Entrepreneurial Finance

Entrepreneurial Finance

- Three core principles of entrepreneurial finance
  - More cash is preferred to less cash
  - Cash sooner is preferred to cash later
  - Less risky cash is preferred to more risky cash

Exhibit 12.3

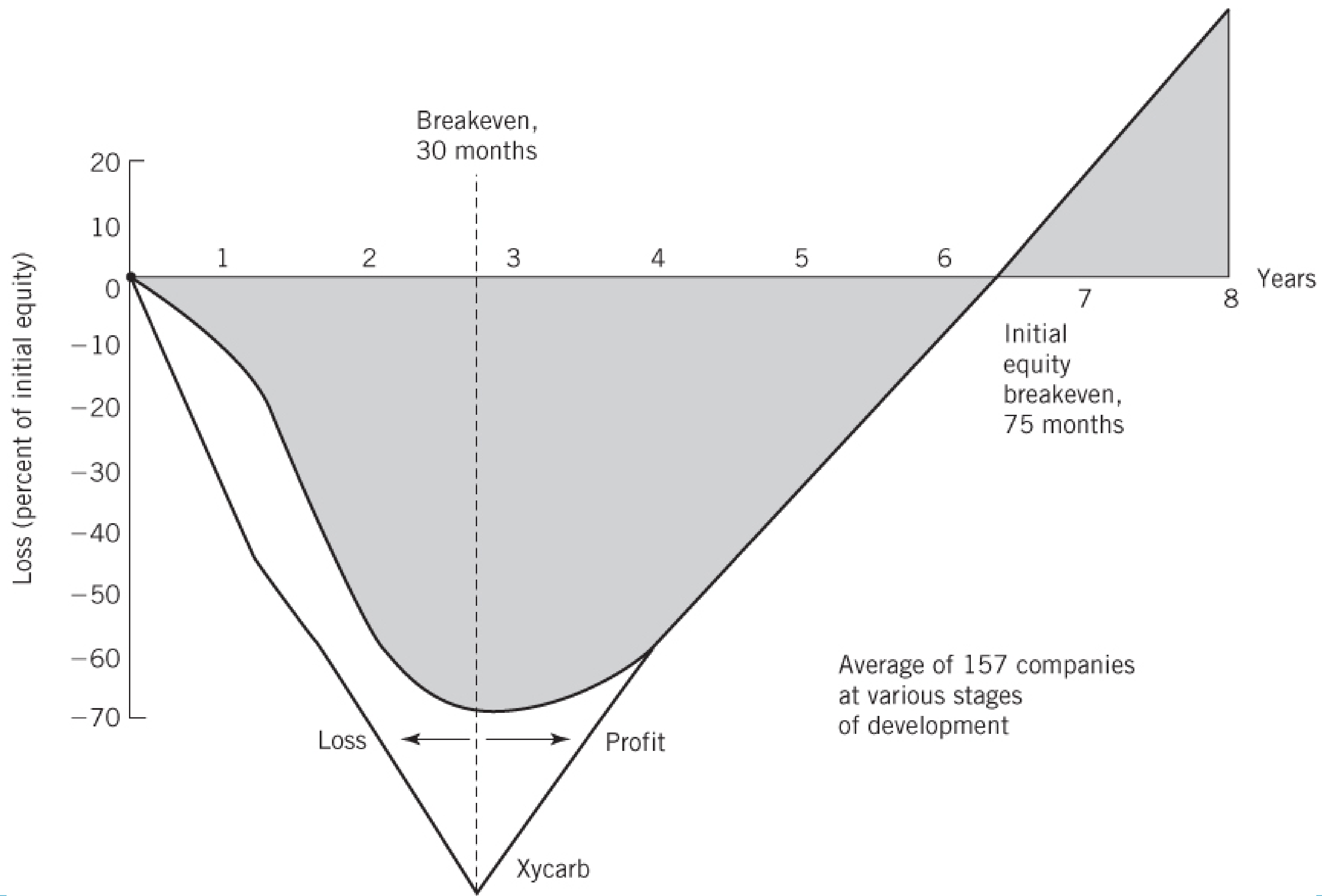
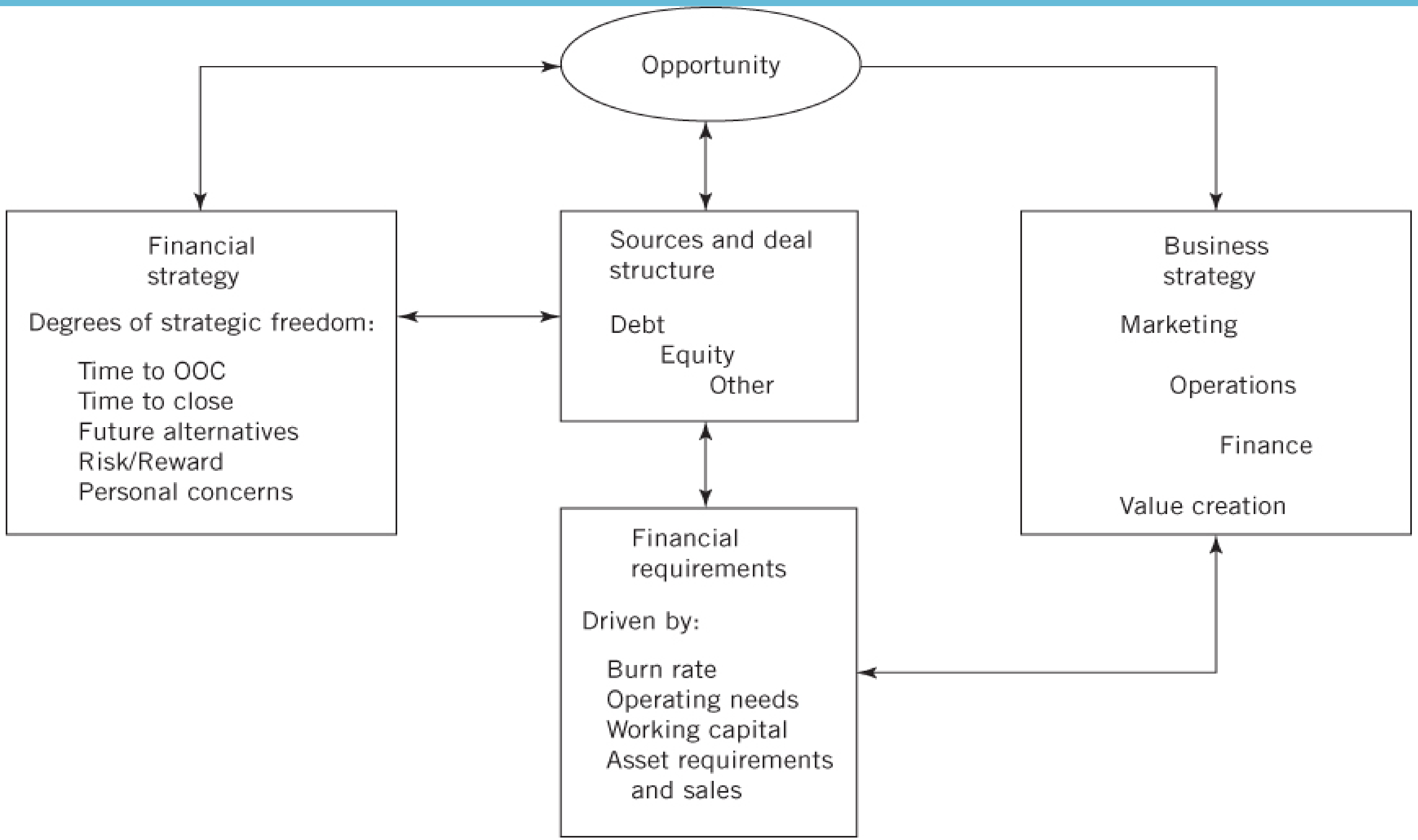

