Every Startup Finance Term Explained

The 79 terms from the film, in the same 7 chapters and the same order. Every definition here is the one used on screen, and every number was checked against the primary source it came from.

79 TERMS · 7 CHAPTERS · IDEASREPAY.COM/ACADEMY/FINANCE-TERMS

1 The Money Coming In

13 terms

Most of the numbers people call revenue are not revenue.

01
Revenue
The money you earned by delivering something. Earned, not received. Hold onto that word, because the next four terms are all things people call revenue that are not.

02
Bookings
A contract signed. Somebody has committed to pay you. **They have not paid you, and you have not delivered anything, so it is not revenue.** A booking is a promise with a signature on it, and promises break.

03
Billings
The invoice. You have asked for the money. One step closer than a booking, and **still not revenue, because sending an invoice is not the same as earning what it is for.** The chain runs booking, billing, cash, revenue, and they happen at four different times.

04
Deferred revenue
What happens when the cash arrives first. A customer pays you $12,000 up front for a year. That $12,000 is not yours yet: on your balance sheet it sits as a liability, because you now owe eleven more months of work. It becomes revenue one month at a time as you deliver it, which means a company can be flush with cash and have earned almost none of it.

05
Revenue recognition
The rulebook that decides when earned actually happens. The short version is that you recognise revenue as you transfer what you promised. Not when they sign, not when you invoice, not when the money lands. When you deliver.

06
Gross vs net revenue
Gross is everything that came in. Net is what is left after refunds, discounts and returns. If somebody quotes you a growth number and will not say which one it is, assume gross, and assume there is a reason.

07
GMV
Gross merchandise value. The total value of everything that transacted through your marketplace: every sale, every booking, the whole flow. **Almost none of it is yours. Andreessen Horowitz put it in three words in their metrics guide: GMV does not equal revenue.**

SOURCE Andreessen Horowitz, metrics guide

08
Take rate
The slice of GMV you actually keep, and the one people leave out. A marketplace doing $100M in GMV at a 10% take rate is a $10M business. The $100M is the number in the press release. The $10M is the company. Whenever someone leads with GMV, ask for the take rate. If they will not give it to you, you already have your answer.

09
MRR
Monthly recurring revenue. The predictable subscription money that arrives every month whether you sell anything new or not. That predictability is the whole reason software companies are worth more than agencies doing identical work for identical money.

10
ARR
Annual recurring revenue. It has a strict definition that almost nobody applies: it is the revenue that recurs. **It excludes one-time fees, setup and installation, consulting and professional services.** Andreessen Horowitz names the two mistakes directly: **counting non-recurring fees, and counting bookings.** Both inflate it, and both are extremely common.

SOURCE Andreessen Horowitz

11
Run-rate
Takes a period, usually your best recent month, and multiplies it out to a year. **That is not ARR.** ARR is contracted recurring revenue. Run-rate is an extrapolation, and it assumes your best month was normal. When somebody says we are at five million, the honest follow-up is five million of what.

12
ACV and TCV
How enterprise deals get described. Annual contract value is what a customer pays per year. Total contract value is what they pay across the whole contract. Sign a three-year deal at $100K a year and your ACV is $100K and your TCV is $300K. Both true. Only one of them is this year.

13
Net new ARR
The number a board actually watches. Break your ARR growth into three pieces: new ARR from new customers, expansion ARR from existing customers paying you more, churned ARR from customers leaving. Add the first two, subtract the third. Two companies can post identical growth while one is filling a bucket and the other is filling a bucket with a hole in it.

2 The Money Going Out

11 terms

Costs, burn, runway, and the ways a growing business runs out of money.

14
COGS
Cost of goods sold. The direct cost of delivering what you sold. For a manufacturer that is materials. For software it is hosting, payment processing, and the support people who keep the thing running. It is the cost that grows when you sell one more.

15
Gross margin
Revenue minus COGS, as a percentage. This single number explains most of why software valuations look absurd next to everything else. A services business might run 30% gross margin. Good software runs 75% to 85%. The same million in revenue is a completely different company.

