What's the Magic Number?

How much money should a SaaS company raise and when?

Early in 2016, private capital markets have tightened. There are no shortage of predictions that valuation multiples will drop, round sizes will shrink and down rounds will steal headlines. Many believe that investors will raise the bar (on new investments and follow-on checks) and be unwilling to stomach previously tolerated burn rates. So, what does this mean for you, the entrepreneur contemplating a 2016 capital raise? In particular, we'll focus on how much you should raise and whether that answer is different today than it was a year ago.

Identifying & Aligning Incentives

First, regardless of market conditions, we recommend that entrepreneurs appropriately weigh the incentives of all parties involved in the capital raising process. Depending on stage and circumstance, several parties might be involved in the decision to fundraise. Before new, outside investors become entangled in the process, it's imperative that all incumbent parties communicate effectively and agree to work toward a common goal.

- ***The Entrepreneur***
  It all starts here. Ultimately, you are responsible for cash management and corporate finance, and you will feel the tension between immediate dilution and long-term value creation most acutely (at least in early rounds). You will have to balance your company's true capital needs with your optimal cash cushion, and secondary liquidity considerations may come into play. Would a small amount of liquidity today reduce your personal stress and allow you to operate more effectively? At a certain stage that often makes sense.

- ***The Board***
  The board will obviously play a significant role in determining how much to raise, when to raise it and how to optimize your balance sheet. In many cases, the board will also provide valuable introductions to prospective investors. The institutional investors on your board will be attuned to the financial impact that additional equity (or debt) will have on their securities, and it's important that everyone around the table understand the realities of the current and pro forma cap table.

- ***The Banker***
  Perhaps the most transparent – bigger rounds equal bigger fees (usually). There are many good reasons to engage a banker to lead your capital raise and if you are seeking a banker's advice on the size of your round, you should understand the dynamics at play. Clearly communicate the terms of your ideal raise upfront and ensure that the engagement is structured appropriately.

- ***The New Investor(s)***
  The market typically dictates valuation and structure, but optimizing check size can be murkier and more subjective. Institutional investors have different fund sizes, capital allocation strategies and hurdle rates, all of which influence perspective on the "right" amount of capital.

Considerations for Your Next Round

There is not a prescribed round size for your company's Series [--]. Determining the appropriate amount of capital requires consideration of several company specific factors and several market dependent factors.

- ***Your Business Model***
  Are you B2B or B2C? Given our investment focus, we will focus on B2B fundraising but this is clearly a material distinction. What's your go-to-market strategy? If you are targeting a specific vertical, your capital needs may not be comparable to a company selling a broader, horizontal application. What's your delivery model? Our advice to a $15 million SaaS company may not hold true for a $15 million medical device company. What kind of traction do you have today? Growth rates, unit economics and customer data points are telling; they should both inform your fundraising objectives and influence investor appetite (though, as we'll discuss, investor appetite ebbs and flows based on market conditions).

- ***Your Market***
  What does your competitive landscape look like? The number of competitors, their relative capitalization and their relative scale are important considerations. How mature is your market? Timing a market is difficult, but you can mitigate risk by managing your balance sheet conservatively (or aggressively when the time comes). If the proof points on adoption aren't there, raising too much and increasing your burn may not drive growth. More likely, you'll be jeopardizing your ability to capitalize on rising tides in the future. If you do have the proof points and wind in your sails, raising too little can leave you exposed. Another company may benefit disproportionately from market momentum if you don't step on the gas.

All of these factors can help you determine how much you need to invest in product development and sales & marketing to build a business with sustainable, strategic value. Of course, depending on your company's profile and market conditions, you may end up raising more or less than this framework would suggest. In Q2 2015, you were likely to raise more – lower costs of capital, higher valuations, expedited diligence cycles and more favorable terms created a fundraising environment in which many companies were able to raise outsized rounds. In Q2 2016, you may be likely to raise less. Before we discuss shifting fundraising dynamics, let's outline the pros and cons of raising larger rounds. While we believe that these pros and cons are applicable regardless of market conditions, entrepreneurs don't always have the flexibility to raise more capital, even if the pros seem to outweigh the cons.

The Case FOR Raising More

You wanted a longer runway, more cushion and greater security. You wanted to minimize distraction for your team by securing more capital in one fundraising process and you wanted to raise more while times were still good (what if public multiples drop 40% over the next year?). You believed that additional engineering resources could accelerate your next product release and strengthen your position in the market. You saw buying signals and thought that it was time to aggressively hire more reps and expand the marketing budget. You saw a clear path to deploying capital with a high rate of return – using your war chest to pursue a roll-up strategy, enter new geographies, etc. You felt that a larger raise would lend credibility and visibility to your business. You were willing to bet that all of these factors would spur value creation to offset increased dilution (or maybe you just got an "out of this world" pre-money valuation!).

