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10 Terms You Must Know Before Raising Startup Capital

J.J. Colao Contributor

There are a lot of ways to get tripped up while building a company. Failing to understand financial jargon shouldn't be one of them.

It's not that investors and venture capitalists are evil or anything. It's just that their interests don't perfectly align with those of entrepreneurs. You want to build a company, keep control and earn a fair share of any windfall. Investors want to profit from your company as much as possible, minimize their financial risk and, often, gain the operating control needed to do so. Balancing these interests is a delicate process that requires a clear-eyed understanding of the terms involved during negotiations.

So in the tsunami of legalese that entrepreneurs face during fundraising discussions, FORBES has uncovered 10 terms that we think are essential to understand. A familiarity with the phrases below will help you avoid needlessly giving up equity, control and profits in the event of a successful exit. This post is no replacement for a lawyer, but it will help you, hopefully, call BS on less-than-forthcoming investors. (For a quick summary of the terms, check out the full list **here**.)

Pre-money vs. Post-money Valuation

Let's start very simply: valuation is the monetary value of your company. Internally, company shareholders often agree on a formula to determine valuation in the event of a partner's death or exit. When looking for venture or angel financing, your valuation is, frankly, whatever you can convince investors to agree on.

The difference between pre-money valuation and post-money valuation is also very simple. Pre-money refers to your company's value before receiving funding. Let's say a venture firm agrees to a pre-money valuation of $10 million for your company. If they decide to invest $5 million, that makes your company's post-money valuation $15 million.

Post-money valuation = pre-money valuation + new funding

These terms are important because they determine the equity stake you'll give up during the funding round. In the above example, the investor's $5 million stake means

Let's consider a counterexample. Say the company was valued at $10 million *post*-money instead, implying a $5 million pre-money valuation. This means that the investor's $5 million counts as half the company's valuation. He comes away with 50% of the company in this scenario, rather than 33%. Given the difference in equity, you can see how important it is clarify between pre and post-money valuations when discussing investment terms.

Convertible Debt (Convertible Notes)

When a company is young, quantifying its valuation is often an arbitrary, pointless exercise. There may not even be a product in hand, let alone revenue. But companies at this stage may still need to raise money, and if investors decide on a pre-money valuation of say, $100,000, another $100,000 suddenly buys control.

Convertible debt (also called convertible notes) is a financing vehicle that allows startups to raise money while delaying valuation discussions until the company is more mature. Though technically debt (see this post on convertible equity for a further explanation) convertible notes are meant to convert to equity at a later date, usually a round of funding. (Often notes convert to equity during a Series A round of funding.)

Investors who agree to use convertible notes generally receive warrants or a discount as a reward for putting their money in at the earliest, riskiest stages of the business. In short, this means that their cash converts to equity at a more favorable ratio than investors who come in at the valuation round. I won't go into detail on warrants and discounts here, but Fred Wilson, a venture capitalist at Union Square Ventures, provides a nice explanation of these terms on his blog.

Capped Notes vs. Uncapped Notes

As discussed above, convertible notes delay placing a valuation on a company until a later funding round. But investors often still want a say in the future valuation of the company so their stake doesn't get diluted down the line. When entrepreneurs and investors agree to a "capped" round, this means that they place a ceiling on the valuation at which investors' notes convert to equity.

So if a company raises $500,000 in convertible notes at a $5 million cap, those investors will own at least 10% of the company after the Series A round ($500,000/$5M).

An uncapped round means that the investors get no guarantee of how much equity their convertible debt investments will purchase, making these kinds of investments

A investors to agree to a $10 million, this means that their convertible note investors are left with just 5% of the company, half of what they would get if they capped the round at $5 million. (For the sake of simplicity, we're ignoring discounts and warrants here.)

Again, you can see how important these distinctions are in terms of retaining ownership of your company.

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Preferred Stock

Venture capital firms are issued preferred stock, rather than common stock in a company. Preferred stock comes with certain rights attached, some of which we'll discuss below. The terms Series A, Series B, etc. refer to the class of preferred stock issued at each fundraising round.

Liquidation Preferences

Let's be very clear: the primary job of venture capitalists is to make money for their investors. Their investments are no good unless they eventually realize a payday. In venture parlance, these paydays are referred to as "liquidity events," the moments when everyone with an equity stake gets a chance to cash out. These events generally come in the form of acquisitions or an IPO. For less successful companies, a liquidation event could also come in the form of a bankruptcy.

Liquidation preferences determine who gets paid what and when during these events. If the company goes bankrupt, for instance, there often aren't enough assets left to pay every creditor and shareholder the money they're due. In this instance, liquidation preferences determine the order in which everybody gets paid. Generally creditors get paid first, then preferred stockholders, then, if there's anything left, common stockholders.

Liquidation preferences are also relevant during more successful outcomes though. The standard liquidation preference is 1x, meaning that preferred stock owners must get their money back (1 x their money) before common stock holders get anything. More on this below.

Participating Preferred vs. Non-participating Preferred Stock

This is where things start to get a little complicated. You see, there are different types of preferred stock, each giving its holder different rights. For our purposes, the rights of participating and non-participating stockholders are most relevant.

