

Venture Capital and Private Equity Management

Management 804, Sections 001 and 002

Fall 2002—Mr. Sammut

Objectives and Course Design

This elective mini-course (0.5 c.u.) focuses on the financial problems faced by private, typically high-growth entrepreneurial companies. It addresses this topic from two distinct perspectives: the capital seekers on the one hand, and the investor's on the other.

“The Entrepreneur’s Perspective” deals with the entrepreneur’s challenge to understand the financial implications of the business plan including its business model, development and marketing strategy, and capitalization plans. Moreover, this point of view describes the basis on which entrepreneur’s must understand the context and mechanics of valuing the business. Together, these matters help define the financing requirements of the business, and suggest the best strategy for where and how to raise capital, and thereafter manage the relationship with investors.

The second point of view is “The Venture Capitalist’s Perspective.” This perspective explores the context of the private equity asset classes and how the history and current environment of the asset class affects the decision-making process and behavior of venture capital professionals. Insights gained from this underlying theme will be valuable for students considering a career in venture capital, as well as provide essential information for entrepreneurs. As we explore the venture capital perspective, we will address several aspects of the investment process including due diligence, term sheet content, structure and negotiation, valuation methods and the impact of successive rounds of financing. The nature and tenor of this aforesaid process sets the stage for the relationship between management and investors, the governance of the company, and management of the exit process.

Much of the learning about venture capital finance achieved in this course can be applied to private equity transactions in general. However, we do not cover buy-outs or acquisitions in more depth because courses on these topics are already offered in the entrepreneurship curriculum at Wharton.

The primary audience for this course is MBA students who are interested in entrepreneurial careers. The secondary audience is students planning private equity careers that have significant interaction with entrepreneurial firms or other business associated with private equity, such as, pension fund managers, consultants to start-ups, etc. It is recommended that students have completed core finance courses and ideally MGMT 801. The course is designed to complement FNCE 750, which emphasizes more the underlying financial theory and practices in the venture capital industry. Students with a serious interest in private equity as a career should attempt to enroll in both courses.

Summary of Learning Objectives

1.0 The Venture Capital Asset Class: History, Motivations and Trends

- 1.1 to develop a framework for critical thought for planning a business for capitalization;
- 1.2 to learn of the workings of private equity industry and markets;
- 1.3 to acquire a fundamental understanding of the issues, motivations and constraints
Confronting private equity investors;
- 1.4 to acquire insight into financing alternatives.

2.0 How Venture Capital Funds are Managed, Evaluated and Funded

- 2.1 to understand the dynamics of portfolio management;
- 2.2 to acquire insight into fund operations;
- 2.3 to learn different approaches to fund evaluation by investors;
- 2.4 to appreciate the process of fund formation and capitalization;
- 2.5 to learn the structure and terms of venture capital limited partnerships;

3.0 Legal Organization of the Business and Relevant Securities Law

- 3.1 to acquire a working knowledge of choice on entity issues;
- 3.2 to acquire a working knowledge of relevant securities law,
and related instruments.

4.0 Validation and Valuation of the Business Plan

- 4.1 to acquire insight into using the venture due diligence process as a guide to planning the venture, as well as conducting “auto-due diligence;”
- 4.2 to employ proven valuation methodologies to privately held companies;
- 4.3 to acquire experience in the critical evaluation and valuation of business plans and models.

5.0 The Investment Transaction

- 5.1 to acquire capital needs forecasting tools;
- 5.2 to acquire insight into dynamics of investment rounds;
- 5.3 to develop a working knowledge of the term sheet negotiation process;
- 5.4 to acquire a working knowledge of the documentation of a private equity transaction, and a critical eye towards common errors and problems encountered in the drafting and

interpretation of these documents;

5.5 to acquire a working knowledge of the documents, instruments and debt financing structures, especially junk bonds, used in the financing of buy-outs.

6.0 Working with Investors before and after the Deal

6.1 to learn fundamentals of compensation in high-risk ventures;

6.2 to review the issues in the entrepreneur/investor relationship;

6.3 to acquire insight into creating the most value-added relationship.

