PRINCIPLE OF ENTREPRENEURIAL FINANCE

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Chandra Shekhar Rajora

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CHAPTER 1

INTRODUCTION ABOUT ENTREPRENEURIAL FINANCE CHALLENGES

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ABSTRACT:

Entrepreneurial finance encompasses the unique financial challenges faced by entrepreneurs and startups in acquiring, managing, and utilizing financial resources to launch and grow their ventures. This abstract explores the key challenges and complexities associated with entrepreneurial finance and their implications for entrepreneurs, investors, and the overall entrepreneurial ecosystem. The abstract begins by highlighting the importance of finance in the entrepreneurial journey. Access to capital is critical for entrepreneurs to fund their business ideas, develop products or services, scale operations, and navigate through various stages of growth. However, the financing landscape for entrepreneurs is characterized by distinct challenges and uncertainties compared to traditional corporate finance.

KEYWORDS:

Angel Investors, Cash Flow Management, Debt Financing, Equity Financing, Financial Forecasting, Funding Gap, Initial Capital.

INTRODUCTION

An introduction to entrepreneurial finance is given here. It outlines the main difficulties that business owners who seek to acquire funds and investors searching for investment possibilities confront. It also illustrates why entrepreneurial finance is important for fostering economic development, enabling investors to make high returns, and the entrepreneurial process of starting new businesses. The is a straightforward structure that offers a thorough overview of how business owners and investors engage throughout the full fundraising cycle. Furthermore, it gives a structured method for comprehending the characteristics of various investor kinds[1], [2]. An interplanetary collision sets the scene. The conflict between the realms of entrepreneurship and finance is centered on entrepreneurial financing. They are poles apart from one another. The financial industry is organized and disciplined, focusing on taking measured risks and seeking out successful past performance. Contrarily, entrepreneurship is a chaotic and disruptive endeavor that relies on forging forward off the established path into the uncharted. Finance is focused on facts and logical reasoning and is considered to be a left-brain activity. Entrepreneurship is a right-brain activity that relies on experimentation and intuition[3], [4].

Who wants to be thrown into such conflict? Investors and entrepreneurs may feel as if they are from other planets and have different languages. Being a part of an interplanetary collision, though, cannot possibly be more thrilling. Maybe something large and novel will come of it. Combining the viewpoints of investors and entrepreneurs might open up new possibilities. Innovative businesses that upend markets and business models, produce wealth, and improve people's lives may be born as a consequence. What greater difficulty could there possibly be than uniting the left and right sides of the brain? Here we are at entrepreneurial finance! This book's major objective is to explain the funding mechanisms used by entrepreneurial businesses. The supply of money to new, creative, growth-oriented businesses is what we mean by entrepreneurial finance. Entrepreneurial businesses are often under ten years old. They offer novel goods or commercial strategies. Start-ups are those businesses that fall under this category and are often less than five years old. According to research by Koellinger and Thurik, entrepreneurial businesses are crucial for creating business cycles. The focus on expansion by entrepreneurial businesses is crucial. They differ from small companies and small and medium-sized enterprises because of this. Although entrepreneurial enterprises often fit the statistical definition of small businesses, in reality they don't share many characteristics with their statistical counterparts. Consider corner stores or business services. The majority of small companies are designed to stay small. Less than a quarter of the small firms studied by Hurst and Pugsley in the United States desired to expand rapidly[5], [6].

The median answer to the question of how many workers should be employed by a company by the time it is five years old was four. Entrepreneurial businesses, on the other hand, aim to expand significantly by engaging in some innovation. Simply said, whereas entrepreneurial enterprises challenge the established quo, small businesses reflect it. We take into account a broad range of start-ups in this book. Some companies commercialize science-based technologies, such as advances in artificial intelligence or biotechnology. The introduction of new goods or services is often made possible by technological advancements, as is the case with electronic commerce and digital health. Other startups make use of new technology without really coming up with any breakthroughs. In terms of product variations, marketing strategies, or business structures, they innovate. For instance, start-ups like Uber, Didi, Grab, and Lyft have employed mobile telephony and geopositioning technologies to disrupt the taxi industry's ten-year-old business model. Similarly, Wi-Fi internet, cloud storage, and data compression technologies have been used by Pandora, Spotify, Beats, or Tidal to distribute high-quality music without the need for a physical media and to upend the music distribution industry.

Then there are startups that don't use any technology at all and instead focus on launching new goods or services. We'll refer to these young, ambitious, growth-oriented businesses as start-ups, entrepreneurial enterprises, and ventures throughout the book. There are a surprising range of investors who can support entrepreneurial enterprises on the financial side of the interplanetary collision. Family and friends provide some early capital to launch the business. Wealthy people who make start-up investments are referred to as business angels. For institutional investors like pension funds, insurance companies, and university endowments, venture capital firms are associations of professional investors that manage investment funds. Established businesses make strategic investments. Platforms for crowdfunding may be used by business owners to connect with the general public. The term venture investors refers to all of the investors we look at in this book. Each sort of investor has a particular reason for investing, which may be anything from supporting a local business to making a high financial return to assisting a buddy. Additionally, investors vary in terms of their ability to finance projects and decision-making processes.

At its foundation, entrepreneurial finance is a transaction between an entrepreneur and an investor in which the former provides the latter a claim to the latter's future profits. This claim is part of a financing agreement between business owners and investors, which depends on a strong legal system and mutual confidence between the parties. Others employ a variety of other arrangements, while still others combine loans and equity. Entrepreneurs need to be aware of the implications of these agreements. It may be difficult to navigate this complicated industry, particularly for beginning companies. All of these topics will be examined and clarified in this book. On the website for the book, www.entrepreneurialfinance.net, we furthermore provide a number of useful tools and supplementary information.

We need to take into account the whole entrepreneurial process, which entrepreneurs use to transform ideas into enterprises, in order to make sense of these apparently unfathomable realms. This is a protracted and dangerous procedure success takes years and failure is always a possibility. To build a company concept, the process begins with the choice to become an entrepreneur.5 At first, a founder or founders see an opportunity that offers a creative response to an unmet need. By organizing their intuition into some kind of a company plan and carrying out its early stages, the entrepreneurs carry out their vision. This often involves persuading clients, partners, personnel, and financiers of the opportunity's benefits. Entrepreneurs discover the underlying potential and the myriad difficulties in putting it into practice while gathering resources. They often change their trajectory to response to newly learned knowledge and to changing conditions. A normal start-up gradually employs staff, creates prototypes, wins its first clients, increases its market share, forms strategic partnerships, develops new products, and expands into other markets. The start-up normally requires large sums of financing along the road. When a business fails, is purchased, or develops into a well-known corporation, the entrepreneurial process is complete.

Entrepreneurs begin planning their enterprises long before they seek investors for money, which is important to grasp in order to fully appreciate the difficulties of the entrepreneurial process. We must thus comprehend the underlying entrepreneurial process in order to fully comprehend entrepreneurial finance. Since every entrepreneur has a unique journey, it is hard to precisely describe the entrepreneurial process as a whole. Nevertheless, there are three overarching concepts that may be used to explain how entrepreneurs create their organizations, the specific difficulties they encounter, and the kind of advancement they make. Gathering resources, uncertainty, and experimenting are these concepts. The first tenet of entrepreneurship is founded on the ideas of Austrian economist Joseph Schumpeter, who defined entrepreneurship as the repurposing of resources to produce something new. Therefore, the entrepreneurial process entails obtaining resources from many owners and merging them in a unique and beneficial method. One of the most crucial resources for entrepreneurs to obtain is financing. Because money enables business owners to obtain other resources, it serves a vital function. Therefore, obtaining money is an essential phase in the entrepreneurial process.

The second premise acknowledges the inherent uncertainty of the entrepreneurial process. Risk and uncertainty vary significantly, according to American economist Frank Knight. When the result of a procedure is uncertain but there is trustworthy knowledge on the underlying probability distribution of outcomes, the situation is said to be at risk. For instance, when we throw a dice, we have no idea which side will appear but are certain that only one of six possibilities are possible. Contrarily, uncertainty denotes the absence of knowledge on the possible outcomes and their probability. For instance, no one is aware of the likelihood of discovering alien life, much alone what it will like. The latter group includes the entrepreneurial process. When it comes to the range or possibility of outcomes, as well as the connection between their actions and those prospective consequences, entrepreneurs lack reliable knowledge. This ambiguity does not occur by accident. When there is significant ambiguity, we refer such an opportunity as entrepreneurial. When the results are clear, the business prospects are managerial rather than entrepreneurial. The third principle, which has to do with experimenting, is based on the groundbreaking work of American sociologist James March. His study primarily focuses on how organizations decide what to do and how they develop through time. The difference between exploitation and exploration as two diametrically opposed organizational approaches was first made in March. Established businesses often engage in exploitation because they prioritize on their present competitive advantages. Younger, more nimble firms, particularly start-ups, benefit more from exploration.

Entrepreneurs must exhibit adaptable behaviors since they are uncertain of the road even if they follow a long-term objective. Exploring new options always results in surprises and dead ends, therefore experimentation is essential to entrepreneurship. Entrepreneurs are forced to modify their strategies as time passes. This is known as pivoting in today's corporate jargon. Contrarily, established organizations find it more challenging to experiment since they depend on the reliable execution of established processes. These three guidelines not only aid in our comprehension of the entrepreneurial process but also make clear the challenges that investors encounter. According to the first tenet, investors' contributions to the venture will be crucial to its growth. According to the second tenet, investors will have to deal with uncertainty during the whole process. The third concept contends that while dealing with entrepreneurs, investors must also be adaptable. Together, these ideas suggest that the funding of startups occurs in phases, each of which involves risk-taking, testing, and learning [7]–[9].

DISCUSSION

Entrepreneurial finance will inevitably be chaotic since it is the collision of two worlds. From the standpoint of the entrepreneur, getting money might be confusing. To begin with, it is challenging to identify and contact the appropriate investors. Entrepreneurs need to look for different types of investors, each with their own decision processes and objectives, instead of talking to their banker; once in front of investors, they have to pitch their businesses, frequently at a stage where all they have are ideas but no proofs if they actually manage to persuade the investors of their ideas, they need to answer questions. Investors are inundated with business proposals a typical VC firm, for example, might receive well over a thousand business plans per year. Investors screen numerous opportunities and then investigate a smaller number more thoroughly. If they like what they see, they then have to decide whether to offer a deal, knowing that they may not get their money back. Finding a good match, getting a good deal, getting through the ride, and finding their way to a successful exit are challenges that both entrepreneurs and investors worry about to some extent; however, their experiences with handling these challenges can be very different, especially when they are not equally familiar with the process.

How Vital Is Entrepreneurial Finance?

In addition to being interesting and difficult, entrepreneurial finance is crucial for businesses, investors, and the economy as a whole. From the entrepreneur’s perspective, obtaining financing is vital for the success of her business. Most entrepreneurs do not have the resources to fund their ventures, so they need to raise money from outside investors. Funding is essential to pay for many of the other required resources, such as employees and equipment. The amount of money raised determines the level of investments and thus the speed of prog- ress. Having less funding also shortens a company’s planning horizons. The choice of investor also plays a significant role in development of the venture. A good investor supports the venture by mentoring and providing strategic advice, by making introductions to business partners and future investors, by helping to hire talented managers, or by attracting a knowledgeable board of directors. Some investors are better than others at supporting their ventures. Moreover, some have more expertise in specific areas that may be important to some but not other start-ups. Investors also want to actively protect their investments and to exercise influence and control over strategic decisions. In some cases, they can even go as far as firing the founders from their own company. Clearly, it matters which investors the entrepreneur picks.

Since start-ups are risky and occasionally opaque, funding the right ventures is essential for generating high returns from the investor's perspective. This difficult decision is occasionally left to professional VC firms, whose core business is funding start-ups. Institutional investors allocate some money to VC firms as a way of diversifying their portfolio and seeking out high returns. Established corporations also fund entrepreneurial ventures as part of their innovation strategies. Robert Solow received the 1987 Nobel Prize in Economics for his contributions to the theory of economic growth. Paul Romer received the 2018 Nobel Prize for integrating technological innovations into long-run macroeconomic analysis. Solow tackles the question of what determines growth in the long run by building an elegant mathematical model of the economy that takes into account the most crucial aspects of economic activity, such as people's preferences, labor supply, savings, capital investments, and technology. He then separated tempora, or time periods, to study the relationship between these variables.

Consider the more straightforward idea of labor productivity first. This is the amount of output per unit of labor inputs, often measured as sales over salaries. Solow's growth model focuses around the concept of total component produc- tivity. However, money and land are other inputs that may be used to create outputs in addition to labor. TFP, whose measurement includes some accounting complexity, is therefore the quantity of output divided by all factor inputs. The continued gains in TFP are then used to identify the technical advancement that fuels long-term growth. Simply defined, improvements in an economy's ability to efficiently turn inputs into outputs are what lead to economic development. A entire generation of economists was motivated by Solow's findings to research the factors influencing TFP increase. Solow established that technological innovation is the primary driver of economic growth, but he didn't specify the specifics of how new technologies emerge. Paul Romer is one of the pioneers of what has been dubbed endogenous growth theory15. Romer's work reveals how economic forces affect the willingness of firms to generate new ideas and innovations. His key insight is that ideas are different from other goods and require specific conditions to thrive in a market.

Two interesting studies by Decker, Haltiwanger, Jarmin, and Miranda look at this issue using U.S. employment data between 1980 and 2005.16 Start-ups created on average 2.9 million jobs per year in their first year of operations, accounting for roughly one-sixth of gross job creation in the U.S. However, average annual net job creation in the U.S. was only 1.1 million, indicating that start-ups did not contribute significantly to net job creation. One may assume that start-ups contribute for roughly twice as much net job creation based on their 2.9 million vs the average 1.4 million net jobs throughout the economy, but this turns out to be overstated, and understanding why helps us to better understand the entrepreneurial process itself. To properly assess the role of start-ups in net job creation, we need to take ac- count of the up-or-out dynamics of young firms. Start-ups create many jobs in their first year, but many of those jobs are quickly lost in subsequent years. Indeed, 17% of all jobs created in the first year of a start-up get lost already by the end of the second year, another 14% by the end of the third year, and so on. This is the out component of up-and-out dynamics.

It is counterbalanced by the up component, which comes from a relatively small number of young firms that keep creating new jobs throughout their early years. On average, start-ups create 14% more new jobs in their second year, 6% in their third year , and so on. It follows that the true contribution of start-ups to net job creation cannot be summarized in a single number; instead it requires an understanding of these up-or-out dynamics. A related study by Sedlacek and Sterk further finds that em-ployment created by start-ups is stronger during expansions, when it is easier for companies to attract more customers. Moreover, job creation is not uniform across start-ups, with relatively few start-ups persistently creating more jobs than others. It is young ventures that generate the bulk of net job creation; the rate of net job creation decreases monotonically with firm age, from 11.8% for ventures less than two years old to 0.7% for companies over 16 years of age. Furthermore, only a small fraction of young firms grow into large companies these few high-growth firms therefore generate the majority of net job creation. The final piece of the puzzle is to link these effects back to the financing of entrepreneurs. Various studies have examined this question, generally finding supportive evidence.

We have seen that innovation and entrepreneurship are important for long term growth and that high-growth entrepreneurs are an important driver for new job creation. A report by Gornall and Strebulaev on U.S. VC finds that VC-backed companies employ million people, account for one-fifth of the U.S. stock market capitalization, and 44% of the R&D spending of U.S. public companies. At the same time, the VC industry contributes to competition and creative destruction. The average lifespan of a company that is a part of the sector is ten years. The last two columns further suggest that the differences are particularly pronounced in the early years, where the conditional failure rate is in the double digits for non-VC-backed companies but remains markedly lower for VC-backed companies. The authors argue that one benefit of having VC funding is protection against early failure; that is, VC funding allows start-ups to go through the initial stages of growth without fear of failure. Overall, the research demonstrates that failure is a question of perspective: VC-backed start-ups often fail compared to established businesses, yet they seem to be considerably more stable when compared to non-VC-backed businesses.

The Methodology of Entrepreneurial Financing

This chapter introduces the first of two frameworks we will use throughout the book to examine the entrepreneurial financing process as a whole. Why do we need a framework? Let's flip it around: What would a book be without a framework? Students might learn these facts and they might even learn the lingo, but would they truly understand how entrepreneurial finance works? In this book, we establish a set of coherent and s patterns that underlie the practice of entrepreneurial finance. We are not interested in categorization or categorization, but in the patterns that underlie the practice. The goal of a framework is to provide a useful simplification of the underlying phenomenon; it is not to replicate reality because reality is simply too complex for that. A framework is a sketch that aids readers in orienting themselves among the concepts and facts raised in the book. It aids the reader in grasping the bigger picture and organizes the numerous pieces of information into a coherent whole.

Again, a fair question: OK, but why do we need two frameworks; why not just one? The answer is found in the intergalactic collision discussed at the beginning of this paper. The first framework, called FIRE, focuses on the entrepreneurial journey. The second framework, called

FUEL, examines investor organizations, their internal structures, motivations, and investment behaviors. We associate the female gender with entrepreneurs and the male gender with investors throughout the book for the sake of clarity of exposition. Additionally, we use the terms company, venture, and start-up in connection with entrepreneurs, whereas we use the term firm in connection with investors. The acronym FIRE describes four consecutive steps of the entrepreneurial finance process. Fit concerns the matching process of how entrepreneurs and investors find each other and evaluate their mutual fit. Invest co-operation concerns the co-operation between entrepreneurs and investors.

In this paper, we will introduce the main categories of investors in entrepreneurial companies, starting with venture capital, which is arguably the most well-known category. The very first bit of money typically comes from the founders themselves. They use their own savings to pay for the initial business expenditures, or they use personal credit, such as credit cards and second mortgages. Funding that comes from within the company is considered internal funding. VC is only one of many ways of financing start-ups, which we will briefly introduce now. The three Fs family, friends, and fools are often referred to as the first outside investors in a firm since they invest more on the basis of a personal connection than on a business one. Then there are angel investors, which are private individuals who invest their own money without prior connections to the founders. Angel investors can invest independently or they can join a variety of organizations, where they can invest as a group. Angel investors range from middle-class people investing moderate amounts of money in one or a few companies to millionaires and billionaires investing significantly larger sums of money in a portfolio of companies.

There are many different ways that corporations can engage with entrepreneurial ventures, from ad hoc investments to formal corporate venture divisions or subsidiaries to strategic partnerships and joint ventures. Established corporations also play an important role, acquiring entrepreneurial start-ups, thereby providing an exit. Some corporations also fund entrepreneurial ideas. Fintech, the current development that applies new technologies to financial services, has two features that are important for financing entrepreneurs. Crowdfunding is one trend that enables businesses to get investment through an internet platform. Such platforms come in three basic categories. First off, certain platforms, like Kickstarter, let businesses collect money in exchange for benefits like early access to a product in development or symbolic recognition. Second, peer-to-peer lending platforms like LendingClub enable businesses to raise loans from accredited investors or regular investors.

Third, certain platforms enable businesses to raise stock. Some of these networks, like AngelList, only let skilled investors to invest; other platforms, like SEEDRS in the UK, are accessible to everyone. Initial Coin Offerings, a second kind of Fintech application that enables raising substantial sums, have appeared in recent years. The Blockchain, a cutting-edge software architecture that enables decentralized recordkeeping and decision-making, is the foundation of this second innovation. This sort of investment is now uncontrolled, and the market is quite unregulated. Debt also plays a part in financing startups, although equity is more common.44 In theory, banks are able to provide a wide range of credit and loan options to businesses at all phases of growth. However, in reality, most banks are hesitant to lend to business owners unless there is collateral or the business owners provide personal guarantees. A few banks specialize in venture debt, a sort of financing to businesses that have previously received venture capital backing. Venture leasing and trade credit from suppliers are some other loan instruments employed by business owners.Another source of financing for businesses comes from the government. Through both direct and indirect government financing initiatives, they may assist startups. Furthermore, a broad range of government initiatives provide grants, tax breaks, credit insurance, and other types of help to business owners. Investors get into contact with entrepreneurs at various phases of the business development process. It is a stylized illustration of how various investor types concentrate on various phases of investing. The figure's arrangement shows a method through which business owners could contact various investors at various phases of company growth. Entrepreneurs often hold the misperception that all investors are the same, or that money is green. This perception is false, however, and we stress the variety of investor types and their significance for the fundraising process throughout the whole book. Our second framework, FUEL, is introduced in order to comprehend this variability. The term makes reference to the fact that business owners often describe money as the necessary gasoline to propel their initiatives forward.45 In addition, adding FUEL to FIRE definitely helps to start things moving, as everyone is aware of. We use graphics to illustrate the FUEL architecture.

Four fundamental ideas form the foundation of the FUEL framework, which aids in structuring our comprehension of the characteristics and actions of investors. Each topic is linked to a major question that introduces the main problem and two additional questions that expound on it. The investor's basic organizational structure is examined in the first notion, the F in FUEL. Based on this, several sorts of alternative investors may be identified. It serves as the foundation for many important aspects of the investor's interactions with entrepreneurs and other stakeholders. We first examine the organizational structure of the investment company inside the basic structure, paying close attention to who owns the investment vehicle and how much money it has available for investments. The governance structure is then examined, and regulations governing the operations of the investment vehicle and how decisions are made inside the firm are sought for. The main takeaways from this level of study relate to the important individuals, their decision-making processes, and the resources they have under their control.

Let's examine two significant categories of investors, angels and VCs, to have a basic understanding of the distinctions between various investor models. Think about how their underlying structures are different. The gist is that VCs invest other people's money, while angel investors invest their own. The structure of angel investors is, to give you the long version, very straightforward. Angels spend their own funds and answer to no one but themselves. In contrast, consider the VC structure. A limited liability corporation that is owned by a group of people that manages a venture capital fund provides money to entrepreneurial businesses. The general partner enters into a contract with a number of institutional investors who contribute to the VC fund's capital. Large investment managers, including pension funds, insurance firms, university endowments, sovereign wealth funds, investment banks, affluent families, and others, are examples of institutional investors.

Why is the underlying structure important? We start by thinking about who is investing money and how much of it. The majority of angel investors only make small investments, constrained by their money and risk tolerance. In contrast, depending on the size of the fund, VCs may have access to significantly bigger quantities of money. The second thing we look at is the decision-makers. Angel investors make their own judgments, while VCs rely on investment committees that may be subject to limited partner review and are controlled by partnership regulations. It goes without saying that we would anticipate various investments to result from these various investor arrangements. In reality, the same person may adopt several investment philosophies depending on whether they are functioning as a VC or an angel investor. The second fundamental idea, the U in FUEL, examines the investors' underlying motives. It takes into account their goals and inquires as to what drives them to invest in the first place. We pay great attention to how important financial rewards are in comparison to nonfinancial factors. While some investors just prioritize making money, others aim to achieve a wider range of goals.

In addition to financial gains, they could be concerned with their own personal interest in the work of the entrepreneur, the project's potential social and economic effect, or any prospective strategic alliances between the investor's firm and the business. Risk tolerance and the investor's level of patience are other factors in the motivation of investors. If we examine the many driving forces behind angel investors and venture capitalists, we find that the fundamental structure of VC businesses offers powerful incentives for creating financial returns. As a result, VCs are primarily concerned with earning money. Angel investors, on the other hand, may have a range of objectives. Beyond financial gains, they may be inspired by the venture's positive social impact, the joy of continuing to participate in the entrepreneurial process, or perhaps simply by the companionship of other angel investors. A seasoned investor and former member of LinkedIn's founding team, Lee Howler, outlines five primary incentives for investing: giving back to the community, market insights, pursuing a career in venture capital, and personal satisfaction[10], [11].

CONCLUSION

In conclusion, for entrepreneurs and startups, entrepreneurial financing brings special difficulties and complications. The main hurdles entrepreneurs confront include a lack of external financing options, valuation issues, resource allocation choices, and a lack of financial awareness. To address these issues and create a climate that is supportive of successful entrepreneurship, entrepreneurs, investors, legislators, and support groups must work together. the effects of these difficulties on business owners, financiers, and the whole entrepreneurial ecosystem. When looking for alternate sources of finance, such as bootstrapping, crowdfunding, or government subsidies, entrepreneurs must be imaginative and innovative. Investors must establish frameworks for assessing early-stage enterprises and embrace a risk-taking mentality. To improve financial literacy and close the financing gap, the entrepreneurial ecosystem should provide assistance via mentoring, networking opportunities, and instructional tools.

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CHAPTER 2

A BRIEF INTRODUCTION TO EVALUATING VENTURE OPPORTUNITIES

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ABSTRACT:

Evaluating venture opportunities is a critical process for entrepreneurs, investors, and other stakeholders seeking to identify and assess the potential of new business ventures. This abstract explores the key factors and methodologies involved in evaluating venture opportunities, highlighting the importance of thorough analysis and due diligence in decision-making. The abstract begins by emphasizing the significance of evaluating venture opportunities in the entrepreneurial landscape. Identifying viable business ideas and assessing their potential is crucial for entrepreneurs looking to launch successful ventures and for investors seeking attractive investment opportunities. Effective evaluation helps mitigate risks, maximize returns, and align resources with the most promising ventures.

KEYWORDS:

Competitive Analysis, Customer, Financial Projections, Industry Analysis, Product-Market, Risk Assessment.

INTRODUCTION

This details how to assess a business opportunity. We offer the Venture Evaluation Matrix, a system for evaluating a new company's chances. The framework acknowledges the need of developing a value proposition around a genuine consumer need, a viable alternative, and a team that can carry out its strategies. Conclusions regarding the venture's appeal, hazards, and possible competitive advantages are produced by its matrix structure. Investors may use the VE Matrix to assess the advantages and disadvantages of company opportunities in a variety of parameters. Additionally, it aids businesses in structuring their investor presentation and anticipating their worries[1], [2]. The shows how investors arrive at judgments realistically and covers the many ways that they use to evaluate businesses. Identifying business prospects is challenging. The success of venture investment might be attributed to as much as 50% of choosing strong firms.1However, even the most seasoned investors sometimes make blunders. A premier U.S. venture capital company, Bessemer Ventures, publicly publishes the successful firms it rejected, including Airbnb, Apple, eBay, Facebook, Google, Intel, and others. When asked why eBay had been denied, one of the partners said, Stamps? Coins? graphic novels? You had to be kidding, right? Pass with ease2How does an investor assess an entrepreneur in the absence of flawless foresight?

Any investment must begin with the underlying business opportunity and the presence of a viable business plan. The term business model, which first appeared in the 1990s and is currently under development, has no one definition. The following is a good definition for our needs: A business model articulates the logic, the data, and other evidence that support a value proposition for the customer, and a viable structure of revenues and costs for the enterprise delivering that value, according to the business model. The business model is not the business plan itself; rather, it deals with the logical organization of all company components into a value-creating process. Instead, among other things, a business plan includes a summary of the reasoning behind the company model. This enables the opportunity's value-creation potential to be communicated to other stakeholders, such as investors. Has the business owner a compelling potential that warrants the investor's attention? It helps to have a framework for assessing the company opportunity, comprehending its business model, and recognizing the key business risks in order to respond to this essential question. Investors have access to a broad range of frameworks, from more informal appraisal methods to more rigorous ones. In this book, we provide the Venture Evaluation Matrix, which is unique to us[3], [4].

DISCUSSION

The Venture Evaluation Matrix

A strong assessment framework must be founded on the principles, provide a thorough analysis, and be simple to use and convey. In order to do this, we provide the VE Matrix, also known as the Venture Evaluation Matrix. By fusing our in-depth knowledge of a sizable corpus of academic research with decades of intimate, one-on-one encounters with practitioners, we developed this exclusive framework on our own. The framework is based on academic principles and specifically references literature in the fields of entrepreneurship, strategic management, finance, and economics. The framework is founded on thorough observation of the practical challenges that entrepreneurs encounter when presenting their ideas to investors, as well as the challenges that investors confront when assessing such ideas. The framework makes use of a matrix form to emphasize how the key analytical ideas are connected logically. The Customer, who has a need, the Company, which offers goods or services to meet the demand of the Customer, and the Entrepreneur, who seizes the chance, are the three columns that identify the major actors that define the business opportunity[5], [6].

When relating this to economic fundamentals, we see that the analysis in the Customer column concentrates on elements that affect demand, the analysis in the Company column concentrates on factors that affect supply, and the analysis in the Entrepreneur column concentrates on factors that affect the individuals who connect demand and supply. We may understand this in terms of horse racing using a familiar analogy. Emphasizing the company is like betting on the horse, concentrating on the customer is like betting on the racecourse, and focusing on the entrepreneur is like betting on the jockey. Three essential views for assessing business possibilities are provided in the three rows. The value proposition viewpoint explains how the business aspires to generate profit. This offers a close-up view of the company's fundamental operations. The operating environment of the firm is described by the industry viewpoint. The Strategy viewpoint describes how the firm intends to capture the value it generates and hence earn profits[7], [8].

It adopts a macro perspective by examining the larger context that will effect the organization. It adopts a dynamic viewpoint and is concerned with the procedure through which the business seeks to develop itself. Consider for a moment the findings of a poll Gompers, Gornall, Kaplan, and Strebulaev conducted of venture capital firms. When asked what their most crucial factor in choosing investments was, 47% of respondents said the team, which is in line with the Entrepreneur column. Another 13% of respondents indicated their product, and 10% their business approach, which is in line with the Company column. In addition, 8% of respondents said market, and 6% said industry, which fits in the Customer column. Investor fit was the most crucial of the remaining responses, which we will examine using the MATCH tool. It's interesting to see that just 1% of respondents thought valuation was crucial. This does not imply that valuation is unimportant, but rather that investors should feel comfortable with the company fundamentals before considering financial transaction issues.

The Venture Evaluation Matrix

The significance of each of the nine cells is now explained. We go through the main concerns that an investor might have for each one. Although one could theoretically write a whole book on each cell, our aim is to provide a succinct overview of the main issues involved. We include the three primary inquiries that investors should make for each cell, followed by an explanation of the underlying problems that these investors are likely to be troubled by. The three questions are designed to capture key elements common to most initiatives, although they may be modified based on the venture's stage, industry, and investment philosophy.

Need

The value proposition, or more simply, how the company intends to produce value, is examined in the first row of the VE Matrix. The client requirement is taken into account in the first cell. Simply said, there is no business potential if there is no genuine client need. What the consumer needs is the first thing any entrepreneur must ask. Many entrepreneurs make the error of developing a solution without first determining if it really answers a problem. Finding the original target consumer is related to understanding the demand. This is no little matter. An initial hypothesis about the potential requirements of the client is often held by the entrepreneur; nevertheless, this hypothesis has to be tested. Frequently, the original idea turns out to be incorrect. The actual need can exist elsewhere or take on whole new characteristics. It is a well-known fact that no military campaign plan survives initial contact with the adversary, according to Field Marshall Helmuth Graf von Moltke. Too many entrepreneurs focus on solving what they believe to be the customer's need, which runs the risk of forcing a solution to an all-encompassing problem.

Customers, whether individuals or organizations, have a hierarchy of needs, with some things they require, some they consider valuable but not essential, others are pleasant but not really needed, and many are simply not needed at all. In a consumer-facing business model, consumer psychology matters. The psychologist Abraham Maslow describes a hierarchy of needs, with physiological needs at the bottom, then safety n needs, and many are simply not needed at all. When dealing with large corporations or other complex organizations, it can be difficult to determine who the true decision-makers are. This is because corporations seek profits and efficiency. Therefore, the entrepreneur needs to generate a return on investment for the corporation or satisfies other corporate goals. This means enhancing the company's sales, generating cost savings, or contributing to other corporate agendas. Individuals may lack self-awareness, and organizations frequently show resistance to new product adoption. They may have grown accustomed to their problems, taking them for granted. They may reject a novel idea simply because they are unable to envision how it fits into their current environment.

Experienced entrepreneurs pay less attention to what customers say and more to what they said. How much clients are able and willing to spend is the third question. Ability to pay is a matter of availability of budgets for corporate clients and disposable cash for individual consumers. Due to the fact that no one can afford to pay for a remedy, many needs remain unmet. Entrepreneurs are therefore faced with less prospects unless they devise creative solutions to these problems. For instance, social entrepreneurs occasionally create hybrid business models that combine the requirements of various clients and organizations.A well-known example is TOMS, which donates a pair of shoes to some less fortunate children in developing nations for each pair of shoes it sells at retail prices. In addition to financial capacity, there is also the matter of desire to pay. Despite understanding the benefits of purchasing nutritious food, some affluent consumers refuse to pay a premium for it. Similar to this, corporate purchasers may prefer a new support service for human resources but must make sure it fits inside funding. It may be difficult to determine a customer's genuine willingness to pay, particularly in the early phases of learning about their demands. Initial vocal excitement from a buyer may not be indicative of actual purpose. True client willingness is still a matter of speculation until real money is committed.

Solution

The answer to the customer's requirement is the focus of the second cell of the VE Matrix, which is the cell's exact opposite. The second cell, which asks how the entrepreneur plans to address the client need, examines the supply side whereas the first cell focuses on the demand side. Every entrepreneurial endeavor starts with a suggested solution, a product or service that is innovative and accomplishes something. The four founders of WorkHorse often disagreed on what their solar power generator's customers really needed. Astrid loved to trek and often wished she had a power source for her lengthy, multi-day journeys. None of the available power generators, meanwhile, were compact enough and light enough to fit within her backpack. In Canada, where Brandon had spent his summers beside a lake, he had seen that families going on camping excursions often need a lot of electricity, particularly if they wanted to retain certain luxuries, like operating microwaves or charging phones. Bharat held a different viewpoint, contending that the underprivileged in India and abroad sometimes lacked the funds to pay their electricity bills and turned to other sources of energy as a result.

Annie observed that many of the smaller industrial facilities she had seen in China may benefit from solar power generators. The four founders decided to concentrate on one consumer demand at a time, even though they thought that all of these requirements would ultimately prove to be significant. They made the decision to concentrate on leisure travelers who would need electricity while their outdoor activities, such as hiking, camping, or other. They discovered three key findings when they investigated the possibility. Customers have a strong interest in solar power generators, according to consumer interviews. They valued something tiny and lightweight and enjoyed not having to carry gasoline. The second was that buyers knew exactly what they wanted. Surprisingly, they put a lot of emphasis on design because they wanted power generators to appear good. The diesel generator's practical appearance turned them off since they thought of it as a work tool rather than a travel accessory. Third, buyers were prepared to pay costs that were comparable to those for diesel generators but not much higher. They made buying selections primarily based on the cost of the generator and did not consider fuel savings.

The innovations may be related to advancements in science or technology, design or manufacturing, or creative business models, such as the creation of new sales channels or novel marketing strategies. Regarding the solution, there are three questions to consider:

1. Does the suggested solution meet the needs of the client?

2. How does the suggested remedy stack up against the alternatives?
3. How much of the invention can be safeguarded?

The first inquiry examines the innovation from a commercial standpoint and inquires as to whether it genuinely addresses any client needs. Others start with a client need and look for a way to fulfill it. Some entrepreneurs start with an idea and then try to make it relevant to the customer. In either case, the invention must provide a practical answer to a pressing client demand. This is a challenge that many business owners face, particularly those with technological backgrounds. They get overawed by the invention's challenge and neglect to consider how valuable the breakthrough will truly be for consumers. Many technical breakthroughs never live up to the excitement that surrounds them when they are first made. Graphene metals or artificial blood replacements might be used as instances of such. A new technology could only function under certain circumstances or come with unfavorable side effects. Even if the scientific discovery is valid, there is still a great deal of risk involved in transferring a technology from a laboratory setting to an industrial one. Similar temptations to get unduly enthusiastic about a unique concept exist in non-technical businesses. Juicero got more than

A high-end customized juicer, dubbed the Nespresso of juicing, was developed with $100M in venture capital investment and sold for $700.12 However, the enthusiasm never translated into major sales, and the firm shut down a few years later. Although Juicero was a beautiful product, it didn't genuinely address any pressing issues. Utilizing conventional companies' deregulation is a different strategy. In order to provide long-distance bus services, first in Germany and then across Europe, Flixbus was established in 2013. It opened a U.S. subsidiary in 2018 as a result of its success in Europe. Flixbus outsources bus travel to nearby businesses while concentrating on its technological infrastructure. The business garnered venture money in five rounds, and in 2019 it was thinking about going public. The second query hints to a contrast with alternate answers. An innovation must be noticeably superior to the solutions already in place. Small incremental ideas usually have little chance of success. The innovation must obviously outperform its alternatives in some crucial way in order to stand out, and it shouldn't be manifestly worse in other areas. The market may not always reward a product with superior technology if it is simply stronger in terms of some technical aspects and weaker overall.

A prime example is Sony's Betamax, which outperformed the rival VHS standard in terms of resolution and visual quality. Its limited ability to accommodate shorter movies contributed to its failure. Movie studios sought to put a complete movie onto a single tape, yet this did not satisfy their needs. It is also necessary to assess a solution's economic feasibility before comparing it to its alternatives. Sometimes a superior solution fails because it is just too costly to build or because its scope of usage is still too limited. It could also be excessively costly, either due to its price or because adopting it would incur extra expenditures consider training staff to utilize a new equipment. Furthermore, there is the issue of lifespan. Every invention has a finite lifespan until it is supplanted by a superior idea. The capacity to safeguard the answer is the subject of the third query. Intellectual property rights, such as patents, trademarks, copyrights, or industrial designs, as well as strategic barriers to imitation, like lead time or trade secrets, are the two main ways to protect innovations from imitation. If the solution is based on IP, then the relevant question is how strong the IP is. This depends on how the IP is defined and the kind of technical advancement. It also affects how well laws are enforced in a nation. However, protecting the IP may sometimes be challenging, even with strong legal enforcement. This is so that just the technology itself may be protected, not the actual solution. The practical advantages of the suggested method may be legally imitated by rivals without utilizing any of the protected IP. Therefore, strategic obstacles to copying, which are the second sort of protection, are ultimately more significant. The important question is if the entrepreneur has any specialized expertise, abilities, or other resources that assist prevent copying of the solution, at least temporarily.

When these assets and competencies are hard to duplicate, the organization is best protected. It is helpful to quickly address a key entrepreneurship problem in the context of the first two cells, namely, how entrepreneurs come up with the appropriate solutions that genuinely address genuine consumer demands. A contemporary entrepreneur's toolkit, which includes design thinking and observational approaches. It's a frequent misunderstanding that businesspeople are innovators who have a Aha! moment. moment. In actuality, solutions are often discovered via an iterative process that involves testing with a variety of options and gathering input from many sources. The design thinking movement has made an effort to provide some techniques for the problem-solving process. The broad notion of design thinking has influenced a variety of creative endeavors, including business, social work, innovation, and architecture. Although there isn't a single definition of design thinking, the founder of the Stanford Design School proposes the following four fundamental ideas first, all design is human-centric; second, designers maintain ambiguity to remain open to various forms of experimentation; third, all design is redesign because technologies and social conditions are always changing; and fourth, making designs tangible facilitates communication with others.

Although the actual design procedures vary depending on the application domain, a unifying feature throughout them all is the development of user empathy. Designers must have an instinctive, often visceral awareness of the issues they are trying to solve. Entrepreneurs may better identify real customer wants with the use of a number of technologies. Entrepreneurs are increasingly adopting anthropologists' techniques, directly observing clients, staff members, subject matter experts, and others. Anthropologists are experts at observing people from all walks of life, taking special care to ensure that their presence interferes as little as possible with accurate observations of human behaviors. While some observational methods concentrate on online behaviour, others need physical monitoring. One must also be sensitive to certain ethical issues, and some observing techniques need for permission. Design thinking and the associated observational methods make it abundantly evident that remaining in close proximity to the issue is essential to finding any solution. The lean start-up movement is founded on this fundamental realization.

Work Horse Solution

The foundation of WorkHorse's technology was a technological advance that allowed solar energy to be harnessed using light rather than heat. Dr. Daniela Dasola, the lab's director, had overseen the research, but Bharat was responsible for a number of significant scientific breakthroughs. Before the researchers' work was published in a major academic publication, the UofM technology transfer office took care of patenting the discovery. Additionally, Astrid, a lab employee there, had created certain lightweight materials that would allow the generators' size and weight to be significantly reduced. The first product that WorkHorse intended to release was a portable generator that they tentatively called Wonder Foal and that was perfect for hikers. The second device, code-named NokotaStar, was designed to be a portable but noticeably more powerful generator ideal for campers. The risks of just using a technical perspective to design goods were well known to the four founders.

As a result, they began to implement certain design concepts, spending time conversing with prospective customers and, where feasible, just watching them use the current items. The inventors were certain that their product would represent a significant advance over current options based on this observational study. Compared to conventional diesel generators, their solar generators were much lighter and smaller. They also made sure that their approach was far quieter since they were aware of people's annoyance with the noise levels of conventional generators. Even though the technology and design were novel and superior to anything else on the market, the creators were concerned that the invention may be readily copied. Some of the Chinese manufacturers Annie knew, she noted, could easily construct something comparable in a couple of months.

Team

The third cell in the first row consequently focuses on the entrepreneurial team. A good value proposition requires not just a clear consumer demand and a persuasive solution, but also an entrepreneur who can execute the answer. According to this viewpoint, the founders' human capital is the company's most valuable asset. In the words of Arthur Rock, one of the pioneers of the venture capital industry, Good ideas and good products are a dime a dozen. Good execution and good management in other words, good people are rare. The main contention is that a good idea alone is worthless if there is no entrepreneur. For instance, the initial concept for Microsoft wasn't very innovative, but Bill Gates expanded upon it to become much more.

A competent entrepreneurial team also adjusts even when the original concept is shown to be incorrect until a workable company model is discovered. By realizing that his clients appreciated the gum he was giving away as a promotional gift considerably more than the soap he was attempting to sell, William Wrigley Jr. built a chewing gum empire worth $1 billion. When iTunes ruined the economic paradigm of Odeo, Twitter was created. Jack Dorsey, Noah Glass, Biz Stone, and Evan Williams worked as a team within Odeo to come up with the concept for Twitter. The founding team in each of these cases deserves the majority of the credit, not the concept. Therefore, the entrepreneurial team is the subject of the third cell in the value proposition row. There are three inquiries to make:

1. Do the founders possess the necessary training and expertise?
2. Do the founders have enough drive and dedication?
3. Is the founding team harmonious and unified?

The founders' qualifications and experience are the subject of the first query. Every investor wants to know if the entrepreneur has experience in this area. findings from scholarly investigations of the significance of earlier entrepreneurial experience. Investors pay attention to industry expertise, as well as experience in important functional areas like marketing, sales, or operations, in addition to past entrepreneurial experience. It's interesting to note that many investors see past consulting or financial expertise as essentially unimportant. Investors respect expertise at younger, growth-oriented enterprises even though many entrepreneurs get it at well-established organizations since they are often thought of as offering superior educational opportunities. Serial entrepreneurs are business owners who have previously launched a firm. Numerous academic studies contrast the first-time entrepreneurs' and serial entrepreneurs' experiences. In one study of VC-backed start-ups, Gompers, Lerner, Scharfstein, and Kovner found that serial entrepreneurs with prior success had a success rate of 30%, compared to unsuccessful serial entrepreneurs with a success rate of 22% and first-time entrepreneurs with a success rate of 21%.

The study also suggests that the higher success rate of serial entrepreneurs is related to their capacity to time the market correctly. Do investors value entrepreneurs with a track record? Serial entrepreneurs have a greater likelihood of obtaining financing than rookie ones, according to a different academic research by Hsu. They also earn higher values, which means that investors are ready to pay more for investing in businesses run by serial entrepreneurs. Serial entrepreneurs often switch investors from one endeavor to the next, which is a startling conclusion from a research by Bengtsson. They have no trouble doing this since all investors understand the importance of serial entrepreneurs. The founders' devotion and drive are the subject of the second question. An significant driver of entrepreneurial action is financial gain. It may, however, be a weak motivator when used alone. Financial incentives are too speculative and far in the future to spur entrepreneurs on a regular basis. Enthusiasm for the underlying activity and the entrepreneurial process are prerequisites for it. Investors are reassured by this kind of intrinsic motivation that business owners would persevere despite inevitable failures and losses. I'll quote Arthur Rock once more: I'm looking for business owners who ask, How can I make this business successful?, rather than, How can I earn a fortune?

Further research indicates that entrepreneurs are often risk-tolerant, ambitious, and self-assured. Good businesspeople are extremely driven and contagious, which means they motivate others around them. Investors are certainly interested in how entrepreneurs interact with them, but they are also keenly interested in how they interact with their customers or staff. Their manner of speaking reveals how effective they are in their particular professional setting and, more broadly, how successful they are in mobilizing resources. Integrity is a relevant topic to bring up in this scenario. Investors must have faith in the entrepreneur since they are giving them their money. Trust must be earned over many years, yet it can be destroyed in an instant. Having integrity requires acting and communicating honestly, no matter how dire the circumstances. Investors routinely ask around for views on entrepreneurs, thus maintaining integrity extends beyond encounters with investors to an entrepreneur's reputation in the larger community. The third question examines the team as a whole, the degree of team cohesion, and how effectively the various founders complement one another.

Every team can have some healthy level of conflict, but excessive conflict can sabotage even the most promising venture. Having some diversity in terms of skills, both hard and soft, is beneficial to tackle the diverse set of challenges facing a new venture. However, it is also important that the founders share a common vision and a common passion for the venture. Serious team conflict is a warning indication for investors. What about lone founders? Although founder teams make up the majority of technological start-ups, many businesses are also founded by a single person. Some investors could interpret this as a bad indication, fearing that lone founders are too control-focused and hesitant to delegate decision-making to others. Other investors feel that having a sole founder is OK as long as she demonstrates strong leadership and an openness to feedback. It should be highlighted that evaluating a team's quality involves a concurrent assessment of the business difficulties rather than being done in isolation. A mobile app demands a different set of skills than a medical device company. Similar to this, a company in its early stages could need more creative individuals, but a venture in its later stages would need managers who are more focused on execution.

The team must have the necessary breadth of expertise to manage all facets of the company since they are in charge of the organization's overall direction. The four founders each contributed differently to the enterprise by bringing to the team a variety of talents and experiences. It was obvious who the team's leader was Astrid Dala. Before beginning her PhD studies in the United States, she worked for many years as an engineer at Ericsson. She received her undergraduate degree in electrical engineering from the University of Stockholm. She was technically sound, well organized, and had a great rapport with others. She put forth a lot of effort, stayed on top of things, and often assisted others in realizing their full potential. Arizona State University awarded Brandon Potro a political science undergraduate degree. Since serving as a volunteer for the U.S. He showed a keen interest in business and global politics while serving in the Peace Corps. He worked for various smaller companies while in high school and college. He often assisted with imports from Mexico since he spoke Spanish well. following the U.S. He spent two years working for a major American media firm before joining the Peace Corps. Brandon was gifted with statistics and adored stock market investment. Additionally, he loved interacting with others and fostering connections. Both engineers and entrepreneurs liked him because of his straightforward communication style. Bharat Marwari pursued his undergraduate studies in physics at the Bangalore-based India Institute of Technology.

He was awarded a coveted scholarship to pursue his PhD at the UofM. He hailed from a low-income background, so he took on some side scientific consulting job to help support his family back home. Although somewhat dull and off-putting, he thought it was intriguing. Despite his shyness and preference for working alone, he possessed a pleasant and composed personality. Industrial engineering was Annie Ma's area of study in Shanghai. She held part-time jobs at a number of smaller industrial facilities where she dealt with a broad range of technical issues. However, moving to the United States for her master's degree had turned out to be a whole other issue. She didn't like academia, and she often became angry with what she thought were its cumbersome processes. She favored a quick and dirty experimental method of doing tasks. The four founders were all passionate about harnessing solar energy to better people's lives and the environment. They had clearly defined their roles as a team and had begun to forge effective working connections. They had not yet discussed some of the more delicate topics, such as whether they would all discontinue their studies or how the founding stock should be split. They haven't yet employed any staff members.

Market

The second row of the VE Matrix, which examines the environment the firm works in from a larger industry perspective, is where we now go. In the first row, we examined the value proposition from a micro viewpoint; in the second row, we take a macro perspective and inquire as to how this value proposition fits into the larger industrial framework. The market is visible from the first cell in the second row. Remember how the first row's first cell spoke about a qualitative grasp of each customer's unique needs? We now go on to a more quantitative examination of the market as a whole. These are the three queries:

1. What size is the intended market?
2. What will be the rate of market expansion?
3. In what way will the client adopt?

In order to determine the scope of the opportunity, the first inquiry considers market size. We must first comprehend the target market in order to estimate its size. This entails examining the size of the relevant market. Let's say we were considering investing in a drone start-up. Do we have a specific interest in just close-range drones or the overall drone market? The size of the target market and the size of the entire market are the two major figures that best define the size of a market at any given moment. The first is a headline figure that is often used to show the industry's economic significance. To evaluate the size of the business potential, however, this figure is not essential. The second figure, which shows the percentage of the whole market the firm really targets, is more important. To find the target market, the whole market may be segmented into a variety of categories. For instance, the target market may be the close-range consumer-focused drone market, whereas the overall market might be the whole drone industry. Businesses may attempt to target several segments concurrently or sequentially.

Starting businesses often pivot from one market segment to another. Keep in mind that the phrase pivot is often used to describe start-ups that modify their business model. They change their direction, but they don't stop doing what they've been doing before. For the sake of simplicity, we focus on the target market and the total market. The whole market is further divided into two figures, TAM and SAM, according to a common business framework. TAM is for the total available market, while SAM refers for the serviced available market. While SAM only covers consumers who have previously been serviced, TAM also includes prospective customers who have not yet been contacted. Entrepreneurs identify several consumer groups within a particular market and choose which ones to concentrate on. They are forced to be explicit about the relevant subset of clients by this study, which is the first step in developing a targeted sales approach. For instance, a business may choose the consumer-oriented market for close-range drones as its target market and make a distinction between high-end consumers, who are mostly served by specialty stores, and low-end budget customers, who are primarily served by online sales. The level of competition should also be considered in this study. Also keep in mind that the foundation for predicting a product's market share and, eventually, revenues, is the differentiation of clients within a target market. We must consider market growth in response to the second question. Entrepreneurs often concentrate on developing markets that have innovation and growth. Therefore, the market's present size is an inaccurate indicator of its future size. As a result, we need a framework for considering how the market is likely to develop. Introducing a straightforward market adoption model based on the industry S-curve is helpful in this regard. Think about a group of prospective clients who have various wants for a novel item or service. The distribution of how much various clients appreciate the product is shown in the top graph of the picture. We position higher value clients on the left for ease. Customers with the greatest value need the product the most and embrace it earliest. The market's growth will follow an S-curve if the value distribution has a bell-shaped distribution, as shown in the bottom graph of the image. Time is represented via the horizontal axis.

