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Early-stage Startup Valuations and Their Impact on Subsequent Investment Rounds

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ABSTRACT:

The purpose of this thesis is to explore how the choice of early-stage valuation methods impacts a startup's ability to secure follow-on funding across different market cycles and developmental stages. In the startup context, valuation is not only a technical calculation but also a critical strategic communication tool for managing uncertainty and narrowing the information gap between investors and founders.

The study uses signaling theory, information theory (hard vs. soft information), real options, and screening mechanisms as its theoretical framework. The work is carried out as a theoretical literature review and synthesis, comparing the most common valuation models, such as market-based approaches, milestone/heuristic models (Berkus and Scorecard), the VC method, and scenario-based models.

The analysis confirms that market-based and traction-driven heuristic models are most effective in the earliest stages of a company. These methods transform subjective entrepreneurial potential into verifiable "hard information," which reduces friction in the investment process and signals institutional readiness. On the other hand, the results indicate that the effectiveness of valuation is strongly context dependent. In favourable, liquid market cycles, simple traction signals are often sufficient. In more challenging "cold" market conditions, scenario-based and risk-aware models become critical for passing investors' stricter screening thresholds.

In conclusion, securing successful follow-on funding requires dynamic adaptation of the valuation strategy according to the company's life cycle and prevailing market conditions. The transition from heuristic benchmarks to more robust risk-weighted scenarios as the company matures improves the startup's chances of survival and supports long-term growth.

KEYWORDS: Startup Valuation, Venture Capital, Early-Stage Financing, Follow-On Funding, Information Asymmetry, Signaling Theory, Market Cycles

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1 Introduction

Startups create jobs and drive innovation, making them an important part of the economy. However, their volatile nature makes them dependent on constant supply of external capital. Progressing from one funding round to the next one is often linked to a company's survival and growth prospects (Puri & Zarutskie, 2012). In this competitive environment, valuation is not just a number: it shapes ownership, negotiating power, and expectations for future investment rounds.

Valuing early-stage startups is hard because information is sparse and unclear. In practice, founders and investors rely on practical toolkits, such as milestone/heuristic scores, market comparables, the Venture Capital method, scenario or option frameworks, and discounted cash flow. According to Stein (2002), when there is a high degree of uncertainty, the way information is presented is important: simple, verifiable "hard" information is usually more convincing than long, assumption-based forecasts.

Comparability is complicated by contract terms of the various deals. Preferred share rights and liquidation preferences mean that the post-money number may differ from the economic value, therefore two "€10m post-money" rounds may generate very different payoffs. These terms affect all valuation methods and change how investors read the company (Kaplan & Strömberg, 2003; Gornall & Strebulaev, 2020).

As financing conditions change cyclically, when capital is abundant, screening thresholds are lowered and recent market comparisons become more important. Conversely, when capital is scarce, investors demand more comprehensive, risk-aware evidence (Gompers & Lerner, 2000). These patterns suggest that context influences which valuation methods are most appropriate for later funding rounds, which provides a basis for the following analysis.

1.1 Purpose of the study

The purpose of this paper is to explore how the choice of early-stage valuation methods impacts a startup's ability to secure the next funding round, and whether the optimal method varies according to the startup's stage and prevailing market conditions. The paper focuses on pre-seed to Series A. The study is based on academic evidence, which can be used to establish simple, theory-based criteria for comparing the most important approaches and explaining what works, when, and why. The most important approaches used in the study are market-based, milestone/heuristic, VC method, scenario/option-based and Discounted Cash Flow approaches.

The study aims to answer the following research question: How does the choice of early-stage valuation methods impact a startup's ability to secure follow-on funding across different market cycles and developmental stages?

To address this question, the study proposes two testable hypotheses. First, I consider whether simple and verifiable evidence is better data for investors in the early stages than long models based on assumptions. If peer comparison and clear traction are easier to assess and compare, they should be more effective in practice. Hence, the first hypothesis is:

H1: Securing the next round of financing in the early stages of a startup is more effective when the valuation method is based on peer comparisons and traction rather than DCF-style long-term cash flow models.

Second, if the effectiveness of the valuation method varies according to the context, the reason should be the information environment and capital markets. In "hot" markets at a very early stage, investors may accept simpler evidence, whereas in colder markets or later stages, they might require a clear risk and downside analysis. This leads to second hypothesis:

H2: In hot and very early stages, peers and traction work best as a valuation method, while in cold or later stages, scenario- and risk-based approaches work better.

These hypotheses are based on well-known concepts in finance, such as signaling and certification, the distinction between "hard" and "soft" information, staged financing and learning, and screening under credit rationing. The hypotheses are tested in the paper by comparing commonly used valuation methods.

1.2 Structure of the study

Following this introduction, which outlines the purpose and hypotheses of the study, the thesis is organized into five subsequent chapters. Chapter two presents the theoretical background. It introduces the key concepts of early-stage financing, summarizes four classic theories (signaling and certification, hard vs. soft information, staged financing and real options, credit rationing) and builds a concise conceptual framework for valuation and follow-on financing. Chapter three examines the most important valuation methods for startup companies (market-based, milestone/heuristic, VC method, scenario-/option-based, and DCF). Each method is described using a concise model that considers the definition and inputs, suitability for the stage/market, and strengths and limitations. Chapter four combines the theories with mechanisms that link valuation information to subsequent funding rounds (signaling, hard-information, staging/learning/flexibility, and screening) and defines the performance metrics to be used later. Chapter five applies clear evaluation criteria, compares methods in a matrix, and directly addresses the research question. Chapter six concludes the findings.

2 Theoretical background

This chapter builds the foundation for the thesis. First, it clarifies the key concepts of early-stage financing (funding rounds, pre-/post-money, ownership and share classes, and the most important financing instruments). Then, this chapter introduces four classic theories that are applied throughout the study. Furthermore, their relevance to the topic is examined. The chapter ends by combining these ideas into a short conceptual framework that links valuation data to future results. Framework also provides evaluation criteria that will be used later to compare methods and interpret our hypotheses.

2.1 Early-Stage Finance: Key Concepts

Early-stage financing typically takes place in priced rounds (pre-seed, seed, and Series A), in each of which new securities are issued to outside investors. The pre-money valuation is the value of the company before new capital, and post-money is pre-money plus the new investment, meaning that the investors' ownership is the investment divided by post-money. Since employee equity programs are often adjusted during a round, effective dilution typically reflects both the new stake and simultaneous adjustments to employee equity.

