

FUNDING EARLY STAGE VENTURES

**Course #45-884 E Mini 4 – Spring 2011**

**Wednesdays, 6:30 - 9:20 p.m.**

**Room 152**

**Instructor: Frank Demmler**

# COURSE DESCRIPTION

Funding Early Stage Ventures is a course intended for students interested in the area of high-risk finance from the entrepreneurial and venture capital perspectives. The class is open to second-year Tepper students and first-year students with the instructor’s permission. It is highly recommended that students have taken Entrepreneurial Thought & Action (#45881). Enrollment is limited to 45 students.

The course will be of interest to the student interested in an entrepreneurial career, and who wants to expand his understanding of finance as it relates to a small company in its early stages of growth. The course will also be useful for the student interested in venture capital or other forms of high-risk investing.

The course intends to build on the concepts introduced in the Entrepreneurship courses (45881 & 45882). The course will extend the concepts to emphasize the financial aspects of entrepreneurship, and particularly the strategy for successfully raising money. The course will be a combination of readings, lectures and case analyses that emphasize each area, with appropriate class visitors.

Upon the completion of the course, the student will understand the complexities and nuances involved in creating successful investment transactions for the company, investors and founders. The student will learn to appreciate the “art of the deal” and how deals get done in the real world.

The course will begin with an analysis of risk in the entrepreneurial setting, and then will proceed to look at the structure of the venture capital industry. It is important to understand the process and context in which equity investors make decisions and how an entrepreneur can favorably affect that decision process.

The course will then look at the due diligence process that both the investor and entrepreneur go through. Simulated negotiations around actual deals will be interlaced throughout the course. The course will conclude with the process by which investors achieve liquidity on their investment through an exit event, while the entrepreneur leads the company into its next phase of growth.

There will be a final exam. Throughout the course, students will be required to turn in homework assignments.

Materials: A course packet of class materials will be available.

**GENERAL REQUIREMENTS**

On-time attendance at each class is expected. If you cannot attend a class, you are expected to inform the instructor before the fact. If you miss a class, it is your responsibility to check for assignments, changes in schedule, and handouts.

**GRADING**

There will be a final exam. Class attendance is mandatory unless the instructor prior to class approves the absence. Throughout the course, homework will be assigned. The grade weighting will be as follows:

Homework assignments: 50 percent

Classroom participation: 30 percent

Final exam: 20 percent

**45-884 A FUNDING EARLY STAGE VENTURES**

# INSTRUCTOR: FRANK DEMMLER

**CLASS SCHEDULE**

Mini 4 – Spring 2011 (Elective)

Class meets 6:30 – 9:20 p.m. Wednesdays

Room 152

A course packet of class materials will be available.

**Office Hours by Appointment**

Frank Demmler

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Off-campus Office Hours: By Appointment Only

Send an email to Frank with your request.

NOTE: Relevant visitors have been invited to most classes. Students should be prepared to engage these real world practitioners in a meaningful discussion.

**Class 1: Introduction**

## Wednesday – March 16, 2011

OBJECTIVE: This class will provide an introduction to the concepts of financial risk in the entrepreneurial setting.

DISCUSSION: What are the key differences between the concept of financial risk for the entrepreneur as compared to that of the professional investor? What causes the investor to consider a situation high risk? What is the interaction between time and uncertainty?

ASSIGNMENT - Prior to Class

1. Read “New Venture Financing”
2. Read “How Venture Capital Works”
3. Read “Funding New Ventures: Valuation, Financing, and Capitalization Tables”
4. Read “Early Stage Company Valuation”
5. Read “The Arithmetic of Deals”

**Class 2: Overview of the Venture Capital Industry and Portfolio Company Valuation**

### Wednesday – March 23, 2011

OBJECTIVE: This class will serve as an introduction to the venture capital industry. In particular, we will look at the structure of the industry. We will examine the context in which venture capitalists make investment decisions. We will look at how venture capitalists determine valuations of potential portfolio companies.

DISCUSSION: What is the rate of financial return that the venture capital industry must achieve? Why?

DISCUSSION: What are the implications for the expected rate of return for each portfolio investment at the time of each investment?

ASSIGNMENT – Prior to Class

1. **Turn in the “Arithmetic of Deals” worksheet (individual assignment) [soft copy available on Blackboard]**
2. Read “A Method for Valuing High-Risk, Long Term Investments – The Venture Capital Method,” pp. 1-17 (through Interim Summary) [The balance of this reading is assigned for Class 5]
3. Read “A Note on Valuation of Venture Capital Deals”
4. Review “National Venture Capital Association (NVCA) Yearbook 2010”

**Class 3: Due Diligence & Deal Qualification**

### Wednesday – March 30, 2011

OBJECTIVE: This class will focus on the due diligence.

DISCUSSION: What role does due diligence play in deal making?

DISCUSSION: What role does due diligence play valuation?

ASSIGNMENT - Prior to Class

1. **Turn in the “Small Piece of a Big Pie” assignment (individual assignment) [soft copy available on Blackboard]**
2. Read “Valhalla Partners Due Diligence Process”
3. Review “Due Diligence Master.xls” [Soft copy available on Blackboard]
4. Read “How Venture Capitalists Evaluate Potential Venture Opportunities”
5. **Turn in three-to-five-person team rosters** for the Trendsetter Case analysis that’s due next week. For future reference, please indicate whether your team prefers to be venture capitalists or entrepreneurs.