16
Fixed vs variable costs
Variable costs move when your volume moves. Fixed costs do not. Your rent does not care how many customers you have. Your payment processing fees care enormously. **Confusing the two is how founders convince themselves that scale will fix a problem that scale will make worse.**

17
Contribution margin
What one sale contributes after every variable cost attached to it. It answers a very specific question: if I sell one more unit, am I better off. If contribution margin is negative you are paying people to take your product, and no amount of volume repairs that. It gets worse, faster.

18
OpEx vs CapEx
Operating expenses are everything that is not COGS: salaries, rent, software, marketing. The cost of being a company rather than the cost of delivering the product. OpEx is spent and gone this period. CapEx is money spent on something that lasts for years, so accounting spreads that cost out over its life rather than taking the hit at once. Remember that CapEx exists. It comes back in chapter seven and it ruins a very popular number.

19
Gross burn
Everything going out the door in a month. Every expense, every outlay, total.

20
Net burn
Gross burn minus the money coming in. The actual hole in the bank account each month. Andreessen Horowitz are blunt about which one matters: investors focus on net burn. And they are right, because net burn is the only one of the two that sets your runway.

SOURCE Andreessen Horowitz

21
Runway
Cash in the bank divided by net burn. How many months until zero. That is the whole calculation, and it is the most important number in an early company, because runway is not a metric. It is a countdown.

22
Burn multiple
Not how fast are you spending, but what are you getting for it. Take your net burn and divide it by your net new ARR: how many dollars did you burn to add one dollar of recurring revenue. David Sacks and Ethan Ruby, who named it in 2021, put the bar at under one being amazing and under two being quite good. Above that, you are buying growth at a price nobody will pay twice.

SOURCE David Sacks and Ethan Ruby, 2021

23
Working capital and the cash conversion cycle
Working capital is the money tied up in running the business: stock on shelves, invoices customers have not paid yet, minus what you owe suppliers. The cash conversion cycle is how long your money is trapped in there. You pay for inventory in January, sell it in March, and the customer pays you in May. For four months you funded that out of your own pocket. Now grow: double your sales and you double the trap. **This is why a business can be profitable on paper, growing fast, and completely out of money. Growth consumes cash before it produces it.**

24
Default alive vs default dead
The cleanest question in startup finance, named by Paul Graham in 2015. Ignore new funding entirely. If your expenses stay where they are and your revenue keeps growing at the rate it has been, do you reach profitability on the money you have left. If yes, you are default alive. If no, you are default dead, and you are running a countdown with a fundraise at the end of it. Most founders do not know their own answer, and it takes about ten minutes to work out.

SOURCE Paul Graham, 2015

3 What a Customer Is Worth

10 terms

Where the most quoted number in startup finance turns out to be a blog post.

25
CAC
Customer acquisition cost. What it costs you to get one paying customer: all of the sales and marketing money, divided by the customers it produced. Simple to say, and quietly easy to manipulate.

26
Blended vs paid CAC
Blended CAC divides by every customer you got, including the ones who arrived free through word of mouth. Paid CAC divides only by the customers your spending actually bought. **Blended is always the prettier number, and it hides the thing you need to know, which is what happens when you spend more.** If your blended CAC is $50 and your paid CAC is $400, you do not have a scalable channel. You have some happy customers and an expensive habit.

27
CAC payback period
How many months of margin it takes to earn that cost back. It is the runway version of the question. A 24-month payback might be perfectly healthy in a stable public company and completely fatal in a startup with fourteen months of cash, because you will be dead before the customer pays you back.

28

LTV

Lifetime value. What a customer is worth to you across the whole relationship, and it is usually calculated wrong before anybody even uses it. Andreessen Horowitz spell out the mistake: LTV is the present value of the future net profit from a customer, and **the common error is to calculate it on revenue, or on gross margin, instead of net profit. Revenue-based LTV can be three or four times the real figure.** The number is inflated before it ever gets compared to anything.

SOURCE Andreessen Horowitz

29

LTV:CAC

The most repeated rule in the subject: LTV to CAC should be three to one. **It comes from one blog post.** December 2009, David Skok, a venture capitalist, writing on his site: "it appears that LTV should be about three times CAC for a viable SaaS or other form of recurring revenue model." **It appears. No study, no dataset, no citation.** And the folklore then inverted it. In his follow-up piece Skok calls those original numbers early guesses, and says the best SaaS businesses run higher than three, sometimes as high as seven or eight. **Three is his floor, not the target.** Use the ratio, it is a reasonable instinct. Just stop quoting it like it came down off a mountain.