7.0 The Exit: Implications for Investors and Entrepreneurs

7.1 to acquire a basic understanding of exit modes;

7.2 to review implications of exit modes and strategies.

8.0 Alternative Sources of Capital

8.1 Angel financing

8.2 “New economy” approaches

8.3 Small Business Investment Companies

8.4 Alliances

9.0 Corporate Venture Capital

9.1 Strategic and financial issues

9.2 Comparisons with venture capital limited partnerships

9.3 Implications of cyclic nature of corporate venture capital

Other course features and resources:

Participants in this course have a Web Café site for the posting of assignments, additional lecture material, and other information. The Web Café will be demonstrated in the first session. Lippincott Library resources on private equity have been extensively expanded.

Wharton Alumni have recently established the “Wharton Private Equity Network” (WPEN) as a means of continuing education, professional development, and the expansion of deal flow. Their website will be a source of valuable information, access to capital, and a venue for career development.

A Quality Circle comprised of students volunteers to advise the instructor of good ideas and needed changes.

Confidentiality

The University is a community for the exchange of ideas and knowledge; policy discourages confidentiality arrangements. In those instances where confidentiality does not interfere with learning, the instructor will honor requests for confidentiality of student projects on a selective basis. Students will be expected to respect the intellectual property of others.

Student Requirements and Evaluation

The assigned readings in the course are in the range of moderate to heavy, and somewhat front-loaded. The heart of the course is a course project that the students should think of as an “Independent Study” level of effort. This syllabus, the assignments, and the bulk pack have been carefully organized so that students can manage the requirements efficiently. As in all courses, the key to success is keeping up with the reading. From time to time, mid-course changes may be made to achieve academic objectives.

The classes will be conducted primarily in an interactive lecture style. Dialog with the instructor is strongly encouraged.

Teams

Assignment Teams: Students will form teams of up to six students for the following purposes:

1. Valuation Problem Set Submission
2. Business Plan Exercise **or** a Project

Assignment Teams should be formed and listed in the “Assignment Teams Folder” of the Web Café by:

Session 3

Note: Projects may be submitted by an individual, but that individual must join an assignment team to participate in the Valuation Problem Set.

Deliverables

Assignment teams should submit either:

1. A one page brief description of the business plan they expect to review, identifying the source of the plan, its author (plan authors may not be on the review team), and a few sentences about the subject matter of the plan; OR
2. A one-page project proposal.

By: **Session 5**

Student grades will be based on the following requirements:

1. One required problem set (P/F requirement) AND
2. Submission of a business plan review exercise (100%), OR
3. Submission of a project (100%).

With respect to all group projects teams are expected to include a brief description of the respective roles of the team members. Teams are expected to identify slackers should be identified, and their lack of participation will be weighed by the instructor.

Valuation Problem Set—Due Session 7

This is a straightforward exercise that should be submitted in hard copy to the instructor. Teams should discuss the approach to all six problems, but may divide the work among team members for a final submission. Spreadsheets are acceptable, but the instructor prefers to see an explanation of the approach that students take. Solutions will be posted on the Web Café, and selected problems will be reviewed in class.

Option 1: Business Plan Review Exercise—Due Final Class

This exercise is designed for students to exercise many of the tools and basis for judgment developed in the course. The instructor relies on business plans submitted by students within the course so that the exercise benefits both “investors” and “entrepreneurs.” Each team will be assigned the review of one plan at the earliest possible date. Student teams have the option of “recruiting” a plan to review from outside the class provided that the plan has made sufficient progress for a thorough review.

Final submission to be in hard copy. The evaluation factors that will be used in grading the business plan review exercise are as follows:

Part 1: Critical assessment of the business and revenue model. Provide a supported analysis of why and why not the model makes sense, and what modifications are necessary.

