Rules for Startups Raising Capital in the Midwest

Part 1: The Basics of Venture Capital

Most entrepreneurs building high-growth companies will need to raise capital to fund the milestones that lead to sustainable growth. The process begins with defining those milestones, understanding the appropriate capital source for each stage, and then matching up the two into a well-formed business plan.

A common misconception is that entrepreneurs must raise a great deal of capital upfront to succeed. That's not the case. However, when concept companies achieve breakeven and concrete milestones, the time is ripe to start mid- and long-term capital access planning.

Things to Know Before Raising Venture Capital

Institutional venture capitalist firms professionally manage capital on behalf of other investors (limited partners). VCs raise money from those limited partners (LPs) and put that money into a fund and then invest, on behalf of the LPs, in various companies in exchange for equity. VC firms are regulated and bear a fiduciary duty to their investors, meaning they have the legal obligation to act in those LPs' best interest.

VCs make money through regular management fees and when their portfolio companies exit. Additionally, after the limited partners have been repaid their original investment, VC funds usually receive a percentage of profits (known as carry or carried interest).

VCs expect a return on their investments commensurate with the risk, a multiple of 10X to 20X. There must be an exit event for VCs to realize their return. VC's Offering Memoranda may state the expectation of a company exit in five to ten years; the reality is that venture funds often run twelve to sixteen years before liquidation.

Venture Capital Is Not for Every Company, but When It Fits, It Opens Doors

> ***"Motorcycles are common. Jet planes are rare. VCs sell jet fuel, which doesn't work in motorcycles. Bad stuff happens if VCs push jet fuel on a bike owner or if a bike owner thinks they can fly."***
>
> **– Josh Kopelman, Founder at First Round Capital**

Not all companies should focus on VC funding. Instead, focus on the funding that is right for the stage of the business. It's like golf. Match the club to the shot.

Most entrepreneurs self-finance through banks and other loans, grants, and personal savings. Only a small fraction of companies—less than 5 percent according to Kauffman Foundation—ever raise venture capital. However, many large technology companies have.

The ideal VC company shows accelerated growth with a scalable business model that addresses extensive market opportunities. Founders are willing to sell a percentage of ownership to scale that growth.

Venture capital firms do not just invest in software. They seek out high potential sectors in hot industries. These include media, food and beverage, life sciences, hard tech, media, and consumer goods in recent years. Many invest in multiple rounds of the same company. Ideally, as the company grows, a good portion of the next investment round comes from existing investors.

Accepting venture capital dollars commits the entrepreneur and the company to a specific path. That path defines an exit strategy, including when, why, to whom, and how much. Venture investment requires creating a board of directors, to whom the CEO reports. Routine and professional financial reporting is also required.

VCs Invest in Seed, Early, and Later-stage Companies

As an example, in 2019, 430 venture-backed companies received $133 billion in funding. About 60 percent ($80 billion) went to later-stage deals, 32 percent ($43.2 billion) to early-stage deals, and the remaining $9.6 billion (about 7 percent) to angel and seed-stage startups.

Seed/Angel Stage

At this stage, the entrepreneur is introducing the product to the market to prove the viability. There are limited sales (0 to $1MM in revenue) and maybe even customer pilots. The company likely has two to five employees. The typical company valuation is $2 to $5 million, with VC investments ranging from $500,000 to $2 million. Typical investors are institutional seed-stage, angel investors, and, occasionally, participation from strategic investors.

Early Stage (Series A/B)

Companies at this stage have proven their concept and are seeking investment to accelerate customer adoption and market penetration. They have annual revenue of $1 to $10MM with meaningful customer traction. The company has demonstrated the ability to scale and employs from 10 to 75 employees. Typical valuations range from $10 to $75MM; typical investments for $1 to $15 MM. Investors are institutional VCs and strategic investors.

Later Stage (Growth or Series C+)

These companies have proven market adoption and are scaling, with 75 to 100+ employees and $10MM+ in revenue. Typical valuations are around $75MM+ with investments of $25MM+

Founders in the Midwest Can Raise Capital from West Coast VCs

Across the Midwest—especially in Ohio—the startup ecosystem is robust. In fact, in 2019, Ohio was in the top five states by venture capital raised in 2019.