SOURCE David Skok, December 2009

30

Churn

Customers leaving. It is the tax on everything you just built, and it compounds. At 5% monthly churn you lose about half your customers in a year. Every single month, before you grow at all, you are refilling a hole.

31

Logo churn vs revenue churn

The distinction that hides bad news. Logo churn counts customers. Revenue churn counts dollars. Lose ten small customers and one enormous one, and your logo churn looks like a rounding error while your revenue churn is a catastrophe. Or the reverse. They tell you different things and they are not interchangeable.

32

Gross revenue retention

The honest number. Of the revenue you started the year with, how much is still here. It can never go above 100%.

33

Net revenue retention

The famous one. Same calculation, but you add in the expansion revenue from customers who upgraded, which is why it can go above 100% and why every SaaS company in the world quotes it. Andreessen Horowitz put it plainly: **net churn understates the losses, because it blends upsells with actual churn, while gross churn estimates the real loss to the business.** So **a company can report 120% net revenue retention while losing a third of its customers**, because a handful of big accounts expanded enough to paper over all of it. When you see it quoted on its own, ask for gross.

SOURCE Andreessen Horowitz

34

Cohort analysis

The fix for all of it. Instead of looking at all customers as one blob, you group them by when they arrived and follow each group forward. It is the only way to see whether the product is getting better, because if January's customers are still here at month twelve and June's are gone by month three, your average looks fine and your business is deteriorating.

4 Raising the Money

15 terms

Where it comes from, what it costs you, and why investors behave the way they do.

35

The stages: pre-seed, seed, Series A, B, C

Labels for how far along you are. Pre-seed is an idea and maybe a prototype. Seed is early evidence that somebody wants this. Series A is a real business with real traction that needs money to scale. Then B, C, D and onward, each one larger, each one buying a smaller percentage at a bigger number. **The letters are not official. There is no committee.** Companies routinely raise a seed, then a seed extension, then a pre-A, because the labels bend to fit the story.

36

Angels, VCs, and the fund behind them

The two kinds of people writing those cheques, and the difference is whose money it is. An angel invests their own money. They answer to nobody and they can decide over coffee. A venture capitalist invests other people's money, from a fund, and that changes everything about how they behave.

37

Carry and management fee: 2 and 20

A VC raises a fund from limited partners: pension funds, endowments, wealthy families. The classic structure is two and twenty. The firm takes roughly 2% of the fund each year to operate, and roughly 20% of the profits. That 20% is the carry, and it is where the real money is. Now the arithmetic that governs everything else: most startups fail, and in a typical portfolio the large majority return nothing at all, so the fund only works if one or two investments are enormous enough to pay for all the rest and still produce a return. That is why a VC cannot be satisfied with your solid, profitable, three-times return. It is not greed. It is the shape of the fund. Once you can see that, you stop reading term sheets as insults and start reading them as arithmetic.

38

Valuation

What the company is agreed to be worth in this transaction. **Valuation is not money. It is not in your bank account.** It is a price somebody agreed to pay for a slice, multiplied out to the whole. A $5M valuation means someone paid a price consistent with $5M. It does not mean the company could be sold for $5M, and it certainly does not mean you have $5M.

39

Pre-money vs post-money

Pre-money is what the company is worth before the investment goes in. Post-money is pre-money plus the money. $4M pre, $1M invested, $5M post, and the investor owns one fifth. **Confuse the two and you have just given away 25% while thinking you gave away 20%.**

40

Dilution

What happens to your percentage when new shares are created. You do not lose shares. More shares exist, so yours are a smaller slice. **And dilution is not automatically bad.** A smaller slice of a much larger thing is the entire point. Dilution only hurts when you gave up the slice for less than it was worth.

41

Fully diluted shares

The denominator every ownership percentage depends on. It counts every share that exists, plus every share that could exist: options granted, options still sitting unissued in the pool, warrants, anything convertible. **Your ownership calculated on issued shares is a flattering number. Your ownership calculated fully diluted is the real one, and it is always smaller.**

42

Cap table

The capitalisation table. The document listing who owns what: every founder, every investor, every option holder, every instrument that turns into shares later. It sounds like admin, and it is the single most important document in the company, because when there is finally money to divide, the cap table decides where it goes.

