

# Activist Growth Investing

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# The faces of activist growth investing

- Unlike activist value investing, which is usually directed at mature companies, late in the business life cycle, activist growth investing has to happen earlier in the cycle.
- In its most common form, activist growth investing takes the form of providing capital to young, start up companies. That capital can be provided by venture capitalists or private equity investors.
- It is also possible for some activist growth investing to occur later in the life cycle, with firms that have growth opportunities that are not being exploited, but that is less common.

# Venture Capital Investing

- The first are venture capital funds that trace their lineage back to the 1950s. One of the first was American Research and Development that provided seed money for the founding of Digital Equipment.
- The second are leveraged buyout funds that developed during the 1980s, using substantial amounts of debt to take over publicly traded firms and make them private firms.
- The third are private equity funds pool the wealth of individual investors and invest in private firms that show promise. This has allowed investors to invest in private businesses without either giving up diversification or taking an active role in managing these firms. Pension funds and institutional investors, attracted by the high returns earned by investments in private firms, have also set aside portions of their overall portfolios to invest in private equity.

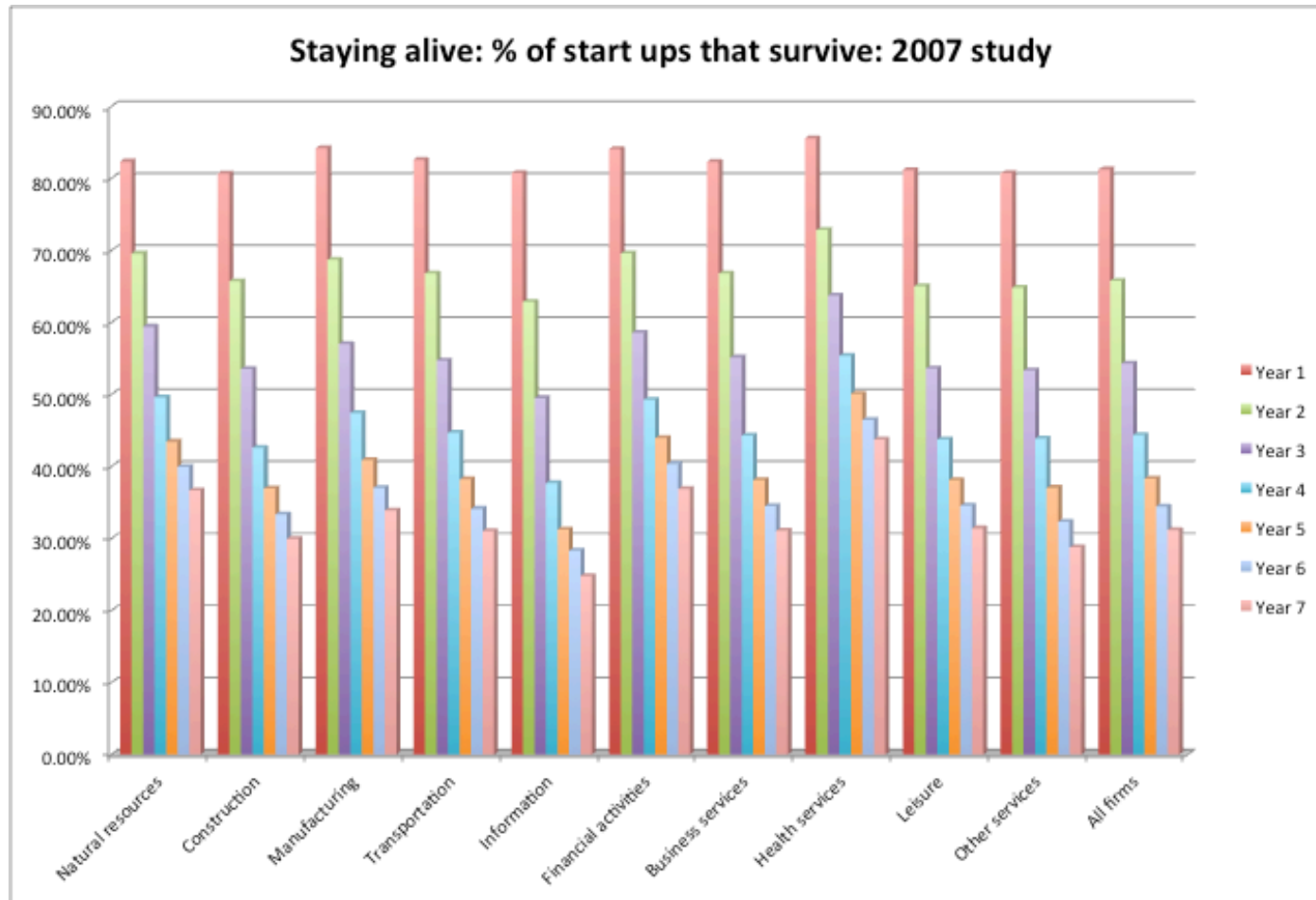
# The Process of Venture Capital Investing

