Entrepreneurship and Venture Capital

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Jerry Engel

- UC Berkeley
  - Founder and Executive Director of the Lester Center for Entrepreneurship and Innovation
  - Chair: Entrepreneurship Faculty
  - Teach Entrepreneurship, Venture Capital & Private Equity, Technology Commercialization in the MBA and Executive Ed
- Outside of Academe:
  - Venture Capital
    - Monitor Venture Partners, General Partner
    - Co-founded: Kline Hawkes Capital early '90s
  - Entrepreneur
    - Co-Founder: AllBusiness.com, ElectraScan Inc., CardioProfile
    - Angel Investor, Board member, Advisor: Maxis, Leapfrog, MedAmerica
  - Big Company Experience
    - 1980s: Ernst & Young, Managing Partner, Entrepreneurial Services
      - » Clients: Apple, Intel, Genentech, Sun, Autodesk,Fair Isaac, The Learning Company and more..
    - 1970s: KPMG

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Entrepreneurship and Venture Capital

- What are the Drivers of Innovation?
- Why are Entrepreneurship and Venture Capital Important?
- What is Entrepreneurship?
- How Does Venture Capital Work
- What are the current trends?
- What does all this mean to me?

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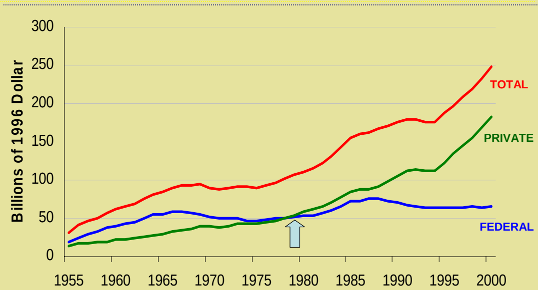
Drivers of Innovation in the US High Tech Model

U.S. Example:
Private **R&D Spending Increasing**



Note: Expenditures are deflated using the GDP implicit price deflator.
Source: National Science Board (2000) and Economic Report of the President (2002)

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The Proportion of Research Expenditure at Our Largest Corporations is Decreasing

Company Size	1981	1989	1999	2000
<1000 employees	4.4%	9.2%	22.5%	22.4%
1,000 - 4,999	6.1%	7.6%	13.6%	15.4%
5,000 - 9,999	5.8%	5.5%	9.0%	8.4%
10,000 - 24,999	13.1%	10.0%	13.6%	14.4%
25,000+	70.7%	67.7%	41.3%	39.5%

Original - H. Chesbrough, 2003 Updated J. Engel 2003
Source: *National Science Foundation, Science Resource Studies, Survey of Industrial Research Development, 1991,1999 and 2000.*

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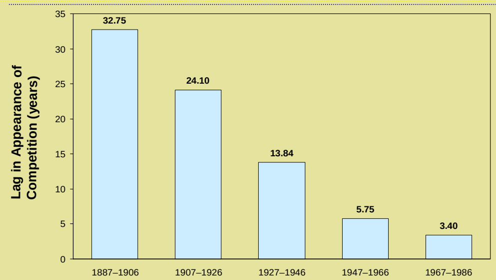
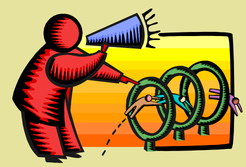
Time to Market Adoption Continues to Decrease



Interval between the introduction of an innovation and competitive entry, 1887-1986. Agarwal and Gort 2001

What is Entrepreneurship ?

- An approach to management that starts with **opportunity**
- Not just small companies
- Not just start ups
- Not simply promoters



Entrepreneurship Bridges the Gap

Entrepreneurship is:

- A process
- Not a person

- About BIG companies that happen to be small
- Not about small business

- Important to BIG business

Entrepreneurship

The pursuit of Opportunity beyond the Resources you currently control

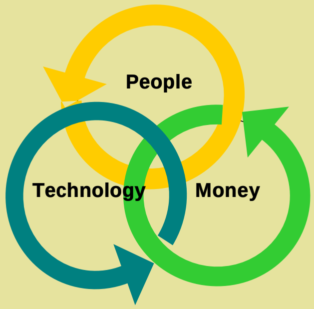
Prof. Howard Stevenson
Working Definition

Entrepreneurial Process

- **Identify** → *Opportunity*
  - Need
  - Solution
  - 'Unfair Advantage'
- **Acquire** → *Resources*
  - Technology rights
  - People
  - Money

The Entrepreneur's Task….

- Key Resources
  - Technology
  - Money
  - People

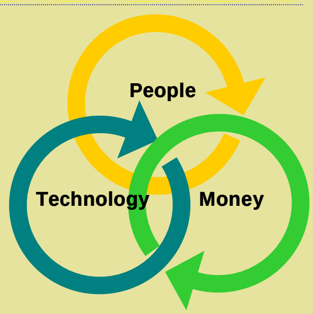


Major Trends……

- Technology
  - Discoveries of large companies and universities commercialized by small companies
- Money
  - From Venture Capitalists: new structures for pooling risk-tolerant investors
- People
  - The rise of the professional entrepreneur and **entrepreneurial teams** as a management process

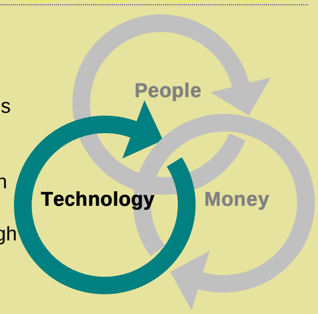
Entrepreneurial Process

- Key Mechanisms:
  - **Mobile** Technology
  - **Mobile** People
  - **Mobile** Money



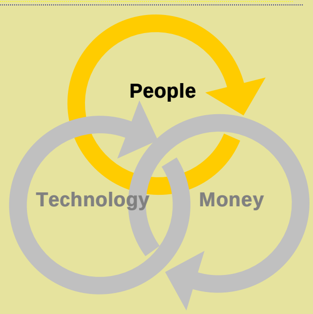
Entrepreneurial Process

- **Mobile** Technology
  - Transfer of technology from research institutions to commercial application
    - Formal - through licensing
    - Informal - through people



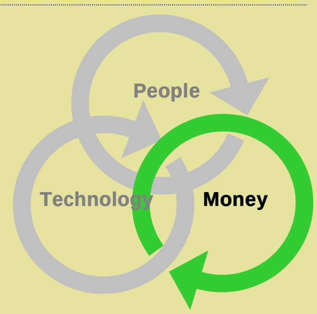
Entrepreneurial Process

- **Mobile** People
  - The emergence of the "professional" entrepreneurial management team
    - Lifestyle: personal mobility, multiple employers
    - Equity compensation
    - Acceptance of the risk of failure



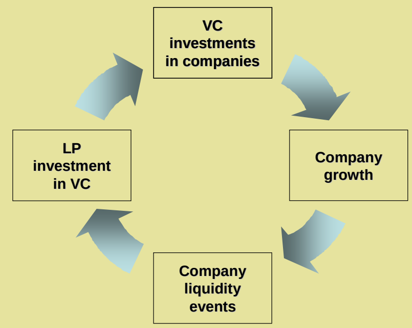
Entrepreneurial Process

- **Mobile** Money
  - New forms of Private Equity
    - International investments by US Venture Capital
    - Multinational corporations become more active
    - Buy-out funds becoming more active
    - Increased sophistication of the Angel communities