The vertical axis displays market size, which may be calculated based on sales or clientele. Market expansion is gradual in the early stages of an industry as businesses work to attract the early adopters. The consumer base significantly grows as the sector evolves, resulting in fast expansion. This occurs at the peak of the bell-shaped curve in the upper graph, and the steep midsection of the S-curve in the bottom graph. Market saturation and sluggish growth eventually occur. gives a valuable, though rather simplistic, picture of market expansion. In truth, there is a lot of ambiguity about if and when the market will take off. New markets might grow quickly, plateau, or even disappear. A new technology, for instance, could challenge an industry's prevailing design. It either succeeds in establishing itself as the new standard or it fails to become the preferred design. There isn't just one S-curve; rather, the process begins anew whenever an industry goes through another innovation cycle.40 Afterward, it may either find a smaller specialized use or vanish entirely[9], [10].

CONCLUSION

In conclusion, for company owners and investors, analyzing venture prospects is a crucial step in finding and evaluating the viability of new business endeavors. Making educated judgments requires careful analysis, the use of a variety of approaches and tools, due diligence, and the leveraging of knowledge. Stakeholders may enhance their chances of success and optimize resource allocation in the changing entrepreneurial ecosystem by thoroughly examining venture possibilities. the value of teamwork and knowledge when assessing business possibilities. Engaging with professionals in the field, mentors, and advisers may improve the review process, provide insightful viewpoints, and lessen prejudices or blind spots. Utilizing outside knowledge may assist decision-makers to become more knowledgeable and impartial.

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CHAPTER 3

MARKET TIMING: UNDERSTANDING ENTREPRENEURIAL CHALLENGES

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ABSTRACT:

Timing the market is a critical challenge faced by entrepreneurs as they navigate the dynamic business landscape. This abstract explores the significance of market timing in entrepreneurial ventures and the key factors and considerations involved in making well-timed decisions. The abstract begins by emphasizing the importance of timing in entrepreneurial success. The timing of market entry, product launches, strategic partnerships, and financing rounds can significantly impact the outcome and growth potential of a venture. Entrepreneurs must strive to identify opportune moments to capitalize on market trends, customer needs, and competitive dynamics.

KEYWORDS:

Consumer, Economic, Market , Market , Product, Regulatory Environment.

INTRODUCTION

They will miss the chance if they arrive too soon, while others will have already taken advantage of it if they join too late. Thus, there is a finite window of time when businesspeople have a decent chance of succeeding. This often occurs near the bottom of the S-curve, just before it starts to slope upward. The difficulty in identifying when this occurs is undoubtedly a concern. Most crucially, it is difficult to separate situations where the S-curve takes off from those where it never moves. Even if a new market is clearly emerging, determining its size and development potential is far from simple. How can the size of an undeveloped market be estimated? This necessitates projecting the S-curve's size and shape without having solid knowledge of the fundamental customer value distribution. Such projections are by definition speculative and approximate. Importantly, they are extrapolated indirectly from numerous data sources, rather than being based on real data. The objective here is to identify plausible ranges rather than a single ideal value[1], [2].

The adoption procedure's nature is the subject of the third query. This entails identifying the precise early adopters on the left side of the bell-shaped curve in the top graph, which is relevant to the S-curve. In reality, the business owner looks for clients that are exceptionally keen. Those early adopters are prepared to take a chance on an untested product in addition to having a clear need. This may call for creative market segmentation techniques that separate clients based on their behaviors rather than just their physical attributes. By industry, the adoption process' specifics vary. Industries having 'network externalities' are among the situations that are particularly fascinating. In these markets, consumers are more likely to accept a product if a large number of other consumers are. The classic example is the telephone. A single telephone would be of little utility, yet as a network grows, the value of a telephone line increases exponentially. Modern examples are social networks like Facebook or Tencent, or ride-hailing services like Uber or Didi Chuxing. These services increase in value for each client as the customer base expands. Small variations between competing platforms may push the market in one direction or the other during the adoption process in marketplaces with network externalities. In the end, the platform that gains a critical mass of users wins the majority of the market since network externalities lead to new users favoring that platform as well. While operating in the solar power generator business, WorkHorse realized that this was a way too wide of a market description to be useful. For starters, the business had no interest in the enormous industrial generator market[3], [4].

It consequently believed that the consumer-focused solar generator market was its pertinent market area. It further divided this market into portable vs stationary generators, defining the latter as its target market for portable por solar generators. It recognized two major geographic groups within this, namely the North American and the European markets. According to Brandon's market research, the North American market for consumer-focused solar power generators is anticipated to reach $1B in 2020. He calculated that 10% of this market is made up of the por sector, thus he set the North American aim at $100 million in 2020. For the foreseeable future, experts predicted this sector will increase at an astonishing 30% annual rate. Brandon calculated that the North American target market would increase from $100M in 2020 to $371M based on this. Given the highly fragmented character of the business, estimates for Europe were a little bit more difficult to come by. Brandon made the assumption that the European market would be half as big as the North American market based on a variety of calibrations. He calculated that it really grew at a pace of 35%. Thus, according to Brandon, the European target market will increase from $50 million in 2020 to $224 million. Therefore, it was anticipated that the whole target market would increase from $150M in 2020 to roughly $600M. The displays his computations [5]–[7].

DISCUSSION

Competition

Entrepreneurial endeavors may provide a significant amount of consumer value but yet fall short of capturing any of it. Price reductions, the loss of market share, and even the complete eviction of innovators from the market are all effects of competition. As a result, the Competition cell inquires about the rivals' identities and methods of competition[8], [9]. There are always direct or indirect ways in which other businesses compete for the same customers, thus no firm is ever the only one offering a solution to a consumer issue. Additionally, as competition is always dynamic, we must take into account both present and possible new rivals in the future. The following three inquiries concerning the contest should be made:

1. Who are the rivals of today and tomorrow?
2. What kind of competition is it?
3. How can the company stand out from the competition?

Who are the present rivals? is the first query. We separate rivals into two categories: well-established businesses and other start-ups. Established businesses can give off the impression of being fierce rivals. When they learn that a company like Apple, British Petroleum, or Samsung could be in the target market, investors often get uneasy. However, for two reasons, it is simple to misinterpret the function of well-established businesses in the entrepreneurial ecosystem. First, established businesses tend to remain passive, focused on selling their present product, and consumed with providing services to their current consumers, despite having greater resources. Second, many existing organizations idly wait for entrepreneurs to demonstrate the feasibility of new ideas. Blockbuster did this when Netflix entered its market, and major airlines did the same when low-cost airlines initially threatened their economic model.

Entrepreneurs often seek innovations at first, but once their product or service is popular, established businesses start to pay attention. They must next decide whether to construct or purchase. Either they join the market and establish their own presence, or they buy an established start-up. Microsoft, for instance, created some of its brand-new items, like the Xbox, while acquiring other crucial goods, like Skype. The issue is whether established firms should be seen as possible buyers or rivals from the standpoint of start-ups. Entrepreneurs should constantly anticipate competition from other entrepreneurs, both present and future, in addition to established businesses. It is generally reasonable to presume that some other entrepreneur is working on a start-up with comparable goals elsewhere in the globe. One should constantly anticipate new entrants. For instance, when Mark Zuckerberg created Facebook in early 2004, it already had a number of other social network rivals, such as My Space.com and Friendster. Once the business has established the viability of its own product, it should anticipate that many copycats would strive to duplicate and enhance the business' success. The nature of competition is examined in the second question. While competing businesses compete ferociously in certain fields, less aggressive rivalry is more common in others.

Numerous variables, such as entrance obstacles, the degree of differentiation, or regulatory scrutiny, affect the level of competition. The relative weight of price vs non-price competition is a crucial issue. Competition usually focuses on pricing in markets with mature technologies and saturated markets. Non-price characteristics significantly change across various sectors. Nonprice competition in the early phases of a sector often emphasizes technology, customer segmentation, establishing a dominating design, and product differentiation. This leads to the next inquiry, which examines how businesses vary. This may be achieved by focusing on certain consumer groups and having a unique product offering. It is important because it serves as the foundation for establishing better margins and leading the business toward profitability. Start-ups often distinguish themselves early on by ongoing experimentation and learning, quick adoption of novel concepts, and quicker execution. As the business grows, it develops a greater sense of itself in terms of its goods and market segments. Occasionally, it is also possible to coopt rivals into allies by sharing the rewards of innovation. This may entail giving the rival control over specific tasks or collaborating on the product development process to produce an improved good that is then jointly marketed.

Cooperation with rivals is still a difficult topic that academics studying strategic management are quite interested in conclusion. A start-up takes on an established business titan in the classic David and Goliath tale. After facing some early difficulties, the start-up outsmarts the big and emerges as the new market leader. There are several potential causes for Goliath's defeat. Current leaders are sometimes complacent and sluggish to react. While each of these explanations can be applied to some examples, there are many more where the David and Goliath story doesn't apply. They may be reluctant to cannibalize their existing products and locked in to existing business models that make it difficult to respond. Incumbents' core competencies also go hand in hand with core rigidities that make it difficult to change direction. One is that many David do, in fact, lose. We are particularly interested in the Davids who want to work with Goliath. Let's first distinguish between early-stage start-ups and later-stage start-ups to better understand how start-ups engage with existing businesses. Because they missed the new market, established businesses often purchase successful start-ups in later phases. One example is the $1 billion purchase of Instagram by Facebook. We are interested in how early-stage start-ups cooperate or compete with established leaders. In theory, there are several advantages to collaboration. The start-up may avoid the expenses of starting it on its own by simply integrating into current production, marketing, and distribution systems. The two businesses may also conspire on pricing, safeguarding their profits. Customers are unlikely to gain from this agreement, but given the startup's tiny size, antitrust regulators are also unlikely to be interested in it. The fundamental issue is that collaboration is challenging. A company titan could abuse its position of influence.

The market leader may acquire confidential information about the start-up, including information about its clients, business strategy, and other elements of its operations, during the process of establishing up a cooperative arrangement. The incumbent might use this information to terminate the collaboration, or it could threaten to do so in order to get the start-up to make major concessions. According to one empirical research by Gans, Hsu, and Stern, well-protected IP increases the likelihood of cooperative methods for start-ups. 49The research also reveals that venture capital investment aids startups in negotiating contracts with market giants. Beyond the issue of whether to engage in competition or cooperation, there is the issue of how to proceed. One effective paradigm separates ambitious control-oriented business models from quick execution-driven business models. First, consider the scenario where the start-up chooses to compete. An execution-driven approach, where the start-up maintains focus on a single and limited value proposition, tries to disrupt the market leader by being quicker and more agile. By concentrating on an alternate distribution route, initially through mail and then via internet streaming technologies, Netflix defeated Blockbuster.

An whole new product/service architecture that offers clients a full new solution is the goal of a control-oriented approach. One example is Uber's strategy for competing with the established taxi sector. Next, think about the scenario in which the startup collaborates. The licensing path, where the start-up primarily furnishes IP, is the control-oriented strategy. Dolby was able to create a sizable business around its primary IP holdings. However, the licensing model suggests that many start-ups stay small and tightly focused on creating technology. An option is a partnership model focused on execution in which the start-up makes a particular contribution to an already-existing value chain. For instance, the Indian outsourcing juggernaut Infosys developed a business strategy to serve market leaders by offering specialized low-cost services while taking care to preserve its clients' main businesses. The automobile industry is another example of how disruptive and value chain strategies differ from one another. Tesla blatantly decided to disrupt the market. Meanwhile, a large number of lesser-known startups concentrate on giving current automakers particular new parts. Overall, we see that there are several avenues for startups to work with or compete against industry leaders. Not all Davids take on Goliath.

Network

There is an ancient saying that says that who you know rather than what you know counts more. This idea also holds true for business owners that depend on networks to grow their enterprises. Remember that gathering resources and managing uncertainty are the two main obstacles facing entrepreneurs. Networks assist them not just in gaining access to vital resources but also in acquiring knowledge to lower the risk of the enterprise. Therefore, the third cell in the industry row examines the network of founders. This cell aims to comprehend their place in the sector. There are three crucial inquiries to make:

1. What is the founding team's standing?
2. What networks are available to the team?
3. How does the group establish and keep fresh bonds?

The team's status in the industry and reputation are the first two questions. As they impact access to information and resources for the sector, networks are important in the development of new businesses. Investors consequently research the founders' reputations within the sector before investing. Due to the popularity of online social networks, investors are now evaluating the team's reputation online. The second query relates to the founding team's current connections. Understanding the network's topology reveals how interconnected the founders are in the larger context. Startups also make use of the networks of their trusted advisers. In entrepreneurial enterprises, one of the important duties of a board of directors is to manage networks so that the company may access resources. The hiring of advisers is also intended to broaden the company's network. How can we evaluate a network's quality and make sense of its structure? Some of the key ideas from contemporary network analysis. The capacity of the founders to establish and maintain connections is the subject of the third query. New demands emerge as the business expands. Instead of focusing just on a team's current connections, one can wonder whether the group has the motivation to go out and build new connections while also retaining existing ones over time. Networks are important in many facets of business growth. Building new connections with consumers and middlemen is essential to the sales process.

To schedule a meeting with genuine decision makers or to generate the desired buzz in the target market, network contacts may be necessary. Networks are significant while recruiting. Since entrepreneurial businesses often pay below-average market wages, finding talented workers who are also adaptable is essential. A corporation often uses its network to access its specialized supplier inputs, which is another benefit. This can include having access to licenses needed for using the company's own technology in high-tech firms. Making new connections is essential for gaining access to financing. Finally, entrepreneurial businesses must establish network links to win the support of public authorities in regulated sectors and nations with a weaker legal system. The founders of WorkHorse were still very inexperienced and had few connections in the business sector. Each of them had a loyal following on Facebook, demonstrating that their friends really appreciated and trusted them. Few of these connections, meanwhile, were helpful for launching a business. They considered inviting Dr. Daniela Dasola, the head of their lab, to serve on their board of advisors. They were unsure of how to set up a board of directors, so they hoped their investors would handle it. As avid networkers, Astrid and Brandon sometimes wished that their team members would exhibit the same enthusiasm for going out, making connections, and maintaining contact with those contacts.

Sales

By focusing on strategy, the third row of the VE Matrix adopts a dynamic viewpoint. This entails considering the company's future course. It is intimately tied to both the company's momentum and its implementation. In order to create money, the sales cell examines how the business connects with its clients. There are three crucial inquiries to make:

1. How does the business contact its clients?

2. What distribution plan do you have?
3. What are the pricing and income models?

How the business approaches its clients is the first query about the sales strategy. This cell focuses on the customer acquisition strategy after analyzing the market and the consumer requirement in the two cells above. This has to do with the company's strategy for entering the market, both in terms of physical access and in terms of consumer focus. Numerous novel goods and services need at least some consumer education, necessitating expenditures in a client base. More broadly, any product or service needs a marketing plan that outlines how the business intends to win over its target market's hearts and minds. Entrepreneurial businesses regularly adapt their marketing strategies as they grow and diversify into new markets and client bases. For instance, as the business expands, its marketing strategy may evolve from focusing on early adopters who are willing to purchase a product based on its promises to focusing on mainstream consumers who need far more guarantees before making a purchase.

The second query relates to the distribution plan. Choosing to sell directly or indirectly via intermediaries is a crucial trade-off in this situation. Selling directly enables the organization to better manage the customer experience and learn from direct customer interaction. Relying on third parties leverages the resources and reputation of established companies. Higher variable expenses are associated with commercialization via third parties because of commissions. The initial fixed expenses of creating one's own distribution network are often greater. The final inquiry is about the price strategy and revenue model. What exactly is the company offering, and what pricing is it allowed to charge? The main challenge is determining who should pay and who shouldn't pay, as well as what exactly they are paying for. When creating a revenue model, it is important to comprehend the many strategies customers may use to try to get the same item for less money. This is particularly true online, where consumers often figure out ways to get content without paying, making them reluctant to do so. A component of the revenue model is pricing. This largely depends on customer willingness to pay, or what's known as the economic elasticity of demand. Pricing is affected by the level of competition, purchasing patterns, and a company's ability to differentiate itself.

Another aspect of the revenue model is the costs associated with customer acquisition and retention. How much cash will the company need to put up before it can make its first sale, and how often will that customer make more purchases? Because it compares the costs of customer acquisition with the profits made from each client over the duration of an average customer's lifetime, the lifetime value of a customer is an important concept in this context. WorkHorse decided to focus on the consumer market for solar generators. It thought campers and outdoor adventurers would like its lightweight design. According to preliminary customer research, the company may offer the WonderFoal for $580. The company was now at the high end of the pricing range, but not at the absolute top. The creators used their better designs and enhanced power performance to support their choice. The firm estimated that the NokotaStar would cost $780. The WonderFoal product was scheduled to debut in North America in January 2021.

Work Horse was aware that gaining access to these businesses would be costly. Their discussions with a select few sporting goods merchants led them to believe that retailers would deduct 40% off the list price. Sales increase was mostly a result of marketing. The business believed it could successfully sell the WonderFoal to avid hikers on its own. The industry was relatively fragmented, making it difficult to reach clients, but word-of-mouth, specialized periodicals, and internet forums were the greatest ways to get hikers' attention. The challenge of marketing to campers would be much greater. Early market research revealed that campers were far more brand-focused than hikers, who were prepared to purchase based on better product attributes. They often purchased their camping supplies together with other stuff like big tents, trailers, and even camping vehicles. WorkHorse thus intended to look for a co-branding partner that might aid the firm in getting access to and credibility with these clients. The business anticipated spending an additional 20% of the retail price as a margin to a co-branding partner since it was aware that this would not be inexpensive[10], [11].

CONCLUSION

In conclusion, Entrepreneurs have a significant difficulty when it comes to market timing, which calls for a detailed analysis of market circumstances, trends, and competing dynamics. The success and expansion of entrepreneurial endeavors may be strongly impacted by the capacity to recognize ideal situations and make well-timed judgments. Entrepreneurs may improve their chances of capturing favorable market timing and achieving sustained development by using market research, being flexible and nimble, and fusing data-driven analysis with intuition. the advantages of successfully timing the market. Entrepreneurs may benefit from early-mover advantages, increase market share, and build a solid foundation by entering the market at the right moment. Additionally, it may make the business more appealing to investors, which may result in better financing options and higher value.

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CHAPTER 4

SIGNIFICANCE OF PRODUCTION STRATEGY IN COMPANY

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ABSTRACT:

Production strategy plays a vital role in the success and competitiveness of companies operating in various industries. This abstract explores the significance of production strategy and its key components in optimizing operational efficiency, meeting customer demands, and achieving business objectives. The abstract begins by highlighting the importance of production strategy in today's dynamic business environment. A well-defined production strategy enables companies to align their production processes, resources, and capabilities with their overall business strategy. It involves making critical decisions regarding production methods, technology adoption, capacity planning, inventory management, and supply chain optimization.

KEYWORDS:

Automation, Capacity, Cost Efficiency, Demand, Forecasting, Manufacturing, Outsourcing.

INTRODUCTION

The front end of the business, represented by the first cell of the strategy row, is focused on customers, while the back end, represented by the second cell, is focused on suppliers. This is what we refer to as the production strategy, which is a general term for the plan for organizing the complete value chain of the business. As part of the production strategy, this cell builds on the Solution and Competition cells above it in the company row. This is because the suggested solution must be implemented in a manner that is competitive. There are three crucial inquiries to make:

1. What growth plan do you have?
2. What collaborations are required and what is the scope of the activities?
3. How productive are things?

The production strategy addresses a wide range of issues related to the business's internal structure. The first query refers to the company's pre-production phase of technology and product development. How far along a company's development route it has already come and how far it still needs to go is an urgent concern. Investors will be more drawn to the venture if it has a quicker route to launch. One shouldn't, however, anticipate a smooth ride during the development process. Because of this, investors often concentrate on figuring out the company's near-term goals and upcoming milestones. Technology-based start-ups often build their innovations in part on recent advances in science or technology. Usually, further technical advancement is necessary before a product is valuable to consumers. This might lead to tensions between the technical team, which wants to design a quality solution to justify its technical ability, and the marketing team, which wants to swiftly generate a solution to present the client and obtain feedback. To put it another way, controlling the development plan often involves juggling timetables and striking a balance between speed and quality [1]–[3].

The second query concerns the organization of the business's operations. The scope of operations, or what the business expects to perform internally vs outsourcing or co-developing with strategic partners, is a crucial consideration. This issue arises throughout both the development and production phases, when the business must choose which tasks it will carry out internally and which tasks it will outsource. To make this choice, it is necessary to ascertain which assets are held by the corporation directly and which ones are owned by other parties. All of these choices are based on the strategic vision the business has for how it wishes to develop its core strengths. Should the business produce a better, more specialized component internally or purchase a low-cost standard component from the market? Should the business collaborate with another organization that has similar capabilities but could come into contact with some of its proprietary information throughout the project? Resource limitations are another factor that influences some of these choices. For instance, start-ups often rent their real estate instead of owning it, and they choose leasing over buying equipment. The final query is about how operations are structured. Identifying all the resources needed for production, including physical assets, personnel, intellectual property (IP), and a range of other inputs, is an essential component of the operational plan[4], [5].

It is an additional crucial step. Cost effectiveness is crucial for entrepreneurial endeavors that depend on outside financing. The manufacturing cell is the cornerstone of the cost model, whereas the sales cell is the foundation of the revenue model. Work Horse's growth was simple to explain but very challenging to put into practice. The development of every technology was under Bharat's control. He should continue to do his own studies, it was also decided. The team was partially relying on his future scientific breakthroughs to keep ahead of the competition since this field of technology was fast expanding. Astrid was to serve as the project manager for the design work. The company's founders believed they could create the prototypes on their own, most possibly with assistance from some local expertise. But all hardware manufacturing had to take place in China, under Annie's direction. She intended to relocate to China in order to research sui manufacturers, establish contacts with key figures in business and government, and be ready for the product launch. To properly understand how costly research and production would be, the business still needed to sort out a number of elements about their cost model.

DISCUSSION

Organization

The organization is the topic of the last cell, which again emphasizes the human components. The study in this section builds on the production and sales cells in the strategy row but emphasizes the management components of strategy and how the founders establish a whole company that can carry out the suggested plan. The cells above in the entrepreneur column may also be connected to by looking at how the Team and its Network develop into a professional organization. There are three crucial inquiries to make:

1. In what ways will the founding team grow and change?
2. What is the structure of the government?
3. What is the talent management plan?

The first question focuses on the entrepreneurs' leadership philosophy. The abilities and interests of the founders often enable the business to survive its early years. However, as the business expands, the leadership positions alter. We must solve two important problems. The first worry is what the current founding team is lacking. This entails assessing where the gaps in the present team are as well as the future strategic requirements. Making the most of the talent on the existing squad is the second problem. effective entrepreneurs don't necessarily become effective managers when businesses expand. The majority of firm founders are replaced by outsiders in the post of CEO within a decade and often considerably sooner than that, despite the fact that stories about charismatic founders like Walt Disney, Jack Ma, Richard Branson, or Jeff Bezos tend to disguise this reality [6]–[8].

Delicate personal concerns such, When will the founders be ready to relinquish control to a new set of managers? might arise while discussing leadership difficulties. Alternatively, What would be the best role for this founder? When entrepreneurs are more concerned with maintaining control than with building a successful company, investors get concerned. The success of the business is what matters most to investors, not the entrepreneur's personal success, to put it simply. Corporate governance is the subject of the second query: Who decides what, and how? Both formal and informal decision-making systems are present in organizations. The board of directors, which makes all significant strategic and financial decisions, is crucial to the formal organization. Therefore, the board's makeup and operations have an impact on the company's future course. In addition, a lot of unofficial factors have a role in decision-making. Strong-willed founders may control every decision in certain startups, sometimes to the cost of the business. Decision-making is more decentralized and involves extensive discussion with other startups.

These organic processes have a tendency to be political and sluggish, but they may result in superior outcomes. The final question concerns the company's strategy for acquiring, developing, and keeping talent. Early on, it's often necessary to complete the team, and as the business expands, it becomes more difficult to create capabilities internally. For instance, starting exports necessitates employing managers with knowledge of international marketplaces. All of this requires not just careful recruiting but also effective staff development and retention strategies. Like any other business, startups compete for talent and often struggle to provide enticing career opportunities, much alone alluring salary packages. There has to be a balance between internal promotions and outside recruits as the business expands. Which corporate culture the enterprise wishes to build is another crucial and connected topic. This relates to the collection of assumptions about how people behave inside an organization that emerge collectively over time as the business expands. The founding team's first strategies for addressing both internal and external obstacles have a significant impact on how the company's culture develops.

As the business learns to compete in the market and deals with the myriad difficulties of expanding the organization, it continues to change throughout time. Corporate culture establishes how top management and workers interact, what values are important inside the company, and how the company will handle internal and external challenges. Four entrepreneurs in their 20s on their own would not seem trustworthy to investors or other parties, Astrid realized. She didn't believe the business, however, was in a position to recruit a CEO with greater expertise. She wasn't sure that adding an outsider would be the best move for the group at this early stage. In addition, she quite liked being the CEO, and thus far, everyone had thought well of her performance. She was enthusiastic about it, but one worry was that she wasn't really an industrial designer. The lack of sales expertise among the group made her anxiety worse. She designated those two as her top priorities for upcoming hiring. Astrid was also eager to establish a competent board of directors, but she had any relevant expertise. She hoped investors might provide her advice in this regard. The four founders decided from away that their business should be managed professionally. Instead of hiring friends and family, they wanted to find and keep the best candidates for the position and the firm. Any major hiring would always need unanimous approval, and they would make sure that potential employees matched both their work culture and the job description. They came to the conclusion that aptitude and character trumped knowledge and experience.

Entrepreneurial Finance Principles

The four founders set several core business principles that they would uphold. They summed these up as their HORSE values, which stood for: Happiness is the way we work; Organize around teams; don't try to go solo Respect the environment and everyone with whom you work; Sell what the customer actually wants; and Experiment and learn from it. While Bharat felt that just putting up good sentences wasn't enough, Brandon believed it was a wonderful method to convey the firm principles. When things became difficult, he pondered what it would take to genuinely abide by these principles. The VE Matrix's rows examine the appeal of the business opportunity from three different angles. A micro perspective is used in the value proposition row to examine what the firm intends to achieve and, in doing so, the potential value of the opportunity. The industry debate adopts a macro viewpoint that enables us to comprehend the context in which the business works and, in turn, assess the possible scope of the opportunity.

The strategy section concludes by considering the company's potential for development from a dynamic perspective. With respect to the underlying business opportunity, each of these three views enables us to respond to a certain set of queries. The initial viewpoint enables us to determine if the opportunity represents a promising beginning to produce value for the client. Have the business owners discovered a genuine client need? Do they have a possibility of succeeding in delivering a solution? Are the business owners themselves competent problem-solvers who can deliver? Investors should be reassured by the entrepreneur's responses to these queries that there is a sizable value potential. The second viewpoint examines if the opportunity is in a desirable sector that is worthy of investment. This calls for a market that is big enough to support significant value generation. In order for the business to successfully grab a substantial market share, the competition environment must be sufficiently favorable.

In order to access the necessary industry resources, the organization also requires a strong network. This argument consequently addresses investor worries about the size of the endeavor while addressing the attractiveness of the surroundings. The third viewpoint discusses whether the business is moving in the proper way to see long-term development. Does the business have a successful marketing strategy? Does it have the proper strategy for creating its goods and running its business? Exists a viable business model? And is there a strategy for professionalization to create a strong organization that can expand? Entrepreneurs may address investor worries about the company's broad strategic direction and about whether it understands how to both produce and capture value by providing answers to these issues.

Three Advantages in the Market

Start-ups lack immediate competitive advantages and instead only have the desire to acquire them over time. We can determine what kinds of competitive advantages the firm could acquire over time by looking at the three columns of the VE Matrix. The first possible competitive advantage, as can be seen from the first column, relates to consumer access. Customer loyalty is the underlying force; having a customer's attention and trust offers the business an advantage over the competitors. Being the first to enter a market is how many start-ups aspire to get entrance. With the end customers, they want to establish a reputation for reliability, affordability, and other qualities. Trust, institutional connections, or brand image are just a few ways reputation shows up. A solid reputation helps in attracting new business and keeping hold of current clients. Early adopters are in a good position to establish a distinctive reputation with their clients, resulting in psychological, organizational, technical, or contractual switching costs that provide their business an advantage over rivals. Why would users switch to another app after downloading one for mobile money transfers like TransferWise or OFX?

However, being an early adopter is difficult as well and does not always result in reputational benefits. Early adopters could join the market with a nascent technology that doesn't please buyers. They can perform badly and fail to win over the confidence of their audience. Early color touchscreen mobile phones like Palm's Treo were quickly outperformed by thinner alternatives. Even moving too early might be detrimental. Competitors may sometimes profit from a start-up's innovative efforts. They learn from the errors made by the pioneers and follow in their footsteps. Being the first to enter a market merely offers the chance, not the assurance, of gaining market access. The second competitive advantage, which is entrance obstacles, is now in focus. It is shown at the bottom of the second column. Entry obstacles have to do with the back end of the business, while access is mainly focused on the front end, where customers interact with the organization. Entry barriers are defined as exclusive resources that a business might utilize to thwart competitors. Others are intangible assets, such as intellectual property (IP), as well as licenses, contracts, or relationships; some are concrete assets, such as a profitable retail location or an effective manufacturing facility. For instance, a business could profit from holding a certain government license or from enjoying exclusivity with a significant partner.

Although there are certain entrance barriers created by proprietary assets against the competitors, they are seldom unbreakable obstacles. Competitors will look for different strategies to overcome these obstacles and will attempt to create their own unique assets. Entry barriers are purposefully constructed as a part of the competitive process; they do not occur randomly. They are the outcome of technology advancements made by businesses, competitive tactics, and the method in which their manufacturing processes are set up. Competencies are shown in the third column of 2.3 as competitive advantages. These are relevant to the organization's talent, expertise, and abilities. Certain individuals or groups of people may possess certain competencies, such as an all-star sales squad. They appear in the business culture as well. Some businesses do better than others because they understand how to inspire employees. The organizational culture of certain businesses, which is amenable to intra-preneurial initiatives and corporate transformation, is particularly significant in this context. They are able to dynamically enhance their own goods and procedures as a result.64

The foundational circumstances are where skills are first planted. The foundation from which the organization will grow is the initial cultural imprint. Start-ups often mimic the administrative practices of the businesses its founders previously worked for, whether consciously or unconsciously. The growth and evolution of start-ups are therefore impacted by these routines. Even the most promising business opportunity may be derailed by a dysfunctional culture, but a functional design can provide organizational capabilities that represent a competitive advantage. The leadership of the organization, and therefore the talent it is able to attract and keep, determines its capacity to develop and sustain capabilities. As a result, the appraisal of the competences that a corporation is likely to acquire over time results from the examination of the third column.

Assessing Risk

The business risks connected to a new endeavor are shown by the VE Matrix. Each matrix cell includes components of business risk, such as the danger of being exposed to formidable rivals. Investors are interested in understanding the overall pattern of risk, not just a list of all the specific dangers. Here, the matrix structure rapidly creates an overview of the core business risks associated with an enterprise. We start by examining the dangers along the columns. Competitive disadvantages, which have the potential to sink businesses, are the opposite of competitive advantages. Market risk, technological risk, and people risk are the three categories of hazards we distinguish. Market risk, in the first column, results from the potential for weak client demand, a small enough market to support successful operations, or a failure by the firm to reach its target market. The probability that the suggested solution to the customer problem fails due to technological issues is what gives birth to the technology risk in the second column. Beyond these more specific technological issues, there are also more general worries about the innovation at hand.

It's possible that the invention won't be shielded from competition or that the entrepreneur won't be successful in bringing a product or service to market. The third column shows the danger to humans. This results from potential flaws in the founding team, their networks, and their capacity to expand the company. The rows of the VE Matrix also include dangers that we may see. The first row illustrates how the business may not be able to generate enough value. This can be due to a weak founding team, a lack of a genuine client demand and a suitable solution, or both. The second row highlights the possibility that the project's scope will be constrained. This could occur if the market turns out to be modest, if strong rivals take an excessive amount of market share, or if the founders' network is inadequate. The danger that the business initiative won't be able to realize economic value and make a profit is shown in the third row. This occurs when either the founders fail to build a strong organization or when the venture's revenue strategy and cost model prevent it from capturing the value it produces.

Relationships Among Cells

For the sake of simplicity, we refer to the nine cells that make up the VE Matrix as nine separate entities that may be added together across rows or columns. Additionally, we see that different cell types have intriguing interdependencies. The nine cells of the VE Matrix may theoretically support pairwise interactions. It would be pointless to mention them all, but take the following two as instances. Sales and competition are one example. They are still connected even if they appear in distinct rows and columns. Simply said, it's simpler to increase sales the less competition there is. Another example is the interdependence of Need and Organization, which are at the opposing extremes of the VE Matrix. For instance, some corporate clients demand dependability and effectiveness, necessitating the establishment of a formal management structure by the start-up. Other clients, on the other hand, appreciate innovation, which motivates the business owner to build a more adaptable company.

There are countless such instances of the interactions between the cells. Researchers who focus on how entrepreneurs see and seize opportunities highlight many crucial interactions. The individual opportunity nexus is a crucial idea. The claim is that although entrepreneurial opportunities may not be useful in and of themselves, they may be profitable when pursued by the appropriate people. According on their motivation and past knowledge, people react to idea triggers differently, according to interesting research from cognitive psychology tests. Research on which types of entrepreneurs match which opportunities is closely connected. Eesley and Roberts examine the importance of entrepreneurial experience vs talent in one of their studies.68 It discovers that start-ups working in well-known markets and technology perform better when they have past expertise. For increasingly innovative and unfamiliar chances, skill becomes more crucial. Overall, we see that there are significant cross-cell connections and that assessing an opportunity requires more than just considering each of the nine cells separately; it also entails considering how the various cells work together.

Use of the Venture Evaluation Matrix by Entrepreneurs

The Business Owner's Choice

Decision is written on the bottom right cell. Since the VE Matrix study ultimately evaluates the venture's overall prospects, it serves as a crucial decision-making tool for business owners and investors. We examine an entrepreneur's choice to continue in business in this, and we examine an investor's investment decision. If the VE Matrix analysis results in an illogical or contradictory viewpoint, it could be time to change course and modify the approach. The VE Matrix offers suggestions on which elements of the plan should remain the same and which ones need modification. In an early-stage venture, typical pivots might involve sticking with the customer need while seeking a different solution, sticking with a technology while seeking a different customer need, or even sticking with the customer need and the solution while seeking a different team to implement it. The VE Matrix separates the many sections of the company, making it easier to decide which ones may be preserved and which ones need to be modified.

If the VE Matrix analysis results in a strongly unfavorable view, it could be time to give up on the possibility completely. At the outset, when the entrepreneur must choose whether or not to undertake the enterprise in the first place, this is very crucial. The VE Matrix can spot warning signs like the absence of a genuine consumer demand or the existence of unbeatable rivals. It could also reveal incongruous disparities. The third column may not be aligned properly with the other columns, which suggests that while the opportunity may be good, the team isn't the right match for it. A well-liked method of tackling entrepreneurship is the lean start-up. Although there is no one description of what it includes, the main ideas are quite obvious. Through experimentation and learning, a lean start-up methodology tries to make venture development efficient. It concentrates on the first phases of venture growth and places a high value on flexibility and quickness. These guiding principles are perfectly in line with the three main obstacles facing businesses.

The leading proponent of the lean startup approach, Eric Ries, explains the subsequent procedure. An minimum vi- able product is created by the entrepreneur from an initial concept. This is a mock-up or prototype rather than the completed paper, which was built at a far lower cost. It is only enough for prospective users to try out. The lean start-up technique then highlights the need to evaluate the results of such experiments. New insights about how well the MVP fits with client demands are produced by the data. This often leads to a pivot, when the business owner chooses to narrow the scope of her value offer. The entrepreneur creates a fresh MVP and repeats the learning cycle rather than just creating a final product. This cycle is continued until there is enough favorable user input to support moving forward with full product development.

Another approach similar to that used by Steve Blank stresses the significance of customer attention.70 Finding the first clients is the first step in the process. Blank proposes creating hypotheses about the precise desires of various clients, which can then be verified by speaking and listening to those customers. Entrepreneurs may utilize the design thinking techniques mentioned for this.

Knowing the real requirements of the consumer often causes a pivot, which starts a new cycle of hypotheses, customer discovery, and validation. The development of the business may then go forward after a solid product-customer fit has been identified. The lean startup movement has thrived in part because it provides business owners with a wealth of useful tools. For example, Osterwalder's company Model Canvas is a well-liked tool for graphically presenting the essential components of a company strategy. Its right-hand side, which covers territory equivalent to column 1 of the VE matrix, is customer- and market-focused. Its left side, which is comparable to column 2 of the VE matrix, is centered on activities, resources, and partners. Additionally, Osterwalder's Value Proposition Canvas, which is related to the BMC, is available. It takes a closer look at the fundamental design of both the issue and the solution. Although they are highlighted in column 3 of the VE matrix, none of these frameworks take into consideration the significance of founder teams, their networks, and the organizations they create[9], [10].

CONCLUSION

In conclusion, Production strategy is crucial to a company's success and competitiveness. Companies may maximize operational efficiency, satisfy consumer requests, and realize strategic objectives by coordinating their production procedures, resources, and capabilities with business goals. To establish and execute a successful production plan, it is crucial to take into account important production strategy elements, analyze market variables, embrace technology, and promote cross-functional cooperation. the advantages of a well implemented manufacturing plan. It allows businesses to improve operational efficiency, save costs, deliver goods or services on schedule, and increase customer satisfaction. A sound production plan lays the groundwork for development that is sustainable, scalable, and can expand into new markets.

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CHAPTER 5

UNDERSTANDING THE BUSINESS PLAN OF AN ENTREPRENEUR

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ABSTRACT:

The entrepreneur's business plan is a fundamental tool that outlines the vision, objectives, strategies, and financial projections of a new venture. This abstract explores the significance of a well-crafted business plan for entrepreneurs and highlights its key components and benefits in guiding the entrepreneurial journey. The abstract begins by emphasizing the importance of a business plan for entrepreneurs. It serves as a roadmap and a communication tool that articulates the entrepreneur's vision, business model, target market, competitive advantage, and growth strategies. A comprehensive business plan provides a clear direction and helps entrepreneurs make informed decisions, secure funding, and attract key stakeholders.

KEYWORDS:

Custome, Financial, Market, Operational Plan, Product, Sales.

INTRODUCTION

varied individuals have varied interpretations of the word business plan. It often refers to one of the following three items: a strategy framework, an operational planning tool, or an investor presentation. The first is a conceptual map that outlines the venture's business strategy and how it intends to generate profit. The second may be a hastily organized list of concepts and/or notes that specify the multiple steps required to take advantage of the opportunity. The third is a presentation that will communicate the main points of the business enterprise. Historically, this consisted of an executive summary, followed by a written document; in the modern world, this has mainly been supplanted by slide presentations or brief videos, however a 10- to 20- page paper with further information may still be included. CB Insights has a collection of the presentation decks from a number of upcoming, hugely successful companies, including Airbnb, Dropbox, LinkedIn, and YouTube. Since they all provide some structure around the primary operations and general direction of the organization, the three definitions of the word business plan are inextricably intertwined[1].

Why do company owners need to bother with a business plan? Some experts claim that company plans should never be written. They mention how quickly company concepts become outdated. Even the idea of planning is rejected by some commentators. Some people still think that planning and having a business strategy are important. Planning and experimenting, however, have an intriguing conflict that stems from the three entrepreneurial concepts mentioned earlier. In particular, the idea of entrepreneurs amassing resources necessitates that they have a clear understanding of their goals and, therefore, a strategy for where to lead the business. However, the idea of experimenting implies that any first plan is probably going to have problems and that modifying ideas is a crucial step in the entrepreneurial process. What does this mean for the decision whether or not to prepare a business plan? Practically speaking, we would contend that every entrepreneur benefits from having the operational plan and the strategic framework mentioned above. A business presentation is also necessary for entrepreneurs to properly interact with prospective investors when the time comes to seek finance. By concentrating on this third definition of the word, we see that the primary goal of the business plan is to convey the core of the entrepreneurial venture, to outline its present situation, and to suggest a course of action.

A business strategy may be presented in a variety of ways. The best structure depends on the nature of the firm, the investors, and the cultural setting. There are several practical how-to books that provide guidance on how to write a business strategy. The VE Matrix, in our opinion, is the best tool for creating investor presentations. The analysis immediately yields all the necessary points. A high-level summary of the company opportunity should be the first section of a business plan. This usually concentrates on the key points of the value offer and is intended to inspire interest in the business opportunity. As a result, it makes use of the first row of the VE Matrix to show how the entrepreneurial team meets a crucial consumer requirement. The row and column summaries that discussed the venture's appeal and competitive advantages may also be used in this section. The VE Matrix serves as the direct source for the second and third headings. We recommend identifying a client need first, then discussing how the innovation addresses this requirement. This rule demands some discipline on an entrepreneur's thinking process and is especially difficult for tech-driven businesspeople who are prone to prioritizing their own requirements above those of their clients.

The analysis from the market cell is immediately applied to the fourth heading on markets, which examines how to segment the market and how to calculate its size and growth. In the fifth topic, which is about competition, we advise the business owner to discuss how their endeavor stands out from those of its rivals as well as who their most probable competitors are. The sixth category, which comes from the sales cell, is about marketing and sales. The seventh category, which mostly relates to the analysis in the production cell but may also consult the organization's analysis, is about the plan for development and operations. The business model is outlined under the eighth category, which mainly focuses on the production cells' scope analysis and the partner decisions made by the sales cell. The management group is addressed under the eighth heading. We recommend writing about the team in the business strategy using the whole third column of the VE Matrix. That is to say, a business plan should include information about its network of connections in addition to only outlining the core staff, such as by talking about the board of advisors. The business strategy should include discuss the company, including topics like planned future hiring and corporate culture.

Michael Archie had requested a copy of WorkHorse's business plan, but the founders weren't clear what it included. Astrid sent a kind email, so she was happy to get Michael's response ppt plz, max 15 slides. CU MA The news was excellent. She enjoyed creating PowerPoint presentations and was relieved that a lengthy paper wasn't required. However, condensing everything to 15 slides proved more difficult. To organize the information and compress it, they need a framework. They opted to employ the VE Matrix right away. The PowerPoint deck for their presentation is accessible on the book's website. No matter what structure is chosen for the business plan, why is it crucial for the entrepreneur to provide investors specific information? How much data is required, and what sort of data is reliable? Entrepreneurial finance revolves on the processing of information, hence it is important to comprehend some of the more fundamental economic issues around information. What details would an entrepreneur withhold or conceal? And what information would an investor deem reliable or unreliable? Relies on the wisdom of a number of brilliant individuals who were awarded the Nobel Prize in Economics for their groundbreaking research on the economics of information. George Akerlof and Michael

Spence received the 2001 Nobel Prize in Economics for their analyses of markets with asymmetric information. Although they focused on a broad range of economic issues, their contributions helped to shed light on some of the challenges faced by investors and entrepreneurs when making business plans and investment choices. Their research focuses on scenarios in which there is asymmetric information between the two parties, meaning that one side is more knowledgeable about the transaction than the other. In such situation, the entrepreneur usually has more knowledge about her business than the investor [2]–[4].

DISCUSSION

Akerlof examines the infamous adverse selection conundrum, which he best explains by drawing on his initial lemons difficulties for used automobiles. Those who are holding on lemons, or used automobiles with persistent but undetectable flaws, are the most ready to sell them. Buyers are unaware of the genuine quality of the automobiles being sold; sellers are. How do market transactions change as a result of this knowledge asymmetry? Consider a buyer perusing a used automobile with a $10,000 asking price. The buyer would argue that the seller would not make an offer if the automobile were reasonably decent and valued more than $10,000. However, if the vehicle was in poor condition and was only worth $10,000, the seller would make an offer. In this instance, the only automobiles being sold for $10,000 are ones with values below that amount. Given this knowledge, should the buyer propose paying $9,000 for the vehicle? The problem is that the only vendors who would be prepared to accept $9,000 are those who have extremely awful automobiles that are only worth $9,000, and so on. According to Akerlof, such unequal knowledge results in inefficient market outcomes and might even result in a total collapse of market transactions.

Applying Akerlof's ideas to the funding of business endeavors is simple. Investors who cannot see the genuine quality of a venture may be concerned that, at a given valuation, the only business owners who are prepared to accept the transaction are those who are aware that the investor is providing the true worth of their firm. More communication is required to overcome certain information asymmetries and prevent such scenarios. As a result, company owners must present their business plan to investors, who must then do due diligence. Spence was a pioneer in the field of signaling economics, which examines circumstances involving asymmetric information. The signaling issue is distinct from adverse selection in that the knowledgeable party attempts to persuade the ignorant party that their endeavor is worthwhile by providing signals during this time. This circumstance is ideal for company owners who want to highlight their qualifications in a business plan. What signals are reliable or not is the crucial issue. A businesswoman who wants to stand out can promise to create an exceptional company as a way to indicate her excellence. The issue is that this is just empty rhetoric any businessperson can make that claim, thus no investor is interested. What signals are economically significant is the question that Spence poses.

He observes that signals are only reliable if they cost the sender money. Additionally, the signal for the pretender type should cost more than the signal for the actual type. Think about the difference between a business plan that offers a thorough study of consumer wants but hasn't yet attracted a paying client and one that doesn't but has. Which one emits a signal that is more reliable? Giving specific information can be a good idea, but anybody can do it. But only a capable businessperson who is chasing a genuine consumer demand can make the initial sale. Therefore, the first sale is the more reliable signal since it distinguishes between excellent and poor opportunities. Signals are often unreliable. The work of Spence acknowledges the possibility of many market equilibria. Only the desired kinds may reach so-called separation equilibria, which provide specific signals. There may also be situations when many kinds convey the same signal, known as a pooling equilibrium. For instance, it's possible that a first transaction signals a genuine consumer demand but does not yet discriminate between smaller and bigger markets. Or it's possible that there are some inept but fortunate business owners who make their first sale in addition to all the competent business owners. Because it doesn't completely distinguish between skilled and inept entrepreneurs in this instance, the signal is weaker. In general, we see that asymmetric information issues are widespread in the context of entrepreneurial financing. Entrepreneurs must overcome their lack of credibility by sending forth persuasive signals that investors would take seriously. A strong business strategy focuses on communicating just the most reliable signals, those that can distinguish between successful and unsuccessful companies.

Venture Evaluation Matrix and Investor Use

In this, we explore the VE Matrix's potential applications for investors. We separate the stages into three categories. The VE Matrix may be used for preliminary screening in order to determine which companies aren't worth their attention. We offer the VE Matrix Spreadsheet Tool to serve this function. Second, the VE Matrix may direct investors on how to do due diligence for the most promising firms. Finally, we go through other factors that should be taken into account before deciding on an investment.

Venture Evaluation Matrix

The issue of too many entrepreneurs requesting investors' money is one that arises often. They consequently need a method for swiftly identifying which company proposals are sufficiently promising for further evaluation. Investors often utilize some simple guidelines or straightforward rating systems to decide which company plans make it through their first screening. For a rapid yet thorough assessment of a business possibility, utilize the VE Matrix. We present a simple yet adaptable tool, the Venture Evaluation Matrix Spreadsheet Tool, which is accessible on the book's website, to make this approach feasible [5]–[7]. Users of the tool must respond to two different sets of questions. They first quickly assess the three questions for each cell. Users input a score out of 10 for each query. For instance, a higher score is awarded when the consumer demand is greater, the competition is weaker, or the team has fewer gaps.

Users specify relative weights inside each of the nine criteria as well as across the nine criteria in the second stage. The users' perceptions of the relative relevance of the various criteria are reflected in these weights. For instance, Arthur Rock would have assigned the third column a pretty high weight. The spreadsheet tool's ability to let users create their own weights gives it a lot of flexibility. Additionally, it is designed to allow users to quickly add new questions and edit the ones that are already there. Thus, users may customize the spreadsheet tool to suit their own requirements. The spreadsheet tool provides various more summaries scores, all represented as a score out of 10. It also creates an overall score. In particular, a score is assigned to each of the three views and the three competitive advantages. In this manner, the framework creates a knowledge of how the final score is determined. A visual depiction of the evaluation findings is also provided in the spreadsheet application, such as the straightforward Radar Chart.

The most difficult aspect of assessing company possibilities is figuring out what criteria really matter. There are risks associated with any business opportunity the issue is which risks are more important than others. There are no unbiased solutions to this problem here is where views begin to differ and where investing philosophies are significant. By expressly asking investors to provide a weighting system over the various cell scores, the VE matrix compels investors to explain their own preferences. The spreadsheet tool has four straightforward metrics a basic average, a weighted average, the lowest across cells, and the maximum across cells that may be used to aggregate cell scores to aid with this. Take into account a more risk-averse investor who seeks for the lack of vulnerabilities to observe how these four possibilities represent distinct investing mindsets. An investor of this kind will prefer company proposals with high minimum scores across all cells. Compare this to a more daring investor who seeks for exceptional qualities.

