Pre-money versus Post-money Business Valuations

"In the business world, the rear view mirror is always clearer than the windshield." Warren Buffett

We know capital is vital to business growth. There are only three ways to finance a business. Funding comes from revenue, debt or equity. Raising money from investors (venture capitalists, banks, friends, and family) is always about the amount of money to be received, what will be done with that money and the amount of control that must be relinquished to get it.

Business Valuations

In every venture capital financing round, the valuation of the business is paramount to the success or failure of the financing. The valuation amount and method can be hotly debated between the founders and potential investors because it affects the Return on Investment (ROI) for the parties to the transaction over the entire life of the business.

Pre-money Valuation

The pre-money valuation of a company is the entity's value **before** it receives outside funding. This valuation is frequently driven by the company's performance metrics provided by the founders and mutually agreed upon formulas provided by prospective investors.

Post-money Valuation

Post-money valuation is the organization's value **after** it receives external funding. There are two primary ways to calculate the post-money valuation of a company. The first method is to add the value of the investment to the pre-money valuation of the business.

The second way is to divide the new investment amount by the number of shares received for that investment and then multiply that amount by the number of shares issued after the investment.

Valuation Differences

Pre-money and post-money valuations depend on when the business valuation is done. It all comes down to timing.

The difference in valuation is critical because it determines the equity share in the company the investors will receive after the financing has been completed. This can have a dramatic effect on the financial and legal implications to the business long after the funding has been done.

Parties to the valuation generally consider factors such as recent comparable business valuations, the entity's historical cash flow, company Key Performance Indicators (KPI) and business succession calculations.

Dilution of Ownership

Each round of outside investment dilutes the founders and subsequent investors' ownership in the business because the founders are trading equity for capital.

The reason founders are willing to sacrifice equity for capital is because diluting their ownership from outside investments can significantly increase the value of each share of the entity's stock. Owning ten percent of a large pie can be much more profitable than owning fifty percent of a small pie especially when external financing is the best way to build a bigger pie!

Economics of the Agreement

Calculating the pre-money valuation of a company is normally much more difficult than a post-money valuation because the entity may not be generating revenue at the time of the valuation.

This is particularly true when an entrepreneur, startup or emerging business has great ideas but no measurable assets or a proven track record. In these instances, investors frequently ask for special assurances or warranties in exchange for bearing the additional risk due to a potentially unsubstantiated valuation.

Performance Counts Big!

The difference in pre-money versus post-money valuations is crucial as the business continues to grow and wants to court new investors.

When a business is achieving its goals; meeting or exceeding its financial forecasts; increasing its profitability; gaining market share and is recognized as an innovator in its industry, new investors cannot use the last post-money valuation as the new pre-money valuation because the entity's valuation has clearly improved since the last investment.

An organization's performance must be reflected in the entity's new valuation before more money is invested. If the company's performance is the same or worse since the last valuation, its net worth will remain unchanged or go down.

How We Can Help You

Pacific Crest Group provides professional services that keep your business focused on your critical objectives. We provide strategic Accounting and Human Resource (HR) services created specifically to help you meet your goals. Through exemplary customer service, clearly defined policies and procedures as well as a forward looking perspective, we provide the outsourced solutions your business needs to grow. A PCG professional is happy to meet with you to discuss solutions for your unique requirements designed to maximize all of your business opportunities.