

Y-Combinator Guide To Seed Fundraising

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WHY RAISE MONEY?

Without startup funding the vast majority of startups will die. The amount of money needed to take a startup to profitability is usually well beyond the ability of founders and their friends and family to finance. A startup here means a company that is built to grow fast. High-growth companies almost always need to burn capital to sustain their growth before achieving profitability.

A few startup companies do successfully bootstrap (self-fund) themselves, but they are the exception. Of course, there are lots of great companies that aren't startups. Managing capital needs for such companies is not covered herein.

Cash not only allows startups to live and grow, a war chest is also almost always a competitive advantage in all ways that matter: hiring key staff, public relations, marketing, and sales. Thus, most startups will almost certainly want to raise money. The

good news is that there are lots of investors hoping to give the right startup money. The bad news is, “Fundraising is brutal”.

The process of raising that money is often long, arduous, complex, and ego-deflating. Nevertheless, it is a path almost all companies and founders must walk, but when is the time right to raise?

WHEN TO RAISE MONEY?

Investors write checks when the idea they hear is compelling when they are persuaded that the team of founders can realize its vision and that the opportunity described is real and sufficiently large. When founders are ready to tell this story, they can raise money. And usually, when you can raise money, you should.

For some founders, it is enough to have a story and a reputation. However, for most, it will require an idea, a product, and some amount of customer adoption, a.k.a. traction. Luckily, the software development ecosystem today is such that a sophisticated web or mobile product can be built and delivered in a remarkably short period at a meagre cost. Even hardware can be rapidly prototyped and tested.

But investors also need persuading. Usually, more than a product they can see, use, or touch is required. They will want to know that there is product market fit and that the product is experiencing actual growth.

Therefore, founders should raise money when they have figured out what the market opportunity is and who the customer is, and when they have delivered a product that matches their needs and is being adopted at an interestingly rapid rate. How rapid is interesting?

This depends, but a rate of 10% per week for several weeks is impressive. And to raise money founders need to impress. For founders who can convince investors without these things, congratulations. For everyone else, work on your product and talk to your users.

HOW MUCH TO RAISE?

Ideally, you should raise as much money as you need to reach profitability so that you’ll never have to raise money again. If you succeed in this, not only will you find it easier to

raise money in the future, you'll be able to survive without new funding if the funding environment gets tight.

That said, certain kinds of startups will need a follow-on round, such as those building hardware. Their goal should be to raise as much money as needed to get to their next “fundable” milestone, which will usually be 12 to 18 months later.

In choosing how much to raise you are trading off several variables, including how much progress that amount of money will purchase, credibility with investors, and dilution.

If you can manage to give up as little as 10% of your company in your seed round, that is wonderful, but most rounds will require up to 20% dilution and you should try to avoid more than 25%. In any event, the amount you are asking for must be tied to a believable plan. That plan will buy you the credibility necessary to persuade investors that their money will have a chance to grow. It is usually a good idea to create multiple plans assuming different amounts raised and to carefully articulate your belief that the company will be successful whether you raise the full or some lesser amount. The difference will be how fast you can grow.

One way to look at the optimal amount to raise in your first round is to decide how many months of operation you want to fund. A rule of thumb is that an engineer (the most common early employee for Silicon Valley startups) costs all-in about \$15k per month. So, if you want to be funded for 18 months of operations with an average of five engineers, you will need about $15k \times 5 \times 18 = \1.35mm .

What if you are planning to hire for other positions as well? Don't worry about it! This is just an estimate and will be accurate enough for whatever mix you hire. And here you have a great answer to the question: “How much are you raising?” Simply answer that you are raising for N months (usually 12-18) and will thus need \$X, where X will usually be between \$500k and \$1.5 million. As noted above, you should give multiple versions of N and a range for X, giving different possible growth scenarios based on how much you successfully raise.

