IS YOUR BUSINESS VALUATION SUPPORTING YOUR GROWTH JOURNEY?

Getting an accurate and reliable business valuation of your tech company could play a key role in its success.

TECHNOLOGY

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BRIGHTER THINKING

A comprehensive guide to valuing your growing technology business.

Business owners and entrepreneurs in the rapidly evolving tech industry are aware of the revenue-generating potential of their business. However, the success of their business depends on the lifecycle of their products and the resources required to bring their potential to fruition. The growth process will inevitably require an accurate business valuation at various points along the way, for example in preparation for funding rounds, for staff equity incentives and in preparation for restructuring, transfer of shares, or sale.

Valuing tech companies can be tricky. Start-ups may not have a revenue history or tangible assets, and even those with prototypes may not be sure of market demand. Although patents and intellectual property rights have value, estimating revenue based on such intangible assets can be challenging.

The valuation of tech companies tends to increase as they grow, but sudden growth spurts can make it hard to predict future profits. Market changes can also cause demand to rise or fall unexpectedly, making profit projections uncertain.

Understanding the right timing to initiate a valuation is essential, as well as finding an advisor who understands the unique challenges involved and how to overcome them.

This guide explores the reasons why a business valuation may be necessary for a tech business, along with important factors to consider during the valuation process. Additionally, it provides an overview of various valuation methods and their suitability for different situations.

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RAISING FUNDING

Tech companies may be reliant on funding rounds to raise the capital necessary whilst preparing a new product or continuing development. Investors will want to know where their investment is going and what returns they could expect.

A valuation assists potential investors and investment funds who are weighing up or justifying an investment. Any valuation would need to be based on a well-supported strategic growth and business plan with detailed forecasts, especially in the current economic climate.

INCENTIVISING EMPLOYEES

Fast-growing businesses are always on the look-out for talented individuals to support the delivery of their strategic growth plan. Tech businesses will require some highly skilled individuals and recruiting them for the right roles is never easy but retaining them can be even more challenging.

One way to retain talented people is for business owners to introduce employee share incentives, for example an Enterprise Management Incentive (EMI) scheme. This tax-efficient scheme allows business owners to give key employees share options, which they can exercise at a pre-defined time in the future, based on the current market value at the time that the options are issued. These schemes are designed to incentivise employees; encouraging them to stay and grow the business, adding to its value over time.

Before introducing an EMI scheme, it is best practice to carry out a valuation and seek the approval of HMRC. This will help to mitigate the risk of a HMRC challenge arising at a later date and optimise the tax advantages for the employees when they come to exercise their options by selling their shares.

Valuations should also be carried out when other employee share incentives are implemented; including Growth Shares, unapproved share option schemes and gifts of shares. Although these do not require the upfront approval of HMRC, open dialouge could help to mitigate risks in the event of an enquiry.

SHAREHOLDERS: THINKING OF REALISING VALUE?

A valuation will also be required if a shareholder is looking to realise value and sell their shares, assuming the Articles of Association or Shareholders' Agreement allows for this.

In some cases, the company will be seeking to buy back the shares, but in order to do so, they need to understand their commercial value and the company's ability to purchase the shares from its resources. This could also be used as part of the severance negotiations.

Alternatively, the majority shareholders may be looking to restructure or exit the business and exploring the various options available. A valuation could assist in their strategic decision making and planning for the future.

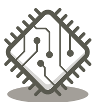
UNDERSTANDING THE INFLUENCING FACTORS

Tech companies can be challenging to value for a variety of reasons.

Early-stage businesses generally lack a revenue-generating track record and tangible assets. Even businesses that have already raised a significant amount of capital to develop a prototype cannot be certain of market demand. Patents or other intellectual property rights have a commercial value, but predicting revenues based on the use of the intangible assets are notoriously difficult.

As tech companies start to trade, its valuation would be expected to grow. Some may experience a sudden growth spurt, which makes it difficult to project profits with certainty. In other instances, markets could shift in an unexpected direction, causing demand to skyrocket or plummet, taking any prospect of projected profits with them.

Some factors that could influence your tech business valuation include:



Software or hardware?

