FUNDRAISING FAQ

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How much money should I try to raise?

There are two alternate answers. First, you could raise only as much as you need to get to the next major milestone—for example, from first prototype to first shippable product. The rationale is that accomplishing this milestone will enable you to raise money at a much higher valuation.

Second, if investors are throwing money at you at a high valuation, then you could take as much as they're offering. The goal would be to never have to raise money again, so you'd have one less thing to worry about. However, no matter what valuation, the more money you take, the more you have to return. For example, when you hear that a company raised $50 million, there are two consequences: First, the company has amassed a large arsenal of funding. Second, the company has to return $500 million to make the investors happy. The latter creates a lot of pressure.

The likelihood that investors will be throwing money at you in the early stages is low, so for most startups, the answer is to take enough to reach the next milestone.

How do I set a valuation for my startup?

I used to tell people that every full-time engineer is worth $500,000 and each MBA is worth $250,000. (And I have an MBA). People thought I was joking—I wasn't.

Some advice. First, you don't set the valuation unless you're one of the rare startups that is turning away investors. For the rest of us, investors try to set the valuation, and you try to raise it. This is called negotiation.

Second, information about the valuation of private companies is imperfect. It's not as if you can pick up the Wall Street Journal and find out what their stock is trading at. The best you can do is use approximations based on companies that are "comparable."

The calculation works like this. Suppose a similar firm raises $3 million. Usually, a startup sells 20 to 25 percent of its equity during such a financing. Backing out the math, if $3 million is 20 to 25 percent, then 100 percent is $12 million to $15 million. This provides an initial starting point, and you negotiate from there. You can find out about these financings by reading websites such as Mashable, Tech Crunch, and The Verge. Wilson Sonsini Goodrich & Rosati also publishes a useful report based on their clients' financings.

Third, you don't need an 800 in the math component of the SAT to think that owning a larger percentage of the startup is better. However, this isn't the whole story—what counts is how much your stock is worth, not how much of the company you own. For example, it's much better to own .001 percent of Google than 51 percent of a $10 million company.

Therefore, don't make yourself crazy trying to maximize the valuation of your startup to minimize the dilutive effects of raising money. You're either going to make more money than you ever dreamed of or you'll end up with nothing. How much your company is worth is more important than what percentage you own.

Do entrepreneurs have to accept the valuation proposed by the venture capitalist who wants to invest into their business?

Whatever the first offer, ask for a 25 percent higher valuation because you're expected as part of the negotiation to push back—in fact, if you don't push back, you may scare the venture capitalist into thinking you're not a good negotiator. It would be nice to also be armed with some arguments to show why you believe your valuation should be higher—saying that this book told you to push back isn't sufficient.

At the end of the day, though, if the valuation is reasonable, take the money and get going. Valuation and owning a few more percentage points seldom make a difference.

I've got a venture capitalist that wants to invest $5 million in my company! What should I expect in terms of how he will want to interact with the company?

As long as things are going well, a venture capitalist will leave you alone. Understand a venture capitalist's life: He's on as many as ten boards that meet at least quarterly and sometimes monthly; he has to raise money to invest and keep about twenty-five investors informed and happy; he's looking at several deals a day; and he's dealing with five other partners. He doesn't have the time to micromanage you—and if he thought he'd have to, he wouldn't have invested in you in the first place.

The more important question is, "What support can I expect from a good venture capitalist?" Here is the answer: five hours a month of mindshare during which he opens doors for you with prospective customers and partners and interviews candidates for high-level positions at your company.

How can I identify the venture capital firms that have new funds with a maturity sufficiently far out so they align with my liquidity timeframe?

You're thinking too much. The timing of a fund is rarely a big factor. You can either convince the firm that you can make money for it or not. If you do, they'll find funds for you. Also, the firm is going to pick you, and not vice-versa, and there is no way to predict a liquidity timeframe.

What is the order of approaching the tiers of venture capitalists: tier one, then two, then three, or the other way around?

You're thinking way too much. Pitch almost any firm you can get into. After trying to raise money for nine months, you'll realize that all money is green. Plus, it's not obvious who is a tier-one, -two, or -three firm.

What is the internal rate of return expected from tier-one, -two, or -three venture capitalists? How firmly do they stand by that projection?

You're thinking way, way too much. First, it is unlikely that a venture investor will admit that his firm is not a tier-one firm. Even if he did, he isn't saying to his partners and investors, "Since we're a tier-two firm, let's just try to get 10 percent."

