# CAN DEAL STRUCTURE IMPACT MARKET VALUATION?



John C. Botdorf

## ASSUMES KNOWLEDGE OF BASIC FINANCE TERMS-COLLEGE LEVEL-CASE STUDY INCLUDED

## BOTDORF RESEARCH GROUP, LLC.

SPRING OF 2023.

## **Can Deal Structure Trump Valuation?**

## DEAL STRUCTURE, VALUATION THEORY, AND THE IMPACT ON ANGEL INVESTORS

Discussion of Pre-Money Valuation: One of the most frequently asked questions I get from investors is,

"What is your Company's pre-money valuation? While certainly an important question, the broader issue of valuation is one of the more controversial subjects in the private equity world. On the surface, it is logical to suggest that the less an investor pays for equity in a particular company, the better the chances are for a larger return assuming the investment results in a larger ownership percentage. However, there are a number of mitigating factors that revolve around the pre-money valuation question that play a significant role in determining, and even predicting, investor outcomes.

In a poorly structured deal involving multiple rounds of capital, the concept of pre-money valuation can often become meaningless to the Angel investors. This can happen when follow-on liquidation preferences, senior creditor rights attached to stock ownership, and other key-stock provisions specified in the corporate by-laws favoring senior investors or even management in some cases are sorted out.

In a well-structured deal, the issue of pre-money valuation at the time of investment can be "locked out" from impacting the investor until certain return objectives have been obtained by the company and directed to the investor before any regular payouts occur. Most investors would rightfully assume that all things being equal, a lower valuation should yield a greater ownership interest in a Company, and therefore outperform a similar ownership interest at a higher valuation which yields a smaller ownership interest. Be careful, a little knowledge can be a dangerous when multiple financial clauses are in play.

**Deal Structure Trump Pre-Money Valuation?** *Yes, it can.* Pre-money valuation in and of itself is just an outside boundary that provides a starting point for the company to issue a certain number of shares at a certain price point at a given moment in time. While it is true that a lower valuation at the time of investment could increase an investor pay-out, it is also possible to purchase shares under a different deal structure (with a much higher pre-money valuation) that compound into a greater number of shares triggered by special dividends, liquidation preferences, and certain conversion rights as an example.

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Upon liquidation in a deal with a high valuation it is therefore possible for an investor to end up with a greater number of shares owned for pay-out purposes or receive a bigger payout for the same deal even though the premoney valuation was twice as high.

Hence it is mathematically possible for an investor to pay more for an investment with a higher pre-money valuation and make as much or more money when all of the details of the deal structure are known. This is when the art of the deal trumps pre-money valuation. This will be illustrated in greater detail with an example comparing a hypothetical deal at a \$34.4M pre-money versus the same deal at \$17.2M pre-money valuation. We then looked at the payout results to see which one performed better across all kinds of exit points for the investor.

Let us pretend we are in a board meeting and the CEO and the Board agree the company should go out to the capital market to raise \$7.5M to finance the launch of the company's software model, now through beta testing. The Board prefers a "smooth capital raise" and therefore informs the CEO they feel a \$17.2M million-dollar pre money is the way to go on valuing the company. The CEO ask the Board a simple question. Would if I could show you that under my proposed deal structure, a \$200,000 investor would make a return of over \$500,000 more or \$3.8M on his or her investment if we go with the higher valuation under the terms I suggest. A Board member ask the question, "you mean to tell us that if you go with a \$34.4M pre-money valuation on terms you feel will sell out the offering, an investor with a \$200,000 interest in the Company makes more money"? "Yes the CEO replies, "that is exactly what I am saying." Another Board member quips in with "How is that possible"?

Now let us stop the train for the moment. Remember things like priority returns, Liquidation Preference payments, and the absence or inclusion of dividend obligations can markedly impact investor outcomes. Also, remember, investors are not going to see the deal you did not present, only the one deal you offered. I have used variations of these themes on dozens of private placements and have always sold out the offerings. Hence, Deal Structure can trump Valuation if you understand your options.