Our internationally recognized research institutions and corporate innovators drive a pipeline of startups and deals. We can point to recent high-value exits. These conditions attract VCs. However, be aware, a startup in the Midwest will generally have a lower valuation than a company at a similar stage on either coast.

Rules of Thumb for Startups Raising Capital in the Midwest

Funding raising is hard, especially in the Midwest. A smaller capital pool equals more competition. The best way to compete and succeed is to plan, prepare, and execute. It all starts with a capital access plan.

Base your capital plan on an indication and measure of startup traction. Understand the key metrics that investors focus on in your industry.

Come up with a plan for achieving those metrics and map that plan against the company's fund-raising timeline. Create a plan that ensures critical metrics immediately before when the company plans to start raising capital.

Part 2: Capital Planning Tool

> *"Invest in lines, not dots."*
>
> **– Mark Suster, Partner at Upfront Ventures**

VCs are looking for patterns of success before they invest. They want to look at the trajectory of your company and see progress over time. Entrepreneurs who meet milestones help VCs connect the dots.

Here's a "getting started" capital planning tool from Rev1 Venture Capital Access Learning Lab.

Capital Planning Worksheet

Step 1: Define transaction indicators and relevant metrics

Understand the key metrics that investors focus on in your industry. Come up with a plan for those metrics and map them against your fundraising timeline.

Relevant metrics:

- Active users
- Annual or Monthly Recurring Revenue (ARR) or (MRR)
- Customer acquisition cost (CAC)
- Churn
- Clinical indication
- Clinical pathways
- Cohort analysis
- Commercially-ready prototype
- FDA stage of the process
- Gross Margins
- Loan-to-value (LTV)
- Monthly growth rate
- Product certifications (i.e. FCC, UL certificates)
- Proof of concept – technical viability study
- Validated in-vivo studies
- Working prototype

Don't forget burn rate and runway, too!

Step 2: Define commercial milestones

1. Create a timeline of value creation milestones for the next 12 to 24 months.

Common traction indicators:

- Betas
- Customer Surveys
- Customers
- FDA Stage
- FDA Stage
- Letters of Intent
- Technical feasibility study
- Wait lists

Examples:

- *Adding first five paying customers*
- *Signing Joint Development Agreement (JDA) with a corporate partner*
- *Approval of STTR Phase 1*
- *Indication of safety/efficacy in FDA trial*

2. Identify resources needed to accomplish each milestone.

Resources:

- Contractors
- Critical hires
- Manufacturing capability
- Lab space
- SBIR/STTR
- Strategic agreements
- IP rights and protections

Examples:

- *Hiring vice president of market development*
- *Contracting 2 JavaScript programmers*
- *Submitting patent application*
- *Leasing lab or contract manufacturing space*

3. Match milestones to resources required to capital needs.

- Identify amount of capital required to achieve each significant milestone for the next 24 months.
- Identify sources of capital that match company's stage of business.
- Allow realistic timeframe to achieve milestones.

4. List key business assumptions—all of them.

- Who buys your product and for how much? Who uses it?
- What are your costs—fixed, variable, direct and indirect?
- How will your business make money?
- How are you going to sell your product? Direct or indirect?
- How will you achieve efficiencies of scale?

5. Create financial projections.

- Prepare monthly financial projections (sales revenue, operating and capital expenditures, grand income, etc.)
- How will the milestones of the first six to eight months enable you to raise the next round of capital?
- Connect the dots!

Come up with a plan for achieving those metrics and map that plan against the company's fund-raising timeline. Create a plan that ensures critical metrics immediately before when the company plans to start raising capital.

Part 3: Building Your Investor List

Silicon Valley Bank compares the fundraising process to a sales funnel. This mindset provides a practical framework to keep any fundraising process on track.
Here are the steps.

- Qualify a list of investors upfront;
- Build relationships early and intentionally;
- Seek the highest quality introduction, and
- Prioritize meetings with investors who can write the first check.

Qualifying and Prioritizing Investors Is Critical

Approach fundraising with a “qualifying” mindset. You don’t want to waste your time talking to the wrong people, and they certainly don’t want to waste time talking to you.

Here are the essential qualifying characteristics for VC and startup deals:

1. Stage

You are seeking funds that invest in your stage of business. (For the Rev1 definition of stages, refer back to Part 1 of this Raising Capital series). “Stage” terminology can be somewhat inconsistent from region to region. Rather than getting tangled in vocabulary, use these two primary questions to define your company’s stage: Do you have a product, customers, and revenue? Do you have a team that can execute in the next stage of development?