There is enormous variation in the amount of money raised by companies. Here we are concerned with early raises, which usually range from a few hundreds of thousands of dollars up to two million dollars. Most first rounds seem to cluster around six hundred

thousand dollars, but largely thanks to increased interest from investors in seed, these rounds have been increasing in size over the last several years.

FINANCING OPTIONS

Startup founders must understand the basic concepts behind venture financing. It would be nice if this was all very simple and could be explained in a single paragraph.

Unfortunately, as with most legal matters, that's not possible. Here is a very high-level summary, but it is worth your time to read more about the details and pros and cons of various types of financing and, importantly, the key terms of such deals that you need to be aware of, from preferences to option pools. The articles below are a decent start.

Venture financing usually takes place in “rounds,” which have traditionally had names and a specific order. First comes a seed round, then a Series A, then a Series B, then a Series C, and so on to acquisition or IPO. None of these rounds are required and, for example, sometimes companies will start with a Series A financing (almost always an “equity round” as defined below). Recall that we are focusing here exclusively on seed, that very first venture round.

Most seed rounds, at least in Silicon Valley, are now structured as either convertible debt or simple agreements for future equity (safes). Some early rounds are still done with equity, but in Silicon Valley, they are now the exception.

CONVERTIBLE DEBT

Convertible debt is a loan an investor makes to a company using an instrument called a convertible note. That loan will have a principal amount (the amount of the investment), an interest rate (usually a minimum rate of 2% or so), and a maturity date (when the principal and interest must be repaid). This note intends that it converts to equity (thus, “convertible”) when the company does equity financing. These notes will also usually have a “Cap” or “Target Valuation” and/or a discount. A Cap is the maximum effective valuation that the owner of the note will pay, regardless of the valuation of the round in which the note converts. The effect of the cap is that convertible note investors usually pay a lower price per share compared to other investors in the equity round. Similarly, a discount defines a lower effective valuation via a percentage off the round valuation. Investors see these as their seed “premium” and both of these terms are negotiable.

Convertible debt may be called at maturity, at which time it must be repaid with earned interest, although investors are often willing to extend the maturity dates on notes.

SAFE (Simple Agreement For Future Equity)

Convertible debt has been almost completely replaced by the safe at YC and Imagine K12. A safe acts like convertible debt without the interest rate, maturity, and repayment requirement. The negotiable terms of a safe will almost always be simply the amount, the cap, and the discount, if any. There is a bit more complexity to any convertible security, and much of that is driven by what happens when conversion occurs. I strongly encourage you to read the safe primer 18, which is available on YC's site. The primer has several examples of what happens when a safe converts, which go a long way toward explaining how both convertible debt and safes work in practice.

EQUITY

An equity round means setting a valuation for your company (generally, the cap on the safes or notes is considered as a company's notional valuation, although notes and safes can also be uncapped) and thus a per-share price, and then issuing and selling new shares of the company to investors. This is always more complicated, expensive, and time-consuming than a safe or convertible note which explains its popularity for early rounds. It is also why you will always want to hire a lawyer when planning to issue equity.

To understand what happens when new equity is issued, a simple example helps. Say you raise \$1,000,000 on a \$5,000,000 pre-money valuation. If you also have 10,000,000 shares outstanding then you are selling the shares at

1. $\$5,000,000 / 10,000,000 = 50$ cents per share
and you will thus sell...
2. 2,000,000 shares
resulting in a new share total of...
3. $10,000,000 + 2,000,000 = 12,000,000$ shares
and a post-money valuation of...

4. $\$0.50 * 12,000,000 = \$6,000,000$
and dilution of...

5. $2,000,000 / 12,000,000 = 16.7\%$
Not 20%!

There are several important components of an equity round with which you must become familiar when your company does a priced round, including equity incentive plans (option pools), liquidation preferences, anti-dilution rights, protective provisions, and more. These components are all negotiable, but it is usually the case that if you have agreed upon a valuation with your investors (next section), then you are not too far apart, and there is a deal to be done. I won't say more about equity rounds, since they are so uncommon for seed rounds.

