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. On the supply side, the amount of private equity under management has increased from under $5 billion in 1980 to over $300 billion at the beginning of 2003. Despite the 2001-2003 downturn in fundraising and investment activity in the venture capital sector in particular, limited partner commitments to U.S. venture capital funds have doubled in the last year, from $9.2 billion in 2003 to $17.8 billion in 2004. In the first half of 2005, US venture firms have raised $9.4 billion, an amount which is comparable to the fundraising pace of 2004. With respect to the number of transactions that closed and the amount of equity investment into venture-backed companies, we observe a slow but steady increase, possibly reflecting the beginning of a new venture capital cycle following the “post-bubble” declines in investment activities in 2000 through 2003.

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” deals with the challenges related to 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 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.

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1 This number includes partnerships specializing in venture capital, leveraged buyouts, mezzanine investments, build-ups and distressed debt. (Source: J. Lerner, International Journal of Entrepreneurship Education, 2003)
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. These include:

- 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
- 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 examples of legal or business documents included for the purpose of illustrating the themes discussed in class.

The short case studies, which will be used in this course are based on actual occurrence and are substantially shorter than the traditional case study. Each has been prepared with the objective of highlighting "best practices", conventions in the industry, or issues that are commonly encountered. Some of these will be handed out in class 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 assignment/case, 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 Case. **Note: the deadline for the formation of study groups is session # 2.**

**Student Grades**

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

- Individual Classroom participation: 20%
- Case memos and other assignments: 10%
- Midterm Paper (Individual Assignment) or Group presentation: 30%
- Final Paper or Presentation (Individual Assignment) or Group Presentation: 40%

**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 me in advance. 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 cases/assignments, 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.

The midterm paper must be written individually and will count towards 30% of the class grade. It must be related to a topic covered during the course, and may not exceed 5 pages in length. On the other hand, the final paper must be written individually, will count towards 40% of the grade, and should not exceed 10 pages in length. It may further develop concepts related to the first paper, or develop a new theme or topic related to the course. Group presentations will be considered as a substitute for the midterm and final papers.

**Credit will only be given to memos which are submitted at the beginning of the class to which the Case was assigned. No credit will be given if the memos which are handed in late or not handed in.**

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

Note that any questions regarding grades should first be directed to the instructor, although challenging grades during the course is strongly discouraged.

**Lecture Notes**

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


Class Cancellation and Make-up Days:

In the unlikely event that a class must be canceled, students will be contacted by e-mail. Generally, if a make-up class can be scheduled, it will be held on the preceding or following Friday in the AM. Make-up classes will be video recorded and posted.

