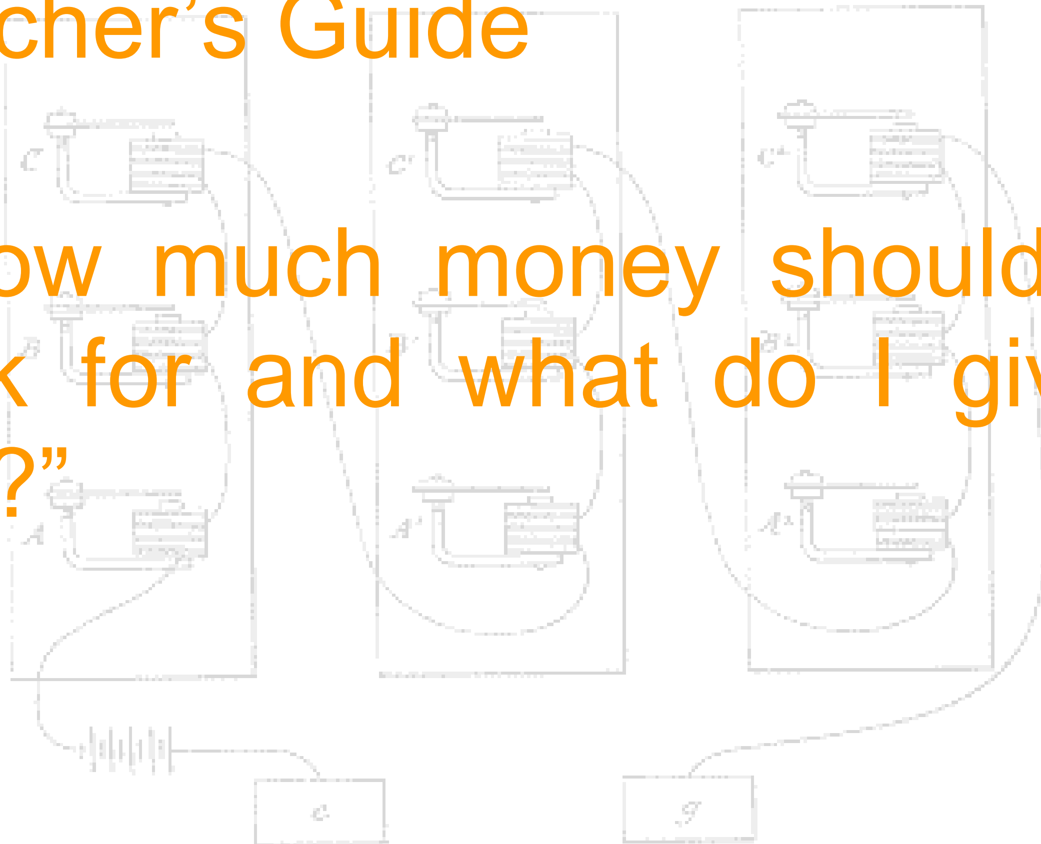
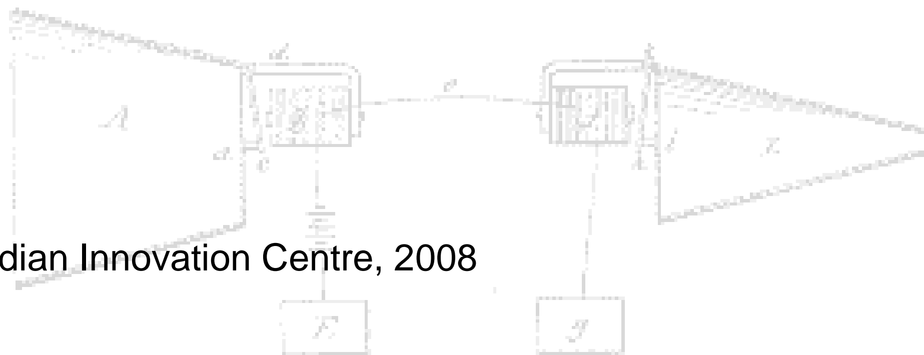


Pitcher's Guide

"How much money should I ask for and what do I give up?"



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Witnesses

Inventor:

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How much money should you ask for?