As noted in chapter one, contract terms can separate a headline post-money figure from economic value. In early-stage financing rounds, preferred shares generally have liquidation preferences, seniority across series, and anti-dilution protections. These cash flow and control rights determine the exit waterfall, which specifies who gets paid first and how the rest is shared. Thus, two deals with the same post-money valuation can yield very different outcomes for common shareholders and option holders. In this study, comparisons are therefore terms-aware: all valuation evidence is interpreted considering the relevant security design and cap-table context (Kaplan & Strömberg, 2003; Gornall & Strebulaev, 2020).

Market conditions reflect changes in capital supply and exit opportunities, which impact pricing, pace, and the type of evidence that investors prioritize. In practice, these can be assessed based on the amount of funds flowing into venture capital funds, public market valuation levels in relevant sectors, and exit market activity, which influence required returns and the size of financing rounds (Gompers & Lerner, 2000; Gibbons, 2023). Economic upturns have also been associated with different idea selection, with investors backing a more extensive range of projects, while downturns skew choices toward safer or better documented options (Nanda & Rhodes-Kropf, 2013). More generally, private equity/venture capital returns are cyclical, which highlights the need to understand early-stage valuations in the context of market conditions rather than as a separate phenomenon (Brown, Gredil & Kaplan, 2021; Ewens & Farre-Mensa, 2020).

To keep the analysis clear, the capitalization table is examined in two ways. First, the as-converted ownership is tracked without taking preferential rights into account. Second, the economic outcomes in probable exit scenarios that follow the waterfall model. Throughout the paper, these different investment conditions are compared. The assessment is based on how convincingly the valuation data is likely to carry over to the next round in different market situations (Kaplan & Strömberg, 2003; Gornall & Strebulaev, 2020; Stiglitz & Weiss, 1981; Hsu, 2004).

2.2 Theories

This section constructs a multi-layered theoretical framework to achieve a robust analysis how early-stage valuations affect subsequent financing rounds. The chosen framework is well-suited to address the core problem from three separate but partially overlapping perspectives: information management, risk mitigation through strategic staging, and market-level equilibrium. By combining these classic and modern theories, the study provides a comprehensive lens through which to apply theoretical criteria that will be used in Chapter 5 to evaluate valuation methods.

2.2.1 Signaling and Certification

Information asymmetry is the primary obstacle in the venture capital market. According to Spence (1973), when quality is difficult to observe directly, signals must be relied on. These are actions that are difficult or expensive to fake and that show others the true level of the actor. In the startup ecosystem, valuation is not just a financial figure, but a signal of the company's confidence and the lead investors' assessment of its future potential.

In addition to the signal provided by the valuation itself, the identity of the investor also provides an important "certification" effect. Megginson and Weiss (1991) argue that reputable intermediaries can certify the quality of a company to less informed market participants. In early-stage financing, the presence of a high-status lead investor acts as a seal of approval, reducing the risk perceived by participants in subsequent rounds. This certification is particularly important because it bridges the gap between the private information of insiders and the external market.

The strategic importance of this certification is also evident in the fact that entrepreneurs are willing to make compromises. Hsu (2004) shows that founders often accept significantly lower valuations from reputable venture capitalists than from less reputable ones. This shows that the long-term value of "certification" and the investors' network (Hochberg et al., 2007) is often greater for entrepreneurs than the immediate cost of equity dilution. In this study, signaling theory explains how certain valuation methods may be chosen specifically for their ability to project credibility to investors in the next round.

2.2.2 Hard vs. Soft Information

The difference between "hard" and "soft" data determines how the value of a company is justified to new investors in subsequent financing rounds. Stein (2002) defines hard data as quantitative and verifiable. This type of information is easy to transfer between different levels of the organization and from one place to another without changing its content. Soft information, on the other hand, is subjective and difficult to verify. It is often linked to the context or relationship in which the information was originally created. For a startup, hard information typically includes historical financial statements, audited unit economic data, and verifiable user traction metrics, while soft information includes, for example, the character of the founders, the long-term vision, or the organizational culture.

Conveying soft information is a key challenge as a startup company grows. Stein (2002) notes that hard information is the most effective way to obtain financing from new and external investors. Numbers and facts are easy to verify; they convince even investors who are not yet familiar with the company. A company must successfully transition from "soft" founders' narratives to "hard" metrics as it moves from the seed stage to Series A. This "hard" information is typically required by institutional investors. This transition is central to the first hypothesis. It states that valuations based on hard and verifiable data improve the certainty of securing the next funding round. They are clearly more reliable than soft and assumption-based cash flow models.

The professionalization of startups involves converting soft, intuitive insights into hard, standardized metrics. This process is often driven by early-stage venture capitalists and is necessary for the company to meet the requirements of institutional capital markets (Hellmann & Puri, 2002). Therefore, choosing a valuation method is not merely a technical exercise, but a strategic communication choice. It determines whether the company's value proposition is based on the founders' subjective "story" or on objective "evidence" from the market.

2.2.3 Staged Financing, Learning and Real Options

Capital is rarely used as a single lump sum in startup investments because it is highly uncertain and involves agency problems. Instead, venture capitalists use staged financing to maintain control and manage risk (Gompers, 1995). Each funding round offers the investor an "option" to abandon the project if its results are poor. Conversely, the investor has the capability to "exercise the option" by reinvesting if certain interim targets are met. This staging creates the opportunity for a "learning process." In it, information is gradually revealed, and uncertainty is eliminated over time (Gompers, 1995).

McDonald and Siegel (1986) developed a concept called the real option. According to it, each round of financing represents a real option. The value of a startup is not just the discounted present value of its future cash flows. It also consists of the value of its management's flexibility to scale, pivot, wait, or abandon the project based on new information. This real option thinking is important for the second hypothesis. It provides a theoretical rationale for why it makes sense to move from static models to scenario-based valuation methods. One example of such a method is the First Chicago method. It prices the value of this flexibility and downside protection against downturns.

