

FIRST CHICAGO METHOD OF VALUATION

It is a valuation approach for businesses and is used by **private equity** and venture capital investors. The first Chicago method merges the elements of the **discounted cash flow** and a **multiple-based valuation**. Developed by and named after the First Chicago bank, the First Chicago method of valuation was initially discussed in 1987. The Chicago bank is the predecessor of the firms GTCR and Madison Dearborn Partners.

The First Chicago Method of valuation is a method used for the **valuation of early-stage companies** by private equity investors and venture capitalists. This method is used for companies' dynamic growth as it combines the components of fundamental analytical and market-oriented methods. Here is a step-by-step guide on the process of this startup valuation method.

#1 Future Scenarios

One way to determine the future scenarios that the company may face is by creating three possible scenarios:

- Worst-case
- Mid-case
- Best-case

To determine the value of a startup through the first Chicago method, you will need essential data such as the **earnings, cash flows, exit-horizon, revenue, the financial forecast for each of the case scenarios**, etc. You will also need a detailed analysis of the market trends of the industry in order to get a good estimate of the scenarios. Typically the mid-case scenario is the expectation of the analyst as it is the most likely outcome.

There is never a winner takes all scenario. You need to set a possibility of total loss in the worst-case scenario. This is why in companies that are driven by an extensive factor, it is best that the investor stays reasonable. There are cases where the outcome of the **financial valuation** is determined by the **initial capital of the startup**. Consider all the strategy-shifts as per the case scenario to have a more accurate valuation of the business and set up financial forecasts.

#2 Determine the Estimate Divestment Price

The **exit price** is also known as the **disinvestment price**. To determine the disinvestment price, you will need to estimate the terminal value of the startup at the time of exit. This is where we start to use multiples. You will have to determine a value of the company by using the

transactions of other similar companies as a basis of comparison. While choosing the startup company that you will use for comparison, make sure that it is in the **same stage, industry, and region**.

For each class, there are numerous forms of suitable multiples. Professionals use multiples based on KPIs such as **revenues** and **EBIT** to determine the exit price. It is essential that the information of transactions used for the market-based approach is of similar startups. Information regarding the M&A within the venture industry is scarce, but there are market specializing data providers. Once you receive all the metrics and information required determine the disinvestment price.

#3 Estimating Required Return of Each Scenario

The majority of **venture capitalists** derive the return internally. The reason they do not trust the **CAPM & WACC** is because of the lack of data in the private market. It is not possible to replicate investments and the payoffs with an assets portfolio. Additionally, in the financial forecasts, the WACC cost of equity is reduced due to the lack of debt capital. This leads to vague assumptions during the valuation of a startup or an early-stage company. For each business, it is important to estimate the market risk in the industry, region, and stage to determine the risk premium.

#4 Estimate Probabilities of all scenarios

In this step, you will have to designate a probability for each case. Naturally, these **probabilities will be correlated to the number of scenarios and your definition of them**. It is not possible to be precise in every case scenario when determining the probabilities. But the overall idea here is to take drastic outcomes in the valuation process. Finally, depending on the scenario calculate, the weighted sum of the valuations.

The first Chicago method is a valuation process with a broad scope. You can see this in the process, as in **step 1**, you are presented with the freedom to consider an event where there is a low probability of huge investment pay-off. Too much flexibility might also bring a bit of complexity to the process. In the second step, we use the information of similar companies. The selection of a multiple here will depend on the industry and structure of the business. This information is not easily available and can be very vague. Then we go on to investigate the market; this is done through a **short-term analysis** that concentrates on the business's potential depending on the case scenario. It also identifies the fundamental market trends by **focusing on the long-term analysis**.

PROS AND CONS OF FIRST CHICAGO METHOD

Many private investors and venture capitalists choose to use the first Chicago method of valuation, but that is not to say there is no downside to it. **Here are some pros and cons about the First Chicago Method:**

The pros of this method are as follow:

- This method is comprehensive and detailed.
- Every calculation is based on precise estimates of the values in the future and the cash flows.
- This method provides a series of potential results
- It keeps in account the high-risk scenarios where there is a huge potential of losses.
- This model provides better and more accurate results for early stage ventures that have a more dynamic growth model.
- This method is best used to evaluate early tech related startups.

The cons to this method are as follow:

- In some cases it can be time-consuming and very intricate.
- To evaluate a startup correctly, one needs to have detailed knowledge about the business and the estimates. Only then can one get an accurate valuation.
- It is not useful for startups with no revenue.
- The freedom of considering different events adds complexity to this method.
- This method applies to companies that are in an industry where there is insufficient data. If there is sufficient information, investors will use other methods.