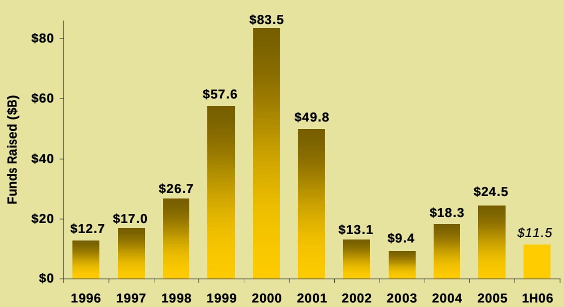
Venture Capital Some Fundementals

Liquidity Cycle in Venture Capital



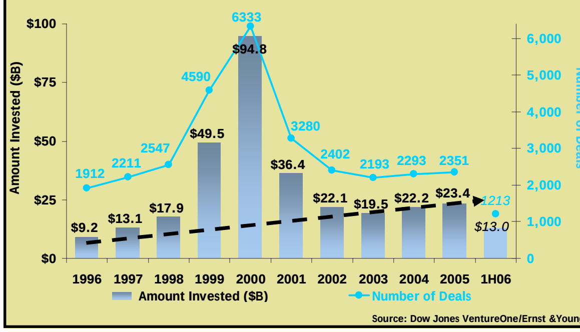
VC: A Cyclical Industry

US Fundraising

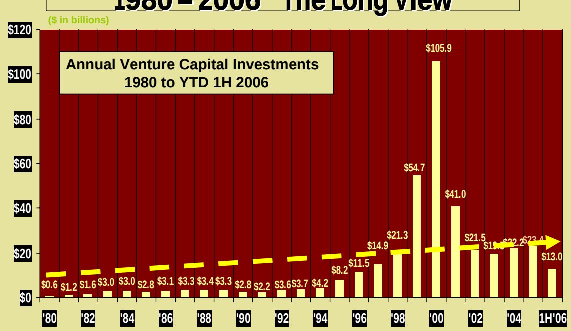


Investment Levels Reflect the Same Cycle

Deal Flow and Equity into Venture-Backed Companies



VC Investment 1980 – 2006 The Long View



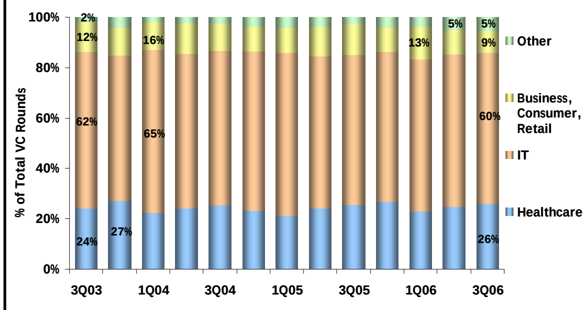
Venture Capital Industry and Geographic Influences

- VC investment is cyclical but on a long term upward trend
- Investment Capital for Entrepreneurial Ventures tends to clump
  - **By Region**
  - **By Industry**
- It is important to understand where VC financing works and Where it does not
- Operating outside the mainstream can add significantly to financing challenges and risk

U.S. Investment: Overall

IT Leads Deal Allocation

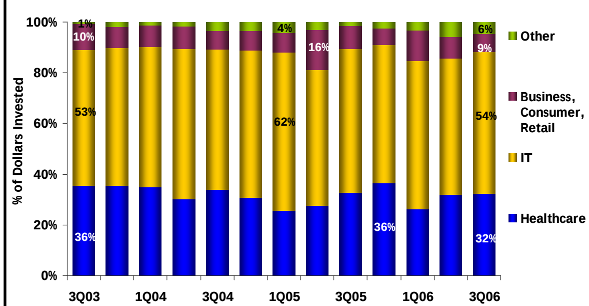
Deal Flow Allocation by Industry Sector



Source: Dow Jones VentureOne/Ernst &Young

IT Dollars Pick Up in 3Q'06

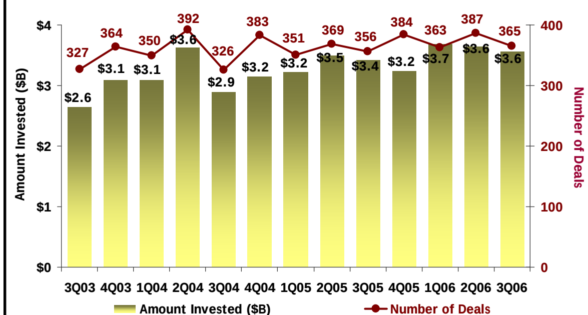
Investment Allocation by Industry Sector



Source: Dow Jones VentureOne/Ernst &Young

Investment in IT Companies Stable in 3Q'06

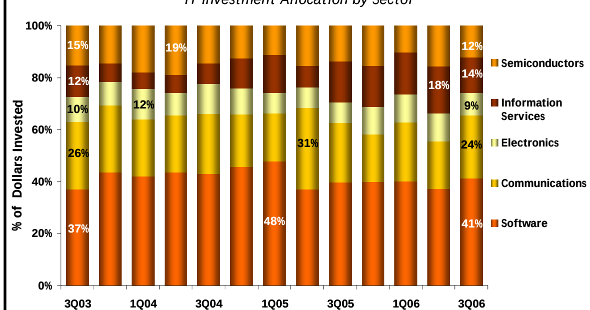
Equity Investment in Information Technology Companies



Source: Dow Jones VentureOne/Ernst &Young

Software Garners Most IT Investment

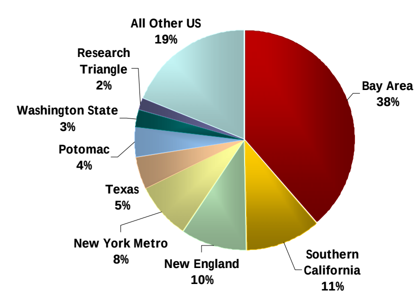
IT Investment Allocation by Sector



Source: Dow Jones VentureOne/Ernst &Young

Bay Area Draws Most Investment Dollars

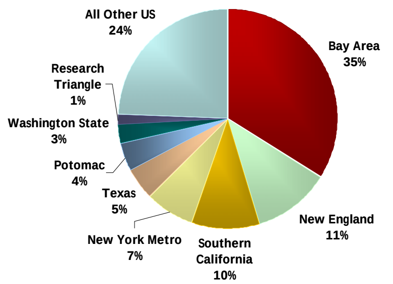
Regional Investment in the United States 3Q'06



