Show me the money! In this section, we're going to talk about price, one of the key economic terms in the term sheet.

Clint: Let's talk price. There are a couple of factors in here when it comes to thinking about price. Could you highlight those for us?

Brad: Sure. The first factor is price—the actual price that somebody is going to pay for your equity. However, one of the things that a lot of entrepreneurs miss is the nuance around things like pre-money versus post-money, or the nuance of whether options are included in the valuation or outside the valuation.

Let me talk about pre-money versus post-money for a second. When you're thinking about price, oftentimes the VC will say "I'll pay this valuation for your company," but, in fact, the valuation that they're telling you may be before the money comes in or after the money comes in. Anyone have a guess as to which is better for the VC?

Student: After, post.

Brad: Post. If the VC says "I'll put in $2 million in your company at a $5 million valuation," it's a big difference between whether that $5 million is the post-money valuation or the pre-money valuation. If it's the post-money valuation, it means that the VC just bought two-fifths of your company, or the $2 million goes in and they get 40% of the business.

The pre-money, in that case, is $3 million. If the valuation is pre-money—that $5 million is your pre-money valuation—the VC's only bought two-sevenths of the company, or about 28% of the company. In that case, your pre-money valuation is $5 million and your post valuation is $7 million.

There's a big difference between those two numbers and the ownership, 40% versus 20%, that the VC is buying for that same $2 million.

Clint: Let's take the $3 million pre-money; the VC invests $2 million, the $5 million posts. Is that $3 million what my company is worth now, or are there other things in there that might make that lower?

Brad: The $3 million is the actual value of what your company's worth in completely illiquid sense. While the VC just agreed to invest $2 million in your company in exchange for 40% of the company, they're not actually buying the company. You can have this mindset that the rest of the business is worth $3 million, but really the right mindset to have is that the rest of the business is 60%, and the goal is to build that into as much value as possible.

In addition, there might be additional pieces in that $5 million that actually lower the amount that the founders get after that financing happens. For example, let's say that as part of the deal, the VC says "I'd like to put in an option plan that represents 10% of the company, but I want that to be in the pre-money valuation." That 10% option pool will be an additional 10% of the company that's allocated and reserved for issuing to employees as you add them to the company.

If you think about the split that way, all of a sudden the $5 million valuation, the post-money valuation goes to a $3 million pre-, but 10% of that is being allocated to employees. So really, another $500,000, or 10% of the $500,000, is lowering your pre-money valuation. In that case, your ultimate pre-money valuation is about $2.5 million.

$2.5 million pre-, plus $500,000 for the options, plus $2 million of the new money that goes in, gets you to the $5 million post.

Clint: We've got pre- and post-money, we've got the option pool, are there other factors in there like that that might lower the valuation?

Brad: Like which ones?

Clint: Warrants?

Brad: Ahh, tricky. You're a tricky VC. In addition, sometimes you might have additional features called warrants. At an early stage deal, you won't see these that often unless you've got some kind of a debt financing that converts in. The idea here would be that you would issue additional equity in the form of warrants. Those warrants might or might not have a strike price that's equivalent to the price per share.

What I mean by that is in the same way that you're reserving options, and that lowers your valuation, if you have warrants that you're issuing—warrants essentially are equity that you can get in the future some time—the VC that gets those warrants, or the investor that gets those warrants, is getting an additional piece of the company for a relatively small amount of investment.

It can get confusing. The best way to think about an early stage deal is, your post-money valuation is what you're getting in total, then you're taking pieces out from that post-money valuation to get to your pre-money valuation. The pieces that you're taking out would be the cash that's getting invested in the company, any options that are unissued that are getting reserved for the future, and anything like warrants that are being issued in exchange for an early investor that gave you some debt that's converting into equity. You have to add all of these things into that initial capitalization.

Clint: We've got the different components. Let's back up. How do you come up with the price to begin with? Where does that come from?

