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**The University of Pennsylvania
The Wharton School
Management Department**

Venture Capital and Entrepreneurial Management

MGMT 804 --- Q1, Fall 2008

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Course Overview and Design

This elective course focuses on venture capital management issues in the context of the typical high growth potential, venture-backed, start-up company. The course is motivated by rapid increases in the supply of and demand for private equity over the past two decades and by the apparent emergence of new and in some cases conflicting trends in venture capital activities as a whole as the industry enters its fourth year of recovery from the dramatic collapse of the technology sector in 2000. Some trends of particular note on the positive side include:

- The modest but steady increase in valuations for venture-backed companies at all stages of growth, from the first round investment through the acquisition event that many companies seize opportunistically even as they are preparing their registration statement for an IPO.
- The increased numbers of companies that are getting funded, due in part to the abundance of cash that is available through traditional venture capital firms, through the active re-appearance of corporate venture investors (Intel, Cisco and Google, to name a few) and, for the first time, through private equity firms that have entered the late-stage mezzanine investment space.

However, although these trends would appear to bode well for the emerging growth company, there are other disturbing patterns that have begun to emerge in the last couple of years, including:

- A decline in the number of venture funds as well as a decline in the amount of money that venture funds are seeking to raise, resulting in part from the longer timeframes and increased capital required to grow a company to the level where an exit event is feasible.
- A decline in the return on investment from the levels earned by venture capital as an asset class over the last 30 years, a trend which some believe is permanent and will lead to upheaval across the industry in general.

The course addresses this area from two distinct perspectives: issues that relate to the demand for private equity and venture capital (the entrepreneur's perspective) on the one hand, and issues that relate to the supply of capital (the investor's perspective) on the other. As well, we will address management issues regarding the working relationship between the VC and the entrepreneur, governance, and compensation issues.

The "entrepreneur's perspective" addresses the challenges in organizing and financing the venture. Examination of this perspective reveals how entrepreneurs gain an understanding of the context and mechanics of valuing the business. Together, these matters help define the financing requirements of the business and suggest the approach for where and how to raise capital, and thereafter manage the relationship with investors.

Complementing the entrepreneur's point of view is the "venture capitalist's perspective", which explores issues of concern to investors in evaluating, structuring and pricing venture capital investments. Insights gained from these class

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discussions will be valuable for students considering a career in venture capital, while also providing essential information for entrepreneurs. As we explore the venture capitalist's perspective, we will address several aspects of the investment process including the term sheet content and structure and negotiation, valuation methods, and the impact of successive rounds of financing on capitalization and ownership. All of these factors set the stage for the relationship between management and investors as well as the governance of the company.

The course is fundamentally pragmatic in its orientation and will attempt to expose students to both perspectives simultaneously. It will cover six principal areas relevant to the privately held high-growth-potential start-up, including:

- A brief overview of the venture capital industry today, as well as a discussion of the typical venture fund structure and related venture capital objectives and investment strategies
- Common organizational issues encountered in the formation of a venture-backed start-up, including matters relating to initial capitalization, intellectual property, and early stage equity incentive and compensation arrangements
- Valuation methodologies that form the basis of the negotiation between the entrepreneur and the venture capitalist in anticipation of a venture investment
- The challenges of fundraising, due diligence, financing strategies and the importance of the business plan and presentation
- Elements of compensation, both cash and equity, that are common to venture-backed companies in the technology sector
- Typical investment terms found in the term sheet and the dynamics of negotiation between the entrepreneur and the venture capitalist
- Corporate governance in the context of a venture-backed start-up company and the typical dynamics that play out between VC and the entrepreneur in the post-financing phase

The course is designed principally to address the interests of students who expect to embark on an entrepreneurial career, expect to assume a managerial role with a venture-backed start-up company, or wish to pursue a career in venture capital. The course will touch upon a range of fields including finance, accounting, strategy and corporate law and will attempt to identify mainstream "best practices" in the area of high growth potential start-ups, ensuring that students completing the course will have a solid understanding of the questions and issues that face the typical start-up.

Other course features and resources

- There will be a dedicated eRoom for our course. Lecture notes along with periodic announcements will be posted on this site.

Requirements and Evaluation

The assigned readings in the course are in the range of moderate to heavy, particularly at the beginning of the course. This syllabus, the assignments, and the Bulkpack have been organized so that students can manage the requirements efficiently. As in all courses, the lectures and discussions in the classroom will be much more meaningful if the required readings have been studied in advance. From time to time, mid-course changes in presentations or materials may be made to achieve academic objectives.

