

## **B40.3165 Private Equity Finance**

*Saturdays 1:00 to 4:00pm*

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### **Introduction**

This course examines the private equity marketplace. Private equity is a major source of capital for both new ventures and established firms. By private equity we mean the investment of capital in the equity of private companies to fund growth or in the public companies to take them private. Private equity is segregated into several sub-markets, of which the principal focus of this class is venture capital and leveraged buyouts. Since its origins after World War II, the size of the private equity market has grown substantially and has become institutionalized. For example, annual capital commitments to private equity funds have grown from \$8 billion in 1991 to an estimated \$140 billion in 2000. It is widely expected that the private equity market will continue to grow in the coming years and will become more institutionalized.

The objective of this course is to provide an overview of the private equity market from the differing perspectives of private equity investors (limited partners), private equity fund sponsors (general partners) and the managers of portfolio companies by focusing on the nature of the market and the strategies employed.

The “private equity cycle” will be explored and developed in the course. The private equity cycle includes: 1. Private equity fundraising and structure; 2. Investment origination, valuation, the investment decision, strategies for value creation and investment management; and 3. Exit strategies. Topics expected to be covered include:

1. Fundraising and Structure
  - i. Private equity risk and return
  - ii. Private equity manager selection
  - iii. Asset allocation

- iv. Structure of private equity funds
  - v. Analyzing a fund investment opportunity
  - vi. Raising a fund of fund
  - vii. Raising a first time fund
2. Investment Origination, Valuation, Value Creation and Management
- i. Structure of private equity investments
  - ii. Private equity valuation methodologies
  - iii. Venture capital investments
  - iv. Buyout investments
  - v. Value creation strategies
  - vi. Investment management
3. Investment Exit
- i. Initial public offerings
  - ii. Sale of portfolio companies
  - iii. Distributions of publicly traded stocks
4. Other topics (if time permits)
- i. Corporate venture capital
  - ii. Community development funds
  - iii. Secondary trading of fund investments
  - iv. The future of private equity

The teaching method will employ extensive reading, some lecture, and case studies. Since this is a mini-course, we will cover topics quickly, touching on the highlights rather than studying issues in depth. We will not discuss every topic or case in class but reading will be assigned on every topic. Students will be expected to actively participate in classroom discussion.

### **Class Prerequisites**

*B01.2311.* Working knowledge of finance, including investments and investment banking, and management policy. Students who have taken similar courses such as Entrepreneurial Finance and Financing New Ventures should not take this class.

### **Schedule**

Class will be held every Saturday from May 17<sup>th</sup> until and including June 28<sup>th</sup> except that no class will be held on Saturday May 24<sup>th</sup> due to the Memorial Day holiday. A written assignment will be distributed on Saturday June 7<sup>th</sup> and will be due on Saturday June 14<sup>th</sup>. The written analysis of a case, distributed on the last day of class, will be due no later than 5:00pm on Monday July 7<sup>th</sup>. For every class except the May 17<sup>th</sup> class and

the June 14<sup>th</sup> class, students will prepare and hand in a short written analysis of a question the instructor distributes the previous week tied to the current reading assignment. Students are expected to work individually on all the assignments and the written paper and case.

## Primary Materials

Harvard Business School cases and notes will constitute the primary course materials.

## Course Outline

### Class One: May 17th

#### Topics

1. Introduction to Private Equity
2. Fundraising
  - i. Private equity risk and return
  - ii. Private equity investment strategies
  - iii. Private equity manager selection
  - iv. Asset allocation

#### Required Reading

Fenn, Liang, and Prowse, “The Economics of the Private Equity Market”, *Board of Governors of the Federal Reserve System*, Release 168, December 1995. Available for download at:

<http://www.federalreserve.gov/pubs/staffstudies/1990-99/default.htm>

#### *Case Study:*

Joshua Lerner, “The Yale University Investments Office: July 2000”

### Class Two: May 31st

#### Topics

2. Fundraising (continued)
  - v. Analyzing a fund investment
  - vi. Raising a fund of funds
  - vii. Raising a first time fund

#### Required Reading

#### *Case Studies:*

Lerner, “Acme Investment Trust”

Lerner, “University Technology Ventures: October 2000”

G. Felda Hardymon & Bill Wasik, “Columbia Capital Corporation: Summer 1998”

Lerner & David Gallo, "Francisco Partners"

*Notes:*

Hardymon & Lerner, "A Note of Private Equity Partnership Agreements"

Lerner, "A Note on the Private Equity Fundraising Process"

Further Reading

"An Introduction to Private Equity Funds, Chapter 1", Schell, James M., *Private Equity Funds: Business Structure and Operations*, (New York: Law Journal Press, 1999).