Brad: It's pretty arbitrary. When you think about valuation for an early stage company, it's basically made-up. Most investors when they invest want to make sure that the entrepreneurs have enough of the company going forward so that their maximally incented to build the business. The investors want to get as much of the company as they can for whatever money they're investing without disincenting the entrepreneurs. There is a little bit of this arbitrariness around it and most financings end up being for 20- to 33% of the company at the early stages.

If you're an entrepreneur, what can you do get the financing that only sells 20% of the company versus the financing for the same dollar amount that sells 33% of the company? The best way to accomplish that is to have multiple separate investors interested in investing in your company.

If you go back to the concept that Jason talked about earlier around the syndicate, the idea that you might have multiple investors investing in the company is fine, but you want to get more than one of them interested in leading your financing, putting down the term sheet, telling you what the terms are. Only when you have multiple people bidding on your company can you drive that price up.

The other thing, of course, that increases the valuation on the company is progress that you've made. So if you can make significant progress—and back to the bootstrapping question, for example, at the very early stages—get product out into the market, get some early customers, generate some early revenue, be in a position where you can make more progress before you have to raise that money, the chances of you being able to get a higher pre-money valuation goes up.

Clint: Questions?

Student: What if I do have two different investors and one gives me a better pre-money valuation that I think represents what my company's actually worth, but the other one gives me a lower valuation but I'd rather work with them? How do I rectify which investor?

Brad: The first thing to recognize is that we're talking about price, but it's not the only characteristic of the deal. We'll get into a bunch of other of the economic terms that determine whether or not you particularly want to work with the investor that gives you a higher price. Just because somebody gives you a higher price doesn't necessarily mean that it's a better deal because of all of the other terms.

The second is, you have to make a judgment as an entrepreneur about working with the best long-term partner. If there's a huge disparity in valuation, you should view that as an important data point, important input into deciding which of the investors you want to work with.

If there's not that much of a disparity and one is a little bit lower than the other, depending on the negotiation dynamics, you might be able to talk the investor up to match the other valuation. Or, if there's really not that much difference, it might be worth it to seal the deal to go with that better investor.

My general advice is always pick the best investor you believe you can find because the journey of building the company is a long one, and trading off a little bit of valuation against quality of investor, make that trade to quality of the investor all the time.

There's no list you go to that says "This is the best investor, and this is the next best investor, and this is the next best investor." The best investor for you might be different than the best investor for Eugene. You might have different views. If I lined up a set of investors and said "Which do you think are the best for your various companies," you might come up with different answers.

Studying the investor and really understanding what the characteristics you're looking for, especially when you have two or three or four different choices for a lead investor, is really important.

Student: From an entrepreneur's perspective, how do I go about having an educated opinion on the value of my company, and going into these discussions with investors so there's not a huge sticker shock or a big bridge in valuations per se? I'm sure that comes up in all discussions when a VC asks me, as the entrepreneur, how much of your company are you willing to give away? Or with the value to put on the company, how do I form that opinion?

Brad: The first thing to know is that when an entrepreneur asks you what the valuation is, the best and most straightforward answer is something like "We're just looking for a fair valuation. We'll let the market tell us what it is." Many investors will try to get a number from you; it's really their responsibility to make the first offer.

Don't fall into the trap of feeling like you have the obligation to tell them. That's sort of basic negotiation. However, it's important for you to have a good expectation like you talked about because if you don't, whatever number they're going to give you will cause you to anchor on that and try to move around versus if you have your independent view of what a fair number is.

The best place to find an independent view is through your peers, talking to other entrepreneurs who have raised money from similar types of investors at the stage you're at. If you're an accelerator program like Tech Stars, you're surrounded by other entrepreneurs who've raised money recently from investors, asking them, not just a specific investor, but the type of business they have; what kind of valuations they got.

Or, if you're in a community where you know some other entrepreneurs, or you have some mentors who are entrepreneurs, asking them. Collect multiple data points and form a point of view. The best way to form that point of view is to get first-person data rather than try to extract it from something else.