

Startup Valuation: When Cashflow Only in Plans

Introduction

There's no doubt that valuing a startup is a crucial part of fundraising for entrepreneurs seeking seed or growth capital. The challenge, however, lies in determining the value of a business without historical data, cash flow, or assets that can serve as a benchmark. Instead, startup valuation is based on assumptions about the future potential of the business and market, making it a subjective exercise. Nonetheless, investors must evaluate the business to determine the appropriate amount to invest, and entrepreneurs want to avoid giving up too much equity too early or pricing themselves out of the market.

This article will explore the various methods of valuing a startup and offer insights into how to apply them in practice. It will also examine the challenges of valuing startups with no cash flow yet, which is often the case in the early stages of a new venture. While each method is unique, they all share the end goal of determining the value of a company through thoughtful analysis of factors such as market size, competition, product potential, team experience, and so on.

By understanding these valuation methods and the factors that influence them, entrepreneurs can better determine their company's worth and negotiate with investors from a position of knowledge and experience. However, it should be noted that valuation is not an exact science, and there are plenty of examples of startups that have sold for far more or less than their original valuation. Nonetheless, having a clear idea of your startup's value is a useful tool for entrepreneurs seeking investment and investors looking to make smart investment decisions.

Methods for Valuing Startups

Valuing a startup without cash flow is difficult as it relies on future projections rather than historical data. However, there are still several methods that investors use to evaluate these startups.

Pre-Money Valuation

The first method is the pre-money valuation method, which evaluates the company based on its estimated value before any outside investment is made. This method looks at both qualitative and quantitative factors such as market size, competition, intellectual property, team experience, product potential, progress towards milestones, and so on. By assessing these factors, investors can arrive at a pre-money valuation for the startup.

One approach to pre-money valuation is the "top-down" method, which estimates the total value of the market the startup operates in and calculates the percentage of that market that the startup could capture. This method relies on industry data and benchmarking to arrive at a potential valuation.

Another approach to pre-money valuation is the "bottom-up" method, which evaluates the startup's value based on its internal factors such as revenue, profits, and projected growth rates. This method is useful for startups that are generating some revenue but may not have established themselves in the market yet.

Investors may also use a combination of both methods to arrive at a more accurate pre-money valuation. Additionally, other factors such as the stage of development and the startup's sector can also influence pre-money valuation. For example, startups in the biotech or healthcare industries may require more investment upfront due to longer research and development timelines, which can impact their valuation.

It's important to note that pre-money valuation is subjective and can vary based on the investor's perspective and the startup's specific circumstances. It's also worth considering the dilution effect of outside investment, which can impact the equity ownership of existing shareholders and the overall value of the business.

Ultimately, pre-money valuation is a critical component of startup financing and can influence the amount of equity that investors receive in exchange for their investment. Entrepreneurs seeking investment should be aware of the factors that investors consider when evaluating pre-money valuation and work to build strong teams, differentiate themselves from competitors, and create innovative products or services that can drive growth and increase their overall valuation.

Berkus Method

Another method that can be used for startups, especially those without cash flow or established revenue streams, is the [Berkus](#) Method, which assigns a value to various aspects of the business. The categories include the strength of the founding team, stage of development, size of opportunity, patent protection, and so on.

Each of these categories is assigned a predetermined maximum dollar value, and the startup's score is tallied to arrive at a potential pre-money valuation. The categories and their corresponding dollar values can vary depending on the investor, but the standard Berkus Method typically assigns the following dollar values:

- Sound Idea: \$0 – \$500,000
- Prototype: \$500,000 – \$1 million
- Quality Management Team: \$1 million – \$2 million
- Strategic Relationships: \$500,000 – \$1 million
- Product Rollout or Sales: \$1 million – \$2 million

By assigning a dollar value to each of these categories, investors can gain a better understanding of the startup's strengths and weaknesses and determine its potential value in the market.

