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# Seed round dilution

Watch the recent webinar about the Startup Fundraising Calculator and its powersTake me thereWith this tool, you get to see the real life consequences of investment terms before you sign the term sheet. Use it to better prepare yourself for negotiations with investors.The numbers might differ slightly from spreadsheet models, because the precision and rounding of every system is different. The algorithm has been developed and tested for several months. However, Ledgy does not take any liability for the accuracy of these calculations. Here's an exampleYou and your co-founder have a startup, with equally split ownership, and an existing seed investment of 500k for 10% from a Seed investor. Then, a Series A investor offers you a pre-money valuation of 10m, with a 2m investment, and demands you create a 10% employee pool before the capital injection.What does that actually mean in terms of ownership? Will you, as a founder, get diluted more than you anticipated? What is the actual impact of the Series A investor's terms?In the video below you can see the difference in the ownership distribution that "small" words can make. Pay attention to the pre- vs. post-money button and the toggle determining who gets diluted with the introduction of employee pool shares.You may have noticed that there is another toggle that determines who is diluted if there are convertible notes involved. Try to calculate the difference if the Seed investor's 500k was actually a convertible note with a 8m cap.Let us know if you find this tool useful or if we can improve the experience in any way! Many startups aren't ready for a Series A. They haven't figured out things like customer acquisition costs, unit economics, business model, and other checkboxes that make a Series A viable. But they still want guidance on general fundraising, meeting investors, and calculating valuations. That may put them in a good position to raise a seed round.How is a seed round different from a Series A?Seed rounds and Series A are both part of the path for a startup's success. But they are two different paths that depend on where a business stands. If the business has a solid foundation, a Series A might be more appropriate. If it doesn't, a seed may work better. A seed round typically can be anywhere from several hundred thousand dollars to several million, and is raised from seed funds and high net worth angel investors. Usually the startup is expected to use the investment for market research and early product development. Investors are rewarded with stock options, convertible notes, or equity.A typical venture capital-led Series A tends to be from \$5 million to \$10 million. The Series A gets its name from the type of equity investors hope to receive one day—Series A preferred shares.These standard definitions are helpful, but they don't necessarily help founders determine what fundraising round is right for them.Are you ready for a seed round or Series A?A Series A often happens after a seed round, but some companies that have bootstrapped their way to success can skip the seed round.You are probably ready for a Series A if you have compelling metrics (growth, unit economics), have figured out customer acquisition, and are growing rapidlyYou are building into a large space that can support a company worth hundreds of millions or moreYou have a strong teamIf these are not true yet, you may want to target raising a seed round. A seed round also gives some additional flexibility: you don't have to have everything figured out yet.Sometimes there are exceptions to the rule: if you have a particularly compelling team or vision you may be able to raise a Series A without metrics. But this is a rare case.Usually, you will need a founding team and to have built something. Not having built something is a warning sign to investors about your ability to execute on the idea.If you don't have the technical capabilities on the founding team, you may not want to wait to raise a seed round before you begin building. From the investor perspective, they have to weigh why they would back you instead of another founding team with technical chops. There are plenty of startups that have a proof of concept or more to evaluate against.How developed should a product be to raise a seed round?A prototype may be helpful, but the level of traction needed to de-risk the full product potential is not usually possible with such prototypes. When it comes to raising a seed round, focus the pitch and communication efforts on de-risking the team and market. The seed investor needs to walk away believing in a huge market potential and the team has what it takes to capture it.Key investment terms to know for your seed roundSAFE (Simple Agreement for Future Equity): A contractual agreement a company makes with an investor guaranteeing them equity in a future priced financing round. This is now the standard for seed investing, because of its simplicity and low cost.Valuation cap (or "cap"): The pre-money conversion price of the investment. These valuation caps apply to convertible notes, which is a hybrid of debt and equity, as well as SAFEs. These caps protect investors and allow companies to postpone setting valuations.Pre-money valuation: The valuation of a company prior to investment or financing. Once a company receives investment and the capital hits the bank, it will have a post-money valuation.Post-money valuation: The company's valuation after the investment (pre-money valuation + amount invested = post-money valuation).How investing environments have evolvedThe investment environment has changed a lot for private technology companies in the past 15 years. Because of a nearly decade-long bull market in tech driven by low interest rates and a mobile boom, money