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VALUATIONS: WHAT YOU GIVE UP

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Quick Summary: The equity percentage for a given investment is only one factor to consider in a financing deal.

Abstract:

Most entrepreneurs are at an extreme disadvantage when negotiating deal terms with experienced investors. The focus seems to be on the convenient but simplistic percentage of equity for a certain amount of capital investment. This arrangement serves as the starting point, but many other factors must be carefully considered to fully understand the true economics of a deal. Often, the reality of those economics is not uncovered until a distribution of proceeds occurs due to a liquidity event.

This is another article that discusses the topic of Valuations. The valuation subject is second only to the topic of raising money, which I hear from entrepreneurs and early-stage companies. The other articles on the CxO-Atlas website that discuss valuations are:

- 3.020501: *“Evaluation and Valuation are Very Different”*
- 3.020502: *“The Valuation Trap”*
- 3.020507: *“Valuation of Early-Stage Companies”*
- 3.020508: *Valuations Who Gets What (this article)*
- 8.020111: *“Valuation of Early-Stage Companies Tool Overview”*
- 8.0201111: *“Valuation of Early-Stage Companies Tool”*

In casual conversations with entrepreneurs when talking about valuations, the comment “I will have to ‘give up’ 20% of my company for the \$250,000. Investment.” The “give up” terms seem to imply they are begrudgingly “forced” to share their ownership with the investor. Of course, nothing could be further from the truth! In fact, investors, with their investment, have placed a bet that the company will be successful and will return their investment, plus hopefully a premium. Investors make the bet knowing that the odds of them getting their money back, let alone a premium, are not in their favor. They make the bets for one simple reason: Hoping the company will be an outlier and return 30, 40, 50, or more times their investment. That one exception will offset the many investments that return little or nothing. The strategy, over the long term, has proven successful for many investment firms.

In reality, the entrepreneur does “give up” far more than equity. Fundamentally, they give up a portion of their freedom to do as they please. A far more appropriate word is “trade.” Entrepreneurs “trade” equity and some level of control for cash. They are now accountable to their investors. The level of accountability can vary significantly based on the terms of the arrangement. Some investors, typically friends and family or Angel Investors, may simply request periodic updates. On the other extreme, a

venture capital investor may require a highly detailed, fifty- to one-hundred-page operating agreement. In the latter case, the agreement may result in the investors having virtually total control over the company's operation and its eventual exit. Their control may be specifically outlined in the agreement or may be more subtle, as indicated by the investors' actions or inactions. One example of the latter situation is when a company is pursuing an additional financing round. A new, would-be investor would certainly ask the company if the current investors were going to participate in the next round. An existing investor could, by refusing to invest, scare off new investors. The new potential investors may assume the existing investors, with their inside knowledge, are aware of some details that has shaken their confidence in the company. One comment like this could have a chilling effect on the new fundraising effort. Just the threat of doing this may force the company to acquiesce to the current investor's wishes.

Aside from the X% equity for \$Y investment, the other financial terms can have a significant impact on what the company "gives up." Those terms, outlined in the Term Sheet, include Liquidation Preferences, Participation Rights, Retained Earnings, Pre or Post-Option Pool Terms, and Warrant Coverage. Term Sheets are not necessarily legally binding. The actual "deal" will be fully defined in the Operating Agreement. Although viewed as a formality by the company, the Operating Agreement can contain detailed language that can impact the assumed Term Sheet agreement. Guess in which direction those "details" favor! Even if the operating agreement terms are distasteful to the company, they may reluctantly accept them instead of restarting the entire fundraising process.

The Excel™ Valuation Tool, as described in the documents listed above, includes a worksheet, "Who_Gets_How_Much," which presents six scenarios illustrating different distributions of funds after an acquisition. The base case (scenario 1) is derived from the equity calculation on the Valuation_Tool worksheet. The other five scenarios allow the user to change certain variables and observe the impact on the dollar distribution for the various groups. Not all of the term sheet's specified variables have been included in the analysis. The purpose of the exercise is to highlight the impact that deal terms can have on all parties.

The tool used an example of an investor's equity of 24% for a \$500K investment. With that as a base, the entrepreneur could then assume they retained 76% ownership of the company. However, when factoring in the other terms shown, the entrepreneur would "walk away" with only 48% of the proceeds after an acquisition, which is 29% lower than their initially anticipated 76%. Similarly, based on the terms and the company sales price, the investor return could vary from 29% to 35% instead of the 24% simple equity calculation. Clearly, this model is simplistic but illustrates the point that relying on the simple "I will give up X% for \$Y investment" is, most likely, very deceiving. If that is not bad enough for the entrepreneur, do not forget the other deal terms that can have an even greater impact.

As mentioned in one of the other valuation articles, "The Devil is in the Details." Be aware and be cautious. Investors make investments for a living; an entrepreneur may make one or two deals in a lifetime. Who do you think is better positioned at the negotiating table?

The tool also contains a worksheet that calculates the share and options price based on the calculated valuation. Just like the assessment itself, the assumptions made about discounts for the lack of marketability can vary significantly.