43

Convertible note

A loan that is designed to turn into equity instead of being repaid. It exists to let you raise money without agreeing on a valuation yet. It is legally debt: it carries an interest rate and a maturity date, and if it does not convert, it is a debt your company owes.

44

SAFE: pre-money vs post-money

Simple agreement for future equity. Y Combinator's instrument, and now the default at early stage. It does the same job as a note without being debt: no interest, no maturity date. You get money now, the investor gets shares in the next priced round. And there are two versions. **YC shipped the original pre-money SAFE in 2013 and replaced it with a post-money SAFE in 2018.** Their own stated reason for the change is the ability to calculate immediately and precisely how much ownership of the company has been sold. Sit with that: **the reason they rebuilt it is that with the old one, founders could not tell how much of their company they had given away. And pre-money SAFEs are still out there.**

SOURCE Y Combinator, 2013 and 2018

45

Valuation cap and discount

The two things the investor gets for taking the early risk. The cap sets a maximum valuation their money converts at: invest at a $5M cap, and if the next round prices at $20M, they still convert as though it were $5M. The discount does a simpler version of the same thing, converting at a percentage below the round price. **And here is the sentence to remember. A valuation cap is not a valuation. Nobody has said the company is worth that. It is a ceiling on a future conversion, and founders quote it as a valuation constantly.**

46

MFN

Most favoured nation. A clause saying that if you later give a different investor better terms, this investor automatically gets those terms too. It sounds harmless when you sign it. Then you stack four SAFEs across eighteen months, give better terms on the last one because you needed the money, and every earlier investor ratchets up to match.

47

Priced round

A round where you actually agree a valuation and issue shares now, rather than deferring it. This is where the real negotiation happens, because this is where the terms in chapters five and six get written down.

48

Down round

A round priced lower than the last one. The damage is not the number. It is the machinery a down round triggers, which is anti-dilution, which is in chapter six, and which is why people fight so hard to avoid one.

49

Bridge and recap

A bridge is a small raise to reach the next real round. It is meant to be a bridge to something, and founders joke about the bridge to nowhere for a reason. A recapitalisation is the serious version: when a company is out of options, the whole cap table can be restructured, and existing shareholders, which usually means the founders and the employees, can be almost entirely wiped out to make the company fundable again.

5 What You Actually Own

9 terms

A warning that is not a formality: this chapter and the next touch tax law and securities law. Nothing here is legal or tax advice.

50

Common vs preferred stock

The fault line running through everything that follows. Founders and employees hold common stock. Investors hold preferred stock. **They are not the same asset with different names.** Preferred carries rights that common does not, and every one of those rights is worth something, taken from the other side. **When you read that an investor paid $10 a share and your options are priced at $2, that gap is not a discount. You are holding a different, weaker instrument.**

51

Option pool and ESOP

A block of shares set aside to grant to employees. You need one. You cannot hire without one, and it is normal for it to be 10% to 20% of the company.

52

The option pool shuffle

What happens to that pool in a negotiation. Here is the sentence, as it appears in a real term sheet: "the $8M pre-money valuation **includes** an option pool equal to 20% of the post-financing fully diluted capitalisation." **Includes. That one word is the whole thing.** Do the naive arithmetic: $8M pre-money, 6M existing shares, and you get $1.33 a share. Now do it properly: the pool has to be created before the money goes in, so you add 2M new option shares to the denominator. $8M divided by 8M shares. $1.00 a share. **Your effective pre-money valuation is not $8M. It is $6M.** And notice who paid for it: the pool was carved out pre-money, so **it dilutes the common stock only, and the incoming investor is not diluted by it at all.** The fix is not to refuse a pool, you need it. The fix is to know that the size of the pool is a price negotiation exactly like the valuation is, and to argue about it with the same energy.

SOURCE A real term sheet

53

Vesting and the cliff

Your shares are not yours on day one. They are earned over time, typically four years. The cliff is the front end of that: a one-year cliff means you earn nothing at all until your first anniversary, and then a whole year lands at once. Leave at eleven months and you leave with nothing. Founders vest too, which surprises people. Investors require it, and the logic is sound: nobody wants a co-founder who quit in month six holding a third of the company forever.

