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Dave Berkus Method

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1 Introduction

The method adds "US$500,000" in each of the following risk reduction elements, allowing for a pre-revenue valuation of up to US$2 Million.

(a) Sound Idea (Basic Value)
The Method does not elaborate on any framework to assess and evaluate. However, one can access factors like Investment thesis, Problem being Solved and its Size, Scalability, and growth.
(b) Prototype (Reducing Technology Risk)
It is a replica of the actual concept of the product to test its viability. A working prototype with feedback from a few users would enhance the valuation.
(c) Quality Management Team (Reducing Execution Risk)
The attributes such as leadership, Integrity, commitments, etc., are generally considered in assessing the management capabilities to run the startup successfully.
(d) Strategic Relationships (Reducing Market Risk)
Product Integration, Partnerships targeting customers alongside scaling the product, etc.
(e) Product Rollout or Sales (Reducing production risk)
Giving attention to market demand, competition, and pricing strategies to access the chances of success.

However, the value need not be restricted to US$0.5 Million for each element and can be adjusted with market conditions and pre-money valuations claimed by similar companies in the space.

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1.1 Background on Dave Berkus Method

The Dave Berkus Method is a venture capital investment evaluation framework developed by the American venture capitalist, Dave Berkus. Berkus has been involved in the venture capital industry for over four decades and has invested in numerous successful startups (By Dave Berkus, Berkus.com). The method is based on his experience as an angel investor and venture capitalist, and it provides a structured approach for evaluating early-stage startups.

Originally created in the mid-1990s to help with the imprecise problem of how to value early-stage companies, especially those in technology, Dave Berkus developed what soon became known as "The Berkus Method" when published in the popular book, *"Winning Angels"* by Harvard's Amis and Stevenson.

1.2 Purpose of Dave Berkus Method

The purpose of the Dave Berkus Method is to help investors and entrepreneurs quickly and efficiently assess the potential of an early-stage startup. It provides a set of guidelines and criteria that can be used to evaluate the chances of success of a startup, including factors such as Sound Idea, Viability of product tested through a prototype, assessment of management capabilities, strategic relationships that the startup has built and effective product roll out and achievement of sales.

Fewer than one in thousand startups meet or exceed their projected revenues in the planned periods. Relying on financial projections as valuation metrics would therefore yield unreliable valuations. Rather than ascribing value to projected financial success, the Berkus method values risk-reduction elements which capture the progress of the startup. The Dave Berkus Method is not meant to be a definitive valuation method, but rather a tool to help provide a rough estimate of a startup's value based on available information and industry data.

The Berkus technique provides aspiring business owners and early-stage investors with a simple framework that enables them to concentrate on risk factors rather than financial projections.

1.3 Popularity and Relevance of the Dave Berkus Method

The Dave Berkus Method has become a widely used and well-respected framework for evaluating early-stage startups. It has been adopted by venture capitalists, angel investors, and entrepreneurs around the world, and is considered one of the most comprehensive and effective approaches for evaluating startups in the early stages of development. Despite being developed over two decades ago, the Dave Berkus Method remains relevant and popular today, and is considered one of the key

frameworks for evaluating startups and making investment decisions in the fast-paced and rapidly-changing world of venture capital.

The Dave Berkus Method is an important tool for startup valuations for several reasons:

- Practicality: The method is simple, straightforward, and easy to understand, making it accessible for both entrepreneurs and investors. It provides a basic framework for valuing startups that lack a significant track record or established revenue streams.
- Early-stage focus: The Dave Berkus Method is specifically designed for early-stage startups, which often have limited financial data and a lack of established market penetration. The method takes into account the unique challenges of early-stage startups and provides a way to estimate their value based on potential future growth.
- Relevance: The key components of the method, such as market size, market penetration, intellectual property, management team, and financial projections, are important factors that investors consider when evaluating a startup. By incorporating these components, the Dave Berkus Method provides a comprehensive view of a startup's potential for success.
- Flexibility: The Dave Berkus Method is not a one-size-fits-all solution, and its various components can be adjusted to reflect the specific circumstances of each startup. This makes it a useful tool for a wide range of startups, regardless of their size, industry, or stage of development.
- Widely used: The Dave Berkus Method is a widely recognized and respected valuation framework in the startup community. Many investors and entrepreneurs are familiar with the method and find it a useful tool for evaluating potential investment opportunities.