Breakeven,
30 months
Loss (percent of initial equity)
20
10
0
−10
−20
−30
−40
−50
−60
−70
1
2
3
4
5
6
7
8
Years
Initial
equity
breakeven,
75 months
Average of 157 companies
at various stages
of development
Loss
Profit
Xycarb

Exhibit 12.4


Opportunity
Financial strategy
Degrees of strategic freedom:
Time to OOC
Time to close
Future alternatives
Risk/Reward
Personal concerns
Sources and deal structure
Debt
Equity
Other
Business strategy
Marketing
Operations
Finance
Value creation
Financial requirements
Driven by:
Burn rate
Operating needs
Working capital
Asset requirements and sales

Bargaining Power

- Three vital corollaries determining bargaining power
  - Burn rate
  - Time to OOC (Out Of Cash)
  - TTC (Time To Close)

Free Cash Flow

- The cash flow generated by a company or project is defined as follows:
  - Earnings before interest and taxes (EBIT)
  - Less tax exposure (tax rate times EBIT)
  - Plus depreciations, amortization, and other non-cash charges
  - Less increase in operating working capital
  - Less capital expenditures

Operating Working Capital

- Operating working capital can be defined as follows:
  - Transactions cash balances
  - ***Plus*** accounts receivable
  - ***Plus*** inventory
  - ***Plus*** other operating current assets
  - ***Less*** accounts payable
  - ***Less*** taxes payable
  - ***Less*** other operating current liabilities