This theory also assumes you have a great Deck, Business Plan, and a solid reputation as ultimately, real investor demand is not just about valuation, it is about how well investors believe in your thesis and what is the probability your management team can execute. Even an absurdly low valuation does not matter if the other issues are not well presented.

In concept it is assumed an investor will do well when a company sells for a high multiple of invested capital. Then, almost any pre-money valuation can make sense on an ROI basis looking backwards. The impact of valuation models on investor return become much clearer when viewed across the outcome spectrum. In other words, how does this same investment perform analyzed across all exit possibilities ranging from selling the company at a loss all the way through selling the company for a substantial premium on invested capital. If the investor is given a chance to perform well in every scenario (except of course via a pure bankruptcy filing where creditor rights could wipe out all investors), then something impressive is happening. The deal structure is overriding valuation.

This can be the key to raising capital with an unproven product and help create a successful private equity offering. Additionally raising your first Series A round and its subsequent valuation with professional investors at a higher valuation suggest the market is valuing your future growth at a premium which will help drive valuations much higher if your product roll out proves to be an impressive roll out where it counts the most, with the customers.

The idea of mitigating risk solely through price adjustment is not logical and is really just a fallacy. The collective IQ of your management team does not rise or fall with your valuation. The factors that make up the true risk/return profile of any private equity deal have little to do with valuation. Factors such as management ability, their investment track records, market timing, market penetration strategies, and sound financial policies often warrant a valuation premium. These metrics along with careful deal structure can provide the proper incentives and can balance the equities between investors, founders, and a complete management team. Other tangible factors such as Intellectual Properties, valuable "blocking" patents, first mover advantages, and the potential for disruptive technology in the marketplace all play a key role in putting a value on the "sum of the parts" that make up pre-money valuations and therefore what one might pay for a private equity investment.

The purpose of this Blog is to mathematically illustrate why and how deal structure is a far bigger factor in investment success than just a pure "pre-money valuation" and to dispel the myth that one should accept or decline an investment decision based on the pre-money valuation.

## A DISCUSSION ON VALUATION METRICS

Understanding your financing options is the key to understanding how to package your deal. A particularly high-risk deal involves extra steps to gain the credibility needed to actually get funded. We will examine a hypothetical deal using a \$17.2M valuation versus a \$34.4M valuation and see what happens when the higher valuation provides the same or superior investor returns regardless of the exit price. This example is intended to prove that how you use other crucial business clauses can actually not only trump a lower valuation but yield higher returns to the investor. It should be noted we are not necessarily advocating an Entrepreneur only consider a higher versus lower valuation, but rather how other terms can offset it in those cases where a higher valuation provides a win/win for investors and management. Let us review some ground rules before we get to the math.

A disruptive technology or any type of truly innovative deal in and of itself helps provide the blueprint for how to structure a deal to investors. It is important to understand every deal from many points of view. This allows for critical thinking and helps drive how a company could be financed. For example, a next-gen technology or drug company needing many years of testing eliminates using debt in the early years to develop a concept. Debt is for companies that have an income stream to pay it back with.

# ValuationTheory 11-1-2023 BOTDORF RESEARCH GROUP, LLC.

A long-term challenge to developing a drug or creating new software model may require a whole new way of financing so the company can last long enough to create real shareholder wealth. This is why we discourage the use of straight or convertible debt to finance early-stage companies embedded in high-risk projects. Using traditional VC financing in this scenario is like having a gorilla babysit your bananas. This choice is a bad match for the company and creates time bombs that encourage the operators to take on ever increasing risk profiles to stay ahead of the lenders. In this case of course we are referring to the investors as the lenders.

How does one put a value on something that could be game changing if a real breakthrough can be achieved? How do you then confront investors about how realistic the odds are for any invention converting into market share with revenue? Let us review how to set up your Pitch Deck to promote an idea that has never been done before. Some themes that can help with this dilemma are listed below.

A) Using a credible third party to validate that if your invention works, it could be game changing. The goal here is not to convince an "expert" you have the answer but rather the need for a better mousetrap is significant and your approach has merit..

