Guest Column: What’s My Valuation?

Part I: Evaluating Valuation

By Stu Strumwasser, Founder & Managing Director, Green Circle Capital

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As an investment banker in the Consumer space (focused on natural products) who often talks with the CEOs and owners of early-stage and growth-stage companies I am frequently asked, “What’s my valuation?” My short answer is: “Whatever the market will bear.” It rarely satisfies.

The long answer is some version of a conversation that all entrepreneurs, business owners, executives, investment bankers, accountants, corporate and M&A attorneys, investors and others have had countless times—a discussion of the methods and metrics utilized to arrive at valuation for investment transactions involving businesses with limited operating histories and/or at a stage in their development where they have not yet generated consistent positive cash flow. The productivity and tone of those conversations depends on the experience, sophistication, and personality of the participants, but also includes a myriad of other factors such as the temperature of the respective rooms they sit in, the “breaking news” on CNN, the direction of the NYSE that day (or minute), whether Mercury is rising (and/or in retrograde) and possibly the early-morning tweets of our elected officials…. As any forensic accountant will explain, the most important data point in any assessment of the "fair market value" of a private stock is what an objective and unaffiliated party has actually paid for shares. (In the parlance of my Brooklyn neighborhood: "Money talks; bullsh*t walks.") In the case of a large, publicly-traded company on a major exchange, one might only need to look as far as the closing price on a particular day in history. For a private stock, it is more complicated. If that private stock hasn't been transacted recently (or ever) it can be far more nuanced. I've had these conversations more times than I've seen a new plant-based, protein-fortified, organic, meal-replacement bar at Expo West, and they often devolve into unproductive philosophical musings or even awkwardly contentious debates. I am sure that every investment banker who works with early-stage or growth-stage companies has asked themselves, on many occasions, "Do I tell this guy the truth and risk losing the opportunity?…. as well as another twenty minutes of time?…" After all, in the end it isn't up to us (the intermediary investment banker); it's what the market will bear. Or bare.

"What's My Line?" was a panel game show that originally ran on the CBS Television Network from 1950 to 1967. The game required celebrity panelists to question a contestant in order to determine his or her occupation by attempting to learn new information and narrow down the options. "What's My Valuation?" is vaguely similar. The more early-stage the business, the less the valuation is a function of traditional metrics (such as multiples to EBITDA and/or revenues) or "math," and the more it becomes a function of artistry. It's actually one of the reasons I like working with smaller company clients (for us, typically $5MM-$50MM in revenues) as it is more creative, we have a greater opportunity to make an impact, and we can add value for our clients by deftly creating the right environment for a transaction and by generating competition for the asset which we endeavor to sell. Unfortunately it also often sets the stage for those meandering "What's My Valuation?" debates, so I thought that it might be helpful to some CEOs/CFOs, business owners, investors, and my colleagues, to jot down some of the thoughts I have shared many times on this subject over the years in individual conversations.

When I meet leaders of growing businesses I ask them to, "Tell me about your business." What I often get in return is a thirty-minute dissertation on their product, often replete with some hyperbole about future (and uncertain) sales opportunities, and very little about what I was actually interested in: the existing distribution, sales velocity (the "mother of all metrics"), gross margins, gross and EBITDA margin goals that are achievable with the evolution of scale, go-to-market strategy, capitalization to date and…. the company's future financing needs and plans. "Important Paradigm Number One" for founders: If most startups that fail do so because they run out of cash, maybe you should spend even more time focused on understanding and securing the financing you need (and less time dreaming up marketing campaigns that you can't yet afford). I became a vegetarian when I was fourteen (and I have now turned 39 twelve times, so that was quite a while ago) and I founded a natural soda company in 2005 partly because I genuinely wanted to help save consumers from harmful chemicals contained in traditional CSDs. So I get it if money isn't your sole priority. However, if it isn't near the top of the list perhaps you should live on a self-sustaining family farm (albeit an organic one) and not be asking other folks to invest millions of dollars in a for-profit business venture.

Why are so many founders/executives/owners of growing businesses deeply concerned—or even obsessed—over valuation? I don't know, but it really can be counter-productive. When I raised capital several times I was of course committed to getting a fair market value, but I was never clutching some hypothetical and somewhat-arbitrary figure with cold, dead hands. I made countless mistakes as a founder and operator (for a summary list just take a look at the playbook for Zevia, check out everything that they did correctly in terms of execution, and then just assume that I did the opposite)—but getting stuck on a valuation goal was never one of them. It leads me to Important Paradigm Number Two: No one ever went out of business due to dilution.

