



Course overview

Venture capital and other sources of private equity play a critical role in the founding and development of new enterprises. Over the past 25 years, there has been an enormous surge in the financial resources allocated to venture capital. According to the National Venture Capital Association, the pool of U.S. private equity funds allocated to pre-IPO investing in private firms has grown from roughly \$1.7 billion in 1980 (in 2008 dollars) to more than \$29 billion in 2011. Venture capital has also been expanding around the globe as a model for the financing of fledgling firms.

In this course, we will review all aspects of starting and operating a venture capital firm. At the end of the course, your ability to answer the following questions should have improved:

- How does the venture capital industry work?
- In what types of businesses do venture capitalists invest and why?
- How do contract structures protect investors?
- How do venture capitalists create value for their investors and for the companies in which they invest?
- How does the North American venture capital model port to other contexts?

To address these questions, we will draw on recent advances in competitive strategy, organization theory, financial economics and economic sociology. Though built on rigorous theory and evidence, the focus of the course is nonetheless highly practical. Please note that though I teach the course from the perspective of the venture capitalist, potential entrepreneurs, investors (limited partners) and policymakers will also find useful a better understanding of the industry.

I have one main goal for the course: I wish to give you a nuanced view of the structure of the venture capital industry and the relationships between venture capitalists and both limited partners and the firms in which they invest. By doing so, I hope to prepare you: (i) to manage private equity funds, (ii) to raise capital for entrepreneurial ventures, and (iii) to choose among private equity investments.

Assessment

I will evaluate your performance in the course on five components: class discussion, one problem set, four individual write-ups, a group assignment, and a group project. I will weight them as follows in determining the final grade.

Component	Weight
Class participation	15%
Problem set	20%
Individual write-ups	20%
Group assignment	5%
Group project	40%

Class participation: Through effective class discussion, we will all learn more about the industry and its operations. You add value when you (i) listen to others, (ii) *constructively* critique others' arguments, (iii) ask questions or pose arguments that improve our understanding of the materials, (iv) describe and connect related personal experiences to the discussion, and (v) integrate material from other courses into the discussion.

Laptops: The usage of laptops imposes a negative externality on the entire class. I therefore do not allow their use during class.

Problem set: All students must complete the valuation problem set, which I will distribute on September 24. You should submit your answers by the beginning of class on **October 1**.

Write-ups: Each student must complete **four** of the (six) case write-up options. Write-ups ask you to focus on a piece of analysis associated with one of the cases (see the bolded WRITEUP OPTIONS among the study questions below). Your write-up should consist of no more than two pages explaining your conclusion and how you arrived at it. To receive credit, you must submit your write-up before the class in which I plan to discuss the case that your write-up considers.

Group project: The group project asks you to analyze a potential investment. I will assign each team to a client company (either an existing business or a potential entrepreneur in need of financing). In addition to writing a 15-20 page report (due **December 10**), your group will present its analysis on December 10.

The report should cover the following elements:

- Issue identification: Identify one to three key issues in the situation. Every potential business has a multitude of risks or hurdles confronting it. You should identify and describe the most important ones.
- Strategy analysis: You should discuss possible solutions to the difficulties the target company might face.
- Valuation: Value the deal. Doing so will require you to come up with reasonable assumptions for a number of factors and to defend them.
- Recommendation: Ultimately, you must recommend whether investors should put capital into the company. If so, how much, and under what special terms?

Instructor

You can reach me by e-mail (olav.sorenson@yale). I will also hold office hours each Tuesday from 1pm to 3pm. My office is in the Evans building, 56 Hillhouse Avenue, on the second floor (Evans 207). If you do not wish to wait, please sign up ahead of time for an available time slot with my assistant, Michelle Pavlik (michelle.pavlik@yale.edu, 203-432-5051)

Schedule

1. COURSE INTRODUCTION (AUGUST 31).

- Reading: Gompers, Paul, and Josh Lerner (2001), “The venture capital revolution.” *Journal of Economic Perspectives*, 15: 145-168
- Reading: vcComp.com 2000 Compensation Survey (available online)
- Case: *Martin Smith, January 2000*

Study questions:

- (a) **WRITEUP OPTION:** At which job can Martin expect to earn the most money?
- (b) Which job offer should Martin accept? Why?

