

FIN 540 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 6%)
- 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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