Communicating with the Instructor

The best way to contact me is by e-mail. I will make every effort to respond promptly. If you want to see me in person you will find it most efficient to coordinate a meeting with me.
<table>
<thead>
<tr>
<th>Session Number</th>
<th>Date</th>
<th>Topic</th>
<th>Case/activity</th>
<th>Submissions Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>TH 1/14/2010</td>
<td>Course introduction and overview</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>T 1/19/2010</td>
<td>The VC industry today - an industry in transition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>TH 1/21/2010</td>
<td>VC firm structure, and activities</td>
<td></td>
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</tr>
<tr>
<td>4</td>
<td>T 1/26/2010</td>
<td>Evaluating Investment Opportunities</td>
<td>Chemdex</td>
<td>Prepare case</td>
</tr>
<tr>
<td>5</td>
<td>TH 1/28/2010</td>
<td>Evaluating investment opportunities</td>
<td>Chemdex</td>
<td>Hand-in assignment questions</td>
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<tr>
<td>6</td>
<td>T 2/2/2010</td>
<td>Evaluating investment opportunity - the business plan</td>
<td>IBAS Case</td>
<td>Read the IBAS plan. Be prepared to evaluate it in class</td>
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<tr>
<td>7</td>
<td>TH 2/4/2010</td>
<td>Evaluating Investment opportunities: the Due diligence content and process</td>
<td>IBAS Case</td>
<td>See assignment posted in eRoom</td>
</tr>
<tr>
<td>8</td>
<td>T 2/9/2010</td>
<td>Organizational issues</td>
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<tr>
<td>9</td>
<td>TH 2/11/2010</td>
<td>Initial capitalization in the formation of a startup</td>
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</tr>
<tr>
<td>10</td>
<td>T 2/16/2010</td>
<td>Valuation methodologies</td>
<td>HBS Problem set case # N9-396-090</td>
<td>Prepare Questions 1 – 2</td>
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<td>TH 2/18/2010</td>
<td>Valuation methodologies (continued)</td>
<td>HBS Problem set case # N9-396-090 (continued)</td>
<td>Prepare Questions 3 – 4</td>
</tr>
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<td>13</td>
<td>TH 2/25/2010</td>
<td>Fund raising Challenges: The Entrepreneur’s perspective</td>
<td></td>
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</tr>
<tr>
<td>14</td>
<td>T 3/2/2010</td>
<td>Lecture on Term sheets</td>
<td></td>
<td>Midterm Paper Due</td>
</tr>
<tr>
<td>15</td>
<td>TH 3/4/2010</td>
<td>Fund Raising – Entrepreneur’s Perspective</td>
<td>Guest Speaker</td>
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</tr>
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<td>16</td>
<td>T 3/11/2010</td>
<td>No Class – Spring Break</td>
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<td>17</td>
<td>TH 3/11/2010</td>
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<td>18</td>
<td>T 3/16/2010</td>
<td>Fund Raising – VC’s Perspective</td>
<td>Guest Speaker</td>
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<tr>
<td>19</td>
<td>TH 3/18/2010</td>
<td>Liquidation preferences</td>
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</tr>
<tr>
<td>20</td>
<td>T 3/23/2010</td>
<td>Analysis of a term sheet</td>
<td></td>
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</tr>
<tr>
<td>21</td>
<td>TH 3/25/2010</td>
<td>Integrating valuation with term sheet structure</td>
<td>Apex A</td>
<td>Case memo</td>
</tr>
<tr>
<td>22</td>
<td>T 3/30/2010</td>
<td>Compensation practices</td>
<td></td>
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<td>23</td>
<td>TH 4/1/2010</td>
<td>No Class</td>
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<td>T 4/6/2010</td>
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<td>TH 4/8/2010</td>
<td>Guest Speaker Anatomy of a Deal</td>
<td>Guest Speaker</td>
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<tr>
<td>26</td>
<td>T 4/13/2010</td>
<td>Review Session</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>TH 4/15/2010</td>
<td>Presentations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>T 4/20/2010</td>
<td>Presentations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>TH 4/22/2010</td>
<td>Guest Speaker Legal aspect of venture capital</td>
<td>Alan Zeiger of Blank Rome</td>
<td></td>
</tr>
<tr>
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<td>TH 4/27/2010</td>
<td>Corporate governance- the role and composition of the BOD in a venture backed firm</td>
<td>Course summary</td>
<td></td>
</tr>
</tbody>
</table>
Detailed Course Outline

Note: The session outline below is subject to change to accommodate the pace of class discussions and guest speakers’ schedules

January 14, 2010
Session 1: Course Introduction and Overview
- An overview and brief history of the venture capital industry and its role in fostering the growth firms

January 19, 2010
Session 2: The VC Industry Today – An Industry in Transition
- The typical venture fund structure; venture capital objectives and investment strategies; role of the general partners
- Current industry trends

Required Reading
- “Venture Capital’s Hidden Calamity” Business Week (October 4th, 2007)
- “VC Fundraising Falls 33%” Red Herring (October 15th, 2007)
- “Corporate Venture Capital Investment at Highest Levels since 2001.” NVCA (August 30th, 2007)
- “Revving up.” Economist.com (October 11th, 2007)

Supplemental Materials
- “VC Exit Market Not Impacted By Market Volatility and Sub Prime Concerns” NVCA (October 1st, 2007)
- “Global Trends in Venture Capital 2007 Survey” Deloitte & Touche

January 21, 2010
Session 3: VC Firm Structure, and Activities
- Structure, activities and practices

Required Reading

January 26, 2010
Session 4: Evaluating Investment Opportunities

Required Reading
- Chemdex.com (HBS Case 9-898-076, revised: June 22, 1999)

Chemdex Case preparation question:
1. How would you describe the opportunity that David Perry identified?

January 28, 2010
Session 5: Evaluating Investment Opportunities – Case Analysis

Required Reading
- Chemdex.com (HBS Case 9-898-076, revised: June 22, 1999)

Chemdex Case preparation questions:
1. Which criteria would you use in general for assessing an entrepreneurial opportunity? What would you – as an entrepreneur and as an investor - look for in a start-up business?
2. Imagine you are considering an investment in Chemdex in 1997. How would you evaluate this specific opportunity?

February 2, 2010
Session 6: Evaluating Investment Opportunities—The Business Plan

Required Reading
- Case: IBAS business plan
- Be prepare to evaluate the plan in class

Supplemental Materials
- Sample business plans

February 4, 2010
Session 7: Evaluating Investment Opportunities – the Due Diligence Content and Process

Required Reading
- IBAS Case — see case assignment in the eRoom

February 9, 2010
Session 8: Organizational Issues

- Forming the company; creating a capital structure in preparation for a venture financing
- Intellectual property: the importance of getting it right
Founders’ stock and basic equity incentive arrangements

Required Reading
- “How to Build an Organization.” Author Unknown.

