Corporate Financial Strategy
4th edition
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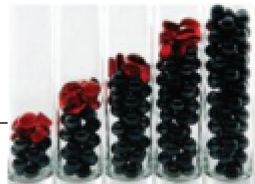
Chapter 7

Start-up businesses and venture capital



Start-up businesses and venture capital: contents

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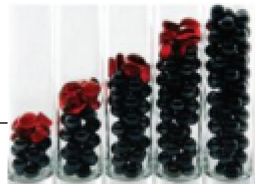


Learning objectives

1. Explain how the life cycle model is applied to the start-up stage of a business.
2. Contrast the different ways that companies use to account for high business risk.
3. Prepare or appraise a venture capital term sheet, and explain the potential impact of some common investor protection clauses.
4. Distinguish the various different forms of early-stage financing and comment on their strengths and weaknesses.

Financial strategy for a start-up business

Business risk	Very high
Financial risk	Very low
Source of outside funding	Venture capital
Dividend policy	Nil pay-out ratio
Future growth prospects	Very high
Price/earnings multiple	Very high
Current profitability (eps)	Nominal or negative
Share price	Rapidly growing but highly volatile

Stages in a start-up

Business making R&D spend

Prototype and market testing

Production & commercialization

Chance to become valuable

Time

The length of each stage depends on the industry and business model

The number of successful entities decreases at each stage

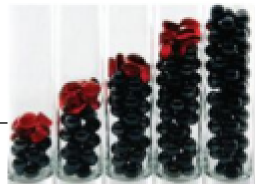
Two ways of accounting for the risk

Probability-adjust cash flows

- Probability-adjust the cash flows to allow for the changes in probability of success as each stage is reached
- This is more complex mathematically, but has the advantage that certain cash outflows are not discounted at a high rate
- It is theoretically more appropriate

Use a higher discount rate

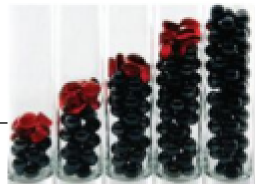
- A high discount rate is applied to the whole project to allow for the overall risk taken on
- This is more commonly used, because it is simpler, but can be misleading



Real options

- Multi-stage projects
- Timing flexibility
- Alternative uses
- Growth potential
- Exit options

Real options take account of the value inherent in flexibility



Venture capital investors and business angels

Venture Capital

- Professional investment firms, generally investing funds they have raised as intermediaries rather than their own money
- Have a portfolio of high-risk investments, often specializing in a particular sector or a specific technology

Both venture capital firms and business angels are investing with the aim of a high financial return

Business Angels

- Individuals, often investing their own money
- Often more informal than professional firms
- Investment criteria include: favourable impression of the management team, familiarity with the sector, geographical proximity, synergy with own skills

Example of corporate venturing

Corporate VC BMW i Ventures inks fifth strategic investment

11 Mar 2013

The venture capital arm of car giant BMW has made a strategic investment in mobile app company Life360, which enables users to see where family members are and optimise routes for them.

BMW i Ventures said the minority stake would be a "long term" investment.

Founded in 2008, Life360 placed first in Google's Android Developer Challenge in that same year and launched its app in 2009.

Life360 is the fifth strategic investment by BMW i Ventures. Other investments include MyCityWay, ParkAtMyHouse, Chargepoint and Embark.

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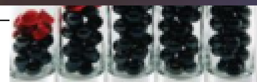
http://www.altassets.net/private-equity-news/by-news-type/deal-news/corporate-vc-bmw-i-ventures-inks-fifth-strategic-investment.html

Deal terms will include

1. Company's constitution
2. Shareholders' agreement
   a. Details of the investment and the terms attached to each of the securities – e.g. votes, vetoes, covenants, rights on exit, conversion terms …
   b. Drag along and tag along rights
   c. Pre-emption rights
   d. Board representation rights
3. Fees
4. Representations and warranties
5. Service contracts
6. Banking agreements

Pre- and post-money

Pre-money value + Investment = Post-money value



Pre- and post-money example

- Entrepreneur seeks £100,000 in exchange for 10% of the business.
- This implies that the business as it stands is worth £900,000 (pre-money)
- And after the investment, it will be worth £1,000,000 (post-money)

£100,000 = 10% (Pre-money value + £100,000)

£100,000 = (10% x Pre-money value) + £10,000

10% x Pre-money value = £90,000

Pre-money value = £900,000

Post-money value = £900,000 + £100,000 = £1,000,000

Anti-dilution clauses, used in a ‘down’ round

If someone else buys more cheaply, you get a refund.

Example

- Original VC investors bought ‘A’ shares at £100 per share. The ‘A’ shares will convert into ordinary shares on a disposal, on a 1:1 basis
- Next stage investors will buy ‘B’ shares at £50 each
- Because the ‘A‘ shares are being diluted, the holders of the ‘A’ shares are issued with new free(ish) shares, to bring their overall cost down to £50 per share. This dilutes the founder’s stake. Or, conversion terms may alter to achieve same effect.

Liquidation preference reduces risk and boosts return

PE company makes sure that on a disposal it gets its money back, or a multiple of its money. Surplus proceeds are then split between parties

Example, where VC has put in £200,000 for 50% of the equity. Sales proceeds for equity of £100k, £300k and £1m.

	£100,000 proceeds	£300,000 proceeds	£1 million proceeds
No liquid'n pref	£50,000	£150,000	£500,000
1x LP	£100,000	£250,000 *(£200k plus half of £100k)*	£600,000 *(£200k plus half of £800k)*
2x LP	£100,000	£300,000	£700,000 *(£400k plus half of £600k)*

OR – the other shareholders may be credited with their own amounts paid for their shares, in a catch-up exercise before the net proceeds are divided