
Venture Capital and Private Equity

Shyam Kamadolli

**Entrepreneur, Venture
Capitalist and Private
Equity Investor**

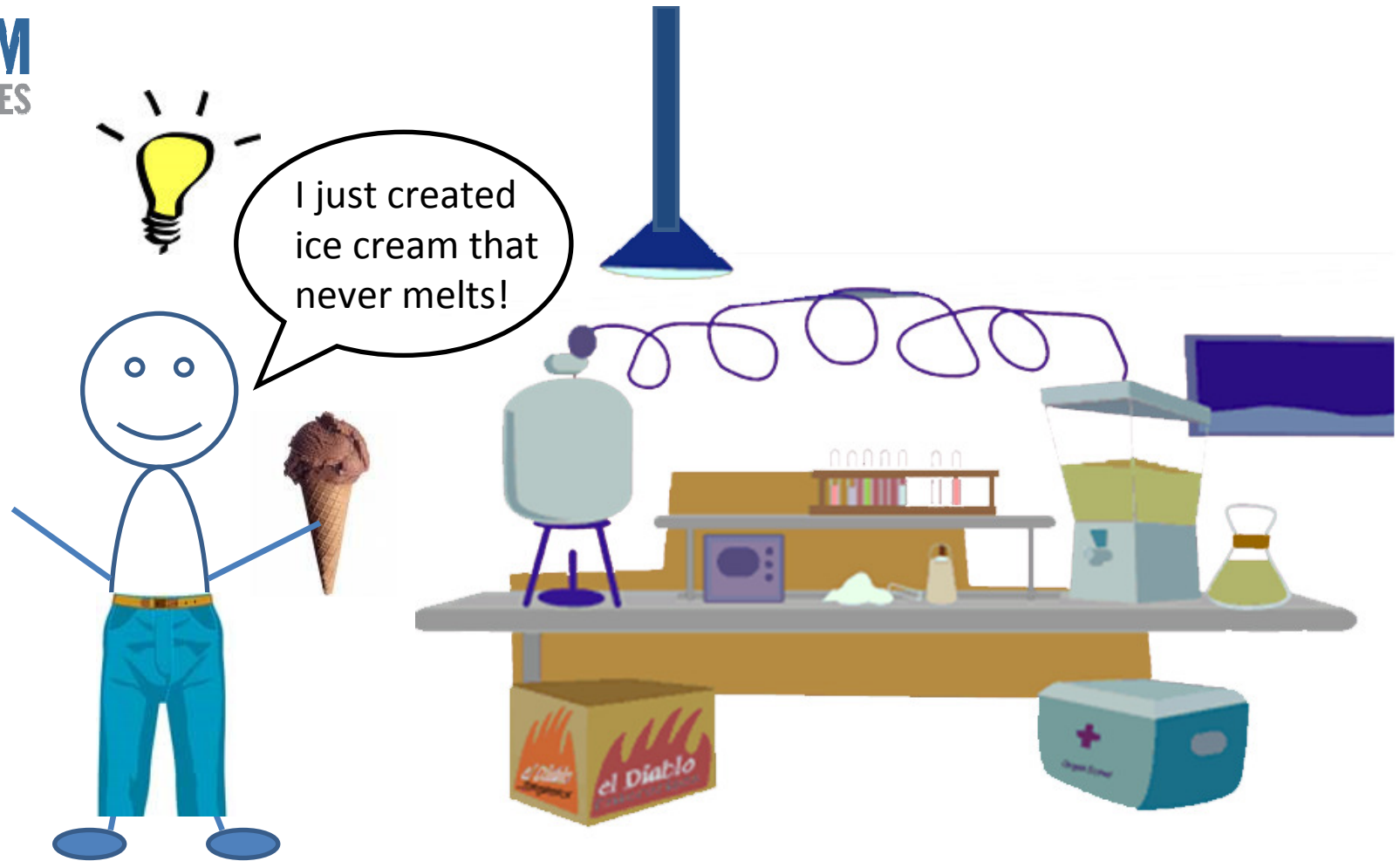


Let us dumb this down

Source: DFJ Gotham Ventures



Venture Capital For A 5th Grader



The Entrepreneur

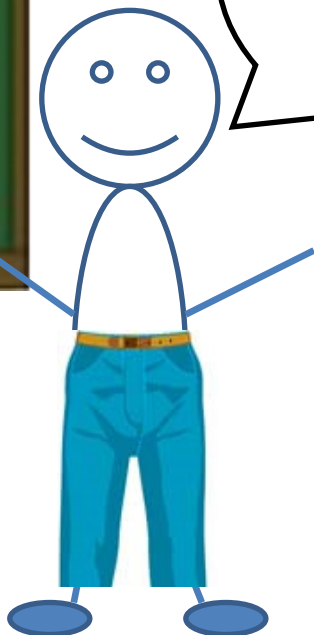
I really need to find a good investment for all this money.



The Venture Capitalist



I need money to build an ice cream plant.



My ice cream is better than others because it never melts.