Overall, the Dave Berkus Method provides a practical, relevant, and widely used framework for valuing early-stage startups, making it an important tool for entrepreneurs, investors, and analysts.

Literature Review:

- **The Berkus Method: Valuing an Early Stage Investment** (**Berkus**, 2012)

  Let us first discuss the article on the Berkus Method written by Dave Berkus himself. In the article, he discusses the challenges of projecting the value of early-stage startups. In particular the technology industry. He argues that relying on revenue and profit projections from the entrepreneur to determine a company's worth is flawed. Very few startups meet or exceed their projected revenues in the planned period. To address this, the author proposes the "Berkus Method". It assesses critical elements of a startup's value without analyzing financial projections, except for the potential to reach over $20 million in revenues by the fifth year of business.

  The "Berkus Method" assigns a maximum value of up to $2 million (or up to $2.5 million post-rollout) to five critical elements of enterprise value, including sound idea, prototype, quality management team, strategic relationships, and

product rollout or sales. But, the author notes that investors can assign much lower values to each element, resulting in valuations well below the maximum amount.

The article emphasizes the importance of keeping startup valuations low enough to account for the high risk involved in investing in early-stage companies and provide room for the investment to achieve a significant increase in value over its life. However, the "Berkus Method" is only applicable to pre-revenue startups, as revenue projections become more reliable once a company has been generating revenue for some time.

The article was then later updated in 2016 to provide for more flexibilities and leeways to the users in adopting the method. Berkus felt the original matrix was too restrictive and should be suggestive rather than rigid. As per Berkus "The Method should be flexible enough for its users to negotiate or create a maximum valuation they are willing to accept in a perfect situation, and to assign risk elements that might be more important to them than those listed above".

Berkus concludes by saying that early-stage startup valuations must reflect for any extreme risks taken by the investor while also enabling opportunity for the investment to achieve a tenfold increase in value over time. He also further states that once the company starts realizing actual revenues; this method no longer becomes applicable as most would start to project value over time.

- **Analysis of Key Factors Contributing Toward Valuation of Pre-Revenue Startups by Means of the Berkus Method (Mahajan et al., 2021)**

  This paper first establishes that the underlying problem of Berkus Method is that it is relatively simple and vague. It lacks proper reference as to how a founder while valuing his pre-revenue startup could assign an appropriate/apt value to the parameters specified in the method. With these problem statements the paper defines its objective to provide key sub-parameters or a guide for allocating values for each parameter under Berkus Method.

  Upon conducting basic quantitative research, the method establishes following sub-categories for each of the parameters to evaluate an early-stage startup

Parameter as per Berkus Method	Sub-parameter established by the paper
Sound Idea	Proprietary nature of the idea
	Well-defined future plan
	Scalability of the idea
	Socio-political relevance
	Validation of idea
Prototype	Completion status of prototype
	Proof of concept and user feedback
	Possibility to license the product
	User interface and salability
	Presence of well-experienced personnel
Quality Management Team	Technical or commercial competency of founding team
	Management awareness of their limitations

(continued)

Parameter as per Berkus Method	Sub-parameter established by the paper
	Share or equity stake among the founding members
	Founder flexibility
	Diversity among founders
Strategic Relationships	Existing rivalry
	Effect of strategic relationship on efficiency of the startup
	Strategic relationship may bring new business/add to existing customer satisfaction
	Capability of strategic relationship to prevent threat from competition
	Whether strategic relationship covers most of the threat the startup is prone to
Product Rollout or Sales	Whether the product has been tested/run through QA
	Evidence that the target customer is willing to pay the target price.
	Customer support team has been properly trained
	Preparation to handle orders
	Clear Go-To Market Plan

1.4 Overview on "How the Dave Berkus Method Is Applied?"

The Berkus method assigns a financial value to each of the four major risks faced by early-stage startups—after crediting the entrepreneur some basic value for the quality and potential of the idea itself. The method adds "US$500,000" in each of the following risk reduction elements (Table 1):

It is to be noted that the above are the maximum limits that can be earned to form the Valuation, allowing for a pre-revenue valuation of up to US$2 million but also allowing the investor to put much lower values into each test.

