How do we value start-ups facing insolvency?

Ludovic Van Egroo examines the particular problems facing start-up businesses when it comes to putting a value on their assets

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"SINCE THE 1990s AND SINCE THE INTERNET BECAME WIDELY ACCESSIBLE, NOT ALL START-UPS WERE AS SUCCESSFUL AS GOOGLE"

Introduction: what differentiates start-ups from other businesses?

The Larousse Dictionary (www.larousse.fr) defines a start-up as a young, innovative company in the new technology sector.

According to Patrick Fridenson[1], the company historian and EHESS director, "*It's neither the age, the size, or the business activity that define a start-up, but the following three conditions:*

1. *Strong growth perspective*
2. *Use of new and innovative technologies*
3. *Need for significant funding, through fund raising.*"

One more criteria can be added to these: Dematerialised intangible assets (software, patents, trademarks, or simply a website or an application).

However, since the 1990s and since the internet became widely accessible, not all start-ups were as successful as Google, Facebook, Uber or Critéo.

So we have to know: do start-ups meet the same difficulties like classical companies? Can they be avoided? If so, how? In case of failure of this new category of businesses, how can we proceed to an evaluation of assets?

What are the key factors of success and the difficulties faced?

In February 2015, the COFACE[2] shortlisted three key success factors for start-ups:

- **Managerial staff training;**
- **Behaviour:** despite of conditions favourable for creation and innovation, cultural norms can slow down the capacity to take entrepreneurial risks; and
- **Financing:** investment in start-ups must be encouraged in order to benefit a larger number of them.

These keys factors of success can also lead to the collapse of a start-up. Indeed, as start-ups grow faster than "traditional" businesses, they must also confront in a short period of time issues related to team management and production process organisation while business profitability is still uncertain. Start-ups are mostly weak during their early stage and not well prepared when facing difficulties that can lead to failure.

In 2002 the Commercial Court in Paris identified the main hurdles as:

- The tax and social security liabilities;
- Assets valued at 1/8th of the liabilities; and
- An issue with the disposal of assets and their valuation.

In case of business collapse, what can be done?

In case of failure, two main questions may be helpful to identify the possible course of action.

Did the company reach its profitability threshold?

If so: the company could be granted a business recovery proceedings and benefit from a recovering program. Or not: it won't be possible to launch a recovery proceedings without the investors' financial support.

How to value the start-up's assets?

When the company collapses and a judicial procedure is implemented (in particular liquidation, safeguarding or restructuring proceedings), a transfer plan can be requested for approval or become an obligation. It thus becomes necessary to evaluate intangible assets. This evaluation helps to define the company's potential for growth and the value of assets.

If the value can help repay liabilities: the company could sell all or a part of its assets and start the business again. If the value cannot repay the liabilities: the start-up probably goes on judicial liquidation.

However, it is sometimes difficult to value start-up assets due to their intangible nature, i.e. non-physical (software and licences, patents, brands, stock in trade, trademarks, copyright…). Start-ups have substantial funding needs during the early phase until they attain their break-even point. During this period, businesses call on venture capital funds and business angels and seek funding from individuals (relatives). In this situation the start-up managers will have to treat with their financial partners and look for a solution while the company is unprofitable. Due to this context the legal investor's situation is important in order to find a solution.

How to treat the investors' legal status ?

A loan can be taken against a collateral whereas, in France, equity investments and the associate's current account will be treated after the unsecured debts. Nevertheless, being a shareholder gives you the right to monitor the company's management, which is not the case of a bank loan.

Typically, start-ups in this digital era often lack the tangible assets (material goods) to secure investments. The company, in its early years, is in a weak financial situation with a high risk of failure as it is yet to become profitable. It is in this context that public institutions may offer the necessary guarantees to support and sustain private investment (which is one of the main challenges for start-ups).

These investments can take the form of loans or acknowledgments of debt, stakes in the capital or associate's current account. In case of bankruptcy, the treatment of creditors – individuals or legal entities – depends on the form of their investment. Indeed, a loan, an equity stake or the associate's current account are not treated in the same way, as shown in *Table 1* below.

