

Understanding Entrepreneurial Finance And Venture Capital In the Corporate Life Cycle

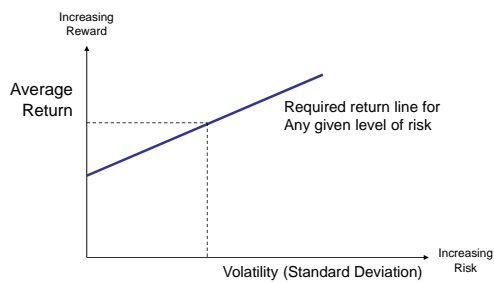
A Risk Symmetric Perspective

by

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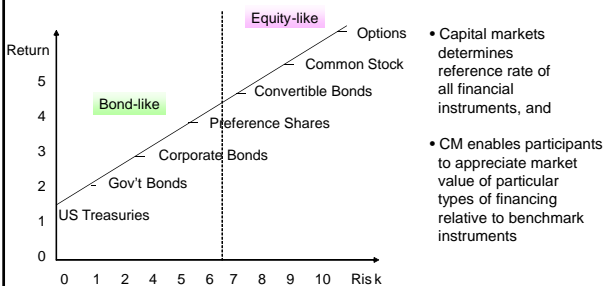
Risk and Return Theory



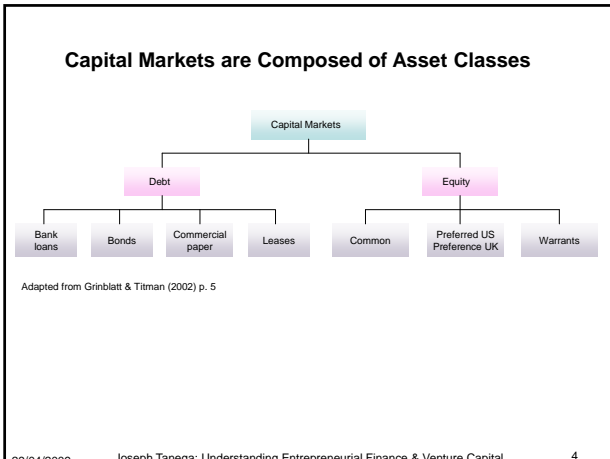
See: Moles and Terry (1999) The Handbook of International Financial Terms, p. xxi.

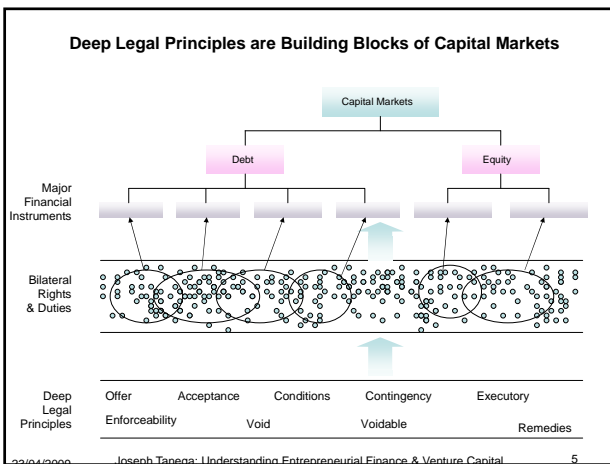
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Asset Classes



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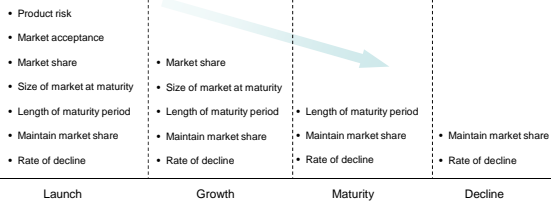




- ### National Venture Capital Association Model Venture Capital Financing Documents
1. Term Sheet
 2. Stock Purchase Agreement
 3. Certificate of Incorporation
 4. Investor Rights Agreement
 5. Voting Agreement
 6. Right of First Refusal and Co-Sale Agreement
 7. Management Rights Letter
 8. Indemnification Agreement
- Source: http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136
- Note: these documents will be discussed in greater detail in the Second Year Course on Merchant Banking & Private Equity – Private Equity & Structured Finance by Prof. Simona Zambelli
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Risks Over the Entrepreneurial Life Cycle

Large group of risks are gradually eliminated over the cycle if the entrepreneurial company is to thrive.