The reason for this is that Berkus sets a 'soft-cap' of US$20 Mil valuation in the fifth year of the business, giving the investor a ten times return potential over the investment's life span in a pre-revenue stage company.

Table 1 Applying Dave Berkus Method

If exists	Add to company value
Sound Idea (Basic Value)	US$ 500,000
Prototype (Reducing Technology Risk)	US$ 500,000
Quality Management Team (Reducing Execution Risk)	US$ 500,000
Strategic Relationships (Reducing Market Risk)	US$ 500,000
Product Rollout or Sales (Reducing Production Risk)	US$ 500,000

1.4.1 Sound Idea

A sound startup idea is basically a hypothesis about why a company could grow rapidly. The Dave Berkus Method, as we understood assigns a value to the business and its key success factors or risk factors. Sound idea represents the basic value a startup can claim, with the highest value being at US$500,000.

Filters and Framework to Assess a Sound Idea
The Dave Berkus Method does not elaborate on any framework to assess and evaluate a "Sound Idea" but evaluation of an Idea by startup investors across the world can be summarized in the following framework:

- Investment thesis filter.
- Problem being solved and size of the problem.
- Scalability of solution.
- Advantages that would enable rapid growth.

1. **Investment Thesis Filter**
   The investment thesis outlines the specific criteria that the investor is using to make investment decisions and the expected outcome or return. It takes into consideration the investor's risk tolerance, investment goals, and market conditions. The investment thesis is based on extensive research and analysis of various factors such as market trends, company financials, and industry dynamics (Alexander Jarvis, 2021)
   A business idea, however good, would not be considered further for an investment round if it does not fit the Investment Thesis framework.
2. **Problem Being Solved and Size of the Problem**
   The problem statement is basically definition of the setting and environment for the subject company that allows it to grow rapidly. Problems not being solved rapidly or at scale may still be good businesses but are generally not considered good investments by VCs. Following are some of the attributes of "Good Problems" (Hale, 2019) to have "Sound Ideas" for:

   - **Popularity and Size:** Good problems are popular problems to solve. A large number of people experience the problem. Problems with smaller number of people are not quite promising to be solved.
   - **Growing Rate:** Problems that have a growing rate are considered good to be solved. More and more people facing the same problem as years go by is considered good as the startup has a growing addressable market.
   - **Urgency:** Problems that require an immediate solution are good problems to address with a solution. Problems that are not urgent to be solved struggle to get traction in the market.
   - **Expensive Problem:** Problems that are expensive if not resolved are good to be solved. It increases the size of the Total Addressable Market (TAM) and creates the opportunity to charge a lot of money from people to solve the problem.

- **Mandatory Problems:** Problems that cannot be done away with and are mandatory to be solved are great problems to solve.
- **Frequent and Recurring:** Problems that require usage of solution continuously and regularly are great problems to solve. The business has the potential to create recurring and predictable sources of revenue while gradually building a model to recover customer acquisition costs and increase profit margins.

3. **Solution that is Scalable**

   The solution statement is the actual "Sound Idea" under evaluation. Solutions are basically the experiments that the startup is running within the given conditions to grow rapidly (Hale, 2019).

   It is important that the solution is developed after a thorough understanding of the problem. Generally, the Solution should not be in search of the problem. The startup founder should not be so much in deep of the solution that they try to shoe horn a problem into the solution.

   Solutions that are also tech enabled with 'one to many' models are considered scalable with the ability to rapidly grow (Steve Blank, 2010).

4. **Insights and Unfair Advantages that Enable Rapid Growth**

   This is all about the reasons why the solution is going to work. What is the unfair advantage that the business holds that sets it up for rapid growth (Hale, 2019). Following are some of the attributes/analysis frameworks basis which the solution could be evaluated:

- Why is this business in a position to win vs. everyone else?
- Why would this business going to be the fastest one to grow?
- Do they have an customer acquisition strategy that is at a scale, free or relatively cheap? Do they have to pay enormous amounts to acquire customers all the time?
- Do they have unfair advantages that would make them a monopoly in the space that they operate?
- Can they grow on network effects and 'one to many' method?