Tech-led businesses tend to be innovators of either software or hardware. In order to produce an accurate valuation, the valuer should ensure they understand the business and the needs of the end user.

How established is the business?

Established businesses have a trading history, which could be used in the valuation if the historic financial performance is reflective of forecast future earnings. Early-stage or high-growth businesses could be valued based on insights from robust forecasting models and a clear understanding of their revenue-generating potential.

Current economic factors

Given the current climate, business owners are faced with an increasing number of challenges. The after effects of the Covid-19 pandemic and Brexit, combined with a sustained period of high interest rates and inflation, mean that it may not be possible to place too much reliance on historic financial results.

What is your revenue-generating model?

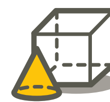
For growing businesses or those looking to scale, understanding how the business will generate revenue is fundamental. For example, the business could generate recurring revenue from royalty payments based on licensing agreements. Alternatively, the primary source of revenue could be direct sales, which might vary from month to month, but provide an opportunity to build strong customer relationships.

Is the market still developing?

Businesses operating in a developing marketplace may attract a higher valuation than those targeting a market that is at a mature stage. Understanding the life cycle of the business will play a key role in determining its value. There may also be barriers to entry in some markets, which need to be considered.

Does the business need to raise funding?

Many tech businesses require an injection of funding to get started or to further their growth plans. In a climate of economic uncertainty and high interest rates, this is likely to become more challenging to achieve, so a valuation should be based on a well-supported strategic growth plan.



Does the business have any assets?

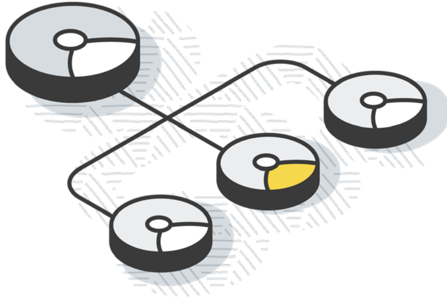
Early-stage tech businesses may lack tangible assets, including property or expensive capital equipment. However, the business may have secured a patent or other intellectual property (IP) rights at an early stage before any details are shared with third parties. IP rights ownership can be a significant factor, due to the Patent Box regime, which allows UK-based businesses to benefit from tax relief on profits generated from the sale of patented technologies.

IP and other intangible assets could make up a large part of a business' value. Even if the business does not have any assets now, it may be developing customer lists that could command a significant value in the future.

Is the timing right?

A business valuation can typically take three to four weeks to complete, longer if HMRC approval is sought, so it is important to plan ahead, ensuring that all documentation and reporting is up to date. Strategic advice on timing considerations should be sought. For some, it may make sense to wait until after the end of the financial year, but in other situations, starting early may be the best strategy; securing a low valuation before the growth journey gets underway.

VALUATION METHODS



There are many factors to consider when producing a valuation, and there is rarely one answer. When valuing a business, it is important to consider timing, key financial data, such as earnings before interest, tax, depreciation and amortisation (EBITDA), and assets. In particular, asset value (tangible and intangible), cash flow and performance trends of the business, as well as market trends and benchmarking data.

The rights attaching to the share and intellectual property in the Articles of Association and Shareholder Agreement, if any, must also be reviewed during the valuation.

Some of the methods that could be used for valuing a tech business include:

Capitalisation of Earnings

The capitalisation of future earnings or 'multiple of earnings' method is typically used for valuing a controlling interest in a business.

The multiple attributed to the business can be based on the growth of similar companies operating in the same market, or on comparable transactions. It should also take account of variable factors such as marketability and control.

The multiples applied can be undertaken with reference to various earnings levels – for example, revenue, EBITDA, EBIT or post tax profits. In most cases, this valuation method delivers an enterprise valuation, and further adjustments based on the debt and cash position of the business would be required to achieve an equity valuation.

This method is particularly appropriate for the valuation of businesses that have steady growth forecasts, regular capital expenditure requirements and a long-term future, so may not be appropriate for an early-stage tech business.

Discounted Cash Flow

Discounted cash flow (DCF) is a method for calculating the value of a business based on its expected future cash flows.

