



HOW TO INVEST LIKE A VENTURE CAPITALIST

SLICE CAPITAL

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Getting Acquainted

Welcome to Venture Capital

Hi there! Welcome to the first step in the lifelong voyage of Venture Capital. Thanks to Regulation Crowdfunding, anyone is now able to invest in this exclusive asset class.

The following 30-something pages will cover the basics of Venture Capital as well as a study of how Venture Capitalists invest. Every claim is sourced from professional articles, investors, or investing websites. We took the liberty of boiling down and organizing their ideas into one coherent whole. Our hope is that this guide will demystify the industry for the common investor.

What is “VC”?

We already have an idea of it, but what *really* is it?

According to [Investopedia](#), Venture Capital (we’ll shorten it to “VC”) is financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. VC investment makes up about \$150 billion in total investment per year, as per [Pitchbook](#). This is merely a drop in the bucket compared to the global stock market (at roughly \$70 trillion in global [public capital](#)). VC, as it exists today, is a niche investment category. There are a few reasons for that.

VC is inherently high-risk/high-reward: 75% of venture-backed startups [fail](#), while a select few hit pay dirt. As we’ll see, failure is an inevitable (and acceptable) part of the industry. The key to success is offsetting a large number of failures with a handful of big wins. This is the mark of a successful VC portfolio.

Naturally, this tends to attract a different breed of investor: namely the risk-takers, the visionaries, and the wildcards. VC follows its own rules with its own principles that bear less resemblance to investing in vanilla stocks and bonds (more on that later). It also has more secretive and relationship-based markets. As a part of the private equity world, these investments are not typically tradeable nor can they be readily found, unlike their public market cousins.

For all of time, these types of investments were closed to the average investor. With the passage of Regulation Crowdfunding, that world has opened from the proverbial 1% to anyone with \$100. This monumental change has yet to permeate through the macro- and microcosms of the economy, partly due to the foreign nature of VC. Nevertheless, in order to play the game, one must know the rules... and that is where we’ll start.

“Alexa, play ominous transition music.”



The Ground Rules

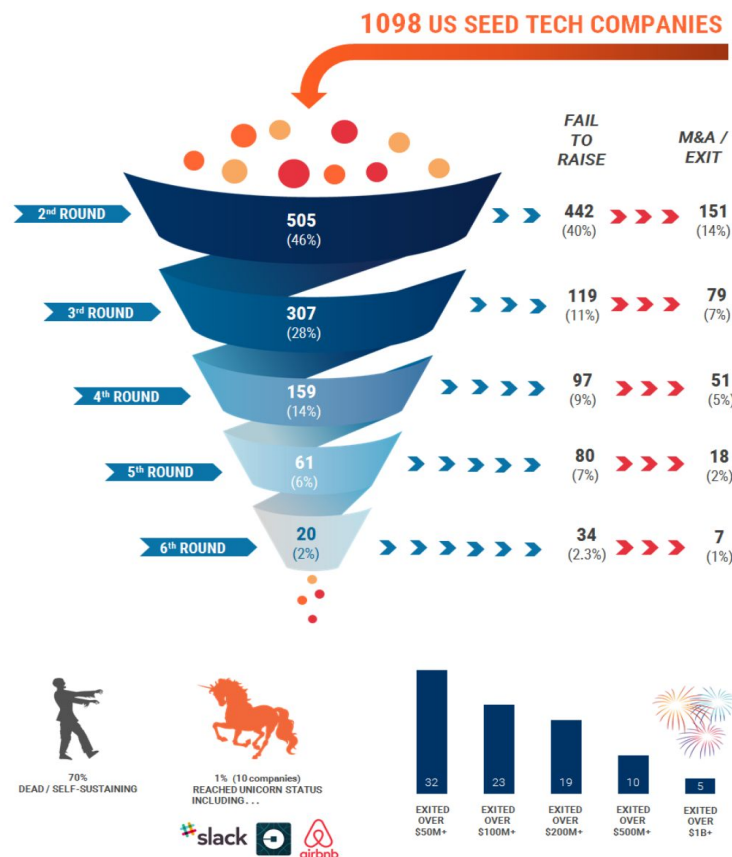
Rule #1: Give the dough time to rise

Startup investing is like baking bread - it takes time to rise. Considering the scarcity of exit opportunities and the monumental hurdles startups must overcome, investments take a long time to get to the point of cashing out. If there is an exit (big “if” as we’ll see) it likely wouldn’t be for at least 6 years, and that can go up to a decade or more. If the company never sells or goes public, then a VC will likely never see a return. As they say though, “lemons rot faster than plums ripen.” Patience is a must.

Rule #2: Expect to fail... a lot

What are the numbers behind the infamous survival rate of startups?

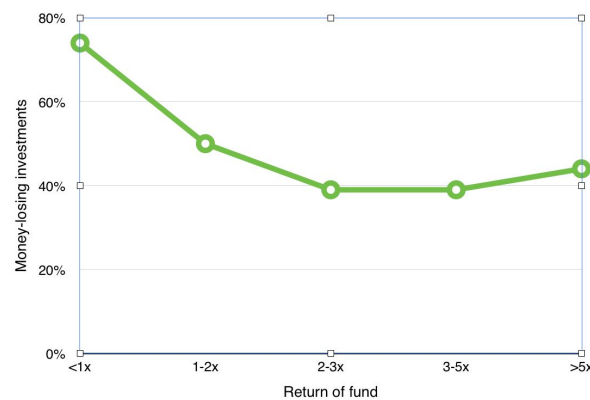
“Alexa, show us a CB Insights chart”



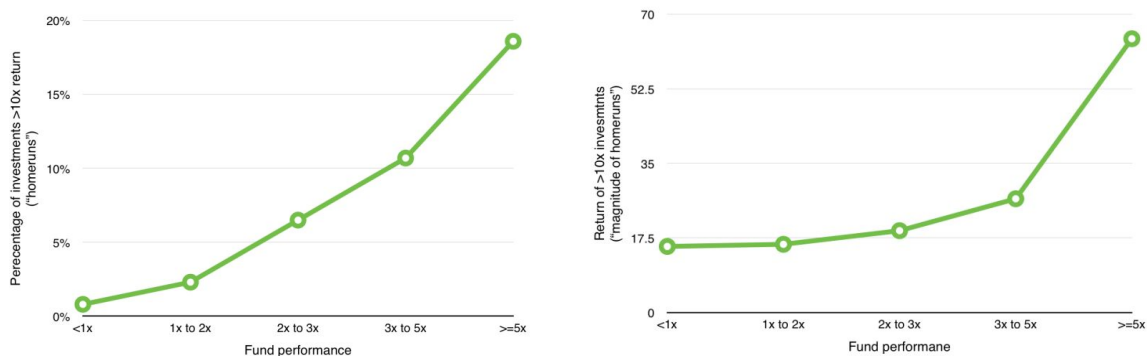
For being such morbid statistics, it really is a pretty chart....

The numbers speak for themselves. Just 1% reached the coveted \$1 billion or more status. 70% failed to exit because they either died or self-sustained. The remaining 29% had some sort of merger or acquisition, which counted as an exit event. Therefore, of the 1,000+ companies that CB Insights used for this sample, only 30% made money for their investors.

The reality is that investors prepare for loss on most investments. It is the nature of the beast. Some call it the [Babe Ruth Rule](#) — investors either strike out or hit home runs, and they strike out a *lot*. As the [graphs show](#), the best performing VCs lose money on more than 40% of their investments:



However, the best performing VCs are also more likely to hit “grand slams”:



There's a mountain of data supporting this trend. The Kauffman Foundation scooped [data on this topic](#) and found that 52% of startup investments don't return the money invested. Horsley Bridge, a VC firm, found that 62% didn't return their money over a 30-year period. In fact, 7% of *exits* generated returns of at least 10x, which accounted for 75% of total returns. Talk about lopsided. A very small number of big wins define a portfolio. This is the [power law](#), which basically states that ~60% of returns come from ~6% of investments. Consider that for a moment. A handful of correct bets make up for many wrong bets. VCs become legends from their grand slams. Look at any prominent



Venture Capitalist's biography. It says their name, their investment firm, and which notable wins they've had. They become trophies that prove someone's credibility in this industry.