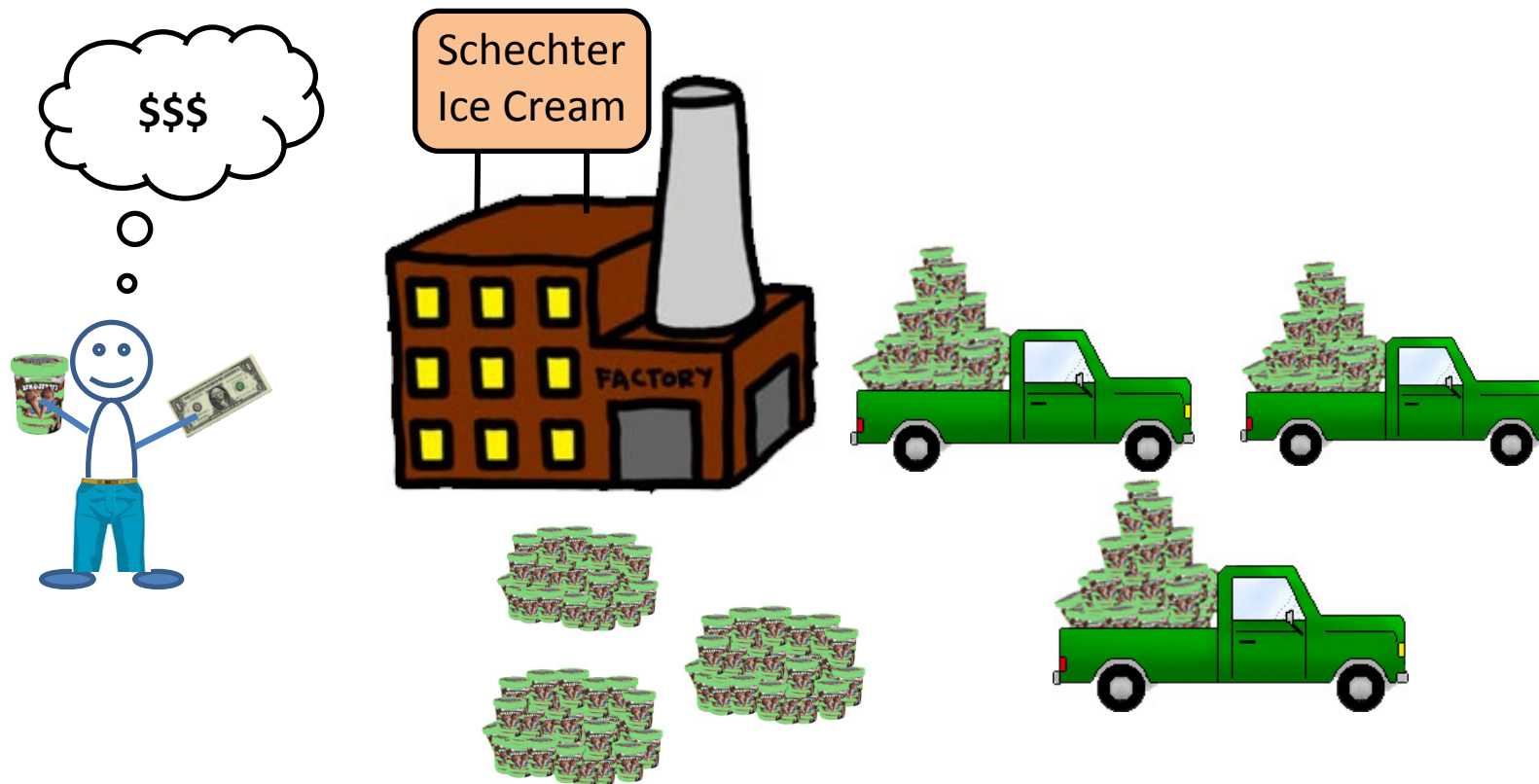
I love ice cream. This could be big!



The Entrepreneur presents his idea to a Venture Capitalist

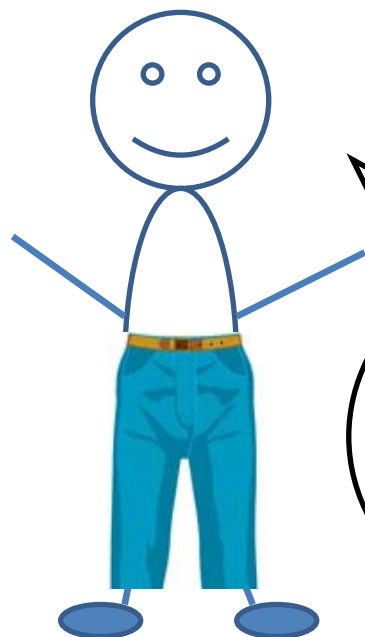


If the Venture Capitalist likes the idea he will give the Entrepreneur money in exchange for a piece of the company



The Entrepreneur uses the money to grow Schechter Ice Cream

1 Year Later...

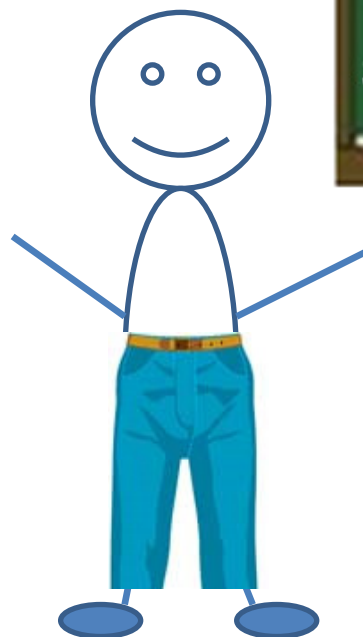


We are selling
10 million
ice creams a day.
We need more
money to keep
growing.

Why don't I introduce
you to someone who
can help.