The Bulkpack is divided into two components: Required Readings and Supplemental Materials. The Required Readings are generally comprised of secondary source materials provided for background. The Supplemental Materials consist of optional reading materials and examples of legal or business documents included for the purpose of illustrating the themes discussed in class.

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The short case studies, or Caselettes, which will be used in this course are based on actual occurrence and are substantially shorter than the traditional case study. Each Caselette has been prepared with the objective of highlighting “best practices”, conventions in the industry, or issues that are commonly encountered. The Caselettes are included in the bulkpack and are part of the required readings. The classes generally will involve both lecture and case discussions, with interaction and dialogue with the instructor strongly encouraged.

For each Caselette, specific study questions have been assigned. In most class sessions, we will consider these questions and the material in the case.

Students are asked to form study group teams of up to 5 students per team. Choose your teammates carefully – changes will not be allowed once your study group team has been formed. Study groups are expected to meet to discuss each Caselette. **The deadline for the formation of study groups is session # 2.**

Student Grades

The Wharton MBA grading practices will be used. The final course grade will be computed as follows:

- Classroom participation 25%
- Case memos and other assignments 25%
- Quiz 50%

Individual class participation: Active class participation is very important for this course. Both quantity and quality of your comments count. Because so much of the learning in this course occurs in the classroom, it is important that you attend every class. If you have to miss class, for one reason or another, please notify the instructor and the TA in advance by e-mail. All students are expected to participate in class discussions. Students should expect to be cold called. Your participation in each class session will be recorded. To enable proper credit you are required to **bring your name card to each class. (Note: Failure to display your name plate in any class session may result in not receiving credit for your class participation in that session.)**

Case memos and other assignments: For each of the assigned Caselettes or cases, the study group team will turn in at the beginning of class (or post in the Web Café before Class) a two-page memo (double space, font 11) in which the study questions are addressed. The names of the students in the study team must appear on front page of the memo. Write these as if you were writing a recommendation to the major decision-maker in the case. The two-page limit is for text only. You may attach as many numerical calculations as you wish BUT your submission must be integrated into a single file. Memoranda will not be accepted after the class has met. **Credit will only be given to memos which are submitted at the beginning of the class to which the Caselette was assigned. No credit will be given if the memos are handed in late or not handed in.**

QUIZ: The quiz may be taken on an open book/open notes basis. Students are asked to bring a calculator to the quiz. No laptops are allowed.

Note:

**The instructor will take great care to grade as fairly as possible and
will NOT discuss grades at the end of the course.**

Lecture Notes

PDF files with the PowerPoint slides used in class will be posted onto the Web Cafe prior to class.

Required Text

Course Bulk-pack: MGMT 804: Venture Capital and Entrepreneurial Management, Fall 2008 edition, compiled by Raffi Amit

VI. Management 804 Course Outline At-A-Glance Quarter 1, Fall 2008

<i>Session Number</i>	<i>Date</i>	<i>Topic</i>	<i>Case/activity</i>	<i>Submissions Due</i>
1	Wednesday, September 3, 2008	Course introduction: The VC industry today- an industry in transition		
2	Monday, September 8, 2008	VC firm structure and activities (formation of study groups due)		
3	Wednesday, September 10, 2008	Organizational issues and initial capitalization in the formation of a startup	Caselettes # 1 Organizational Issues in the Formation of a Start-Up	Case Memo
4	Monday, September 15, 2008	Valuation methodologies	HBS Problem set case # N9-396-090	Prepare Questions 1 & 2
5	Wednesday, September 17, 2008	Valuation methodologies (continued)	HBS Problem set case # N9-396-090 (continued)	Prepare questions 3 – 6
6	Monday, September 22, 2008	Financing strategies from an entrepreneur's perspective	Guest Speaker Jeff Grass, buySAFE	
7	Wednesday, September 24, 2008	Valuation Methodologies (wrap up) and Fund raising challenges	Caselette # 3 Considerations in Establishing the Initial Capitalization of the Start-Up	Case Memo
8	Monday, September 29, 2008	First round financing; Lecture on term-sheets	Caselette #4: Issues Encountered in Connection with a First Round Financing	Case Memo
9	Wednesday, October 1, 2008	Liquidation preferences and anti dilution formulas Compensation	Caselette # 5: Liquidation Preferences and Anti-dilution Formulas Hand out negotiation materials	Case Memo

