

Dictionary of Terms

Understanding and Maximizing the Value of Your Company in an Early Stage Financing

Financing Terms

- Fully Diluted Equity (aka “FDE”) is a calculation of the total division of economic interests in a Company and is usually expressed as the total number of shares of Common Stock issued or issuable under existing arrangements (often called “as-if-converted to Common stock basis”)

Fully Diluted Equity is calculated as:

- All outstanding shares of Common Stock +
- All shares of Common Stock issuable upon conversion of all Preferred Stock
- All shares of Common Stock issuable upon exercise of In-the-Money Warrants/Options
- All shares of Common Stock issuable upon the conversion of convertible debt

In most cases, Fully Diluted Equity will also include:

- Common Stock issuable upon exercise of Out-of-the-Money Warrants/Options; and/or
- Common Stock reserved for issuance under an existing OR PROPOSED Option Plan.

Note: the ratio of Common Stock to Preferred Stock usually begins at 1:1 but may adjust due to anti-dilution protection or common stock splits.

- Pre-Money Valuation – The Fair Market Value of the whole Company, before accounting for the influx of the new cash. Usually determined by a private negotiation between the Company and the investors.
- Pre-Money Valuation Per Share – The Pre-Money Valuation divided by the Fully Diluted Equity.
- In-the-Money options and warrants are those with an exercise price per share of Common Stock less than the current FMV per share of Common Stock (i.e., options with value)
- Out-of-the-Money options and warrants are those with an exercise price per share of Common Stock greater than the current FMV per share of Common Stock (i.e., ‘worthless’ options).
- Post-Money Valuation – The Pre-Money Valuation plus the gross amount of invested cash (there is typically no deduction for the deal expenses in thinking about this number).
- Up-Round – A financing in which the Pre-Money Valuation Per Share is greater than in the previous financing round.
- Down-Round – A financing in which the Pre-Money Valuation Per Share is less than in the previous financing round.
- Flat-Round – A financing in which the Pre-Money Valuation Per Share is the same as in the previous financing round. Note that if additional options or shares have been issued following the prior round (that were not included in the prior FDE calculation), then the Post Money Valuation Per Share of the prior round will not equal the Pre-Money Valuation Per Share in the current

round even where the Post Money Valuation of the old round equals the Pre-Money Valuation of the current round.

- Liquidity Event – The sale, merger, or IPO of a Company (or its assets) wherein the shareholders of the Company have a meaningful opportunity to sell their equity at the then prevailing fair market value.
- Discounted Cash Flow Valuation Methodology – Valuing a company by using the net present value of all future net cash flows, each discounted by an amount representing both the time value of money and the risk associated with the cash flow. An annuity based terminal value (calculated at a termination date, often 10 years) is added.
- Price / Equity (Book) Ratio – P/E or P/B is the ratio, for a public company, of the Company's book value to its market price. This ratio is useful in comparing how the markets value the free cash of mature companies with relatively stable operating histories. Because book value does not accurately measure brand and other intangible value, P/E or P/B is often based used with hard asset companies.
- Public Comparables – Valuing a private company by using the metrics from public companies (such as Price to Operating Margin or Price to Gross Margins) and applying those ratios to a private company with similar Operating Margins or Gross Margins.
- Transaction Comparables – Valuing a private company by comparing it to the value paid for a similarly situated target company by an acquirer. The range of targets is often weighted to reflect greater or lesser relationship to the Company being valued. In strategic (as opposed to financial) transactions the relative “synergy” value is also considered.
- Capital Efficiency – The ratio of capital expended to revenue (or value) produced. Capital efficiency may tell one something about Burn Rates and the time to profitability, but may not indicate the overall scalability of the business.

Accounting Terms

- Net Asset Value – The book value of the Company's assets after subtracting the book value of the Company's liabilities.
- Burn Rate – The (monthly) rate at which a Company is consuming cash (i.e., it is the average monthly rate of negative cash flow). Burn rate is typically only concerned with cash and not the consumption of other items of value held by the Company. Assets divided by Burn Rate gives one the ability to see when the Company will need to raise additional capital or cease operations.
- Revenue – The amount invoiced by the Company for sales, services and royalties. Usually this is reported after deducting discounts and does not include revenue collected by the Company that will be turned over to a third party. Revenue recognition rules are complicated and governed by FASB and AICPA.
- Cost of Goods Sold (COGS) – the direct costs of producing the goods sold or services provided (i.e., the revenue earned) by a Company, including the direct material cost, direct labor cost (to produce, not to develop the product), manufacturing and packaging. COGS usually excludes distribution, commissions, and research and development.

- Gross Profit (aka Gross Margin) – the cash amount derived by deducting COGS from Revenue.
- Gross Profit (Margin) Percentage – a percentage derived by dividing Gross Profit (Margin) by Revenue. Ex. A company with \$1 million in sales and COGS of \$600,000 would have a Gross Profit (Margin) Percentage of 40% ($\$1,000,000 - \$600,000 / \$1,000,000$).
- EBIT/EBITDA (Earnings Before Interest Taxes / Depreciation and Amortization) – The number obtained after deducting from Gross profit all of the costs of selling, general operating and administrative expenses, including research and development, and then adding back Interest and Taxes (and for EBITDA, the Depreciation and Amortization charges). The term “Earnings” is often used in a non- technical accounting sense to describe Net Income, EBIT or EBITDA.
- Operating Margin – The percentage derived by dividing EBIT by Revenue.
- Normalization – The process of adjusting (or “recasting”) historical financials and projections to reflect “normal” operations. Often used where a management team has been taking distributions from an LLC or Partnership, rather than market level salaries, or to eliminate large one-time items of revenue or expense.