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Valuation of a Start-Up

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Introduction to Startup Valuation

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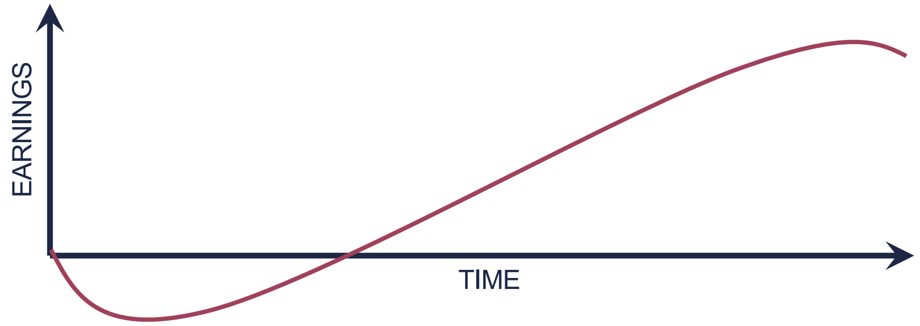
Presented by Hon. David R. Jones, Meredith Lahaie, Bassam Latif and Darren Richman

The Life Cycle of Companies

The prospects of a company can change dramatically over time – as can its capital structure and methods of valuation

Primary Investor Universe	Angel Investors / Seed Capital	Venture Capital / Growth Equity	Public Markets / Private Equity



Operating History	None	Limited	Operating History Relevant to Valuation
Comparables	None	Limited	More Robust Peer Set
Source of Value	Future Growth	Mostly Future Growth	Existing Assets Important, but Growth Profile Still Relevant

Note: Illustrative and simplified for purposes of presentation

Various Approaches to Valuation

Valuation is not "one size fits all" - there are benefits (and drawbacks) that inform what is appropriate, and when a particular approach should be utilized

- Checklist
- Risk Factors
- Trading Comparables
- Venture Capital Method
- Discounted Cash Flow
- Scorecard
- Transaction Comparables

Traditional Approaches to Valuation

Tried and true methods of valuing (mature) companies

Method	Discounted Cash Flow	Trading Comparables	Transaction Comparables
What it is	• Estimate of cash flows over the forecast period of 3-5 years (assumes steady state cash flows achieved in that time frame) • Estimate of the terminal value beyond the forecast period for the remainder of an asset's useful life, or company's existence • Apply an appropriate discount rate to reflect risk and the time value of money to arrive at an estimate of present value of future cash flows	• Identify comparable companies • Calculate average / median / high / low multiples of relevant trading metrics • Multiply the chosen trading metric by the relevant range of multiples to inform a potential range of valuations	• Identify comparable companies that recently transacted • Calculate average / median / high / low multiples paid of relevant metrics • Multiply the chosen metric by the relevant range of multiples paid to inform a potential range of valuations
Why it Works	✓ Driven by company-specific assumptions re cash flows ✓ Incorporates growth trajectory over time and ultimate terminal value ✓ Impacted by assumptions relating to risk and interest rates	✓ Widely understood by market participants ✓ Straightforward to apply based on observable information ✓ Incorporates company specific information and applies it to sector and market specific datapoints	

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Traditional Approaches to Valuation
Issues for Startups

Tried and true methods of valuing (mature) companies can present challenges in valuing young startups

Method	Discounted Cash Flow	Trading Comparables	Transaction Comparables
Potential Issues	Traditional valuation approaches require observable characteristics that may not be present in a startup – operating history, cash flow visibility (and timing), and / or applicable comparables		
	• Hard to extrapolate the future based on a limited past • Insufficient historical data, especially across macroeconomic cycles • Identifying an appropriate discount rate can be challenging • Terminal value assumptions often account for the most overall value, yet assume a stable cash flow and growth profile – when does growth stabilize, and what does the company look like at that time? Likely to take significantly longer than 3-5 years to achieve business viability and stable cash flows and growth	• There is often no "perfect comparable" particularly in the startup context; in the case of unique products or business models, no comparables at all • Companies that have achieved an exit (either public or private) are often larger and provide a different risk and growth profile than startups • Revenue multiples don't provide profitability datapoints and negative EBITDA is often present • Differences in investment terms and complicated capital structures of startups obfuscate comparability (i.e., liquidation preferences, performance shares, and multiple classes of common and preferred stock) • Past transactions (even recent) may not reflect current valuations	

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How do Early Stage Investors Value Companies in Practice?

Traditional methods of valuing (growing) companies in the context of venture capital investing