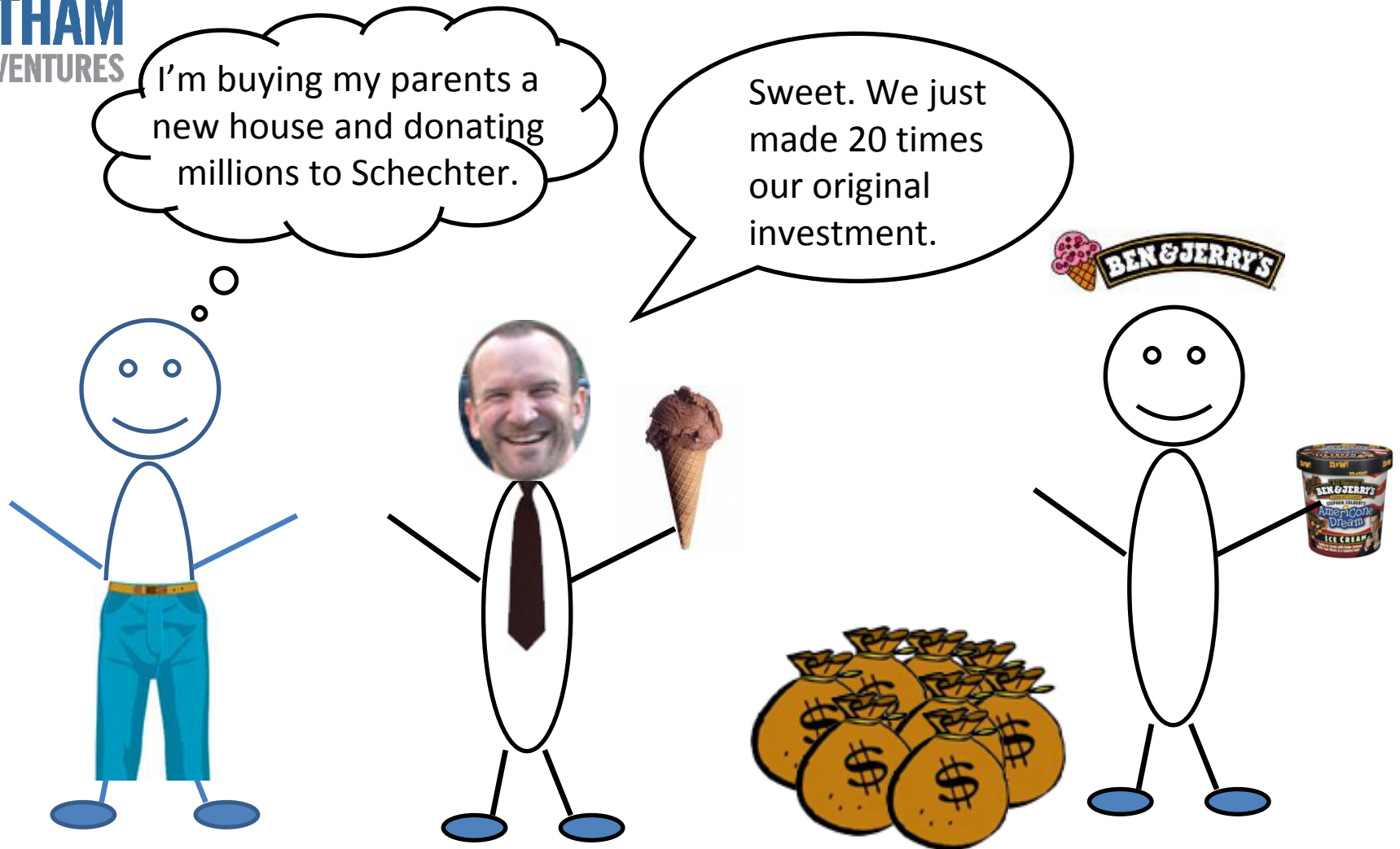
So many people want ice cream Schechter Ice Cream can't
make enough



This is great but maybe we should just buy the company.



Schechter Ice Cream presents their business to Ben and Jerry's



Ben and Jerry's offers to buy Schechter Ice Cream for a lot of money

Who knew ice cream could be worth so much money.

Schechter Ice Cream
\$100 Million Entrepreneur
+
\$100 Million Venture Capital
=
\$200 Million Total

Where should I invest next?



The Entrepreneur keeps half the money and the Venture Capitalist keeps the other half

Getting serious now, where do we begin?

- ❑ **The world of financial services**
- ❑ **Introduction to Venture Capital and Private Equity**
- ❑ **Entrepreneurship**
- ❑ **When VCs meet Entrepreneurs**



What is Finance?

- ❑ **Finance involves the selling or buying of investment instruments on behalf of either oneself or customers**
- ❑ **Aspects of finance include (but are not limited to)**
 - **Interest rate analysis**
 - **Credit analysis**
 - **Risk management**
 - **Portfolio theory and application**
 - **Financial engineering**
 - **Psychology**
 - **Sales, marketing, and general management**



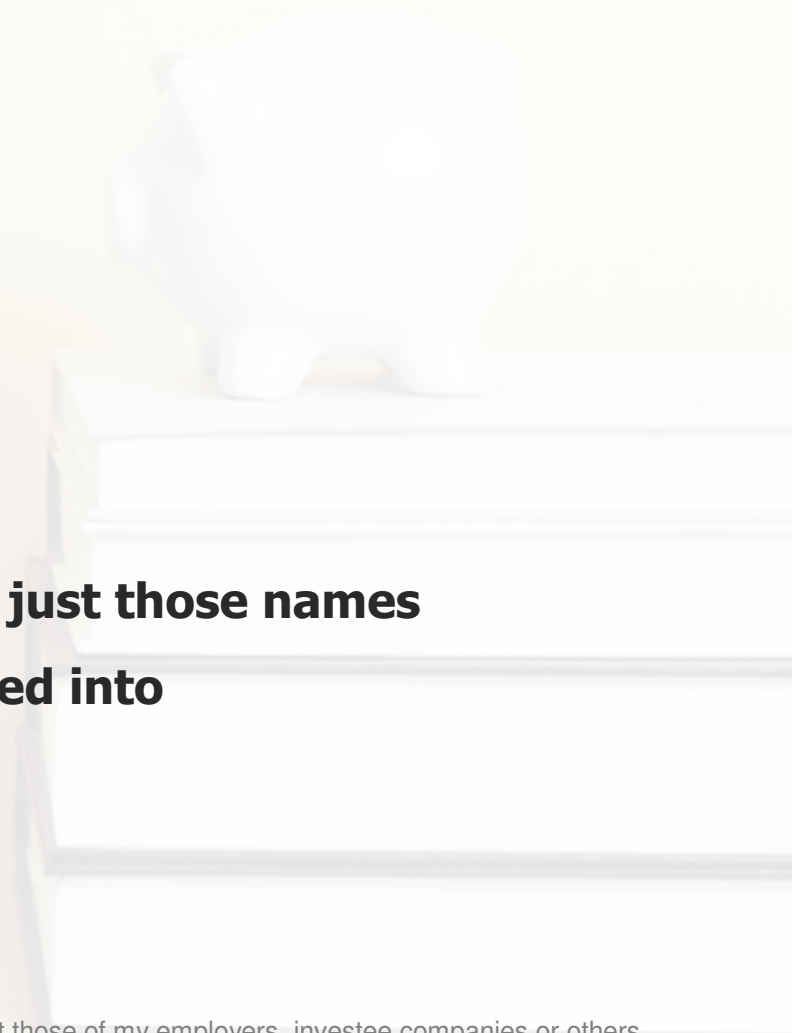
Source: Careers in Finance

By Scott Peng

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What is Finance?

