IS A SMALL PIECE OF A BIG PIE WORTH MUCH?

By Frank Demmler

When a venture capitalist is speaking to a first-time entrepreneur and valuation comes up in the conversation, almost without fail, the VC will say, "A small piece of a big pie is better than a large piece of a small pie."

Usually the conversation stops there. Apparently the compelling logic doesn't require explanation. In this article, we're going to put some numbers around that statement, and you can decide for yourself if it's meaningful or not.

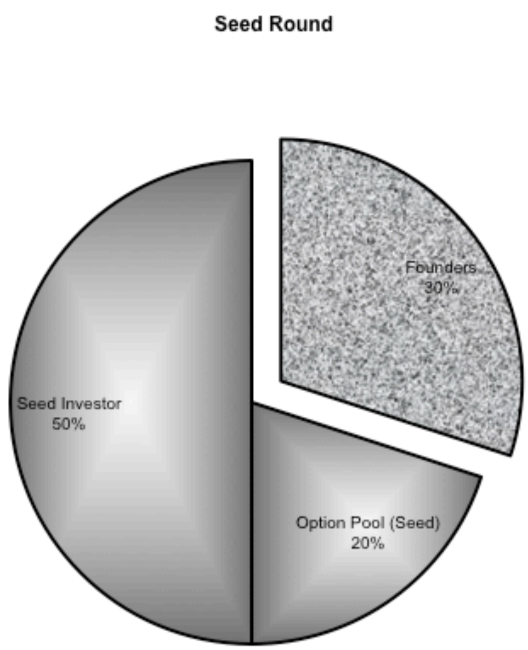
In The Beginning, There Were The Founders

When a company is first launched, the founders own 100% of the company. The valuation unknown.

Company Valuation	?
Founders' Ownership	100.00%
Founders' Value	?

The Seed Round

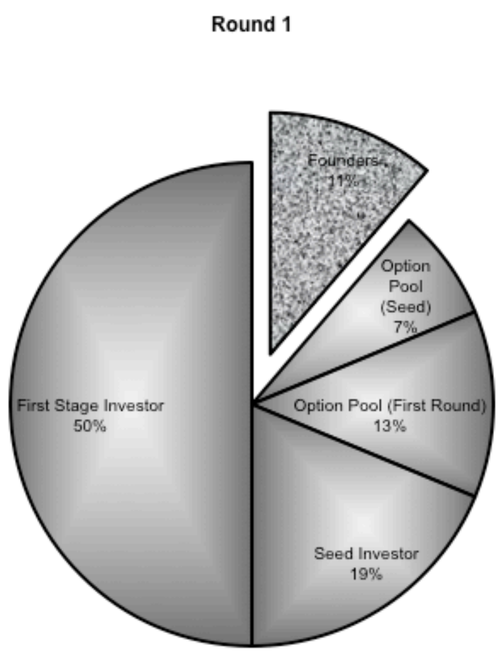
Attracting an initial, seed round of investment can be a mixed blessing for you. On the one had, you're ecstatic that you've attracted investment and can now pursue your dream with vigor. But on the other, you're in shock over how much of your company you've had to sell to get it. You sure hope that this concept of a smaller piece of a bigger pie works for you!



