Ideas @ Edelweiss Multi Strategy Funds – The Other Side of Valuation

Technology start-ups in India have achieved dizzying scale both in terms of their operations as well as their valuations. A lot of credit needs to be given this new breed of entrepreneurs and their flair at execution. However, one thing that the public and the media fails to appreciate is that headline valuations on privately held start-ups are not the same as valuations of listed equities.

For one, most agreements have a liquidation preference or the right for the last investor to exit first in the case of a sale, wind-up or business termination. This cascading waterfall chain goes all the way back to the founding promoter who stands last in line. For example, if a company has two share holders - the promoter and a private equity investor who has invested 100 crores for a 20% stake, then the implied valuation of the company is 500 crores. In the event, that the company is sold for 400 cr, the private equity investor will still receive his 100 cr and then the promoter will receive the balance 300 cr. In this case of a down-round, the private equity investor ends up owning an effective 25% stake due to their liquidation preference. This is a simplified example, but one that illustrates the point that not all investors are treated equally as is the case with listed equities.

Secondly, there are often significant restrictions on the sale and transferability of shares. This makes sense because the founders are integral to the success of the start-up. A valuation is only as good as the price that someone else is willing to pay. Illiquidity does not imply lack of value, but restrictions on sale and transferability does merit some discount.

Lastly, valuations are all imputed. As in the example above, a start-up needs capital to grow and the stake is negotiated between founders and investors. You could hypothetically invest 1 cent for a 0.000000001% share of a company, but that does not make a unicorn.

Regardless of which side of the tech-bubble debate you are on, the next time you read a eyeball-grabbing headline about funding, deals and valuation - it is well worthwhile to think what restrictions come with the valuation.