Source: Dow Jones VentureOne/Ernst &Young

45% of Deals in California Companies

Regional Deal Flow in the United States 3Q'06

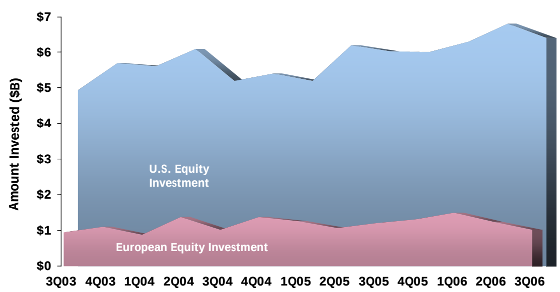


Source: Dow Jones VentureOne/Ernst &Young

European Investment: Overview

Perspective on European Market

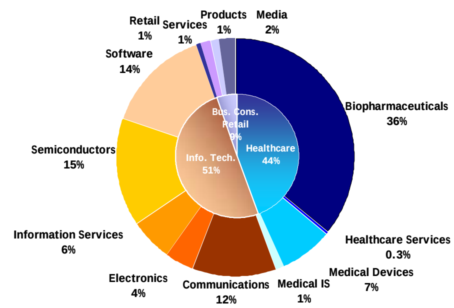
Equity Investment in Venture-Backed Companies, US vs. Europe ($)



Source: Dow Jones VentureOne/Ernst &Young

Biopharm Leads Investing

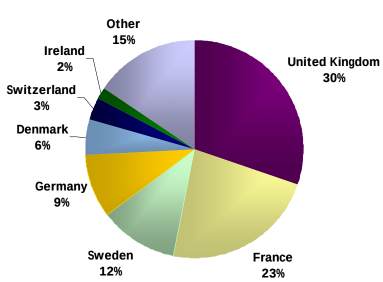
Equity Investment in European Venture-Backed Companies by Industry, 3Q'06



Source: Dow Jones VentureOne/Ernst &Young

UK & France Garner Over Half of Deal Flow

Total Deals in Europe by Country, 3Q'06



Source: Dow Jones VentureOne/Ernst &Young

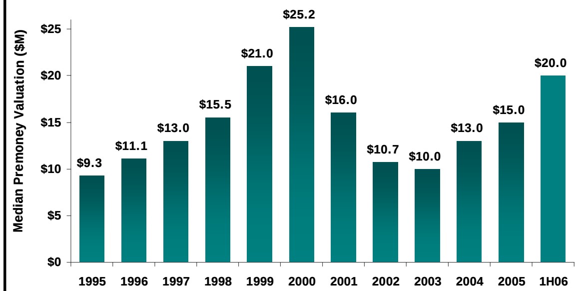
Valuation of the Venture Capital Funded Venture

U.S. Investment: Valuations

This section will be updated in December.

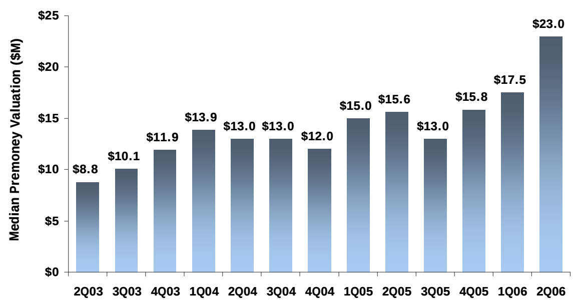
Valuations Continue Upward Trend

Median Premoney Valuation by Year



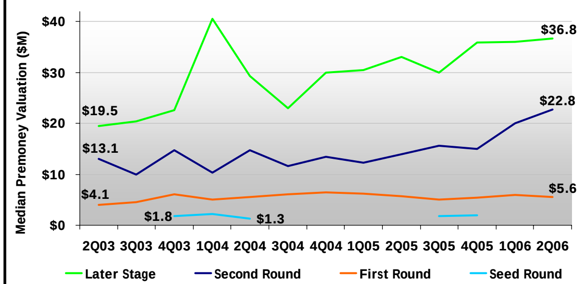
2Q'06 Valuations Soar

Median Premoney Valuation



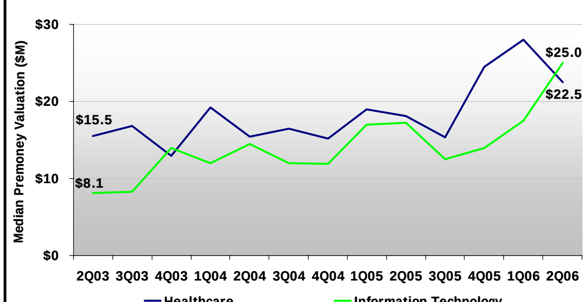
Second Round Valuations Climb

Median Premoney Valuations by Round Class (All Industries)

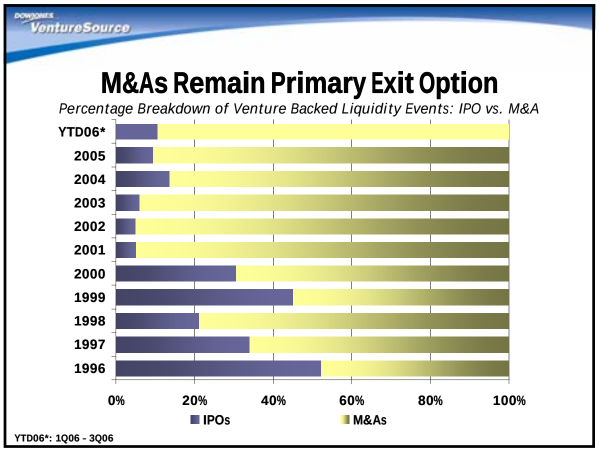


Rising IT Valuations Surpass HC

Median Premoney Valuations by Industry



U.S. Liquidity



What are the Trends we have Observed?

- Venture Capital is a very special and unique category of PE
- It is highly concentrated in a few unique locations and industries
- Cyclicality and uncertainty are key factors
- There are surprising consistencies given these factors
- UC Berkeley, right here, right now – is a unique and great place to study VC!