Compare and contrast to similar models. Two pages. (20 points of 100)

Part 2: Identify 7 to 10 annotated due diligence issues (one page) that you feel will need the most attention. Select two for in-depth treatment and execute diligence (two pages each) (20 points of 100)

Part 3: Based on your diligence, your validation of the business plan, the capital needs analysis, the exit strategy, comparables, and other relevant factors, develop and support a valuation analysis. One page. (15 points of 100)

Part 4: Specific recommendations to the entrepreneur on the major elements of the plan, the business model, the financials, the market and competitors, operating strategy, exit strategy and

capitalization strategy. Recommend three to five venture capitalists and justify your suggestions. Two pages. (15 of 100)

Part 5: Construct a term sheet specifically for this deal. This assumes that you will have obtained a complete capitalization table from the entrepreneurs. Whether you liked the deal or not, you will have to issue a term sheet. Your terms should reflect those issues about which you have the most concern. The amount of capital, number of shares, price per share, tranches, milestones, price protection, etc. should all be consistent and reflective of your enthusiasm or lack of same for the company. You may want to annotate in places to explain your reasoning. You need not include the boilerplate issues we will discuss in class. Five or more pages (30 of 100)

Option 2: Course Project Due Final Class

An individual or group course project that may be a significant venture capital related topic, a case study, or a business plan (developed on one's own behalf or as a consultant to another party). The instructor will consider allowing submission of a business plan that is being prepared for another course, provided that the other instructor so approves. In these instances, Mr. Sammut will identify specific expectations of the business plan, and will also expect a detailed capitalization plan and strategy to accompany the plan. Schedule of Project submissions (all project submissions must be made via hard copy):

Possible Project Topics

For students who do not have an idea for a project or a business plan, or who do not wish to prepare a business plan, the instructor has a few potential projects available. Students are encouraged to discuss one or more of the following with the instructor:

1. **Creation of a case study** for use in future courses. Students can propose specific companies, or the instructor has a few in mind. Some areas that would be useful: The funding of a specific company by angel investors; or through an angel network; a company with a complex intellectual property portfolio and, therefore, a complex valuation problem; a university spin-out; off-balance sheet financing of an existing company; venture or LBO funding of a roll-up; a specific international venture deal.

Scoring Parameters for Creation of a Case:

Scope and Definition of Situation	10
Thoroughness and Quality of Research	15
Analysis and/or Commentary	20
Creative or original input	20
Conclusions, recommendations, lessons	20
Definition of problem to be solved	10
Quality of presentation	5
Total	100

Submission of a Business Plan that includes a supplemental—but significant—capitalization strategy. This strategy should include a detailed analysis of cash needs, staging of investments, identification and justification of targeted venture capital funds, an analysis of comparable deals and their implications for valuation.

Scoring Parameters for Business Plan

Presentation of Business Model	10
Market & Competitive Analysis	10
Implementation and Operations Planning	15
Financial and Funding Analysis	15
Overall effectiveness of plan	25
Capitalization Strategy and Plan	25
Total	100

2. A research topic of your choice related to entrepreneurial finance, venture capital, leveraged buyouts, etc. In the past, students have selected such areas due diligence methods, portfolio performance evaluation, venture resources in selected regions, emerging markets, special legal issues, and the like.

Scoring Parameters for Research Submissions:

Scope and Difficulty of Topic:	10
Thoroughness and Quality of Research	20
Analysis and/or Commentary	20
Creative or original input	20
Conclusions, recommendations, lessons	25
Quality of presentation	5
Total	100

Late Submissions:

Your instructor is indeed a flexible person, but there is a price for lateness: 3 points per day, which is probably enough to knock you out of the DS category.

Grading Policy

Final grades will be distributed according to the guidelines of the Wharton School. The instructor observes Wharton School requirement that the students at the bottom 10% of the class be issued the grade of “Qualifying Credit.” Generally, the instructor will base a “QC “grade on points accumulated, but the instructor reserves the right to consider identification of “slackers” by teammates, the quality of case memos, class participation and attendance in making a final determination for this grade. “No Credit” will be issued for students whose point accumulation is less than 70 points.