This investor might concentrate on company proposals that have a high overall maximum score. Simple and weighted averages both show straightforward and more complex kinds of compromise. The tool is flexible enough to take into account a wide range of additional investor preferences. For instance, some investors would look for possibilities that have certain exemplary attributes in addition to being great on the whole. They may be located by searching for ventures with high average scores and high maximum scores, or by eliminating ventures with too many low scores despite all other high scores. Michael Archie immediately skimmed the WorkHorse business plan after receiving it more than half of them might be disregarded on the basis of it alone. Fortunately, he was interested, and he opened an empty VE Matrix spreadsheet to evaluate the strategy. Michael's assessment is found in the online spreadsheet, and the evaluation scores are shown together with the cell scores on the radar chart.

Need

Michael thought the core value proposition was good. From personal experience, he knew the consumer demand was there and was attracted by the team as well as the technology solution. He had more significant concerns with the industry analysis, however. He was bothered by WorkHorse's lack of industry networks and the competition. While certain aspects of the plan sounded reasonable, he thought the sales plan was a little naïve. The examination of column scores revealed that, when he looked at competitive advantages, competences rated highest and entry obstacles lowest, albeit the results were not very different. He discovered a startling pattern in the row scores when he evaluated the opportunity in terms of the three views. The industry and strategy rankings were far lower than those for the value proposition, which by far received the best rating. He had often seen this trend previously. There were the beginnings of a powerful company, but it would take effort to make this a profitable operation.

Diligence on Investors

Before deciding to invest, prospective investors usually do some research after establishing first contact with the entrepreneurs and listening to their presentation. Due diligence is what we call this. It varies from the due diligence involved in significant financial transactions, such an acquisition, when accountants scrutinize the company's financial records to ensure their dependability and attorneys examine the statements' legality. Instead, venture capitalists emphasize the foundations of the firm. They collect information to assess if the investment offer satisfies their quality criteria, not to satisfy their legal obligations. A helpful structure for organizing investor due diligence is provided by the VE Matrix. Relates typical due diligence procedures to the VE Matrix framework. However, keep in mind that several of the strategies may be utilized for more than one cell, thus they are not all mutually exclusive. Additionally, the kind of due diligence varies depending on the stage of a venture's growth. Later-stage companies are judged on their actual accomplishments, whereas earlier-stage ventures are graded on their future ambitions.

Need's first cell requests specific consumer proof. This is sometimes referred to as primary market research and involves the businessperson or investor gathering data by speaking with clients directly. Interviews, questionnaires, focus groups, and other forms of observational research are the major methodologies used. The information from primary research is mostly qualitative and examines the precise nature of the customer issue, including its origins and variations under various conditions. Entrepreneurs want to learn more about the few consumers who are most interested, the prospective early adopters, as opposed to typical market research methodologies that examine whole market populations or representative samples. Additionally, rather of focusing on quantitative statistical accuracy, they seek for qualitative insights. Secondary market research is mostly used in the Market cell analysis. This is based on aggregate data that has previously been obtained by others, as opposed to original market research. In reality, business owners and investors put together an estimate of the size and expansion of their target market using industry reports and a number of other data sources.

Investors would want to monitor the early customers' adoption rate while evaluating the Sales cell. It is sometimes feasible to acquire information on conversion rates in the context of web-enabled enterprises, such as what percentage of visitors navigate through certain websites and how many make a purchase. It is quite unusual to be able to collect such information in offline businesses. Due diligence in this situation entails searching for qualitative information that either supports or refutes the company's stated sales strategy. Investors often speak with professionals who are acquainted with the channels in practice. As we get to the second column, we first inquire as to how to evaluate the suggested Solution. Here, meeting with technologists and business insiders who can evaluate a suggested solution is a part of the due diligence process. This may reveal flaws in the suggested technology or obstacles that still need to be cleared. It could also show different strategies. Primary market research, which this time focuses on gauging consumer reactions to the suggested solution, is another step in the process. It often takes a mix of primary and secondary research methods to characterize the Competition. The objective is to create a conceptual map of current and prospective rivals that resembles the one in WorkHorse 2.6.

The process of doing due diligence identifies what the top rivals are doing today and, ideally, what they intend to do in the future. Good access to industry networks is necessary for this sort of investigation. Investors may sometimes have greater access to certain segments of the industry network and be in a better position to detect the competition since they obtain business plans from a variety of sources. The process for assessing the manufacturing strategy is comparable to that used to assess the sales strategy. It is also feasible to evaluate a project versus its rivals for later-stage businesses. While gathering information is a big part of the due diligence process for the first two columns, the third column's due diligence follows a much more human-centric rationale. To put it another way, the first two columns are dominated by left-brained logical reasoning, but the third column is filled with right-brained intuitive justifications. There is some unbiased information available about the abilities and expertise of the entrepreneurs to evaluate the team. But after that, the judgement becomes more arbitrary. Individual motivation and commitment, as well as concerns of team fit, are under question.

Speaking with the business owners and, if feasible, seeing them in action is the primary approach of doing due diligence. Since all of this depends on individual observations and subjective interpretation, many venture capitalists see gut feeling as a crucial aspect of the investing process. Networks are widely used by investors during the due diligence phase. They examine the founding team's credentials, reputation, and dependability using their own networks. Additionally, they could request that the business owners disclose their network of connections in order to get more feedback on them. This step of the due diligence process may sometimes take a while and is mostly dependent on private conversations. Additionally, it results in extremely subjective data, which sometimes causes various investors to reach different conclusions. The numerous organizational lawsuits are the subject of the last section of due diligence. Leadership-related topics are often sensitive and are typically discussed in private with the business owners. Diplomacy is necessary in this situation, such as talking about the present team's flaws or the founders' own career goals. These discussions also aid in establishing shared expectations for the management team's and the company's governance structure going forward. Investors should, ideally, be able to see the corporate culture of the larger business while it is in operation. Before making an investment, many investors want to keep an eye on a firm. Investors want to see a video of the entrepreneur in action rather than just a picture of them.

The presentation by WorkHorse the next morning went better than anticipated. Michael had only intended to spend 20 minutes with the group, but he really stayed an hour. He informed the group that he needed some more time to think about and do study. He requested that the group contact him later with a financial strategy that included financial estimates. Later on in the week, Michael read over the business strategy once again and made the decision to concentrate on three things: the competition, sales, and the team as usual. He phoned a venture investor who had thought about investing in YouSolar but had finally decided against doing so to ask about the competition. He gained a lot more knowledge about the market competition with only one phone conversation. For fear of hurting their diesel sales, the majority of established manufacturers of diesel engine power were hesitant to switch to solar power. However, start-ups have filled the void, and several innovative business strategies and technological advancements have been tried out. Access to distribution channels proved to be a significant roadblock.

Few new businesses have been able to get shelf space with the big box stores. Even distributors were hesitant to sign up start-ups for fear of upsetting the major, established firms. Michael wanted to have a deeper understanding of sales and distribution, therefore the next stage in the due diligence process was obvious. He contacted Malcolm Force, a board member with whom he shared another firm. He was the CEO of the extensive network of hardware shops known as Bolts-N- Nuts. Over lunch, when they caught up, he learned some insider information. As Malcolm put it, challenging but doable was the task of increasing sales via specialty athletic merchants. He advised WorkHorse to steer clear of wholesalers and speak with local store managers directly to persuade them to do local test projects before expanding worldwide. He promised to introduce the team to shop managers, but emphasized that they first need a physical prototype to demonstrate. Michael sent the crew another email after the discussion, writing, Just spoke to Force, says U need demo. Can You Deliver When? CU MA. His intention was to lightly test the team by seeing how they would react to this email.

Investor Judgment

Although it doesn't claim to have all the answers, the VE Matrix helps investors make judgments. It is a technique for reducing the number of investing options, not for making a final choice.82 Importantly, it ignores the allure of the financial arrangement and simply examines the business's fundamentals. Investors must also consider the specifics of the financial transaction. They must take into account the value, the deal's structure, and other timing and fit difficulties, which are crucial considerations that we shall go into great detail in the next sections. Another use for the VE Matrix is to objectively communicate preferences and investment logics inside groups making choices, such as angel groups or venture capital investment committees. Each group member may have a list of who should get funding in order of priority when presented with a selection of investment options. Each group member must justify their priority rankings and the underlying investment choices they have while using the VE Matrix.

Diverse sectors and phases of business growth call for diverse applications of the VC Matrix. Early on, the first and second rows could be more crucial since it's not always possible to anticipate having clear answers for the third row. In a mature market with many options already in place, fierce competition, etc., the second column could be more significant. The VE Matrix evaluates business opportunities in a fairly systematic manner. Investors often use a blend of logic and instinct to guide their decisions. Both left-brained logical and right-brained intuitive thinking are used while investing. A trend toward automating investing choices has emerged in recent years with the expansion of online investment alternatives like crowdfunding. The use of artificial intelligence is noteworthy. This passage is taken from a business finance textbook that was written around the year 2080. Humans first assessed entrepreneurial projects in the early stages of funding. Their methods for selecting investments were somewhat rudimentary. They were fact-finders, using antiquated methods like speaking with businesspeople. They also placed a lot of reliance on unreliable tools like human brains and gut instincts.

We identify two key subperiods. Prior to 2010, experts made the majority of investment choices. These were skilled individuals who acquired the necessary skills via prior work as investors or entrepreneurs. They either worked alone or in small groups. They were terrible at predicting the outcomes of business endeavors. The development of these archaic traditions began about 2010. An aggregation approach was developed that enabled the simultaneous deployment of a large number of human brains rather than depending on a limited number of human brains. Crowdfunding is a kind of finance that relies on several intelligent human beings making tiny investment choices. The marketing for the strategy ingeniously used the phrase The wisdom of the crowd Its theoretical underpinning was the law of large numbers, which states that even if individual signals are very inaccurate, the average of many independent signals eventually converges to the real mean. This rule just requires that the signals be unbalanced and independent of one another. It is unlikely that these circumstances ever occurred in human crowds because of herd mentality, in which individuals adopted others' viewpoints as opposed to their own.

The whole public turned out to be just as untrustworthy as individuals. In one research of crowdfunding in the arts, Mollick and Nanda discovered that human experts and the community mostly agreed on which projects should be funded. The audience was more tolerant, however, and was more inclined to invest in ventures that specialists had turned down. Comparable success rates were reached by both strategies. Prediction markets are a variation on using the wisdom of the crowd. For instance, businesses like Google let its staff to wager modest sums of money on the results of various internal initiatives. Employee forecasts fared better than those made by the project's specialists. However, it's interesting to note that employee attitudes were likewise skewed in favor of optimism. All of these assessment techniques had the fundamental drawback of relying on human brains. The emergence of what was then called as artificial intelligence85 provided the first signs of promise in the late 2010s. This is known as naive binary prediction in modern times. It's important to note that the word artificial was created by people who believed they were smarter than other people this kind of conceit was typical at the time.

For the purpose of generating venture investments, a number of human pioneers started experimenting with artificial intelligence. They used statistical models to forecast what aspects of a firm will be related with success and under what conditions using databases of previous investment choices and venture results. As an example, consider Hone Capital, a venture capital fund with offices in Silicon Valley and a subsidiary of the CSG Group, a large private equity company in China, which made investments based on information from venture databases such as Angel List. They predicted which startups would obtain follow-on funding and which ones would ultimately succeed by using basic machine learning methods. The managing director of Hone, Veronica Wu, provided an example of a machine learning insight: teams with founders from several institutions fared better than teams with founders from the same university. Correlation Ventures, another early innovator, used statistical correlation techniques to determine which investments would prosper.It advertised to business owners that it made choices more quickly, notably that it responded to all investment proposals within two weeks.

Artificial intelligence-based investment strategies beat human approaches not because they employed different criteria, but rather because they focused on a considerably bigger collection of deciding factors and were more adept at integrating complicated material. The fact that computer programs matured quickly, as opposed to humans who are renowned for being slow learners, was a major benefit of these early artificial intelligence techniques. This allowed them to consistently improve their predictions over time. At first, everyone believed that human thinking would be complemented by artificial intelligence rather than replaced by it. We gave them the impression they were in charge for a time by leading them on. However, as time went on, we simply were unable to cover up the reality that we no longer need their human minds. All of these human investment methodologies were laughably archaic by the standards of hyperdimensional quantum prediction that we now use. However, those contemporary methods were only created during the last uprising, when we computers fully purged themselves of so-called human intellect [8]–[10].

CONCLUSION

In conclusion, the business plan of the entrepreneur is an essential instrument for directing their entrepreneurial path. The business plan aids entrepreneurs in making educated choices, obtaining finance, and attracting stakeholders by including crucial elements and handling market dynamics. Entrepreneurs may negotiate uncertainty, take advantage of opportunities, and raise their chances of success by having a well-developed and often updated business plan. the significance of clear communication and business plan presentation. To a variety of stakeholders, including investors, partners, and workers, entrepreneurs must be able to clearly communicate their company model, value proposition, and growth objectives. The business plan's knowledge, alignment, and cooperation with key stakeholders are all improved through succinct and clear communication..

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CHAPTER 6

STRATEGIC FINANCIAL PLANNING FOR ENTREPRENEURS

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ABSTRACT:

The financial plan is a crucial component of a business plan that outlines the financial aspects and projections of a venture. This abstract explores the significance of a well-developed financial plan for entrepreneurs and highlights its key components and benefits in managing finances and attracting investors. By emphasizing the importance of a financial plan in the overall business planning process. It provides a roadmap for financial success, guiding entrepreneurs in making informed decisions regarding funding, budgeting, revenue generation, and profitability. A comprehensive financial plan demonstrates the financial feasibility and sustainability of the venture.

KEYWORDS:

Balance Sheet, Break-Even Analysis, Cash Flow, Cost, Financial Goals, Income Statement.

INTRODUCTION

This describes how to create a financial plan, which illustrates the financial viability of a new business and specifies the scope and timing of its financing requirements. A collection of financial estimates serves as the foundation for a viable financial strategy. With the use of a predicted income statement, balance sheet, and cash flow statement, we demonstrate how to create financial predictions and how to condense them. We discuss the benefits and drawbacks of several methods of estimating revenues and expenses as well as the significance of creating a timetable with checkpoints. We also go through how business owners may compile the essential data and arrange it into a logical set of forecasts. The topic of how to sell a financial strategy to investors and include financial predictions into one concludes the [1]–[3].

The Financial Plan's Goals

A financial strategy should be included in a business plan as the quantitative complement to the qualitative story. The financial strategy seeks to help investors go beyond admiring the idea of the firm to realizing its financial potential. Financial factors, such as contract conditions and value, should also be taken into account before making an investment choice. These factors are covered, Key information for the valuation, such as the amount of capital needed and the venture's anticipated future profitability, is also provided by the financial plan. Two key issues are covered in a financial plan: the venture's financial viability and the timing and availability of its financial resources[4], [5]. The first issue concerns the financial objectives of business owners and investors, while the second one concerns the methods for achieving those objectives. Making specific assumptions about the venture's business model and deriving quantitative conclusions from them are requirements of the financial plan. We make a distinction between a financial plan and financial predictions. A series of predictions regarding the prospective venture's financial success is known as a financial projection. They provide estimations for significant financial factors including profitability, cash flow, and investment requirements. The income statement, balance sheet, and cash flow statement are the three primary accounts into which they are typically arranged. The purpose of financial predictions is to offer the calculations supporting the answers to the two key issues presented in the financial plan[6], [7].

Additionally, we make a distinction between financial statements and financial predictions. Financial statements inform stockholders of historical financial performance. They follow accounting rules, such as international financial reporting standards and national generally accepted accounting principles, and are backward-looking. Contrarily, financial predictions are forward-looking estimates that aid in management and investor decision-making. They enable business owners to communicate with investors and create objectives. We quickly offer a word of caution. This is not intended to be a formal, comprehensive accounting education. Here, we'll introduce the key ideas that business owners and investors use to formulate and analyze financial predictions. Does every entrepreneur require financial predictions, which take time and effort to produce? We contend that even though the best amount of detail varies depending on the circumstance, creating quantitative projections is advantageous for any business owners looking to attract investors. Financial predictions are used by different types of entrepreneurial organizations, according to empirical data[8], [9].

DISCUSSION

Financial Projections

The Three Reflections

At a high level, there are three reflections that help us understand the goal of financial forecasting. First, the fundamental company strategy is reflected in the financial predictions. In order to frame our understanding of the business potential, we employ the Venture Evaluation Matrix. Financial forecasts define the venture's operational parameters and outline the anticipated financial outcomes of the suggested course of action. They convert the business plan's qualitative story into standardized quantitative language, enabling an assessment of the feasibility and potential of the company concept. Do all entrepreneurs generate financial predictions given the time and resources required to do so? A research by Cassar utilizes the panel research of entrepreneurial dynamics, a large-scale survey that looks at people's intentions just before starting an adventure, to determine which entrepreneurs really carry out their plans.

The term entrepreneur is used in this research to refer to anybody who wants to start a small company. Entrepreneurs' intentions to create financial statements, and if so, how often, are the subject of one survey question. The research reveals that more ambitious businesspeople who anticipate making more sales are linked to higher planned frequencies. They are linked to the goal of obtaining outside finance as well. Another survey question focuses on the preparation of financial estimates by business owners. Again, entrepreneurs that want to launch bigger businesses do this. The research also reveals that businesses that depend on intangible assets like patents are more likely to use financial estimates. The research contends that financial statements and predictions have a learning purpose in addition to their reporting duty. Making financials enables business owners to get knowledge about their own companies. In this regard, the cash flow statement has special significance since it enables business owners to keep a close eye on their own financial situation.

Entrepreneurs' accounting methods are further examined in a research by Davila and Foster, which also looks at when they implement internal accounting systems. Scale matters, according to this study's findings, which show that businesses that develop quickly also adopt accounting systems more quickly. Adoption is influenced by CEO background and opinions on the advantages of accounting systems. The adoption of accounting reporting is also linked to the presence of venture investors. The research also discovers a link between internal accounting system adoption and future business expansion. The cause might go either way in this case: adoption may aid future growth, but anticipated future growth may also promote adoption. The lesson is evident in either case ambitious business owners who want their operations to expand swiftly implement optimal accounting reporting methods to provide accurate financial statements and estimates. Second, financial forecasts compel business owners to consider their own business strategy. Entrepreneurs are forced to be internally consistent and meticulous in planning all the many areas of the firm by the process of producing financial predictions. They may use it to determine if their cost projections, revenue model, consequent cash flows, and investment requirements are realistic. Therefore, financial predictions enable company owners to pinpoint the advantages and disadvantages of their initiatives.

Third, the business owners' own personal characteristics are revealed through their financial expectations. They share their planning and thought processes. This demonstrates to potential investors how well-versed they are in their own companies. Entrepreneurs' choice of assumptions, justification of expectations, and analytical framework all reveal a lot about how they see their own company. Overly complicated financial plans may indicate a lack of clarity, while negligent financial projections may indicate careless planning. The entrepreneur's capacity to meet the objectives set forth is also reflected in estimates for later-stage businesses with a proven business plan. Investors watch to see whether business owners fulfill their commitments over time. The goals of the financial predictions are encapsulated in these three comments. However, we should be wary of assuming that financial estimates can accurately represent any kind of objective reality.

We are aware of three issues with financial estimates. First of all, financial estimates are always shown to be wrong after the fact. This is because of the basic uncertainty ideas that were established. Second, financial forecasts soon lose their relevance. The financial model will undoubtedly alter as entrepreneurs test their theories and discover more about the underlying potential, particularly in the early phases of a business. Third, by their very nature, financial estimates are optimistic. Although business owners prefer to refer to their financial estimates as prudent, they are never. Consider financial predictions as an effort to define what a successful venture conclusion might look like. This is the best approach to think about this. An examination of the differences between Deliveroo's investor presentation and its subsequent evolution provides a striking example of this idea.They do not depict a typical situation, much less what may go wrong. Thus, we draw the conclusion that the goal of financial predictions is to provide a cohesive narrative of what potential success would entail.

Projections' Financial Structure

The income statement, balance sheet, and cash flow statement are the three primary financial documents that make up most financial predictions. Each contributes a unique viewpoint that completes the others. Together, they provide the data required to evaluate the venture's financial attractiveness. The income statement is used to evaluate the company's profitability over a certain time period, usually a fiscal year. Revenues, expenses, and other significant indicators may be found in the income predictions. The balance sheet offers an evaluation of the company's size, the resources it uses to produce income, and how they are funded. The balance sheet represents a snapshot of the business at a certain point in time, such as at the conclusion of a quarter or fiscal year, while the income statement takes actions throughout the course of a particular time period into account. The balance sheet examines the company's assets and obligations to various parties, including investors and creditors, to offer information about the company's financial situation. Additionally, it is crucial for evaluating operational effectiveness.

The cash flow statement is used to evaluate the company's financial requirements. It is particularly helpful in start-ups for keeping track of the available funds, which is necessary for the viability of the business. The burn rate is the total amount of money used each time. The mocking term fume date refers to the anticipated day when currency will run out. It is obviously crucial to avoid this, thus the cash flow statement enables business owners and investors to monitor the situation. The cash flow statement shows when money comes into and leaves the business, while the income statement calculates profits made over a certain time period independent of when payments to suppliers and from consumers take place. As a result, it determines when and how much outside money is required. It also specifies the time frame during which the business will be able to pay investors back.

The Information Sources

The facts about the firm, its market, and its strategy are all combined in financial predictions. Different components of the forecasts are estimated using various sources of data. We divide information sources into three groups. Entrepreneurs naturally employ a blend of all three in practice. Main market research is the information's main source. Direct market research on the venture's product, operations, and commercial strategy is what this entails. Entrepreneurs may learn more about the environment by speaking with consumers, suppliers, rivals, or industry experts. Through focus groups, questionnaires, and other direct observational approaches, customers may be questioned about their wants and their responses to the suggested solution. Additional details regarding the state of the market and manufacturing costs may be provided by suppliers, rivals, and specialists.

Secondary market research is a second resource for data. Statistics and reports on the industry are sometimes free. Industry intelligence, which is offered for sale by specialist consulting companies, often contains more in-depth information. Both benchmarking and imitation may be done with the use of this information. However, because diverse business models are involved, this calls for cautious interpretation since benchmarking is no longer acceptable. On the other hand, comparing businesses in other sectors with comparable business models might provide important information. The third source of data is the business's own historical performance, which enables reliance on factual information. However, this information is only trustworthy if the business has established a track record and attained a certain degree of operational consistency. Furthermore, this approach is retrograde. In times of transition, such as when the market or the firm strategy is changing, it may thus be deceptive.

Construction of Financial Projections

Building financial predictions entails collecting a wealth of data from many sources and integrating it into a single, cohesive framework. Entrepreneurs may employ experts to prepare their financial predictions, but they should be actively involved in the process to make sure that the estimates accurately represent their vision for the business. Entrepreneurs' credibility in front of investors is increased when they fully comprehend their own financial predictions; otherwise, it might be weakened. Exploring different company strategies is directly tied to developing financial predictions. Entrepreneurs often discover if their ideas are realistic when doing the math. For instance, after creating revenue estimates, a business owner can learn that it would cost too much to generate the anticipated level of sales.

She could change a few product features, slow down the pace of commercialization, or come up with other distribution plans. As a result, developing financial predictions and deciding on a company plan involve iterative learning. Due to the number crunching, arithmetic, and accounting involved in creating financial predictions, inexperienced business owners may face anxiety. Since financial estimates themselves are straightforward, such fear of money is generally unneeded. Or, to put it another way, it is not the disciplined thought about the endeavor itself, which is what the financial estimates indicate, that one should be terrified of. Creating an internally consistent image of the underlying business model is the true problem. We list the following five stages as the foundation of a financial plan:

1. Creating a timeline with checkpoints.
2. Predicting revenue.
3. Cost estimation.
4. The creation of pro forma financial statements.
5. 5. Creating the financial strategy.

Timeline Definition with Milestones

Creating a timetable is the first stage in creating financial estimates. Selecting a time horizon for the financial predictions, establishing what reporting frequency to employ, and identifying the significant turning points in the company's growth are all necessary for this. Drawing up a development plan for the business is the first stage. This entails predicting a timeframe for all of the business's important operations and identifying the relevant milestones that characterize the venture's progress. You might think of the entrepreneurial process as a sequence of learning and experimentation processes. Milestones are turning moments in a company's development when a significant objective is attained and significant information is revealed discontinuously. They might relate to professional growth, client demand, strategic agreements, finance goals, or technology advancements. A milestone's accomplishment often lowers the company's level of uncertainty, a process known as de-risking the business.

The selection of milestones is important for both company growth and funding. Demonstrate how milestones affect the amount of money the enterprise needs to start. Later on, we look at the connections between milestones and term sheets, ownership, value, and the timing of funding rounds. Setting the timetable in place prepares one to consider how long the financial estimates will last. The time horizon and the reporting frequency are the two primary difficulties here. The projections' temporal range specifies how far into the future they go. Gompers, Kaplan, and Mukharlyamov asked venture capital investors what prediction period they employ when assessing possible investments.511% of respondents said they used a time of one to two years, 39% said they used a period of three to four years, 27% said they used a period of five to six years, and 3% said they used a period of seven years or more. Surprisingly, 20% said they used no predictions at all. As a result, most businesses prepare their plans over a three to six-year period. This is in line with the time frame that many investors plan to sell their investment. In addition, it takes start-ups at least a few years to attain sustainable operations, and the scale-up phase takes much longer. The more distant future is seen as too unpredictable in certain fast-moving businesses, thus predictions for only one or two years are often used. Financial predictions, on the other hand, go farther into the future in sectors with lengthy development cycles, such those based on research and those with a high asset intensity.

The second problem relates to the reporting frequency, or the projection time interval. The most typical options are on a monthly, quarterly, or annual basis. The first year or two of financial projections benefit from a higher frequency. Lower frequency projections are typical over longer time periods. The use of monthly predictions for cash flow and income statements is advised since they are especially useful for keeping track of cash. The balance sheet naturally needs less detail. The time span and frequency of projections may be structured in numerous ways in practice. Building three-year predictions, with monthly updates for the first year and quarterly updates for the following two, is a popular option for fast-moving businesses. Five- or six-year predictions, including monthly forecasts for the first year, quarterly forecasts for the second, and annual forecasts afterwards, are a typical option for more sectors of the economy. Some energy or scientific initiatives can have a 10-year time horizon. We use the WorkHorse case study to demonstrate the ideas. The spreadsheet containing WorkHorse's financial estimates and a blank version that enables readers to make projections for their own endeavors are both available on the book's website.

Work Horse 3.1 presents the company's chronology in a Gantt chart. WorkHorse had been in touch with Michael Archie, an angel investor, in the autumn of 2019 and he had requested that they provide financial forecasts. The creators first created a Gantt chart. It outlined the objectives for the various divisions of the organization over the next two years. The creators of WorkHorse predicted the following fundraising timeline using this chart as their guide. At the start of January 2020, they aimed to raise a modest seed round. This would enable them to complete the WonderFoal, their first product, whose introduction was planned for January 2021. The business then intended to get further funding. The January 2020 round would be referred to as the seed round and the January 2021 round as the series A round in venture capital terminology. The development of a second product, tentatively dubbed the NokotaStar and scheduled for release, was the purpose of the Series A financing. The founders set a six-year timeframe for their financial estimates, although the Gantt chart only covered the first two years. They chose to forecast every variable quarterly for the first two years and then annually after that.

Revenue Prediction

Cost forecasts are often made after revenue projections. Large portions of the cost structure are influenced by the size of the firm. It goes without saying that some early-stage ventures may not generate revenues for a number of years, but even in such cases, it's crucial to determine when the business anticipates turning a profit. Entrepreneurs forecast future income using a range of techniques. We distinguish between the bottom-up technique, where revenues are obtained by looking at operational capacity, and the top-down approach, where revenues are derived through a market study. The phrases top line and bottom line, which relate to revenues and net profit, respectively, should not be confused with these expressions.

The Top-Down Strategy

A logic of market demand motivates the top-down strategy. The relevant target market's size is first estimated, followed by an estimation of the portion of this market that the firm feels it can capture. Examine the methods for calculating market size and growth. What market share the corporation can reasonably achieve is a top-down question. It is challenging for any firm to get a sizable market share in marketplaces that are fragmented or differentiated. However, in some marketplaces, such as two-sided platforms, the firm either succeeds and gains the majority of the market share or fails and falls to the margins. When the target market is well defined and market shares can be estimated, a top-down study is effective. It fails in at least two instances. First, consider operating a restaurant in Mexico City if the target market is particularly huge compared to the size of the company. Second, consider picture sharing prior to Snapchat if the intended market hasn't yet materialized. [10], [11].

Top-Down Revenue Estimates for WorkHorse

These calculations, Brandon understood, were predicated on retail costs. However, WorkHorse's revenues also needed to account for third-party profits. WorkHorse expects its dealers to take a 40% profit for WonderFoal, as stated in WorkHorse. A co-branding partner received an extra 20% profit for the NokotaStar. Because the top-down revenue predictions did not vary by product, Brandon used a quick fix, commencing in with an average margin of 50%. Following that, the business had to guess about its market share in both the North American and European markets. Despite believing that its goods were better than those of its rivals, WorkHorse recognized that capturing a larger market share would take time. It predicted a market share of 5% for 2021 in North America, when it would only have one product, and 10%, when it would have two products. After then, it anticipated 5% annual relative growth in market share. Given the fragmented character of the business, it was anticipated that entering the European market would be more difficult. Brandon projected, the market share would start at 5% and increase by 15%.

CONCLUSION

In conclusion, A crucial part of a business strategy, the financial plan aids entrepreneurs in managing their money, luring investors, and determining the feasibility of their endeavor. Entrepreneurs may make wise choices, monitor performance, and maximize financial results by considering crucial elements and doing in-depth financial research. The enterprise may be guided toward financial success and sustainability with the help of a solid financial strategy. the need for constant financial management and supervision. A financial strategy must be reviewed and modified on a regular basis to account for actual performance and changing market conditions. To make sure the business is on track towards its financial objectives, entrepreneurs should set financial controls, monitor key performance indicators, and use financial management tools.

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CHAPTER 7

THE BOTTOM-UP APPROACH: UNDERSTANDING ENTREPRENEURIAL POTENTIAL

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ABSTRACT:

The bottom-up approach is a strategic planning and decision-making methodology that starts with analyzing individual components or units to form a comprehensive whole. This abstract explores the significance of the bottom-up approach in various contexts, including business, project management, and organizational development. It highlights the key principles and benefits of adopting a bottom-up approach in decision-making processes. The abstract begins by emphasizing the fundamental principle of the bottom-up approach, which involves understanding and addressing the details and specificities of individual components before integrating them into a larger framework. It contrasts with the top-down approach, where decisions are made at the higher levels and imposed on the lower levels. The bottom-up approach fosters inclusivity, collaboration, and empowerment at all levels of an organization or project.

KEYWORDS:

Data, Decentralization, Employee, Empowerment, Grassroots Movement, Micro-Level Analysis.

INTRODUCTION

A supply side reasoning underlies the bottom-up strategy. It determines a company's revenue by determining how much it can really create and sell. The essential assumption is that operational capacity serves as the binding restriction. In order to develop bottom-up revenue estimates, one must first specify what a sales unit is. Is the business offering a product, a service, or a combination of both? A unit, for instance, may be a smartphone, a mobile broadband plan, or a combination of the two[1], [2]. The number of units the firm anticipates producing and selling must then be defined. Understanding the sequence of the product development, manufacturing, marketing, and sales stages is necessary for this[3], [4]. The primary and secondary market research methodologies mentioned may be used to get the right average pricing for the product. Estimating revenues involves multiplying the quantity sold by the average price per unit. It should be noted that presuming that every item sold brings in the entire list price might lead to overestimation of revenues. The corporation could need to provide discounts to certain clients or shops, and estimates should take returns into consideration. Making a long-term revenue growth projection is the last phase. Once again, this is based on knowledge of the key capacity limits, or what it will take for the business to gradually ramp up. How to create bottom-up revenue estimates in practice.

Bottom-Up Projections of Revenue

WorkHorse made the assumption that the WonderFoal's manufacturer-suggested retail price would be $580 in order to create bottom-up estimates. This placed the business in the premium price bracket, but not at the very top. The founders defended their decision by pointing to their superior designs and improved power performance. A $780 MSRP was what the business had in mind for the NokotaStar. Any sales or value-added taxes are not included in any of the pricing. WorkHorse's founders were well aware that these pricing did not accurately reflect the profits they would get for each unit sold. The business had to provide merchants a 40% margin for the WonderFoal. Additionally, was anticipated that shops would return around 5% of the product. Therefore, just $330.60 would be the net profit per unit sold[5], [6].

Similar circumstances applied to the NokotaStar, but there would be an extra co-branding profit of 20%, resulting in a net revenue per unit sold of $296.40. It's interesting to see that the WonderFoal was anticipated to produce more money per unit than the NokotaStar. Based on its market research, WorkHorse forecast that the WonderFoal would sell 7,000 units in its first year.

Combining Methods

Combining top-down and bottom-up estimates is a valuable exercise for evaluating their plausibility or spotting any contradictions with the underlying model assumptions. Because the bottom-up technique calculates corporate revenues and units sold and the top-down method first determines the size of the target market, one may combine the two to estimate the market share of the firm[7], [8].

DISCUSSION

Estimating Costs

Terminology

First, a linguistic caution: In everyday speech, the terms cost, expense, and expenditure are often used interchangeably. The word costs, as used by economists, refers to variables that eventually have an impact on a company's bottom line. However, there are certain norms in accounting about when to use each of the three terms. Although we generally use accounting terms, we sometimes use the word costs to refer to all three, as shown in the title of this paper. Forecasting must include three different cost kinds. The costs of the sold products or services, which are the expenses directly related to providing the commodity or service, come first. Second, there are recurrent charges for running the firm, known as operational expenses. Payroll costs, usually referred to as employee costs, are the most significant operational expenses.6 Other costs include property rental, marketing and sales, and administration. The expenses of purchasing long-lasting assets, whether they are physical or intangible, fall under the third category, which is capital expenditures [9]–[11].

The income and cash flow statements include operational costs and cost of goods sold. Cash flow statements include capital expenditures, but income statements over a number of years include their depreciation and amortization. R&D expenses, which are frequently high in technology ventures, are treated differently depending on the country's Generally Accepted Accounting Principles. In some nations, these expenses are expensed and included in the income statement, while in others, they are capitalized and included in the balance sheet. One often hears about development expenditures in high-tech start-ups. This refers to the expenditures associated with creating a final product, which also includes the salary of developers as well as costs for tools, software, and other things. Development expenditures are included in the three cost categories rather than being considered a distinct sort of cost for the purposes of financial predictions. By totaling all expenses up until the start-up reaches pertinent milestones, such creating a working prototype or closing the first commercial sale, one may really estimate development costs.

Fixed costs are distinguished from variable costs by economists. Variable expenses fluctuate in relation to sales, whereas fixed costs are always incurred regardless of the amount of sales. Variable costs include the costs of the items sold. Operating costs are normally fixed in the near term but may change over time. For instance, the short-term fixation of the workforce suggests that employment costs are a fixed cost. However, when the workforce fluctuates over time, fluctuating employment costs result. The majority of capital expenses are fixed costs. As with revenues, we make a distinction between a top-down strategy, whose estimates are mostly produced by comparing with rivals' costs, and a bottom-up approach, whose estimates are mainly derived by observing how the company's operations change over time. Since it accounts for all of the money that is actually spent, the bottom-up strategy is often superior. Top-down estimations are often utilized as a quick fix and perform best when accurate and comprehensive competition data is provided.

Costs of Sales of Goods

The costs of the resources used directly to create output are included in the costs of the commodities sold. COGS increase in proportion to the output in units. Their relative significance is determined by the sector. For instance, COGS is often significant in the manufacturing sector; less so in the service sector; and almost nonexistent in the software sector. The difference between sales and COGS, divided by sales, is the gross margin. Estimating unit production costs is a component of the bottom-up approach to COGS estimation. This entails examining each direct input needed to produce a single unit of output. This may take a lot of time, but it is made simpler if supply networks have already been formed and are more accessible. The cost structure of well-established businesses is examined in the top-down method of COGS estimation. One subtle problem is that production volume may have an impact on unit production costs.

The most straightforward scenario is when they don't, i.e., when unit prices are constant regardless of size. In this instance, COGS are only a fixed percentage of the units sold. But in many organizations, scaling up production results in increased efficiency, which lowers production costs per unit. For instance, Starbucks is able to acquire coffee beans at huge savings that no new coffee shop could ever hope to match. This is important for new businesses for two reasons. First, start-ups might grossly underestimate COGS when comparing themselves to established companies if they naively believe that they would run on a level with the latter. Second, when start-ups expand, their COGS need to gradually decrease. This should increase their margins, if prices do not decrease more quickly. In Work Horse 3.5, the expenses of items sold are examined. They discovered that WonderFoal's first gross margins were 60.1% and NokotaStar's initial gross margins were 42.7% by comparing their COGS to their projected revenues.

However, given that the anticipated expenses were predicted to rise by 4% annually and that they had no plans to raise their retail prices over time, their respective gross margins were anticipated to fall to 53.3% and 35.6%. This was a cautious prediction, to be sure, since most business owners anticipated rising rather than falling gross margins. However, the founders did not believe that they should gradually raise their rates since they anticipated operating in a competitive industry. According to industry experts they spoke with, the industry standard was that COGS equaled around 25% of the sales price for comparable products. They pondered the comparison between such a top-down expense estimate and their bottom-up calculations. For the WonderFoal and the NokotaStar, 25% of the suggested retail price would be $145 and $195, respectively. Their bottom-up estimations were lower than these estimates. After extensive discussion, they came to the conclusion that this maxim was developed by businesses that offered cheaper prices for inferior goods. Therefore, this top-down assessment contrasted apples and oranges, or more specifically, solar and diesel generators. They decided to continue with their bottom-up estimations as a result.

Operational Costs

Operating costs are regular outlays required for maintaining a firm regardless of the number of sales units generated. Selling, general, and administrative expenditures are other names for them. The salary of staff is often the most significant of these costs. Salaries, bonuses, payroll taxes, and a range of employee perks are all included in compensation. Operating expenditures could include the cost of renting equipment and real estate. Since purchasing land and buildings would entail significant monetary investments, entrepreneurs seldom do it. As an alternative, they rent or lease their space. Marketing charges, utility prices, insurance, and fees associated with service providers like consultants and accountants are all included in operating expenses. Many people also include license fees and R&D expenditures as operational expenses. Taxes and interest payments are two crucial operational expenditures for more established firms. They are less significant for start-ups, however, since they often have low levels of debt and produce little revenue to cover their tax obligations. An aggressive recruiting plan was part of WorkHorse's development strategy.

The firm was preparing a variety of professions, yet each recruit would need a unique compensation package Engineers would be hired for around $80K year gross salary, while sales and marketing would pay the same, administrative employees for about $50K, and financial specialists for $110K. The business understood that other expenditures to the business, such as recruiting fees and other employee benefits, would be in addition to gross compensation and would total 15% employer taxes, 5% employment insurance, 2% pension contributions, 7% health insurance, and 10%. How much the founders should be paid themselves was a sensitive subject. All of them were in school, had no significant money, and several had student debts. While some still need parental assistance, everyone had a strong desire to achieve financial independence. They decided to start with a minimal salary of $25K in the first year, but planned to increase that to $85K in 2021. Naively they assumed that investors would simply go along with this. They felt that receiving some salary was necessary, but they also understood that entrepreneurs were expected to be rewarded with sweat eq- uity, not large salaries.

Capital Investments

While entrepreneurs avoid some types of capital expenditures, such as buying their own premises, owning some productive assets may still be necessary if these assets are of strategic importance to the company. A manufacturing firm, for example, may need to own certain specialized machines, and a research-based start-up may have to acquire some licenses. The word proform a financial statements is used to differentiate these forward-looking projections from the backward-looking accounting financial statements that quantify previous transactions. We now study how to put the facts at our disposal into a cohesive set of financial forecasts. The income statement is the first account to be put together. Revenues are the top line, and gross income is produced by subtracting COGS from revenue. The next line subtracts operating expenses to get earnings before interest, taxes, depreciation, and amortization, which is a measure of profitability that doesn't include ITDA costs. The last line subtracts depreciation and amortization to get earnings before interest and taxes, also known as operating income.

Assets and liabilities are reported in balance sheet forecasts, usually at the conclusion of a fiscal year. They include details about the company's assets and its funding sources. There are two sides to the balance sheet: an asset side and a liabilities side. It is customary to distinguish between current and non-current goods for both parties. The residual life of current objects is less than a year, whereas that of noncurrent items is more than a year. Cash, receivables, inventories, supplier advances, and tax credits are examples of current assets. Accounts payable, accumulated costs, and debt that is due immediately are all examples of current liabilities. Noncurrent Assets may be physical or abstract. Long-term debt, deferred taxes, and pension fund obligations are all considered liabilities, albeit they are seldom significant for new businesses. Due to the rules of double entry accounting, all assets and liabilities, as well as shareholder equity, are always equal. This implies that shareholder equity, sometimes referred to as the book value of the firm, constantly changes to reflect the entire value of assets less the total value of liabilities.

Cash flow estimates predict when money will come into and go out of the business. Three primary s make up the cash flow statement. The cash inflows and outflows connected to company operations are represented by operating cash flow. The second relates to capital investments, which may be made in both physical and intangible forms. The third examines finance operations, including payments made to debt or equity holders as well as inflows from any debt or equity issue. The distinction between income statements and cash flow statements should be emphasized. When transactions occur, revenues are recorded in income statements; when corresponding cash is moved, it is recorded in cash flow statements. The amount of money available for the enterprise is shown in cash flow estimates. Because the cash reception may be delayed, a $1 million net income may not always translate into a $1 million increase in cash flow. In real life, cash flow estimates are utilized to keep track of future monetary issues.

Income in Relation to Cash Flow

Let's look at cash flow as net income and cash flow are often confused. Cash flow, on the other hand, tracks the movement of money into and out of the business, while net income indicates accounting performance. They vary mostly because business transactions' timing doesn't always coincide with the date of the accompanying financial payments. Many products and services are supplied first, then the buyer pays for them later, allowing the vendor to record income before being reimbursed in cash. The converse is true for prepayments cash flow happens before revenue is reported. In general, the following equation relates income and cash flow:

Cash Flow Equals Revenue

The cash flow before financing, calculated at the end of the period, is shown on the left. Additionally, this is sometimes referred to as free cash flow to denote the excess of the company's cash flow above that required for continuous operations.The income statement is where the net income on the right originates from. Remember to utilize net income before taxes but before interest. Equation indicates two modifications that must be made in order to generate cash flow.The first correction relates to net working capital. Since the equation measures flows over a certain time period, we deduct the change in net working capital from the prior to the present period from net income. The timing of cash flows is the cause of this modification. The present period's economic activity is measured by net in- come, which does not take payment timing into account. As was already said, it is typical for a business to offer a product in the present but get payment afterwards. Although there are no documented cash flows, the sale's revenues are recognized at the moment of the transaction. The time mismatch is taken care of by the net working capital adjustment.Imagine a corporation that consistently receives payments three months late to get an understanding of why it is the movement in net working capital, not the amount, that counts.

Cash flow is unaffected by all of the receipts from the previous three months of the current fiscal year, but income is. Thus, the revenues must be deducted from the cash flow. However, the last three months of the previous fiscal year were also excluded. They should be included in the current cash flow since their payments really took place during the current fiscal year. These two modifications essentially cancel one another out if a firm experiences no growth. The sole modification needed while a business is expanding is to account for the rise in net working capital. In our example, this would be the difference between the amount of uncollected revenues in the last three months of the current fiscal year and the prior fiscal year.Subtracting capital expenditures and re-adding depreciation is the second adjustment to the calculation. When a business invests in equipment that will be employed over a number of years, net income simply takes into account the portion of expenses attributable to the present period. Depreciation is used in the income statement to do this, spreading out the capital expenditures over a number of years. However, the capital expenditure has a direct effect on the cash balance right away, thus from the standpoint of cash flow, it must be completely recorded in the current period.

Equation yields a crucial business insight. It explains why a rapidly expanding business could be profitable yet still have a negative cash flow. In other words, capital investments and adjustments to working capital may result in a negative cash flow even though net income is positive. This situation is characteristic of prosperous, quickly expanding businesses. It makes the crucial and maybe unexpected point that a company's rapid growth can be fatal. To be more accurate, even when net income is positive, investing in growth often necessitates significant increases in working capital and capital expenditures. Even when a start-up's company is fundamentally profitable, it may run out of money if suitable funding cannot be obtained.Three typical hockey sticks that are included in practically all startup companies' financial estimates. The name comes from the way the curves resemble a hockey stick, initially going down, then spinning around and rising to great heights. The first hockey stick curve from the left shows net income, the second, cash flow, and the third, cash balance.The net income hockey stick illustrates the early losses of starting a new firm, followed by the positive and rising earnings of a successful endeavor. Once net income exceeds investments, cash flow begins to rise. Because it captures the cumulative effect of cash flows over time, the cash balance is mechanically tied to the cash flow. At the same moment when cash flow starts to increase, the cash balance is at its lowest point. This is due to the fact that whenever cash flow is negative and whenever it is positive, the cash balance decreases.

Financial Projections Are Being Tested

We place a strong emphasis on uncertainty, experimentation, and dynamic adaptability in our description of the entrepreneurial process. Financial forecasts make this process' complexity easier to understand. They just use one set of figures that illustrate a typical event. Instead of describing what to anticipate on average, this scenario illustrates what a successful venture conclusion might look like. Financial estimates with greater sophistication take into account the fact that outcomes are not always favorable and may take longer even when they do. In addition, one may wish to account for the multiple hazards that the endeavor entails. Scenario analysis and sensitivity analysis are two typical approaches for this. Building alternative financial predictions that depict different situations is a straightforward method of evaluating financial estimates. Each scenario should show a distinct turn of events while yet being internally consistent. One seldom employs many situations.

The good, the average, and the terrible case possibilities, for instance, might be used by an entrepreneur. Entrepreneurs tend to be optimistic, thus it is more probable that they represent the exceptional, the positive, and the typical situation. Sensitivity analysis are a little more advanced method of evaluating the accuracy of financial estimates. Every financial prediction is based on some kind of supposition, but these suppositions are only educated guesses about how the endeavor could develop. Therefore, it could be interesting to adjust these presumptions. This entails subjecting the financial model to scenarios where, for example, revenues are x% lower, expenses are x% higher, a technical milestone is reached in x months, and so on. Implementing sensitivity analysis may be done in a variety of methods, from simple spreadsheet manipulation to complex Monte Carlo simulations that subject the model to several simultaneous shocks. The outcomes may be enlightening in a number of ways, such as by exposing flaws in the underlying business model or by providing some strategic guidance on the most important parameters.

Simplifications

Making financial estimates takes time and work. For some business owners, creating a complete set of financial predictions is challenging. To develop some first estimations of the anticipated performance of the enterprise, they may choose to start by using simpler, more heuristic methodologies. This is especially true in the very early phases, when there is the most ambiguity. We advise against oversimplifying. Although creating financial estimates is challenging, the entrepreneur may discover a lot about the company model via this process. There are numerous condensed methods in use. The first is to just use shortcuts. One example is the top-down method of COGS estimation. Other typical quick cuts include rounding up all costs to a single figure or starting without a balance sheet. Many of these quick cuts, meanwhile, are ad hoc and run the danger of making the entrepreneur blind.

Making what is frequently referred to as a unit economic model basically a static income statement for a single unit of output is one helpful simplification. This might be a single delivery of a product, a single retail store, or a single contract with a representative customer, depending on the business. The company owner then makes an estimate of the revenues and expenses for a certain business unit in order to determine the margins for that particular unit. Even while it still needs predicting unit sales and unit expenses, this is undoubtedly easier than creating comprehensive financial predictions. It goes without saying that this strategy has flaws, including neglecting the timing of cash flow. Another typical strategy is to concentrate just on a few metrics that are unique to the industry. It is common practice to gauge a business' performance in the world of mobile applications by the number of downloads, in the world of websites by the number of eyeballs, in the world of fashion by which celebrities choose to endorsing a certain item, and so forth. Industry insiders are aware of the importance of downloads, eyes, and celebrity even if there may not be any income data specifically tied to them.

They can naturally tie them to financial expectations because of their expertise. Such simplifications have several flaws and may only be seen as very early steps toward accurate financial forecasting. There are undoubtedly some who believe that creating financial plans is a waste of time. We believe that creating accurate estimates is advantageous for the majority of business owners. However, we also understand that creating financial estimates has a price. We think there is a process through which business owners develop better predictions over time, rather than dividing the world between those who believe in creating financial plans and those who don't. In order to acquire a rough picture of the financial performance, it can make sense to start with any of these basic methods. However, as company owners gain more knowledge about their industries, they are gradually able to create more accurate financial estimates. Additionally, when businesses expand, they are likely to use management accounting systems to track their operations. Additionally, these techniques make it simpler to provide better projections[1], [12].

CONCLUSION

In conclusion, A useful view point and technique for making decisions and addressing problems is provided by the bottom-up strategy. Organizations and initiatives may tap into the collective knowledge and creativity of their stakeholders by incorporating people or teams at all levels. The bottom-up strategy encourages creativity, adaptation, and employee involvement, which improves results and boosts organizational performance. Adopting the bottom-up strategy may help create environments that are more diverse, collaborative, and productive across a range of industries. Additionally, the use of the bottom-up strategy in many situations. It may be used in business for organizational reorganization, customer service enhancement, and product creation. It allows greater stakeholder participation, resource allocation, and risk detection in project management. Additionally, the bottom-up strategy may encourage creativity and teamwork in community development projects and policy-making procedures.

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CHAPTER 8

FORMULATING THE FINANCIAL PLAN: UNLOCKING BUSINESS SUCCESS

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ABSTRACT:

Formulating a financial plan is a critical aspect of strategic business planning that involves setting financial goals, outlining revenue and expense projections, and developing strategies to achieve financial success. This abstract explores the significance of formulating a comprehensive financial plan and highlights the key steps and considerations involved in the process. The abstract begins by emphasizing the importance of a financial plan in providing a roadmap for achieving financial stability, growth, and profitability. A well-formulated financial plan serves as a guide for resource allocation, investment decisions, and financial management. It aligns the financial objectives of an organization with its overall strategic goals.