2. RAISING A FIRST FUND (SEPTEMBER 10).

- Preparation: Examine the websites of two or three VC firms. Try to get a sense of their investment strategies from their listed portfolio companies.
- Reading: Venture Capital Index (available online)
- Reading: Gompers, Paul, and Josh Lerner (1996), “The use of covenants: An empirical analysis of venture partnership agreements.” *Journal of Law and Economics*, 39: 463-498
- Case: *Weston Presidio Offshore Capital: Confronting the Fundraising Challenge*

Note that the in the second part of Exhibit 5 that the “Capital gains” column refers to the amount invested and the “Company valuation” column to the exit value of those investments.

Study questions:

- (a) Does Weston Presidio’s proposed investment strategy seem attractive to potential limited partners? Why or why not?
- (b) **WRITEUP OPTION:** How successful have Cronin and Lazarus been as investors? How would you compare their performance to private equity investors?
- (c) As an investor, would you have any concerns about the relationship with Mercury Asset Management?

3. SCREENING INVESTMENTS (SEPTEMBER 17).

- Reading: Kaplan, Steven N., and Per Stromberg (2000), “How do venture capitalists choose investments?” Working paper, University of Chicago
- Reading: Kawasaki, Guy (2006), “The top ten lies of entrepreneurs.” http://blog.guykawasaki.com/2006/01/the_top_ten_lie_1.html
- Case: To be distributed
- Case: *FEED Resource Recovery*

Study questions:

- (a) Does FEED appear to be an attractive venture capital investment?
- (b) What concerns would you have about FEED?

4. VALUING INVESTMENTS (SEPTEMBER 24).

- Reading: Sorenson, Olav (2007), “Valuing new ventures.”

5. STRUCTURING DEALS (OCTOBER 1).

- **PROBLEM SET: *Valuation Problem Set Due*** (TBD: September 24)
- Reading: Sample term sheet (available online)
- Case: *FEED Resource Recovery*

Study questions:

- (a) How would you value FEED? What type of financial instrument would you use to invest in the company?

- Case: *Walnut Venture Associates (A): RBS Group Investment Memorandum*

Study questions:

- (a) Evaluate the potential investment in RBS from Walnut's point of view.
- (b) As a Walnut investor, on what critical issues would you want additional information before deciding whether or not to invest?

6. NEGOTIATING TERM SHEETS (OCTOBER 8).

- Reading: Kawasaki, Guy (2006), "The top ten lies of venture capitalists."
http://blog.guykawasaki.com/2006/01/the_top_ten_lie.html
- Case: *Walnut Venture Associates (A)*
 - **GROUP ASSIGNMENT:** Instructions to be distributed to groups on October 1.

7. REVISITING AND MANAGING INVESTMENTS (OCTOBER 22).

- Case: *Investor Growth Capital: The Bredbandsbolaget Investment*

Study questions:

- (a) Should IGC invest more in Bredbandsbolaget?
- (b) How much capital would it take to get Bredbandsbolaget to break-even?
- (c) **WRITEUP OPTION:** How much of the company's equity might new investors need to justify an investment that would solve Bredbandsbolaget's financial problems?

- Case: *Venture Capital Vignettes*

In each case, please review the vignette. Consider the key issues, the perspectives of each party and the ways in which the problems can be addressed.