Asking for the right level of investment is very important as it shows to potential investors that you have a good understanding of what the business needs to be successful. It shows why the business needs the money and precisely how the investor's money will be spent. There are a number of different things the investor will determine from this:

- Where you are in the development/production/launch phase of the product – based on what you plan to spend the money on
- An understanding of the cash flow of the business, to demonstrate how far the money will get the business and specifically is this all the outside money the company needs or is this just the first step in seeking increasing rounds of external finance
- An appreciation of your knowledge, experience and approach in commercializing this innovation in order to determine your overall level of competence and realism
- A demonstration that you have carefully thought out the roadmap for commercial success and that you will be able to manage it well, both in terms of meeting timelines and managing budgets. In turn this will give investors performance milestones against which future performance can be tracked
- A level of confidence that you will not run out of money when you are half way along the commercialization path, as if you do this without planning for it – raising future money is challenging
- How you will leverage the investor's money to attract other money and resources
- The level of attention and competence that you will bring to financial matters, which are often different from the skill set involved in developing a solution or taking it to market

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What do investors like to see in your investment plan (and what they don't like to see)

Here are seven of the things that investors like to see in an investment plan, to justify why you are asking for a specific amount. In general these are seen as positive reasons for investment:

- Detailed information on precisely how much you need and what you need it for (this can include a contingency)
- Money to be spent on scaling up production
- Money to be spent on entering new markets
- Money to be spent on increasing adoption
- Money to complete approvals process or complete patent
- Money will leverage other equity and non-equity sources of finance
- Money to be spent on building channel relationships

Here are five of the things that investors don't like to see in an investment plan. In general these are often seen as a reason not to invest:

- Little detailed information on how much you need or why you need it
- Payment for research or technology development
- Payment to retire old debts, payout existing shareholders or fund founders salaries
- Payment for previously incurred expenses
- Large expenses for legal or other "non-productive" costs

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The importance of asking for the right amount at the right time

Raising money is one of the most challenging things you will ever do in your business. It is difficult (only 1 in 100 entrepreneurs succeed). It is takes up a good deal of time and ends up costing you a substantial share of the business – and should not be started without a good deal of thought. However it is also a key turning point in the development of a business, the point at which the growth of your business rapidly accelerates, the time when an you are able to persuade an independent third party of the value of the opportunity and the point at which you start to share control of the company with others who were not founders.

The time and cost of raising this money is such that you want to do it as infrequently as possible, the actual process of raising the money costs about the same if you are raising $25,000 or $200,000. The costs of raising money are usually a function of your time and distraction and the legal/diligence costs. Therefore, raising money in two steps rather than one often increases the costs of raising money, unless you can raise the second amount at the higher valuation. So how should you decide how much to ask for at this time?

Answering the following questions will help you come up with a plan. Asking for the right amount at this time is extremely important, it shows the investor that you know what you are doing, it ensures that you don't run out of money and it minimizes the amount of equity you will have to give up. Importantly you need to raise enough now to take the company to a point where there is a demonstrable and significant increase in company value – in order to minimize how much equity you will have to give up. Remember your company's value increases as it develops, so you will have to give up more equity now for a given amount of money than you will in the future (If this sounds complicated see the example in the text box).

Deciding how much to raise is a three step process:

- First you need to draw up a budgeted profit and loss account for the next three years, on a month by month basis - including all development and/or marketing costs
- Second you need to calculate the negative cash flows to see how much money you need each month to get you to each stage in the business
- Third you need to identify whether there are any points in the development of the company where the value of the business significantly increases

Advice on prudent budgeting

Based on experiences of hundreds of innovators, we usually apply the "Rule of ∏" to all timescales and budget costs. That is everything will take 3.142 times as long as you expect and cost 3.142 times as much. You need to come up with realistic numbers which you can justify and build-in some sort of contingency to make sure you do not get stranded between milestones.

The first two items are self-explanatory; the third is a little more complicated. A significant increase in the value of the company typically occurs at six points in the commercialization path where one of the following happens:

- At the point where the technology development is either complete or overcomes the single most important technological challenge.
- At the point where there is a working prototype or some important approval process is passed
- At the point where there is favourable external recognition of the business
- At the point where there is a fully working version of the product available
- At the point where customers start to purchase the product
- At the point where the growth of the business is enhanced through the signing of some long term contract with an OEM, distributor or other strategic channel partner.

How the amount you ask for links to the investment decision

- Money raised at this time is the most expensive money you will ever raise. This is because it carries the highest level of risk. As time progresses, you achieve more milestones and get closer to commercial success and the risk is reduced. The higher the risk, the more you will have to provide back to the investor. Early-stage high-risk translates to high returns for early stage investors.
- The value of a company is based on its proven ability to generate profit. Further profit this year is seen as having more value than profit next year. At the early stages of a company's growth, the potential profit is usually quite uncertain and at some time in the future. This translates to a low current value. As a result, investors will want a significant portion of your company, for even a relatively small investment. This makes it a very expensive time to raise money.
- If you raise too little money, you are likely to run out of money between milestones and be unable to raise additional investment. This will leave you and your investor with either a worthless investment, or one where the value drops enormously. However, reaching such a milestone successfully, allows you to justify an increase in company valuation (partly because you are nearer to making money and partly because the risks are reduced). At this point you will have to give up less equity for the same amount of money.