The modern "lean startup" investment environment has further accentuated the above-mentioned dynamics. Ewens et al. (2018) point out that the cost of technological experimentation has fallen. This decline has enabled smaller and more frequent funding rounds. Through them, investors learn about the viability of the company. It means that early-stage valuation is not about finding a permanent price for the company. What is more important is to create a fair starting point from which to continue developing the company. Therefore, in times of uncertainty, flexible models are better than traditional and straightforward predictions. These models consider a range of different options and assign value to future choices.

2.2.4 Credit Rationing & Screening

The final pillar of the theoretical framework deals with the allocation of capital in imperfect markets. In these markets, it is difficult for investors to distinguish high-quality projects from low-quality ones. Stiglitz and Weiss (1981) noted that in markets with asymmetric information, valuation does not necessarily clear the market. Instead, there is credit rationing, in which some potentially viable companies are denied capital altogether. This is because raising prices would only attract the riskiest projects. In such an environment, venture capitalists need to use rigorous screening. This allows them to select only the most promising candidates. Sørensen (2007) emphasizes that the ability to screen out the best projects is the most important characteristic of professional investors. They therefore use their expertise as a filter to separate the most promising candidates from a large pool of applicants.

The intensity and nature of the screening process are highly cyclical. They vary directly with market conditions. Competition among investors lowers their screening thresholds when the market is “hot” and capital supply is abundant. In such cases, projects are examined less thoroughly. Investment decisions are also based more on simpler and more observable signals (Gompers & Lerner, 2000). During economic downturns or “cold” markets, investors’ risk appetite decreases significantly. According to Nanda and Rhodes-Kropf (2013), investors then focus on screening safer targets or targets that are particularly well documented.

This market-dependent screening is an important justification for the second hypothesis. In cold markets, simple signals of traction are not always sufficient to make investors more rigorously screen. Instead, investors want more robust and risk-aware evidence (Nanda & Rhodes-Kropf, 2013). As market conditions become more tightened, the focus of negotiations shifts from the value of the company to contractual terms that protect investors. These terms can include, for example, liquidation preference and seniority. According to Kaplan and Strömberg (2003) and Gornall and Strebulaev (2020), these terms define an economic value that exceeds the headline post-money figure. It is

essential to understand how the valuation method and market screening interact. According to Gompers & Lerner (2000), interaction helps predict the success of follow-on funding.

2.3 Conceptual Framework: From Valuation to Follow-On Funding

This section combines signaling (Spence, 1973), information theory (Stein, 2002), real options (Gompers, 1995), and screening mechanisms (Stiglitz & Weiss, 1981) into a unified framework. It helps the research identify specific pathways through which valuation information is transformed into follow-on capital. The section models subsequent financial performance. The valuation of start-up companies is a body of information that guides the expectations and decisions of prospective investors.

The central logic of the framework follows a sequential and multidimensional process. First, the choice of valuation method determines the type of information to be used, that is, whether the information is "hard" or "soft." This information is produced and documented in detail during the due diligence process (Stein, 2002). Second, this set of information serves as a signal that certifies to the quality and professionalism of the startup to the broader market (Megginson & Weiss, 1991; Hsu, 2004). Third, the interpretation of this signal is strongly influenced by prevailing market conditions and the current stage of development of the startup company. Both determine the strictness and focus of the investors' screening process (Gompers & Lerner, 2000; Nanda & Rhodes-Kropf, 2013). Finally, the interaction between the information produced and market screening leads to measurable follow-on funding outcomes. These include, for example, a successful closing "up-round," the time between funding rounds, and the reputation of the next lead investor (Puri & Zarutskie, 2012).

In addition, conceptual framework defines the evaluation criteria used in Chapter 5 to assess the effectiveness of different valuation models. These criteria, which are verifiability, comparability, terms-awareness, flexibility, and context fit, are directly based on

the theoretical pillars presented in Chapter 2.2. For example, the criteria of "verifiability" and "comparability" stem from the need to produce hard information that reduces asymmetry (Stein, 2002). In turn, "terms awareness" reflects the need to consider complex securities designs and the exit waterfall of the capitalization table (Kaplan & Strömberg, 2003; Gornall & Strebulaev, 2020). "Flexibility" stems from the perspective of real-options, where staged financing is seen as a series of strategic choices (McDonald & Siegel, 1986; Gompers, 1995). According to Sørensen (2007) and Nanda & Rhodes-Kropf (2013), contextual fit examines the nature of credit rationing and market-based screening. The analysis determines the impact of the approaches on the survival of start-ups. The thesis examines valuation using a framework that provides a solid basis for evaluation.

3 Valuation Models for Startups

Valuing early-stage startups is a central dilemma in the finance industry. These companies typically do not have historical cash flows, and their future is unpredictable. For this reason, it cannot be assumed that the theoretical value of a company is the present value of its future cash flows. To address this problem, the industry uses various models to estimate the value of startups. Chapter analyses these models and relates them to financial research. This combination is used to assess the effectiveness of the models in generating information and managing risk.

3.1 Market-Based

The market-based approach determines the value of a company by identifying comparable companies. Comparable companies include, for example, recently funded start-ups or publicly traded companies. The method applies the valuation multiples of these comparable companies to the target company, which are often expressed as:

$$\frac{EV}{Revenue} \text{ or } \frac{EV}{EBITDA} \quad (1)$$

The market-based approach is preferred for its simplicity. It also can provide a “market-clearing” price that reflects the current sentiment of investors (Metrick & Yasuda, 2021).

Broader economic conditions affect the performance of multiples. Venture capital valuations change as the availability of capital changes (Gompers & Lerner, 2000). Gompers and Lerner (2000) found that investor competition intensifies when a lot of money flows into an industry. They coined the term “money-chasing deals.” Valuations become too high, creating pressure. Gompers and Lerner (2000) argue that because of pressure, price tags attached to companies can reflect market momentum more than sustainable

value. In the market-based approach, the multiples are based on observable market data and audited financial data. The first hypothesis emphasizes that comparable data creates a direct signal. It reduces information asymmetry that hinders subsequent financing rounds. “Hard information,” as defined by Stein (2002), is essential in the market-based approach. Hard data is easily verifiable and transferable to new investors.