Check [these ones](#):

1. Bill Gurley

Benchmark

GOT A PAYDAY FROM: GrubHub, OpenTable, Zillow

NOTABLE CURRENT INVESTMENTS: Uber, Stitch Fix, Nextdoor

2. Chris Sacca

Lowercase Capital

GOT A PAYDAY FROM: Twilio, Twitter

NOTABLE CURRENT INVESTMENTS: Stripe, Uber

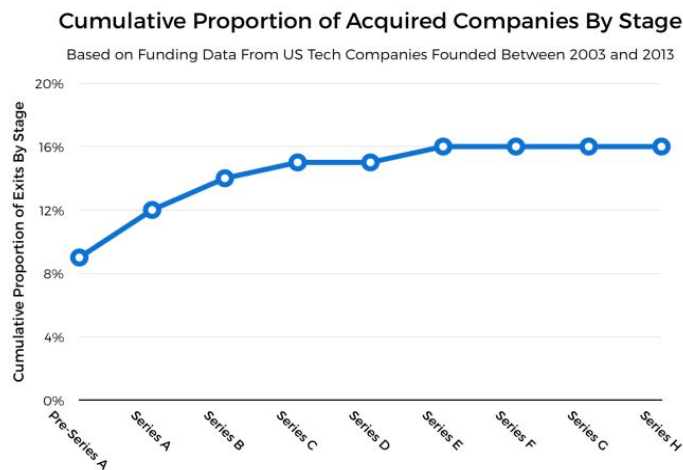
3. Jeff Jordan

Andreessen Horowitz

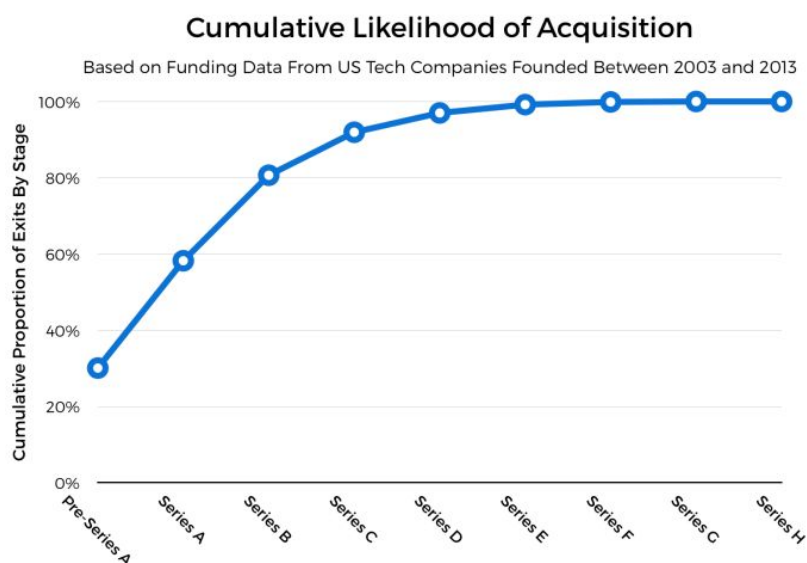
GOT A PAYDAY FROM: Tilt

NOTABLE CURRENT INVESTMENTS: Airbnb, Instacart, Pinterest, OfferUp

This is all to say that it is very difficult for startups to exit, as CB Insights previously claimed. They aren't the only ones to examine the nature of exits though. TechCrunch ran the [numbers](#) on 15,000 companies over the course of 10 years. They found that companies were 16x more likely to sell than IPO. TechCrunch's data showed that about 16% of companies end up getting acquired, as seen below:



Of those that do get acquired, the vast majority get bought up relatively early in the process. The chart below shows that 80% of the total acquired companies had raised 3 or less funding rounds by the time they were snatched up:



Buyers tend to pick the fruit from the vine before it grows too sweet.

It's notoriously difficult to pick winners in this business. That's partly because no single opportunity will ever seem perfect, as each has its own strengths and weaknesses. That's why the best approach seems to be to construct a portfolio that [balances these](#) different strengths, weaknesses, and characteristics. Ultimately, VCs fail frequently. Betting on "insane" looking companies has a higher failure rate, but also tends to [make it all worthwhile](#).

Rule #3: Diversify everything

"I sent in my application to The Real World, so I'm hoping to hear back from that. I'm putting a lot of my eggs into that basket, the MTV basket. And if that doesn't work out I'm thinking about getting a gun, and dealin' crack. Being a crack dealer. Not, like, a mean crack dealer, but like... like a nice one. Kinda friendly, like, 'Hey, what's up guys? You want some crack?' I'm just kinda waiting on those two things to flesh themselves out."

-Ricky Bobby



Sometimes it's good to put all the eggs in one basket, like if one has a solid crack-dealing backup plan. This industry is not one of those scenarios though. "Seasoned VCs" appear to put their eggs in as many baskets [as they can](#).

The logic goes that it's very hard to predict which industry or individual startup will win-out. There are too many uncertainties out there. Therefore, the best way to mitigate that risk is to bet on as many good looking horses as possible. Given that payouts can be huge, one big win makes up for many little losses.

This means it's important to practice diversity whenever possible, i.e. by type, size, industry, founder demographic, geography, etc. Theoretically, VC is very progressive. Anything that makes a portfolio more diverse is a plus. In practice, this fails to play out given VC is [widely known as](#) a California white men's club. Fortunately, recent public backlash is shining a light on this and there are now [seeds of change](#).

As a whole, Venture Capital tends to account for a small corner of an investment portfolio. In other words, investors should not have all of their money invested in startups. Experts say startup investments [should make up](#) less than 15% of one's entire investment portfolio, and some suggest [even less](#). It's like the food pyramid. Balance makes a healthy whole. This means Venture Capital complements other asset classes like real estate, stocks, and bonds. If stocks and bonds are the bread and butter, VC is like Ben and Jerry's ice cream. It's great in moderation, but too many solo pints on a Saturday night can leave you in a dark place.

Experts [say](#) it's best to invest in 10-12 companies at a time. Their logic goes:

"Typically, if you invest in 10 companies, two will be successful, three will 'do OK' and five will fail."

Some studies say to go even higher though, A simulation from [the University of Willamette](#) shows that larger portfolios are more likely to generate positive returns. They found that 12 investments gave one a 75% chance of earning a 160% return on investment, while 48 investments gave someone a 95% chance of doing the same.

Too much diversification can hurt returns though. Fundersclub [states that](#):

"(diversification) can reduce the impact of negative events within a startup portfolio, but excessive diversification can also reduce the likelihood of a portfolio outperforming the asset class."

The flip side of too much diversification is that it lowers the potential ceiling. Spreading investments across 48 startups might improve one's odds of a *positive* return, but it also damages one's odds of a *large* return. Diversification itself is about balance.

One of the [basic practices](#) of diversification is investing across different industries. Consider the "green energy" investment craze of the late 2000s. If a Venture Capitalist had focused all her capital on that sector during the run-up, she [would have been broke](#) by the end of the period. Balancing industries within a portfolio can help mitigate the consequences of cyclicity.



Research shows how important it is to diversify by founder demographic. The race, gender, and background of founders are X-factors to bigger returns. As the Harvard Business Review shows, female-led firms have [higher rates of return](#) on average than male-led firms. As First Round Capital corroborates, female-founded portfolio companies have [outperformed male counterparts](#) by 63% within their portfolio. Similarly, race and background are tangibly [valuable](#) to returns. Broad demographic changes mean that the majority of domestic consumers will be minority populations by 2050. Logically it follows that the best way to sell to *all* groups of people is to support businesses by *all* types of founders. The numbers back it up too. Companies in the top 25% for racial and ethnic diversity are 35% more likely to [outperform their peers](#). Conversely, companies in the bottom 25% for diversity are statistically less likely to win out over peers. For every 10% increase in diversity among senior executives of a company, profit rises by 0.8%.

Finally, diversifying by geography even [has its merits](#). Different parts of the economy move in different directions based on countless factors. What is good for Silicon Valley startups isn't necessarily good for Midwest startups, and vice versa. Balancing out investments by geography means avoiding concentrated risks. Furthermore, geographical diversification means funding different people, cultures, and ideas. Just as it's unwise to concentrate bets on one company, it is also important to diversify bets by location, as it has been shown to [boost returns](#).

Diversification isn't a hard concept to understand. Spread the eggs out. The wider the exposure, the better chance there is of generating a solid return. Venture Capital is inherently uncertain. The only way to mitigate risk is to balance it.

Rule #4: Always be closing exiting

Liquidity. This science sounding word is essential to understanding VC. Liquidity in the financial sense is the fluidity of which an investment can be sold — so it's not a completely random application of the original word. More [technically](#), it is the measure of how easily an investment can be sold *without affecting its price*. While Apple stock can be sold in an instant without any measurable effect to its price, a 20% stake in a Series B company would be lucky to attract one buyer every few years. VC is one of the *least* liquid categories of investments, meaning VCs don't expect to sell their stakes for long periods of time.