**Class 4: Term Sheets and Deal Structure**

### Wednesday – April 6, 2011

DISCUSSION: What are the key elements of a successful deal?

DISCUSSION: What are the key elements of a term sheet? How do you discriminate between boilerplate and substance?

DISCUSSION: What makes convertible preferred stock the security of choice by venture capitalists?

DISCUSSION: How can these concepts be applied to Trendsetter.com, Inc.?

DISCUSSION: How do you evaluate the two term sheets presented to Trendsetter.com, Inc.?

ASSIGNMENT – Prior to Class

1. Read “Term Sheet Negotiations for Trendsetter.com, Inc.”
2. **Turn in the Trendsetter assignment (team project) [soft copy available on Blackboard]**
3. Read “Return Logic, Inc. (A)” and be prepared to discuss the following questions:
   1. Should the founders agree to the terms of the Series A term sheet? Why or why not? Which terms, if any, do you recommend they negotiate with Insight Ventures?
   2. As Ward, how would you handle the condition from Insight Ventures that one of the founders be CEO?
   3. Assuming that the founders accept the valuation and are able to agree on the other terms and conditions, how should they reallocate the remaining 55% equity?
4. Read TowerCare Technologies materials (Business Plan, Financial Projections, & Investor Pitch)
5. Read “Notes on Financial Contracting: Deals”
6. Read “Deal Structure and Deal Terms”
7. Read “A Note on Private Equity Securities”
8. Read “The truth about venture capitalists, Parts 1, 2 & 3”
9. Read “Guide to Term Sheets”

**Class 5: Venture Capital Partnerships**

### Wednesday – April 13, 2011

### Venture Capital Partnerships and Strategies

OBJECTIVE: What factors should a venture capital firm consider when deciding whether or not to raise a follow-on fund?

We will examine this from the perspective of Adams Capital Management.

DISCUSSION: Adams espouses a “market first” analysis of opportunity by looking for discontinuities. Is this substantive or window-dressing? Do the four types of discontinuities represent applicable guidelines? Are they comprehensive, or are there other discontinuity templates that a venture investor would find useful?

DISCUSSION: Analyze Structured Navigation. Is this a valid measurement of progress in early stage investing? Could such a program ever be a hindrance to company development?

DISCUSSION: If you were an LP in ACM I, II and/or III, would you commit to invest in Adams Capital Fund IV? How should ACM partners position and sell Fund IV?

ASSIGNMENT - Prior to Class

1. **Turn in Trendsetter anti-dilution protection analysis homework**
2. Read “What is Your Company Worth?”
3. Read “Adams Capital Management: Fund IV”
4. Explore the Adams Capital Management website (www.acm.com)
5. Read “A Note on the Private Equity Partnership Agreements”
6. Read “A Note on the Private Equity Fundraising Process”
7. Read “Venture Capital Negotiations: VC versus Entrepreneur”
8. Read “A Method for Valuing High-Risk, Long Term Investments - The Venture Capital Method,” pp. 17-54. (See HBS - Class 2 materials)

### Class 6: Anatomy of a Deal & The Private Investor Alternative

### Wednesday – April 20, 2011

### Anatomy of a Deal

OBJECTIVE: This class will examine the results of the term sheet negotiations conducted by the pairs of class teams. We will compare and contrast the key elements of the term sheets, including the capital structure, the type of security, valuation, protective provisions, etc.

DISCUSSION: To what extent are the desires of the entrepreneurs and investors similar?

DISCUSSION: To what extent are the desires of the entrepreneurs and investors different? How are these differences accommodated in your deal?

DISCUSSION: What are the implications of the company performing much better or much worse than plan? What are the practical responses to such situations? To what degree does your deal anticipate such outcomes?

### The Private Investor Alternative

OBJECTIVE: Most firms will never receive investment from venture capitalists. Even those that do rarely attract it at start up.

A portion of this class will review other sources of funding for early stage businesses including, but not limited to, angels, angel groups, Federal research grant programs, and economic development initiatives.

DISCUSSION: What role does the private investor play in private equity landscape? How can funding from that source be solicited?

DISCUSSION: What is the role of angels in providing early stage financing?

DISCUSSION: What are the pros and cons of non-equity sources of capital?

ASSIGNMENT - Prior to Class

1. **Negotiate, finalize & turn in the TowerCare Technologies Series A Term Sheet & the assigned 2-page memo**
2. Read “An Entrepreneur’s Guide to Raising Private Investment”
3. Read “VC vs. Angel Money: A Primer”
4. Review “Angel Investment Groups, Networks, and Funds” [available on Blackboard]

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**Class 7: Achieving Liquidity**

### Wednesday – April 27, 2011

### Achieving Liquidity

OBJECTIVE: This class will also focus on the issues of developing liquidity in an investment.

We will do this from the perspective of RightNow Technologies.

DISCUSSION: Based upon the data in the case, what is a fair value for RightNow? If the company hits its forecasts, what could the company be worth in the future?

DISCUSSION: As Gianforte, what is the lowest valuation you would accept? As the venture capital (VC) investors, what is the highest valuation that you would offer? If these answers are different, how should Gianforte’s views and desires be weighed against those of other board members and investors?

DISCUSSION: If the company does not accept this offer, what should it do? What is your assessment of RightNow’s future potential as an independent company, given its new strategy? Assess the option of going public – what are the advantages and disadvantages?

ASSIGNMENT - Prior to Class

1. Read “RightNow Technologies”
2. Read “A Note on the Initial Public Offering Process”