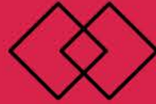

THE BIG BOOK OF PRE-IPO PROFITS

How to find, fund, and profit from pre-IPO startups — just like a venture capitalist.

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PART 1: THE FOUNDATION

INTRODUCTION

Welcome to ***The Big Book of Pre-IPO Profits***.

In this easy-to-read book, you'll learn how to find, fund, and profit from early-stage startups, just like a professional venture capitalist. Even better, you can get started in this market with just a few hundred dollars.

Perhaps this is your first step into the world of startup investing. As you're about to learn, being an early-stage investor isn't just exciting — it can also have a big impact.

First of all, startup investors are essential to helping world-changing companies get started. Without these early investors, companies like Apple, Google, and Amgen wouldn't exist, and our lives would look vastly different.

But just as important to you, startup investors can make a fortune. The way they make their profits is straightforward: they invest in tiny private companies when their shares are still dirt cheap. his is well before these startups go public in an Initial Public Offering (IPO). That's why they're called pre-IPO startups. And when these companies start trading in the stock market, their early investors can cash out.

For example, as of 2021, Uber's first startup investors were sitting on estimated profits of 8,000x their money. Facebook's earliest startup investor made $1 billion when the company went public. And Airbnb's first startup investors made an estimated 100,000x their money. Investments like these could change your life overnight.

But let's forget about those extreme examples for a moment. Instead, let's look at the long-term averages. According to Cambridge Analytics, an advisor to institutions like The Rockefeller Foundation, Harvard University, and the Bill Gates Family Office, over the past twenty-five years or so, investing in startups has returned fifty-five percent per year.

Here's how to put that number in perspective:

If you could earn fifty-five percent each year on a portfolio of startups, $5,000 would turn into $400,000 in ten years. Meanwhile, if you invested $5,000 into the stock market for ten years and earned the average returns for stocks, your money would grow to just $10,000.

In fact, a shift has happened over the past few decades: the biggest financial returns have moved from public stocks to private startups. We'll show you what we mean later in the book, with the Story of the Burning Match.

But the returns aren't the only reason that pre-IPO investing is so powerful:

- For starters, investing in pre-IPO startups provides diversification away from the stock market. In fact, even if the market crashes, startups can keep growing in value.
- Startups also offer a hedge against inflation. With inflation currently at multi-decade highs, that's a valuable trick.
- Furthermore, great companies can get started even during the bleakest of times. For example, Disney was founded during the Great Depression of 1929. Microsoft was founded in 1975, while U.S. GDP was taking its worst hit in nearly two decades. And Airbnb was founded during the Great Recession of 2008.

But investing in pre-IPO startups can be risky. If you don't have the right knowledge, it's likely that you'll invest in the wrong deals and lose your shirt.

But it doesn't have to be that way. The professionals in this market use a time-tested investment process. Some of them have been using it successfully for more than fifty years. This process helps them minimize risk and maximize returns. This is how they're able to earn annual returns of fifty-five percent.

So when we set out to create this book (as well as its interactive version, ***The Early-Stage Playbook***, which you can read about in this book's Appendix), we made it our mission to learn about this process.

We reached into our network and secured interviews with dozens of professional pre-IPO investors. Such investors are called venture capitalists or angel investors. And over time, they shared their proven strategies with us for finding and profiting from the most promising early-stage startups.

Our book and online program are the only ways to find all this information in a single place. In this book, for example, we'll show you how a group of college professors used this playbook to turn $70,000 into $355 million. We'll also show you how a chess player turned $500,000 into $1 billion. In addition, we'll introduce you to one of our business partners — a gentleman who, in just three years, turned what probably amounts to a monthly paycheck for you into far more than a million dollars.

But those are extreme examples. And we don't need to earn returns like that to be successful early-stage investors. While we're always excited to swing for the fences, we're more focused on the singles and doubles that can help us earn market-beating returns.

But perhaps you're wondering something. Maybe you're wondering if venture capitalists are able to earn such enormous returns because they're financial masterminds, or as brilliant as rocket scientists.

But that's simply not the case. Don't get us wrong. Many of them are smart. But they're no more intelligent than you are. They don't have PhDs in finance or computer science. In fact, one of the most successful VCs we know was an English major in college.

So don't worry if you're not a technology guru or a financial wizard. By the time you get through this book, you'll see that investing in startups is straightforward. It's certainly more straightforward than trading options, or digging into a company's SEC filings.

All you need is some common sense, and the discipline to apply the step-by-step playbook you'll learn about in ***The Big Book of Pre-IPO Profits***.

We have a simple objective with this book:

To show you how to be a successful early-stage investor.

By the time you reach the end of Chapter 12, you'll know how to do three things:

1. Find and get access to thousands of early-stage deals.
2. Quickly filter out the ones that aren't worth your time.
3. Dig into and invest in the ones that are worth your time.

But before we go any further, we should make one thing clear. We have no financial relationship with any of the startups or investment platforms that you'll learn about in the book. None. It's as simple as that.

Instead, we make our living by providing education and investment research that's entirely independent. You can read more about what we do in this book's Appendix, or by visiting our website at Crowdability.com.

Now let's take a deeper look at what you'll learn in this book.

We broke up ***The Big Book of Pre-IPO Profits*** into three parts.

The first part is foundational. This is where you'll learn about the basic concepts of private equity and early-stage investing.

The second part is about strategy and tactics. In particular, you'll learn the time-tested framework used by professional venture capitalists. We call it the ASE Process. ASE is an acronym. It stands for Allocate, Screen, and Evaluate. This is a simple three-step process for finding, filtering, and hopefully profiting from pre-IPO startups.

The third part is about taking everything you've learned, and applying it to real-world investing.

Then, to wrap things up, we'll explain exactly how to make a startup investment, we'll review what happens after you invest, and best of all, we'll show you how you'll get paid when one of your investments is a winner.

Ready to dive in? Let's get started.

CHAPTER 1

EARLY-STAGE BASICS

To kick things off, let's look at what you'll learn in this initial chapter.

First, we'll explain what we mean by private equity. Specifically, we'll show you what it means to invest in private startups, and we'll explain how it's different from investing in the public stock market.

Then we'll give you the quick history of startup investing, and tell you about the professionals investors in this market who are called venture capitalists.

After that, we'll show you how the biggest financial returns have shifted from public stocks to private startups, and tell you the Story of the Burning Match.

And finally, we'll introduce you to "equity crowdfunding." Equity crowdfunding is a new type of venture capital. This is what lets Main Street investors like you invest small amounts of capital — $50 here, $100 or $200 there — into private startups.

To start, let us explain what we mean by private equity, and describe how it's different from public equity, which is what the stock market offers.

When we talk about investing in early-stage startups, we're talking about investing in private businesses. But what do we mean by private? Simply put, we mean any company not listed on a public stock exchange like the NYSE or the Nasdaq.

Companies like Ford, Facebook, and Google are all listed on a stock exchange. They're publicly traded. That means they have ticker symbols (F, FB, and GOOG, respectively), are regulated by the U.S. Securities and Exchange Commission, and can be bought and sold by any investor during market hours.

They became publicly traded by going through an Initial Public Offering, or IPO. In the IPO process, an investment bank like Goldman Sachs or J.P. Morgan helps a company raise a large sum of money by selling a stake in the business to institutional investment funds and countless individuals like you.

Once a company is public, new investors can buy and sell its shares. But prior to its IPO, its shares are privately held. The only people who own shares are the company's founders and employees, and sometimes, pre-IPO investors.

When a startup is private, it doesn't have a ticker symbol, and it doesn't have all the SEC filing requirements of a publicly traded company. Furthermore, until recently, only wealthy people who had a direct relationship with the startup were permitted to own shares.

For example, when Facebook was still a small, private startup, it needed some seed capital to help it grow. It received that capital from a wealthy investor named Peter Thiel.

Thiel is an accredited investor. That means he has a net worth of at least $1 million, or that he earns more than $200,000 per year. Being accredited gave him the legal right to invest in private startups. Furthermore, he had a pre-existing relationship with Facebook's founders.

These requirements about being accredited and having a pre-existing relationship were put in place by the Security Exchange Commission in the 1930s. The SEC was founded by Joseph P. Kennedy, the father of John F. Kennedy, Bobby Kennedy, and Ted Kennedy.

Joe Kennedy helped create the laws that govern the stock market, including the 1934 Securities & Exchange Act. This law was meant to protect the public from charlatans peddling deals that were too good to be true. Such deals were everywhere after the stock market crash of 1929.

But sadly, this law did something else. For 82 years, it prevented ordinary people from investing in and profiting from pre-IPO deals.

But now, because of a new set of laws called The JOBS Act, the rules have changed.

We'll explain the new rules in a moment. But simply put, this is what finally allows Main Street investors like you to invest in private startups. And that's what this book is all about: learning how to invest in these startups successfully.

Your timing is very good here. The investment opportunities created by this new set of laws have been around long enough now that they've been battle-tested. In fact, you'll learn about a few of this sector's success stories in this book. Furthermore, as you'll learn later in this chapter, the biggest returns in the market have recently shifted — from the stock market to the private market. But most Main Street investors still haven't heard about or taken advantage of The JOBS Act or equity crowdfunding. You're ahead of the curve.

Now that you know what you'll be learning about in this book, let us tell you a few quick stories about the birth of startup investing.

Not so long ago, for example, the region we now call Silicon Valley was known for its fruit. It was a scenic part of San Jose, California, covered with fragrant orange groves.

But in 1957, a group of engineers started one of the first venture-backed startups. It was called Fairchild Semiconductor. At the time, most electronics used semiconductors made from a chemical element called germanium. But the executives from Fairchild proposed using something that was more cost-efficient — a material called silicon.

After setting up shop in Mountain View, California, they went to work building their new transistors. And before long, they had 12,000 employees and were bringing in more than $100 million in revenues.

Then, based on the success of Fairchild, a bunch of other transistor companies set up shop right around the corner. These companies used silicon, too. And ever since, the area has been called Silicon Valley.

These technology companies were born in the Valley. But the venture capitalists (VCs) who funded them were from the East Coast. More specifically, the venture capital industry was born in Cambridge, Massachusetts.

The first venture firm was founded in 1946 by Georges Doriot. It was called American Research & Development Corporation, or ARDC for short. Doriot was a business school professor, and he established ARDC to provide capital to soldiers returning from World War II, so they could set up their own businesses.

In its twenty-five years of existence, ARDC invested in more than 150 startups. One of its first success stories was its $70,000 investment in Digital Equipment Corporation. That single investment ultimately became worth $355 million.

Venture capital firms are instrumental to startups. Without specialized funds that are dedicated to investing in high-risk, high-potential opportunities, the world wouldn't be where it is today.

You see, entrepreneurs in risky industries like technology, healthcare, and biotech don't have the luxury of walking into a bank and applying for a loan. For one thing, loan officers at commercial banks don't understand these types of businesses. For another, such enterprises are speculative. You wouldn't want your bank using funds from your savings account to bet on a high-risk biotech company.

Therefore, specialized investment funds run by managers with specific expertise are essential. These funds help companies in high-technology industries get started and thrive.

Now that the venture industry has had more than seventy-five years to evolve, it's become sophisticated and very large. For example, according to Dealroom, a venture analysis firm, in 2021, venture funds invested more than $675 billion into startups worldwide.

Some venture funds focus on specific sectors. For example, a fund called Union Square Ventures only invests in software companies, while a fund called OrbiMed focuses on healthcare.

Other types of funds concentrate on companies at certain stages of development. For example, Kleiner Perkins mainly invests in later-stage startups that are generating millions of dollars in revenue. These are called growth-stage VCs.

At the other end of the spectrum, certain funds only invest in companies at their earliest stages. These are called seed-stage funds. They provide the initial seed capital that helps a company get off the ground.

Over the last ten years or so, the market for providing seed capital has become increasingly popular. The reason why is simple. Investors figured out that the financial returns from seed-stage investing can be enormous.

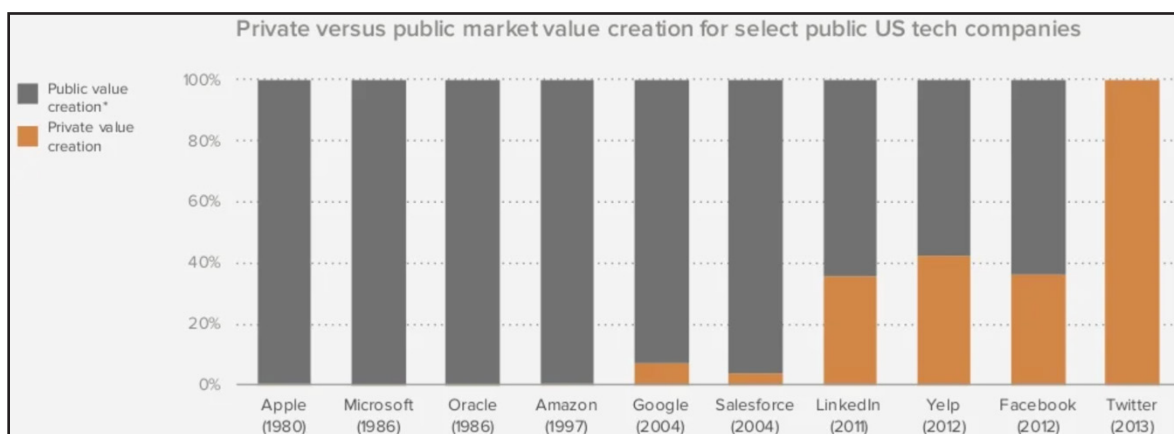
But there's also another reason this has grown so much. Nowadays, hundreds of low-cost or even free technologies exist to help startups get off the ground. Twenty years ago, before all these services existed, a startup would need at least $1 million to get its business launched. But today, a company can get started for as little as $100,000, and sometimes even less.

This means, for the first time ever, startups in need of seed capital can bypass professional venture capitalists. Instead, they can go directly to individuals like you. Individual startup investors are known as angel investors. Angels invest anywhere from a few hundred dollars to a few hundred thousand dollars into various deals.

A study from the Center for Venture Research at the University of New Hampshire found that, in 2020, angels invested about $25 billion into startups.

There are two main reasons that angels invest so much capital into this market. First of all, it's because they enjoy it. As you'll learn in this book, being an angel can be incredibly exciting. And secondly, if they build their portfolios the right way (in other words, if they use a system like the one you'll learn about in this book), they can potentially earn returns that vastly exceed what they could earn in the stock market.

In fact, many investors have woken up to the fact that a shift has happened over the past few decades: the biggest financial returns have moved from the public stock market to the private startup market. To show you what we mean, take a look at this chart:



This data comes from CapitalIQ, the research division of S&P Global, one of the world's largest providers of data and research.

The grey part of each bar chart reflects the profits captured by stock market investors. And the orange part shows the profits captured by private investors. As you can see, for many years, public investors reaped the lion's share of returns. For example, look at Microsoft (NASDAQ: MSFT). It's all grey. That means that stock market investors captured nearly all of the investment returns the company delivered. And it's the same thing for stock market investors in companies like Apple, Oracle, and Amazon.

But look what happened after 2004. You can see it in the orange bars. Beginning with Google, early private investors started capturing a big chunk of the gains. And by the time Twitter went public in 2013, private investors were capturing nearly all of the gains.

This explains why Jason DeSena Trennert, managing partner at Strategas Research Partners, a markets and economic analysis firm, has a warning for investors like you who might be interested in investing in IPOs: "Individual investors are going to get in too late. They're going to be the last investors in..."

For example, look what happened recently with the transportation company, Lyft (Nasdaq: LYFT.) Lyft's IPO was one of the most anticipated financial events in recent history. It was expected to make many investors very rich. Its IPO was priced at $72. So if you ran a big investment fund on Wall Street, you got your shares at $72 each. But if you were an ordinary investor, you couldn't buy shares at $72. You had to wait until they hit $85.

Unfortunately, about a week after Lyft's IPO, its shares were trading for about $68. So if you bought Lyft at the IPO, it cost you about 20% of your investment. Meanwhile, as of early 2022, Lyft shares were trading for less than $40. So investors in the IPO had lost more than half their investment.

But a different set of investors made a fortune from Lyft's IPO. Specifically, investors who got into Lyft when it was just a tiny private startup made an estimated 3,000x their money when the company went public. As ***The New York Times*** reported: "Lyft's I.P.O. was a huge success, just not for investors who bought on Friday."

Which brings us to the Story of the Burning Match. This story illustrates what we've just described: how the biggest financial returns have moved from the public stock market to the private startup market. Here it is:

Imagine you're at a party, standing in a circle with five people. The person to your right strikes a match. While the match is still burning bright, it gets passed to the second person. Then, as the

match gets passed around the circle, the flame keeps getting smaller and smaller. As it gets passed along to the third and then the fourth person, there's barely any flame left at all. And by the time the match reaches you, it's gone out completely. There's no fire at all. It's just a tiny puff of smoke.

The thing is, the Story of the Burning Match also describes what happens when it comes to creating a new idea, a new company, and new wealth:

An entrepreneur with a big idea is like a match that's just been struck: the idea is red-hot. Then he or she raises some seed capital from friends, family, and angel investors to get the idea off the ground. These investors are like the second person holding the match. At this point, the match is still burning bright. Then the startup raises funds from venture capitalists, until it eventually goes public in the stock market. That's the final pass of the match, when it reaches typical Main Street investors. But by that point, there's no fire left at all. The potential to create wealth from this once-hot idea is almost dead. The money has already been made.

It's just like you saw in the above chart, about how private investors are now capturing nearly all of the market's gains. The biggest gains today don't belong to stock market investors. They belong to angel investors, and to professional venture capitalists.

Speaking of venture capitalists, let us tell you about the ones who contributed to this book. And to start, let us explain why we interviewed thirty different VCs and angels.

Perhaps you've already read our biographies. But in case you haven't, here's a quick summary.

We've been involved with startups for more than two decades. For example, both us have been successful technology entrepreneurs. And both of us have advised, mentored, and invested in dozens of other peoples' startups. But we made most of our money by starting, growing, and then selling our own startups to bigger companies.

So when we started conceptualizing the idea for this book, we asked ourselves a question: who would be the best people to explain startup investing to new investors?

We quickly realized that the answer was straightforward: people who have done it successfully, over and over again. That's why we spent the better part of a year speaking with dozens of venture capitalists and professional angel investors. In other words, people who have made their livings and their fortunes by investing in startups.

If you want to be a successful startup investor, nothing makes more sense than to find the best early-stage investors, and then copy them. After all, if you want to become a great value investor, you should copy the strategies of Warren Buffett. If you want to get rich investing in commercial real estate, you should study Sam Zell. He's responsible for three of the largest real estate IPOs in history. And if you want to be a successful early-stage investor, you should learn the ropes from professional VCs and angels — like the ones we brought together for this book.

These professionals have made billions of dollars by investing in startups. Peter Thiel made a billion dollars on his Facebook investment alone. Jim Breyer from Accel is worth over $2 billion. And Michael Moritz from Sequoia is worth over $3 billion.

What's even more impressive is that all these billions represent just twenty percent of the profits these investors have generated. You see, VCs don't usually invest their own money. Instead, they invest other peoples' money. This is similar to how mutual funds or ETFs work: the manager of a fund from a company like Fidelity or Vanguard isn't managing his own money; he's managing the money of investors like you.

The way VCs make their billions is straightforward. They charge investors what's called carried interest, or carry. Carry is the VC's share of the profits. Here's an example of how it works.

Let's say that, over the course of five years, the VC invests a $100 million fund into a portfolio of startups. And in total, the successful startups end up being worth $300 million. So the fund tripled its money. The first thing the fund does is return the $100 million that its investors put in. That leaves it with $200 million in profits. And as its share of the profits (as its carry), the VC generally takes a twenty percent cut.

In this case, the carry would be calculated as follows: $200 million in profits multiplied by twenty percent. That's $40 million. Not a bad way to earn a living. But the important thing to note here is that VCs only make significant money when they earn a big profit for their investors.

This is fundamentally different from how it works for a stockbroker. A stockbroker gets paid each time there's a trade in your account, or earns an annual fee based on the assets that he or she manages for you. (For example, on a $500,000 account, perhaps they charge one percent per year, or $5,000.) But regardless of whether they make or lose money for you, they still get paid.

It's a different story for a venture capitalist. A VC is incentivized to become a master of her domain. The better she learns her trade, the more money she can earn. And the best of these VCs can earn billions of dollars.

This incentive system is set up to produce some outstanding venture investors. And these are the professionals sharing their expertise with you in this book.

Before we move on, let's quickly recap what we've gone over so far.

So far, you've learned about the difference between public equity (the stock market), and private equity (startups). In this book, you'll be learning about private equity.

Then we went over the history of the venture capital industry, from Silicon Valley's early days as an orange grove, to the enormous impact and importance it has today.

We also looked at the different types of venture funds, and explained why angel investors have become such a significant part of the private-equity ecosystem.

But now it's time to dive into the next generation of angel investing. And this is where you come into the picture.

Thanks to a new set of laws, Main Street investors like you can finally invest small amounts of money into private startups — $25 here, $100 or $500 there.

As just one example of this, we recently invested in an app called Pearachute. Mark Cuban offered to put half a million dollars into it on an episode of his TV show, "Shark Tank." But we invested just $25. This is what's so exciting about equity crowdfunding. You can start small, go slow, and manage your risk.

This is a game-changer. Traditionally, angel investors had to invest between $25,000 and $100,000 per deal.

Keep in mind, in exchange for your investment, you'll receive an ownership stake. So if the startup you invest in becomes successful, you can share in the profits.

The law that made this possible is H.R. 3606, Jumpstart our Business Startups Act — the JOBS Act for short. Congress started passing this new set of regulations in 2012 to create, you guessed it, jobs. It realized that most new jobs in the U.S. aren't created by big companies like General Motors. Instead, they're created by small businesses and startups.

That's why Congress decided to make it legal for startups to raise capital from "the crowd" — in other words, from millions of investors like you. Essentially, it believed that, if all of us chipped in to help get more new companies off the ground, there would be more hiring. That's why you can invest in startups now.

There are two key components of the JOBS Act to be aware of: Title III and Title IV.

Title III, also called Regulation Crowdfunding, enables all U.S. citizens, regardless of their income or net worth, to invest in certain private startups. (To see the details about how much you can invest into these startups annually, refer to the Appendix.) Startups can use Title III to raise up to $5 million per year.

Title IV, also called Reg A+, is similar to Title III in that it enables all U.S. citizens to invest in certain private startups. But there's one main difference: it focuses on helping later-stage startups raise up to $75 million per year.

This new type of venture capital is called Equity Crowdfunding. ***Equity*** refers to ownership, because your investment entitles you to an ownership stake in the startup. And ***crowdfunding*** refers to "the crowd" of Main Street investors each making small investments.

This is a game-changer. To put things in perspective, consider the fact that 100 million individual investors in the United States control about $30 trillion in assets. If they transfer just one percent of those assets to early-stage investing, that's $300 billion in new capital going towards startups.

In other words, new startup investors like you aren't just setting yourself up to make big returns. You're also setting yourself up to make a big impact!

CHAPTER 1 REVIEW

We covered a lot of ground in this chapter, so let's do a quick review.

Structure of the Book — First we went over the three-part structure of this book. In the first part, you'll learn the basics of early-stage investing. In the second part, you'll learn the process the professionals use to find, fund, and profit from startups. And in the last part, we'll give you the tools and knowledge you need to invest in real-world startups yourself.

Private Equity — Then we introduced you to the concept of private equity (i.e., startups), and explained how it's different from public equity (the stock market).

History of Venture Capital — After that, we looked at the history of early-stage investing. As you learned, it all started with semiconductor companies in Silicon Valley getting funding from early venture capital funds.

Evolution of VC and Angel Investing — We also looked at how the venture industry has evolved over the last seventy-five years or so. Venture funds now tend to specialize, and angel investors are playing a bigger role in the ecosystem. Furthermore, you learned how a shift has occurred over the past few decades: the biggest financial returns have moved from the public stock market to the private startup market.

Equity Crowdfunding — And finally, we introduced you to the JOBS Act. This is the new set of laws that opens up startup investing to Main Street investors like you. This new type of venture capital is called Equity Crowdfunding.

That was a lot of information, and much of it might have been new to you. So before starting the next chapter, consider giving it a quick skim!