2. Location

Nearly 60 percent of VCs invest in companies in the same state. Do the funds you are targeting invest within your geography? Unless you live on the Coasts, the answer is likely not. More than 70 percent of the capital invested in the US in 2019 went to California, New York, and Massachusetts.

There is, however, a growing awareness of investment opportunities outside traditional hubs. Cost advantages, a favorable business climate, robust pipelines of university talent, research institutions’ innovation, plus ecosystem and state support for small businesses are causing VC to rethink heartland opportunities. Significant to VC investors, the Midwest is very capital efficient. Capital efficiency refers to what a startup can accomplish with its funding. It is an advantage to startups that can reach critical de-risking milestones with less funding.

Midwest investors are also in our backyard. They value traction and customer validation, so it can be difficult to raise without revenue. Midwest investors prefer industries in their regions and states—financial services, healthcare, and business-to-business (B2B) platforms and software instead of consumer apps. Startups are NOT constrained to fundraising in the Midwest, but it pays to have realistic expectations and triple the VC research when considering fundraising on the coasts.

3. Demographic

Some VCs focus entirely on founders' particular demographic (for example, female, Black, Latinx, LGBTQ, minorities, etc.). Other VCs invest broadly but segment select funds to target a particular demographic. Founders for Change lists VC investors from diverse backgrounds and indicates the VC's demographic focus.

4. Sector

VCs tend to invest in industries they know or industries where they have resources and connections. Read the VC's website to find the firm's sector focus. The team page and sometimes blogs identify which partners are assigned to which industries and sectors. Crunchbase breaks down a VC's deals by sector. Check out which person is listed on the funding round to narrow in on the firm's right partner.

5. Check Size

Does the VC fund write check amounts that fit with your raise and business plan? Venture capitalists typically invest $2MM to $5MM in companies with early revenue and show a pathway to growth and profitability. VCs invest as deal leads, co-leads, or co-investors. Be aware that any funding the company accepts before a VC round (friends/family, debt, angel/seed rounds, etc.) must be appropriately structured.

Additional Qualifying Characteristics

There may be multiple VCs with qualifying characteristics that match your company's objectives and deal aspects. Refine your prospect list further by assessing the maturity of the fund and the fund's portfolio companies.

- **Fund Vintage Year** – When did the VC raise the fund that seems relevant to you? The lifecycle for a VC is 10+ years. The first three to five years of a fund's lifecycle are typically the new investment years. When your firm needs follow-on capital in subsequent rounds, the best scenario is to raise money from VCs that have already invested in your business. You want to understand whether or not your investors are likely to have "dry powder" in future years.

- **Recent Investment Activity** – Learn about a VC's focus and preferences by studying the other companies in their portfolio. Do their deals include companies in your sector? Is there any conflict of interest between your company and any of the current companies? Do you know or have business relationships with the founding teams of any of the portfolio companies?

Create a List of Potential Investors Based on Criteria and Priorities

PitchBook, CB Insights, and Crunchbase are public, fee-based sources of information about VCs. Subscribers can perform an indirect search based on stage, industry, keywords, etc., or search investors directly based on their descript and indicated stage or industry preferences.

Search LinkedIn to find people within your network with connections to particular investors you are trying to reach. Building relationships with other entrepreneurs and starts will help you and they both to leverage connections.

Make it easy for investors to find you with a Crunchbase profile based on keywords and industry terms. Keep your LinkedIn page current, and ensure that your employees have the company listed as their employer on their personal LinkedIn pages.

Your introduction to a VC determines where your company enters a VC's deal evaluation funnel. A warm intro from another portfolio CEO or a VC's attorney or CPA, for example, is powerful. Contact via a cold call or a recommendation from another VC who passed on your deal is a neutral approach.

Following a disciplined approach to identifying well-qualified investor prospects will lead to a more effective and efficient fundraising process.

Part 4: Due Diligence

Investing in startups is inherently risky. Due diligence is the rigorous process venture capitalists and other investors use to identify and assess every deal's specific risks.

