Business Valuation Basics

There’s really no way around it: judging value is a subjective process. Whether you’re shopping for a new television set or helping a client seek investment for a start-up company, it all comes down to perceived value. In the case of television shopping, you can quiz salespeople or read Web sites to compare features, brand names, and other factors that play into product value. But what factors affect the value of a small company and how do you assess those factors?

Incubator managers already know many of these factors. When screening clients, managers must synthesize various threads of disparate information about an applicant – from capital assets to the entrepreneur’s enthusiasm – to answer the question, “How likely is this company to succeed?”

When a company undergoes a formal business valuation, experts examine similar criteria, including the company’s history of operations, the growth history and potential of its target market, and its business environment (including the benefits that an incubator provides). The valuation process results in a final appraisal that entrepreneurs can use when negotiating investments and loans, selling a company, creating compensation packages, and more.

Michael Wierwille, a managing director at Standard & Poor’s in Los Angeles, California, and Lynne Pastor, principal analyst at Inflection Point Consulting in Pittsburgh, Pennsylvania, agree incubator managers can help increase their client companies’ value simply by understanding the basic techniques of valuation. Here the two business experts describe the valuation process and the role of incubator managers.

Q. Can you define valuation?

A: Wierwille: Business valuation is a process by which to determine what a company is worth at a given point in its life cycle. It’s important information for a venture capitalist, lending institution, prospective buyer, or incubator manager who wishes to monitor client development or demonstrate how incubator services impact value.

Pastor: Value has many meanings depending on the situation. It is highly dependent upon the individual goals of each participant. For investors, value is getting the greatest return relative to the risk of losing an investment. For an acquiring company, value is tied to the strategic benefits and/or increased profits that will result from acquiring a company – this makes value highly variable from one acquirer to the next. In both instances, the investor or buyer prefers a lower appraised value for a company, which will in turn provide a greater return on investment.

From the other perspective, an entrepreneur seeking investment or selling a business wants as high a valuation as possible.

In the end, a third-party valuation seeks to take into account all of these viewpoints to form a single appraisal. It is essential that all parties involved in a valuation understand that it is not a final answer. Valuation is the basis of negotiation; understanding the underlying assumptions used in the process of the valuation is just as important as the final valuation number given to a company.

Q. Why would an entrepreneur want to determine the value of his or her company?

A: Wierwille: An entrepreneur frequently has a need for capital but doesn’t want to give away the store when negotiating with investors or banks. Having a realistic picture of a firm’s worth can help an entrepreneur make a prudent deal. For instance, in many cases a venture capital firm will command a large toll charge (in the form of equity) to lay its money down. The valuation will give a
pre- and post-money valuation of the company, showing how the venture capital will impact the company. The difference between the amount of money a business needs and the amount of money an investor is willing to provide can act as a guideline for the amount of ownership the investor might reasonably request.

A bank likes valuations, not only because it wants to make sure its money has a good chance of getting repaid, but also so that it can focus on assets that might be claimed as collateral.

*Pastor:* Although there are lots of applications for a valuation, most entrepreneurs are looking for investment, or an emerging company may be offering stock or stock options to entice people with key skill sets to join the company. Also, as a company executes its business model, it may be approached by another firm interested in acquiring it.

For investors, valuation of the firm is critical because it will determine the price they pay for their stock and the amount of the firm that they will own. But keep in mind that investors will usually challenge a valuation done by the company in hopes of reducing their risk and increasing their potential return.

[Relative to enticing employees,] valuation provides the basis for the possible upside (gain when the stock is bought and sold) for the employees in the future. Or, if the deal includes partial company ownership, then the value of the company has to be part of the determination in how many shares to distribute.

It should be noted that the value of the company is dynamic. As time passes and circumstances change, so does the value of the company – hopefully it increases. Therefore, valuations are valid for only limited amounts of time and are frequently done a number of times during a company’s life.

**Q. Can every company be valued in the same way?**

**A:** *Wierwille:* Absolutely not. Valuation methods depend on the company’s stage of development, its product or service, and its ability to make valid projections. Some companies will be difficult to value at any stage of development. This is often the case for a company that is developing technology for which there is high market potential but no demonstrable cash flow forecast, such as a new pharmaceutical compound. Others will be easy to value because they produce a common good/service that can be easily compared with existing markets. Sometimes a company might be near death and looking for ways to cut its losses and sell the pieces. For instance, a company might have an obsolete product but still have a valuable trade name or assets in a manufacturing capacity [that could be] easily adapted to an alternate use. In those cases, the parts must be examined separately to obtain the value of each asset and how they contribute to the whole.

