How to Value Your Start-Up for Venture Capital
By Mark Grossman

Summary: So, you need some money to get your tech start-up moving. How much of your company should you give up to get the money? This article explains how to value your company for venture capitalists.

Author: The author of this article, Mark Grossman, is a shareholder at Becker & Poliakoff, P.A., in Fort Lauderdale, Florida. He concentrates his practice exclusively in the computer and e-commerce areas on issues such as web site development, online contracting, technology procurement, Y2K, intellectual property rights, vendor liability and computer litigation. He is licensed to practice law in the state of Florida. Mark would like to acknowledge the research assistance of Andrew Chulock, Michael Cummings, Adam Feinsilver and Sarah Santoro. E-mail: comments@mgrossmanlaw.com.

The Golden Rule

So, you need some money to get your tech start-up moving. You are now a part of a large club of startups in the same boat. All of you face the same early question: How much of my company should I give up to get the money?

Of course, the answer is as little as possible.

Having said that, it's important understand that while the valuation of early stage companies is more art (some would say voodoo) than science, there are some rules. The first rule is the "Golden Rule" -- "He who has the gold makes the rules." Understand that everything that follows is a subset of this rule.

I don't espouse the Golden Rule because I represent venture capitalists. In fact, I don't represent a single venture capitalist. I end up on the side of those who need the money. I bemoan the Golden Rule along with them. Still, it's the rule. If you can't live with it, get a job with an established company because you're not going to like this fund raising game.

I take the position that while you must accept the Golden Rule, it doesn't have to discourage you. The fact is that if a potential investor is talking to you, it means that you have something that interests him. While you may have to play by his rules, you do have some negotiating power.

Before and After the Money

To begin to understand the valuation game, you must fully understand the terms "before the money" and "after the money." Venture capitalists say things like, "We will invest $2.5 million based on a $10 million valuation."

The founders might think that simple arithmetic tells them that the venture capitalists would own 25 percent of the company. They may be surprised to learn that the venture capitalists think they get 33 percent of the company.

The ambiguity arises because the parties didn't clarify whether the $10 million valuation was "before the money" or "after the money." It's an unfortunate deal killing ambiguity. You must clarify your terms early.

"Before the money" refers to the value of the company before the venture capitalists' investment. "After the money" refers to the value after the investment.

If the venture capitalists were saying that the $10 million was "after the money," they were also saying that the "before the money" valuation was $7.5 million. As such, they should get 33 percent of the company.

The arithmetic is actually quite simple. The "before the money" value plus the investment is equal to the "after the money" value.

Flipped around, the other way to see this is that the "after the money" value minus the investment is equal to the "before the money" value.

It seems simple and is, but if you don't find math intuitive, you do have to stop and think about this. During a heated negotiation, don't be embarrassed to start working these before and after the money values and percentages with paper or a calculator.

A More Complicated Scenario

The first scenario was as simple as it gets. A variation has the investment being broken into two rounds. I'll use simple numbers to make the illustration easier.

Let's say the venture capitalists will invest $5 million based on a $10 million "after the money" valuation. If you did this in a single round, this would yield a 50 percent interest for the venture capitalists.

If they do this in two rounds, it gets more complicated. To keep it as simple as possible, let's assume that it will be an initial cash infusion of $2.5 million with another $2.5 million to follow when some agreed milestone is met.

It would seem that after the first round, the venture capitalists would own 25 percent and after the second round, they would own the other 25 percent, thus yielding the same ownership as in the single round scenario. The problem with this intuitive logic is that it's wrong.

Here's the arithmetic. Let's assume that we start with the founders owning 5 million shares. If the deal called for a single round of $5 million for a $10 million "after the money" valuation, the venture capitalists would get 5 million shares (assuming $1 per share) and own 50 percent.

With two rounds, the arithmetic takes a dramatic twist. After investing that first $2.5 million, the venture capitalists will get 2.5 million shares at $1 per share.

If we add these 2.5 million shares to the founder's 5 million shares, we have a company with 7.5 million outstanding shares. Since the venture capitalists own 2.5 million of the 7.5 million, they own 33 percent not 25 percent.

In this scenario, the venture capitalists end up with 50 percent after the completion of the financing The practical value to the venture capitalists is that they are getting a bigger piece for their first investment. If they never complete the financing for whatever reason, they own 33 percent instead of 25 percent.

The fact is that these are two very simplistic examples of the arithmetic of investments. The schemes can get much more complicated than this. Unless somebody on your management team has the requisite financial sophistication and experience, you will have to look to your hired professionals to analyze the consequences of the various investment schemes that may be thrown your way.

How Much are You Worth?

Now, let's go back to the first question. "How much of my company should I give up to get the money?"

The answer is it depends on what you're worth. In applying the Golden Rule, we know that it doesn't matter what you think you're worth, it only matters what the people with the money think you're worth.

Still, while this may be true, you should never forget that not even the Golden Rule can force you to make a deal that you hate. You can always walk away and try to find other investors.

Venture capitalists will use a number of formulas and subjective factors in trying to value your company. Even the formulas are highly subjective and different "standard" formulas will often yield dramatically different results.

For example, the venture capitalists might ask how many multiples of their investment can they expect to make from the time of the investment until the IPO (initial public offering).

Other variations include an analysis of ROI (return of investment) per year, what percentage of the stock will the venture capitalists control with their investment and many others.

Some of the subjective factors in a valuation (as if the formulas weren't subjective enough) include things like the general outlook for your industry, customer trends and tastes, your likely standing in your industry, your ability to use intellectual property laws to protect your idea, and the regulatory climate.

It all boils down to you're worth what you can agree you are worth. As a start-up, you're not about things like hard assets or cash flow. You're about potential.

How strong is your management team? How good are your ideas? How far along are you in taking your idea and making it real. What advantages do you have over your competition? How long will you be able to maintain your advantage?

These are some of the high level things at which potential investors will look. In some ways, everything else is an attempt to quantify these very high-level questions.

Develop strong answers to these questions and you'll see your value go up.