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Valuation of Venture-Backed Companies Part I: The Method and the Madness

When you read about the latest venture financing for some company – let's call it Newco – in the press, among the items commonly reported is the valuation of Newco. That figures: the valuation of the deal is an obvious point of interest, if only because people like to keep score, and folks want an idea of how big a piece of Newco the investors acquired in exchange for their capital. It's all pretty straightforward, right?

Well, yes and no.

Here's how it works. When a venture capital fund invests in Newco, it acquires shares of stock equal to a certain percentage of the total fully-diluted outstanding stock of Newco. So, for example, let's say a VC invests $1 million in Newco, and in exchange receives 25% of the fully-diluted outstanding stock of Newco.

The value of Newco after the investment (the post-money valuation) is calculated as $1,000,000/.25 which equates to $4 million. To take it a step further, the implied value of Newco before the investment is the post money valuation of $4 million less $1 million invested, which results in a $3 million pre-money valuation. (Note that the per-share price of the shares the VC purchased doesn't even figure into this calculation.)

The above approach to valuing companies backed by VCs – let's call it the "Standard Venture Valuation Metric" (SVVM) – is simple, widely reported, and … pretty much always wrong. Why? Because it is rooted in a fiction: that all shares and series of stock of Newco – common, and preferred – have the same value; the value of the preferred stock sold in the last financing round. And, that's almost never true.

Consider that preferred stock is "preferred" because it has various preferences: voting rights, protective provisions, liquidation (exit) preferences, etc. As a result, preferred is more valuable than common stock. Further, different series of preferred stock (A, B, C, etc.) have different preferences as between them, with the most "senior" having the most

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valuable set of preferences. Putting a particular value on the various classes and series' of stock, with their various preferences, is problematic. Assuming they are all equal in value may be computationally convenient but otherwise is nonsense.

In truth, preferred is almost always worth more than common, and more senior preferred is worth more than less senior preferred. That means that the SVVM, which bases the valuation of the company on the fraction of ownership obtained by the most recent sale of the most senior preferred stock, is almost always wrong. It is too high.

Let's take a simple example. Newco has 500,000 shares of founder common stock outstanding, 500,000 shares of Series A Preferred stock outstanding (sold at $0.50/share), and 500,000 share of Series B Preferred stock outstanding, which was sold for $1.00/share. On these facts, the SVVM post-money valuation of Newco at the Series B close is $1.5 million.

Except, Newco can't really be worth $1.5 million at the close of the Series B financing, because we know the Series B shares are worth more than the Series A shares, which in turn are worth more than the common shares. So, while the aggregate value of the Series B shares is $500,000 (the price just paid for it), the aggregate value of the Series A shares is something less than $500,000 (though quite possibly more than $0.50/share) and the aggregate value of the common shares is something less than that. Thus, the $1.5 million figure derived from the SVVM must be too high.

The valuation widely cited in the popular press (and widely used as a valuation benchmark by VCs and entrepreneurs alike) is almost always wrong, even at the instant the applicable round of financing closed. How wrong depends on the respective rights and privileges of the common, Series A and Series B stock. In rare circumstances, it might not be off by much; in most circumstances, it is likely off by quite a bit. Probably even 50% or more in some cases.

Of course, if we knew how much more the Series B was worth than the Series A, and the Series A the common we could calculate the "real" valuation of Newco. Unfortunately, even if we know all if the particulars of the special rights and preferences of the Series A and Series B, even the proverbial best and brightest folks will have trouble agreeing on the value of the Series A and common. Folks will disagree about the value of the various preferences and the marketability of the various shares. Most of their analysis will be based assumptions that are little more than educated guesses.

So why does everyone use the SVVM when reporting on venture capital investments and company valuations? First, it is simple to calculate and easy to understand. Second, it also reflects one future reality (more or less) in the unlikely event that the company achieves what most founder's (only) dream about: the aforesaid IPO exit that forces conversion of all stock to common. Finally, there is no "right" method for calculating the value of the various classes and series of stock absent a liquid market for all those classes and series; at least, no right method that leads to a consistent result when applied by different people.

Next time, the "so what?" question. Do the flaws of the SVVM model matter? Is there a better alternative?

Related People

Paul Jones
Of Counsel

pajones@michaelbest.com
T 608.283.0125

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125