Ultimately, the validations, discoveries, and, yes, surprises produced in due diligence determine whether a venture capitalist fund or investor invests in the company. Successful entrepreneurs understand that preparing for due diligence is preparing for success.

What Is Due Diligence?

Due diligence is a process by which investors verify and analyze the inner workings of a business. Their goal is to gain the best understanding possible of the business to aid in their investment decisions.

Formal due diligence often (but not always) includes a checklist of items that investors want to see and a set of questions or requests to aid in their analysis. Here is a comprehensive example from the Angel Capital Association.

However, due diligence begins well before the checklist arrives. Due diligence begins the moment a qualified investor asks the first question about your business plan. Especially in the early days of discussions and relationship building with a potential investor, due diligence can be anecdotal, information, and conversational.

The more serious an investor becomes, the more formal, documented, and detailed the due diligence requirements will be. Due diligence investigations become increasingly deeper until the investor(s) purchases equity in your company or decides to walk away from the deal.

Often, but not always, they supply a set of questions that drive their process in their investigation. You can expect requests for information covering every aspect of your business, including background checks on you and your management team.

- Financial and business models
- Human resources
- Legal and corporate matters
- Product development
- Primary research and intellectual property sources and protections
- Sales and marketing
- Strategic planning

Create a Data Room

Develop due diligence discipline from the beginning company. Do not wait until an investor is interested and starts asking for more information. Due diligence shouldn't be a scramble but a mindset.

Create an online, virtual data room that provides scalable storage capacity and allows for data sharing. There are many secure, cloud-based tools available for storing and accessing company-sensitive and confidential data, from Box to Google Drive, to Vault Rooms, and more. Consider ease of use, accessibility, and cost. Take the appropriate steps to safeguard privacy and data security.

Pre-populate the data room as you build the company. You can start with your articles of incorporation and the current resumes and references for each startup team member. Every time the company signs a contract or a financial agreement—from leasing space to equipment purchases, store the documents electronically in the data room—the same for every item relating to human resources, from interview rubrics to non-disclosure agreements.

Document your investor pitch in the data room. That includes your customer pipeline, financials, strategic partnership agreements, development contracts, patent filings, and more. Individual investors will have unique requests, but you can pre-populate your data room.

- Breakdown of capital needs
- Cap table
- Employment contracts
- Examples of major contracts
- Financial model
- Financials
- Formation documents
- Intellectual property
- Market/competitor analysis
- Patents, patent applications
- Pitch deck

Institutional Investors Expect Entrepreneurs to Be Prepared

It takes time to build out a capital access plan and to prepare for due diligence. Then due diligence to closing can easily take six months once your startup becomes an active investment prospect. Don't slow the process down by being poorly prepared.

Part 5: Investor Outreach

Funding raising is hard, especially in the Midwest. A smaller capital pool equals more competition. The best way to compete and succeed is to plan, prepare, and execute.

A key aspect of your plan is building relationships with potential investors at least a year before you expect to need funds. Strengthen those relationships as you achieve the milestones of your business plan with the intention of fundraising in earnest with at least six months of runway.

There will be a lot to accomplish in those six to twelve months. It takes at least six months (wise entrepreneurs plan for more) before active fundraising, to build your capital access plan, and prepare for due diligence.

Once you become an active investment prospect (when investors start requesting information), diligence closing (responding to those requests and the questions that follow) will likely take another six months. The process is one of lines, not dots. Demonstrate a progression of business progress that meets the milestones of your business plan.

Fundraising Is a Sales Process

Model your fundraising process on the best practices of customer acquisition. Approach your plan with a sales funnel mindset. With qualified and prioritized investors set up in your CRM (customer relationship management) system, use email analytics to track touchpoints and open and click metrics.

Examples of tools and resources:

- Ensure deal room and due diligence documents are ready to go and aggregated in a secure, online document collaboration platform, such as Box
- Compile investor list from Crunchbase
- Upload list into your customer relationship management system (CRM) or Foundersuite
- Upload deck into a secure mail solution, such as DocuSend or PandaDoc
- Draft template email in CRM
- Send contact email within your email management platform
- Track opens, clicks, and email analytics

- Schedule follow-ups based on replies
- Annotate specific details from their response such as metrics, stage, or traction necessary for raising capital

Additional tools and resources

- **Investor Databases & Places to Connect:** FounderSuite, Signal, Visible.VC, Crunchbase
- **Email Tracking:** Mailchimp, Bannanatag, Boomerang
- **CRM:** Salesforce, HubSpot
- **Documents Tracking:** DocuSend for deck analytics
- **Connection Research and Contacts:** LinkedIn

Effective Email Communications

Be thoughtful when you compose your emails. Develop a personalized template that works for you. It is practical and efficient to standardize a structure and some aspects of your message.

