number of operational initiatives ensures a company is generating optimal cash flow and is well positioned to achieve a successful liquidity event.

We will address commonly used valuation methods, determination of discount and capitalization rates, financial statement analysis and common size financials in future articles. An understanding of these concepts at best will alter your decision making and at a minimum give assurance that more informed decisions are being made.

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CFO Advisory also provides business valuation services that assist its clients in developing growth or exit strategies. Glenn has performed valuations of early-stage and middle-market companies in connection with financings, exits as well as for stock option valuations. If we can be of service, please contact Glenn at gcato@cfo-advisory.com.