1. Provoke equity investor's interest: Its capacity to do so will depend upon the business it is in and the track record of the managers in the firm.
2. Valuation and Return Assessment: In the venture capital method, the earnings of the private firm are forecast in a future year, when the company can be expected to go public. Multiplied by an expected earnings multiple in a future year you get the exit or terminal value. This value is discounted back to the present at a target rate of return, which measures what venture capitalists believe is a justifiable return, given the risk that they are exposed to.
3. Structuring the Deal: You have to negotiate two factors.
  - First, the private equity investor has to determine what proportion of the value of the firm he or she will demand, in return for the private equity investment. Private equity investors draw a distinction between what a firm will be worth without their capital infusion (pre-money) and what it will be worth with the infusion (post-money). Optimally, they would like their share of the firm to be based upon the pre-money valuation, which will be lower.
  - Second, the private equity investor will impose constraints on the managers of the firm in which the investment is being made. This is to ensure that the private equity investors are protected and that they have a say in how the firm is run.

# Post-deal Management

- Post-deal Management: Once the private equity investment has been made in a firm, the private equity investor will often take an active role in the management of the firm. Private equity investors and venture capitalists bring not only a wealth of management experience to the process, but also contacts that can be used to raise more capital and get fresh business for the firm.
- Exit: There are three ways in which a private equity investor can profit from an investment in a business.
  - The first and usually the most lucrative alternative is an initial public offering made by the private firm. While venture capitalists do not usually liquidate their investments at the time of the initial public offering, they can sell at least a portion of their holdings once they are traded.
  - The second alternative is to sell the private business to another firm; the acquiring firm might have strategic or financial reasons for the acquisition.
  - The third alternative is to withdraw cash flows from the firm and liquidate the firm over time. This strategy would not be appropriate for a high growth firm, but it may make sense if investments made by the firm no longer earn excess returns.

# The biggest risk in Venture Capital: Survival



# The VC's way of dealing with survival risk...

- The Venture Capital approach: In the venture capital approach, you hike the “discount rate” well above what would be appropriate for a going concern and then use this “target” rate to discount your “exit value” (which is estimated using a multiple and forward earnings).
  - Value = (Forward Earnings in year n \* Exit multiple) / (1 + target rate)<sup>n</sup>
- In the VC valuation, the value is then kept in check by doing one or more of the following:
  - Use conservative estimates of revenues and future earnings.
  - Use “lower” estimates for the exit multiple, through both the “comparable” firm list and the choice of multiple.
  - Use a high target rate of return to discount back the value.

# VC target rates of return

- Across the board, target rates of return demanded by VCs are significantly higher than the rates of return you see in most public company valuations or even in conventional private company valuations.
- The target rates of return used by VCs will be different for different investments, depending upon where the young company is, in terms of product development and commercial success.



# The Payoff to Private Equity and Venture Capital Investing: Thru 2011

<i>Fund Type</i>	<i>1 Yr</i>	<i>3 Yr</i>	<i>5 Yr</i>	<i>10 Yr</i>	<i>15 Yr</i>	<i>20 Yr</i>
Early/Seed Venture Capital	27.60%	3.76%	6.87%	-0.44%	41.23%	31.44
Balanced Venture Capital	32.73%	11.21%	13.15%	4.99%	13.53%	21.71%
Later Stage Venture Capital	22.06%	2.54%	5.88%	3.25%	28.56%	24.60%
All Venture Capital	26.34%	4.31%	7.37%	1.25%	30.89%	27.35%
Russell 2000	37.41%	7.77%	4.08%	6.27%	7.37%	9.82%
Nasdaq Composite	31.49%	6.55%	5.01%	2.53%	5.83%	9.21%
S&P 500	30.69%	3.34%	2.94%	2.72%	6.50%	8.73%

# Determinants of Success at Growth Investing

1. Pick your companies (and managers) well: Good venture capitalists seem to have the capacity to find the combination of ideas and management that make success more likely.
2. Diversify: The rate of failure is high among private equity investments, making it critical that you spread your bets. The earlier the stage of financing – seed money, for example – the more important it is that you diversify.
3. Support and supplement management: Venture capitalists are also management consultants and strategic advisors to the firms that they invest in. If they do this job well, they can help the managers of these firms convert ideas into commercial success.
4. Protect your investment as the firm grows: As the firm grows and attracts new investment, you as the venture capitalist will have to protect your share of the business from the demands of those who bring in fresh capital.
5. Know when to get out: Having a good exit strategy seems to be as critical as having a good entrance strategy. Know how and when to get out of an investment is critical to protecting your returns.