Method	Checklist	Scorecard	Risk Factors	Venture Capital Method
What it is	• Assign a fixed value to each of [5] characteristics that the investor deems important • Characteristics can include the following (but the framework is flexible): good idea, limited technology / execution / market / production risks • Binary outcome for each factor – sum of satisfied criteria produces an aggregate value	• Determine average valuation of similar companies • Assign a weight of (0-100%) to characteristics such as strength of team, size of opportunity, technology, competitive environment, partnerships, etc. in the aggregate to arrive @ 100% • Multiply weightings by a comparison % for a target comparable company, and multiply aggregate by such target comparable company's latest valuation	• Determine average valuation of similar companies • Assign a range of points (i.e., -2 to +2) to characteristics such as management, sales, competition, technology, reputation, potential for exit, etc. • Adjust the average valuation by the product of the allocated points and an assumed value (i.e., [$1mm] per point) based on risks observed	• Determine the time and valuation of the company's assumed exit • Discount the assumed exit value back to present value using the assumed required rate of return • Deduct the contemplated funding amount to understand the value of the subject company on a pre-money basis
Why it Might Work	✓ Financial projections are inaccurate for early stage companies – this is a simpler approach to valuing key considerations ✓ No financial metrics, no problem ✓ Flexible framework – each investor decides which factors should be included	✓ Simple approach, but more nuanced given no binary outcomes (i.e., degrees of comparability versus binary outcome for each characteristic) ✓ Relative valuation provides insight into positioning given comparison to average of similar companies	✓ Simple approach, but often compares more characteristics than other methods utilized ✓ Relative valuation provides insight into positioning given comparison to average of similar companies	✓ Simple approach ✓ Takes into account an outcome where the company grows and executes a successful exit ✓ Flexible framework – assumed required rate of return is investor specific

Note: Illustrative and simplified for purposes of presentation

How do Early Stage Investors Value Companies in Practice?
Issues in a Bankruptcy Context

Traditional methods of valuing (growing) companies in the context of venture capital investing

Method	Checklist	Scorecard	Risk Factors	Venture Capital Method
Potential Issues	An approach that lacks granular analysis of company specific details often overlooks the potential for an outlier and ignores the significant interim capital reinvestment required to achieve the business plan and reverts to the mean for the sake of simplicity			
	• Overly simplistic • Ignores market dynamics • Ignores sector dynamics	• Relies on comparison to similar companies – unlikely to be a single "perfect comparable" • Average valuation subject to interpretation / incorporation of outliers • Potential for false precision given quantitative approach to a qualitative exercise (i.e., % precision, yet likely limited operating history of the subject company)		• Overly simplistic • Terminal value assumptions critical - market assumptions today aren't always consistent with market assumptions in the future • Capital structure – and any subsequent dilution via additional capital raises – will meaningfully impact returns

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Faculty

Hon. David R. Jones is Chief U.S. Bankruptcy Judge for the Southern District of Texas in Houston, initially sworn in on Sept, 30, 2011, and named Chief Judge in 2015. Prior to becoming a judge, he was a partner in the bankruptcy group at Porter Hedges, LLP in Houston, specializing in bankruptcy and bankruptcy-related litigation. Judge Jones received his B.S. in electrical engineering from Duke University in 1983, his M.B.A. from Southern Methodist University in 1986, and his J.D. from the University of Houston in 1992, where he served as editor-in-chief of the *Houston Law Review*.

Meredith A. Lahaie is a partner with Akin Gump Strauss Hauer & Feld LLP in New York and San Francisco. She represents debtors, creditors, bondholders, debtor-in-possession lenders and acquirers of businesses and assets in large, complex chapter 11 cases and out-of-court restructurings. Ranked as one of the industry's leading restructuring lawyers by *Chambers USA* and *Legal 500*, and recently named one of *The Deal*'s Top Women Dealmakers in Restructuring, Ms. Lahaie advises on complex restructuring cases of all sizes, both in and out of court, and has handled matters for clients in industries as varied as real estate, retail, energy, shipping and entertainment. She is regarded as one of the industry's leading young restructuring lawyers, and in the last five years deals in which she played a central role have been recognized with 14 awards. Following law school, Ms. Lahaie clerked for Hon. Adlai S. Hardin in the U.S. Bankruptcy Court for the Southern District of New York. She received her B.A. *magna cum laude* in 2002 from Tufts University and her J.D. in 2005 from the University of Connecticut School of Law.

Bassam Latif is a managing director of Moelis & Company in Houston, where he specializes in capital structure advisory for companies, sponsors and creditors across a wide range of industries. He has also been instrumental in building out the firm's Maritime Shipping Advisory business, where he focuses on M&A and strategic transactions. Prior to joining Moelis & Company, Mr. Latif held roles at Rothschild Inc., where he focused on restructuring and M&A transactions. He received his B.Sc. in mechanical engineering and B.A. in economics from Rice University, and his M.B.A. from Columbia University.

Darren L. Richman is co-founder, co-portfolio manager and co-managing partner of Kennedy Lewis Investment Management LLC in New York and co-chairs the firm's Investment and Executive Committees. He previously was a senior managing director with Blackstone from 2006-16, where he focused on special situations and distressed investments, and he sat on the Investment Committee for many of GSO's specialsituation-oriented funds. Before joining GSO Capital Partners, Mr. Richman worked at DiMaio Ahmad Capital, where he was a founding member and the co-head of its Investment Research Team from 2003-06. Prior to joining DiMaio Ahmad, he was a vice president and senior special situations analyst at Goldman Sachs from 1999-2003. Mr. Richman began his career with Deloitte & Touche, ultimately serving as a manager in the firm's Mergers & Acquisitions Services Group from 1994-99. He sits on the boards of Eastman Kodak and Outward Bound USA, and the executive board of New York University's Stern School of Business. He previously sat on the Board of Sorenson Communications, F45, Seneca Mortgage and Warrior Coal. Mr. Richman is a member of the Economic Club of New York and formerly served on its strategic planning committee. He was formerly a Certified Public Accountant and a member of the American Institute of Certified Public Accountants. Mr. Richman received his B.S. and B.A. in accounting from the University of Hartford in 1993 and his M.B.A. from NYU's Stern School of Business in 2000.