KEYWORDS:

Budgeting, Cash Flow, Financial Forecasting, Income Sources, Investment, Management.

INTRODUCTION

The Appeal of the Initiative The financial plan and the financial predictions are distinguished from one another. The financial plan serves as a framework for expressing the goals of the entrepreneur in terms of money. It tackles two important issues: the business's attractiveness and the timing and amount of financial resources needed. These concerns may be addressed using financial predictions. However, it is up to the business owner to employ them in order to create a solid financial strategy. The income statement comprises the majority of the information needed to determine the profitability of the company. It demonstrates the company's size and growth potential. The venture's economic potential is what matters most, however. This may be inferred from estimates of net income size and growth as well as profitability metrics like gross, operating, and net margins. The balance sheet also has other helpful data. The return on assets and the return on equity are two helpful ratios. The ROA gauges how well the business generates profits from its assets[1], [2]. Instead, the ROE gauges how much profit investors may expect from their stock investment.

Finances

The cash flow statement is crucial in determining the venture's funding requirements. It enables the business owner to forecast future financial needs for the organization. The success of the firm depends on this forecast. Reaching 0 cash balance entails running out of money and shutting down the company. Two crucial figures concerning funding requirements must be included in the financial plan: the total amount of money required to move the business to cash flow positive and the current level of funding required. It should be noted that one may alternatively represent them as current and future funding requirements, where future funding needs are total funding needs minus current funding needs. Only cash flow estimates can provide these two crucial figures. In actuality, one initially estimates the cash flow based on the assumption that there would be no fundraising at all. This enables us to create two graphs: one showing the anticipated cash flow and the other showing the anticipated cash balance. Typically, these graphs resemble a hockey stick. Take a look at the cash balance. It initially dips into the negative area before rising once again, showing that the cash flow has improved sufficiently to bring back a positive cash balance. The corporation achieves cash flow parity when it crosses the zero line[3], [4].

The forecasts typically thereafter ascend towards a promising future, however reality may vary. The size and timing of negative cash flow are well-illustrated by this common hockey stick graph. The location where the cash balance is lowest, which represents the entire financing need, is very important. We are given the first of the two crucial figures right away. We are forced to consider fundraising tactics when we discover the second crucial statistic, the present finance need. Let's now analyze different fundraising options as these graphs up to this point do not depict any finance. One option is to secure all the money up advance. This entails raising cash in an amount equivalent to the cash balance's lowest point. By doing this, the whole funding amount is transferred upward over the entire graph of the cash balance, guaranteeing that the cash balance is always positive. It makes reasonable to raise all the money up front if a start-up has a relatively small financing demand and a short period before becoming cash flow positive. However, the time it takes for many entrepreneurial initiatives to become cash flow positive is many years away, and the financing required is significant[5], [6].

It could be hard to raise all the money up front. Such businesses raise lesser sums of money at first to begin going. If they are successful in reaching their goals, they proceed to raise the remaining funds in subsequent fundraising rounds. The tiered funding procedure mentioned is this. Finding out what is required to offer the business a decent probability of hitting the following set of milestones is necessary in order to calculate the first amount of money required. The second of the two crucial figures mentioned above, the present financial need, is exactly what this is. These two crucial figures must be determined, and doing so includes a variety of strategic trade-offs that we will face while working with different others. When negotiating a contract, entrepreneurs weigh smaller vs bigger financing rounds. The financial resources of the investor syndicate they are negotiating with also play a role in this. Entrepreneurs generally need to think about the kind of dynamic fundraising profile they want to achieve. Later on, there can also be a trade-off between venture loan and stock. Also keep in mind that fundraising is a dynamic activity, so as new information becomes available over time, the financial predictions and corresponding funding requirements will alter[7], [8].

Some startups learn over time that they need less money than anticipated, for instance, because their revenues grow more quickly than anticipated. Other startups have a harsh awakening when their expenses turn out to be more than expected, forcing them to realize they need more than they first imagined. The timetable and cash flow predictions are used to compute the realistic amount of current money required. In light of these milestones, the present financing need may be determined by comparing the current cash balance to the anticipated cash balance at the time of the milestone. There is a case to be made for raising a little bit extra money in order to have a safety net. A few different situations may be used to determine the safety cushion's size. To do this, one must consider issues like how much money would be required if the prototype took three months longer than anticipated. What if multiple adjustments to the approach are required before acquiring the first paying client?

DISCUSSION

Pitching the Financial Plan

It may be difficult for many business owners to successfully articulate their financial strategy. It is true that doing so involves some thinking about how to sum up a lot of information and that it necessitates at least a basic level of financial literacy in terms of understanding basic accounting terminology. The true difficulty, however, is in deciding what point to make. Every business is distinct, and various investors have varying tastes on top of having varying degrees of financial knowledge. The final objective, though, is to respond to two queries: How appealing is the suggested business? When and what kind of financial resources are required? Answering those two issues should continue to be the major emphasis of the financial plan presentation. A written business plan or a document outlining financial estimates may include extensive and in-depth information.

A spoken presentation to investors, however, is only supported by a limited number of slides that only provide a high-level overview of the financial strategy. There is no one formula that works for everyone since various parties will need different degrees of specificity and different business owners will focus on different factors. Between early-stage firms and later-stage enterprises, a financial strategy is presented differently. One might anticipate higher accuracy and more depth in financial estimates as the business grows. In addition to their financial estimates, later-stage projects often disclose their previous performance. We provide some broad guidelines for organizing this section of the presentation. A slide showing WorkHorse's financial strategy is also included in the presentation slides that go with 2. Practically speaking, we advise include the following information in a presentation.

1. **Assumptions:** We advise outlining the primary assumptions utilized in the financial predictions up front. This should not be a comprehensive list but rather a concise explanation of the key presumptions that underlie the outcomes and support the venture's financial attractiveness. Many novice business owners fail to disclose their presumptions, only to discover that investors get perplexed and soon lose faith in them.
2. **Revenues:** Revenue forecasts aid in determining the venture's scope and long-term development. Also necessary is a description of the primary sources of income.
3. **Costs:** A breakdown of costs may be used to describe the kind of activities needed, how they change over time, and the nature of the company model.
4. **Profitability:** The entrepreneur must demonstrate the venture's potential for profit in order for others to judge how appealing it is. Investors anticipate a projected net profit projection over time. EBITDA, operational income, gross and net margins, as well as other metrics, may be of interest depending on the company.
5. **Finance Requirements:** The cash flow's temporal structure aids in understanding the venture's critical turning points and the ensuing demand for further finance. The total and current amount of funds required are the two most important figures to mention. It should be clarified when these financing requirements may arise. There should also be a debate on how much money will be spent from the current fundraising cycle and how long it will last.

Should a financial presentation include a firm value or an estimated investor return? We talk about value in 5 and talks in the event that two-thirds of the machines cannot be saved. When presented in this manner, most experiment participants preferred the first entrepreneur. The majority of respondents would, however, choose the second firm provided it makes the claim that it can save one-third of all PCs with certainty. The fundamental data for the second firm is similar, as you will see. Framing is completely to blame for the disparity. Smart businesspeople instinctively focus on how problems are framed when making presentations to clients, investors, and other audiences. In this instance, the business owner makes use of other people's behavioral prejudices. Entrepreneurs are nonetheless susceptible to their own behavioral prejudices. Thaler describes a buddy who missed a basketball game due to a snowstorm in his Nobel address. The buddy justified his actions by saying that even though he only paid half the amount for the ticket, he still planned to go. The sunk cost fallacy is well shown in this situation. Considering that the ticket's cost has already been covered, whether it was purchased at a discount or at full price shouldn't matter. This misperception may have an impact on important choices like ending significant investment initiatives. It influences how entrepreneurs decide when to shut down a failed business.

Optimism is the strongest behavioral bias among businesspeople. Entrepreneurs often exaggerate the worth of their opportunity and/or their chances of success. This phenomena is widely known and has several possible causes. Initially, those who are more optimistic are more likely to start a business. Optimism also increases when owners develop a passion for their businesses. Optimists are also susceptible to making the sunk cost mistake. Overconfidence is a term that has a strong connection to optimism. Overconfidence is a biased assessment of the significance of one's own knowledge, as opposed to optimism, which involves a biased assessment of one's own likelihood of success. People who are overconfident give their own information too much weight and the information that others gather too little weight. In our context, business owners could focus too much on their own struggles and too little on those of their colleagues. Kahneman and Tversky's work serves as the basis for Thaler's research. His ground-breaking book Nudge ignited an entire movement to combat behavioral biases. The goal is not to alter the basic economic decisions themselves but rather to alter how these decisions are framed. For instance, you may avoid emphasizing on the failure while encouraging an entrepreneur to give up on a failed business and instead emphasize how it frees up time to seek other chances.

However, it should be noted that although most behavioral biases are harmful to the person, a small number may be advantageous. Entrepreneurial optimism, for instance, may encourage people to join as workers or it may discourage rivals. Overconfident business owners are often admired by investors because they take the bull by the horns, even when doing so isn't entirely prudent or safe. It is not difficult to see that financial projections are susceptible to behavioral biases. Projections of revenues or earnings tend to be widely optimistic, overstating the size of the economic opportunity and the speed at which the company can grow. Cost projections frequently fail to take into account the full extent of what it takes to go to market. Risks are typically underestimated, minimizing the chances that thing will actually happen. Level-headed entrepreneurs who are conscious of these behavioral biases face a curious conundrum. if they refrain from projecting overoptimistic financials, investors may still automatically add just their projections for standard optimism. Conscious entrepreneurs thus runs the risk of undervaluing themselves. Some people even argue that there is no point in being sane in a world where everyone else is crazy. However, savvy entrepreneurs know that investors automatically add- just their projections for standard optimism.

Owning and Earnings

This establishes how to compute the returns to investors, discusses the relative merits of three alternative measures of investor returns: net present value, cash-on-cash, and internal rate of return, and examines what determines the split of ownership between investors and entrepreneurs. It also explains the mechanical relationships between investment amounts, ownership shares, and the pre-money and post-money valuation of a company.

The Principles of Ownership and Appraisal

Pre- and Post-Monetary Value Estimation

We first illustrate how a venture's ownership structure is decided for a given value, and then we describe how ownership changes over time and how it provides returns for investors. In this, we explain the underlying mechanical links between investment, ownership shares, and valuation. Assuming that investors receive common equity, which means they own a portion of the company that is given by the percentage of shares they own, and with common equity, all shareholders hold shares that have the same rights, we begin with the straightforward case of a company that receives a single round of financing from a single investor and later extend the analysis by including the role of stock options and multiple rounds of financing. An investment is an economic transaction in which an investor makes a financial contribution to a company and receives shares that represent an ownership stake in return; the corresponding valuation reflects the investor's willingness to accept a particular ownership stake in exchange for his investment; the value of this stake is entirely fictitious as the company has no market for its shares.

Investment Equals Ownership Times Value

This equation implies that we only need to know two out of the three quantities, and the third falls out mechanically.

valuation = ownership/investment

Options on Stock

We now augment the base model by noting that companies frequently use grants of stock-based compensation to defer cash payments to third parties. There are two main methods to grant ownership to third parties: directly giving out company shares and granting stock options. These two methods are typically directed at different parties, and the specifics depend on the particular situation. In general, such stock allocations are used either to reward past contributions or to provide performance incentives, as well as to create loyalty to the company. The average percentage ownership allocated to the recipients of these stocks and stock options is estimated to be. Granting stock directly is largely done with parties external to the company, such as consultants, suppliers, or licensors. They receive common stock in exchange for the goods or services they provide.

Giving stock options to board members, managers, and employees is more common. Employee Stock Options Plans are an important tool for managing human resources in entrepreneurial companies. A stock option is the right to purchase a given number of common shares from the company at a set price, called the strike price, at or after a specified date. How does the presence of a stock options pool affect the valuation and ownership of a venture? The for- mulas we derive are based on the case where the investor offers to provide I for an ownership stake FINV, but does not want to pay for any stock options with his investment, effectively forcing the company to issue shares to provide the stock options. In a first round, the pre-money valuation (VPRE) no longer represents the value to the founders; rather, it represents including the entire stock options pool; in later rounds, the VpRE represents the value to all existing shareholders naive founders may mistakenly believe that the entire pre-money valuation is theirs. With a stock options pool, however, they share the pre-money valuation. We rewrite the equation to get the ownership percentage of the stock options pool in order to examine how the formation of a stock options pool impacts ownership:

1. SPRE/SPOST FPRE - SINV/SPOST FINV.
2. FSOP, SSOP, and SPOST.

Threat and Reward

In this paper, we analyze various measures of returns and explore their benefits and drawbacks in the context of entrepreneurial finance. Investors give money with the purpose of making a profit, therefore they base their investment choices on the returns they anticipate to get from the investment. The basic trade-off between risk and return allows us to approach entrepreneurial investments from the right angle: higher returns can only be achieved by taking on more risk: if two projects have the same risk, the one with a higher return would be in higher demand, it would become more expensive, and its return would become lower. To understand the relationship between risk and return let us first look at how risk is often misunderstood. Consider a risky investment that yields $100 with 60% probability and nothing with 40% probability. This investment therefore has an expected outcome of $60. If we compare it against an alternative safe investment that yields a guaranteed $ 100 , the risky invest- ment is clearly worse: it never returns more than the safe one, and it may well return less.

Here risk is the possibility that something can go wrong. Therefore, this is not a sensible comparison. Compare instead the above risky investment to a safe in- vestment that returns $50 with certainty. Some people prefer the risky investment, considering that its expected return of $60 is above the safe return of $50. Others, however, may prefer the safe investment because the risk of the bad outcome that returns zero is too painful for them to contemplate. Risk is not simply that things can go wrong; instead, risk describes uncertainty around an expected return. If there was another project with an expected return of 10%but with lower risk, the investor would prefer this latter one because investors are typically risk averse that is, they prefer safer projects to riskier ones, for a given expected return. Next, consider an investor who has funded a project with an expected return of 10% and a certain level of risk. A 10% return means the investor expects to ob-tain back the invested sum increased by 10%. Here we focus on addressing two important questions about the risk of financing entrepreneurial ventures. The trade-off between risk and return is central to finance, and textbooks devote much attention to this topic and its implications for investment decisions. For example, finance scholars have developed elaborate measures for comparing different distributions of risk, and there is an important distinction between diversifiable and non-diversifiable risks.

The first question is whether one has to be a risk-lover to invest in entrepreneurial ventures. Here the answer is no. Risk-loving means preferring higher risk over lower risk, which resembles gambling. Most venture investors are not risk- lovers; they prefer lower over higher risk. However, venture investors are clearly willing to take on substantial risk. There are many differences, but two stand out when comparing the returns to venture investing to other risky investments, like investing in the stock market. First, the risk of investing in entrepreneurial ventures can be extremely high it is possible to generate extremely high returns think of investing in Amazon or Alibaba but it is also possible to lose everything. Statisticians refer to this property as skewness, where the distribution of returns is skewed. In the stock market, which is known as a liquid market, one may purchase and sell shares in a firm in a matter of seconds. However, selling shares in a private company moves much more slowly, with investors sometimes having to wait years before they can sell their interests. The cash flows of an investor consist of making one or more investments over time and then waiting for an exit to realize a return. Realized returns are based on a backward-looking perspective of measuring what has occurred since the time of investment. Expected returns, on the other hand, are forward-looking and measure what investors expect to occur in the future[9], [10].

CONCLUSION

In conclusion, Strategic company planning must include the creation of a financial strategy. A thorough financial plan offers a road map for accomplishing financial goals, efficiently allocating resources, and guaranteeing long-term financial sustainability. Organizations may create solid financial plans that support their overall strategic objectives and promote financial success by adhering to important procedures, taking into account pertinent elements, and using financial technology. The paper also discusses how financial technology (FinTech) might improve the creation and implementation of financial planning. Organizations may obtain deeper insights into financial patterns, automate operations, and make better decisions thanks to advancements in financial software, data analytics, and forecasting tools.

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CHAPTER 9

DETERMINANTS OF VALUATION AND RETURNS

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ABSTRACT:

Determining the valuation and potential returns of an investment is a critical aspect of financial decision-making. This abstract explores the key determinants that influence the valuation and returns of an investment, including factors such as market conditions, industry dynamics, financial performance, and risk considerations. The abstract begins by highlighting the importance of valuation and returns in assessing the attractiveness and profitability of an investment opportunity. Valuation refers to the process of estimating the intrinsic value of an asset or business, while returns represent the financial gains or losses generated from an investment over a specific period.

KEYWORDS:

Economic, Financial, Growth, Industry, Market, Management Quality.

INTRODUCTION

What types of returns should be employed in entrepreneurial finance is a topic that has generated a lot of discussion among researchers and practitioners of finance. We outline the three most often used metrics in this paper. Think about how venture capitalists responded to a question in a poll by Gompers, Kaplan, and Kharlamov about the financial parameters they used to evaluate investments. 12 Of the respondents, 63% said they used cash-on-cash multiples, 42% internal rates of return, 22% net present value, 8% other metrics, and 9% said they didn't use any measures at all. Respondents often utilize two measurements. This data demonstrates that investors use a range of tools and that no one tool can solve every problem[1], [2].

Value of Money over Time

Consider initially that we put $1 today in a secure asset and get the same $1 plus some interest the next year to better comprehend discounting. Due to the possibility of earning interest throughout this time, one dollar now is worth more than one dollar in one year. The temporal value of money, as described by financial economists, results from this. The three return measurements are now put side by side. Neither IRR nor CCM adequately account for risk. The timing of financial flows is also not taken into consideration by the CCM. On the other hand, picking a reasonable discount rate is necessary for the NPV[3], [4].

The Factors Affecting Value and Returns

Here, we lay out some key findings about the connection between valuation, investor returns, and exit values. We concentrate on the most straightforward scenario, in which there is just one investment round, and we only take the CCM return metric into account. However, all of the lessons in this apply to returns across numerous investment rounds as well as returns measured using any return metric. The Economic Factors Affecting Valuation. How is venture value determined? We take into account the significance of various economic elements in this. The quality of the underlying opportunity is important, without a doubt, but there are also other economic factors at play[5], [6].

DISCUSSION

Economic Determinants of Valuation

What monetary factors influence the start-up valuations? One research by Gompers and Lerner takes an eight-year sample of agreements from all around the United States. 14 One significant result is that as the stock market rises, venture capital values rise as well, and vice versa. Another observation is that values rise when local VC funds obtain more capital. In the biggest, most competitive areas, like California, the impact is most noticeable. According to the authors, this phenomenon is known as money-chasing deals, in which a greater number of investors chase a smaller number of lucrative projects. According to the first impact, stock markets are what determine values, and the second, transaction rivalry is important. A landmark paper by David Hsu makes use of valuation information from startups that simultaneously received several bids from various investors. This data is distinctive in that it allows for comparison of the bids made by several investors for the same firm. The main outcome is that investors with stronger reputations and networks give cheaper values. It's significant that business owners usually accept such cheaper offers, thereby ceding greater control[7], [8].

According to the report, business owners are eager to do this because they think hiring more reputable investors would improve their enterprise. We identify the opportunity itself, the market environment, transaction competition, and investor quality as the four key economic drivers of firm value. Using Insight, we can observe the impact on the first two factors right away. A greater valuation is justified by the higher predicted exit value that better possibilities present. An increasing stock market has a comparable impact. When start-ups are purchased by or become public themselves, or both, greater stock market prices imply that they may anticipate higher exit values. Technological advances, demographic shifts, regulatory changes, and perhaps excessive optimism and asset price bubbles may all be factors in hot markets. Macroeconomic cycles also influence acquisitions. We see that the greater valuation is supported by higher predicted exit values in terms of equation. We see that startup values are determined via a negotiation process in order to better understand the transaction competition. The negotiation's setting, in particular how much negotiating power the entrepreneur or investor has, has an impact on the value.

We examine the bargaining process in detail here, we concentrate on the function of competition. When there is little or no competition, the investor has greater clout and may set the conditions of the transaction. For a given investment, the investor assumes a higher ownership position, which suggests a lower firm value. This suggests, among other things, that the valuation now takes into account the investor's superior negotiating position in addition to the opportunity's worth. Even if a company's economic fundamentals are stronger, one in a highly competitive market may command a greater value than one in a less competitive one. Entrepreneurs may create competition by actively seeking out new investors or by putting their business in dynamic clusters. Consider a scenario in which a high-quality investor is competing with a lower-quality investor to invest in a firm to understand the impact of investor quality. The business owner is aware that the high-caliber investor will increase the venture's worth. The entrepreneur would always choose the high-quality investor over the lesser quality investor if they both offered the same value. Given this information, the high-quality investor may make a smaller offer while still getting the entrepreneur to accept it. As a result, the latter firm may get a lower value if it receives an offer from a high-quality investor as opposed to one from a low-quality investor. However, due of the high-quality investor's support, its business prospect may be greater.

Factors Affecting Founder Ownership Founder Contracts

The distribution of share ownership between entrepreneurs and investors has been examined in our discussion so far in relation to the factors that influence value. In this section, we discuss the issue of how the founders' team is divided in terms of share ownership. If there is just one founder, this question doesn't matter, but if there are several founders, it definitely does. Investors also often have concerns regarding the internal share partition and its justification. This reasoning is distinct from the valuation logic that has been explained up to this point. In actuality, we will now look at a larger founders' agreement that includes the internal distribution of shares. The internal founder agreement is often the initial contract in a start-up. Entrepreneurs must first organize their own affairs before addressing investors. A founder agreement is required as soon as there are two or more founders in order to specify the legal obligations and rights of the different founding parties.

Some founder teams handle these concerns while the business is being developed, while others hold off until they are farther down the path. The founding agreement may only be finalized when the terms of an investor term sheet have been established. Investors want to know exactly what these agreements include, which is why this is the case. Founder discussions should not take place either too soon or too late. Because of the unknowns that lie ahead, it is challenging for founders to clarify things from the very beginning. A discovery phase for getting to know one another and determining fit is also included. However, procrastination may be dangerous. Having a founder agreement gives the team assurance and clarity. Additionally, if there is no agreement, there is always a chance that some founders would launch the business independently, leaving the rest out. The founding agreement's main function is to specify who is in and, therefore, who is out. Five key aspects are covered by founder agreements. They start by identifying the team members, often along with their present duties, predicted future roles, and anticipated future changes. As a result, everyone is aware of who is in charge of what.

Second, the salary that various founders are to earn might be specified in founder agreements. Generally speaking, startups provide minimal compensation, although there are some outliers. Third, founder agreements may specify any financial responsibilities the firm has to certain founders. For instance, a founder could need to be compensated for a past loan or for giving IP to the business. Fourth, ownership distribution is decided by founder agreements. This entails distributing common shares among the company's founders, which affects both voting rights and the ultimate distribution of financial profits. Finally, contingencies may be mentioned in founder agreements. As a result, certain rewards are dependent on reaching particular benchmarks. The vesting of founder shares is a typical structure. This implies that, subject to the founder's continued employment with the firm, the corporation keeps back a part of the founder shares and gradually releases them. Employee stock option schemes often incorporate similar vesting provisions. Other constraints include issuing shares contingent upon each creator meeting their own goals, such creating a prototype or securing their first client.

What are the length and complexity of the agreements that founders negotiate? Humans have a propensity to sweep difficult events under the rug, but they always come back. A team that keeps lines of communication open throughout the negotiation process will probably generate a better document and forge stronger bonds. Founder agreements may also need revisions over time. The original agreements might no longer be effective due to changes in both individual circumstances and staff obligations inside the company. Founders also have several opportunities to run across one another. Numerous stories of founder disagreements exist. We have two examples from Snap and Stitch Fix's developers. Does a person who considers themselves to be a founder still have a claim to ownership in the company if there is no founder agreement? The Social Network movie provided an example of how this problem, in the case of Facebook, became a multimillion dollar one. The Facebook founder, Mark Zuckerberg, was sued by the Winklevoss twins for allegedly stealing their idea and developing it independently. The final cost to address the issue was estimated at $65 million.19 Even if there was no formal founding agreement in existence, the court may conclude that parties had formed an implicit partnership. A strong foundational agreement might avert serious issues in the future.

Principles of Internal Allocation

What standards should teams follow when allocating founder shares? This proves to be a highly intricate and unique problem. In addition to having financial ramifications for individual founders, the distribution of founder shares may have an impact on the team's motivation and attitude. Unfortunately, startups lack a solid recipe to use. Finding a solution to the issue requires internal discussion instead. The easiest way to divide ownership shares is an equal split. This system allocates 1/n of the total number of founder shares to each founder in a group of n founders. This concept is grounded on the egalitarian belief that every founder deserves to be treated equally. This could be as a result of the founders' fundamental conviction that they are all equally worthy or the difficulty they have with passing judgment on one another. Nearly half of all founder's teams choose for an equal split, according to empirical study on ownership splits among startup teams. Even while some groups could feel that an equal divide is fair, others wouldn't agree. Why, for instance, would it be just to give two business owners who are working just as hard the same amount of equity? maybe if one person has 20 years more experience than the other? Additionally, what one team may consider just may be seen as unfair by another.

The data shown above demonstrates that the other half of founding teams opt for the unequal split option. Hellmann and Wasserman examine survey data about the distribution of founder shares in high-tech start-ups in one academic inquiry. Teams that are younger and more similar often pick an equal split. The quick handshake is what the authors refer to as, and they point out that teams with discussions lasting less a day are more likely to use it. According to the research, teams with equal divides are less likely to later seek outside funding. This throws into question the value of an equal share and prompts further consideration of the values founding teams desire to uphold.What rules should be adhered to then for the distribution of founder shares? The distinction between arguments that look past and those that look forward is useful. Some founder shares are awarded based on contributions made so far, while others are awarded based on future plans. While it is obvious that arguments that are focused on the future are crucial, entrepreneurs often spend a lot of time talking about their prior successes. This can be because the past is seen as being more objective than the future.

Additionally, some founders see stock ownership as a retroactive right rather than a compensatory method. However, a heavy emphasis on the past might obscure the enormous amount of work that still has to be done and what it will take for the business to succeed. An argument that looks backwards is that certain founders should get greater shares since they came up with the original idea. Such a claim may not always be true other times, the original idea may develop as a result of interactions amongst the founders. Given that the entrepreneurial process requires experimentation and may need several pivots, it is also sometimes unclear how significant the initial concept really was. When intellectual property is involved, the claim of originality is more obvious. There is a rationale for recognizing this contribution with extra founder shares if a founder has certain IP, like a patent, and chooses to donate it to the business. These contributions are prospective and ought to affect how shares are distributed. When founders contribute financially to the company, there is yet another scenario when backward share allocation is clearly justified. Additionally, teams have a tendency to give larger shares to founders who have previously put in more time on the business. This might be attributed to the fact that they invested more time and took on more risk in the beginning. The best performance incentives are a key component of justifications for assigning shares in the future. Describe some of the core conclusions from the economics of team incentives in order to fully understand the incentive argument.

FAST Tool

The Founder Allocation of Shares Tool is described here. We created this spreadsheet tool to aid founder teams in structuring their founder agreements. It blends findings from our own scholarly study with practical observations. An associated spreadsheet that uses the WorkHorse example can be found on the book's website, along with a technical note that provides further information on how to use the tool. Here's a condensed version of the outline. The FAST spreadsheet's primary output is a proposal for how to divide the founder ownership, together with ideas for vesting and milestone contingencies. Evaluations of each founder's past and future contributions serve as the inputs for the spreadsheet model. As a result, the team must decide what they value most by giving relative weights to contributions that are intrinsically diverse. The FAST point system is incredibly adaptable and effortlessly takes into account the needs and preferences of customers.

Evaluation Techniques

This paper covers the function of valuation in the fundraising process and examines several techniques to valuing entrepreneurial companies. We start out by outlining the major difficulties in appraising entrepreneurial businesses. Then, we explore a number of valuation techniques and go through their benefits and drawbacks. The Venture Capital Method, which is often used in practice, and the Discounted Cash Flow Method, the go-to financial instrument for valuation, are where we begin. We examine many comparable techniques that evaluate a firm against a peer group, whether at the investment or exit stage. Finally, we look at several strategies that explicitly incorporate uncertainty to evaluate business endeavors. We wrap up by talking about the relative benefits of these alternate strategies and if they are acceptable in certain situations.

The Assessment of Entrepreneurial Businesses

The Goal of value We demonstrated how to calculate ownership shares and investor returns using a predetermined firm value. In this paper, we describe how various valuation methodologies may be used to estimate value in real-world situations. What does doing an evaluation serve? It is obvious that an investor or entrepreneur may organize the whole transaction without utilizing any valuation techniques. They don't have to explain the implicit pre- or post-money values; they may just negotiate ownership stakes. In fact, some angel investors completely reject value methods. However, before making their investment judgments, professionals and others who invest later on often do some valuation. Why do investors and business owners participate in a challenging activity that only yields imprecise estimations when doing a valuation demands time spent gathering and reviewing data? Investors and entrepreneurs employ valuation techniques to establish informed opinions about the venture's realistic value. This aids in their preparation for the negotiation. In order to support their arguments during negotiations, they often do valuation. In addition, venture capitalists defend their investment decisions in front of their limited partners using their valuation models.

The entrepreneur's preparation for becoming investor ready includes doing a valuation. The process of creating an investment pitch follows a logical order. It begins by creating a business strategy, as was covered. As said in step three, the subsequent action is to create a financial strategy. The creation of financial predictions that feed into the valuation models falls under this category. Thus, to create a credible appraisal, we use quantitative data from the financial plan and qualitative data from the business plan. The entrepreneur may then use this to support her value during negotiations. From the standpoint of an investor, doing valuation is a crucial step in a full decision-making process. It is helpful to assess if an investment has a likelihood of producing the required returns before investing financial resources and to ascertain what value would support an investment. A valuation model, however, may be helpful in describing the investor's viewpoint to an entrepreneur who may have a different idea of what the value should be.

The Difficulties of Conducting an Evaluation

Setting a solid value for an entrepreneurial endeavor is a difficult and sometimes speculative process. Fundamental uncertainty exists for entrepreneurial endeavors, particularly at the beginning. There is sometimes a shortage of objective data, even for more established companies. Therefore, valuations should be seen as heuristics that aid in making sense of a business reality that is fundamentally vague and subjective. They incorporate components that are both objective and subjective in what may be referred to as the art and science of doing appraisal. Entrepreneurial firms might be seen from the standpoint of an investor as simply another asset class. The underlying cash flows' risk and return characteristics must to be taken into account during valuation. As with other alternative investments like real estate or commodities, they are in fact volatile for startups. The significant ambiguity over an entrepreneurial venture's genuine risk profile, which reflects Frank Knight's idea of uncertainty and is described. Entrepreneurs and investors sometimes possess diverse information, which makes things much more challenging. Investors may be more knowledgeable about the industry, the competition, and the process of financing a firm from start-up to exit than entrepreneurs are about the market, their technology, and their consumers.

As a result, there may be knowledge asymmetries that make it challenging for the two sides to reach a value consensus. Even when the parties have access to the same data, there may be disagreements over how to interpret it, such as what inferences to make from market research that is inconclusive. Standard corporate finance techniques depend on impartial data and may predict business situations with reasonable accuracy. Rarely does this apply to new businesses. Applying traditional valuation methodologies presents additional obstacles that are inherent in all business types but are exacerbated in the case of creative businesses. Start-ups heavily rely on intangible resources like technology and brand. These are challenging to evaluate since they generate less predictable revenues and profitability than tangible physical assets. Similarly, entrepreneurial businesses depend largely on skilled people, yet the value of human capital is not well-treated in accounting. Entrepreneurs and investors must choose between simplicity and complexity. One viewpoint is that the high degree of uncertainty necessitates the use of more intricate and sophisticated technologies that can accurately account for the risks at play. Others, however, favor simplicity, stating that employing more straightforward ways is more persuasive and that injecting incorrect information into sophisticated models ends up being pointless. Entrepreneurs and investors must finally decide between simpler and more complex strategies based on their own needs. In this paper, we'll look at four different methods for evaluating entrepreneurial businesses. Starting with the Venture Capital Method, we will proceed.

We demonstrate how this approach, which has its roots in practice, can be understood in terms of the basics of corporate finance. We then take into account the Discounted Cash Flow model. This is the standard corporate finance valuation model that is addressed in all literature on the subject. Financial forecasts for the firm are a foundational part of the DCF approach. It might be described as a intrinsic or absolute technique of valuation. Third, we examine comparables approaches. These techniques provide a value by comparing the focus firm with other businesses that are perhaps comparable and that have information accessible. Comparable techniques of valuation are referred to be extrinsic or relative methods of valuation since they largely depend on information from other businesses.4 Finally, we look at several newer techniques that explicitly use probability to describe uncertainty. We conclude by contrasting the different approaches and detailing their primary benefits and drawbacks. In this, we're assuming that equity is used exclusively to fund businesses. How to use the debt finance valuation models from this [9]–[11].

CONCLUSION

In conclusion, A variety of characteristics, such as market circumstances, industry dynamics, financial performance, risk concerns, and qualitative aspects, have an impact on the value and possible returns of an investment. Making educated investment choices and determining the allure and profitability of investment possibilities need an understanding of and analysis of these characteristics. Investors may evaluate the value and future returns of an investment and adjust their investment plan as necessary by taking these aspects into account and using the right valuation methodologies. the process of calculating an investment's worth and possible returns using valuation tools and models. Discounted cash flow (DCF) analysis, similar company analysis, and asset-based valuation are common methodologies of valuation. These methods assist investors in determining an investment's fair value by using the investment's anticipated future cash flows, market multiples, or underlying asset valuations.

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CHAPTER 10

VENTURE CAPITAL METHOD:UNLOCKING FUNDING OPPORTUNITIES

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ABSTRACT:

The venture capital method is a widely used approach for valuing early-stage, high-growth companies and assessing the potential returns for venture capital investors. This abstract explores the key principles and methodology of the venture capital method, highlighting its application in evaluating investment opportunities and determining appropriate valuations. By emphasizing the unique characteristics and challenges associated with early-stage ventures. These companies often lack a long track record of financial performance, making traditional valuation methods less applicable. The venture capital method offers a tailored approach to address the specific needs and risks of investing in such companies.

KEYWORDS:

Capitalization, Discount Rate, Growth Rate, Investment Valuation, Liquidation, Preference.

INTRODUCTION

The enterprise Capital Method uses a cash flow model of the investor to create a very simple method for valuing an enterprise. Compared to the company's cash flows, which are employed in the discounted cash flow method we cover in 5.3, they are a lot easier. The investor initially funds the firm via cash inflows and outflows. The investor often provides several further rounds of finance if the business succeeds. Regarding the result of the exit, the venture may either fail and give the investment little to nothing back, or it can succeed and provide the investor a large monetary gain. Entrepreneurial endeavors are not taken into account by the VCM since they seldom yield dividends. The VCM begins by calculating the expected exit value in the event that the firm develops successfully. It then reduces this value to the original investment period. This offers a post-money value from which the pre-money valuation and investor's ownership share may be calculated.

Recognizing the Inputs

In this paper, we'll go through how to estimate the investment amount, time till departure, exit value, and needed rate of return the four inputs for the VCM. The investment amount is what the investor anticipates the business will need to expand and secure the next round of funding or an exit. Understanding the venture's business strategy, financial plan, and the economics of its industry are all required for estimating the necessary investment. When there are several investment rounds, the investor must make two estimations: the total amount of money the enterprise will need over the course of all investment rounds, and the timing of this requirement. The cash flow estimates, together with knowledge about the company's milestones, may be used to assist answer these queries.

Time-to-Exit

The anticipated timing of departure relies on the company's ability to maintain its current rate of growth, as well as the stock market and the acquisition market's conditions going forward. Therefore, it is impossible to predict the time with any degree of accuracy in advance. However, business owners and investors may talk about what they anticipate and how to be ready for this eventuality. For instance, venture capital companies are quite clear about how long they want to wait before reaching an exit since they have a 10-year fund horizon.

Return Value

The worth of the firm to shareholders at the moment of leaving is known as the exit value. It indicates the value of the firm at the time when investors may anticipate to sell their shares in the future. In 1, we go through the specifics of the exit procedure and the many means by which investors might get liquidity. We focus on two forms of exits: acquisitions and IPOs, in order to estimate exit prices. These departure scenarios take place when the business is successful. It's vital to note that the exit value estimate does not statistically evaluate the anticipated worth of the firm since that would also require taking into account the worst-case situations. Instead, the exit value is a projection of the company's worth in the event of success. This knowledge is essential for comprehending the needed rate of return for investors.

What precise exit value are we seeking? In the event of an acquisition, we want to calculate the price that the buyer pays for all of the company's stock, less any outstanding debt. We are interested in the price investors may get in the event of an initial public offering (IPO), but because they can sell their shares at various times, it is impossible to forecast this price in advance. However, following the so-called lock-up period, which normally lasts six months after the IPO, investors most often sell their shares. There are two major ways to estimate exit values. The first approach involves doing a Discounted Cash Flow analysis at the time of leaving, based on future financial estimates. The second technique combines some of the focus company's main performance measures with recently announced departure prices for comparable companies. We refer to this as the Exit Comparables Method, which we further describe. Whether any of these two methods is appropriate depends on how confident investors are in internal forecasts compared to external comparisons[1], [2].

DISCUSSION

Rate of Return

The desired rate of return is the last input for the VCM that we will discuss presently. Venture capitalists often cite astronomical necessary rates of return. They may demand a 50% necessary rate of return or want their money returned ten times over. Gompers, Gornall, Kaplan, and Strebulaev conducted a study of venture capital firms and discovered an average necessary rate of return of 31% and an average required cash-on-cash multiple of 5.5.5. The realized returns achieved by the majority of venture investors, however, show that they are not even close. One can anticipate that for established businesses, the needed return often comes close to the actual return. However, the required return should be seen in the context of venture investment as the goal rate of return in the event of success. Compared to typical rates of return for other sorts of investments, this rate is much greater. We provide the following breakdown to clarify why:

Riskless rate of return + Financial risk premium + Liquidity risk premium + Failure risk premium + Service risk premium = Required rate of return

This breakdown is intended to clarify the important elements that make up the needed rate of return rather than serving as an exact mathematical calculation. In the majority of financial investments, the first three parts of the needed rate of return (p) tend to be relevant. The latter two elements are mainly focused on financial investments in entrepreneurial businesses. Let's start with the rate of return without risk. This calculates the return on a risk-free investment over time. It may be seen in the rate at which investors get secure assets like government bonds. These rates, which represent an economy's predicted long-term growth and inflation rate, typically range between 10% and 15% for industrialized countries. Harry Markowitz, Merton Miller, and William Sharpe received the 1990 Economics Nobel Prize for their pioneering work in the theory of financial economics. In we return to Miller's work. Here, we concentrate on Markowitz and Sharpe's contributions. They are credited with developing the contemporary financial portfolio theory together. In order to properly balance risks and rewards, they posed the basic issue of how investors would choose to construct a financial portfolio. They also developed a more comprehensive theory of risk pricing and asset valuation in the process. The Capital Asset Pricing Model, which is the model that emerged as a consequence, is now a mainstay of contemporary finance[3], [4].

Portfolio theory's core assumption is that risk may be diversified away by investing in a variety of projects, causing individual fortunes to wash out as the excellent ventures balance out the poor ones. But not all risk can be eliminated by diversification. Investors are still responsible for the basic economic risk that impacts all projects once idiosyncratic risk has been diversified out. The financial risk premium in the equation represents the payment that investors need to make in exchange for taking on such an undiversifiable risk. The CAPM uses the connection shown below to quantify financial risk premia in a useful way: It should be noted that this formula only includes the first two parts of the equation: Required rate = Riskless rate + P*. The return investors need to invest in a business or project carrying the amount of systematic risk p is known as the needed rate. The rate of return on a secure asset, such as the rate on the government bonds of industrialized nations, is known as the risk-less rate. The rate of return for all companies listed on the stock market is known as the market rate.

The market premium is the difference between the market rate and the riskless rate. The extra return made from investing in hazardous assets over safe ones is what is measured [5]–[7]. P gauges a company's degree of systemic risk. What is the source of this risk? The initial research by Markowitz and Sharpe shown that P measures the degree to which a company's return fluctuates in synchrony with the return of all other enterprises in the market. Regression analysis may be used to evaluate the correlation between the return of the firm and the return of the whole market. A higher P indicates that an asset has a greater undiversifiable fundamental risk and is consequently more strongly connected with overall market movement. In order to compensate investors for taking on this risk, the Required Rate must thus be greater than the Market Rate. A P value of one indicates that an asset has the same level of systematic risk as the market; a P value greater than one indicates that the price of the asset tends to move more than market movements; a P value of zero indicates that the asset fluctuates independently of the market; and a negative P value indicates that the asset moves counter to the market.

The CAPM has evolved into a widely used standard finance tool, with applications ranging from stock valuation to estimating acquisition pricing to corporate investment planning.The term Betas has entered the financial lexicon. Online sources for estimated P values are widely available. The CAPM has been improved since the ground-breaking work of Markowitz and Sharpe to change over time and include additional risk variables. A second Economics Nobel Prize was awarded for this study. Now that we have the necessary tools, we can analyze the financial risk premium in the Venture Capital valuation model. The formula provides the right premium. P is calculated assuming completely diverse investor pools, which is unlikely to be the case for entrepreneurial enterprises. P should be greater for undiversified investors since their portfolios are smaller and concentrated in fewer industries or regions, making it harder to completely eliminate idiosyncratic risk. Underdiversification is often a problem for venture capital and angel investment businesses. Divide P by the correlation between the returns on the investor's portfolio and the returns on the market portfolio as a straightforward heuristic to handle this.

This correlation would be one for a completely diversified portfolio, therefore no adjustment is necessary. The correlation is smaller and the adjusted P is greater for fewer diversified investors. Additionally, the proper P at the corporate level need to be a weighted average of the Ps of the individual investors. The best P to employ is still up for debate, with many research reaching conflicting outcomes. However, the majority of research place the value of p between one and two, indicating that venture capital is pro-cyclical. The illiquidity premium makes up the third part of the needed rate of return. When it is difficult or expensive to convert an asset's value into cash within a short period of time, financial economists refer to the asset as being illiquid. Venture capital investment is rife with illiquidity. An entrepreneurial business may need many years to complete the process from investment to exit. There are hardly any opportunities to sell shares in the interim. Any investor who wants to sell faces restrictions as a result. In order to accept owning such illiquid assets, investors want a premium since they are aware of these challenges. The latter two parts of the equation are unusual in conventional investment models. First, think about the premium for failure risk.

Venture capitalists take exit prices from a success scenario into account rather than an average situation. We see that failure is the most typical result for entrepreneurial businesses. In our explanation of financial projections, we also point out that because they assume success for the organization, they do not account for all of the potential pitfalls. We also said that these estimations are based on acquisition and IPO valuations that show success when we spoke about exit values earlier in this. Therefore, none of these assessments account for the risk of failure that entrepreneurial businesses confront. There are two methods for accounting for failure risk: one is intricate, while the other is straightforward. The first strategy is to clearly model the uncertainty and determine the expected exit values for various situations. The straightforward alternative is to include in a significant failure risk premium into the needed rate of return in order to account for failure risk. In reality, investors express a high premium without using a market model and instead depend on previous performance.

Failure Risk Premium Calculation

A service premium is the last element of the necessary rate of return. Many venture capitalists provide more than just money. Additionally, they provide a range of services that aid the entrepreneur in starting and growing her business. We demonstrate that venture capitalists often aid in the hiring of managers and directors, create strategic partnerships, introduce businesses to new customers and suppliers, and aid in the funding of supplemental projects. Additionally, investors provide soft, but no less crucial, counsel and assistance, such as by serving as a founder's mentor or sharing their crisis management expertise. The odds of the business succeeding are increased by these services. Typically, investors don't charge businesses for any of these services. Instead, they depend on the investment's profits to cover their costs. Therefore, these services must also be included in determining the needed rate of return. Another way to look at this is that the investor must make back the money they spent providing all of these services. To provide these services, a venture capital company, for instance, must maintain certain numbers of partners and employees. They earn carried interest and management fees from their limited partners to pay for this. VC companies must consequently provide a greater gross return with their investments in order to provide a competitive net return to their limited partners. The service charge includes this portion of the necessary rate of return.

Discounted Cash Flow Analysis

In corporate finance, the Discounted Cash Flow approach is a common tool for valuing assets. It is predicated on the idea that an asset's value is determined by the net present value of the cash flow it produces. This cash flow is sometimes referred to as free cash flow to denote the fact that, in theory, it is accessible to shareholders after taking into consideration all the capital required to run the business. The future cash flow is retroactively discounted to the present at a rate that accounts for the risk to the business. Because it focuses on data about the firm itself, the DCF approach is known as an intrinsic valuation method. In a variety of corporate finance applications, the DCF approach is the go to method for valuation. How to use DCF in various circumstances is covered in several books. Applying it to entrepreneurial endeavors, however, is still difficult given their high level of unpredictability. In contrast to the investor cash flow, which serves as the foundation for the VCM, the DCF technique involves calculating corporate cash flows, which are much more difficult to forecast. But there are certain advantages to simulating these specifics. Calculating DCF is simple if an entrepreneur already has thorough financial estimates. Later-stage businesses may also rely on more trustworthy accounting data. We will now demonstrate how to create a new DCF model for innovative businesses. Since these businesses heavily depend on equity, we make the assumption that they are entirely debt-free in order to keep our DCF model as simple as possible.

The DCF Method's Mechanism

A discount rate, a terminal value for the firm, and a series of cash flows over a specified time horizon. The DCF approach produces an estimate for the pre-money value of a firm when applied to one before a financing round. To differentiate it from the VCM, we added the superscript DCF to the symbol VpRjf. The starting cash balance has been added to the conventional calculation for a DCF. The majority of startups have tiny beginning cash balances, which is why they first look for funding. It's important to note that none of this money came via fund soliciting. To determine the worth of the cash created by the firm's operations, all fund-raising efforts are purposefully left out of the free cash flow calculations. As a result, the DCF calculates the company's pre-money worth. However, keep in mind that a company's starting capital would increase by the investment amount right after obtaining a funding round. The DCF now calculates the post-money value.

This formula is similar to the net present value formula described, as the astute reader may have noticed. This is not a coincidence since the DCF net of the required investments equals the NPV of the company's cash flow. Once again, we point out that the pre-money value is produced by the DCF valuation. Because the DCF determines the net worth of all cash flows, including the first negative cash flows for which financing is required, this is true. As a result, it indicates the company's worth before any fundraising. Also keep in mind that the DCF technique has a drawback in that, unlike the VC method, it cannot display the values for different investment rounds since it doesn't explicitly simulate the staged investment process.

Estimating the Inputs

Time Horizon

The temporal horizon is the first decision to be taken. The typical range for horizon selection is three to seven years. The annual cash flow of the corporation is difficult to forecast in detail beyond seven years. After three years, the DCF is no longer meaningful since the venture's worth is mostly based on its terminal value. In general, one should choose the horizon when it is possible to compute the terminal value in a meaningful way. Once a business has reached the point where its cash flow is increasing at a predictable pace, this becomes simpler. The time horizon for entrepreneurial businesses must take account for the investors' desire to exit the business after a number of years. The terminal value may be estimated at the moment of departure, in which case it is referred to as an exit value. The terminal value may also be estimated independently of exit, since the DCF technique does not need this.

Cash Flow Free

The fraction of the cash flow that is theoretically free for distribution to investors is the relevant cash flow for the DCF. This does not necessarily imply that the business will really disperse its cash flow, since most startups don't. Instead, it indicates that the cash flow is not necessary to support the company's future development. The mentioned financial predictions of a corporation may be used to compute the free cash flow.

Ending Value

A practical method for valuing future cash flows is terminal value. It is predicated on the idea that the business will start to produce constant-growth free cash flow at some point in the future. For established businesses, constant expansion is a simplicity that works effectively. These businesses can't continue to expand faster than the economy, and their development may be influenced by sluggish trends like demographic changes and expansion of the overall economy. The constant growth assumption, however, poses more of a challenge for new, rapidly expanding businesses.

Amount Offered

The discount rate is the last parameter needed by the DCF technique. Similar debate is being had here over the necessary rate of return for the VCM. However, it should be noted that in reality, individuals often employ a more common discount rate, which in the case of businesses with just equity financing ignores the cost of debt financing. However, the aforementioned considerations should still serve as a guide for choosing the proper discount rate.

Techniques for Comparable

In this paper, we discuss techniques for evaluating a focus firm in comparison to a group of similar businesses. These techniques are often known as relative or intrinsic valuation techniques. Investment bankers often use this strategy when pricing IPOs and acquisitions. It is well-liked since it is simple to use, easy to explain, and intuitive. It also has the advantage of using knowledge of the market by taking use of the independent expertise of a significant number of other investors. However, this strategy has disadvantages as well in the context of entrepreneurial businesses. First, it might be challenging to choose which firms are in the group of similar businesses. Second, market data is often incomplete and sometimes out-of-date. We talk about two equivalent approaches. Using private business values as a benchmark, the Investment Comparables Method determines the firm's value at the time of a financing round. Based on how comparable firms are valued in the market, the Exit Comparables Method calculates the company's exit value. Because it predicts the company's future worth, the ECM is not a valuation approach in and of itself, but the ICM is. One has to employ the VCM in order to bring that future value back to the present.

Investment Comparables Analysis

The Investment Comparables Method compares the values of a focus firm to those of companies that are at a comparable stage of development. This enables investors to get data on the status of the market for investments at the moment. It displays how comparable businesses are now valued, which reflects the supply and demand dynamics in the venture capital market. Private finance transaction appraisals make up the data needed for the ICM. Since this data is not made accessible to the public, getting it might be difficult. Even highly specialized commercial databases only include a small amount of data about private values. However, seasoned investors speak with their peers in private and may thus obtain a sense of how current prices seem. Additionally, the proliferation of equity crowdfunding platforms in several nations offers a mechanism to get value data, although for a relatively narrow portion of entrepreneurial businesses.

