How do you judge business opportunities? Say you are a VC and you get tons of business plans; how to quickly screen so that you are left with a few high-quality business ideas that you can do due diligence on? Ask the following 5 questions:

- Is there a customer need for the product/service? (high need or low need?)
- Are the customers willing to pay for the product? Because there could be a need but they might not want to pay!
- Is the market in which the business plans to operate attractive? Large? Growing? Are the margins good?
- Does the business have favorable cash cycles? Can you ‘collect early and pay late’? (a la Dell)
- How is the promoters’ strength?

VC Due Diligence Check List (from book by Justin J. Camp):

- Quality of the deal source? Who referred it to the VC?
- Quality of risk of other investors in the firm, advisers to the firm?
- Market space compatibility—is the market space the company is targeting compatible with your investment strategy? (say you don’t invest in BioTech and the business idea is in that space).
- Are there top-quality managers with a record of past success on the team?
- Is the management team complete or is it lacking in any functional areas? (Biz. Dev? Marketing?)
- Are the company’s key employees governed by non-competition agreements?
- Does the company have IP protection on its key algorithms, processes?
- Do any of the existing investors in the company have ‘veto’ rights? Do they hold rights of first refusal? (Rights to be first offered newly issued shares before such shares are offered to outside investors)

Key Risks for a new venture:

- Technical Risk: Does the technology work? Does the product work?
- Market Risk: Is there a market for the product? Is it large? Is it growing?
- Operational Risk: Can the firm produce at the specified cost?
- Distribution Risk: Can the firm get the products into the hands of the customers?
- Team Risk: Can this team work together? Can they execute? Do they have the skills?

Bottomline in funding new ventures: Fund an A team with a B idea rather than a B team with an A idea.

What do VCs do?

- Formulate business strategy, marketing plans, and operational planning.
- Interface with investor groups and open doors to future rounds of financing.
- Recruit professional management; attract management talent.
- Provide introductions to key customers and suppliers through network contacts.
- Monitor company’s performance.
- Serve as sounding board to entrepreneur’s team.

Financial instruments used to fund new ventures:

- Preferred Stock: has a liquidation preference over common stock in that, in the event of a sale or liquidation of the company, the preferred stock gets paid ahead of the common stock. The amount that is paid back is the face value, which is generally the cost basis the VC pays for the stock.
- Redeemable Preferred: sometimes called ‘straight preferred’, is preferred stock with no conversion into equity. Its intrinsic value is its face value + any dividend rights it carries. VCs use redeemable preferred in conjunction with common stock. So someone might invest $1.5M into a venture with that as the face value + a 50% equity in the venture, say. In this case the VC would be getting his money back and also keeping the investment at the same time. This is ‘double dipping’.
- Convertible Preferred: is preferred stock that can be converted into common equity upon the shareholder’s option. Convertible preferreds generally have a mandatory conversion term which forces conversion into common equity. Also, there are anti-dilution provisions incorporated, which adjust the conversion price of the preferred down if new shares are sold below the original conversion price.
- Participating Convertible Preferred: It has the feature of a redeemable preferred as long as the company is private, but can convert to common equity when the company is going public, when it acts like a convertible preferred. So in the case of a liquidation, PCP holders receive face value + equity participation as if the stock were converted.

VCs prefer convertible preferreds as the choice vehicle of funding a new venture. Implications:

- Participation rights give VC liquidation preference in a fire sale. Seniority in debt.
- Use of preferred stock increases the likelihood of management’s stock value becoming zero, if firm fails. This implies that management will not take undue risks thereby aligning their interests with the VC’s. Also management will not pursue private benefits at the firm’s expense—they’d rather boost the value of the firm.
- Tax popularity: since convertibles are senior in right to the common stock, they reduce the economic value of the common stock. So management can buy common at a lower price without incurring taxable income.

