RISK FACTOR SUMMATION METHOD

In valuation, questions often arise like how to **evaluate an early-stage startup**, how the startup works, how to justify **startup valuation** for fundraising, and many more. The majority of founders are worried about all these questions at the beginning of their fundraising journey. This is where various valuation methods come into play; the **risk factor summation method** is one such method.

WHAT IS A RISK FACTOR SUMMATION METHOD?

Simply put, the risk factor summation method, also known as the **RFS method**, is a rough **pre-money valuation method for new startups**. The risk factor summation method utilizes a base value of a comparable startup for the **company's valuation**. This base value is adjusted to **12 common risk factors**. This indicates that your startup is compared to other startups in terms of evaluating that you have a higher or lower risk. The following steps will make it more straightforward for you on how risk factor summation method works:

- Begin with an **average company's valuation** formulated on similar companies in your area and region. Draw some time for this step. Fetching relevant data of a **comparable company** will need some time!
- Next, analyze the **different risk factors for your startup** from a very low to a very high range.
- **Lower risks** increase your company's valuation, while **higher risks** decrease the valuation.
- To enhance your company's valuation, you will have to **work on the risks** and **map out ways to reduce the risks**.

STEPS TO IMPLEMENT RISK FACTOR SUMMATION METHOD

As discussed above, the risk factor summation method is a pre-money valuation method that defines the pre-money valuation of a target startup. **Given below are the steps that you can apply to implement the risk factor summation method**.

STEP 1: FIND THE AVERAGE INDUSTRY PRE-MONEY VALUATION

This step is similar to the first step of the **scorecard valuation method**. In this step, we need to attain the average industry pre-money valuation of the target startup. **For example**, a company's pre-money valuation in a particular city and industry as $2 million for a base.

STEP 2: CONSIDER 12 RISK FACTORS

The next step involves **considering the 12 risk factors** that are correlated with the startup and its industry. **These risk factors are**:

- Risk of the Management
- Stage of the business
- Political risk
- Supply chain or manufacturing risk
- Sales and marketing risk
- Capital raising risk
- Competition risk
- Risk of Technology
- Risk of Litigation
- International risk
- Risk of Reputation
- Exit value risk

STEP 3: CASTIGATE ALL THE RISK FACTORS

The third step is to **assign ratings to all the above-mentioned factors of risk**. Once the assessment is done, perform an adjustment to the average pre-money valuation of the startup. Rather than assigning percentage weights and multiples, we allow the following ratings to each risk factor. **Ratings to each risk factor can be evaluated as follows**.

Rating	Risk Rationale	$ Adjustment to Pre-Money Valuation
+2	Extremely Positive Mitigation	Add $500,000
+1	Positive Mitigation	Add $250,000
0	Neutral	Add/Minus Nothing
-1	Negative Mitigation	Minus $250,000
-2	Extremely Negative Mitigation	Minus $500,000

After this, a standard pre-money valuation of pre-revenue businesses in the region is adjusted. **For instance**, let us consider a tech startup with an influential management team, a fully developed prototype with increasing friction focusing on the local market in commencement. The obstacles when entering a market are high. The market is not highly regulated, and the geography for growth is stable. The startup has developed a partnership with a significant corporate partner that may be a potential acquirer in the next few years.

Risk Factors	Ratings	Addition/Subtraction ($)
Management Risk	+2	$ 500,000
Stage of the Business	-1	$ (250,000)
Legislation/Political Risk	+1	$ 250,000
Manufacturing Risk (or Supply Chain Risk)	0	$ -
Sales and Marketing Risk	+1	$ 250,000
Funding/Capital Raising Risk	0	$ -
Competition Risk	-2	$ (500,000)
Technology Risk	-1	$ (250,000)
Litigation Risk	0	$ -
International Risk	0	$ -
Reputation Risk	0	$ -

Risk Factors	Ratings	Addition/Subtraction ($)
Exit Value Risk	+1	$ 250,000
Sum	-	**$ 250,000**

In this table, the various risk factors are rated (from -2 to +2) and times by $250,000, to reach the adjusted figure of $250,000. As we notice that even when the risk factor summation seems complicated, it yields good results.