Example: Investor Outreach Email

Each element of an effective investor email will either directly or indirectly answer these questions.

- Why should the investor open your email?
- Legitimize who you are and your connection with the investor? (Do you have any personal ties?)
- What problem is the startup solving and what's the solution/product? Is it clearly understood?
- Does the startup have empirical evidence supporting the business model and momentum?
- Is this the right team for the job? Do they have direct experience/credible people?
- What is the startup asking from me, the investor?

Example: Template for Effective Investor Email Inquiry

Subject line: Your investment in [SIMILAR COMPANY]

Body of email:

Hi [INVESTOR],

[MUTUAL CONTACT] suggested I connect with you given your involvement with [SIMILAR COMPANY]. We found their recent beta launch [OR OTHER NOTEWORTHY NEWS/LAUNCH/PARTNERSHIP] insightful, helping to inspire our go-to-market approach. I'm the founder of [COMPANY] and we thought you might be interested in our solution based on your expertise in the [INDUSTRY] industry.

[2-3 SENTENCES MAX: DESCRIBE THE PROBLEM YOU SOLVE, YOUR SOLUTION/PRODUCT, AND THE VALUE PROPOSITION THAT YOU PROVIDE TO CUSTOMERS.]

[INSERT KEY METRICS/TRACTION/VALIDATION DATA HERE.]

We would welcome the opportunity to share our solution and trajectory with you to gather your input. We're gearing up for [INSERT NEXT MILESTONE] and your feedback would be invaluable. Our deck is included HERE for reference.

Are you available for 15 minutes in the next few weeks to share your candid feedback?

Example: Sample Investor Email Inquiry

Subject line: XYZ COMPANY - IoT Location Tracking

Body of email:

Hi [INVESTOR],

Bill Smith suggested I connect with you given your involvement with RADAR. I'm the founder of XYZ COMPANY, a machine learning-enabled location tracking software for the retail industry. Our company may be of interest to you based on your experience and interest in seed stage data analytics startups.

Our location tracking system can quantify foot traffic near product displays to help retailers optimize product placement. We've helped retailers increase the sales of tracked products by 43% with our systems. We have 7 enterprise accounts, including Target, Walmart, and Bath and Body Works. These seven companies generate $525K in annual recurring revenue, with 25% MoM revenue growth. As of June, we have 2,500 monthly active users, with 90% daily engagement, a 100% rate of retention, and have analyzed over 1.5 million data points.

We would welcome the opportunity to discuss our solution and trajectory to hear your feedback. Our deck is included HERE for reference.

Are you available for 15 minutes in the next few weeks to give us your candid perspective on our business?

Ideally, a mutual connection will introduce you to a potential investor. If so, mention that in your email. However, do not EVER claim to have a mutual relationship with a connection if it does not truly exists. It is surprising how many company founders try this trick. That violates the most essential aspect of an investor/startup relationship—trust.

Best Practices and Pitfalls for Email Outreach

Best Practices

- Achieve an introduction through mutual connections. Cold outreach is a last resort.
- Research the individual and their firm before reaching out.
- Personalize your message.
- Be brief. Limit your email to one to two sentences per section, with 2-3 sections total.
- Avoid business jargon and acronyms.
- Limit links and attachments in the first email to avoid ending up in a spam folder.
- Highlight your differentiators.
- Quantify your value proposition and milestones.
- Include a call-to-action. Example: “Are you available for a 15-minute call in the next week or two to provide candid feedback?”
- Build the relationship first before asking for money.
- Appeal to their altruistic nature; consider asking for advice or expertise on a specific matter based on their experience.
- Track emails (opens and clicks on links).
- Use a CRM to track the entire process and notifications/triggers for follow-up reminders.
- Proofread, and then proofread again to avoid misspellings and errors.