Supplemental Materials
- “Venture Capitalists” Hi-Tech Start-Up, by J. Nesheim
- Summary of Principal Terms: Sample Venture Capital Fund I, LP
- 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 2001 Stock Option Plan
- 2001 Stock Option Plan/Notice Grant and Stock Option Agreement
- Restricted Stock Purchase Agreement
- Form of standard employee offer letter
- Form of At-Will Employment Agreement, Confidential Information, Invention Assignment, and Arbitration Agreement
- Form of Consulting Agreement

February 11, 2010
Session 9: Initial Capitalization in the Formation of a Startup

February 16, 2010
Session 10: Valuation Methodologies
- Financial valuation methodologies; the art and the science of valuation
- Financing strategies and the impact of dilution

Session 10, continued...
- Case Discussion: The Venture Capital Method – Valuation Problem Set (HBS case # N9-396-090)
  - Prepare Questions 1 & 2

Required Reading

February 18, 2010
Session 11: Valuation Methodologies Continued
Required Reading
- “Ownership, Dilution, Negotiation, and Valuation,” Chapter 7, Hi-Tech Start-Up by J. Nesheim
- Case Discussion: The Venture Capital Method – Valuation Problem Set (HBS case # N9-396-090) continued
  - Prepare Questions 3 – 4

February 23, 2010
Session 12: Valuation Problem Set – wrap up and review
- Case Discussion: The Venture Capital Method – Valuation Problem Set (HBS case # N9-396-090) continued
  - Prepare Questions 5 – 6
  - Wrap up and review

February 25, 2010
Session 13: Fundraising Challenges – the Entrepreneur’s Perspective

Required Reading
- “Non-Traditional Financing Sources” G. Sneddon and J. Turner
- “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” HBS (July 22, 2004)
- “Angel Investing Lags in First Half” Red Herring (Sept 21, 2007)
- “Venture Capital Goes Big” WSJ (Oct. 5, 2007)
- “Google’s New Role: Venture Capitalist” Business Week (Sept 12, 2007)
- “Venture Capital: The Dealmaker.” San Jose Mercury Times (June 28, 2007)
- “Fundraising Workshop” Deloitte & Touche
- Cinta Networks $50 Million Series C Convertible Preferred Stock (July 2001)

March 2, 2010
Session 14: Lecture on Term Sheets
March 4, 2010
Session 15: Guest Speaker – Fundraising
(Entrepreneur)

March 16, 2010
Session 16: Guest Speaker – Fundraising (VC)

March 18, 2010
Session 17: Liquidation Preferences

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)
- “VentureOne Deal Terms Report” Dow Jones (Fourth Edition)

March 23, 2010
Session 18: Analysis of a Term Sheet

Supplemental Reading
- Memo of Terms for Private Placement of Series A Preferred Stock
- Memo of Terms for Private Placement of Series C Preferred Stock
- First Amended and Restated Articles of Incorporation

March 25, 2010
Session 19: Integrating valuation with term sheet structure
- Prepare the Apex Investment Partners (A): April 1995 Case Study

Case preparation Questions:
1. How has AccessLine financed itself to date? Why have they chosen this strategy? What have been the implications for the firm?
2. Why does Dan Kranzler regard Apex Investment Partners as an attractive source of venture capital? Why does Apex find AccessLine to be an attractive investment?
3. How attractive are the terms that AccessLine has proposed to Apex for the Series B financing? What are the key differences from those in Series A financing round? What issues, if any, should concern Apex?
4. What is an appropriate valuation for AccessLine? Do analyses using the comparable method, discounted cash flow method, and the “venture capital” method. Do these methods suggest similar or different values for AccessLine?

March 30, 2010
Session 20: Compensation Practices in Venture Backed Companies
- Compensation Elements
- ISOs and NSOs
- Implications of IRC section 409A
- Alternative forms of Incentive Compensation

Required Reading
- “Now is the Time to Reform SOX Section404.” Venture Capital Journal (June 2006)

April 8, 2010
Session 21: Guest Speaker: Anatomy of a deal

April 13, 15, 20, 2010
Session 22, 23, 24 : Review Session/Presentations

April 22, 2010
Session 25: Guest Speaker: legal aspect of venture capital
- Guest Speaker: Alan Zeiger
  Blank Rome

April 27, 2010
Session 26: Corporate Governance – the Role and Composition of the BOD in a Venture Backed Firm
- The roles and composition of the BOD
- Overcoming difficult times
- Compensation issues
- Course Wrap up