Valuation: Understanding pre-money value and post-money value

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The terms "pre-money value" and "post-money value" arise regularly throughout the course of a venture investment, whether drafted into a term sheet, included in a capitalization table or brought up during discussions with company founders or investors.

Because these terms are so fundamental and ubiquitous, one should think carefully about what they mean, what they represent and how they impact financing.

What does "pre-money value" mean?

A company's pre-money value is simply the amount that an investor and the company agree to deem the company to be worth immediately prior to the investor's investment, for the purpose of determining how much the investor will pay per share for the stock it is purchasing.

> ***Example:*** BigVC is going to invest $2 million into GiantCo based on an $8 million pre-money valuation. The pre-money value is $8 million. This represents what BigVC and GiantCo have agreed GiantCo is worth at the moment immediately prior to BigVC's new investment.

How is pre-money value determined?

On each full moon that falls on the 29th day of February, a night rainbow will appear somewhere near Sand Hill Road and guide those who know to look for it toward an ethereal portal flanked by golden unicorns wearing VR headsets. Those who pass through that portal may briefly gaze upon a book, bound in banana leaves and shimmering in the moonlight, which lays out instructions for arriving at a pre-money valuation for a pre-revenue company.

For those of us who miss the above opportunity, it may be most useful to think of pre-money value as a negotiated number that is a proxy for the company's enterprise value at a given moment in time. That said, it is important to note that the number is often not derived from accounting measures such as revenue, free cash flow or EBITDA (especially in the case of early-stage companies that are pre-revenue, where this would be impossible). Rather, it is often highly negotiated, driven by market forces and inherently speculative.

What does post-money value mean?

A company's post-money value is simply the amount that a given pre-money value infers the company to be worth at the moment immediately following an investment. Thus, the post-money value is the sum of the pre-money value and the new money received in the financing.

> ***Example*:** Big VC is going to invest $2 million into GiantCo based on an $8 million pre-money valuation. The post-money value is $10 million. This equals the $8 million pre-money value *plus* the $2 million of new money that is in GiantCo's coffers immediately following BigVC's investment.

Which type of valuation is used more often?

Although either valuation approach can be derived from the other, we tend to see term sheets use pre-money value more often than post-money value. Occasionally, we'll see a term sheet that uses both pre-money value and post-money value. Occasionally, the use of the two terms will conflict. We recommend using only one, and sticking to pre-money, as it reduces the potential headaches that can arise if and when investment amounts fluctuate.

How does pre-money value impact the financing overall?

Pre-money value has the single biggest impact on the size of the investors' ownership stake in the company from their investment (and, as a result, what percentage of the company the existing stockholders will retain). This is so because the price per share (PPS) that an investor will pay for its stock is driven by the following formula:

PPS) = pre-money value / fully diluted capitalization

Setting aside for the moment fully-diluted capitalization (addressed here), because PPS and pre-money value are directly proportional (*i.e.*, as one goes up, the other goes up), the higher the pre-money value, the more an investor will pay per share for its investment, and thus the fewer shares the investor will receive for a given investment.

***Example 1*:** BigVC is going to invest $2 million into GiantCo based on an $8 million pre-money valuation. After the investment, BigVC will own 20 percent of GiantCo ($2 million equals 20 percent of GiantCo's $10 million post-money value).

***Example 2*:** BigVC is going to invest $2 million into GiantCo based on a $7 million pre-money valuation. After the investment, BigVC will own ~22 percent of GiantCo (BigVC's $2 million investment equals ~22 percent of GiantCo's $9 million post-money value).

Takeaway

The phrases *pre-money value* and *post-money value* are used throughout the venture investment process. These valuations also have the biggest impact on determining the percentage of a company an investor is going to acquire for a given investment, as well as the percentage of the company the existing stockholders will retain. Because of this, it is important that parties think carefully about what they mean when they are using these terms, what such terms represent to them and how the terms may support a given number.
