

Entrepreneurial Finance and Venture Capital (FINC 445)
Kellogg School of Management
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A. Course Overview

Entrepreneurial activity has been a potent source of innovation and job generation in the global economy. In the U.S., the majority of new jobs are generated by new entrepreneurial firms. The financial issues confronting entrepreneurial firms are drastically different from those faced by established companies. The focus on this course will be on analyzing the unique financial issues faced by entrepreneurial firms and to develop a set of skills that has wide applications for such situations. The course also covers material useful for managing a venture capital firm (GPs), including fundraising (relationship with LPs) and sourcing, investing and managing portfolio firms (relationship with entrepreneurial firms). Finally, it provides tools for investors (limited partners) who want to understand venture capital as an asset class.

Throughout the course, analytical tools will be introduced and utilized. Financial analysis, various valuation methods, negotiations, and deal structuring will be examined in the context of entrepreneurial firms. In addition, investment analysis and due diligence issues will be explored.

Using the case method, the course covers all stages of the financing process, from startup to harvest and exit. This area is populated by players who often use sub-standard techniques to evaluate and fund entrepreneurial firms. Indeed, about 75% of venture capital firms operating in the US are not able to provide sufficient returns for their investors, exactly because they use questionable methodologies to make investment decisions. We will only focus on methodologies that are found to deliver consistent positive results. Often, this will imply that we would challenge some widespread practices, or retool them to make sure that could be applicable to the specific case. The course will go into great details with respect to structuring multi-staged financings and valuing entrepreneurial firms also providing insights on how venture capital partnership work, why do they take the forms they do, and where the crucial problems and opportunities for innovation exists. Consideration is given to the incentives faced by investors in early ventures, and how to properly make financing decisions and negotiate contractual terms. Emphasis is given to high growth start-ups searching for funding in the US (or in countries with very similar characteristics) as opposed to more traditional entrepreneurial and family firms operating globally (see FINC945 for these topics) and to Leverage Buyouts (see FINC-448 for LBOs). However, there is a strong connection with these two classes. The course is aimed primarily at people who may be involved in an entrepreneurial venture at some point in their careers whether in a startup, a spinoff

from a large organization, or a turnaround. The course is also useful for venture capital careers and students interested in Venture Capital as an asset class (Limited Partners).

B. Prerequisites

The course assumes knowledge of corporate finance from the start at the level of Finance II (FINC-441) or Finance I/II (FINC-440). If you believe, you already have the knowledge of FINC -441, you need to follow the procedure for waiving the class (consult the finance department web pages). These courses may not be taken concurrently with FINC-445. The key tool that you need to have is a good understanding of valuation (APV analysis). Having taken Fin Decision before this class is extremely valuable, though I will review valuation techniques in a non-mandatory review session.

C. Course Structure

There are five main topics:

- (1) Evaluating Entrepreneurial Opportunities – evaluating the qualitative attractiveness of investing in a start-up. Qualitative Framework for evaluating an entrepreneurial firm; Quantitative Valuation, DCF, and the venture capital Model. Evaluating high growth startups, evaluating a spinoff opportunity. The focus will be on high growth ventures.
- (2) The Structure of VC Partnerships. Introduction to the VC Industry. Who invest in VC funds? Partnership and fee structures. How to calculate returns for the investors after fees.
- (3) The Structure of VC Deals – Early stage venture capital deal decision, VC investment in a capital intensive industry. Venture capital late stage with debt.
- (4) Term Sheet, Valuation of the Contract and Negotiation in a VC deal. VC Term Sheets. Negotiating Term Sheets. Evaluating Options in a Later-Stage Deal. Negotiating a deal in Emerging Market
- (5) Exit decisions, either to IPOs, or buyouts. Different perspectives: the entrepreneur's view and the investor perspective. Evaluation of a rollup strategy.

The course will combine lectures, cases, and guest speakers.

D. Course Material

a. Required Material

A packet of copyrighted material (this includes cases and notes that are copyrighted and cannot be posted on BlackBoard). All the other material (supplementary readings and other required material) will be posted on Blackboard, including my lecture slides and case assignment questions (though not "solutions" to cases, see above).

b. Optional Material

- 1) Lerner, Leamon, Hardymon, Venture Capital, Private Equity, and the Financing of Entrepreneurship, John Wiley, 2012.
- 2) Levin, Structuring Venture Capital, Aspen Publishers, 2009.
- 3) Bartlett, Fundamentals of Venture Capital, Madison Books, 1999.
- 4) Bagley and Dauchy, The Entrepreneur's Guide to Business Law, West Educational Publishing, 2003.

