

Better in Early-Stage Funding?

Executive Summary-

Valuing an early-stage startup is more art than science. Founders and investors often struggle to agree on valuation because traditional methods do not always fit young, fast-growing businesses. Two commonly discussed approaches are the **Discounted Cash Flow (DCF) method** and the **Venture Capital (VC) method**. This article explains both in simple terms and highlights which method works better for early-stage funding in the Indian startup ecosystem.

Historic Background: How Startup Valuation Evolved

- Traditionally, businesses were valued using **DCF**, which estimates value based on future cash flows.
- This worked well for mature companies with predictable revenues and profits.
- With the rise of startups over the last 10–15 years, especially in technology and internet businesses, cash flows became uncertain or even negative in early years.
- Venture capital investors therefore developed the **VC method**, focusing more on exit value and expected returns rather than near-term cash flows.

In India, as startup funding accelerated post-2014 with the Startup India initiative, the VC method became more common in seed and Series A rounds, while DCF remained relevant for regulatory and compliance purposes.

Understanding the DCF Method (In Simple Words)

- ❖ **What it is:** DCF values a company based on the money it is expected to generate in the future, adjusted for risk.
- ❖ **How it works (simplified):** - Forecast revenues, costs, and cash flows for the next 5–10 years - Estimate a terminal value after the forecast period - Discount these future cash flows back to today using a discount rate
- ❖ **Why it sounds logical:** - Value is based on fundamentals - Widely accepted by regulators and auditors - Commonly used for mature businesses
- ❖ **Key challenge for early-stage startups:** - No stable revenue history - Cash flows are often negative - Small changes in assumptions can dramatically change valuation

In practice, DCF for an early-stage startup becomes highly assumption-driven and less reliable.

Understanding the VC Method (In Simple Words)

- ❖ **What it is:** The VC method values a startup based on what it could be worth at exit, and works backward to today's valuation.

- ❖ **How it works (simplified):** - Estimate exit value (based on revenue multiples or comparable exits) - Decide expected return (IRR) required by the investor - Discount exit value back to today to arrive at post-money valuation
- ❖ **Why investors like it:** - Focuses on upside potential - Aligns with how VCs think about exits - Faster and more intuitive
- ❖ **Key limitation:** - Depends heavily on exit assumptions - Less grounded in operational fundamentals

Despite this, it is widely used in seed to Series A discussions.

Understanding the VC Method (In Simple Words)

Aspect	DCF Method	VC Method
Cash flow focus	High	Low
Suitable stage	Growth / mature	Seed / early-stage
Assumption sensitivity	Very high	High, but simpler
Investor acceptance	Limited in early stage	High
Regulatory acceptance (India)	High	Moderate

What Works Better for Early-Stage Funding?

For **early-stage startups**, the **VC method generally works better**, mainly because:

- Investors are betting on growth and exit, not near-term profits
- Financial projections are highly uncertain
- Speed and flexibility matter during negotiations

However, this does **not mean DCF is useless**. In India:

- DCF is often required for **fair value reporting**, ESOP valuations, and FEMA-related valuations
- Regulators and auditors still rely on DCF as a defensible framework

As a result, many startups use a **hybrid approach**: -

- VC method for investor discussions
- DCF for compliance and documentation

Conclusion: What Founders Should Keep in Mind

There is no single “correct” valuation method for early-stage startups. The VC method is more practical and investor-friendly during fundraising, while DCF remains important for compliance and governance. Founders should focus less on the method and more on the assumptions behind it. Working with an experienced valuation and transaction advisory firm can help startups strike the right balance between investor expectations and regulatory requirements.

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