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Startup Funding and Valuation

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Lately, it has been raining Unicorns. Companies having a $1 Billion Valuation, are increasing rapidly. Not just the number, but even the time taken for few like Mensa brands to become a unicorn, has gone down to as low as 6 months! Due to these fast-paced transactions, it becomes important to understand the Start-up Funding and Valuation space at the basic level.

Today, Startups, whether funded by internal capital or external capital, are making it huge. Companies like Zerodha, Zoho have become unicorns without external fundraising. Nevertheless, most of the startups consume capital as quickly as they want to grow. The Startup Lifecycle starts from a Prototype (used for Product discovery) to building a Minimum Viable Product (used for customer validation) to reaching a Product Market Fit (used for customer creation) to finally Growth and Scaling. The ideal stage for a Seed Funding is after the MVP stage.

Startup Funding can be split into 2 broad categories:

1. Equity

a. Direct Equity:
This method is usually for the founder's infusion in the company. Direct Equity is also at times given to advisors who have played an instrumental role in helping the founder's build the company from the very beginning.

b. CCPS:
Most of the Startup funding that happens, is done via CCPS. Investors prefer this over direct equity because of the obvious liquidity preference. Nowadays, there is also very prominent use of the iSAFE (India Simple Agreement for Future Equity) by early-stage founders where deriving a valuation at the present stage may be difficult as very little discovery may have happened. It legally takes shape of a CCPS but helps standardise the documentation process. It postpones the tedious negotiation process for the clauses like Tag along, Drag along, Board Seat, etc, which may not be of significance at the early stage of a startup.

2. Debt

a. Convertible Notes:
These are originally debt instruments convertible into Equity going forward. The process is simpler to a full-fledged Equity transaction but comes with a monthly interest payout. It is beneficial at a point of time where valuation derivation is difficult. These can become complicated going forward as the conversion depends on the round dynamics of the future round which is very uncertain. In case a future round does not happen as expected, one may end up having the headache of monthly interest payments for a longer time than expected.

b. Venture Debt:
This form of fundraising is used for mature/venture-backed (having already raised several successful rounds) startups who may not want to dilute their Cap table any further. Venture debt can be provided by both banks specializing in venture lending and non-bank lenders. Venture Debt is given without any underlying security, as startups do not own any assets that can be used as a collateral. The lenders are compensated with

the company's warrants on common equity for this high-risk debt instrument.

Coming to **Valuations**, since the companies are at a very early stage with barely any measurable bottom line, it can be tricky and subjective. Startups are all trying to create something new and have a moat, hence there is no history, no track record and barely any comparison.

These modern companies need a modern approach. One cannot stick to the traditional textbook methods. Having seen the early-stage startup industry closely in the past, I have realised that there is no one answer to Valuations. But, there are few factors to be accounted for the same:

1. Quality of Founders: Since these are mostly just ideas, backing the right founders is important. Their domain expertise and execution skills is something which will matter in the long run. There will always be more than 1 company trying to build the same thing. But, the founders who execute it better, wins the valuations game.

2. IP: Having an IP helps create a differentiating factor and a high entry-barrier for other startups. This ensures a higher market share for the company. IP also creates an asset for the company which will have value in the future, if one is selling off the business. Hence, this ensures a higher valuation when there is some kind of disruption happening via IP creation

3. Key Metrics: As Bottom line is negative for startups, one has to approach the topline or any other key metrics that may be relevant to a particular startup. Today, many companies are being valued at a Multiple of their ARR (Annual Recurring Revenue). Software/SAAS companies are able to get higher multiples than Hardware based companies. Companies without any revenue can measure it based on number of Downloads, User engagement and Analystics, Community built, etc.

A lot of early-stage funding also depends on the amount of capital needed by the startup and the extent of dilution they are willing to undergo. Certain investors do not invest if they do not get a specific percentage ownership in the startup.

Companies that have steadier cashflows may still follow the regular Discounted Cashflow Method (DCF). Peer Comparison is something that we do to calculate the Enterprise Value for the purpose of Valuation Reports, but practically that is also very subjective. Startups are all about execution! Just because a company raised big in the US, does not mean a company in the same domain is meant to be given a high valuation when it is still at Stage Zero.

Deriving higher Valuations for startups riding the trend like Web3, Blockchain, Crypto, etc. may be good for the startup founders and their early investors at present, but us CAs should be vigilant of the real situation and advise startups correctly, while deriving the Valuation Reports.

It is eminently seen how startups like Paytm, Nykaa, Policy Bazaar having gone for IPO with high valuations, are now falling down. While entering this space for investment, do not get blown away by the valuations that are being seen, but decide whether the company can be profitable/viable at in future and return something to the investors. Otherwise, it is loss of wealth rather than wealth-creation for the general public who is trusting these valuations and putting their hard-earned money in these listed startups. So, while startup funding and valuation is tricky, investors have to exercise Caveat Emptor, and only time will tell whether the Valuations are justified or a sham!

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