Alumni Ventures

Network-Powered Venture Capital

eGUIDE

A Deep Dive Into Valuations

Learn about the importance of a company's valuation and how it's calculated

For disclosure Information, please refer to the Important Disclosure section on page 12 of this presentation.

Nearly all of our belongings hold value, from homes to vehicles, furniture to collectibles, etc. Factors like age, wear and tear, upgrades, and demand can impact the valuation of these objects, and their physical traits are helpful in determining their worth. On the other hand, it's much more complex to put a price on the value of an intangible asset, such as the current and potential worth of a young, fast-growing startup.

This guide will discuss how early-stage companies are valued, methods venture capitalists use to assess a company's worth, how these numbers change across different fundraising stages, and examples of companies in our portfolio that have changed valuation over time.

How Are Valuations Determined?

Determining a company's valuation requires a deep analysis of its current assets (including intangibles) and future growth potential,[1] considering factors such as revenue and/or profitability analysis, commercial momentum, and more. The resulting valuation data for a private sector company can help venture investors decide if they should participate in a round and what terms to negotiate.[2] There are several methods venture capitalists use to assess a company's worth, and we'll explore a few.

Back to the Start & the Power of Term Sheets

In 1987, Harvard Business School professor Bill Sahlman created what is known as the **"Venture Capital Method"** for determining a company's valuation. Sahlman's core formula involves multiplying the company's projected revenue with its projected margin and industry price-to-earnings to decide on its future value.[3] Many VCs still widely use this formula, with slightly different versions.

Valuation determination is a market-driven system, especially in venture capital (VC). Companies operate in a specific sector and look to accelerate their growth by raising capital from established VCs, especially those with relevant industry expertise. A term sheet lays out the financial terms of the investment, including how much a startup is worth, what rights and protections various investors are entitled to, and who will share in the profits if the company is sold or goes public.[4] While valuations are among the many terms laid out in a term sheet, other items — such as board seats and who is getting company control — are also factored into the negotiation.

"A company may receive multiple term sheets at various valuations as a company is fundraising," says Andrew Ervin, Senior Vice President of Investment Operations at Alumni Ventures. "It's not one person saying, 'I'm

1 James Chen, "How the Valuation Process Works," *Investopedia*, May 31, 2020.

2 "How To Value A Company: An In-Depth Guide To The Business Valuation Process," *CB Insights*, February 3, 2021.

3 Ibid.

4 Jonathan Norris, "How to Read a Term Sheet," *Silicon Valley Bank*, July 24, 2020.

going to go out and raise money at this valuation.' Instead, it's a market-driven system. If a VC is willing to put money to work at a given valuation, then that's the price."

A Method for Private Markets

Unlike publicly traded companies with easily accessible share prices and market capitalizations, determining a private company's value is less straightforward (as they have yet to IPO or exit). In such cases, a helpful technique is **comparable company analysis (CCA)**, which involves assembling a group of peer companies with known valuations that closely resemble the company being valued (e.g., similar sector/industry, similar stage, similar KPIs and growth trajectory, etc.), and comparing and adjusting accordingly.

For example, suppose you were trying to determine the valuation of a small plant-based food company. In that case, you might compare its growth and potential to the trajectory of public companies like Beyond Meat or Oatly. According to Ervin, this also involves viewing the health and trends of the specific market. Then, once the industry is established and analyzed, averages of their valuations can be calculated to provide a sense of where the private company fits within its industry.[5]

5 Jonathan Norris, "How to Read a Term Sheet," *Silicon Valley Bank*, July 24, 2020.

> **"With earlier-stage companies, valuation is often more art than science..."**

Moving Through Stages

Well-positioned venture portfolios are diversified across stage, sector, and geography. But that diversification can present challenges when it comes to valuation.

As Yevgeny Gelfand, VP of Venture Portfolio at Alumni Ventures, says, "With earlier-stage companies, valuation is often more art than science, given more limited data, uncertain growth outlook, and still-evolving business models. As you approach later stages with more mature companies, the dynamic shifts more towards science."

The same is true if a company is entering an entirely evergreen space such as new tech. In these circumstances, the VC leading the round will analyze other factors such as team, idea, runway, and growth potential in order to determine a realistic valuation.

Additionally, Seed-stage companies versus Series D companies often differ in terms of the product and services they offer. For example, when valuing an early-stage company (Seed, Series A), VCs often look to the market for analysis of a similar industry. Whereas, a company raising a Series D or Series E will have in-place revenue and possibly profits, enabling metrics-based financial analysis that can be used to calculate a valuation.