"Structuring Formation of Private Equity Fund, Chapter 10", Levin, Jack S., *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, 10-1 to 10-31*, (Frederick, MD, Panel division of Aspen Law & Business, 2000).

Class Three: June 7th Topics

3. Investment Origination, Value Creation and Management

- i. Venture Capital
- ii. Valuation
- iii. Structure of Securities

Required Reading

*Case Studies:*

Hardymon & Wasik, "Securicor Wireless Networks: February 1996"

Hardymon & Wasik, "Metapath Software: September 1997"

*Notes:*

Linda Cyr, "A Note on Pre-money and Post-money Valuations (A & B)"

Lerner & John Willinge, "A Note on Valuation in Private Equity Settings"

Hardymon & Lerner, "A Note on Private Equity Securities"

Further Reading

"Term Sheet: The Substance of The Deal Between the Founder and Investors, Chapter 9", Bartlett, Joseph W., *Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed.)*, pp. 187-210, (Frederick, MD, Panel division of Aspen Law & Business, 1995).

“A Project Is Not a Black Box, Chapter 10” Brealey,  
Richard A. and Stewart C. Myers, *Principles of Corporate Finance (6th ed.)*, (New York:  
McGraw-Hill, 2000).

Class Four: June 14th Topics

3. Investment Origination, Value Creation and Management (cont.)
  - iii. Leveraged Investments
  - iv. Value Creation, Management and Restructuring

Required Reading

*Case Studies:*

Walter Kuemmerle & William J. Coughlin, “Ducati &  
Texas Pacific Group—A “Wild Ride” Leveraged Buyout”

Malcolm S. Salter, “Regal Cinemas (A) and (B)”

*Notes:*

Carliss Baldwin, “A Technical Note on LBO Valuation (A)  
and (B)”

Class Five: June 21st

Topics

- iv. Value Creation, Management and Restructuring (Cont.)
4. Investment Exit
  - i. Initial Public Offerings
  - ii. Sales of Portfolio Companies
  - iii. Distributions of public stocks

Required Reading

*Case Studies:*

Andrew D. Regan, Charles M. Williams & Timothy A.  
Luehrman, “BW/ IP International, Inc.”

Stuart C. Gilson & Jeremy Cott, “Donald Salter  
Communications Inc.”

Lerner, Dino Cattaneo & Giampiero Mazza, “Investitori  
Associati: Exiting the Savio LBO (A & B)”

*Notes:*

Lerner, “RogersCasey Alternative Investments: Innovative  
Response to the Distribution Challenge”

Lerner, “A Note on the Initial Public Offering Process”

Further Reading

“Exit Strategies: Structuring IPO or Sale of VC-Financed Portfolio Company, Chapter 9”, *Levin*, 9-1 to 9-30.

Class Six: June 28th

Topics

5. Other Issues (as time allows)
  - i. Corporate venture capital
  - ii. Community development funds
  - iii. Secondary trading of fund investments
  - iv. Class summary
    - a. Private equity firm strategies
    - b. Private equity investment vignettes

Required Reading

*Case Studies:*

Lerner, “Martin Smith: January 2002”

Hardymon, Lerner, “Martin Smith: May 2000”

Hardymon, Lerner, “Martin Smith: May 2002”

Hardymon, “Venture Capital Case Vignettes”

*Notes:*

Lerner, “A Note on Corporate Venture Capital”

Unlike many finance courses this course is not an overly quantitative course. While the section discussing valuation contains quantitative work, the main focus will be on analytics, especially qualitative factors. This course places a strong emphasis on presentation and discussion skills. Students will need to explain their thinking about an issue to the class and the instructor. Participation will be an important element of the final grade as described below. Participation will be judged primarily on the quality of the insight provided in the classroom comments rather than on the quantity of the participation. Students will participate either by volunteering or by being selected to participate by the instructor. Relatively frequent contributions to the discussion that demonstrate logical and complete analysis will be required to excel in the participation portion of the grade.

**Assessment**

The instructor will follow the suggested grade distribution standards for the department of finance. Grades will be based 35% on the written assignment due June 14th, 45% on

the written case analysis due July 7<sup>th</sup>, 10% on the four weekly assignments and 10% on class participation.

## Course Packet and Useful References

The course packet consists of the notes and the cases that will be discussed during the course. **The course packet and the Federal Reserve paper (available on the website above) are the only required texts.** However, students may find the following books to be useful references at various times during the course.

### General references:

Brealey, Richard A. and Stewart C. Myers, *Principles of Corporate Finance (6th ed.)*, (New York: McGraw-Hill, 2000).

### Private equity references:

Bartlett, Joseph W., *Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed.)*, (Frederick, MD: Panel division of Aspen Law & Business, 1995).

Lake, Rick and Ronald A. Lake, *Private Equity and Venture Capital: A Practical Guide for Investors and Practitioners*, (London: Euromoney Books, 2000)

Levin, Jack S., *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions*, (Frederick, MD: Panel division of Aspen Law & Business, 2000).