3.2 Milestone/Heuristic

In the seed stage, Berkus and Scorecard approaches are common if traditional numbers do not yet exist. The models measure, for example, team strength, product readiness, and market potential. Each stage of development is assigned its own rating or importance level. Investors provide guidance in addition to money and internal business operations (Hellmann & Puri, 2002). Entrepreneurs tend to prioritize key development goals and long-term planning stages favoured by institutional investors, as heuristic models act as an early-stage screening mechanism. Valuation choices can reflect more than just numbers. Certification also shapes early assessments (Hsu, 2004). Reputable investors may offer less money but still attract top founders. Their position sends a signal to the broader market, and decision-making is no longer based on speculation. Reputable investors build credibility for the company and that market. These methods improve on traditional models, which cannot always take into account the hidden factors that affect startup performance.

3.2.1 The Berkus Method

The Berkus approach provides a way to determine the value of a company without knowing its financial history. Early-stage financing is easier to obtain when valuation is based on traction and milestones rather than DCF-type long-term cash flow models. This is essential for the first hypothesis. DCF models are based on steady-state growth models, which are inherently lacking in most startups. In the absence of revenue, DCF models are

based on assumptions that can lead to misleading results (Damodaran, 2009). The Berkus approach does not consider uncertain forecasts at all. It considers five qualitative “traction” milestones in its assessment.

The model works on the principle that the value of a startup is built through the successful mitigation of certain development risks. According to Berkus (2016), the method assigns a separate monetary value to five categories: a sound idea, prototype, a quality management team, strategic relationships, and initial sales or product rollout. The monetary value can be up to \$0.5 million per category. This systematic framework, presented in Table 1, allows for a maximum valuation of \$2.5 million prior to funding.

Table 1. The Berkus Method (Berkus, 2016).

If Exists:	Add to Company Value up to:
Sound Idea (Basic Value)	USD 0.5 million
Prototype (reducing technology risk)	USD 0.5 million
Quality Management Team (reducing execution risk)	USD 0.5 million
Strategic relationships (reducing market risk)	USD 0.5 million
Product Rollout or Sales (reducing production risk)	USD 0.5 million

From the perspective of Hypothesis 2, the Berkus method is a typical example of why traction-based approaches work best in the "very early stages." Later-stage or "cold" market valuations may require the more rigorous scenario-based approaches mentioned in H2. In contrast, in an early stage "hot" environment, speed, signal, and concrete milestones are valued. This is confirmed by Miloud et al. (2012) and Sievers et al. (2013), who show that non-financial information and qualitative company characteristics are the most important determinants of value when financial statements offer little predictability.

The emphasis on prototypes and management quality is also consistent with the signaling and professionalization theories that are relevant to this study. Hellmann and Puri (2002) show that venture-backed companies use milestones in their development. Their purpose is to accelerate the professionalization of the company's internal operating processes. Similarly, Audretsch et al. (2012) emphasize that for start-up companies, the presence of a prototype is an important financial signal. Because it reduces the information asymmetry between founders and investors. The Berkus method prioritizes these traction points over unstable financial forecasts. Heuristic models based on traction provide a more realistic picture of a company's potential at the seed stage than traditional corporate financing methods, and this strengthens the thesis' argument.

3.2.2 The Scorecard Method

Bill Payne's Scorecard method differs from the Berkus method by adding a sharper judgment through comparisons. The Scorecard method tracks not only internal progress characteristics but also external characteristics. The method measures value by comparing startups to other companies in the same industry and region. The method ties valuation estimates to the current view of investors. As a result, pricing is generated based on market sentiment rather than long-term cash flow models (Payne, 2011; Metrick & Yasuda, 2021).

The method adjusts the peer average of the comparables using a weighted assessment of seven qualitative factors. Table 2 shows that these factors highlight the elements that institutional investors value most in pre-revenue companies.

Table 2. The Scorecard Method (Payne, 2011).

Comparison Factor	Range	Target Company	Factor
Strength of Entrepreneur & Team	30 % max	125 %	0.3750
Size of the Opportunity	25 % max	150 %	0.3750
Product/Technology	15 % max	100 %	0.1500
Competitive Environment	10 % max	75 %	0.0750
Marketing/Sales/Partnerships	10 % max	80 %	0.0800
Need for Additional Investments	5 % max	100 %	0.0500
Other factors	5 % max	100 %	0.0500
Sum			1.0750

The Scorecard Method provides theoretically robust support for Hypothesis 1. The model favors verifiable traction and peer metrics rather than the speculative projections criticized by Damodaran (2009). The heavy weighting given to "Strength of Entrepreneur & Team" (30%) reflects the empirical findings of Miloud et al. (2012) and Sievers et al. (2013). According to them, without a financial history, human capital and strategic qualitative factors are the most important predictors of a company's value. The inclusion of "Product/Technology" as a key factor is an important factor. The technological readiness of startups is a critical economic signal that reduces information asymmetry (Audretsch et al., 2012).

The average return by location forms the starting point for the model. The phenomenon of "money-chasing deals" developed by Gompers and Lerner (2000) allows founders to benefit from the market in "hot" markets. Peer data stands out better when liquidity is high. According to Stein (2002), such figures speed up investors' decisions. When using the scorecard method, founders compare performance with peer projects, which supports greater professionalism in early-stage companies. Systematic reviews play a key role in the development of startups, as they encourage companies to strengthen internal functions more quickly (Hellman and Puri, 2002). According to Stein (2002), "hard data" lowers the screening threshold for follow-on investors. The approach supports the core

idea that peer-based, quality-based reviews are better than traditional internal methods in the early stage.

3.3 Venture Capital Method

The Venture Capital method combines heuristic milestones and financial modeling into a coherent whole. The method was developed by Sahlman and Scherlis (1989). However, Sahlman (2009) developed the method further. In the venture capital method, investors' return on investment requirements are taken into account before traditional accounting measures. The method determines the value of the company by considering the potential value in a future exit event

The method calculates the post-money valuation by discounting the expected exit value to the present value using the investors' target ROI and the expected exit time (t). This is shown in more detail in formula (2).

$$POST = \frac{\textit{Anticipated exit value}}{(\textit{Target ROI})^t} \quad (2)$$

After the post-money valuation, the method calculates the pre-money valuation by subtracting the current investment amount. This is shown in more detail in formula (3).

$$PRE = POST - \textit{Investment} \quad (3)$$

The VC method is based on measurable market outcomes. The method uses expected exit values from similar companies in the same industry and uses prices set by previous acquisitions or IPOs for similar companies. The figures used in the VC method are derived

from actual transactions, so they provide a stronger basis than models based on internal cash flow projections. Later investors value this kind of “hard data” over the displays of traditional DCF models. The VC method is very strongly linked to the second hypothesis, because in later stages or “cold” markets, investors use risk-based assessments. In formula (2), the “target ROI” acts as a high discount rate. This rate usually varies between 40 and 60%. The venture capital method requires a very high-risk premium for the investment. It can be concluded that in economic downturns, special risk awareness is needed to pass investor screening. Sahlman (2009) and Hellmann (2001) argue that such setups lead to agency problems. Fast-growing firms often face information asymmetries, to which these models respond directly.