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10	Monday, October 6, 2008	The Term Sheet	Caselette # 6: Analysis of a Typical Venture Capital Term Sheet	Case Memo
11	Wednesday, October 8, 2008	Term sheet negotiation and Debriefing	Teams must be ready to present their negotiated term sheet	See negotiation instructions for the content and timing of your deliverables
12	Monday, October 20, 2008	Corporate Governance issues primer Course summary		
13	Wednesday, October 22, 2008	Quiz		

*Course Syllabus***Detailed Course Outline****Wednesday, September 3, 2008****Session 1: Course Introduction: The VC industry today – an industry in transition**

- An overview and brief history of the venture capital industry and its role in fostering the growth firms
- Current industry trends

Monday, September 8, 2008**Session 2: VC firm structure and activities**

- The typical venture fund structure and investment terms; venture capital objectives and investment strategies; role of the general partners

Required Reading:

- "A Note on the Venture Capital Industry." Harvard Business School (July 21, 2001)
- "How Venture Capital Works." B. Zider, Harvard Business Review
- Chapters 1 & 2. "The Economics of the Private Equity Market." by Fenn, Liang & Prowse (December 1995, The Board of Governors of the Federal Reserve System)
- "Venture Capital's Hidden Calamity." BusinessWeek (October 4, 2007)
- "VC Fundraising Falls 33 Percent." Red Herring (October 15, 2007)
- "Corporate Venture Capital Investment at Highest Levels Since 2001." NVCA (August 30, 2007)
- "Revving up." Economist.com (October 11, 2007)

Supplemental Materials:

- "Does Venture Capital Foster the Most Promising Entrepreneurial Firms?" by R. Amit, L. Glosten & E. Muller, California Management Review, 32 (3): 102-111, 1990
- "Venture Impact." Global Insight (Fourth Edition)
- "VC Exit Market Not Impacted By Market Volatility and Sub Prime Concerns." NVCA (October 1, 2007)
- Summary of Principal Terms: Sample Venture Capital Fund I, L.P.

- "Global Trends in Venture Capital 2007 Survey." Deloitte & Touche

Wednesday, September 10, 2008**Session 3: Organizational Issues and Initial Capitalization in the Formation of a Start-Up**

- Forming the company; creating a capital structure in preparation for venture funding
- Intellectual property
- Founders' stock and foundations of equity incentive arrangements
- **Caselette #1:** Organizational Issues in the Formation of a Start-Up (**Due at the beginning of class**)

Required Reading:

- "The Legal Forms of Organization." Harvard Business School (February 19, 2004)
- "The Legal Protection of Intellectual Property." Harvard Business School (April 17, 1998)
- "How to Build an Organization." Author Unknown.
- "Guide to Trademark Issues for a New Company." WSGR (2005)

Supplemental Materials:

- "Venture Capitalists." Hi-Tech Start-Up, by J. Nesheim
- Memorandum on the Operation of Newly Formed Delaware Corporations Operating in California
- Certificate of Incorporation
- Action by Unanimous Written Consent of the Board of Directors in Lieu of First Meeting
- Action by Written Consent of Sole Director
- Bylaws
- Founder's Assignment Agreement
- Equity Compensation Overview Memorandum (WSGR)
- 2001 Stock Option Plan
- Notice of Grant and Stock Option Agreement
- Restricted Stock Purchase Agreement
- Form of standard employee offer letter
- Form of At-Will Employment, Confidential Information, Invention Assignment, and Arbitration Agreement
- Form of consulting agreement

Monday, September 15, 2008**Session 4: Valuation Methodologies**

- Financial valuation methodologies; the art and the science of valuation
- Financing strategies and the impact of dilution
- **Case Discussion:** The Venture Capital Method – Valuation Problem Set (HBS case # N9-396-090) **(Questions 1 through 2 are due at the beginning of class)**

Required Reading:

- “Ownership, Dilution, Negotiation, and Valuation.” *Hi-Tech Start-Up*, by J. Nesheim
- “Valuation: What It’s Worth.” *VentureEdge* 2001
- “A Note on Valuation in Private Equity Settings” (HBS, 9-297-050 Rev April 8, 2002)

Wednesday, September 17, 2008**Session 5: Valuation Methodologies**

- **Case Discussion:** The Venture Capital Method – Valuation Problem Set (HBS case # N9-396-090) **(Questions 3 through 6 are due at the beginning of class)**

