Forbes

Marianne Hudson Contributor

I cover angel investing – trends, ideas and how to succeed.

ENTREPRENEURS 10/21/2016 @ 2:18PM | 980 views

Do Startup Valuations Matter As Much As Most Angels Think?

Angel investors are constantly seeking new tools, strategies and approaches to invest wisely. After all, picking winners isn't easy. Angel portfolio research shows a better than 50% probability that an angel investment will result in a loss. Obviously this is moderated by some big key wins that make up the difference. However, the spiky win-loss ratios that angels experience aren't surprising since angels invest so early in startups. This makes it extremely challenging to mitigate market, product and team risks. That's why angels rely on things like pre money valuations as part of their decision-making on investment opportunities.

As with all things in early-stage investing, angels have different experiences and views about what works best. And we keep searching for new ideas. That's why I was intrigued when I heard the approach used by Keyvan Firouzi, Director of Valuation Services for Gust. Results of a two-year research project he conducted have emblazoned Keyvan with a point of view that many will find controversial—and intriguing. Keyvan says, "Over-emphasizing pre-money valuation is a dangerous way of thinking." He backs this up with some thought-provoking ideas that he will share at an upcoming ACA webinar which is sure to inspire a lively debate. Here's a primer on his approach.

Keyvan Firouzi, Director of Valuation Services for Gust

A Strict Reliance on Valuation Might Mean Missing Big Home Runs

Angels rely on smaller pre-money valuations to increase their company ownership. However, using a small pre-money valuation as an investment criterion could significantly curtail an angel investor's upside. In researching first reported financings that resulted in big investment wins, Keyvan found that companies like Square, Etsy, Shopify, Twitter, Lending Club and others, all have much higher pre-money valuations compared to industry averages or medians. These companies are not the norm. They are outliers, and they are the kinds of companies Keyvan says angels should look for.

The most negative impact on an angel investor's ownership comes from future down-rounds, future preferred investors with higher preference multiples or forced for dividend, or other structural components.

jordanlebeau [2:20 PM]

Keyvan's point is thought-provoking, especially when research on angel portfolio performance is factored in. It shows that only 10% of an angel's portfolio will be responsible for an average 2.2X cash-on-cash return. Angels need these returns to balance out their losses. This makes finding home runs critical. Digging more deeply into the numbers behind these companies shows that an investor using low valuation criteria – e.g. not investing in companies with a valuation above a certain size or that is +50% greater than the median for the sector and stage, would have missed out on 80% of home runs in the past three years.

The question is, how many home runs could you be missing by relying too heavily on valuation? And what kinds of questions do you focus on to decide if a company might really be exceptional? In my mind, there are still many entrepreneurs out there with unrealistic valuations and don't have the juice to match the valuation – to be exceptional.

New Thinking on Deciding if Startups Could Be Home Runs

As early investors, angels face many challenges that can make picking winners almost impossible. That's why they rely on certain analysis like scorecard valuation, especially when making investments in startups without revenue, proof of concept, or a proven team. A common approach for angels is to begin valuation negotiations early in conversations to avoid wasting time on due diligence if the valuation expectations of the entrepreneur are unrealistic.

Keyvan postulates that to better know if they are looking at exceptional startups, angels need to shift their focus on multiple levels. The first step is to move away from projections and valuation. Instead there are more telling indicators. He says, "Good investments are all subject to elements of progress coming together that make it the right time to bet on a startup." I would add that these startups must be able to execute.

This new thinking shifts the focus of due diligence at the earliest level of investments to two important lines of questioning:

- "Why now?" is the most important question an investor can ask, and should absorb at least half of due diligence. This is about understanding if innovations and necessary elements are coming together to make it the right time for their new innovation. For instance, hugely successful Salesforce couldn't have gotten where they are without improvements in cloud computing and Uber would not have been a huge success without rapid smartphone adoption. To understand if it's the right time to invest in a company, angels can ask questions like "Why hasn't this been done before?" and "What has changed that makes this a feasible solution now?"

- "Why you?" is also important in this framework, taking 40% of angels' due diligence. This is about analyzing how the team can execute on commercializing their idea, whether they have the ability to execute, what skills are required to overcome the near and long-term milestones, and if there are any skill gaps that angels should be aware of. Angels should dig in to understand the key performance indicators and milestones the company will need to hit during different stages of growth and what capabilities they have to hit those performance levels.

The rest of due diligence would then be on everything else, including pre money valuation.

The main consideration for angels is to de-risk the investment and create tighter alignment between the investor and entrepreneur. For example, oftentimes the higher funding and valuation an entrepreneur asks for is needed to achieve monumental milestones with many potential pitfalls that could derail progress along the way. A lower risk, more aligned approach is for angels to fund smaller milestones that are focused on solving a specific problem, generally at a lower valuation. The approach is to boil down the hypothesis that the management team has to its simplest form—what problem are you solving for a given market sector? This makes the cost to deliver on the list of milestones smaller, and enables phased testing of the idea, while providing traction and reducing the overall investment risk.

This new thinking focused on exceptional companies means less focus on valuations, but it doesn't mean valuation isn't a factor at all. Keyvan concedes, "It's always best to get the lowest valuation possible, but if due diligence shows the company is a true outlier, valuation shouldn't deter the investment."