3.4 Scenario- and Option-Based

Scenario-based methods take uncertainty into account. This section highlights the First Chicago method. The method considers success, survival, and failure. The final value of the model is calculated as the probability-weighted average of the valuations for each scenario (Venionaire, 2015).

$$Valuation = \sum_{i=1}^3 p_i Valuation_i \quad (4)$$

Where,

p_i = probability of scenario i

$Valuation_i$ = value in scenario i

The First Chicago method takes into account the irregularity, where often only a few startups generate almost all the startups’ revenue. The method uses industry-specific exit rates in different scenarios, which helps to avoid the limitations of static models. According to Venionaire (2015), the FCM directly considers the risk of failure and the

value of hedging against a downturn. This is useful in “cold” markets or when companies reach later stages. At these times, investors demand a more detailed analysis of negative scenarios, which is emphasized in accordance with Hypothesis 2.

According to McDonald and Siegel (1986), the value of waiting is valuable when conditions are uncertain. During the waiting period, new information about the situation can be obtained. Scenario and option-based models incorporate the learning process into probability-weighted scenarios. Investors require a careful analysis of future strategic choices and risks, which makes the model robust. According to Gompers (1995), venture capital thrives on staged investments. This is related to real options theory, which is based on making decisions over time. According to the milestone results, investors can abandon the investment or commit to additional resources, which creates a real option for the investor.

3.5 Discounted Cash Flow

Corporate finance often relies on the Discounted Cash Flow (DCF) method. In this model, the value of assets is determined as the net present value of all future free cash flows. In a start-up valuation, cash flows are projected over a certain period. This value is discounted to the present using the cost of capital. The cost of capital reflects the risk profile of the business. However, Damodaran (2009, 2012) shows clear difficulties when applying DCF to early-stage ventures. Early-stage ventures often miss past financial records, steady profit ranges, or consistent expansion patterns. However, these would be needed so that the predictions based on assumptions would be good enough in the eyes of external investors.

$$DCF = \sum_{t=1}^n \frac{CF}{(1+r)^t} + \frac{TV}{(1+r)^n}$$

(5)

One reason the DCF model struggles is how much it depends on uncertain estimates, according to Hypothesis 1. Koller, Goedhart, and Wessels (2010) point out that the valuation of high-growth companies is highly sensitive to assumptions. Even small shifts in long-term growth rates or terminal value produce large swings in results. The DCF model relies heavily on what Stein (2002) defines as "soft information." This characteristic weakens the model's effectiveness in securing early-stage funding compared to peer-based or milestone-driven methods. Because early-stage startups do not often yet generate income, new startups rely heavily on founder-led narratives. Instead of verified numbers, assumptions shape their initial worth. This view is also supported by Miloud et al. (2012) and Sievers et al. (2013). They show that qualitative factors are much more relevant in early-stage valuation. Because financial records simply fail to forecast outcomes with any reliability.

Furthermore, the DCF model often ignores a startup's critical survival risk. Puri and Zarutskie (2012) present empirical evidence that venture-capital-financed companies face exceptionally high failure rates in their early years. Larrabee and Voss (2012) examine cash flow discounting mechanisms as part of company valuation. However, they acknowledge that the static nature of the model does not capture the managerial flexibility or "learning options" typical of start-up companies. The scenario-based models presented in Hypothesis 2 offer a more dynamic structure than DCF. The linearity of the DCF model prevents it from producing the analytical evidence needed in a market downturn to convince risk-aware investors.

Finally, the use of DCF in early-stage financing may hinder the signaling and certification processes that are essential for long-term growth. Hsu (2004) notes that reputable investors provide a "seal of approval" that reduces the risk of future financing rounds. DCF models are easy to manipulate by changing their underlying assumptions. For this reason, they provide a weak signal of quality compared to the "hard information" provided by completed prototypes or strategic partnerships. Hellmann and Puri (2002) show that startup companies professionalize their reporting as they mature. The DCF model works

best as an additional tool for later-stage companies whose unit economics are already sufficiently predictable for institutional capital markets.

3.6 Summary of Methods

In summary, the selection of a valuation model is a strategic decision that reflects the startup's stage of development and the prevailing market sentiment. As discussed in this chapter, different models serve different types of signals to potential investors. In line with Hypothesis 1, heuristic and market-based models are superior in the early stages. These models emphasize verifiable traction milestones and objective peer comparisons, which constitute "hard data." Investors generally prefer this evidence over the assumption-laden "soft information" characteristic of DCF models (Stein, 2002; Damodaran, 2009).

Furthermore, the effectiveness of these models depends on the context, which is consistent with Hypothesis 2. Market-based multiples and simple heuristics work best in "hot" markets where capital is abundant and speed is valued. However, this changes when moving to institutional capital, which requires more robust and risk-aware frameworks (Gompers & Lerner, 2000). Scenario-based and VC method explicitly prices the uncertainty and survival risks identified by Puri and Zarutskie (2012). This feature makes them preferred tools when market conditions tighten or a company matures.

Table 3 presents a conceptual summary of the models discussed and evaluates them based on the theoretical criteria established in Chapter 2.3. The matrix shows that follow-on funding requires a shift from "soft" narratives to "hard" data, regardless of the market cycle.

Table 3. Comparison of Valuation Methods.

