

FIN 514

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 (consultant for McKinsey)
 - Manzi 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 in 1991

Costs of Venture Capital (cont.)

Apple

Steve Jobs was the CEO/co-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 in 1985

- 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
- In 1993, 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 4%)
- 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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