

How to determine a valuation for your startup

A **startup valuation** is the financial value of a startup's equity at a given point in time. In other words... how much your startup is worth.

Unlike public companies - where the stock is listed on an exchange and fluctuates throughout the day based on trading activity - private startup valuations are agreed upon by the investors and the founder(s) when the startup goes out to fundraise.

This valuation is based on a variety of factors:

- How much revenue the business has
- Business experience of the founders
- Competition in the market
- Macro market conditions
- Investor demand

The last point on "investor demand" is one you should definitely pay attention to. While the other factors do matter, a startup's valuation is not actually about how much your company is worth, but about the **supply and investor demand of your round**. Let me explain.

Example #1:

Imagine your goal is to raise \$200k at a \$1M valuation. But you discover that you have a lot of investor demand. In fact, these

investors are offering a total of \$500k... \$300k more than you're aiming to raise.

This means you have more demand in your company than available equity, so you can safely increase your startup's valuation and still secure the capital you're looking for.

Example #2:

Imagine your goal is to raise \$2M at a \$5M valuation. But no one is interested. Then your valuation is, well... \$0. Because there's no investor demand to participate in your startup's round.

You can't raise money at a \$0 valuation. But you can lower your valuation to a sweet spot where you'll get to investor demand. Alternatively, you could improve your pitch deck to try and convert more investors. Or you could work to grow the business and "earn" your desired valuation.

In practical terms, determining your valuation is less about your "actual" worth and more about what investors are willing to pay. So founders can set a value for their own startups, but VCs will also perform due diligence to determine a valuation they'd feel comfortable investing at. The two sides may then negotiate an acceptable valuation for both parties.

Still with me?

Because there are two different kinds of valuations that you should know: the pre-money valuation and the post-money valuation.

Pre-money and post-money valuation

The **pre-money valuation** is the valuation of the business before it receives any outside investment.

The pre-money valuation doesn't take into consideration the money the founder is planning to raise. So if a startup has a pre-money valuation of \$2M, and she's planning to raise an additional \$500K, her pre-money valuation is still just \$2M.

This number is important because it tells investors how much they'll need to put in to purchase their desired equity stake. The pre-money valuation will usually change every time the startup raises a new round of financing.

For instance, a seed-stage startup might raise at a \$5M pre-money valuation. After 12-18 months of growth, it'll return to raise its Series A at a \$10M pre-money valuation. The increase in pre-money valuation would represent the additional value the startup has created by acquiring more customers, improving its product, building its brand, etc.

Let's take the example of the company with a pre-money valuation of \$2M. If an investor wants to purchase a 20% equity stake, it means that the investor will need to put in \$500k at a \$2.5M post-money valuation. ($\$500k / \$2.5M = 20\%$).

As the name suggests, the **post-money valuation** is the startup's valuation *after* receiving outside investment. Unlike the pre-money valuation, the post-money valuation is easy to determine: simply add the investment amount to the pre-money valuation.

A startup on a good trajectory should see its post-money valuation increase with every new financing round (i.e., investors should view it as growing in value). If the post-money valuation goes down round-over-round, it's called a **down round** and could signal the business is in peril.

High valuations aren't always a good thing

While high valuations leave founders with a larger percentage of ownership in their startup, there's more to consider.

Consideration #1: Investor incentives

We already know that investors can be really, really helpful. But with 24 hours in a day, they're only able to give meaningful help to their highest-priority investments. So if an investor has a 1% stake in your business and a 10% stake in another business, and you're at the same stage, which company do you think they'll dedicate more resources and time towards?

Consideration #2: Startups need time to grow into valuations

Let's say a founder generates interest in her idea or an early version of her product. She raises money at a \$12M post-money valuation.

She uses that money to improve the product, acquire users, and hire a few people. After 8 months of working on the business, the founder doesn't see the traction she was hoping for. And she's out of money. She decides to raise another round of funding.

Only this time, investors have less conviction in her business. Since she hasn't proved that her idea is successful, they might recommend a lower valuation, but that can look really bad. Decreasing the valuation is a signal to investors that there is something wrong with the business. And since investors see anywhere from 10 to 1000 pitches every month, they're more likely to invest their money in a new company instead of writing this founder another check.

Ironically at the time of this writing (January 2023) where capital is really tight, down rounds are not negative signals. It's a sign that someone wants to invest. So this is the exception to the rule.

Consideration #3: Recruiting

Most startups don't have the capital to offer competitive salaries to high-quality talent. That's where the ESOP comes in. By attracting talent with stock options, founders are able to conserve cash while employees feel like they have ownership of the company. Those employees are incentivized to work really hard to make the business successful because if the business does well, their options will be worth a TON of money. Right?

Here's the problem: joining a team with a high valuation means that the price for the stock options is also high. Employees will realize that they can't actually afford to buy their options.

Couple that with the low salary and long hours, and they won't be incentivized at work. This can lead to ugly company culture and low productivity.