Pitfalls

- Don’t bombard. Don’t assume any investor will respond immediately. Give it a week before following up.
- Don’t use illogical language. Avoid statements like “This is a 50X ROI opportunity, guaranteed returns in 12 months, very conservative forecasts, best deal you’ll ever see, once in a lifetime opportunity, etc.”
- Keep your email simple. Don’t overly format with fonts and colors.

Investor Updates Are Powerful Tool for Fundraising

Regular investor updates are a high-leverage activity for CEOs. Ask potential investors if you can add them to your regular investor updates to track the business's progress. Do this BEFORE you need to raise.

Provide high-level, non-confidential company news about teams and hiring, business development, product launch, referenceable customers (with their permission), and critical partnerships.

Hearing about your progress and needs informs existing investors so they know how and when they can help. Turning milestone dots into connected lines of progress may help move hesitant investors over the fence when you finally accomplish the appropriate milestones.

Interpreting Investor Replies

Fundraising is an iterative process. You can't get to yes without a series of nos. Every question, pushback, or objection is a moment to collect and gather feedback. Don't be afraid to dig deeper into why your company isn't a fit for an investor.

When you don't know the answer to a question, figure it out. If one person asked the question, the chances are that someone else will request it too. Consider all the feedback you receive. You don't have to act on everything. Not all feedback is relevant. Plus, VCs won't always say what they think.

An investor's issues may be with the company, for example, lack of traction, lack of a coherent story, or a lack of direct experience or expertise. These are issues the company must try to fix. If one investor has these concerns, likely so will the next.

However, a VC may reject your deal for issues of their own. These could include lack of capital or dry powder for subsequent rounds, competitive investments or conflicts of interest, or even previous bad experience in the sector.

Listen, consider, then act. Over time, you will learn to discern which information you should add to your deck and which information you hold back. Many more VCs will pass on your deal than will invest. Reflection is critical, but don't overthink their response. Your company cannot be everything to everyone.

Part 6: Deal Terms

After months of courting investors and more months of due diligence, your Series A round is finally underway. The time has come to draft the terms. You are about to enter the most important discussions of your company's brief history.

Series A terms determine the percent of the venture that the entrepreneur gives up, how much control investors have over future decisions, and, perhaps as importantly, this negotiation process sets the tone for the entire future relationship between you and your investors.

Fact vs. Fiction on Deal Terms

No two Series A deals are precisely the same. However, the more an entrepreneur understands the process and the realities, the more successful the outcome of any particular deal discussions will be.

Fact and fiction are more nuanced.

1. Venture Capitalists want as much ownership as possible.

Not really. Venture Capitalists' share of the company will be based on the valuation and amount of capital raised, not on how much of the business they control. Assuming there are co-investors, VCs will typically insist on at least 20 to 25 percent of early-stage companies, which will bring the total share to 40 to fifty percent.

2. Entrepreneurs should raise capital at as high a valuation as possible.

Not necessarily. The correct valuation is the valuation that yields enough money to build the business. The higher the Series A valuation, the higher the bar for revenue growth. When a startup strikes a deal that sets a bar too high to achieve, the company misses milestones. As a result, initial investors may decline follow-on rounds. That sends the wrong signal to new investors.

3. Entrepreneurs want to raise as much capital as possible.

Match the capital raise with the funds required (with a contingency) to meet the next set of company milestones.

4. Entrepreneurs should take the first term sheet they can get.

Often this is the case, but not always. However, if you have done the right job of targeting the right investor and building a relationship based on a shared vision for your company, the first term sheet can be the right one—and most likely, the only one. While there may some negotiation, remember that potential investors learned everything there is to know about the company during due diligence. So, while there may be some room for discussion, for the most part, the deal they propose is likely the deal.

Convertible Debt vs. Equity Rounds

Convertible debt is a debt instrument often used by seed investors with a maturity and interest rates. Convertible debt is structured as a loan intended to convert into equity at a specific milestone, NOT to be repaid. Thus, using convertible notes moves the complex discussion of startup valuation to the next round of financing.

The convertible note will likely carry an above-market interest rate considering the early-stage noteholder's increased risk. In addition, if the startup company lacks the cash flow to make quarterly payments, there may be provisions for the interest to accrue until the next funding event.

There are many possible terms in a convertible note. The two most important are the valuation cap, which is the maximum valuation that shares could convert to, and the conversion discount rate. The discount rate allows the investor, at the next round, to convert the principal and accrued interest of the convertible debt into shares of stock at a discount.