All venture investors are looking for a high return on your specific investment, not a return that matches their target average. (Remember: They know there is a high likelihood that your company will flame out.) But your question misses on another point. Although venture firms are ranked against one another by their IRR performance, venture investors do not evaluate individual deals by calculating prospective IRRs.

Practically speaking, investors look at cash-on-cash returns—that is, if they put in $1 million today, what can they expect to get back in four or five years? ($5 million would be a 5× return.) Expectations for cash-on-cash returns vary by the type of investor and the sector of investment, not by the prestige of the firm. For an early-stage, high-tech investment, you had better be able to convince the investor that there is a realistic plan for returning 5× to 10× his money in three to five years.

Should I admit that our sales to date are lackluster (or even nonexistent)?

Yes, but I would spin it: Your sales aren't lackluster—you're "early in the sales cycle with an innovative product." Also, this is why the longer you can bootstrap, the better.

Should I admit to the venture capitalist that I am new to all of this?

You won't have to because it will be obvious. Thus, you might as well tell the truth. However, to ameliorate this situation, surround yourself with directors and advisors who are experienced. Also, express that you'll "do what's right for the organization and step aside if this is the right thing to do" and mean it.

How much do venture capitalists talk among themselves? Will my faux pas in front of one be the talk of the watering hole and poison the well for me with the others?

It's unlikely that venture capitalists will talk about you because there isn't enough time in the day to discuss all the lousy meetings they've taken and the clueless entrepreneurs they've met. You'd have to do something astoundingly stupid to be a topic of conversation.

Is it necessary to have hired a law firm and accounting firm prior to fundraising?

It's not necessary, but it's better if you have a law firm for three reasons. First, assuming you pick a law firm that's recognized for its corporate finance/venture capital work, it shows that you know what you're doing. Second, a good lawyer can help you find investors. Third, you need an experienced corporate finance lawyer to work through the paperwork of a financing. An accounting firm is less important because there's not much to account for yet.

Is it better to ask for the cash to support the whole project up to a liquidity event or just what is needed for the first one or two years?

Neither. You can't possibly know if there will be a liquidity event, when it will occur, and how much money you'll need to get there. However, what you want to get, and what investors want to give, is enough capital to get to the next big milestone, plus six months of cushion for when you're late.

Does my business need to be fully functioning and profitable in order to attract investment capital?

The venture capital business is cyclic—some would say bulimic. During times of feast, venture capitalists will fund anyone who can boot PowerPoint. During times of purging, most venture capitalists turn cautious and want "fully functioning and profitable" companies.

Your job is to find venture capitalists who make early bets on "unproven" startups. When venture capitalists tell you that they only invest in "proven" companies, they're lying. What they are saying is, "We don't get it, so we're blowing you off by telling you this. If we really got it and believed, we'd take the chance with you."

Does the existence of a clear leader in my target market preclude me from getting funding?

I can unequivocally say, "It depends." If it's early in the life cycle of the market, and it's "clear" that the market will be huge, you can get funding. Commodore was the clear leader in personal computers, and plenty of companies got funded after it. On the other hand, it would be difficult in a mature, capital-intensive industry such as automobiles.

It also depends on the investor. Some will be scared off by a market leader. Others will see the existence of a market leader as proof that there is a market and be willing to take the leader on.

There's one more thing to think about. Your question is about funding. However, fundability and viability are not the same thing. Your idea to take on the market leader may not be fundable, but it could still be viable, so don't let negative responses from investors stop you.

Is it better to have fewer, bigger investors or numerous, smaller ones?

You should be so lucky to have the choice. Fewer investors means that there are fewer relationships to manage. Also, bringing in more investors may mean you're also getting less sophisticated ones.

However, there are several compelling reasons to get additional investors: (1) More investors means that there are more people helping you by opening doors, recruiting, and generating buzz. (2) When you need additional capital, it's nice to have several sources already in the deal. (3) It's dangerous to have one investor calling the shots when (not if) you have disagreements.

When accepting angel money, is it reasonable and customary to have a buyout clause, to allow me to retain my stock if I am able to pay back the angel's loan with interest?

You can try for this, but it's tacky. Angels aren't banks trying to make a spread between the cost of capital and the interest you'll pay. Angels are putting money into your company at the riskiest time, so they should reap the upside. If you do pull off a buyout clause, you'll rack up bad karma points—and a startup needs all the good karma it can get.

Should current investors attend company pitches to prospective investors?

If it's OK with the prospective investor, this is usually viewed positively: "The current investors care enough to come with the company to our meeting." If the current investor is a famous person, by all means bring him or her.

Which would appeal more to investors: a product concept that has a proven billion-dollar market in which there are already some big players, or a product idea that will create a new, potentially billion-dollar market that has no competitors in the short run?