Remember that preferred stock owners often get a 1x liquidation preference, meaning that in the event of a sale or bankruptcy, they get their money back before common stock holders get a chance to recoup anything.

time of their investment. In this case, preferred stock owners can still exercise their liquidation preference to get their money back, but if everyone else is making four times that money, it makes more sense to convert those preferred shares into common stock to enjoy the 4x gains. During successful outcomes, preferred stock owners are essentially forced to convert to common stock.

For non-participating stockholders, this is where it ends. They convert their shares to common stock and enjoy the same 4x returns as everyone else. Simple enough.

Participating preferred stock, however, works differently and allows venture investors to essentially double dip in the company's gains. Participating stockholders get to exercise both their liquidation preference and enjoy a pro-rata (see below for an explanation) share of common stock gains simultaneously. So if a participating stockholder owns 25% of the company at the time of a liquidation event, they get their money back plus 25% of the remaining proceeds. Let's use an example to illustrate the differences:

Say a company sells for $10 million. Investors originally put in $2.5 million at a $5 million post-money valuation, leaving them with 50% of the company. If they have non-participating preferred shares, they're obligated to convert those shares to common stock, leaving them with $5 million. Simple and fair, right?

Now let's say instead that these investors own participating preferred stock. The outcome changes significantly. In this scenario investors can exercise their 1x liquidation preference, leaving them with $2.5 million. But it doesn't end there. In addition to getting their money back, they're entitled to a 50% share of the remaining $7.5 million. This means that they get another $3.75 million, leaving them with $6.25 million. In this case, they capture most of the exit's value even while owning just half of the company.

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Pro-rata Rights

The term pro-rata gets thrown around a lot during financing discussions, often in different contexts. Pro-rata is Latin for "in proportion." Replacing the Latin with it's English equivalent is generally helpful in deciphering its meaning in legal documents.

Pro-rata rights refer to the right of investors to participate in later funding rounds so they can maintain the amount of equity they own in a company. Let's say that a company raises $10 million at a $100 million valuation. In order to maintain a 25% stake, the investor needs to throw in at least 25% of the new funding, or $2.5 million. Otherwise their stake in the company will be reduced.

Pro-rata rights obligate the company to leave space in subsequent funding rounds so investors can avoid such dilution.

Be on the lookout for “super pro rata rights” which allow investors to increase their equity stake in subsequent funding rounds. Mark Suster explains why entrepreneurs should avoid agreeing to such terms in a blog post here.

Option Pool

Option pool is a term used to refer to a chunk of equity reserved for future hires. Sounds harmless right? Unfortunately, the size of your option pool, as determined during a round of funding, has a direct impact on your company’s valuation and hence, your ownership.

This is because the option pool is often included in the pre-money valuation of a company. So let’s say investors agree to invest $2 million at a $10 million pre-money valuation, implying a $12 million post-money valuation. Option pools are expressed as a percentage of post-money valuation, so if the deal includes a 20% option pool, that means the pool is worth $2.4 million. Your $10 million pre-money valuation is now effectively a $7.6 million pre-money valuation. The investor isn’t taking a larger percentage as a result—they’ll still own 16.7% of the company in this case—but you will be substantially diluted because the option pool will come directly from management’s stake. So if you owned 100% and think you now own 83.3%, you’re wrong. That 20% option pool, reserved for future employees, means you now own 63.3% of company.

In preparing to negotiate the size of an option pool, AngelList founders Naval Ravikant and Babak Nivi suggest creating a hiring plan for the next 12-18 months, then adding up the equity you intend to give new hires. Often, this kind of reasoning will leave entrepreneurs with a smaller option pool than investors suggest.

Board Control

Companies are ultimately responsible to their shareholders and to their board. So even if you manage to maintain a controlling stake of the company after a financing round, if you suddenly take on three outside board members you have effectively lost control of the company. Slip up and your board can now fire you at will.

Group, suggests pushing for neutral board members, agreed upon by both the entrepreneur and investors, as a compromise to investors pushing for board control.

Vesting

This term doesn't directly relate to raising capital, but it's an important financial term to consider nonetheless and investors will expect to know your employees' vesting schedules. A vesting schedule is imposed on employees who receive equity, and determines when they can access that equity. This is useful because it means that if you give 5% of your company to a partner, that partner can't just quit a couple of months later and keep the equity.

A typical vesting schedule takes four years and involves a one year cliff. The "cliff" means that none of the employee's shares vest for at least one year. After that year, typically 25% of the employee's equity is released, and the rest vests on a monthly or quarterly basis.

Special thanks to the authors of the posts listed below, which were helpful references in putting this piece together:

Yokum Taku, What Is Convertible Equity?

Fred Wilson, Financing Options: Convertible Debt

Sam Wu, Liquidation Preferences

Venture Hacks, The Option Pool Shuffle

Mark Suster, Why Super Pro Rata Rights Are Not A Good Deal

Scott Walker, Demystifying Term Sheet Board Control

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