**Q. At what stage of development can a company undergo a valuation?**

**A:** *Wierwille:* A valuation can take place at any stage of development, but an early-stage company’s value is often dependent on the eyes of the beholder. A young company may have a good idea for business but little data to support it, leaving much of the valuation to speculation. For this reason, many investors may not require a valuation for younger businesses but simply put up the required seed or ongoing capital needs in return for a significant stake.

Once the company moves on to later stages, valuation becomes more quantifiable and less speculative. There is a history to reference along with a more grounded business plan. The need for a solid valuation becomes even more critical as the company moves through these later stages of development. It is arguably more valuable, but at the same time, these companies often have a greater need for investment to make it to the next level.

**Q. Whom should an entrepreneur contact to perform a valuation?**

**A:** *Pastor:* There are business support firms that specialize in valuation. Generally these folks have a good understanding of finance and may include accountants and lawyers. Referrals from other emerging firms and from folks who have invested in other emerging firms are very helpful. Valuation is an arduous process. It is important to have someone who can work closely with management and who is willing to work iteratively as new information becomes available. You should make sure that whoever you hire is familiar with valuing early-stage firms, and that he or she has
a good understanding of your product or service. Companies that are based on tangible products have different issues than companies that sell intangible services or whose competitive advantage lies in intellectual property.

A good valuation professional will not only provide his or her clients with a valuation report, but will provide the entrepreneur with new insights into improving the company’s business model, which should result in a higher valuation. It is imperative that whoever performs the valuation remains independent so that outsiders can rely on the valuation during negotiations.

Q. Is it necessary to hire a third party to perform a valuation? Or can an entrepreneur obtain similar results with the help of an incubator manager?

A: Wierwille: Incubator managers and clients can and should use valuation techniques for self-monitoring purposes, but they should be aware that some investors prefer third-party evaluations. Entrepreneurs are very close to their “offspring” and will often not have a realistic value perspective. Investors are by nature cautious and skeptical. The external valuation process can serve as a mechanism to bridge the resulting value gap.

Also, incubator managers may elect to use valuation techniques for their own purposes. When choosing from a pool of applicants, an incubator manager can use valuation-type techniques to distill the applicant pool down to those that are most likely for success.

In many ways, a manager is looking for a good company to invest in. An incubator manager can also use valuation techniques to estimate the

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**THE VALUE OF INCUBATOR BENEFITS**

It can be difficult to put a precise value on the many benefits that incubators provide their clients. But following the lead of valuation experts can make that task a lot easier for incubator managers. The valuation techniques that experts use can help managers arrive at hard numbers for use in attracting clients or negotiating equity agreements. Michael Wierwille, managing director at Standard & Poor’s in Los Angeles, California, cites the following as the most valuable benefits that incubators provide their clients.

**Benefit of professional services.** This is the difference between the discounted price the client paid to professional service providers and the market price the firm would have had to pay if not associated with the incubator.

**Benefit of the incubator management and administrative support.** Calculate the compensation for the additional administrative staff members that the client company has avoided hiring through its association with the incubator. Or take the costs of running the incubator and divide by the number of incubator clients.

**Benefit of the facilities.** This is the difference between market rent and what the company pays for rent in the incubator.

**Benefit of the entrepreneurial environment at incubator.** Although an important benefit, this is hard to calculate. However, this environment may help a company reach later-stage development a year or two earlier than it normally would.

By calculating the values of these benefits, an incubator manager can gain hard evidence of its impact on client companies. Wierwille offers the example of a company in a Northern California incubator. “We calculated the estimated benefits of the incubator as roughly $50,000,” he says. “The next step was to determine the percentage of the total company value that is attributed to the incubator.” To do this, Wierwille calculated the post-money valuation of the company, which is the value after the proceeds from venture capitalists and the incubator have been added to the company. The company had roughly a $2 million post-money valuation, so Wierwille divided the incubator’s proceeds ($50,000) by the $2 million overall value. “The result showed that approximately 2.5 percent of the company’s value was attributable to the incubator,” Wierwille says. “An awareness of the worth of the incubator’s contributed services is invaluable for an incubator when you’re negotiating for an equity position in a company or trying to demonstrate to a prospective client what value you bring to the table.”
value of the services an incubator provides for the purposes of attracting clients or negotiating equity agreements.