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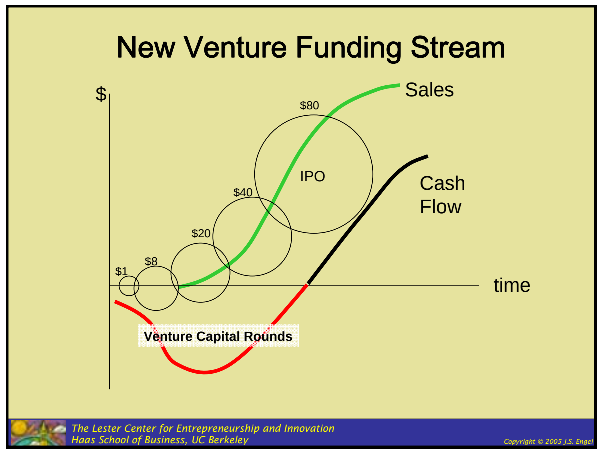
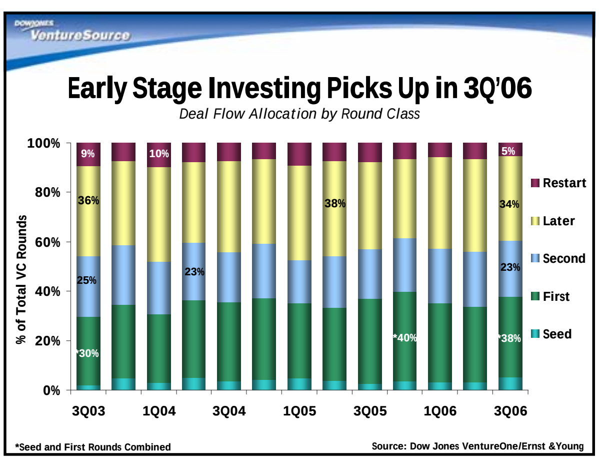
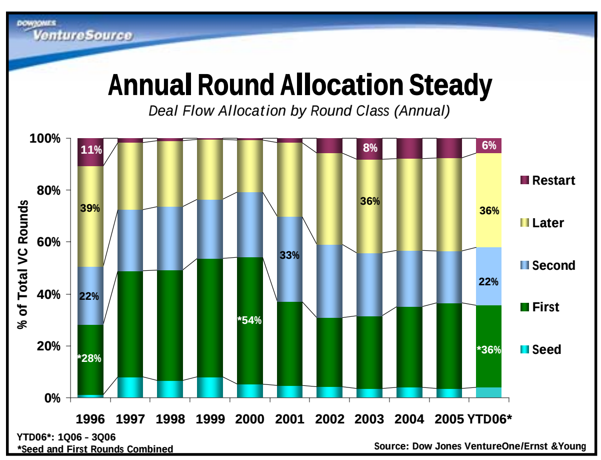
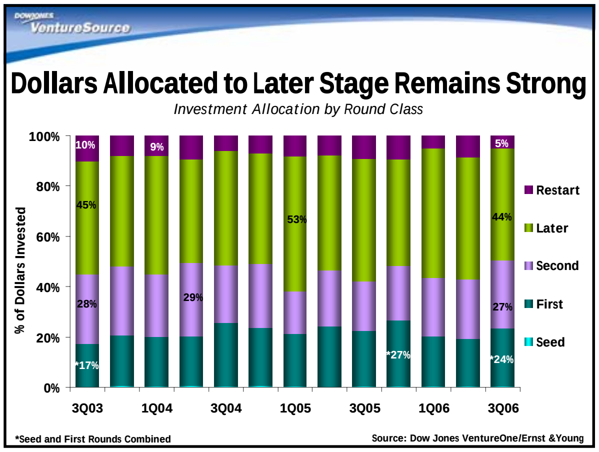
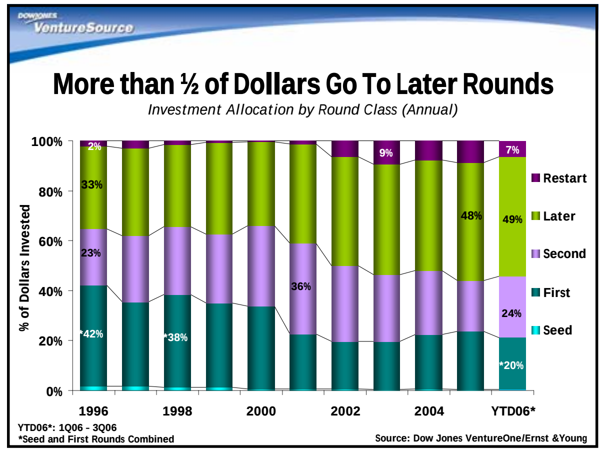
Financing Design of the Venture Capital Funded Venture

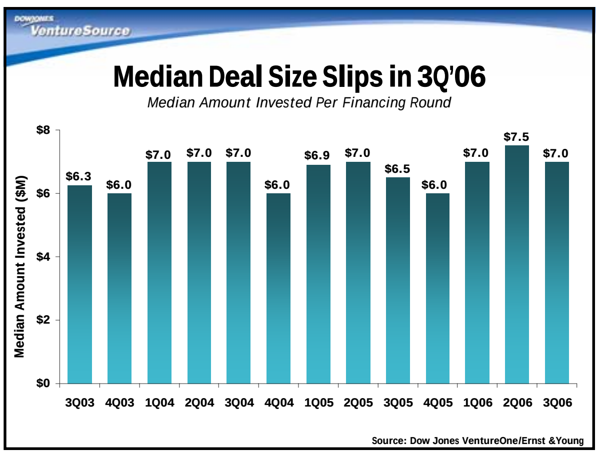


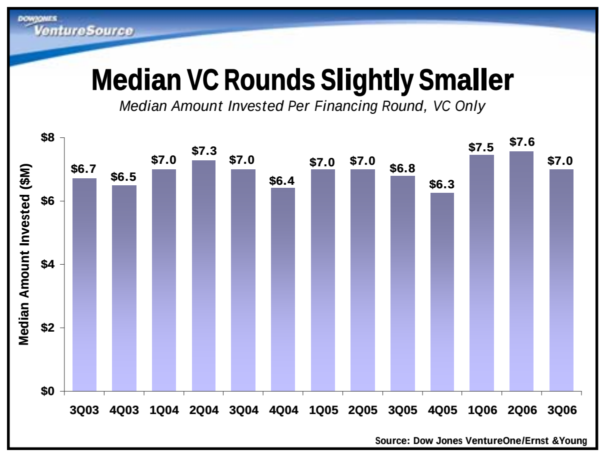


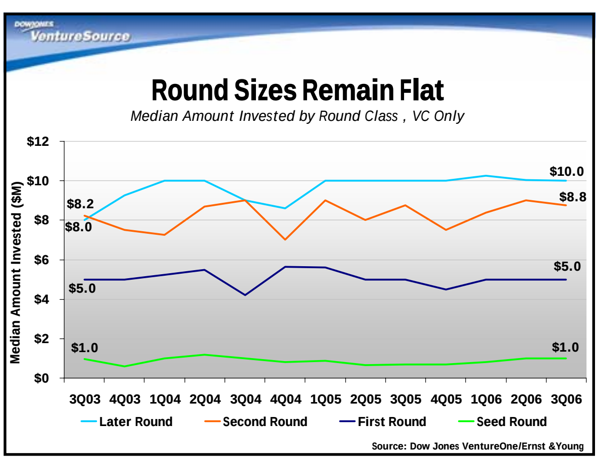


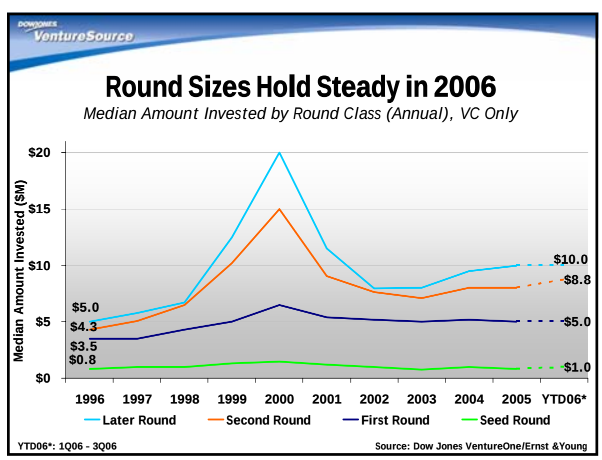

VentureSource
Dollars Allocated to Later Stage Remains Strong
Investment Allocation by Round Class
% of Dollars Invested
100%
80%
60%
40%
20%
0%
10%
9%
5%
45%
53%
44%
28%
29%
27%
*17%
*27%
*24%
3Q03
1Q04
3Q04
1Q05
3Q05
1Q06
3Q06
Restart
Later
Second
First
Seed
*Seed and First Rounds Combined
Source: Dow Jones VentureOne/Ernst &Young