- ❑ **When one says finance, one usually thinks of ...**
 - **ICICI**
 - **HDFC**
 - **Kotak**
 - **Citibank**
 - **HSBC**
 - **India Infoline**
 - **Edelweiss**
 - **Enam**
- ❑ **But ... there is a lot more to finance than just those names**
- ❑ **Finance companies can be broadly grouped into**
 - **Buy side**
 - **Sell side**



Buy Side

- ❑ **Invests clients money in exchange for a fee, a share of profits or to provide some other service**
 - **Financial entities: Government and non-government pension funds, university endowments**
 - **Commercial banks: invest your money for their profits after paying you interest**
 - **Mutual funds: invest your money for a fee (up to 3%)**
 - **Money managers: invest your money for a fee (2%) and/or share of profits**
 - **Insurance companies: invest policy premiums to generate profits, some of which provide a hedge against risk and savings vehicles**
 - **Hedge funds: invest your money in risky special strategies to maximize gains in exchange for fees**
 - **VC/PE: more on this later**
- ❑ **Performance judged against benchmark index**
 - **Fixed deposits, savings accounts: government bonds**
 - **Equity funds: S&P 500, Nifty, Sensex**
 - **Bond funds: Lehman Aggregate Index**
 - **Hedge funds: "alpha", a measure of outperforming the relevant index**
- ❑ **Key career roles**
 - **Credit analyst, Risk manager**
 - **Portfolio manager / Trader**
 - **Client relationship manager**

❑ Investment banking

- **Investment banking: help raise capital for corporations via sale of equity shares or fixed income securities**
- **Mergers & Acquisitions: usually involves exchange of cash, stock or both**

❑ Sell side firms are generally considered as either large “bulge-bracket” or smaller niche firms

- **“Bulge bracket”:** largest investment banks
 - **Broadest array of equity and fixed income products**
- **Niche – banks which focus on some specialties**
 - **Mortgage-backed securities**
 - **High yield bonds**
 - **Equity IPO**
 - **Financial futures**

What Makes You A Good Candidate to work in Finance?

❑ Knowledge

- Read and understand the product and role for which you're interviewing

❑ Teamwork: Show you can operate in a team environment as both a follower and a leader

- Student government
- Intramural sports
- Volunteer

❑ Communications: Must be a good communicator

❑ Well rounded: Have interest outside of the your curriculum

❑ Education choices: (these help but are not necessary and surely not sufficient)

- CFA, CPA
- PhD in Finance, Economics
- MBA

Any questions?



Moving on

- ❑ The world of financial services
- ❑ Introduction to Venture Capital and Private Equity
- ❑ Entrepreneurship
- ❑ When VCs meet Entrepreneurs



Venture Capital

- ❑ **A term used to broadly describe investments in early stage companies**
 - **Businesses could range in maturity from an idea drawn on a napkin to a profitable multi-million dollar business**
 - **Investors are typically high net worth individuals or buy side firms with specific agendas: pension funds, university endowments**
 - **Investors adhere to an asset allocation model: only a small portion of their net worth ends up in risky asset classes like Venture Capital**

- ❑ **Question: Why would investors invest in venture capital if it is risky?**

- ❑ **The industry includes many kinds of “venture capital”**
 - **Angel: seed stage**
 - **VC: true venture capital supports early stage ideas with little market traction**
 - **Private equity: backs companies that have an established model that need capital to scale up**
 - **Mezzanine: investors that provide funding just before a company goes IPO**
 - **Other: buy-out, distressed, etc.**

- ❑ **Question: For these investments,**
 - **What/who is the sell side?**
 - **What/who is the buy side?**

Angels

- ❑ **Angels**
 - **Typically high net worth individuals**
 - **Look to do very early stage seed investments**
 - **Often bring relevant domain knowledge**
 - **Occasionally form “Angel Funds”**
 - **This group can some times be broadened to include “friends, fools, and family”**
- ❑ **Examples: Mumbai Angels, Band of Angels**
- ❑ **Investment preferences:**
 - **Knowledge of the market and need**
 - **Gut feeling/trust in the entrepreneur**
- ❑ **Returns expectations:**
 - **10x+**

Venture Capitalists

- ❑ **VC Firms grew out of Silicon Valley in the 1950s**
 - **Largest concentration around R&D Universities**
- ❑ **Examples:**
 - **Globally: Kleiner-Perkins, Sevin-Rosen**
 - **Locally: IDG Ventures, Canaan Partners, Ojas Ventures**
- ❑ **Investment Preferences:**
 - **Proven management team**
 - **Intellectual property or other assets that create high barriers**
 - **Large addressable market**
 - **Customer traction**
- ❑ **Desired returns:**
 - **Typically a minimum of 10X on an investment**
 - **Aim to return 35% to 40% IRR to their investors**

Venture Capital Structure

Limited Partners



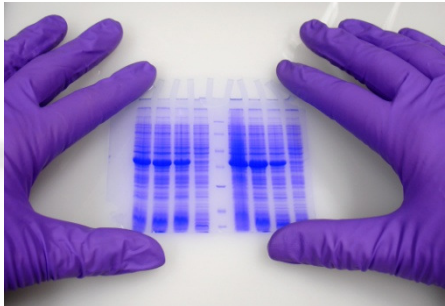
- Public Institutions
- Individuals
- Funds of funds
- Mutual Funds

Venture Fund LLP



General Partners
Collect 2% to 3% fees
20% to 30% carried interest
(share of profits)

Venture Investments



Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

Venture Capital Business Model

❑ Successful VC funds:

- Out of ten investments made after 3-5 years:
 - One big home run – at least 10X or more return
 - Four marginal survivors
 - Three on life support
 - Two total failures

