

Capitalization Table Forecasts For Companies Seeking Venture Capital

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I. Summary

Companies seeking venture capital must realize that their investors expect to make money. One tool which financially sophisticated investors use in conjunction with pro forma financials is a forecasted capitalization (cap) table. This article explores why they care about the cap table and how a company should prepare one.

II. Cap Table Basics

The cap table looks at the funding needed now and in the future and the expected value of the company at various times. In the end, the key question is whether the company can **ever** have a value high enough to give the current investor return sufficient for the level of risk faced.

The cap table captures details about the amount of equity capital used to fund the company, when the capital was contributed, and who owns the company. When the effect of options and warrants are included, it shows the fully diluted percentage ownership of different parties. With a valuation assumption, it calculates the value of each party's share holdings. Furthermore, a forecasted cap table calculates these values at each expected funding event and at a future liquidity event, e.g. the sale of the company.

Investors use this information to understand their return on investment, which can be calculated as a multiple of the initial investment or an IRR. Investors will compare the share price they receive at exit to the share price today. Different investors have different criteria for investment. Some want a twelve times return; others might be satisfied with six or eight times. Some expect an IRR of 70%; others maybe 40%. One critical part to working with the investment community is finding out their criteria and being able to demonstrate that your company can achieve their objectives.

Two pieces of terminology will help explore the cap table:

- **“Pre-money valuation”** is the value of the company before the investment is made. Pre-money valuation divided by fully diluted shares outstanding equals the price per share for the angel round.
- **“Post-money valuation”** is pre-money valuation plus the amount invested.

III. Pre-Money Valuation

The pre-money valuation is a critical measure. It determines the price per share, because price per share = pre-money valuation divided by fully diluted

shares outstanding. Then, the number of new shares issued is the amount raised divided by the price per share. Given the new shares, it is easy to calculate the percentage of the company the founders retain after each round of fund raising.

Determining pre-money valuation is more of an art than a science. Research the pre-money valuations for recent angel and VC deals. Some VC firms do a weighted average of four cases: grand slam, home run, hit, strikeout. In the end, pre-money valuations are negotiable. Companies need money, so the investor sets the deal terms, limited by market conditions. There is a clearing price for funding, but often there is little room to negotiate terms.

Determining future valuations for the exit is somewhat more of a science. In fact, finance textbooks are filled with arcane formulas on how to determine the value of a company in a single equation. Some of the popular shorthand ways include P/E multiples, EBITDA multiples, and revenue multiples.

To argue for a higher future valuation at exit, you must show a sustainable competitive advantage. In most five-year plans, over 80% of the value (as measured by discounted cash flows) are in the post-planning period, the sixth and subsequent years. The exit value is always based on expectations of future earnings, which will in turn depend on a sustainable position. Sources of sustainable position include new products, platforms, patents, etc. You have to demonstrate why “me-too” companies will fail, why a competitor who catches on to the idea as the company matures is in some way shut out from competing successfully.

IV. Other Cap Table Issues

One inescapable fact about the cap table is dilution. It is useful to see exactly how much of the company founders own and the value of those shares **even** if everything goes according to plan. If founder stakes are worth less than expected then consider whether it is possible to start the business with less money. Re-work the strategic financial plan to reduce funding needs, which will reduce dilution.

Also, when forecasting the cap table, check consistency between pre-money valuation, amount raised, price per share, shares outstanding, and shares issued. This is simple algebra, but entrepreneurs often miscalculate these values, so be you're yours are accurate.

Check that growth in pre-money valuation is reasonable, given time between rounds and milestones achieved. Check that IRRs decrease for each round. Know if there's a dependency on a large next round. Check that rounds are properly sized. Do you need all that money at each point in time? Since

valuations tend to increase over time, founders own more of the company if they raise what is needed (and not extra) at each round. Finally, for due diligence purposes, document all people who have shares/options/warrants in the company.

IV. Cap Table Analysis

How good is your cap table forecast? Minotaur Financial offers a complimentary 10-point review of your company's systems. To get a report on your materials, contact David Brode at (303) 444-3300 or email to David@Brode.net.

About Minotaur Financial

Minotaur Financial is a 12-year-old consulting company based in Boulder, Colorado with expertise in finance and financial systems development. Minotaur Financial customizes financial models to support fund raising, M&A, and strategy development, designs and implements planning, budgeting, and reporting software systems for operating companies, and has served as a corporate finance advisor to startups through Fortune 500 companies.