Bharat Kanodi of Veristrat

Speaker1: [00:00:04] This is the Investor Connect podcast program. I'm Hall Martin and the host of the show in which we interview Angel Investors, venture capital, family offices, private equity, many other investors for early stage and growth companies. I hope you enjoy this episode. Interested in learning more about investing in startups, launching a new startup need to raise funding to start funding espresso as a daily podcast and a short, concise format delivered to your inbox every day Monday through Friday, the time it takes to drink an espresso and to learn about startup funding, to subscribe to a dog and put your email into the Pop-Up Box. Hello, this is Hall Martin with Investor Connect. Today, we're here with Bharat Kanodi, founder and chief appraiser, overstretched Bear Strategies Professional Services Company, headquartered in Pleasanton, California. They provide various valuation and advisory services to provide services to value various tangible, intangible and financial assets for the purpose of financial and tax reporting purposes. Fairness, pinions, purchase price allocations, goodwill impairment litigation and dispute resolution and more Bharat . Thank you for joining us with that.

Speaker2: [00:01:15] Sounds like a mouthful when I hear it. Thanks for having me.

Speaker1: [00:01:21] All right, so tell us about your background. What did you do before valuations?

Speaker2: [00:01:26] I've always been in valuations. That was the first job I got out of college. Except, you know, I did all different kinds of valuations. I started doing industrial assets and then I did real estate and then I did financial assets. And in between those, I have done some most unique or interesting assets in the world. So I've been around the block and valuation a few times.

Speaker1: [00:01:50] Oh, great. So how do you help startup and growth companies with valuations

Speaker2: [00:01:55] Start up and growth companies are my favorite because they need a valuation every three to six months. They're always raising capital. They're well, they're either in the middle of raising capital or they want to raise capital or they just have raised capital and now they're looking to distribute equity to their employees. So they're the kind of clients that keep on giving.

Speaker1: [00:02:25] That's great, and so what's the challenge for doing valuations for startup and growth companies?

Speaker2: [00:02:31] Well, you know, when when you're working with a startup, the first thing you always see is a hockey stick projection. Right? They're going to go from a zero to a billion dollars in six months. Right. And God bless them. If they didn't think that, they probably wouldn't be in that ecosystem. But it is my job to sort of do a gut check and see how can they get there. Does the market sustain it? Do they have the operations to do it? So the worst thing about valuing a startup is because I have to tell them that, no, their company is not worth a billion dollars just yet. And most founders don't want to accept that.

Speaker1: [00:03:17] And so has his staff prepare for that challenge of finding the right number.

Speaker2: [00:03:24] The right number really starts with the investment, so the first time a startup gets the investment, that's really the starting point. And, you know, there's really not much rocket science to it. Most people think that old startup valuations are too much involved. But no, the first time a startup gets a valuation is the most rudimentary way. So you ask them, hey, how much are you looking to raise? So say if they're looking to raise a million dollars, you take a million dollars divided by 10 percent and then you take a million dollars and divided by three percent. So the value of the startup is anywhere between three point three and 10 million. And then it's the negotiation between the investor and the founders that where we're at, where or how the cookie would crumble and how much will they accept or are willing to give up for a million dollars a raise.

Speaker1: [00:04:21] And so who should the startup recruit to help them with that, finding that right position on that curve?

Speaker2: [00:04:26] You mentioned that is really between them and the founder. That is between the founders and the investors. See, the investors. Will smart investors also know that they shouldn't take more than twenty five point thirty three percent, 33 percent of the high end? Because if they do that, they are shooting themselves in the foot and it will be difficult for them to raise future capital and they almost would never accept less than 10 percent because then it's like, OK, who cares? Right. This has to be worth their while. It has to keep things interesting for them, too. So it's generally between ten and twenty five percent.

Speaker1: [00:05:09] Right. And then if you talk about growth stage companies, those that are past the startup phase, but now on the growth curve upwards, there is A, B, C and so forth. What does a company need to do to keep the valuation going up there?

Speaker2: [00:05:24] At every inflection point haul, investors want to see the valuation at least double. So if if that seed or angel around the valuation will say a million dollars at the next round, they want to see at least two million, if not more, because unless they're doubling the valuation at each raise or each inflection point, the investors aren't really able to show unrealized gain to their LP's and which makes them look bad. Right.

Speaker1: [00:06:00] And so where do you see most companies under-invest in this process? What should they be investing in to grow their business in order to achieve that doubling of the valuation? Where should the company be focusing on to actually merit that doubling of valuation?

Speaker2: [00:06:19] At the end of the day, it's all about customer acquisition. Now, you call it customer, you call a user or you call it whatever you want to call it. It is acquiring more and more people to your story or to your platform or to your product, what have you. And that is really the crux of it. If you can convince more and more people to use your product or services, the better you are.

Speaker1: [00:06:48] And do you ever see companies that overinvest in parts of the business that don't turn out to have that valuation multiple for you?