Method	Primary Input	Information Type	Optimal Context (H2)	Effectiveness (H1)
Market-Based	Peer Multiples	Hard	Hot Markets	High (Peer Comparison)
Milestone /Heuristic	Traction Milestones	Hard / Hybrid	Very Early Stages	High (Traction-based)
VC Method	Exit Multiples / ROI	Hybrid	Scaling / later Stages	Moderate
Scenario-/Op-tion-based	Probabilities	Risk-Aware	Cold Markets	Moderate
DCF	Forecasted CF	Soft	Mature / Stable	Low (Early Stage)

4 Mechanisms: From Valuation to Follow-On Funding

This section connects key parts of the study in a focused way. Following the theory laid out in Chapter 2, practice took centre stage in Chapter 3 through applied valuation methods. Building on both, Chapter 4 turns attention to how early decisions shape later results. Section combines signaling theory, information theory, real options, and screening mechanisms. The core idea of the chapter is that the choice of valuation method involves more than technical calculations. The choice of method affects how future investors see the opportunities.

Each model affects the sustainability and expansion of a startup in different ways. The chapter analyses how valuation methods change according to economic trends and business level. It also explains how these models provide different levels of "hard" and "soft" information to achieve results. At the same time, the analysis provides answers to both hypotheses. Ultimately, metrics like the chance of securing an "up-round" or the reputation of the next lead investor set clear benchmarks. For evaluating how well each valuation approach performs, these guide the upcoming assessment.

4.1 Signaling and Certification Pathway

Valuation influences follow-on funding through several mechanisms. The first of these is the signaling and certification process. In an uncertain environment, it is difficult for investors to assess the true quality of a startup due to the lack of reliable information. According to Spence (1973), valuation serves as a critical signal that entrepreneurs use to convey the unobserved quality of their company to potential investors. It is costly and costly to fake effective signals to maintain trust. At the same time, effectiveness requires that the information be easily verifiable by the recipient.

Market-based and peer-comparison methods are effective signals that support the claim made in hypothesis 1. Because these rely on data labelled "hard information" by Stein

(2002), verification becomes simpler for those investing, more so than relying on guesses. Tied closely to visible market standards, worth gains clarity when measured against audited peer company metrics. The following investors find such grounding useful, because it reduces effort needed during evaluation phases. Starting from where investors stand tends to carry greater weight than company-generated projections. These "soft" narratives are often prone to founder-led optimistic bias

A boost comes through what Hsu (2004) calls a "seal of approval," tied to how value gets confirmed. This seal is created when valuations stem from trusted benchmarks. Valuations can also be based on the support of earlier well-known venture capitalists, which adds credibility. Subsequent investors experience less uncertainty when a well-known investor is already involved in the project. Trust helps to move to the next round of financing. Signaling and certification reveal deeper roles in the value of the company than just the market price. Investors lack a complete view, so it is important to verify the true value of the company. These tools turn vagueness into clear promises that open new doors for securing follow-on financing.

4.2 Hard Information and Peer Comparisons

Stein (2002) defines "hard information" as numbers that anyone can verify. This data is obtained by converting hidden strengths into numbers. An early-stage company can compensate for its lack of financial history by using clear market standards. Such data flows well between banks and funds. Peer comparisons anchor value to market data, which makes signals simpler. Investors also see fit more quickly because it is easier to assess based on known examples. In valuing startups, using industry-specific metrics against clear data becomes a reliable method. "Hard information" is much less susceptible to the "cheap talk" that is often associated with optimistic entrepreneurs. This practice reduces the information asymmetry between founders and investors. Reliability is built by relying on market-confirmed pricing rather than personal assumptions. This

distinction is important because markets rely on signals to distinguish strong companies from weak ones (Miloud et al., 2012; Sievers et al., 2013).

Professional peer comparisons serve as an important certification for a startup. As Hsu (2004) suggests, a valuation based on market data gives investors a seal of approval. This shows that the company has achieved institutional readiness and operates within the parameters of the current market sentiment. Certification is essential for securing capital in subsequent "up-rounds" because it provides follow-on investors with verifiable evidence needed to justify higher price points. The effectiveness of a valuation method depends directly on how well it can produce hard and comparable data of a company's value. This is essential for the method of meeting the high-quality standards set by professional capital markets.

4.3 Staging, Learning and Real Options

The third mechanism linking valuation to follow-on funding is staging, learning, and real options pathway. This mechanism forms the primary theoretical foundation for Hypothesis 2. According to this hypothesis, scenario- and risk-based approaches are particularly effective in cold markets or in the later stages of a company's development. At its core, pathway recognizes that venture capital is deployed through staged financing rather than as a single investment. Staged financing creates a learning process where knowledge is gradually revealed (Gompers, 1995). This allows investors to see each investment round as a real option. Investors can either reject a project due to poor performance or continue financing based on good results.

Scenario-based frameworks help investors make decisions. By visualizing scenarios, management choices, and strategic flexibility can be calculated as part of the company's value. By estimating the probabilities of different outcomes, uncertainty can also be included in the calculations. The method directly prices downside protection and failure risk, which are often ignored in traditional models (Venionaire, 2015). The probability-

weighted approach is directly based on McDonald and Siegel's (1986) real options theory. The ability to wait for new information or pivot based on revealed information is a very important part of the value of a startup. The method treats decisions made under uncertainty as economic choices. Future prospects are as important as the current state when setting terms. The approach takes into account new information and reversals, which helps to secure follow-on financing even in difficult market conditions. In a "cold" market, investors' "market screening" becomes stricter, and negotiations shift from growth to risk management signals.

4.4 Screening and Market Cyclicity

Valuation is linked to subsequent rounds of financing as companies filter through market cycles. This solves a fundamental problem of capital allocation in the market. It becomes more difficult for investors to select strong companies from weak ones when markets are functioning. Asymmetric information leads to credit rationing, where some good ideas go completely unsupported (Stiglitz & Weiss 1981). Simply raising prices or valuations would only attract riskier projects to the market. To solve this problem, professional investors use strict screening mechanisms to "sort" the best projects. Skilled venture capitalists stand out from the crowd because of this (Sørensen, 2007). Changes in the economy shape how financiers examine each opportunity. In "hot" markets, screening standards may be relaxed, and in tougher times, scrutiny becomes more intense.

"Hot" markets force investors to compete intensely for opportunities. This is known as the "money chasing deals" phenomenon. High valuations can be misleading at the peak of a market cycle (Gompers & Lerner, 2000). In such cases, the prices that explain the market reflect more the overheating of the market than the prospects for sustainable growth of the startup. In times of high liquidity, investment decisions are based more on simple signals. In line with Hypothesis 2, a high-liquidity environment favours the heuristic and market-based methods discussed in Chapter 3.