54

Acceleration: single vs double trigger

What happens to your unvested shares when the company is sold. Single trigger means the sale alone accelerates your vesting. Double trigger means two things have to happen: the company is sold, and you are terminated. Double trigger is the market standard, and it is the one that matters, because without acceleration an acquirer can buy the company, keep your unvested shares hostage, and let you go.

55

Strike price

What you pay to convert an option into an actual share. If your strike is $1 and the shares are worth $10, you exercise at $1 and you hold something worth $10. If the company is worth less than your strike, your options are worthless, and that is what underwater means.

56

409A valuation

An independent appraisal of what the common stock is worth, which sets the strike price for employee options. The regulation gives you a safe harbour if you use one, and it has to be less than twelve months old. **It also explains a number that confuses everybody: the 409A value is almost always far below the price investors just paid, and that is not a trick.** Common stock really is worth less than preferred, for all the reasons in chapter six. The gap between the 409A price and the preferred price is the market pricing everything the preferred holders get first.

57

ISO vs NSO

Two kinds of stock option, and the difference is entirely about how they are taxed. Incentive stock options can receive more favourable tax treatment, but only if you meet conditions written into the tax code. The main one is a holding period: two years from the date the option was granted, and one year from the date you exercised it. Sell before either and the favourable treatment is gone. There is also a $100,000 a year limit on how much can first become exercisable, and anything above it stops being an incentive stock option. Non-qualified stock options carry none of that and are generally taxed as ordinary income when you exercise. The consequence can be enormous and it depends on your own circumstances, so this is exactly the point where you talk to an accountant rather than a video.

SOURCE The tax code

58

The 83(b) election

The most expensive piece of paperwork in a startup. If you hold shares that vest over time, you can be taxed as each portion vests, on its value at that moment, so if the company grows you owe tax on paper gains for shares you cannot sell. The 83(b) election lets you choose to be taxed at the start instead, when the shares are worth almost nothing. The window is thirty days from the transfer of the shares. That is in the tax code itself, and the code also says the election cannot be revoked once made. Thirty days, no extension, no appeal. Ask your accountant about it on the day you are granted shares, not later.

SOURCE The tax code

6 Who Actually Gets Paid

10 terms

Ten terms, and together they decide where the money goes when the company sells.

59

Liquidation preference

The right to be paid first. When the company is sold, before common shareholders see a single dollar, the preferred shareholders take their money off the top. **And it applies to any exit, not just a bad one. The word liquidation is misleading: this is not a bankruptcy clause. It is the clause that governs a sale of any size, including a good one.**

60

The preference multiple: 1x, 2x

How much they take first. A 1x preference means they get their investment back. 2x means they get double their money back before anybody else gets anything. 1x is the standard, and in a hard market you will see 2x. Watch what that does: somebody invests $10M and takes $20M off the top of the sale price, so on a $50M exit, $20M of it is spoken for before a single founder share is valued.

61

Participating vs non-participating

The term that does the most damage while sounding the most technical. Non-participating preferred means the investor chooses: either take the preference, or convert to common and take their percentage. One or the other, whichever is worth more. Participating preferred means they do not choose. They take the preference off the top, and then they also share in whatever is left, pro rata, alongside common. They get paid twice. Run it: investor puts in $10M for 20%, on a $50M exit. Non-participating, they compare $10M against 20% of $50M, which is also $10M, and it is a wash. Participating, they take their $10M first, then 20% of the remaining $40M, which is another $8M. $18M instead of $10M, and every dollar of that difference came out of the founders and the employees. Stack that with a 2x multiple and you have the $50M exit where the founders take home almost nothing.

62

The participation cap

The compromise that makes participation survivable. It says the investor participates only until they have received a set multiple of their money, and then they stop. A 3x cap on a 1x preference means they take 1x first, then keep participating until they have 3x in total, and beyond that they stop and the rest flows to common. If you cannot negotiate participation away, negotiate a cap on it.