Some business owners think, “Well, can’t I just start real high and know that I can always come down in price if necessary?” Um, not necessarily. When you are trying to make a deal with someone who you think is asking for something unreasonable, do you always make a counter-offer and try to work it out? In the case of a prospective investor assessing a potential investment, bear in mind that the biggest factor in his or her decision will often be their evaluation of you, the entrepreneur. Appearing unreasonable or, perhaps, potentially uncompromising or difficult to work with, is not a good way to begin.

Here’s one other thing to consider: If you think that your deal, inclusive of proposed valuation, is “fair,” is that really enough? When you go shopping, whether it be for a car, a skateboard, a stock…. A private stock in an early-stage natural products company…. Do you find yourself looking for a “fair deal” or “the best deal?” It is sometimes lost on Founders and CEOs that the investors they are pitching (sometimes with the help of a firm like mine) see a lot of investment opportunities. In fact, most institutional investors or serious angels look at a few hundred each year. They might make perhaps one or two investments each fiscal quarter, and some even less. So, whether one acknowledges it or not, you are competing with hundreds of other investment opportunities, some of which are surely also attractive. You are soliciting investors who may “pull the trigger” on around one percent of the opportunities they see, so anything that may give them a reason to pass on a deal is actually helpful to them in managing their time and dealflow, and narrowing down their choices. Don’t let getting stuck on an above-market valuation be the reason you miss out on getting the cash you will certainly need to grow a capital-intensive CPG business, or lose a chance to connect with some folks who might have been excellent value-added partners. Closing on a timely financing or acquiring great partners can turn out to be a critical component in your success, and giving up a few extra points in dilution will never be the reason you fail.

In Part II, Strumwasser examines the methodology for actually arriving at fair market value for growth-stage natural products companies using comps and other tools. Check back next week.

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Part 2 – So… What is My Valuation?

By Stu Strumwasser, Founder & Managing Director, Green Circle Capital

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In Part I of this series we talked about some of the misnomers related to valuation for early-stage and growth-stage natural products companies. Our key advice is to avoid getting too dug in about a particular valuation if the market tells you it is not the right number, and also to avoid marketing a number that may appear to be clearly above-market.

So how does one arrive at a fair valuation for shares of a private stock that has not recently been transacted (by NON friends and family members)? Like anything else one might wish to sell, such as a house or a car, it begins with "comps." Using the common analogy of real estate, think about it this way: if you own a 750 square foot one-bedroom apartment on the Upper West Side of Manhattan that you have decided to sell (perhaps because you want to upgrade and come live in Brooklyn, Yo!) you begin by checking the most recent sales for other one-bedrooms on the UWS. Once you can stop patting yourself on the back for how "smart" you were to buy that apartment years ago (and once you are done daydreaming about how many thousands of square feet, and acres of property, you could trade it for if only you could get comfortable with the idea of waking up every morning in central Jersey) you have a basic range of value that might apply to your apartment. Then, you can justify a premium (or concede a reasonable discount) to the average price based on whether your apartment is bigger or smaller than most, is on a nicer block, contains a recently-renovated kitchen, has a better or worse view…. Comparables (or "comps") are the second most useful guide for arriving at a fair valuation on any asset. And what makes for a "good comp" is that it is most similar to your own asset.

What's a bad comp for an early-stage natural products company? Krave! Krave is a bad comp. I am aware that Krave was sold at a very high multiple to sales. However, unless your business already generates over $30MM in annual sales, is enjoying stunning triple-digit growth, makes a ground-breaking natural product that has completely revitalized what was formerly a stale category, and is about to get purchased by one of several large and uneasy strategic acquirers who are losing market share on many of their core products… your company is not (yet) Krave. Here's another: Bai. In the context of an early-stage CPG company a premium or discount to average valuation isn't imparted because of the size of the apartment or the view. The factors include things like growth rate, size/scale of the business, sales velocity, margins, previous successful exits by management, size of the category, industry tailwinds, etc. A young business that is kicking ass at a run rate of, say, $3.4MM (up from only $1.9MM just a year ago) still isn't Bai. Don't get me wrong: a unique product that's enjoying nearly 100% growth is amazing, but it still doesn't make sense to compare that apple to Bai's.