Investors' risk aversion becomes more pronounced, and caution increases as the economy declines. This leads to a much stricter screening process. According to Nanda and Rhodes-Kropf (2013), in such circumstances, investors shift their attention to projects that are either inherently safer or have a particularly well-documented risk profile. This change directly reinforces the second part of H2: in tight market conditions, simple signs of traction may no longer be enough to pass an investors' strict screening process. Instead, investors prioritize risk-aware evidence based on scenarios and option-pricing models. These explicitly consider the risks of downturns and the probabilities of failure. Thus, the screening process shows that the "best" valuation method depends on the context. This is because the criteria for follow-on funding are determined by the prevailing market screening and its requirements. These relate either to growth-oriented signals or to evidence mitigating risks.

4.5 Outcome Measures

The final part of this chapter defines specific indicators that will be used to assess the effectiveness of the valuation pathways and models discussed above. It is now necessary to move from theoretical mechanisms to practical comparative analysis. To this end, objective indicators need to be established to determine success at different stages of the venture capital lifecycle. These metrics form the basis for the benchmarks presented in the matrix in Chapter 5. They can be used to systematically assess how different valuation methods promote access to follow-on financing as market conditions change.

The probability of an up-round is a key success indicator in the study. An up-round occurs when the valuation of a startup rises between consecutive financing rounds. An up-round is a clear sign that the hard information and certification effect produced by the original valuation method were reliable. It confirms that the startup has successfully achieved the interim goals required by the market. Conversely, a "down-round" or inability to raise follow-on funding indicates that the initial valuation did not correspond to

market reality. This is often a sign that the process did not produce the risk-aware evidence needed to pass the investor screening.

In addition to the valuation price, the efficiency of the funding cycle is measured by the time between rounds. A shorter time between rounds combined with an increase in valuation indicates a successful valuation process. It shows that the method used has effectively reduced information asymmetry and screening friction, which speeds up capital allocation. In addition, the quality and reputation of the next lead investor serve as a long-term performance indicator. As Hsu (2004) has noted, attracting high-status venture capitalists provides a "seal of approval." It improves the company's chances of survival and professionalism despite the immediate dilution effects. Finally, valuation efficiency is reflected in the robustness of investment terms and the long-term survival rate of the company. In "cold" markets, terms such as liquidation preferences or seniority are often more important than price alone. Terms protect the financial value of shareholders.

5 The Effect of Early-Stage Valuation Methods on Follow-On Funding

This chapter combines theory, presented valuation models, and transition mechanisms to answer the core research question. The chapter examines how valuation methods affect the subsequent financing of startups in different market situations and development stages. The analysis assesses the credibility of the methods and how they meet the strict requirements of professional investors. The methods are evaluated based on the framework in Chapter 2.3.

5.1 Criteria

Five key criteria have been defined for the study to assess the effectiveness of early-stage valuation methods in securing follow-on financing. The reliability of the information produced by the method is important in the assessment. According to Gompers & Lerner (2000), such data can withstand pressure in financial arenas regardless of economic changes. The first criterion is verifiability, which measures the ability of the valuation method to produce "hard data." According to Stein (2002), verifiable data reduces uncertainty by shifting attention from founders' narratives to actual market data. At the same time, it facilitates the comparison of companies with other companies. Comparing a company to similar and recently funded companies sends a standardized signal to the market (Metrick & Yasuda, 2021). The signal lowers the investment threshold for follow-on investors and strengthens the professionalism of the startup company (Metrick & Yasuda, 2021).

The valuation method should effectively handle complex security structures, such as liquidation preferences and anti-dilution protections. The valuation of a company after a financing round can deviate significantly from its true economic value if these factors are not taken into account. Kaplan and Strömberg (2003) and Gornall and Strebulaev (2020)

emphasize the importance of understanding the impact of contractual terms. This is essential for managing investor expectations and modeling a company's "exit waterfall." Without this awareness, the valuation may give a misleading picture of the actual economic position of different share classes.

Finally, valuation methods must be analysed in terms of their flexibility and context fit. Flexibility based on real options theory is a key part of dynamic valuation. It examines how well a valuation incorporates the value of managerial discretion and staged learning. Gompers (1995) and McDonald and Siegel (1986) argue that early-stage investments should be treated as a series of strategic options rather than static forecasts. In this case, value is based on the ability to expand or abandon a project based on new information. Context fit as a criterion considers the cyclical nature of market conditions and investors' changing screening thresholds (Nanda & Rhodes-Kropf, 2013). In "hot" and "cold" markets, the evidence required varies from rapid growth signals to careful risk management (Gompers & Lerner, 2000; Nanda & Rhodes-Kropf, 2013). The best valuation method should be in line with the current capital supply and exit environment requirements.

5.2 Comparison Matrix

Table 4 simplifies the comparison of startup valuation techniques with the standards presented in Section 5.1. The main focus is on their effectiveness in attracting future investment rounds. The matrix shows clear differences between different valuation methods. Some of them emphasize "hard information", while others are designed to describe complex risks and the ability to adapt to changes (Stein, 2002; Gompers, 1995).

Table 4. Comparison of Valuation Methods against Theoretical Criteria.

Method	Verifiability	Comparability	Terms-Awareness	Flexibility	Context Fit
Market-Based	High	High	Moderate	Low	High (Hot)
Heuristic	High	Moderate	Low	Low	High (Early)
VC Method	Moderate	Moderate	High	Moderate	High (Later)
Scenario-Based	Moderate	Low	High	High	High (Cold)
DCF	Low	Low	Low	Low	Low (Early)

Market-based and heuristic models stand out in the matrix. For example, the Berkus and Scorecard methods work well because they make it easy to check the data and compare it to others. Therefore, they are clear and easy for investors to use. By tying the value to the prices of other companies and the results to be checked, a strong basis for calculating the price is created. This provides clear signals that facilitate the selection work of investors both in a “hot” market and at the very beginning of the company (Metrick & Yasuda, 2021). These methods turn guesses about the company's potential into clear facts. According to Stein (2002), this is the best way to get money from outside investors who do not know the company before.