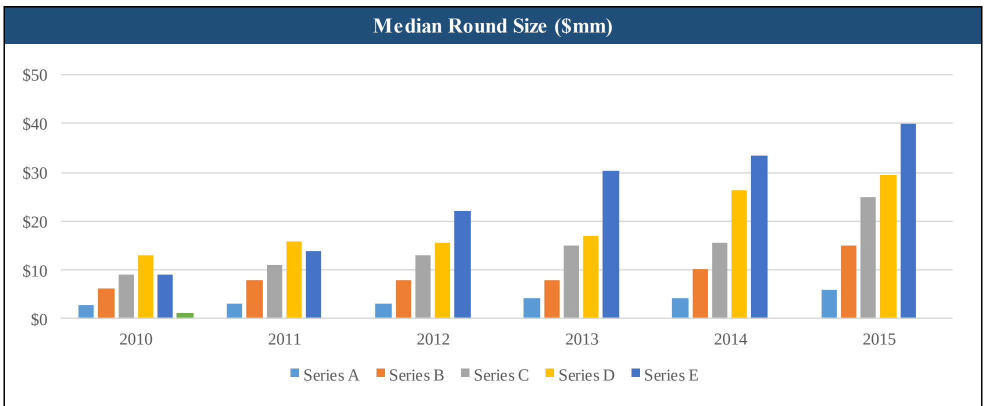
The Case AGAINST Raising More

You deviated from your original fundraising goals. You adjusted the operating model to support a larger capital investment, but you're not sure that it's really prudent to hire that many reps that quickly. While you know that your new investors will want a certain return on each dollar invested (3x? 5x? more?) over a reasonable period of time, you aren't sure that you have that many high ROI ways to deploy an additional [$X] million. You feel pressure to put the capital to work and you're worried that your processes and systems can't scale that quickly. You wonder if your team will maintain the same sense of urgency with such a large sum in the bank. You know that the bar for the next round will be higher, that new investors will expect you to make more progress on [$Y] million than [$Z] million. Your dilution is greater than originally anticipated and your equity is sitting under a larger preference stack.

What We've Seen

Over the last couple of years, we have seen a shift toward larger rounds at earlier stages and we're not the only ones (see chart below); the "case for raising more" has prevailed against the backdrop of favorable market conditions. A $5 million business that would be best served to raise $7 to $10 million (in our estimation) receives multiple $25 million term sheets and chooses the larger check. At the time, these raises are certainly defensible, but they are often deviations from an entrepreneur's original operating plan and don't always accelerate growth, as discussed in our **2014 SaaS Report**.

In consistently favorable fundraising environments, the negative aspects of these outsized rounds are difficult to see. However, the pitfalls of "too much, too soon" can quickly be exposed when capital markets turn. We have seen companies try to scale with unproven (or ineffective) sales & marketing efforts only to burn cash without requisite growth. While the next round may be there if markets are hot, that aggressive capital deployment could make it more difficult to raise again if investors pull back.



Source: Pitchbook Data

You should understand the economic impact of raising larger rounds, as well as the heightened expectations that come with bigger checks. When company needs take a back seat to investor preferences (e.g., rationale for a larger round is based on your lead investor's minimum check size, not your base case model), misaligned incentives can lead to poor outcomes.

Dilution

Dilution is a straightforward concept. The math around today's fundraise is simple, but it is difficult to assess the long term impact of any single capital raise. The table below illustrates a basic fundraising principle – in a vacuum and assuming constant valuation multiples, equity is more expensive for earlier stage companies. Setting market conditions aside, entrepreneurs can maintain a larger equity stake by raising capital incrementally. Structuring multiple tranches in a given round can also be helpful in managing dilution; entrepreneurs can avoid unnecessary dilution upfront while maintaining access to a larger pool of capital in the event it's needed.

Implied Dilution Based on 5.0x Revenue Multiple						
	Revenue					
Round Size	$5,000,000	$10,000,000	$15,000,000	$20,000,000	$25,000,000	$30,000,000
$5,000,000	16.7%	9.1%	6.3%	4.8%	3.8%	3.2%
$10,000,000	28.6%	16.7%	11.8%	9.1%	7.4%	6.3%
$15,000,000	37.5%	23.1%	16.7%	13.0%	10.7%	9.1%
$20,000,000	44.4%	28.6%	21.1%	16.7%	13.8%	11.8%
$25,000,000	50.0%	33.3%	25.0%	20.0%	16.7%	14.3%
$30,000,000	54.5%	37.5%	28.6%	23.1%	19.4%	16.7%

Of course, you are likely to raise multiple rounds of capital, and your ultimate financial success is tied to both the cost of capital on the path to exit and the value you create with that capital. There are stories of entrepreneurial failure and success on both ends of the spectrum (too aggressive, too conservative) – it's important to understand tradeoffs and to position yourself for success.

