

## Venture Capital approach

The VC method can be used to value early-stage, pre-revenue companies, which is why, it is known as valuation approach by venture capitalists all over the world. So, how does the venture capital method value a business? The idea is simple: VCs, as well as any other investors, realize their returns when a liquidity event (an exit) occurs, and they expect a certain rate of return for their investments.

**This can be expressed as:**

Expected Return on Investment (RoI) = Exit Value / Post-money Valuation

*which means*

Post-money Valuation = Exit Value / Expected Return on Investment (RoI)

### EXIT VALUE

The *Exit Value (EV)*, or *Terminal Value*, is the value the company is expected to be sold for. In the Venture Capital method, this is usually calculated as a multiple of the company's revenues in the year of sale. Since this method is often used to value early stage, pre-revenue startups with negative cash flows, **EBIT** multiples are usually not applicable. Furthermore, for public companies finding the proper multiple is an easy task, their revenue and market cap information is free and readily available. For private companies, especially startups, this can prove to be a challenge. Data points are created only in events like fundraising or exits, and data is most commonly not published. Therefore, a mix of public company data and PE/VC databases is the best starting point for estimating an exit multiple. Illustrating on a practical example for a company that:

- is expected to generate 30 million in revenues at the year of sale
- assuming a sales multiple of 2

the anticipated Exit Value is 60 million.

### RATE OF INVESTMENT

The *Rate of Investment*, or *Rate of Return*, is often expressed as a multiple of the initial investment. The RoI is a function of risk perceived by investors. Since startups are inherently risky, and statistically most do not break even, the few that do succeed must "cover" for the rest, in order for the entire portfolio to provide sufficient returns. In addition, unlike traditional, public company investors, VCs are usually not fully diversified, most commonly holding 5-10 companies in their portfolio. For these reasons, the targeted RoI for early-stage companies are quite high, often reaching 10x.

**Let's go back to our example:**

*Exit Value of 60 million / expected RoI of 10*

**=6million Post-money Valuation**

In the case of a 500,000 investment, the *Pre-money Valuation* comes out to be 5.5 million. The investor's stake would be:

*500,000/6million*

**= 08.33%**

FURTHER REMARKS:

This calculation does not take into account future dilution. More likely than not, an investor in earlier rounds will experience dilution before an exit happens by the company issuing new stock in subsequent rounds. There are multiple ways to account for this effect. However, keeping true to VC method's primary advantage of simplicity, we can just reduce the *pre-money valuation* by the expected dilution in future rounds.

Please refer to our sample valuation template to value your startup by Venture Capital Method.