On the other hand, the Venture Capital method and the Scenario-based models allow much more flexibility and consider the investment conditions better. This is important when a company moves to the next stage or tries to cope with a difficult and “cold” market situation. The risk of company failure and uncertainty about the direction, as highlighted by Puri and Zarutski (2012), requires a thorough price calculation. These models solve the problem by calculating the risk of failure and the extent to which

management decisions affect the outcome (Sahlman, 2009). These methods can be more difficult to compare with others because they are based on company-specific assessments of success. The fact that they are in line with real options still provides investors with important and risk-aware evidence (Gompers, 1995). Therefore, they are essential to pass the strict screening of professional investors when money is hard to come by (Stiglitz & Weiss, 1981).

The DCF method is consistently the worst option for early-stage companies by almost any measure. It relies entirely on “soft information,” that is, distant forecasts that are almost impossible to prove correct with facts (Stein, 2002; Damodaran, 2009). This makes the data difficult to verify or compare with others. It erodes investor confidence, especially when the situation is already uncertain. Small changes in terminal value or growth assumptions can lead to different results in the DCF model, making it easy to manipulate. This weakens the signal quality of the method. According to Hellmann and Puri (2002), it slows down the growth of the company, which would require professional insight. The table shows that securing new financing requires “hard data” or strong consideration of risks in calculating the price. The choice must be carefully tailored to the market in question and its specific requirements.

5.3 Best Method

The study has found that there is no single best way to value early-stage startups. The effectiveness of methods depends on the stage of the startup’s life cycle and how well the chosen method matches the current market situation and its requirements. According to Hypothesis 1, market-based and traction-based heuristic models are the best tools in the early stages. They connect the company’s price to actual market prices and results that can be verified. According to Spence (1973) and Stein (2002), this gives investors a more reliable signal of the company’s potential. Examining the impact of valuation decisions compared to later funding rounds supports Hypothesis 1.

The second hypothesis emphasizes that pricing effectiveness changes with market fluctuations. Research shows that the best method changes with the market and growth. The focus then shifts to risk-aware frames of reference, such as the first Chicago method. In these situations, simple evidence of growth alone is often not enough to pass the strict screening and funding barriers that Stiglitz and Weiss (1981) have studied. Instead, investors demand valuations that incorporate strategic flexibility by pricing the “option to abandon” or scale based on revealed information (Gompers, 1995). This approach is fundamentally consistent with real options theory (McDonald & Siegel, 1986). Market-based methods provide the strongest signal when the market is highly liquid. However, the situation changes during a downturn, when the most effective method is one that provides a rigorous assessment of downside risks (Nanda & Rhodes-Kropf, 2013).

Ultimately, the impact of valuation on follow-on funding is determined by how effectively the method professionalizes the company's image in the eyes of investors. It must also be able to respond accurately to the specific screening criteria by the next investor (Hellmann & Puri, 2002). The research question is answered with the conclusion that the most effective valuation strategy is dynamic in nature. It requires a shift from the objective "hard" market benchmarks values of the early stages to more complex and risk-weighted scenarios as the information environment evolves (Stein, 2002; Puri & Zarutskie, 2012). By choosing a valuation method that offers high context fit and verifiability, founders can effectively mitigate information asymmetry. Regardless of the economic situation, the strategy increases the probability of an "up-round."

5.4 Stage and Market

Startups' adaptation to market cycles shapes valuation (Nanda & Rhodes-Kropf, 2013). Reliance on early signs of growth slowly gives way to deeper scrutiny as uncertainty demands more disciplined assessment. Over time, the availability of financing for maturing has changed (Hellmann & Puri, 2002; Gompers & Lerner, 2000). These findings support Hypothesis 2. It is difficult to evaluate companies in the pre-seed and seed stages due to

a lack of information. Heuristic approaches are often emphasized when weighing core development risks against uncertain returns (Stein, 2002). Investor competition intensifies in overheated markets. According to Gompers and Lerner (2000), in such a market, indicators derived from comparisons of similar companies become the best methods for allocating funds.

Investors' demands become more stringent as startups reach Series A. During downturns, scrutiny becomes more stringent, and capital shortages force investors to make more careful choices. In downturns, credit rationing forces investors to adopt stricter screening thresholds to prevent adverse selection (Stiglitz & Weiss, 1981; Nanda & Rhodes-Kropf, 2013). The Venture Capital method is useful in the most difficult markets. It takes into account the potential for collapse and the ability of management to adapt according to real options. According to Gompers (1995) and McDonald and Siegel (1986), risk-aware evidence that helps companies survive economic downturns is important.

6 Conclusion

This thesis examines the impact of early-stage valuation methods on a startup's ability to raise additional funding across different market cycles and stages of development. Valuation serves as a tool for managing uncertainty and bridging the information gap between founders and investors. The study emphasizes that valuation is a fundamental strategic communication tool. Traditional financing models often fail to adequately value early-stage startups. Therefore, new models have been created for startups that offer flexibility to take qualitative factors and strategic potential into account.

The study's results strongly support the hypotheses presented. The results show that market-based and traction-driven heuristic models are the most effective tools in the early stages of a company, which supports the first hypothesis. These methods successfully transform subjective information into verifiable information. This facilitates the investment process and signals institutional readiness. The second hypothesis is supported by the fact that the effectiveness of valuation depends on the context. Simple traction signals are often sufficient to allocate capital in favourable market cycles. Scenario-based models are critical to maintaining credibility in the most challenging markets, where risk-informed evidence is needed for investors.

The study has certain limitations, as it is a theoretical review based on a synthesis of existing literature. The application of the discussed models may vary by industry, as well as due to geographical variations in venture capital ecosystems. The study provides a decision-making framework that can be modified according to the needs of the company. The diversity of the startup field prevents the application of a single universally valid valuation formula, so flexibility is mandatory. Further research of the study should focus on empirical validation using longitudinal investment data. This would allow for comparison of valuations obtained using different methods, as well as how companies would fare in the financial markets in the long term.

In summary, the thesis shows that securing follow-on funding primarily depends on the choice of valuation methods. The methods must be adapted to the stage of the company and the market situation. Founders are advised to move from heuristic benchmarks to more robust, risk-weighted scenarios as the company matures. This shift will put them in a better position when it comes time to respond to new investor demands. Choosing the right valuation strategy is a critical success factor for a startup, improving the company's chances of survival and supporting long-term growth.

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Appendices

Appendix 1. Writing Notes

Gemini 3 was used only for identifying and correcting grammatical and typographical errors in this thesis. All intellectual content, including research arguments, references, and conclusions, was developed and written by the author.