

Entrepreneurial Finance

Venture Capital, Deal Structure & Valuation, Second Edition

CONTENTS

List of Illustrations xiii

Abbreviations xix

Preface xxiii

Acknowledgments xxix

About the Authors xxxi

PART 1 Getting Started

Chapter 1 Introduction 3

1.1 What Makes Entrepreneurial Finance Different from Corporate Finance? 3

1.2 Entrepreneurship and the Entrepreneur 9

1.3 Hypothesis-Driven Entrepreneurship 17

1.4 The Stages of New Venture Development 23

1.5 Financial Performance and Stages of New Venture Development 25

1.6 The New Venture Business Model 28

1.7 Summary 30

Review Questions 31

Notes 32

References and Additional Reading 33

Chapter 2 New Venture Financing: Considerations and Choices 36

2.1 The Sequence of New Venture Financing 37

2.2 Sources of New Venture Financing 39

2.3 What's Different About Financing Not-for-Profit Ventures? 59

2.4 Organizational Form and Financing Choices 61

2.5 Regulatory Considerations 62

- 2.6 International Differences in Financing Options 66
- 2.7 Recap: Considerations in the Choice of Financing 67
- 2.8 How Financial Distress Affects Financing Choices 71
- 2.9 Summary 73
 - Review Questions 74
 - Notes 74
 - References and Additional Reading 77

PART 2 Financing of High-Risk, High Growth Ventures

Chapter 3 Venture Capital and Angel Investing 83

- 3.1 Development of the Venture Capital Market 84
- 3.2 The Organization of Venture Capital Firms 94
- 3.3 Investment Returns and Compensation 103
- 3.4 Impact of Compensation on Investment Selection 107
- 3.5 Aspects of the VC Industry Structure 108
- 3.6 How Venture Capitalists Can Add Value 110
- 3.7 Luck Versus Skill: What Accounts for Venture Capital Success? 112
- 3.8 The Role of Reputation in the Venture Capital Market 113
- 3.9 Angel Investing 114
- 3.10 Summary 118
 - Review Questions 119
 - Notes 119
 - References and Additional Reading 122

Chapter 4 Venture Deals 126

- 4.1 The Economic Framework for Financial Contracting 127
- 4.2 Essentials of Contract Design 132
- 4.3 Elements of VC Deal Structure 138
- 4.4 Analysis of Key Term Sheet Provisions 149
- 4.5 Deal Structures of Angel Investments 156

- 4.6 Summary 159
 - Review Questions 161
 - Notes 162
 - References and Additional Reading 163

PART 3 Financial Aspects of Strategic Planning

Chapter 5 New Venture Strategy and Real Options 169

- 5.1 Product Market, Financial, and Organizational Strategy 169
- 5.2 The Interdependence of Strategic Choices: An Example 171
- 5.3 What Makes a Plan or Decision Strategic? 172
- 5.4 Financial Strategy 172
- 5.5 Deciding on the Objective 173
- 5.6 Strategic Planning for New Ventures 175
- 5.7 Recognizing Real Options 177
- 5.8 Strategic Planning and Decision Trees 182
- 5.9 Decision Trees and Contract Negotiation 191
- 5.10 Rival Reactions and Game Trees 192
- 5.11 Real Options with Continuous Distributions 197
- 5.12 Summary 199
 - Review Questions 199
 - Notes 200
 - References and Additional Reading 201

Chapter 6 Developing Venture Strategy Using Simulation 204

- 6.1 Use of Simulation in Business Planning: An Example 205
- 6.2 Who Relies on Simulation? 207
- 6.3 Simulation in New Venture Finance 207
- 6.4 Simulation: An Illustration 209
- 6.5 Simulating the Value of a Financial Option 214
- 6.6 Describing Risk 216

- 6.7 Using Simulation to Evaluate a Strategy 219
- 6.8 Valuing Real Options and Comparing Strategic Choices 228
- 6.9 Summary 239
 - Review Questions 239
 - Notes 240
 - References and Additional Reading 242

PART 4 Financial Forecasting and Assessing Financial Needs

Chapter 7 Revenue Forecasting 245

- 7.1 Principles of Financial Forecasting 246
- 7.2 Forecasting Revenue 247
- 7.3 Estimating Uncertainty 254
- 7.4 Building a New Venture Revenue Forecast: An Illustration 256
- 7.5 Introducing Uncertainty to the Forecast: Continuing the Illustration 259
- 7.6 Calibrating the Development Timing Assumption: An Example 267
- 7.7 Summary 268
 - Review Questions 269
 - Notes 270
 - References and Additional Reading 270

