Chapter 15

The Deal: Valuation, Structure and Negotiation

Evaluation

• More art or craft than science.
• Cash flow forecasts usually a wild guess.
• Age of companies.
What is a Business Worth?

- Depends on many factors.
- Determinants of value.
- Key to entrepreneur:
  - Cash
  - Time
  - Risk

Value Issues

- Long versus short term.
- Psychological factors.
- Boundaries and ranges.
- Investor’s rate of return.
Valuation Methods

• The Fundamental Method:
  • Simply the present value of the future earnings stream.

• The Venture Capital Method:
  • Appropriate for investments in a company with negative cash flow at the time of the investment, but which in a number of years is projected to generate significant earnings. Investors share of ownership.
**EXHIBIT 15.5  EXAMPLE OF THE FUNDAMENTAL METHOD**

<table>
<thead>
<tr>
<th>Percentage Growth of Revenue</th>
<th>Revenue (millions)</th>
<th>After-Tax Margin</th>
<th>After-Tax Profit (millions)</th>
<th>Present Value Factor</th>
<th>PV of Each Year's Earnings Year ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  50%</td>
<td>53.00</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.400</td>
<td>-0.0</td>
</tr>
<tr>
<td>2  50</td>
<td>4.50</td>
<td>4.0%</td>
<td>9.18</td>
<td>1.960</td>
<td>0.09</td>
</tr>
<tr>
<td>3  50</td>
<td>7.0</td>
<td>0.4%</td>
<td>2.744</td>
<td>0.17</td>
<td></td>
</tr>
<tr>
<td>4  50</td>
<td>10.11</td>
<td>9.0%</td>
<td>3.842</td>
<td>0.20</td>
<td></td>
</tr>
<tr>
<td>5  50</td>
<td>15.10</td>
<td>11.0%</td>
<td>5.378</td>
<td>0.31</td>
<td></td>
</tr>
<tr>
<td>6  40</td>
<td>21.26</td>
<td>11.5%</td>
<td>7.530</td>
<td>0.33</td>
<td></td>
</tr>
<tr>
<td>7  30</td>
<td>27.64</td>
<td>12.0%</td>
<td>10.541</td>
<td>0.32</td>
<td></td>
</tr>
<tr>
<td>8  20</td>
<td>33.17</td>
<td>12.0%</td>
<td>14.758</td>
<td>0.27</td>
<td></td>
</tr>
<tr>
<td>9  15</td>
<td>38.15</td>
<td>12.0%</td>
<td>20.661</td>
<td>0.22</td>
<td></td>
</tr>
<tr>
<td>10 10</td>
<td>43.99</td>
<td>12.0%</td>
<td>28.926</td>
<td>0.17</td>
<td></td>
</tr>
</tbody>
</table>

Total present value of earnings in the supergrowth period
Residual future value of earnings stream
TOTAL PRESENT VALUE OF COMPANY

**EXHIBIT 15.2  INVESTOR’S REQUIRED SHARE OF OWNERSHIP UNDER VARIOUS ROR OBJECTIVES**

Assumptions:
- Amount of initial startup investment = $1 million
- Holding period = 5 years
- Required rate of return = 50%

Calculating the required share of ownership:

<table>
<thead>
<tr>
<th>Investor's Return Objective (Percent/Year Compounded)</th>
<th>30%</th>
<th>40%</th>
<th>50%</th>
<th>60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price/Earnings Ratio</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10x</td>
<td>37%</td>
<td>56%</td>
<td>76%</td>
<td>106%</td>
</tr>
<tr>
<td>15x</td>
<td>25%</td>
<td>36%</td>
<td>51%</td>
<td>70%</td>
</tr>
<tr>
<td>20x</td>
<td>19%</td>
<td>27%</td>
<td>38%</td>
<td>52%</td>
</tr>
<tr>
<td>25x</td>
<td>15%</td>
<td>22%</td>
<td>30%</td>
<td>42%</td>
</tr>
</tbody>
</table>
Valuation Methods

• The First Chicago Method:
  • Employs a lower discount rate, but applies it to an expected cash flow.

Rule of thumb:
  • Operating assumptions include initial sales, growth rates, EBITA/sales, and (net fixed assets + operating working capital)/sales; also note relationships and trade-offs.

Ownership Dilution

• Additional fundraising and dilution.
• Forecast future rounds.
• Estimate timing and amount for each round.
• Not a reliable method.
Development Stage

- Early stage ventures are grouped by:
  - Series a
  - Series b
  - Series c
  Most often technology companies.
REality of Market Fluctuations

- Capital market cycles.
- Cram down round.
- Last money in.

Conflicts

- Entrepreneur perspective:
  - my price–your terms.
- Investor perspective:
  - my price – my terms.
- Styles of users versus suppliers.
- Long term goals contradictory.
Stage Capital Commitments

- Investors and venture stages of development.
- Incentives for entrepreneur.
- Exit options.
- Control of management team.

What is a Deal in Entrepreneurial Finance?

- Deals—economic agreements between at least two parties that involves the allocation of cash flow streams (with respect to both amount and timing), the allocation of risk, and hence the allocation of value between different groups.
Deal Characteristics

- Characteristics of successful deals:
  - They are simple.
  - They are robust.
  - They are organic.
  - They take into account the incentives of each party to the deal under a variety of circumstances.
  - They provide mechanisms for communications and interpretation.

Deal Characteristics

- Characteristics of successful deals:
  - They are based primarily on trust rather than on legalese.
  - They are not patently unfair.
  - They do not make it too difficult to raise additional capital.
  - They match the needs of the user of capital with the needs of the supplier.
  - They reveal information about each party.
Deal Characteristics

- Characteristics of successful deals:
  - They allow for the arrival of new information before financing is required.
  - They do not preserve discontinuities.
  - They consider the fact that it takes time to raise money.
  - They improve the chances of success for the venture.

Minimising Surprises

- Tips to consider when raising capital:
  - Raise money when you do not need it.
  - Learn as much about the process and how to manage it as you can.
  - Know your relative bargaining position.
  - If all you get is money, you are not getting much.
  - Assume the deal will never close.
  - Always have a backup source of capital
  - The legal and other experts can blow it -- sweat the details yourself.
Negotiation

• Steps of principled negotiation:
  • Separate the people from the problem.
  • Focus on interests, not positions.
  • Generate a variety of possibilities before deciding what to do.
  • Insist that the result be based on some objective standard.

Beyond ‘Just the Money’

• Critical aspects of the deal:
  • Number, type, and mix of stocks and various features that may go with them that affect the investor’s rate of return.
  • The amounts and timing of takedowns, conversions, and the like.
  • Interest rate in debt or preferred shares.
  • The number of seats, and who actually will represent investors, on the board of directors.
  • Possible changes in the management team and in the composition of the board of directors.
Beyond ‘Just the Money’

- Critical aspects of the deal:
  - Registration rights for investor’s stock.
  - Right of first refusal granted to the investor on subsequent private or initial public stock offerings.
  - Stock vesting schedule and agreements.
  - The payment of legal, accounting, consulting or other fees connected with putting the deal together.

Burdensome Issues For Entrepreneurs

- Right of first refusal.
- Ratchet anti-dilution protection.
- Washout financing.
- Forced buyout.
- Demand registration rights.
- Key-person insurance.
Sand Traps

- Strategic circumference.
- Legal circumference.
- Status and size.
- Unknown territory.
- Opportunity cost.

- Under estimation of other costs.
- Greed.
- Fundraising treadmill.
- Too anxious.
Sand Traps

- Impatience.
- Take the money and run myopia.