VCs also use ‘staging’ in their funding of new ventures. Implications:

- Staging enables to reduce uncertainty for the VC—VC can get out of the venture at low cost without having sunk his entire money in a venture which has not met milestones in successive stages. Also staging motivates the entrepreneur to meet the milestones so that more funding will be available.
- More uncertainty in a venture => more number of stages in VC financing.
VCs also use ‘syndication’ to spread their risk—often VCs will invest in bunches; this allows one VC to check his/her due diligence with his peers and also limits his exposure to the venture.

Dominant organizational form of new venture investment in the U.S: Limited Partnerships—they are governed by a complex set of contracts between the GP (General Partner—the VC) and the LP (Limited Partner—investors: pension funds, college endowments, etc.).

- Limited partnerships manage an estimated 80% of the pvt. Equity investments in the U.S now. GPs invest 1% capital in a fund, while LPs invest 99%. The profits are shared as follows: GPs—20% (carried interest) and LPs—80%. In addition GPs (VCs) charge management fees for managing the fund and monitoring and mentoring the companies. This is 1-3% of invested capital, not committed capital.
- Life of a limited partnership is typically limited to 10 years. GPs have to go out frequently and raise money—every 3 to 5 years. So, reputation becomes a key for a GP to stay in business because the VC world is really small!
- To ensure that the GP’s and LP’s interests are aligned, LPs use a bunch of contracts, covenants, and compensation based mechanisms. Covenants sample are as follows: (a) GPs can’t invest more than a certain amount in a single firm. (b) GPs can’t keep throwing good money after bad (c) GPs can’t invest personal money in portfolio companies. (d) GPs can’t invest in general market financial vehicles or in firms which are not in the expertise of the GP.

What are the common routes to exit for new ventures?

- IPO
- Merger/Acquisition (trade sale)
- Liquidation
- MBO (Management Buy Out): Typically when a lot of debt was used to finance the buyout of a firm it is called an LBO (Leveraged Buy Out). If the management did that buyout, it is an MBO.
- Gradual Disinvestment

Steps in IPO Process

- Incorporate company and convert accounting books to meet with GAAP, SEC standards.
- Select Underwriter: a ‘beauty parade’ is conducted where IBs (Investment Banks) pitch to lead the firm’s IPO. A key aspect in picking a particular IB is to consider their analyst ratings and reputation and whether he will cover the stock or not. Underwriter compensation is typically 7%.
- Negotiate Deal: how many shares to float? Where to market the firm? To which investors? Which market to go public in? (NYSE, Nasdaq) All of this is IB’s due diligence. They also help in preparing for regulatory filings (S-1).
- IPO is registered by filing with the SEC (S-1). SEC reviews the document and gives comments. The focus of SEC is on whether the company has disclosed all material information and not whether the information is right or not.
- Road Show: IB helps the firm sell shares to investors. IB prepares a prospectus (red herring), which markets the firm. Road show gathers the demand information—number of shares investors are willing to buy at certain prices.
- Once the SEC gives reviews to the firm and the firm makes changes to the S-1, SEC designates offer as “effective,” which means the firm is ready to go public.
- IPO Pricing: this happens the night before the firm is to go public.

Book Building procedure: In a road show, investors let their interest known to underwriters and the price at which they are willing to buy a certain number of shares. All such information is entered into a ‘book’ by the IB. The IB uses the investor interest / demand in the book to determine the exact pricing of the shares. Bookbuilding method is better than other methods (auction, say) because it makes better use of the information about market demand conditions.

IPO Underpricing: Underwriters price IPO shares lower to make sure that investors stay in the market and do not feel subjected to “winner’s curse.” Otherwise, investors might feel they got ripped off and might quickly rush to the market to sell off their shares. Also, if you underprice, you protect yourself from any potential litigation. Money left on the table is the difference between the closing price on first day of trading and the offer price, multiplied by the number of shares offered. From 1990—1998, the cumulative money left on the table was $28B. But check this out, the money left on the table in 1999 alone was $35B!!!