UNIVERSITY OF WASHINGTON
Graduate School of Business Administration

ENTREPRENEURIAL FINANCE

Fin 457

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3:20

COURSE OBJECTIVE

Entrepreneurship, in the words of Paul Gompers, is "the relentless pursuit of opportunity without regard to resources currently controlled." Entrepreneurial finance is, then, the collection of financial skills necessary to execute this apparent act of legerdemain.

If one is to pursue opportunity without regard to resources currently controlled, it is necessary to be able to identify attractive business opportunities, to estimate the resources necessary to undertake these opportunities, to secure such resources on favorable terms, and to prudently manage them in pursuit of the opportunity. The aim of this course is sharpen your skills in all of these activities.

Part I of Entrepreneurial Finance covers what might be called "small business survival skills," including assessing financial performance, financial planning, identifying external financing needs and business valuation. Part II of the course will address the issues and challenges associated with one common source of financing for entrepreneurial enterprises: venture capital. In particular, we will analyze the terms and provisions of typical venture capital agreements, critically evaluate them and examine how they can be used to address the underlying risks and opportunities facing entrepreneurs and venture capitalists. We will also examine the structure of venture capital organizations and the issues associated with initial public offerings.

Entrepreneurial Finance is intended for individuals interested in careers in small businesses, family enterprises, entrepreneurial new ventures, and private equity and venture capital investing. The course should also appeal to individuals interested in general management careers in larger companies who believe that an entrepreneurial perspective is valuable in all walks of business life.

When you complete this course you should be able to:

- Assess company financial statements to identify strengths and weaknesses.
- Prepare pro forma financial forecasts and cash budgets.
- Estimate a company's future need for external financing.
- Value business opportunities using three techniques: discounted cash flow, comparable firms and trades, and the venture capital method.
- Critically evaluate the terms and provisions in typical venture capital agreements.
- Understand the issues associated with initial public offerings (IPO's).

REQUIRED MATERIALS

- Cases and readings available at the UW Bookstore under the Finance 457 course title.
- Higgins, Robert C. *Analysis for Financial Management*, 9e, Irwin McGraw-Hill, 2007.
- Note that additional course materials and course announcements are available on Blackboard.

GRADING AND WRITTEN DELIVERABLES

Your grade will be based on the following cases and your daily class work. For cases that are turned in, you may either bring a hardcopy to class with you or email me your write-up **in PDF format**. Please do not email me Excel or Word documents, because the are typically very time consuming to print out and decipher.

Your grade will be based on the following.

Assignment	Due Date	Weight
Daily class work	Daily	25%
I. Hampton Machine Tool	Tuesday, April 10	15%
II. Calaveras Vineyards	Tuesday, April 30	15%
III. Apex Investment Partners Part I	Tuesday, May 22	15%
IV. Apex Investment Partners Part II	Thursday, May 24	15%
V. W.R. Hambrecht + Co.	Thursday, May 31	15%
Total		100%

Daily class work grades will a based on three things: 1) your presence -- it's hard to contribute to class learning when you are not there, 2) my assessment of the extent to which you helped to make the class a productive learning experience, and 3) my assessment of the depth of your command of the material.

DAILY PREPARATION AND PARTICIPATION

Most of our class time will be devoted to discussion of assigned cases. To get the most out of class and high grade, you must prepare conscientiously and participate actively in class discussions. Failure to participate robs others of your perspective and increases the chances that the discussion will not be relevant to your interests and abilities. **Furthermore, participation is an important part (30%) of your grade. Those who fail to participate actively are effectively taking a zero for a substantial fraction of their course grade**. Those who participate actively and consistently by asking questions both of me and of other students, engaging in class debates and volunteering to present their solutions will receive high participation grades. Those who participate only sporadically and make only ‘off-hand’ or less substantial contributions will receive low participation grades. So please participate actively.

So what is conscientious case preparation? Read the case carefully; identify the principal issues to be addressed; attempt to analyze these issues using the appropriate tools or techniques; and note any action recommendations implied by your analysis. Alternatively, if you find yourself hitting a roadblock, try to articulate what your problem is. Often identifying roadblocks is as valuable as a complete analysis.

For each case assigned you will note below that I have posed one or more preparation questions. The questions play several roles depending on the case. Usually the questions are simply to help you get started on your analysis, and you should not feel constrained by them. Nor should you assume that answering all of the preparation questions necessarily constitutes a complete analysis. In other instances, I may give you additional information in the questions, or when the case is a mechanical one, I may ask you to perform specific calculations.

Do not be surprised if after conscientious preparation you still feel there are some loose ends in the case you are not certain about. If it were otherwise, there would be nothing for you to learn in class, and I would have been guilty of selecting a case that was too simple. Your test of whether you are learning the material, and progressing adequately, should be how you feel after the class discussion, not before. You are doing fine if after a class discussion you believe you could adequately handle a similar situation in the future.