B) Creating a white paper that spells out why your approach is unique and addresses the short falls inherent in the current product landscape provides a concise road map on why your solution might succeed. Hint: The answer lies with how you plan to avoid inherent roadblocks to achieving a breakthrough.

- 1. A survey or acknowledgement from end-users that confirm they want to see a better solution and are willing to pay for it. Remember you must save your customers significant money to get them to migrate to your product.
- 2. A credible pay back model that shows the value proposition to the customer first, then the investors.
- 3. A detailed Source and Use Statement that can effectively move the needle toward creation of a worthwhile and commercially viable prototype.

You now have the tools that together can be incorporated into a "Valuation Study" preferably done by an outside expert. This data can then be incorporated into your Pitch Deck or Business Plan if funds do not allow you to afford a credible third-party review. There is a small percentage of investors who will take a chance on a higher risk profile but the Entrepreneur must have proved the concept is viable at least on paper, or with alpha code, and the path to sales can be achieved preferably within 12 months. Many innovative breakthroughs might take years to develop. In this case, investors will be investing to advance a passionate cause and will more likely agree to fund a deal more out of passion for the cause versus the expected risk or return involved. These types of investors rarely fund someone they do not know given the much higher risk profiles. In this case you may wish to partner with a group that is expert in your cause and has the capacity to fund the project.

## THE PRIVATE EQUITY GREAT DEBATE-HOW MUCH EQUITY FOR A SEED ROUND IS TOO MUCH?

This is a common question I get when asked to review a Seed Round proposal. The first thing to know is that there is no right answer but there are some wrong answers. The short "test" is to sit down with your projections and ascertain how much money you need to get to profits. I have always followed two concepts when starting a company.

**DEBT IS NEVER CHEAPER THAN EQUITY IF YOU (THE ENTREPRENEUR) GET WIPED OUT.** It is impossible to go broke if you are debt free. This applies to business and your personal life. In reality most startups fail, so common sense says to go as long as possible (preferably until you have profits) and resist the notion of straight debt or convertible debt. While there are exceptions such as a strong backlog with production in place, it might be more prudent to take a slower, debt minimized approach to starting your company. Incurring too much debt *early on in your start up curve* is the number one reason that startup companies fail. Failure to capture market share with decent margins goes hand in hand with this concept since profits eventually will lower your cost of capital because you can pay down debt instead of increasing it.

I have had companies struggle for years because I did not accept debt. I/we eventually got a big break by working hard and eventually the companies took off and got to profit without having to pay our earnings out to debt holders. You are far better off doing \$300,000 in sales with \$50,000 in profits without debt, then you are doing \$900,000 in sales with \$150,000 to investors because you borrowed \$1.3M with a 9% pay out rate. Yes, there are exceptions to this rule but in many cases, you are taking on too much risk.

Valuation experts will rightfully point out that the higher revenue exit multiple creates more shareholder value on paper and therefore the debt model is superior. That may be true in the short term, but as you grow and your debt grows, your ability to withstand a huge set back is much smaller than the low to no debt model. What is the point of creating say 10M in shareholder equity if the risk profile rises to the point of being wiped out? Case in point, Covid 19, a new competitor, an expensive lawsuit, a patent getting revoked, on and on. I have seen it all. It is not that debt is a bad concept, it is best taken on when either the probability of higher reoccurring revenue is extremely high or already in place.

MAKE SURE YOU TEST YOUR SET BACK MODEL, in Finance and in Entrepreneurial Land for every rule, there is an exception so we are talking about probability here. As a rule of thumb, take a look at your projections and figure out when you can defend getting to profitability. Then, double the time you have projected and increase your expenses by 50%. Now you have your template. Ideally, you should save 50% of the equity for yourself and your employees. That gives you up 50% of your total equity to give over the lifetime of your project to investors until it sells and distributions are made. If your project cannot withstand this test, your deal is in the bottom half of equity deals and is not likely worth the risk.