Source: Ward (2004) "Developing Financial Strategies – A Comprehensive Model" in *Strategic Business Finance* edited by Tony Grundy and Keith Ward. Kogan Page, p. 43.

Risk =
Volatility in future expected returns

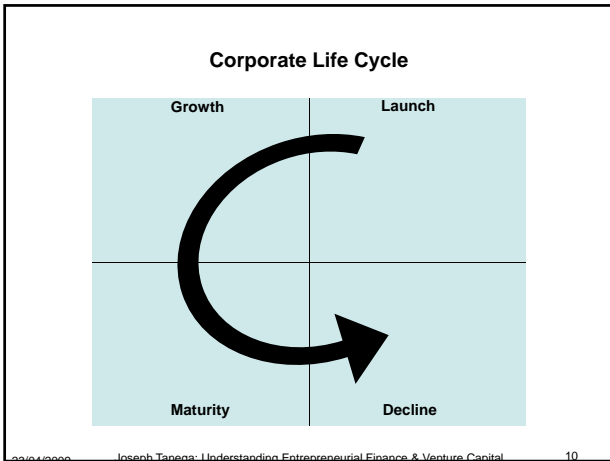
Financial Risk =
Volatility of fulfilling financial obligation

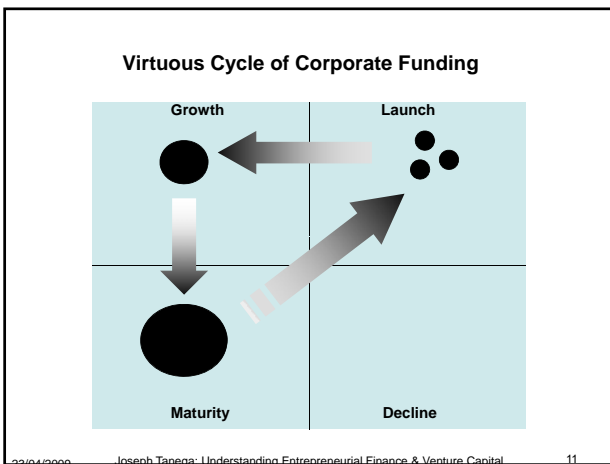
- Depends on capital structure and financial policies
- E.g. high level of debt = high perception of financial risk (since principal balance plus interest must be paid despite profitability of the firm)
- E.g. High level equity → lower level of financial risk

Business Risk =
volatility of business industry

- Distinguish high volatility in start-ups to low volatility in mature companies

HI	High business risk firm should use equity financing	Very high risk of total failure Or Very high returns after debt is paid
Business Risk	As company matures Company becomes "fat and happy" (doesn't Borrow), then becomes a takeover target; good business but has a bad financial strategy	Raider introduces large debt to increase the value of the equity. No change in competitive strategy, just added value by repositioning financial strategy with business profile of company
LO	LO	HI
	Financial Risk	





Business Risk

<p style="text-align: center;">Growth <i>High</i></p> <p style="font-size: x-small;">e.g. hi growth not apparent to competitors. Must focus on market share development, otherwise market development expense is unjustified since it benefits only competitors</p>	<p style="text-align: center;">Launch <i>Very High</i></p> <p style="font-size: x-small;">e.g. product not working Or market demand too small</p>
<p style="text-align: center;"><i>Medium</i></p> <ul style="list-style-type: none"> • Very high relative market share of a large total market. • Recoups investments of earlier stages 	<p style="text-align: center;"><i>Low</i></p> <ul style="list-style-type: none"> • Cash flow reduced
Maturity	Decline

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Cash Flow Analysis

Growth		Launch	
Cash Inflow • from sales	High	Cash Inflow • from sales	Low
Cash Outflow • Marketing, fixed assets, working cap	High	Cash Outflow • R&D marketing	High
Net Cash Flow	<u>Negative</u>	Net Cash Flow	<u>Negative</u>
Maturity		Decline	
Cash Inflow • from sales	High	Cash Inflow • from sales	Low
Cash Outflow	Low	Cash Outflow	Low
Net Cash Flow	<u>Positive</u>	Net Cash Flow	<u>Neutral</u>

