JUNE 2019

TRANSACTION ADVISORY

Know your worth: how to value a tech company

For many entrepreneurs, conducting a business valuation on an early-stage or startup tech company can be a challenging process. Multiple factors, both within and outside of your control, can impact the worth of your business.

While values for established tech companies have tapered off recently, asset prices for early-stage companies remain strong. As Canada's technology sector continues to grow and the competition for capital intensifies, it's more important than ever for tech companies to obtain a credible market valuation that can help them meet their business objectives and compliance obligations.

Why is a formal valuation important?

Getting an accurate estimate of your company's worth is crucial. A proper valuation sets the precedent for every step that follows, whether your goal is to obtain financing or plan an eventual exit from the business.

If the value is too low, entrepreneurs could be needlessly sacrificing equity in order to obtain financing. Setting a value that's too high can be equally as damaging—even if it seems like a strategic move. An unrealistically high valuation could lower investor confidence in what is an otherwise sound business or idea. Entrepreneurs also run the risk of diluting their initial investor or underperforming, which can adversely affect future rounds of funding.

How do you measure your tech company's worth?

Like the tech industry itself, early-stage and startup valuations are highly nuanced and complex. For many entrepreneurs, the qualitative aspects of the business—including the company's journey and vision—can be difficult to measure and articulate. Value drivers can be unpredictable and forecasts are more uncertain as compared to other industries.

Tech company owners should consider these valuation factors in particular:

- **Stage of the company**

  Where a company is in its life cycle can determine which factors will have the greatest importance during a valuation. Where does your company sit in terms of its maturity? Has it already raised its seed money or Series A funding? Is your product at the prototype phase or has it been tested and rolled out?

  For early-stage startups, qualitative aspects, such as the strength of the idea or the potential of the investment opportunity, are often the most important. As a startup becomes more sophisticated, quantitative measures, such as projections and historical financial performance, play a greater role.

- **The leadership team**

  The people behind your company are just as significant as the product or service you're offering. An established, experienced team with a strong entrepreneurial track record can offer less risk for potential investors.

A savvy investor or private equity firm knows that even the best idea can fail without the right leaders to execute it. Entrepreneurs must be able to demonstrate the strength of their team, determine the skillsets needed to achieve key milestones, and identify gaps in their workforce.

- **Market size and trends**

Consider the total addressable market and your company's place within it, in the past, present, and future. Does your idea align with current trends? Is the market size (and your potential market share) large enough?

Investors will be influenced by what's hot in the market—and to an extent, so will your company's value. Your product or service may also have significance to a larger player who is seeking strategic acquisitions. A full understanding of where your company falls within the market can help you enhance your value and reach investors that align with your goals.

- **The company's financials**

As with any valuation, numbers play a significant part in telling your company's story. Are there projections for future earnings? What are the growth expectations? What is the quality of your revenue—is it recurring or dependent on net new business? Investors are increasingly concerned with the ability to earn net revenue, rather than top line gross revenue, which may not be as profitable or easily leveraged.

Ultimately, investors want to know how their funds will be used and whether the company has enough capital to reach its next milestone or financing targets. Your financial data should provide a realistic, easily digestible picture of past and future performance.

The investor perspective

To understand and communicate the value of your startup, it's important to know the mindset of an investor or private equity firm. Before any money leaves their pocket, a potential investor will consider a number of questions, including:

- What is my risk tolerance relative to the life stage of the company?
- What is the capacity for growth within the industry or market space?
- Who is leading the team and executing the strategy?
- Do I have a full understanding of the business?
- Do the financial records and general market trends support the forecast?

What should business owners and entrepreneurs do next?

Determining the true value of your young company is a blend of art and science. Challenges can arise if there are no historical earnings, if the company falls within a niche market, or if the business is based predominantly on intangible assets, such as intellectual property.

Entrepreneurs should consider the following:

1. **Define your goals** - While most early-stage companies conduct a valuation to raise capital for growth, some may undertake the process to support tax optimization or the issue of stock options. Setting clear objectives from the start can help you determine which milestones your company needs to reach and how to enhance your value drivers later on in the process. This also helps reduce tax risk or reporting complications, which can otherwise result in major business, financing, or deal issues.
2. **Know how to articulate your story** - Company owners must go beyond the technical aspect of the business and communicate a larger story and vision. Sharing this journey helps to form a stronger connection with investors and provides them with a full understanding of what your business does and why it has value.
3. **Be aware of disruption and market changes** - While the market can be difficult to predict, it's important to anticipate potential changes as much as possible. Stay in tune with the political, economic, social, and technological disruptors that could affect your industry and influence the value of your early-stage company.
4. **Organize your financial records** - Strong financial records add credibility to your valuation, as well as greater visibility into your cash flow rates and funding needs. While keeping track of finances can be a challenge for an already busy entrepreneur, cloud bookkeeping services can help owners strengthen operations and make informed business decisions.
5. **Don't go it alone**—engage an unbiased advisor - A professional valuations advisor can provide you with a complete and realistic assessment of your company's worth. An experienced consultant can help you prepare to negotiate with investors and navigate the opportunities and obstacles that come with raising capital.

Understanding your company's unique needs

A valuation is your story to be told. At BDO, we understand the significance of sharing that story with the world and the impact it can have on the future of your company.

Our team of experienced Chartered Business Valuators (CBV) works with tech companies across a broad range of industries and life stages to provide accurate value assessments. We tailor and scale our approach to meet your unique needs and help you gain insight into the investment community and potential financing sources.

Contact us today to start the conversation.

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