Common sense will then dictate when starting up a risky venture never sell more than *5% to 20%* of your company in a seed round unless you feel you are just one round away from profitability and can stay on or around the 50% rule for all of your rounds combined. In this case, if an investor will fund 100% of your capital needs to get to profits then giving up more equity might make sense because you feel strongly you have all the capital you need. This is more the exception than the rule and you should be an expert in your field (or retain one) to make this call.

Some companies that may need several million dollars or even hundreds of millions over the long run can raise future rounds by creating meaningful shareholder wealth along the way, thereby selling stock down the road at much higher prices. You need to save stock in your Cap Table for future rounds if you are a small start-up. It is Ok to sell stock at a cheap price to get startup capital. The goal should be to use the startup capital to obtain or get close to revenue and therefore allow you to raise the next round of capital at 2-6 times the price you sold your seed round. This does not apply to deals where the management team has access to public money or large Hedge Funds that are looking at metrics other than profits to drive investment into a project. In recent years we have seen "the number of users" often drive an investment thesis, even though the company may be producing wide losses for several quarters or years in a row. Twitter is a good example of how their business model lost over a billion before posting profits. This opportunity accounts for less than 1% of all deals that can stand this type of loss profile.

**Pre-Money Valuation-The Valuation Fallacy**- I once led an effort to raise over \$16.5M for a start-up with six rounds of capital, all while being pre-revenue. The key was to drive the technology and patent strategy closer and closer to commercial deployment. If you have a breakthrough technology, your drivers for success may be other than just revenue. You may have a platform worth significant money and shareholders are looking at how relevant and game changing is your IP and its potential impact on your future cash flow model. These types of deals tend to favor Entrepreneurs with a strong track record and are allowed more rope that Entrepreneurs with less experience. Be sure and measure your background for what it is and ask yourself whether you would invest in a deal like yours with a complete stranger. If the answer is no, it is likely you should consider breaking your business plan into smaller bites. Working toward reducing risk by getting a protype developed, land beta customers who can validate your software, or line up a patent strategy or proof of concept can validate your value prop. This will help drive downstream investor interest making it a better time to pitch your deal. Look at how many Entrepreneurs got funding on Shark Tank by offering a sample to the investors. While their revenue may have been small, the proof was in the product sample.

**Shoot Out Comparison of \$7.5M Series A Raise at Two different Valuations-** As you are pitching your deal to sophisticated investors the subject of valuation will eventually come up. While it is true that valuation matters, what matters even more is how much risk is on the table and what is the projected return on that risk profile? It is also true an Entrepreneur with a great idea who needs funding may end up on the short end of distributions when all of the creditors, lenders, preferred investors, and even management payouts can all trigger priority pay-outs. In some cases, a different deal structure might have better protected the Entrepreneur.

This theory may ring true in some cases, even most cases if you ask a VC purist, but what happens if you put this notion to the test using rational offsets on the other business terms, like liquidation preferences, compounding clauses, and dividend payout obligations. For example, is it possible one could offer a deal at a \$34.4M valuation and produce a superior return profile than if that same deal had been offered at a pre-money valuation of \$17.2M? The answer is yes, it is possible and I have done it using multiple variations of these themes. The key is understanding what tools are available to the Entrepreneur to offset the higher valuation. Keep in mind a higher valuation that does not get funding is never superior to a lower valuation that does get funding. Let us look at how deal structure can provide some options. Before doing so, let us review the assumptions underlying each deal so we are comparing apples to apples.

## Key Investment Similarities on our simulated \$7.5M dollar Offering:

A-Each Deal share have the exact same amount of Pre-Money and Post Money Shares Outstanding by year four.

B-Each Deal should use the same exit price per share for every year.

C-The model shall assume the Company could be sold any year from Year One through Year Six.

D-Each Company assumes the same value increase per share starting at an Exit Price of \$1.00 in Year One to \$25.00 in Year Six.

E-Each Deal assumes the same Liquidation Preference of two times in cash in addition to a stock payout.

F-Investor Priority for each Deal is the same, Preferred Series A is First, Seed Investors are second, and MGMT is third.

G-The model assumes each deal raises \$7,500,000 and sells out.