When an investment is sold, it's called an 'exit', a.k.a. a "liquidity event." We hear this term frequently among startup founders, employees, and investors. A liquidity event is a rare opportunity for founders and investors to convert their shares into sweet, sweet cash. As a VC investor, this is "hitting the paydirt." The sweetest of all liquidity events is the initial public offering ("IPO"). This happens when private stock first gets listed on public exchanges so that anyone can purchase it - usually only the best of companies ever make it to this point. IPOs are extremely rare but *extremely* profitable. They're the "pie in the sky" dream for all VCs. More common exit paths are mergers and acquisitions by existing companies for strategic reasons. For example, Amazon [recently bought](#) Ring, and paid in cash and/or Amazon stock to acquire it. Anybody with Ring stock at that time proverbially "cashed out" with a collective payday of a billion dollars.



If VCs are to make any money in this business, they will need to wait for an exit. It is usually the only way one can turn their investment into cash. Most VC-backed companies are structured to hit that goal. Everyone with an equity interest in the company — founders, employees, and investors — are incentivized to exit.

What are typical returns for VCs?

Startup jargon refers to returns in terms of X's. Not the hugs and kisses kind either. A 1X return means getting one's money back, a 2X return translates to doubling one's money, 3X tripling, and [so on](#). For example, a \$5,000 investment with a 2X return means an investor gets \$10,000 back when cashing out. The most legendary of returns can get into the hundreds of X's (Instagram at over 300X).

This all translates to an ROI, or return on investment, which can be expressed as an average return per year. What does the data say about typical returns for VC funds?

From 2006 to 2016, Yale University's VC fund [delivered](#) an 18% annual return. The S&P 500 did 10% per year over the same period. The Thomson Reuters Venture Capital Research Index had an average return of 19.7% [per year](#) since 1996, despite the 2000 dot-com collapse and the 2007-09 recession. Kevin Dick of Right Side Capital Management found that average returns are about 4.05X, or about 26% per year. Angelblog [says](#) expectations are for at least a 20% return per year for VCs. Mark Suster of Union Square Ventures [aims for](#) a 1/3, 1/3, 1/3 return, where 1/3 of investments return nothing, 1/3 return the original investment, and the final 1/3 make all the profits. This translates to a goal of 30% per year. By the way, Mark Suster is a great snapchat follow (@msuster). Overall, Venture Capitalists shoot for a 20-30% average annual return on their money. For comparison, the S&P 500 index of the largest public stocks yields an average of 10% [per year](#).

What makes VC exciting is the potential for a huge hit. As [CNBC](#) puts it:

"If you end up getting lucky and putting your cash into a successful startup that eventually gets bought or even goes public, you could multiply your cash over in just a few years. As Swart said in an email, it could 'be like an exit from an angel round where an investor would be looking for returns of 10x to 20x what they initially invested.' That would be like turning \$2,000 into \$20,000 to \$40,000. And if you get super lucky, like an early Instagram investor, you might multiply your investment more than 300 times over."

The ultimate goal of venture capital is to hit the next Instagram and 300X an original investment. An Instagram-like investment comes around once a generation, but even 10X or 20X initial investments are opportunities for a solid payday.

A hypothetical situation is the best way to illustrate how a portfolio balances out. Consider an investor with a portfolio of \$2,000 invested across 10 startups in equal increments (\$200 each). Let's assume the prior logic of:

"Experts [say](#) it's best to invest in 10-12 companies at a time. Their logic goes 'typically, if you invest in 10 companies, two will be successful, three will 'do OK' and five will fail.'"



An investor's goal would be to have two investments that "hit." Let's say one investment returns 10X and the other returns 20X (these are [standard goals](#) for Venture Capitalists), while the rest fail. This would mean the 10X one generated a return of \$2,000 ($\200×10), while the other generated a return of \$4,000 ($\200×20). That comes to a total of \$6,000 with \$4,000 being profit (\$6,000 minus the original \$2,000 investment). Now let's assume those returns are generated over six years. That means an investor's money would have grown at 33% per year, on average, over those six years (\$4,000 *profit* divided by the \$2,000 *original investment* equals a 200% total return; 200% divided by six years equals roughly 33% per year). This all goes to show that it just takes a couple of big wins to generate market-beating returns.

Any way it's sliced, VC returns are consistently one of the most lucrative investments an investor can access.



How to Invest like a VC

We now know some of the rules of the game, but that's only half the battle. Now we need to know how to navigate the course, steer the ship, plunder the enemy, and stave off the pirates.

Alright, enough with that. Let's walk the plank and dive in.

The following guideposts are expert-sourced and intended to serve as a general framework. Click the links to check where we pulled the info from. The questions proposed are natural extensions of the underlying logic within the framework. There aren't specific answers to any of the following questions as every startup has different circumstances. Regardless of the specific situation, startups should always have logical answers supported by fact.

Know the business

Pretty straightforward. It should go without saying, but a VC needs to [understand the business](#). Why does a company exist and how does it offer a solution? There's a great Simon Sinek [Ted Talk](#) on this essential business question (it's worth watching even for general life purposes). Start with the why, then work out the rest. This is the most obvious rule. VCs clearly need to know the ins and outs of the business before they can make a logical decision on whether it will succeed or not.

It's not enough that an industry or company is "hot." Investing solely based on look or feel is a misguided approach. "Vanity investing" (as it's called) leaves VCs [doomed to fail](#).

There are a few [essential questions](#) to ask at the onset of any opportunity. First, who is going to buy this product or service? Once that is answered, will this even be valuable to that target audience? VCs look at existing solutions and compare what makes this new company better than the existing. Talking to potential customers can be one approach to that. VCs like to see companies solving "pain points," or known problem areas, that are causing inefficiencies. There's clear and instant value in that. Hence, what is the pain point this solves? Another good question: is this scalable? Can this business ramp up quickly enough to serve or produce for many people? A craft pottery store has its place, but it's likely not for Venture Capital. All of these prior questions should be clearly communicated by the company in their pitch. If it's not, VCs throw the red flag and challenge that ish'.

The gold standard is to find a company with a solution to a real, burning problem that hasn't been solved by other companies in the marketplace. This presents the greatest potential. It should be either much better or much cheaper than [anything else out there](#). If it's both, then congrats, that might just be the next Tesla.



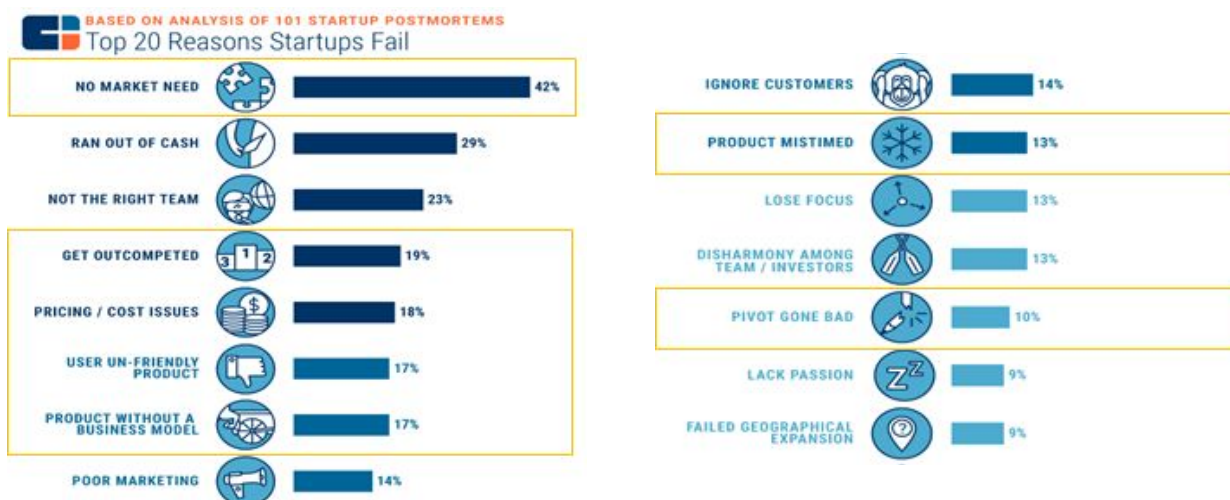
Side note:

VCs always like to know where the money [is going to](#). They ask what the purpose of the funds are and ensure that it makes sense. Bonus points if it goes towards growing the team or business in some tangible way. The more detailed, the better. Negative points if it's going to backpaying for prior services or going to legal costs in a lawsuit. Yuck.

Learn from the losers

More than half of companies that fail cite [business problems](#) as their core reason for crashing and burning. Understanding the business model and key risks are therefore the most essential factors when VCs evaluate startups. This includes evaluating pricing. How does their pricing stack up against competitors? Are their costs low enough that they'll eventually make a profit? Getting outcompeted is a big reason for startup failure. How does the startup stack up against peers, and how do they differentiate? In regards to the product or service itself. Has it launched? Do consumers like it? Is it consumer-friendly? Strategy and planning are necessary for long-term viability. Does the business have a sound plan for growing and generating profit in the long-run? Deficiencies in any of these prior factors caused more than 75% of startup failures, and they all tie back to business model. There's no standard checklist for a successful startup. That's part of the mystery. This doesn't mean that VCs don't try to [ask the right questions](#) and seek logical answers anyways.