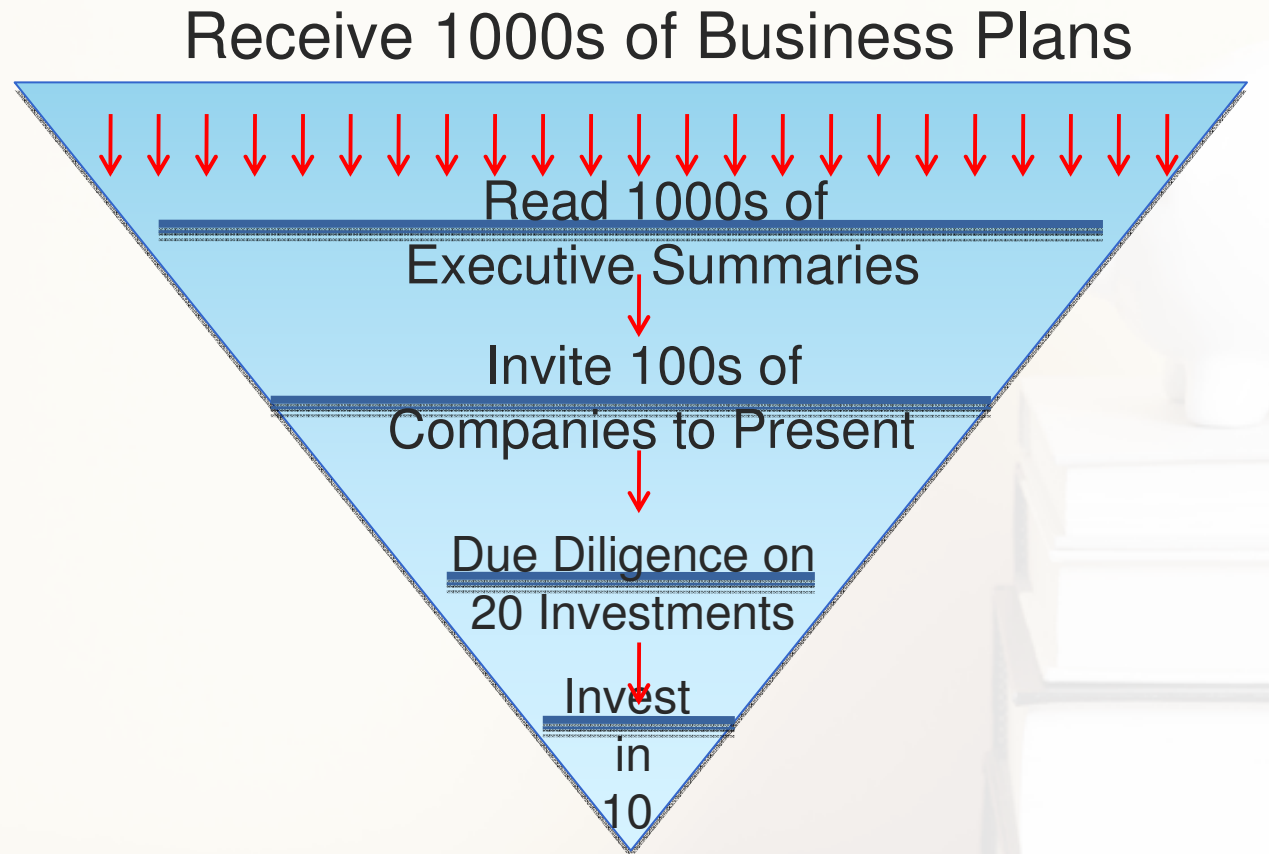
❑ “1 home run (10x) out of ten investments”Chrysalis VC Fund

❑ Historical Returns – High teens to >30%

- The funds aspire to 30%+ but very few achieve this

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

VC Deal Flow: or why is it hard to find a VC



1-2 Winners

10X Returns

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP



Private Equity

- ❑ **Globally, private equity generally implies:**
 - **Late stage funding (after a company is profitable)**
 - **Use of operating and financial leverage**
 - **What is operating leverage? Combination and restructuring of businesses, revamping management teams, etc.**
 - **What is financial leverage? Using cheap debt to improve returns to equity.**
 - ◆ Think of this as buying a home with a mortgage (EMI payments).
 - ◆ Example: You put only 10% towards the house and have a bank finance the remaining 90%. (\$1M and \$9M loan)
 - ◆ You sell the house after one year for a gain of 25% (\$12.5M)
 - ◆ You repay the bank loan and still have \$2.5M gains left over
 - ◆ Your \$1M initial payment has now returned 150% in one year (disregarding interest payments)
 - ◆ If you did not have the EMI your gain would only be \$2.5M on a \$10M investment or 25%. So your return as an equity investor in your house was 6x what it would be without leverage
 - ◆ Imagine what leverage can do for businesses.
 - **Question: Why would you not take on more debt?**
- ❑ **In India, regulations prohibit use of debt to buy equity**
 - **Private equity is “growth equity,” where investors contribute capital without leverage. They actively help a company scale the business**
 - **The only difference between VC and PE (generally) is the stage at which investments are made**
 - **Local examples: Fidelity Growth Partners India, Sequoia Capital, IDFC, ICICI, Standard Chartered, Barings Asia, Warburg Pincus**
- ❑ **Returns expectations: generally 3x to 4x on every deal and 25% IRRs**