1.4.2 Prototype

A Prototype is a replica of the actual concept of the product to test its viability. The main objective with which a prototype is built to face the challenges and holes in the solutions in its practical implementation before making large investments in technology, time, energy, and priorities. ("What Is Technology Risk?", Retrieved from https://reciprocitylabs.com/resources/what-istechnology-risk/)

A working prototype, to a large extent, reduces the technological risks and allows for a confirmation of the technical viability of the product.

A working prototype need not, at its very core, have a beautiful UI/UX, fast processing speeds or use complicated tech stacks. It could be built on primitive technology or can even be human driven. However, it must be in a position to demonstrate functionality, reliability, and scalability of the solution (Ramirez, 2018).

A well-built excel sheet that takes a certain input to provide an output can also be a working prototype.

A lack of prototype would significantly reduce the valuation of the subject company while a working prototype with feedback from a few users in the target market would enhance the valuation and can potentially rank closer to US$500,000 mark in the Dave Berkus Method.

1.4.3 Quality Management Team

The quality of the management team, including the founders, is a crucial factor in venture capital investment decisions. VC firms assess the team's experience, skills, and ability to execute their plans, as well as their track record and unique advantages. The management team's leadership structure and ability to drive success and growth are also important factors. The quality of the team is seen as key to the success of the company and the potential for returns on investment, making it a critical consideration in VC investment decisions.

The Dave Berkus Method considers the Quality of Management as one of the attributes for valuation. A high-quality management team reduces the risk of execution and increases the likelihood of success of a startup.

Following attributes are generally considered (MOI, HBR, 2019) by investment managers in assessing the management capabilities to run the startup successfully:

- **Founder's Domain and Track Record**—The background and accomplishments of the founder in their respective field can greatly influence the potential of the startup. Previously successful founders are most likely to succeed in the venture than those founders who are starting up for the first time.
- **Founder Advantage**—If the founder is a product engineer at Google or Microsoft, it does not really establish a founder advantage. This is because there are hundred other product engineers at Google or Microsoft. However if the founder has developed, say a niche patent in battery manufacturing process or had earlier built a successful startup that scaled very well, the same would be considered a founder advantage. Founder advantage is rare to have and such startups deserve higher valuations.
- **Clarity of Thought**—Intellectual prowess is nowhere near as valuable as clarity of thought—the ability to take in disparate ideas, process them and process challenging questions. It takes extra effort and time to be crisp and concise in communicating the business model, strategy, and goals. Such founders effectively manage their teams, co-founders, and investors all alike.
- **Intellectual Integrity—**Founders who are introspective, understand their strengths and weaknesses very clearly. Founders who are self-aware tend to avoid mistakes, which are costly, in early-stage startups and instead seek for help in areas where they lack either from their co-founders or from the investor's team.

- **Solo Founder vs. Co-Founders**—Startup success rates have been closely linked with whether the company is run by a solo founder or a team of founders. Investors prefer co-founded startups for many reasons including better productivity because of leaders handling different priorities and moral support for one another. Founders who have worked together earlier or have known each other from a long time also stick together for longer periods of time.
- **No Other Commitments**—Founders who prioritize the success of their startup above other commitments are more likely to succeed than founders who run their startup on a part-time basis while running other startups or being in employment.
- **Clarity on Leadership**—Founders who have clarity on who the CEO or face of the company is, would work well together as there is minimal room for disputes as each of the co-founders are happy with their roles.

1.4.4 Strategic Relationships

Strategic Relationships can play a significant role in reducing market risk in early-stage startups. A company may enter into strategic alliances to expand into new markets, improve its product line or develop edge over a competitor. The arrangement allows two businesses to work towards a common goal that will benefit both (Kamau, 2019; Blakely, 2023, Picincu, 2018; Wakeam, 2003).

