

NEW YORK UNIVERSITY STERN SCHOOL OF BUSINESS

New Venture Financing (B40.3373)

Final Examination

May 2002

**Only turn over when instructed.**

**Instructions – Read carefully**

1. Allowed time: 2 hours
2. The use of programmable calculators is allowed. However, you must state your assumptions and show your calculations to obtain full points. **Just stating a numerical answer (where applicable) is not sufficient.**
3. Remember to write **your name** on the exam!
4. **Answer all questions.** The points add up to **100**. Remember to write coherent text where required.
5. The use of books, articles, notes or any other material is **not** permitted.
6. Do not leave the room until the invigilator has collected your script. **You must hand in the question sheet.**
7. When leaving early, please do so **quietly**.
8. **GOOD LUCK!**

Name: \_\_\_\_\_

## A. Term sheets

Term sheets set out the proposed conditions governing a VC's investment in a company.

1. (10 points) Please fill in the blanks.

*[Here I will test your knowledge and understanding of some of the main features of a term sheet, as set out in the HBS Note on Private Equity Securities in your readings, the Stanford Law School article on VC contracting, as well as our discussion of the VC contracting and case term sheets in class. The "blanks" that you'll need to fill in are of two types: a) definitions regarding a main term sheet feature or its operation, and b) a brief explanation of the reasoning behind a statement I'll make.*

*Here's a short example – shorter than the 10 points' worth of filling in blanks that you'll have on the actual exam:*

*VCs who are concerned about the founder leaving to compete with the venture often include \_\_\_\_\_ provisions in the term sheet. These serve to incentivize the founder to stay because \_\_\_\_\_.*  
*Such provisions can be made more or less stringent by altering the \_\_\_\_\_.*

*VCs who are concerned about the founder leaving to compete with the venture often include VESTING provisions in the term sheet. These serve to incentivize the founder to stay because HE LOSES UNVESTED STOCK WHEN HE LEAVES. Such provisions can be made more or less stringent by altering the % OF EQUITY COVERED, THE TIME UNTIL FULL VESTING, AND THE VESTING SCHEDULE (E.G. MONTHLY VS. ANNUAL.)*

2. (10 points) The main differences between XXXXXXXXXXXXXXXXXXXX and  
YYYYYYYYYYYYYYYY are ...

*[Here I will test your understanding of the differences between two standard term sheet features.]*



b) (10 points) Comment on ..... What purpose does ..... serve?

c) (10 points) Compare the ..... described above to a .....  
structure, whereby .....

## B. VC behavior

*[Here, I will ask you two questions about VC behavior. These will be in the spirit of “What do VCs do?”, which we’ve talked about extensively in class, and which is covered in the readings.*

*Amongst the topics we have covered are:*

- The financing challenge: we began by outlining four categories of reasons why raising outside capital can be hard: asymmetric information, uncertainty, the nature of assets and (product and financial) market conditions.*
- We then discussed ‘what private equity investors do’ and how they mitigate the four impediments to raising outside capital. In this context we looked at different VC ‘business models’, the dominant one in the US obviously being the limited partnership. We also looked at new entrants (OffroadCapital.com) and the issue of unbundling.*
- I showed you a bunch of statistics on the private equity market, by way of context and background. One key point we made was that the risk-return characteristics of investment in private equity (from the point of view of say a pension fund) are not well-understood, owing to the illiquidity of investment in private equity.*
- Foreseeable problems: we discussed the generic problems of conflict of interest which may arise when using someone else’s money: adverse selection, moral hazard and hold-up. Much of the contractual detail you subsequently encountered can be viewed as a response to these conflicts of interest, and we used various case studies to discuss some such problems as well as covenant design to help solve them.*
- Contract completeness: in practice it’s impossible to write a comprehensive contract (and probably undesirable, for it would limit flexibility too much), so there must be other ways to prevent disaster from happening. One is ‘reputation’, the other is compensation design.*
- Financing decisions: we looked at the way in which VCs structure their investments in portfolio companies. We dealt with syndication, contract design (convertible preferreds and so on), staging, and the way equity and options are used to incentivize portfolio companies’ management and employees. An important consideration here is the option nature of much of these compensation and financing contracts. This is of interest because of the effect options have on taking risk.*
- Strategic decisions: VCs obviously don’t rely on contracts alone in managing their portfolio companies, they also retain many of the control rights, via board seats or powerful veto rights. ]*

4. (10 points) Why do .....

5. (15 points) Why are .....

### C. Exit considerations

6. (20 points) “.....” Discuss

*[Here, I will ask you to discuss one aspect of the exit process.*

*Amongst the topics we have covered are:*

- We looked at what exit routes exist and (some of the) reasons why each is chosen. An interesting question here is why IPOs appear to generate higher valuations than trade sales. In the context of IPOs, we noted that the IPO itself is rarely the exit: VCs tend to be locked in for a while (say 6 months). The actual exit can take place either via share sales in the market, or stock distributions. We looked at the stock distributions in particular, and noted that these are extremely contentious because they often flatter the VCs' performance figures.*
- Why go public? In addition to the VC perspective on this question, we outlined the pros and cons of an IPO from the owners' perspective. Mostly, these are pretty intuitive. The cases (and the recent hot IPO market!) illustrated how opportunistic the IPO decision can be, which led us to look at windows of opportunity. Interestingly, the evidence suggests that VCs may be able to 'time' IPOs to take advantage of the valuation 'peaks' during such windows.*
- We looked at 'How to go public?', with a special focus on i) selecting the underwriter and ii) interacting with investors via the roadshow. This brought us to considering bookbuilding and other ways in which issuers can influence the price they obtain in the IPO.]*