For entrepreneurs in B2B SaaS, it's critical to understand the metrics that drive your business and generate return on invested capital (bookings, churn, payback and other well documented elements of the unit economic model). Having a strong grasp on unit economics and clearly defining your uses of proceeds can mitigate the risk associated with raising an insufficient or excessive amount of capital.

The following table shows the impact of two different fundraising strategies that a $5 million company could pursue. Regardless of strategy, this analysis assumes that the company will need $25 million of equity to grow beyond $25 million of revenue. In case #1, the company elects to raise $25 million in a single financing. In case #2, the company elects to spread that $25 million over multiple financings. At the end of the day, both strategies result in the same amount of revenue growth (assuming constant payback on sales & marketing), but the second strategy allows management to retain 15% more equity ownership. Of course, this is an extreme (and theoretical) example. It is useful in illustrating the balance between fundraising and stage of development. However, courting investors is distracting and time consuming; the dilutive benefits of raising incrementally over time may easily be offset by the brain damage associated with repeatedly fundraising.

Managing Dilution As You Go					
Case #1	***Raise $25 million in single financing***				
	Series A				
Revenue	$5,000,000				
Valuation Multiple	5.0x				
Pre-Money	$25,000,000				
Capital Raise	$25,000,000				
Post-Money	$50,000,000				
Mgmt. Ownership	**50.0%**				
Case #2	***Raise $25 million in multiple financings***				
	Series A	**Series B**	**Series C**	**Series D**	**Series E**
Revenue	$5,000,000	$10,000,000	$15,000,000	$20,000,000	$25,000,000
Valuation Multiple	5.0x	5.0x	5.0x	5.0x	5.0x
Pre-Money	$25,000,000	$50,000,000	$75,000,000	$100,000,000	$125,000,000
Capital Raise	$5,000,000	$5,000,000	$5,000,000	$5,000,000	$5,000,000
Post-Money	$30,000,000	$55,000,000	$80,000,000	$105,000,000	$130,000,000
Mgmt. Ownership	**83.3%**	**75.8%**	**71.0%**	**67.6%**	**65.0%**

Notes:
(1) Case #2 assumes that every invested $ turns into $ of revenue

Investor Hurdle Rates

While most fully grasp the dilutive impact of each equity round, many entrepreneurs fail to consider the implications a new financing has on exit timing and value. From fund to fund, there is variance in return thresholds. Your new investor is likely underwriting to a 3.0x to 5.0x return (maybe higher depending on stage and perceived risk) and hopes to realize that gain in three to seven years. From a timing perspective, new rounds effectively "reset the clock" and introduce a new set of expectations. With larger rounds, this effect is more dramatic.

Consider a $10 million business seeking to raise a round of capital. The business receives two term sheets with the same pre-money valuation; Investor A's proposal is based on a $15 million investment, and Investor B's is based on a $30 million investment. Investor B not only receives a larger stake in the business (38% vs. 23%), but also needs a larger exit event to make a 5.0x return (i.e., the additional ownership that an investor gets with a larger check doesn't necessarily offset higher dollar gain expectations on incremental capital). In this example, Investor B needs the business to sell for $400 million to make 5.0x, whereas Investor A only needs a $325 million exit. Importantly, all of the incremental value creation (from $325 million to $400 million) accrues to the new investor, not you.

Investor Hurdle Rates

	Investor A	Investor B
Revenue	$10,000,000	$10,000,000
Valuation Multiple	5.0x	5.0x
Pre-Money	$50,000,000	$50,000,000
New Investor $'s	**$15,000,000**	**$30,000,000**
Post-Money	$65,000,000	$80,000,000
New Investor Ownership	23%	38%
New Investor Return Expectations		
Exit Value to Make 5.0x ROI	**$325,000,000**	**$400,000,000**
Implied Management Proceeds		
Exit Value to Make 5.0x ROI	**$250,000,000**	**$250,000,000**

The risk associated with the larger check can be amplified (or decreased) by changing market conditions. If market multiples decrease, that $400 million exit may be even harder to achieve. Raising capital introduces risk that you can control (execution) and risk that you cannot (market).

After factoring in all of the considerations discussed above, a larger round may be the right answer, but you shouldn't overlook investor hurdle rates. Larger rounds can introduce more risk for management teams and create misalignment in evaluating liquidity events.

The Security Myth

Securing cash and extending your runway are key goals of any financing. So, if there is more money available, why not increase your cushion and kick that next fundraise out another 18 months? In our experience, having more cash the day after close does little to protect a company (or a management team). Very few have the discipline to preserve the flexibility and runway that additional cash can provide and investors generally fund with the expectation that their capital will be put to work in a timely manner.