One final note: whatever form of financing you do, it is always best to use well-known financing documents like YC's Safe. These documents are well understood by the investor community and have been drafted to be fair, yet founder-friendly.

VALUATION: WHAT IS MY COMPANY WORTH?

You are two hackers with an idea, a few months of hacking's worth of software, and several thousand users. What is your company worth? It should be obvious that no formula will give you an answer. There can only be the most notional sort of justification for any value at all. So, how do you set a value when talking to a potential investor? Why do some companies seem to be worth \$20mm and some \$4mm? Because investors were convinced that was what they were (or will be shortly) worth.

It is that simple. Therefore, it is best to let the market set your price and to find an investor to set the price or cap. The more investor interest your company generates, the higher your value will trend.

Still, it can be difficult in some circumstances to find an investor to tell you what you are worth. In this case, you can choose a valuation, usually by looking at comparable companies that have valuations. Please remember that the important thing in choosing your valuation is not to over-optimize. The objective is to find a valuation with which you are comfortable, that will allow you to raise the amount you need to achieve your

goals with acceptable dilution, and that investors will find reasonable and attractive enough to write you a check. Seed valuations tend to range from \$2mm-\$10mm, but keep in mind that the goal is not to achieve the best valuation, nor does a high valuation increase your likelihood of success.

INVESTORS: ANGELS & VENTURE CAPITALISTS

The difference between an angel and a VC is that angels are amateurs and VCs are pros. VCs invest other people's money and angels invest their own on their terms. Although some angels are quite rigorous and act very much like the pros, for the most part, they are much more like hobbyists. Their decision-making process is usually much faster--they can make the call all on their own--and there is almost always a much larger component of emotion that goes into that decision.

VCs will usually require more time, and more meetings, and will have multiple partners involved in the final decision. And remember, VCs see LOTS of deals and invest in very few, so you will have to stand out from the crowd.

The ecosystem for seed (early) financing is far more complex now than it was even five years ago. There are many new VC firms, sometimes called "super-angels," or "micro-VCs", which explicitly target brand-new, very early-stage companies. Several traditional VCs will invest in seed rounds. And there are a large number of independent angels who will invest anywhere from \$25k to \$100k or more in individual companies. New fundraising options have also arisen. For example, AngelList Syndicates lets angels pool their resources and follow a single lead angel. FundersClub invests selectively like a traditional VC but lets angels become LPs in their VC funds to expand the connections available to its founders.

How does one meet and encourage the interest of investors?

If you are about to present at a demo day, you are going to meet lots of investors. There are few such opportunities to meet a concentrated and motivated group of seed investors. Besides a demo day, by far the best way to meet a venture capitalist or an angel is via a warm introduction. Angels will also often introduce interesting companies to their networks. Otherwise, find someone in your network to make an introduction to an angel or VC. If you have no other options, research VCs and angels and send as many as you

can a brief, but compelling summary of your business and opportunity (see Documents You Need below).

CROWDFUNDING

There are a growing number of new vehicles to raise money, such as AngelList, Kickstarter, and Wefunder. These crowdfunding sites can be used to launch a product, run a pre-sales campaign, or find venture funding. In exceptional cases, founders have used these sites as their dominant fundraising source, or as clear evidence of demand. They usually are used to fill in rounds that are largely complete or, at times, to reanimate a round that is having difficulty getting off the ground. The ecosystem around investing is changing rapidly, but when and how to use these new sources of funds will usually be determined by your success raising through more traditional means.

MEETING INVESTORS

If you are meeting investors on an investor day, remember that your goal is not to close--it is to get the next meeting. Investors will seldom choose to commit the first day they hear your pitch, regardless of how brilliant it is. So book lots of meetings. Keep in mind that the hardest part is to get the first money in the company. In other words, meet as many investors as possible but focus on those most likely to close. Always optimize for getting money soonest (in other words, be greedy) 2.