Check out the rest of the [top 15 reasons for failure](#) from CB Insights. The boxed yellow sections tie back to business model problems. It's not mutually exclusive. Startups frequently cite multiple reasons for failure:



While not seemingly “core” functions of a business, marketing and customer outreach were aspects of failure 37% of the time. 14% of failures came from ‘ignoring customers,’ 14% came from ‘poor marketing,’ and 9% from failed geographic expansion. Marketing and customer support might not be the product or service itself but it has certainly been a path to failure if not adequately addressed.



VCs have metrics to evaluate marketing effectiveness, but at the very least, they are evaluating a company's message and considering its impact.

Approaches vary, but it's always better to have facts, metrics, and evidence to back up claims.

A large market and a strong strategy

The #1 reason for startup failure was “no market need.” 42% of businesses cited a lack of buyers as their primary reason for failing. A target audience may not be interested in buying the product or service for a variety of reasons. This could be because the product is inferior, it's targeting the wrong group, or the market just simply doesn't exist. Market research is one of the most important business factors to dig into. Specifically, will people buy what is being offered?

Markets come in [all shapes and sizes](#). There are fat and fast ones and there are lean and steady ones — both are good and bad in their own ways. A fat and fast one has plenty of room to grow, but even more competition. A lean and steady one has less room to grow, but more opportunity to be a big fish in a small pond. Markets are dynamic over time. Just because a market isn't fat and fast today, doesn't mean it can't be tomorrow. In that case, getting in early might pay off significantly. For example, Tesla was a first major mover on the electric vehicle market. The year the company was born (2003), the Washington Post declared the electric car industry “all but dead.” In 2019, the industry will hit \$270 billion [in annual revenue](#). Tesla used to be a big fish in a small pond, but now it faces competition from every major automobile maker. The dynamics have surely changed, but Tesla investors benefited from first mover advantage in a growing market, considering its 344% [return](#) over the past six years.

When talking market size, it is [often expressed](#) in terms of a big round number, e.g. “*market size of \$85 billion*.” All that means is there is \$85 billion in potential annual revenue “*up for grabs*” for a given industry. Market share is how much of that total a company is able to capture, e.g. 30%, or \$25.5 billion in annual revenue.

As a VC, it's a major responsibility [to check that](#) A) the market (or future market) is big enough to sustain the company B) the company has a clear strategy for capturing market share, and C) the company has a strategy for maintaining market share.

Entrepreneur.com [says](#) startup investors should look for a large, addressable market with evidence of such. “Large” means it can generate at least a billion in annual revenue (market size of at least \$1 billion). Within the overall market, the company should know which subsegment they are focusing on and how large it is. For example, Airbnb started by focusing on the young budget traveler looking for a new experience. This was a small part of the \$23 billion hospitality industry. Now, they've expanded to focus on business traveler subsegments, ultra-luxury subsegments, and “experiences.” They started with a niche corner of the market and grew from there. All the while, they demonstrated a strategy to keep capturing more market share.

VCs look for these numbers in the business plan. Concrete evidence supporting market claims are always better than pulling numbers out of thin air. There are several resources for confirming market size independently. VCs [can do a](#) “top down approach” and find professional advisory research from



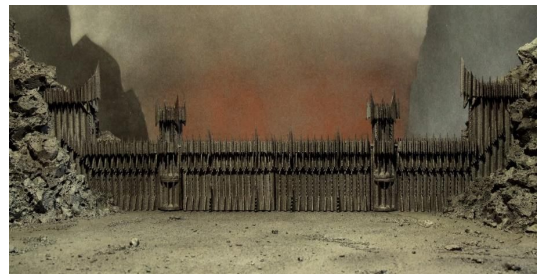
firms like McKinsey or Deloitte (who put out market research showing how large a market is and it's trajectory moving forward). Statista is also a [great free resource](#) for finding quantitative projections. Conversely, "bottom up approaches" mean getting feedback from potential customers and checking their willingness to buy the product. This gets back to the "no market need" issue. By verifying directly with real and potential customers, Sherlock Holmes-like VCs can get a direct pulse on what the market thinks of the business. While putting on a detective hat sounds enticing, this approach can be time consuming and [statistically flawed](#). Even though neither is perfect, VCs use both bottom up and top down analysis to get a rounded view of a market's size and potential.

Moats, yo

Ever hear of a 'moat'? Tech execs [love to talk about them](#) and good VCs understand when they're helpful or harmful. Moats are a play on 'barriers to entry', a [business term](#) that evaluates how hard (or easy) it is for new businesses to enter and compete in a given market. Moats can be like walls or head starts.

As walls, it takes new competitors huge investments to set up a rival business. Think of a telecom company like Verizon. It's very difficult for a new entrant to compete with the top telecom companies because they've already invested billions into their infrastructure. This serves as a deterrent for any new competitors. This is great as a Verizon investor, but a mountainous hurdle as a startup competitor.

In terms of head starts, first movers win by growing quicker than competitors in a bid to lock-in network effects. [Network effects](#) are the positive feedback loops that occur when a company has momentum in growing its user base. Consider Airbnb. Their value isn't in technology, in fact, it's pretty [easy to replicate](#). Airbnb's value is in their network. Their head start reinforced their position as a leader, which has allowed them to attract capital to grow their business [quicker than everyone else](#). Since the network gets more valuable as more people join it, the first mover generally wins, thus making it more difficult for late entrants to win. Once a network is established, it's very difficult to break apart. In this case, investors in first-movers reap the benefits, while investors in competitors have large barriers to overcome. Trying to jump a wide moat is more like trying to scale the Gates of Mordor - it's possible but it'll probably suck.



VCs know that every successful startup will eventually [get copied](#) by competition. It happens across all industries, because it's inherent to a free competitive market. As a VC, it's vital to assess moats and decide whether they will be helpful or harmful. Moats protect profits, which is why they're valuable to investors.

All this talk about moats relates back to one essential concept: competition. Evaluating competition is essential. It may seem comforting to have few competitors, but that might [signal an underlying issue](#) with the industry. Is it a graveyard out there? In other words, are there few competitors because they all failed? If the investment doesn't have a new and innovative strategy to overcome previous failures,



then few competitors can be a bad sign. However, if the market is in its nascent stages then few competitors could mean it's on the forefront of a budding market. Different market dynamics have different implications; reasoning it out is an essential task for investors. One thing is for certain, getting outcompeted is the [fourth biggest reason](#) for startup failure (at 19%). VCs check the landscape and ensure their startup has a clear proposition for beating out the competition.

Moats aren't surefire protection though. In fact, Elon Musk thinks they're [overrated](#). Musk sees the more important factor as the "pace of innovation," something that is determined by a solid team and culture. Which is why VCs like to...

Invest in stallions



One surefire competitive advantage is a skilled team of leaders and employees.

Everyone has heard the timeless proverb of the investor who took a bet on a founder with the thought that they were driven and smart enough to figure it out. That's essentially what [Paul Graham did](#) when he bet on Airbnb.

According to [Investopedia](#), management is the most important factor to an early-stage investment. VCs like to invest in founders that have previously built businesses and generated high returns for their investors. This opportunity sounds too good to be true because it often is. The second best bet is someone who is experienced in the industry and qualified to run a business. This is often a judgement call on the part of the investor. As [they say](#),

"(VCs) would prefer to invest in a bad idea led by accomplished management rather than a great business plan supported by a team of inexperienced managers."

Although, as we'll see, there's still much debate about this.

