

Valuation:

**How do VCs view valuation
and its link
to the rest of deal metrics?**

David Fisher

The Six Ps that occupy VCs

- **P**ension Funds (super funds) – how to access \$
 - **P**rotect capital (paranoia) – preference shares
 - **P**articipation (in follow on funding)- keep some powder dry to follow the winners
 - **P**ortfolio (construction) – timely exits, risk mitigation
 - **P**arsimonious (frugal) use of capital – tranching investments
 - **P**re money valuation – making the maths work
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- The new **P**aradigm – capital efficiency

The First P that occupies VCs



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- **Superannuation Funds:** appetite for VC is $\frac{3}{5}$ ths of $\frac{5}{8}$ ths of FA. What is the problem?
- Venture as an asset class has not produced good consistent returns - ever
- In a world of almost infinite choice (for investments), VC is well down & close to non-existent in their thinking.

The Next P that occupies VCs

- Lets take a simple **P** Portfolio:
 - 9 investments (3 per year), each receive \$4 million for 50% equity in each; Lets say
 - 3 fail completely,
 - 2 generate capital back,
 - 2 generate 2 times capital,
 - 1 generates 4 times capital, and
 - 1 produces a home run (10 times capital)
 - Exits are 7 years after first tranche of \$\$
 - Standard management fees plus audit etc
 - **IRR = 13.8%**

Two more Ps – pre money valuation & preference shares

- **Scenario # 2:**

- The same investments as scenario #1 but with a 33% lower **pre money valuation** for each
- **IRR = a 12% improvement**

- **Scenario #3**

- The same as scenario #1, but rather than 3 fail completely to return capital, **two have preference shares such that investors get 50% of their capital back**
- **IRR = a 2.5% improvement**

Capital Efficiency P – time to exit and tranching investments

- **Scenario #4**, same as #1:
- **Exit after 6 years, not 7**; and
- Adjusting funding to needs: say \$1m for pre clinicals in year 1 and \$3m in year 2 for start of clinical trials (rather than \$2m plus \$2m), ie **adjusting tranches (Parsimonious use of capital)**
- **IRR= a 3.5%** improvement over base case.

Summary

For early stage cash flow negative companies:

- Valuation is as much an art as a science - pricing risk is difficult
- Most first time entrepreneurs underestimate by a large margin the time and cost of commercialising a new innovation
- Industry comparators are a good benchmark together with some financial modeling (noting that historically many deals have been overvalued)
- Strategic buyers (eg Big Pharma) are not judged by venture return criteria but on value add to their business.

Another big P

- Good News:** BIG Pharma: 'R&D' becomes 'Search and Development' : The ROIC for internal R&D has fallen sharply in the past 10 years
- Cost per successful drug up tenfold since 1980 (now ~\$2 billion);
 - New drug approvals have not kept pace with R&D spend;
 - Regulatory hurdles for new drugs are higher and periods of economic return are shorter; and
 - About 40% of R&D spend is in pre-phase II research, where attrition rates are very high (<10% probability of reaching market).

The VC model is still relevant – but with a much stronger focus on capital efficiency

- **Top quartile US VC returns continue to out-perform S&P 500**
 - No reason why this should not happen in Australia
- **Now leaving a period of above average capital access with below average returns to:**

below average capital chasing the best deals (but no bubble!)
- **Expect that returns from 2010 and onwards funds likely to be better and above average, BUT**
 - More careful allocation of capital (better due diligence)
 - Reduced entry valuations
 - Talented management available and aligned with investors