Class Cancellation and Make-up Days:

If the instructor must cancel a class, 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 Tuesday in the early evening. Make-up classes will be video recorded.

The Instructor

Mr. Sammut is Venture Partner, Burrill & Company, a private merchant bank and venture capital fund focused on the life sciences. Previously, he was Chairman & CEO of Buttonwood Ventures, a merchant bank and private equity firm that was acquired by Burrill & Company. Buttonwood places and oversees venture investments on behalf of two major multinational corporations, and also provides venture capital and corporate development advisory services. Buttonwood's clients include the International Finance Corporation of the World Bank, Mitsubishi International, the Sarnoff Corporation, McKinsey & Company, IBM, Lucent Technologies, and other major corporations. Mr. Sammut has been involved in the creation of nearly 40 biotechnology, Internet, and information technology companies. He is on numerous Boards of Directors and Advisory Boards. Mr. Sammut currently holds appointments as a Lecturer at the Wharton School, the Law School and the School of Engineering and Applied Science of the University of Pennsylvania, where he teaches courses in private equity and related securities instruments, entrepreneurial finance, mergers and acquisitions, intellectual property management, and bioventure creation and management. He is the author of numerous articles on technology transfer, private equity, mergers & acquisitions, securitization and trading of alternative assets, developmental economics and investment in transitional economies. Previously, Mr. Sammut was Managing Director of Access Partners, a seed stage venture firm focusing on the formation and funding of life science firms built around university technologies. During his career, he was Managing Director of the Center for Technology Transfer at the University of Pennsylvania; Vice President of Teleflex Equities, the corporate development and venture capital arm of Teleflex Incorporated (a diversified Fortune 1000 manufacturing firm); and Vice President, S.R.One, Ltd., the venture capital fund operated by SmithKline Beecham. He co-founded and served as CEO of the Delaware Valley Organ Transplant Program from 1976 to 1983. Mr. Sammut holds graduate and undergraduate degrees from Villanova University, attended Hahnemann Medical College, and holds an MBA from the Wharton School.

Contacting Instructor:

Mr. Sammut can be contacted as follows:

Office hours: Room 431 Vance Hall, typically Mondays and Wednesdays
Appointment sign-up sheets will be posted on the door of Room 428
Vance. New sheets are posted every Wednesday at 10:30 AM.

By telephone: (610) 642-6626 (between 8:00 AM and 10:00 PM)

By fax: (610) 642-6629 (please limit faxes to 3-5 pages)

E-mail: sammutmgmt804@aol.com or smsammut@wharton.upen.edu

Please see E-mail courtesies, below

Campus mail box: Entrepreneurial Center, 4th Floor Vance Hall

By snail mail or over-night courier (please sign to authorize "drop-off"):

300 East Lancaster Avenue, Suite 1002

Wynnewood, PA 19096

E-Mail Courtesies

E-mail should be used for routine contacting of the instructor. Generally, assignments should be posted to the Web Café. In the event that you are unable to access the Web Café, assignments may be e-mailed. E-mail is a powerful means of supplementing the faculty-student relationship. Many instructors receive hundreds of messages in the course of a week from students. One way of making life a little easier for your instructors, especially when attaching assignments is to select a document designation thoughtfully, typically your name and a good title, e.g. "Smith804Project.doc"

Acknowledgements:

Mr. Sammut would like to acknowledge Professors Raffi Amit and Ian Macmillan of the Wharton School for their encouragement and suggestions in the creation and development of this course. The course has also benefited from the lectures and books of Frederick D. Lipman, Esq., a partner at the law firm Blank Rome Comisky and McCauley. Mr. Lipman periodically teaches with Mr. Sammut in the Law School offering of the course. He also wishes to acknowledge and thank Professor Josh Lerner of the Harvard Business School, for suggestions and materials that have been incorporated into this course. Professor Lerner has made numerous significant contributions to the study of venture capital and deserves the credit for creating rigorous approaches and courses in the field. His work is reflected in this course. In addition, Professor Steven Kaplan of the University of Chicago Business School has generously shared his experiences and materials of his course on entrepreneurial finance, and has recommended several of the readings in this course.