The savvy people who are smart enough to ask about valuation and exercise price will realize that the opportunity isn't as good as they thought. So if you have too high of a valuation, hiring those people will become very difficult.

How cap tables, shares, and vesting all work together

A cap table is a spreadsheet that lists all the people and entities that own pieces of your company. In the beginning, there may just be two lines for you and your co-founder. It'll list your names and how many shares you both own.

The shares in themselves are meaningless. But they are meaningful when you see how much of the pie they represent as a percentage. Every time you give a slice of pizza to an investor or a key employee, they will be granted shares and have some equity in the pie. Their

name will then be added to the cap table with the respective % numbers next to their name.

Here's an example of what a cap table looks like. You can also make a copy of our template [here](#).

Company Valuation					
	Total Value (\$)	Per Share (\$)	# of Shares	% of Total	
Series A					
Pre-Money Valuation	\$7,500,000	\$8	1,000,000	75.00%	
New Equity Raised	\$2,500,000	\$8	333,333	25.00%	
Post-Money Valuation	\$10,000,000	\$8	1,333,333	100%	
Company Ownership Cap Table					
	Capital (\$)	Common Shares	Preferred Shares	Total Shares	% Ownership
Shareholders					
Founders	\$0	800,000		800,000	60.00%
ESOP Pool		200,000		200,000	15.00%
Investor Tam	\$150,000		20,000	20,000	1.50%
Investor Kera	\$450,000		60,000	60,000	4.50%
Investor Eric	\$300,000		40,000	40,000	3.00%
Investor Shiyan	\$250,000		33,333	33,333	2.50%
Investor Elizabeth	\$900,000		120,000	120,000	9.00%
Investor Janel	\$200,000		26,667	26,667	2.00%
Investor Brian	\$100,000		13,333	13,333	1.00%
Investor Haley	\$150,000		20,000	20,000	1.50%
Total	\$2,500,000	1,000,000	333,333	1,333,333	100%

In this example, our post-money valuation is \$10M. New investors are coming in for \$2.5M. That means they now own 25% of the business. The cap table also has an ESOP pool of 15% (more on what that is below). Which leaves the founders with 60% ownership after the investment round.

Founders get **common shares** while investors earn **preferred shares**. There are three main differences.

- Voting power: Common shareholders get to vote on important company decisions whereas preferred shareholders usually don't have voting rights.
- Dividends: Preferred shareholders get preference on liquidity when the company IPOs/exits. This means they get paid out before the common shareholders.
- Risk: Common shares are a bit riskier. If the company has to close down, founders will be the last to get any money back from what's left, whereas preferred shareholders may recoup some of their money.

Founders and employees earn shares by working for the startup, but their shares typically **vest** across four years. This means they don't get all the shares upfront when they start working at the company.

A typical vesting schedule is as follows:

- The employee earns 25% of their allocated equity after working for the company for 1 year
- Over the next 3 years, they earn the remaining 75% of their equity on a monthly basis.

Once a founder or an employee has vested some shares, that's technically just a right to exercise the option to buy those shares for a cheap price (in most cases). Once your shares have vested, you can exercise or buy your options - pay the cheap price to get your shares - at any time that you are still at the company.

Most people do not exercise their options as long as they are still at a company, because they want to wait and see as long as possible how the company is doing to decide whether or not to spend the money. People typically exercise their options when they leave the company, because once you leave the company, you typically forfeit any options that have vested that you haven't bought.

If the company is doing well, buying their vested shares is generally a good deal for the employee (especially early employees) because the price for each share is directly related to the valuation of the company at the time the employee joined. So an employee who joined a startup early could buy their fully-vested shares at, say \$.05 per share, even if the current valuation of the company at that time is much higher.

Vesting prevents people who only stay with the company for a month or two from running away with tons of shares. Investors expect founders to have vesting in place for everyone. This includes advisors, whose shares typically vest over 1-2 years.

You might be wondering, "What if everyone stays on until their vesting schedule is complete and exercises all their options?" Then

you'll have a **fully diluted cap table** where everyone who was allocated shares will indeed get all their shares.

If investors are investing on a SAFE, they technically do not own shares at that point. Remember the last chapter? Investors using SAFEs will have a ticket to claim the pizza later, but not actually own the slice in that present moment. So these investors will NOT be added to the cap table until their SAFEs/notes convert into actual shares.

This is another reason why founders don't realize how much of the pie everyone owns. There are investors who have invested money but aren't technically on the cap table yet. We recommend founders use [Pulley](#) (a plug for one of our portfolio companies), which makes cap tables super easy to understand even if someone invested through SAFEs.

When you raise money from investors, they will often ask you to create an **employee stock option pool (ESOP)**. This means setting aside some shares for your employees to incentivize them to stay longer and do great work. Investors typically expect founders to set aside 10% of the pie for ESOP but this percentage amount can be negotiated. 15 years ago, this percentage was typically 15-20%, and we may revert back to that if the markets get worse.

An ESOP can dilute the cap table faster than you might expect. For example, if you're being diluted down by 20% by the next round of