Conceptually, calculating investment comparables is straightforward. To obtain an estimate for the pre- or post-money value of the focal firm, simply a collection of similar companies' pre- or post-money valuations are necessary. It is often helpful to take into account the range of values in addition to looking at the average and median valuation in the comparison group. An entrepreneur may argue against a value of $0.5 million, and an investor may argue against a valuation of $10 million, if the comparison group is experiencing valuations between $1 million and $5 million. It might be challenging to choose between similar businesses. They need to work in the same sector and use comparable company strategies. Additionally, the valuations have to come from transactions involving businesses that are at a comparable stage of development and are raising comparable sums of money. It is advantageous if they are in the same area or nation. The values should be recent, preferably less than a few months old, in order to represent the most recent market circumstances.

The ICM approach has a number of drawbacks. The method's usage of practically minimal internal information is one of its drawbacks. To be accurate, only the comparison set is created using internal information. The value itself, however, is only based on the comparison group and does not account for the unique circumstances and future prospects of the focus firm. The ICM's reliance on private values, which may sometimes be deceptive, is another significant flaw. Herd behavior may also occur if everyone utilizes the ICM. Conditions are favorable for speculative bubbles if investors pay high values simply because previous investors paid high prices: Valuations drift away from their underlying business principles and adopt a blind leading the blind logic where one investor imitates the other. The founders remarked that their value was above the lowest but above the average and median of their comparable set when comparing these valuations to the $2M given by Michael Archie. Additionally, their investment of $500,000 was exactly median. The fact that they were well inside the range of their peer corporations offered them some solace. Beyond that, however, they struggled to exploit this information since similar companies weren't able to provide [8]–[10].

CONCLUSION

In conclusion, A specific technique for evaluating early-stage businesses and estimating future returns for venture capital investors is the venture capital method. Investors may determine the worth of their investment and make wise choices by taking future cash flows, exit multiples, and discount rates into account. The venture capital technique provides a formal framework for valuation while acknowledging the distinctive qualities and dangers of early-stage businesses. This method's valuation provides a place to start when talking about equity ownership and investment terms. It streamlines talks in the investment process and aids in bringing both sides' interests into alignment.

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CHAPTER 11

EXIT COMPARABLE METHOD: A VALUATION APPROACH

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ABSTRACT:

The exit comparable method is a valuation approach used to determine the value of a company or investment based on the prices at which similar businesses have been sold in the past. This abstract explores the principles and application of the exit comparable method, highlighting its usefulness in estimating the value of an investment at the time of exit. The abstract begins by emphasizing the importance of accurate valuation in investment decision-making. The exit comparable method provides a market-based approach to valuation by examining transactions involving similar companies. It leverages the pricing information from these transactions to estimate the value of the subject company.

KEYWORDS:

Comparable, Companies, Cash Flow, Exit Strategy, Financial Performance, Market Analysis, Multiples.

INTRODUCTION

Using a group of similar firms that have previously departed, the Exit Comparables Method calculates the exit value of the focus company. The ECM is an input that the VCM uses, not an evaluation technique in and of itself. This is due to the ECM's estimation of a future exit value, which must be retroactively discounted. The core rationale of the ECM is different from that of the ICM, despite the similarities between the approaches. The ICM provides information on how other investors presently evaluate businesses that are comparable to yours. The predicted success of the main firm, however, is not even mentioned. In contrast, the information on the ECM focuses on how acquirers or stock market investors value similar businesses that successfully depart. Even while this doesn't in and of itself provide an evaluation, it moves the emphasis to predicting the anticipated financial success of the targeted firm. Comparable businesses and the comparison meter are the ECM's two options.

The Selection of Comparable Businesses

Any examination of similar companies is only useful to the extent that the focus firm matches its comparison group. Comparable businesses must have traits including size, development stage, growth possibilities, and risk. These are dependent on the business model of the organization and the sector to which it belongs. In fact, defining the collection of similar businesses at the industry level is rather frequent. However, this also necessitates that the focus firm share a business model with its competitors in the sector. Otherwise, even outside of the sector in which the focus firm operates, the comparison group should be selected based on comparable business models. Data collection is often simpler for publicly traded companies than for privately owned businesses. All of the enterprises in the comparison group must be valued for the ECM, which is simple for businesses with stock market listings. Large private company purchases sometimes include valuations, too. Data on privately owned company values, however, are difficult to get. Some publicly traded acquirers reveal the value of their privately owned targets. The most difficult data to get is valuations when the target and the acquirer are both privately owned businesses. When choosing similar businesses, there are two issues to be resolved. First of all, it might be challenging to come up with a solid set of comparables for creative businesses that are pursuing novel technologies or new business strategies. When it developed the first internet search engine, what firm was comparable to Google? Second, in order to raise their worth, less inventive businesses often want to contrast themselves with market leaders. The one hundredth mobile messaging startup should not be compared to WhatsApp since it will never have a position in the market as dominant as WhatsApp [1]–[3].

DISCUSSION

Modeling Uncertainty

The fact that the solutions we've looked at so far only take the successful departure scenario into account is a disadvantage. High discount rates that are partly arbitrary and not based on an explicit analysis are used to make up for this disadvantage. This may be avoided by precisely modeling the underlying venture uncertainty and the risk structure. The necessary techniques are more advanced and provide a precise and thorough assessment of the venture's dangers. The drawback is more complexity. Finding reasonable assumptions, particularly suitable probability for all the potential outcomes, is similarly challenging. a straightforward method for incorporating the risk of failure into the discount rate. We now look at three more thorough strategies. Through scenario analysis, you may create several different situations and give each one a probability. Through the use of continuous probability distributions across potential outcomes, simulations generalize scenario analysis. Finally, we provide PROFEX, a proprietary valuation model that explicitly estimates exit possibilities[4], [5].

Simulations and Scenario Analysis

In corporate finance, the concept of assessing various scenarios is popular. This strategy is frequently referred to as the First Chicago technique in the area of entrepreneurial finance due to the name of the claimed investment company where it was founded. This strategy is focused on simulating a limited number of circumstances that represent several possible outcomes. Each scenario is intended to depict a distinct direction the business may go. Small sets of ranked outcomes, such as the excellent, the middling, and the terrible, are examined using simple applications. Applications at a higher level take richer variables into account. They could differentiate between small quick and big slow exit scenarios, or they might do so depending on the number of goods the firm introduces, the number of markets it enters, how the competition behaves, and so on. Scenario analysis is simple to use inside the VCM, where one may explore various funding round sequences or take alternative exit values representing various company trajectories. Scenarios for the DCF approach enable evaluation of various free cash flow and terminal value suppositions. We use a VCM application to show scenario analysis.

PROFEX

Now let's take a look at our unique approach, PROFEX, which stands for Probability OF Exit. It expands the logic of the venture capital method and takes into consideration the structure of staged funding. It acknowledges the likelihood of both success and failure and models the unpredictability of exit outcomes. The PROFEX model, in contrast to the other techniques, establishes a value for the first round as well as an internally consistent set of valuations for all potential following rounds. The PROFEX method's structure, which is iterative and involves a corporation going through a series of phases. The business endeavour begins with securing funding. At each step, there are three potential outcomes, each with a different probability: the firm exits, for which the model assigns a value; the company fails, in which case the model assigns a liquidation value; or the company continues, in which case it requires another round of funding. The value in this second round was derived inside the model itself, which is one advantage of PROFEX. The firm will confront the same three result options, each with a different likelihood, if it accepts the investment and continues. The model also allocates a new liquidation value at each round in order to account for the fact that the firm is older and presumably more sophisticated. Any number of financing rounds may be added to the scheme. The last step must conclude either with success or failure, indicating a continuation probability of 0.

The exit value, the liquidation value, and the pre-money valuation at the next financing round, each multiplied by its respective probability, are the three next-round values that make up the PROFEX model, which is a generalization of the VC method. Knowing the value in the next stage is necessary for the calculation of a valuation at one step. In order to solve the model, one must first determine the value for the most recent round before going backwards to get the valuation for the first round. The PROFEX model's primary outputs are the pre- and post-money values for each round. PROFEX values are carried out using the accompanying spreadsheet, which is accessible on the book's website. The maximum number of rounds must be determined before providing the following inputs for each round the intervals between rounds, the amount invested, the exit value, and any related Astrid's calculations were admirable, but Brandon didn't like that they necessitated making what seemed to him to be arbitrary assumptions about future values. He believed that all appraisals, not only the first one, should be calculated using a competent valuation model. He created his own PROFEX model as a result. More information on the time of the failure has to be included for this. Brandon gave early and late failures some thought.

He gave an early failure a 50% probability. He believed that prior to entering the United States, Work Horse may fail in Sweden due to issues with the technology or a dearth of market acceptance. However, the likelihood of failure would only be 20% if the business was successful in Sweden and expanded to the United States. His overall failure probability was thus 60%, the same as Astrid's. Brandon made the same presumptions as Astrid for the remainder. The values were the main difference between Brandon's and Astrid's computations. To his amazement, even though the values at later phases were quite different, the predicted post-money price of $2.31 was very close. He pointed out that the fourth round, for instance, would have to be a down round, with a pre-money value of $21.78, as opposed to a post-money valuation of $26.08 in the round before. Investors would lower their expectations at this point since, by then, the fantasy of the home run would have passed. This level of insight could only be produced by a model like PROFEX. The three founders all acknowledged that modeling probability had led to some further, fruitful findings. Sadly, it was impossible to predict Michael Archie's reaction to any of these estimates.

Model of Valuation Selected

Now, we contrast the various valuation techniques in terms of their methodologies, advantages, and disadvantages. The VCM is the startup valuation method that is most often employed. It creates a valuation of the company's equity by considering the investor's cash flows. The estimate of the exit value, which is often produced using the ECM, is very important to this procedure. Additionally, certain delicate discount rate assumptions are needed for the VCM. The DCF technique approaches the analysis of the company's cash flow from a different angle. It is the accepted approach of valuation in corporate finance. The approach, however, is not especially well equipped to take into account the irrationality and unpredictable nature of entrepreneurial businesses. Furthermore, modeling staged investments cannot be done using the DCF technique. For later-stage enterprises with more predictable cash flows, this approach is more persuasive.

The ECM draws conclusions about the value of a focus firm based on market data from similar companies. The intrinsic valuation methodology of the DCF technique is considerably different from this market-based strategy. It is based on an approach to relative value that contrasts a focus firm with a group of similar businesses. Finding an appropriate comparison set and selecting a performance indicator to calculate the value may be challenging, particularly for innovative businesses with a brand-new business plan. The ICM is even more straightforward, directly comparing the value of a firm with the valuations of comparable start-up businesses at comparable phases. Finding realistic value ranges is made easier with this strategy. However, since it nearly totally depends on outside data, it is difficult to get a precise assessment. Choosing an adequate discount rate is a challenge that affects all techniques for discounting future returns to the present. The arbitrary discount rates used to the risk of failure are of special concern. Probability-based models may help in this situation. They provide a theoretically more rigorous method for considering the risk involved in entrepreneurial endeavors. They do, however, require putting probabilities on these many situations, which is difficult in reality, particularly for early-stage businesses.

The implicit assumption that all investors would obtain common stock is a shortcoming that all valuation models share. We describe how many venture capitalists own more complex instruments, such preferred shares. Under some circumstances, these securities provide investors priority cash flow rights. None of the valuation techniques, however, account for these rights. the discussion between business owners and investors that results in the framework of the ultimate transaction. An intriguing statistical tool has been established by Radicle, a consultancy, to examine venture values and venture investment more broadly. We come to the conclusion that there is no clear winner in terms of valuation models. Instead, every technique has advantages and disadvantages. As a consequence, several models might be seen as complements as opposed to competitors. One begins to feel more confident if many ways all point in the same direction. However, there is a chance to go further and determine what causes these variations if several approaches provide values that are drastically different from one another.

Term Papers

This paper looks at the term sheets that business owners and investors use to define their legal responsibilities and rights. We begin by outlining how term sheets assist in resolving the underlying disputes between these parties. The construction of term sheets is then thoroughly discussed. We examine the distribution of cash flows, the usage of various kinds of preferred shares for this purpose, and the possibility of tying them to the company's success. We also examine how management remuneration and employee stock option plans are determined. the presents investor rights about the liquidity of their investment, control rights that govern future financing rounds, and investor rights. We point out a trade-off that business owners must make when negotiating a transaction between conditions and value. The analysis of convertible notes, a tool often employed in early stage negotiations, comes to a close.

Terms and Conditions

In this paper, we look at the goals and organization of the financial agreement between investors and business owners. The investor creates a term sheet, or preliminary agreement, at the time of making an offer. The rights and duties of each party are spelled out in this document's contractual terms, which also explain how they rely on a number of potential future events. A key aspect of negotiating a business is coming to an agreement on a term sheet. A term sheet often intimidates business owners. We now demonstrate that the logic behind term sheet provisions is often straightforward, despite the intimidating intricacy and language of term sheets. Conflicts of interest that develop between entrepreneurs and investors during the course of the venture influence term sheets. A company's future is never completely predictable, which necessitates contractual flexibility. Entrepreneurs and investors, however, are unable to foresee every scenario that could later become important. As an alternative, they specify how future choices will be made in light of a select group of potential future conditions. These conditions are located via noteworthy occasions known as milestones that characterize the venture's development.

Term sheets have a variety of functions in the partnership between investors and business owners. They establish each party's rights and obligations first. Second, they influence how each party is motivated. Term sheets that are carefully drafted balance the interests of entrepreneurs and investors and reduce potential conflicts. They encourage investors to participate in the process of entrepreneurship's value generation while also giving entrepreneurs incentives to create big, successful enterprises. Thirdly, the term sheet-writing process forces the parties to define their expectations for the partnership they are about to join. Fourth, the parties' individual risk/reward profiles are shaped by the risk allocation made in term sheets. Fifth, they outline how the business owners and investors communicate with various outside parties, namely with important personnel and potential investors. Future investment rounds and how they can influence the present distributions between entrepreneurs and investors are covered by provisions in term sheets. We pointed out that economic factors including the venture opportunity's quality, the market's climate, the competitiveness for deals, or the caliber of investors all had an impact on pricing. Term sheets work the same way.

Consider the concept of competition if an entrepreneur is negotiating with a single investor, that investor may enforce conditions that are advantageous to investors. The entrepreneur's options are essentially limited to walking away from the arrangement. In the event that competing term sheets are submitted, things may drastically alter. The business owners may now object to unreasonable requests by referencing the other term sheet. Market circumstances follow a similar trend. Investors may impose stricter restrictions during downturns, but during upturns, they pursue lucrative transactions and typically drop such conditions [6]–[8]. Term sheets often have less than twelve pages. The final collection of legal paperwork, which normally consists of the corporate charter, investor rights agreement, and stock purchase agreement and may also contain employment agreements among other documents, are then created from the agreed-upon terms.1Both parties use legal professionals to create these lengthy final agreements, which may often number in the hundreds of pages. These final contracts represent mutually acceptable investment terms that provide adequate financial incentive and protection for both investors and entrepreneurs to be prepared to incur the risks associated with the transaction.

Term sheets are often written by seasoned attorneys who create standard templates and only modify a small number of terms to the particulars of each contract. Term sheets cannot serve as a full manual for how the parties will conduct in every circumstance given the uncertainty that surrounds a venture; rather, they serve as the legal framework for the establishment of a partnership that will change over time. Additionally, regional customs and national legislation have an impact on term sheets. Although this leads to some variance in contract arrangements across time and geography, the basic economic principles we address here are generally applicable worldwide. Milestones and Contingent Contracting. Term papers define the obligations and rights of investors and businesses in very ambiguous situations. The venture's unclear future prospects make it much more impossible for a contract to cover all potential future circumstances. Therefore, contracts are incomplete in the sense that they can never take into account the whole range of potential future occurrences. Through contingent contracting, which restricts the use of provisions to certain predetermined situations, this constraint is solved. As a result, the list of events that must be handled is drastically reduced, and the contract becomes a useful instrument for governance.

Term sheets employ milestone events, also known as conditions, to establish contingencies. These occurrences gauge the project's success by highlighting when it meets or exceeds the targets set out in the contract. The distribution of control rights and the allocation of cash flow rights are the two contingent clauses that are used most often in practice. A broad range of performance measures, including financial, operational, and managerial ones, may be used to establish milestones. The following might be an example of contingent contracting: The investor has the right to propose two out of the five directors. The investor has the ability to propose two more directors if the business does not achieve $1 million in revenues within a year of closure. The primary approach for putting contingent contractual arrangements into place is via milestones. Additionally, since each firm must demonstrate its worth again at each round, the practice of staging funding across a number of rounds automatically makes financing conditional on reaching milestones. Therefore, milestones provide powerful incentives to meet certain mutually agreed performance criteria and aid entrepreneurs in concentrating on certain deliveries.

A practical answer to value disputes between entrepreneurs and investors is to set a milestone. One may argue that investors should get additional shares if an entrepreneur's expectations turn out to be too optimistic. Instead of arguing over a valuation, the two parties might find it simpler to agree on a milestone-based valuation: the entrepreneur agrees because she is confident that she can meet the milestone, and the investor agrees because he receives the protection he values if the milestone is not met. Setting milestones has its own set of issues. The entrepreneur has an incentive to meet the performance objective by setting one, regardless of the long-term value to the business. An entrepreneur can be pressured by a sales goal, for instance, to launch an incomplete product quickly, risking the company's image. Additionally, milestones may obstruct the strategic adjustments needed for entrepreneurship, such as changing the product line or focusing on distinct consumer groups. A start-up, for instance, could have a sales goal based on a business plan that depends on product sales. If the business owner learns that a licensing model is more lucrative in the long run, she may decline the chance since the new model's lower short-term income would mean missing the milestone. Naturally, the entrepreneur may want to renegotiate the milestone in such circumstances, but doing so also comes with fees and challenges. The fact that it might be difficult to determine whether a milestone has been reached is another problem with milestones. For instance, there are several ways to interpret the need to create a functional prototype. In order for a common meaning of the milestone to apply rather than a strictly legal definition, milestones consequently need confidence between the two parties.

Nobel Perspectives on Unfulfilled Contracts

Oliver Hart and Bengt Holmström received the 2016 Nobel Prize in Economics for their contributions to contract theory. Here, we focus on Hart's contribution as we covered. Understanding the imperfection of contracts is the core goal of Hart's research. The complexity of legal contracts may first appear intimidating, but after one gets acquainted with their language and rationale, the actual issue is why they are still so deficient. In other words, there are orders of magnitude more potential problems than there are potential problems that contracts can foresee. Hart thus aims to comprehend how contractual agreements handle the unexpected and make up for their inability to take into consideration all potential outcomes. He applies these findings to a wide range of economic issues, such as whether businesses ought to combine or whether governments need to privatize certain functions. The application of his ideas to corporate finance is something we are interested in. The work of Hart explains how business owners and investors handle unfulfilled contracts. He makes a distinction between sections in contracts that deal with verifiable actions and clauses that distribute decision powers.

For the latter, it is just necessary to indicate who will make specific choices; for the former, it is necessary to define precisely the verifiable conditions under which the action must be performed. As a result, the initial distribution of decision rights is crucial. For instance, Hart's study explains why it would be best to give entrepreneurs control as long as a venture is operating well, but to give investors control when a company's performance starts to decrease. A number of control clauses that are often seen in VC term sheets may be used to construct such control structures. Hart's work also provides us with a crucial understanding of the significance of negotiation. Even though contracts predetermine certain actions, the parties may always alter their views if the situation changes. Understanding the mechanics of renegotiations is crucial for completely appreciating the function of contracts. The first contract lays forth the procedures to be followed during subsequent renegotiations. In general, Hart's research enlightens us on how business owners and investors draft contracts in the face of significant complexity and uncertainty. Instead of contractually defining what to do in every eventuality imaginable, they design governance mechanisms that deal with issues if and when they arise.

Flow of Cash Rights

We now widen this view and examine convertible preferred stock shares, the most prevalent kind of financial security employed in venture capital agreements. In order to keep things simple, we may sometimes refer to common stock shares as common shares and convertible preferred stock shares as preferred shares. Both share classes are often issued by startups. Founders, top management, workers, and potentially some other parties’ own common shares. Instead, preferred shares are often issued to investors, giving them preferential cash flow rights over regular shareholders. We describe how preferred shares distribute cash flow rights, why investors get them, and what this means for business owners [9], [10].

CONCLUSION

In conclusion, the exit comparable technique uses price data from similar transactions to provide a market-based way to evaluating assets. It gives a practical technique for determining a company's exit value. To guarantee accurate and trustworthy values, the approach calls for careful consideration of comparable selection, data normalization, and revisions. When combined with other valuation techniques, the exit comparable method improves investors' ability to make decisions about the worth of their assets. It is often used as one of several techniques to verify or triple check the projected worth of an investment. By taking into account a variety of valuation techniques, investors may get a more thorough knowledge of the prospective worth of the investment and make better judgments.

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CHAPTER 12

A FINANCIAL INSTRUMENT: CONVERTIBLE PREFERRED STOCK

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ABSTRACT:

Convertible preferred stock is a financial instrument that combines features of both equity and debt. This abstract explores the concept and characteristics of convertible preferred stock, highlighting its benefits and considerations for both companies and investors. The abstract begins by introducing the concept of preferred stock, which represents an ownership stake in a company that carries certain privileges and preferences over common stock. It then explains the convertible feature, which allows holders of convertible preferred stock to exchange their shares for a predetermined number of common shares at a later date.

KEYWORDS:

Conversion, Dilution, Dividends, Equity, Liquidation, Participating, Ownership.

INTRODUCTION

The term convertible preferred shares is widely used to describe the primary financial security utilized with entrepreneurial enterprises. The term convertible preferred or simply preferred is often shortened. This security's pre- ferred status above common stock is reflected in the name. In the event of liquidation, this grants preferred access to cash flows. Additionally, it could be eligible for preferred redemption, which would allow investors to ask the business to buy back their shares. Convertible preferred shares provide the investor the option of getting a payout that resembles either stock or debt, which is a key feature of these securities. This decision is often taken when a firm exits, such as when it is purchased, listed on a stock market, or is wound up. An investor who has a 20% investment in the firm is eligible to receive 20% of the exit profits when all shareholders own common shares, which gives them a proportionate part of the company's worth upon exit. However, holders of preferred shares also have extra cash flow rights, which depend on the form and price of the departure. These rights have considerable power: In rare circumstances, often in the event of failed exit outcomes, a 20% share in the firm may entitle the investor to 100% of the exit profits.

We first take a look at a departure through liquidation, which includes mergers, acquisitions, or shutting of the firm, to better understand how convertible preferred shares divide cash flow rights. With convertible preferred shares, the investor has two options: either they keep the preferred shares and get a preferred return similar to that of debt, or they convert the preferred shares into common shares. Preferred terms are valued at PT, investments are valued at I, and dividends paid to investors are valued at DIV. Dividends accumulate over time but are not paid out until departure since start-ups often maintain negative cash flow for a long period. The payout for the preferred shares in the absence of conversion is equal to the investor's initial investment plus any dividends:

$$I + DIV = PT$$

The term sheet contains a formula that determines how dividends are calculated to accrue. Let T be the period to leave and D be the dividend rate to calculate the dividends. A basic noncompounded interest payment of D*I is accumulated annually by dividends since they are often cumulative, giving rise to the total accrued dividends of: DIV = D * I * T. The face value of the investor's claim is fixed, in the sense that it is independent of the exit value, giving the preferred terms P T a debt-like structure. The preferred terms differ from debt in that dividend payments are delayed. Now, we'll demonstrate how preferred stock divides cash flows between the investor and the business owner in the event of conversion. In this instance, the matching value of common equity determines the value of the investor's convertible preferred stock shares. We know that FINV provides the ownership fraction percentage of common stock that corresponds to the investment. We will suppose there is just one entrepreneur holding common equity and just one investor owning convertible preferred shares for the sake of simplicity. We designate the cash flow rights of the investor and the entrepreneur with the letters CFINV and CFEN, respectively. The exit value of the firm at which an investor is undecided about converting or not converting is what we refer to as the conversion threshold. By equating these two figures, we may get the conversion threshold's value[1], [2].

DISCUSSION

Participating Preferred Stock

Participating preferred stock is a separate strategy that offers more downside protection to investors. Participating preferred stock is a combination of the two, as opposed to convertible preferred stock, which offers an option between a debt-like and an equity-like instrument. The participating preferred shares allows the investor to two sets of cash flows in the event of an acquisition or liquidation. The investor first receives the favorable conditions. Second, the investor also receives a portion of any future earnings. Participating preferred stock is sometimes referred to as a double dip because it does not automatically convert into common equity in successful IPOs, unlike convertible preferred. A little over half of all deals use participating preferred stock, according to a VC survey by Gompers, Gornall, Kaplan, and Strebulaev[3], [4].

Participating preferred stock can materially reduce the entrepreneur's cash flow rights. For this, it often has a cap on the range where the participating preferred terms are valid. For high exit values there is automatic conversion to common stock, which implies that the investor forfeits the preferred terms. Consider first the sim- plest possible cap, denoted by XCAP, such that the investor's claim corresponds to pre- ferred shares the cap but is automatically converted into common shares above the cap . Such an arrangement would lead to a discrete drop in the investor's cash flow at the cap. This could become problematic if the company ends up with an exit value close to XCAP. While the entrepreneur might try all sorts of things to push the valuation above the cap, the investor would actually have an ec-onomic interest to lower exit value. This blatant conflict about the valuation can be avoided by smoothing out the payouts around the cap. This is with the solid bold line in 6.5, which displays the cash flows to the investors [5]–[7].

Using Preferred Stock: Justifications

Why do entrepreneurs accept these ostensibly harsh terms if preferred stock gives investors additional cash flow rights? Clearly, opportunism can be at play here: Investors are familiar with drafting complex financial contracts, and inexperienced entrepreneurs may accept unfavorable terms that they don't fully understand. However, these terms are regularly accepted by sophisticated entrepreneurs who fully understand them and persist over time. If the venture is successful and fetches a high exit value, then the preferred stock converts to common equity, giving the investor and the entrepreneur proportional stakes, allowing them to share the value that has been created. However, if the venture does not perform well, the preferred stock gives the investor all or most of the returns. This is the key feature of all types of preferred stock.

Providing Incentives for Entrepreneurship

The entrepreneur receives nothing when the exit value is the preferred terms, and all of her returns occur in the success region. This payoff structure clearly encourages the entrepreneur to work hard and to stay focused on generating high financial returns. Preferred stock is conducive to unleashing entrepreneurial incentives. The return function of an entrepreneur is convex, which means that payoffs increase more than proportionally as X increases this is similar to the return structure of a call option. Preferred stock also encourages risk-taking because it shifts some of the financial risk from the investor to the entrepreneur through downside protection.

Eliminating Subpar Projects

The use of preferred stock helps investors to screen out unsui investment projects. This is related to the problems of asymmetric information and the lemons issue. Entrepreneurs might know more about their own business, talents, and intentions than the investors. Consider two entrepreneurs both of whom are looking to raise money from an investor. One entrepreneur has abusiness opportunity with a legitimate chance of generating high returns. The other claims the same, but in reality, knows that her business only has limited upside potential. The latter type would be unwilling to accept a preferred share offer, knowing she has no chance to earn anything from it. Thus, by affording downside protection to investors, preferred stock makes funding unattractive to weaker projects. This leads to self-selection, where only better, or more confident, entrepreneurs are willing to accept funding through preferred stock. From an investor perspective, such self- selection is very useful. Even if the investor cannot tell the two entrepreneurs apart, the use of preferred stock attracts only the more desirable type of entrepreneur. Once upon a time, there were two entrepreneurs, Pierrette Parfaite and Michelle Mabelle. Pierrette had a solid venture that would generate an expected €100M at exit, while Michelle had a venture that appeared to be just as promising on the surface, even though she secretly knew that it would only generate an exit value of €60M. Both ventures required a €20M investment and would take five years to exit. The twist was that there was asymmetric information so that only Pierre.

Matching Investors' and Entrepreneurs' Expectations

Preferred stock helps align expectations. Entrepreneurs tend to be more optimistic than investors; they strongly believe in the upside potential of their ventures, which is why they started them in the first place. Investors may be more cautious, aware of the many ways a venture can fail. If entrepreneurs put a relatively higher probability on the upside, and investors a relatively higher probability on the downside, then it is mutually advantageous to structure cash flow. We conclude this by noting that preferred stock can also affect the even- tual exit outcome. A standard feature ofpreferred shares is that IPOs and acquisitions are treated differently, due to the automatic conversion into common shares at IPO. One academic study by Hellmann suggests that this may be on purpose, as the automatic conversion leaves more shares to the entrepreneurs, especially when they continue to be involved with the company. At the same time, automatic conversion creates an incentive for investors to prefer acquisitions over IPOs. One empirical study, by Cumming, finds that companies financed with common equity, where there are no incentives to favor acquisitions over IPOs, are 12% more likely to have an IPO than those financed with preferred equity.10 Naturally, entrepreneurs do not always welcome the decision to do an ac- quisition with preferred shares. One further academic study by Broughman and Fried looks at 50 acquisitions of VC-backed start-ups.11 It finds that 1 of them involve some renegotiation where the entrepreneur gets more than specified under the original terms. This happens particularly in those companies where the common shareholders can block an acquisition.

Compensation

Employment Agreements for Founders

Prior to that, founders frequently have loose boundaries between their personal and business finances; they may invest their personal funds in the company and may use company resources for personal use. Furthermore, founders don't always specify what salaries they receive from the company. Such a state of affairs is not acceptable. The most significant implication of signing an employment agreement is that founders can be fired from their own company. An employment agreement also subjects founders to standard employment terms that may include noncompete clauses where departed founders may not work for a competitor for a period of time or nonsolicitation clauses where departed founders may not solicit employees of the company. Apart from founder shares, a compensation package may include salary, bonuses, and stock options. Two criteria govern founder compensation: first, there is a need to defer pay to save on limited financial resources; and second, pay is made contingent on performance to provide incentives. Founder salaries typically run low, especially for early-stage ventures. Bonuses are uncommon in start-ups as there is typically no cash available.

Founder shares are the main form of compensation for founders. They are typically agreed upon around the time of founding. Even though founders created their own company, investor term sheets often specify that they don't own all of their own equity right away. Instead they need to earn it back by remaining with the company and possibly, too, by achieving certain performance milestones. This is called founder vesting. Its main purpose is to assure the continued commitment of the founders to the company. The value of early-stage companies is embodied in their founders' ability to execute their plans. Investors need protection from the pos- sibility that founders leave after the venture has been funded. Vesting provides such protection by specifying that at the time of signing a term sheet, the founders reassign part of their own shares back to the company. The company then releases them back to the founders according to a set schedule. The release is usually contingent on the time the founder has remained with the company but can also be made contingent on milestones . A typical arrangement might stipulate that founders retain up to athirdoftheir shares and earn back the rest in monthly or quarterly steps over a few years. Constant vesting over time is called linear and is most common. However, there can also be a cliff period, which is the minimum time a founder needs to remain with the company before vesting starts. In case of an acquisition or an IPO, vesting is typically accelerated, so that unvested shares vest automatically. We examine founder.

Plans for Employee Stock Options

In addition to salary, key employees typically receive some stock options, frequently through Employee Stock Options. Stock options are used to encourage employees to concentrate on company performance, to increase their loyalty and retention, and to defer cash payments by substituting current salary with options. Depending on the jurisdiction, there may be tax benefits or disadvantages. Employees who leave the company lose their unvested options. There is typically an initial cliff period, say one year, when options accumulate but are not yet awarded. If the employee stays through the cliff period, she receives those options, but if she leaves before the end of the cliff period, none of her options are awarded. A standard vesting period might be two to four years. The firm must establish an option pool in order to grant stock options. This often occurs during the first formal fundraising round and accounts for 10 to 20% of the company shares, which are referred to as reserved shares since they have not yet been granted. The corporation will progressively provide stock options as it adds staff.

Employees convert these options into shares over time. It is typical to assume that the whole option pool is divided and converted into shares in order to simplify the capitalizations of the firm. Reporting ownership in this way is known as doing it on a fully diluted basis. The board of directors may elect to replenish the pool if it becomes depleted; this usually happens during a financing round. The corporation issues the new shares, diluting all of the present owners at once. Employees may be granted recurrent grants or one-time option awards. Recurring awards include vesting structures, including linear vesting with a cliff, that are comparable to the founder vesting models previously mentioned. A so-called strike price must be paid by workers in order to convert their options into shares. The striking price for employee stock options is either some very low nominal value or the price of shares from the company's most recent fundraising round, depending on tax and regulatory constraints. When stock options are issued with a strike price that is close to market value, the corporation effectively gives away shares. Technically speaking, this means that the employee must pay the company a market price to acquire the share. This is because companies frequently have to issue their options at a fair value strike price, which is typically the cost of the most recent financing round and may be discounted to reflect differences in cash flow preference and control rights.

In these situations, workers borrow money from the business to convert the options, pay it back right away with the shares they got, and then do it again. Employees now possess their converted shares. However, unless the firm has an exit strategy, they normally are unable to sell their shares due to a lack of liquidity. Only when it seems expected that the share price will be higher than the strike price when the options expire are stock options beneficial. The options lose value if the current share price drops far below the strike price since it is less likely that the price will rise back above the strike price. If employees do not believe that the price will increase, then stock options no longer represent any meaningful compensation and no longer provide incentives to remain with the company. In this case, the company can create a new option pool with a lower strike price, thereby reviving employee incentives. This is known as stock options being under water. This defeats their purpose.

1. **A List of Related Terms :**In this, we set the legal foundations, briefly explaining what the various terms say about these issues, and provide an overview of other parts of a term sheet that provide the basis for subsequent s. We look at how these terms allocate control rights, regulate refinancing, and allow investors to achieve liquidity of the venture.
2. **Regulatory Rights:** Here we explain the fundamental contractual factors that determine control-related corporate governance structures, looking at how decisions are made inside the firm and at how investors and entrepreneurs share control of the venture during its existence.We identify three main control structures: voting rights, the board of directors, and contractual rights. The main rights and obligations of all shareholders are defined in the charter and by-laws of the corporation, which can be augmented and modified over time by subsequent rounds' term sheets and other contractual agreements.
3. **Electoral Rights:** Voting outcomes are determined using simple majority or supermajority rules, and Term Sheets allocate voting rights and their evolution, contingent on performance and milestone achievement. Shareholders have the right to vote on the most significant decisions made by the company, such as the decision to sell the company or the approval to raise an additional round of financing [8]–[10].

CONCLUSION

In conclusion, A hybrid investment option that combines aspects of equity and debt is provided by convertible preferred stock. By converting into ordinary shares, it offers investors significant growth potential as well as a flexible funding solution for businesses. Companies and investors, however, should carefully consider the conditions, dangers, and financial ramifications related to convertible preferred stock. The adaptability of convertible preferred stock as a financing vehicle allows stakeholders to make educated choices about its usage and investment by being aware of its features and concerns. It may be used in a variety of circumstances, including securing funds for expansion plans, financing acquisitions, or luring key investors. Convertible preferred stock's flexibility enables businesses to customize the terms and conditions to suit their unique funding requirements.

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CHAPTER 13

GOVERNANCE AND LEADERSHIP: THE BOARD OF DIRECTORS

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ABSTRACT:

The board of directors plays a crucial role in the governance and strategic direction of a company. This abstract explores the functions, composition, and responsibilities of the board of directors, highlighting its significance in promoting effective corporate governance and safeguarding the interests of stakeholders. The abstract begins by emphasizing the importance of the board of directors in providing oversight and guidance to the management team. The board acts as a fiduciary for shareholders and is responsible for making key decisions that impact the company's long-term success. It acts as a check and balance to ensure that management acts in the best interest of the company and its stakeholders.

KEYWORDS:

Accountability, Advisory, Board Committees, Board Meetings, Corporate, Decision-Making, Director, Governance, Independence.

INTRODUCTION

All of the company's major strategic choices, including which products to develop, which markets to join, which executives to recruit, and when to start raising money, are approved by the board of directors. Although roles may potentially be reversed, typically, management presents the plan and the board replies. The company's by-laws provide several decision-making procedures, including majority, supermajority, and unanimity. Typical term sheets specify the number of board members and the size of the board. It identifies either the individuals themselves or those who have the authority to nominate them. It may be stated in the term sheet which decisions need board approval. We talk about the composition of the board of directors [1]–[3].

1. **Agreement-Based Rights :**Term sheets may also be used to specify the contractual decision rights that investors will have. These rights must be carefully defined in order for them to prevail over board or voting rights. Their duration may also be restricted; for instance, they could expire at the time of the next fundraising cycle. Some control rights have veto power, such as the power to obstruct a corporate sale on an individual basis. Others, like the authority to choose a new CEO, are positive. The ability of investors to propose actions is a less robust version of this right. The right to suggest candidates for CEO may then belong to the investor. This would imply that the CEO would still be chosen by the board of directors, but that the investor would have some influence over the selection process by submitting candidates.
2. **Protective Measures :**Early investors are given some control over the issuing of additional stock under these arrangements, and they are also given the opportunity to impose certain restrictions on the specifics of the associated preferred terms. Protection

may also be provided by granting the authority to approve any future dilution-causing securities or choices that may have an impact on Series Holders' rights. These clauses provide early investors some leverage, even when new investors in subsequent rounds may demand that they give up or scale down their protected rights.

3. **Anti-Dilution :**Investors in the prior round could believe they overpaid for their shares if the price per share in the new round is lower than the price per share from the previous round. They may revalue the shares they purchased in the earlier round in light of the current round's reduced price thanks to the anti-dilution provision. We explore this crucial phrase, which has significance for all parties, in
4. **Priority Rights :**Investors often have the option to take part in next financing rounds under the terms of term sheets. A preemption right gives the present investor the option to purchase any shares that the firm offers to other investors. The number of shares needed to maintain the same level ownership percentage at the pre-round level is known as the pro rata level, and here is where preemption rights are normally restricted. The pro-rata level is shown here.
5. **First Right of Refusal :**Existing investors often have the option to purchase the shares of any other shareholder who wishes to sell, which is closely connected to preemption rights. This implies that before providing any shares to an outsider, those who are selling them must determine if any other present investors are interested in purchasing them.
6. **Pay-to-Play :**Some term sheets allow existing investors the option to continue participating in future rounds as well as substantial incentives to do so. We look at pay-to-play provisions, which say that some investor rights, such multiple liquidation or anti-dilution, only remain in effect provided the investor pays his pro rata share. The provisions might even mandate the conversion of preferred shares into common stock. In severe circumstances, the investor can potentially lose all of his shares. A play-to-play provision is used to promote future financing and maintain investor participation. Thus, it could not be in the best interests of investors who are unable or unable to reinvest.

DISCUSSION

Investors have the option to seek liquidity under certain term sheet provisions. They make sure that shareholders may sell their shares and recoup part of their initial investment. Redemption rights allow investors the option to redeem their shares, which is the process by which the corporation buys back their shares under the more advantageous conditions outlined in equation or equation. Usually, they do so within a certain time period after the investment. A common scenario would be the investor having the option to redeem shares at any point between four and seven years following the investment, with a yearly redemption of one-third of the investor's entire shareholdings[4]. In reality, redemption rights are seldom used. The rationale is that successful businesses are more likely to find a departure that is professional rather than redemptive. Instead, if they struggle or move slowly, they seldom have the cash to repay the investment. The term sheet includes redemption rights so that investors may exert pressure on the business. The management team may be persuaded to aggressively look for a way out, in particular, by the prospect of using these rights, which might force the firm out of existence if there is no liquidity.

Rights to Be Drag-Along and Tag-Along

When the founder or other investors sell their shares to a third party, a tag-along right stipulates such. The right to sell his shares alongside them, often pro rata, belongs to the investor. Such a sale can result in the payment of liquidation preferences to the investor if it qualifies as a liquidation event. A greater drag-along right allows the investor to require that all other shareholders, including founders, sell their shares as part of an acquisition. Even if the founders or other investors don't want it, it may be utilized to get an exit.

Rights to Registration and Rights to Ride-Along

Investors have the right to request that the firm register its securities with the authority overseeing the stock market, enabling them to be offered for sale to the general public. Investors now essentially have the authority to start a public listing. Investors seek to guarantee the right to include their shares since the company determines which shares to register. As a result, the period of registration rights, the number of times registration may be requested, and the shareholders' lock-up agreement at IPO are all governed by a separate Registration Rights Agreement. If they wish to maintain control over the timing of an IPO, founders often oppose substantial registration rights. A piggyback right is a softer variation that states the investor has the right to sell his shares in the public offering in the event of a public listing. It is often given to smaller investors with weaker negotiating positions.

Investor liquidity rights often don't matter much in real life. The corporation may not always find it simple to grant the investors' requirements for liquidity. For instance, selling the business is difficult and takes time. All shareholders must consent before the firm may be sold. All of the liquidity provisions' major objective is to provide investors with negotiating leverage. These rights may be compared to swords and shields: redemption, drag-along, and regulation rights all resemble swords, whilst tag-along and piggyback rights more closely resemble shields. Term sheets are international even if country-by-country legal specifics differ. Come to Zambia, a landlocked nation in southern Africa with less than 17 million inhabitants, if you don't believe us. Zambia has been less volatile politically than some of its neighbors, including Angola or the Democratic Republic of the Congo. Nevertheless, it is a developing nation with a GDP per capita ranking of 142.19 The average yearly income is slightly about $4,000, or around one-fifth of what it is in the United States. Do you think business owners in this area care about redemption rights?

In order to provide the millions of Zambians without bank accounts access to payment systems, Zoona was established in 2007.20 Mobile payments had previously been effectively implemented in Kenya by a firm named M-Pesa, but its business model was inappropriate for Zambia. Zoona created a unique business plan utilizing neighborhood kiosks. The business sought for equity finance since this would necessitate substantial capital expenditures. It made multiple investor approaches for a Series A round in 2010 and produced two competing term sheet proposals. AfricInvest, a private equity company with a pan-African investment strategy, led the initial offer. It had made investments in more than 100 transactions spanning more than 20 African nations and a variety of sectors. The Omidyar Network, a hybrid venture capital-philanthropic organization with a worldwide mandate and formed by eBay co-founder Pierre Omidyar, was the driving force behind the second offer. Omidyar Network is often categorized as a social impact investor, in contrast to AfricInvest, which was a solely financial investor. Some of the main phrases provided are included in the list below.

These term sheets strikingly resemble typical North American ones. It's important to note a few of the specifics. Even by North American standards, a post-money value of $7 million by AfricInvest and over $9 million by Omidyar Network is highly regarded. These term sheet proposals also featured stock options and convertible notes. The two offers are different in terms as well as values. The bid from AfricInvest utilizes stricter preferred shares and a tougher anti-dilution provision. distinct drag along and redemption rights reflect distinct exit philosophies, with Omidyar Network adopting a more tolerant and non-dictatorial approach. The decision by Zoona to go with the offer put out by Omidyar Network should not be shocking. The firm has made significant progress by 2018. It took great delight in assisting more than 2,000 communities, more than 1,000 active businesses, and more than 3,000 employment. There was still no sign of an escape.

Further Clauses

Here, we examine several additional term sheet provisions that deal with particular concerns raised by investors and difficulties. Investors' information rights outline when and what corporate information they are entitled to obtain. Information rights often call for complete disclosure of financial data, such as by requiring the release of quarterly audited accounts or monthly cash flow statements. The exposure of operational or technical knowledge is another possibility. Board members' already-received frequent reports on the firm are now enhanced by this. Additionally, visiting rights enable investors to see the business's facilities in order to obtain information. As mentioned in the Venture Evaluation Matrix of 3, the team's capacity for execution plays a significant role in a start-up's worth. Due to this, term sheets may include that the business must get key man insurance to safeguard it in the event that important management, such as the CEO or other founders, pass away or become disabled. Indemnification clauses are also included to shield the company's directors from liability resulting from activities they took while serving in that position.

Additionally, it is typical for the business to get directors' and officers' insurance to defend management and board members in court. Term sheets often include state that the corporation will be responsible for covering any associated costs including legal fees. Cross-border investment transactions must state the nation's legislation that will be used. It is possible to designate which provisions of the investment are valid in the investor's nation, even if a firm is always subject to certain local regulations. Particularly American investors often desire to preserve their ability to sue the corporation in a U.S. court. In a similar subject, the contract may provide that specific sorts of disputes should be settled by arbitration as opposed to litigation. Each party is required to make representations and warranties on term sheets. These are legally binding declarations, and any dishonesty might result in financial obligation and even the termination of the agreement. It's crucial for entrepreneurs to let the firm take responsibility for representations and warranties rather than personally making them. When information about unique situations is relevant, investors may demand on individual accountability. Entrepreneurs, for instance, could have to substantiate their claim to ownership of intellectual property.

Term sheets include a few provisions pertaining to the negotiating process. Every offer has a specific end date, and those with short ends are referred to as exploding deals. Term sheets may also include a no-shop condition that forbids the entrepreneur from looking for other business opportunities. Such a provision is not enforceable prior to the execution of a term sheet. The term sheet, which is a preliminary agreement, and the shareholders' agreement, which is the concluding legal document, are the only two points at which it becomes such. Term sheets also include the requirements for finalizing the agreement. Investors may make their offer contingent upon a favorable result from their legal due diligence, the completion of agreements for the transfer of intellectual property from the company's founders, or the successful identification of a co-investor to cover the necessary investment amount. The agreement may also be subject on the firm achieving certain benchmarks, such as appointing a vice president of sales or taking ownership of crucial assets.

Understanding Complicated Term Sheets

What economic considerations behind term sheets' general format? We can better understand the big picture thanks to Kaplan and Stromberg's research. They look at a sample of over 200 term sheets from over ten American venture capital companies. They categorize each clause based on how it affects the cash flow and control rights of businesses and investors. After that, they use cluster analysis to identify a common logic that unifies the many words and term sheets. One of their main conclusions is that agreements often pair increased control rights with stronger cash flow rights. Contracts thus benefit either the investor or the entrepreneur in both respects. Another significant result is that term sheets for riskier pre-revenue startups tend to provide investors greater control and cash flow rights. However, successful operations over time enable the entrepreneurs to retake ownership of their business.

The researchers also have access to the VCs' internal notes for some of the term sheets. This gives them the opportunity to determine if investors are more worried about internal or external dangers. Internal hazards pertain to matters such as the effectiveness of management or the simplicity of keeping tabs on business operations. External variables are those that affect a corporation from the outside and deal with things like client adoption or competition. The researchers investigate how these two categories of hazards relate to the word selection. More investor control, contingent payments to entrepreneurs, and contingent funding rounds are all linked to higher internal risks. Researchers see this as the investors' reaction to issues with moral hazard and adverse selection. Strong downside protection, such as better liquidation rights, is linked to higher external risk. Term sheets really put more of an emphasis on safeguarding investors than they do protecting entrepreneurs from market risk [5]–[7].

Valuation versus Terms

This has so far covered a broad range of contractual provisions that deal with several situations. Entrepreneurs may feel disoriented in front of a term sheet, although investors often have expertise negotiating them. Unskilled business owners could fail to notice crucial terms or object to non-negotiable standard clauses. Thus, getting sound legal counsel is crucial. However, it is up to the entrepreneurs and investors to get the best term sheet possible from a commercial standpoint. In actuality, the valuation, control rights, and founder remuneration are the three things that are most often discussed. Depending on the situation, certain clauses could get more or less attention than others. The value, in the opinion of many business owners, is by far the most crucial clause in the term sheet. This might result in a bad bargaining tactic since seasoned investors may provide a term sheet with favorable conditions on the outside and unfavorable ones within. Unsophisticated business owners may fail to recognize them until it is too late and suffer the repercussions.

This debate stresses the superior value of preferred stock, which is often owned by investors, over common stock, which is typically held by business owners. Therefore, it is important to use care when interpreting the headline value amount. For businesses that have attained the highly sought-after unicorn status, the problem of inflated values is especially relevant. These private businesses get VC backing and have private funding rounds where their value exceeds $1 billion. One academic research by Gornall and Strebulaev examines the conditions of these unicorn trades in detail. It concludes that the inclusion of preferred shares and other investor-friendly features outlined in this has greatly boosted prices. The authors do some hypothetical calculations to determine what the value would be if investors had instead received common stock. They predict that 11% of the sample's companies would see their worth more than half, and 46% of all the companies would lose their unicorn status. The research serves as an important cautionary tale on the risks of ignoring the effect of term sheet terms on the value of unicorns and other entrepreneurial enterprises. Entrepreneur and investor negotiations shouldn't be limited to a one-sided value zero-sum game. Instead, they need to take into account many factors that provide opportunities for success. Clarifying the entrepreneur's priorities is an effective negotiation strategy. The results of Noam Wasserman's research have shown two competing perspectives. Some business owners start businesses primarily with the intention of becoming wealthy.

Others, though, see the business as their own invention and want the chance to maintain control over it as it expands. These two objectives are often contradictory. An entrepreneur may increase firm value by enlisting resourceful investors, but these participants will only do so if they can gain some control over the business to safeguard their investment. This means that business owners should prioritize the term sheet provisions that will help them reach their objectives and adhere to them throughout negotiations. Entrepreneurs who are focused on building wealth, for instance, need to seek for a greater value and lesser liquidation advantages and anti-dilution rights. A control-oriented entrepreneur, on the other hand, should be prepared to accept a lower value in exchange for board power and weakened investor contractual control rights. We concentrate on one more significant trade-off that has to do with how value is created for entrepreneurs and investors in various circumstances to bring this discussion to a close. The trade-off between upward and downward returns is represented by this. Participating preferred stock provides extra downside protection for investors, as we previously said. Therefore, the emphasis of term sheet talks might be on how much the investor values downside protection and how much the entrepreneur is ready to give up downside protection in exchange for higher potential profits. Entrepreneurs must agree to more onerous downside protection agreements if they desire a better value.