Monday, September 22, 2008**Session 7: Financing strategies from an entrepreneur’s perspective**

Guest Speaker: Jeff Grass, buySAFE

Wednesday, September 24, 2008**Session 6: Fundraising Challenges**

- Raising Capital; the role of the business plan; fundraising strategies
- Due diligence: content and process
- **Prepare Caselette #3:** Considerations in Establishing the Initial Capitalization of the Start-Up **(Due at the beginning of class)**

Required Reading:

- “Non-Traditional Financing Sources.” G. Sneddon and J. Turner

- “Bootstrap Finance: The Art of Start-ups.” A. Bhide, *Harvard Business Review*, Nov-Dec 1992
- “How to Write a Great Business Plan.” W. Sahlman, *Harvard Business Review*, July-Aug 1997
- “How to Choose and Approach a Venture Capitalist.” G. Tankersley, Jr.
- “How to Find the Right Investors for Your Business.” Author unknown.
- “Meeting with the Venture Capitalist.” W. Kingsley
- “New Venture Financing.” Harvard Business School (July 22, 2004)
- “Angel Investing Lags in First Half.” Red Herring (September 21, 2007)
- “Venture Capital Goes Big.” Wall Street Journal (October 5, 2007)
- “Google’s New Role: Venture Capitalist.” *BusinessWeek* (September 12, 2007)

Supplemental Materials:

- “Venture Capital: The dealmaker.” San Jose Mercury News (June 28, 2007)
- “Fundraising Workshop.” Deloitte & Touche
- Cinta Networks \$50 Million Series C Convertible Preferred Stock (July 2001)

Monday, September 29, 2008**Session 8: First Round Financing; Lecture on Term Sheets**

- **Prepare Caselette #4:** Issues encountered in connection with First round Financing **(Due at the beginning of class)**

Required Reading:

- “Structuring the Financing.” Stanley C. Golder
- “Venture Capital Negotiations: VC versus Entrepreneur.” Harvard Business School (March 2, 2000)

Supplemental Materials:

- Memorandum of Terms for Private Placement of Series A Preferred Stock
- Memorandum of Terms for Private Placement of Series C Preferred Stock

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- First Amended and Restated Articles of Incorporation

Wednesday, October 1, 2008**Session 9: Liquidation Preferences & compensation**

- **Prepare Caselette #5** Liquidation Preferences and Anti-dilution Formulas (**Due at the beginning of class**)

- Compensation Elements
- ISOs and NSOs
- The impact of 123R on Incentive compensation in the high growth potential company
- Implications of IRC section 409A
- Alternative forms of Incentive compensation

Required Reading:

- "It's Time To Do Away With Participating Preferred." Venture Capital Journal (July 2006)
- "The Entrepreneurs Report: Private Company Financing Trends." WSGR (Fall 2007)
- "Now Is The Time To Reform SOX Section 404." Venture Capital Journal (June 2006)

Supplemental Materials:

- "VentureOne Deal Terms Report." Dow Jones (Fourth Edition)

Monday, October 6, 2008**Session 10: The Term Sheet**

- **Prepare Caselette #6:** Analysis of a Typical Venture Capital Term Sheet (**Due at the beginning of class**)

Wednesday, October 8, 2008**Session 11: The Term Sheet Negotiation Debriefing**

VC and Entrepreneur teams present the results of their negotiations

Monday, October 20, 2008**Session 12: Corporate Governance issues primer****Course Summary**

- Board members' duty
- Composition and Roles of the Board of Directors in the private company
- Sarbanes Oxley and the private company

Required Reading:

- "A Brave New Board Era." Venture Capital Journal (March 2006)
- "How To Turn A 'Bored' Meeting Into A Real Board Meeting." Venture Capital Journal (August 2006)
- "Rites Of Passage." Pascal N. Levensohn (January 2006)
- "NVCA and Dow Jones VentureOne Release First Ever Study..." (April 10, 2006)
- "After The Term Sheet." Dennis T. Jaffe and Pascal N. Levensohn (November 2003)

Supplemental Materials:

- "The Basic Responsibilities of VC-Backed Company Directors." By working group on Director Accountability and Board Effectiveness (January 2007)

MONDAY October 22, 2008**Session 13: Quiz**

- **Bring your calculator.** (no laptops allowed)
- *Open books*
- *Open notes*
- *Open minds*