Speaker2: [00:06:56] Oh, that's that's really the slippery slope so many times. And founders, you know, they may have they are lucky enough to get to term sheets, one to say 50 million and one to say one hundred million in valuation. And the rookie mistake is to obviously go for the hundred million. But as I said, at every inflection point, they have to double the valuation. So if they took 50 million, the next inflection point is at least one hundred. If they took one hundred million, next inflection point is at least two hundred. So they have to be careful. Sometimes taking more money can be detrimental to help.

Speaker1: [00:07:35] And so what happens when the startup gets to that next fundraiser, but they may be a little bit short on the metrics for the valuation that they want, who takes the haircut and by how much? Does the investor take it to startup? Take it. Do they split a 50 50? What happens when you know you have to raise that next round, but you're really not quite there and the valuation is going to be a little bit less?

Speaker2: [00:08:00] Great question. That happens all the time and they may not get a lower valuation, right? So it is it is to the founder's benefit as much as it's to the investors benefit to ensure the valuation keeps doubling at least, or if not tripling at each inflection point. But what they might do is kick in more terms and conditions under the surface. They might ask for more preference or they might ask for a higher dividend rate, or they might ask for a two X cap or something or a. dilution round or something, which wouldn't really show up in the media because what you hear in the media, they raise 10 million to one hundred million dollar valuation. That's really just the tip of the iceberg. The terms and conditions that are baked into the term sheet are far different, which you hear in the media is just post money calculation.

Speaker1: [00:09:03] So there are many valuation methods out there. What are the top three use most often for startup and growth companies?

Speaker2: [00:09:12] The three traditional methods of valuation, the income approach, the market approach and the cost approach. Those are not much helpful when it comes to startup valuations because in the income approach, you're trying to value the profitability of the cash flow they have done in a market approach. Well, they aren't too many competitors or the market is probably being created as they go along or they don't have any profits. So the only metric they have left is revenue if they have revenue. And the third method is cost approach, which is really not used in valuing companies much anyway. So the real method of valuation is really a startup specific method. Which one is based on the last transaction that you received? A valuation of 10 million then the last transaction. And it has been a year since your last raise. How has the company done between then and now? Right. That's one benchmark. Or the second way of doing it is something called it's a bit of a mouthful. It's called P Wurm Probability weighted expected returns method where you're looking at four or five, maybe 10 different scenarios of what the potential exit would be like for the company and trying to present value that exit today.

Speaker1: [00:10:42] Cool. And so how do you choose the right valuation method among those three?

Speaker2: [00:10:49] It depends on the company, depends on the facts and circumstances, so if they recently raised a round, well, that's the valuation. Somebody just cut them a check for that number. So that's the valuation. If they raise it around, say, two years ago and the company has changed dramatically and now they're getting closer to an exit. So now the valuation that we should be looking at is what somebody might pay when they were if they were to buy that company. So it really depends on the stage in the life cycle of where the startup is. These are great questions all.

Speaker1: [00:11:24] We do evaluations all the time, and it's a bit of a challenge because there's different methods. And I find what most actors do is they go through five or six different models and whatever gives them the best number, well, that's the right one. Then the investor on the other side of the table is doing the same thing and one that gives them the best ownership. Well, then that's the right one. And so I always tell people it's really not a formula. It's a negotiation because everybody's bringing their formula to the table. But the winner is the one that negotiates. So let's talk about that for a moment. How do you negotiate these valuations when you have opposing models on the table?

Speaker2: [00:12:04] You don't negotiate, you tell a story. The investor is telling their story, the founder is telling her story, and it's a dance. They meet somewhere in the middle. You you start to negotiate. It's kind of like negotiating with your future, you know, father in law. That's not a good sign, right? I mean, an investor is going to be working with you for a long time. Hopefully that person is going to be a part of board. That person is going to be part of your work family. You want to treat them nicely. So you've got to listen to their story. You got to listen to what they're saying, what their logic is. Look, they want you to be successful. The guy is cutting you a check. Mean it's to his detriment to not have you succeed. He wants you to succeed. Listen, know, hear him out and then hope that he would hear you.

Speaker1: [00:13:03] Oh, so what do most people get wrong about valuations when you work with both the startup and the investor? What's the most common mistake people have about it?

Speaker2: [00:13:15] The most common mistake is people think there is a right answer. There is no right answer. It's always a range. But we're all taught and grown up in society to find that right, number four plus four is eight. Always find that right? No. Well, it doesn't work like that in Valuation's.

Speaker1: [00:13:35] And so what's the best way to approach valuations, to talk about telling a story and listening and so forth, but what do you how do you advise people to approach this thing when it's range and not a no?

Speaker2: [00:13:47] Except that it's a range, right? So that's why I say that, you know, it's it's less about negotiating, it's more about storytelling. And listening to the other side of the story, you know, it's not necessary. So if you have two term sheet, one says 50 million and one says one hundred million, it is not necessary that the hundred million dollar terms sheet is better for you long term. You got to look you've got to look under the hood. You've got to see who the investor is, who that is. Is he going to help you when when shit hits the fan? Right. Because, look, you're running a startup, things are going to go awry, right? You want to work with people who are not going to call you and bitch and moan at you. You want to work with people who are going to say, hey, I heard what happened, what can I do to help? These are the people you want to go to battle with.

