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Fear and Dilution

4-5 minutes

VCs are known for asking *how can I be helpful*, and trying obsessively to be "value-add." In the course of raising our round, some, however, tried to use an interesting tactic - fear - to get in our round.

These VCs used our fear that not taking a check could contribute to the headwinds working against an already fragile startup.

When we were deciding if we wanted to take an offer from a well-known firm at a lower valuation than that of our seed round, the partner told us:

> Doing a startup is hard, and chances are it's going to fail. If there's even a remote chance our check could help, you should probably take it. I would argue that you are worrying about the wrong thing if you are worried about that extra 10% dilution.

If you take this argument to the extreme, you would give away your entire company at a low valuation, for hope that someone somewhere may be helpful at some point.

These downside protection pitches come in several forms, for example: "If anything goes wrong, our accelerator provides you with a great network!" and "we make raising your Series A a piece of cake, regardless of metrics!"

The hard truth is that investors aren't going to build your company, and there's a limited amount of help they can offer. This is actually good news; it means you are free from the pursuit of maximizing some helpfulness-of-investors function.

In fact, there are diminishing returns as you bring on more investors. Many investors are familiar with early-stage hiring, sales, and engineering, you don't need (or want) 10 sources of different advice.

Founders should be wary of firms whose value proposition preys on fears that founders may have. Things like providing backup options or community are certainly nice-to-haves, but they are expensive to purchase in equity.

What should founders purchase in equity?

- The approximate amount of money founders need at a competitive valuation
- Relationships with VCs who will help with growth - be it personal growth or company growth (ideally both)
- Relationships with VCs that will fight for the company when everything goes wrong.

Be skeptical of low valuations, extras, swag, prestige, and hype. Choose the best mentors, the most skilled former founders and operators, and the fairest terms.

Signs of Good VC

• Invests regardless of confirmed lead or big name firm

• Positive references from portfolio founders

• Previous founder experience

• Low partner to company ratio (pro-tip - ask how many companies they are working with / on the board of!)

• Helps with hiring, fighting regulations, key introductions

Signs of Downside Protection VC

• Waiting for lead investor to wire

• Makes promises to intro you to firms / customers after you sign term sheet

• Nice brand name

• Only interested now that firm XYZ invested

• Follows hype

• Promises extras

• Sends swag

A troubled framework for dilution

Paul Graham proposes a framework (http://www.paulgraham.com/equity.html) that suggests dilution is worth it if the value after investment is equal to or greater than the previous value.

It proposes you should take investment if the expected growth is greater than 1 / (1 - n) where n is the percentage of your company to sell.

From his essay:

> Let's suppose "Y Combinator offers to fund you in return for 6% of your company. In this case, n is .06 and 1/(1 - n) is 1.064. So you should take the deal if you believe we can improve your average outcome by more than 6.4%."

This type of thinking is great for investors - it encourages founders to take deals where investors barely grow the pie. Giving away 6% in exchange for 6.4% growth is a break even trade. Would you hire a new sales rep if the results were break even - just barely paying their own salary?

The opportunity cost framework

A better way to think is in terms of opportunity cost. If we don't give 7% equity to Accelerator X, how many rockstar engineering and sales hires could we make? How much could those hires grow the business?

It was never the 7% dilution we were worried about - it was the opportunity cost of 7%. The strong-minded founder should be asking how she can use equity to drive exponential growth and returns, not to buy downside protection insurance.