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Capital for Early Stage Firm
Terms & Fundraising Example

The purpose of this document is to provide a starter to understanding to common terms regarding an equity raise for an early stage firm and give a simple example.

I created this document to help some friends who were starting firms or considering joining start-ups, to work through how companies require multiple rounds of funding. With each round of funding the hope is that the equity will be invested into activities/products that increase the firm's valuation. Also with each round, there is a dilution of the founders and prior investors' position.

PAGE TWO: TERMS

This page provides common terms and a simple calculation of 'Pre-Money' and 'Post-Money' valuation. A couple of items to take away from this page:

1) These terms are the basics, I have intentionally excluded the next levels of complications (anti-dilution, warrant coverage, etc.). To give yourself a view of how complicated a term sheet can get, go to www.wsgr.com and look under "Venture Capital". The law firm of Wilson Sonsini Goodrich & Rosati offers an on-line term sheet generator which is really cool.

2) You can spend all day (and night) calculating and justifying your valuation, but the reality is your valuation is what your investor is willing to offer or accept. Build a good financial/operational model, but it's not what investor's buy.

3) No two investors are alike, so be prepared to negotiate on different issues for each one.

PAGE THREE: EXAMPLE OF FUNDRAISING ROUNDS

This page provides a simple example of four rounds of fundraising and common factors that angel/early-stage investors consider for valuation. Remember that for early-stage companies, there is either no or insufficient cash flows to create a standard valuation, so there is more art than science.

Items to take away from this page:

1) As a company moves through its different phases the valuation should increase as investor risk declines as you get closer to commercializing your offering. Again, using simple terms, the phases of an early-stage company
   a) Prove you have a product with an interested client base
   b) Prove the product works in production (beta test)
   c) Go through a limited client rollout
   d) Full rollout

2) The greatest amount of funds required is at full rollout, so raising money upfront is great - but you really need to understand the full amount of investment required until your operations can generate cash.

3) If you are looking at an early-stage firm, there are three key elements for success:
   a) Good management team
   b) The intellectual property (IP) is protectable (not easily copied or replicated)
   c) There is a significant enough market for the capital required

My favorite book on Start-ups is Guy Kawasaki's "Art of the Start" - see Candidates Resources for a link.

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Capital Structure Discussion Terms

1) Pre-money Valuation = Share Price * Pre-money Shares

2) Investment = Share Price * Shares Issued

3) Post-money Shares = Pre-money Shares + Shares Issued

4) Post-money Valuation = Pre-money Valuation + Investment

5) Fraction Owned = Shares Issued /Post-money Shares

6) Fraction Owned = Investment / Post-money Valuation = Investment / (Pre-money Valuation + Investment)

Investor proposes an $2MM investment at $3MM million premoney valuation - then investor will own 40% of the company after the transaction:

Investment		$ 2.0
Pre-Money Valuation	$ 3.0	
Investment	2.0	
		$ 5.0
Percent owned by Investor		40.0%

Assume 1.5 million shares outstanding prior to the investment, to calculate the price per share:

Pre-Money Valuation ($Millions)	$ 3.0
Pre-Money Shares	1.5
Share Price	$ 2.00
Investment ($Millions)	$ 2.0
Share Price	$ 2.00
Shares Issued	1.0

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Capital Structure Discussion
Example of Fundraising Rounds
Each Round Represents Completion of Activity to Increase overall Valuation

	Round #1		Round #2		Round #3		Round #4	
	Build Working Model		Operate Beta Test		Limited Rollout/HQ		Full Distribution	
Investment for Round		$ 5.0		$ 1.0		$ 1.0		$ 1.0
Pre-Money Valuation	$ 3.3		$ 5.0		$ 7.0		$ 10.0	
Outside Investment	5.0		1.0		1.0		1.0	
Total Value		$ 8.3		$ 6.0		$ 8.0		$ 11.0
Percent owned by New Investor		60.0%		16.7%		12.5%		9.1%
Pre-Money Valuation ($Millions)		$ 3.3		$ 5.0		$ 7.0		$ 10.0
Pre-Money Shares Outstanding		22.0		54.9		65.9		75.3
Share Price		$ 0.15		$ 0.09		$ 0.11		$ 0.13
Investment for Round		$ 5.0		$ 1.0		$ 1.0		$ 1.0
Share Price		$ 0.15		$ 0.09		$ 0.11		$ 0.13
Shares Issued per Round (1)		32.9		11.0		9.4		7.5
Value of Investment by Round:								
Round 1		$ 5.0		$ 3.0		$ 3.5		$ 4.4
Round 2		-		1.0		1.2		1.5
Round 3		-		-		1.0		1.0
Round 4		-		-		-		1.0
Outside Investor Value		$ 5.0		$ 4.0		$ 5.7		$ 7.8
Founders/Mgmt Team		3.3		2.0		2.3		3.2
Total Post-Money Value		$ 8.3		$ 6.0		$ 8.0		$ 11.0
Post-Money % owned by Founders/Mgmt Team		40.0%		33.4%		29.2%		28.8%
Logic for Valuation (2)								
Good idea/Protectable Intellectual Property		$ 1.0		$ 1.0		$ 1.0		$ 1.0
Good management team		1.0		1.0		1.0		1.0
Interested buyers/Viable market		1.0		1.0		1.0		1.0
Working Prototype		-		1.0		1.0		1.0
IP application/patent		-		1.0		1.0		1.0
Beta Test		-		-		1.0		1.0
Signed agreements/Customers		-		-		1.0		1.0
Initial clients successful						-		1.0
Ready for full rollout		-		-		-		2.0
Valuation		$ 3.0		$ 5.0		$ 7.0		$ 10.0

Notes:
1) Excludes anti-dilution provisions for institutions/saavy investors
2) Excludes valuation via multiples of Revenues or EBITDA, recent sales, DCF calculation