There are a few simple rules to follow when preparing to meet with investors. First, make sure you know your audience--research what they like to invest in and try to figure out why. Second, simplify your pitch to the essential--why this is a great product (demos are almost a requirement nowadays), why you are precisely the right team to build it, and why together you should all dream about creating the next gigantic company. Next, make sure you listen carefully to what the investor has to say. If you can get the investor to talk more than you, your probability of a deal skyrockets. In the same vein, do what you can to connect with the investor. This is one of the main reasons to do research. An investment in a company is a long-term commitment and most investors see lots of deals. Unless they like you and feel connected to your outcome, they will most certainly not write a check.

Who you are and how well you tell your story are most important when trying to convince investors to write that check. Investors are looking for compelling founders who

have a believable dream and as much evidence as possible documenting the reality of that dream. Find a style that works for you, and then work as hard as necessary to get the pitch perfect. Pitching is difficult and often unnatural for founders, especially technical founders who are more comfortable in front of a screen than in a crowd. But anyone will improve with practice, and there is no substitute for an extraordinary amount of practice. Incidentally, this is true whether you are preparing for a demo day or an investor meeting.

During your meeting, try to strike a balance between confidence and humility. Never cross over into arrogance, avoid defensiveness, but also don't be a pushover. Be open to intelligent counterpoints, but stand up for what you believe and whether or not you persuade the investor just then, you'll have made a good impression and will probably get another shot.

Lastly, make sure you don't leave an investor meeting without an attempted close or at the very minimum absolute clarity on the next steps. Do not just walk out leaving things ambiguous.

NEGOTIATING AND CLOSING THE DEAL

A seed investment can usually be closed rapidly. As noted above, it is an advantage to use standard documents with consistent terms, such as YC's safe. Negotiation, and often there is none at all, can then proceed on one or two variables, such as the valuation/cap and possibly a discount.

Deals have momentum and there is no recipe towards building momentum behind your deal other than by telling a great story, persistence, and legwork. You may have to meet with dozens of investors before you get that close. But to get started you just need to convince 5 one of them. Once the first money is in, each subsequent close will get faster and easier 6.

Once an investor says that they are in, you are almost done. This is where you should rapidly close using a handshake protocol 19. If you fail at negotiating from this point on, it is probably your fault.

NEGOTIATIONS

When you enter into a negotiation with a VC or an angel, remember that they are usually more experienced at it than you are, so it is almost always better not to try to negotiate in real-time. Take requests away with you, and get help from YC or Imagine K12 partners, advisors, or legal counsel. But also remember that although certain requested terms can be egregious, the majority of things credible VCs and angels will ask for tend to be reasonable. Do not hesitate to ask them to explain precisely what they are asking for and why. If the negotiation is around valuation (or cap) there are, naturally, plenty of considerations, e.g. other deals you have already closed.

However, it is important to remember that the valuation you choose at this early round will seldom matter to the success or failure of the company. Get the best deal you can get--but get the deal! Finally, once you get to yes, don't wait around. Get the investor's signature and cash as soon as possible. One reason safes are popular is because the closing mechanics are as simple as signing a document and then transferring funds. Once an investor has decided to invest, it should take no longer than a few minutes to exchange signed documents online (for example via Clerky or Ironclad) and execute a wire or send a check.

DOCUMENTS YOU NEED

Do not spend too much time developing diligence documents for a seed round. If an investor is asking for too much due diligence or financials, they are almost certainly someone to avoid. You will probably want an executive summary and a slide deck you can walk investors through and, potentially, leave behind so VCs can show to other partners.

The executive summary should be one or two pages (one is better) and should include vision, product, team (location, contact info), traction, market size, and minimum financials (revenue, if any, and fundraising prior and current).

