



Backsolve Method: The silver bullet for valuing a startup's common stock

Valuation of startups has always been vexing, especially when most valuations are based on future cash flows and the companies lack a concrete business plan or operational history. In the absence of these building blocks and veritable theoretical concepts, an appraiser looks for other quantifiable metrics such as competitive advantage, on-paper revenue growth and scalability, and eventual profitability.

The Backsolve approach, a recent solution on the horizon, seems to address several concerns of appraisers. It is an objective method, using which they can conduct a reliable valuation of the common stock.

The method is considered the most dependable indicator of current value since it benchmarks the original issue price (OIP) of the company's latest funding transaction. This is based on the premise that the OIP is a result of rational negotiations and comprehensive due diligence by sophisticated financial investors, inherently making it a fair market valuation.

It is rightly called the "Backsolve" method as it first computes the value that can be allocated to each security (including the issuances of the latest round) such that the allocated value per share (new issuance/latest preferred round) is exactly equal to the OIP. The equity value derived as a result of this iterative process to match the allocated value to the OIP is the implied equity value of the company as of the valuation date.

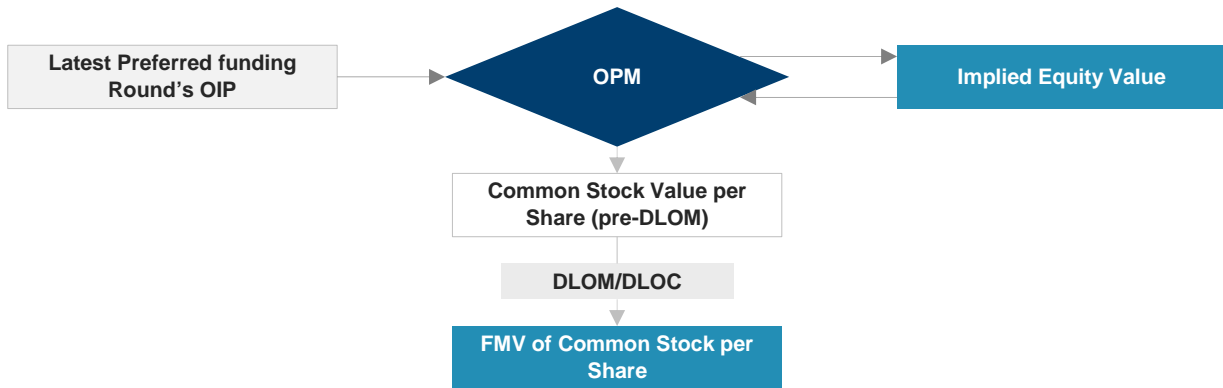
How does the method work?

The Backsolve method works on the principles of the Option Pricing Model (OPM).

For example, in the scenario below, until the company's equity value is \$5,873 or below, only Series B preferred shareholders would get any value due to their LP over other classes of securities. Alternately, a Series A shareholder would consider converting to common stock only when the equity value surpasses \$8,805.

	Event description	Participating Class	Participating shares	Break Point
1	Enterprise Value is zero	None	-	0
2	Liquidation Preference – Series B	Series B	2,000	5,873
3	Liquidation Preference – Series A	Series A	1,000	6,988
4	Exercise of options issued @\$0.2	Common Stock	1,000	7,188
5	Exercise of options to be issued @\$0.3			

The Backsolve Approach



Given its objectivity, it is no surprise that Backsolve approach is the preferred appraisal method used by auditors and tax authorities for financial reporting and tax assessments (option grants). As a market-based approach, it has proven to be the most reliable indicator of fair value for companies that do not have defined quantifiable metrics for traditional valuation.

About Aranca

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