Q. What preparation is required of an entrepreneur who wants to determine company value?

A: Pastor: Entrepreneurs should begin to gather information, both financial and marketing, on competitors and any firms that they believe have analogous products and services. The management team members need to understand who their customers are, the value that their product brings to those customers, and how much the customers are willing to pay. They need to have a good understanding of the costs related to producing and promoting the product and the costs related to running the company. And they should have information about the growth of the industry, the general outlook of the economy and how it will impact sales, and the ability of the company to sell equity. Also, it is very important that whoever is doing the valuation fully understands the company’s business model; it is critical that the entrepreneur is able to communicate that clearly.

For example, several book companies may offer similar products but have different distribution channels. For people who do not want to spend the time to go from one bookstore to another, online shopping provides added value to those customers, for which they may be willing to pay. The cost structure as well as the marketing strategy will be very different depending on the business model. An expert who understands “bricks” but not “clicks” may not be able to address all these differences efficiently.

Q. What aspects of a company are examined during a valuation?

A: Pastor: There is good bit of research and due diligence involved in performing a valuation. The results can be put into a set of projected financials so that the level and timing of profitability and cash flow can be evaluated. Some of the most important assumptions made in producing the projected financials are:

- Size of target market (number of customers).
- Growth history and potential of the target market.
- Competitors for the same target market.
- Initial penetration into this market and rate of subsequent growth of sales.
- Pricing of product or service.
- Purchase horizon – the time from initial customer contact to receiving payment from customers. With some products and services this may take more than a year. During this time, expenses are incurred and cash is paid out.
- Costs related to producing products and services, and the timing of those costs.
- Risk factors. Among the risk factors to discuss are issues like legal exposure for consumer safety, regulatory risks, risk of new competitors or products entering the market, and any other issues that would prevent the company from carrying out its business plan.
- Information on the industry and the general economy.

Q. If multiple entities, such as an incubator and investors, have equity in a company, how does that affect a company’s value?

A: Wierwille: If someone has already made an investment, whether it is monetary or through services provided (such as an incubator), you’re already dealing with a post-money perspective. The company’s chances for survival are greater because of that investment, and it becomes a benchmark for the company to use in future valuations. An entrepreneur can point to this instance and say that the company received this much money, for this much equity, at this point in the company’s maturity.

Pastor: The amount of equity given up early in fund raising may affect the ability of a firm to raise capital in the future. As more shares of equity or stock are issued to new investors, the percentage ownership of the earlier investors is reduced or “diluted.” Major investors such as venture capitalists may require that the entrepreneur buy back some or all of the early shareholders’ stock. One of the reasons for this is that a major investor would expect to have significant input into how the company is run and would not want to have to negotiate with a block of minority shareholders in influencing management. On the other hand,
without early-stage financing and the use of equity to lure talent, most companies would not get to a stage in development that a major investor would be willing to provide a cash infusion.

Q. What role does intellectual property play in a company’s valuation?
A: Pastor: Intellectual property provides a barrier to entry for competitors. This is very important for any firm. It provides the firm with protections from competition so that it has enough time to develop and market its products and services.

Then, once in the market, the company is the single source for its customers, allowing the company to control prices and realize higher profits. This market control is true of any barrier to entry, such as cost advantages or trade regulations, not just intellectual property.

Q. How much does a valuation cost?
A: Wierwille: An average appraisal by a relatively small valuation firm would cost $10,000 to $15,000. A fairly rigorous valuation by a larger firm would cost $25,000 to $35,000 and up. Unfortu-

RATIO ANALYSIS 101
Ratio analysis is a technique that valuation experts often use to assess a company’s financial health. It’s a benchmarking method that uses proportions to detect financial strengths and weaknesses. Incubator managers can use this same technique to monitor clients’ stability. Some common ratios include:

- Current ratio – current assets divided by current liabilities

- Interest coverage ratio – earnings before interest expenses and taxes divided by interest

- Quick ratio – current assets, excluding inventory, divided by current liabilities.

- Sales-to-assets ratio – sales divided by total assets

- Debt-to-equity ratio – amount of money borrowed divided by equity

Michael Wierwille, managing director at Standard & Poor’s in Los Angeles, California, describes several ways that incubator managers can use these ratio analyses for client-monitoring purposes.

“First of all, you have to ask if the firm’s ratios are moving from borderline distress – a company that could fail at any moment if it doesn’t get some coddling and financial resources to keep it alive – to ratios representing a going concern.