Management is very important but how does an investor evaluate them? There are several guideposts to do this:



- 1) **Tenure.** It's always important to know how long they have been around. Are they the original founders, or were they brought in later on? If there was a change, that's a noteworthy event to dig into. What caused it?
- 2) **Goals.** Management captains the ship, and accordingly, sets the goals. What does the mission statement say? Jargon-y ones might get called out like this:



Following

2017 JARGON WINNER!

This company just raised \$36M via an ICO

And the business involves:

- ✓ blockchain aka distributed ledger
- ✓ AI
- ✓ P2P
- ✓ identity management
- ✓ marketplace
- ✓ robots (detailed in article)

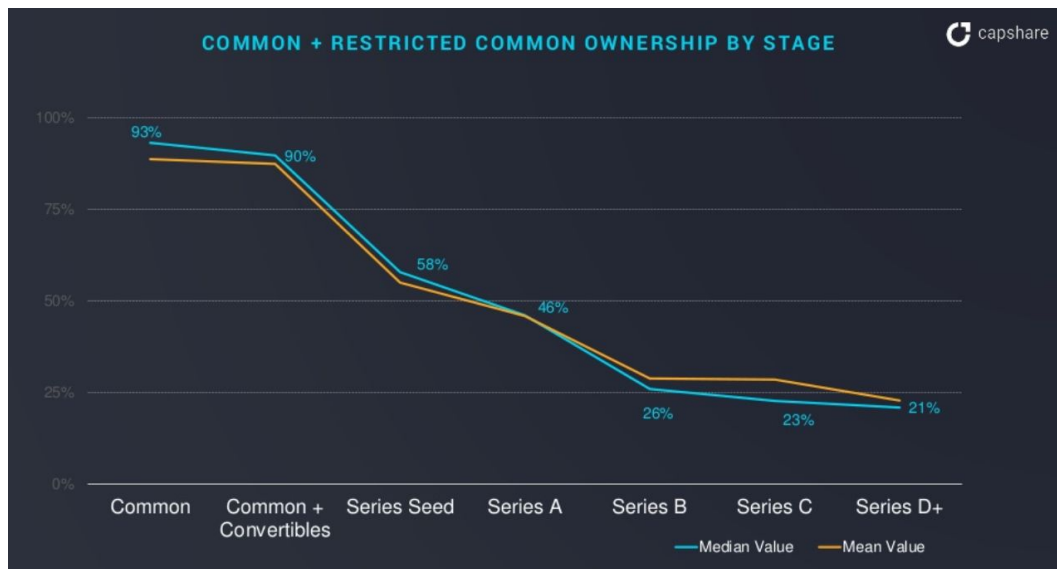
[techcrunch.com/2017/12/22/sin ...](https://techcrunch.com/2017/12/22/sin...)

"Proprietary marketplaces exist, like the Amazon Web Services for instance. What we're creating here is a decentralized marketplace, more like BitTorrent. There's no central dictator deciding what gets in there. Anyone can put an AI online, wrap it in our API, announce it to the network and any business that needs AI as a service can request it.

"Then you need a good reputation system to grade the best AIs with a high rating. We need blockchain to let us do this in a peer to peer, decentralized way. P2P software that is reliable and not easily hackable and involves payment, but it would still need a distributed ledger. BitTorrent doesn't involve payment or identity management or high security, which is why we are doing this on blockchain.

- 3) **Incentives.** Management's incentives can be key to company success. How much ownership does management have? How much have they personally sunk into the venture so far? In both cases, the more the better. Logically, the more upside they can gain *and* the more downside they have to lose, the more motivated they will be to figure it out. The following graph shows what the average founder ownership is at each round, to give a sense of what's high or low:





- 4) **Compensation.** On a related note, management compensation can be a telling sign. Cash vs equity compensation is important to consider. Early teams tend to have more equity compensation and less cash compensation. If a company isn't generating positive cash flow, management can't justify high salaries from the business. This isn't to say they shouldn't have a salary though. They'll need enough to live and produce, thus requiring a basic income. Generally speaking, the higher the salaries and lower the equity, the less upside they have to gain from future growth.
- 5) **Skills.** Competency is a very important area to tackle. Does management have competency in the industry? If it's an AgTech startup, did they come from a commercial farming background? If it's a SaaS company, did they build the product themselves, or have they previously worked at a successful software company?
- 6) **News.** One easy due diligence check is identifying any public relations gaffes. Have there been any public conflicts, and if so, how were they resolved? Where there is smoke, there is usually fire. If management can't keep their operations disciplined, then it may just be a dumpster fire. This isn't to say that all bad news means bad investment. If a management team was able to steer the ship through the gaffe and overcome it with a respectable solution, then this may be a sign of strength.
- 7) **Location.** In 'Where Good Ideas Come From', Steven Johnson argues that physical proximity is an essential asset for any team. His TED Talk connects London coffee houses and the community they bred to the birth of The Enlightenment era. As he puts it, "*chance favors the connected minds.*" Working remotely is fine but investing in teams that work together may be better.
- 8) **Balanced Ownership.** Founders should have enough equity to keep them engaged for the long-run, but the ownership split *between* founders is also vital. The split shouldn't be unfairly lopsided. The goal is to keep all parties motivated. What constitutes a fair split



depends on the situation, responsibilities, and qualifications of each involved person. An imbalance might cause internal conflicts down the line.

The age old debate of betting on the horse (company) or betting on the jockey (management) has no clear cut answer. Both the business and the management team are important and trying to delineate between the two is a false dichotomy.

Susan Preston, a successful Angel Investor, was asked about the most important factor to consider when investing. Her [answer](#):

“Many people have said that the management team is the most important factor in assessing a company, but I’ve come to the conclusion that we can’t say one factor is more important. Having gone through this a number of times, they are all important.”

This doesn’t mean people don’t try to delineate anyways. Steven Kaplan from the University of Chicago sees [management as more important](#):

“You can have a good idea and poor management, and lose every time,”

And conversely,

“You can have a poor idea and good management, and win every time.”

Good management has its limitations though. The Oracle himself, Warren Buffett, sees it differently:

“When a management team with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.”

If Buffett is to be believed, relying on management alone is a losing strategy.

At the end of the day, management related issues are a factor in 65% of [startup failures](#). Not the right team stood highest at 23%, losing focus at 13%, disharmony among team/investors came in at 13%, lack of passion with 9%, and burn-out at 8%. While some debate its standing in importance, no one debates its general importance. Picking a management team with passion, experience, and chemistry can make all the difference.

Some other considerations

Beyond the core business and management team, there are some less recognized factors that can add up to big differences.

- 1) **The big bad law.** Can regulatory or legal issues arise? For example, backing a marijuana startup under a Jeff Sessions regulatory environment is especially risky. Legal [hurdles](#) can be costly, time consuming, and fatal to a business. Nothing thwarts business like bureaucracy. In fact, 8% of startups [cite this](#) as a reason for failure. This also relates back to the ethics of management. VCs need to trust the team they are backing.
- 2) **Timing.** Timing can [make or break](#) a startup. Is this the right product for today, or for 10 years from now? There have been plenty of genius inventions that were simply mistimed.



Leonardo Da Vinci conceived the airplane in the 16th century, but the technology didn't develop for another 400 years. A more modern example is Tesla. When it first started, battery capacity was not efficient enough to mass produce electric cars. This played into Musk's strategy to start with a luxury car and move to the masses as battery technology advanced. Timing is interconnected to business strategy — does management recognize the issue and are they addressing the gap? It can go the other way too, if the product is hot right now, the startup may need to prioritize quick growth to have a chance at long-term survival. Product mistiming accounted for 13% of startup failures.

- 3) **The Exit Strategy.** What is it and how does management plan to take investors there? This is crucial for VCs. If the management team isn't thinking about the eventual exit plan, it could be a red flag. If management isn't building to sell, then investors might never be able to monetize. Does the company want to be acquired eventually, will it attempt to IPO, or are they content operating as a standalone entity? Remember, acquisitions and IPOs are investor friendly.



Important Metrics Cheat Sheet

Jargon may be the language of VC, but numbers are the backbone. Understanding both will help tell the story of a company and separate the good from the bad. In this section, we'll go through 10 common metrics VCs consider, and how they are used to evaluate companies.

The following basic metrics are specifically for high-growth tech companies. Each metric is appropriate in some cases, but not in others. Overall, each situation is dependent on a variety of factors. The following list can be thought of as a 'cheat sheet' to be used for relevant situations.

- 1) **Revenue Growth Rate.** Revenue growth rate (or just growth rate) is the month-over-month or year-over-year percentage increases in revenue. Month-over-month measures how much revenue is growing monthly, while year-over-year is the same for years. These measures are the most [basic means of evaluating](#) a startup's performance. They are most useful for companies that have a basic product and are beginning to produce revenue. As Paul Graham, the legendary co-founder of Y Combinator, says:

"If there's one number every founder should always know, it's the company's growth rate. That's the measure of a startup. If you don't know that number, you don't even know if you're doing well or badly."

Furthermore, Steve Schlenker, a Managing Partner at DN Capital, argues:

"The ability to accelerate monthly revenues while decreasing monthly burn is the #1 thing I look for in a growth stage business."

Revenue growth rates are a great starting point for evaluating an investment opportunity.

