7 Approaches to Raising Money

A Guide to Money Raising for Start-ups

QUESTION #1 – To Raise Money or Not to Raise Money?

Boot Strap/Sweat Equity/Self Funding
The simplest (though not necessarily easiest) way to start a company is to do it on your own with your own time and effort and your own money.

Advantages:

1. You own 100% of the business
2. You don't have to raise any money
3. Consequently you don't have to answer to anyone

Disadvantages:

1. You may not have enough money to achieve your goal
2. You probably won't have enough money to hire other people
3. You won't have anyone with whom else to discuss your strategy and business

Every business ever started was started by entrepreneur with an idea who spent a considerable amount of his/her own time and effort to at minimum formulate and articulate the idea before even thinking of raising money. A good idea has value and any work done or money and time spent to develop the idea only serves to make the idea potentially more valuable.

So how does one decide whether or not to boot strap an idea or to raise money? Usually the answer is easy. There simply is no way to afford the expense. So the first question to answer is what is money needed for. In many cases the money is needed to simply cover living expenses. In other words doing the initial work doesn't involve any concrete out of pocket expense but I simple can't afford to work for nothing as I need to pay my rent and for my food etc. In this case the only amount of money needed is enough to cover living expenses. If you have enough money in savings to at least cover living expenses then at least to begin with you can go it on your own. If you either don't have enough money to cover living expenses or you prefer not to use your own savings then you probably have no choice but to raise a little money to get started.

QUESTION #2: HOW MUCH MONEY DO I NEED TO RAISE?

Once you decide that you need to raise some money the first question you must answer is how much do I need to raise? Most entrepreneurs have a very clear initial idea. I only need $50,000. Or if I had a million this would be a huge success. The problem is that this is a trick question or at least a more complicated question. The real questions should be:

HOW MUCH MONEY DO I NEED SO I WON'T HAVE TO EVER RAISE MORE MONEY?
This would be the amount of money you need to develop your business into a profitable venture. If you know that you need initial start-up capital and that you will need additional capital for a period of time while your business is growing but still losing money then ultimately the amount of money you need to raise is all the up front money plus all the money to cover losses until the business becomes cash flow positive. I say cash flow positive because cash flow is more important to a start-up then profitability (more on this later). So before you think about raising money you must calculate the total amount you will need over time to become cash flow positive.

HOW MUCH DO I NEED TO RAISE NOW?
This is a critical question and not entirely easy to answer. First of all lets define Now. Now could mean a lot of things – it could be three months, six months, a year or even two years. What Now really means is for the short term. And it also means that its not enough to get you to the promised land of cash flow positive. The reasons for raising less then the total amount needed are usually either:

1. There is no easy means to raise the full amount right away or
2. You would have to give away too much equity in the business now to get all of the money up front.

WHAT DO I NEED THE MONEY FOR?
You will need to be very specific with the need for money. This is good discipline for your planning and budgeting purposes but is a typical requirement for explaining to prospective investors how you intend to use the money. By determining very precisely what you need the money for you will probably be able to limit the amount you need to raise at least in the short term. Be sure to account for all needs including a reasonable salary for yourself, travel expenses, office expenses etc.

WHAT IS MY LONG TERM FUND RAISING PLAN?
If your plan calls for needing $3 million to achieve profitability after 5 years, there are a variety of approaches to raising the money. It does not necessarily have to be all raised up front and in many cases there may be good reasons to delay the raising of some of the funds. However, in some cases it may make senses to raise all the money up front if you can.

QUESTION #3: HOW DO I DETERMINE THE VALUATION OF MY COMPANY?

Question 2 cannot really be answered without also answering question 3. If you decide to raise money then before you do you must determine a valuation for your company. This is the basis upon which people make an investment. When someone makes an investment in your company they are in fact buying part of the company. So before you sell them a piece of the company you have to decide what its worth. Sounds simple enough but in fact it is very difficult to determine and can be very subjective for start-ups. Once a company is established, has revenues and hopefully makes a profit then there are many conventional means of valuing a company. For example if a company does $10 million in revenues and makes $1 million in profits it may be valued at 6-8 times profits. In other words someone might pay $6-$8 million to buy the company. Sometimes the valuation might be less than that and sometimes more depending on the growth and future prospects of the company, but the main point is the company's value can be determined by its size and profitability.