Required Texts:

Course Bulk Pack: MGMT 804: Venture Capital and Private Equity Management, Fall 2002 edition, compiled by Stephen Sammut
Slide Set: Downloadable from the Web Café

Recommended but Not Required

Gompers, Paul and Lerner, Josh. *The Venture Capital Cycle*, MIT Press, 1999.

Harmon, Steve. *Zero Gravity*. Bloomberg Press, 1999.

Levin, Jack S. *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions* (1996 Edition), Little, Brown & Company, 1996.

Lipman, Frederick D. *Venture Capital and Junk Bond Financing*. ALI-ABA, 1996.

Lipman, Frederick D. *Financing Your Business with Venture Capital*. Plenum, 1998.

Internet Sites

See Web Café for Links

Course Schedule Fall 2002

Session 1, Monday, September 9/ Wednesday October 23 “Course Introduction; The Venture Capital Industry”

Agenda: Introduction to the course
Assembly of teams and Quality Circle
Review of deliverables and assignments
Review of course requirements
Monday dinner meetings
Business Plan review exercise description

Lecture: “The Venture Capital Industry;” the structuring of venture funds, their role, operational methods, goals, investment criteria, investment strategy, company stage orientation, and expectations. The dynamics of the venture capital industry will be described in detail so that the students can understand how relationships and approaches to venture investors can produce desired result.

Readings: Lecture 1 Slides: Download from Web Café
From Bulkpack:
“The Economics of the Private Equity Market”
“A Note on the Venture Capital Industry”
“The Organized Venture Capital Community”
“How Venture Capital Works”

Deliverable: None

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Session 2 Wednesday, September 11/ Monday October 28

“The entrepreneur’s perspective: determining the amount, type and timing of financing the venture. Review alternative sources of financing”

Reading: Download Lecture 2 Slides from Web Café
From Bulk Pack:
“Advanced Planning to Raise Capital”
“Milestones for Successful Venture Planning”
“How Much Money Does Your New Venture Need?”
“Preliminary Legal Considerations in Forming a New Enterprise”
“Tax Implications of Choice of Entity”

Deliverable: None

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Session 3, Monday, September 16/Wednesday October 30
“Fundamentals of Venture Fund Operations: Introduction to Valuation”

Lecture: Fundamental issues of private equity and venture fund management

Read: Download Lecture 3 Slides from Web Cafe

From Bulk Pack:

“The Venture Capital Method”

“Structuring Venture Capital Investments”

“A Note on Valuation in Private Equity Settings”

“A Note on Pre-Money and Post Money Valuation”

Deliverable: Team Identification on Webcafe

Session 4: Wednesday, September 18/ Monday November 4
“Valuation, Stages of Financing and Dilution”

Lecture: Company Organization and the Mechanics of Deal Financing and Dilution

Read: Download Lecture 4 Slides

From Bulk Pack:

“Note on Financial Contracting: Deals”

“Structuring the Financing”

“Securities Law and Private Financing”

Deliverables: None

Session 5: Monday, September 23/ Wednesday November 6
“The Business Strategy and Plan vis-à-vis the Due Diligence Process Part 1

Lecture: The venture capital due diligence processes continued. While every entrepreneur carefully develops business and operating plans, the due diligence discipline of the fiduciary funds can provide significant value to the company by addressing strategies, alternatives, strengths and weaknesses in the proposed enterprise.

Read: Download Lecture 5 Slide Set from Web café

From Bulkpack:

“How to Check References When References are Hard to Check”

“Do You Kick Your Dog?”

