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Guest Corner: The Science and Art of Valuing Your Technology Company

By Michael Gurau

If you've got a technology business, chances are you need to find sources of capital to support your development and/or growth. Once you've exhausted friends, family and government funding, you'll inevitably knock at the door of some wealthy individual or venture capital investor to help move your company to the next level. After you've done the mating dance -- "you like me and what I'm doing, I like you (well enough) and your money" -- the subject of the economics of the relationship will come up: "How much of my company do I have to give up to get a given amount of capital?"

With publicly traded companies, value is established by the market as a function of the earnings power at a given level and growth of sales. In smaller, privately held companies, however, valuation is not so straightforward -- it's one part science, one part art.

The Science

Comparable Company Analysis

One data point in an investor's analysis is comparable company information. In this analysis, an investor will look at the "most likely" path to growth at a given level of investment -- this future either will be consistent with or, more likely, more conservative than your own projections. The investor then will ask, "If we sustain a given growth rate over several years, how will a buyer (or the public market, if it's a IPO) value the business." They would start by looking at comparable companies.

If you run a software business, you can look at

publicly traded, large companies to gauge what sort of value, or market capitalization, might be placed on your business. Public markets look at, among other things, price-earnings ratio. But you likely will need to use the price-sales ratio as a proxy -- young companies' earnings vary widely in the early years, depending on the requirements of growth.

Software businesses such as Microsoft and SAP tend to trade at valuations ranging from two to five times the sales. Public markets place higher value on companies with high growth and gross margin. This sales multiple provides investors a proxy for your company's "public" worth. A second proxy for comparable value is mergers and acquisition data, if available. If you can find a comparable company that has been recently acquired, you'll have a sense of what your value might be if you follow that same path.

Of course, public companies are both larger and, presumably, have achieved stability of revenue and earnings. A typical valuation technique involves using publicly traded exit and/or acquisition multiples. A private or institutional investor in your company cannot easily trade his or her shares (illiquidity) and often holds a minority ownership position, vis-à-vis you, the founder and owner. Therefore, your company's market value should be discounted 25 percent for illiquidity and 25 percent for minority ownership.

Stage and Business Risk Analysis

Using this comparison, investors see the possibilities for value creation, if things go according to the conservative plan. Next, assess the level of risk in getting to sales and profitability targets.

In venture investment analysis, investors look at two shades of risk: stage risk and business risk. Stage risk speaks to the youth or maturity of the company:

Early stage companies in early phases of commercialization typically have losses; development and late-stage companies have meaningful revenue and customers. Failure rates are higher the earlier a company is in its evolution; thus, investors face a higher risk. To compensate, early stage investors require a return 10 to 100 times their cost over a four- to seven-year period. Development and late-stage investors, who face lower failure rates

in established companies, require as little as 2.5 to four times the cost over the same period. Early stage risk can be materially offset by reduced business risk elements. Investors may evaluate how a company stacks up against an ideal business in various categories - such as management, market, technology/product, financial, legal and business. For example, the ideal management team:

- Has deep experience in a similar domain as the current venture - such as a CEO who worked for Microsoft and is now starting a Windows-based application company. By contrast, a biotech executive starting a software company cannot readily transfer the prior domain's knowledge and network.
- Has worked with, and made money for, venture investors in the past.
- Is complete - that is, all functional areas (marketing, finance, operations) are staffed.
- Has worked together as a team previously. Individuals who have not worked together may discover potentially insurmountable interpersonal differences during the stresses that accompany any startup.

The investor assesses your team against this ideal. If your group, like most, doesn't match this ideal, then the investor assumes that risk; greater risk demands greater reward. While no formula weight-averages the risk factors in each business risk element, investors typically over-weight management ("we bet on the jockey, not the horse") in evaluating a given opportunity. Entrepreneurs, who may lack in some of these elements, typically emphasize the technology, product and/or market as being the basis for high valuation (and, thus, low dilution for them).

The Art

The science of stage and business risk is evident: Early stage companies fail at higher rates than more developed businesses and teams; you've either got relevant domain or investor experience or you don't; your product is either provably better/cheaper than competition or is not. The art relates to the investor's assessment of whether risk can be mitigated sufficiently to achieve a minimum level of success - and before running out of money. The primary risk is that of execution, which falls to management.

Much of the "art" of evaluation (and valuation) lies in an investor's judgment about management strengths and weaknesses, the market's particular state of development and competition, and the plan's achievability.

Investors will spend time with your management team to learn, among other things, about how you think, how you talk and listen and what drives you. They call your acquaintances and former co-workers to learn about your working style, in good and bad times. They try to form a picture of what it will be like to work with you as a partner. They look at the chemistry and fit with, and among, your team, as well as with investors. These soft analytics are arguably more critical than those of the technology and market.

Summary

Valuing the business is a complex analysis, carrying equal measure of personal and interpersonal assessment and market-product-technology analysis. Technology business valuations, especially in the earliest stages, may present unique challenges -- such as a biotech business with no meaningful revenue for the investment period. However, the overarching issues are the same for businesses, regardless of sector.

Entrepreneurs are, by necessity, optimists. Venture capitalists are, by nature, hopeful. But, from experience, they are conservative. By appreciating and conveying their understanding about these risk elements, owners will enhance their ability to negotiate effectively, while creating a constructive relationship with new investors and partners.

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Last modified August 18 2006 04:27 PM