STEP 4: ADD THE PRE-MONEY VALUATION

In this last step, you have to **add the average industry pre-money valuation with adjustments**. The average industry pre-money valuation was taken as $2.5 million and in the above step, we got an adjustment sum of $250,000. Right now, all we need to do is add both these values. So, we obtain the pre-money valuation of the target startup as $2.75 million ($2,500,000 + $250,000).

PROS AND CONS OF RISK FACTOR SUMMATION METHOD

As with all other methods, this summation method also has its own fair share of pros and cons. **They are defined below**:

PROS:

- One of the best benefits of this method is that this method is relatively simple when considering areas that the **Berkus** and **Scorecard methods overlook**. It is almost straightforward to apply when associating with other startup valuation methods.
- In case the startup has been **growing its portfolio**, you have a good chance at raising money.
- In case more founders seek more money than **investors** are willing to invest, this could affect your business valuation. It also involves a business owner's desperation to **secure investment** and **an investor's willingness to pay a premium**.
- Investors are more likely to pay a premium when buying equity if the target company belongs to a **popular industry**. This means that the target startup will be worth more if it falls in the industry and sector.

CONS:

- This method is a glass-half-empty way of assessing a startup. This means that this method looks at all the things that could go wrong but doesn't reflect on things that could go right. In this method, it is assumed that everything is **equally weighted**. For instance, a strong management team only gets the exact weighting as reasonable litigation risk, whereas a team is generally much more important than other areas. Ultimately, this method relies only on the initial group of startups that you select as the representative benchmark for comparison.
- In case a startup **refers to a sector that depicts bad performance**, investors will not be interested in the whole sector.
- An **incapable management team is another disadvantage**. It is when the management team has no track record or reputation or key positions are missing.
- The founders go to the **funding market** when they urgently need the money. This is a situation when they are almost running out of capital. For most investors, this is a red flag.

HOW DOES THE RISK FACTOR SUMMATION METHOD WORK?

To determine the **pre-money valuation** of pre-revenue companies, the risk summation approach works on in-depth factors when determining the pre-money valuation of companies. This method also intrigues investors to take notice of numerous risks that a specific venture must achieve. Note that the **greater the number of risk factors**, **the greater will be the overall risk**. The most prominent way to escape these risks is to manage these, which in return requires specific consideration. This method also inspires users to assess other risk factors which are mentioned above.

A risk factor summation method example will explain to you better on how this works. The average pre-money valuation of pre-revenue companies in your industry is adjusted either positively by $200,000 for every +1 (+$400,000 for a +2) or negatively by $200,000 for every -1 ($400,000 for a -2). For instance, a company with no manufacturing risk (+$400,000), no reputation risk (+$400,000), no legislation risk (+$400,000), a low competition so positive for growing the company (+$200,000), but potential management risk (-$200,000), will be valued at $1.2m.

BEST PRACTICES FOR RISK FACTOR SUMMATION METHOD

There is no one particular best method, just like the Risk Factor Summation Method; every other method has its pros and cons. Good practice suggests using a combination of at least **three**

startup valuation methods to determine the appropriate pre-money valuation. In case all the methods give roughly the same number, consider opting for the average of the three. If one is an outlier, then average the other two, or use the fourth method to bring three of them in close agreement.

Different business valuation methods have **different levels of complexity**. Some are more complex than others. Also, note that various forms may result in different valuations for the same underlying asset.

Choosing an appropriate business valuation method also depends on factors such as the reason for why you need a valuation. For example, you will want a higher valuation to sell the company, then you may go for the more aggressive valuation methods. But on the other hand, in case you want to acquire a business, you will likely favor a more conservative appraisal to avoid overpaying. Another major factor to consider is whether a company is **asset-heavy** or **service-oriented**. In the case of the company being asset-heavy, the net book value method might best capture its value.

THINKING OF USING THE RISK FACTOR SUMMATION METHOD FOR YOUR STARTUP?

All things considered, this method is a reliable method to **calculate the pre-money valuation**. The best practice considered for angel investors in pre-revenue ventures is to use multiple methods to establish the pre-money valuation for seed/startup companies. The Risk Factor Summation Method is helpful as one such method. It is simple and is used primarily for pre-revenue, pre-money startups. It is a valuable methodology to calculate various pre-revenue for startups, and will give you a basic understanding of where the company stands. However if you want a proper valuation for your company, it's better to hire professionals.

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