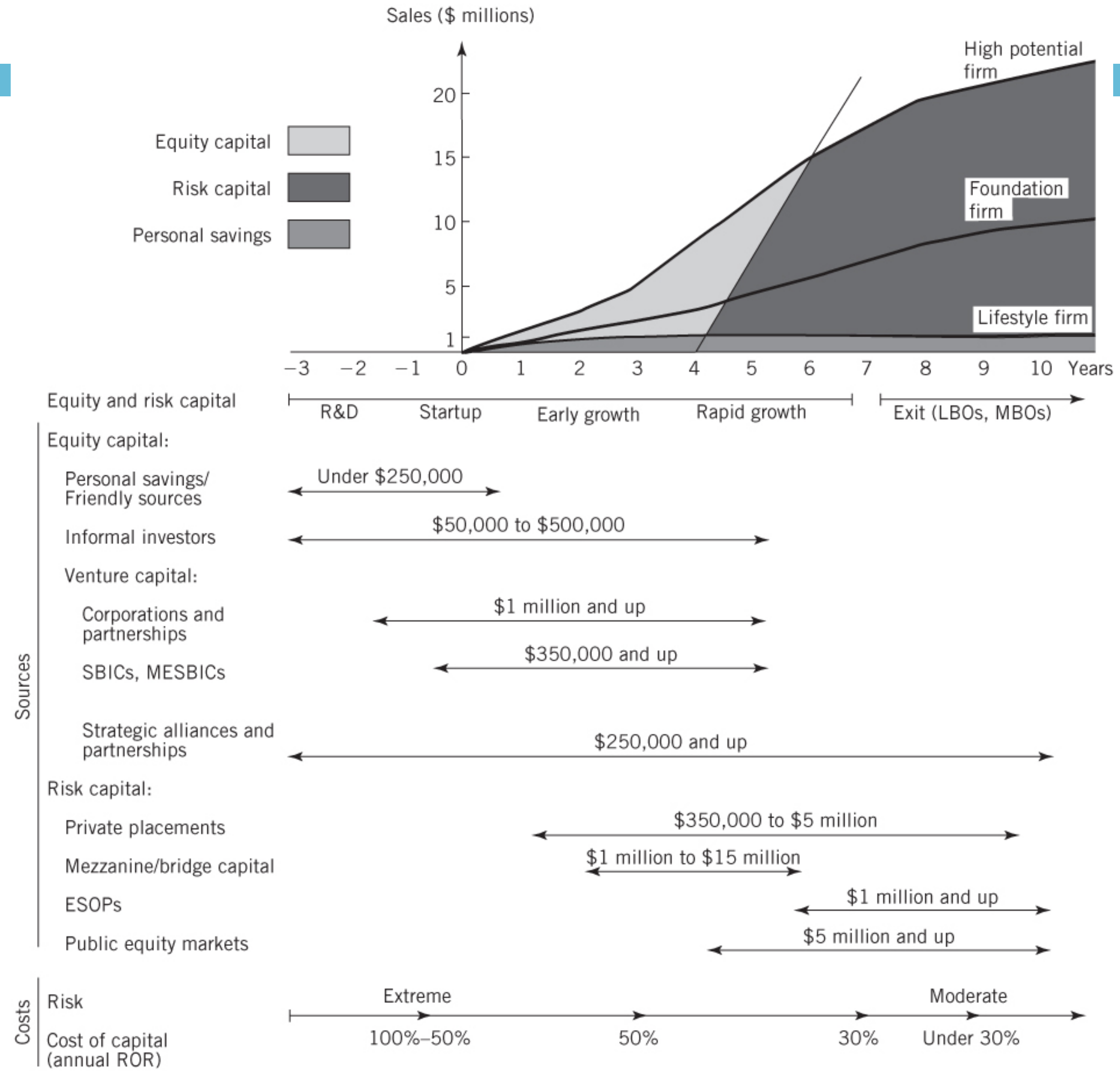
Factors Affecting Financing

- Accomplishments and performance to date
- Investor's perceived risk
- Industry and technology
- Venture upside potential and anticipated exit timing
- Venture anticipated growth rate
- Venture age and stage of development

Factors Affecting Finance

- Investor's required rate of return or internal rate of return
- Amount of capital required and prior valuations of the venture
- Founders' goals regarding growth, control, liquidity, and harvesting
- Relative bargaining positions
- Investor's required terms and covenants

Exhibit 12.6



Sales ($ millions)
20
15
10
5
1
−3 −2 −1 0 1 2 3 4 5 6 7 8 9 10 Years
High potential firm
Foundation firm
Lifestyle firm
Equity capital
Risk capital
Personal savings
Equity and risk capital
R&D
Startup
Early growth
Rapid growth
Exit (LBOs, MBOs)
Sources
Equity capital:
Personal savings/ Friendly sources
Under $250,000
Informal investors
$50,000 to $500,000
Venture capital:
Corporations and partnerships
$1 million and up
SBICs, MESBICs
$350,000 and up
Strategic alliances and partnerships
$250,000 and up
Risk capital:
Private placements
$350,000 to $5 million
Mezzanine/bridge capital
$1 million to $15 million
ESOPs
$1 million and up
Public equity markets
$5 million and up
Costs
Risk
Extreme
Moderate
Cost of capital (annual ROR)
100%–50%
50%
30%
Under 30%

Obtaining Risk Capital

- Three central issues to be considered
  - Does the venture need outside equity capital?
  - Do the founders want outside equity capital?
  - Who should invest?

Angel Investors

- Who are angel investors?
  - Most are self-made entrepreneur millionaires
  - Many are in their 40s and 50s
  - Most are well educated
  - Ninety-five percent have college degrees from four-year colleges
  - Fifty-one percent have graduate degrees (Forty-four percent are in a technical field and thirty-percent percent are in business or economics)
  - Ninety-six percent are men

Informal Investors

- What type of ventures lends themselves to the use of informal investors?
  - Ventures with capital requirements of between $50,000 and $500,000
  - Ventures with sales potential of between $2 million and $20 million within 5 to 10 years
  - Small, established, privately held ventures with sales and profit growth of 10% to 20% per year

Informal Investors

- What type of ventures lends themselves to the use of informal investors?
  - Special situations, such as very early financing of high-technology inventors who have not developed a prototype
  - Companies that project high levels of free cash flow within three to five years

The Classic Superdeal

Characteristics of the Classic Superdeal from the Investor's Perspective

Mission

- Build a highly profitable and industry-dominant market leading company.
- Go public or merge within four to seven years at a high price-earnings (P/E) multiple.

Complete Management Team

- Led by industry "superstar."
- Possess proven entrepreneurial, general management, and P&L experience in the business.
- Have leading innovator or technologies/marketing head.
- Possess complementary and compatible skills.
- Have unusual tenacity, imagination, and commitment.
- Possess reputation for high integrity.

Proprietary Product or Service

- Has significant competitive lead and "unfair" and sustainable or defensible advantages.
- Has product or service with high value-added properties resulting in early payback to user.
- Has or can gain exclusive contractual or legal rights.