In class I tend to vacillate between asking for volunteers and calling on individuals to present their analysis. **If you are not prepared, please notify me before class so we can all avoid embarrassment.** If you have spent several hours on the case, but still feel unsure of your opinions, count yourself prepared. If you have made the effort, you should never feel embarrassed by the result.

ASSIGNMENTS

ASSESSING FINANCIAL PERFORMANCE AND FINANCING OPERATIONS

Tuesday, April 24 –**Private Business Valuation: Implementing Discounted Cash Flow Valuation**

Prepare: Commercial Fixtures Inc. 9-393-115 Rev. November 3.

a) What does Commercial Fixtures do? What is their competitive position in the market place?

b) What would you as an outside third party bid under the same conditions (with the same information) for the *entire* company (both halves)? Why?

c) What do you expect Albert Evans to bid for Gordon's half interest? Why?

d) What should Gordon Whitlock bid for Albert's half interest? Why?

Thursday, April 26– **Guest Speaker:** Todd Patrick, President & CEO of C3-Jian, Inc.

Prepare: Commercial Fixtures Inc. 9-393-115 Rev. November

Continue with questions above.

ISSUES WITH VENTURE CAPITAL VALUATION AND VENTURE CAPITAL AS A FUNDING SOURCE

Tuesday, May 1- **Private Business Valuation: Implementing Discounted Cash Flow Valuation, con't.**

Graded Assignment II due at start of class today.

Please submit a brief (1 page) memo summarizing your discounted cash flow valuation of Calaveras Vineyards requested in question a) below. I anticipate you will submit a 1-page spreadsheet with your assumptions and calculations. Please submit your assignment in pdf form.

Prepare: Calaveras Vineyards UVA-F-1094

a) Assume you are advising Dr. Martinez (NOT the Bank) in valuing Calaveras for purchase. Based on her projections prepare a discounted cash flow valuation of Calaveras Vineyards.

b) Would you advise Dr. Martinez to purchase Calaveras' at the proposed price? Why or why not?

c) Does Dr. Martinez have any particular competitive advantage in running Calaveras relative to others, including the current owners?

If Dr. Martinez buys the company, how would her incentives change? Does that impact your answer to c) above?

Thursday, May 3- **Introduction to Venture Capital and Lecture on Venture Capital Method of Valuation**

Simulations Exercise: The Lemon's Game

Tuesday, May 8 - **Lecture: Venture Capital Method of Valuation**

Read: A Note on Valuation in Private Equity Settings 9-297-050

Prepare: Please answer questions 1 through 3 in The Venture Capital Method – Valuation Problem Set.

Thursday, May 10– **Term Sheet Components**

Read: Contracting and Control in Venture Capital 9-298-067

Prepare: Note on Contents of a Term Sheet 9-B02N-015

Make the following change to the information in Appendix A: In the ownership section of the term sheet, set the post-money shareholding of the ESOP plan to 760,000 shares. The total number of post money shares will thus be 15,708,716. Note that the ownership shares will also have to be adjusted. This will remove unnecessary complications in calculating the pre and post money valuations.

Carefully read and analyze the term sheet in Appendix A. You should focus on the valuation, securities, conversion, dividend, liquidation preference, price adjustment, voting rights, mandatory redemption and shareholders' agreement sections of the term sheet. Be prepared to discuss and ask questions about the details of the provisions. In particular, consider the following questions:

1. What are the pre and post money valuations for this company ? Does the pre money value belong to the entrepreneur ?
2. How much will the VC receive in the event of an asset sale or merger ? How does the VC's payoff depend on the value of the company ?
3. How much will the VC receive in the event of an IPO ? How does the VC's payoff depend on the value of the company ?
4. Why are the payoff's the entrepreneur structured this way ? Draw a diagram of the entrepreneur's payoff as a function of the value of the company. What basic financial instrument has a similar payoff function?
5. What does it mean that the preferred shares are 8% cumulative preferred stock ? Does the dividend clause affect your answers to 2. and 3. above ? Why incentives do cumulative dividends give the entrepreneur ?
6. Why does the Voting Rights section allow the Series X preferred shares to vote as if they were common shareholders ?
7. How does the Price Adjustment Provision work and why is it included in the term sheet (Note: this provision is often referred to as a "full ratchet" provision) ? For

concreteness assume that, in the future, the company sought to raise funds from new investors (say, Series Y).

a. Suppose the Series Y investors will invest $3M at an issue price of .2604 per share. What will the new capitalization table look like ?

b. Now, suppose the agreement did *not* contain a Price Adjustment Provision (i.e. no full ratchet) and a Series Y investor invested $3M at the same pre and post money implied by the example a) above (i.e. at an issue price of .50). What would the capitalization table look like in that event ?

c. How would your answer to a) above change if the Series Y investors wished to invest $3M the issue price was 1.50 per share ?

d. Why would a VC want to include such a provision in the agreement ?

8. How does the mandatory redemption clause work and why is it included ?

9. What restrictions does the term sheet place on future actions of the management ?

Tuesday, May 15 – **Term Sheet Components**

Read: Note on Contents of a Term Sheet 9-B02N-015

Continue with questions above.