CHAPTER 2

THE FUNDING PLATFORMS

In Chapter 1, you learned why early-stage investing can be so exciting and profitable. You also learned about a new type of venture capital called Equity Crowdfunding.

This is a way to make small investments into startups, and receive ownership stakes in exchange. So if one of your startups turns into the next Google or Facebook, you'll own a share of the business, and a share of the profits.

To kick things off in Chapter 2, we'll show you where to find these startup deals.

For example, can you find them through an online broker like Schwab or eTrade? At your local bank? On Robinhood? That's what we'll be covering now.

In this chapter, you'll learn about:

1. Special websites called funding platforms where you can find startup deals.
2. How these platforms work.
3. What types of opportunities you'll find there.

To get started, let's look at a new type of website called a funding platform. These sites play matchmaker between entrepreneurs who need capital, and investors like you.

In some ways, they're similar to a stock exchange. When you want to buy shares in Microsoft, your broker gets them on the Nasdaq. And when you want to buy shares in a startup, you go to the funding platforms.

The birth of these sites coincided with Congress passing the JOBS Act, which happened in 2012. At the time, Congress realized there needed to be a special type of business to do this matchmaking. That's why these platforms were born.

Funding platforms are regulated by two federal agencies. The first is the SEC, which is responsible for regulating the securities industry and enforcing the laws. And the second is the Financial Industry Regulatory Authority, or FINRA. FINRA is the largest independent securities regulator in the U.S. It aims to protect investors by maintaining fairness in the U.S. capital markets.

We're not fans of over-regulation. But when a new type of investment like equity crowdfunding catches on with Main Street investors, a little bit of regulation can be helpful in keeping the wolves at bay.

Since the JOBS Act was passed, hundreds of funding platforms have popped up. Each one is a little bit different from the others:

- Some focus on technology startups, where you might find the next Google or Facebook.
- Others focus on food and beverage products, where you might come across the next Ben & Jerry's ice cream, Snapple iced tea, or Casamigos tequila.
- Still others focus on biotech deals or med-tech devices.

By the way, in the Appendix, we'll provide you with a curated list of sites you should be paying attention to. Plus, we'll show you an easy way to see all the best deals in a single place.

But first, let's review how these platforms work. Let's start from the perspective of the entrepreneur, so you can see how startups get onto the platforms in the first place.

For illustrative purposes, let's come up with a fictional company. We'll call it ACME Widgets, and the founder is a woman named Sally. For years, Sally worked as an engineer at Tesla. She learned a lot there and enjoyed the work. But she kept dreaming about starting her own company. Eventually, she came up with an idea for a new business. It's a device that could revolutionize the self-driving car industry.

After spending all of her nights and weekends building a prototype, Sally decided it was time to resign from Tesla so she could focus on ACME full-time. Sally knows engineering inside and out. But she doesn't have experience in business or marketing. So she recruited a colleague of hers from Tesla named Nick. Nick is a marketing executive. He doesn't know about engineering, but with his expertise in business and marketing, he and Sally make a great team.

Now there are two full-time employees, Sally and Nick. They'll both need salaries. They'll also need capital to hire additional teammates, rent office space, and do some marketing to attract customers. In total, they calculate that they'll need $500,000 to get the company off the ground. But where are they going to get $500,000?

They have a few options:

1. They could ask their friends and family. But that can be awkward. And besides, their friends and family might not have any money to spare.
2. They could go the traditional route and try to raise funds from angels or venture capitalists. But Sally and Nick don't have access to people like that.
3. They could use an equity crowdfunding platform.

It's clear to Sally and Nick that equity crowdfunding is the right path for them. Simply put, the funding platforms could help ACME Widgets put its investment opportunity in front of hundreds of thousands of investors like you. So, after visiting several funding platforms, they pick one, and apply to raise money on it.

Although any startup can apply for funding, the vast majority won't be accepted. According to one platform, it accepts just one-half of one percent of the companies that apply. That's one out of every 200, which means that getting accepted to use its platform to raise funding is even harder than getting into a college like Harvard.

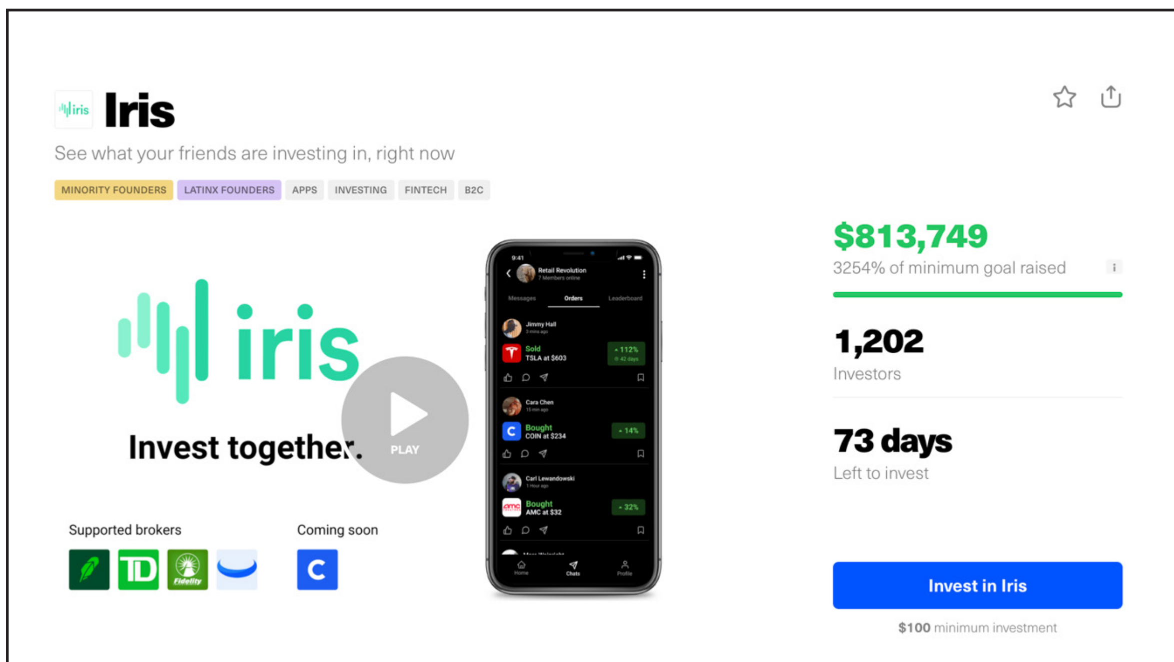
Now let's look at how the platforms determine which companies get accepted, and how they guard against investors putting capital into low-quality or even illegitimate deals.

To start their screening process, the platforms do some basic vetting. For example, they'll confirm the founders' identities and make sure they're not criminals. They'll also make sure that the company has been incorporated correctly. This vetting doesn't help you pick winning investments. But it ensures that the startups you invest in are legitimate.

Then the platform will ask the entrepreneur for various information — for example, legal documents, a summary of its business, or a video that shows how its products work. This information is meant to help prospective investors make an investment decision, or help them get up to speed so they can ask informed questions.

The platform will then review all this information and put it through a series of filters. The purpose of these filters is to determine which startups are promising enough to be shown to investors like you. Each platform has a different set of filters for which startups to accept, but they're all trying to achieve the same goal. They're trying to make sure that only the highest potential startups are put in front of investors.

Once a deal is accepted on a platform, investors can review all the details. Here's an example of what a deal looks like on a platform. This one was for a social investing app called Iris. As you can see, Iris had already raised a total of about $800,000 from 1,200 investors, and the minimum investment was $100.



Let's say that our fictional company ACME Widgets gets accepted. When its funding page is complete, you'll be able to review it. Usually, you'll have to register in order to see all the details. The platforms need your registration information to comply with the rules from SEC and FINRA.

Later in the book, we'll explain how to register on the major platforms. But in the meantime, keep in mind that the platforms are free to join, have good deals to share, and make it easy to invest small amounts of money online. So the registration process is definitely worth it.

The SEC would prefer that the platforms get to know their customers. Accordingly, some platforms may call you to learn about your financial goals, and to hear what sort of deals you might be interested in. In our experience, these chats have been enjoyable. It's helpful to speak with a real person about how their platform works. So don't hesitate to ask them questions. They're there to help.

To quickly recap, here's how a funding platform works:

1. An entrepreneur has a business idea and needs capital to launch it. She decides to raise that capital using equity crowdfunding.
2. She applies to list her deal on a specific funding platform.
3. The platform puts the entrepreneur and business through a screening process.
4. If the deal is accepted, it gets listed on the platform. That's where you'll find it.

And by the way, if you decide to invest, you can complete the entire process online. It's easy and straightforward, similar to ordering a book on Amazon.com.

Keep in mind, these platforms are for-profit businesses, just like the NYSE or Nasdaq. They earn money in a few different ways.

The first way is to charge a fee based on how much money was raised. For example, if the platform helped Sally raise $500,000, and it charges a five percent fee, it would charge the startup $25,000. (Although this fee is almost always paid by the startup, not you, you should still be aware of it.)

The second way that a platform gets compensated is more interesting. It aligns your interests with theirs by compensating it for picking a winner. The way it works is that, in addition to earning a fee in cash, it also earns a small amount of equity. For example, a platform might earn two percent of the funds it helps raise in equity. In the example we looked at above, where Sally's startup raised $500,000, that would equate to $10,000 in equity. ($500,000 multiplied by 2 percent equals $10,000.)

Again, with this arrangement, your interests are aligned with the platform's. The platform owns $10,000 of the startup's equity. So, just like you, it's hoping that Sally's startup is winner.

Try getting a deal like that with your stockbroker. You pay your broker a commission when you buy shares, and another commission when you sell shares. He gets paid coming and going, regardless of whether he's making you a profit.

From our perspective, the platforms add enormous value. For the entrepreneurs, they bring potential investors to the table. That in itself can be invaluable. But thanks to their technologies and websites, they also handle many of the functions that make fundraising so challenging — getting paperwork signed, setting up bank accounts and escrow, transferring payments back and forth, etc. This means the entrepreneur can spend less time raising money, and more time building a business.

And the platforms are valuable for investors, too. Keep in mind, according to the Census Bureau, more than 5.4 million new U.S. businesses were created during 2021. That's the highest total on record, and it would mean a lot of business plans to read through. The platforms sort through startups for you, put the management teams through a background check to toss out the frauds, and then present you with the highest-potential deals. After that, they help handle all the paperwork and funds transfers. Plus, you can always get someone on the phone. To us, that's an enormous amount of value.

But to be fair, it's only an enormous amount of value if the platforms actually deliver high-quality startups to their investors. Some have wondered whether venture capitalists are keeping the best deals for themselves, and leaving the scraps for the platforms.

This is a legitimate question. But let us quickly put that fear to rest with a quick story. A business partner of ours invested in Uber back when it was still a private startup. To make a long story short, for every $5,000 he invested, he quickly made $2 million. And guess what: Uber is an example of a startup that raised capital on a funding platform. So you could potentially have become one of its early investors, too.

And that's just one example of the high-quality deals that are showing up on these websites. We'll tell you about others later in the book. But for now, let's take a look at the different types of opportunities you'll see when you visit a funding platform.

We've mentioned our fictional startup ACME Widgets a few times now. To boil it down to the basics, it has two founders, an early version of its product, and a big vision for its future.

And as it turns out, this is the type of startup you'll tend to find on the funding platforms. First of all, all kinds of companies need capital to grow, so you'll find all kinds of companies on these platforms:

Tech companies, green-tech companies, food companies, blockchain and crypto-related companies (investing in crypto startups is an exciting way to get involved in this sector without investing in crypto-currencies themselves), and so on and so on.

But these companies have a common element that's worth mentioning. Simply put, if they're successful, they could provide an enormous return to their investors.

Compare that to the local businesses you see around town, like the pizza parlor or nail salon. You won't find many local businesses like these on the funding platforms. The reason why is straightforward. Local businesses are what we call lifestyle businesses. They're not trying to become the next Google or the next Starbucks. Instead, they're aiming to improve the community while supporting the lifestyle of the founder, her family, and her employees.

Those local businesses are the backbone of America. We have enormous respect for them. But they don't offer investors like you the massive upside potential of a startup.

You might think that all companies that aren't publicly-traded can be lumped into the same category. After all, they're all private companies. But that's not the case.

Private companies vary greatly. In particular, they vary in terms of how far along they are in building their business, and how much progress they've achieved.

You'll find three stages of startups on the funding platforms: seed-stage startups, intermediate-stage startups, and growth-stage startups.

Let's start with seed-stage companies. This refers to a company that's less than a year or so old, and has fewer than five or six people on its team. Furthermore, a seed-stage company has an unproven business. It might have just a few customers so far, or no customers at all. Maybe it's just an idea on a piece of paper. And finally, when it comes to fundraising, seed-stage companies are typically raising less than a $1 million, and usually they're raising less than $500,000.

The next stage is intermediate-stage startups. These businesses are further along in their progress. Generally, they will already be generating at least $1 million in annual sales. So while they're still risky, they're less risky than a seed-stage company with no revenue, like Sally and Nick's.

And the final stage is growth-stage startups. These companies already have dozens or even thousands of employees, and tens or hundreds of millions of dollars in revenue. The thing is, they're still private. That means we can still buy shares in them before they potentially get acquired by a bigger company, or go public in an IPO.

Growth-stage deals don't offer the mind-blowing returns of seed-stage opportunities. You're not going to make 400 times your money on these deals. But you could potentially earn three or five or even ten times your money. And in general, these deals are less risky than seed-stage deals. In the Appendix, we'll show you how to get access to these deals. We'll even show you how to buy a basket of them all at once, like a mutual fund.

But for the most part, this book focuses on seed-stage deals. This is where your investment dollars go the furthest, and where you can earn the biggest potential gains.

Now let's look at how much capital these companies are raising. Early-stage startups tend to raise between $100,000 and $5 million. And remember, with equity crowdfunding, a company raising $100,000 doesn't get all that capital from one investor. Instead, the capital comes from many investors. For example, it might come from two hundred people each investing $500.

And because there are hundreds of thousands of investors on these platforms, small deals can fill up fast.

For each deal, there are two things you should note right away. The first is called the target amount of the raise. And the second is called the maximum. The target amount is what the company needs to raise in order to say the round is "successful" and start using the funds. This is the minimum dollar amount the startup needs in order to hit its next set of goals, whether that means launching the next version of its widget, or reaching its next level of sales. If it can't raise this minimum amount, it won't have enough capital to make any progress. So there's no sense in it raising anything at all.

If a startup fails to reach its target, the funding platform won't release the funds it's raised. Let's look at ACME Widgets again as an example. It might have a target raise of $250,000, and a maximum raise of $1 million. If it doesn't reach that $250,000 target, it will return 100% of any funds that investors committed. But if it does reach the target, it can raise up to $1 million.

CHAPTER 2 REVIEW

In this chapter, you learned about the basics of how funding platforms work.

First, we introduced you to the concept of a funding platform. We also reviewed the laws and regulations behind them, and showed you the different types of platforms that exist.

Then we walked you through how a hypothetical company gets started, and how it goes about getting itself listed on a funding platform. You also learned about the main screening criteria the platforms use to accept or reject the startups that apply.

Finally, we reviewed how to get started on a funding platform as an investor, and what types of deals and information you'll see there.

We covered a lot of new information here, so it might make sense to browse through it again. After all, this is new territory for almost everyone.

CHAPTER 3

CRITICAL CONCEPTS IN PRIVATE EQUITY

You've already learned a lot in the first two chapters of this book.

For example, you learned about a new type of venture capital called Equity Crowdfunding. You learned about the funding platforms that list these deals. And you learned about the types of deals you'll find on these sites.

This is an exciting market. And with the potential to earn fifty-five percent annual returns, you're probably champing at the bit to get started.

But before you do, there are a few key things you need to know about. For example, the private startups you'll be investing in don't trade on an exchange like the New York Stock Exchange or the Nasdaq. Generally speaking, they don't trade at all.

Once you invest, there's no way to get your money back unless the company is acquired, or unless it goes public in an IPO. And acquisitions and IPOs don't happen every day. So in this next chapter, we'll introduce you to the following key topics:

1. Liquidity for early-stage investments.
2. How you get your money back after you invest.

The first thing we'll look at is something called liquidity.

To kick things off, let's look at something you probably know about already: buying or selling stock in a big, public company. Let's use Intel as an example. Every day, about 30 million shares of Intel (INTC) change hands. Let's say you buy a few hundred shares today. Next week, or next year, if you need to sell those shares to invest in a new home, you won't have any trouble finding a buyer. The price may have changed, but there will still be plenty of buyers.

This is what's called a liquid market. In other words, you can snap your fingers andliquidate your shares of Intel for cash.

But with startups, it's a different ballgame. Startups are private companies. Their shares are owned by a tiny group of founders and employees. And generally speaking, these shares don't trade anywhere. They just sit in a drawer somewhere, or in an online ledger.

If these startups need capital to grow their business, they can sell some of their shares to investors

like us. We're not buying shares from another investor, like we do with Intel. Instead, our money goes directly into the company, so it can put gas in the tank and get where it needs to go.

The key thing to remember is this: once we own those shares, there's no easy way to turn them into cash. There's no liquid market for them.

Why? Because with most startups, there isn't enough demand for a company's shares to create a marketplace. To create a market, you need supply and demand. There might be plenty of shares for sale, but if there's nobody on the other end to buy them, you have an illiquid market.

That's why, to get your money back, one of two things needs to happen:

1. The startup gets acquired by a bigger company.
2. The startup goes public in an IPO.

In the meantime, we're just locking our shares in the desk drawer and keeping our fingers crossed. That's why we say private company shares are illiquid.

You may have heard about a type of business that lets you trade private shares. For example, perhaps you've heard of EquityZen or Forge. These are online marketplaces that allow investors to trade their private shares *before* the companies go public. In addition, some of the funding platforms have started offering a limited amount of "secondary" trading, so early investors can try to sell their shares.

But for now, you should forget about this topic. The reason why is simple. We don't want you thinking there's an "escape hatch" to sell your private shares. Sure, once in a blue moon, someone will be able to sell private shares of a startup before it gets acquired or goes public. But that is still an unlikely scenario.

So when you invest in startups, keep in mind that you can't get your money back just because you need it for the mortgage or for groceries. Your shares are illiquid. So you should only invest money that you don't need back anytime soon.

One way to look at it is like this. Investing in startups can be like investing in a new home. When you buy a home, you don't expect to move in, unpack your stuff, and then turn around and sell it thirty days later. You get into it with the understanding that it will be a long-term investment.

Which brings us to our next point. How long do you need to wait before you can take those stock certificates out of your desk drawer and turn them into cash?

Looking at historical averages, it takes about five to seven years. Let's explore why it takes so long.

Think about what happens when we invest in a startup. A tiny company that hasn't started selling a product yet is going to use our investment capital to start building its business. For example, it will lease an office, hire some staff, and start developing its product.

Let's say it takes six to twelve months to get a beta version of its product out the door. But customers might not like this first version. So the company will have to go back to the drawing board, and figure out how to make it better. After a few attempts, it builds a product that customers seem to like. But by this point, the startup is starting to run out of money. So it will need to spend a few months raising a new round of capital.

And once it raises the round, it still has to figure out how to market and sell its product. And if you've ever run a business, you know that this is one of the hardest things to figure out. And by the time a company figures this part of the puzzle out, it might be time to raise money again.

This can be a long journey. But eventually, a few startups will figure it out. A few of them will become the next Google, Facebook, or Microsoft. But between the time we invest in them, and the time we get our money back, there are a lot of twists and turns. For a successful company, it takes an average of five to seven years.

So now let's look at how successful startups deliver your profits.

Let's say that you end up investing in many startups. Over a few years, you build a portfolio of them. As you'll learn in this book, many will fail. That's OK. That's what we expect to happen.

Others will keep stumbling along, trying to get on their feet. That's to be expected, too.

But one of your investments turned into a gold mine. As an example of a gold mine, let's look at a company called Nest that was acquired by Google. Nest is a thermostat you can control from your

phone. It can help save you money on energy costs, and it's beautiful to look at. One day, you get an email letting you know that Nest was acquired by Google for $3.2 billion. This is the early-stage payoff you've been waiting for. You're going to make a serious windfall from this one.
When a startup is acquired by a bigger company like this, it's called an exit. It's called an exit because investors are exiting their investment. Their shares are being acquired by someone else. Sometimes you'll hear about this type of exit referred to as M&A, or Mergers & Acquisitions, or a takeover.

When this happens, you will receive your share of the acquisition price. To use simple math, let's say you own one percent of Nest when it gets acquired. In that case, you'd get a check for one percent of the $3.2 billion acquisition price. That's $32 million. Not bad.

Now let's look at why these acquisitions happen in the first place. In other words, why would Google acquire a thermostat company?

The answer is simple. Big companies like Google need to keep innovating so they can keep their shareholders happy. Certainly, it will always pay careful attention to its core search business. That is its bread and butter. But it also has a big R&D budget for new initiatives. That's why it is constantly experimenting with things like virtual reality glasses and self-driving cars.

Nowadays, Google is a huge enterprise, so it moves more slowly than it used to. Startups are different. They're nimble. They're quick. They take bigger risks with unproven ideas. Most new startups don't work out. But when they do work out, and they find themselves in the middle of an important trend, big companies are quick to take notice.

Perhaps Google's team looked at Nest and thought, "That's smart. A nice-looking device that consumers have in their living rooms, and it's connected to the internet. Hmm. Google should be in the living room, too, so people can use Google search while they're sitting on the couch. So, should we build one of these devices from scratch? Or should we just buy Nest?"

At this point, Google will do a business analysis called Build Versus Buy. And when it decides to buy a startup like Nest, that's when early investors can cash out. According to business journal TechCrunch, early investors in Nest made a profit of about 2,000%.

Let's look at another example of Build Versus Buy. A few years ago, Apple spent $3 billion to acquire a company called Beats. Beats is a music company. It has a streaming service, and it also makes

headphones. But Apple already had a music company: iTunes. As of 2020, iTunes was being used by about 70 million people. That's a successful business. So why would Apple spend $3 billion for a different music business?

First of all, it needed to play catch-up. iTunes was the leader in online music a few years ago, but nowadays, streaming services like Spotify are killing it. Apple believed Beats could help. To start, Apple could leverage its streaming service. Secondly, Apple needed more people from the music industry on its team. Beats was founded by a legendary music executive named Jimmy Iovine. Jimmy has produced albums for Springsteen, John Lennon, U2, even Lady Gaga. In the music world, he's royalty.

Apple needed an executive like that to help negotiate with the record labels. That's a role that Steve Jobs himself used to fill. Could Apple have figured out how to build what Beats had built? Perhaps. But it concluded that buying Beats would help it do so faster, and would put the right people in charge of it.

But acquisition prices aren't usually $3 billion. And they're not $19 billion, either, like Facebook's acquisition of WhatsApp. Those are the outliers.

The reason you see billion-dollar price tags like that is because those are the stories that the press likes to write about. The numbers are mind-blowing, so it makes a great story. But M&A comes in all shapes and sizes. Let's look at a few examples.

On the low end, a big company might buy a smaller one for just a few million dollars. When this happens, it's generally because the big company wants access to the startup's employees, not because it wants to own the company's product or service. Even if a startup isn't having much success, if it has a few strong employees or engineers on its team, it might sell for anywhere from $1 million to $5 million**.**

These small acquisitions are called "Acqui-hires." They're a mixture between an acquisition and a hiring plan, and they take place often.

But most acquisitions aren't acqui-hires or $19 billion deals. If you study the data, you'll find there's a "sweet spot" for M&A. In brief, most deals get done for $100 million or less.

The thing is, the early investors in these startups can do very well financially. In fact, sub-$100 million M&A is one of the surprising secrets to success in early-stage investing. It's deals like these that can help you earn market-beating returns.

Keep this $100 million number for M&A in mind. When we start to look at Deal Terms in the next chapter, you'll see why it's so important.

But M&A isn't the only way to get an exit. The private company you invested in might be one of the rare startups that goes public. This is called an Initial Public Offering, an IPO.

An IPO happens when a company gets big enough and popular enough to generate interest not just from private market investors, but also from public investors, too. After a company goes public, it will start to trade on an exchange like the Nasdaq. And that's when you'll have the chance to sell your shares.