VentureSource
More than ½ of Dollars Go To Later Rounds
Investment Allocation by Round Class (Annual)
% of Dollars Invested
100%
80%
60%
40%
20%
0%
2%
9%
7%
33%
48%
49%
23%
36%
24%
*42%
*38%
*20%
1996
1998
2000
2002
2004
YTD06*
Restart
Later
Second
First
Seed
YTD06*: 1Q06 - 3Q06
*Seed and First Rounds Combined
Source: Dow Jones VentureOne/Ernst &Young


VentureSource
Median Deal Size Slips in 3Q'06
Median Amount Invested Per Financing Round
Median Amount Invested ($M)
$8
$6
$4
$2
$0
$6.3
$6.0
$7.0
$7.0
$7.0
$6.0
$6.9
$7.0
$6.5
$6.0
$7.0
$7.5
$7.0
3Q03 4Q03 1Q04 2Q04 3Q04 4Q04 1Q05 2Q05 3Q05 4Q05 1Q06 2Q06 3Q06
Source: Dow Jones VentureOne/Ernst &Young

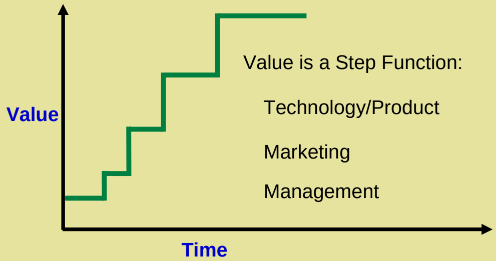

VentureSource
Median VC Rounds Slightly Smaller
Median Amount Invested Per Financing Round, VC Only
Median Amount Invested ($M)
$8
$6
$4
$2
$0
$6.7
$6.5
$7.0
$7.3
$7.0
$6.4
$7.0
$7.0
$6.8
$6.3
$7.5
$7.6
$7.0
3Q03 4Q03 1Q04 2Q04 3Q04 4Q04 1Q05 2Q05 3Q05 4Q05 1Q06 2Q06 3Q06
Source: Dow Jones VentureOne/Ernst &Young


VentureSource
Round Sizes Remain Flat
Median Amount Invested by Round Class , VC Only
Median Amount Invested ($M)
$12
$10
$8
$6
$4
$2
$0
$8.2
$8.0
$5.0
$1.0
$10.0
$8.8
$5.0
$1.0
3Q03 4Q03 1Q04 2Q04 3Q04 4Q04 1Q05 2Q05 3Q05 4Q05 1Q06 2Q06 3Q06
Later Round
Second Round
First Round
Seed Round
Source: Dow Jones VentureOne/Ernst &Young

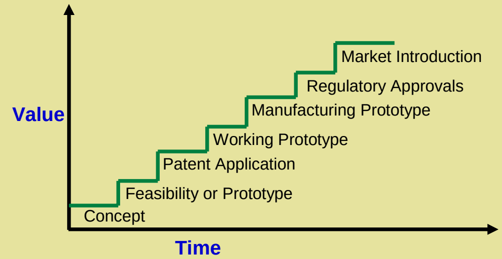

VentureSource
Round Sizes Hold Steady in 2006
Median Amount Invested by Round Class (Annual), VC Only
Median Amount Invested ($M)
$20
$15
$10
$5
$0
$5.0
$4.3
$3.5
$0.8
$10.0
$8.8
$5.0
$1.0
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 YTD06*
Later Round
Second Round
First Round
Seed Round
YTD06*: 1Q06 - 3Q06
Source: Dow Jones VentureOne/Ernst &Young

Structuring the Financing

The “Why” of multiple rounds



Adding Technology Value



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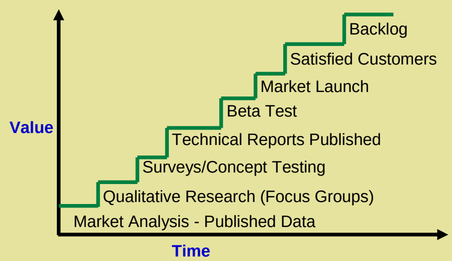
Adding Market Value



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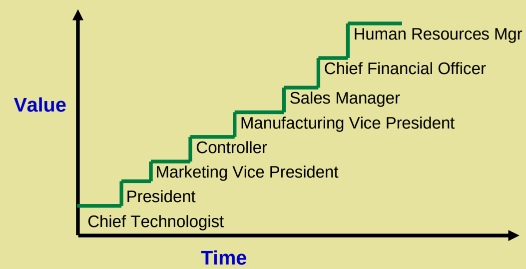
Adding Management Value



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Startup Company Valuation Model: The Expanding Value Pie*

* [or not confusing ownership with value]

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Company Formation

Founders A, B and C each purchase 1M shares of Common Stock at a purchase price of $.001 per share.

Person	Shares	% Total	Value
Founder A	1,000,000	33.3%	$1,000
Founder B	1,000,000	33.3%	$1,000
Founder C	1,000,000	33.3%	$1,000
totals	3,000,000	100%	
		Post-Money Valuation	**$3,000**

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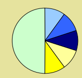
Hiring a President/CEO
Creation of an Option Plan

The company hires a chief executive officer who purchases 1M shares of Common Stock at a purchase price of $.01 per share. Additionally, in order to attract additional key employees, the Company establishes an employee stock option plan and reserves 1M shares of Common Stock for issuance under this plan. The pre-financing valuation is $30,000.

Person	Shares	% Total	Value
Founder A	1,000,000	20.0%	$10,000
Founder B	1,000,000	20.0%	$10,000
Founder C	1,000,000	20.0%	$10,000
President	1,000,000	20.0%	$10,000
Option Plan	1,000,000	20.0%	$10,000
totals	5,000,000	100%	
		Post-Money Valuation	**$50,000**

Initial Venture Capital Round

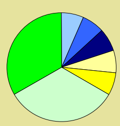
$5,000,000 venture capital financing at a purchase price of $1 per share, representing a pre-financing valuation of $5,000,000 (5M shares with a value of $1 per share). The new shares are typical venture capital Series A Preferred Stock, with each share of Series A Preferred Stock being convertible into one share of Common Stock.



Person	Shares	% Total	Value
Founder A	1,000,000	10.0%	$1,000,000
Founder B	1,000,000	10.0%	$1,000,000
Founder C	1,000,000	10.0%	$1,000,000
President	1,000,000	10.0%	$1,000,000
Option Plan	1,000,000	10.0%	$1,000,000
Series A Inv	5,000,000	50.0%	$5,000,000
totals	10,000,000	100%	
		Post-Money Valuation	**$10,000,000**

Series B Preferred Financing

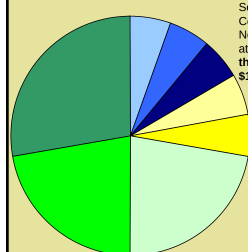
$10,000,000 Series B Preferred Stock financing at a purchase price of $2 per share, representing a pre-financing valuation of $20,000,000 (10M shares with a value of $2 per share). Like the Series A Preferred Stock, each share of Series B Preferred Stock is convertible into one share of Common Stock.