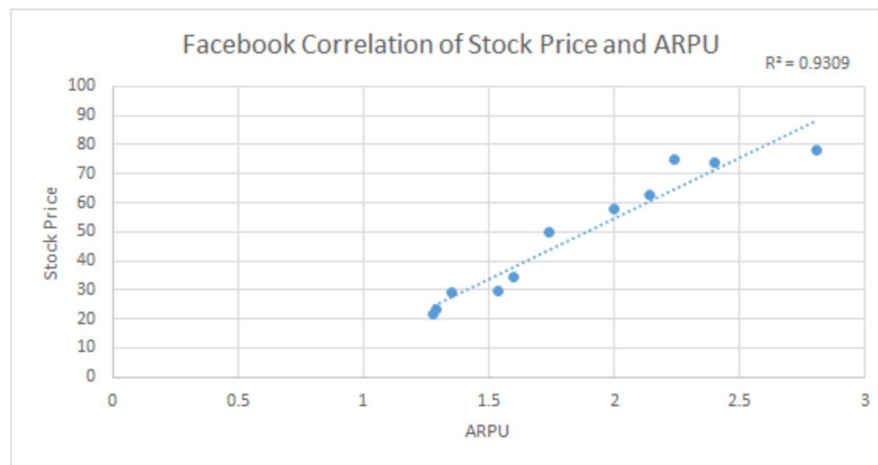
- 2) **Average Revenue Per User ("ARPU").** ARPU is straightforward in nature — how much money is a company generating per customer/user? The trend is [important here](#). It may not yet be feasible for a startup to deeply tap customers' pockets for revenue. Investors want to see this number rising over time, which means the business is finding more ways to extract revenue from customers. This is like picking apples - it's easier to grab the ones right in front of you than the ones at the top. In business terms, it's likely easier to [upsell](#) existing customers, then it is to go find new ones. Furthermore, a rising ARPU tells us about the health of the business. A rising metric may mean that customers are either buying more product, or the business is raising prices. Both are ideal, as long as the overall revenue is also growing.

There are [pitfalls to watch](#) with ARPU though. It is usually a "macro metric," which doesn't differentiate between segments of users. For example, a social media company might have increasing ARPU from businesses but decreasing from individuals. This changes the strategy and risk profile of the company. In this case, it might have a longer sales cycle and a different marketing need moving forward. Also, a declining ARPU [isn't necessarily a bad](#)



[trend](#). If a company is finding ways to reach lower-income populations on a mass scale, then this can be a positive indicator despite falling ARPU. As always, connecting the numbers to the back story is key. In fact, a flat ARPU may be a negative indicator for a company. This [could mean](#) they are not experimenting with pricing or product, in which case, they could stagnate.

ARPU is powerful in determining a business's viability. Facebook became so valuable because it found more ways to monetize its user base. Check out this [chart](#) showing the relationship between its ARPU and stock price:



- 3) **Recurring Revenue.** Recurring revenue is the portion of a company's revenue that is highly likely to continue in the future. [Recurring revenue](#) is predictable, stable, and dependable for the future. For this reason, it is more valuable than one-time sales. Recurring revenue is particularly important for SaaS (software as a service) and subscription businesses.

First an anecdote. Remember the software company Adobe (the gods that created the PDF)? On April 23, 2012, they moved from a non-recurring revenue model, where they sold their software for a one-time upfront fee, to a recurring revenue subscription model. This change resulted in a 35% decrease in revenue the following year. Big mistake, right?

Nope, according to the [Harvard Business Review](#),

"in April 2016 Adobe's stock price had nearly tripled from its value four years earlier."

As [Baremetrics](#) puts it,

"...even though Adobe experienced short-term losses, the company understood the long-term value of shifting to a model that offers more predictability."



More predictability means more value for investors of any ilk. This is partly because recurring revenue locks customers in and results in higher “lifetime value,” which is our next topic of discussion.

- 4) **Lifetime value (“LTV”).** Lifetime value seeks to discover:

“How much will a customer be worth to a company over the duration of their relationship?”

Monetizing relationships is a weird but essential metric for startup investors to consider. It also completely changes the meaning of that annoying childhood song:

“Make new friends, but keep the old. One is silver, and the other gold.”

Old people ruin everything.

LTV is forward looking, so it predicts on average how much a company will generate from a single customer.

Andreessen Horowitz [calculates](#) LTV as the present value of net profit for a customer over the duration of the relationship. There are a couple key concepts in that. For one, it’s a *net* calculation, a.k.a. how much is left over after accounting for relevant costs. Second, it’s the present value, which is an advanced financial calculation that tells investors how much future cash flows are worth today. Then there are all sorts of other considerations that come with calculating the LTV, like churn rate, duration of relationship, and discount rates — all of which come with controversial assumptions in their own respects. As one can imagine, this calculation can get quite advanced. LTV is great, but it’s pretty useless on its own. It’s really only valuable when balanced against customer acquisition costs (a.k.a. “CAC”).

- 5) **Customer Acquisition Cost (“CAC”).** The yin to the yang. The sun to the moon. The pea to the pod.

CAC tells investors how much it costs to acquire new customers — totally intuitive. These are the promos we often see — like “try Blue Apron free for 30 days!” or “refer a friend and get \$10 towards your next Uber ride!” Those things that make us feel rich for a hot sec. CAC is also any sort of marketing effort that goes towards acquiring customers — like the classic advertisement. The goal is obviously to convert potential customers into lifetime customers, which is why CAC balances nicely against LTV. Here’s a rule to remember:

LTV must be greater than CAC or there will be no chance for profit.

In simpler terms, a company needs to generate more money from a customer than it takes to acquire them. CAC is rarely ever zero. Everyone wants a company that brings customers in



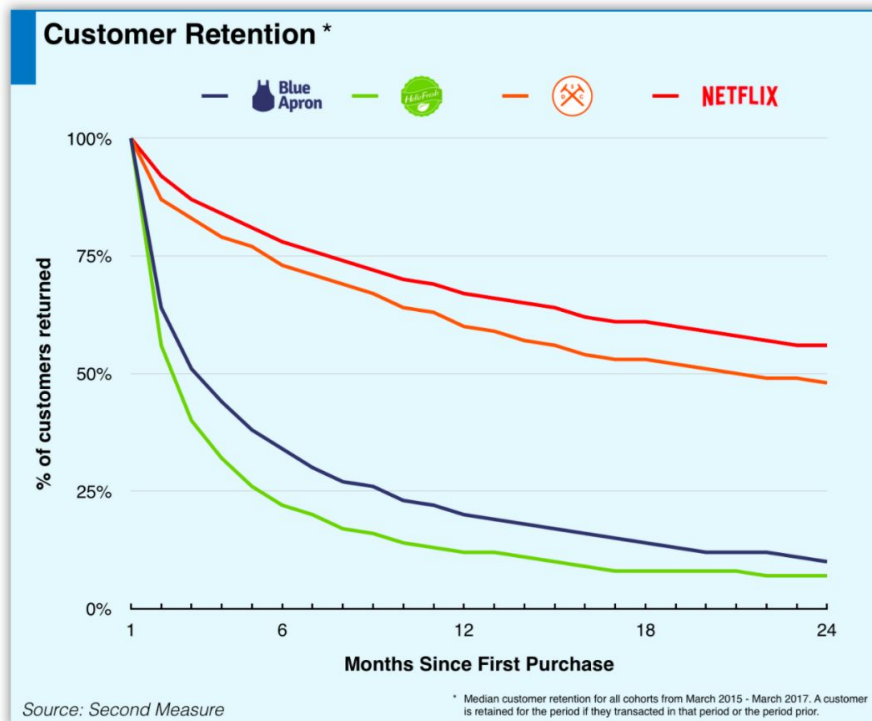
like mosquitos to a street light, but getting a message out there almost always takes significant time and money.

Some CAC is normal. However, the more it takes to acquire customers, the more suspicious the company's value proposition is. If the margin between CAC and LTV is small, it may mean that either customers don't find the product compelling, or they don't easily understand it. But to be fair, this may occur in the beginning if the company brings a unique concept that isn't well understood by the market, or if the company is aggressively trying to scale a network. This needs to come down over the long-term if the company wants [a chance at turning a profit](#).

Calculating CAC is more straightforward than calculating LTV. It's a blend of total acquisition costs divided by total customers acquired. Total acquisition costs are essentially marketing expenses. It's even more helpful if a company can tie back how many customers were acquired from paid marketing channels, but this is tougher to gauge. Andreessen Horowitz further [shows that](#) CAC goes up as a company tries to reach a larger audience. This is because a company's first customers are acquired for cheap because they are the most excited about trying the product/service. The later ones are on the fence and need more convincing, and hence, more investment.

Consider Blue Apron. Raise your hand if you tried their free initial offer. Okay, put it down. Same here. Now, raise your hand if you immediately abandoned the service. Alright, put it down. Again, same here, and same with a lot of other people. Blue Apron suffered from many people who tried the service and never stuck with it. Just look at these pitiful retention metrics:





Blue Apron's CAC is *high*. At one point, they were spending \$460 per new customer. This was somewhat digestible though, considering their annual ARPU was \$774. Then, this ratio flipped the wrong way, and Wall Street punished the stock. Still, compare this against a Snapchat-like company that had next to no marketing budget until recently. Snapchat generates less lifetime value from their customers, but it costs nothing to acquire them. The value really depends on the company, but the theme is that LTV should always be greater than CAC, and that margin should ideally widen over the long-term. Snapchat's situation was obviously ideal, so what was the deal with that?