Schell, James M., *Private Equity Funds: Business Structure and Operations*, (New York: Law Journal Press, 1999)

### Valuation references:

Copeland, Tom, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies (2nd ed.)*, (New York: John Wiley & Sons, 1994).

Damodaran, Aswath, *Damodaran on Valuation*, (New York: John Wiley & Sons, 1994).

Pratt, Shannon P., Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies (4th ed.)*, (Burr Ridge, IL: Richard D. Irwin, 2000).

## Other Comments

If you miss a class, you are responsible for any material that you miss, including any weekly assignments and administrative announcements.

To be fair to other students, there will be no extra-credit assignments.

Your final grade will be determined solely by the system described above.

The written assignment due June 14<sup>th</sup> and the written case analysis due July 7<sup>th</sup> will be available from the instructor.

## **Instructions for Preparing Written Case Analyses**

1. Read the case carefully. Identify the significant points and relationships. Use the exhibits to help you understand and/or interpret the text.
2. Analyze the data presented in the case and evaluate it in light of the situation. Try to understand not only the present situation, but also its historical origin and how it developed.
3. Decide what the major problems are and, if appropriate, prioritize them.
4. With the problems in mind, identify the feasible alternative courses of action. Determine what additional information is necessary to evaluate the alternative courses of action. Obtain that additional information.
5. Decide what your specific recommendation is to be. In doing so, use your understanding of the alternatives to frame a solution to the problem(s), and predict and evaluate the probable consequences of your solution.
6. Decide how you will organize the presentation of your solution to the case.

## **Document Organization**

1. **Problem Statement:** Identify the problem(s) concisely, using whatever case facts are necessary to show significance and/or priority.
2. **Analysis:** Avoid generalities. Be as specific as possible. Express your ideas clearly, supporting them adequately with evidence, explanation, and references to appropriate exhibits. The strengths and weaknesses of alternative courses of action should be developed. The analysis should build to support your recommendation. Reasons for accepting or rejecting alternatives should be stated and, if necessary, defended.
3. **Recommendation:** State your recommendation clearly and in detail sufficient to guide implementation. Discuss both the positive and negative results of following your recommendation and why you think that it is the appropriate course of action. Make sure that the recommendation follows logically from your analysis.

## **Document Format**

The case solution will be written as a report to senior management. The first page should provide a short executive summary that is no more than two paragraphs long. The detailed analysis should be presented on the following pages. The written text should not exceed 5 pages. All pages should be numbered and the document typed with one-inch margins and double spacing. Use a 12 point font or larger. Tables, charts, spreadsheets, or any other supporting materials may be attached as exhibits. Each exhibit must be referred to in the text and clearly labeled.

## Case Packet

1. Yale University Investments Office: July 2000, HBS # 9-201-048
2. Acme Investment Trust, HBS # 9-296-042
3. University Technology Ventures: January 2000, HBS # 9-201-043
4. Columbia Capital Corporation: Summer 1998, HBS # 9-899-255
5. Francisco Partners, HBS # 9-200-063
6. A Note on Private Equity Partnership Agreements, HBS # 9-294-084
7. A Note on the Private Equity Fundraising Process, HBS # 9-201-042
8. Securicor Wireless Networks: February 1996, HBS# 9-899-134
9. Metapath Software: September 1997, HBS # 9-899-160
10. A Note on Pre-money and Post-money Valuation (A & B), HBS # 9-801-446
11. A Note on Valuation in a Private Equity Setting, HBS # 9-297-050
12. A Note on Private Equity Securities, HBS # 9-200-027
13. Ducati & Texas Pacific Group- A “Wild Ride” Leveraged Buyout, HBS # 9-801-359
14. Regal Cinemas (A) and (B), HBS # 9-902-019 & HBS # 9-902-020
15. A Technical Note on LBO Valuations (A) & (B), HBS # 9-902-004 & HBS # 9-902-005
16. BW/ IP International Inc., HBS # 9-295-058
17. Donald Salter Communications Inc., HBS # 9-295-114
18. Investitori Associati: Exiting the Savio LBO (A) and (B), HBS # 9-299-048 & HBS # 9-299-106
19. RogersCasey Alternative Investments: Innovative Responses to the Distribution Challenge, HBS # 9-296-024
20. A Note on the Initial Public Offering Process, HBS # 9-200-018
21. Martin Smith: January 2002, HBS # 9-298-076
22. Martin Smith, May 2000, HBS # 9-200-046
23. Martin Smith: May 2002, HBS # 9-802-160
24. Venture Capital Case Vignettes, HBS # 9-801-408
25. A Note on Corporate Venture Capital, HBS # 9-201-036