Speaker1: [00:14:46] And so what's your advice for investors seeking value in an early stage company where there's little to no revenue? How do you find that number there?

Speaker2: [00:14:56] As I said, there, there is no no, if you justify you, you say what you're going to raise, as you say, how much you need to raise as long as you can justify it. And then you take that number, you divide first that by 10 percent because that's the minimum start the angel or seed investor will accept. And you divide that by twenty five or thirty three percent because that's the highest they might take. And the value or the answer is somewhere in the middle and we're in the middle. That really depends on the supply of potential opportunities to the investor and the demand for the founder's body of work.

Speaker1: [00:15:43] All right, we are the traditional way is started, goes and finds an investor that wants to lead the round, had that discussion set, the valuation put in the term sheet and then all the other investors follow on, is that the best way to do it? Is there a better way?

Speaker2: [00:16:01] That's just the way it's always done. Generally, I am not I don't know if I have thoughts around if there's a better way to do it. Investing, I do think, is a team sport. And the reason I believe it's a team sport is because you want more and more people involved, because they can help you. They can guide you. Chances are if they're investing in your company, they've invested in a company like that before and they have seen other founders make same mistakes so they can help you not make those mistakes.

Speaker1: [00:16:36] So I always tell people the valuation is basically an exercise in articulating the value propositions in the business, and when I talk to some managers, they say my valuation is X and and I ask, how do you get to that? And the answer is, well, I calculated how much I need to own at the end of this process. And so I must be worth that. And I tell them that's that's really not a compelling story to say that you really need to be talking about what's in the business was the team product sales, you know, really articulate very clearly was there because that's what stands out. No matter what number you put out there, the investor is going to ask, well, how do you arrive at it? So you have to have a good reason for arriving at it. Maybe that's telling the story, but what do you think about that?

Speaker2: [00:17:23] No, I totally agree. I think if a partner is saying that this is how much I need to own at the end, I mean, it's like, come on, that's that's OK. You should not be working with that founder. Walk away. Walk away. Now, it's kind of like somebody going to their boss and saying, hey, boss, I need a raise. Why do you need a raise? Because I have more expenses. It doesn't work like that.

Speaker1: [00:17:51] Well well, you know, the early stage world is filled with first time founders and not everybody understands fully how it works. And I find these deals, the entrepreneurs looking at the deal from the with the the opportunity to look at the opportunity side of it. But the investor comes in, they are skeptical. They're looking at the risk involved. And so one thing I think most founders don't realize is that the investors don't necessarily share the same view you have because they're yes, we're all looking at the same deal, but we're looking at different sides of that coin and then trying to meet in the middle. Is the challenge there as well. How do you see that?

Speaker2: [00:18:32] You know, it becomes contentious and that's the worst thing you can do is to sour the relationship in the beginning, you want to work with people who you're going to be working with so, you know, don't and don't do too much haggling in the beginning, because if you cash in on your chips in the haggling and, you know, you go into a relationship sour, that's not going to be good for everybody. Listen to you investors. Listen to those people. They're they're cutting you a check that they're not going to lie to you. They're not going to I mean, you know, given a few bad apples, those are side. Right. There's always exceptions, but they're there to make sure you're successful. They want you to be successful. Ask them. Right. You know, not everybody's a Mark Zuckerberg. We hope you are, but you're no Mark Zuckerberg just yet. Prove yourself first. So if you ask your investor if they're talking to you, they're interested. They want you to be successful.

Speaker1: [00:19:35] Well, that's good advice. Well, in the last minutes that we have here, what else should we care that we haven't?

Speaker2: [00:19:41] No, at the end of the day, evaluation is all about business model, and even though venture investors are looking for that big payday, the big payday comes from companies that have recurring revenue and requires least management to grow it. So at the end of the day, you want a business model that gives you recurring revenue, just like real estate. If you can have a business model that's around that, all investors are going to love you.

Speaker1: [00:20:16] Well, great. Well, how best for listeners get back in touch with you.

Speaker2: [00:20:20] We have a YouTube channel called it Worth. And if you go to that channel under about it has an email, you can email us Vialet.

Speaker1: [00:20:29] Right. We'll put that in the show notes. Want to thank you for joining us today and hope to have you back for a follow up to

Speaker2: [00:20:34] The great talking to you. All right.

Speaker1: [00:20:41] Investor Connect helps investors interested in startup funding. In this podcast series Experience, investors share their experience and advice. You can learn more at Investor Connect. Doug Alti Martin is the director of Investor Connect, which is a 5.1 C3 nonprofit dedicated to the education of investors for early stage funding. All opinions expressed by Hall and podcast guests are solely their own opinions and do not reflect the opinion of Investor Connect. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions.