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The Valuation vs. Traction Matrix - Jason Calacanis

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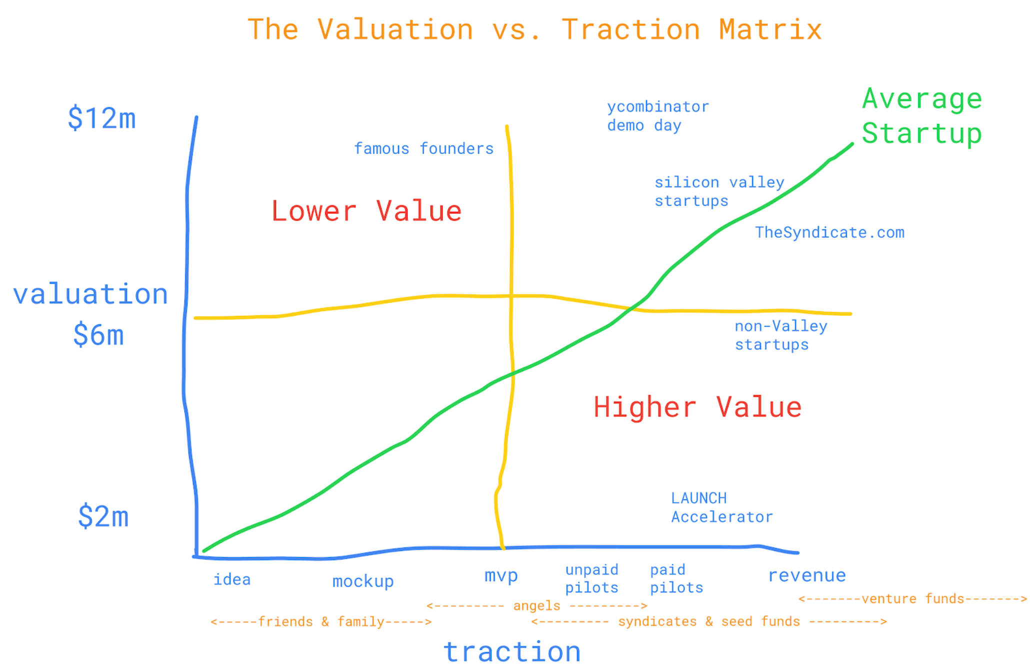
6-8 minutes



Early-stage valuations for startups are hard to understand because typically there is very little traction or data to go on in the first year or two of a startup.

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Startup valuations are not science, but they're not magic either. It's a bit of alchemy, combined with bizarre marketplace dynamics like famous founders getting 3x the price for half the traction, or Y Combinator hosting a gigantic demo day in order to create FOMO with novice investors who are explicitly told not to think things through and just cut a big check (literally, that's their bad advice to investors).

The chart above, a work in progress, is called "The Valuation vs. Traction Matrix" and it pivots on two variables: traction (aka "stage") vs. valuation.

I started the valuation at the basic valuation we tend to see in technology startups, which is $1-2m and go up to the eye-popping $12m (which is actually not the peak, just the highest end of normal).

When you have just an idea or mockup, you are likely to do a "friends and family" round in the $1m range.

If you have an MVP or unpaid pilots, you might get some angels or seed funds involved.

When you get to paid pilots or revenue, then you are most likely to get seed funds and syndicates involved, after which the VCs start buzzing around. VCs invest, on average, when you have $2-3m in revenue these days (they might engage you in discussions a lot earlier, obviously).

Above the green line tends to be less value and below the line is more value.

As you can see, I try to operate just below the line with two of my investment vehicles, the LAUNCH Accelerator and TheSyndicate.com. We do this by finding startups that are not in Silicon Valley AND that have customers paying them.

The green line in this chart approximates the average startup. I would say that most startups in the United States would go along this trajectory unless one of four things happens:

1. You have a famous and successful founder, which gets you 3x the valuation for 90% less work.
2. You create a marketplace where many investors are competing for an allocation, which is the double-edged sword that the demo day FOMO device is designed to create.
3. Your engagement or product is otherworldly.
4. You find the dumb money which doesn't understand that you can invest in two or three startups — with the exact same traction — for the price of one overpriced startup.

We see number four all the time when a founder tells you not to worry about the valuation of $18m because it will all work out when they're a unicorn, which is true, but this assumes you don't have better deals you can prioritize.

In our case, we typically have so many opportunities that we can place three $6m bets in startups that are just as good (or better) than the founder demanding $18m.

The Danger for Founders

This is the danger of founders overoptimizing for valuation early, which is, they drive away the smart money and open up the floor for dumb money. The other well-known phenomenon is that a founder who succeeds at getting a massively high-valuation early on might raise too little money in a "party round."

In this scenario, a founder might raise $1m at a $20m valuation, only diluting 5%. If they are burning $75,000 a month they then have about a year to build a company worth $20m. To be worth $20m for a SaaS or consumer subscription product, that would be around $100-200,000 a month in revenue.

It's possible for a founder to do this, but it's not probable. What happens if they don't get to $150,000 a month in revenue to justify the previous $20m cap? One of three things:

1. They lower the valuation and do a down round.
2. They get bridge funding from their existing investors.
3. They shut down or sell the company.

If the same founder raised $1m at a $5m valuation, they would only need to hit $25-50k in monthly revenue to get a round done at ~$10m.

Accelerators

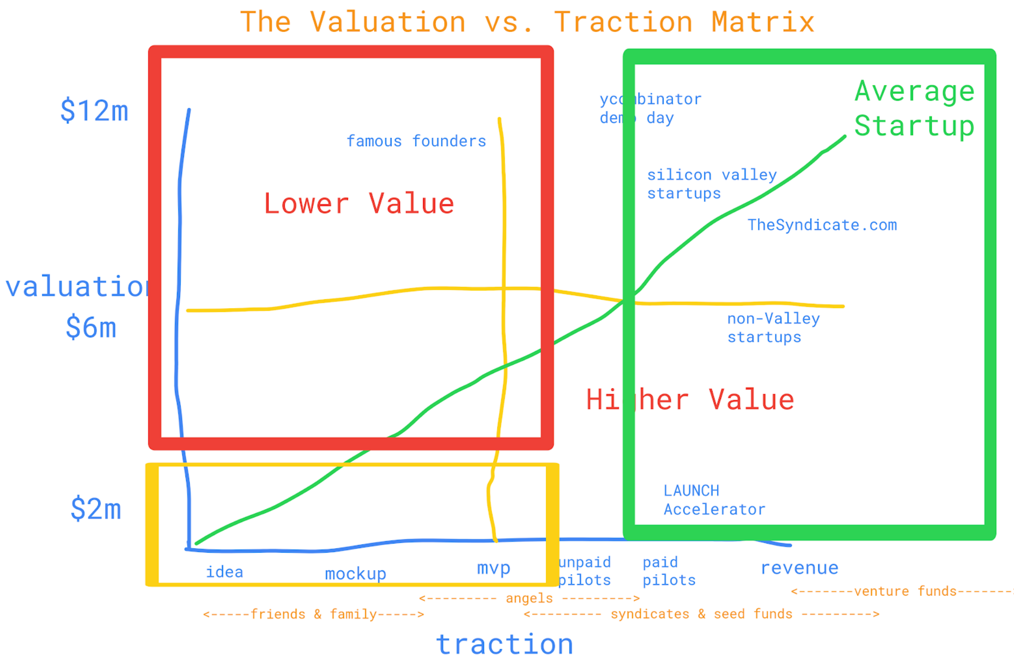
When a founder goes to an accelerator like LAUNCH, Techstars or YC they have a ~$2m valuation, which is a function of accelerators getting half their equity for cash ($100-150k) and the other half for running a program. Accelerators are a great deal for investors, but they require massive work. You need to have a large, full-time staff, space and a massive interview process to run an at-scale accelerator, which I think costs most programs ~$25-100k per startup.

If you add the operational cost back, an accelerator is likely investing on a $3-4m valuation. Still a good deal, but it's 100x the work of a solo angel investor and 50x the work of a seed fund.

I suggest new angel investors and seed funds do their first 25 deals in the space to the right of unpaid pilots, in the area in the green box below. In this box you can pay above or below the line, knowing that you've eliminated the founders who can't get to some basic level of product/market fit because it's very hard to fake paying customers.

You should absolutely avoid Investing in the red box, where founders are looking for really high valuations for their ideas, mockups or MVPs. If you're going to take on the risk in the idea and pre-traction phase, the yellow box, you at least want to get three or four swings at bat for the price of startups in the product/market fit phase.

So, if you invested $100k for a $10m startup with $750k in yearly revenue in the green box, I could see you investing $25,000 into four ~$2-3M startups.



Angel University

We will be discussing this important topic and more at the Angel.University tour, which is making the following stops:

- April 19: Washington, DC (hosted by Riverbend Capital)
- April 23: Boston, MA
- April 24: New York City (supported by EquityZen)
- April 26: Columbus, OH (hosted by WillowWorks)
- April 29: Miami, FL
- June 17: Sydney, Australia
- July 15: San Francisco

The AU course is four hours followed by a dinner. Look forward to seeing you at this highly interactive course, which is worth attending if you've done zero or over 100 investments.