E. Course Procedures

a. Course Sessions

This course is designed to be a time-consuming and challenging course. In some weeks you will have to prepare two case studies. In each other week you will have to prepare one case study and absorb material from lectures. We will also employ quantitative methods for financial valuation. We will employ some options pricing techniques to value the options found in VC contracts. If you do not have the time to devote to these requirements, you should not take this course. Also, while attendance is not mandatory, a good fraction of the course is based on class participation. If you do not show up, you will be marked down on attendance. If you think you need to miss classes for work or recruiting is best that you plan to take the course at a different time.

b. Case Studies and Working in Groups

The course packet contains the cases for the course. The schedule that will be posted on Blackboard outlines the cases that we will cover in each class session. For each case, I will assign study questions concerning the case. I will post these questions on Blackboard one week in advance, with some data from the case exhibits in Excel format.

Students are required to work in groups of 3-4 students and must hand in a case analysis on the assigned case prior to the start of the classroom session.

The case write-ups should take the form of a memorandum. Write these as if you were writing a recommendation to the major decision-maker in the case. There is a limit of two pages of text, where you may use font no smaller than 11 point and line spacing no smaller than 1.5. In addition, you may include up to 3 pages of numerical exhibits and calculations. Longer memoranda are not necessarily better, although you must answer the questions thoroughly. ***Write-ups will not be accepted after the start of the class.***

Please note that I consider rotation of case responsibility to be a violation of the honor code in this class. By rotation, I mean that one of the persons in the group is designated to do the assignment in a given week with little or no input from other group members. If a case analysis is handed in with your name

on it, it must be the case that you performed a significant part of the work involved in that analysis, and your ability to answer questions on the material in that analysis should reflect that effort.

In the past, students have asked me to hand out my case analysis after the class has discussed the case. I will not do this, because there are usually no absolute right answers. The best cases are deliberately written to be ambiguous. While there are no right answers, there are good arguments and bad arguments. This course is designed to help you learn to distinguish between sensible and senseless arguments. Handing out my analyses would reduce the ambiguity in the cases and partially defeat the purpose of doing cases. Handouts also tend to circulate. ***If you are uncomfortable with this ambiguity, do not take this class. This will not be renegotiated.***

F. Grading

a) Class Participation

Class participation will count for 20% of the final grade. I will judge your performance based both on the quality and the quantity of your comments. Because so much of the learning in this course occurs in the classroom, it is very important that you attend every class. Low class participation combined with several absences will hurt your grade. Also, violation of etiquette, such as tardiness, texting, emailing, surfing the web will affect class participations (do not worry: I can detect these behaviors very easily, I have two teenage kids who can text with their phone in their pockets).

It is extremely important that you attend every class, arrive on time and be prepared to participate. To help me out, you should bring your name cards to each class. Students without a name card will not be able to participate to the discussion.

To help me keep track of class participation, there will be a seating chart handed out on the second day of class and you should sit in your assigned seat from that point on.

b) Case Write-Ups (Memoranda)

The memoranda will count for 30% of the final grade. I may give the case write-ups greater importance for students on the borders.

The cases will be graded on a point scale under which you can achieve a maximum of 10 possible points. Total points on the cases will be added to obtain your total score for the course on cases.

I will not talk about the cases with anybody before the write-up is due. You may ask clarification questions, but I am the arbiter on whether they can be appropriately answered prior to when the case is due.

IMPORTANT: Memoranda should be posted on Blackboard prior to classes when the case is to be discussed. DO NOT EMAIL memoranda TO ME.

c) Peer Review

To make grading more equitable and assist students in reducing the free-rider problem, 10% of the grade is based on peer review. Students will evaluate group members. An online group evaluation survey will be sent out electronically during exam week.

d) Final Exam

The final examination will count for 40% of your final grade. The final examination will be an *individual*, take home case analysis. You will have approximately one week to work on the case. Unlike the memoranda, it is forbidden to consult with your team members, classmates, or anyone else about the final exam during the time between the exam is handed out and the time when the exam is due.

Summary of weights used in grading:

Class Participation	20%
Case Write-Ups	30%
Peer Review	10%
Final Exam	40%

e) Other Policies

i.) Standard of Conduct

Each student in my class is expected to abide by the Kellogg Honor Code. Any work submitted by a student in this course for academic credit must be the student's own work. Collaboration in groups is allowed where stated.

ii.) Laptop Policy and Smart phones

Laptop and smart phones use is prohibited during classroom sessions unless I specify otherwise.

iii.) Attendance

Already discussed in class participation section.

iv.) Tardiness and Politeness

Class sessions should be considered business engagements. You would not be late to such meetings. You also would not check your email and/or text during a business meeting, nor surf the web, or work on other assignments. *Etiquette violation will be reflected in your class participation grade.*

v.) Coming and going

Students leaving class during the session should have a good reason. If you are dressed in interview clothes, I will assume you are going to an interview, which is a good reason. However, if you schedule all your interviews during my class, that probably is not a good thing. Etiquette violation will be reflected in your class participation grade.

vi.) Intellectual property

The class notes and past exams are the intellectual property of the instructor. You may not distribute class notes electronically or in any form to anyone outside this class or outside Kellogg. You may not duplicate these notes for use by your employers after graduating from Kellogg without my written consent.