When I ask a prospective client what they think might be a fair valuation for their business I am not looking for a hard answer. After all, it isn't ultimately up to them any more than it is up to me—it's only decided by someone who can sign a check (that clears). What I am looking for is a rough sense of what you expect and whether it is fair and reasonable based on the current market. That gives me insight into whether exploring the opportunity is a good investment of my time. My job as a banker is to get the best possible price and terms for my client. If he/she is looking for something completely unrealistic, I am less likely to achieve his/her goals (and less likely to earn a living, as the vast majority of my compensation comes only in the form of a "success fee," paid if and when a transaction closes, and my time is my most valuable—and limited—asset).

The natural products space is on fire. According to an article in AdAge (by Jack Neff, 9/30/2015) Catalina stated that 9 out of 10 of the 100 largest CPG companies that sell food or beverages (in other words, essentially "all" of them) had lost market share from June 2014 to June 2015. That trend has not changed, and market share is being lost to startups and growing companies, almost all of which are disrupting large and established categories with natural/organic and other better-for-you alternatives. To a guy like me this is amazing and inspiring, and I feel gratified all the time for opportunities to work with such entrepreneurs. ("Those who can't do, teach," and those who can't found and then exit, bank.) Anyway, valuations are high. They may or may not be too high, but the fact is that they are high. Still, there is high, and there is really high (like a THC-enriched product available only at dispensaries in CO). Founders/CEOs of sub-ten million dollar food and beverage brands often tell me that they want to get a valuation of three, four, or even ten times sales. That's high.

When I was raising money for my own company a decade ago I sometimes referenced Vitaminwater. I cringe now to think how some investors may have been smirking on the other side of those phone calls. More recently, it was commonly reported that DPSG paid around seven times trailing sales for Bai. So let's break it down:

- With size/scale comes multiple expansion. If a business that is doing a few hundred million in revenues (such as Bai) is worth seven times sales, a business that is three percent as large as that is worth… less.

- Bai was in national distribution, growing rapidly, probably had far better margins than most early-stage businesses and still enjoyed substantial headspace in an enormous category (non-alcoholic beverages) with tremendous favorable dynamics (in the form of billions in CSD sales eroding every year and being transferred to natural and low-calorie offerings). All of those factors point to a premium valuation for Bai (or a lower one for a company that does not embody all of those attributes).

- With a “change of control” in an exit (a sale of the company) comes an additional premium in valuation that investors will pay, versus lower multiples that are typically applied to minority investments made in growing companies.

So what is the right valuation for a growing brand, generating perhaps $5MM or $8MM in revenues, that makes a cool and timely natural product, with good growth and healthy margins? Answer: whatever the market will bear. Guidance: in a normal universe, the answer might be a range of one or one and a half times LTM (last twelve months) sales, but these days, it’s probably closer to two or three times sales. Still, it’s not five, and it is certainly not nine—despite what our heroes got for vastly different businesses.

Unfortunately, there aren’t a lot of other tools that one can draw upon to assess (or defend) the valuation of an early-stage business with a limited operating history and/or not yet generating positive cashflow. I asked my colleague, Jeremy Friedman for his input. Jeremy’s the “finance guru” on our team. (He spent a lot of time at Booth perfecting Excel skills and just generally being real smart. Just ask him…) Anyway, I asked Jeremy whether he thinks that a Discounted Cashflow Analysis (DCF) really has merit when applied to early-stage businesses. I got a two part-answer, the first section of which I kind of expected, and the second part of which was very insightful to me, and may therefore be helpful to you.

About DCF: The use of a Discounted Cashflow Analysis, wherein the analyst assesses the future cashflow-generating capacity of a business and then backs into a current valuation by applying a certain discount to market-rate multiples based upon the degree of perceived risk, is not necessarily applicable if there IS NO cashflow. Analysts will often rely on projections, but that only raises another question: How reliable are your projections? Early-stage companies rarely hit their latter-year projections. It’s okay. We get it. No one is going to love your baby as much as you, and you may not be wholly unbiased when it comes to your progeny’s potential, so being a bit overly optimistic about where you’ll be in five years is normal, and easily forgiven by investors. However, sophisticated investors are not going to agree to a valuation that is based on little more than your hopes and dreams. Having one or two great years of sales growth does not necessarily make for a reliable trend, and explaining all of the reasons that your business is going to Krave-Bai into the stratosphere at some point in the future doesn’t mean it will definitely happen. Sometimes, early-stage businesses actually fail to achieve their projections. I swear. It can happen.