Venture Debt

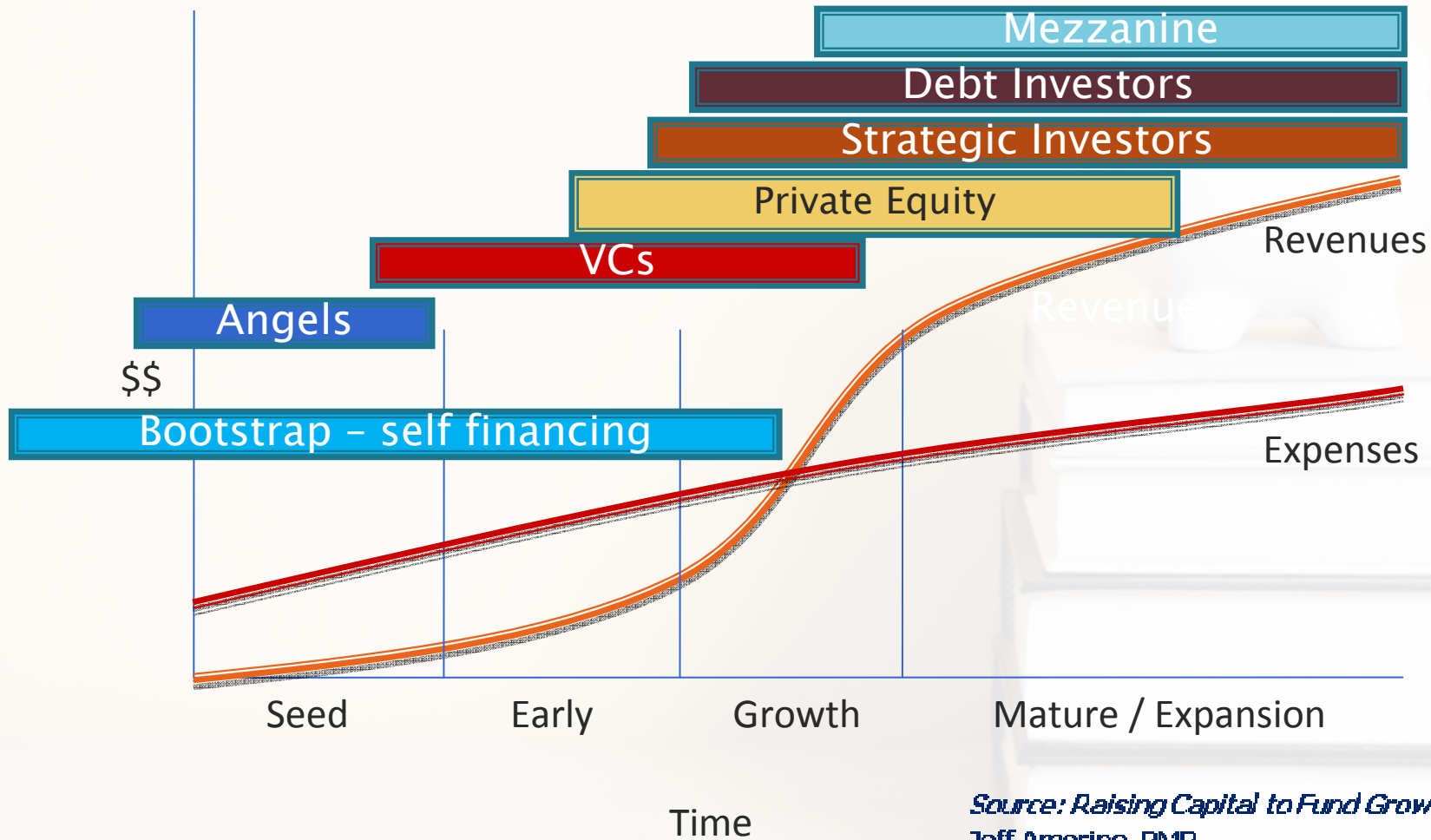
❑ **Some venture firms focus on debt**

- **Gives first preference on assets**
 - **Can be convertible to equity**
 - **Avoids/limits shareholder dilution...**
 - **But it has to be paid every month**
-
- **US Examples: Western Tech Investments, Silicon Valley Bank, Commercial banks/SBA loans**
 - **Local example: Silicon Valley Bank India**

Mezzanine Funding

- ❑ **Growth financing to get to liquidity event**
- ❑ **Targeted at profitable companies that need to scale**
- ❑ **Last stage financing before M&A activity or IPO - 😊**
- ❑ **Typically \$10M-\$100M or more in financing**
- ❑ **Can be debt/equity and is typically a syndicate of private equity funds**