#### Key Investment Difference:

Deal One has a \$34.4M Pre-Money Valuation.

Deal Two has a \$17.2M Pre-Money Valuation.

**DEAL ONE**: Raises \$7.5M in a Series A round with a pre-money valuation of \$34.4M. The Company will sell 5M Pref A shares at \$1.50. The Company will offer a two times liquidation preference in the form of cash and return of capital equal to a priority payout of \$22,500,000 on the \$7,500,000 investment. The Company will also pay a 10% stock dividend every year equal to 500,000 shares per year on the original five million shares offered. The Company is also obligated to issue another 5M shares to the Pref A shareholders if the company is not sold after 36 months. All accrued stock dividends shall be paid first to the investors on the sale of the Company.

**DEAL TWO:** In the alternate event, the Company will offer the same deal to raise \$7,500,000 but instead will offer ten million (10M) shares of Preferred Series A stock at (.75) cents a share, at a \$17.2M pre-money valuation. There will also be a two times return on capital as a liquidation preference in cash upon the sale of the company in addition to the stock sold. For purposes of this example, the Company is not offering a dividend, just 2X on your money first paid out, then you get a second payment on your stock that was purchased.

	COMPARATIVE ANAL: \$34.4M	SYSIS OF RAISIN	G \$7.5M AND LOO	DKING AT TWO VA	LUATIONS-\$17.M	I VERSUS		
	What happens to	a \$200,000 Investo DEAL <mark>e</mark> STU	or on \$7.5M Raise a JCTURE COMPAR	it twice the Valuation NSION	?			
Deal One	Pre Money Valuation of \$34	.4 Million	Year l	Year 2	Year 3	Year 4	Year 5	Year 6
LP is equal to 2X Share	s Out 22,933,3	33						
\$200,000 \$1	.50 133,000 Shares Sold in Reg	D Offering	133,000	133,000	133,000	133,000	133,000	133,000
Triggers on month <u>37</u> if not sold	Triggers on month 37 if not sold Conditional Stock Div		0	0	0	133,000	133,000	133,000
Liq Prem also paid in Cash	\$200K at 2X-plus	principal	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000
Annual Dividend is paid in Stoc	k 13,333	10%	13,333	26,666	39,999	53,332	66,665	79,998
Shares Owned by Investor at Ye	ar End Cum Shares		146,333	159,666	172,999	319,332	332,665	345,998
Deal Two	Pre Money Valuation of \$17	.2 Million						
LP is equal to 2X Share	s Out 22,933,3	33						
\$200,000 0.	.75 266,000 Original Shares		266,000	266,000	266,000	266,000	266,000	266,000
Liq Premium is paid on sale in c	nium is paid on sale in cash Liquidation Premium-cash only		\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000
Shares Owned by Investor at Ye	ar End		266,000	266,000	266,000	266,000	266,000	266,000
	Return on Investment for \$2	00,000 at a \$17.2M	l Pre-Money compa	red to \$34.4M Pre-M	loney			
		SH4	ARES OUTSTAND	ING ON DEAL ONE	1			
Deal One-ROI Review on \$200,000 investment with \$34.4M Valuation			Year l	Year 2	Year 3	Year 4	Year 5	Year 6
	Shares before Offering		22,933,333	22,933,333	22,933,333	22,933,333	22,933,333	22,933,333
Shares Sold	Shares on \$7.5M Round	\$1.50	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
36 month benchmark	Conditional Shares Issued		0	0	0	5,000,000	5,000,000	5,000,000
Seed Round Shares Sold	Seed Round	0.20	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Increases 100K per year	Management/Dir Options	100,000	720,000	820,000	920,000	1,020,000	1,120,000	1,220,000
			146,333	159,666	172,999	319,332	332,665	345,998
	Total Shares Out at Sale	\$34.4 P-Value	29,799,666	29,912,999	30,026,332	35,272,665	35,385,998	35,499,331

