



Stanford eCorner

Understanding Early Valuations

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Venture capitalist Dana Mead lays out the basic math behind early-stage valuations. Using his experience focusing on life sciences companies, Mead explains the dynamics of equity stakes, dilution, management pools, and he also describes what early series money can do for a company.



Transcript

Let me tell you, there is no formula on how these values happen, right. So with a big company, a big company is buying another company, they are trying to value, they do discounted cash flow analysis to figure out valuation, our net present value to figure that out. You can't do that in our businesses. So in this example, we picked a pre-money of \$5 million. Now, how did we arrive at \$5 million? Well, it's kind of about the number that a very new venture with an unproven technology, many times they come in and they are valued in that anywhere between \$2 million and \$10 million range. So they've raised a \$1 million. They've done some good work. They've got some intellectual property. They have some good ideas on how they want to move forward. So let's pick that pre-money of \$5 million.

Let's just make this easy especially for me, it's \$1 a share. So the founders have \$5 million shares because that's the pre-money, a \$5 million. They are going to divide that up between what they keep and what they're going to put in a management pool and that equity will be used to track other talent to the company. And then Kleiner Perkins says that's great, you have a \$5 million valuation, you need \$5 million, we're going to put \$5 million in and buy 5 million shares, okay. So then the post money value would be \$10 million, right; \$5 million pre, \$5 million new money, \$10 million. And then the post money fully diluted ownership would be, Kleiner Perkins would own 50%, the founders would own 30% and the management pool would own 20%. So that's very similar to what most cap tables look like right after a Series A investment if you just have one investor going in the company. So let's go back to this. So, you've gotten that investment, your \$5 million, so normally what that gets you in a life science venture is kind of a first inhuman experience. So you take your technology, you club all together, it may not be your final technology, but you try it in a patient.

That's the first thing. Then you need to raise money again, the Series B round and what's your goal when you raise money the next time? Well, to have a higher valuation on the company, so that the new investor has to pay more for those shares. So they get fewer shares and it dilutes you less, right. The fewer shares you sell, the less dilution you get. So that's really the process you go through all the way through. And this would be a basic 5, 10k device venture, where you're probably going to raise \$50 million to \$60 million over the life of the venture from four to five venture capitalists over that time.