Company Valuation	$2,000,000
Founders' Ownership	30.00%
Founders' Value	$600,000

The First Round

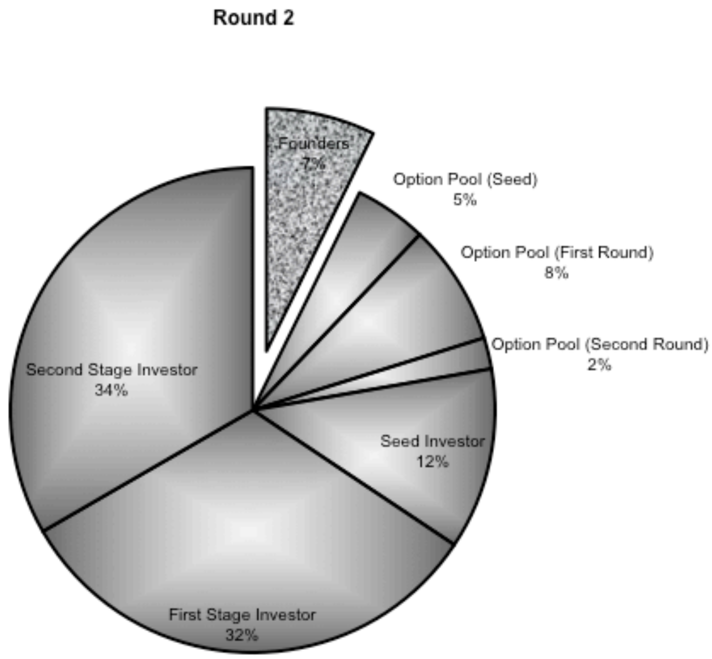
Well, things have gone well. You've been able to attract an investment from a venture capital firm at a step up in value. Your share of the company has gone down again, but not to the degree you suffered with the seed round. While still concerned about the "smaller piece" issues, your paper value is moving in the right direction.



Company Valuation	$10,000,000
Founders' Ownership	11.25%
Founders' Value	$1,125,000

The Second Round

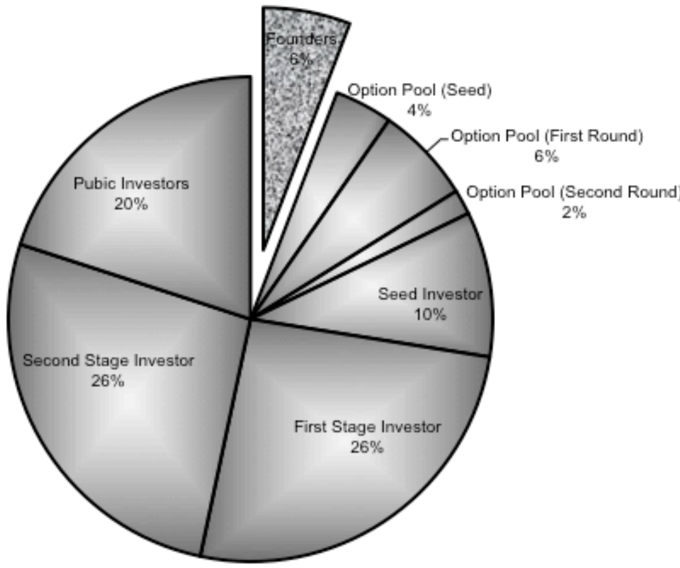
Damn, you're good! Things continue to progress according to plan and a big league, first-class, well known and highly regarded venture capitalist has made a significant investment into your company, again at a step up in valuation! And the VC is only investing because they think that they can get at least a five times multiple on their investment. If things go well, next step is an IPO!



Company Valuation	$30,000,000
Founders' Ownership	7.27%
Founders' Value	$2,179,688

Initial Public Offering

Halleluiah! You've gone public, just like you had hoped you would all those years ago when your seed investors convinced you that a smaller piece of a bigger pie was what you had to work for!



Guess what? They were right!

Company Valuation	$187,500,000
Founders' Ownership	5.81%
Founders' Value	$10,898,438

Advice To Entrepreneurs

1. Never, in the history of venture capital and entrepreneurship, has a company ever hit its plan.
   a. The vast majority, well over 90% in my experience, are below plan, often WAY BELOW plan.
   b. A very small fraction exceed plan and exceed the hoped for exit opportunity for the investors.
2. As has been noted previously, it is the rare founder who can grow with his company and meet the changing demands placed upon management as the company grows and prospers.
3. For this specific scenario to play out, the company has to be able to attract next round investment at increasingly higher valuations. In recent years that has been extraordinarily difficult and rare. Many follow on rounds have been at LOWER valuations.

4. Stock option pools will be part of your company if you attract institutional investors. In terms of their impact on valuation, they are really neutral, as long as you include them at appropriate levels in your fund raising efforts and integrate their impact when negotiating each round.
5. Venture capital investment is not for every company, even if it were available to you.
6. All of the related calculations were the result of converting percentage endpoints into numbers of shares. After all, deals are negotiated with percents, but structured with shares.
7. Build a network of mentors, advisors, professionals, and entrepreneurs who have "been there and done that."