63

Anti-dilution: full ratchet vs weighted average

What protects an investor if you later raise at a lower price. Full ratchet is the brutal version: if you sell a single share at a lower price, the earlier investor's conversion price drops all the way to that new lower price, as if they had invested at it all along. One cheap share can reprice an entire round, and the dilution lands on common. Weighted average is the reasonable version and the market standard: it adjusts their price partially, based on how much was raised at the lower price and how big the round was. Within weighted average there are two flavours, broad-based and narrow-based. Broad-based counts more shares, which produces a smaller adjustment and is friendlier to founders. If you are agreeing to weighted average, broad-based is the one you want.

64

Pay-to-play

A clause that says if you do not participate in the next round, you lose your preferred rights and convert to common. For years it was rare. In a hard funding market it comes back, and it changes the room, because it means an existing investor who cannot or will not write another cheque can lose everything their preference was worth.

65

Protective provisions and board control

The list of things the company cannot do without investor consent: sell the company, raise more money, issue new shares, change the board, take on debt. **This is where control actually lives, and it is separate from percentage. You can own 70% of your company and be unable to sell it, because a protective provision says a class of shareholder has to agree.** Board control is the other half of that. The board hires and fires the chief executive, including a founder chief executive, and who sits on the board is usually negotiated in a single line of a term sheet, which makes it more consequential than several of the numbers.

66

Drag-along and tag-along

Two clauses about being carried into somebody else's decision. Drag-along means that if a defined majority agrees to sell the company, everybody else has to sell too: you can be dragged into an exit you voted against. Tag-along is the protective one. If a major shareholder sells their stake, you have the right to tag onto that deal on the same terms, so you cannot be left behind in a company whose backers just quietly got out.

67

Right of first refusal and co-sale

The rules for when somebody wants to sell shares privately. Right of first refusal means the company, or the investors, get the chance to buy those shares first, on the same terms, before an outsider can. Co-sale means other shareholders can join the sale proportionally. Between them they mean your shares are not really yours to sell to whoever you like.

68

The waterfall

All of it at once: the order in which money flows on an exit. **Not everybody gets a percentage. Everybody stands in a queue.** Debt is paid first. Then the preferred shareholders take their preferences, in order, and the last money in is usually the first paid out. Then participation, if participation exists. Only what survives all of that reaches the common stock. **Founders and employees are at the bottom of the waterfall, always, which is why the headline sale price tells you nothing about what anybody actually received.** The valuation is the number you negotiate. The waterfall is the number that pays you.

7 Judging It and Getting Out

11 terms

How a business gets judged, how it gets priced, and how the equity finally becomes money.

69

Unit economics

The whole discipline in one question. Strip away the fundraising and the growth: does one customer, on its own, make money. Revenue from one customer, minus the cost of serving them, minus the cost of getting them. If that is positive, growth makes you stronger. If it is negative, every additional customer loses you money, and every dollar you raise gets you to the end faster.

70

EBITDA

Earnings before interest, taxes, depreciation and amortisation. The intent is reasonable: strip out financing choices and accounting choices so you can compare two businesses on their operations. **But it gets used as a stand-in for cash, and it is not cash.** The clearest words belong to Warren Buffett, in the Berkshire Hathaway shareholder letter for the year 2000: **"References to EBITDA make us shudder. Does management think the tooth fairy pays for capital expenditures."** He makes it concrete with FlightSafety, a business Berkshire owned that trained pilots on flight simulators: it spent roughly $272M a year on simulators, about equal to its depreciation charge. That money was not optional and it was not growth. It was the cost of staying in the same place. **Add back depreciation and you have made that spending disappear from the page. It has not disappeared from the bank account.**

SOURCE

Warren Buffett, Berkshire Hathaway shareholder letter, 2000

71

Profit vs cash flow, and free cash flow

Profit is an opinion arrived at under a set of rules. Cash is a fact you can check. They diverge constantly: you can book a large profitable sale in March, be taxed on it, and not be paid until August. The profit is real. The insolvency is also real. Free cash flow is the honest version: the cash the business generated, after the capital spending needed to keep it running. It is EBITDA with the capital spending put back in.