has poured into the tech ecosystem—all in search of high-growth startups.Add to that the inventions of Y Combinator's Demo Day and the SAFE. On Demo Day, YC startups will pitch in front of an audience of hundreds of Silicon Valley investors (with even more watching online). These investors will invest in YC companies using SAFEs. By bringing all investors together on one day and making it easy to invest in them, YC has done the closest thing ever to creating a liquid market for startup equity. This is the equivalent to the fundraising invention of agriculture. Understanding high-resolution fundraisingStartup investing has changed to be high-resolution fundraising: early investors will often be rewarded with lower valuation caps than later investors.For example, a company might raise and collect its first \$500,000 pre-Demo Day at a \$6 million cap, and then raise another \$1 million at an \$8 million cap after Demo Day. It is lower risk for an investor to invest once the company has already raised some of its money, because it is much more likely they will get to the whole amount they need. This can be better for founders, because it often minimizes total dilution they take in the seed round.However, founders must properly estimate the total dilution they will experience to avoid raising too much, often leading to greater dilution of their ownership stake than first thought when all of these SAFEs convert in a Series A.Your narrative is your fundraisingOnce you have landed your pitch narrative, make a concise deck to go alongside it. Limit your seed-stage pitch deck to six compelling slides that follow your narrative, and if you break some of these points into more slides, make sure each slide truly adds value.Problem Scope of problem Why now Solution Traction (if any) TeamHow to pick a valuation for your seed roundOne of the hardest things with seed stage fundraising today is picking a valuation. This is hard because you generally need to tell investors you are fundraising at a certain valuation before you really know what demand at that price point is. Too low of a valuation can be a negative signal, especially if you are participating in a program like Y Combinator.What is an average seed round valuation?Generally seed stage valuations are anywhere from \$2 million to \$10 million and upwards of \$20 million (for more experienced entrepreneurs). This is a huge range, reflecting a huge range in demand for different kinds of companies.Market size should also affect the valuation that investors are willing to invest at. Make sure your valuation reflects reality and that the industry you are building is big enough to support the desired outcome.Process for calculating your seed valuationWhen it comes to raising a seed round, it's hard to know how to value your startup. That's because you're raising money before you've found product market fit, determined your growth goals, and built a team. Even so, it is possible to calculate a seed valuation. Start by:Setting Milestones: At minimum, you need to set milestones that you want to achieve in a certain amount of time. For example, you might want \$50,000 monthly revenue within two years, a team of 10, and expansion into two new verticals. From there, you must decide on the resources you need to reach these milestones and how much this will cost you on a monthly basis. This becomes your burn. Define an equity pool: Decide on how much equity you will give away at this early stage, knowing that you may need to give more away in additional funding rounds. Calculate your pre-money valuation: Pre-revenue valuation is more art than science because all investments are based on potential, not results. They are forward-priced and are based on gut-level estimates from seasoned angel and seed stage investors. Valuation at this stage serves as a signal for where the company, based on team and space, can ultimately go. Sending the wrong signal can attract wrong investors, which can set the company up for the wrong growth trajectory.Mentors and programs:Like any other part of the company-building process, it helps to seek advice from those who have done it before. Having a founder or investor to mentor you throughout the early stages of your company can make all the difference. Outside of informal relationships, there are structured programs or bootcamps to help you prepare for the valuation process.Other factors affecting seed roundsWhen raising a seed round, there are a few other factors to consider. A few include:Timing: Don't try to raise a seed round when people tend to be away—think August, December, July.Dilution: Fundraising isn't easy, but that doesn't mean you have to take every penny that you can get. Be wary of dilution and set a maximum amount to raise.Approach: Do you want to raise at different caps and valuations over time, or in one batch? Paul Graham advocates for minimizing the amount of time in fundraising mode, so you can focus on business.Valuation caps: In seed rounds, it's common to raise money through convertible notes and SAFEs. But when investors use convertible notes, they use valuation caps. The valuation cap is the pre-money conversion price of the investment.These valuation caps apply to convertible notes, which is a hybrid of debt and equity. These caps protect investors and allow companies to postpone setting valuations.Discounts: Discounts give investors the opportunity and right to purchase shares at a discount in subsequent funding rounds.Types of seed investorsThere are also several different types of seed stage investors. It's good to know which kind you are talking to in order to understand their goals and objectives.Angel investors: Typically high net worth individuals who have made their money by investing, starting a company, or being an executive. They can make decisions very