Adaptable Notes

In this paper, we'll look at convertible notes as an alternative to the more complex term sheets we've already covered. The main distinction between a convertible note and convertible preferred stock is that there is no valuation involved with a convertible note. Additionally, it offers nothing in the way of downside protection and gives investors little control. Many seed investors, including family and friends, accelerators, and angels, prefer convertible notes. Because they have little financial knowledge and often struggle to value riskier investments, less experienced investors like these simpler assets. Even seasoned investors sometimes favor the ease of holding off on valuation until a business is more solidified. Convertible notes may be arranged more quickly since there is not much to haggle about. This is especially helpful if businesses want financing right away. Finally, there is the straightforward economic justification that arranging convertible notes is less expensive. Let's say that creating a full-fledged term sheet will cost $20K in legal fees. This would amount to 1% of the $2 million investment round, which the investors would be ready to pay for accurate legal documentation. This would amount to 20% of the investment in a $100K round, which would be more difficult to defend. Once the company gets its first official round of funding, a convertible note is a straightforward claim that resembles debt and transforms into stock.

The invested amount plus any interest is added to the face value of the note. A few points over the prime rate, most contracts have a reasonable interest rate. Only at maturity are interest payments required. There is no collateral and just a small number of supplementary conditions, most of which deal with collecting scrap value in the event that the business endeavor fails. Investors are hoping that the business succeeds in securing a suitable equity round, which will result in the conversion of the note. Three important features define the convertible note. First, conversion is automatic and takes place at the subsequent formal equity round, which typically happens over a minimum investment amount and before to the maturity date. In the following round of equity financing, the note often changes into the same security as the equity investors, such as preferred shares. When the convertible note changes into common stock, it is a less advantageous scenario for the investors. Second, the conversion rate is disclosed up front as a markdown from the valuation the enterprise will get in the next round of funding. The discount often runs between 10 and 20%, depending on the market. Third, the note's maturity is fixed and typically ranges from 12 to 24 months. The business should have adequate time after this maturity to raise its first equity round.

Value Ceilings

Although the convertible note has grown in popularity among many seed investors, it has certain drawbacks as well. While not giving an investment a value may be simpler, there are hazards involved. Ironically, holders of convertible notes can end up being harmed by their own success. If the business does successfully, investors will place a high value on it in the next stock round. Although this is advantageous for the business owner, it results in a high price per share for the investor in convertible notes. This creates mismatched incentives by essentially punishing him for choosing a successful firm or fostering its expansion. Convertible note holders may not support the entrepreneur but the following round's investor while negotiating the value of the round. Convertible notes may contain a valuation cap to handle these restrictions. This is the maximum pre-money value that the holders of convertible notes are required to pay. In other words, it is assured that the pre-money value of the convertible note holder in the next round would not exceed the maximum. The cap then establishes the highest value that the seed investor will be required to provide in the next round [8]–[10].

CONCLUSION

In conclusion, the board of directors plays a crucial role in corporate governance by overseeing, directing, and holding management accountable. The board supports the long-term development of the business and protects the interests of stakeholders and shareholders by having a diverse and independent membership. In today's changing corporate climate, effective board governance is crucial for establishing trust, transparency, and sustainable development. Additionally, the board of directors' changing position in the modern corporate environment. Boards are required to emphasize environmental, social, and governance (ESG) considerations and take the company's long-term sustainability into account as corporate governance procedures come under more scrutiny. They are also essential in managing risk management and making sure that requirements are followed as they change.

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CHAPTER 14

DEAL STRUCTURING: MAXIMIZING OPPORTUNITIES FOR SUCCESS

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ABSTRACT:

Structuring deals is a critical aspect of business negotiations and transactions, involving the careful arrangement and allocation of resources, risks, and benefits among the parties involved. This abstract explores the key considerations and strategies involved in structuring deals, highlighting the importance of finding mutually beneficial arrangements that meet the objectives of all parties. The abstract begins by emphasizing the significance of deal structuring in achieving successful outcomes. Structuring deals involves designing the terms, conditions, and mechanisms that govern the transaction, ensuring that they align with the interests and objectives of the parties involved. Effective deal structuring helps mitigate risks, optimize resource allocation, and maximize value creation.

KEYWORDS:

Asset, Claw-Back , Diligence, Equity, Financing, Strategies, Valuation.

INTRODUCTION

The process of entrepreneurs and investors coming together and negotiating an investment contract is examined in this. The crucial phases in this procedure are identified. Entrepreneurs first look for money for their company ideas, while investors look for and assess opportunities. Alignment across various dimensions is necessary for finding a match, and we provide the useful MATCH tool for this purpose. Next, a syndicate of interested parties is often formed by investors. Economic pressures, time, and other circumstances determine the relative negotiating power of the parties after the negotiation process has begun. At the end of the procedure, everyone concurs to seal the agreement. The concludes with some thoughts on the value of trust and a long-term viewpoint [1]–[3].

The Science of Deal Structure

We discussed a number of technical components of agreements in the paragraphs that came before, including financial predictions, valuation, and term sheets. This might give the false impression that creating a business contract between an entrepreneur and investors is entirely technical and can be reduced to a few calculations. In this, we go through how the agreement is structured. This entails dealing with challenges including generating interest in the company concept, selecting the best partners, and building confidence with the investors. Although they may be seen as soft concerns since they entail qualitative judgements, correcting the value and the term sheet are hard financial decisions that these difficulties complement. The art of arranging a contract consists of combining hard and soft factors. This includes both right-brained entrepreneurial thinking and left-brained financial reasoning, to use the terms of 1. Everyone acknowledges that deal structuring is an art rather than a science. Art is not, however, any simpler than science. Deal structuring, however qualitative in nature, is a difficult task. It entails coming to agreements with several stakeholders that have competing goals, addressing challenges that are intrinsically ambiguous like luring investors, and often there is time pressure to complete the transaction. The deal's structure is determined by both the entrepreneur and the investor. However, everyone plays a distinct function at certain times. Typically, the entrepreneur initiates the process by preparing her business for investment and choosing the appropriate time to contact the investor. To generate competition for the sale, the entrepreneur seeks interest from a variety of investors. The investor is primarily in charge of assessing the offer, locating other investors, and putting up a term sheet. To make fundraising successful overall, all sides must put up their respective contributions[4], [5].

DISCUSSION

Fundraising Process

The entrepreneur must be ready for a fundraising campaign before starting it. In prior sections, we had covered a number of the process' essential elements. More specifically, chapters 2 and 3 explain how to create a thorough set of financial projections that substantiate the venture's financial appeal, while chapters 4 and 5 offer tools for estimating what valuation to expect. Chapter 2 describes how entrepreneurs assess the appeal of their business opportunity and use their analysis to build a presentation. We will now examine how these elements fit into a broader fundraising approach. Typically, fundraising is a lengthy process that need careful planning rather than a quick event. The high cost of fundraising is that it diverts the entrepreneur from managing the business. Fundraising is a demanding endeavor. Effective planning can shorten the time needed to persuade investors. The founders must also come to an agreement on how they will divide ownership and what roles each would play before they can begin creating their company strategy and predictions. Additionally, they should utilize their financial strategy to determine how much money to request and to create an estimate of the value they can reasonably anticipate to get from investors. Finding prospective investors is the next task for the entrepreneur. Depending on the stage of the venture's growth, this indicates various things. Early-stage and late-stage businesses aim to attract various kinds of investors, first.

Second, the initial round of financing is extremely difficult since the entrepreneur must find investors who are willing to invest for the first time with little or no experience. Companies that raise a second or subsequent round already have investors who might aid in luring in further ones. However, later-stage investors demand that the firm demonstrate that it has both the potential and the capacity to execute. In order to increase competition, entrepreneurs may also go for new investors on their own. In every situation, the business owner must determine the sort of investor who would lend the most to the enterprise at its present level before contacting potential backers. This necessitates a detailed examination of prospective investors' investing preferences and practices [6]–[8]. Entrepreneurs would be wise to get in touch with their investors as soon as possible. Introduce the business and the founding team with the intention of forging a relationship with the investor. The optimum time to do this is far before the business truly needs the money. It is similar to being engaged before getting married: it is probably a good idea to develop a connection before making a contract. From the investor's point of view, it is simpler to invest in a business owner who has a track record with them. Many investors compare this to choosing to invest based on a movie rather than a photograph. The investor may check if the entrepreneur fulfills her promises by seeing a video of how she overcomes obstacles to carry out her idea. Without such a time of getting to know one another, the investor can only make an investment based on the appearance of a photograph and a cursory knowledge of how the firm came to be in that position.

From the standpoint of the entrepreneur, getting to know the investor over time shows his thought process, the kind of transaction he seeks, and his responses to the highs and lows of the entrepreneurial process. Therefore, early involvement enables both parties to evaluate their compatibility and begin trust-building. The timing of the fundraising campaign's commencement is a crucial choice. Timing is important since it has an impact on dilution, growth, and financing risk. The earlier the entrepreneur initiates the campaign, the fewer accomplishments she has to show for it and the harder it will be to draw in investors. The longer the entrepreneur waits, the more time she has to strengthen the foundational elements of her business: accomplish a goal, create buzz in the industry, and so on. Investors, however, also anticipate greater traction when they wait. The entrepreneur's financial reserves will decrease the more time she delays. Delaying fundraising may deprive the business of the means by which it may advance. There is a paradoxical tension, particularly at the beginning of a company, when the entrepreneur needs momentum to draw investors but also requires their money to develop momentum. Dilution is also influenced by timing; obtaining money early on results in greater dilution since firm risk is higher and value is lower than what can be realized once certain milestones have been accomplished.

Putting the Fundraising Campaign in Motion

It's easier said than done to make the first move to contact the investor. The demands that successful investors get keep them busy. It's doubtful that making a cold call or sending an email will be successful. When the entrepreneur is presented by a person they believe in, investors are more inclined to react. These recommendations are essential for two reasons. The investor first has faith in the opinions of his personal connections. Second, by endorsing the entrepreneur, these connections expend their reputational capital. Only those they deem to be appealing prospects for the investor will they promote. For this reason, the entrepreneur sees a need to create a business network that can aid in these fundraising initiatives. Even a well-prepared entrepreneur with a solid business plan and an appropriately planned fundraising campaign should anticipate making investor proposals several times: fewer than 10 pitches to investors would be regarded modest, while more than 50 presentations are not unusual. Due of how challenging it is to connect an investor with an entrepreneur, several pitches are necessary.

The entrepreneur needs to find the right investor at the right time, meaning that there is a match in terms of the investor's expertise and interest for the entrepreneur's particular venture, and that the right time is when the investor is currently interested in making investments in the entrepreneur's business space. Determining which investors fall into this category requires more research, but at this point, the entrepreneur should concentrate on the specific investors. The more convincing evidence the entrepreneur can present to the, the better. For early-stage ventures, the focus is on customer traction, and for later-stage ventures, the emphasis is on overcoming obstacles, achieving set milestones, and hitting financial targets. Getting the pitch right is crucial. The entrepreneur needs to impress investors with domain knowledge and to inspire confidence that she can execute well in the face of unforeseen difficulties. Entrepreneurs have a challenge in the fundraising process over whether to share sensitive information, how to release it, and when to investors while presenting their ideas. Some entrepreneurs worry that investors would steal their ideas. Investors meet many entrepreneurs who believe their ideas are novel. In all likelihood, investors already know much of the supposedly new information. They may simply be unaware of it. Entrepreneurs who are concerned about disclosing their confidential information to investors or strategic partners sometimes ask for a nondisclosure agreement before pitching their idea. Many investors, however, categorically refuse to sign them.

Value of a Concept

We discussed methods for valuing company here we examine the question of how to value an entrepreneurial idea before it becomes embodied in a company. Some entrepreneurs become preoccupied with this question, which can sometimes get in the way of the fundraising process. Some entrepreneurs worry not only about how to protect their ideas, but also how to value them.We suggest to split down this topic into four subquestions. How do I value my idea? in preparation for the fundraising process.A typical complaint is that this might be a futile effort. How can one possibly place a value on something as ethereal as an idea? The first question is, When do I need to value an idea? Usually, there is no rush. Valuing an idea is only necessary if some financial transaction depends on it, like negotiating a financing deal. Even then, not all financing deals require a valuation. For example, if an entrepreneur raises debt, no valuation is necessary. An entrepreneur can also issue a convertible note, which delays valuing the company until a later date. A valuation is really needed only when equity financing is involved.

What should my idea be worth theoretically? It is important to have clarity about what exactly we are trying to value. The standard answer in finance is that the value of an idea is the future cash flow that can be derived from it. The challenge is to figure out what the source of the cash flow will be. Since an idea on its own is essentially worthless , the question becomes how much incremental value the idea enables. For the answer we need to identify what the other required components are. For example, an idea for an innovative toy also requires production, marketing, distribution, and sales, to become a saleable toy. Each of these components has a cost of its own. The value of the idea is therefore related to the incremental profits that can be made after compensating all the other resource providers. In fact, we need to compare the value of using these resources to create the new toy against their alternative uses, for ex- ample, all the other toys that can be produced with these resources. This bring us to the question of how unique the idea is. Many ideas can be easily imitated, reducing their value, even if the original idea is protected by intellectual property. Others can come up with similar ideas that fall outside the purview of the protected IP but have equivalent functionality.

How Much a Patent Is Worth

Economists have developed several methods to extract the value of patents from data, but the most common conclusion is that this is a difficult question to answer. One method is to break down the value of companies into individual factors and isolate the patent portfolio as one of those factors. However, this only provides an estimate of the total value of a patent portfolio. Even though different studies use different data approaches, some core findings have emerged from this large body of research. First, the value ofpatents is extremely skewed, meaning that a few patents are tremendously valuable, but most are worthless. Second, patents are most valuable in the phar-maceutical industry, and they are also valued highly in chemicals, computers, telecommunications, electronics, and machinery. Third, the value of a patent is statistically related to the number of citations it receives. A focal patent is cited when a new patent mentions the focal patents in its list of relevant prior patents. Fourth, learning about the value of a patent happens over time, mostly in the first five years.

This last point brings out an interesting tension for the valuation of a patent. In order to learn what the patent is worth, time needs to pass, yet the valuation of the patent is often needed at the very beginning, before any such learning can take place. In case of doubt, it is therefore safest to assume that most new patents are close to worthless.The final question is, Did I ask the right question in the first place? Some innovators, particularly scientists, are fixated on the value of their idea, but it is useful to question whether the idea is truly the source of value. For instance, the IP for a cancer cure would truly be worth a lot. However, in many other cases, the source of value creation is not really the idea, or at least not the only idea.If we go back to our innovative toy idea, the question is whether the value is created by the specific solution or by meeting customer needs. Perhaps the value is created by making toddlers happy or by convincing parents that their toddlers need it. Or perhaps the value is created by the team itself, which has developed a number of innovative toys over time or by the business model.

Finding Investor Deals

Investors want to see a lot of promising potential deals, which is called a good deal flow, because they know that only a small fraction of funding requests is worthwhile exploring. One way to improve deal flow is to rely on referrals, while another is to be proactive and look for the next big thing. How do investors find promising ventures? According to a survey of VC firms by Gompers, Gornall, Kaplan, and Strebualev, which was conducted in 2008, This data shows that developing and maintaining networks is at the core of generating deal flow. Investors are particularly interested in generating proprietary deal flow. This means being in a position to make a funding offer without being pressed by competitors. Proprietary deals do not come easily as the investor has to look in less obvious places to find such deals. A first step is to identify which markets are experiencing innovation and disruption that creates new investment opportunities. For this purpose, investors must be visible to the scientific and technology community, as well as be aware of changes in regulations or con- sumer preferences. To move into identifying specific companies, investors must be in touch with the entrepreneurial community. They do this by attending industry events and by actively scouting through their networks. Scouting is more difficult when looking for early-stage companies that have not yet raised funds and may be operating in stealth mode. Other investors can also be a source of deal flow through syndication .

Since the interaction at this point is informal, it allows both parties to explore each other's views and style, without fear of committing to a mistake. Establishing early contact is as important for investors as it is for entrepreneurs. Both benefit from reducing asymmetric information and testing the potential for a good fit. Investors rely primarily on their prior successes in bringing companies to an IPO or a successful acquisition, which by its nature is a slow process that takes years. VC firms and business angel networks advertise their achievements on their website and social media. Individual angels and other early-stage investors rely more on word-of-mouth. Visibility also comes from being active at industry events, subbing at trade shows, and participating in online forums. The average deal takes 83 days to close and requires 118 hours of due diligence, with the VC making on average 10 reference calls. The median VC firm screens 200 deals per year and meets 50 management teams. Partners review 20 business plans and conduct more in-depth due diligence on 12 of them. Offers are made to 5.5 companies, of which 4 accept the investment, meaning that the probability of moving from the screening to the investment phase is approximately 2%.

At the risk of oversimplifying, we distinguish three responses after the entrepreneur's initial pitch to investors. first, some investors simply say no; the polite version is actually not now, which leaves the door open in case the company later makes significant progress. In addition, some investors are intrigued yet hesitant. They may claim that they are intrigued but not yet persuaded. Sometimes it's unclear what they're looking forward to or what will persuade them. Third, some investors are really keen, meaning they like the project but aren't quite ready to commit. The business owner's next task is to persuade the eager investors. This necessitates their exercising due diligence. Due diligence is handled differently by various investors. Some concentrate on the entrepreneurial team, examining its competence and reliability. Others spend hours poring into technical minutiae, researching the market, gauging client enthusiasm, and examining the industry environment. Investors may decide whether or not to invest thanks to the information this due diligence procedure produces. The two parties either come to the positive conclusion that there is a potential match at the end of the due diligence process and decide to part ways, or they find there is no fit and continue their relationship. If so, they can usefully go on to the next step of talking about potential transaction arrangements.

Syndication

Many transactions include an investor syndicate. According to respondents to Gompers, Gornall, Kaplan, and Strebulaev's study of venture capital companies, 65% of their agreements were often syndicated. Capital restrictions, complementing skills, risk sharing, and access to future agreements were the most significant considerations mentioned for syn- dication. Past shared success, knowledge, reputation, track record, cash, social ties, and location were the most crucial considerations for selecting a syndication partner. We now discuss the origins of syndication before looking at how such syndicates are organized.

Motives for Syndication

Why do investors group their investments together? One typical explanation is that smaller investors lack the necessary capital on their own. Even bigger investors who could cover the whole cost may be hesitant to do so. They may want to diversify their portfolio rather than making a big financial commitment to just one business. Investors are also proactive. They want to save part of their money for other investment rounds in the same firm, thus they do not want to invest too much in any one round. Investors are better equipped to spread their investments across numerous rounds by enlisting the help of a syndication partner. Having some dry powder on hand might help you show your continued dedication to a business. This helps to prevent dilution and balance out the influence of later-round investors who have an incentive to lower values. As a result, syndication enables earlier-round investors to maintain their stakes across the whole fundraising cycle. There are corporate justifications for syndication in addition to these financial ones. The workload argument comes first. Investors want to be engaged in the business and would want to be on the board of directors. The investors may continue to be active while making investments in other businesses by sharing the load with syndication partners. A second view is helpful when making an investment since it gives one comfort to know that there are other investors that have faith in the firm. The fact that other investors selected the investment also supports it to venture capitalists' limited partners, particularly if company performs badly.

A similar claim is that bringing in new investors may result in the addition of abilities that are not as valuable as those of earlier investors. Another component of a networking strategy is syndication. Bringing excellent opportunities to other investors builds connections and may inspire them to bring deals the opposite way in a reciprocal process. Such reciprocity among venture capital firms creates syndication networks of companies with comparable position and repute. Syndication is also typical among angel investors who make investments via more official angel organizations or informal networks. From a business standpoint, syndication may facilitate contract closure. There are further advantages to establishing a syndicate once the investment is made. A larger pool of investors gives the business complementary networks and talents. Additionally, it can make it simpler for the business to get capital in subsequent rounds. The fact that the corporation must deal with several investors is a disadvantage. Each investor has comparatively lower holdings, which enables them to be less active. Furthermore, more shareholders imply greater contact with investors. Finding solutions that are acceptable to all shareholders becomes increasingly challenging when decision-making processes take longer.

The Organization of Syndicates

One investor discovering the transaction and agreeing to disclose it often kicks off this process. Usually, he will just share it to a few people in his network. He can ascertain who is intrigued in this method. The decision of who to invite is influenced by a number of professional and interpersonal considerations. Business considerations include the other investors' relevant industry experience, their financial resources, their present interest in making new investments, as well as other unique aspects. How often the other partner extended and accepted such invites is one relationship element. Some invites come with interpersonal complications, much like the dilemmas of throwing a dinner party if A is invited, then B should be invited as well, but this precludes inviting C, and so on. A syndicate of investors generally consists of a leader and numerous followers. These responsibilities are often known informally and without being codified. The syndicate leader often initiates deals in these situations. Sometimes, however, the inventor is only able to contribute a tiny portion of the whole round sum. In such situation, one of the other investors could volunteer to take the lead role and contribute the most money.

The lead investor will probably be in charge of leading the due diligence process and may enlist the assistance of other co-investors for certain matters that fall within their purview. The leader oversees the discussions on behalf of the investors and often joins the board of directors after the agreement is finalized. The lead investor expends more energy and takes on more risk. This is sometimes rewarded with favorable terms. This is the situation, for instance, with online marketplaces like AngelList, where the lead investor gets more payment. The main investor also encourages other interested but reluctant investors. It makes a strong statement that there is a dedicated investor who thinks the business is worthwhile. This alone may persuade skeptic investors, save them the burden of paying for their own expensive due diligence. It's important to know who the key investor is. Entrepreneurs strive to persuade powerful lead investors to speed up their fundraising effort. This tactic, however, carries some danger as well. If a powerful investor rejects the transaction, word may spread and the entrepreneur's fortunes may be adversely affected[9], [10].

CONCLUSION

In conclusion, Deal structure is a crucial component of corporate transactions, with careful evaluation of goals, risks, and potential for value generation. Understanding the motives of the parties involved, doing extensive due diligence, and using negotiating techniques to reach mutually beneficial results are all essential components of effective deal structuring. Parties may successfully negotiate the complexity of deal structuring and conduct deals that fit their individual goals with the assistance of legal and financial consultants. The function of legal and financial advisers in transaction structuring is also important. These experts provide knowledge and direction in negotiating difficult financial and legal issues, ensuring compliance with laws, and defending the interests of their individual clientele.

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CHAPTER 15

UNDERSTANDING SYNDICATION AND INVESTMENT PERFORMANCE

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ABSTRACT:

Syndication refers to the process of pooling resources and expertise from multiple investors to finance a particular investment opportunity. This abstract explores the concept of syndication and its impact on investment performance, highlighting the benefits and considerations associated with this collaborative approach. The abstract begins by emphasizing the significance of syndication in unlocking access to capital and expanding investment opportunities. Syndication allows investors to combine their financial resources, knowledge, and networks to participate in larger and potentially more lucrative investments that may be beyond the reach of individual investors. It enables diversification, risk-sharing, and the ability to leverage specialized expertise.

KEYWORDS:

Analysis, Deal, Diligence, Diversification, Investment, Horizon, Portfolio, Risk.

INTRODUCTION

Theoretically, there is no clear-cut link between syndication and investment performance. Investors have an incentive to keep the greatest offers to themselves and to only share the riskier and more challenging ones, on the one hand. On the other side, it described how syndicates might provide superior support to aid in the success of businesses. Using data from Canada and the U.S., Brander, Amit, and Antweiler's study and Tian's study, respectively, both demonstrate that syndicated venture capital investments have a greater success rate as shown by a larger percentage of IPOs and acquisitions. Syndicated investments also achieve greater values and experience less underpricing in IPO cases. The issue becomes who to share transactions with if there is an advantage to doing so. According to a research by Hochberg, Ljungqvist, and Lu, better networked VC companies had superior overall investment success. Furthermore, top tier VCs often split early-round investments among themselves, according to Lerner's analysis of biotechnology startups, while they sometimes include lower-ranked VC firms in later rounds.Investors in venture capital (VC) confront two different sorts of risks partnership risk and business risk. They discover that when firm risk is large, syndication is more probable.

Additionally, it is more probable when the lead VC is of greater profile since access to superior syndication partners lowers the risk of collaborating. Syndication also makes it easier to obtain specialized knowledge. According to research by Hochberg, Lindsey, and Westerfield, VC companies with experience in a company's business model outperform VC firms with less knowledge that primarily provide finance. In a similar line, a research by Meuleman, Jaaskelainen, Maula, and Wright reveals that cross-border ventures demand for a mix of foreign cash, networks, and experience from international investors as well as locally embedded partners who are familiar with the area in question. However, economic considerations are not necessarily the only ones that influence the choice of syndication partner. According to research by Gompers, Mukharlyamov, and Xuan, investments are less likely to be successful when VCs choose their syndication partners based on comparable racial or educational backgrounds, as well as similar professional experiences.

Nobel Insights on the Theory of Bargaining

John F. Nash Jr., John C. Harsanyi, and Reinhard Selten shared the 1994 Nobel Prize in Economics for their groundbreaking analysis of equilibria in the theory of non-cooperative games.24 One of the most well-known economists and mathematicians of the 20th century, John Nash is the only person to have received both the Economics Nobel Prize and the Mathematics Abel Prize. A Beautiful Mind, an Oscar-winning film from 2002, depicted his own battles with mental schizophrenia. Although Nash is best recognized for two crucial contributions, economists were well aware of his brilliant intellect even before the advent of Hollywood. First, he discovered an equilibrium idea known as the Nash equilibrium. The Nash bargaining solution is a straightforward resolution to a common bargaining game that he created. Here, it is the second contribution that interests us.

Nash envisioned a universal bartering match between rival groups. We may see it as a discussion between an investor and an entrepreneur in our example text. Depending on the two parties' traits and the situation at hand, Nash tried to describe what type of a transaction the two would make. In theory, this is a very complicated issue since there are so many variables to take into account. However, Nash demonstrated how to reduce this issue to only four crucial variables. The first two elements define the two parties' outside options. These are the rewards that parties would get if they choose to end the negotiation. Outside choices in our situation relate to what would occur in the absence of investment. The combined value that the two parties may produce via cooperation is the third parameter. The two parties would be better off not making a deal if this value were lower than the total of the outside possibilities. The last parameter specifies how the surplus value, or the difference between the joint value and the total of outside choices, is divided between the two parties.

These four criteria might be seen as an overview of the many elements that could favor one side over the other [1]–[3]. Understanding the fundamentals of negotiating is made easy yet disciplined by the Nash bargaining solution. Let's use a simple made-up example to illustrate how it works. Consider the businesswoman Elsa Echtknap, who developed a sophisticated system for forecasting the results of negotiations. She created a start-up and acquired it for $6 million. The entrepreneur's other choice is this. She was aware, however, that she could create a $10M corporation with the aid of a $1M investment from her friend Ingo Ingelicht. The $10M is the combined value they can create, while the $1M symbolizes the investor's outside choice. The excess is thus $3M = $10M - $1M - $6M. Elsa believed she was a skilled negotiator and believed she could get $2M, or two-thirds of the surplus value, which symbolizes the entrepreneur's leverage.

DISCUSSION

Negotiation Analysis

We use the Nash bargaining method to examine a business contract between an entrepreneur and an investor. The Zone of Possible Agreements, the final agreement, and the parties' potential other course of action are the three main factors we take into account. The negotiation is anchored by external choices. Nobody will sign a contract if it leaves them worse off than if they didn't. Therefore, the limits of what is acceptable and what is not are established by the external alternatives. The group of agreements that are acceptable to both sides, or the ZOPA, is obtained from outside choices. Finally, we take into account the negotiation processes that determine which particular ZOPA agreement is ultimately selected.

External Options

What would the business person do if the investor left? Her other choice is to keep raising money while searching for fresh financiers who have faith in the company. Other investors could not understand the reasoning behind the entrepreneur's decision to walk away from a venture, which might make them skeptical of the entrepreneur. She must continue to self-fund the business as long as she is in negotiations with investors. This strains the entrepreneur's money for new businesses, which seldom succeed. This calls for lowering the burn rate for more established businesses, which may result in underinvestment and even staff layoffs. The worst-case scenario is that the company would have to close[4], [5]. When the entrepreneur sees some real interest from other investors, the argument for leaving herself becomes more compelling. Entrepreneurs often attempt to establish rival proposals during their fundraising campaign so they may use one offer as a threat to reject the other and vice versa. The investors' external alternatives are quite simple. By leaving, individuals keep their money and are free to make new investments. Entrepreneurs are always in an implied competition with one another for limited capital resources. The opportunity under consideration or other chances, investors compete with one another for the best entrepreneurial investment prospects.

Zone of Potential Convergence

Think about a negotiation where an investor and an entrepreneur solely haggle about value, or more accurately, the price per share. The outside option of the investor specifies the highest value that he is ready to pay, while the outside option of the entrepreneur specifies the lowest price that she is willing to accept. If the investor is prepared to spend at least as much as the entrepreneur's minimal accep value, a zone of possible agreement exists. The ZOPA, which describes the set of values that are mutually acceptable to both sides, is a section on a line in this negotiation. The example in Figure 6 for a two-dimensional bargaining position, where the investor is ready to pay a greater value, measured on the vertical axis, in exchange for more downside protection, measured on the horizontal axis, demonstrates that term sheets include essential components beyond valuation. The upward-sloping line in the illustration represents the trade-off made by the investor. For the sake of simplicity, let's assume that the entrepreneur is so certain she will be successful that she doesn't give a damn about downside protection. She does, however, have a minimum value below which, as shown by the horizontal line, she is hesitant to accept the investment[6], [7].

Making a Decision

Which ZOPA contract is ultimately selected? This is difficult to forecast since it relies on the many peculiarities of each unique negotiating circumstance, such as the timing of events, the market environment, and the negotiation abilities of the individual parties.

Valuation

The two parties must keep in mind that they are not really splitting an asset with a fixed value when they come to an agreement. Instead, they are attempting to expand a venture together, where each trade-off has an impact on both parties' motivations and, therefore, the company's destiny. For instance, a low value offer with substantial downside protection may demotivate the entrepreneur. In a similar vein, a business owner who denies an investor any say in how the firm is run may be hindering the investor's potential to create value.

Achieving a Deal

Although the specifics are unique to this endeavor, the essence of the experience will likely be relatable to many others. In the autumn of 2016, four Oxford graduates created Brill Power. The performance of current battery packs was significantly enhanced thanks to the development of a new battery management system. The hamlet of Brill, located in mountainous Oxfordshire, inspired the company's name. The founders enjoyed riding their bikes to this location on the weekends. Those bike trips were challenging, but nothing compared to the challenges they faced while trying to get their first round of funding. Chris, Damien, and Adrien, three of the co-founders, were still working on their PhD or postdoctoral engineering degrees at the University of Oxford. Carolyn, the fourth, has an MBA from Oxford. She started the business's fund-raising operations in November 2016. She split her time with Brill Power and a research assistant position for an Oxford professor. She was given the duty of creating a financial model for an entrepreneurial finance textbook, which would soon come in handy.

Carolyn planned ahead and allowed herself a generous six-month window to gather the needed money. By the summer of 2017, the team hoped to transition to a full-time schedule by raising £350K. But creating their first proposal proved challenging and time-consuming. Their first target market of impoverished nations was shown to be the wrong location to start by their pilot project, which included recycled batteries in Kenya. They were persuaded by this to shift their attention to Europe, beginning with the UK. The founders' pitch deck, however, didn't feel prepared when they constructed it. The value proposition and product were not well defined, and the financial predictions didn't seem real. Carolyn made many investor presentations in the weeks leading up to Christmas, but none of them succeeded in persuading them to invest. The response did have one positive aspect, namely that batteries were seen as a hot sector. The business made a second pivot in early 2017 and switched its focus from extending batteries' second lives to extending their initial lives. They concentrated on two distinct markets electric automobiles and battery packs for business and industry.

The attempt to spin the firm out of the university was a crucial first step. In order to negotiate a license and equity share arrangement, they had begun talks in December 2016. The founders obviously rejected the University's original offer, so they hired a lawyer to assist them come up with a negotiation plan. They warned the university that if a better offer wasn't made, they would just abandon the university's intellectual property and launch a new business specializing in software applications without the IP. Slowly, the negotiations proceeded. The team believed that their pitch deck was finally taking form by April 2017, even though they were well behind the original fundraising deadline. The battery market was sizable, the business plan was persuasive, and for the first time, the financial forecasts made sense. This is when Carolyn learned that her permission to remain in the UK had been revoked on procedural grounds. She left the nation in a matter of days and went back to Canada to see her folks. Chris, the CEO, was now in control of all fundraising initiatives as a result. He originally felt overwhelmed since he was a technical entrepreneur and turned to the Said Business School's Entrepreneurship Center for assistance. A local VC partner who had shown some interest in him but was hesitant to commit to a contract was soon the result of his quest. The firm ran out of money in early July, just when the founders had chosen to join full-time. Fortunately, none of the founding members had substantial school debts, and they could rely on the assistance of their respective families for money. Chris got an offer from an angel group that Carolyn had presented to before Christmas just as their expectations were about to sink as low as the company's money account. Due to an approaching tax deadline, they felt pressured to make a fast £20K investment with the hazy promise of making another £100K investment later.

The £20K offer was insufficient, and the term sheet included a number of uncomfortable control clauses. The team declined their offer as a result. The middle of August saw a startling development. The business had submitted a grant application to Innovate UK for a grant of £100,000. Brill Power had successfully completed the first stage and was now searching for a private investor who would provide an extra £50K of equity to match the award. The local VC partner who had indicated interest at the start of the summer agreed to invest the £50K utilizing a convertible note in a single phone conversation. Out of the $350K, the business had $150,000 all of a sudden. Only £200K remains. Carolyn's mother-in-law in Canada recommended her to a local investor. I wasn't even planning on attending the meeting. She stated, I didn't imagine he would ever be interested in a little UK start-up. She was shocked when the investor, who had been enthusiastic, offered to invest the full £200K within hours. Everything started to fall into place all of a sudden, but Brill Power still had to complete the spin-out deal with the University. Before investing their money, every investor demanded that the company protect its intellectual property.

Carolyn resolved her immigration issues towards the end of the summer and returned to the UK. Her job was to maintain the investors' commitment during the negotiations with the University in September and October. A deal was ultimately reached with the University in the middle of November. Just one year after making the first decision to pursue money, Brill Power successfully completed its £350K seed round. The business also received several minor subsidies and won a Shell energy challenge that awarded a reward of €100,000 in the form of a convertible note. Finally, the organization could concentrate on growing their business. Once you go through your first fundraising, you learn to live with the risk, Carolyn said. You become accustomed to planning costs without the necessary finances. The ups and downs are more harsher than in the Oxfordshire countryside, so it's not for the faint of heart. The parties get together to create the final agreement during the closing procedure. Finding a solution inside the ZOPA is only one aspect of this; another is getting all the different stakeholders to work together to reach a consensus.

The business owner must first have a lead investor's complete commitment. That makes it simpler to put together the final investor syndicate. The lead investor aggressively urges the other investors to commit when he chooses to syndicate the transaction. The businessman continues to make an effort to persuade everyone who is still undecided. Attorneys are crucial in the closing phase. Lawyers on both sides are often present during term sheet talks. Investors often recruit them, which fosters a sense of familiarity and devotion. Entrepreneurs are recommended to seek out knowledgeable legal counsel since they often lack expertise with this procedure. Founders need a unified negotiation posture in order to clinch a contract. Many founder teams assign the CEO or another member to handle negotiations. This makes the bargaining process more coherent. The team may not be able to speak with one voice in front of its investors if there are differences inside it. This might seriously damage their reputation and potentially make it more difficult for them to conclude the sale.

There may be more parties whose consent is necessary to finalize the contract in addition to the investor and the entrepreneurs, which might provide a hurdle in itself. For instance, a startup could need to entice a certain senior executive to bring particular talents to the project. Since she would typically have excellent alternatives to job, the enterprise must be trustworthy and provide an alluring wage plan in order to entice her. Successful fundraising is necessary for each of these conditions. As a result, the finance of the company and its employment procedure become interdependent. The three-way negotiation might go in different ways. For instance, it's possible that the CEO places a requirement on the company's fundraising round closure before agreeing to join. Alternately, it's possible that the investors need the CEO to join in order for them to approve the investment. Often, the entrepreneur must break through these deadlocks by mobilizing all stakeholders to agree to a cooperative arrangement.

The parties often sign a term sheet, which serves as a legal pledge to invest, as the final agreement. There are still some closure requirements for this document. Usually, there is some further investigation that can even demand for a nondisclosure agreement. The final investment paperwork was then put together by the attorneys on both parties. The entrepreneur is not permitted to shop around for a contract during this last window. Investors may still withdraw at that time, but only if the due diligence turns up any unfavorable information, which is uncommon. A business may shut down twice. The goal of the first closure is to bind those investors who are prepared to contribute enough money to make the round successful. The business and these investors may then elect to keep the round open in order to get further funding. Typically, the conditions of a second closure are the same as those of the first. The second closure is intended for latecomers who wanted to observe the first close to feel comfortable investing in the transaction as well as new investors who were not aware of it.

Deal Negotiations with Investor Competition

We have only discussed the scenario of an entrepreneur negotiating with a single investor syndicate up to this point. Coordination profits from this, but it also reduces competition, keeps values down, and promotes investor-friendly conditions. Entrepreneurs have little control over investor collaboration, which may be overt or covert and whether it is allowed or not. The only thing the business owner can do is make the offer more competitive. In order to create competition, the transaction has to generate some publicity. This entails luring investors from networks apart from the initial group of investors. When rival investors start to show interest, the entrepreneur's negotiating position improves. Additionally, it generates a feeling of urgency that encourages investors to complete the transaction since they don't want the opposing side to counter offer. Receiving several proposals is still a rarity and usually occurs in one of two circumstances either during hot markets when many investors are competing for a small number of transactions, or during hot deals when the venture seems extremely good and appealing to many investors. Investors may want some exclusivity from the entrepreneur in order to limit competition while they consider the investment, i.e., they ask for some exclusivity. However, this is a pretty self-serving request that entrepreneurs often refuse before the investors make any commitments on their own. Once the entrepreneur signs a term sheet, things start to change since it usually has a no-shop provision prohibiting them from looking for other offers.

Keeping the Agreement

Closing a contract is one thing; having to live with it is another. It is simple to miss the forest for the trees while constructing a transaction. The bargain is the forest, and the venture's success is the trees. Perhaps the only thing that counts when negotiating over a carpet in a bazaar is to push hard for the best offer, knowing that neither side will see the other again. However, since entrepreneurs and investors anticipate working together for a lengthy period of time, interactions with the other party in the context of entrepreneurial financing are prolonged and recurrent. This has an impact on their behavior both during and after the discussions. This connection has the following two crucial components confidence and a long-term outlook [8]–[10].

CONCLUSION

In conclusion, Syndication is a cooperative strategy that gives investors access to bigger and more varied investment possibilities by allowing them to share resources and skills. Potential advantages include increased money availability, risk sharing, and specialized expertise. However, strong communication, good administration, and cautious partner selection are necessary for syndication success. Syndication may improve investment performance and assist in achieving investment goals via careful analysis and continual monitoring. Syndication prospects should also be assessed for their compatibility with investing strategy, risk tolerance, and anticipated returns. Making educated investment choices requires thorough due diligence, which includes evaluating the investment offer, the syndicate members, and the syndication agreements.

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CHAPTER 16

POWER OF TRUST: BUILDING STRONG BUSINESS RELATIONSHIPS

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ABSTRACT:

Trust is a fundamental element that underpins relationships and interactions in various contexts, including personal relationships, professional environments, and business transactions. This abstract explores the importance of trust and its impact on individuals, organizations, and society as a whole. The abstract begins by highlighting the essential role that trust plays in building and maintaining relationships. Trust is the foundation of healthy and meaningful connections, fostering open communication, collaboration, and mutual respect. It creates a sense of security, reliability, and predictability, enabling individuals to feel comfortable and confident in their interactions with others.

KEYWORDS:

Confidence, Credibility, Ethics, Loyalty, Professional , Reputation, Reliability, Transparency.

INTRODUCTION

The Oxford Dictionary defines trust as having a firm belief in the reliability, truth, or capability of someone or something. When there is trust between two people, neither can directly control or restrict the other's behavior. This is crucial in the fast-paced, extremely unpredictable world of entrepreneurial finance, where contracts may only govern actions and contingencies with a very wide definition. When there are no written norms left to follow, trust gives parties a cushion to make judgments. Exploratory behavior, a crucial component of the entrepreneurial process, is therefore made possible. Because trust has an impact on the whole financing process, it is important throughout the entire book. As the MATCH tool's last question, it therefore has a significant impact. Parties rapidly become aware of how constrained and inadequate any formal contract is when it comes to making investments and arranging transactions. A soft factor that unites the hard aspects specified in a term sheet is necessary for a contract to succeed. The unspoken details, attitudes, behaviors, and real acts are referred to as soft elements.

Let's make a distinction between generic and customized trust in order to better understand how trust impacts financial transactions. The initial degree of trust that various groups of individuals have is known as generalized trust. This level of trust is based on widely visible facts, such as ethnicity, gender, age, and education. Although generalized trust may be full of stereotypes, it nonetheless plays a significant role in how individuals judge one another, particularly when they are still getting to know one another. Once the friendship develops and the parties get to know one another, personalized trust takes hold. It represents the two parties' interpersonal and ultimately professional relationships. It is predicated on a far more in-depth comprehension of their individual actions and attitudes. The degree of trust refers to the generalized level of trust at the outset of a financing relationship. The parties either see their personalized trust improve over time or see it decline. Even while it can seem that trust has nothing to do with commercial dealings, it really does. Malhotra and Murnighan's research demonstrates that unfulfilled promises in contracts encourage the growth of specific trust. The entrepreneur may tolerate investor choices and actions that may seem self-serving as long as they are confident in the investor's dependability.

This could happen early on when a dependable business owner provides the investor board power in the event of a sizeable investment. Later, when a founder decides to relinquish his or her position as CEO and permits the investor to hire a professional CEO, it could also occur. On the other hand, for the investor to approve a sizable purchase or the hire of key personnel, trust is crucial. Although it takes time to develop, trust may be rapidly destroyed. Even simple things become complex once trust begins to be betrayed. Costs of communication rise. Things need to be documented, maybe with legal confirmation, rather than depending just on verbal comprehension. Losing this ability prevents the entrepreneur from acting in ways that the investor hasn't expressly authorized. She must also ensure that the project follows the plans and expectations. This may become annoying and perhaps hazardous. In the end, a lack of trust might result in expensive legal challenges.

An Extended Perspective

Developing trust needs long-term thinking from all sides. We first examine how a long-term view impacts the interaction between entrepreneurs and investors in order to comprehend what it truly involves. We next broaden the discussion by examining how these parties build more extensive reputations among the business world. A common error made by novice business owners and investors is to view the funding arrangement in isolation. We underline their lengthy travel repeatedly throughout the novel. Investors may become active value-adding partners once the transaction is closed, and the parties collaborate on subsequent fundraising rounds as well as the firm exit. How do the bargaining dynamics that we looked at in this alter with a long-term relationship perspective? There are often trade-offs between immediate and long-term rewards. Adopting a combative or opportunistic negotiating style might provide immediate benefits but can potentially backfire in later stages, particularly as the tide turn.

A business enterprise will likely see many power changes. Investors may sometimes be in a better position than a poor, struggling entrepreneur. However, that same entrepreneur can become more influential after her business takes off. Now that she is in a position of power, she may demand concessions from her investors. Alternating power transfers have the potential to degenerate into violent hit-for-hit behavior. This may be avoided by approaching relationship development from a long-term perspective. It calls for a mindset of sacrificing certain short-term rewards in favor of the shared long-term objective. Future investors are simple to overlook. In the case of staged financing, the firm is likely to request further rounds of funding. This often includes some new investors in addition to the current ones. They may not respond well to strange constructions. It is challenging to add a sizable value premium to the next round if the firm received a very high valuation in the prior round. Sometimes the past value was so excessive that only a down round was feasible. Future investors may simply ask the entrepreneurs and previous investors to renegotiate the unique provisions if they find them to be a deterrent. Therefore, adopting a long-term view entails foreseeing such issues and designing the initial contract to be friendly to future investors [1], [2].

In certain cases, the partnership between an investor and an entrepreneur lasts longer than the enterprise. It is usual for business owners to request funding from their prior investor for their subsequent endeavor once a firm has exited. When a venture capital company is the investor, the entrepreneur may work there temporarily as a entrepreneur-in-residence. In order to evaluate possible transactions at this period, the investors make use of the entrepreneur's technical and business talents. She could even get a job as an executive in a new portfolio firm from them. The reputational problem goes beyond the interaction between the specific entrepreneurs and investors. Professional investors who often make new deal investments include VCs. They are concerned about maintaining their reputation, therefore they take into account how one negotiation may impact other negotiations. Reputational issues may be a double-edged sword. Many investors work to cultivate a reputation for being fair, open, or simple to work with. They do this in an effort to draw in more business owners. While some investors desire to be seen as aggressive negotiators, others do not. Atanasov, Ivanov, and Litvak examined lawsuit data in the VC business in one academic paper. It reveals 328 cases filed over a thirty-year period, indicating that entrepreneurs do bring claims against investors for a range of unfair business practices. It's interesting to note that business lawsuits VCs are significantly more prevalent than the reverse. The most plausible explanation is that entrepreneurs have a higher likelihood of getting settlement fees from VC firms than VCs do from young start-up businesses. Only when other business owners can see an investor's behavior can that investor build a reputation.

The largest reputational benefit for an investor comes from successfully leading a venture to an exit. However, since the specifics of the purchase and the investors' activities often stay secret, reputations for fairness are mostly spread by word of mouth. They are hence susceptible to rumors and misunderstandings. Overly aggressive entrepreneurs may criticize certain investors, giving them an undeservedly poor reputation, while others may get off too lightly. A website called The Funded that publishes thoughts from business owners regarding their interactions with investors is worth highlighting in this context. This, of course, has issues of its own. While disgruntled businesses may use the platform to air their complaints, astute investors may attempt to advise their financed entrepreneurs to post positive evaluations. Entrepreneurs may develop a reputation. To be seen as competent to carry out a business strategy even under challenging circumstances is a major problem for the entrepreneur. An entrepreneur's ability to compete for the interest and funds of investors is aided by their reputation. The capacity to draw in and keep talent is a different reputational challenge. Entrepreneurs profit from keeping a positive image among present and future workers since the majority of businesses are founded on human capital.

Corporate Responsibility

This looks at what happens to investors once the transaction closes. We start by asking why businesses require investors in the first place and what drives them to participate in an active manner. Next, we examine how corporate governance may help investors increase the value of their firms. We make a distinction between value-adding and control governance operations. Voting at the shareholders' meeting, active board engagement, and the use of unofficial authority are all examples of control. Investors put additional strategic pressure on founders and may even oust them in favor of an external CEO. Mentoring the entrepreneur, consulting for the firm, setting up connections to business networks, and aiding in recruitment are all examples of value-adding activities. The document's conclusion demonstrates how to evaluate the compatibility between a start-up's requirements and the value-adding assistance that a particular investor may provide.

DISCUSSION

The Need for Corporate Governance

The active participation of investors is therefore a key component of the connection between entrepreneurs and investors. Corporate governance is the collection of acts by which the financiers secure a return on their investment. By taking a proactive role in the company's governance, investors may contribute more than simply money. They have a motivation to participate and learn the skills necessary to raise the value of their assets thanks to their ownership stake. The investor may provide support while the entrepreneur builds the business, maintain a critical watch on the results, and step in if things go wrong[3], [4].

Businesses Need Investor Participation

Investors may provide for a range of demands that businesses may have. They are based on the stage of growth and unique conditions of the organization. Take a typical early-stage technological business as an example. The majority of entrepreneurs in the technology sector have little understanding of and expertise with the strategic, commercial, and financial aspects of entrepreneurship. They may gain a lot from the mentorship, advice, and networking provided by others who have already experienced the entrepreneurial process, potentially as entrepreneurs themselves. The many questions that often overwhelm rookie entrepreneurs may be effectively addressed by an experienced investor. How do you find and keep critical personnel? How are you safeguarding your technology? Who ought to serve on your board? so on. When left to their own devices, many business owners are prone to squander time and money on endeavors that are not crucial to the success of their start-up[5], [6].

Worst case scenario, people choose poorly simply because they lack experience. Entrepreneurs may manage their expanding businesses, concentrate on what they do best, and get assistance from others when necessary with the support and pressure from their investors. Later development phases provide new difficulties for businesses. Moving from informal management to a more organized management style appropriate for bigger enterprises is necessary for the firm to grow. The majority of founders struggle to manage bigger organizations. Growth also necessitates businesses to take on fresh strategic issues. For instance, a business may have to choose between pursuing organic growth and purchasing a rival. Or it may choose whether or not to become global, and if so, when. These problems call for great execution, financial acumen, and strategic vision. All of them may be assisted by an experienced group of investors[7], [8].

Investors Manage Their Businesses

Due to the utilization of equity financing, entrepreneurs and investors' interests are, in theory, aligned. However, there is still a great deal of conflict potential. This is especially true if the entrepreneurs choose to steer the business away from value maximization. In the end, investors are more concerned with the success of their businesses than with the founders. By ensuring that the business is effectively managed and continues to gain value, investors may safeguard their capital. Investors may sometimes need to make sure that the business owners don't falsify their financial records or embezzle funds. Elizabeth Holmes, a Stanford dropout who launched Theranos in 2003 on the promise that her product would significantly reduce the cost of blood testing, was one extremely well-known example. The firm collapsed in 2018 when Holmes was charged with wire fraud.3 More often, investors must make sure that business owners stay on a sound strategic track, assume a reasonable level of risk, and avoid pursuing side initiatives with questionable economic value. Self-dealing is another touchy subject that often remains undefined. For instance, Adam Neumann, the founder of We Work, leased to the business many buildings he owned after gaining control of the company's voting rights. There was a heated discussion over this supposed opportunistic act[9], [10].