Public offerings happen less often than you might think. But when they do happen, the returns can be staggering. One of Google's first startup investors, Andy Bechtolsheim, made about 15,000 times his money when the company went public. And when Facebook went public, its first startup investor made one billion dollars. He earned a return of 200,000% on that single investment.

But remember, when you invest in a startup, you're not expecting to see an IPO. You're far more likely to see M&A. And it's likely to be worth less than $100 million.

In our next chapter, we'll take a deeper look at this typical exit range. And we'll see how it relates to the price we should be paying for our startup investments. In other words, the *valuation* we should be paying.

As you'll learn, investing at the wrong valuation could mean the difference between big wins or heavy losses.

There's also one more type of startup you should be aware of. It's not very common, but when it does happen, it can lead to a great result for early investors.

In fact, one of our business partners had this type of exit, so we saw it first-hand. It's known as a secondary sale. And to illustrate how it works, I'll tell you more about our partner's situation.

Well before Uber went public in an IPO, our partner invested in one of its early private funding rounds. But as the company grew, it needed massive amounts of capital to expand — hundreds of millions of dollars. So the company decided to bring on large institutional investors to help support its growth.

When these new investors came on board, they decided they liked the company so much, they wanted to own as much of it as they could. So they approached the existing investors and offered them cash for their shares. And at that point, our partner turned every $1,000 he'd invested in Uber into $400,000. So for every $5,000 he had, he was looking at a windfall of $2 million. Again, that's $2 million for every $5,000 invested.

It's real stories like this that make equity crowdfunding so exciting. You see, individual investors like you finally have the opportunity to see similar returns.

Can you imagine what it would be like to turn $5,000 into $2 million on a singleinvestment? That's life-changing.

CHAPTER 3 REVIEW

We went over a few big concepts in this chapter.

First we covered the illiquid nature of early-stage investing. The fact is, you have to treat these investments differently from stocks and bonds. Only invest money you know you won't need for several years.

We also reviewed the different ways you can earn your profits. First we talked about Mergers & Acquisitions, as well as the three different types of M&A you're likely to see:

1. Big acquisitions, like Apple's purchase of Beats Music for $3 billion.
2. Smaller "acqui-hires," where a large company acquires a startup for its people.
3. And the sub-$100 million "sweet spot" where most M&A takes place, and where you'll probably see the bulk of your financial returns.

After that, we explained the less common but lucrative scenario of a company going public.

And finally, we reviewed an exciting example of what can happen in a secondary sale.

In the next chapter, we'll be teaching you about one of the most important but widely misunderstood concepts of startup investing.

CHAPTER 4

VALUATION

In the first few chapters of this book, you learned about everything from where to find early-stage startup deals, to how long it tends to take to see a return on your investment.

But now it's time for something new. It's time to learn the most basic rule about making money from startup investments. Ready for it? Here it is.

The trick is to "Buy Low and Sell High."

You probably know what those words mean with respect to an investment in the stock market, or in a piece of real estate. But what do they mean when we're talking about early-stage startups? This is what we're going to cover in Chapter 4. Specifically, you're going to learn about something called valuation.

Simply put, valuation refers to the total value of any enterprise. It's another way of saying market capitalization or "market cap." For public companies, we say market cap, and for private companies, we say valuation.

So, in this chapter, you're going to learn three things.

1. All about the concept of valuation.
2. How valuation is set.
3. And the factors that can affect valuation.

In a later chapter, we'll give you a straightforward method for determining whether a valuation is "fair" or not. But for now, let's dive into the basics.

As we just mentioned, in the stock market, a company's valuation is its market cap.

Market cap is calculated by multiplying a company's number of shares outstanding by its share price. For example, if a company has 200 million shares trading at ten dollars, its market cap (or valuation) is 200 million multiplied by ten. That's $2 billion.

It's the same thing for startups. Its valuation can be derived by multiplying its number of shares by its share price. But for startups, there's just one hitch: as you've learned, startup shares don't trade anywhere. And if its shares don't trade, how can we figure out the value of the company?

The answer is that a handful of different methods are typically used to calculate a startup's valuation. In a moment, we'll review three of them. And later, we'll also show you how to make sure you never overpay for your startup shares. In other words, we'll teach you how to determine if a valuation is fair or not.

But for now, let's get back to the three methods that are used to determine a startup's valuation.

To set the stage here, let's look at the stock market. In the stock market, investors are bidding on shares based on things like revenues and profits — numbers that are factual. But generally speaking, startups don't have any revenue yet, never mind profits. So we're going to need some other ways to handle this.

Just like with any financial transaction, the buyer will want the lowest price, and the seller will want the highest price.

To translate this concept to startups: you, as the investor, want a low valuation. And the founder of the startup (the person who owns the shares) wants a high valuation.

Why is this? Here is how to think about it simply:

The lower the startup's valuation, the more of it you'll own.

Let's look at an example with simple math so we can see why this concept is so important:

Let's say a food-delivery startup called Bring Me Food is raising a round of financing. Its valuation is about $1 million. So if you invest $100,000, you would own ten percent of it — in other words, $100,000 divided by $1 million.

Now let's say that Bring Me Food does very well over the next few years. In fact, it does so well that DoorDash (DASH), an established food-delivery company, decides to buy it for $10 million.

Since you own ten percent of Bring Me Food, you'll get a check for $1 million. You made ten times your money. You're so excited with this success that you turn around and immediately invest $100,000 into another startup.

But this time, the valuation of the startup isn't $1 million, it's $5 million. So instead of owning ten percent of this new company, you only own two percent. In other words, $100,000 divided by $5 million.

A few years go by, and just like last time, a competitor comes along and buys this startup for $10 million. But this time, since you own two percent of the company instead of ten percent, you'll only make $200,000 on your $100,000 investment.

In other words, since the valuation was so much higher, your ownership stake was far smaller. And that translated into a smaller piece of the profits.

The lesson here is simple. All things being equal, we should always aim to invest at the lowest possible valuation. The lower the valuation, the more of the company we own.

Before we explain how valuation is determined, there is one other concept we need to cover: "pre-money" valuation vs. "post-money" valuation.

After you understand this simple concept, you'll be better informed than ninety-nine percent of the investors out there.

Simply put, the pre-money valuation is the startup's value *before* you invest. And the post-money valuation is its value *after* you invest.

Now let's look at how this concept relates to how much of the company you'll own. And to illustrate it, let's look at an example using some round numbers:

A startup is valued at $4 million. That's its pre-money valuation — its value before it takes investment dollars. And its goal is to raise $1 million.

If it is successful raising $1 million, the company will have a post-money value of $5 million. Why? Because "post-money" is equal to the pre-money valuation *plus* the capital invested.

If you invested $1 million, how much of the startup would you own? You might think that if you invested $1 million at a $4 million valuation, you'd own twenty-five percent.

But that's not the case. To calculate your ownership, you need to do the math based on the post-money valuation. And based on a $5 million post-money, your $1 million is worth twenty percent of the business.

Remember, the post-money valuation equals the pre-money valuation *plus* the new cash from the investment round. And your ownership stake is based on the amount of your investment, divided by the post-money valuation.

Let's see what happens in the future if the company sells for $50 million. You're going to receive a check for twenty percent of that $50 million. That's $10 million. Again, you invested $1 million for a twenty percent stake. And when the company was acquired for $50 million, you received $10 million of it.

And by the way, these new concepts might seem confusing at first. But by the end of this book, this will all be second nature to you.

For now, though, let's keep moving forward. Let's look at a few different ways that valuations get determined. Specifically, let's look at scenarios where:

1. The entrepreneur sets the valuation.
2. The investor sets the valuation.
3. The "market" sets the valuation.

In the first scenario, the entrepreneur determines the valuation. Using the example we talked about a moment ago, the entrepreneur was willing to sell twenty percent of his business to investors for $1 million. And as we learned, that implies a pre-money valuation of $4 million.

If investors agree with the entrepreneur's proposal, they've got themselves a deal. But sometimes, investors aren't quite so agreeable. This brings us to the second way a valuation gets set.

In the second scenario, an investor sets the value. In particular, the valuation is set by what's called the Lead Investor. Let us explain what that means. Generally, a professional investor won't take down an entire investment. In other words, with a $1 million round, it's rare that a single investor will invest the entire $1 million.

But they might "lead the round." That means they will negotiate the valuation, and also make a significant investment. The way it happens is that they approach the entrepreneur and say something like, "I like what you're doing here. So I'm willing to invest $200,000, and I'm willing to lead your round at a $4 million valuation."

If the entrepreneur agrees, they have got themselves a deal. And what's interesting about this approach is that as soon as the lead investor writes their check, other potential investors will be more likely to invest alongside them. Why? Because they know that a professional investor has already set the valuation, negotiated the terms, and invested their own money. They have real skin in the game.

So that's what it means to lead a round.

But what happens if the entrepreneur doesn't like the investor's proposal, and the investor doesn't like the entrepreneur's proposal? This leads to a third way of determining a valuation: the market determines the value.

In this scenario, the entrepreneur goes out and talks to a bunch of investors. Over time, she tries to find a few of them who are interested enough to start a negotiation. And with a bunch of back and forth between the entrepreneur and multiple investors, a valuation will emerge that everyone can live with.

For example, the entrepreneur might start the negotiation by talking about comparable valuations she's seeing in the market. She might say, "Well, Mr. Investor, my competitor raised money last month at a $6 million pre-money valuation — so let's use that."

But remember, the investor always wants the lowest possible valuation. So he might push back and say, "Hey, not so fast. That's a different type of company, so that data point isn't relevant."

The thing is, if the entrepreneur is talking to a bunch of different investors, it's more likely that a "fair" valuation will bubble up to the surface.

If every investor is pushing back on her valuation, the entrepreneur might lower it. But if only one investor is pushing back, that lone investor will usually get on board.

And at the end of the day, this process can create a good outcome for everyone.

Now let's look at some other factors that could affect a company's valuation. And let's start with the factors that can increase the valuation.

Essentially, anything that lowers the company's perceived risk of failure or increases its odds of success will increase the company's valuation.

For example, let's look at revenue. If a startup already has revenue coming in, even a small amount, that means someone is willing to pay for its service or product. That's a good sign, and it makes the startup less risky.

Or maybe the management team is really strong. For example, maybe they have what's called "domain experience" — in other words, they've already worked in the same sector that their new business is in. The expectation here is that they'll have a good lay of the land and some industry connections, so they'll spend less time figuring things out, and more time executing on their plan.

Or perhaps they've already been thru the craziness of launching a tech startup. If so, they might already know the importance of managing cash and managing hiring.

Here's a great example of this, and it's pretty dramatic:

A venture capitalist friend of ours named Dan recently made two startup investments. The first startup had a twenty-two-year-old founder with no prior experience. Dan invested in this company, but he valued it at $1.5 million.

But Dan's second investment had a founder with a lot of experience. He'd previously started a company, taken it public, and then sold it to a private equity firm for about $2 billion. For this investment, Dan paid up. The valuation was $23 million.

And here's something else that tends to increase valuations: a startup that has graduated from an "accelerator" program.

An accelerator is a mentoring program for startups. These programs accept just a small fraction of the companies that apply. Sometimes just one percent of them. Then they put them through several months of "boot-camp" to get the startup's business model into shape, fix its website, and sort out its marketing plan.

Then the startup gets mentored by world-class VCs like Fred Wilson. Or by big-shot tech CEOs like Dick Costolo, the ex-CEO of Twitter.

All these activities and coaching add a tremendous amount of value to a startup, and remove a lot of risk.

One accelerator that you might hear about is called TechStars. Over the course of about five years, more than 200 companies graduated from its program, and twenty-two of them were quickly acquired. We'll explain why this statistic is so impressive later in the book. But twenty-two acquisitions in such a short time is impressive. It's a strong signal that TechStars is doing something right.

Other high-quality accelerators include Y Combinator, 500Startups, and DreamIt.

If you see that a startup is a graduate of one of these programs, expect its valuation to be higher. Because, remember, it's been partially de-risked.

But more generally, let us give you a good rule-of-thumb relating to valuation:

As a company's perceived risk goes up, its valuation tends to go down. And as its risk goes down, its valuation tends to go up.

Now let's look at the valuations of companies listed on the funding platforms.

The good news is, if you're investing on one of the funding platforms, you'll never need to negotiate the valuations yourself. By the time a company has started raising money on a funding platform, its valuation will already have been negotiated and set.

It was either set by the company or by a professional investor. So you won't need to negotiate anything. That being said, you'll still need to figure out if you're willing to *accept* a given valuation. So how do you make that determination?

Like I mentioned a moment ago, we'll teach you how to make that call later in the book. It can be complicated to do well, so we built a special tool to do it for you. It's called **CrowdabilityIQ**, and you can read more about it in the Appendix.

But we'll explain it here quickly so we can keep things moving.

In the last chapter, you learned that the most common type of exit for a startup is an acquisition. And furthermore, you learned that most M&A takes place under $100 million.

Now it's time to explain how this $100 million figure relates to valuation:

Earlier, we reminded you about the most basic investment rule: "Buy Low and Sell High."

With startups, "buying low" means investing at a valuation that gives you the best shot to earn ten times (10x) your money. We'll explain why your profit target should be 10x later in the book. But if you're shooting for a 10x return, and you know that most startup acquisitions are for $100 million or less, the conclusion is clear: you should be investing at valuations of $10 million or less.

In other words, if you invest at a $10 million valuation, and the company is acquired for $100 million, you'll make 10x your money. ($100 million/$10 million = 10x.) If you invested at a $50 million valuation instead, that same acquisition would lead you to profits of just 2x. ($100 million/$50 million = 2x.)

Of course, be mindful that valuation is relative. There's no sense investing in a startup just because its valuation is "low." A startup with a $1 million valuation might fail and your investment will go to zero. Meanwhile, a startup with a "high" valuation of $20 million might be acquired for $200 million, so you'll make 10x your money.

Furthermore, if a startup goes public and turns into a $100+ billion company, it doesn't much matter if you invested at a valuation of $5 million versus $10 million. For example, many thought investors were crazy to pile money into Facebook when it was a high-risk startup valued at more than $1 billion. But with Facebook (or as it's called today, Meta) currently valued at nearly $1 trillion, those early investors pocketed a 1,000-bagger. In other words, for every $1,000 they put in, they could have made about $1 million.

But as you've already learned, billion-dollar exits are few and far between. For most startups that have a successful exit, the acquisition price will be $100 million or less. So to play it safe, when you're investing in seed-stage startups, all else being equal, you should generally look for valuations of $10 million or less.

CHAPTER 4 REVIEW

Before we move on, let's quickly re-cap the big takeaways from Chapter 4.

1. The pre-money valuation is what the company is worth before you invest.
2. The post-money valuation is simply the pre-money valuation plus the new capital the company raises.
3. To calculate your ownership stake, divide the amount you invested by the post-money valuation
4. Valuations can be set in three different ways: by the entrepreneur, by the lead investor, and by the market.
5. We also reviewed some good rules of thumb:

First of all, there's an inverse relationship between risk and valuation. The less risky the company, the higher its valuation.

And finally, since the acquisition price for most successful startup exits is $100 million or less — and since you're targeting 10x returns — you should generally look for valuations of $10 million or less.

For now, that's about it for valuations.

Later in the book, we'll show you **CrowdabilityIQ** quickly calculates a startup's "fair value" for you, and we'll explain the math behind it.

But in our next chapter, we'll be diving into a different foundational concept: deal terms. And definitely pay attention, because deal terms are incredibly important.

Keep in mind, you're only a few chapters away from putting all this information to work. There are just a few more big concepts you need to know about first.

CHAPTER 5

DEAL TERMS

By this point in the book, you've already learned about the deals you can invest in on the equity crowdfunding platforms.

You've also learned about some critical concepts like valuation.

But in this chapter, we'll be diving deeper. Specifically, we'll be reviewing the most important deal terms you need to be aware of when you're evaluating a startup. This is very important. If you don't get a handle on these terms, it could mean the difference between a profitable investment, and a total loss of capital.

So here's what we're going to go over in Chapter 5:

First, we'll go through the various deal terms you're going to see with early-stage investments. Then we'll highlight the terms that are favorable to you. And finally, we'll highlight the terms that work against you.

Generally speaking, there are two types of deal structures for startup investments:

The first type is equity. This is where you get a direct ownership stake in the business you're investing in.

And the second type is called convertible debt.

Technically, convertible debt isn't an ownership stake in the business on Day 1. But as its name implies, the debt converts into an ownership stake in the future. This might seem confusing, but we'll explain all of it in a minute. And soon you'll see how it fits into everything you've been learning so far.

To start, let's look at equity deals.

An equity transaction has four basic terms:

1. Valuation. This is the price you'll invest at.
2. Type of Equity. There are two types. We'll go over both of them.
3. Pro-rata Rights.
4. Information Rights.

Let's start with valuation.

As you learned in the last chapter, valuation is an extremely important deal term. It dictates how much of the company you'll own in exchange for your investment.

Generally, valuations on equity crowdfunding sites are stated in pre-money terms. But to figure out what your ownership stake will be, you'll do your calculation based on post-money terms. For example, you might see a company with a pre-money valuation of $4 million. If it raises $1 million, its post-money valuation will be $5 million. (Because we add the $1 million in new funding to its $4 million pre-money valuation.)

If you invested the whole $1 million, you'd own twenty percent of the company. In other words, $1 million / $5 million = twenty percent.

We originally covered the concept of pre-money and post-money valuations in Chapter 4. If you have any questions about it, take a minute and review it now.

The next deal term in an equity transaction is the type of equity you'll be buying. There are two types of equity investors can buy: Common Stock and Preferred Stock.

Common stock is what the founders of startups own. It's issued when a corporation first gets formed. And preferred stock is what the investors like you should receive. Preferred stock comes with special legal rights, including the right to get paid back first if the company gets acquired.

Let's look at why getting paid back first can be so important. Let's say investors put $1 million into a company that's raising money at a $4 million pre-money valuation. That means the post-money valuation will be $5 million, and the investors will own twenty percent of the company.

And let's say that, because these investors weren't well-informed, they bought common stock instead of preferred. If someone comes along in the future and buys the whole company for a low price (let's say for $1 million), the investors would receive twenty percent of the proceeds. That's $200,000. And

the entrepreneur would take home eighty percent of the proceeds, or $800,000. That might be great for the entrepreneur, but it's a loss for the investors. That doesn't seem fair, right?

But now let's look at a scenario where the investors had purchased preferred stock instead. This is a different story. Now preferred shareholders will receive payment ahead of everyone else. In fact, common shareholders won't get a dime until the preferred holders get paid back in full. So if the company gets acquired for $1 million, the preferred shareholders — the investors who put in $1 million in cash — would get back their entire $1 million.

In other words, because they owned preferred instead of common, they broke even on an investment that, otherwise, would have been a loss.

Now let's move onto the next deal term: pro·rata rights. This word might sound complicated, but it refers to a simple concept. Let's say you invest in a company at the seed stage and the company hits all of its goals and makes enormous progress.

Somewhere down the road, the company might go out to raise more money. And in that scenario, the existing investors would experience what's known as dilution.

Let us explain how dilution works in simple terms. Let's say you own one slice of an apple pie that has ten slices in it. So you own ten percent of the pie. Then one day, the pie gets much bigger. And now that it's bigger, it has twenty slices.

You'd still own your one slice. But now it represents a smaller portion of the overall pie. Now you'd only own five percent of the overall pie, instead of ten percent.

Essentially, that's what dilution is: owning a smaller piece of a much bigger pie. And in the world of early-stage investing, it's not necessarily a bad thing. You see, generally, dilution only happens when the startup is doing well, and new investors want to put more money in. Therefore, the startup doesn't just create more slices of the pie. It also increases the overall *price* of the pie. So while it's true that your original stake got diluted, now it might be worth three or four times as much as you paid for it.

But sometimes investors don't want to get diluted at all. They think the company looks like a winner, and they want to own the same percentage of the pie as they always did. Well, if they invested in an earlier round of funding where they were granted something called pro-rata rights, they'd have the right to continue to invest in the business in the future.

This doesn't mean they have to invest more. But pro-rata rights give them the right, the option, to invest more. To get more specific, they would have the right to invest enough money so they can

maintain their existing percentage ownership in the company.

To make this point clear, let's go back to our pie example. Let's say you owned one slice of a ten-slice pie, or ten percent. If that pie grows to twenty slices and you have pro-rata rights, you'd have the option to purchase one additional slice. And if you did so, instead of owning just one slice of the twenty-slice pie (five percent of it), you'd now own two slices of it, so you'd stay at your ten percent ownership (two divided by twenty equals ten percent).

Keep in mind — we know some of these terms might not seem simple the first time you hear about them. But stick with us. Because these details will become second nature to you by the end of this book. And getting familiar with these terms now will give you every possible opportunity to succeed in the future.

The next deal term we'll review is another type of shareholder right. It's called Information Rights. Generally, investors in private companies don't receive detailed information or ongoing communication. After all, the startup is busy building its business, and it generally doesn't have a big staff that can put together information for investors.

Furthermore, unlike public companies, most private startups have no legal obligation to share financials or internal-performance metrics.

But some investors insist on being granted information rights. Such rights can include quarterly or annual financial statements, access to internal reporting dashboards, or regular phone calls with management. Although these types of rights aren't very common for seed-stage companies, you might see them occasionally.

Now let's move to the second type of private investment transaction: convertible debt. Remember when we were talking about valuation in an equity transaction? Well, sometimes an entrepreneur and potential investors can't agree on what the fair value is for the startup — in other words, what the right price is.

In fact, this is a common scenario for early-stage companies. But entrepreneurs still need to raise capital, and investors don't want to miss out on good deals. So when these two parties can't agree on valuation, a startup will raise money by issuing convertible debt.

With convertible debt, the entrepreneur and investor essentially play kick-the-can. They agree to let a

professional investor set the valuation later. In the meantime, the convertible acts as a kind of stop-gap. The entrepreneur gets the capital, and the investor gets access to the deal.

Here's how it works at a high level. Instead of raising $500,000 as an equity investment, a startup raises $500,000 by issuing a convertible note. A convertible is a debt instrument, but it's not ordinary debt like a loan from a bank. The investors have no expectation to be repaid in regular installments, as if they'd invested in a bond.

They're not looking for income. Just like the equity holders, they're looking for long-term gains. So instead of being paid back in cash, when the debt converts at a later date, it's paid back in equity. This conversion is triggered by something called a Qualified Financing.

A Qualified Financing is when a professional investor, usually a venture capitalist, steps in to invest, and as part of his investment, he negotiates an exact valuation. Typically, this happens twelve to eighteen months after the convertible is issued. And at this point, the convertible debt converts into equity based on the valuation that the professional determines.

But here's the nice thing about convertibles. For earlier investors like you, the note converts at a lower valuation. And as we learned earlier, a lower valuation means more equity. To explain how this works, let's walk through the four main deal terms of a convertible note.

The most important terms are what we call the Discount and the Cap. Then there's the length of the loan, and the interest rate.

Let's start by looking at the discount and the cap. Remember, with a convertible, the entrepreneur accepted money from an investor, but the valuation hadn't been set yet. They agreed that the valuation would be set in the future by a professional investor.

The thing is, the investor who put money into this startup when it was just an idea on the back of a napkin took some extra risk compared to the new investor. And he should be rewarded for that extra risk. He shouldn't get the same terms as a new investor who's getting involved after the company is already firmly established. In other words, he shouldn't be paying full price for his shares. And generally, he won't. He'll receive what's known as a discount.

Here's an example. Let's say you invest in Startup XYZ's convertible debt round. You put in $500,000 that entitles you to a twenty percent discount when it converts. Now let's say twelve months goes by. The company is chugging along and it gets the attention of some big venture capitalists. Ultimately, Union Square Ventures invests $2 million at a $8 million pre-money valuation. That means the post-money valuation is $10 million.

Your $500,000 convertible note is going to convert into equity. But not at the $10 million valuation. Remember, you have a twenty percent discount. So instead of getting your shares at the $10 million valuation, you're going to get a twenty percent discount. And that means you'll get your shares at an $8 million valuation.

You'd own shares at a lower valuation than Union Square Ventures, the professional venture firm. Again, the discount is a way to reward you for taking the extra risk of investing in an unproven company.

Now let's look at a different scenario with Startup XYZ. Let's say it waits to raise money for an additional six months. And it makes so much progress in those six extra months that it's able to increase its valuation to $25 million. Well, even with a twenty percent discount, with a $25 million valuation, you're barely going to own any of this company. You put $500,000 into it, and now you're talking about owning just two percent of its shares.