Using this method, the valuation of a business depends on an assessment of its future net cash flow, subject to a 'discount' that takes account of any risks associated with achieving those cash flows and the time span over which they will be achieved.

While it may be used for any valuation, it is particularly useful when valuing high-growth tech businesses or those with irregular cash flows.

This model requires reliable cash flow forecasts, and it must also be possible to identify a suitable discount factor.

Net Asset Value

An asset-based approach to valuation is based on the company's net asset value. In simple terms, it can be described as taking the value of a company's assets and subtracting any liabilities.

This method is most appropriate for businesses that derive income exclusively from their asset base. This approach however will not incorporate much of the intangible value in a business and should not be used for valuing a trading entity, so is unlikely to be suitable for innovation led entities.

Intangible assets could make up a large part of a tech business' value and they should always be considered as part of any valuation. They can include computer software, patented technology, databases and licence agreements.

When valuing intangible assets, different methods can be used which include the cost approach looking at the replacement cost; the market approach looking at information from market transactions involving comparable assets; or the income approach looking at the cashflows that the asset can be expected to generate in the future over its remaining useful life. This can include using the relief from royalty method which is the present value of forecast royalties avoided, or multi-period excess earnings method which is the present value of residual forecast cash flows.

Traditional valuation methods may not always be suitable for valuations of start-ups. Alternative methods such as the Scorecard method, Venture Capital method or Berkus method may be more appropriate:

Scorecard method

The scorecard method is based on comparisons with similar start up companies that have recently been funded to obtain an average pre-money valuation. This value is then adjusted based on certain aspects that are important to the company being valued. These can include the management team, product/service provided, the technology involved, size of the market for the service and competition and size and need for additional investment.

Each aspect is assigned a percentage score based on its importance, then compared to similar companies and assigned a score on whether it is stronger than the other companies. This weighted average is applied to the average pre-money valuation to obtain the value of the company.

This method can be suitable for start-ups where there is limited or no historical financial information, although it requires a detailed understanding of the company involved, the sector and process of the method.

Venture Capital method

The Venture Capital method is used to establish the pre-money value by assessing the exit value.

The value is estimated at the time when an exit is anticipated and is based on the expected multiple of earnings at that point. This value is then discounted back to the valuation date to obtain the pre-money value.

This method requires reliable forecasts, and it must also be possible to identify a suitable discount factor.

Berkus method

The Berkus method is an early stage valuation method to find a starting point for a company’s value. It focuses on five areas and applies a value by assessing the quality of each area.

The areas are the quality of the management team, the company’s idea, working prototype, the quality of the board of directors and product rollout and sales. The sum of the values applied to each area provides a base pre-money valuation.

This method can be suitable to find a starting point of a start-up’s value where there are limited or no financial forecasts, although again it requires a detailed understanding of the company involved, the sector and the process of the method. It is not suitable for a company with recurring revenue.

The most appropriate method should be applied taking into consideration the economic benefits and the valuation inputs available. Considering a valuation under multiple approaches is advisable where possible.

FINDING THE RIGHT ADVISOR TO VALUE YOUR BUSINESS

It is important to choose the right team of advisors who have relevant knowledge and experience, combined with a genuine interest in supporting the growth journey of your business.

Our advisors will work closely with you to gain a full understanding of your tech business and its market potential, offering:

- Knowledge of the tech sector
- Experience and understanding of the target market
- Grasp of specific challenges and opportunities facing the company
- Business' strategy and objectives
- Experience of preparing valuations using more than one appropriate valuation methodology

With the right advisors at your side, you will be better prepared for negotiations with investors, potential and existing employees or exiting shareholders, and better placed to realise growth on the way to a successful future.

NEXT STEPS

Menzies has a team of business experts dedicated to the fast-paced tech sector, all of whom understand the unique challenges faced by growing technology businesses. If you would like to discuss any of the topics raised in this guide, or get expert advice about how to grow and manage your business, please contact one of the team members below, or email: advice@menzies.co.uk

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Our team has vast experience of working with businesses of all sizes from large corporates to SMEs and privately managed businesses.

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