72

Accrual vs cash accounting

The reason the two diverge. Cash accounting records money when it moves. Accrual accounting records revenue when it is earned and costs when they are incurred, regardless of when cash changes hands. Accrual gives a truer picture of performance. Cash gives a truer picture of survival. You need both, and if you only look at one of them, look at the one that tells you whether you can make payroll.

73

Rule of 40

Your growth rate plus your profit margin should add up to at least forty. Grow 40% and break even, you pass. Grow 20% at 20% margins, you pass. It is a way of saying you may buy growth with profitability or profitability with growth, but you have to be doing one of them well. And it is quoted like an accounting standard. **It comes from a blog post by Brad Feld, in February 2015.** Read how he introduces it: he says he heard something he had not heard before from a late-stage investor at a board meeting, and that the investor's firm called it the 40% rule for a healthy software company. **The investor is not named. There is no study in the post. No dataset, no analysis, no evidence of any kind.** One person repeated something another person said in a room, and it became a standard.

SOURCE Brad Feld, February 2015

74

Magic number

A sales efficiency measure. It compares the new recurring revenue you added to what you spent on sales and marketing to add it. Above one, roughly speaking, means your sales spending is producing more than it costs and you should spend more. Below one means it is not paying for itself yet, and spending more will not fix that.

75

The valuation multiple

How companies are actually priced in practice. Nobody builds a discounted cash flow model for a startup. They take a metric, usually ARR, and multiply it. **And the multiple is not a fact about your company. It is a fact about the market on the day.** The same business with the same revenue was worth twenty times ARR in one year and six times ARR two years later, having done nothing differently.

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Due diligence

The examination an investor or acquirer runs before the money moves: contracts, accounts, code, customers, cap table, employment agreements, intellectual property. Everything you have said gets checked. Diligence does not create problems, it finds them. The cap table you never cleaned up and the contractor who was never assigned their intellectual property are already problems. Diligence is only when they become expensive.

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Secondary sale

Selling existing shares rather than issuing new ones. In a primary round the money goes into the company. In a secondary, an existing shareholder sells to a buyer and the money goes to that shareholder. It is how founders and early employees take some money off the table before an exit, and it is more common than it used to be.

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Earnout and escrow

Two reasons the sale price is not the price. An earnout means part of what you are paid depends on hitting targets after the sale, while working inside a company you no longer control, on goals set by people who now own it. Escrow means a portion of the price is held back for a period, to cover any problems that surface later. So when you read that a company sold for $100M, some of it may be contingent, some may be held, and the rest goes into the waterfall from chapter six.

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The exit: M&A, IPO, acquihire

The event where equity becomes money, and there are three shapes. An acquisition is another company buying yours: by far the most common outcome, and where every term in chapter six finally does its work. An initial public offering is selling shares to the public. It is rare, it is expensive, and it is not really an exit at all, because the founders are usually locked up and now run a public company. An acquihire is a company buying yours for the team rather than the product: the people get jobs, the investors get some money back, and the common shareholders often get very little, because the price is set low enough that the preference stack absorbs most of it.

The thing worth keeping

- The two most quoted benchmarks in startup finance are the **LTV to CAC ratio of three to one**, which is one sentence in a blog post from 2009 beginning with the words “it appears”, and the **Rule of 40**, which is an unnamed investor’s remark at a board meeting in 2015. Neither is wrong. Both are reasonable instincts from experienced people. But nobody ran a study and nobody published data. They are heuristics that hardened into rules because they were repeated by people who sounded certain. When somebody quotes you a benchmark, ask where it came from. Both of these took about ten minutes to trace.
- Booking, billing, cash and revenue happen at **four different times**. A founder who quotes whichever one is highest this quarter is not lying. They are choosing. So when somebody says we are at five million, the honest follow-up is five million of what.
- Everything in chapter six follows from the shape of the fund. Most startups fail, so a fund only works if one or two investments are enormous enough to pay for all the rest. It is not greed, it is arithmetic, and once you can see it you stop reading term sheets as insults and start reading them as arithmetic.
- **The valuation is the number you negotiate. The waterfall is the number that pays you.** They are not the same negotiation, and only one of them is on the front page of the term sheet.

Chapters five and six touch tax law and securities law. Nothing here is legal or tax advice. What it is for is so that you know which questions to take to a real lawyer and a real accountant before you sign, instead of finding out afterwards.