6-6-2009

VALUATION PRACTICES OF INFORMAL VENTURE CAPITALISTS: BEYOND "INSTINCT" AND "INTUITION" (INTERACTIVE PAPER)

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Recommended Citation
Available at: http://digitalknowledge.babson.edu/fer/vol29/iss2/8
INTERACTIVE PAPER

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Principal Topic

The valuation practices of informal venture capitalists have been described as “intuition” and “instinct” because the sources of information used and methods employed by business angels are largely unknown – even to the angels themselves (Paul, Whittam and Wyper, 2007). This paper explores the sources of information and valuation practices adopted by business angels.

Methodology

A grounded theory approach aims to identify unknown variables and processes (Charmaz, 2004). Using a tape-recorded verbal protocol, respondents talk “out loud” their thoughts while reviewing a provided investment scenario. Verbal prompts by the researcher helped explicate their observations. The initial sample are ten self-selected business angels attending a national conference. They invest independently, are members of business angel networks, and some are syndicated. They are habitual angels.

Results & Implications

A variety of variables and processes were established regarding valuation. A heuristic that involved asking for specific equity splits (30 percent) was a common theme. For example, 30 percent is a split that was widespread in California. Another indicated that the numbers, proformas and estimates were largely irrelevant because 30 percent equity was appropriate to signify the amount of responsibility due to the entrepreneur and the risk assumed by the angel. Yet another indicated that -- even in the face of valuations that suggested otherwise -- they would want 30 percent. Other valuation techniques such as discounting and future earnings projections were also cited. One, a former venture capitalist, worked with a specific multiple objective for the deals in his portfolio which were worked backwards to determine the equity split.

The implications of this research are threefold. 1) If entrepreneurs know that angels’ valuation techniques are rudimentary, they could begin negotiations with well-developed valuations to lure angels to their thinking. Alternatively, where 30 percent is a rule of thumb, entrepreneurs may want to adjust their “ask” to ensure they are getting good value. 2) Whereas some angels have slight knowledge regarding valuations, policy makers could make this a target for educational interventions or angel academies. 3) Finally, business angels should recognize this as a limitation that, if improved, could enhance their contracts and returns. More research, continuing to use an inductive and grounded approach with iterations built upon previous findings, will develop insights into angels’ reasoning and processes.

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