That's not fair. After all, you're the one who took all the upfront risk. And this brings us to the second deal term for Convertible Notes.

Let's say the scenario I just mentioned actually happens: the startup you loaned money to eighteen months ago just raised a big round at a $25 million valuation. But now let's assume that there was a *cap* on your convertible note. To put it simply, a cap is the maximum pre-money valuation you'll have to pay when the note converts.

So if a company ends up raising money at a valuation that's higher than the cap, your shares would convert at the cap price, not the higher valuation the company just raised money at.

In this scenario, let's say the cap was $5 million. That means your $500,000 wouldn't convert at a $25 million valuation. Instead, it would convert at a $5 million valuation.

So instead of owning about two percent, you'd own closer to ten percent. Now we're talking. That seems more fair.

So again, Discounts and Caps are very important. They make sure that you're compensated for the risk you took!

Now let's look at the other common deal terms associated with convertible debt, including the length of the note, and its interest rate.

You see, in addition to a qualified financing, convertibles can also convert when they hit their maturity date. So if the convertible note has an eighteen-month term, eighteen months after you invest in it, it

might automatically convert into stock. And the valuation it converts at is the cap.
So when you invest in a convertible note — which is common in early-stage investing — pay attention to the cap. Even without a qualified financing, the cap may end up becoming your valuation.

And that brings us to the fourth and final deal term. Just like an ordinary note or bond, convertibles have an interest rate. Generally, it's low. Common rates are between two percent and five percent. But all this interest adds up. You see, down the road, when the note converts, you get a little kicker: you get all the interest that has accrued in equity.

So, for example, if you invested $100,000 into a twelve-month convertible, and it has a five percent interest rate, at the end of that year, you'd get an extra $5,000 of equity. Not bad.

So now that you understand the standard deal terms for equity and debt financings, let's go over which terms work in your favor, and which ones could lead to more risk.

By now, you probably already have a pretty good idea about which terms are going to work in your favor. But let's break them out by type of financing to make sure that everything is crystal clear.

First we'll cover deal terms for Equity Financings.

For equity financing, look for low valuations. We've gone over this before, but again, all else being equal, owning a company at a lower price is better than owning the same company at a higher price.

You'll also want to look for deals where you'll own preferred stock. Remember, an investment can quickly become a loss if you're left holding common stock. Preferred stock is a way to protect yourself as an investor, so aim to only focus on deals that offer preferred.

Some deals offer information rights so you can track a startup's progress in detail. But even without these rights, startups raising capital on the crowdfunding platforms are legally required to keep you up to date on the most important news.

So now let's move on to deal terms for Convertibles.

Since a convertible note only has a few basic terms (remember: the real terms are being "kicked down the road" until a Qualified Financing), there are only a few things to look out for.

First, if you see a deal that doesn't have a cap, walk away. That's like the entrepreneur saying, "You know what? I don't care if you're taking extra risk right now. You should feel lucky to even get into this deal." That's bad news.

Next, regarding the discount, the norm is generally twenty percent or so. And finally, typical interest rates tend to be in the range of two percent to five percent.

CHAPTER 5 REVIEW

Let's quickly review what you learned in this chapter about private equity deal terms.

First you learned about the difference between Equity and Convertible Notes. Then you learned about deal terms for each type of financing.

For equity rounds, you learned about:

1. Valuation. Remember, all else being equal, lower is better.
2. Common Stock vs. Preferred Stock. You'll always want Preferred.
3. Pro-rata Rights and Information rights. Take them if you can get them.

And for Convertibles Notes, pay attention to:

1. The Discount.
2. The Cap.
3. The Interest Rate.
4. And the Term.

This may seem like a lot of information. But after you've evaluated a handful of deals, it will become second nature to you.

Keep in mind, at this point, you probably know more than 99% of investors about early-stage deal terms. In fact, I bet you know more about private equity than your broker or financial advisor.

Now that we've completed our foundational chapters about early-stage, pre-IPO investing, we're ready to move onto our proprietary investment framework.

The process we're about to teach you was born from decades of early-stage investment experience. It's based on more than thirty hours of interviews we conducted with top venture investors.

Furthermore, as of the time we're writing this book, we've spent more than eight years and millions of dollars studying the equity crowdfunding market.

Now we've collected the best practices for finding, filtering, and profiting from early-stage deals. And we've boiled it all down into a concise, dependable framework you can use every day. So let's jump in.

PART 2:
STRATEGY & TACTICS

CHAPTER 6

ALLOCATION STRATEGY

We've finally wrapped up the foundational chapters of this book.

In those early chapters, you learned about everything from the history of venture capital, to the basics of equity crowdfunding, to the deal terms you'll need to focus on. At this point, you probably know more about early-stage investing than ninety-nine percent of the investing public.

But this chapter marks the beginning of something new — the Strategy and Tactics section of our book. This is where we start to teach you the time-tested process the professionals use to find, filter, and profit from the best early-stage companies.

As you might remember, to create this book, we interviewed more than thirty venture capitalists and top angel investors. Then we boiled down their best practices into a series of lessons and rules you can follow to build your own portfolio.

To make this as easy as possible for you, we broke down the best practices into a three-step process we call the "ASE." Each letter stands for a different step in the process:

Step One is where we **"Allocate."** This is where you'll learn how much of your total investment portfolio to allocate towards early-stage deals, and how much capital to put into each deal.

Step Two is where we **"Screen."** This is where we'll show you how to take hundreds or even thousands of early-stage deals, and quickly filter them down to a small and manageable handful that you'll dive into more deeply in Step Three.

Step Three is where we **"Evaluate."** This is where you'll dive into each individual opportunity. We'll show you the criteria the professionals look for in their winning investments — deals like Uber, where our business partner made 400x his money. Or Twitter, which earned private investors thousands of times their money.

And if you follow this process and stick to this framework, you'll have the opportunity to earn the same sorts of returns that the professionals earn.

This chapter is all about diving into the first step of the ASE process: Allocate. This is where we'll show you how to set up your early-stage investment strategy.

It's based on the same strategy the professionals use to maximize their upside and protect their downside. And it will be the foundation for all of your early-stage investing efforts going forward. So this is going to be an exciting and important chapter!

Here's what you're going to learn:

1. How much of your portfolio to allocate towards early-stage deals.
2. How much to invest into each deal.
3. The secret to earning consistently high returns.

Remember, on average, professionals in this space have earned fifty-five percent per year. At that rate, they can essentially double their money every two years or so.

So, to kick things off, let's define what we mean by Allocation. And to do that, let's take a step back and look at your finances.

If you're reading this book, perhaps you have a portfolio of investments already. For example, maybe you own some stocks and bonds, or even some REITs, options, and cryptos, too.

All of these investments represent different asset classes in your portfolio. If you're younger, maybe you have a bigger share of more speculative or growth-oriented investments, like stocks and options. And if you're older or retired, maybe you're more focused on income, in which case you own more bonds or fixed income investments.

This concept of holding different types of assets based on your financial goals is known as your asset allocation strategy. And that's exactly what we're reviewing in this chapter. You see, you can't look at early-stage companies as investments you're going to take a flyer on. You can't cherry-pick one startup and then "bet it all on black."

Instead, you need to think of startups as another asset class in your portfolio. In other words, you need to commit a certain percentage of your overall portfolio to startups, and then, over time, invest in a portfolio of them.

This is the same thing you do with stocks or bonds. And it's important for a number of reasons:

1. It allows you to spread your bets around. As you'll soon learn, this is more important than you think.
2. It lets you put your money into non-correlated assets. That means the returns from your early-stage investments won't be related to what's happening in your stock or bond portfolio. The stock market might go up, it might go down. But your startup investments won't follow the market. They'll follow their own course. This helps smooth out the inevitable bumps in the road.

So that's what we mean by Allocate. You set aside a portion of your overall portfolio to invest in a number of early-stage, private companies.

So now we need to figure out how much to allocate to early-stage deals. Should you put one percent of your portfolio into startups? Ten percent? Fifty percent?

Actually, there really isn't just one answer. It depends on your investment goals, and your tolerance for risk. Many of the professionals we interviewed suggested an early-stage allocation of five percent to fifteen percent. One suggested thirty percent. But one of the smartest responses we heard wasn't a specific number, but more of a rule of thumb. And we thought we'd pass it along to you now.

Have you ever heard the old rule of thumb for determining how much of your portfolio to allocate to stocks, and how much to allocate to bonds?

You start with 100, then you subtract your age. That's the percentage of your portfolio to put into stocks. And you invest the remainder into bonds. For example, let's say you're fifty-five years old. 100 minus fifty-five is forty-five**.** So you should put forty-five percent of your assets into stocks, and the remainder into bonds.

It turns out there's a similar rule of thumb for early-stage investing. Basically, you subtract your age from eighty, then divide the result by two. That gives you the highest percentage of your assets you should put into early-stage deals.

So if you're fifty-five years old, subtract fifty-five from eighty and you get twenty-five. Then divide

twenty-five by two, and you get twelve-and-a-half. That means you should put no more than twelve-and-a-half percent of your portfolio into early-stage companies.

Here's another example. Let's say you're sixty-five years old. Eighty minus sixty-five is fifteen. Divide fifteen by two and you get seven-and-a-half. So you'd put no more thanseven-and-a-half percent of your portfolio into early-stage investments.

Now let's bring this into the real world. Let's say you're sixty-five years old, and you have $500,000 in investable assets, not including your home. Like we just calculated, the most you should invest into early-stage companies is seven-and-a-half percent of your assets. And seven-and-a-half percent multiplied by $500,000 equals $37,500. That means, at most, you should be putting $37,500 into startups.

And remember, that's what you'll invest into your startup portfolio — the whole portfolio! That's not how much you'd invest into a single startup.

It's also worth mentioning that, historically, this sort of allocation would have been impossible. Until equity crowdfunding came along, most startups had a minimum investment of $25,000. And sometimes it was more like $50,000 or $100,000. But with equity crowdfunding, companies are accepting investments of a $100, and sometimes even less.

This brings us to our second topic for this chapter. Now that you know how much you should put into the startup asset class overall, how much should you invest into each deal?

Before we answer that, let's review a simple but powerful concept. Actually, it's the key to early-stage investing success. The concept I'm talking about is diversification.

Once you grasp it, you'll understand why it's so critical to your investment returns, and you'll also know exactly how much to invest in each opportunity.

You see, if there's one certainty when it comes to startups, it's that most of them fail. In fact, statistically, the percentage of failure is about seventy-five percent. And with a seventy-five percent failure rate, it's likely that three out of every four startup investments you make will fail. And that's if you're lucky.

It's like flipping a coin. Each time you flip, you have a fifty percent chance that the coin will land on heads, and a fifty percent chance it will land on tails. But just because you got tails on your first flip doesn't mean you'll get heads on your second. You could flip tails ten times in a row, fifteen times in a row, maybe even twenty times in a row. And it might never come up heads.

It's the same thing with startups. You could make twenty investments and still not hit a winner. The professionals we spoke with understand this. They know that, even though they have a time-tested process for finding and filtering for the best early-stage companies, the odds are that most of these businesses will ultimately flop.

And that's OK. Why? Because generally, the startups that do work out will return ten times your money or more. Investors just need to make sure they invest in enough companies for the probabilities to play out. For example, to go back to our coin-flipping analogy, if you flipped a coin twice, you might get heads twice in a row. That's not unlikely. But if you flipped the coin 1,000 times, you'd probably end up with something pretty close to fifty/fifty heads and tails.

It's the same thing with startups. The pros know that, if they only invest in four or five deals, the twenty-five percent success rate isn't likely to pan out. But if they invest in dozens or even hundreds of startups, as long as they're the "right" type of startups, it's very likely that they'll have enough winners in their portfolio to generate meaningful returns.

One successful venture capitalist you'll hear about often is Fred Wilson. Fred was an early investor in several multi-billion-dollar companies like Tumblr, Twitter, Etsy, and Coinbase. And Fred operates using what he calls "the rule of thirds." Let us explain what that means.

After a thirty-year career in venture investing, Fred has determined that a good early-stage portfolio generally turns into three equal buckets.

The first third of the companies will go to zero. In other words, Fred will lose all of his money on one-third of his investments.

The second third will break even or be modestly profitable.

And the final third will return ten or more times his money, or usually, far more than ten times his money.

Keep in mind that Fred is one of the best venture investors in the world. He's had many, many of his early investments go public or be acquired for hundreds of millions or even billions of dollars. But the fact is, even investors like Fred are wrong the majority of the time.

So again, even the professionals know that:

1. Not all of their investments will work out.
2. They need to invest in a portfolio of startup in order for the odds to play out properly.

So, how many startups should you invest in so the odds work in your favor? Most of the pros we spoke to suggested making somewhere between twenty-five to fifty investments over time.

But we came across a fascinating study that answered this question not with conjecture, but with data. This was a long-term research project by the Kauffman Foundation, one of the largest private foundations in the U.S.

Essentially, the Kauffman Foundation conducted the largest study ever performed on the returns of early-stage investing. To gather the data, the authors took results from 539 individual angel investors and eighty-six different angel investor groups that were involved with 1,130 startups.

After completing its study, the Kauffman Foundation made its findings publicly available. And from there, a number of investors, data scientists, and businesspeople performed their own analysis on it.

One study was from Alex LaPrade, who had worked in Strategy, Corporate Development, and Data for startups including Dispatch, which was acquired by Vista.

According to LaPrade's initial data, if you invest in fifty companies, your odds of doubling your money over time can reach ninety-six percent. If you invest in 100 companies, your chances for a double go up to ninety-nine percent. And if you invest in 500 companies, you'd have a greater than ninety-six percent chance of tripling your money.

To be clear, LaPrade's study makes some big assumptions. So take his conclusions with a grain of salt. But for us, the takeaway is clear. By increasing the number of startups you invest in, not only do you increase your odds of success, but you also increase your overall returns.

Given what the professionals told us, and given the studies we've reviewed, here's the bottom line:

At a minimum, you should be investing in twenty different startups. Thirty to fifty would be better. And ideally, your startup portfolio would eventually include about one hundred deals.

That's how you'll put yourself in position to earn the greatest returns with the least amount of risk.

So now that you know how many startups you should invest in, we can revisit our original question: how much money should you be putting into each deal?

Let's go back to our example from a minute ago, where we assume that you're a sixty-five-year-old investor, and you're going to allocate seven-and-a-half percent of your portfolio to early-stage deals. Let's further assume that you have $1 million in investable assets. Seven-and-a-half percent of $1 million is $75,000. So you can invest up to $75,000 into early-stage deals.

If you decide that, based on the data we just shared with you, your goal is to invest in fifty deals over the next few years, you'd invest $1,500 into each deal. In other words, $75,000 divided by fifty deals. And if you wanted to invest in 100 deals instead, you'd put $750 into each one.

At this point, our students tend to have a number of questions. So we'll aim to answer a few of the most common ones right now. Here's the first questions:

"Do I really have to stick to the rule of thumb about asset allocation, or limit my startup investments to five percent to fifteen percent of my overall portfolio? Can't I invest more?"

And here's the answer:

Sure you could invest more. But we wouldn't recommend it. Remember, these companies are risky, and they're privately held. There's no public market for their shares. So if you need to pay a tax bill or an unforeseen expense, you can't simply go and sell your shares. That cash is locked up. So regardless of your risk tolerance, you really shouldn't be thinking about allocating a big portion of your portfolio to startups.

You might also be wondering, "What if I invest in a portfolio of companies, but they all turn out to be bad? Then, no matter how many deals I invest in, I'd lose money, right?"

Yes, that's right. But that means you weren't using our framework for finding and filtering for only the most promising opportunities.

And that's what the rest of this book is all about. It's about showing you the qualitative and

quantitative factors that professional investors use when they're making investment decisions.

For example, factors like the quality of the startup team. Or the stage of the startup. Or how to leverage the research that other professionals have already done. But don't worry about that right now. By the end of the book, you'll have a firm grasp on how to identify high-potential opportunities.

Another concern you might have is about time. As in, "How am I ever going to find the time to make fifty or one hundred of these investments?"

That's a valid question. And to be clear, your goal isn't to make all of these investments at once. You should make them over the course of several years. For example, you might invest in five or ten new deals every year. In fact, in the Appendix, you'll see mention of our special report, "The 60-Minute Angel Investor." This report shows you how to build a portfolio of startups by spending just ten minutes on research each night.

Or maybe you're wondering what to do if you fall in love with a certain startup. For example, what if you find an early-stage company that's in an industry you know, is run by strong entrepreneurs, and its business plan seems fantastic?

You should put way more money than usual into this deal, right? Way more than your ordinary $1,500. No, you shouldn't. It's tempting to think you can predict success. But remember, if the best investors in this market are wrong seventy-five percent of the time, it's possible you'll be wrong at least that much.

Once you start putting too much capital into specific deals, you're setting yourself up for failure. Remember, invest just about the same dollar amount into each of your investments. That's the key to making sure your losers never take away from your winners.

I also know (and this is from personal experience) that early-stage investing can be thrilling. And once you get started, you might be tempted to go out and invest in twenty companies next month.

Our advice? Don't do it.

It's always possible that you stumbled onto twenty truly great startups the very first month of your angel-investing career. But it's not very likely. Most VCs spend three to five years investing all the capital from their funds. They take their time. There are many reasons they do it like this. But the primary reason is that it's really hard to find great deals. In fact, with startup investments, you should plan to say "no" at least ten times more often than you say "yes."

On this particular topic, I'll defer to one of the greatest investors of all time: Warren Buffett. Buffett

has a great quote. I'm paraphrasing here, but it goes something like this:

Imagine you have a punch card with twenty slots on it. Every time you make an investment, you use up one of the slots. And once your twenty investments are up, you're done. You can't make any more investments. If that were really the case, you'd be very selective about your investments.

And this is the approach we believe you should take for early-stage investing.

CHAPTER 6 REVIEW

We covered a lot of important material in this chapter. Let's quickly review it all before moving on.

First you learned about the proven, three-step process the professionals use to find, filter, and profit from early-stage deals. It's a process we call the "ASE."

Each letter stands for a different part of the process:

"A" is for Allocate.

"S" is for Screen.

And "E" is for Evaluate.

In this chapter, we primarily focused on the Allocate step. First you learned the basics of asset allocation, including how to determine how much of your portfolio to allocate to early-stage deals. Remember the formula: eighty minus your age, divided by two.

Then you learned the "secret" to early-stage investing success: diversification. Again, at a minimum, you should be investing in twenty startups. Thirty to fifty would be even better. And ideally, your startup portfolio would eventually include about one hundred deals.

Which brings us to the final allocation step: determining how much you'll put into each deal. And we have a straightforward formula for this, too. Take the dollar amount you're allocating to early-stage investments, and divide it by fifty deals. So if you're planning to allocate $50,000 to early-stage deals, you'd put $1,000 into each deal.

You might be tempted to invest more capital into certain deals. But history has shown that you shouldn't do so. Instead, you need to stay disciplined. Follow the system used by the professionals, and you'll do just fine.

And now you're ready to move onto the second step in the ASE framework: Screen**.**

In this next chapter, we'll teach you a simple process for quickly filtering out the good deals from the bad. This is the first step in making sure you're only looking at the best ideas, from the best entrepreneurs, at the best prices.

CHAPTER 7

SCREENING STRATEGY

In the last chapter, we went over the Allocate part of our ASE framework.

You learned how startups fit into your overall investment portfolio — from how much to allocate toward early-stage investing, to how much to allocate to each deal.

In this next chapter, we're going to dive into the S part of our ASE framework. S stands for **Screen.** This is where you'll learn how to get access to a huge volume of deals and then quickly filter them down, so you're only looking at the best ones.

Every year, millions of new businesses get started in the United States. Remember, according to the Census Bureau, more than 5.4 million new U.S. businesses were created during 2021. Even if only a tiny fraction of them were raising capital, it would be impossible to do research on so many deals. So we need a quick way to screen them, so we're only focusing on the ones with the most potential.

And that's what we're going to cover now. By the end of this chapter, you'll understand the following concepts:

1. You'll know where to find new deals.
2. You'll know how to screen these deals so you're only looking at the best ones.
3. You'll learn how to avoid the deals that could spell disaster.

To get started, let's take a look at how the professionals do it. After all, professional investors see thousands and thousands of deals every year. How do they sort through them all to select ten or twenty of the best ones?

As we learned during our research, each investor has a unique approach.

For example, some investors narrow the universe by focusing on a specific sector, like healthcare, clean technology, or e-commerce. These are called sector investors.

Other investors focus on big themes or trends. For example, they might just invest in startups building video games for the iPhone, or startups rolling up hundreds of ecommerce companies that sell on Amazon, or wearable technologies like FitBit bracelets that show you how many calories you're burning.

When they invest in themes, that's called thematic investing. And by investing in a specific sector or

theme, they become experts in that area. That makes it easier to filter out the good deals from the bad.

But there's a downside to this approach. What happens if they're dead wrong about an entire sector? Or what if their timing is off about a specific theme? Clean-tech, for example, has been a huge theme for years and years. Professional investors have spent billions on it. But not many of them have made money here yet. Maybe they never will.

For VCs working at a big fund, this wouldn't be a big deal. If one VC at a fund is focusing on clean-tech, and four or five others are focusing on other big trends, that could work out fine. Hopefully, one of them will hit the right trend at the right time and earn massive returns for the entire fund.

But angel investors like you don't work at a fund. We work for ourselves. And there's only one of us. So we're going to lay down the law here. Stay away from thematic investing, and stay away from narrowly-defined sector investing.

Instead, we recommend something called Quantitative Investing.

As the name implies, quantitative investing means investing in a large number ofdeals. This probably sounds familiar. In our last chapter, we concluded that you should be making between twenty and one hundred investments. That's a lot of investments. That's quantitative investing.

But to be clear, you shouldn't be investing in every company you see, just like a baseball player isn't going to swing at every pitch. You should only be investing in deals that meet certain criteria. And the criteria aren't so obvious:

1. They should be seed-stage companies.
2. They should be capital efficient.
3. You should be investing in a lot of these companies.

And now let's do a deeper dive on each criterion, one by one.

First of all, you should only be investing in companies that are at the seed-stage. If a company is at the seed-stage, that means it's very early in its life cycle. It might be less than a year old, and it probably has a small team, perhaps two or three people.

Furthermore, a seed-stage company has an unproven business, which means that it probably doesn't have any customers or revenues yet.

And last but not least, when it comes to fundraising, seed-stage companies are typically raising less

than $1 million. In fact, usually they're raising less than $500,000.

The reason these factors are so important is because these are the characteristics that make seed-stage companies inexpensive to invest in. In other words, this is why they have low valuations. And because their valuations are so low — and because you already know that most successful startups are acquired for less than $100 million — these are the companies that give you the best shot at earning ten or more times your money.

Now let's look at the second part of what we said: you should invest in companies that are capital efficient. Such companies have a few main characteristics:

They don't need much money to get started, or to make it to profitability. They don't need millions of dollars to manufacture their product. And they don't need millions more to keep their lights on.

In other words, if you were looking at a company's Income Statement (or in the case of a startup, its projected financials), you'd look for a business with low startup costs, low Costs of Goods Sold, and low capital expenditures.

In general, certain types of businesses meet these criteria. For example, companies that are technology-driven, like software companies and internet companies. With just a little bit of capital from angel investors and a little bit of elbow grease from the founders, tech companies like these can make significant progress.

And since they're so inexpensive to run, they have a lower risk of going out of business. We'll explain why that's so important in a moment.

As an added bonus, bigger companies love these kinds of startups, and they often pay a significant premium to acquire them.

And here's the third and final part of our investing strategy: you need to invest in a large number of these businesses. In other words, you need to diversify. In our last chapter, we reviewed how many investments you need in your portfolio to be considered diversified. And remember: the more diversified you are, the higher your returns, and the lower your risk.

Again, the idea here is simple, and the math backs it up. Many of the startups you invest in won't work out. You already know that. But the ones that do work out should more than make up for the losers.

For example, imagine you invest $1,000 into 100 different startups. That's $100,000 in total. Let's say forty of these startups go out of business, returning nothing. The next thirty break even, returning

$1,000 each. That's a $30,000 return of capital. And the final thirty startups return five to ten times your money. Let's average that out and say seven-and-a-half times your money. That would be a return of $225,000.