One of the benefits of the Berkus Method is that it's easy to understand and apply, even for novice investors or entrepreneurs. However, it's important to note that this method is subjective and can vary based on the investor's perspective and how they weight each category.

Additionally, the Berkus Method has some limitations, as it may not account for all relevant factors that can influence a startup's valuation, such as market size, competition, or product potential. For this reason, the Berkus Method should be used in conjunction with other methods for a more comprehensive evaluation of the startup.

In summary, the Berkus Method is a useful valuation method for startups, especially those without cash flow or established revenue streams. Entrepreneurs seeking investment should be aware of this method and consider its limitations when presenting their startup to potential investors.

Scorecard Method

The Scorecard method can also be used to evaluate a startup with no cash flow, although it must be modified to account for the stage of development. It involves evaluating the startup based on various factors such as the management team, market size, competitive landscape, product or service differentiation, and potential for growth.

Each factor is assigned a weight based on its importance and the startup's stage of development, and then multiplied by a coefficient related to the startup's stage of development. The coefficients used in the Scorecard Method are typically lower for earlier-stage startups, reflecting the higher risks and uncertainties that come with investing in these companies.

The total score is then multiplied by a predetermined valuation factor, which varies based on the investor's risk tolerance and industry sector. For example, an investor may use a higher valuation factor for startups in the healthcare industry, where there may be longer research and development timelines and higher initial investment costs.

One of the benefits of the Scorecard Method is that it allows investors to evaluate multiple aspects of a startup and assign them relative weights based on their importance. This method also considers the startup's stage of development, which can impact its overall potential and risk level.

However, the Scorecard Method is still subjective and can vary depending on the investor's perspective and the specific circumstances of the startup. For example, different investors may assign different weights to the same factor or use different coefficients based on their experience and knowledge of the industry.

In summary, the Scorecard Method is a valuable tool for evaluating startups, especially those without cash flow or established revenue streams. Entrepreneurs seeking investment should be familiar with this method and focus on building strong teams, differentiating themselves from competitors, and creating innovative products or services that have the potential for significant growth. Investors should consider all relevant factors when using the Scorecard Method and use other methods as needed for a more comprehensive evaluation of the startup.

Berkus Method vs. Scorecard Method?

You may be wondering – what's the difference between the Berkus Method and Scorecard Method outlined above. Let's clarify:

– the Berkus Method uses predetermined maximum dollar values for each category and tallies the startup's score to arrive at a potential pre-money valuation, while the Scorecard Method assigns weights to each factor and multiplies them by a coefficient related to the startup's stage of development.

– the Berkus Method is easy to understand and apply, even for novice investors or entrepreneurs, while the Scorecard Method provides a more comprehensive framework for evaluating multiple aspects of a startup and assigning them relative weights based on their importance.

– the Berkus Method may be more appropriate for early-stage startups that have not yet established themselves in the market, while the Scorecard Method may be more useful for startups with some traction or revenue streams.

Overall, both the Berkus Method and the Scorecard Method are valuable tools for evaluating no-cashflow startups, and different investors may prefer one method over the other based on their experience and investment criteria.

VC Method

Lastly, the Venture Capital (VC) method can also be used to evaluate startups with no cash flow. However, it should be modified to account for the startup's stage of development and the sector they are in. Investors use industry benchmarks and historical data to determine a startup's valuation, taking into account factors such as the stage of development, industry sector, and competition.

When startups do not yet have cash flow or established revenue streams, it can be difficult to use more conventional valuation methods such as discounted cash flow analysis or revenue multiple analysis. The VC Method overcomes this challenge by estimating the startup's potential future cash flows and discounting them to their present value. This method allows investors to evaluate the startup's potential value based on its growth potential, market size, competitive landscape, and other factors that impact its financial projections.

In addition, the VC Method considers the startup's stage of development and the associated risks and uncertainties. By using different discount rates for earlier-stage startups versus later-stage startups, investors can reflect the higher risk of investing in startups that are still in the early stages of development.