Valuing a start-up is much more difficult. That's because we have to give value to the idea and the potential for the idea. This can be very subjective. In raising money for a start-up there are always three issues that are of equal concern to the entrepreneur and the investor:

1. How much is it worth – what is the valuation?
2. How much money is being asked for?
3. Who will have ownership control after the investment?

VALUATION FOR A START-UP

The chicken or egg questions are How much is it worth? Or how much do I need? The reason is that most entrepreneurs want to maintain control of their companies. Therefore they have to make a case that the amount of money being asked for is less than the value of the business. Of course this can be hard to do in the early stages. In other words if you have for $1 million, you need to demonstrate that the idea or business is worth more than $1 million to maintain a majority stake in the business. This is calculated by a simple equation known as pre-money and post money valuation (more on this shortly).

So what is the valuation of the start-up? That depends on a lot of things such as:

- How good or novel is the idea?
- Is there a patent?
- Is there something unique about it?
- Does the company own or control some exclusive rights?
- Who is the founder? Do they have relevant experience or a track record of success starting businesses?
- Does the company have top quality management?

- Does the company have any strategic alliances, contracts or partnerships with well known established businesses that will lead to revenues?
- How far along is the idea? Is it just an idea on paper or is the web site, store or factory already built?
- Has any compelling market research been done about the idea that would suggest strong potential for the business?
- Does the company have any well-known board members that add credibility to the idea?

All of the items listed above factors in determining a valuation for a start-up. The other strong factor is the usual condition that most entrepreneurs set which is to keep majority control of their company. So this is the initial question and tension in raising initial capital. Assuming the entrepreneur wants to maintain control then the absolutely must substantiate a valuation which is greater then the amount of money they are raising.

QUESTION 4: WHAT IS PRE-MONEY AND POST MONEY VALUATION?

In raising money all start-ups must determine a pre-money valuation for their idea or business as a basis for selling a part of their company. Conceptually what needs to be understood is that you are not really raising money; instead you are selling part of your company. Raising money is what schools, churches and non-profits do. They raise the money and they keep and spend it. Businesses get money by selling part of their company. They get the money, they get to spend it but in exchange they sell part of the company.

A pre-money valuation is the value that the entrepreneur places on the idea or company. The reason it is called pre-money because this is the value before money is invested. So for example you could say I have a great idea for a new business. I have researched it. I have developed it and it is ready to go. All I need is some capital and then this will grow to become a profitable business. You might then go to some prospective investors and say I'd like you to invest $1 million. I have determined that the idea alone and the work I have done on this to date makes it worth $2 miliion. If the investors agreed then the pre-money valuation would be set at $2 million and the post money valuation would be $3 million. The post money valuation is a simple calculation:

PRE-MONEY VALUATION + INVESTED CAPITAL = POST-MONEY VALUATION

In the above example the investor would get a 33 1/3% stake in the company as follows:

Pre-Money Value	$2 million
Capital Investment	$1 Million
Post-Money Valuation	$3 Million

EXAMPLE:

Pre-Money Valuation $2 Million

Investor Ownership Stake $1 Million Invested = 1/3 or 33.33% stake for investor
$3 Million Total Value

Founder Ownership Stake $2 Million Initial Value =2/3 or 66.67% stake for founder
$3 Million New Value

Once this basic calculation is understood its easy to see how the stakes could change dramatically by changing either the numerator – the Pre-Money Valuation – or the denominator which is effected by the size of the investment.

If the valuation stays the same but the size of the investment changes then the resulting ownership stakes could be very different and lead to a loss of control.

CHANGE THE VALUATION

Pre-Money Valuation $1 Million

Investor Ownership Stake $1 Million Invested = 1/2 or 50% stake for investor
$2 Million Total Value

Founder Ownership Stake $1 Million Initial Value =1/2 or 50% stake for founder
$2 Million New Value

CHANGE THE AMOUNT INVESTED

Pre-Money Valuation $2 Million

Investor Ownership Stake $3 Million Invested = 3/5 or 60% stake for investor
$5 Million Total Value

Founder Ownership Stake $2 Million Initial Value =2/5 or 40% stake for founder
$5 Million New Value