As a result, larger rounds often place more pressure on management teams to hit growth milestones quickly and efficiently. This dynamic can create healthy, motivating urgency for a company with sufficient proof points and a thoughtful operating plan. However, if external forces lead to an unnaturally large round at the wrong time, this dynamic can exacerbate scaling challenges and set the stage for management turnover and future fundraising issues.

We have seen this play out several times as of late. Entrepreneurs that raise significant rounds and subsequently fail to show sufficient progress find themselves in the hot seat quickly. Investors may look at growth (or lack thereof) and the remaining cash balance and decide to replace leadership; they hope that a (still) well-capitalized asset can attract talent and that the company can demonstrate traction under new leadership in advance of a future fundraising event. While that cash surplus may enable the company to pivot, you may not make it to the other side.

As for future fundraising, prospective investors will evaluate your historical performance against the backdrop of your past financings. New investors expect more progress coming off of a $30 million round than a $10 million round. If that doesn't materialize, entrepreneurs can expect less appetite for the next round (regardless of prior round size).

Maintaining Flexibility

For the reasons discussed above, raising too much is more likely to jeopardize your future success than raising too little. In either case, great performance mitigates risk. If you raise a large round and generate attractive returns on invested capital, you will be in a great position to raise more (in private / public markets) or to pursue an exit. This also applies when you raise a small round; when a good business has momentum, there is rarely a shortage of capital.

A comparison of outcomes in downside scenarios is more interesting:

Poor Performance After Large Round	Poor Performance After Small Round
▪ Greater imbalance between cost structure and top line growth (excess capital can lead to overinvestment in headcount, overhead, etc.) ▪ Less organizational flexibility to pivot, especially with elevated burn rates ▪ Greater gulf between current and pro forma capitalization ▪ Unknown – how does size of last round impact support from incumbent investors?	▪ Smaller imbalance between cost structure and top line growth; clearer path to "right size" the company ▪ More organizational flexibility to pivot, especially with lower burn rates / headcount ▪ Smaller gap between current and pro forma capitalization ▪ Unknown – how does size of last round impact support from incumbent investors?

Every situation is different, but we have generally observed that raising smaller rounds based around specific performance milestones preserves flexibility in downside scenarios without compromising upside. If you do raise a larger round, you can preserve flexibility by monitoring yield on capital deployment more diligently. When something isn't working, don't be afraid to pull back. Redeploy cash elsewhere or wait until you find high ROI opportunities to invest. Companies that manage cash efficiently during trying times are often well positioned to capitalize and take disproportionate market share when conditions improve (whether that improvement is tied to macro trends or an adoption wave in a specific category).

Fundraising in 2016 & Beyond

As you seek to raise capital in tightening markets, these considerations are helpful to keep in mind. Market conditions may limit fundraising options and investors will increasingly scrutinize unit economics and cash consumption plans. You should expect longer fundraising cycles and a greater emphasis on achieving milestones more efficiently. Approach budgeting with your next capital raise in mind. Could you flip to breakeven if necessary? If your forecast calls for additional capital in Q4, will you have demonstrated sufficient progress to facilitate that fundraise? If not, what levers can you pull to extend your runway and better position your business for long term success?

River Cities Overview

River Cities first encountered the SaaS model with its EVault investment in 2001. Since then, we've invested more than $90M in 16 portfolio companies and have had five successful liquidity events, including two IPOs. Since 2009, River Cities has published the **SaaS Operations Metrics and Benchmarking Study**, which considers operating metrics from public SaaS companies during their developmental period (pre-$50M in revenue). The report offers entrepreneurs insight into River Cities' perspective and experience gained from 15 years of supporting SaaS entrepreneurs.

The focus of our SaaS investment strategy is backing progressive management teams in companies that offer business-to-business solutions architected on a single-instance, multi-tenant infrastructure with a critical mass of customers in a large market. Investment candidates demonstrate attractive gross margins, strong customer renewals and efficient customer acquisition models.

As a firm, River Cities invests in world-class management teams − backing progressive, proven leaders in the markets of information technology and healthcare. A consistent, cohesive team has honed its strategy over five funds with compelling performance. River Cities seeks to be a business partner first and a capital provider second, investing significant human capital to leverage its domain expertise and a network of thought leaders assembled over the last 20 years. With more than $500M of capital raised and a consistent track record of success, River Cities has established itself as a preferred source of growth capital. We are actively seeking new investments for our $200M Fund V. Leading investments in the $5M - $30M range, River Cities offers entrepreneurs the flexibility to raise an appropriate amount of growth capital for the company's stage of development.