$30,000 + $225,000 equals $255,000. So that's a $255,000 return on a $100,000 investment. Even if it took three to five years to get there, you'd still earn average annual returns of twenty percent to thirty percent. That's almost four times higher than the stock market averages.

100 investments might sound like a big number, and a lot of work. But don't worry about that. Because as we mentioned earlier, we built some software, **CrowdabilityIQ**, that handles all the hard work for you. Again, we'll explain more about it later in the book.

For now, just remember to stick to your strategy of investing in dozens and dozens ofcapital-efficient, seed-stage companies.

Since you're going to be investing in a large number of deals, now it's time to show you where to find these deals. In other words, where to source them.

As mentioned earlier, millions of companies get started every year in the U.S. But where are they, and how do you find the ones that are raising money? Well, you might hear about an occasional deal through friends, or at work. But if you're looking to build a diversified portfolio, like a professional, we recommend using the equity crowdfunding platforms.

Like you learned in Chapter 2, these platforms play matchmaker between entrepreneurs who need capital, and investors like you. The platforms do a lot of the initial heavy lifting for you, and a lot of the pre-screening. And they're very thorough about it, too. One of these platforms only accepts about three percent of the companies that apply. Another accepts just one-half of one percent of the companies that apply. That's one out of every 200. It's like having a team of analysts working for you, just like the big VCs do.

As you know by now, dozens and dozens of crowdfunding platforms exist. And as you might remember, Crowdability aggregates deals from the best platforms and publishes them all in one place. To see them, simply go to the "Deals" page of our website. (We'll link to this page from the

Appendix.) When you see a deal that catches your eye, just click on it. That'll take you to the platform that's hosting the deal. And remember, if you haven't already registered on the platform, you'll need to do so. Registration is free, and it'll only take a few minutes.

Now let's look at an example of the information you'll see for a specific deal. There are a couple of categories of information. The first one covers the basics. For example, a brief Summary of the business, information about its sector, an Executive summary, and detailed information about the Team.

And the second category contains details about the deal. For example, how much the company is raising, how much it's already raised, and who else is investing. Pay special attention to who else is investing. We'll explain why later.

If you have questions about any of these things, you can always call or email the platform. Remember, you can usually get these guys on the phone.

Now let's show you how to take all this information and use it to separate the good deals from the bad.

Every month, you're going to come across dozens or even hundreds of new deals. And each deal will have all the data points we just listed above as well as many others. That's thousands of data points to review. There is no way you could digest and make sense of so much information. There just aren't enough hours in the day.

So the trick the professionals use — and the trick that you can use — is to focus on just a small handful of criteria. That way, you can quickly identify the deals that are worth diving into. And once you learn how to do this, you'll be able to do it in just a few minutes per company.

So let's take a look at the criteria the professionals use to quickly separate the wheat from the chaff. And over the next few chapters, we'll dive deeper into each one.

Simply put, this is a way to quickly filter out the good deals from the bad.

We're about to show you three core filters for your initial screen. Remember, these filters can quickly help you get through the hundreds or even thousands of deals you'll see on the equity crowdfunding platforms.

(But don't forget: you'll still need to do more research on the deals that make it through your screening process.)

The three filters are:

- The team.
- The team's progress.
- The company's valuation.

Let's start with the first filter. For early-stage deals, the single-most critical success factor is the team. We'll get into the details about this in Chapter 8. But at a high-level, here's what you want to look for when evaluating a startup team.

You need a team that:

1. Knows and understands the industry it's playing in.
2. Has technical experience.
3. Has more than one founder.

For example, if you see a deal for an e-commerce business for pet supplies, but nobody on the team has ever worked in e-commerce or in pet care, you should scratch that one off your list.

Furthermore, since you're going to be looking at businesses that are technology-enabled, someone on the founding team should have technical experience.

Remember our fictional startup from earlier, the ACME Widgets company?

ACME had two founders, Sally and Nick. If both founders had been business-oriented people like Nick, with no technical founder, we would have passed on the deal.

And if you see a company with just one founder, you might want to pass on that one, too. As it turns out, single-founder companies don't perform nearly as well as companies with multiple founders.

Now let's move on to the second filter. This is a way to measure the team's progress. Remember, these are seed-stage ideas, so we don't expect them to have millions of dollars in revenues. But the team should be showing us some signs of life.

For example, have they attracted great people around them as mentors, advisors, or investors? Are there any signs that users like their product?

What we're looking for here is proven progress. And at the very least, the company should already have built an early prototype of its product. We'll dive into the concept of progress more deeply in Chapter 9. But for now, let's just say that if a startup is showing progress, that's a sign that it's worth digging into it more deeply.

Now let's move on to the third factor. And this is something you've already learned about — valuation. Earlier, we noted a key reason to invest in seed-stage companies: their valuations are still very low.

Like you learned, you should be aiming to earn 10x your money on each early-stage deal. And since most startup acquisitions take place at $100 million or less, to stack the odds in your favor of earning ten times your money, you should only be looking at companies that have a valuation of $10 million or less.

This particular filter means you'll be saying "pass" to a lot of startups that look exciting. And these startups might go on to be very successful. But if we're going to be disciplined about following the system the professionals use, we need to avoid paying up for expensive deals.

Furthermore, when we invest at a low valuation, our hurdle rate for making asuccessful investment becomes much lower. For example, as long as you own preferred stock, even if a startup gets acquired for just $5 million, if you invested at a $5 million valuation, you'll get your money back.

We just covered some of the most important criteria to screen for in your potentialinvestments. In other words, these are the characteristics you want them to have.

But what about the characteristics you *don't* want them to have. In other words, what are the characteristics of a startup that indicate it has a higher likelihood of failure.

The most fundamental reason a company fails is that it runs out of money. So we should avoid the types of companies that are more likely to run out of money.

This is such an important part of startup investing that we built special software that can help us mitigate this risk. This is part of **CrowdabilityIQ**, which we've mentioned before. And this particular part of it helps you rank startups based on their relative risk of running out of capital. We call it the Risk of Ruin Index.

What we tried to do when we created the Risk of Ruin Index was come up with an objective way to look at a company's risk of running out of money, and see if its risk is higher or lower than other companies.

For example, let's say you're looking at two companies. Company 1 has some revenue coming in, and $300,000 in the bank. Company 2, on the other hand, has no revenue, and only $50,000 in the bank. Company 2 might become the next Facebook. But all else being equal, compared to Company 1, it has a higher risk of running out of money.

At its simplest level, that's how our risk index works. But behind the scenes, it's based on an extensive research project we conducted for the better part of a year. We identified twenty-five different factors that are statistically correlated to a company's probability of going out of business.

We'll look at the top few factors now so you get a quick sense for them. But keep in mind, you won't need to do this analysis by hand unless you want to. The software we built does it all for you automatically.

We'll cover:

1. A startup's investors.
2. Its revenues, if any.
3. Its fixed costs.

Let's start with the first factor, a startup's investors. You see, knowing who else is investing in the startup can be extremely important. For example, would you rather invest in a company that was backed by a professional VC, or by your lawyer?

Your lawyer might be smart, but you should always opt for the VC. This makes sense intuitively. After all, the VC is an expert investor. But there's a less obvious reason, too. Let's look at some data to learn why.

A recent study performed by Redpoint Ventures shows that a startup that raises its seed round from a venture fund (as opposed to individual investors) is sixty-three percent more likely to raise a Series A round down the road. In other words, startups that raise from VCs have a higher chance of raising more money later on. And as we've learned, the more cash a startup has, the longer it can stay in business.

So if you have the choice between investing in two equivalent companies, but one has a VC as a co-investor, and the other has angels, statistically speaking, you're better off investing in the one with a VC. That's the one with a lower Risk of Ruin.

Now's let's look at the second factor, Revenue. This one is pretty straightforward. If a company has revenues coming in, it can last longer.

So if there are two equivalent companies, and one is creating revenues and the other isn't, the one with revenue has a lower relative Risk of Ruin.

Then there's the third factor, high fixed costs. If a startup has high fixed costs (in other words, high overhead), that's a big red flag. In general, you can eliminate businesses like these by sticking to tech and software companies, but it's worth pointing out that not all tech companies are created equal.

For instance, an e-commerce company like eBay is more capital efficient than an e-commerce company like Amazon. This is because Amazon holds inventory. It has goods and warehouses and physical fulfillment centers all over the world. eBay just acts as a middleman. It lets its users handle all the expensive, heavy lifting. This is why eBay's net income is five to ten times higher than Amazon's, even though its revenue numbers are far smaller.

So relatively speaking, you should choose to invest in startups like eBay, rather than startups like Amazon.

In addition to these three examples, there are dozens of other factors we analyze, too. For example:

- Did the startup graduate from one of the accelerator programs?
- Does it have name-brand mentors or advisors?
- Do the founders have advanced degrees that are relevant to their company?

Keep in mind — the Risk of Ruin index isn't meant to help you make an investment decision on individual startups. Instead, it's a screening filter. So if you're evaluating ten deals, you can focus on the ones with the lowest Risk of Ruin.

CHAPTER 7 REVIEW

That wraps up the screening portion of our ASE framework. That was a lot of new information, so let's quickly review:

We started by setting a clear strategy for your early-stage investments. Remember, you'll be investing in a large number of seed-stage technology companies that are capital-efficient.

Then we established that you'll source your deals from the equity crowdfunding platforms.

After that, we reviewed your three screening filters. You'll use these filters to whittle down your universe of potential investments. Again, you'll still need to perform more research on the individual deals that pass your screen. But this initial process will help you cut through the clutter and speed things up.

The three filters we discussed were:

1. The Founding Team. A founding team should have multiple people with industry and technical experience.
2. Progress. Generally, you'll want to look for companies that have momentum.
3. Valuation. Focus on startups valued at less than $10 million.

And finally, we introduced you to our Risk of Ruin Index. We showed you how we use this tool to compare startups, so we can determine which has the lower relative risk profile. There are twenty-five different criteria we look for, and we reviewed three of them. We looked at:

1. The company's investors. If you invest alongside a venture capitalist, you're investing in a startup that has a higher likelihood of raising more money down the road.
2. Revenues. The more revenues a company has, the less likely it is to go out of business.
3. The company's fixed costs. Aim to invest in businesses that are capital efficient. The lower a company's fixed costs, the more efficient it can be with its cash.

We also introduced you to some special software we built, **CrowdabilityIQ**. This tool automates all the necessary analysis and filtering, so identifying good deals is faster and easier for you. You can learn more about it in the Appendix.

In the next chapter, we'll be kicking off the most important part of our book. In fact, we'll be dedicating three chapters to it, so we can show you the whole "E" part of the ASE.

You're about to learn how to evaluate each deal that's passed your screen. Essentially, you're about to learn how to perform due diligence like a professional investor.

This process will ultimately determine your overall investment success. So let's dive in.

CHAPTER 8

EVALUATING THE PEOPLE

Now we're about to dive into the most in-depth and critical part of this book.

In the last couple of chapters, we covered the first two phases of our early-stage investment framework, the ASE. We covered the A for Allocate, and the S for Screening.

This chapter marks the beginning of the E portion of the ASE framework: Evaluate.

This is where we'll teach you how to do a deep dive on every deal on your short list. You'll learn how to evaluate everything from the professional background of the team, to the company's likelihood of reaching its goals.

Bottom line, you'll learn how to evaluate whether a deal is worth investing in.

Because this information is so important, we broke it into three separate chapters. This first chapter, Chapter 8, is all about how to evaluate the people involved in a deal. And we're not just talking about the founders. We're talking about the executive team, the company's advisors, even its other investors.

This is one of the most important chapters in the book. You see, historically, angel investing was done locally. Angels would invest in people and companies they could get to know in person. Partially this was due to geography. But for the most part, it's because, prior to the JOBS Act (the new set of laws that lets ordinary people invest in startups), investors needed to have a direct relationship with the company they were investing in.

But with equity crowdfunding, it's a different story. It's unlikely you'll meet the entrepreneurs you'll be investing in. And frankly, some investors might consider this a negative. But we believe the pros far outweigh the cons. First of all, while you might not meet the entrepreneurs face-to-face, plenty of online tools are available nowadays so you can do deep research on them. You can evaluate pretty much everything you'd ever want to know.

Furthermore, because the platforms have already done basic screening and background checks on the founders, you'll be assured that there's no fraudsters or criminals involved.

Secondly, with equity crowdfunding, you'll be able to invest in many more startups than the typical angel. This new form of venture capital gives you the ability to invest in dozens, even hundreds, of startups. And remember, this level of diversification is one of the most important rules for successful early-stage investing.

So here's what we're going to cover in this chapter:

First you'll learn why evaluating the people involved in a startup (specifically, the team) is the single most important criteria for an early-stage investment.

Next we'll show you the three qualities to look for when evaluating a company'sfounders.

Then you'll learn how to evaluate a company's investors. We'll teach you about the precise type of investor you'll want right next to you.

And finally, we'll show you the specific websites and resources you can use to quickly gather all this information.

So let's get started!

For most professional investors, the team is the most important piece of the early-stage puzzle. And the team should be your main focus, too. You see, startups create products that are new. They don't have any customers yet. For the most part, they don't even have any evidence that there's a market for their idea.

So startup founders have an incredibly challenging job. They have to create a product, and find a market for their product, at the same time. In the lingo of startups, we call this challenge, "Finding the product/market fit."

Product/Market Fit is when a startup's product really catches on with its target audience. Once a startup finds that fit, that's when it can begin to grow. But until it reaches this stage, the company is constantly at risk of going out of business.

For example, a startup might spend six months building a new product. And when the product is finally introduced to the market, the startup might get some bad news. No one's interested in it. So what do the founders do then?

If the team is just average, they won't see the writing on the wall. They'll refuse to believe they've got a dud on their hands. So they'll just slog along, making minor changes to their product. Or even worse, they'll start adding new features — new bells and whistles — and then cross their fingers and hope that fixes the problem.

The thing is, it's rare that adding more features to a product fixes the problem. To create something people really want, you generally have to simplify a product. In other words, you have to reduce it to a form where it solves a very specific problem, or meets a very specific need.

So great entrepreneurs will go back to the drawing board, dig into what they've learned, and try something new. And they'll do this before their money runs out.

In the startup world, this process I'm referring to (where an entrepreneur takes what they've learned and uses that knowledge to switch directions) has a name. It's called pivoting. Let's look at a few pivots from the real world, so you see what we mean.

This first one's a great story. It's a story about the fastest-growing company in the history of business. The company is called Groupon. And the story we're about to tell you took place well before Groupon went public, and well before its stock took a tumble.

You've probably heard of Groupon before. Maybe you still use it. It's the daily deals company started by Andrew Mason. But Groupon wasn't always the company we know today. When it was founded in 2006, it was a tiny startup called The Point. Back then, The Point was aiming to help non- profits and social causes be more effective at fundraising. The gist of it was that Mason thought people would be more likely to donate if they knew their donation would actually make a difference.

You see, traditionally, when you make a donation of $20 or $50 to a cause, it won't have much impact unless thousands of other people are also contributing. Otherwise, there won't be enough money to accomplish anything. So if a cause needed a total of $100,000 before the money could make a difference, The Point made sure a donor's credit card wouldn't get charged until the cause reached $100,000 in commitments — in other words, a $100,000 "tipping point."

In theory, this was an interesting idea. But in practice, it didn't work. It didn't catch on with users. And by the time Mason realized it wasn't working, he'd burned through nearly all of his seed capital.

But Mason was smart. He sat down and took an honest look at what he could salvage from his business. And that's when he realized something: the underlying idea of The Point — the concept of a tipping point — could also be used for commercial purposes. Essentially, if enough customers were willing to buy its service or product, a business could offer a special deal.

For example, a local restaurant or nail salon might be willing to offer a huge discount if it could get one hundred new customers all at once. So Mason decided to focus all his efforts on this new idea — something he called group-buying.

And it worked. In fact, his business exploded. So he renamed the company Groupon, and a few years

later, it went public, making its early investors a fortune.

The thing is, Groupon's story isn't so unusual. Pivoting is far more common than you'd think. Take Twitter for example. Twitter started life as a podcasting service. It was like an online radio station.

But then Twitter's founders went through a series of pivots. And eventually, their business became theTwitter you know today — which, by the way, is worth about $30 billion.

Here's what these examples have in common. Their founders were willing to admit their business wasn't working, and they were smart enough to pivot while they still had money in the bank.

So here's the big question:

How do you find a good team? In particular, how do you find a good team that will:

- Be resourceful enough, and frugal enough, not to burn through all its cash before it reaches Product-Market fit?
- Quickly test new ideas until it finds the one that works?
- Be intellectually honest enough to admit when things aren't working, and quickly change course?

The challenge here is figuring these things out about the team before they've made much progress. Because remember, we're investing in companies that are still at the seed-stage.

But as it turns out, the professionals have identified a small handful of attributes to look for when evaluating a team. These attributes can help predict how an entrepreneur will handle the inevitable bumps in the road. Let's go over each one now.

One of the first things you need to look for (and we touched on this briefly in our last chapter on screening) is founders with domain experience. If we say someone has domain experience, we mean they have direct and substantial experience working in the same industry as their startup. There are a few reasons this is so important.

First of all, founders who've already spent time in their industry are more likely to have first-hand experience with how the industry operates, and what its problems are.

Secondly, it means they're more likely to understand their customer.

And lastly, it means they'll know people who can be helpful. In other words, they'll be well-connected.

That's a big list of benefits. And these benefits can help a startup make more progress, more quickly. They help founders avoid time- consuming and expensive trial and error.

And as it turns out, domain experience happens to be one of the rare areas that academic studies all agree on. Studies have shown conclusively that a startup's risk of ruin (its likelihood to fail) goes down dramatically when its founders have relevant industry experience.

Having the right background, network, and industry knowledge allow entrepreneurs to rapidly test their product and their business idea. The faster they can move, the less money they'll spend — and the more likely it is they'll be able to pivot their way into Product/Market Fit.

The second attribute is all about the size and composition of the team. And on this one, too, the data is clear: a startup team with more than one founder has better odds of success.

To understand why, consider the age-old phrase, "Time is Money." You see, this phrase is particularly true for startups, because startups have just a tiny window of time before they run out of money. And a team with multiple founders can get more done, more quickly. In fact, a famous study called "The Startup Genome Report" found that "solo" founders, the entrepreneurs who try to do it on their own, take three-and-a-half times longer to gain momentum compared to a founding team of two.

But it's not just the size of the team. It's also its composition. In other words, the attributes that each of the founders brings to the table. As it turns out, balanced teams — where, for example, there's one technical founder and one business founder — have far more success. Balanced teams are able to raise more money. And they grow their customer base almost three times faster than teams that are strictly technical, or strictly business-heavy.

Then there's the third criteria: the team's education level.

You've probably heard the stories about college dropouts who end up becoming wildlysuccessful. People like Bill Gates, Steve Jobs, Mark Zuckerberg. But those are the exceptions. Sure, it's fun to talk about the fact that they never graduated. But if you look at the statistics, you'll see that people who graduated college — or even better, graduated with advanced degrees — have far higher success rates with their startups.

That's why we believe you should stick with the data: invest in people who've invested in their own education!

This chapter is all about evaluating the people behind a startup. And so far, we've looked at the team. But a startup isn't just about the team. Other people are involved, too, and they all need to be evaluated.

The next set of people we need to look at are the co-investors. In other words, the people or funds investing alongside you. What you're looking for here are professional investors who've already committed their capital.

And when we say a professional investor, we mean one of two things. First, a venture capitalist, someone who invests other peoples' money. Or second, an active angel investor, someone who consistently invests their own money.

Let's look at a few of the main reasons it can be so beneficial to have co- investors who are professionals.

First of all, they've already done the due diligence for you. Having a professional on board means that someone who invests for a living has already vetted the company and the investment for you. They've reviewed the business, they've dug into its pros and cons, and they've determined that it has a shot at success.

They've also reviewed the startups' merits as an investment. For example, they've vetted its valuation, and they've looked at what sort of rights the investors have. Essentially, they've determined that everything looks OK. For people who are new to investing in private deals, this can be incredibly valuable.

The second reason it's so valuable to have professional investors involved is that they can provide more capital in the future. In other words, they can help the company stay in business. You see, professional investors are in the business of providing capital. It's their job to allocate money towards startups. So a year from now, if the seed capital that you invested into a startup is running out, these professional investors can provide the startup with more capital. This additional capital gives the startup more time to figure out the right path. Maybe it'll help them figure out a pivot and get some traction.

And here, too, the statistics are clear. Startups that have a professional VC in their seed round stay alive longer, and usually that's because the startup is able to raise future rounds of financing. In fact, startups with at least one VC in their seed round raise future rounds of funding sixty-four percent

more often than startups that only have angel investors.

The third reason it can be so valuable to have professional investors involved is because of all the small things they can do — are in business to do — to help increase a startups' odds of success. Maybe it's a connection they can make. Maybe they'll help a startup pivot. Maybe they'll help it get acquired.

We're not saying to follow these professionals blindly. Remember, even the professionals strike out the majority of the time. But all these small benefits add up, and they sure can't hurt.

On a related topic, many of our students have asked if it's valuable for a startup to have prestigious advisors. In a nutshell, the answer is yes. It sure can't hurt, especially if the advisors have industry experience. But statistically speaking, advisory boards don't have magical powers to turn a failing startup into a success. Most advisors don't get deeply involved. They have their own businesses to run, and typically, they don't own enough equity in the startup to prioritize it. So while it's a good sign to see a startup with strong advisors, take their value with a grain of salt.

You just learned about the types of founders and investors you'll want to be involved with. For example, founders with domain experience, and investors who are professionals. But how do you find this information? And how do you verify it?

In other words, how do you know if an entrepreneur has industry experience? Or if one of your co-investors is a professional VC who can provide future financing?

So now we'll show you how to use a few online tools to help with your research.

Historically, when investors were trying to evaluate the team behind a startup, they might check some references or even run background checks. But with equity crowdfunding, the platforms do all this legwork for you.

So the first place you should look when digging into the team is the funding platform that's listing the deal. This is where you'll find biographies of the founders and key executives, as well as basic info about some of their notable investors.

As we mentioned earlier, the platforms have already conducted background checks on the entrepreneurs, so all the facts on the platform should be accurate. But from our perspective, it pays

to dig deeper. In particular, to find detailed information on the key people involved with the company, you should visit third-party websites.

One of the best places to review someone's professional background is LinkedIn.com. LinkedIn has more than 700 million members. In some ways, it's similar to Facebook. But instead of being a social network where you can connect with friends, it's a professional network, where you connect with your colleagues, or with people who might be relevant to your career.

Most startup entrepreneurs and professional investors already have a profile there. It's their online resume. And once you've registered and set up your own profile, when you're reviewing the members of a startup, you can see if you have any connections in common.

If you have people in common, this is a great way to do a reference check. But even if you don't have anyone in common, LinkedIn will show you a member's background and work experience. You can look at their past places of employment, how long they were there, the positions they held, and any endorsements they received from co-workers.

And here's another important way to leverage LinkedIn. Let's say you're thinking about investing in a fashion-related technology startup. And the CEO says she has significant industry experience because she used to work at Neiman Marcus. You might be thinking, "Great! The team has domain experience, I can check that off my list!" But when you actually dig into her LinkedIn profile, you learn that she only worked there for six months, in a very junior role.

We wouldn't consider that significant industry experience. And this knowledge could potentially change our perspective on making an investment.

Another great resource for information about entrepreneurs and investors is AngelList.com. AngelList is an equity crowdfunding platform for wealthy accredited investors. So it may not be relevant to you as a source for deals.

But before it was a crowdfunding platform, it was a networking site for entrepreneurs and investors. So tens of thousands of companies, entrepreneurs, and investors already have profiles there.

And here's where it gets interesting. Remember how we mentioned that companies that raise seed-stage funding from a venture capital fund are more likely to raise another round of financing in the future, and will be more likely to survive?

Well, on a startup's crowdfunding page, you might see that one of its investors is a venture capital firm. If so, there's a chance that it's an active fund that continues to invest in its portfolio companies over time. As we've mentioned before, having that kind of fund involved can be very helpful. It might

help ensure that a company stays solvent. But what looks like a fund at first blush, may not actually be a formal venture fund. Over the years, we've seen many entities that look like funds turn out to be the personal investment vehicles of angels.

