

## **FIN 423 -- Corp Fin'l Policy & Control: Venture Capital**

### **Sources of capital for private firms:**

- **personal wealth**
- **friends & family**
- **bank loans**
- ***venture capital equity***

## **Why Seek Venture Capital?**

- 1. Lower cost sources of capital are exhausted**
- 2. Venture capitalists have expertise that will aid business development  
e.g., marketing, organization, production**

## **Why Seek Venture Capital? (cont.)**

### **1. Lower cost sources of capital are exhausted**

- **some types of firms require large investments in R&D or fixed investments before cash flows begin**
  - **biotech**
  - **chip manufacturing**
- **banks are restricted from making equity investments in these types of activities**
  - **since there are no short-term cash flows, it's hard to design a debt security that matches the financing demands of these firms**

## **Why Seek Venture Capital? (cont.)**

### **1. Lower cost sources of capital are exhausted**

- **friends and relatives often have limited resources and/or unwillingness to make a large undiversified investment**

## **Why Seek Venture Capital? (cont.)**

### **2. Venture capitalists have expertise that will aid business development**

- usually require a majority equity stake
  - perhaps among a set of VC firms
- VC partners often become active board members
- VC partners help hire complementary personnel
  - people who have the skills not held by incumbent management
  - e.g., if the entrepreneur is an R&D specialist, hire a CEO who can manage marketing, production, etc.

## **Why Seek Venture Capital? (cont.)**

### **2. Venture capitalists have expertise that will aid business development**

- the process of preparing a sequence of business plans forces the company to focus on the financial viability of their projects

## **Costs of Venture Capital**

- 1. High cost of capital**
  - target required returns in 20-40% range
  
- 2. Loss of control**
  - VC's claim rights to control most important decisions
  
  - high failure rate
  
  - founder/entrepreneur can be displaced
  
  - frequent financing rounds require constant performance

## **Costs of Venture Capital (cont.)**

### **Turnover of founders - case studies**

- Lotus
  
- Compaq
  
- Apple
  
- all of these firms had significant VC investments

## **Costs of Venture Capital (cont.) Lotus**

### **Mitch Kapor was founding CEO**

- took cash flows from sales of Lotus 1-2-3 and reinvested them in
  - "Symphony" (first office suite)
  - artificial intelligence software
- board (dominated by VC firms) fired Kapor and replaced him with Jim Manzi
  - Manzi: a marketing person who was tasked to maximize profits from 1-2-3
  - Kapor was a major stockholder when he was fired
  - Manzi was later replaced (by IBM takeover) because he was not maximizing the value of Notes

## **Costs of Venture Capital (cont.) Compaq**

### **Rod Canion was founding CEO**

- original business strategy was to sell an IBM-clone PC that was much higher quality than IBM for a slightly higher price
  - as high quality/low price clones began to make inroads in the business community (e.g., Dell, Gateway, etc.), Compaq profits fell

## **Costs of Venture Capital (cont.) Compaq**

**Chair (Ben Rosen) was one of the original VCs**

- he asked whether Compaq should be trying to compete with Dell etc. by making a lower quality/price product
  - Canion repeated engineers' answer that it would take a long time to develop such a product
  - Rosen sent a couple of mid-level engineers to go to a trade show, buy components, and create a clone in their hotel room
  - it took them less than 3 days to create a workable product!
- this led to Canion's firing

## **Costs of Venture Capital (cont.) Apple**

**Steve Jobs was the CEO/founder**

- he was good at R&D
- product development & marketing were slow
- pricing was expensive
- Jobs was spending a lot of money on developing the "Lisa" machine

## **Costs of Venture Capital (cont.) Apple**

**VCs on the board fired Jobs and replaced him with John Sculley**

- marketing person from Pepsi
- at the time Jobs was the largest single shareholder (about 14%, I think)
- Apple started to focus on making Macintosh a commercial success
- later, Apple replaced Sculley
  - Michael Spindler
  - Gil Amelio
  - finally Jobs, again

## **Costs of Venture Capital (cont.)**

**Contrast with Microsoft**

- they had only a small VC equity position
- even now, Gates owns a very large block of stock (over 8%)
- Gates could not be fired – he removed himself from operational activities voluntarily
- on the other hand, he seems not to have fallen into the errors that affected Lotus, Compaq, and Apple

## **Costs of Venture Capital (cont.)**

### **Common features:**

- **VCs have strong equity positions and continuing board membership**
- **they have enough control to fire the founding CEO, even in "successful" companies**
  - **even when founder has a large remaining equity position**

## **Model Financial Structure**

### **Convertible preferred stock**

- **since there aren't often taxable profits, tax deductibility is not a big issue**
- **convertible into equity at the IPO**

## **Model Financial Structure**

### **Staged financing**

- **forces the firm to return for capital infusions frequently**
- **lots of chances to exercise the abandonment option**

## **Model Financial Structure**

**Contrary to common opinion, VCs do not often cash out at the time of an IPO**

- **they may distribute shares in the public companies to their limited partners, though**
- **often they will sell their shares within the first two years after the IPO**

## What Industries Use VC?

### Industries with large capital needs, long horizons

- computer hardware/software
- biotech
- communications

### Geographically concentrated

- Silicon Valley (CA)
- Route 128 (MA)

### Specialized knowledge by VCs

- also, easy on-site monitoring

## Cycles in VC?

### Supply:

- pension funds, endowments, others with long horizons
- wealthy individuals
- tends to increase when recent realized returns are high
  - e.g., profitable IPOs that were financed by VCs

### Demand:

- tends to be concentrated by industry

## Cycles in VC?

### Pricing:

- Gompers & Lerner find prices increase when supply increases
- demand pressure somewhat similar to what happens to inflows into mutual funds that have had recent good performance
- implies that future performance of investments made in "hot" markets may not be the same as the period that attracted investors

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