The Revaluation of a Company

A company's valuation is not a static figure. A company will periodically be revalued to measure the impact of growth, traction, or failure, coming in the form of up-rounds and down-rounds. An **up-round** is when a company has raised additional funds at a higher per-share price than the prior round. Conversely, when a company raises capital at a lower price per share, it's a **down-round**.[6]

A company is often revalued when raising a new round of funding, merging, or selling to another company; going "public" via an Initial Public Offering (IPO); or liquidating (shutting down and divesting assets).

The Impact on Acquisitions and Exits

Many elements influence an increase or decrease in valuation, such as shifting markets, (in)sufficient runway, success over time, use of capital, and beyond. Fluctuations in valuation also can impact a company's ability to go public or attract an acquisition.

"If you raise a round at a significant valuation, you've set a high bar for when you try to raise your next round or be acquired," Ervin explains. "When markets fluctuate, and valuations go down overall, venture capital flows less plentifully, making acquisitions less common or more distressed."

The most significant impact on valuation comes from the changing of markets, so it is essential to look at all aspects of a business to avoid pricing a valuation too high.

"You need to be careful as the CEO or founder of a business about not raising capital at too high a valuation because it limits your options down the road," Ervin notes. "It impacts a CEO's decision about when to go public or when to be acquired based on the valuation they raised at previously."

6 Simunovic, Anton. "Paper Gains Explained," *Alumni Ventures*, July 6, 2021.

Examples From AV's Portfolio

Examples From AVs Portfolio

At Alumni Ventures, we update the valuations on our portfolio companies when they announce new funding rounds. We also review all of our portfolio companies quarterly to verify if there have been any valuation changes based on an arm's length, third-party transaction that sets a new price for the company.

Examples of up-rounds and down-rounds from our portfolio include:*

1. **SonderMind** is an online marketplace connecting therapists with consumers. The Denver-based behavioral health network aims to address a three-sided marketplace between consumers, private practitioners, and enterprises using software that ties customer support to medical billing systems. We first invested in SonderMind's $2.5 million seed round at a $5.5 million pre-money valuation and recently participated in the company's $150 million Series C at an approximately $1.5 billion valuation.

2. **Mythical Games** is a game-technology platform enabling true ownership of digital assets, verifiable scarcity, and integrated secondary markets. We invested in the company's $19 million Series A in November 2019 and $75 million Series B in June 2021. The company then raised $150 million at a $1.25 billion valuation in November of 2021, which we also invested in.[7]

3. **Bloom Energy** — a manufacturer and installer of solid oxide fuel cells for onsite distributed power generation — went public at a price below its previous valuation[8] and below what AV paid to participate in the original investment.

While Mythical and SonderMind are examples of companies who lived up to — and even exceeded — their valuations, companies like Bloom demonstrate that not all investments are successful. Other companies end up with a valuation of zero, which underscores the need for a diversified portfolio with a number of investments.

7 Dean Takahashi, "Mythical Raises $150M at $1.25B Valuation for Playable NFT Game Platform," *VentureBeat*, November 4, 2021.

8 Nichola Groom, "Bloom Energy Share Sale Marks Valuation Drop of More than 40 Percent," *Reuters*, March 15, 2016.

*For illustration purposes only. These investments are not intended to suggest any level of investment returns; not necessarily indicative of investments invested by any one fund or investor. Many returns in investments result in the loss of capital invested. These investments are not available to future fund investors except potentially in certain follow-on investment options.