PAYOUT ON SALE OF DEAL ONE											
\$34.4M-Pre-M	Represents the Price per Share on Sale		\$1.00	\$5.00	\$8.00	\$10.00	\$15.00	\$25.00			
\$7,500,000 Raise	Reg D Offering	Bankruptey	\$29,799,666	\$149,564,995	\$240,210,656	\$352,726,650	\$530,789,970	\$887,483,275			
1,000,000	Shares Owned by Seed Investors	\$0.00	\$1,000,000	\$5,000,000	\$8,000,000	\$10,000,000	\$15,000,000	\$25,000,000			
	Liq Prem Share Outstanding		5,000,000	5,000,000	5,000,000	10,000,000	10,000,000	10,000,000			
	Cost of Stock Liq Prem Payout to Investo	ors \$0.00	\$5,000,000	\$25,000,000	\$40,000,000	\$100,000,000	\$150,000,000	\$250,000,000			
	Number of Dividend Shares Out		500,000	1,000,000	1,500,000	2,000,000	2,500,000	3,000,000			
	Cost of Dividend Payout to Investors-on sale Cost of Cash Liq Prem (2X) Payout to Investors		\$500,000	\$5,000,000	\$12,000,000	\$20,000,000	\$37,500,000	\$75,000,000			
			\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000			
	Return to Investors	\$0.00	\$29,000,000	\$57,500,000	\$82,500,000	\$152,500,000	\$225,000,000	\$372,500,000			
	Return to Management/Directors	\$0.00	\$799,666	\$92,064,995	\$157,710,656	\$200,226,650	\$305,789,970	\$514,983,275			
	Liq Prem to \$200,000 Investor	\$0.00	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000			
	Stock Payout to \$200,000 Investor	\$0.00	\$146,333	\$798,330	\$1,383,992	\$3,193,320	\$4,989,975	\$8,649,950			
	Total Payout to \$200,00 Investor	\$0.00	\$746,333	\$1,398,330	\$1,983,992	\$3,793,320	\$5,589,975	\$9,249,950			
PAYOUT ON SALE OF DEAL TWO											
Deal Two-ROI Review o	n \$200,000 investment with \$17.2M Valua	tion	Year l	Year 2	Year 3	Year 4	Year 5	Year 6			
Pre-Money Outstanding	Shares before Offering		22,933,333	22,933,333	22,933,333	22,933,333	22,933,333	22,933,333			
	Shares on Sell out w LP	0.75	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000				
								10,000,000			
	Seed Round	0.20	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000			
	Management/Dir Options	A17 A1 4 4 4	720,000	820,000	920,000	1,020,000	1,120,000	1,220,000			
	Total Shares Out at Sale	\$17.2M Value	34,653,333	34,753,333	34,853,333	34,953,333	35,053,333	35,153,333			
\$17.2M Pro-M	Represents the Drice Der Share on Sale	\$0.00	1ear 1 \$1.00	1ear 2 \$5.00	1ear 5	stear 4	sis 00	\$25.00			
\$7.500.000 Raise	Reg D	Bankruntau	\$1.00	\$1.00	\$240,210,656	\$10.00	\$530 789 970	\$25.00			
\$7,500,000 Raise	Seed Investor 1 000 000	\$0.00	\$1,000,000	\$5,000,000	\$8,000,000	\$10,000,000	\$15,000,000	\$25,000,000			
	Cash Liquidation Obligation at 2X	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000	\$22,500,000			
	Stock Payout Obligation	10M Shares	\$10,000,000	\$50,000,000	\$80,000,000	\$100,000,000	\$150,000,000	\$250,000,000			
	Return to Management/Directors	\$0.00	\$1,153,333	\$72,064,995	\$129.710.656	\$220,226,650	\$343,289,970	\$589,983,275			
Total Liq Pref Amount	Liquidation 2X on \$7,500,000+Seed Obli	g \$0.00	\$23,500,000	\$27,500,000	\$30,500,000	\$32,500,000	\$37,500,000	\$47,500,000			
Total Stock Pref Amount	Total Payout to Seed plus Investor	\$0.00	\$33,500,000	\$77,500,000	\$110,500,000	\$132,500,000	\$187,500,000	\$297,500,000			
	Liquidation Payout to \$200,000 investor	\$0.00	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000			
	Stock Payout to \$200,000 investor	\$0.00	\$266,000	\$1,330,000	\$2,128,000	\$2,660,000	\$3,990,000	\$6,650,000			
	Total Return to \$200,000 Investor	\$0.00	\$866,000	\$1,930,000	\$2,728,000	\$3,260,000	\$4,590,000	\$7,250,000			
	Year l	Year 2	Year 3	Year 4	Year 5	Year 6					
\$34.4M Shares Outstanding		29,799,666	29,912,999	30,026,332	35,272,665	35,385,998	35,499,331				
	\$17.2M Shares Outstandin	ıg	34,653,333	34,753,333	34,853,333	34,953,333	35,053,333	35,153,333			
		Difference	-4,853,667	-4,840,334	-4,827,001	319,332	332,665	345,998			
	\$34.M Payout on Sale	\$200,000	\$746,333	\$1,398,330	\$1,983,992	\$3,793,320	\$5,589,975	\$9,249,950			
	\$17.2M Payout on Sale	\$200,000	\$866,000	\$1,930,000	\$2,728,000	\$3,260,000	\$4,590,000	\$7,250,000			
		Difference	(\$119,667)	(\$531,670)	(\$744,008)	\$533,320	\$999,975	\$1,999,950			
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**Question of the Day?** Let us say your imaginary Uncle called and said he was going to finance a company for \$7,500,000 and given the management team, expected the deal to do very well. He further offered to put the shares in your name as a gift to you. Which deal would use choose? Does it make a difference what price the company sells for? Does Deal One at a Pre-Money Valuation of \$34.4M mean you are paying twice as much as the \$17.2M Valuation? Wouldn't you rather pay one half the value since the terms appear remarkably similar? Why pay twice as much? Which deal pays out the highest amount to the shareholder?