In equity rounds, investors purchase ownership shares in a company at a set price (value) per share. Founders and employees generally own common stock, while investors generally own preferred stock.

The valuation of the venture has two components before the investment (called pre-money)—the existing or current value and the imputed future value of the enterprise. The pre-money plus the investment equals the post-money valuation. Ownership percentages are determined by dividing each party's investment by the post-money valuation.

The Math of Valuation

The assets and agreed upon future value at the time of investment equals **$1,000,000***. You own 100% of the business.*	→	Pre-money Valuation:	**$1,000,000**
You raise **$500,000** *by selling 33.33% of your company in a Series A round.*	→	+ Investment:	**$500,000**
You now own 66.66% of a company worth **$1,500,000***. Your share is worth $1,000,000.*	→	Post-money Valuation:	**$1,500,000**

Getting Down to Negotiations

Successful entrepreneurs develop realistic expectations of investment terms. In Series A, you will sell part of your ownership stake to third-party venture capitalists. You will be held accountable to generate a return on the investment—for yourself, your team, and most of all, your investors. You are no longer your boss. You will be accountable to the Board of Directors and investors, whether they sit on the board and not. If these realities don't fit with your expectations, then you might not be the right leader for a venture-funded growth business.

Any entrepreneur who chooses to proceed with VC funding should engage qualified and experienced legal counsel to advise and represent them in negotiations. Ask for references and choose counsel that is a cultural fit with your company. This is the start of a meaningful relationship that you will want to build on over time, not only for the Series A round but for any subsequent funding rounds.

Counsel will advise you on using the capitalization (cap) table, a model that shows the pro forma ownership in your company, to evaluate the impact of the terms under negotiation on the percentages of ownership. Savvy legal advisors will analyze investors' valuation of your business to understand how it was determined, explain it to you in terms that you know, and then teach you how to talk about valuation with potential investors.

That deep dive will detail everything from your company's milestone commitments to market comps to percentages of ownership and dilution considerations. Many entrepreneurs believe that the company will generate the cash the business needs to grow after first-round funding.

Experienced legal advisors know that most ventures, whether they are immediately profitable or not (most aren't), need subsequent investment rounds to scale up in three to five years. They understand that an entrepreneur's percentage of ownership is likely to decrease over time. They make sure that an entrepreneur understands that, too.

Common Goals and Understanding Creates Smoother Negotiations and Builds Constructive Relationships.

Entrepreneurs will be better prepared to value their companies after considering valuation from the investors' point of view. Drop any belief that investors love risk. They don't. They love returns. They know that your company, like most entrepreneurial ventures, is likely to need more time and funding than you expect. Listen to them and learn.

The relationship between investors and entrepreneurs is all about long-term trust. When relationships begin with two-way trust, the company, the team, and the investors all benefit, especially when the business hits a rough patch, as it inevitably will.

Additional Resources from Rev1 Ventures

Capital Planning

- 5 Ways Entrepreneurs Can Ace the Due Diligence Process
- 5 Ways to Bootstrap Your Startup's Finances
- Capital Access Planning
- Capital Planning Toolkit
- Sources of Capital for High-Growth Companies
- Who Is Responsible if Your Company Runs Out of Money?

Additional Topics

- 4 Tips Every Investor and Startup Can Use to Create Inclusive Entrepreneurship
- 5 Mistakes to Avoid When Starting a Business
- 5 Questions for Choosing the Most Effective Financial Modeling
- Advice on Taking Advice
- Business Models for High-Growth Companies
- Company Formation: Corporation or LLC
- How to Plan for a Successful Sale of Your Business

Attracting the Right Investors

- 11 Dos and Do Nots for Winning Investor Communications
- 6 Tips for a Strong Start with Every Potential Investor
- Checklist: 14 Red Flags Every Investor Looks For
- How to Connect with Investors and Choose the Right One
- How to Write a Startup Business Plan
- Investors Say Yes to User Interface Prototypes
- Nailing Your Investor Pitch - 1
- Nailing Your Investor Pitch - 2
- The Top 10 Things to Never Say in an Investor Pitch
- The Top 6 Things Early Investors Want to See
- Tool: Investor Pitch Template
- Video: Best Practices for Virtual Pitches to Investors