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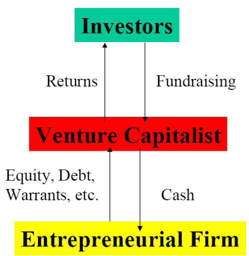
Lecture 1 – Introduction to Venture Capital

- Venture capital (entrepreneurial financial)
  - Incredibly difficult to attract capital for start ups
    - Risky (outside control of entrepreneur)
    - Illiquid investments
    - Intangible assets
    - Difficult to valuate
    - Not funded through public financing/debt
  - Tradition Assets – publicly traded shares, bonds, foreign exchanges, commodities, real estate
  - Alternative Assets
    - 1980s – investments in ostriches (eggs, oil, zoo, feathers, leather, meat)
    - Notes and coins
    - Taxi plates → not worth as much anymore due to Uber disruption
    - Defined as: limited investment history, clearly differentiated features from traditional asset classes, requires specialist skills to manage
    - E.g. Venture Capital & Private Equity Funds most common
  - Definition: VC is specific type of Private Equity – provides finance for start-ups
    - Other private equity – distressed, buy outs of mature underperforming firms
    - Typically; superannuation, wealthy individuals, university endowments (5%)
  - Performance of Private Equity
    - Private Equity – 16.5% return vs. S&P – 9.1% return
- Perspectives towards VC
  - Entrepreneur – daunting, people advising them about business, partially owned by investor
  - Ultimate investor – diversification, exposure to rapidly growing business
  - Intermediaries – opportunities to guide start-ups, provide expertise
- Venture Capital Cycle
  - Entrepreneurs have ideas → require substantial capital → lack tangible assets, expect several years of negative earnings, uncertain prospects → investors lack understanding of projects → central issue: managing co contributions of human and financial capital from separate parties
- 

  - Venture Capitalist
    - Raise a fund on a periodic basis (3-5 years) → funds are structured as limited partnerships (approx. 10 years) → funds are returned to investors → new fund is raised
    - Review of proposed investments
      - Examples
        - Ford Motor Company → 37 mil return on $10,500 invested
        - Federal Express → negative return for first VC
        - Digital Equipment Corporation → 500 times return
        - Starbucks → 90 times return
        - Microsoft → 200 times return
        - Webvan (online grocery store) → bankrupt after 2 years
        - Pet.com → bankrupt
    - Monitor current investments (preferred stock over common stock)
    - Exit investment
      - Successful firms are taken public (approx. 10%)
      - Selling to strategic buyer (e.g. Microsoft bought hotmail US$400 mil)
      - 2-6-2 rule: 20% of investments will be winners, 60% will continue but not worth, 20% will not exist
- Reasons for Private Equity

    - Moral Hazard/Agency Problem – take risks or make value destroying decision because costs are not felt by the risk taking/decision making party
        - Unable to truly observe actions/effort of entrepreneur
        - Consumption of perquisites – no costs to actions (if entrepreneur doesn't have that much ownership)
    - Information asymmetry
        - Inability to observe counter party's preferences/abilities prior to making an agreement
        - Good projects have heavy discount
        - Signal of quality – warrantee or *ownership retention*
        - Higher ownership theoretically leads to greater firm value
    - Capital Gap
        - If firms require: too much capital for personal financing, too risky for banks, public markets have agency problem & information asymmetry
        - Bridging this gap → Venture capitalists
        - Normal start-up: Savings + cash flows (more than half), credit cards, friends & family, banks (fund very few because no secured assets), venture capitalists
        - New non-venture funding – Crowd funding, incubators/accelerators (programs for ex-entrepreneurs providing resources)
        - Prime candidates for VC – high growth start ups
        - No tangible assets
- VC Industry
    - Underdeveloped in Australia (6 VC funds raised in 2016)
    - ICT and Healthcare are the largest sectors
    - VC returns are really poor, VC + PE is slightly better however not as good as S&P
    - Currently $450 million in VC funds in Aus, US has $121 billion

Lecture 2 – Fund Raising and Fund Structure

- Forms of Private Firm Financing
    - Source of Equity Finance
        - First stage: bootstrapping (own money, savings, credit cards, personal loans, family members, tax rebates) → contributes 31% of all forms of financing
            - Median startup capital in the US is around $10000
            - Example: Ross Perot started with around $1000 ($5000 nowadays) to digitise records → now a division of HP
            - Ensures high returns for entrepreneur
            - Signal/leverage to raise external funds
        - Reasons external capital should not be obtained too early
            - Incentives to spend, expand and squander
            - No opportunity for correcting errors/poor decision
            - VC become impatient (5-year exit) and can hinder innovation
        - Second stage: Angel Investors/Seed Capitalists
            - Professional investors investing with their own funds (e.g. wealthy individuals)
            - Objectives: high returns early, returns from adding value, preparing for VC
        - Equity Crowd Funding (happens around the Angel stage)
            - Lack of monitoring/professionals, regulatory constraints
            - E.g. Acorns – rounding up purchases and investing the savings
        - Expansion stage

Table D: Equity Financing Rounds over the Early Life of a Company

Financing Round	Definition	Typical Amounts	Who Typically Plays
Seed	Prove a concept/qualify for start-up capital	$25,000-500,000	Individual Angels Angel Groups Early-stage Venture Capitalists
Start-up	Complete product development and initial marketing	$500,000-3,000,000	Select Individual Angels Angel Groups Early-stage Venture Capitalists
First	Initiate full-scale manufacturing and sales	$1,500,000-5,000,000	Venture Capitalists
Second	Working capital for initial business expansion	$3,000,000-10,000,000	Venture Capitalists Private Placement Firms
Third	Expansion capital to achieve break-even	$5,000,000-30,000,000	Venture Capitalists Private Placement Firms
Bridge	Financing to allow company to go public in 6-12 months	3,000,000-20,000,000	Mezzanine Financing Firms Private Placement Firms Investment Bankers

Source: Interviews; definitions taken from Pratt's Venture Capital Guide

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    - Sources of Debt Finance
        - Bank Loans (overdrafts, commitments, term loans); 30% of funding for pre-IPO firms (difficult to obtain for start-ups – lack of stable cash flows, collaterals from tangibles)
        - Mezzanine funds – for firms which are about to get to IPO (bridge funding)
        - Venture lending (and leasing) – requires backing of existing VC, small debt
    - Financing Path to IPO
        - eBay: 1995 – online shopping → 250000 to 2 mil transactions in 1 year