Valuation of Technology Companies

Over the past decade, technology firms that have intangible assets and provide innovative products and services have surged in value as well as other financial and non-financial parameters. Such firms pose a challenge to traditional methods of valuing businesses, and require unconventional thinking to adapt such accepted approaches to valuation, said experts from accountancy and law firms at a recent webinar organised by the Singapore Academy of Law (SAL) and Institute of Valuers and Appraisers, Singapore (IVAS), themed "Valuation of Technology Companies".

The obstacles to valuation

Mr Ashish McLaren, Director of Valuation Advisory Services in Duff & Phelps (Singapore), and a Chartered Valuer and Appraiser as well as Member of IVAS' Standards and Technical Working Group, noted that standard methods of valuation may not be suitable as they are for technology firms with intangible assets, products and services, particularly if they are in the early stages of development. He explained that these approaches need to be customised based on investor and market participant considerations. He further elaborated:

1. The market approach to valuing businesses requires valuers to study the performance of comparable companies, but such technology firms typically offer disruptive and unique products and services. "It's difficult to find similar businesses, and whatever market information is available may be incomplete or unreliable."
2. The cost approach may be untenable as the technology firms may not be able to fully account for their incurred costs. "The companies may have tracked their spending on computers and software licenses, but they may not be able to quantify other costs, such as the manpower costs of developers and senior management who have poured their heart and soul into building the start-up. The cost approach also does not truly capture the future value of assets."
3. The income approach relies on income projections and discount rates, which may be skewed by biases. "The financial results of technology companies, especially in the early stages, are highly volatile and unpredictable. Some do well initially but are unable to sustain their performance. There is also research which shows that many firms fail when they have to scale up, because the team or business is not ready to meet the demand."

Five alternatives methods of valuation

Valuers must understand the businesses and consider many factors, including the firms' stage of development, the state of their fundraising efforts, previous investments in them, and the condition of their industries. Mr McLaren added that valuers could use other, more suitable valuation approaches, including:

1. The limited or calibrated market approach

This involves studying the firm's latest round of arms-length financing and the implied revenue multiple or earnings multiple, calibrating the multiple to how the market has moved since then, and then applying the figure to the firm's latest financial performance to produce a valuation.

2. The venture capital approach

By estimating the future exit prices for investments in the firm and working backwards from them, and accounting for the costs, time and risks taken by the investors, valuers can derive a current valuation for the firm.

3. The probability-weighted expected return approach

This approach considers multiple scenarios of the firm's future, the firm's value in each scenario, and the probability of the scenarios. “Valuers should ask themselves, what are the likelihoods that the firm will fail, in which case its value would be zero, that it makes just enough to return the investments that people have made into it, and that it achieves some or even great success.”

4. The contingency claims analysis approach

This requires assessing the rights of right owners for each asset class or share class, to determine, for example if the company reaches a liquidity event, the amount of money that the owners would be paid, based on the claims that they have from the rights that they earned in the business.

5. The milestones-based approach

This method examines whether the company is meeting its planned milestones, and if it is ahead of or lagging behind them, to create or adjust its valuation.

Mr. McLaren concluded that these methods, while they appear different, use the same fundamentals of the other traditional approaches and better adapted to the needs of early stage, high growth and intangible-led companies.

The importance of intellectual property

Patents and other intellectual property (IP) rights, such as copyrights and trade secrets, are also be a key factor in technology firms' valuation, said Ms Wai Yeng Chan, Patent Attorney and Head of IP Strategy at Taylor Vinters Via.

“A company may have a great business idea, but if the founders did not research the market well enough and do not know that there is a third party that has already been granted a patent for a similar idea, that will have a debilitating impact on the company and hurt its valuation,” she explained.

Conversely, by obtaining patents, firms can better defend themselves if they are sued by competitors. “There are also other types of IP rights that may be more suitable to protect their business. Fundamentally, founders of technology firms need to have a conversation with a patent professional so that they can make more informed decisions,” she added.

Mr Alvin Lim, Special Counsel at Withers KhattarWong, highlighted that technology firms can monetise their intangible assets in three ways: translating them into products and services, licensing the assets to others for royalties, and selling the assets.

“Firms sitting on innovative intangible assets that don't have the capital or market access to take advantage of them can always think about opportunities for sale or licensing. Even as our world is being disrupted by the COVID-19 pandemic, companies are adapting their business models to survive and thrive," he noted.

In order to take advantage of monetisation and business strategies, he stressed that companies and business owners need to increase their awareness of their intangible assets, including:

- what intangible assets do they own / potentially have?
- what are the nature and extents of risks related to these assets?
- what is the impact of each asset on company performance?
- what are the business cases in which these assets can add value to their own business and those of other companies

He stressed that having the right protection and monetization strategy is essential to obtaining a favourable valuation of a company or their intangible assets. After all, transaction valuations have elements of negotiation and judgment. Obtaining favourable valuations can in turn help companies achieve favourable commercial outcomes, such as successful mergers and acquisitions, sale or divestment of assets or business units, or attracting investment.