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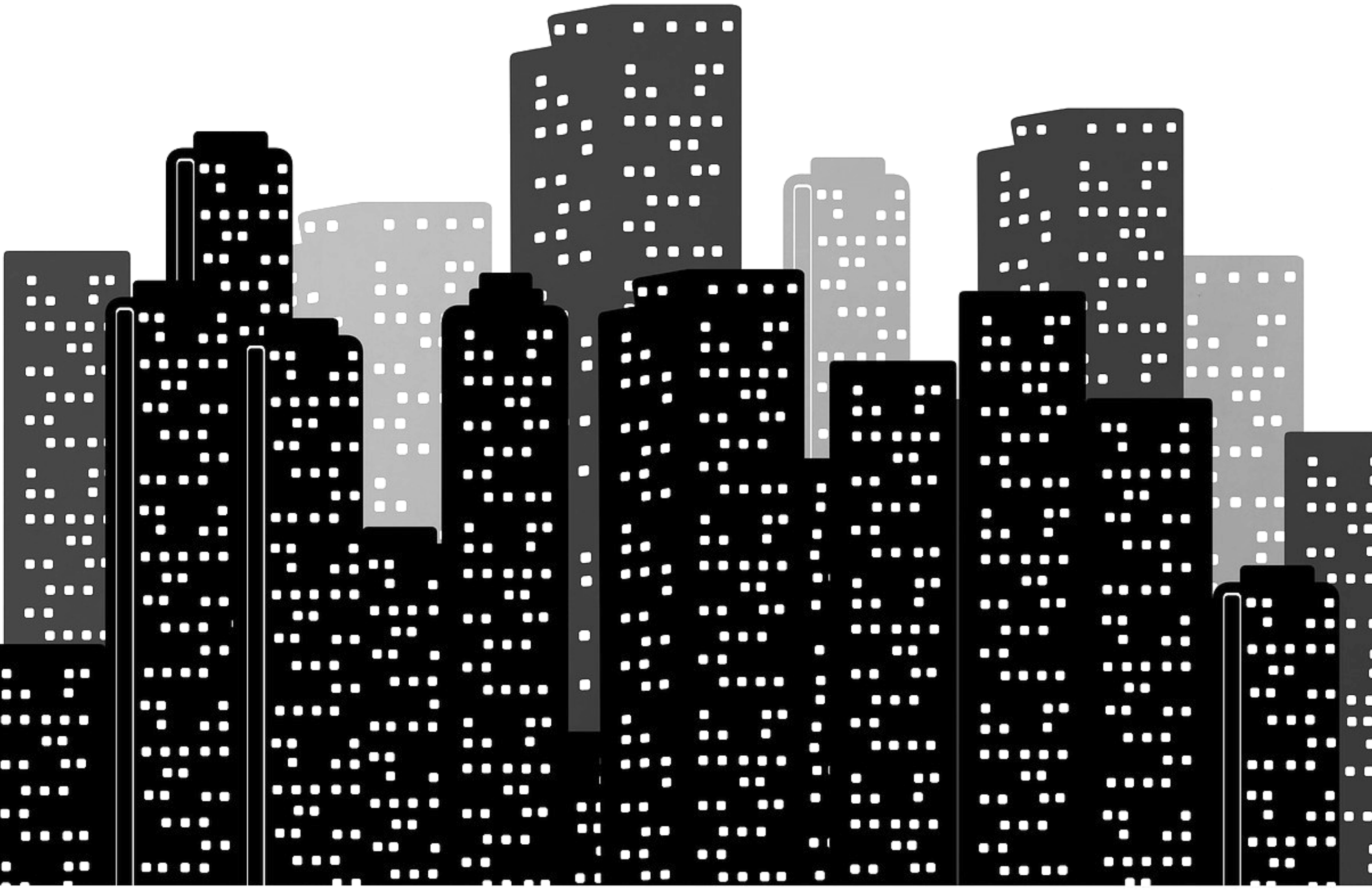
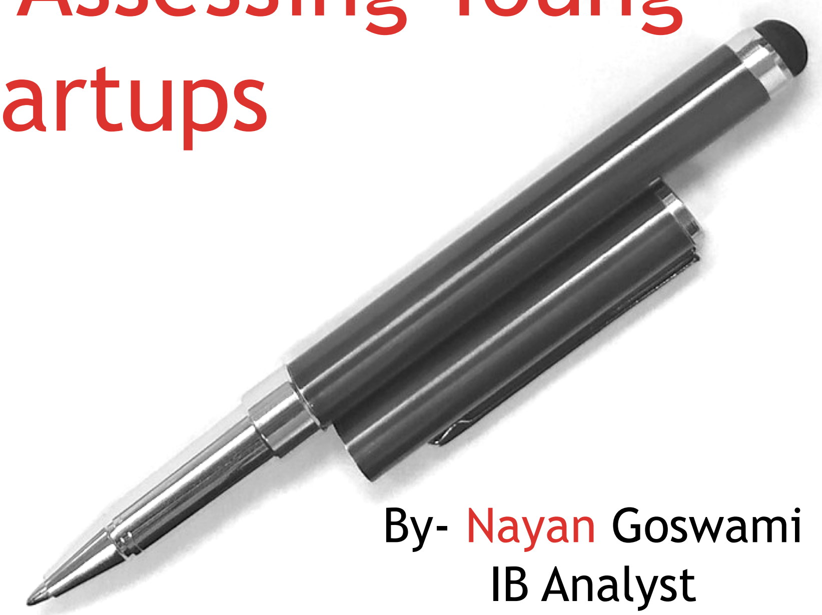