- 6) **Virality.** Snapchat, Instagram, and Facebook all had it. Any startup dreams of it. Going viral without spending on marketing.

"Instagram hit one million users in three months. Then that became two million, which then became 10 million users. Unlike many apps at the top of the charts, Instagram didn't have to spend a dime to get where it was. It was organic growth." TechCrunch

That's the dream. And while not every startup will have Instagram's legendary growth, a strong virality score can be the difference in identifying an early success. Virality can be measured, and its measurement tells investors how strong word-of-mouth, or buzz, is for a given company. It's the number of new users an existing user generates. If this number is



high, it means users love the product/service enough to tell their friends about it for free. This is the [best marketing tool](#) a company can have.

The technical term for virality is 'k,' and the equation is the number of current users times the number of invitations sent to outsiders times the successful conversion rate of said invitations, all divided by the number of current users. If this calculation is greater than 1, it's considered 'viral.' A score over 1 may indicate organic growth and/or product quality. The startup's quality and mechanisms for growth are inherently baked into virality because the marketing department doesn't have influence over it. Therefore, virality is a great measure of organic growth.

- 7) **Churn Rate.** Growing is great and all, but how well does a company retain users? The "churn rate" measures exactly that. Churn rate seeks to answer how "sticky" [a customer base is](#), which helps with a number of other calculations (like LTV). It's especially valuable for SaaS companies, networks, and marketplaces.

Think about how many apps you've abandoned over the past year. Well guess what, you were part of the churn for that company (sorry, Simple Habit). It's similar to the LTV-CAC analysis where the absolute values are important, but the trend is even more important. It's also like virality in the sense that it tells an underlying story about the quality of the product or service. A falling churn rate may mean the company is doing something right by finding ways to keep customers engaged [with high-value offerings](#).

Churn is measured over a period of time, so it's important to specify such. A 5% churn rate can be extremely good or extremely bad depending if that is over a year or a month, respectively. There are [two types of churn](#) to measure. The first is simple churn, which measures the number of users or amount of revenue lost over a certain period, divided by the number at the beginning of said period. This number can only be from 0 to 100%. 0% means no customers or revenues were lost over the period, in which case, congratulations you discovered the holy grail. Meanwhile, net churn is net business lost or gained over a period, divided by the beginning value. What does that mean? Basically, how much revenue was lost from leaving clients (bad thing) minus how much more was sold to existing clients (good thing). If bad minus good is a negative number, then you've got yourself an attractive net churn rate (math is fun). Put [another way](#), a negative net churn means you are generating more new revenue from existing clients than you are losing from defecting ones. That's the goal.

As previously mentioned, churn rate fits neatly into other metrics. Churn helps calculate average customer life, an [essential component](#) of LTV. For [example](#), an annual churn rate of 25%, which means 25% of customers leave within a year, translates to an average customer life of 4 years. If it is 33% churn, then it's 3 years. Get the pattern? Going back to the Blue Apron example, it's a good "check and balance" to user growth. Sure, Blue Apron added enough users to get investors salivating, but their churn rate was worse than a Four Loko hangover.

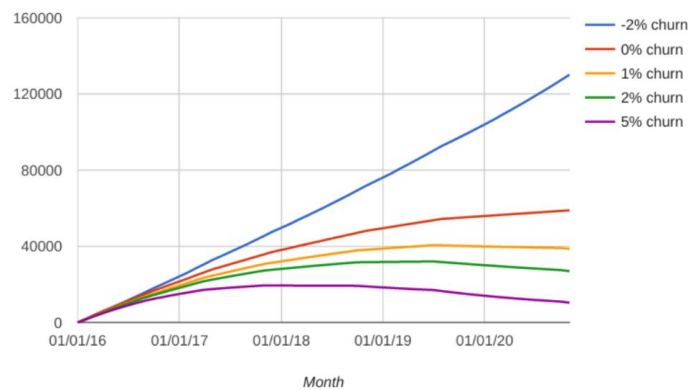


As one VC put it, high churn is like:

“...running backwards on a treadmill blindfolded while lighting \$100 bills on fire... eventually you might reach your goal weight, but you look like an idiot and waste a lot of money in the process.”

And as a VC, burning money is not an attractive proposition.

The numbers might seem insignificant, but small variations make a big difference when it comes to churn. Check out the differing user growth rates based on small changes to churn (remember -2% is *net churn*):



One caveat: a falling churn rate can mean the product is getting better, but it could also just mean that the company stopped aggressively marketing. Think about Blue Apron again (trust me, this isn't a promo for them). Their churn rate will likely fall when they stop their aggressive free trials. The people signing up in that case are more likely to have an initial interest in the company, which should translate to more long-term customers. If the churn rate dramatically falls off, VCs check to see if it's due to an improvement in the business, or a change in the marketing strategy.

- 8) **Active Users.** Daily, weekly, monthly — it comes in all shapes and sizes. Active users are often presented as a rate, measuring how much of a user base is active over the course of a given day, week, month, or year. This is important stuff, or at least, second important:

“The best thing to measure the growth rate of is revenue. The next best, for startups that aren't charging initially, is active users. That's a reasonable proxy for revenue growth because whenever the startup does start trying to make money, their revenues will probably be a constant multiple of active users.”

- Paul Graham, Co-Founder of Y Combinator

It may go without saying, but the more, the better.



Active usage measures engagement in some way within a web or mobile app. It's one of the primary measures of growth and engagement for these types of businesses. Again, absolute numbers vary by type of app, but for anything, VCs want to see a steadily increasing rate, which indicates core value.

Different time periods are relevant to different industries. For example, Snapchat cares much more about Daily Active Users, while Airbnb cares more about Yearly Active Users.

One important caveat is to ask and understand how a company defines active users. When Facebook hit a billion Monthly Active Users, they failed to mention that they counted people that somehow didn't even go to the site [during the month](#). It can also be a superficial metric too. It's surface-level considering it doesn't tell outsiders how deeply users engage with the app, or if they are even engaging in the way the company wants them to.

- 9) **Burn Rate.** Burn rate is one of the most popular metrics. Most have heard of it before in the context of, *"how much runway does a startup have?"* Burn rate helps measure the length of time a startup has until they go under, assuming no new money flows in.

"Burn rate is the financial version of faking it till you make it." [Inc.](#)

Burn rate [specifically measures](#) how much money goes out the door each month (or year, less commonly) and is used to calculate *runway*, which is the number of months (or years) until bankruptcy. Going back to [CB Insights](#), running out of cash is the 2nd biggest reason for startup failure, with 29% citing it.

For example, if a company has a \$100,000 burn rate, and \$1,000,000 in the bank, they have 10 months of runway. Very simple, very straightforward, but an essential metric VCs need to know.

Be mindful of the assumptions around this simple metric. As Fred Wilson of Union Square Ventures points out:

"Assuming a constant burn rate can be very dangerous. Always know if your burn rate is going up or down and include that fact in your analysis."

Another important aspect is analyzing the spending of the startup. If the company is burning money, they probably should not be spending it on nice offices and perks. Instead, it should be going towards gaining a critical mass of users or getting a product to a certain [stage of development](#). [1000 Angels](#) says that a company should have 12-18 months of runway at early rounds, but 18-24 is acceptable if the fundraising market is going cold. Ideally, investors want companies to have 18x their burn rate in cash (post-funding), otherwise they risk not figuring their ish' out in time.



- 10) **Profit.** The elusive dragon's tail of the startup world. Any successful business will need to generate it at some point, but that point varies for each company and stage. Profit is simply [what is left over](#) after subtracting costs from revenues. For many startups, the goal is to reinvest everything into growing, then later turn a profit upon reaching scale. Some, however, can generate it from the onset. A profit margin is net profit divided by total revenue. If a company generates \$1,000,000 in revenue and has a profit of \$200,000, then margins are 20%. Normal levels ultimately depend on the industry. For example, a social media company will likely have fatter profit margins than a manufacturing company. It all has to do with the nature of the business.

VCs like to see businesses that aggressively reinvest their profits into growth initiatives. There are some [interesting notes](#) to look out for as an investor when it comes to spending and generating a profit:

- a. A great looking headquarters might be a warning sign that they aren't spending their money wisely.
- b. Founders who show restraint in spending will typically put money to the most efficient use.
- c. Bootstrapped companies, or companies that didn't take investor money and grew organically from their own business, are usually the best examples of efficient spenders.