To use the VC Method, investors first estimate the startup's terminal value – this is the potential value of the startup when it is acquired or goes public. The terminal value is determined based on factors such as market size, growth potential, and comparable acquisitions in the industry.

Next, the investor estimates the expected cash flows for a set number of years, typically between five and ten years. These cash flows are then discounted to their present value using a discount rate, which reflects the time value of money and the risks associated with the investment.

The discount rate used in the VC Method can vary based on the investor's perceived risk level of the investment. Typically, earlier-stage startups are seen as more risky and require a higher discount rate than later-stage startups.

Finally, the investor adds the discounted cash flows to the terminal value to arrive at the startup's enterprise value. This figure is then adjusted for any debt or other liabilities and divided by the number of outstanding shares to arrive at the pre-money per-share valuation.

Overall, the VC Method is an effective tool for valuing no-cashflow startups because it uses financial projections to estimate the startup's potential value and accounts for the realities of investing in early-stage companies. It is important to note, however, that the accuracy of the VC Method depends on the quality and accuracy of the financial projections used in the calculation.

Startups seeking investment should focus on building strong teams, creating innovative products or services, and demonstrating their potential for revenue growth. Investors should carefully consider all relevant factors and use the VC Method in conjunction with other methods for a more comprehensive evaluation of the startup.

Summary

In summary, while valuing a startup without cash flow presents challenges, there are still several methods that investors can use. It's important to keep in mind that each method is subjective and should be used in conjunction with other methods to arrive at a more accurate valuation.

Factors that Influence Startup Valuations

When valuing startups with no cash flow, investors take into account various factors that can influence the overall valuation of a business. While these factors may vary depending on the type of startup and the industry it operates in, there are some common ones that are universally considered.

Market Opportunity

One of the primary factors that influence startup valuations is market size. The larger the market opportunity, the greater the potential for growth and revenue. Therefore, startups operating in large and growing markets are more likely to receive higher valuations.

Competitive Advantage

Competition is another factor to consider when evaluating a startup's potential valuation. Investors look for startups with unique products or services that have a competitive advantage over existing players in the market. The ability to differentiate their offering and stand out in a crowded market is crucial for startups to attract investment.

Technology or Innovation

Intellectual property is another key factor that can impact startup valuations. Patents, trademarks, and other forms of intellectual property protect a startup's innovation and make it harder for competitors to replicate their products or services. Strong intellectual property protection can increase a startup's valuation by reducing the risks of infringement and lawsuits.

Team Experience

Team experience is also an important factor that can influence startup valuations. Investors look for teams with a track record of success in the industry, as well as expertise and skills that are relevant to the startup's business model. A strong founding team can instill confidence in investors that the startup has a better chance of success.

Product Potential

Product potential is another factor that can impact startup valuations. Investors look for startups with breakthrough products or services that have the potential to disrupt the market and achieve sustainable competitive advantages. Startups with innovative and scalable business models are more likely to receive higher valuations from investors.

Milestone Achievements

Investors consider the progress of a startup towards critical milestones such as product launch, customer acquisition, and revenue generation. The closer a startup is to achieving these milestones, the more likely it is to receive a higher valuation. By showing progress and execution, startups can instill confidence in investors that they are on the right track.

Fundraising Progress

Finally, while the startup may not have cash flow yet, it may have made progress in raising funds from other sources such as grants, loans, or seed funding. Investors will want to assess this progress and understand the startup's level of traction.

Overall, the key factor that investors will be looking for in startups with no cash flow is their potential for future growth and value creation. By considering these factors and evaluating the startup's overall potential, investors can arrive at a pre-money valuation that accurately reflects the startup's worth. At the same time,

entrepreneurs should work to build strong teams, differentiate themselves from competitors, and create innovative products or services that can disrupt the market and drive growth.