You will notice in the Excel Spreadsheet below in the case of bankruptcy we have just assumed that both sides are wiped out and that if the Company owed more to creditors and it was unable to sell its assets for more than its liabilities. In this case it clearly does not matter which deal you invested in as both deal structures would result in a total loss of capital. We therefore now look at the entire spectrum of profitable exit possibilities and something interesting appears.

The point of this exercise is to make sure you do not rush to judgement when solely looking at valuation. While this is an important yardstick to measure in any deal, it is not the sole determiner of how much money can be made by the investor. In this example, we have proven that deal structure can trump valuation when the terms are adjusted. The lesson to remember here is that a deal should be measured by all of the terms taken together, not just one or two metrics like just valuation or percentage of stock owned at point of funding. Our concept here is to prove that Deal Valuation by itself is not a reason to invest or not invest in a deal.

It is also important to note that in most cases, creating business terms for a private placement should be kept as simple as possible to avoid interpretation conflicts. Also, we are not mandating these shares be structured as Preferred versus Common Shares. I have done deals both ways and have also used variations of these themes on dozens of private placements with success. While I typically have not used "benchmarks" to reward shareholders, it is possible to use them with success, provided you stay away from things like "Revenue Metrics" like Sales or Net Profits.

That is alright for a management contract if carefully crafted but with investors, the terms need to be even simpler and should have a good reason for granting special rights. In our scenario below, we cite that the higher valuation deal, must pay out 5M shares to the investors in this round if the company is not sold by the 37<sup>th</sup> month. This is pretty black and white; it is either sold or it is not. It provides an incentive for management to get liquidity faster. Which side does this clause benefit? Since after year three, both deals have ended up issuing 10M shares, have remarkably similar shares outstanding, and have identical liquidation preference rights, which one is better for management versus the investor? We use the same price per share starting at \$1.00 a share up to \$25.00 a share on the exit price. **Shoot Out Results-** It is noticeably clear the way we structured Deal One and Deal Two that except for bankruptcy where the investor loses some or all of their investment, we note that the deals end up splitting the answer. In the first three years the lower valuation pays out more to the shareholder, even without a dividend. However, look what happens in year four, when Deal One (\$34.4M valuation) is obligated to issue 5M shares because management did not feel, even by issuing the 5M shares, that it was in the best interest of either the shareholder or for management to sell in year three.