Generally, make sure the slide deck is a coherent leave-behind. Graphics, charts, and screenshots are more powerful than lots of words. Consider it a framework around which you will hang a more detailed version of your story. There is no fixed format or order, but the following parts are usually present. Create the pitch that matches you, how you present, and how you want to represent your company. Also note that like the executive summary, there are lots of similar templates online if you don't like this one.

1. Your company / Logo / Tag Line
2. Your Vision - Your most expansive take on why your new company exists.
3. The Problem - What are you solving for the customer--where is their pain?
4. The Customer - Who are they and perhaps how will you reach them?
5. The Solution - What you have created and why now is the right time.
6. The (huge) Market you are addressing - Total Available Market (TAM) >\$1B if possible. Include the most persuasive evidence you have that this is real.
7. Market Landscape - including competition, macro trends, etc. Is there any insight you have that others do not?
8. Current Traction - list key stats/plans for scaling and future customer acquisition.
9. Business model - how users translate to revenue. Actuals, plans, hopes.
10. Team - who you are, where you come from and why you have what it takes to succeed. Pics and bios okay. Specify roles.
11. Summary - 3-5 key takeaways (market size, key product insight, traction)
12. Fundraising - Include what you have already raised and what you are planning to raise now. Any financial projections may go here as well. You can optionally include a summary product roadmap (6 quarters max) indicating what an investment buys.

NEXT

It is worth pointing out that startup investing is rapidly evolving and it is likely that certain elements of this guide will at some point become obsolete, so make sure to check for updates or future posts. There is now an extraordinary amount of information

available on raising venture money. Several sources are referenced and more are listed at the end of this document.

Fundraising is a necessary, and sometimes painful task most startups must periodically endure. A founder's goal should always be to raise as quickly as possible and this guide will hopefully help founders successfully raise their first round of venture financing. Often that will seem like a nearly impossible task and when it is complete, it will feel as though you have climbed a very steep mountain. But you have been distracted by the brutality of fundraising and once you turn your attention back to the future you will realize it was only a small foothill on the real climb in front of you. It is time to get back to work building your company.

Many thanks to those whose knowledge or work has contributed to this document. Of course, any errors are all mine. Please send any comments or questions to (redacted).

Fundraising Rules to Follow

- Get fundraising over as soon as possible, and get back to building your product and company, but also...
- Don't stop raising money too soon. If fundraising is difficult, keep fighting and stay alive.
- When raising, be "greedy": breadth-first search weighted by expected value 2. This means talking to as many people as you can, prioritizing the ones that are likely to close.
- Once someone says yes, don't delay. Get docs signed and the money in the bank as soon as possible.
- Always hustle for leads. If you are the hottest deal of the hour, that's great, but everyone else needs to work like crazy to get angels and other venture investors interested.
- Never screw anyone over. Hold yourself and others on your team to the highest ethical standards. The Valley is a very small place, and a bad reputation is difficult to repair. Play it straight and you will never regret it. You'll feel better for it, too.
- Investors have a lot of different ways to say no. The hardest thing for an entrepreneur is understanding when they are being turned down and being okay with it. PG likes to say, "If the soda is empty, stop making that awful sucking sound with the straw." But remember that they might be a "yes" another time, so part on the best possible terms.

- Develop a style that fits you and your company.
- Stay organized. Co-founders should split tasks where possible. If necessary, use software like Asana to keep track of deals.
- Have a thick skin but strike the right balance between confidence and humility. And never be arrogant.