Person	Shares	% Total	Value
Founder A	1,000,000	6.7%	$2,000,000
Founder B	1,000,000	6.7%	$2,000,000
Founder C	1,000,000	6.7%	$2,000,000
President	1,000,000	6.7%	$2,000,000
Option Plan	1,000,000	6.7%	$2,000,000
Series A Inv	5,000,000	33.3%	$10,000,000
Series B Inv	5,000,000	33.3%	$10,000,000
totals	15,000,000	100%	
		Post-Money Valuation	**$30,000,000**

Initial Public Offering (IPO)

A total of 5M shares to be sold in the offering, including 3M shares sold by the Company and 1M shares sold by each of the Series A and Series B investors. Shares will be sold at a price of $10 per share, representing a pre-financing valuation of $150,000,000 (15M shares with a value of $10 per share.)



Series A and Series B Preferred Stock automatically converted into Common Stock. All shares sold in offering will be Common Stock. Note that the interest of each founder has decreased from 33.33% at the Company's formation to 5.55% following the IPO. However, **the value of the interest of each founder has increased from $1,000 to $10,000,000.**

Person	Shares	% Total	Value
Founder A	1,000,000	5.6%	$10,000,000
Founder B	1,000,000	5.6%	$10,000,000
Founder C	1,000,000	5.6%	$10,000,000
President	1,000,000	5.6%	$10,000,000
Option Plan	1,000,000	5.6%	$10,000,000
Series A Inv	4,000,000	22.2%	$40,000,000
Series B Inv	4,000,000	22.2%	$40,000,000
Public IPO	5,000,000	27.8%	$50,000,000
totals	18,000,000	100%	
		Post-Money Valuation	**$180,000,000**

How to Evaluate a Deal from the Company's Perspective

- Founder's Issues
- Employee's Issues
- Corporate Issues
  - Sufficient Capital
  - Freedom of Operation
- Previous Investor and Creditor Issues
- Etc.

How to Evaluate a Deal from the Investor's Perspective

- Potential for Adequate Return
- Opportunity for a Home Run?
- Potential 'Fatal Flaws'
- Time Requirements
- Follow-on Investment Requirements
- Portfolio and Fund Compatibility
- Etc.

Effect of Eleven Factors on Company Valuation

Variables	Lower Valuation	Higher Valuation
Technology		
• Stage of Development	Concept	Product
• Patent Status	None Filed	Issued
• Time to Market	Long	Short
Market		
• Demonstrable Need	No	Yes
• Size & Growth	Small	Large
• Market Penetration	Slow	Rapid
Management Team	Novice	Tested
Financial		
• Profit Margins	Low	High
• Total Capital Required	High	Low
Return on Investment		
• Potential Future Valuation	Low	High
• Time to Liquidity	Long	Short

The Term Sheet

- Corporate Form
  - Typically NOT a pass-through
- Common Stock [*sweat*]
  - Founders Stock
    - Nominal Issuance
    - Vesting
  - Incentive Stock options
- Preferred Stock [*money*]
  - Convertible
  - Liquidation Preference
  - Dividends
  - Antidillution Protection
  - Voting Rights
  - Board Representation
- Protective Provisions
  - Sale of Company
  - Additional Issuances of Stock
  - Co-investment Rights
  - Information Rights
  - Demand and Piggy-Back Registration Rights
- Expenses

The Venture Capital Model and The Professional Entrepreneur

Venture Capital and the Professional Entrepreneur

- Staged financing to match the stages of growth
- How the Professional Entrepreneur manages rapid transitions through the stages
- How the Entrepreneurial Ecosystem supports rapid growth

The Professional Entrepreneur

Meshing with VC model;

- How does the entrepreneur have to behave?
- How does company have to be structured?

TO ACHIEVE HYPERGROWTH!

The Professional Entrepreneur

This means starting new businesses that are designed to grow rapidly

This rapid growth poses special problems and requires special skills

The Professional Entrepreneur

Motivations:

- **To make money**
- **To build an ego monument**
- **To to put some new technology to use**
- **To runs one's own show**
  - **To avoid authority**
  - **To build something new**

The Professional Entrepreneur

Opportunity:

- **Lethargy of the big boys (girls)**
- **Speed of the process lies in access to *resources***
- **Entrepreneurs are not necessarily *strong managers***
- **Entrepreneurs are gatherers of resources**
- **Managers are efficient allocators**

The Professional Entrepreneur

People who start new companies need to know how to attract resources:

- Concept of the company
  - **Business model**
  - **Customer and need**
  - **Why it is an opportunity for the *investor***

The Professional Entrepreneur

People who start new companies need to know how to attract resources:

- Oral presentation skills
- Reference accounts
  - **Why they would buy from this company**
  - **Are they spending money now?**

The Professional Entrepreneur

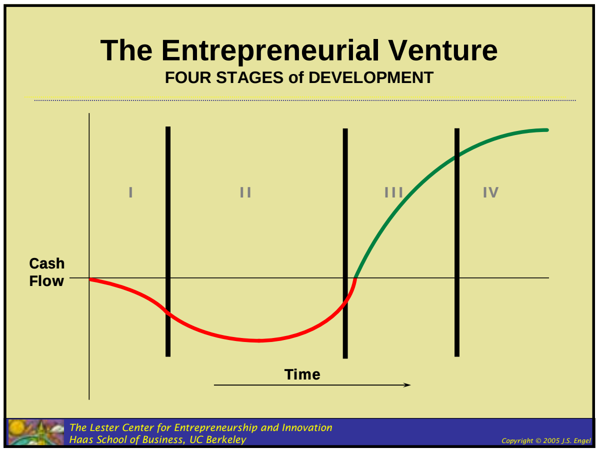
VC's look for:

- Big opportunities and the talents for rapid acceleration
  - **Obvious strategic alliances**
  - **Well-rounded management team (how much time will it take to advise)**

The Professional Entrepreneur

What makes someone "professional?"