The company ends up selling in year six, and the \$200,000 investor ends up with a payout of \$2M higher on the higher valuation deal than the lower valuation deal of \$17.2M. Beware, our model shows the \$200,000 investor made \$9,249, 950 versus \$7,250,000 on payout. Both are outstanding returns, both issued 10M shares over time, and both paid out a two times liquidation preference but why did the higher valuation deal pay out so much more? The answer is the power of dividends of course, which even under Deal One, did not compound. They were issued with no interest. One might argue, well it is not a fair comparison. No, it is not, it was never intended to be. This exercise was intended to prove that *it is the combination of terms* that determines investor payouts, not simply just valuation. I have sold either one of these deals out in various deals throughout my career.

In fact, I have done so using terms of each one of these themes in this examples over the course of many decades. Getting a much lower valuation in this case (\$17.2M), a first priority two times return, and shares to sell in a disruptive model that comes with shares, it not a bad deal at all. It is really a convertible loan disguised as equity. The advantage is the rate of interest (if computed over any one of the years one through six, is significantly higher than any standard convertible bond or preferred share deal.

Understanding How to Use Financial Incentives to Protect the Entrepreneur- In the world of corporate finance we have several financial options that can be used to raise capital. It is important to maintain a positive open dialogue with your investors but it can be a thin line when it comes to negotiating a Term Sheet. It is therefore imperative you understand which math options (i.e., Incentive clauses, Liquidation Preferences, Formula Return Collars, Priority returns, and relative capital obligations) are not only at your disposal, but how they can be manipulated to produce different outcomes. Remember there are no fixed rules on how you can structure your deal.

As a general rule, the KISS (Keep it simple is always better), that does not mean you cannot play around with the terms. It is also well worth the effort to build an excel model that can provide "what if" scenarios so the risk/return profiles can be mathematically illustrated. Often a deal could have been made if a more refined method of finance were used to protect the investor or incentivize the Entrepreneur.

In order to close a deal, you have to create a win/win for each of the stakeholders and moreover, align the collective risk profiles to work together regardless of how the deal terminates. The challenge here is to protect all of your investors regardless of what round they might have invested in and to do so no matter what the outcome possibilities. In our summary deal used in this report, the Seed investors made \$25,000,000 dollars on an investment of \$250,000. Yes, I did it in my cellular deal but it was only 99 to 1. In summary, this means your investment offering has a reasonable chance of making them good money and a fair chance of making them a lot of money on their invested capital.

You further need to convince them that you have done your homework and have all the answers to how and why you can get your product to market, make a good margin, and then sell it at huge premium or in the alternate event, create large volume to create shareholder wealth.

If you and your partners/employees are lucky and smart enough and you can make a good case why your team is capable, your product is needed, the price point is right, you have some barriers to entry, may have filed for strong potential blocking patents, then you are just down to how much should one pay as an informed investor to get into your deal. Even better, should you stumble along the way and the deal turns out to be only marginal, you will make it up by providing a large priority return to the investors, thus giving them a great return if the company only performs marginally well.

A proper deal structure for the investor is when almost any outcome short of bankruptcy protects the investor. I have used each of the deal structures (Deal One and Two) will enormous success to raise capital successfully for over 30 years as well as many hybrid themes to get a deal done. It works and it works well if you understand it but it requires solid knowledge of how the pieces move together to protect all of the stakeholders, not just the investors over the Entrepreneur or vice versa.

There is nothing wrong with including protective language in your deal to protect the Entrepreneur's interest. Notice we did not say it has to come first, just that the rights of the Entrepreneur and his or her management team are just as important as any other stakeholder like a creditor or an investor. Our next financial blog will look at the fallacies inherent inside the Internal Rate of Return calculation, why it is a proven method of calculating returns, and where it can be flawed. We will also do a deep dive into "compounding dividends" and how the method used can produce vastly different outcomes.

Wishing your all the best on your next raise!

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