Financing lifecycle

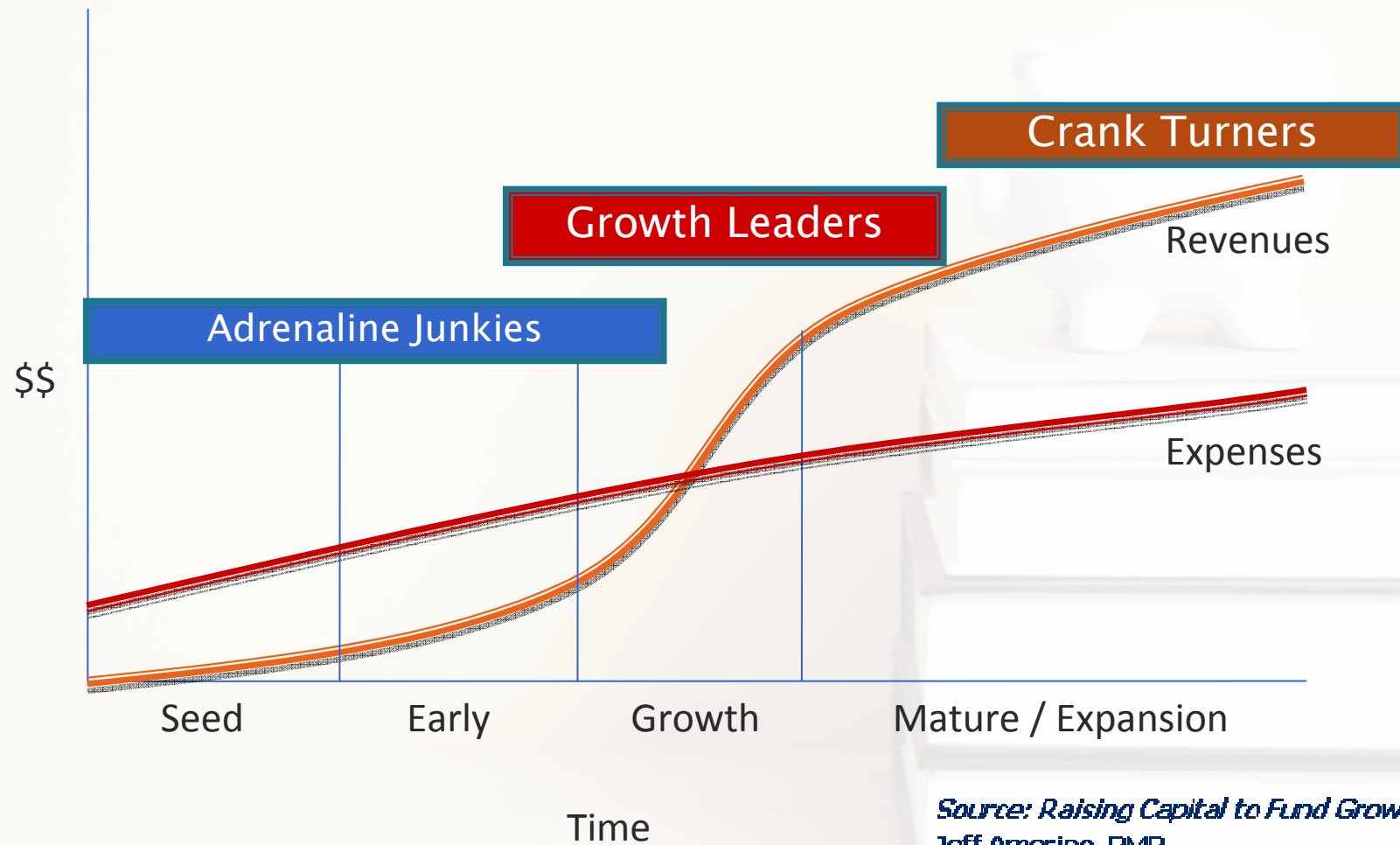


Next on the agenda

- ❑ **The world of financial services**
- ❑ **Introduction to Venture Capital and Private Equity**
- ❑ **Entrepreneurship**
- ❑ **When VCs meet Entrepreneurs**



Entrepreneurs: who are they?



Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

Success factors as an entrepreneur

- ❑ **Passion and commitment: You have to be a true believer**
- ❑ **Value proposition: Solves a real problem or meets a real need**
- ❑ **The team: Onboard the bus and in the right seats**
- ❑ **Competitive advantage: Better, faster, cheaper**
- ❑ **Focus, focus, focus: Avoid trying to “boil the ocean”**
- ❑ **Repeatable, scalable processes: Execution is key**
- ❑ **Choose your customers well!**

- ❑ **Remember accounting profits are great but cash is king!**

Financing options: Equity or Debt?

- ❑ **Equity finance = selling shares or membership units**
- ❑ **Advantages: Does not impact cash flow, higher risk tolerance.**
- ❑ **Disadvantages: Loss of control; dilution of interest**
- ❑ **Debt finance = taking a loan from a bank or individual**
- ❑ **Advantages: Does not dilute ownership**
- ❑ **Disadvantages: Loan payments, personal guarantees, banks don't lend money to startups without assets**



Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

Bootstrapping: the most common first round of financing

- ❑ **Bootstrapping= working for free or using "FFF" money**
- ❑ **Advantages: May not dilute ownership, friendly terms**
- ❑ **Disadvantages: Family issues, personal guarantees, not eating or having fun☺....**



Friends



Family



Fools



Source: Raising Capital to Fund Growth
Jett Amerine, PMP

What do investors look for?

- ❑ **Management Team, Management Team, Management Team**
- ❑ **Intellectual Property or some other asset that can be a barrier to entry**
- ❑ **Customer traction – can the company execute?**

- ❑ **Physical proximity to the investors**
- ❑ **Other interested investors – usually nobody wants to be first**
- ❑ **Entrepreneur skin in the game**

- ❑ **Realistic valuation – this depends a lot on where you sit**

VC Investment Considerations

- ❑ **Industry Preference**
- ❑ **Stage Preference**
- ❑ **Investment Size Parameters**
- ❑ **Geographic Preference**
- ❑ **Risk Balancing and Age of Fund**
- ❑ **Fund Experience and Expertise**
- ❑ **Due Diligence**



VC Risk assessment

- ❑ **Based on VC perceived risk, usually not the risk the entrepreneur sees**

- ❑ **Four main risk categories:**
 - **Product/Technology risk**
 - **Market risk**
 - **Execution/Management risk**
 - **Financing Risk**



Valuation game

❑ No “standard” way to determine valuation!!

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

❑ Examples:

- Net Present Value of Discounted Cash Flows
- Multiple of Annual Revenues
- Multiple of Net Income
- Multiple of Subscribers
- Valuation by Comparison
- Use of Valuation Tools – www.equitynet.com

❑ Recommendation:

- Look at the comparable companies in your space
- Set your valuation within the range of the comps
- Be conservative

❑ Pre-revenue startups seldom have valuations greater than \$3M-4M even with great IP and management

VC Term Sheet

- ❑ **Term Sheet – a proposal to invest**
- ❑ **Not binding**
- ❑ **Outlines the deal points**
- ❑ **Investment contingent on negotiation and due diligence**

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

- ❑ **Key Points**

- **Pre-money valuation**
- **Post-money valuation**

- ❑ **Pre-money valuation = \$4M**
- ❑ **Investment = \$1M**
- ❑ **Post-money valuation = \$5M**

- ❑ **VC ownership = $\$1M / \$5M = 20\%$**

- ❑ **VCs typically want *preferred stock***

Due diligence process

❑ Comprehensive review of everything

- Management references
- Market size & need
- Sales Pipeline & Customers
- Strategic relationships
- Financials
- Intellectual property
- Legal issues

❑ Grueling process that will find the BS!