- **Separation of what is good for the person from what is good for the company (required if outside investors)**
- **Recognition of what one is *not* good at**
- **Ability to change one's role to fit needs**
- **Serial entrepreneur**


The Entrepreneurial Venture
FOUR STAGES of DEVELOPMENT
I
II
III
IV
Cash Flow
Time
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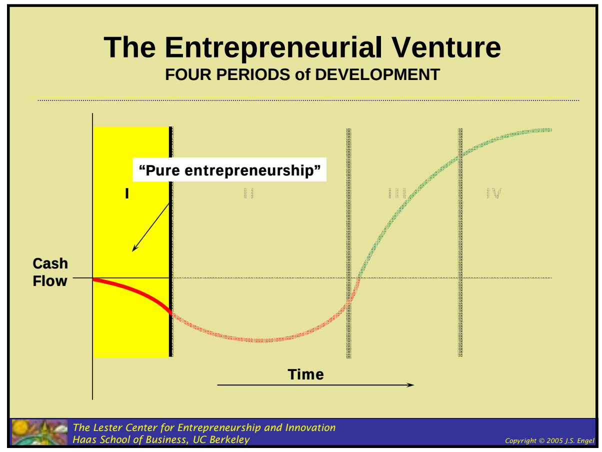
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FOUR PERIODS of DEVELOPMENT
"Pure entrepreneurship"
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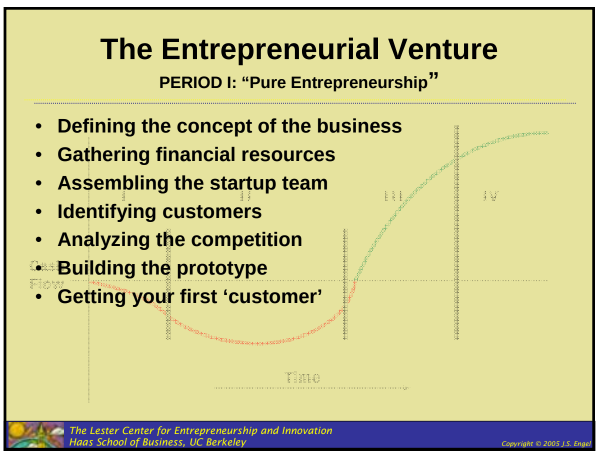
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PERIOD I: "Pure Entrepreneurship"
• Defining the concept of the business
• Gathering financial resources
• Assembling the startup team
• Identifying customers
• Analyzing the competition
• Building the prototype
• Getting your first 'customer'
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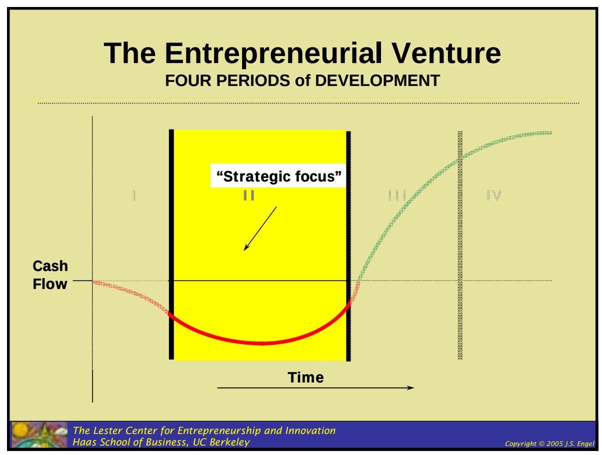
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FOUR PERIODS of DEVELOPMENT
"Strategic focus"
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Cash Flow
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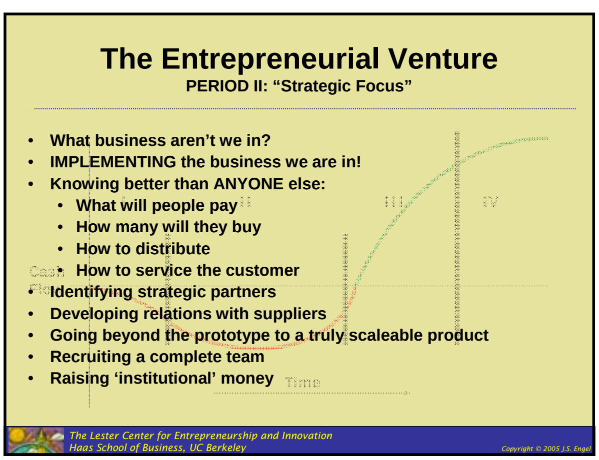
The Entrepreneurial Venture
PERIOD II: "Strategic Focus"
• What business aren't we in?
• IMPLEMENTING the business we are in!
• Knowing better than ANYONE else:
• What will people pay
• How many will they buy
• How to distribute
• How to service the customer
• Identifying strategic partners
• Developing relations with suppliers
• Going beyond the prototype to a truly scaleable product
• Recruiting a complete team
• Raising 'institutional' money
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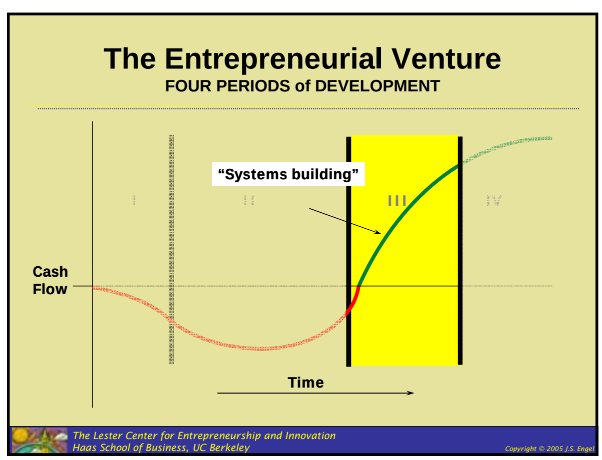
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FOUR PERIODS of DEVELOPMENT
"Systems building"
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III
IV
Cash Flow
Time
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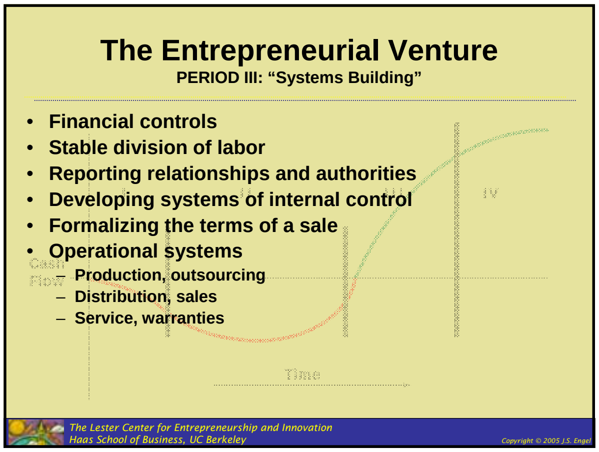
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PERIOD III: “Systems Building”
• Financial controls
• Stable division of labor
• Reporting relationships and authorities
• Developing systems of internal control
• Formalizing the terms of a sale
• Operational systems
– Production, outsourcing
– Distribution, sales
– Service, warranties
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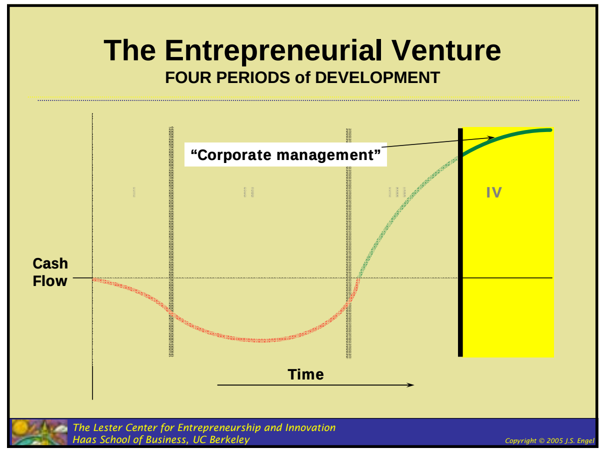
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FOUR PERIODS of DEVELOPMENT
“Corporate management”
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IV
Cash Flow
Time
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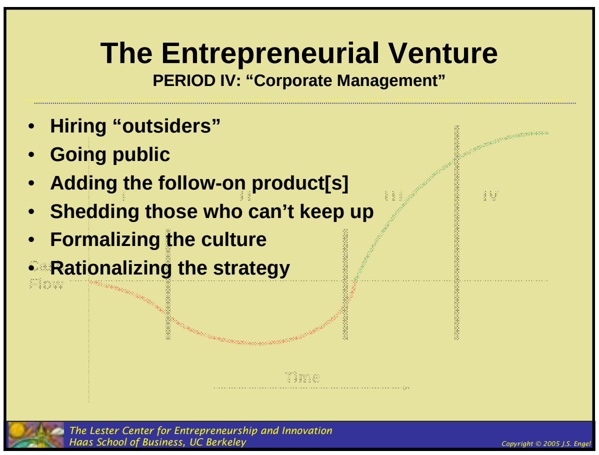
The Entrepreneurial Venture
PERIOD IV: “Corporate Management”
• Hiring “outsiders”
• Going public
• Adding the follow-on product[s]
• Shedding those who can’t keep up
• Formalizing the culture
• Rationalizing the strategy
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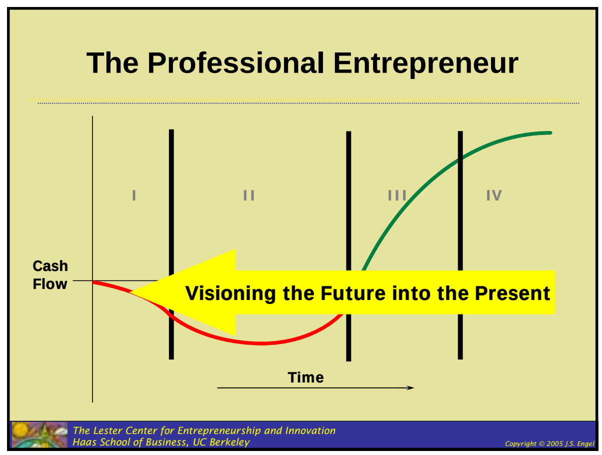
The Professional Entrepreneur
I
II
III
IV
Cash Flow
Visioning the Future into the Present
Time
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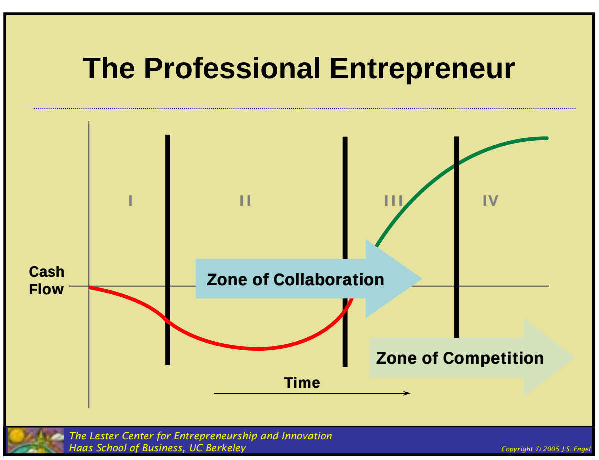
The Professional Entrepreneur
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III
IV
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Zone of Collaboration
Zone of Competition
Time
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Venture Capital and the Professional Entrepreneur
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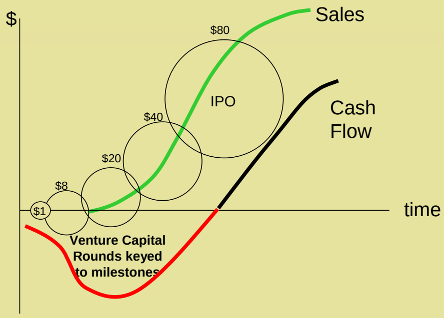
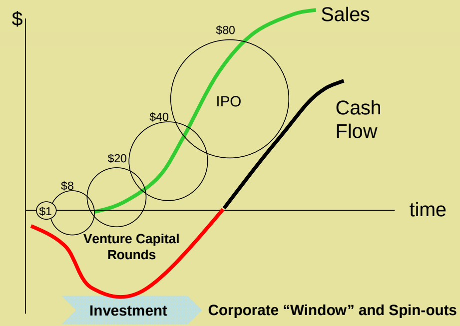
New Venture Funding Stream