There's nothing wrong with this. But keep in mind: unless the angel allocates funds for a living, having them involved doesn't necessarily give you the same advantages as having a professional venture fund on board.

To see how active the fund is, and to gauge whether it continues to fund deals over time, look up its history of investments. It's all right there on its AngelList profile.

You might also discover some pleasant surprises here. For example, you might find that your potential co-investors are fantastic. Maybe you're contemplating an investment in a startup that focuses on organic food. And when you look up some of the company's investors, you see they've backed dozens of organic food startups. And a couple of these startups were acquired in big takeovers or went public.

This scenario happened to us in the past. There was deal on a crowdfunding platform for an e-commerce startup called Abe's Market. Abe's was focused on organic foods and products. And if you'd looked up its investors, you'd have noticed a fund called Mistral Equity Partners. Mistral is one of the world's top private equity investors, and it specializes in natural and healthy consumer brands. For example, some of its other investments include Jamba Juice (Nasdaq: JMBA) and Hain Celestial (NASDAQ: HAIN), the owner of Celestial Seasonings. Mistral is an expert in the organic food industry. So we'd jump at the chance to invest alongside it in an organics deal.

And that's the type of information you can verify on AngelList.

By the way, if there's no information about the entrepreneur and the other investors on AngelList or LinkedIn, here's what to do. In those rare cases (and they *should* be rare if you're investing in the right types ofcompanies), you can search for them on Google. But be careful about this. Sometimes you might pull up information on the wrong person. For example, if I search for Wayne Mulligan, one of the authors of this book, I might accidently pull up information for Wayne Mulligan, the professional football player.

So be sure to double-check your information when using Google.

CHAPTER 8 REVIEW

That just about wraps up the first of our three chapters on evaluation. Specifically, we looked at how to evaluate the people involved in a startup.

Let's quickly re-cap what we learned before moving on to the next chapter.

First, we showed you why the people behind a startup are often the most important factor in a company's success. That's why we spend so much time evaluating them.

Next, we went over the three most important attributes to look for in a founding team:

1. Domain Experience. Remember, you should aim to back founders who have significant industry experience.
2. Team Size & Composition. Look for teams with more than one founder. And ideally, one founder will be business-focused, and the other will be technical.
3. Education Level. We often read about college dropouts that hit it big. But statistically speaking, the higher the level of education a founder has achieved, the greater his or her chances for startup success.

Then we explained how to evaluate a company's other investors. Specifically, we showed you the benefits of investing alongside professional VCs. They can assist with everything from future fundraising, to recruiting, to helping a company get acquired.

And finally, we showed you several sources that can help you gather information on a company, its team, and its investors.

All this evaluation requires some effort. But when we're talking about the potential to earn market-beatings profits, we think it's more than worth it.

And now, in the next chapter, we'll teach you how to evaluate a company's progress and goals.

CHAPTER 9

EVALUATING PERFORMANCE AND FUTURE PROSPECTS

In our last chapter, we kicked off the final phase of our early-stage framework — the ASE. We dove into the E phase, which stands for Evaluate.

We taught you how to evaluate one of the most important components of any startup: the people. In particular, we showed you how to assess a company's founders, as well as its investors and advisors.

In this chapter, we'll dive even deeper into the evaluation phase. This is where you'll learn how to judge a startup's performance. First, we'll show you how to analyze a company's past performance by analyzing three key metrics. And then we'll show you how to evaluate a company's prospects for future performance.

In both these evaluations, we'll show you how to spot the entrepreneurs who are most likely to wisely manage your investment capital. Remember, entrepreneurs often need to change direction several times before they find product/market fit. So you want to be confident that they'll be thoughtful and strategic about deploying their funds.

Therefore, understanding how an entrepreneur has performed in the past, and how they talk about their business plans for the future, are critical to this process.

Let's dive in.

As you're probably starting to see now, getting a good handle on a startup's potential can be challenging. It's probably the hardest part of early-stage investing. After all, you're not trying to evaluate a huge company with a fifty-year operating history and billions of dollars of revenues. To be fair, that's plenty challenging already. Top financial analysts get paid millions to do that kind of evaluation. Instead, you're trying to evaluate a startup — a company that has no operating history, and sometimes has little more than an idea sketched on the back of a napkin.

With a startup, you need to use your imagination. You need to imagine what the world might look like in the future, and then evaluate the company's potential to fit into that world. Any way you slice it, that's tough. But thankfully, there's a way to cut through all this imagining. It's a way to look at just the facts. And those facts can help guide your evaluation, and ultimately, your investment decision.

How do you do it? Professional investors recommend that you look at the company's traction. Traction is a measure of how much quantifiable progress the company has made in terms of penetrating its target market. This is important, because it's based on fact. It helps remove any

personal bias you might have. You see, maybe you wouldn't use the startup's product or service, and you can't imagine why anyone would. But that's just opinion. The fact is, if a startup sold a thousand widgets last month, and that's twice as many as it sold the month before, it has traction. This gives you evidence that it's onto something.

How do you measure this traction? By looking for quantifiable results. You're looking for proof that customers are using the startup's product, or even better, that they're willing to pay for it. And if a company has this data, rest assured it will share it with you. It would put it on a billboard on Times Square if it could afford to. After all, it helps strengthen its story, and it makes its pitch more appealing to investors.

Here are a few metrics a company will share with you when it's talking about how muchtraction it's getting.

The first set of information you might see is about how many users or customers a startup has. Remember, at the seed-stage, a company might not have any paying customers. But even if it has free users, that could be a positive sign. Does it have one hundred users? A thousand? A hundred thousand? Equally as important, what's the growth rate of those users? In other words, is the startup attracting an increasing number of users each month? If it was adding five thousand new customers a month right when it got started, but now it's adding ten thousand a month, that would be a good sign.

What's even better is seeing an increasing number of active users. That means not only is the company attracting new users, but existing users are sticking around too. That's a strong indication that the company's product or service is meeting a need in the market.

Let's dig into this concept a little bit more. Because measuring traction isn't just about how many users a startup has. It's also about how many of those people are actually using the startup's product on a regular basis. If a startup has a website, for example, how many times do its users visit the site every month, or every day? These are called active users. And if a product has a significant proportion of active users, that's a sign that the product is valuable.

There's another set of information a startup might show you. It might show you data about how good it is at retaining users once it attracts them. Because retention is a big challenge, too. For example, maybe the startup sells a monthly subscription service that delivers fresh flowers to someone's home. Once someone becomes a paying customer, how long do they stick around? If they're only paying for the service for a month or two before they quit, that's telling you something important. To the end user, the business isn't very valuable. But if customers are sticking around for six or eight or twelve months, the business might be very valuable, indeed.

For example, take a look at a King.com, a mobile gaming company that went public back in 2014. King.com was the maker of the highly addictive iPhone app, Candy Crush. If you look at King.com's IPO filings, you'll find a chart showing the number of active users who played its games each month. At the beginning of 2013, it had 138 million monthly active users. But by year-end, it had 408 million monthly active users. In this case, we see strong acquisition *and* retention metrics.

With a seed-stage startup, the numbers you see won't be this large. But the takeaway is the same: user activity is a key metric for measuring a company's traction.

And then there's the holy grail of traction: revenue. Remember, we're talking about startups here, so the absolute numbers may seem small to you. But if a startup has paying customers, that's a great sign.

First of all, if someone is willing to pay for the startup's service or product, that provides evidence that the service has real value. As investors, this validates the startup's idea for us. As mentioned earlier, we might not like a certain product. But if thousands of other people do, who are we to argue?

And secondly, if a company has revenues, that lowers its risk of going out of business. We looked at this concept back in Chapter 7, when we introduced the **Risk of Ruin.** Remember, at the end of the day, the most basic reason a company goes out of business is because it runs out of money. But the more money a company has coming in the door, the longer it can last. It's got more time to figure things out, and more time to pivot if it needs to.

And it's an even better sign if revenue is accelerating. For example, maybe the company is bringing in just $20,000 a month right now and that seems low to you. But if that's up from $10,000 last month, and $5,000 the month before, that's a great sign.

As you can see, evaluating a startup based on its traction is a shortcut. It cuts straight through all the guesswork. It's a brute-force method of determining whether a startup might be promising.

But some startups might not have these metrics to look at. In that case, there are four attributes you can look for that indicate early signs of traction. We call them the **Four Signs of Life**. Let's take a look at each of them now.

When we're looking for signs of early traction, the first thing we look for is whether the company has been able to attract great people around it. In particular, we look at how many full-time employees the company has. We're not interested in part-timers. Part-timers aren't committed in the same way.

It's hard to convince potential employees to take a chance on a startup. Startups are risky, and generally, they don't pay so well. So if a startup has been able to attract a staff, that's a sign of life. A sign of traction.

The second Sign of Life is when a startup has attracted good investors, especially venture capital funds or serious angel investors. If the startup was able to get good investors on board, that's a sign of life, and a sign that it's got some hustle.

The third Sign of Life is when a startup has been able to get some early business development deals signed. If the startup has already signed deals with future partners, or even just letters of intent, that shows there's genuine interest for its product or service.

And the fourth Sign of Life is when a startup has been able to create an early version of its product. Let's say it's making something that sounds crazy, like a flying car. It might sound crazy, but if the company has been able to create a prototype that actually flies, that would be a good sign of life.

So those are the four Signs of Life. If a startup has none of these signs, you should feel comfortable passing on the investment opportunity.

If it has some but not all of the Signs of Life — like a working prototype and a few full- time team members — that might be enough for you to give it some consideration. But there are plenty of high-potential startups that meet all of our criteria. So we'd advise you not to compromise.

We should also tell you about what we call Armchair Entrepreneurs. These people are always talking about a big idea, but they never actually build anything. Maybe they have an impressive resume or business plan, and they say a team is lined up to join them as soon as they raise money. But if you keep tabs on them for long enough, you realize that they never make any progress. They never build anything, and the team never comes on board. You want to avoid people like that.

In this day and age, if an entrepreneur can't build a prototype of her product before soliciting investors, she probably doesn't deserve your time, let alone your money.

And here's another red flag you should be on the look-out for. Let's say that a startup raised money a year or two ago. And today, it's raising more money. Depending on when it last raised money and how much it raised, it should have made some progress.

For example, we recently saw a startup raising money on a crowdfunding platform. (We won't mention any names.) At first blush, we were pretty excited about it. It had what looked like a strong team and a strong idea. But when we looked under the hood, we saw that it had raised $1 million more than a year ago. And since then, even though it had a million dollars to work with, it hadn't even finished building it technology. It had made almost no progress. That's a red flag.

So now that we've given you some guidelines about how to evaluate a company's past, now it's time to help you understand how to look forward. We're going to show you how to evaluate a startup's plan for the future.

And here's something to keep in mind. We're not talking about trying to dig into its business plan too deeply. The plan might change along the way. We understand that there will be pivots over time. For now, we just want to see some evidence that the founders have given their plan some serious thought.

For example, does it have a roadmap for the steps it will take to grow the business? Does it have a budget for how it will use the funds it's raising? If it doesn't have a roadmap and a budget, and if it doesn't have a framework for what it's doing and how it'll make decisions, it will just be reacting to whatever comes along. That's a dangerous way to run a business.

Regardless of whether the company succeeds or fails, you should feel comfortable and confident that the founders are going to be good custodians of your capital. And to us, that means having a plan.

Here are a few attributes we like to look at when we're evaluating a startup's plan for the future.

The first is **Use of Funds.** If a startup is aiming to raise $500,000, it should be able to tell you what it's going to use that capital for. It shouldn't be saying something casual, like "We need like $500,000 to pay some salaries and do some marketing." It should have a written document called a Use of Funds. And that document should be very specific.

It should be able to say something like this: "Based on our Use of Funds plan, over the next eighteen months, we'll spend $350,000 on marketing, $100,000 on salaries, and $50,000 on rent, legal, software and travel."

Again, it's not that its plan might not change. It probably will. The important thing is that the founders

are thinking about this like a real business, and they can prove to you that they're being thoughtful about building a plan.

When we look at a startup's Use of Funds, we like to see that some thought went into it. And that, in general, it makes sense. For example, if it's a hardware company making a physical product, a big chunk of its Use of Funds should be earmarked for manufacturing and warehousing. If not, there's a problem.

And if it's selling a product to other businesses, a big chunk of its Use of Funds should be earmarked for high-quality salespeople. If it's not, you've got a problem.

So look at the industry it's in, and see if its Use of Funds makes sense.

And by the way, if the company doesn't have a use of funds, ask for it. If it can't produce one, pass on the investment.

Once you know exactly how the startup is planning to use your capital, then you'll want to know what it plans to achieve with that capital.

It's one thing for a startup to say it will need $350,000 for marketing. It's another thing entirely to hear what that $350,000 is expected to accomplish. For example, you want to know that, with those funds, it's projecting to acquire 100,000 new customers who will ultimately be worth $1 million.

And even if its projections aren't so optimistic, you want to know that, at the very least, the founders have goals associated with their use of funds. Maybe they need capital to finish building out their technology, and the goal is launching their service. Or they need to hire a key salesperson, and the goal is closing a major deal.

Whatever they're spending money on, they should have goals associated with that spending, and they should tell you what those goals are.

We especially like it when entrepreneurs spell out their goals as a series of Milestones. In other words, as a series of tasks that build on top of each other. This shows us the entrepreneur understands the nature of her business, and has a roadmap for how to build something.

For example, if I were driving from New York to Florida, I'd have to drive through Maryland, Virginia, the Carolinas and Georgia first. Those would be my milestones along the way. An entrepreneur should be thinking in the same way.

Milestones will be different for every company you look at, but here's a simple example we saw a few years ago.

- Product Development (2022)
- Initial Marketing (2023)
- Commercialization with Major Brand Partners (2024)
- Expansion into New Products and New Markets (2025)

Usually, we look for milestones that are more granular. But for our purposes today, here's what we liked about them:

First of all, this shows an understanding of how a business gets built. In other words, first a company builds its product; then it markets it; then it expands; etc.

The second thing we like about these milestones is that they show a realistic perspective on how long things actually take. This startup isn't saying it's going to launch its product and become a billion-dollar company next year.

Frankly, when we see a company raising a few hundred thousand dollars and forecasting tens of millions in revenue in 12 months, that's a red flag. It's great that the founders have goals. But if their goals aren't grounded in reality, the founders probably don't have a good grasp of their business.

And the third thing we look at is the company's fundraising plan. Not just how much it's raising in this round. But realistically, how far this capital will get them, and what its plan is for raising additional capital in the future.

Like you know by now, it's challenging for a startup to predict the future. But it's clear that it needs enough gas in the tank so it can at least launch a product and do a pivot or two. And as a rule of thumb, this process generally takes twice as long and twice as much money as anyone bargained for.

The classic red flag here is a startup that's building what looks like a complicated new product or technology, and it's clearly not raising enough money to reach its next set of milestones. For example, maybe it's raising $250,000, which is only enough to cover its costs for twelve months or so. And meanwhile, it's forecasting that it will start bringing in revenues in a year.

The risk of ruin on a company like this is very high. If it costs more or takes longer than it expects to build its product and start selling it, it will go out of business before it even gets started. What typically happens is that a company like this won't see the writing on the wall for nine or ten months. And by that point, it hasn't made enough progress or given itself enough time to raise more money. So it goes belly up.

The lesson here is simple. Make sure that the startup you're thinking about investing in has a few things:

- A detailed plan for how it will use the capital it's raising.
- Solid milestones that seem reasonable.
- A good handle on how long its capital is going to last, and a plan for when it will need to start raising more money again.

There's just one more piece of research we like to review before completing the Evaluation stage. It's a way to get a comprehensive look at the company and its sector, and make sure there are no red flags.

To access this information, go to a special SEC database called EDGAR.

EDGAR stands for the Electronic Data Gathering, Analysis, and Retrieval system. This is the primary system used by companies that need to submit documents to comply with various regulations including the Securities Act of 1933, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

You can visit the EDGAR by clicking here, or by typing this address into your browser:
https://www.sec.gov/edgar/searchedgar/companysearch.html

When you get there, you'll see a form that looks like this:

Just enter the name of the startup you're doing research on and press "Search."

You'll then see one or more documents called Offering Statements. These documents include a gold mine of information. This might include details about the backgrounds of the founders and existing investors, the specifics of prior funding rounds, and the features of its business development deals.

Simply put, this is a way to see every piece of information that the startup is required, by law, to file with the SEC. We highly recommend taking a look.

CHAPTER 9 REVIEW

Now let's review the big takeaways from this chapter.

First, we went over three different ways to measure a company's traction:

1. Users and User Growth.
2. User Activity.
3. Revenue.

We also showed you a way to evaluate traction when these metrics don't yet exist. We called this method the Four Signs of Life.

To identify these signs, look for startups that have:

1. Attracted a committed team.
2. Raised money from venture investors.
3. Put together a business development deal or a Letter of Intent.
4. Built a prototype.

In this chapter, we taught you how to evaluate a company's past performance and future potential. We evaluate the startup's past performance to get a sense for how much uncertainty exists. If a company has zero revenue and no users, there's a high level of risk.

In that scenario, you should be cautious about making an investment. This is especially true if you're dealing with an armchair entrepreneur. If all the founder is presenting you with is a rosy vision for the future, but he or she has no measurable traction to point to, we'd recommend walking away.

But if the startup's performance passes the test, you can move onto evaluating its future potential. We showed you three different ways to evaluate a company's plans. You can look at its:

- Use of Funds.
- Milestones.
- Funding Plan.

Remember, startups face an uncertain path. That's why you should align yourself with a team that's thoughtful and strategic. Reviewing how they plan to use your capital can offer a clear clue into how the team thinks, and how they'll adapt to the challenges ahead.

In the next chapter, we'll be looking at a concept that's familiar to you by now: valuation. But this time, we'll be looking at it in a new way. We'll be showing you how to determine if the valuation the company is seeking is *fair.*

CHAPTER 10

DETERMINING A STARTUP'S FAIR VALUE

In the last nine chapters, you've learned an enormous amount about early-stage investing. You've learned everything from the types of companies you should be investing in, to the types of companies to avoid.

But one of the most critical concepts we covered is valuation. That's why we keep coming back to this concept again and again.

And the reason we keep coming back to it — the reason it's so important — is because the price we pay for an investment determines how much money we can earn. To earn ten times your money on a startup that gets acquired for $50 million, you need to invest at a valuation of $5 million. If you invested at a valuation of $10 million instead, you'd only earn five times your money.

If you could earn 5x your money on every investment you made, that would be one thing. But that's not how investing works, especially not early-stage investing. Remember, if you're doing this right — if you're using a system like the one the professionals use — two-thirds of your investments probably won't work out so well.

So if your winners don't return at least 10x your money, you won't have a shot at earning the market-beating returns we keep mentioning.

The thing is, valuing early-stage companies is very difficult, especially seed-stage companies. As we've mentioned, if you stick with deals from the funding platforms, you'll never have to negotiate a valuation yourself. But you will have to figure out if the valuation is fair or not. You'll have to determine whether it's high or low.

And that's what this chapter is all about: determining a fair value for a startup.

To determine a fair value, you need a reliable system. So in this chapter, we're going to teach you ***The Big Book of Pre-IPO Profits*** valuation system. Our system is based on three of the most important valuation methods used by professional seed-stage investors.

First we'll teach you about each method individually. Then we'll show you how we tie them all together. Each method is named after the investor who pioneered it, and all three methods are actively being used today by top seed-stage investors.

The three methods you're going to learn about are called The McClure Method, The Berkus Method,

and The Right-Side Method. And once you've learned about each method, we'll teach you how to combine their results in order to make the right investment decision.

And don't worry, you won't need any textbooks or reference books for this exercise.You'll just need a calculator and a bit of practice.

Keep in mind, you'll be seeing hundreds or even thousands of potential investments each year. And for every investment you make, you'll be saying "no" to ninety-nine others. One of the simplest ways to get a clear "no" is by staying disciplined about valuation. In other words, never overpaying for an investment.

And one final note before we dive into this:

These valuation methods were originally developed during a different era — an era when average startup valuations were closer to $5 million, and the average exit price for startup M&A was closer to $50 million. That's why the maximum "fair" valuation a startup could earn using two of these methods is $5 million.

But as you've learned in this book, the average exit price for M&A in today's market is about $100 million. That's why we can invest today at valuations up to $10 million. In other words, with a $100 million potential exit, we could make 10x our money by investing at a $10 million valuation. And that's why, as you'll see in a moment, we'll adjust the results of these methods upwards to account for what's happening in the market.

Furthermore, this tweak is dynamic, depending on market conditions. For example, if the average price for startup acquisitions goes down, we'll need to adjust our "fair" valuation number down. And conversely, if the average price for acquisitions increases, we'll adjust our fair valuation number up.

So let's get started.

A very successful early-stage investor named Dave McClure created a dead-simple method to determine valuations.

McClure has been involved in thousands of seed-stage deals. A couple of his investments include Mint.com, which was acquired by Intuit for $170 million, and3D Printing company, MakerBot, which was acquired by Stratasys for over $400 million.

To kick things off, let's start by looking at his valuation method. Essentially, McClure has a list of five attributes a startup might have. And for each attribute, he'll add $1 million to the company's valuation.

The five attributes are Team, Market, Product, Users, and Revenues. Let's go over each one so you can see exactly what you should be looking for.

1. A great team

The first attribute on the list is easy. We already explained all the details in Chapter 8.

Remember, startups create products that are new. A new company doesn't have any customers yet. And for the most part, there's no evidence there's even a market for its idea. So startup founders have a challenging job. Just like we told you about with Groupon and Twitter, the founders have to keep readjusting and pivoting until they figure out their business.

That's why, as you learned in Chapter 8, you need to look for three attributes in the founding team:

First, you're looking for a team that has significant industry experience — what we calldomain experience.

Second, you're looking for a team that has more than one founder and is balanced. Remember, one founder should be technical, the other should be more business oriented.

And lastly, you're looking for a team that's graduated college, even has advanced degrees.

If the team meets each of these three criteria, the startup will earn a million dollars towards its valuation.

2. The Market

The next attribute is about the market. One of the first things venture capitalists look at when they're evaluating a startup is the size of the company's market.

They're trying to determine whether a startup can become a billion-dollar company. But when a company is at the seed-stage, when it hasn't even generated one dollar in revenue yet, how are you supposed to know if it can generate a billion dollars?

Here's how we recommend tackling this one. For a startup to earn a $1 million "credit" towards its valuation for its Market, look for one thing. Look for a company in the same industry that's currently doing $1 billion in sales.

In other words, if you can find a similar company that's reached $1 billion or more in revenue, add a million dollars to its valuation.

3. Product

This next one is straightforward. If the company has already built a product (even an early prototype of its product to prove that its concept works), it will earn an additional $1 million towards its valuation.

That may seem like a lot of value simply for having a product. But we can't tell you how many investment pitches we see every week from entrepreneurs where all they have is an idea on a piece of paper. They haven't built anything at all.

Having a prototype means the team is actually capable of building something. It means they've got some hustle and they can make things happen.

4. Users

The fourth item on McClure's list is users. And here's why this item is so important.
If a startup has people using its product, especially if they're using it a lot, that's a clear sign of traction.

From an investment standpoint, this answers one of our most fundamental questions: "Do people care about this product? And do they care about it enough to actually use it?"

If the answer is yes, you can add one million dollars to the company's valuation.

5. Revenues

The fifth and final factor McClure looks at is revenue. Having users is great. But if a startup has revenues — paying customers — that's an even stronger sign of traction.

First of all, if someone is willing to pay for a service or product, that provides evidence that the service has real value. As investors, this validates the idea for us. Like we mentioned in Chapter 9, we might not like a certain widget ourselves. But if thousands of other people do, and they're willing to pay for it, who are we to argue?

Secondly, if a company has revenues, that lowers its risk of going out of business. We reviewed this concept back in Chapter 7, when we talked about the Risk of Ruin.

Remember, the most fundamental reason a company goes out of business is because it runs out of money. But the more money a company has coming in the door, the longer it can last. It's got more time to figure things out, and more time to pivot if it needs to.

And now we can wrap all this up. According to the McClure method, each of these five attributes is worth one million dollars towards the company's valuation. So if a company has three of these attributes, that's a $3 million pre-money valuation. And if it has all five, it would earn a $5 million valuation.

Then, to account for the increase in average M&A exit prices that we mentioned earlier — from about $50 million to $100 million — we'll multiply these figures by two. So in today's market, instead of earning a $3 million valuation, a startup would earn a $6 million valuation. And instead of a $5 million valuation, it would earn a $10 million valuation.