Following are a few examples of early-stage startups that have successfully leveraged strategic relationships:

- Stripe and Shopify: Stripe, a payments processing company, and Shopify, an e-commerce platform, have a strategic partnership that enables Shopify merchants to easily accept payments through Stripe. This strategic relationship has helped both companies grow by providing Shopify with a reliable payment processing option and giving Stripe access to Shopify's large merchant base.
- Airbnb and American Express: Airbnb, a platform for booking short-term rentals, has a strategic partnership with American Express that allows Amex cardholders to use their points to book Airbnb stays. This partnership has helped Airbnb expand its customer base and provide additional value to its hosts, while also increasing the value proposition of Amex's loyalty program.
- Lemonade and Google: Lemonade, a digital insurance startup, has a strategic partnership with Google that allows Google Home users to ask for insurance quotes and receive policy information. This partnership has helped Lemonade reach a wider audience and improve its brand awareness, while also providing Google Home users with a new functionality. Additionally, Lemonade has access to Google's technology and resources, which can help the startup innovate and improve its products.
- Impossible Foods and Burger King: Impossible Foods, a plant-based meat substitute company, has a strategic partnership with Burger King that has resulted in the popular "Impossible Whopper" menu item. This partnership has helped Impossible Foods gain visibility and market share, while also enabling Burger

King to appeal to a growing demographic of consumers interested in plant-based options.

Zerodha's multiple strategic tie-ups: Zerodha, an online discount stock brokerage firm in India has formed multiple strategic tie ups to enhance customer experience in investment and trading. Some of its strategic tie ups include

- Smallcase—Zerodha has partnered with Smallcase, an investment platform that allows users to invest in a basket of stocks that reflect a particular theme or strategy. Zerodha customers can use Smallcase to invest in a range of curated portfolios, including those based on themes such as "Smart Beta," "Value Investing," and "ESG Investing."
- Streak—Zerodha has also partnered with Streak, an algo-trading platform that allows users to create and backtest trading strategies. Zerodha customers can use Streak to create their own trading strategies or use pre-built ones, and automate their trades based on specific conditions.
- Sensibull—Zerodha has partnered with Sensibull, an options trading platform that provides users with real-time data and analytics. Zerodha customers can use Sensibull to analyze options strategies and make informed trading decisions.
- GoldenPi—Zerodha has partnered with GoldenPi, an online platform that allows users to invest in corporate bonds. Zerodha customers can use GoldenPi to invest in high-yield bonds issued by top-rated companies.
- Ditto Insurance—Zerodha's strategic partnership with Ditto an insurance advisory startup has further strengthened its ambition of expanding horizontally in the retail investment space.

In assessment of strategic relationships, following are some of the broad points to note:

- The partnership should increase target customer benefit and reduce friction or problems of the target customer.
- The partnership should compliment the business model in scaling the product offering of the startup.
- Both partners must understand each other's cultural environments. Since there is lot of uncertainty surrounding the offerings of early-stage startups, the partners must rely on intangibles such as executive leadership's vision, morals and values. Some of the matters to check alignment on include importance given to end users experience, customer relationship and its responsiveness, focus on building processes and integrity in business operations.
- Terms of the partnership—The terms of the partnership should be commercially beneficial and not lead to onerous arrangements where achievement of positive economics is a pipe dream.
- Integrations—Where product-level integrations are part of the partnership, such integrations should be relatively easy without requiring resource-intensive or distracting solutions. Partnerships that do not satisfy strategic objectives generally require detailed and customized solutions for integrations.

1.4.5 Product Rollout or Sales

A product rollout is a critical milestone for startups as it marks transition from development to market launch.

It involves careful planning and execution to ensure that the product meets the needs and preferences of the target audience (Kirsch, 2019). Early-stage startups must pay close attention to market demand, competition, and pricing strategies to optimize their chances of success. Additionally, startups need to adopt an agile approach to rollout, where they can adapt and refine the product based on feedback from early customers. Overall, a well-executed product rollout can have a significant impact on the long-term success and growth of a startup.

Following are the two key reasons why a product rollout is important in early-stage startups:

- Demonstrating proof of concept—A successful product rollout provides concrete evidence that the startup's product has value and is in demand in the market. This helps to demonstrate proof of concept for the startup, which is a key factor in valuing early-stage startups.
- Testing and refining the product—A product rollout provides an opportunity for the startup to test and refine its product based on customer feedback. This can help to improve the product's functionality, usability, and overall value proposition which is important for long-term success.