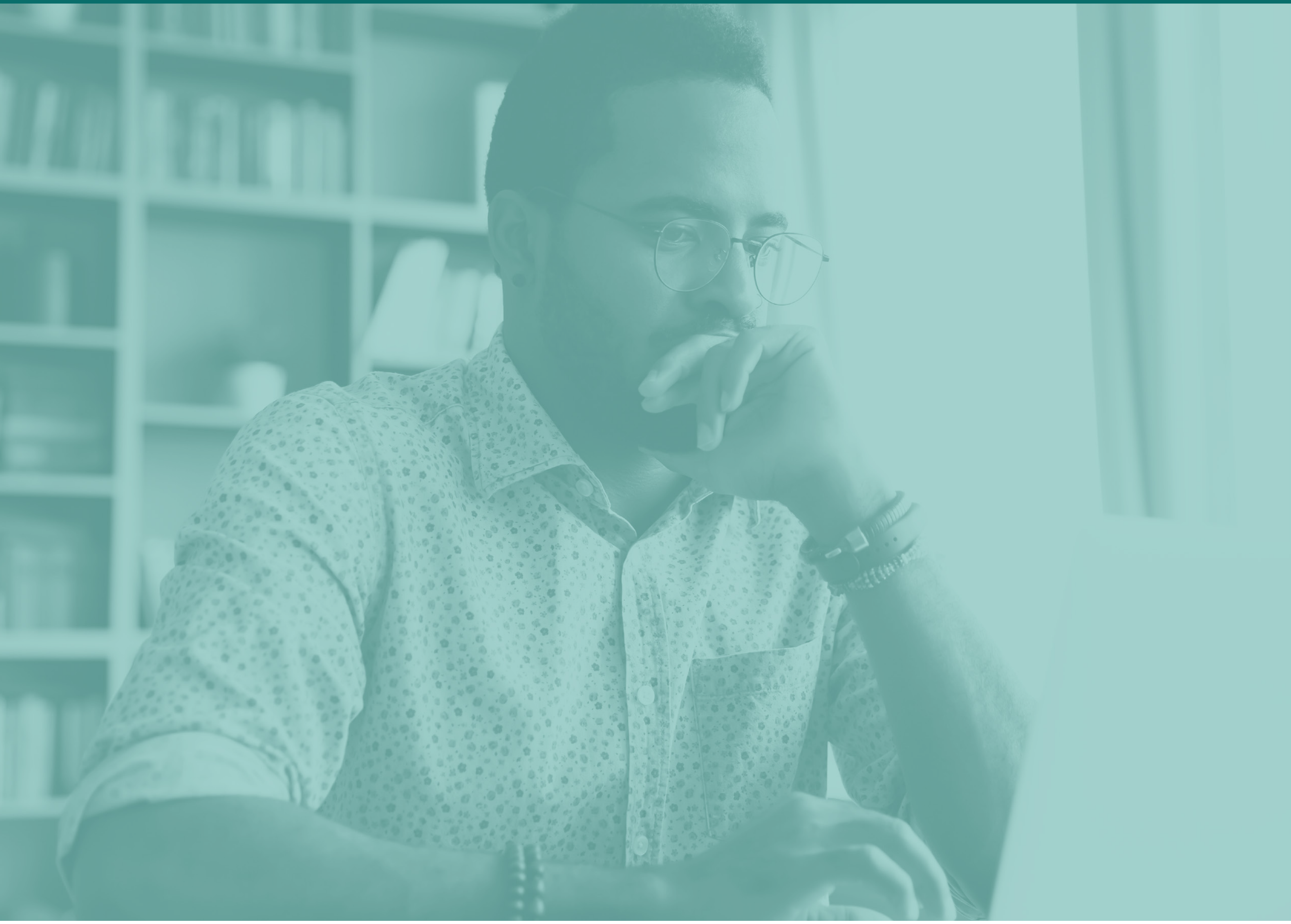
Final Thoughts

Valuations provide a baseline that allow companies to estimate worth by analyzing areas of strength and weakness. They also project future expectations, measure progress, identify gaps, help CEOs better manage their business, and offer a gateway to capital.[9]

The techniques used to calculate private company valuations can be more art than science, particularly for young startups or companies defining new markets. But through analysis of comparable companies, teams, structures, and business potential, venture investors can arrive at a reasonable valuation that can give a company sufficient runway to hit future milestones and put it on a path to potential future success — a win-win for all parties.

9 Carla McCabe, "The Importance of Valuations," *Truelytics*, April 22, 2018.

Important Disclosure Information



Important Disclosure Information

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AV offers smart, simple venture investing to accredited investors. Specifically, AV provides a path for individuals to own an actively managed diversified venture portfolio with a single investment co-investing alongside experienced VC firms. Traditionally, with limited investment capital and contacts, individual investors have had limited access to desirable deals alongside experienced VC firms, and even if they could access one or more such deals, it would take an inordinate amount of time, money and negotiation to build a diversified portfolio. With AV Funds, investors can choose from a number of funds to make a single investment to gain exposure to a diversified portfolio of investments selected by an experienced manager. AV Funds' simple fee mechanism permits investors to avoid constant capital calls throughout the life of the fund as found in other private investment vehicles.

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