What Not to Do While Communicating with Investors

DON'T:

- Be dishonest in any way
- Be arrogant or unfriendly
- Be overly aggressive
- Seem indecisive - although it is okay to say you don't know yet.
- Talk so much they cannot get a word in edgewise
- Be slow to follow up or close a deal
- Break an agreement, verbal or written
- Create detailed financials
- Use ridiculous/silly market size numbers without clear justification
- Claim you know something that you don't or be afraid to say you don't know
- Spend time on the obvious
- Get caught up in unimportant minutiae - don't let the meeting get away from you
- Ask for an NDA
- Try to play investors off each other when you are not a fundraising ninja
- Try to negotiate in real-time
- Over-optimize your valuation or worry too much about dilution
- Take a "No" personally

A Brief Glossary of Key Terms

The term you are looking for is not here? Disagree with the definition? Go to Investopedia for a more authoritative source.


- **Angel Investor** - A (usually) wealthy private investor in startup companies.
- **Cap / Target Valuation** - The maximum effective valuation for an investor in a convertible note.

- **Convertible Note** - This is a debt instrument that will convert into stock; usually preferred stock but sometimes common stock.
- **Common Stock** - Capital stock typically issued to founders and employees, having the fewest, or no, rights, privileges and preferences.
- **Dilution** - The percentage of an ownership share is decreased via the issuance of new shares.
- **Discount** - A percentage discount from the pre-money valuation to give safe or note holders an effectively lower price.
- **Equity Round** - A financing round in which the investor purchases equity (stock) in the company.
- **Fully Diluted Shares** - The total number of issued and outstanding shares of capital stock in the company, including outstanding warrants, option grants and other convertible securities.
- **IPO** - Initial Public Offering - the first sale of stock by a private company to the public.
- **Lead Investor** - Usually the first and largest investor in a round who brings others into the round.
- **Liquidation Preference** - A legal provision in a company's charter that allows stockholders with preferred stock to get their money out of a company before the holders of common stock in the event of an exit.
- **Maturity Date** - The date at which a promissory note becomes due (or at which it will automatically convert to stock in the case of a convertible note)
- **Equity Incentive Plan / Option Pool** - The shares allocated and set aside for grants to employees and consultants.
- **Preferred Stock** - Capital stock issued in a company that have specific rights, privileges and preferences compared to the common stock. Convertible into common stock, either automatically (e.g., in an IPO) or at the option of the preferred stockholder (e.g., an acquisition).
- **Pre-money Valuation** - The value of a company prior to when investor money is added.
- **Pro-rata rights (aka pre-emptive rights)** - Contractual rights that allow the holder to maintain their percentage ownership in subsequent financing rounds.
- **Protective Provisions** - Provisions in a company's charter that give exclusive voting rights to holders of preferred stock. For example, the approval of these stockholders, voting separately from other stockholders, may be required for an acquisition.

- **Safe** - Simple Agreement for Future Equity - Y Combinator's replacement for convertible debt.
- **TAM** - Total Available Market. In pitches, this is the estimated total revenue available for the product(s) you are selling.
- **Venture Capitalist** - A professional investor in companies, investing limited partners' funds.

RESOURCES

1. [A Fundraising Survival Guide](#), Paul Graham
2. [How To Raise Money](#), Paul Graham
3. [The Equity Equation](#), Paul Graham
4. [The Future of Startup Funding](#), Paul Graham
5. [How to Convince Investors](#), Paul Graham,
6. [Investor Herd Dynamics](#), Paul Graham
7. [“Venture Deals”](#), Feld and Mendelson
8. [Raising Money for a Startup](#), Sal Khan
9. [Venture Hacks: Debt or Equity](#), Babak Nivi
10. [Venture Hacks: First Time](#), Babak Nivi
11. [How Much Money To Raise](#), Fred Wilson
12. [“Startup = Growth”](#), Paul Graham
13. [Venture Hacks / Babk Nivi: Should I Raise Debt or Equity](#)
14. [Fred Wilson: Financing Options](#)
15. [Mark Suster on Convertible Debt](#)
16. [Clerky Guide](#)
17. [Announcing the Safe](#), Paul Graham
18. [The Safe Primer](#),Carolynn Levy
19. [The Handshake Deal Protocol](#), Paul Graham

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