Thursday, May 17– **Term Sheet Negotiations**

Prepare: Trendsett 9-801-358

This case describes two aspiring entrepreneurs who have just received offering documents for venture funding (known as term sheets) from two venture capital firms. With neither of the entrepreneurs having experience in raising capital nor any legal background they are wondering how to compare the two proposals and which one they should choose. They need to make a decision fast.

Please consider the following questions:

a) What are the main differences and similarities between the two term sheets?

b) Prepare "water-fall" diagrams for each of the term sheets. Under what circumstances does the Alpha term sheet provide a higher payoff to Borg and Kushdog ?

c) If you were the entrepreneur and could not negotiate any of the terms in either term sheet which one would you prefer?

d) How would you seek to alter the terms in each term sheet during negotiations with each venture capitalist? Which terms would you seek to alter first?

e) Does it make a difference to your answers whether you expect Trendsetter.com to grow as or grow slowly?

f) Does it make a difference to your wealth whether you expect to realize on Trendsetter.com through an IPO or a merger?

What aspects other than term sheets would you take into consideration when choosing among potential venture capital investors?

Tuesday, May 22– **Term Sheets and Valuations**

Graded Assignment III due at start of class today.

Prepare: Apex Investment Partners (A): April 1995 9-296-028

Read: How Venture Capitalists Evaluate Potential Venture Opportunities 9-805-019

AccessLine Technologies is a telecommunication company is seeking $16 million in Round B financing. Apex Investment Partners is a venture capital firm leading this financing round.

Using a memorandum format, please address the questions below. Please attach your spreadsheet analysis, including capitalization tables and waterfall diagrams. Also, please ***ignore*** the warrants in the Series A term sheet.

a) What is Accessline's competitive position in the market place?

b) Is AccessLine an attractive investment opportunity? Why or why not? What are the key risks associated with the investment?

c) Do you think Accessline's exit value would be maximized in a merger/asset sale or IPO?

d) How has AccessLine financed itself to date? Why have they chosen this strategy? Who are the Series A investors? What have been the implications of this financing strategy for the firm? Why is Dan Kranzler now considering raising funds from Apex Investment Partners and not the Series A investors?

e) How attractive are the terms that AccessLine has proposed to Apex for the Series B financing? Does the deal structure adequately address the risks of the investment? What issues, if any should concern Apex?

f) Prepare "water-fall" diagrams for both merger/asset sale and IPO scenarios for the proposed term sheet. Please ***ignore*** the warrants in the Series A term sheet. How does it compare to the other term sheets that we've examined ?

Thursday, May 24 – **Term Sheets and Valuations**

Graded Assignment IV due at start of class today.

– Term Sheets and Valuations

Prepare: Apex Investment Partners (A): April 1995 9-296-028

Please address the questions below in a memorandum to Apex Investment Partners. Attach any spreadsheet analyses.

a) How, if at all, would you change the provisions in Accessline's proposed term sheet for the Series B preferred stock? Specifically, how would you change the:

   a. Valuation: What do you think of AccessLine managements' suggested valuation? You may use the following estimates for revenue and income, based on Access's projections, and a discount rate of 60%:

	Revenue	Net Income
1997	120.3	8.8
1998	164.1	24.1
1999	208.0	45.8

   b. Rights and preferences of the Series B preferred stock: These rights and preferences *may* include: dividends, liquidation preference, conversion, voting rights, anti-dilution protections, board representation etc. You may ignore registration rights.

   c. Prepare adjusted waterfall diagrams that account for your proposed changes.

b) What is your rationale for your proposed changes to the valuation and terms? How do your changes alter the founders incentives and Apex's controls versus the proposed term sheet? Do these incentives and controls address the risks and opportunities facing Apex?

c) Do you see any trade-offs between the valuation and the rights and preferences of the Series B preferred stock?

d) How does the Series A investors' power to veto a deal affect your proposed changes ?

e) How would you convince Dan Kranzler to accept your changes?

Tuesday, May 29 – **Lecture on IPO's**

Thursday, May 31 – **Exit Strategies: The Initial Public Offering (IPO)**

Graded Assignment V due at start of class today.
Prepare: W.R. Hambrecht + Co: Open IPO 9-200-019

Please prepare a brief report addressing the following questions:

a) What offerings has W.R. Hambrecht + Co. underwritten since its founding?

b) What strategic considerations may an entrepreneur have to evaluate when determining whether to use the "Dutch auction" or the traditional IPO approach to taking a company public?

c) What are the motivations of underwriters in the "Dutch auction" verses the traditional IPO approach to taking a company public?

d) Why do you suppose that such a diverse mix of companies (some very large and well known and others very small) has chosen to forgo traditional offerings in favor of Dutch auctions? What is it about Dutch auctions that makes them attractive to very large and very small companies? How does this relate to your answers in parts a), b) and c) above?