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Financial Risk

Growth Low	Launch Very Low
Medium	High
Maturity	Decline

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Source of Funding

Growth Equity: Growth Investors	Launch Equity: Angel Funding Or Venture Capital
Debt and Equity (Retained Earnings)	Debt
Maturity	Decline

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Dividend Policy: Pay-out Ratio

<small>Growth</small> Nominal	<small>Launch</small> None
High	Total
<small>Maturity</small>	<small>Decline</small>

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Future Growth Prospects

<small>Growth</small> High	<small>Launch</small> Very High
Medium/Low	Negative
<small>Maturity</small>	<small>Decline</small>

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Price/Earnings Multiple

<small>Growth</small> High	<small>Launch</small> Very High
Medium/Low	Low
<small>Maturity</small>	<small>Decline</small>

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Earnings Per Share

<p>Growth</p> <p><i>Low</i></p>	<p>Launch</p> <p><i>Nominal</i></p>
<p><i>Low</i></p> <p>Maturity</p>	<p><i>Declining</i></p> <p>Decline</p>

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Share Price/ Volatility

<p>Growth</p> <p><i>Growing/High</i></p>	<p>Launch</p> <p><i>None/Very High</i></p>
<p><i>Stable/Stable</i></p> <p>Maturity</p>	<p><i>Declining/Volatile</i></p> <p>Decline</p>

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UK FSA Risk Groups

<p>Business Risk</p> <ul style="list-style-type: none"> • Strategy • Market, Credit and Operational Risk • Financial Soundness • Nature of Customers, Users and Products, Services 	<p>Control Risk</p> <ul style="list-style-type: none"> • Organisation • Internal Systems and Controls • Board, Management and Staff • Business and Compliance Culture
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Source: FSA (Feb 2003) The Firm Risk Assessment Framework.
Available at: www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf

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FSA Risk Elements

Business Risks

1. Quality of strategy
2. Nature of business
3. Credit Risk
4. Insurance underwriting risk
5. Market risk
6. Operational risk
7. Litigation/legal risk
8. Adequacy of capital
9. Liquidity
10. Earnings
11. Type of customer and/or user/member
12. Sources of business and distribution mechanisms
13. Types of products/services
14. Market efficiency
15. Proper markets

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FSA Risk Elements

Control Risk

<ol style="list-style-type: none"> 16. Sales force training and recruitment 17. Basis of remuneration of sales force 18. Financial promotion 19. Accepting, advising and reporting to customers and/or users/members to customers and/or users/members 20. Dealing and managing 21. Security of customer and/or users/members assets 22. Disclosure/adequacy of product literature 23. Membership arrangements 24. Clarity of legal/ownership structure 25. Jurisdictions/characteristics of controllers/group entities 27. Risk management 28. Policies, procedures & controls 29. Management information 30. IT systems 31. Financial and regulatory reporting and accounting policies 	<ol style="list-style-type: none"> 32. Compliance 33. Internal audit 34. Outsourcing/third party providers 35. Professional advisers 36. Business continuity 37. Money laundering controls 38. Market cleanliness 39. Clearing and settlement arrangements 40. Corporate governance 41. Allocation and definition of management responsibilities 42. Quality of management 43. Human resources 44. Relationship with regulators 45. Cultural issues and business ethics
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Problems

1. How would you rank the following instruments on the risk and return graph?

- (1) Mezzanine debt
- (2) Convertible bonds
- (3) Subordinated debt
- (4) Senior debt
- (5) Mortgage-backed debt
- (6) Government debt
- (7) Preferred stocks
- (8) Common stock
- (9) Warrants and options

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Answers

1. How would you rank the following instruments on the risk and return graph?

- (1) Mezzanine debt
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- (4) Senior debt
- (5) Mortgage-backed debt
- (6) Government debt
- (7) Preferred stocks
- (8) Common stock
- (9) Warrants and options
- (10) Asset backed debt