So now that we've covered the McClure Method, let's move onto our second way todetermine a valuation.

The second way is what's called the Berkus Method. It's named after Dave Berkus, a long-time member of a prominent angel-investing group called The Tech Coast Angels.

Berkus believes it's impossible to do a deep financial analysis of a seed-stage company. There simply isn't enough data and information yet. So, similar to McClure's million-dollar points, Berkus has a list of five different attributes a startup might have. And depending on whether it's a bear market or a bull market, each attribute is worth either $500,000 or $1 million in additional valuation.

In a bull market, a company that exhibited all five attributes could have a maximum valuation of $5 million. And in a bear market, it could have a maximum valuation of $2.5 million. The five attributes are as follows:

Idea, Prototype, Team, Strategic Relationships, and Product Rollout or Sales

Let's look at each attribute in a bull-market scenario. In other words, where each one will be worth $1 million in valuation.

1. Idea

To recognize the basic value and potential of an idea, if a startup has an idea, even if it's just on the back of a napkin, credit is given. This gives the company a $1 million baseline valuation.

2. Prototype

For the second attribute, credit is given if the company can show you an early version of its product. As you know, a company's product usually evolves over time, but the idea here is that a working prototype gives us evidence that the team can build what needs to be built.

For example, if a startup says it's building a flying car, ideally we'd be able to see some evidence that it can actually get a flying machine up in the air. Even if the final product looks different than the prototype, it's good to know that the company can manage all the engineering that's required. And if it can check this one off, it earns another $1 million in valuation.

3. Team

For the third attribute, credit is given for a strong team.

We've gone over this one many times already. A quality team should be able to pivot its way to success. So you're looking for a team that has domain experience, is balanced, and is college-educated. If it hits all those points, the company gets an additional $1 million added to its valuation.

4. Strategic Relationships

The fourth attribute is something Berkus calls Strategic Relationships. In other words, does the company have relationships in place with larger firms that can help the startup accelerate its growth?

For example, if it's a financial technology startup, does it have a marketing partnership in place with a company like eTrade? If so, that would earn the company an additional million dollars in valuation.

5. Product Rollout or Sales

This one is straightforward. If a company is already showing sales and revenue, it would earn an additional million dollars in valuation.

And that wraps up Berkus' five attributes.

So a startup with an idea, a prototype, and a strong management team would earn a pre-money valuation of $3 million. And if a company is already creating revenues, it could earn a maximum valuation of $5 million.

And again, to account for the increase in average M&A exit prices, we'll multiply these figures by two. So in today's market, instead of earning a $3 million valuation, a startup would earn a $6 million valuation. And instead of a $5 million valuation, it would earn a $10 million valuation.

The third valuation method we uncovered is different than the other two. It's more quantitative. And the fact that it's so different is valuable to us. It gives us a different viewpoint as we try to determine a company's fair value.

We learned about this method from a successful venture capitalist named Kevin Dick. Kevin focuses exclusively on seed-stage investments. And since his firm is called Right Side Capital, we call this the "Right-Side" method.

We'll start by explaining the theory behind it, and then we'll dive into how to calculate the numbers.

To come up with their methodology, Kevin and his partners started by asking themselves a simple question: "When it comes to a startup that's raising its first round of capital, who's taking the greatest financial risk? The investor or the entrepreneur?"

Initially, you might assume that it's the investor, given the fact that it's the investor's money on the line. But if you think about it, it becomes clear that the entrepreneur is the one taking more risk. The entrepreneur is giving up the security and income of her day job so she can launch a new company. She's giving up a salary so she can turn her idea into a reality.

That's why the core of the Right-Side method is something called the "Price to Salary" ratio. The theory here is that, if you add up the market-rate salaries of all of the founding members of a startup, you can determine their opportunity cost. In other words, you can determine the dollar amount they're giving up by investing their time into a startup. Then you apply a multiple to that number to determine a fair valuation for their time, and a fair value for the company.

Let's review this concept using the hypothetical company we discussed earlier, ACME Widgets. As you'll remember, the two founders of ACME are Sally and Nick. And they founded their own startup, they were executives at big companies.

Let's assume they had been making $200,000 per year each. According to the Right-Side Method, the "Salary" component for calculating the Price-to-Salary ratio would be $200,000 x 2 people, or $400,000.

Then, Right Side would apply a multiple to that number. Without going into the details, the multiple is a number between 2 and 4. In a moment, we'll go over some of the factors that influence the multiple. But first let's look at a quick example to show you how it works.

Let's say the multiple comes in at two. Two times $400,000 would give the startup a valuation of $800,000. Now let's say the multiple is at the other end of that range, four. Four times $400,000 would give the startup a $1.6 million valuation. Since the Right-Side Method allows for a twenty to

twenty-five percent margin of error with these numbers, even if ACME was pricing its round at $2 million instead of $1.6 million, Right Side could still say "yes" to investing in it.

According to the Right-Side Method, there are nine different criteria that go into calculating the multiple, and thirty-four individual data points. We won't go over all of them here, but the big factors that influence the multiple are some of the factors we've discussed earlier in this book. For example, founders with domain experience; founders' level of education and technical experience; etc.

You just learned three valuation methods used by professional seed-stage investors. And each of these methods was backed up by our own academic research. But maybe you've heard about other methods. For example, many investors use something called comps, which stands for comparables. This is a way to look at similar deals in the marketplace to determine what's fair.

For example, if the average valuation for a New York-based tech startup jumps to $20 million, many investors might start thinking that $20 million is "fair." But remember, with most exits currently taking places at $100 million or less, you'll be far less likely to make 10x your money on those deals. Again, with the market where it is now, to earn 10x your money, you need to invest at valuations of $10 million or less.

So if you're seeing comps above $10 million, you shouldn't change your tune all of a sudden and start thinking it's OK to pay up for your startup deals. The investors who paid up for those deals might not do so well financially. Stay disciplined.

For some investments, it's possible to calculate a valuation by using what's called Discounted Cash Flow, or DCF analysis. To do this, you'd look at future projections of revenue or profit, then discount those projections by a suitable interest rate.

It's like asking this question: What would you be willing to pay today for a hundred-dollar cash payment that you'd receive five years from now? (Hint: it would be far less than one hundred dollars. That's because of the time value of money, which states that a dollar today is worth more than a dollar in the future.)

This is the type of financial modeling that analysts use for big, publicly traded companies. But for seed-stage companies, this type of analysis will be useless. As we've mentioned before, it's nearly impossible to predict what a seed-stage company will do in revenue twelve months from now, let alone five years from now.

This type of analysis is more suitable for publicly traded companies and later-stage private deals.

Another valuation method is called the ScoreCard Method. With this method, you aggregate a number of different factors (for example, a startup's competitive environment, or the size of its target market), assign them weightings, and then rank each factor as better or worse than the average startup.

As you might notice, this is highly complex and subjective. Bottom line? We don't think it's an appropriate method for you. We don't believe it would give you reliable results.

As we mentioned earlier, valuation is an art not a science. There's no perfect method to determine valuation. That's why we use all of the three methods that we described — The McClure Method, The Berkus Method, and the Right-Side Method.

Each method might give you a different valuation. And that's OK. In fact, it's expected. But that's why there's one final step you need to take after you've gotten your results from these three methods. Here's what you should do:

Take the valuations you came up with from each of the three methods, and write them down on a piece of paper. Rank them in a column, from highest to lowest. For example, let's say that the Right-Side method gave you a valuation of $4 million, the McClure method gave you a valuation of $6 million, and the Berkus method gave you a valuation of $8 million. So you'd write down $4 million, $6 million, and $8 million, and you'd leave some space between each number.

Then, write down the valuation of the deal you're evaluating. In other words, the valuation you're seeing on the crowdfunding platform. Put that valuation in its appropriate place on the scale. How does it look?

If its valuation is $12 million, that means you should pass on this deal. That valuation is higher than every other valuation on the scale, and it's higher by far.

And if its valuation on the funding platform is lower than the valuations you've determined, that's great — you just found yourself a good deal.

A word of warning. You need to be careful when you're going through this exercise.Especially if

there's a big gap between two of the valuations. For example, let's say the McClure method came in at $5 million, but the other two methods were closer to $1 million. If you really liked the company and it was raising money at $5 million, you might be tempted to focus strictly on the McClure method. In psychology, this is called confirmation bias, and we're all susceptible to it. Essentially, we tend to overvalue data that confirms a belief we already hold.

In this case, we love the company, and we're eager to invest in it. Therefore, we might tend to ignore the data indicating that a $5 million valuation is too high.

Be aware of this tendency, and do your best to fight it. If the facts don't back up your feelings, always go with the facts.

Don't forget, it's OK to pass on a deal. You should be saying no at least ten times more often than you say yes. Other investors might be willing to pay up, but that doesn't mean that you should.

CHAPTER 10 REVIEW

This was an intense chapter. The research we introduced you to might seem complicated time-consuming. And it *is* complicated and time-consuming.

But early-stage investing is risky. And if you don't put in the research and the legwork, you're less likely to be successful as an investor.

That being said, keep in mind that we built special software for you to handle a lot of the heavy lifting. You'll find a link to our software tools in the Appendix.

But for now, let's quickly review what you just learned. This chapter was all about determining whether a company's stated valuation is fair. In order to make this determination, we reviewed three different valuation methods for seed-stage companies.

First, we went over the McClure method. This method evaluates five attributes. For each attribute a company has, we award the company an additional $1 million in valuation. Again, those attributes are Team, Market, Product, Users, and Revenue.

Then we went over the Berkus method. The Berkus method is similar to the McClure method, but it allows us to change a company's valuation credit depending on prevailing market conditions. If we're in a bull market, a company would receive $1 million per attribute. And if we're in a bear market, that number would drop to $500,000.

The attributes we look at in the Berkus method are Idea, Prototype, Management, Team, and Strategic Relationships and Sales.

Furthermore, to account for the increase in today's M&A market, we'll multiply these figures by two. So for example, instead of earning a $3 million valuation, a startup would earn a $6 million valuation. And instead of a $5 million valuation, it would earn a $10 million valuation.

And finally, we went over the Right-Side Method. Again, this method is based on the theory that an accurate way to price an early-stage deal is to determine the founders' financial opportunity cost. The most difficult part about the Right-Side Method is calculating the salary multiple. But we've built some software to do that for you.

Then, we mentioned some other valuation methods that you might hear about. But you won't be using them, because they're not reliable for seed-stage investing.

And finally, we showed you how to put all these methods together to determine whether a company is fairly valued.

There was a lot of new information. So you might want to review it before moving onto the next chapter!

PART 3: READY FOR REAL-WORLD INVESTING

CHAPTER 11

EVALUATING PERFORMANCE AND FUTURE PROSPECTS

Now we're in the homestretch. We're getting close to the end of the book. At this point, you know how to build a portfolio of high-quality, early-stage investments.

But perhaps you're wondering something: "When am I going to learn how to analyze a company's business model and market?"

Or maybe you're wondering when we'll get to topics like how to analyze a company's competition, or how to evaluate its product.

But there's a good reason we didn't cover those topics. And to explain why, let's back up a second. This book, ***The Big Book of Pre-IPO Profits***, was designed for angel investors like us and like you. We back companies at their earliest stages — at the seed stage.

As you know, we interviewed dozens of professional investors to create this book. But not all of them focus exclusively on seed-stage investments. Some of them run nine-figure venture funds, and a lot of their deals are later-stage. When we talked to them about their later-stage investing strategy, it was clear that they cared a lot about a company's product, market size, and competitors.

But when we talked to them about their early-stage strategy — and when we talked to investors who only do seed-stage investments — no one focused on these topics. They weren't agonizing over the size of a company's market, or painstakingly calculating how much market share the company could capture. And they hardly mentioned analyzing the competition, or their products, either.

That might sound surprising. It's natural that you'd want to know if a company has an advantage over its competitors, or if its product is any good. In fact, when you read articles or blogs about private investing, they cover these topics a lot. But as we came to learn, these weren't key topics for seed-stage investments. In fact, for seed-stage investments, the idea that these criteria are important is a bit of a myth. Which is why we decided to call this chapter "The Myths of Product, Market and Competition."

To some investors, what we're about to say may sound like sacrilege. But after lengthy conversations with highly successful seed-stage investors, and after analyzing financial and academic studies, we're confident about our position. And in this chapter, we'll explain why.

Here's what we'll review.

First, we'll talk about the Myth of Product. Then we'll talk about The Myth of Market, or more specifically, the myth of only investing in companies going after large markets. And finally, we'll talk about The Myth of Competition.

Let's get started.

The Myth of Product

The concept of evaluating a seed-stage company's product is probably the biggest myth in startup investing.

If you read the blogs written by top venture capitalists, you'll see that one of their favorite topics is how much they love certain products. In particular, products built by the companies they invested in. In fact, many of the VCs we spoke to only invest in companies that build products they would use themselves, or products they could see their kids using.

We can relate to this sort of thinking, because we used to buy into this myth ourselves. We'd assume that because we liked a product, and because we were excited about it, other people must like it, too. But if you think about it, the logic here is spotty. One or two peoples' opinions about a product — regardless of how brilliant they are — isn't enough to determine whether or not a business will succeed. Case in point: as you've learned, even the best venture capitalists are wrong seventy-five percent of the time.

However, there are still many successful venture capitalists who rigorously evaluate a company's product before they invest. Why? Here's the answer. Because many times, VCs are investing at a different stage than you. They're investing at a later stage.

Like we explained a moment ago, most big VCs don't invest at the seed-stage. They invest after a company has already gotten off the ground. Maybe the company already has dozens of employees. Maybe it's generating real revenues. Or maybe it's reached "Product/Market Fit." Once a company gets to this later stage, the investor has a lot of information to analyze that's based on fact and historical data.

So if you have a successful VC who loves the product the company has built, and has enough data to

see that other people like the product, too, she'll be basing her decision less on whether she likes the product, and more based on data she's able to glean from the market.

In contrast, let's look at the situation for seed-stage investors. Most of the time, seed-stage investors have no data about a company's product. As you learned, startups go through a long journey. Even if they ultimately succeed, there are lots of twists and turns along the way. And this is especially true when it comes to the startup's product.

Remember, most of the startups that eventually succeed do so with a product that looks very different from the one they started out with. Again, this process is called pivoting. And the fact is, nearly every successful startup has had to pivot at least once along its journey.

In fact, when you get into an early-stage startup, you should expect the company to go through several pivots before a successful product, marketing funnel, and business model emerge.

Now that we understand all this, it becomes clear that evaluating a seed-stage company's existing product isn't a reasonable basis for investment.

Of course, that isn't to say that the product doesn't matter. The product matters a lot. It's the core of the business. Without an amazing and disruptive product, it's unlikely the company will succeed. It's just that the product we'd be trying to evaluate won't be the company's ultimate product.

Look at some of the successful companies we mentioned in this book — companies like Twitter and Groupon. These "homerun" investments started life as something else. Originally, Twitter wasn't even called Twitter. It was called Odeo. And the company's initial investors thought they were investing in an online radio station. But twelve months later, the team shut down the radio service completely and relaunched as something new. And it's the same thing for Groupon.

So again, what the professional seed-stage investors recommend (and what we truly believe) is that you should "bet on the jockey, not the horse." In other words, with seed-stage investments, you need to choose the right entrepreneur, not the right product.

In Chapter 8, we taught you how to evaluate the people behind a company. Specifically, we told you only to invest in entrepreneurs with significant industry experience. If an entrepreneur is an expert in her market, eventually she should have the knowledge and experience to pivot her way into the right product.

Here's the example that one of the VCs we spoke with used:

"If two college kids came to pitch me on a new type of fuel-efficient car that used hamsters to power

the engine, I'd laugh and tell them to get out of my office. But if the same pitch came from the former CEO of Ford, I'd at least listen to him. I mean, who knows more about the auto industry, him or me?"

That's why it's so important that you evaluate the founders of a startup. Ultimately, it's these people who will determine whether or not a company succeeds.

The Myth of Market

Now let's move onto the second myth — the "Market Myth."

When an entrepreneur meets with an investor, the entrepreneur is often asked questions about market size. For example: "How big is the market you're going after?" Or the inevitable, "Tell me: how can this be a billion-dollar business?"

Generally, the entrepreneur will stammer a bit, come up with some market-size estimates, and then toss out a total guess. But just like the Myth of Product, if we're investing in early-stage startups, these questions aren't applicable.

Sure, an entrepreneur needs to be confident she's going after a market that can generate a substantial profit. And she should be enough of an industry expert to know if the opportunity is worth her time. But when a company is at its earliest stages, when it hasn't even generated a dollar in revenue yet, how is someone supposed to know if it can generate a billion dollars? That's why these questions don't carry much weight with seed-stage investors like us.

That being said, they do matter to later-stage investors. To explain why, let's do a quick refresher on the economics of the venture capital industry.

Let's say you're the manager of a $20 million venture fund. You make a decent salary via the management fees that you charge. But your real pay day comes from your carry, your 20% of the profits. You spend three to five years investing in forty different startups, putting $500,000 into each one. Your goal is to own roughly 20% of every startup you invest in.

Now let's assume that your returns are typical for a successful seed-stage fund. That means you'll earn a return of two to three times your money on the overall portfolio. To keep things simple, let's use three times your money. So your $20 million turns into $60 million. You pay the investors back their $20 million. And then you take 20% of the $40 million in profits. That's an $8 million pay day.

But then you start to think, "Hmmm, $8 million is great. But if I'd had $200 million to invest instead of $20 million, I'd have earned $80 million instead of $8 million."

So for your next fund, you go out and raise $200 million. Initially, you stick with your strategy of investing small amounts of money at a low valuation. For example, $500,000 investments at a $2 million pre-money. But then you realize that it's taking a long time to invest your fund. If you keep writing $500,000 checks for a $200 million fund, you need to make 400 investments. That could take you ten to fifteen years.

So instead of investing in seed-stage companies, you start to invest in later-stage companies. You start to invest in Series A and Series B rounds, where valuations are more like $20 million or $40 million.

If you're still aiming to own a 20% stake in each of these companies, at $40 millionvaluations, you'd have to invest $10 million into each one.

But now your yardstick for measuring what makes a successful investment just went up a lot. Let's say you invested in a seed-stage deal at a $2.5 million post-money valuation. To earn ten times your money, it would only need to be acquired for $25 million. Since most M&A occurs below $100 million, a $25 million acquisition is reasonable.

But what about the later-stage investment you just made with the pre-money valuation of $40 million? The yardstick for success for that company is much higher. To earn ten times your money, the company needs to get acquired for $400 million. Those types of exits do happen, but they happen less frequently. And if you need big exits like that to make your economics work, you can only swing at pitches that could turn into home runs. In other words, you can only invest in companies that might turn into billion-dollar businesses.

And that explains why later-stage VCs ask the billion-dollar question. Essentially, since they're running larger funds, they need larger exits.

But seed-stage investors like us don't need to hit home runs to earn market-beating returns. We can do very well by investing in singles and doubles. And if we happen to hit an occasional homerun, that's just icing on the cake.

The Myth of Competition

Now let's move onto the final myth: the myth of competition.

This is one of our favorite myths in early-stage investing. People tend to look at a new product idea that seems familiar and say, "But another company is already doing something just like this!" Or, "Couldn't Google just copy you?"

The answer to these questions might be yes, but that doesn't mean the business won't succeed. The internet is filled with success stories from companies that, at first blush, seemed like "me too" businesses. Or companies with products that seemed easy to copy.

For example, when Facebook launched in 2004, it was one of hundreds of social networking sites. All these sites looked similar in terms of functionality and features. Not only that, but several dominant players already existed. MySpace, for instance, had been acquired by News Corp. for $580 million. And Friendster.com, one of the world's first social networks, was well funded and already had millions of users. If investors had bought into the myth of competition, they would never have invested in Facebook.

So why do we always hear about the need to evaluate the competition?

Well, one reason relates to what we covered in the billion-dollar market myth. When a venture fund gets to a certain size, it needs to invest in companies that can capture a large piece of an enormous market. That's the only way they're going to earn home-run returns.

And one of the only ways to get a home run is by having a virtual monopoly in a particular industry. As an example, look at the search engine market. Sure, Bing and Microsoft still exist. And once upon a time, Yahoo! had its own search engine. But Google is the dominant force. It controls more than ninety percent of the global search market.

It's the same thing with Facebook. Sure, there are other social networking sites that serve specific purposes, like LinkedIn for professional networking. But for online personal networking, Facebook dominates the world. With nearly three billion users, no one else comes close.

And companies that control their respective markets have provided investors with huge returns. Facebook's first investor made 200,000% when the company went public. And as you might remember, one of Google's first startup investors, Andy Bechtolsheim, made about 15,000 times his money.

That's why, if you're running a $200 million fund and you need massive wins in order to generate enormous carry, questions about competition might be important to you.

The thing is, even then, many successful investors believe you should bet on the jockey, not the horse. This goes back to the same logic we mentioned earlier with the Myth of Product. Companies run by experienced industry veterans have the ability to shift their product strategy — and therefore, their business — until they figure out what works. If they're getting killed by the competition, hopefully they'll adjust.

That's why, once again, our best bet is to back strong founders.

CHAPTER 11 REVIEW

Some of the concepts you just learned about may have come as a surprise to you.

After all, people love to talk about investing in the products they like. They love to imagine how big a market or business might get. And it seems like human nature to be wary of potential competitors.

But when you're investing in seed-stage startups, such things don't matter so much. If you're getting in early, things like product, market size, and competition shouldn't impact your analysis.

And now, before moving on to the final chapter of this book, let's quickly review what we just covered.

In this chapter, we discussed three common myths of early-stage investing.

First, we discussed the myth of product. This is when an investor tries to predict thefuture success of a product based on how he or she feels about it. But as we explained, it's impossible to know how an early-stage company's product will evolve. Startups pivot. In fact, some of the most successful companies ended up succeeding with a product that looked far different than their original vision.

Next, we went over the myth of market size. As you learned, later-stage investors who manage large funds need to focus on billion-dollar businesses. Simply put, due to the size of their funds, they need massive returns to earn massive profits. But their yardstick for success is higher than yours. Seed-stage investors like you can invest at a $5 million or $10 million valuation, and earn ten times your money from exits of $50 million to $100 million. And if you happen to hit one out of the park, that's icing on the cake.

Last, we reviewed the myth of competition. As you learned, it's smarter to bet on a good entrepreneur than to try and evaluate every current and future competitor.

Keep in mind, if we bought into the myth of competition, plenty of today's most successful businesses should never have succeeded. For example, at the time Google was founded, dozens of search engines existed. In fact, back then, Yahoo! was the No. 1 property on the web, and it had its own search engine. That might have seemed daunting to Google and its investors. But things can change quickly in the world of startups. And today, no one comes close to Google in terms of market share.

So stick to your screens. Stick to your strategy. And trust the evaluation techniques you learned in this book.

Now you're ready to move on to the book's final chapter, where we'll walk you through the exact process for investing in a startup deal.

CHAPTER 12

PUTTING IT ALL TOGETHER

By this point in the book, you've learned just about everything you need to know to be a successful early-stage investor.

Now you're probably champing at the bit to make your first investment. But if you're like most folks, you might have some questions about how the actual investment process works — from what happens on the funding platforms, to what happens after you invest.

So in this chapter, we're going to walk you through the exact steps you'll take to make an investment. And we'll explain what you should expect to happen afterwards.

Picture yourself getting ready to make your first investment.

This is exciting. If you've made it this far, you'll already have registered on the platform that's hosting the deal; you'll have made sure that the company and the deal pass the ASE framework; and you'll know how much capital you're planning to invest.

Now there are just three simple steps to take before you invest:

The first is going through something we call The Angel Investor Check List.

The second is executing The Investment Process.

And the third is transferring your funds and confirming your investment.

Once you're done with these three steps, you'll be ready to press the button and invest. So let's look at each step, one by one.

The first step is The Angel Investor Checklist. This is a short list you'll review to make sure you're on the right road, you're heading in the right direction, and you know what your final destination is.

There are only a few items on the list. First, you need to ask yourself if this deal fits the basic criteria for your startup investments. In other words, is it a capital-efficient, seed-stage technology company? If you don't remember what that means, head back to Chapter 8. And if you do remember, and the startup you're looking at meets these criteria, you can check this box.

