Valuation Focus

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On Pricing a Startup, Pre-branding

Startup and Mature Companies Should Not be Valued the Same

I have asked entrepreneurs of startup companies seeking venture funding to incorporate in their presentation the *valuation rationale* to their stock price proposition. The basis for the price they would have investors pay should be well rehearsed and *integral to their business plan* because the timing, circumstance, and expected pricing of the investor's exit event is integral to the decision to invest. Entrepreneurs of consumer product ventures often compare their potential enterprise to the best known companies in their industry category. These are the most successful, fastest growing stocks with recognized prospects, representing the most attractive investment imaginable in the category/sector. In essence they are saying that while the investor may have missed investing in the last opportunity in this space that returned twenty times investors' money, the entrepreneur's company should be viewed as another chance to get onboard early of the next surefire winner. There is nothing wrong with that kind of boosterism and self-promotion if it ends there. Selling the belief to the investor audience is part of the investment process. But when the comparisons become strained, the entrepreneurs must acknowledge that credulity is being demanded as part of the investment decision. Those well known, public companies have gotten to their current size through the deliberate and patient development of a strong brand. *The power of branding lies in its ability to influence purchasing behavior.* Brands are a collection of perceptions in the mind of the consumer and, therefore, can exert a robust strategic dynamic between a business and its target market.

The Entrepreneur In Search of a Better Valuation Model

Brands command market share, create options for growth, attract and retain talented employees, and promote shareholder value, thereby creating value for all stakeholders. *When companies create strong brands, they are rewarded in the capital markets as well as through higher earnings multiples and lower required rates of return.*

It is a huge burden the entrepreneur is foisting onto the potential investor when he asks the investor to assume that the startup company will achieve the same strong brand commanded by the comparable publicly traded companies. The entrepreneur requires this buy-in implicitly every time he points out that those very high earnings multiples the "comparable public companies" are trading at will be applied to his company's expected liquidity event in several years.

Specific expectations are attached to the dollar investment companies make into their brands. *It is not a certainty that management will succeed in their mission to create this intangible asset.* But when the evidence mounts and the business impact of a brand is unmistakable, one of the best barometers is the ascent of shareholder value. So how are stakeholders to know whether the private company has created a brand? The following indicators signal that the company's brand building effort is gaining traction, the product is developing a broadening audience, and the audience is bonding with the product. Market validated brands will:

* Grow Market Share
* Increase Revenue Growth
* Improve Margins and Profitability
* Reduce Operating Risk
* Create Business Opportunities
* Build Shareholder Value

No Empty Comparisons

The previous discussion provides some of the fundamental principles regarding how an investor will *know* that brand exists as a business asset. If a company has built a brand, the market will value its stock with this intangible asset in mind, along with all of the other assets the company holds. The following section discusses the compelling reasons why.

What the Investor Receives for Investing in a Branded Company

Brand is a function of the promises a company makes of its product and the experience the consumer has regarding the product's performance and delivery on those promises. Henry Ford said "you can't build a reputation on what you are going to do." It is not a reasonable assumption today that a product with a strong brand will emerge out of the current investment round or even from future rounds. Therefore, the investor should not pay for this non-existent asset by way of high earnings multiples and low capitalization rates today when there is no evidence the company will ever achieve a strong brand. That price will be paid by future investors who invest in a company with more operating history than a startup. We have summarized four significant effects that brand has on a company's cash flow, further demonstrating the value added *from investing in a solidly branded company. It is these realized results from brands that deliver higher cash flows to investors with less uncertainty that warrant higher valuations today. Conversely, if you cannot now reasonably expect the occurrence of the four cash flow dynamics that are produced through strong brand building, then the price you pay for future cash flows should not reflect them either. Accordingly, their present value will be heavily discounted and the company's enterprise value and stock price today diminished.*

Brands Increase Cash Flow Streams

There is a demonstratable link between brands and shareholder value that stems from the most important driver of value: cashflow. Brands increase value by growing and protecting a company's cash flows. Strong brands have been shown to command greater market share and in many cases command premium prices. Brands can reduce the buyer's sensitivity to premium pricing. Strong brands more readily access international markets and extend business offerings, such as new products, services, and market segments.

Brands Accelerate Cash Flows

Brands accelerate cash flow by reducing the lead time required to turn investment into realized cash returns and increased shareholder value because the holding period has been condensed. This effect reduces the period over which the time value of money calculation diminishes the present value of future cash flows. Strong brands launch new products and services faster than weaker brands (or companies with no brand for that matter) because existing levels of awareness and trust facilitate consumers' acceptance. Strong brands may help to stimulate product innovation, further increasing the return on investment through additional cash flows generated from product development.

Brands Extend the Duration of Cash Flows

When a brand is maintained over a long time horizon, it becomes a "cash cow" and extends the duration of cash flows from an investment. Asserting this proposition another way, we can see that maintaining a strong brand increases shareholder value because one of its intrinsic characteristics is a relatively higher level of customer loyalty, which is quantifiable through the enduring cash flows and consistent profitability from existing customers.

Brands Reduce the Uncertainty of Returns

A brand's impact on shareholder value is felt nowhere greater than when it reduces the risk of future cash flows. This lower level of uncertainty (risk quantifies the uncertainty that a future event will occur) that anticipated cash flows will reliably materialize increases the value of these cash flows. As the present value of cash flows increases, greater shareholder returns are created.

Creating the Startup's Brand

The following six elements of brand[1] are essential for organizational strategic focus and alignment with the company's values while following such branding fundamentals as relevance with the target market and differentiation from competitors:

* **Meaning - Brand Essence**
* **Beliefs - Defining Values**
* **Customers - Target Audience**
* **Uniqueness - Key Differentiators**
* **Value-add - Overarching Experience**
* **Expression - Logo, Look, Messaging**

These organizing elements can be imparted to the company's / product's brand immediately upon the formation of the business through the seven actions summarized below:[2]

Focus on a Single Brand A startup will always feel pinched for resources. Focus all branding energy and resources on building a single brand. Do not try to create separate brand identities for the company and for each of its products.

Register the URL When considering alternative names, make sure you can own the domain name.

Keep it Simple The names should be short, memorable, hard to misspell and hard to mispronounce. People should be able to find the name in a search engine.

Choose one naming dynamic: descriptive, evocative, or whimsical Descriptive is a name that is explanatory. Evocative is a name that says nothing about the business, but is vividly haunting. Whimsical is a memorable, non-meaningful word.

Avoid branding by committee or focus group If you form a committee and put everything to a vote, the likely result is a least-common-denominator brand that's bland, uninspired, and may seem more like a minotaur than the thoroughbred you have in mind.

Apply the brand consistently Consistency of usage and application of the brand is paramount. The company should have a united look, feel, and expression. Formulate the company's image, then go big with it so that the audience is informed.

Protect the brand Trademark the company name, logo, and tagline with the US Patent Office. Display copyright notices on all electronic and printed materials.

Footnotes

1. Yohn, Denise Lee. "Startups Need a Minimum Viable Brand." HBR. (June 2014).
2. Price, Jim. "7 Keys to Creating a Killer Brand." Business Insider. (August 5, 2013).

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