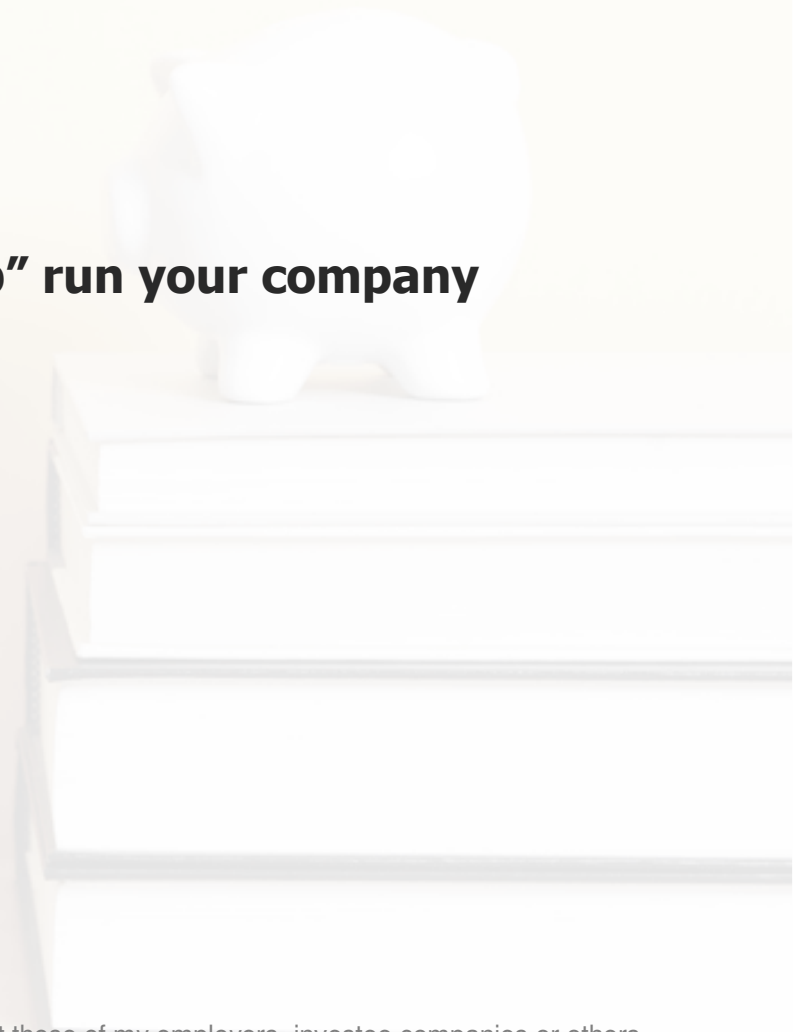
❑ Can last 30-90 days

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP



Pitfalls

- ❑ **Entrepreneurs' Disease: $100\% \times 0 = 0$**
- ❑ **Unrealistic valuations**
- ❑ **Lack of preparation for having a VC "help" run your company**



VC ready deals

- ❑ **Excellent management that has a track record**
- ❑ **Intellectual Property or Subject Matter Expertise or an asset that creates a competitive barrier**
- ❑ **Solves big problems in big markets - \$1B++**
- ❑ **Customer traction – i.e. somebody will buy your widget**
- ❑ **Entrepreneur “skin in the game”**

Case study: Skype

□ Skype

Source: Raising Capital to Fund Growth
Jeff Amerine, PMP

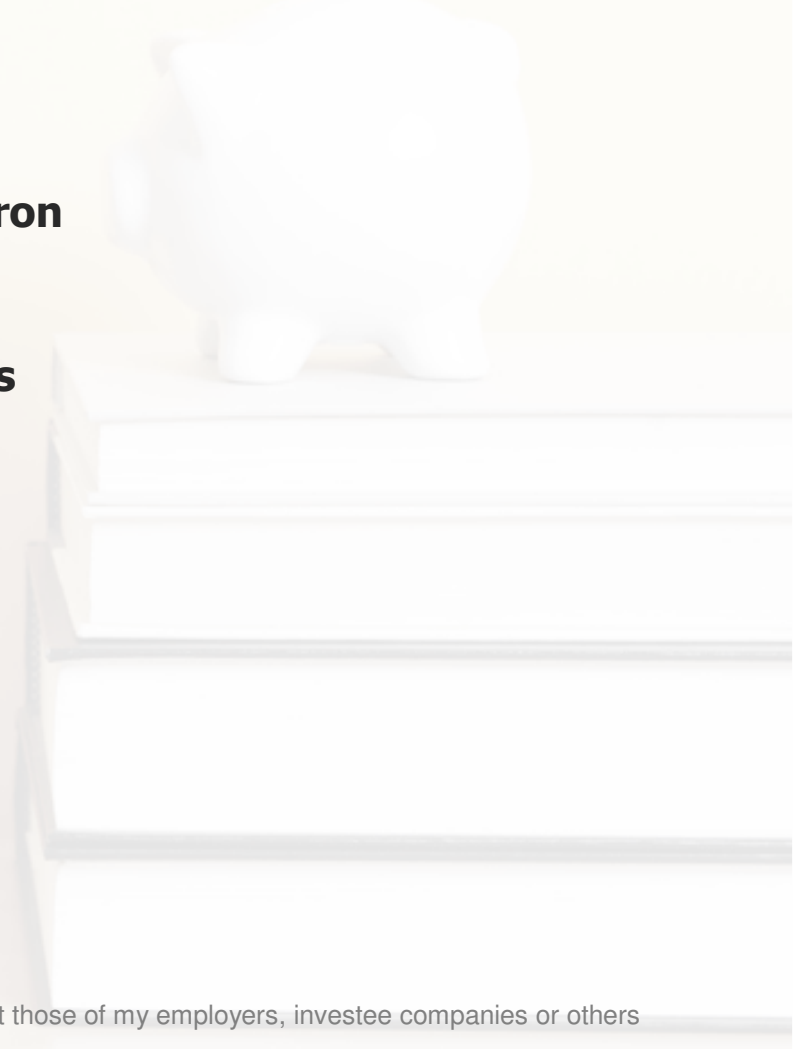
- **VOIP service provider**
- **Revenues based on “eyeballs”, advertising or some such**
- **No cost for PC-to-PC calls**
- **Initial VC investors:**
 - **Draper –Richards: Bill Draper and Howard Hartenbaum - \$250,000 initial investment**
- **Sells to eBay in 2006 for \$2.1B**
- **Initial VCs make 1300X return on their initial investment**

Irrational Exuberance?? Possibly, but some big hits still happen – RARELY.

Strategic Investors

- **Existing Fortune 500 firms**
- **Look to invest in technologies that can benefit their business portfolio**
- **Open to “Extrapreneurship” i.e. spin-outs**
- **Create their own venture funds**
- **Examples: GE, IBM, Intel, Honda, NEC, Chevron**

- **Upside: Can bring tremendous market access**
- **Downside: Very slow moving typically**



Any questions?



Acknowledgements

This is a presentation in an academic setting and borrows freely from publicly shared works as follows:

Raising Capital to Fund Growth

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VENTURES

Venture Capital
For A 5th Grader



Source: Careers in Finance

By Scott Peng