quickly, because they are investing their own money. Investment decisions can be made on their gut feel, whether they have experienced the problem or have knowledge of the market, and how compelling they find you as a founder.Typical check size: \$10,000 - \$300,000Seed funds: These are funds that focus on investing in seed rounds of startups. They can either participate, or lead a round. Often the funds have multiple partners, and you may have to meet more than one to get a check.Typical check size: \$100,000 - \$500,000Venture capital funds (VCs): Generally speaking, VCs only invest in seed deals as lead generation for Series As. They want to stay close to you so that in the event you actually build a good company they can build a relationship and lead your next round.Typical check size: \$200,000 - \$1 millionWhat all investors have in commonInvestors want to invest in things that have fundraising momentum already, which is why the first check is the hardest to get. None of these investors are investing for a 10% internal rate of return. Many companies present an idea that can be a fine business, and will become profitable, but may not turn into a big industry. Seed-stage tech investors don't typically invest in those companies because seed stage investors are looking for double digit multiple returns from single investments, which in turn pay for all the failed companies they invested in.When you think of fundraising, think of it like a sales funnel. Not every lead is going to get to the bottom and close, and you shouldn't take offense when someone says no.In order to close a certain number of sales (AKA raise your round) you will need to fill the top of the funnel with many leads, and it's healthy to expect attrition and rejection.How to get introductions to investorsThere are two types of people you should target to help provide intros to investors: founders who have been funded by that investor and investors who have invested in your company already.It pays to optimize your process: When you sit down with friends who are investors and ask for intros, come prepared with a list of people you want to talk to and ask who on the list they know. That's a lot easier for your allies than asking them to tell you what investors would be interested in your company. Odds are, your friends won't have a mapping of investors to types of companies they are interested in in their heads.Cold emailing investors almost never works. Most people who are out there as investors have been cold emailed before, and may have even met up once or twice with one of those founders. However, they almost never lead to an investment. It pays to put in the time and effort to find a warm intro.After you get introduced to an investor, arrange a meeting with them. A successful meeting will be more conversation than pitch. You may choose to walk through your deck, but be prepared to have a conversation around your narrative without it.You can tell if an investor is engaged if they are asking questions about your business. They may come up with ideas for where you can take your startup. This is when you really know you've got a good chance to close them.How to close a seed funding investmentUsually you can close seed investments quickly. Skilled (and/or lucky) fundraisers can close a round in 4-8 weeks. Successfully raising an investment round involves many basic sales tactics to engage your audience.The number one tip? Be direct. Your goal in a meeting is to move the conversation along and get a firm commitment for an investment. Many founders struggle to directly ask an investor to invest and instead wait for the investor to ask for the terms of the deal and suggest they are interested. Resist the temptation to talk around it.Ask the pointed questions that you want answered.Once you have a firm commitment, make sure the deal is one that works for you. Consider whether the investment terms are fair, and have your lawyer walk through the options with you.1. Don't dally on sending paperwork, either: Have your lawyer send a SAFE. 2. Clarify your time frames. Don't put an arbitrary "soon" date on your round—clarify the time so you can bring about a legitimate sense of urgency. Make it clear what date you want money in the bank, which will also filter out investors who aren't prepared to move quickly enough. 3. Observe the handshake protocol. Startups move faster than complex legal processes, hence the need for a way to enforce commitments before they can reach their legal conclusion. The YC Handshake Protocol is recognized as a code of ethics (by most) in Silicon Valley. Commitments go both ways: don't back out from investors—or feel guilty if investors back out from your seed round—after the following four steps have been completed:The investor says "I'm in for [offer]."  
The startup says "Ok, you're in for [offer]."  
The startup sends the investor an email or text message saying "This is to confirm you're in for [offer]."  
This offer is valid for 48 hours, please confirm acceptance. You agree to fund your investment no later than 10 business days from the date of your acceptance of this offer."The investor replies yes.Discipline is key for seed-round fundraisingAs you raise your seed round, stay disciplined and work systematically to make the best decisions for your company. This requires making sure you're knowledgeable about seed rounds and their terms, cultivating relationships with the right people, and preparing to meet with investors.For help exploring the impact of SAFEs and convertible notes on founder ownership, LTSE Software offers SAFE Genie, a free calculator. Learn more at : LTSE is neither a law firm nor provides legal advice. Before making decisions on matters covered by this post, readers should consult their legal adviser.

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