Picking the Right Grain: Valuing and Assessing Young Startups



Nucleus ADVISORS

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Getting Started

Valuing and assessing a promising idea or a startup is a common conundrum for early stage investors. For startups with little or no revenue and less-than-certain futures, the job of assessment is tricky. For mature, publicly listed businesses with steady revenues and earnings, normally it's a matter of valuing them as a multiple of their earnings before interest, taxes, depreciation, and amortization (EBITDA) or based on other industry specific multiples. But it seems like a nightmare to value a pre-revenue company or a new venture with little proven record.

Both sides of the table, the founders and the Investors who are looking to raise capital or thinking to put money into one, should know the real worth of the business to make an informed decision.

Before diving into assessment we should able to identify early startups from their unique attributes.

The common attributes shared by Early stage ventures:

- **No Proven Track Record:** Most investors make an informed decision by looking into trends and past historical data. However, these nascent stage companies do not have database of information related to operations and financing for more than a year or two.

- **Small revenues, big operating losses:** Many young companies have little or no revenue at all. Most of their expenses are towards business establishment, rather than generating revenue. The effect of which result in significant operating losses.

- **Question of survival:** According to the U.S. Bureau of Labor Statistics (BLS), approximately 20% of new businesses fail during the first two years of being open, 45% during the first five years, and 65% during the first 10 years. Only 25% of new businesses make it to 15 years or more.

- **Multiple claims on equity:** It is quite common that few equity investors want to have first claims on cash flows and others to have additional voting rights.

These characteristics of a young startup doesn't initiate insuperable problems in singularity, however these factors coming together in a particular startup makes the valuation game questionable. No wonder why majority of investors and analysts give up.

Assessment & Valuation Issues

Due to the unavailability of historical data and diminutive market information, analysts struggle to value early stage ventures with traditional valuation methods like discounted cash flow, precedent transaction analysis and other common forms of valuation techniques.

Therefore, majority of investors don't even try to value an early stage venture on an intrinsic basis, rather rely on compelling stories to vindicate investment decisions.

Are there any parameters to assess nascent stage startups?

Honestly, there are no set rules while valuing early stage startups. However, the most successful investors tend to take investment decisions within this assessment of valuation framework.