New Venture Funding Stream



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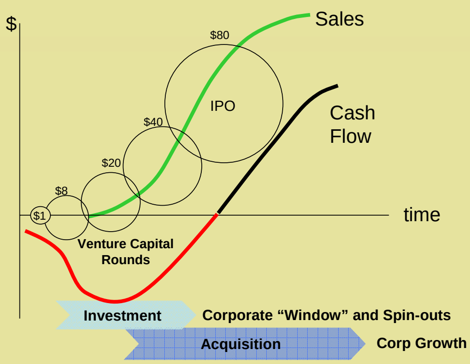
New Venture Funding Stream



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The Professional Entrepreneur

The game changes over time. What makes one good at it at one point may actually hurt at another.

Dilemma - entrepreneurial success leads to managerial failure.

Why?

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The Professional Entrepreneur

Axiom: Difficulty of managerial work driven by problem complexity

Axiom: Problem complexity driven by complexity of the company

Axiom: Company complexity increases with growth

The faster the company grows, the more difficult it is to manage.

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The Professional Entrepreneur

The better a person is at being an entrepreneur, the faster the company grows.

The Professional Entrepreneur

People start with some level of managerial skill and learn as they go along.

The smarter they are, the faster they learn, and their learning curve is more steeply sloped.

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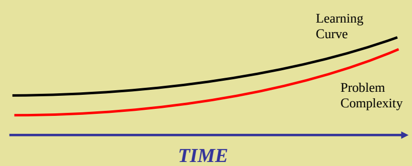
The Professional Entrepreneur

Slow growing firm



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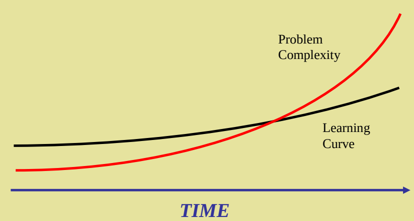
Fast growing firm



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The Professional Entrepreneur

So**:**

- **Rapid growth often requires an infusion of managerial expertise**
- **Founders have to lower their influence or exit**
- **The motivations discussed earlier are impacted differently - so prioritize**

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The Professional Entrepreneur
Building Relationships

Strategic partner/ Distribution

Key Suppliers

Accounting Firm

Advisory Board

Key Hires

Reference Customer

Exec Search

Law Firm

Venture Capital 1

Venture Capital 2

Venture Capital 3

Venture Capita 4

TIME

Angel/ Seed

Series A

Series B

Series C Venture Debt Mezzanine

Entrepreneurship @ Haas

Entrepreneurship is a Team Sport

Thank You