So when I asked Jeremy to give me suggestions for other tools that growth-stage business owners can utilize to try and ascertain reasonable valuations, he advised me to advise you to not try and rely too heavily on math, or DCF analyses. I thought he might say that. What surprised me was that he then suggested empathy. Empathy. I swear. It happened. I had already suggested using comps with some “artistry,” but then he threw empathy into the mix. At first I thought that perhaps it was time to cancel the article. Then he explained: Just try to put yourself in the shoes of the investor. If you have a $5MM or $10MM or even a $16MM revenue food or beverage business, there is still a lot of risk. At its core, every investment is a balancing act between assessing the risk and the potential reward. Jeremy pointed out that the majority of entrepreneurs fail. Of the ones who succeed, only the smallest fraction ever found a business that one day grows into having a value of a billion dollars. Only a very small fraction launch a brand that ever even achieves an enterprise value of $100MM. Is $100MM shabby? From our perspective, if one started a business on nights and weekends that somehow grew into a real company and then one day was worth $100MM, that would be an incredible accomplishment.Now think about the investors who were asked to fund such companies during their Seed or Series A financings. If the company was generating $7MM in sales and the owners insisted on a $12MM pre-money valuation for a $3MM capital raise (meaning a post-money valuation of $15MM) achieving an enterprise value of $100MM someday would translate into a nearly 7X return on capital for early-stage investors. That's good, even if they did take a lot of risk. Conversely, if the owners insisted on a pre-money valuation of 4X trailing sales, or $28MM (as some attempt to do) achieving a $100MM enterprise value someday would only translate into a return of around 3X for investors who took tremendous binary risk ("binary" as in maybe win a lot, or maybe lose it all). Even institutional investors deserve a little empathy. Sometimes. Seriously, it's simply not market (or fair) to ask investors to make an investment wherein the only chance of them getting a return that is commensurate with the risk they took, is if your brand becomes the one-in-a-million-unicorn worth billions.

So now you know the secret. How does one arrive at valuation on a growth-stage company? With artistry and empathy. Check Wikipedia; it says so right there. And this entire discussion of empathy reminds of a parable which I will now share with you in closing the second installment of this series: If you encounter someone who you think is a jerk (or wrong about your valuation!) don't judge him until you walk a mile in his shoes. If you do, and you then decide that he's still a jerk, well at least you're a mile away. And you do have the guy's shoes.

In the third and final installment of this series, we will talk about the uses (and mis-uses) of convertible notes in growth-stage transactions for natural products companies.

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Pt. 3: Should We Just Agree To Disagree?

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Part II of this series focused on the correct and reasonable methodologies for determining fair market valuation for a growth-stage natural products company by using comps and other tools. When a business is too early stage (or not yet generating consistent positive cashflow) relying on traditional financial metrics (starting with multiples to EBITDA adjusted for growth rate, size of margins, etc.) is not possible. In such scenarios, one must rely heavily on comps, artistry, a vague assessment of risk/reward and, as we suggested, the utilization of "empathy." (Yes, I am aware that sounds odd. Rather than explain it again, please glance at Part II). Comps are very important, and in Part I we discussed what makes for a good comp or a bad one. Most importantly, just try to find apples that are most similar to your own apple, and don't get confused (or appear stubborn or unfair) by trying to draw comparisons to oranges.

Speaking of things that are orange, in Part III I'm going to address that pink elephant in the virtual room—Donald Trump. JK. What I really want to comment on is convertible notes. Using convertible notes, as opposed to equity with a specific share price and corresponding valuation, allows the company and investors to avoid agreeing on price, when doing so is tricky and uncertain. However, convertible notes are like pina coladas. There is a time and place for them, but you don't want to use them in most ordinary situations. Stated differently: it's great to sip on a pina colada once a year when sitting poolside during your tropical vacation, but you don't want to be overheard ordering that concoction at 10PM on a regular Tuesday night at Peter McManus's. Similarly, convertible notes can be an appropriate instrument in certain situations—such as bridge financings funded by existing shareholders—but the idea that convertible notes are a panacea to help companies and investors avoid the need to fairly agree on price is incorrect.

A convertible note is a debt instrument, or loan, that eventually will be converted into equity (stock) at pre-determined terms and usually at a time triggered by some future event like the next financing. The loan will convert into shares at a discount (often 20% or 30% less than what new investors are paying) and interest payments which accrued (if they accrued and were not paid out in cash) may also convert into additional shares. Using a convertible note without a "cap" (or maximum conversion price) is something very few sophisticated investors will ever do. Doing so is tantamount to loaning a company money so it can create value and thus justify a higher valuation in the next round (when those original investors will be converting) thus costing themselves money. It literally ends up enabling the company to use investors' own money against their economic interests.