It is to be noted that Berkus method is best applicable primarily to pre-revenue early-stage startups. That means, the usual expectation is to assign a value of 'zero' to the Product Rollout or Sales criteria. Once the company starts generating revenue, projection of such revenue anyway becomes possible and a Discounted Cashflow approach to valuation may be better suited while the Berkus method would not be the best framework to value the startup (William Bruce, 2014).

Why a US$2 Million—2.5 Pre-money Valuation?

As we have discussed earlier, the Berkus model places as a maximum valuation of pre-revenue early-stage startup at US$ 2 Million and a startup with some revenues can be assigned valuation of up to a US$ 2.5 Million.

However, the matrix is not restrictive and the value that can be assigned to each of the element need not be restricted to US$0.5 Million. It is important that the investor or appraiser considers market conditions and has some knowledge of pre-money valuations claimed by similar companies in the space.

If, for example, the average pre-seed, pre-revenue companies' pre-money valuations in the Silicon Valley, USA is about US$10 Million then the value that can be assigned to each of the elements could be US$ 2.5 Million with a maximum pre-money of US$12.5 Million if the company is earning revenues. Similar adjustments could be made considering pre-money valuations in different sectors and geographies. (Berkus, D. After 20 years: Updating the Berkus method of valuation. Retrieved from https://www.angelcapitalassociation.org/blog/after-20-years-updating-the-berkus-method-of-valuation/#:~:text=The%20Berkus%20Method%20assigns%20a,potential%20of%20the%20idea%20itself)

2 Case Study

Let us go through the following case study to understand the practical application of Dave Berkus Method.

Startup: Silver Arrow HealthTech (Fictitious)

Business Model: Silver Arrow HealthTech is a software platform that uses machine learning algorithms to analyze health data and provide personalized health recommendations to users.

Milestones: The startup has developed a working prototype of their platform and has secured a partnership with a local hospital to pilot their product.

Management Team: The team consists of four experienced software engineers with expertise in machine learning and health data analysis.

Competition: There are several other companies in the healthtech space, but Silver Arrow HealthTech has a unique approach to personalized health recommendations that sets them apart from their competitors.

The company is yet to start earning revenues.

Solution

Allocation of value across various attributes can be made as follows, considering Maximum Pre-Money Valuation for Pre-Revenue Startups at US$2 Mil and US $500,000 for each attribute (Table 2).

The above valuation should be substantiated by a brief search of average pre-money valuations for pre-revenue startups in that geography.

Table 2 Solution of the Case Study

Attribute	Add to Value	Reasoning
Sound Idea	US$200,000	This is investor's subjective consideration for allocation of value. Typically, the full value is attributed if the investor is bullish on the idea.
Prototype	US$150,000	Since a fully functional working prototype is ready, a majority value can be attribute. However, the prototype is yet to be tested in real life scenario and the maximum value may not be attributed because of this reason.
Quality Management Team	US$100,000	Even though a competent panel of software engineers are heading the company, there is lack of skills diversity across other important aspects of running a startup like Sales, Marketing, Finance and experience of building startups
Strategic Relationships	US$50,000	The company has now built a relationship with a local hospital to test their prototype. However, strategic relationships in relation to confirmed usage by hospitals, channel partners who can strategical place SilverArrow in existing eco-systems are not present. Hence a lower valuation is attributed
Product Rollout or Sales	NIL	Since this a pre-revenue startup, no valuation for turnover or product rollout can be attributed.
Total valuation	US$600,000	

3 Conclusion

The Dave Berkus Method is particularly useful for early-stage startups that may not yet have significant revenue or assets to base a traditional valuation on. By taking into account attributes that were discussed above, the method provides a more holistic view of the company's potential value and risk reduction for an investor. It is also important to note that the method does not replace traditional valuation techniques but rather complements the. (Bruce, 2014; Teten & Allen, 2017).

The utility of the method also lies in its simplicity, in that it does not require detailed analysis but rather an opinion on various attributes that reduces risk and makes the startup worthy of success. The Berkus Method is not a precise formula but it simplifies valuation.

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