Startup Round Pricing and Cap Tables

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How do startups talk about the pricing of a round to investors? What terms are used?

Startups discuss round pricing using terms like "pre-money valuation," the company's value before investment, and "post-money valuation," the value after. They mention "equity stake," the percentage of ownership investors receive, and "dilution," the reduction of existing shareholders' ownership. Key terms include "term sheet," outlining investment terms, and "liquidation preference," which defines payout order in a sale.

How is pre-money valuation calculated?

Pre-money valuation is calculated by determining the company's value before new investments are added. It typically considers factors such as market conditions, revenue, growth potential, and comparable company valuations. To calculate it, subtract the investment amount from the post-money valuation (the company's value after investment). For example, if a startup is valued at $5 million post-money and receives a $1 million investment, the pre-money valuation is $4 million.

How is post-money valuation calculated using the amount invested and the percentage ownership given to the new investor?

Post-money valuation is calculated by dividing the amount invested by the new investor's ownership percentage (expressed as a decimal). For example, if an investor puts in $1 million for 20% ownership, the calculation is:

Post-money valuation = Amount invested / Ownership percentage

Post-money valuation = $1,000,000 / 0.20 = $5,000,000.

This means the company's total value after the investment is $5 million.

Explain the dilution that occurs to existing investors in a startup round.

Dilution occurs when a startup issues new shares, reducing existing investors' ownership percentage. For example, if a startup has 1,000 shares and issues 500 new shares, the total becomes 1,500. An existing investor with 100 shares now owns 6.67% (100/1500) instead of 10% (100/1000). This means their voting power and claim on future profits decrease. Dilution is often a trade-off for raising capital to grow the business. Understanding the cap table helps investors see how their ownership

Founders start with 100% ownership in a startup. How much dilution can they expect in early rounds?

Founders can expect significant dilution in early funding rounds. In a typical seed round, founders might give up 15-25% of the company. In Series A, additional dilution can range from 20-30%. By the end of Series B, founders might retain around 50-70% ownership, depending on the total funding raised and the valuation. Dilution varies based on negotiation, investor interest, and market conditions. It's crucial for founders to understand how each round affects their ownership and control.

What is the standard amount of dilution for founders in startups that reach an IPO?

Founders typically experience dilution of 20-30% by the time a startup reaches an IPO. This dilution occurs through multiple funding rounds where new investors buy equity. The exact percentage can vary based on the startup's valuation, the amount raised, and the terms negotiated. It's important for founders to understand how each funding round impacts their ownership percentage and to plan accordingly.

How is the price per share calculated in a startup round?

The price per share in a startup round is calculated by dividing the pre-money valuation by the total number of outstanding shares before the round. For example, if a startup has a pre-money valuation of $5 million and 1 million shares outstanding, the price per share would be $5 ($5 million ÷ 1 million shares). After the investment, the new shares issued will affect the total share count, which is important for future calculations. Always consider dilution effects when new shares are issued.

In a startup round do the founders sell their shares or does the startup sell newly issues shares?

In a startup round, the startup typically sells newly issued shares to investors. This increases the total number of shares outstanding and dilutes existing shareholders, including founders. Founders may sell some of their shares, but this is less common in early rounds. The cap table will reflect these changes, showing the ownership percentages before and after the round.

If a round includes an option pool, how are these shares accounted for?

In a startup round with an option pool, the shares for the pool are included in the pre-money valuation. This means existing shareholders experience dilution from the option pool before new investments. The cap table reflects the option pool, affecting ownership percentages. Clearly outlining the option pool size in the cap table is essential to understand its impact on ownership and valuation.

What is a cap table?

A cap table, or capitalization table, is a document that outlines a startup's ownership structure. It details equity ownership for shareholders, including founders, investors, and employees with stock options. The cap table shows the number of shares owned, ownership percentage, and share value. It is crucial for understanding equity distribution and is important for fundraising and financial management. A well-maintained cap table is essential for tracking a company's financial structure.

Who uses a cap table?

A cap table is used by startup founders, investors, and financial analysts. Founders use it to understand ownership stakes and dilution. Investors refer to it to assess their equity position and potential returns. Financial analysts may analyze cap tables to evaluate a startup's financial health. Additionally, legal teams use cap tables during funding rounds to ensure compliance and transparency.

When will a VC ask to see the cap table?

A VC typically asks to see the cap table during the due diligence phase after expressing interest in investing. This usually occurs after initial meetings or pitch presentations. They want to understand the ownership structure, existing investors, and how their investment will affect equity distribution. It helps them assess potential dilution and the overall financial health of the startup. Be prepared to provide an updated cap table that reflects current ownership and any pending investments.