The next item on the list is ensure you're following your allocation strategy. Remember, in Chapter 6,

you learned about the Allocation process — how you should be investing just a small portion of your assets into startups, and how you need to diversify that allocation into many, many seed-stage deals.

For example, maybe you decided to allocate a total of $100,000 to startups over the next few years. To be diversified, you should be investing that $100,000 into fifty or so companies. On average, that's $2,000 into each one. So if you're looking at an investment with a $25,000 minimum, as much as you may love the company, you should pass. You need to be disciplined about your investment strategy.

And here's the final check. Are you certain that you don't need this capital to pay for your rent or mortgage, for groceries, or for your kids' education? Because remember, startup investments aren't just risky, they're illiquid. You can't just get your money back if you need it to pay the mortgage.

But if you don't need this money for "the basics," and it's capital you can live without, then you're all good on the initial checklist.

Now let's move onto the second step, the investment process itself.

The entire process will take place on a funding platform. Remember, the platforms are set up to handle everything — from reviewing and signing your documents, to helping you fund your investment, to keeping tabs on the startup's progress after you invest.

The investment process itself is simple. Generally, there are just three simple steps.
These steps might differ slightly from platform to platform. But the three basics we'll review now will give you a good idea about what you'll find no matter where you go.

1. Once you've clicked the button to indicate your interest in investing, enter your investment dollar amount.
2. Verify your identity, as well as any other information required by the SEC. This step might feel familiar. It's just like setting up a brokerage account.
3. Read the legal agreements. There'll be some fine print. Definitely read it. If you have any questions, ask your lawyer, or better yet, call the platform.

Once you've read the documents and understand them, you'll sign them. This is almost always an online process, so there's no back-and-forth with postal mail or FedEx.

After that, you'll be ready to fund your investment. But for some people, a tiny alarm might go off in their heads. "Wait a minute!" they say to themselves. "I still have questions!" And it's good to have questions. This is normal.

So before we go any further, let's look at the top few questions angel investors typically have about the investment process. Hopefully these will answer your questions, too.

QUESTION NO. 1

As you've learned, some startups will succeed, others won't. But you might be wondering what happens if the crowdfunding platform itself goes out of business.

There's no need to worry about that. The platforms have already taken precautions to ensure that, even if they go out of business, it won't affect your ownership in the startup you're investing in. You'll still own your shares.

You see, when you invest in a deal from one of the funding platforms, you're investing in an investment vehicle known as a Special Purpose Vehicle, or an SPV for short. It's a separate legal entity that's used to hold your funds and equity. And in the event that the platform goes out of business, the SPV will be there to protect you.

QUESTION NO. 2:

Once you've decided to invest, maybe you're wondering if you can fund your investment from your retirement account. In many cases, the answer is yes. Most self-directed retirement accounts allow you to invest in private deals.

If you're curious about this option, email or call the funding platform and they'll point you in the right direction.

QUESTION NO. 3

Maybe you're concerned about what happens if you wire your funds, and then the deal doesn't close.

Not to worry. Your investment dollars go into an escrow account. Escrow is simply a safe holding place for capital until a deal is closed. And that account is controlled by a third-party bank, not the startup or the platform.

If for any reason the deal doesn't close, 100% of your money will be returned to you, with no fees taken out.

QUESTION NO. 4

Wondering what happens if you're not a U.S.-based investor?

Generally, there are no citizenship requirements as long as you're at least 18 years old. But regulations around international investors are evolving, and each platform handles such investors differently.

Our advice is to call the platform and ask if they accept citizens from your country.

QUESTION NO. 5

Perhaps you're wondering if the startup you're interested in will always accept your investment.

It depends. Sometimes your investment will be accepted right away. In other scenarios, the company may have already reached its maximum funding target, but is still accepting new indications of interest. The reason for this is simple. A handful of investors always tends to get cold feet — when it comes time to wire funds, they'll decide not to invest. So in case a few investors back out, the platform likes to have some "reserve" capital waiting in the wings.

Those are the top few concerns that new investors seem to have. If you have other concerns or questions, just call or email the platform.

If you've made it this far in the investment process, it's time to wire funds. This part is easy. Simply enter the information of your bank or brokerage account.

The platforms use the latest encryption technology, and they've already processed more than $1 billion of investments without issues. But if you'd prefer not to enter your information online, just call the platform on the phone and they'll handle it for you offline.

Once you've given the platform your information and confirmed your investment, your funds will be transferred into the escrow account. And remember, your funds will stay in escrow until the entire fundraising round is wrapped up and closed. Once the round is closed, you'll get a confirmation notice, as well as all the counter-signed subscription documents. The whole process is straightforward. And again, if you have any questions, just call the platform.

Once you've wired your funds, your job is just about done.

But the startup you backed still has a long journey in front of it. So let's take a look at that journey, and see how it might impact you. In particular, there are four situations and scenarios you should be aware of. Let's review them now.

1. Day-to-Day Operations

Let's start by looking at the day-to-day operations of the business. As you've learned, startups have a big challenge ahead of them even after they've raised funding. For starters, they have to build a product, recruit a team, and market and sell their product.

These efforts will take up ninety-nine percent of the startup's life. And generally, you won't hear too much about them. The company might send you an occasional update, but unless you have detailed information rights, you're probably not going to hear from the company very often. And that's OK. You don't want startups spending all their time communicating with shareholders. You want them focused on building their company and increasing its value.

2. Future Rounds of Funding

As we explained earlier, if the company is doing well, it might decide to go out and raise more money in the future. This is a good sign. It means the company is hitting its milestones.

If you were granted pro-rata rights when you initially invested, the company will notify you that it's planning to raise more money, and ask you if you'd like to invest in this new round, too.

You may be tempted to write a check, but we don't recommend it. Follow-on financings might be attractive if you're a venture fund trying to deploy as much capital as possible, but they're not so attractive for angel investors.

For one thing, participating in follow-ons would decrease the amount of capital you have to invest in other companies. And for another thing, as company's raise additional rounds of financing, their valuations tend to go up. And investing at higher valuations decreases your Return on Investment, your "ROI."

For example, let's say you own one percent of a company that raised a seed round at a $2 million valuation. In other words, you initially invested $20,000. Then the company goes out to raise a new round: $2 million at an $8 million pre-money. So it's selling twenty percent of the company.

Like we explained earlier, if you don't participate in this new round, you'll be diluted by a small amount. In this case, you'd be diluted by twenty percent. So now, instead of owning one percent of the company, you'll own twenty percent less, or 0.8%. If the company gets acquired in the future for, say, $20 million, you'd earn $160,000 on your $20,000 initial investment. That's a 700% net ROI.

But now let's look at a scenario where you participate in the follow-on round. Say you decide to invest another $20,000 to maintain your one percent ownership. Now your invested capital would be $40,000: the $20,000 you invested for your initial one percent, plus the additional $20,000 you invested to maintain your ownership. Using the same $20 million acquisition price, your one percent stake would earn you a payout of $200,000.

As you can see, your absolute dollar return is larger than before. In the first scenario, you received $160,000, and in the second, you received $200,000.

But what happened to your Return on Investment, your ROI? It went down.

In the first scenario, we calculated your ROI by subtracting your initial investmentfrom the payout of $160,000, leaving you with $140,000 in net profits. Then we divided that by your investment of $20,000. So you earned a return of seven times your money. That's 700%.

In the second scenario where you invested in the new round, you'd need to subtract a $40,000 investment from the payout of $200,000. That leaves you with $160,000 in net profits. Dividing that by your $40,000 investment gives you a return of four times your money, or 400%.

So that's how the math works. A 400% return versus a 700% return.

And simply put, that's why we recommend not doing follow-on financings as an angel investor.

3. Company Goes Under

An unfortunate but inevitable part of investing in high-risk, early-stage companies is that many of them will go out of business.

And when they do, it's generally because they ran out of capital. So when they shut their doors, you shouldn't expect there to be any funds left over for a distribution. You'll write most of these investments off as a zero.

This is part of the game. And remember, you've already planned for this. Since you've taken a quantitative approach to your angel investing, you'll be diversified across fifty to one hundred companies. So when some of them inevitably go out of business, you won't lose your shirt. You'll still have plenty of other horses in the race.

4. The Company Has an Exit

This is the scenario you've been waiting for. A company you invested in has either been acquired, or it's gone public. And that means you're entitled to your share of the gains.

So how do you get your money? And when do you get your money?

First of all, going back to a concept we mentioned earlier, you didn't invest into the startup directly. To help make the administration of the funding round simple, you invested in what's called a Special Purpose Vehicle (SPV for short), and this SPV holds your startup equity. In other words, the SPV owns the equity in the startup, and you own equity in the SPV.

So when an IPO or acquisition takes place, the appropriate proceeds go into the SPV. Then, the money in the SPV gets distributed to each investor proportionately, or "pro rata." That means you get 100% of your fair share.

For example, if you own 1% of the startup's shares, and the startup gets acquired for $50 million, you'll get $500,000 — i.e., 1% of $50 million.

The process and the math might seem complex. But it all happens behind the scenes. You don't need to worry about any of this. You just need to be aware that this process is taking place, and that it takes a bit of time to do properly. So don't expect to be notified of an exit on Monday, and have a check in your mailbox by the end of the week. It takes a little while to sort through all of the paperwork.

Keep in mind, the process that you've learned about in this book is the one we use for all of our startup investments. Here are a few recent investments we've made using this process:

In the Med-Tech/Biotech sector, we invested in a startup called InnaMed. InnaMed is developing a blood-testing device you can use at-home. Similar startups whose technology didn't even work were once valued at $10 billion. But this company's tech has already been proven to work.

We also invested in Beta Bionics, which is creating a new type of medical device to treat diabetes. Basically, it's creating what it calls a "bionic pancreas." And on this one, we invested alongside major biotech companies like Eli Lilly. If it can pull this off, Beta Bionics will save millions of lives. And for early investors like us, it could deliver massive returns.

We also invested in a healthcare startup that aims to provide better primary care by using Artificial Intelligence. It's called Circle Medical. And with this one, we've already had an exit — this startup was already acquired by a bigger competitor.

Then there's the cannabis sector, which is an exciting place to invest right now. In this sector, we've invested in startups like HelloMD, an ecommerce company that's aiming to be the Amazon of Cannabis. And we also invested in LEAF, a device that helps people grow cannabis at home.

And of course, we also get involved in a lot of tech companies. For example, we invested in LiquidPiston, which is building the first new type of combustion engine in more than 85 years. It's called the X-Engine, and it's already landed about $9 million of contracts with the U.S. Department of Defense, including with DARPA.

More recently, we've been investing in the new "Space Race." Not rockets, per se, but tech startups like Solstar, which is building the first commercial Wi-Fi network for outer space.

By the way, these are the types of startups we introduce to our clients every month.

For example, we informed them of an opportunity to invest in a private company called Cruise Automation, which builds software for self-driving cars. Six months after our clients had the chance to invest, General Motors stepped in and acquired it for $1 billion. Early investors made an estimated profit of 1,011%. That's more than 10x their money.

As another example from the transportation sector, we introduced our clients to Elio Motors, which aims to create a car that sells for just $8,000. Just two months after our clients invested, Elio went public. Many of our clients tripled their money. One of them, Marie from California, emailed us the following: "A few months back my first investment [was] Elio Motors. I made over 325% profits when Elio went public..."

As another example, we introduced some of our clients to a startup called ReWalk Robotics. ReWalk was developing a robotic exo-skeleton that could help paraplegics to walk again. And just about one year after raising money from pre-IPO investors, ReWalk went public, and those investors made gains of 387%.

These are the types of deals that our system helps us identify over and over again: small, private startups that other people won't hear about for years, but have the potential to deliver enormous profits to their early investors.

We've nearly wrapped up the final chapter of this book.

Now let's review what you learned in this chapter. After that, we'll do a quick recap of the whole book, and we'll explain what to do next.

In Chapter 12, we started by walking you through the three things you need to do before you make an investment.

The first thing was going through the angel investor checklist. Going through this list is a good habit to get it into. Even though you've already put the company through multiple screens and evaluations, sometimes it's easy to get caught up in the moment and forget something. So always go through your checklist one last time before you invest.

Then we walked you through the online investment process. For example, we showed you how to wire funds for your investment, and how your equity in the investment is held by what's called a Special Purpose Vehicle, or SPV.

Again, if anything is unclear about this process, contact the platform where you made your investment. They will be able to answer all your questions.

From there, we reviewed a handful of general questions people have about investing in startups online. For example, whether you can invest from outside the U.S., or through your IRA.

And finally, we showed you what happens after you invest, and walked you through four different situations and scenarios:

1. A startup's day-to-day operations.
2. A company raises future rounds of funding. Remember: you shouldn't be investing in these follow-on rounds.
3. A company goes out of business. Again, this is expected. You've planned for this. So there's no need to get alarmed.
4. A company has an exit. This is where you learned about the process for receiving your funds, and how all the profits will be divided.

As you make more and more investments on the platforms, you'll see how easy all of these procedures are. The hard part was identifying the right types of companies, run by the right types of entrepreneurs, who are raising money at the right prices. Compared to that, everything else is easy.

If anything is unclear, go ahead and read through the chapters again. Or better yet, check out the Appendix to see how you can keep learning.

And now, before we do a quick review of the entire book, let's take a step back and look at the highlight of what you learned, because it's a substantial accomplishment.

You learned how to identify the right types of startups... run by the right types of entrepreneurs… who are raising money at the right prices.

Now, we made a promise to you throughout the book. And if you're reading this wrap-up, I think you'll agree that we've kept it. At this point, you're better informed than ninety-nine percent of the investing public. In fact, you're probably as informed about private equity and venture capital as many of the professionals in this sector.

When we first began this journey together, I'd bet that concepts like private equity and early-stage investing were brand new to you. Things like pre-money valuations, equity crowdfunding platforms, preferred stock. These were concepts you'd never heard of before, let alone thought about or understood.

But now you can sit down with anyone — an entrepreneur, an experienced angelinvestor, even a venture capitalist — and have an intelligent conversation. Frankly, you should feel proud of yourself.

So now let's quickly review everything you've learned so far. Then we can tell you what will happen next.

In the first half of the book, we covered the foundational elements of early-stage, private investing. In Chapter 1, we introduced you to the concepts of venture capital and angel investing. You learned about the history of this asset class, and about the companies and industries it's given birth to.

Then you learned how the JOBS Act has created a new form of venture capital: equity crowdfunding. Now any investor, regardless of their income or net worth, can participate in startup investing, the most profitable asset class of all time. Furthermore, you learned how a shift has occurred over the

past few decades: the biggest financial returns have moved from public stocks to private startups.

In Chapter 2, we dove deeper into equity crowdfunding. You learned about the funding platforms and how they work, and we showed you what to expect once you get there.

In Chapter 3, you learned about some of the most important concepts of private equity investing. For example, we went over the concept of liquidity. You learned that early-stage, private investments are illiquid. In other words, there's usually no market for these securities.

But you also learned how investors get liquid. They do this when the startup they invested in gets acquired by a bigger company, or goes public in an IPO. And when these exits happen, it can lead to big returns.

In Chapter 4, we dove into a topic that would come up again and again throughout this book: valuation. You learned about the different ways a company's valuation gets set, and the factors that can impact it.

Chapter 5 was our final foundational chapter. In that chapter, we did a deep dive into the various deal terms and deal structures of early-stage investment opportunities. You learned about equity and convertible debt financings, and you learned about the various deal terms associated with each.

You also learned about key concepts like common stock versus preferred stock, dilution, and the importance of a convertible note's cap and discount rate.

And finally, you learned about which deal terms you should be looking for, and which ones to avoid.

Then we went into the second half of this book, which is all about Strategy & Tactics. Remember, even though the foundational concepts you learned were critical, the most difficult part about early-stage investing is having a process in place for:

1. Finding a high volume of high-quality deals.
2. Having a screening process in place to filter down those deals to just a small handful of opportunities.
3. Having an evaluation system for choosing only the best deals — in other words, for choosing the right type of company, being run by the right type of entrepreneur, and selling for the right price.

And those are the things we tried to teach you in the rest of this book.

So in Chapter 6, we introduced you to the early-stage investing process we call the "ASE." As you learned, the ASE is broken out into three discreet steps. Each letter stands for a different step in the process:

"A" stands for Allocate. "S" stands for Screen. And "E" stands for Evaluate.

Chapter 6 was all about the first step — Allocate. In that chapter, you learned how to set up your asset allocation strategy. In other words, you learned how much of your overall investment portfolio to allocate to early-stage deals.

Then you learned about how much to put into each deal, and how many startups you should ultimately be investing in. Remember: the more diversified you are, the lower your risk, and the higher your potential returns.

Then, in Chapter 7, we went over the second step in the ASE — "S" for Screen. This is where you learned how to get access to a high volume of high-quality deal flow, and then quickly screen out the good deals from the bad. The way you do that is by looking for companies with strong management teams, that have already made some measurable progress, and are raising funds at a $10 million valuation or less.

You also learned how to pare your list down further by filtering out the companies that have a higher Risk of Ruin as compared to the others. Again, we should avoid companies that look like they have a relatively higher likelihood of running out of money. Those are the ones more likely to go out of business.

In Chapter 8, we started our deep dive into the "E" portion of our process, Evaluate. This is where you take the handful of companies that passed your initial screen and do a deep dive into each one. Essentially, this is where you're going to make a "Yes" or "No" investment decision. (Remember, you're going to say no a lot more than you'll say yes.) This is where you learned how to evaluate the people behind a startup — the management team, as well as your fellow investors.

Then, in Chapter 9, we went even further. In this chapter, our goal was to determine if the management team would be good custodians of your capital. To do this, we showed you how to evaluate a company's past performance and its future goals.

In Chapter 10, you learned 3 methods for evaluating a company's valuation. And then you learned how to tie them all together to determine if the price you're paying is fair. Again, only by investing in the right types of companies, with the right management teams, and at the right prices, will you be able to build a portfolio of high-quality, early-stage startups.

Then, in Chapter 11, we went over a few early-stage investing myths. In particular, you learned why you should ignore the urge to evaluate a company's product, predict its future market size, or play "game theory" about its competition. At the seed-stage, these factors shouldn't overly impact your investment decision.

And now, in Chapter 12, we're starting to bring the whole book together.

We know this was a long book. We covered a lot of material, and we introduced you to a lot of complex topics. Some of it might seem overwhelming, or like hard work. But as we've mentioned throughout the book, that's why we built special software for you. This software automates the most difficult and time-consuming tasks. And combined with all the knowledge you've already acquired, it can put you on a path to finally start building your early-stage portfolio — without spending hours every day on research.

Which brings us to our next order of business. Now that you have all of this knowledge and tools, what exactly do you do next? In other words, how do you start to find, filter and fund early-stage, private companies, so you can start building your portfolio?

To get you started, and to keep you on the right path, we've prepared a special report for you. It's called the "60-Minute Angel Investor." In this report, we'll provide you with a definitive process to follow that should only take an hour or so a week. That's less than 10 minutes a day. You can find a link to it in the Appendix. And at the end of the report, you're going to find a weekly checklist. Go ahead and print it out. Keep it next to your computer.

And that's it:

You're finally an early-stage angel investor!

But before we wrap things up, a quick note. We're not leaving you on your own. We'll still be here to help as you dive into early-stage investing. Reaching the end of this book is just the beginning of your career as an early-stage investor.

Now you're ready to start finding, funding, and hopefully profiting from investing in early-stage opportunities. And we're excited to be there with you along the way. Early-stage companies have changed our lives dramatically. So it's been our pleasure and honor to share our experiences and learnings with you.

We'll continue to share our learnings with you every week on our website, Crowdability, and through our Crowdability newsletter. Now that you've completed this book and understand the most important concepts, we imagine you'll enjoy our articles and essays even more. The topics we'll discuss and the opportunities we'll highlight will help you build your portfolio, and will set you on your way to become a successful early-stage investor.

In the meantime, happy investing!

BIOGRAPHIES

Matt Milner is a Media & Technology executive. After selling a technology startup he founded to Hearst Magazines, he joined Hearst's management team, first launching the company's brands online, then acting as Entrepreneur-in-Residence.

Prior to becoming an entrepreneur, he worked on Wall Street in Sales & Trading. Matt received his BA from Cornell University, and his MBA from the Kellogg School of Management at Northwestern.

In addition to his role at Crowdability, he's the founding venture partner at Collective Spark, an international venture capital fund. Matt lives in New York City with his wife and two kids.

Wayne Mulligan is a Financial Media entrepreneur and executive. Most recently he was CEO of The Institute for Individual Investors (IFII), a financial education & publishing company. At IFII, he helped spearhead the company's sale to the world's largest financial newsletter publisher.

He joined IFII when it acquired a startup he had founded — a technology platform for investors who were seeking answers to finance & investing questions.

A graduate of Columbia University, Wayne began his career on Wall Street. In addition to his role at Crowdability, Wayne is currently an Advisor to several financial media startups.

APPENDIX

In this Appendix, we've put together resources to help you continue your journey as a pre-IPO investor.

Table of Contents

1. Resources from Crowdability.com
2. Top Equity Crowdfunding Platforms
3. The Rules and Regulations of Title III and Title IV

1. Resources from Crowdability.com

Now that you've completed this book and understand its big concepts, we imagine you'll enjoy our articles and content from Crowdability.com even more.

Several times a week, we share learnings and news with readers through our website and newsletter. The topics we discuss and the opportunities we highlight will help you build your portfolio and become a successful early-stage investor.

Popular Free Resources

Deals — On our Deal page, we aggregate the best new deals from across the web.

Article Archive — Here's an archive of our articles and essays about early-stage investing.

Videos and Whitepapers — This is a series of easy-to-watch videos and evergreen white papers that can get you up to speed about angel investing.

Your Free Bonus Reports

A Mutual Fund for Startups
After learning about the potential profits you can earn from pre-IPO investing, you might be excited to build a portfolio of these deals quickly. In this special report, that's exactly what you'll learn how to do.

Double-Digit Returns in Private Income
In this report, you'll learn about private-market investments that currently offer yields as high as 17%. If you're looking for steady income, like what you'd get from bonds, CDs or Treasuries, this report will open your eyes to a new world of opportunity.

Dozens of Pre-IPO Investments — With Just One Click.
In this report, we show you how to get access to a basket of later-stage deals — the kind of deals that are already close to an IPO.

Case Studies — How to Invest Like a Shark
If you've ever seen the TV show ***Shark Tank***, you might wonder how those high-powered investors evaluate deals. In these case studies, we walk you through two real-world early-stage investments, step-by-step, so you can see how investors make decisions.

The 60-Minute Angel Investor

In this report, we provide you with an investment process for pre-IPO deals that should take you just an hour or so a week.

Crowdability's Premium Products and Services

Early-Stage Playbook — This is an in-depth video series that helps you master the proven process used by industry professionals to build a portfolio of early-stage startups.

CrowdabilityIQ — This is the special software we referenced throughout the book. Essentially, it's an easy-to-use "stock screener" that quickly helps you identify the most promising early-stage startups to invest in.

Private Market Profits — This is the world's first investment research service that provides individual investors like you with private market opportunities offering significant upside potential. With this service, we do all the work for you, and invest right alongside you in one deal per month.

Income Unlimited — With this investment research service, we provide individuals with high-yielding income-generation opportunities from the private market.

2. Top Equity Crowdfunding Platforms

There are dozens and dozens of equity crowdfunding platforms. Here are the ones we recommend exploring first:

- Republic
- WeFunder
- StartEngine
- MicroVentures
- Netcapital
- SeedInvest

3. The Rules and Regulations of Title III and Title IV

As a non-accredited investor, the amount you can invest in Title III deals in any 12-month period depends on your net worth and income. (An accredited investor is someone who earns $200,000+ a year, or has a net worth of $1+ million.)

For Title III deals, as of 2021, as a non-accredited investor, you can invest the greater of:

- $2,200; or
- If your annual income or net worth is less than $107,000 — you can invest 5% of the greater of your annual income or net worth; or
- If both your income and net worth are equal to or more than $107,000 — you can invest 10% of the greater of your income or net worth, not to exceed $107,000.
- This limit applies across all Title III deals.

For Title IV deals (also called Regulation A+):

- Non-accredited investors can invest up to 10% of their net worth or annual income per offering, whichever is greater.
- There are no limits as to how much accredited investors can invest in Reg A+ offerings.

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