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How much equity should you give up

The idea of obtaining equity investment is that investors share the risk and share the reward. They invest their money with the idea of seeing it rise in value over the next 3 – 5 years, usually to at least double what they invested and in many cases much more. They calculate the chances of his happening by working backwards, so they calculate the value of the company at the time when they sell their shares, and work out how many shares they will need to have at the point in relation to their original investment.

This helps them determine how many shares they should ask for now. The simpler way they calculate this, is by working out the value of the company, before the investment and determining the percentage increase in value their investment brings. They then ask for this amount. It is important to note that their investment actually increases the value of the business in two ways – through the cash they inject and through their participation. In many cases entrepreneurs underestimate the value of the investors participation – but there is significant evidence to suggest that their participation in the business is more valuable than the money itself.

<u>Understanding how investors value their investments</u>

Let us assume that you need a $100,000 investment for your company.

If you offer the investor 20% of the company for this – investors do a simple calculation.

The value of the company, will increase by $100,000 due to their investment, for which you offer 20%

If after the investment, 20% of the company is worth $100,000 then the whole company is worth $500,000.

This means that the value of the company before the investment of $100,000 is

$500,000 - $1000,000 = $400,000

You can see from the example how investors determine what you value the company at. You need to be prepared to justify this value. It is important both in building your credibility and making sure the deal is right for both parties. Importantly, we have already identified that the investor's participation in the company can be more important than the money. If you assume that this is the case, then the investor can suggest that they make a bigger contribution to the company, hence they can justify a bigger share of the equity. At times this is an important consideration – but this can also have an impact in who controls the company, which is discussed further in the section on what investors are looking for in a deal.

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Some ways to justify your valuation

Although this sounds like it should be easy, there are very few hard and fast rules on this and it is very difficult to do for an early stage company. The simplest way to value a business is to take the present net value of the expected profit, assuming that growth will stabilize within 5 years. However if you are at the pre-revenue stage, the level of uncertainty around all these numbers is so great, that this becomes meaningless. Company valuations based on unsubstantiated projected future revenues are equally flawed, as is accumulated expenditure or investments already made in the company.

An expert can do sophisticated valuations, but we provide a brief summary of the three major methods used by investors, based on Net Present Value, Comparables, or Exit Valuation. Each of these puts limits on what investors are willing to accept as reasonable valuations, and even if you feel you can justify a higher valuation, reduce this amount because investors are always choosing between options. Thus if they can see a company with the same growth potential, but a lower valuation, they will chose this investment as their return will be higher.

Valuation justification methods

Net Present Value: First calculate the cash flow of the business for the next five years. Second bring these cash flows to today's value by discounting by the appropriate interest rate (If you don't know how to do this it is a built in function in Excel). This is the value of the company. If to do this you need the investment money, then this is the value of the company after the investment has been made.

Comparables: Suppose your company already has revenues. Then you multiply this revenue by the factor that similar companies use when their value is quoted on the stock market. Industry and specific multiplier are readily available.

Exit based Valuation: This is a combination of the two methods (and the most common). First you forecast revenue in five years, then you multiply this number by the factor that similar companies use in their stock market valuation. Finally you discount this valuation back by the compound interest rate over the next five years.

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Some ways to reduce the amount of equity you have to give up

There are five ways you can reduce the equity you have to give up;

- Identify other sources of money, such as credit cards, government loans and grants and banks who will all provide cash without taking equity
- Reduce the amount of cash you need by finding less expensive ways to move forward, postponing some investment or sharing resources
- Engage with customers or other supply chain partners at an early who may be willing to help as in the long term there will be a direct benefit to them
- Find a way to justify to the investor an increase in valuation
- Stage the investment to reduce the dilution (see example below)

A simple example – Reducing dilution by staging investment

Suppose you need $200,000 and you have valued your company at $300,000

After the investment, the company will be worth $500,000 ($200,000 + $300,000)

Therefore you will have to give an investor 40% of the company (200/500)

This leaves you with 60% of the company.

Instead suppose you only ask for $100,000 now - you will give the investor 25% (100/400)

Let us assume that the company grows in value to $900,000

Now you ask another investor for $100,000 – you will give this investor 10% (100/1000)

The original investor will own 25% of 90% or 22.5%. The two investors together own 32.5%

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