This depends on the investor. There are a handful of investors who like "brave new world" investment, but the vast majority are similar to buffalo: running with their heads down toward a cliff because the rest of the herd is, too. At some level, raising money is a numbers game: You've got to make a lot of pitches to find one investor to write a check, so you can't be picky.

Which should we put more focus on: Pitching how the product addresses pain and a competitive analysis, or pitching how the investors can get x percent return?

The former, never the latter. No one can predict when and how liquidity will occur. Attempting to do so will make you look silly.

When should an entrepreneur give up on getting capital from an investor?

I've never seen an entrepreneur reverse a negative decision by arguing. When an investor says no (in so many words, as discussed in the list of venture-capitalist lies), accept the decision gracefully.
Do go back, however, when you can produce "proof." Proof means finishing your product, opening prestigious accounts, raising money from other sources, and building a great team. Persistence, with proof, can succeed.

What is a reasonable salary that a CEO should set himself up with that will not scare an investor away?

This is hard to answer in absolute numbers. Circa 2014, for technology startups, the answer is probably $125,000 per year. An answer that can better stand the test of time is this: The CEO should not be paid more than four times the lowest-paid full-time employee.

Angels want entrepreneurs to have some skin in the game. I don't have any money to invest in the business. How do I overcome this? What do venture capitalists look for these days as far as "skin in the game"?

An entrepreneur's skin in the game, for a venture capitalist or an angel, is nice to have—but not a necessity. Certainly you shouldn't believe that because you were stupid enough to put money into a lousy idea, other investors will follow suit.
If you think that the only reason a potential investor declined was because you didn't have skin in the game, you were going to get a negative answer anyway. What's more important is how long you've been working on the product and what progress you've made.
Conversely, if the investor agrees to provide capital primarily because you have skin in the game, then the investor is a fool, and you wouldn't want him. Also, in almost all cases, you will have a lot of skin in the game in the form of months of sweat equity.

If an angel investor asks what his return will be, what is the best answer?

The best answer is to tell him that he must not be a sophisticated investor because such an investor would know better than to ask a question that has no answer. I'll bet, however, that you don't have the guts to do this. Instead, you can ask him to go over your financial projection with you and then ask him, "What do you think is realistic?"

What do I wear to meetings with venture capitalists?

It depends on what part of the country you're in. On the East Coast, you should wear a jacket and tie. On the West Coast, you can be much more casual—Dockers and a polo shirt will do. No matter where you are, if you're the geek genius, you can get away with a clean t-shirt and jeans.

Would investors ever be interested in making their return through profit sharing or a buyout from the founders of the company in five to ten years?

Only if the investor is your mother. If the investors are professional investors, you can forget about raising money without a shot at an IPO or acquisition. If they're angels, investing in your startup might represent a flight of fancy or sympathy—then liquidity doesn't matter as much. But profit sharing or buying out investors is attractive to few investors.

How can one protect an idea, given that few investors will sign an NDA (nondisclosure agreement)?

You're right. Few investors will sign one, and even if they did, hearing your idea had better not render it defenseless. I've never seen a case where an entrepreneur told an investor about an idea, and the investor ripped it off.

Investors are looking for people who can implement ideas, not only come up with them. Ideas are easy. Implementation is hard—and where the money is. Quite frankly, few investors are capable of implementing an idea—that's why they're investors . . . but I digress.

Here are the fine points of using an NDA:

- If you're asking for an NDA to merely present your idea, keep your day job because you're clueless. No one who would sign one just to hear your idea is an investor that you'd want.
- Freely circulate your executive summary and PowerPoint pitch. These documents should entice investors to go to the next step. They should not reveal your magic sauce.
- Ask for an NDA if an investor is interested in your deal and wants to learn more at the source-code or pure-science level. It is reasonable for an investor to ask for this kind of information in the due diligence stage. It is reasonable for you to ask for an NDA at this stage, too.

Once patents are filed, you should feel pretty safe in discussing your magic sauce under an NDA—not that you'll have the time or resources to sue for patent infringement. The best protection of an idea is great implementation of the idea.

When do I stop trying to find/negotiate a better deal and take what's offered?

It's a good idea to stop looking and negotiating if you can't meet payroll. If the deal that you're offered is within 20 percent of what you wanted, take it. Focus on building your business, not finding the best deal. In the long run, the quality of your business determines how much money you'll make, not the deal you cut years before with an investor.

Should I worry more about dilution, the real needs of my business, or the amount the investor wants to put in?

Here's the priority: the real needs of your business, the amount the investor wants to put in, and, last and least, dilution.