- **Big Potential Market:** There has to be a large market for the product that the startup is working on. A large market for a product increases the probability of high revenue growth for sustainable period of time.

- **User Engagement:** The most common assessment tool for valuing a promising startup engaged in developing a platform is user traction. Any startup where 40%-50% users use the application or platform everyday has a high chance to come on the winners table.

- **Control on Expenses:** Young startups are often not disciplined in tracking and controlling expenses, whilst chasing high revenue numbers. Investors tend to stick with startups that manage their operating expenses frugally.

- **Dependence on Human Capital:** Early startups are more about the key team than the business itself. Focus is always on the startups that have built solid bench to back up the key personal.

- **Unique product/solution:** The product that the startup has built should be distinctive from other market products/solutions, as success of a young firm will attract competition from larger corporates having deep pockets. Therefore, the product built by young firms should be difficult to imitate. This exclusivity can either come from patents, brand name and technology.

Delta > 4 Theory

Another interesting theory called the Delta 4 coined by Kunal Shah (founder of CRED & Freecharge) helps to assess whether an idea going to be a winning business. To take a deep dive in the theory one should understand the three traits of Delta 4 theory.

Irreversible: This trait can be well understood by asking one simple question. Will I book my train tickets offline if I have used IRCTC before? Majority of the answers will be no for obvious reasons. It's because using an IRCTC app to book tickets is much efficient than booking offline. Therefore, once users get the chance to use a delta product like IRCTC, there is an ultimate possibility to stick around the product for sustainable period of time.

Once the business or a product reaches this stage it's irreversible growth which leads to the success of the product.

What businesses should keep in mind or do to increase the Δ4?

Affordability (No one would take a train if they can afford a flight everywhere)

Readiness (Youtube wouldn't be popular if data was not cheap enough)

Learning effort (Tally may not be the most efficient software in the market. However, thousands of CA's stick to it because they devoted long hours to learn the software)

Micro Configurations (Mom's usually don't tend to let go her maid as she made many configurations on how to do a particular job)

Collective participation (getting users use to your product. e.g. TikTok.)

Branded lanes/verbs (using WhatsApp me or google it, instead of text me or search for it on web)

UBP>USP

UBP stands for **Unique Brag Worthy Proposition:** Anyone who have used an efficient state of product would brag to others in the inefficient state. Remember, when we got our first smartphone we would brag to our friends who had an normal cellular phone where the inbuilt camera option was unavailable or using a TrueCaller. Almost everyone downloaded TrueCaller not because they saw an ad but because someone who is already using it bragged out it. USB creates a state of efficiency and get a higher delta score.

High Tolerance: This third trait explains the state of efficiency where people stick to the product even after facing certain problems while using the product. Example: We tend to use IRCTC, UBER, etc even after facing certain issues as it offers a higher state of efficiency. Thus, improves the delta score.

To sum up, using these traits one can score the state of efficiency of a particular business idea or product within a range of 1-10.

Thus, any product or service offers Δ4(Delta 4) creates enormous wealth.

Every time the Δ is less than 4, it may result in a reversible behaviour. There would be no UBP with no tolerance.

If Δe = >2 but <4, Business becomes unstable and you may need to pour in more money(can be referred to OLA CABS or give discounts) to increase the delta. If Δe = <2 The business is not worth doing.

Before starting with your business or implementing an idea, make sure that your business will be at least Δe = 4. Make it Brag Worthy.

This Proposition can help Entrepreneurs & Investors to save a lot of time and money.

Epilogue: Rules for the Road

Valuing and assessing an early stage startup is not an easy task to do, as it is highly risky, but if done right, it is a high return proposition.
In a nutshell, an investment worthy startup have a great founding team with sheer passion and a compelling vision. They should be equipped with great technical and product skills with coachability as a trait.

"No matter how brilliant your mind or strategy, if you're playing a solo game, you'll always lose out to a team"
- Reid Hoffman, co-founder LinkedIn

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