Chapter 8 Financial Modeling 271

- 8.1 An Overview of Financial Statements 272
- 8.2 Working Capital, Growth, and Financial Needs 277
- 8.3 Developing Assumptions for the Financial Model 283
- 8.4 Building a Financial Model of the Venture 291
- 8.5 Adding Uncertainty to the Financial Model 303
- 8.6 NewCo: Building an Integrated Financial Model 308
- 8.7 Summary 318
 - Review Questions 319
 - Notes 320

References and Additional Reading 320

Chapter 9 Assessing Cash Needs 321

- 9.1 Cash Flow Breakeven Analysis 322
- 9.2 Sustainable Growth 327
- 9.3 Planning for Financial Needs When the Desired Growth Rate Exceeds the Sustainable Rate 332
- 9.4 Planning for Product-Market Uncertainty 334
- 9.5 Assessing Financial Needs with Sensitivity/Scenario Analysis 337
- 9.6 Assessing Financial Needs with Simulation 341
- 9.7 Summary 348
- Review Questions 348
- Notes 349
- References and Additional Reading 350

PART 5 Valuation

Chapter 10 Foundations of New Venture Validation 353

- 10.1 Perspectives on the Valuation of New Ventures 354
- 10.2 Myths About New Venture Valuation 355
- 10.3 An Overview of Valuation Methods 359
- 10.4 Discounted Cash Flow Valuation 363
- 10.5 The Relative Value Method 374
- 10.6 Valuation by the Venture Capital Method 378
- 10.7 Valuation by the First Chicago Method 380
- 10.8 Reconciliation with the Pricing of Options 381
- 10.9 Required Rates of Return for Investing in New Ventures 384
- 10.10 The Entrepreneur's Opportunity Cost of Capital 386
- 10.11 Matching Cash Flows and Discount Rates 392
- 10.12 Summary 396
- Review Questions 398

Notes 398

References and Additional Reading 401

Chapter 11 New Venture Valuation in Practice 405

11.1 Criteria for Selecting a New Venture Valuation Method 405

11.2 Implementing the Continuing Value Concept 407

11.3 Implementing DCF Valuation Methods 413

11.4 New Venture Valuation: An Illustration 428

11.5 The Cost of Capital for Non-U.S. Investors 442

11.6 Some Practical Caveats on Implementation 443

11.7 Summary 444

Review Questions 445

Notes 445

References and Additional Reading 446

Chapter 11 Appendix The Entrepreneur's Perspective on Value 448

11A.1 Estimating the Entrepreneur's Commitment to a Venture 448

11A.2 Valuing Partial-Commitment Investments 453

11A.3 Implementation: Partial Commitment 455

11A.4 Shortcuts and Extensions 459

11A.5 Summary 464

References and Additional Reading 465

Chapter 12 Designing and Valuing Staged Investment with Real Options 467

12.1 Staged Investment: The Venture Capital Method 467

12.2 Staged Investment: CAPM Valuation with Discrete Scenarios 474

12.3 Using Simulation to Design Financial Contracts 482

12.4 Valuing Different Types of Financial Claims 493

12.5 Summary 494

Review Questions 495

Notes 495

References and Additional Reading 496

PART 6 Harvesting and Beyond

Chapter 13 Harvesting 501

- 13.1 Going Public 502
- 13.2 Acquisition 519
- 13.3 Valuing Private Transactions 522
- 13.4 Management Buyout 526
- 13.5 Employee Stock Ownership Plans 527
- 13.6 Roll-Up IPO 531
- 13.7 The Choice of Harvesting Method 532
- 13.8 Harvesting Choices of VC-Backed Firms 536
- 13.9 Summary 538
 - Review Questions 538
 - Notes 539
 - References and Additional Reading 545

Chapter 14 The Future of Entrepreneurial Finance 551

- 14.1 Completing the Circle 552
- 14.2 Public Policy and Entrepreneurial Activity: An International Comparison 557
- 14.3 Breaking New Ground 569
 - Notes 574
 - References and Additional Reading 576