“Checklist for Evaluating a Company (NASA)”

Deliverable: Project Proposal or Identification of Business Plan to be reviewed

Session 6: Wednesday, September 25/ Monday November 11
“The Business Strategy and Plan vis-à-vis the Due Diligence Process Part 2”

- Lecture:** Due Diligence Continued
- Read:** Download Lecture 6 Slides from Web Café
From Bulkpack:
“Intellectual Property Analysis in Venture Capital”
“Intellectual Property Assets: Development and Assessment “
- Deliverable:** None

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Session 7: Monday, September 30/ Wednesday, November 13
“Term Sheet Development and Legal Documentation Part 1”

- Lecture:** Structuring and Negotiating Terms
- Read:** Download Session 7 Slides from Web Café
From Bulkpack:
Termsheet for First Round Venture Capital Financing (Bring to class)
- Deliverable:** Valuation Problem Set (In Section 3 of Bulk Pack)

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Session 8: Wednesday, October 2/ Monday, November 18
“Term Sheet Development and Legal Documentation #2”

- Lecture:** **Structuring and Negotiating Terms**
- Read:** Download Lecture 8 Slides from Web Café
From Bulkpack:
CASE: Term Sheet Negotiations for Trensetter.com
“Meeting with the Venture Capitalist”
“Venture Capital: More than Money”
“How to Chose and Approach a Venture Capitalist”
“Strategy vs. Tactics from a Venture Capitalist”
“Negotiating with a Professional Venture Capitalist”
“You Can Negotiate with Venture Capitalists”
- Deliverable:** None

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Session 9: Monday, October 7/ Wednesday, November 20

“Venture Capitalist / Entrepreneur Dynamic: The Approach and the Management Team”

Lecture: The Venture Capitalist and the Management Team

Read: Download Lecture 9 Slides from Web Café

From Bulkpack:

“The Role of the Founder in Creating Organizational Culture”

“The Founders”

“Who are the Entrepreneurs?”

“Impact of Entrepreneurial and Management Experience. . .”

Deliverable: None

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Session 10: Wednesday, October 9/ Monday, November 25

“Managing Incentives and Compensation Structures”

Lecture: Hiring and Compensation Issues

Read: Download Lecture 10 Slides from Web Café

From Bulkpack:

CASE: Handspring

“Compensation Incentives in High Potential Ventures”

“Advanced Planning”

“Unlocking Shareholder Value Through Compensation Strategies”

“Equity Compensation in the Private Company Context”

“Tax Benefits Associated with Qualified Small Business Stock”

Deliverable: None

Session 11: Monday, October 14/ Wednesday, November 27

“Governance and Exit Strategies”

Lecture: Long term planning for exits: the Merger or the IPO

Read: Download Lecture 11 Slides from Web café

From Bulkpack:

CASE: Amazon.com Going Public

“Capital Market Myopia”

“Venture Capitalists and the Decision to Go Public”

“Going Public”

“Securities Laws and Public Offerings”

“Netscape Corp. IPO: Managing Risk and Uncertainty “

“Too Soon to IPO”

“Who’s to Blame for the Bubble”

“NASDAQ Booklet: Going Public”—to be distributed in class

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Session 12, Wednesday, October 16/ Monday, December 2
“Fund Formation and the Evaluation of Venture Capital Fund Performance”

Lecture: Critical Assessment of Venture Fund Performance and the Implications for Entrepreneurs

Read: Download Lecture 12 Slides

From Bulkpack:

CASE: University Technology Ventures

“The Structure and Governance of Venture Capital Organizations”

“A Note on Distribution of Venture Investments”

“A Note on Private Equity Partnership Agreements”

“Distribution Provisions”

“Important Fund Formation Developments”

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Session 13: Monday, October 21/ Wednesday, December 4
“Corporate Investors and Other Alternative Sources of Investment”

Lecture: “Working with Corporate Venture Capital Investors”

Read: Download Session 13 Slides from Web Café

From Bulkpack:

CASE: Lucent New Ventures

“Dealing with the Corporate Strategic Investor”

“A Note on Corporate Venture Capital”

“Corporate Private Equity”

“SBIC Flowchart”

Deliverable: Business Plan Review OR Project Due for 1st Quarter Section

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Session 14: Monday December 9 Final Class for Second Quarter Offering

Class to be announced

Deliverable: Business Plan Review OR Project Due for 2nd Quarter Section