Profit is a VC's best friend, but it takes time to actually generate one. VCs tend not to fret if it isn't there right away.



Valuation

One can write a book on startup valuation, and [people have](#), but we'll introduce some ideas to think about when venture investing. Startup valuation follows the [overused truism](#) of "*it's more of an art than a science*." What does that mean? Basically, there is no financial model or method that perfectly fits every situation, so investor judgement is a significant part of the process. There are some scientific approaches to valuation but no method will get one to a perfect valuation. This is because valuations are inherently uncertain amid limited data, especially for early-stage companies. Nevertheless, here are some approaches, courtesy of [Investopedia](#):

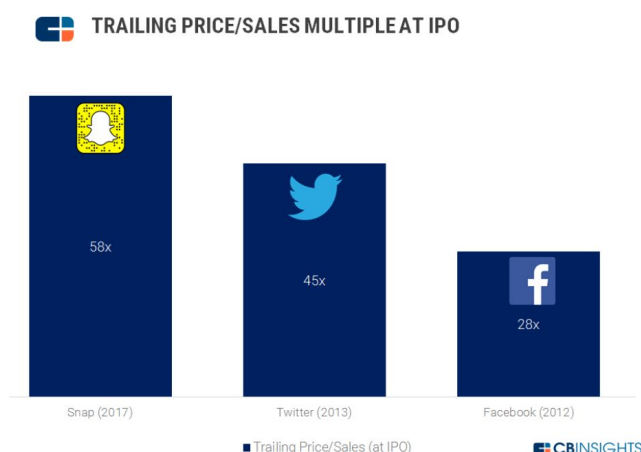
1. Cost-to-duplicate (a.k.a. the low-ball method)

How much would it take to reproduce everything the startup has done or made so far? That is the baseline value of a startup. This can be done by adding up the labor, materials, research and development, patent protection, and development expenses, then coming to a final figure. This method is best for a tangible product like software or a tool. The advantage of this method is that it's objective and measurable, plus it gives an idea of barriers to entry from competitors. The disadvantage is that it "low-balls" the work of the founders and team. It undercuts the value since it doesn't consider future earnings potential, nor does it capture intangible assets like brand value, team skills, strategy, design, and intellectual capital. Therefore, it's best used as a starting point more than anything else.

2. Market multiples (a.k.a. the measuring stick)

Market multiples measure valuation by comparing similar companies to each other. Hence, the measuring stick method. For example, a popular way to compare startups is price to sales, or how much was paid for similar companies relative to their annual revenue.

Below is Snapchat's [breakdown](#) vs. peers at the time of their IPO:



Snapchat was being valued at 58 times their annual sales at the time of their public offering. This is an ambitious valuation. This high valuation represented investors' belief that Snapchat would generate higher revenues, and eventually earnings, in the future. They used price to sales as a measuring stick because they weren't generating a profit at that point.

Investors look at the types of companies and their relative performance metrics and try to find an appropriate comparable to use. This ties back to the "more of an art than a science."

The caveat is that finding comparable deal information is notoriously difficult — try looking up deal values on Google. The terms are rarely announced, and when they are, they may be inaccurate or incomplete. Making apples-to-apples comparisons with perfect information is rare. Nevertheless, it is another method to know, and it's a tool for the belt.

3. Discounted Cash Flow (a.k.a. the scientific approach)

If you plan on calculating this, more power to you. A DCF (as it's called) is an advanced financial calculation used by professionals. The premise is that you consider a startup's future expected cash flow over a certain time period, say 5 years, then use a "discount factor" to incorporate the risk of those cash flows not materializing (hence the "discounted" part). The final number is a present value of future cash flows, plus a "terminal value." The further out the cash flows, the more they are discounted. Intuitively, this makes sense. Predicting cash flow next year is a lot more certain than predicting it five years from now. There are a million unpredictable events that can happen in between then and now that would affect the cash flow value. Ultimately, the calculation sums the discounted future cash flows, plus a terminal value, which equals the present value of the company - voilà.

As opposed to the other methods, this is a highly scientific approach based on many uncertain assumptions. As such, the saying "*crap in, crap out*" has meaning. The model is only as good as the assumptions that back it. Combine that with proper forecasting and picking an appropriate discount rate, and we have a method best left to financial professionals. This is especially true when it comes to startups, which have highly uncertain cash flows (if any). However, it's good to get familiar with if it is referenced by someone else.

4. Rough guideposts by stage (a.k.a. rules of thumb)

The most informal approach is the "rule of thumb" method, which estimates value by stage. The following [Investopedia](#) guide gives a high-level idea of how startups should be valued by their general progress:



Estimated Company Value	Stage of Development
\$250,000 - \$500,000	Has an exciting business idea or business plan
\$500,000 - \$1 million	Has a strong management team in place to execute on the plan
\$1 million – \$2 million	Has a final product or technology prototype
\$2 million – \$5 million	Has strategic alliances or partners, or signs of a customer base
\$5 million and up	Has clear signs of revenue growth and obvious pathway to profitability

This is by far the most informal method, and it certainly doesn't account for many other important factors.

Ultimately, using a variety of different methods is how VCs [approach](#) valuation. A combination can be used to find a balanced valuation based on the situation. Finding that balance plays into the artistry involved with the process.

Like anything else, valuations go up and down depending on market forces:

“Expect lower valuations during a recession and higher in boom times when there is more competition for investment. Startup valuations may also be adjusted up or down based on the strength of the management team, location of the business, industry or market.” Marianne Hudson, [Forbes](#)

Marianne also describes four additional methods for approaching valuation, further proving there are even more approaches to consider:

- [Venture Capital Method](#) calculates valuation based on the expected rate of return at exit.
- [Berkus Method](#) attributes a range of dollar values to the progress startup entrepreneurs have made in their commercialization activities.
- [Scorecard Valuation Method](#) adjusts the median pre-money valuation for seed/startup deals in a particular region and in the business vertical of the target based on seven characteristics of the company.
- [Risk Factor Summation Method](#) compares 12 characteristics of the target company to what might be expected in a fundable seed/startup company.

The more tools VCs have in their belt, the better they'll be at spotting over or undervalued deals.



Valuing a deal

We now know some approaches for valuing a company, but how does one value a deal?

Anyone who has ever watched Shark Tank gets the [basic premise of this already](#), but in reality it gets much more complex. Investors will often be offered some percentage of ownership in the company in exchange for a sum of money. One can then back into a total valuation through simple math. There are many different nuances to address though. One of the biggest is differentiating between pre- and post-money valuations. As Priori puts it,

“The difference between a pre-money valuation of a company and a post-money valuation of a company comes down to timing. A pre-money valuation of a company refers to the company's agreed-upon worth before it receives the next round of financing, while the post money valuation of a company refers to its value immediately after receiving the capital.”

The pre-money valuation is negotiated between the founders and investors. The post-money valuation is calculated based on the size of the investment and the pre-money valuation. As [Priori](#) further explains,

“...if an investor gives a company \$250,000 of capital, those investors would receive an equity share of 20 percent if the pre-money valuation of the company were set at \$1 million. This percentage jumps to 25 percent if the pre-money valuation of the company were set at \$750,000.”

There are other avenues for investing in a company though. One popular route is through convertible notes and [SAFEs](#). More info on that can be found in the link.

The general point is this: if the deal being offered doesn't align with an investor's valuation on the company, that can be either an opportunity or a red flag.

Ultimately, valuation is an elusive concept because it's one of the purposes of Venture Capital.

A Final Word

Great investors are often able to find patterns over time. One great way to recognize patterns is to study case studies of the best. Conveniently, CB Insights has assembled a list of 28 of the greatest VC investments ever. Check out this [list](#) as some homework.

Hope you have enjoyed this read. Please [reach out](#) and let us know what you think!

-The [Slice Capital](#) Team



65 Questions VCs Ask Before Investing

Richard Harroch of Allbusiness.com assembled a list of 65 questions VCs ask before investing. Check out his [article](#) for the whole list, which is a great resource to have on hand. Otherwise, a small sample is posted below:

Overview:

- What big problem does it solve?

Market:

- What is the actual addressable market?
- What percentage of the market do you plan to get over what period of time?

Founders & Team:

- What key additions to the team are needed in the short term?

Products & Services

- What are the major product milestones?

Competition

- Compared to competition, how do you compete on price, features, and performance?
- What are the barriers to entry?

Risks

- What do you see are the principal risks to the business?
- What legal risks do you have?

End Game

- When do you see the exit happening?

Intellectual Property

- Would any prior employers of a team member have a potential claim to the company's intellectual property?

Financials/Financing

- What are the key assumptions underlying your projections?
- What are the key metrics that the management team focuses on?
- What is the planned use of proceeds from this round?
- What milestones will the financing get you to?