Large, Robust, and Sustainable Market

- Will accommodate a $100 million entrant in five years.
- Has sales currently at $200 million, or more, and growing at 25 + % per year.
- Has no dominant competitor now.
- Has clearly identified customers and distribution channels.
- Possesses forgiving and rewarding economics, such as:
  —Gross margins of 40% to 50%, or more.
  —10% or more profit after tax.
  —Early positive cash flow and break-even sales.

Deal Valuation and ROR

- Has "digestible" first-round capital requirements (i.e., greater than $1 million and less than $10 million).
- Able to return 10 times original investment in five years at P/E of 15 times or more.
- Has possibility of additional rounds of financing at substantial markup.
- Has antidilution and IPO subscription rights and other identifiable harvest/liquidity options.

What to Look for in Investors

- Seek investors who:
  - Are considering new financing proposals and can provide the required level of capital
  - Are interested in companies at the particular stage of growth
  - Understand and have a preference for investments in the particular industry

What to Look for in Investors

- Seek investors who:
  - Can provide good business advice, moral support, and has contacts in the business and financial community
  - Are reputable, fair, and ethical and with whom the entrepreneur gets along
  - Have successful track records of 10 years or more advising and building smaller companies

What to Look Out for in Investors

- Attitude
  - Be wary if getting through to a general partner in the investment firm is an ordeal
  - Be wary if the investor thinks he or she can run the business better than the lead entrepreneur or the management team
- Over commitment
  - Be wary of lead investors who indicate they will be active directors but who also sit on the boards of six to eight other startup and early-stage companies or are in the midst of raising money for a new fund

What to Look Out for in Investors

- Inexperience
  - Be wary of dealing with venture capitalists who are under 30 years of age and have:
    - An MBA
    - Only worked on Wall Street or as a consultant
    - No operating, hands-on experience in new and growing companies
    - A predominantly financial focus

What to Look Out for in Investors

- Unfavorable reputation
  - Be wary of funds that have a reputation for early and frequent replacement of the founders
  - Be wary of those where more than one-fourth or the portfolio companies are in trouble or failing to meet projections in their business plans
- Predatory pricing
  - Be wary of investors who unduly exploit conditions during adverse capital markets by forcing large share price decreases in the new firms and punishing terms on prior investors

Presenting Information to Possible Investors

- A concise presentation should include the following:
  - What is the market opportunity?
  - Why is it compelling?
  - How will/does the business make money?
  - Why is this the right team at the right time?
  - How does an investor exit the investment?

How VCs evaluate opportunities

- Siegelman, KPCB
  - Big markets, competitive edge, great team
  - Technical due diligence is big, some customer and industry diligence, background checks on team
  - $500K smallest investment, $3-$5m to $10m,
  - FAST deals – a week or two
  - Don’t invest in low price products without a low price channel, $200K price tag for enterprise software
  - 50% gross margin on hardware
  - Looking for IPO

Wang, Trinity Ventures

- Team, market opportunity, value proposition/product
  - Focus on the CEO
  - It's a sector bet – thesis process every quarter
    - Everything looks like its going to be a multi-billion dollar market
    - We avoid arm-wrestling with 'wild eyed technologists'
    - Focus on smaller opportunities with less uncertainty
    - 18 month window, Series A
    - Lot of time on financial model – bottom up

Simon, Alta Partners

- I think markets trump people and technology
  - I look for big opportunities, big painful problems that customers have
  - We don't target market shares, we target revenue $60-$80m in 3 years
  - Ideal case – four PhDs solve a problem after a year or two and it's 2 orders of magnitude better than whatever else is out there
  - Lot of focus on personal motivations of people
    - are they in it for the long haul (with passion)
  - Need to "monetize" customers (e.g. Skype)
  - One or two "brave new world" investments
    - Bet on marketing or technology side
    - 1-6 month decision frame
    - Exit at $200m market and $60-$80m company size
    - Advise clients to not dilute a good business which won't grow to that size (and thus is not a good venture opportunity)
    - Check out Sand Hill Road, Menlo Park, CA

Value-added of smart investors

- Fund-raising know-how and contacts
- Recruiting
- Industry contacts and networking
  - potential strategic partners and customers
- Unbeatable market intelligence
  - Technological know-how
- Ability to redirect the team or refocus the business
- A vested interest in the startup's success