8. EMERGING TRENDS: INCUBATORS AND ACCELERATORS (OCTOBER 29).

- Preparation: Do a little research into one other accelerator or incubator? Most of you have probably heard of Y Combinator or TechStars but there are literally hundreds out there. Pick one and do a little research into it. What does it offer entrepreneurs? What does it do differently from ideaLab?
- Case: *ideaLab*
 - Browse the ideaLab website a little to get a sense of how it works:
<http://www.idealab.com/>
 - Watch at least 22 minutes of the interview with Bill Gross:
http://www.idealab.com/inside_the_lab/videos/billgross_interview.html
It's a fairly long video. The most relevant parts run from 0:00 to 6:15, about 18:20 to 26:40, about 35:25 to 41:00, and about 78:30 to the end. However, particularly if you are interested in entrepreneurship, the interview has many fascinating asides throughout – including his life story, his thoughts on the importance of testing and social media and the stories behind the .tv domain name and Overture.

Study questions:

- (a) Is ideaLab successful? If so, why?
- (b) Does ideaLab differ from a venture capitalist? If so, how?
- (c) As an entrepreneur, would you find ideaLab an attractive option? Why or why not?

9. EXITING INVESTMENTS (NOVEMBER 5).

- Case: *Grand Junction*

Study questions:

- (a) **WRITEUP OPTION:** What do you think of Charney's final offer? Is it a fair valuation for Grand Junction?
- (b) Evaluate the final offer from the perspective of the senior management and Board of Cisco Systems: Should Cisco accept this offer?
- (c) Should Grand Junction go public or be acquired? Why?

- Case: *KTM – Venture Capitalist Exit*

Study questions:

- (a) How should BC European exit KTM?
- (b) **WRITEUP OPTION:** What is a fair price for BC European's stake in KTM?
- (c) What happens if BC European and KTM disagree on the price?

10. EMERGING TRENDS: VC IN DEVELOPING COUNTRIES (NOVEMBER 12).

- Case: *Agora: Investing with Impact* (TBD)

Study questions:

- (a) Has Agora been a success?
- (b) What special challenges does Nicaragua pose as a setting for early stage investors?
- (c) How might Agora change its investing strategy to deal with these issues?

- Case: *WI Harper*

Study questions:

- (a) How should WI Harper allocate its investments geographically?
- (b) Where should WI Harper locate its professionals?
- (c) How large of a fund should WI Harper target for fund seven?

11. EMERGING TRENDS: THE VC MODEL IN OTHER CONTEXTS (NOVEMBER 26).

- Case: *Creative Capital: Sustaining the Arts*

Study questions:

- (a) Does Creative Capital have a sustainable business model?
- (b) How does Creative Capital's model compare to a grant model?
- (c) **WRITEUP OPTION:** Which elements of the venture capital model transfer to this context? Which elements might create problems? Why?

12. VC AND PUBLIC POLICY (DECEMBER 3).

- Reading: Samila, Sampsa, and Olav Sorenson (2011), "Venture capital, entrepreneurship and economic growth." *Review of Economics and Statistics*, 93: 338-349

FINAL GROUP PRESENTATIONS (DECEMBER 10).

Materials

Course reader contents:

1. *Martin Smith, January 2000*, HBS Case 9-298-076
2. *Weston Presidio Offshore Capital: Confronting the Fundraising Challenge*, HBS Case 9-296-055
3. *FEED Resource Recovery*, Babson Case BAB156
4. Sorenson, Olav (2007), "Valuing new ventures."
5. *Walnut Venture Associates (A): RBS Group Investment Memorandum*, HBS Case 9-899-062
6. *Investor Growth Capital: The Bredbandsbolaget Investment*, INSEAD Case 109-047-1
7. *Venture Capital Vignettes*, HBS Case 9-801-408
8. *Grand Junction*, Stanford GSB Case SB186
9. *KTM – Venture Capitalist Exit*, Ivey Case 907N03
10. *Agora: Investing with Impact*, Yale SOM Case
11. *WI Harper*, Stanford GSB Case E257
12. *Creative Capital: Sustaining the Arts*, HBS Case 9-810-098