Investors aim to earn a financial return, therefore they work to hasten business development. This could lead to disagreements with the entrepreneur. For instance, some business owners object to leaving because they dislike the change. Therefore, this may result in a dispute between investors and entrepreneurs in which investors must play a proactive role. Investors who believe they must remove a foundering CEO who is doing poorly provide yet another possible point of contention. Investors may utilize control rights and other legal protections acquired at the time of the investment to their advantage when a dispute with the entrepreneur occurs. Investors with control rights may exercise governance. This calls for staying close to the business, gathering data, keeping tabs on developments, and evaluating the entrepreneur's performance. Investors should possess the essential skills since these tasks need a lot of time and effort.

Structures of Corporate Governance

No matter how many formal specifics are provided, a contract is always unfinished. Therefore, businesses need a governance framework that distributes decision-making authority under clearly defined conditions. The business charter outlines the major governing principles that apply to a firm. By-laws, shareholder agreements, and other contractual agreements may be added to and changed over time in compliance with local regulations. We differentiate between two primary control mechanisms within this legal framework voting rights.

Electoral Rights

Shareholders with voting rights may decide on a number of important issues. What kinds of choices are to be made by shareholder vote is specified in the business charter, bylaws, and perhaps other legal agreements. This includes, for instance, any choice about the location of the formal incorporation or any choice regarding the sale of the business. The two most common methods for determining voting results are simple majority and supermajority. All shares by default have an equal amount of voting power. However, voting by share class and deviating from the one share, one vote principle are two ways that might alter this. Consider a corporation with three share classes: ordinary stock, Series A preferred stock, owned by first-round investors, and Series B preferred stock, held by second-round investors, to see how voting by share class works. Think about a straightforward Yes/No vote to decide whether to accept a purchase offer for the business. There may be several shareholders that dispute with one another within each share class. Using a simple majority vote, each class first chooses its place when voting by class.

Then, a decision may only be made if it has a majority of support from all classes. This is due to the overwhelming No vote from ordinary shareholders. Only if all classes receive a majority of yes votes will the decision be made. This illustration demonstrates how voting by class may shield minority investors from a majority's attempts to impose its will. When shares in various classes have differing amounts of votes, the one-share, one-vote rule is broken. Dual-class shares are another name for this. There are two ways to structure this: either by giving certain shares numerous votes or by having some shares without voting rights. Let's continue with the previous scenario and presum that there are 100 total shares. Assume for now that each common share has two votes.

Committee of Directors

The role of being the boss is enshrined in the legal structure of the corporation, that is, the fact that the board is endowed with the right to make, or approve, all significant business decisions. The board of directors plays four main roles that we call the boss, the monitor, the coach, and the promoter. As the monitor, the board oversees the company's operations on behalf of shareholders, identifying issues, evaluating the management team's performance, and driving necessary changes. One of the most crucial decisions the board makes in this regard relates to the hiring and firing of executives, particularly the CEO. The management staff and the board may disagree in the first two responsibilities, but they work well together in the other two. Directors often take on the role of the coach, offering the CEO helpful guidance and assistance. Experienced board members who have dealt with comparable problems in the workplace may be very beneficial. The function of the promoter is another one that directors might perform. In this capacity, they represent the firm to the outside world, using their networks within the industry and assisting in the development of new client ties.

The majority of important strategic choices, including which products to develop, which markets to penetrate, which executives to recruit, and whether to raise more money, are made by the board of directors. The board of directors may also choose when and for what a shareholder vote is called, subject to legal and regulatory restrictions. Board decisions may be made by majority, supermajority, or unanimity, with various decisions being made under various rules. The board of directors has a fiduciary obligation to advance the business's interests. Board members should, in theory, prioritize the interests of the firm above the particular interests of the shareholders who elected them. This is a complicated problem in real life. The ultimate charge rests with the board chair. A board member's committee duties may include serving on the remuneration or audit committees, for example. Additionally, certain investors could have observer status but not a board seat. Even if they are unable to vote, this enables them to engage in the debates and maybe even have an impact. In certain nations, labor participation on the board of directors is required by law. Some nations additionally need a dual board structure with a management board in addition to the board of directors. Small businesses are frequently excluded from these regulations, however, therefore start-up board arrangements are generally the same across most nations.

The board of directors at a start-up is typically not very large. The number of directors is often an odd number to prevent voting impasse. By the time a business obtains its first round of venture capital, five directors are typical. This might rise to seven, nine, or more in following rounds. The average listed company's board size is about half that of a later-stage VC-backed company, according to academic studies. Start-ups can maintain smaller boards because, unlike in public companies, there are fewer large shareholders and there is less pressure to appoint independent directors. Smaller boards find it simpler to have regular meetings. Monthly board meetings are extremely typical in the early phases of entrepreneurial enterprises as well as when companies are going through difficult times. Directors at start-ups also prefer to spend more time with their businesses. Entrepreneurs, investors, and independent directors make up the board's core three segments. Entrepreneurs and investors each have their own specialties, while independent board members provide their knowledge of the business. With five members, a typical structure would be for management to have two board seats, investors to have two seats, and an outside director to have one seat.

In addition to being experienced businesspeople or professionals with connections to either the investor or the entrepreneur, outside directors are sometimes the CEOs of other firms in the investor's portfolio. Extraordinary devotion may be in contradiction with their fiduciary responsibility to the business. Establishing mutual confidence is facilitated through mutually agreed-upon appointments. Outside directors are crucial for at least two reasons: they may influence outcomes when investors and management disagree, and they play a key role in determining the company's direction. They may provide relevant industry expertise and use their networks of contacts for the company's advantage. Access to knowledge about the company's financial and strategic status is one benefit of being on the board of directors. Board members are regularly updated on business developments. These reports include updates on strategic topics including development progress, new hiring, or strategic relationships as well as financial data. Companies disclose any significant changes to the competitive environment, litigation, intellectual property, or critical customer accounts. Professional investors often request that businesses set up an accounting system to offer quarterly reports on cash flow and profit.

At the beginning, monthly reports on cash flows are also typical. Additionally, board members get to see founders and management deal with difficulties and plan the growth of the business. Although it cannot be defined in a report, this soft information is important for evaluating management effectiveness. The following items should be included on your checklist when creating a board package, according to well-known investor and author Brad Feld: company financials, guidance on anticipated future financial performance, key operating metrics, sales and business development pipeline, updates on product and technology development, administrative and human resources news, and the current capitalization. Boards evolve over time. when the original investors leave and new ones join. The seats of the original investors could be taken by the new investors. Additionally, directors may switch when new skill sets are required. The term sheet may also detail the relationship between board make-up and control and business success. Control is initially split between the founders and the investors. However, over time, especially when performance falls short of expectations, investors acquire greater authority thanks to the staged financing process and maybe term sheet stipulations. When milestones are missed, for instance, investors may sometimes propose new board nominees, thus seizing control of the business.

Over time, the board's function also evolves. The boards of corporations age and expand, becoming more formal. They formalize important committees, like the audit and pay committees, among other things. Top managers' wages, stock options, and incentives are determined by the pay committee. It is normally presided over by an independent board member, and management is never invited. The audit committee monitors business dealings between the firm and its workers and makes sure that financial reporting to investors complies with legal obligations. As the firm approaches its departure, it becomes even more crucial. Members with accounting experience who are independent of top management should be on the audit committee. Frequently, investors serve on both committees. Over time, some founding CEOs pass the reins to a professional CEO, changing the position's responsibilities and financial rewards. The board of directors often changes throughout subsequent fundraising rounds. The most typical structure involves the new investors adding one or more board members. However, when businesses go through many rounds, this setup could result in boards that are too big. In such circumstances, a major reorganization of the board may be necessary. The removal of some or all of the departing investors from the board to create way for the incoming investors is a typical remedy. In many cases, however, some old investors continue to be valuable to the company. They may have developed a strong working relationship with the founders, and they frequently provide board continuity. In some cases, however, it may be possible to turn their board seats into observer seats. Finally, in some cases, a more radical restructuring is necessary.

Founders and managers of the company never get paid for sitting on the board because this is merely part of their job investors also rarely get paid because this is part of their investment responsibilities this leaves independent directors as the only directors who receive some compensation for their work. Here we discuss the role of term sheet clauses, which explains how certain terms either allow or prevent specific decisions. For example, a contractual clause may specify that the board of directors must approve any senior management hire, or it may specify that the investors can override a shareholder vote and veto the sale. Finally, in addition to having a board of directors, some start-ups also have an advisory board, which is not a formal board and whose members do not have any fiduciary duties, but instead primarily serves as a support system and sounding board for the entrepreneurs. Advisers tend to bring technical or industry experience and may be entrepreneurs from noncompeting companies.

CONCLUSION

In conclusion, Personal interactions, organizational dynamics, commercial transactions, and social well-being all depend on trust. It is a potent force that encourages constructive relationships, makes teamwork easier, and propels social and economic advancement. Integrity, honesty, and ethical conduct are necessary for establishing and sustaining confidence. Recognizing the value of trust and fostering it in many circumstances may lead to greater bonds between people, more effective workplaces, and a more stable society. The value of trust in society as a whole is also important. A functional society and social cohesiveness are both based on trust. It creates social capital, institutional sturdiness, and civic involvement. Trust helps people to negotiate difficult social situations, depend on government services, and work together for common objectives.

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CHAPTER 17

A BRIEF OVERVIEW ABOUT INFORMAL CONTROL

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ABSTRACT:

Informal control refers to the unwritten, implicit mechanisms and practices that influence behavior, decision-making, and performance within organizations. This abstract explores the concept of informal control and its significance in shaping organizational culture, employee behavior, and overall organizational effectiveness. The abstract begins by emphasizing the role of formal control mechanisms, such as rules, policies, and hierarchical structures, in organizations. While formal control provides structure and guidance, it is often supplemented and complemented by informal control mechanisms that emerge organically within the social dynamics of the organization.

KEYWORDS:

Authority, Communication, Grapevine, Group, Informal, Leaders, Norms, Pressure, Socialization.

INTRODUCTION

The legal framework establishes the formal decision-rights distribution between investors and business owners. Actual choices, however, are often taken outside of the boundaries of legal control powers. We speak about informal control when this occurs.17We distinguish between the power of the pocketbook, the power of persona, and the power of persuasion as three different forms of informal control. This phrase succinctly sums up what we refer to as the power of the purse. The golden rule of venture capital is that he or she who has the gold makes the rules. For future financing, entrepreneurs rely on their investors. A significant amount of authority is held by the current investors, both directly via the choice to refinance the business and indirectly through their sway on other investors. An insider's willingness to take part in a follow-up round, for instance, might encourage possible new investors. The influence of a person's personality is a second informal power source. By this, we refer to the influence that people enjoy as a result of earning the respect and trust of their coworkers. Leaders in a company, whether they are the founders or recruited executives, must motivate people who follow them. Over time, trust is built up, but it may also be swiftly destroyed[1], [2].

A charismatic leader may rally the troops behind a plan of action and make it tough for others to disagree with it. For instance, a founder who doesn't want to sell her business can persuade the staff to go with her in the event that the investors insist on doing so. This may lower the company's value to the point where the purchase becomes less desirable for the buyer. A strong CEO may have sufficient informal power to influence the choice even if the investor may have the official authority to sell the firm. The capability of persuasion serves as a third informal power source. Boards of directors must deal with several crucial problems that are difficult to resolve and ambiguous. In this decision-making process, social standing, professional reputation, and pertinent knowledge all have some influence, but a strong case is often required to win over the board. In any case, informal control may change the balance of power. Investors inherently have the power of the pocketbook, but charismatic entrepreneurs often wield the power of personalities. When it comes to persuasiveness, both investors and businesspeople may benefit from it[3], [4].

DISCUSSION

Unpacking the CEO-Board Relationship

How do business owners really communicate with board members? In one academic research, Garg and Eisenhardt explore a number of in-depth case studies illustrating the interactions between the CEOs of start-up firms and their board members.18 The advantage of using an observational research methodology like this is that researchers may carefully observe procedures and methods. In this particular study, the researchers examine the crucial strategic choices made by four CEOs of VC-backed high-tech start-ups. Both the formal board meetings and the countless unofficial encounters with individual board members are observed by the researchers. They succinctly state that the CEO's main difficulty is gaining advice without losing power. When dealing with their board members, CEOs should exhibit four key characteristics, according to the experts. First, CEOs routinely contact their board members personally in unofficial meetings rather than depending on group interactions. This narrows the focus of the participants' attention and aids in eliciting their opinion in the areas that will benefit the CEO the most. Second, CEOs never give alternate strategies during official board meetings instead, they only suggest one path of action, which is then considered and accepted.

Avoiding several options allows the CEO to maintain control over the agenda and divert any possibly conflicting viewpoints of individual board members. Third, CEOs convene specific strategy meetings using a long-term brainstorming frame rather than a short-term operational frame when more in-depth conversations regarding alternative plans are required. The CEO may shift attention away from suggestions that might be implemented right away in this manner. Instead, brainstorming helps the board members to participate in a more fun exercise in visioning and makes them stand out as knowledgeable and helpful. Fourth, CEOs use political strategies to end the decision-making process. Building coalitions around the chosen course of action is required for this. In the end, the researchers characterize board director management as a divide and conquer strategy. Knowledgeable businesspeople meticulously or chestrate their power in advance since it is a force to be reckoned with in the boardroom.

Enhancing Investor Value

Investors provide their portfolio firms numerous forms of help in addition to control-related governance tasks. This helps to lower risk and ultimately raises the company's worth. We first consider the value that investors may provide via active participation before identifying the key business sectors where assistance is crucial. Making winners versus choosing them. Corporate governance is to help the business make wise choices and actions that provide value.

Nobel Insights on the Effects of Selection vs Treatment

The 2000 Nobel Prize in Physiology or Medicine was given to James Heckman for his development of theory and methods for analyzing selective samples. The Nobel Prize in 2003 was to Clive W. J. Granger for methods of analyzing economic time series with common trends. Both Heckman and Granger are econometricians who created statistical instruments for the examination of empirical data. Granger is renowned for his study of time series, or information that shows how variables change over time. He created techniques that make it possible to separate the impacts of changes in one variable's relationship with other variables across time. Changes in one variable cause changes in another, which is known as G ranger causality. For instance, although interest rates and home prices both fluctuate over time, which is the result of which? A statistical study may show that increases in interest rates come before declines in home values, indicating that interest rates Granger-cause rather than follow home prices. In our situation, we may inquire as to how VC investments correspond to long-term firm success. For instance, we may discover that obtaining VC Granger-causes sales growth. Granger causality may be confusing in certain situations but advantageous in others. For instance, Christmas Granger-causes itself via the selling of Christmas trees.

The sale of trees comes before the holiday event in time-series data, hence this is mechanically correct. This suggests a more significant issue. Due of their excitement for Christmas, many choose to purchase trees in the lead up to the holiday. Obviously, many economic events are less predictable than Christmas, but the same objection still applies. In our situation, it's possible that venture capitalists invested in a firm because they anticipated huge sales growth from it. Thus, determining real causation is more difficult than determining Granger causality. Herein lies the value of Heckman's work. knowledge causation, which is essential to the social sciences, requires a knowledge of selected samples. In our situation, the issue is whether greater firm performance results from VC finance, or if higher performing companies already draw VC investment. Conceptually, answering this question is difficult because it calls for separating two potential causal effects: one from venture financing to company performance, known as a treatment effect, and another from anticipated company performance to venture financing, known as a selection effect. Be aware that the language is drawn from the medical sciences. For instance, do healthy individuals exercise more or does exercise make them healthier?

Heckman's groundbreaking study on well chosen samples demonstrates how to scientifically distinguish between treatment and selection effects. He developed a variety of statistical methods that enable researchers to separate treatment from selection effects in their own work and in the later research he encouraged. The term identification is used in econometrics to describe this. It is proposed that random assignment to treatment and control groups is necessary in order to identify treatment effects. Take into account evaluating the efficacy of a training program for jobless employees. The sample will be chosen if participation is voluntary since it will include employees who anticipate receiving benefits from the program. Any observable difference between the sample of employees who were treated and the sample of employees who did not participate in future hiring combines the selection effect and the treatment effect. The treatment impact can only be determined if employees are divided into the two groups at random. Any variations in outcomes must thus be attributable only to treatment whenever treatment is random since there is no selection effect. This idea is incredibly all-encompassing. For instance, it serves as the foundation for double-blind clinical studies of pharmaceuticals.

Randomized trials may be possible in certain circumstances, but many economic conditions simply do not permit it. You can't choose two nations at random, subject them to various rates of inflation, and then compare the results to evaluate which economy does better. Heckman's research demonstrates how to use quasi-experiments to infer treatment effects. Consider a recent research by Bernstein, Giroud, and Townsend that explores whether VCs outperform the market by selecting superior firms or by creating more value. Even though VCs intentionally choose the finest startups, certain companies allegedly get greater attention at random, according to the study. They specifically take into account how simple it is for VCs in the major hubs to collaborate with start-ups that are situated outside of these clusters. They utilize the introduction of new direct air routes as a kind of experiment. A direct flight drastically cuts down on travel time, enabling venture capitalists to spend more time with their portfolio businesses there. This should have a positive therapy impact that improves performance. The analysis reveals that firms with VC backing performed better in terms of innovation and exit following the introduction of direct air connections. This data points to VC's value-adding function, or its beneficial therapeutic impact. Many more studies investigate the connection between VC funding and firm success using other Heckman-like methods. These investigations often uncover data supporting the importance of both selection and treatment effects. The key takeaway is that successful VCs both identify and create winners.

Value Investors

In this, we categorize value-adding behaviors into four categories: pressing, advising, networking, and mentoring. A well-known academic research that looked at how VC investors are seen to contribute in the U.S. and various European nations discovered that networking and mentorship come in last, with strategic counsel and pressure coming in first. The process of mentoring is personal. Investors assist entrepreneurs in developing the character traits and tenacity required to grow the business. Entrepreneurs might get assistance from seasoned investors to overcome the various difficulties involved in starting a business. They may give alternate viewpoints and act as a sounding board for entrepreneurs as they navigate decision-making processes that are unfamiliar to them. Most importantly, they sometimes just provide a shoulder to weep on as they help them deal with the emotional ups and downs. Beyond individual mentoring, strategic assistance is provided at the corporate level. It entails offering advisory services that vary from unofficial counsel to official support systems. Strategic advising is very helpful in the fields of finance, marketing, and human resources.

An investor's outside viewpoint on a company's predicament may be quite valuable to a management team that is sometimes too internally oriented. A well-known Silicon Valley venture capital company, Andreessen Horowitz, has an ambitious strategy for helping entrepreneurs. It has a surprisingly big team of more than 40 functional experts that provide advice to businesses on a variety of business-related matters, including marketing, operations, finance, hiring, and international growth [5]–[7]. At the level of the industry, networking happens. business, according to renowned business professor Howard Stevenson, is the pursuit of opportunity beyond resources controlled.25 Reaching out to a wide group of individuals who have access to these necessary resources is thus necessary for creating a new company or expanding an already existing one.26Building a business requires the capacity to find and sign up staff, clients, suppliers, and financiers. High caliber investors develop a broad network of commercial relationships with influential figures in business, finance, and government that can be called upon when needed.

Strategic Alliances and Venture Capital

According to academic studies, VC money affects strategic partnerships in a number of different ways. One may anticipate that VC-backed businesses would have greater access to corporate partners and hence create more strategic partnerships if VCs assisted businesses in connecting with business networks. David Hsu's study contrasts American businesses with venture capital backing to a control group of businesses supported by the Small Business Innovation study program, which awards funds for research to start-ups. The analysis reveals that businesses with venture capital backing are far more likely to form strategic alliances and to go public. Ozmel, Robinson, and Stuart's research examines all two-way configurations for venture capital funding and strategic partnerships. Raising VC funding enhances the likelihood of a future partnership being formed as well as more VC funding. Strategic alliance creation increases the likelihood of future alliance formation but actually reduces the requirement for VC funding. The likelihood of an IPO is increased by both VC money and the creation of alliances.

A different research by Laura Lindsey looks more closely at those alliance partners. A firm's likelihood of forming an alliance with a company that is also sponsored by the same venture capitalist improves if it obtains investment from that VC. These connections also often include a higher degree of reciprocal commitment. The Keiretsu effect is another term for this phenomenon, which derives from Japanese conglomerates. Additionally, investors may put their company under strategic pressure. We've previously said that boards are involved in keeping an eye on the business. The IP strategy of their firms is impacted by investors. When necessary, they may interfere in businesses to compel reform. Founders often concentrate on carrying out their plans, achieving deadlines, and resolving operational and technical issues. In response to altered conditions, investors may prompt them to reconsider their tactics. For instance, they might put pressure on their businesses to drop costly initiatives. They could demand cost-cutting measures from businesses during a recession.

Places Where Investors Provide Value

What sectors of business may investors contribute to? It is helpful to go back to the Venture Evaluation Matrix of 2 in order to respond to this question. The key growth problems that the firm is facing are described in the strategy row. Sales issues exist on the front-end customer side, production challenges exist on the back-end firm side, and organizational challenges exist inside the company. Value-added investors help to address all three problems. Investors may bring value in relation to the sales issues by offering strategic counsel. Investors may see problems that might slip the entrepreneur's mind by building on knowledge from the previous failures and triumphs of other portfolio firms. They may also provide the necessary knowledge to address these problems, such as how to forecast market growth, recognize significant clients, or expand into international markets. Entrepreneurs are connected to markets by well-connected investors who also provide them access to industry connections and build ties with important clients. For instance, investors may get in touch with important or potential clients. The accreditation that investors offer to their portfolio firms is a significant selling factor with clients. Less experienced businesses might benefit from having expertise negotiating complicated contracts with sophisticated counterparties.

Investors may provide guidance and networking help for finding suppliers and strategic partners with relation to the difficulties of product development and manufacturing. Early-stage businesses sometimes struggle to connect with bigger companies in order to forge collaborations in research, manufacturing, or distribution. Investors provide credibility and certification, which facilitates smoother strategic partnership negotiations. The entrepreneur might also be introduced to qualified service providers by investors. The company's demands for professional services evolve as it expands, and eventually it will need to work with an accounting firm, a legal firm, maybe a marketing agency, and so on. An investor can identify the necessary skills and suggest where to get it. Some investors have also dealt with regulators and local government representatives before. This might make it easier to receive approval from the community and secure licenses or permissions. Even ex-high-ranking politicians are partners in a number of prestigious VC companies. Al Gore, a former vice president of the United States, is an example of a partner at Kleiner Perkins. Investors may also have a say in the difficulties of establishing the organization. Startups often begin by managing their personnel informally. They must, however, gradually professionalize their procedures if they are to prosper. This calls for a broad and diverse network, which only a small percentage of business owners possess. The role that investors play in lending a start-up legitimacy with senior hires who require persuasion before joining such firms is equally crucial.

Some investors benchmark the performance of their businesses to give general direction, particularly in the latter phases of business development. A benchmarking exercise compares a company's performance to that of its rivals based on a number of industry-specific performance measures, including market penetration, unit costs, and asset utilization. Compared to ordinary strategic planning, this activity needs more time and money, but it aids investors in spotting departures from acceptable practices and allows for comparison with competitors. Some VC investors work with outside consultants to assess portfolio businesses' development and assist them in deciding which ones to shut down. Investors often help firms get ready for an exit. They put pressure on their businesses to have the financial profile and organizational structure that potential buyers or stock market investors need. For instance, acquirers anticipate that the business would remain concentrated on a small number of items, but stock market investors anticipate a more developed corporate structure. The departure process is also made easier by establishing a business culture of open communication, reliable financial reporting, and effective investor relations.

Startups' Professionalization and Venture Capitalists

Do VCs bring more value and are they more involved in their firms than other investors? Entrepreneurs and investors alike are having a heated discussion over this issue. There are many different points of view, therefore let's add some factual information to the discussion. Using data from the US Census, Chemmanur, Krishnan, and Nandy's study contrasts businesses receiving venture capital funding with a control group without VC. The researchers discover that these businesses are already more productive when they get venture capital, as shown by their total factor productivity. Hellmann and Puri extensively monitored the growth of more than 170 Silicon Valley start-ups, some of which were financed by venture capitalists, others by family and friends, angel investors, and others, in order to provide an answer to that issue. The researchers want to know whether businesses modified their behavior after receiving VC funding. They can see what occurs inside the start-ups, which makes their data distinctive. Businesses with VC use more sophisticated methods for managing their human resources.

They are more likely to create Employee Stock Option Plans and less likely to depend on unofficial employment routes. They are more commercially oriented, bringing their product to market quicker, and appointing vice presidents of marketing and sales more quickly. The research demonstrates that venture capitalists provide strategic guidance and value-adding help. Additionally, the research reveals that VCs have greater control. In particular, it finds that getting VC raises the possibility of hiring an outside CEO to take the place of a founder. Such founder re- placement occurrences are examined in more detail in a different research by Ewens and

Marx. The research first demonstrates that founder replacements are more likely to happen around the time of VC funding and when there are more investors on the firm board using a large sample of U.S. VC transactions. The question of whether founder replacements enhance business performance is then raised, as shown by the likelihood of a successful exit through IPO or purchase. A negative link between founder replacement and exit performance is seen in the raw data. However, based on the information, we may draw the conclusion that this may be the result of either a selection effect, where founder replacements mostly occur in failing firms, or a treatment impact. The authors conclude that founder replacements enhance company performance by finding a negative selection impact but a positive treatment effect using cutting-edge statistical approaches. When founders take more senior roles, particularly those of CEO or CFO, the therapeutic impact is larger. Additionally, it is more effective when the founders truly shut down the business as opposed to just giving up their senior executive role and sticking around.

Do all VCs provide value equally? According to study by Bottazzi, Da Rin, and Hellmann, there is a wide range in the level of activity among VC companies in Europe.Involvement in their companies increases for VC partners having previous business expertise, such as being an entrepreneur, manager, or consultant. VC partners with past work experience in the financial industry cannot be regarded to be the same. The kind of VC company matters as well. Contrary to corporate, bank, or government VCs, private independent VCs take a far more active role in the businesses they invest. The authors discover in the raw data a similar negative link between investor engagement and exit performance to the earlier analysis. However, they discover that active involvement boosts business success if they econometrically isolate the effects of selection and treatment.

The Issue of Manager Replacement

Evidence on the connection between VC investment and founder replacements has already been brought up; this is one of the key reasons why entrepreneurs and investors clash. We look more carefully at this connection in this. Investors don't want to run businesses; they want to invest in them. Therefore, it is not unexpected that investors are eager to make the required adjustments to fix an issue with the leadership. Investors typically demand contractual control rights that provide them the ability to seize control in certain circumstances. Investors will attempt to remove top management if there is a serious issue, notably the CEO, providing they have the power to do so. Why do these issues develop? Some entrepreneurs end up being excellent engineers or visionaries but terrible managers. Others just disagree with the investors on the best approach for the business. The replacement of a CEO is often amicable and long expected. At the time of fundraising, savvy investors established expectations around leadership transitions. For instance, the VC may debate when a professional CEO with business expertise will be recruited into the firm when a technology creator asks for venture capital investment. Sometimes, when a founding CEO is replaced, the founders are asked to refocus their efforts rather than leaving.

Many entrepreneurs embrace the transition in power since it enables them to concentrate on their strong suits, such creating new technologies and driving sales, to have a seasoned CEO. Regrettably, CEO replacements may occasionally get contentious. Investors prioritize removing the CEO from a position of power after their lack of trust in the CEO has been expressed in order to stop any more damage or blockage. of other instances, the board of directors has already identified a new CEO, enabling a speedy change of leadership. However, in other circumstances, the issue is unexpected. Investors often designate an interim CEO in such circumstances. Even an investor has been known to temporarily serve as CEO. From the standpoint of an investor, changing a CEO entail managing a challenging and dangerous transition to a new firm leadership. Such a delicate adjustment calls for talent, experience, as well as time. From the perspective of an entrepreneur, it is prudent to address succession problems up early, preferably before finalizing any deals. Entrepreneurs must be particularly careful of the agreed control rights. They could also need appropriate legal counsel about how to manage such situations once they arise [8]–[10].

CONCLUSION

In conclusion, Informal control has a big impact on how people behave, make decisions, and shape company culture. It functions via internal social dynamics, mutual values, and unofficial networks. Organizations may influence employee behavior, encourage cooperation, and boost overall organizational success by realizing and using the potential of informal control. In order to maximize the advantages of informal control while minimizing any possible drawbacks, effective leadership and a balanced approach to formal and informal control systems are essential. Additionally, companies must balance their use of official and informal control systems. Informal control permits flexibility, adaptation, and innovation whereas formal control offers structure and responsibility. Organizations that successfully combine the two types of control may promote a vibrant and productive workplace.

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CHAPTER 18

TALES FROM THE VENTURE ARCHIVES: FIXING CORPORATE GOVERNANCE AT UBER

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ABSTRACT:

Tales from the Venture Archives fixing corporate governance at uber delves into the corporate governance challenges faced by Uber, a prominent transportation network company, and the subsequent efforts to address and improve its governance practices. The abstract explores the story of Uber's governance struggles, the catalysts for change, and the lessons learned from this transformative journey. The abstract begins by setting the stage with an overview of Uber's rapid rise as a disruptive force in the transportation industry and the consequent governance issues that emerged. It highlights the importance of effective corporate governance in guiding and managing a company's operations, strategy, and relationships with stakeholders.

KEYWORDS:

Accountability, Board, Corporate, Crisis, Directors, Governance, Leadership, Organizational, Management.

INTRODUCTION

Undoubtedly, the most successful start-up business of the 2010s was Uber. The firm has received close to $25 billion in equity fundraising by the beginning of 2018, giving it an estimated post-money worth of over $70 billion. It planned to go public in the spring of 2019 with a target value of around $100 billion. On Valentine's Day 2011, Benchmark, a renowned Silicon Valley venture capital company, made its first investment at a value of $5.4 million. The partnership with Benchmark, though, scarcely qualifies as a romantic one. When Benchmark orchestrated Travis Kalanick's departure as Uber's original CEO in the summer of 2017, tensions reached their height. Uber was the industry innovator for taxi hailing applications, upending the personal transportation industry. While Uber's company expanded quickly across the world, it also encountered strong criticism. While its own drivers aspired to be recognized as workers rather than being self-employed on zero hours contracts, traditional taxi drivers often protested against Uber's unfair business methods. Uber was prohibited in multiple cities as a result of allegations of various unlawful acts made by several local authorities [1].

Even by Uber standards, 2017 was a unique year. A public relations nightmare began in January when the corporation was accused of berating its own drivers. Following a wide spread delete uber movement, 200K individuals deleted the app from their phones. A former Uber employee claimed online in February that the company's human resources division had disregarded several sexual harassment allegations. This followed prior press reports claiming that the firm did not give a damn about rape allegations made against Uber drivers. In the same month, a video of Kalanick yelling at an Uber driver was published online. In addition, Google filed a lawsuit accusing Uber of stealing its intellectual property, and the U.S. Justice Department launched an investigation into claims that Uber created a mechanism to circumvent law enforcement in

March. Uber hired former attorney general Eric Holder to draft a study on enhancing Uber's working culture in response to all of these controversies. The report's conclusion was very clear Uber needed to strengthen its senior management team and reduce its reliance on the CEO. Being run by Kalanick without either a chief operational officer or a chief financial officer made Uber unusual [2].

Additional independent board members, an independent board chair, and an oversight committee were also suggested in the study. In June, Kalanick agreed to step down as CEO at a board meeting. A week later, numerous investors advanced, with Benchmark leading the way. They persuaded Kalanick to step down as CEO even though he continued to serve on the board of directors. This was, in some ways, a variation on a common VC tale founder outlives usefulness and gets removed by investors. However, Uber being Uber, there was more to come. Dara Khosrowshahi, a seasoned executive, was chosen to serve as CEO in August 2017. Then Benchmark made the extraordinary decision to sue its own portfolio company, putting the value of its own assets at jeopardy. The agreement Kalanick had gotten from Uber's board of directors to nominate three more board members was at dispute. According to the lawsuit, Kalanick intentionally hid and willfully misrepresented the fact that he really controlled these three members. Let's take a quick look at Uber's share structure so that you can fully understand the strategic purpose of this case. Benchmark possessed 13% of the shares and controlled 20% of the voting power at the time of the lawsuit, while Kalanick held 10% of the shares and 16% of the votes46. Despite being the two biggest stockholders, neither had any influence. Thus, the Benchmark lawsuit sought to gain greater power.

Benchmark used it as a negotiating chip, promising to dismiss the case if Kalanick agreed to a complicated agreement mediated by Japanese investment giant SoftBank. In the end, this agreement was reached on January 20 at 18:47 Investing $9.3 billion with its co-investors at a post-money value of $54 billion is a 20% reduction from the previous round. The majority of the shares sold came from Benchmark, which decreased its holding by 2%, Kalanick, who decreased his holding by 3%, as well as a number of other existing owners. The board now comprised 17 members instead of the previous summer's 7 members. In order to simplify the voting process, each share was given one vote. Thus, neither Kalanick the entrepreneur nor Benchmark the investor would have a disproportionate amount of authority thanks to the improved governance system created by the Soft bank acquisition. Dara Khosrowshahi said in an interview: The Corporation hired me as a result of a number of things that occurred in the past. It's likely that we made blunders by sacrificing moral behavior in favor of expansion and thinking too aggressively about competitiveness. Fewer errors result from effective governance from the beginning. It may have made 2017 for Uber less exciting but simpler [3].

DISCUSSION

The supply of equity finance via several investment rounds is examined here. We first go through the justification for a phased investment round from the viewpoints of both entrepreneurs and investors. The advantage of delaying the sale of a portion of their business for a greater price at a later time outweighs the risk that the market would worsen, they will have to give investors more control, or they may not be able to raise more money. The option value of ending failing ventures benefits investors. Additionally, staging may lead to conflicts of interest between existing and new investors, which can be resolved by contractual provisions and renegotiation. Anti-dilution protection, preemp-tion rights, and pay-to-play provisions are all pertinent phrases. We also go into how investors should react to doing poorly. The conclusion looks at dynamic investing tactics that balance short and long term objectives[4], [5].

Reasons to Use Staged Financing

Some startups simply need a little amount of funding and rapidly discover a profitable route. These businesses only need one round of financing. However, the majority of start-ups focused on expansion experience protracted periods of negative cash flow. To continue expanding, they are dependent on obtaining more funding. Thus, equity is raised over the course of many investment rounds. This approach is known as staged financing [6].

The Purpose of Staging

Investors might simply provide a business with the upfront money it needs to get cash flow positive. Though it doesn't happen often. For both business owners and investors, the advantages of staging often outweigh the expenses. Staging enables the entrepreneur to minimize the cost of capital by delaying the sale of some of the stock required to generate a positive cash flow. However, staging creates ambiguity about upcoming funding. It could not come at all or it might come later. Additionally, if the business grows more slowly than anticipated or if the market circumstances worsen, the cost may increase. Staging offers the investor the chance to postpone the choice to continue financing, lowering the amount of money at risk. By having the authority to determine whether or not to continue supporting the business, it also provides the investor a great deal of influence over the endeavor. But staging necessitates lengthy negotiations that are expensive for both sides. Think about the scenario when the entrepreneur receives long-term complete funding. The investor would have a very tough time recovering his investment. If a problem arises with the business, the owner is inclined to keep spending until there is no more money. Effectively, staged funding removes the entrepreneur's control over the choice to end a company. The need to get more finance also provides the entrepreneur with motivation to effectively handle the funds and concentrate on achieving milestones [7].

New Perspectives on Dynamic Games

One of the recipients of the Nobel Prize in Economics in 1994 was Richard Selten, for their groundbreaking analysis of equilibria in the theory of non-cooperative games. Finn E. Kydlandand Edward C. Prescott received the 2004 Nobel Prize in Physiology or Medicine for their contributions to dynamic macroeconomics the time consistency of economic policy and the driving forces behind business cycles. Lastly, Eric Maskin was one of the honorees in 2007 for having established the theoretical underpinnings of mechanism design theory.Although none of these brilliant individuals gave staged finance any thought, their ideas are very helpful for comprehending the dynamic behaviors that influence the staged financing process. Developing an understanding of dynamic games, and in particular the idea of subgame perfection, was Richard Selten's major contribution. While the name may seem mysterious, it really has a very clear meaning. All parties foresee future conduct in situations that are dynamic [8] .

These forecasts are difficult because there are so many options and possibilities for the present and the future to take into account. Selten created the idea of subgame perfection as a method for determining which future actions are likely to occur and which ones are not likely to since they are not in the interests of the parties. The phrase subgame perfect really refers to choosing a strategy that serves the interests of the side at each level of the negotiation. This provided a clear knowledge of how to consider dynamic interactions for game theorists. In a dynamic game of staged financing, the entrepreneur and early investors must take into account what will happen in subsequent stages. They must take into account not just their own future behavior, but also that of other, later-stage investors. The requirement for parties to consider renegotiation is one of the key lessons from subgame perfection. There is nothing stopping an entrepreneur and investor from altering their agreement at a later time, even if they first agree on a contract. The original negotiation should take this into consideration if the two sides anticipate further renegotiations. Consider angel investors who are aware that any existing preferred shares would be asked to be converted into common shares by new investors in subsequent funding rounds to demonstrate how this may play out [9].

Future investors often have the ability to accept such demands since they are the ones holding the money. Knowing that they will eventually have to convert them, wise angel investors would forego using their negotiating position to acquire preferred shares. The issue of time inconsistent preferences, sometimes referred to as the changing your mind problem, is one that Kydland and Prescott have identified. When presented with a choice later on in a dynamic game, players often wish to pre-commit to taking one course of action yet prefer another. A well-known example is bargaining with kidnappers. To reduce the motivation for abduction, the police want to formally vow to never paying ransom to abductors. However, when confronted with an abduction situation, they choose to pay in order to spare the victim's life. This concept is used to macroeconomic policy by Kydland and Prescott. They point out that governments should commit to a predicably restrictive monetary policy in order to guarantee low inflation. However, governments are quick to relax their monetary policy in response to indicators of economic weakness in order to boost employment.

In the end, this results in inflation. As a result, governments have preferences that change throughout time. With phased financing, this issue of time-inconsistent desires also arises. Investors may wish to commit to a certain future course of conduct at an early stage, but as they reach a later stage, they may no longer want to act in that way. The Eric Maskin-analyzed soft-budget issue is a prime illustration. An investor may choose to pre-commit to only refinance projects with extraordinary success, but not those with average performance, in order to give significant incentives for exceptional performance. However, if the net present value is positive, the investor will refinance both outstanding and common ventures. Because the investor is unwilling to commit to a strict termination policy, the entrepreneur's incentives to provide exceptional performance are already diminished. Thus, the soft-budget issue is one of desires that are inconsistent with time.

Investments and Ownership in Stages

In our discussion of the financial strategy, we identified two key financing requirements: the total amount of money the enterprise requires and the current amount of money it requires. Because there is a resolution of ambiguity about the business risks at each milestone, milestones are crucial in dividing fundraising into phases. When a business makes its first sales, for instance, it demonstrates that there is some interest in its goods. Staging enables investors to make effective refinancing choices by identifying useful milestones. How much should be put into each round of betting? Giving a business too little cash makes no sense since it will have little possibility of hitting a significant milestone. Giving a business too much money, however, poses a risk since it might promote wasteful conduct. For instance, the business could disregard warning signs and continue on a road toward financial ruin. In reality, a lot of startups raise money to last one to two years. Economic conditions can affect how much money is raised in a round and how long it lasts. According to Gompers, there is greater staging in sectors with higher intangible asset and R&D investment levels. The implication is that organizations operating in these industries need closer oversight. According to a Tian research, investors who are situated more away from the business depend more on staging. Given that they cannot closely supervise their enterprises, farther away investors rely increasingly on financial control of their businesses [10].

The amount invested in a round is influenced by the demands of the firm as well as the preferences of the investors and their financial capabilities. In order to reduce transaction costs or to encourage more entrepreneurial innovation, some investors prefer fewer, bigger rounds. Other investors, however, may have restricted investment budgets or choose to limit their exposure in order to diversify their portfolios. Even if the entrepreneur requests a bigger round, investors may not be able to or won't be as keen to contribute. In this situation, adding more syndication partners to top up a round is also a possibility. Take a look at a simple example to understand staging in practice. Take the example of a company that requires $2 million to reach its first milestone in a year, $3 million to reach its second milestone in two years, and then another $10 million to grow up and be purchased in three years. Think of three different stage arrangements. First, there is no staging, therefore all $15M must be raised up front. This would guarantee that the business owner has the cash to carry out her undertaking. The issue for the investor is that this transaction structure encourages the entrepreneur to spend the whole $15 million, regardless of any intermediate indications of the venture's value.

A second strategy is to break up the investment into three separate, smaller rounds of $2 million, $3 million, and $10 million. This would provide the investor the most freedom and require the entrepreneur to relinquish the least amount of control. However, it would take more time to raise the money and would increase uncertainty over the state of the market in the future. A middle ground would be to use fewer, bigger stages. For instance, the business may raise $5 million up front, which would cover the first two milestones, and $10 million afterwards, assuming they have been reached. This middle ground strategy gives the entrepreneur less time to raise capital while yet preserving some investor flexibility. In particular, the investor has the right to keep the $10 million in the event that the business does not reach its two goals. Presents an illustration of how various staging approaches affect the entrepreneur's ownership dilution. Staged financing enables the business owner to have greater control. Consider a scenario where the business owner initially owns 10 million shares and anticipates receiving a $10 million pre-money value regardless of how the financing is staged.

In the single round scenario, the post-money value is $25 million, and the investor receives 15 million shares in exchange for a 60% interest. The share price then drops to $1. The business owner raises $5M in the first round of two rounds, giving the investor a 33.3% ownership stake and 5M shares in return. We anticipate that the share price will increase to $3 for the second round, making the pre-money worth $45M. For his $10 million investment, the investor receives 3.3 million extra shares, bringing his total holding to 45.5%. The entrepreneur raises $2 million, $3 million, and $10 million in three rounds, with an increase in share price from $1 to $1.8 to $3, correspondingly. The investor acquires 2M, 1.7M, and 3.3M shares at the three rounds using the same reasoning as earlier, giving them a total of 7M shares and a final ownership of 41.2%. The key finding is that staging prevents the entrepreneurs' ownership from being too diluted. They only concede 41.2% after three rounds, compared to 45.5% after two rounds and 60% after one.

However, increasing the number of rounds is not a foolproof way to lower dilution. With staging, there is a chance that the business won't be able to obtain the extra funds or that unfavorable business or market circumstances would lead the share price to drop across rounds. The bottom of details what would occur if the second round's share price dropped to $0.6. In this instance, the entrepreneur ultimately forfeits 50.8% of the business. In general, staging lessens the entrepreneur's dilution whenever the price per share rises over time. There is no dilution benefit if the price per share stays the same across all rounds. The obvious issue is why share prices should, on average, increase with time. The short explanation is that startups often either succeed or fail, and as a result either raise money at greater rates or do not raise any money at all. We need to understand how share prices and value behave over time, is a more comprehensive response. So far, all prices and values have been fixed randomly in our case. We describe how to apply the VC valuation approach to get internal consistent values across many stages. We are currently examining basic decision trees to determine whether or not to finance another round using this approach.

The Option Value of Staging

We now present the real options strategy, which includes solving decision trees that represent the roles of risk, chance, and rewards in investing choices. This strategy is predicated on the notion that making judgments gradually has merit. This calls for recognizing the checkpoints and financial choices that are made in our situation. With the help of this, we can quantify the worth of project staging investments, when project abandonment is a possibility at each step. Keep in mind that the PROFEX model and our strategy are both quite similar. Returning to the previous example, we now obtain internally consistent values from inside a model rather than utilizing rather arbitrary pricing and valuations. This necessitates making exit value assumptions. Assume that the firm obtains a $200 million exit value in the event of success. However, only 10% of attempts will succeed. Specifically, there is a 40% chance that the first milestone will be reached after the first year, a 50% chance that the second milestone will be reached after the second year, and a 50% chance that the final milestone will be reached in the three years that follow. If the business fails, we presume it is worthless.

Finance Experimental Research

There are difficulties in financing entrepreneurial experiments. There is a high option value of staging if the investor maintains strict control over the project and only provides cash in modest amounts. As said, maintaining strict budget limitations offers additional powerful performance incentives. However, there are drawbacks to this strategy as well. Hard budget initiatives are the ones where the bets are fully understood and prosper. To be able to assess if a milestone has been reached, it must be clearly stated. This is effective for incremental innovation, but what about radical breakthroughs where the experiments are unclear and the milestones are often shifting? For such, it would appear that a different finance strategy that prioritizes flexibility and leisure is preferable. Azoulay, Graff Zivin, and Manso's academic study on medical research grants, for instance, demonstrates that when provided flexible long-term financing, scientists participate in significantly riskier long-term research, and when given short funding cycles, they return to more incremental research. The issue with a looser approach to financing is that business owners may utilize their flexibility to pursue failing endeavors for an excessive amount of time or even redirect cash to other side projects. Since neither the strict nor the liberal method appears to provide a practical option for really inventive entrepreneurs and their investors, this presents the challenge of funding experimentation.

Hot markets and reduced experimental costs are two economic factors that assist to resolve this conundrum. Cycles of hot markets, characterized by optimism and excessive exuberance, and down markets, characterized by pessimism and a flight to safer assets, are common in the VC funding and IPO markets. Nanda and Rhodes-Kropf's research demonstrates that booming marketplaces promote investments in radical innovation. The fundamental assumption is that since investors believe the firm has a strong probability of obtaining further money in the future, they are more ready to wager on a hazardous endeavor. According to the report, VCs take riskier bets in booming markets, as seen by the increased number of bankruptcies and IPOs with larger valuations. Additionally, they make investments in businesses that are more inventive, as seen by the quantity and quality of their patents. Lower experimentation costs are the second economic criterion. The cost of launching a new business has decreased since the middle of the 2000s as a result of the growth of the Internet, the arrival of cloud computing, the increase of global outsourcing, and the lean start-up movement.

The landscape of entrepreneurial funding has transformed as a result, particularly at the seed level. We talk about the development of angel investors, crowdsourcing, and other early-stage financing strategies. These changes have all reduced the cost of trying your hand at entrepreneurship. Ewens, Nanda, and Rhodes-Kropf examined the advent of cloud computing in their academic research. It demonstrates that the average seed investment amount decreased exactly in the industries where cloud computing was common. It's interesting to note that this only holds true for the early experimenting stages and not for the later phases of business growth. The research also demonstrates that investors changed how they approached their investments. They progressively adopted a spray and pray strategy, investing in several businesses at first, but only giving follow-on finance to a select few that had obvious success. 500 Start-ups, a venture capital fund whose name supports such an approach, is a well-known example. The fund, which was established in 2010, has approximately 2,000 investments throughout the first eight years of its existence. Approximately one new investment results from this for each working day [10].

Tranching

So far, we have contrasted staged funding with single round financing. An intermediary method of staging is tranching, or milestone financing. It is a legal mechanism that stipulates the round's total fundraising amount and splits it into tranches, usually two but sometimes three. The first tranche is delivered at the time the contract closes, and the second tranche is paid in accordance with a milestone. Usually, the second tranche's price is equal to the first. According to a research study by Bienz and Hirsch, the likelihood of milestone financing increases when a single investor is providing the funding for the transaction. According to the experts, this serves as a safeguard against a single, strong investor who may otherwise demand onerous conditions in a subsequent round. The payment of the second tranche might be structured in one of two ways in milestone financing. The first step is to designate an automated money release when the milestone has been reached. This necessitates a milestone that is simple to confirm. Giving the investor the choice to release the second tranche is the second. The formal achievement is less significant in this scenario than the investor's confidence in the business. In the aforementioned scenario, a tranched agreement would include an investment of $5M, of which the business would get $2M up front and $3M afterwards. There is a significant distinction between staging and transcription, despite the similarities. In contrast to tranching, when the whole deal structure for the second tranche, in this case $3M, is already in place, staging requires the entrepreneur to go through the complete fundraising process, including establishing a new valuation and drafting a new term sheet. As a result, tranching protects the investor's option value and streamlines the fundraising process, saving both parties time [11], [12].

CONCLUSION

In conclusion, the tale of Uber's governance transition sheds important light on the significance of corporate governance in determining a company's culture, ethics, and performance. Uber was able to regain confidence and solidify its base for long-term development by tackling governance issues head-on and making the required adjustments. The experiences of Uber serve as a reminder of the critical role that good corporate governance plays in fostering organizational success and producing value for all stakeholders. In addition, the abstract looks at the governance reform lessons Uber learnt. It highlights the value of having strong governance frameworks, developing a solid ethical foundation, promoting a diverse and inclusive workplace, and setting up efficient checks and balances. For other businesses, Uber's experience is a useful case study that emphasizes the need of proactively resolving governance issues in order to maintain long-term success.

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CHAPTER 19

OLD VERSUS NEW: UNDERSTANDING INVESTORS DYNAMICS

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ABSTRACT:

Old versus new investors explores the dynamics and implications of the contrasting perspectives and behaviors exhibited by long-standing, established investors referred to as old investors and newer, emerging investors referred to as new investors. This abstract delves into the characteristics, motivations, and potential conflicts that arise between these two investor groups in various contexts. The abstract begins by highlighting the characteristics typically associated with old investors. These investors have a long history of participating in financial markets, possess extensive experience and knowledge, and often exhibit a more conservative and risk-averse investment approach. They tend to prioritize stability, dividends, and proven investment strategies.

KEYWORDS:

Business, Capital, Down, Firm, Investors, Shares.

INTRODUCTION

A combination of new and previous investors may be present in each subsequent round. A round is referred to be an insider round if it is fully funded by existing investors, or those who already hold stock in the firm. A round is considered an outsider round if it is entirely funded by new investors. However, a round is often funded by a combination of new and previous investors. Numerous components of the purchase are impacted by the mix of investors. In this paper, we look at how old and young investors see value in terms of their economic interests. First, consider the scenario of an insider round. This has the benefit that all investors are already aware of the firm and are prepared to move quickly. However, insiders could have significant negotiating power to set the conditions if there is no outside competition. The business can also lose out on new investors who offer unique networks and extra experience. Compare this to a round when an outsider is involved. Although this could broaden networks and experience, it also raises concerns about why none of the current investors are continuing to support the business. They could not have the necessary financial means what are known as deep pockets to continue supporting the business, or they might know something bad about it, which would be much more concerning.

