Relevant soft factors to assess startup companies

Investing in early stage companies is a risky business. In recent years, many venture capitalists have discovered painfully, the consequences of pursuing less than thorough risk assessments. Although it's the negative experiences that tend to be heard first, it's the success stories that make it all the more worthwhile. Prior to taking the plunge in backing a startup company, one can never underestimate the importance in conducting a careful assessment of all the intricacies of a company. Only after the adequate due diligence has been performed, can an investor honestly become comfortable about their investing decision. But by utilizing a consistent and step-by-step approach, an investor can attempt to correctly extract important value drivers and soft factors relevant and unique to each company.

Before any company valuation or investment decision can begin, extracting and individually assessing each soft factor is a vital prerequisite. This is not without its challenges, as there are many hurdles that need to be overcome in finding the right criteria and method which allow these soft factors to be assessed accurately.

The following points contain the assessment approach which Venture Valuation has utilized for more than 250 company valuations. Although the relevant criteria may vary slightly from sector to sector, the general soft factors of focus often include: (1) the company's mission and condition, (2) the management, (3) the market, (4) the product and technology as well as (5) the financing stage.

The Company

In assessing a company, two key areas require particular attention. The first centers around the company`s actual *mission and strategy* and aims to determine: *How does the company intend to earn money, to acquire customers and intend to position itself in the market?* The second key area of focus tries to determine the company`s *current* condition. Here the assessors focus should be on: *Does the company have the resources to achieve stated goals? Are there any gaps? Who are the existing customers and/or partners? How much cash does the company have to achieve these goals (i.e. cash burn rate, etc.)?* Understanding the company`s mission and the company`s current state are the initial steps that need to be determined before a detailed assessment of a company can begin.

In the points below, additional soft factors are discussed which focus on more specific parts of a company.

Management

The management is of course one of the most relevant key success drivers within any organization. The most relevant areas of focus are the management's qualifications and experience; namely, does the management have all the necessary skills needed to bring a product to market? Additional factors that need to be weighted accordingly include whether or not adequate incentive structures for management exist or intend to be available, and if key management are also equity shareholders themselves in the company. Finally, assessors should never overlook the advantages an advisory board can add to a company`s existing skills base.

Market

Knowing and assessing the target market is another crucial area for the success of any company in a competitive marketplace. A good model that has been utilized in the past for a comprehensive market analysis of a specific industry was one provided by Michael Porter who created the five forces approach. According to Porter, relevant market forces can be assessed and grouped within five key areas, including: (1) The existing rivalry within a market, (2) the threat of substitutes, (3) barriers of entry for new competitors as well as the dependency on single (4) suppliers and (5) customers. By being able to challenge specific areas of a company to the market, this helps in determining whether or not planned business scenarios are realistic. This further tests existing business plans and allow an assessor to make an informed decision about the strength of a company when compared to the marketplace.

Product and Technology

Assessing a company`s products and/or technologies are also important considerations in a thorough valuation. A particularly useful approach when it comes to individual product assessment is what is known as the unique selling proposition (USP). This approach aims to determine a product or services ability to differentiate in the marketplace. The method attempts to determine *what the competitive advantage of the product or technology is?* And *what is the company able to offer which its competitors are not?* Furthermore, the product or service has to match potential market demand and the pricing has to be within the customer's expectations.

In addition to the *USP*, the assessor should also be cautious not to overlook the IP (intellectual property) situation, the time for the product/service to reach market and most importantly, the future pipeline of further company products (i.e. is there more than one product/service?).

Financing stage

The financing stage of a company can be a good indicator of what risk level a potential investment may be at. In most instances, younger companies share a higher risk profile than longer established companies. This risk however, can disproportionally decrease as a company is successfully developed. The following table gives an overview of the classical financing stages and the characteristics associated with these stages.

Phase	**Characteristics**
Seed stage	▪ Existing business idea ▪ Business plan is in the process of development ▪ May be first prototype ▪ Foundation of company in progress
Startup Stage	▪ Company has been officially founded ▪ Management team is in place ▪ "Proof of concept" (does the product work?) developed ▪ Preparation / start of production and first customer contacts
First Stage	▪ Marketing most relevant product/service ▪ Start of production and market entry ▪ "Proof of market" (has the product been accepted by the market?) ▪ First sales, usually cash flow negative

Second Stage	▪ Further development of sales in home market ▪ Decreasing risk ▪ Market entry successful, reaching point of break even
Later Stage	▪ Diversification ▪ Restructuring if necessary ▪ Possibility for debt financing ▪ IPO possible within one year

Table 1: Classical Financing Stages and their Characteristics

In order to get a reliable picture of a company and the risks within, a top-down company assessment, including the above mentioned criteria 1 to 5, have to be completed. Of course, not all factors will be equally relevant in all situations. In fact, certain factors may also vary from industry to industry and depending on the financing stage, some criteria might even overpower others. Additionally, some company`s may also exhibit "killer criteria" which – if not met – can be so relevant that an investment might not be possible (e.g. a good management team has a product with a relevant USP available but due to the lack of patents, the competition will sweep through fast). But following through on the key focus areas outlined will ensure that a balanced assessment has been performed that equally matches the risks being undertaken.

In conclusion, even though the above mentioned assessment criteria will help to highlight the main value drivers and risk factors in any given company, one can never be short on experience when it comes to making an informed investment decision.

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