Conclusion

Valuing a startup is a crucial part of raising capital and attracting investors. While valuing startups can be challenging, especially in the early stages when there is no historical data or cash flow, it's essential to arrive at an accurate valuation that reflects the true worth of the business.

To do this, investors generally use various methods such as discounted cash flow, multiple of revenue, scorecard, and venture capital. These methods allow investors to evaluate the startup and arrive at a pre-money valuation. For startups with no cash flow, investors can use methods such as pre-money valuation or the Berkus method to arrive at a fair valuation.

While these methods can be useful, they are subjective, and there is no single perfect way to value a startup. Factors such as market size, competition, intellectual property, team experience, product potential, and progress towards milestones can all influence a startup's valuation.

In conclusion, it's essential to consider all relevant factors when valuing a startup and use multiple methods to arrive at a more accurate valuation. Entrepreneurs should be aware of the different methods used by investors and work to build strong teams, differentiate themselves from competitors, and create innovative products or services that can disrupt the market and drive growth.

Ultimately, valuing a startup is both an art and science, and there is always an element of risk involved. However, by carefully evaluating all relevant factors and using the right methods, entrepreneurs can make informed decisions about their businesses, and investors can make smart investment decisions.

Additional Resources

If you are looking to learn more about startup valuation, there are numerous resources available that can help you gain a better understanding of the process. Whether you're an entrepreneur looking to understand your startup's worth or an investor seeking insights into making smart investment decisions, here are some additional resources to consider:

Books:

- “Venture Deals” by Brad Feld and Jason Mendelson
- “Startup Valuation and Financials” by Lorenz Gruber
- “The Art of Startup Valuation” by Alejandro Cremades
- “Angel Investing: The Gust Guide to Making Money and Having Fun Investing in Startups” by David S. Rose

Websites:

- Angel Capital Association (ACA) – www.angelcapitalassociation.org/ – a professional association of angel investors that provides resources, education, and networking opportunities.

- AngelList – angel.co/ – an online platform that connects startups with investors and offers insights into startup valuations, trends, and data.
- SeedInvest – www.seedinvest.com/ – a platform that makes it easy for accredited investors to invest in startups and offers educational resources on startup investing.
- Investopedia – www.investopedia.com/ – a comprehensive online resource that offers definitions, explanations, and practical advice on various aspects of startup valuation.
- Dave Berkus – en.wikipedia.org/wiki/Dave_Berkus

Definitions:

“seed capital”

refers to the initial funding provided to a startup or entrepreneur to help them get their business off the ground. This can include funds for developing a product or service, conducting market research, and building a team. here are some examples of investors or sources of seed capital investments:

- Angel investors: Angel investors are individuals who provide capital to startups in exchange for an ownership stake in the company. These investors typically invest early in a startup’s development and may provide ongoing support and mentorship.
- Venture capitalists (VCs): Venture capitalists are professional investors who provide capital to startups with high growth potential. VCs typically invest larger amounts of money than angel investors and may also provide strategic support and guidance to the startup.
- Crowdfunding: Crowdfunding is a method of raising capital from a large number of people through an online platform. This can include rewards-based crowdfunding, where backers receive a product or service in exchange for their investment, or equity-based crowdfunding, where investors receive an ownership stake in the company.
- Accelerators and incubators: Accelerators and incubators provide resources and support to startups, including funding, mentorship, office space, and networking opportunities. These programs are designed to help startups get off the ground and may be affiliated with angel investors or VCs.
- Grants: Some startups may be eligible for grants from government agencies, nonprofit organizations, or foundations. These grants can provide seed capital to startups without the need for equity ownership or repayment.

Overall, seed capital can come from a wide range of sources, and different investors or funding options may be more appropriate depending on the startup’s specific circumstances and industry sector.

“growth capital”

refers to funding that is provided to a company that has already established itself and has a track record of success. This funding is intended to help the company expand its operations or scale its business, such as by investing in new products or services, opening new locations, or expanding its workforce.