“For instance, young companies often have the same investment in assets as a company that’s been around awhile, yet they are just beginning to generate sales; hence, they show a lower sales-to-assets ratio than a going concern. What you would monitor is that this ratio is increasing as the company matures. As the ratio moves toward the industry average, profitability should follow. (By the way, the venture capitalists become interested long before the ratio matches the industry norm; in fact, they often sell out by then.)

“Another aspect to look out for is a new firm’s interest coverage ratio, since many young companies need to borrow funds. A distress signal should sound when the firm’s income-before-interest to interest expense approaches a ratio of 1. That means the firm is very close to not generating adequate income to cover the interest expenses due on its debt.

“Equally telling is the firm’s debt-to-equity ratio. In companies that haven’t gone through any purchase transactions, equity is made up of two components: contributed capital and retained earnings. In a start-up company, contributed capital often represents money out of the owner’s checkbook. Retained earnings are likely to be negative. Therefore, the equity part of the debt-to-equity ratio could be less than zero (for instance, $100 in contributed capital minus $150 in deficit earnings equals -$50 equity). It could be a bad sign if the debt-to-equity ratio continually increases. If there’s no prospect for turning the situation around, the business is in trouble.”

For those incubator managers looking to compare their clients with up-to-date benchmarking information, Wierwille recommends Annual Statement Studies, published by Risk Management Association (RMA) of Philadelphia, Pennsylvania. RMA compiles financial data and benchmarks from more than 150,000 firms, organized by firm size.
nately, a company’s stage of development doesn’t generally have an effect on the price of a valuation, even though a start-up company may be more difficult to value than a later stage company. The choice between types of valuations is a personal one. Some entrepreneurs choose a smaller valuation firm because of price concerns. Others choose larger firms because those firms may be able to incorporate the valuation of the company’s individual assets, both tangible and intangible, or specialize in valuing specific types of firms, such as biotechnology companies. Something to consider is that a prospective investor might foot the bill for valuation in order to gain a better investment position. In those cases, the appraiser can even be jointly retained by both parties, which is good because it synthesizes both parties’ specific and opposing views and goals.

Q. How much time does it take to complete a valuation?
A: Wierwille: The time required is relatively straightforward once the company gathers the required information. If it’s all there, it can be completed in a couple of weeks. If not, there’s a back and forth between appraiser and entrepreneur to synthesize the information. Three to four weeks is a typical valuation period – forty-five days is considered a long time.

Q. Does the fact that a company resides in an incubator increase its value?
A: Wierwille: Yes and no. The analogy is like a child still residing at home. The child has support systems in place that can ameliorate some of the risks of being out in the world. At the same time that those risks are reduced, costs may not reflect what it’s really like in the real world. For this reason, the value of a company once it’s outside the incubator might be different than while it’s inside. But in the end, the assistance an incubator provides should add an intangible element that would ultimately benefit a company’s value.

It’s also good to note that even with all these considerations, a company in an incubator is not harder to value; an appraiser just has to appropriately account for these other factors – something that an incubator manager might assist with during the valuation process.

Pastor: Since a lot of money can be wasted in the early days of a company on trial and error, the expertise and experience that companies have access to in an incubator will allow companies to develop further before needing to begin raising funds. Both the expertise as well as the higher level of development reduce risk and therefore increase the firm’s value. Additionally, investors must rely heavily on the management team to make the business model work. Therefore, choosing the right management team and the right service providers will increase the value of the firm. Most incubators provide services to help companies identify and recruit these critical skill sets.

Q. What are some ways that an incubator manager can assist a business in increasing its value?
A: Wierwille: Incubator managers can assist mainly by understanding what goes into a valuation. A lot of companies working with incubators have great ideas and believe that their products/services have tremendous opportunities for success. The critical component for the manager is to get that notion to a point where it’s believable to others through hard facts and numbers. Incubator managers and their clients must pinpoint the milestones needed for success and the hurdles along the way so that there is an achievable plan that is credible, not only in terms of funders but for those ascertaining value. It must always be a team effort between the manager and the entrepreneur to be realistic for these estimations, because in the long run, untruths are only going to hinder the company’s growth and reputation.

But when it comes down to it, the whole purpose of an incubator manager is to help his or her clients succeed, thus contributing to the client’s value. So helping a company increase its value is second nature. Ultimately, an incubator manager increases a client’s value simply by doing his or her job.

By Brian Walker

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