Using such an instrument can make sense when the people funding are existing shareholders who already have a stake in the company's success (or continued existence). Not only are these shareholders/investors looking to make a good return on the new investment, but they have other factors affecting their investment decision—their desire to protect their initial investment which is already made. As they are already owners of the Company investing in a transaction that is preferential to the Company is more acceptable to them. Furthermore, if the Company is low on cash, or in some way distressed, it might be beneficial to the Company (and thus to their existing investments) to avoid the perception of a "down round" and finance continued operations and growth with an un-priced security (the aforementioned convertible note) because that could be best for the Company, and thus for their stock in it.

That is not, however, the case for new investors. They have no existing and vested interest in the business yet, and therefore would have no motivation to help the Company maintain valuation optics. They certainly have no reason to want to allow their capital to be used against their own economic interests, and asking them to do so would be unreasonable. To illustrate: if a company is worth between, say, $4MM and $6MM, and the founders and investors can't agree on a price, they might decide to kick the question down the road by using a convertible note. They might agree to give investors an 8% accruing dividend and to convert at a 25% discount to the price established in the next round (when there are sales and better metrics by which to assess fair valuation). Perhaps the company raises two million dollars in the convertible note round, and with it they generate great traction and meaningful sales. At the next round, two years later, it might be reasonable that the company justifies a $15MM valuation to new investors. The initial investors who participated in the convertible note will therefore convert at roughly a 41% discount (25% plus two years of 8% dividends) or a valuation of $8.85MM. That sounds good compared to $15MM, but it is still far more than the $4MM-$6MM they all thought the company was worth when they invested. Their own money was used against them. And who are these initial investors who participated in a convertible note with no cap? Well, it is unlikely that they were professionals. They were probably friends and family of the founder(s)—and they were given a raw deal, usually without the founders even intending to do so. They thought it made sense to avoid pricing the round because someone incorrectly decided that it was "too early to determine a fair value."

In recent years, the use of convertible notes is usually inclusive of a "cap." However, a convertible note with a cap is not an "un-priced round"—it is simply a round with a "maximum price." While this does limit the risk to investors of their money being used against their own interests, excessively, it can still create other problems. Having a "maximum price" starts to appear, in terms of optics, like a "price" to investors who will assess the investment in the next round. The cap was agreed upon as a "maximum" because both parties felt that it was the highest possible fair valuation. It is therefore quite logical to expect that the next round might need to be priced lower than the cap in order to be priced attractively when the time comes to raise more capital. It may then beg the question, “What went wrong?” even though nothing did, and may give the company the stigma of appearing to be conducting a “down round” because the business is struggling, when in fact things might be going quite well.

Using a convertible note is also a fundamentally flawed way to begin a relationship with your capital partner. It can lead to unrealistic expectations or disappointment over perfectly acceptable outcomes—all of which might have been avoided by better clarifying the valuation of their investment and simply agreeing on a specific price upfront, ensuring that everyone knew exactly what they signed up for when the wires hit. To read a bit more about why convertible notes can be problematic check out a great post by another opinionated guy—Mark Suster from Upfront Capital posted an article called “Bad Notes On Venture Capital” on September 17, 2014. I don’t know Mark, but when a friend forwarded this blog post to me a couple of years ago it had a real impact on me (how great an impact, exactly, will be determined by applying a 25% discount to the amount of the impact at the time of my next life-changing experience).

Here’s one last point that many passionate and confident entrepreneurs also lose sight of when getting stuck on valuation: If you really believe that you have a chance to be the next Bai, or Krave, or Whitewave, or Chobani, or popchips, or Kind, or Plum Organics, or Annies… then a few points either way on your valuation is immaterial. A valuation below what you might have otherwise gotten won’t kill you; but a great, value-added capital partner is often transformative to helping a business succeed and scale. So make a fair deal. Get the money, because cash is still king, and because no one ever went out of business because of dilution. While the odds simply dictate that many of you will fail, some of you WILL succeed. I, for one, will be rooting for you all, because you are the artists of the business world. You are the pilots of innovation and when your talents are applied to consumable products, you also generate ancillary benefits to the world at large, by contributing to the health revolution taking place in America. As a guy who was often criticized for the way I ate, decades ago, I feel a bit vindicated, and included, every time I see another one of you succeed—even if I am occasionally still a bit jealous.

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