"TYPICALLY, START-UPS IN THIS DIGITAL ERA OFTEN LACK THE TANGIBLE ASSETS (MATERIAL GOODS) TO SECURE INVESTMENTS"

1. Summary comparison between an equity stake and an associate's current account

Kind of investment	Loan	Current Account
Guarantee	Can guarantee assets	None
Decision makers	Can decide to require judicial assistance in case they are not paid	Can require judicial assistance as soon as they consider the situation needs it. Can take the decision to inform the start-up manager about the situation and the solution.
Information access	Get the information notified by the start-up director	Must be aware about the financial and economic decision to make
Priority refund	Can get some priorities (e.g. conciliation as judicial procedure)	It is the last resort

IT IS IMPORTANT TO ENHANCE THE RELIABILITY AND SYSTEMATISE INDICATORS WHICH WILL HELP TO EVALUATE THE COMPANY'S INTANGIBLE ASSETS

2. Summary comparison between traditional and digital leasehold rights components

Leasehold rights component	Traditional retail funds	Digital business
Leasehold rights	Condition of the shop	Condition of the web site / application
	Lessor (contract)	Web site host / platform (hosting contract)
	Address and location	Domain name and key words
Clients and their loyalty	Rate of frequentation (primary or secondary street)	Web site visitors and referencing
	Customer catchment zone	Consumer habit and qualified web site frequency

In such conditions the current account investors' interest is to be more engaged than the loan investors who could guarantee some assets. In both cases, the main issue is to value the start-up assets.

How can we value intangible assets?

Start-ups' intangible assets can be:

- Registered and protected at INPI (e.g.: trademarks, patents, licences etc)
- Unregistered and unprotected intangible assets (e.g.: domain name, website, application etc). Usually combined with a registered asset but not taken into consideration during evaluation or a contract. However, in the absence of judicial protection, these assets can be forgotten or destroyed without any evaluation.

Start-ups' assets evaluation can be done using the conventional revalorisation approach (leasehold rights and client Loyalty…). Thus, websites, domains names and applications could be considered as digital business capital.

A summary comparison between traditional and digital leasehold rights components is shown in *Table 2* above.

Indeed, we can quantify and qualify web sitetraffic thanks to new technologies and collect consumer insights (e.g.: purchase or interests) which can represent a substantial value for investors or the company's purchaser.

This intangible asset valuation for start-ups means that the position of the website and platform hosts should be reviewed and they could be considered as traditional shop leasehold right lessor. Website hosts and lessor are a potential non-recovered asset that can quickly be depreciated.

During judicial procedures, judicial representatives and judicial administrators may have to conduct an in-depth research and analysis of assets in order to get all the information needed for optimising their evaluation.

Conclusion

The differences between a start-up and a traditional company is in particular due to its innovative aspect that needs a substantial source of funding. If a start-up struggles to reach its break-even point and collapses, it must be able to convince the buyer and the investor of its value and its growth perspectives. Intangible asset valorisation is thus necessary for start-ups but not only, as "traditional" businesses are also progressively going digital (e.g.: e-commerce or applications for services activities of chemist's offices, hairdressing salons, restaurants etc). That is why it is important to enhance the reliability and systematise indicators which will help evaluate the company's intangible assets.

The company's funder and manager must also take in consideration the investors' status and the consequences in case of difficulties. Indeed, their position will change taking in consideration their goals and objectives and possible dependency.

Moreover, in order to facilitate the research and the implementation of solutions, start-ups and creditors can request the "*médiation inter-entreprises*"[3] assistance (help for mediating between companies) with the objective of negotiating an agreement that satisfies the parties involved. ■

Footnotes:

1. Published in the newspaper Capital 10/08/2015 "By the way, what is a start-up?" www.capital.fr/bourse/actualites/au-fait-c-est-quoi-une-start-up-1063221
2. COFACE PANORAMA, France, a suitable land for Start-ups development? February 2015
3. Business mediation: https://lannuaire.service-public.fr/gouvernement/administration-centraleou-ministere_188194

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