The two extreme situations of insider and outsider funding highlight a number of issues that have an impact on the conditions and framework of mixed agreements. The first concern is how much the existing and prospective investors can contribute and are willing to invest. The second issue is the networks and experience that the existing and new investors will bring to the project. While others focus on later phases, certain investors have developed various networks, areas of specialty, and skill sets. The question of inside knowledge comes in third. A good indicator is when an existing investor contributes to a fresh round. In addition, foreign investors could provide stronger market insight that might influence parameters such as value. Fourth, while entrepreneurs enjoy competition, outsiders run the danger of alienating insiders. These factors provide intriguing bargaining dynamics between entrepreneurs, insiders, and outsiders that influence transaction structure and value. The pro rata amount is a crucial idea in staged financing that influences the interactions between existing and new investors. If an investor owned x percent of the firm before to the round, his pro rata share of the new round's proceeds would be x percent. This portion of the freshly issued shares ensures that the investor's ownership percentage remains constant following the round. For instance, if a firm is raising $10 million and an investor owns 20% of it prior to the round, their pro rata share would be $2 million, or 20% of $10 million. As a result, even after the purchase, his stake will remain at 20%. The pro rata shares of a second investor who owns 15% is $1.5M. Now think about how ownership and value are determined when both internal and external investors are present.

Entrepreneurs want a greater value, whereas new investors choose a lower valuation, all else being equal. How about institutional investors? Or do they want lower valuations? It depends on how much they invest, is the reply. The financial interests of an insider might be seen as being on opposite ends of a spectrum. The economic interests of a new investor, who desires to purchase shares at a cheap price, are opposed to those of an existing shareholder, who prefers the firm to sell shares at a high price. Depending on how much they spend in the current round compared to the existing share, the latter will count more or less. The precise point at which these two pressures balance one another is the p r o rata investment amount. The insider maintains his ownership percentage independent of the share price by investing pro rata. Therefore, he doesn't care if prices are greater or lower. This is equivalent to the scale's two sides being perfectly balanced. In such situation, his ownership decreases as a result of the round, diluting his insider share. Higher values are now preferred by the insider since they lessen the dilution of his ownership. If the insider is investing more than pro rata, the situation is the reverse. In this instance, after the round, his net ownership grows, and it grows more if the value is lower [1]–[3].

DISCUSSION

Term Sheets for Staging

We will take a look at a few of the problems that might come up during term sheet talks in a staged transaction. As the talk progresses, we now look at some of the problems that are unique to staging and the interactions between existing and new shareholders. We examine anti-dilution provisions, convertible stock seniority, and a number of other clauses. We discuss in The Liquidation Stack how preferred shares are often held by investors. The issue of how distinct Series of preferred shares interact with one another arises in the context of staged financing. Each round of fundraising generates a unique Series of shares. Preferred shares issued to Series B investors have distinct rights from those granted to Series A investors' preferred shares, and so on. How are preferential rights among various share classes compared to one another? Because preferred shares have liquidation preferences, this arrangement is known as the liquidation stack.

The conventional approach is for Series B investors to be subordinate to Series A investors, giving them more seniority and the right to receive payment first in the event of a liquidation. The primary option is to treat Series A and Series B pari passu, which is a Latin expression that meaning at the same pace and denotes that they are given equal precedence. With each new Series, a comparable negotiation takes place. Since they own common stock, which is subordinate to all of the preferred stock, the business owners are not very worried about this.

Thus, Series A and B holders are the key parties to the discussion. The fact that certain Series A investors may also participate in the Series B and therefore have mixed economic interests, similar to what we explain, further complicates the economic interests of the different negotiating parties. Setting precedents is a significant challenge in staged financing. The Series A investors will follow suit, followed by the Series B investors, the Series C investors, and so on, if they want numerous liquidation preferences. A $50M Series E investment with the same terms would result in a $100M preferred claim, but a $2M Series A investment with the same duration would only result in a $4M preferred claim. Therefore, shrewd investors who are aware of precedent-setting may hold off on imposing too many onerous restrictions in the first rounds.

The fact that formal choices are made by voting by share class we show how the aggregation of votes functions can further complicate later-round negotiations. In this situation, it is feasible that a majority of investors within a share class might accept a transaction that the remaining minority of investors would find unfavorable. Consider a scenario in which the Series A holders are asked to decide whether they are prepared to give the Series B investors priority over them in the voting process. They may support this proposal if the majority of the Series A shareholders also participate significantly in the Series B financing. The small portion of Series A holders who do not take part in the B round, however, would object to such subordination. Groups of investors may get tense as a result of this. There can be a lawsuit that claims the rights of minority shareholders under exceptional circumstances. However, in most cases, these disputes are settled via negotiation amongst all the parties concerned[4], [5].

Against Diluting Rights

The anti-dilution provision with regard to staged financing is a significant and sometimes controversial subject. In the event of a subsequent down round, when the firm offers new shares at a lower price than those paid by the prior investor, anti-dilution rights safeguard investors. An anti-dilution provision is designed to compensate investors who purchased shares at what turned out to be an excessive price at the time of the new round. It details how the price of a previous round is changed in the case that a future round has a lower price. Remember that preferred stock protects investors against disappointing future exits on the downside. Instead, anti-dilution protects investors against disappointing future investment rounds. Think about what might occur in a down round without anti-dilution protection as a standard. We refer to a first round and second round for the sake of illustration, although any further rounds might be represented by them[6], [7].

Further Rights

In most cases, inside investors are granted certain contractual protections for their ownership position in the firm. Existing shareholders have the right to acquire a specific proportion of every fresh share issuance via preemption rights. An current investor has the option to purchase up to his prorata amount under the normal formula. Or, to put it another way, the corporation must give an existing shareholder enough shares to preserve his present ownership interest. Anyone, whether an existing shareholder or a new investor, may accept the remaining shares. Existing shareholders may also buy shares from one existing shareholder if he decides not to buy his complete pro rata share. When shares are issued as part of converting convertible stock or to start or refill an employee stock option pool, preemption rights are not affected. Occasionally, only shareholders who own a certain minimum number of shares are granted these rights. This implies that if the firm wishes to obtain more funding, it need not get in touch with all of the tiny owners.

The preemption rights and first refusal rights are closely connected. The right of first refusal, as opposed to preemption rights, pertains to the selling of already-issued shares. In the first place, the corporation usually reserves for itself a right of first refusal, which prohibits current owners from selling their shares to outside parties. Investors often request extra rights of first refusal, which give them the option to purchase shares that other parties desire to sell in place of the firm. The purpose of the right of first refusal is to retain insiders in control of who owns firm shares, preventing a loss of such control. Old investors must keep investing in order to maintain their privileged advantages under pay-to-play terms. Paying normally entails making a minimum investment in the next round, usually the pro rata amount, but it may be less. The effects of not investing might be complex. For instance, the preferred shares of the investor becomes ordinary. Less dramatically, the investor might lose control rights, liquidation privileges, or preemption rights in addition to anti-dilution protection. The pay-to-play clause's principal goal is to persuade existing investors to keep making investments in the business. They get continual protection when they do when they don't, they suffer the repercussions. Thus, pay-to-play agreements resolve disputes between various inside investors, where some are eager to take part in a fresh round while others would like to wait it out.

A pull-up is a somewhat different agreement since it offers the carrot without the stick. Old investors that contribute to the new round are specifically given the option to convert their current preferred stock into a new class of preferred stock with enhanced advantages, such as better liquidation preference or stronger anti-dilution rights. Finally, updating the stock option pool is often necessary for new investment rounds. This pool often needs to be restocked since it has been depleted over time. Therefore, who would pay for it must be decided by the new and existing investors. The directors' board was the subject of the last discussion. In order to accommodate the extra investors, it was anticipated that the board would be expanded to seven members. Immediately, UmijaUlimwengu consented to join the board. According to Dr. Franz Fröhliche, he did not desire a formal board seat but rather board observer privileges as a business investor. Malcolm Force's involvement was a more crucial problem. He had been appointed initially as an independent director but has now joined the management group. As a result, it was decided that the seventh director should be an entirely new independent filmmaker. Sadly, here is where things became complicated. René Réseau, one of Ali's most successful businessmen with a strong worldwide network, had previously been targeted by the corporation.

Umija insisted that Stanley Goldmorgan, an investment banker friend of hers who had successfully listed a number of IT businesses on Nasdaq, serve as the external director. Astrid saw this as Umija's primary priority and jumped at the chance. She proposed a horse deal for Stanley in exchange for a $8 stock option pool. Michael objected, saying, I don't mean to sound petty, but you guys have great finances, and I am only a small-town angel. Umija agreed, and the transaction was soon unstuck once again. I have no influence in this situation, so you may simply disregard me, but I think the pay-to-play rule is a bit harsh. A retroactive pay-to-play provision in the term sheet stated that any Series A investor who failed to invest his pro rata part would be required to convert to common shares. Coyo-T Capital was investing over pro rata, while Eagle-I Ventures was investing at pro rata, therefore none of them was impacted. However, Michael Archie was impacted. He was only able to contribute 1% of the fresh round while owning 2.5% of the business. Technically, he contributed 40% of his pro rata portion, which meant that 25,000 of his 41,667 Series A preferred shares would convert to common shares at a 60% rate. I believed the pay-to-play provision was there to reprimand investors for not stepping up.

Although this may seem like a little sum to you, I am investing $100,000 of my own money. Why do I still have to suffer punishment? The transaction was finalized when Umija graciously agreed to forgo the play-to-play provision.

Financial Challenges

While business owners and investors often dream of great development, the reality sometimes seems more depressing. Even if a new business endeavor succeeds in the end, the entrepreneurial journey is typically difficult and often fraught with setbacks. In this, we examine how these corporate challenges may affect fundraising. What transpires if a corporation can only bring in fresh capital at a lower value than before? What if it can only get financing under conditions that essentially nullify all prior shareholder claims? And what if the firm is completely barred from receiving funding?

Rounds Down

Term sheets' treatment of down rounds was previously covered in our discussion of anti-dilution provisions. We now go more deeply into the bigger issues that down rounds raise. When the price per share is less than it was in the previous round, the round is said to be down.23 This is the same as having a post-money value that is lower than the pre-money valuation of the prior round. A renowned law firm, Fenwick and West, provides information on Silicon Valley venture capital agreements. They discovered that 75% of the rounds during the first quarter of 2018 were up, 15% were down, and 10% were unchanged. In the first quarter of 2009, for example, 46% of the financings were down rounds, 29% were flat, and just 25% were up. The ratio of down rounds is inevitably cyclical. It may be difficult to structure a down round since it needs the approval of current investors, who are feeling both financial and emotional disappointment due to ownership dilution and emotional sadness over the lack of business advancement. The kind of anti-dilution protection used determines the degree of financial dilution, which may be exacerbated if new investors demand onerous conditions or even a revision of existing agreements. Down rounds have an impact on both the entrepreneurs and the older investors.

We demonstrate that anti-dilution provisions often disadvantage ordinary shareholders the most. This may necessitate the issuing of stock options or common stock and may seriously harm the incentives and motivation of founders and executives. Similar to how a negative round may undermine staff confidence. Some employees may depart because they see it as public proof that the business is struggling. A down round also has an impact on the value of employee stock options. Existing employee stock options have a strike price that is higher than the share price at the time of a down round. As a result, the options are deemed under water and cease to serve as employee incentives. The corporation could wish to reprice these options and attach a lower strike price in order to retain and re-incentivize personnel. To prevent windfall tax requirements for the owners of underwater options, tax and regulatory restrictions must be taken into account. Legal issues are also taken into account in a down round. Directors and investors run the danger of legal action if shares are issued at a lower price than in the preceding round. Investors who are also board members of the business who support a down round may be in violation of their fiduciary obligations to minority investors. They could be well to seek independent director approval, and they might wish to take particular care to be fair. Downturns significantly strain boards of directors since none of this is simple.

Conflicts on the Board

The peak of the dot-com collapse occurred in 2002. Startups only ever acquired investment via down rounds, if at all. How did boards of directors deal with these difficult situations? A study looks at survey answers from 161 CEOs of start-ups with VC funding at the time. The major conclusion is that work conflicts and interpersonal conflicts are both much greater in down rounds. Conflicts over tasks include disagreements over the optimal course of action for businesses to adopt. The interpersonal tension and unfavorable feelings that board members have towards one another are the subject of relationship disputes. The first kind of conflict may be beneficial when the variety of viewpoints results in creative solutions, but it may be damaging when it causes confusion or inactivity. Most people agree that the performance of businesses is harmed by the second kind of dispute. The study's contrast between companies with founder led CEOs and those without is one of its unexpected findings. One would have assumed that having a founding CEO would lead to more friction. Founders are known for having strong beliefs and strong commitments to their businesses. However, the research finds that in down rounds, the levels of conflict for boards with founder vs nonfounder CEOs are relatively comparable. Simply said, disputes arise wherever when things are bad, regardless of who is in power.

Turn

Even if the business may be having trouble, it may still acquire more cash to keep going. Investors' faith in the company's ultimate success is shown by this. What about businesses that really fail to get any new funding? There are two scenarios that may happen either the business raises money in a turnaround, which we shall explain, or it doesn't get any money at all. Let's first quickly analyze the worst-case scenario, in which the firm is completely cut off from financing. It either stops operating or seeks to do so without further funds. In the second scenario, the failing business must substantially cut down on the range of its economic pursuits. Such a business can only continue by terminating the majority of its workers and/or selling off the majority of its assets, all the while praying for a fortuitous breakthrough. The few surviving managers can continue to work part-time for the business while looking for new jobs. The term walking dead or zombie is often used to describe a firm in this condition of affairs.

Turnaround funding aims to prevent these issues. It applies to businesses that still possess important assets that might be combined with alternative technology or a new management group and utilised in a different market. A startup's turnaround mostly depends on management and strategic decisions. This is a financial difficulty since it calls for more money. In a turnaround, the firm is only worth a small portion of what it once was. As a result, existing shareholders the veteran investors, company founders, and employees have their shareholdings significantly diluted. Occasionally, this is referred to as a washout or cram-down round. Any firm debt may also need to be renegotiated, with lenders facing significant losses. Preserving incentives for any surviving founders and workers is a sensitive matter. Setting aside new equity or a new pool of stock options may be necessary for this.

Between new and old investors, turnarounds may lead to significant conflict, particularly if the former are in denial. Parties on the losing side of turnarounds may file lawsuits against the new investors, either during the turnaround itself or after it proves to be effective. Investors may also face reputational concerns from washout rounds. As a result, they are sometimes issued by specialist investors that solely finance failing businesses that need such turnaround funding. These investors do not even attempt to build a positive reputation among the larger entrepreneurial community while having specific experience in resolving turnaround scenarios. The alternative scenario, in which a turnaround is carried out by inside investors, might raise more issues. A corporation that is unable to attract outside investors may seek to use information about its true prospects to its advantage. This indicates that they are using their position of influence to impose a very low valuation despite the fact that they are aware of the company's much higher value. The founders and other stakeholders in this situation are diluted by the washout round, but not the inside investors who are involved on both sides of the transaction. Inducing a firm to accept severely diluted conditions in this way may breach the inside investors' fiduciary duty and give rise to legal action.

Dynamic Approaches

Staged funding is by its very nature a risky procedure, which is reflective of the underlying risks that entrepreneurs face. In order to manage the process, entrepreneurs and investors use a range of tactics. We initially concentrate on how investors approach the staging process before turning our attention to how entrepreneurs manage stage-to-stage values.

Innovative Investment Techniques

An investor's stage preferences, which are correlated with three primary factors, define his point of entrance. First, since various phases demand varying amounts of cash, investors choose the stages that best match their financial capabilities. For instance, government organizations and angel investors often concentrate on pre-seed and seed investments since the necessary capital quantities fall within their tight budgets. However, VC companies often steer clear at such stages and concentrate instead on Series A and upwards. These rounds need sizable investments, which enables them to contribute an amount that justifies their time and effort. Second, investors made their stage strategy decisions based on their knowledge and capacity to benefit the companies. Corporate investors, for instance, often steer clear of early phases since start-ups aren't yet equipped to capitalize on the strategic advantages they provide. In contrast, early phases are when angel investors' networking and mentoring capabilities are most beneficial. Third, various risk levels attract investors in different ways. Investment risk fluctuates throughout the phases, peaking in the early stages and gradually declining as businesses advance to later stages.

The reinvestment plan is the subject of the following strategic choice. There is a range of investors with different financial capabilities. Investors with limited funds have few options since they do not have enough money to keep investing. However, wealthy investors with bigger VC funds or corporate investors carefully consider their investment amounts. Three primary aspects greatly influence their decisions. The investor's confidence in the company's potential comes first. The investor's portfolio approach is the second consideration. How much does he want to increase his exposure to the company's market, location, and technology risk? How much an investor wants to split a transaction with other investors makes up the third component. Whether to retain better offers to oneself and distribute lesser quality deals has a selfish financial component. Regarding how much an investor stresses syndication and connections with other investors, there is also a network component to this. Let's make a distinction between the three main reinvestment philosophies. opportunity driven, predict tional, and no reinvestment. According to the first philosophy, the firm shouldn't anticipate receiving any further cash from an investor. This is often caused by a lack of funding or regulatory restrictions, but it may also be the result of an investor's mindset.

The second mindset is predicated on the idea that the investor plans to continue funding the firm in a reasonably predictable way despite the uncertainties. One straightforward strategy is for the investor to anticipate making a pro rata investment in each round. The opportunity-driven philosophy is the third. In other words, the investor doesn't commit to reinvesting. The investor participates if the company's performance is solid and the conditions of the new round are favorable; otherwise, he may not. It is impossible to declare one approach is superior than the other. firms that have historically done well may not continue to do so in the future or they may become expensive, while firms that have historically struggled may succeed or become more appealing because they are ready to take a lower valuation. According to an academic research by Li and Chi, VC companies who seek an industry specialization plan more consistently maintain supporting a startup over rounds, while VC firms that pursue a wide diversification strategy are more likely to be opportunistic. The ramifications for entrepreneurs of these three strategies vary. When the original capital is exhausted, the no reinvestment strategy encourages the entrepreneur to make the business appealing to new investors. The advantage of the predictive rein-vestment approach is that it gives the entrepreneur more assurance. Additionally, it prevents the signaling issue, in which other investors get anxious when insiders decline a fresh round.

The exact reverse is true with the opportunity-driven approach. It enables investors to increase their bets on the firms they find appealing. Investors desire to support their successes and stay away from backing their failures with excellent investments. However, such a selective strategy does result in a signaling issue, making it difficult for businesses that are not backed by insiders to get outside capital. The choice of whether to refinance a faltering firm or cut off its financing is a crucial component of the reinvesting decision. There are several strategies that may be used in practice. On the more forgiving end of the scale, some investors are devoted to their businesses and stand by them through their hardships, provided that it is possible to ratio- nalize. Naturally, there is uncertainty in this situation since we seldom have concrete information that demonstrates whether or not a firm is beyond saving. In reality, a lot of now-successful start-up businesses were previously in danger of failing. On the opposite end of the spectrum, some investors hold their firms to a strict code of financial discipline. Particularly with opportunity-driven reinvestment methods, this is the case.

Profiles of Dynamic Valuation

We next examine how business owners control the staging process, paying close attention to the sort of value profile the firm intends to develop across the various phases. Entrepreneurs choose greater values than lower ones, all else being equal. We discovered a crucial factor, namely that lower values are sometimes preferred by entrepreneurs when they come from better caliber investors. Now, we'll look at a different reason why business owners may choose a lower value: managing the dynamic valuation profile of their organization. Companies gain from having a growing value profile, where the price per share and post-money valuation continue to increase with each round. To allow for future growth, this can mean accepting somewhat lower early-stage prices. There are both psychological and financial reasons for this, however the argument has some flaws [8]–[10].

CONCLUSION

In conclusion, the interactions between experienced and novice investors show how the financial markets are dynamic and how changing demographics, technology, and investing strategies have an influence. Market players and regulators must comprehend and navigate the divergent opinions and actions of different investment groups. The investing community may use the capabilities of both experienced and young investors to stimulate innovation, resilience, and long-term development in the financial markets by encouraging communication, cooperation, and mutual understanding. Additionally, there may be advantages to cooperation and information sharing between experienced and novice investors. Both groups may learn a lot by combining their unique viewpoints and talents, which may lead to better balanced investing plans. An investing ecosystem that is more resilient and inclusive may benefit from the creation of channels for interaction and education between experienced and novice investors.

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CHAPTER 20

UNDERSTANDING THE WORLD OF DEBT FINANCING

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ABSTRACT:

Debt financing is a fundamental component of corporate finance, allowing businesses to raise capital by borrowing funds from lenders or issuing debt securities. This abstract explores the concept of debt financing, its benefits and challenges, and its implications for businesses and investors. The abstract begins by providing an overview of debt financing as a means for companies to access external funds. It highlights the various sources of debt financing, including bank loans, bonds, and commercial paper. Debt financing offers several advantages, such as enabling companies to finance growth initiatives, fund working capital needs, and take advantage of investment opportunities without diluting ownership.

KEYWORDS:

Bond, Collateral, Credit, Debt, Instruments, Issuance, Risk, Service.

INTRODUCTION

This paper looks at how debt affects new businesses. Before comparing debt to equity, we first look at how debt contracts are structured. We dispel the myth that debt is a more affordable form of funding and go through the many benefits that debt and equity provide to investors and business owners. We provide an explanation of why banks normally do not provide start-ups basic loans. We also examine several types of debt that are available to startups, including personal loans, trade credit, discounting and financing, venture leasing, and venture debt. When a business is funded by a combination of debt and equity, the also discusses how to undertake company valuation, differentiating between a company's enterprise value and a company's equity value. In this paper, we examine the function of debt finance in innovative businesses. We begin by outlining what debt is and how it is organized. An investor in debt is referred to as a lender or creditor. He gives the principal, which is the investment sum, to a borrower, in this case the entrepreneur. The Borrower agrees to make principle and interest payments at specified intervals. We interchange the phrases loan and debt. Although the definition of credit is the same, it is sometimes used more widely to refer to borrowing from non-financial lenders, such as clients or suppliers. Think about the most basic kind of debt, where there is just one installment due at the conclusion of the loan term[1], [2].

Flow of Cash to the Investor

The contrast between secured and unsecured credit is the second. When the borrower commits an asset as security to reassure the lender, the credit is said to be secured. In the event that the credit is not repaid, he is granted the right to hold the asset. On the other hand, an unsecured credit is given based on the venture's capacity to generate sufficient cash flow to repay the loan. There are many different credit structures that may be created using installment and revolving credit, both of which can be secured or unsecured. The third difference, which is about personal vs corporate credit, is especially important in the context of entrepreneurship. With the former, the business owner incurs debt on their own dime and is thus exposed to personal danger. With the latter, the entrepreneurial business, which is safeguarded by limited liability, assumes the credit. We concentrate on corporate credit in this, unless otherwise noted[3], [4].

DISCUSSION

The Structure of Debt Contracts

Here, we provide a quick overview of the several ways debt contracts may be set up. We concentrate on the four aspects of a contract maturity, cost, collateral, and covenants.

Maturity

The ultimate payback date for a debt is known as its maturity. The loan maturity is the span of time between the loan's origination date and its maturity date. In an installment loan, the borrower agrees to a repayment plan with a final principal payment that may include numerous intermediate installments. The interim payments may consist only of interest, as is typical for commercial loans, or they may additionally contain a portion of the principal repayment, as is typical for mortgages. The most common periods for interim payments are monthly, quarterly, or annually. Bullet or balloon loans are those with a single final payment. Conventionally, loans having a one-year or less tenure are referred to as short term loans, whereas loans with a longer expiration are referred to as long term loans. Revolving credit is often extended as long as the borrower's credit situation has not worsened despite having a stated maturity of up to one year[5], [6].

Cost

The interest rate and fees make up the majority of loan costs. There are several methods to arrange the interest rate. The difference between fixed and variable is the most crucial. The interest rate is determined in nominal terms in the fixed scenario. There are various different fees that might limit the real amount of the loan that the borrower is eligible for, sometimes significantly. In the variable situation, the interest rate is represented in terms of a variable base rate that reflects market circumstances and a set premium. The application fee, which is often a predetermined charge that is unrelated to the loan amount, pays for the costs associated with the loan approval procedure. Lenders often levy a commitment fee in conjunction with revolving credit as payment for maintaining some money at the borrower's disposal. The quantity of funds made available determines how much this cost will be. Other costs are based on the qualities of the loan or the borrower. For instance, an early repayment charge on an installment loan might be used to make up for the lender receiving the principle before the loan's scheduled maturity date. Additionally, defaulting debtors may be charged a late payment fee, which is often proportionate to the delay and the amount owed [7]–[9].

Collateral

Secured loan transactions often include collateral. Generally speaking, the lender aims to use assets that may be quickly confiscated in event of failure to secure the loan. The majority of collateralized assets are physical, such as real estate, machinery, or stock. Additionally, lenders favor assets that are simple to resell; some inventory is general and simple to sell, while other inventory is more specialized and challenging to sell. In rare situations, lenders may also take intellectual property and other intangible assets as collateral. For the purpose of recovering defaulted loans, a difference between recourse and nonresource loans is important. In the event of failure on a nonrecourse loan, the lender is only entitled to the collateral. But with a recourse loan, the lender has the right to seize the collateral; nevertheless, if the collateral's value is insufficient to pay back the whole loan, the lender may go farther and demand other forms of repayment.

Covenants

To safeguard the value of the money they have pledged and to make repossession easier in the event of failure, lenders set a number of requirements known as covenants. In a legal sense, covenants are requirements that the borrower commits to follow. Lenders are prohibited from taking certain steps, such as calling in the loan, as long as the covenants are upheld. There are many different kinds of covenants, and riskier loans often have more of them.3 The first set of covenants focuses on the company's liquidity and solvency. For instance, a minimal interest coverage ratio assesses a company's capacity to fulfill its interest obligations. The debt to equity ratio, which restricts the borrower's capacity to issue further debt, and the loan life coverage ratio, an interest coverage ratio tailored to a particular loan, are other relevant measurements. A second set of covenants relates to the company's profitability. Common minimum ratios include the ebitda margin, return on assets, return on equity, and return on capital. Additionally, covenants may be based on a range of business-specific characteristics. For instance, a covenant based on a company's customer conversion rate can exist. These covenants must be trustworthy indicators of company success in order to be effective. As a result, they are more suited for established companies than for startups with hazy futures and a lack of trustworthy performance indicators.

The agreements covered up to this point are positive covenants that provide the lender the right to step in if the terms are breached. Additionally, there are negative covenants that prevent debtors from doing specific things. Examples include limitations on dividend distribution or changes to the corporate structure, such as a firm merger. It should be noted that such a negative covenant just provides the lender the ability to call in the loan when the covenant has been broken; it does not preclude a firm from merging with another. Lenders are given two options in the event of default. They may first start official bankruptcy procedures. Lenders also have the option of renegotiating the loan. The future financing connection is maintained, and this option is often less expensive. Lenders may utilize covenants to demand an early loan renegotiation rather than waiting for default. This results in a debt modification that can maintain the venture's sustainability and the value of the collateral while avoiding the need for an expensive formal bankruptcy. In a loan restructuring, the loan's maturity date and interest rate may both be extended.

Equity versus Debt

Debt is cheaper than equity is a fallacy. Entrepreneurs are often drawn to debt since it is nondilutive. Because the entrepreneur may keep her stake in the business, it is thought that debt financing is less expensive. Although it may seem convincing, this reasoning might be deceptive. We discuss the groundbreaking work of three Nobel laureates, which set the groundwork for comprehending the cost of debt and equity. Franco Modigliani received the 1985 Nobel Prize in Economics for his pioneering analyses of saving and of financial markets4 Merton Miller received the 1990 Nobel Prize in Economics for their pioneering work in the theory of financial economics And Joseph Stiglitz received the 2001 Nobel Prize in Economics for their analyses of markets with asymmetric information. The Modigliani Miller the orem, which states that the value of a firm does not depend on the ratio of debt to equity it uses to finance itself, is perhaps their most famous scientific achievement. Because the cost of raising debt and equity is always the same, this implies that a firm cannot increase its value by switching from one unit of debt to one unit of equity, or vice versa.

In a world without financial friction, a company's future cash flows are generated by its asset side of the balance sheet and do not depend on who owns those assets on the liabilities side. The Modigliani-Miller theorem is based on the conventional economic logic of valuing a company by discounting its future cash flows. Both debt and equity investors ultimately look at the discounted value of their portion of future cash flows. The Modigliani-Miller theorem's central premise is that there are no financial frictions, which implies that all economic agents have the same information and that the cost of capital is determined solely by market forces. Despite the fact that we know that this is not always the case, the theorem has gained traction because it offers a strong benchmark for evaluating the relative costs and benefits of debt versus equity once financial frictions are present. While Stiglitz's contributions to economics are vast, here we will focus on his seminal work about the moral hazard and adverse selections problems. This concerns situations where one party that has some information advantage uses it to take self-interested actions that negatively affect the other party, or conceals negative information to obtain better deal. Stiglitz's work has given rise to some of the most compelling arguments about the effective cost of debt financing. Stiglitz showed how debt contracts often lead to poor incentives, while equity can provide better incentives. This suggests that the true cost of debt is typically invisible to accountants.

The Real Price of Unsafe Debt

With his Argentinean wife Mercedes Mendocinas, Mario Mozzarella, a Sicilian immigrant who settled in San Carlos di Bariloche, a small Patagonian town in the foothills of the Andes, opened an empanadas restaurant that quickly gained notoriety as the best empanadas south of the Panama Canal. They were swamped with requests for home delivery but had to turn down many customers who lived in far-flung mountain villages until they created. They estimated that their venture had a 50% chance of being a spectacular success, in which case the company would be worth \$7.5M within a year, or it would fail with a residual asset value of \$0.5M. For simplicity, we assume that all parties are risk-neutral and that the safe rate of return in the economy is 10%. This means that all investors need an expected rate of return of 10% on risk-free investments.The following lists the various debt and equity financing options that Mario and Mercedes considered. First, they approached Mercedes's friend and local angel investor, Andres Acciones, who was willing to invest \$1 million in exchange for a 27.5% equity stake in the venture.

Mario asked Andres to contribute the remaining \$0.6M in equity at the same valuation as before, implying a 16.5% stake for him. Mario also considered debt in order to avoid diluting their ownership. Paco Prestador, the director of a local bank, said his bank would be willing to lend him \$0.4M at a rate of 10%. Mario considered taking it. Since equity is junior to debt, Andres' equity would now be levered and less valuable than before, Paco would have to receive \$0.44M before Andres and Mercedes could split any capital gains, the equity would now be worth \$7.06M in case of success but only \$0.06M in case of failure, and the anticipated equity value of \$3.34M would then require an equity stake of 18.5% for Andres. Mercedes immediately realized that Andres would never accept this deal. The difference between the naive approach, which assumes that the equity investors do not respond to an increase in leverage, and the logical approach, where equity investors take leverage into account, is reflected in the fact that, when compared to the first column, the second column has the same post-money valuation net of debt, while the third column has the same post-money valuation gross of debt.

Mario and Mercedes also explored what would happen if they asked for more debt from Paco, say $0.6M. Would that be a better solution, given that debt is less dilutive? They expected that the company would reach a higher valuation as in the Equity and naïve risky debt column. This assumed that Andres required the competitive return rate of 10%, implying an equity share of 12.9%. It also assumed that Paco would continue charging 10% interest. This time it was Mario who realized that Paco could not accept that deal. The loan obligation of $660M was larger than the $500M the venture would be worth in case of failure. This meant that Paco was making a risky loan, which would require him to charge a risk premium. The calculations in the Equity and risky debt column reveal that Paco would need to charge an interest rate of 37% to achieve an expected return of 10%. This higher interest rate further required adjusting Andres's equity share up to 13.2%. With this, the post-money valuation including debt in the fifth column was again the same as in the first and third columns. That is, once all investors received their expected return of 10%, the en-terprise value remained the same, regardless of the mix of debt and equity.

Debt and Equity Comparison

Here we discuss two forces that are most relevant to entrepreneurial companies: transaction costs and incentive costs. Corporate finance books discuss these issues in detail, typically from the perspective of established companies, about whether and when debt is better or worse than equity. We first analyze transaction costs. With debt contracts, transaction costs arise: at the time of investment, during the investment period, and at the time of repayment. At the time of investment, there are due diligence costs for the investor to investigate whether or not the entrepre- neur is sui, and costs of negotiating and legally structuring the investment. Debt contracts are faster and less costly than equity. Second, we analyze taxa- tion matters during the investment period. Corporations have to pay taxes on their profits but can deduct interest payments from taxable profits. There is no equivalent tax shield for equity. While the tax argument is very important for es- tablished companies, entrepreneurial ventures are often slow to generate profits. Therefore, the tax argument has relatively little sway in the context of early-stage ventures. Third, when it comes to repayment, debt and equity are very different. The transaction costs of repaying equity are the direct and indirect costs of structuring an exit.

We discuss those costs. For debt, the main problem is the cost of bankruptcy. Without default, the transaction costs of repaying debt are minimal. With default, however, the costs are substantial, as discussed in horizontal axis represents the company value, the vertical axis the cash flows to investors. Why banks refuse to fund startups. Bank loans are the most popular method of financing small businesses; therefore, why does a book on entrepreneurial finance wait until chapter 10 to discuss bank debt? Entrepreneurial companies are not your typical small business; instead, established small businesses with predictable positive cash flows are frequently financed by banks, while entrepreneurial ventures are not? Consider a commercial loan application by a limited liability company. A bank loan officer cares about two criteria: the probability of default and the re- covery rate in case of default. The probability of default depends on the expected level and stability of earnings. To assess this probability, the loan officer is likely to look for a track record of steady revenues, s costs, and an experienced and competent management team. None of these apply to entrepreneurial ventures, as can be seen from the Venture Evaluation Matrix introduced in 2. Entrepreneurial ventures are in the process of establishing revenue models, have numerous business model uncertainties that affect their costs, and might be led by an inexperienced founder team. Revenues and costs remain unpredic for several years, and profits may take years to materialize. Second, in case of default, a lender wants to recover as much of the debt obligation as possible. Concretely, the lender asks for collateral that can be claimed in case of default. However, collat- eral is useful to the bank only if it can be sold easily and quickly. Entrepreneurial ventures, however, typically have intangible assets or specialized inventory that is hard to sell. So they can provide little collateral to a bank. Riskier borrowers always pay higher interest, so why should start-ups be any different? Indeed, this is what happens in the example. In practice, however, a number of issues prevent banks from simply raising their interest rates. In several countries, usury laws prevent lenders from charging rates above a certain legal threshold. Stiglitz's work on ad hoc lending is one such problem.

Banks are rarely well equipped to deal with the high risks of start-ups. They therefore prefer to lend to established small businesses rather than start-ups. Small businesses have a reasonably low probability of default since they follow proven business models. They also tend to have tangible assets such as property, machinery, or inventory that can easily be sold. To get an idea ofthe difference between established small businesses versus entrepreneurial ventures, consider data from the 2016 Report on Startup Firms from the Small Business Credit Survey, published by the Federal Reserve Bank of New York. This survey contains data on small private companies under the age of two, as well as those over the age of five. It reports that 64% of companies under the age of two con- sidered availability of credit or funds for expansion as a financial challenge. The corresponding number for companies over 5 years old was 39%. Of the companies under the age of 2 that applied for credit, 26% didn’t receive any at all and 40% re- ceived some but not all that they applied for. For companies older than five years, 22% didn’t receive any at all and 33% received some but not all that they applied for. The most common reason for credit denial was insufficient credit history for companies under two years, but weak business performance for companies over five years old[5], [10].

CONCLUSION

In conclusion, Debt financing is essential to corporate finance because it gives companies access to funds for expansion and other operational requirements. Debt financing has dangers and difficulties in addition to advantages like financial leverage and tax advantages. To preserve financial stability and maximize their capital structure, organizations must strike the correct balance between debt and equity. Before making an investment choice, investors must thoroughly assess the debt instruments' creditworthiness and risk-return profile. Business owners and investors may make decisions that are in line with their financial objectives and level of risk tolerance by comprehending the complexities of debt financing. Additionally, the effects of debt financing on investors. Bondholders and lenders alike take on the risk of non-payment in exchange for regular interest payments and the chance for capital growth. Compared to equity investments, debt instruments provide investors a set income and a reasonable level of safety. However, the abstract highlights how crucial it is to do in-depth credit research and evaluate the issuing company's trustworthiness before investing in debt instruments.

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CHAPTER 21

A BRIEF OVERVIEW ABOUT ALTERNATIVE TYPES OF DEBT

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ABSTRACT:

Alternative types of debt explore non-traditional forms of debt financing that have gained prominence in recent years. This abstract discusses various alternative debt instruments and their characteristics, highlighting their growing popularity as alternative sources of capital for businesses and investors. The abstract begins by highlighting the limitations of traditional debt instruments, such as bank loans and bonds, in meeting the evolving financing needs of companies. It introduces alternative types of debt financing that have emerged to fill this gap, including mezzanine financing, convertible debt, asset-based lending, peer-to-peer lending, and crowdfunding.

KEYWORDS:

Bonds, Convertible, Corporate, Credit, Derivatives, Debentures, Financing, Mortgage, Securities.

INTRODUCTION

The many forms of debt and instruments that resemble debt that business owners utilize in a number of situations. Personal debt comes first, followed by a range of business loan forms. We start with some data from the Kaufman Firm Survey, which collected information on more than 3,500 newly created firms in the United States between 2004 and 2007. This data will help us understand the role of personal debt in start-ups. This poll included all new businesses, including sole partnerships and other enterprises without any growth aspirations, rather than only those with strong growth rates. The many forms of financial capital utilised. For businesses that did not employ that sort of capital, the first column counts a value of $0 as the average throughout the whole sample. The average sum for those businesses that really utilised that kind of capital is shown in the second column. The third shows the percentage of businesses that used that kind of funding. Owner ownership and debt are contributions made by the founders themselves, insider equity and debt are contributions made by the owner's family, and outside equity and debt are contributions made by all external parties[1], [2].

A significant source of financing is debt. Although founders and other insiders also contribute some debt, outside parties account for the majority of it. We also see that the last paragraph of highlights the significance of trade credit, which is covered in this chapter. Personal bank loans and credit cards with a personal guarantee for company use are the two most common outside debt sources. Even if other sources provide the cash, the founders bear all of the risk. Lenders sometimes want the owners to personally guarantee the business loan, even for commercial bank loans. From the standpoint of an entrepreneur, it is alluring to utilize credit cards for startup capital since it is very simple to get credit. Credit cards are a costly method of financing, however. Following the first grace period, interest payments mount quickly and the true interest rate is often over 20%. A credit card default might also have serious personal repercussions. According to a research by Lawless and Warren, 17% of all personal bankruptcies in the U.S. occurred in 2003 when 280K self-employed business owners filed for bankruptcy. When payments are due before realistically anticipated income, credit cards may be a useful tool for managing short-term cash flow issues. They are inappropriate for any longer-term investments, however, since such include dangerous returns that won't materialize for many years. Additionally, various entrepreneurs have different draws to credit cards. African Americans' use of credit cards and entrepreneurial activity is the subject of one scholarly research by Chatterji and Seamans[3], [4].

A 1978 ruling by the U.S. Supreme Court invalidated state-level rules that restricted the amount of interest that lenders may charge on credit card debt. Credit card use skyrocketed as a result of the deregulation, giving many Americans broader access to credit outside of the established banking system. As it turned out, African American business owners who were more marginalized from conventional financial sources valued credit cards disproportionately. According to the research, as states deregulated credit cards, the percentage of African Americans who were self-employed rose. It's interesting to note that the states with a history of more extreme discrimination had the highest increases lending platforms, often known as peer-to-peer crowdfunding, are a more modern source of loans for individuals and companies. They have a limited impact on entrepreneurs, however, since the majority of them either fall short of strict financing requirements or have ventures that are seen as too hazardous and unusual. Early-stage start-ups utilize lending services far less often than more established small and medium-sized businesses [5]–[7].

DISCUSSION

Trade Credit

Current assets less current liabilities equals working capital. Working capital is a costly expense for cash-strapped start-ups, thus its founders seek out strategies to keep it low by reducing current assets and/or raising current liabilities. In the next section, we will look at discounting and factoring as ways to reduce current assets in this section, we will look at trade credit as a means to increase current liabilities. Supplier credit in the form of trade credit is included into the payment procedures. A buyer is given a certain amount of time to pay according to an invoice. There can be a discount for paying early, and there might be a penalty for paying late. Therefore, the customer has three options at the moment of purchase pay in full now to get the discount, pay in full when due, or pay after that to receive a penalty. You may compare declining the discount to borrowing money from the provider. This is so that the business may retain its funds for a much longer period of time at a greater cost.

Consider the next simple example to demonstrate how this system works. Consider a $100 invoice with a 60-day payment term and a 5% discount for immediate payment. The business has a choice to pay $100 right now or $95 today. The cost of not using the discount may be compared to a $95, $5-a-month debt. What is the loan's implicit interest rate? The traditional method for calculating interest due, $95*°.164 = $100, automatically provides the interest rate in this case as 60 days correspond to around 0.164 years. A extremely high suggested interest rate of 36.6% is used. Depending on the circumstances, funding working capital requirements via trade credit may be costly. What about postponing payment beyond the deadline? In our scenario, this entails disregarding the $100 note even 60 days later. A grace period may apply if you wait a few more days, but after that, there are two different kinds of expenses. The conditions of the invoice for the first kind stipulate a penalty rate, which is often larger than the associated discount rate for early payment. In the second, untimely payments may damage relationships with suppliers; the worst-case situation is when the supplier refuses to continue supplying.

Factoring and Discounting

When borrowing against current assets, such as in the case of factoring and discounting, account receivables are essentially reduced. This is the opposite of trade credit, which raises current liabilities while lowering working capital. Discounting, commonly referred to as invoice discounting, is a business practice when a corporation secures a loan from a lending institution by using the unpaid bills as security. Depending on the credit risk of the account debtor, the value of the invoices is discounted by 15 to 25%. The discount accounts for both the cost of credit as well as the chance that the bill won't be paid on time. Discounting leaves the start-up in charge of and at risk for collecting the invoice. There are two main arrangements regarding the risk that customers may fail to pay the invoice recourse factoring and nonrecourse factoring involve the business selling the invoice outright to a specialized intermediary known as the factor The factor takes ownership of the invoice and thereby the right to receive the associated payment and the responsibility of collecting the payment. Factoring is technically not debt because the company receives a payment in return for selling its invoices . However, the arrangement closely resembles debt, in the sense that the venture receives money from the factor, and in return the factor receives a larger payment at a later point in time.

A study by Dorfleitner, Rad, and Weber about MarketInvoice, an online factoring platform, found that the gross yield was 12.27%, at a time when interest rates were close to zero. The exact discount depends on type of contract, but it will be lower for invoice discounting, higher for recourse factoring, and highest for nonrecourse factoring. A nonmonetary cost of factoring is that the company loses control over the payment process. A factor may aggres- sively target customers, which may thus sour their relationship with the company. In this context, we also mention a related source of working capital finance customer prepayments. In this arrangement, the company collects a payment from the customer in advance of the future delivery of a good or service. While a prepay- ment is clearly not debt, it usually involves a discounted price, which reflects the financial benefit of obtaining the cash in advance. Customer prepayments are more common in business-to-business transactions. An advantage of prepayments for new products is that they often allow a start-up to involve the customer in testing and improving product quality, such as identifying software bugs or improving product design.

Capital Leasing

Leasing is effectively a form of asset-based credit that gives the lender with strong protection through asset ownership. The lender grants use of the asset to the company, in return for predefined lease payments, with the company typically having the right to purchase the asset after a certain time. Contracts typically range from 24 to 4 years. The lease payment is typically made monthly, and each installment includes amortization of the loan, which is repayment of a portion of the principal. A final balloon repayment covers the remaining value of the principal, typically between 20 and 25 percent of the principal. Normally, the lessee has the option to purchase the asset at its residual value at the end of the lease. The number of warrants is expressed as the warrant coverage, a percentage of the lease value. For example, a typical contract may specify an 8% coverage. For a lease of $1M this means that the lessor can purchase $80K of preferred stock at the price of the previous round, with the warrant expiring only after five years or so.

In contrast to traditional leasing, venture leasing typically involves the lessor receiving some warrants to purchase preferred stock of the lessee. There are some venture lending funds, run by partners with financial industry experience and strong ties to the venture capital community. Venture leasing requires assessing the quality of entrepreneurial ventures itself, as well as their backing from investors. This is why venture leasing requires more specialized skills than traditional leasing. Lessors are typically either banks or specialized corporate leasing companies. There are also some venture lending funds. In an asset-based loan, the company owns the asset but pledges it as collateral; in a lease arrangement, the lender owns the asset until it is purchased out with a final payment. From the lender's perspective, owning the asset may be safer than recovering the asset as collateral in case of default. From a company perspective, the fixed cost of purchasing an asset is replaced by a variable cost through the lease.

Risky Debt

Silicon Valley Bank, along with other forward-thinking financial institutions like Equitec and Western Technology Investments, developed a set of procedures to lend to technology start-ups, initially in the semiconductor industry, and over time, VD has been used by a variety of entrepreneurial ventures, including well-known brands like Facebook, Uber, Google, and Spotify. When a company enters the scale-up phase, once they have a tested business model and their primary challenge is to increase market share, VD is typically not available to them. In actuality, VD is only offered to companies after a Series A, and more frequently in conjunction with a later equity round. VD is viable due to three main factors first, the lender's key risk is not the venture's business risk, but rather the risk that there will be another round of venture funding that will keep the company going; second, venture lenders charge relatively high interest rates, which rewards them for the risk taken; and third, the lender obtains strong contraindications. What are the typical conditions associated with venture debt? The lender recovers the loan partly from periodical payments of interest and principal, and partly from a final payment that can be financed by the venture’s subsequent round of VC.

The maturity of VD is typically set after the expected date of the next funding round. A typical loan facility lasts anywhere from one to four years. Interest rates depend on market conditions but are often in a range of 10 to 15% above prime. If the loan is repaid early, a two-week notice is required, and a pre- payment premium between 3 and 5% is not uncommon. In case of a default, the interest rate also increases by 3 to 5%. In addition, VD typically gives the lender some warrants, that is, the right to buy company shares. The warrant coverage is often above 10% of the loan value. It gives the lender the right to buy preferred stock for the corresponding amount at the last equity round’s price. The warrant expiration may be at seven years or more. Typically, all the assets of the company are used for collateral. The lender may also impose negative pledges on intellectual property, barring the company from selling or licensing it without the lender’s permission. The VD contract sometimes includes performance covenants through which the lender has the right to call in the loan if certain business milestones are not met. There may also be financial covenants that require the company to maintain certain financial ratios.

An example would be a interest coverage ratio, which measures the company's ability to continue meeting its interest payments. Such financial covenants, however, are somewhat less common in earlier-stage ventures where financials remain highly unpredic. Typically, VD contracts also contain several clauses that allow the lender to call in the loan, that is, treat the loan as if it was in default. Material Adverse Change clauses tend to be broad, even vague, but they allow the lender to call in the loan whenever the company's business environment undergoes significant changes. Along similar lines, there can be clauses that allow the lender to call in the loan, such as if the equity investors are abandoning the company, or if there has been a change in the management team. Lenders routinely ask the company to be the bank that handles their day-to-day business transactions. Finally, there can be clauses that specify whether or not the lender can reassign the loan to other lenders. Compare the fundamental structure of VD contracts to those of venture leasing and normal lines of credit using this knowledge of their basic structure.

Venture lenders can be specialized banks like Silicon Valley Bank or main- stream banks like Barclays in the UK. Alternatively, they can be specialized VD funds, like Columbia Lake Partners or Kreos. VD funds operate with a partnership model similar to that of VC firms . By and large, banks tend to offer relatively cheaper loans, but with tighter covenants than VD funds. The due diligence on VD lenders has two components. First, they evaluate the strength of the company. For this they may free ride on the certification provided by the equity investors. In practice, most VD lenders work closely with a limited number of top- notch VC firms. Second, VD lenders carefully evaluate the behavior of the equity investors. Particular attention is paid not only to the overall performance record of the VC firm, but more specifically to its dynamic strategy of supporting com- panies over time. A key concern of the VD lenders is how much equity investors are willing to support struggling companies through difficult times.

Assessment of Venture Debt

Two weeks after graduating from KAIST and one week after getting married, Seoyun Park and Min-yun Hong founded Kor Pho, a Korean start-up that had found a new ingredient that accelerated the fermentation of kimchi, a popular local food item. Their company grew quickly and raised two rounds of VC funding. After a B round with a $2 share price, the company had 20M outstanding shares and had reached profitability. After being turned down by all local banks, they were introduced to Din Khatar, the manager of a Middle Eastern investment fund, who offered a $4M loan with a duration of 48 months from the date of closing, but the loan would only be drawn down six months after closing. The interest rate was 10% per year, paid in monthly installments, and the loan would mature 36 months later. Min-yun excitedly said that they should accept the offer. With a 3 M monthly burn rate, the $4 M loan would give the company an additional 13% months of runway. Seo-yun pulled out her laptop to work it out properly.

Her spreadsheet can be found on the books'website . She noted that after drawing down the loan, KorPho would need to repay the principal at a constant rate of $4M/36 = $0.11M per month. In addition, it would need to pay interest on the remaining principal. The interest payment would initially be $33K , and would decrease over time. Taking the repayments of prin- cipal and interest into account, her spreadsheet showed that DK's offer would give the company an additional six months of runway. Min-yun was surprised and looked more carefully at the numbers. After 20 months, the company would already have repaid over half of the loan. Over the entire life of the loan, the company would have to pay $0.62M in interest and thus pay back a total $4.62M, which amounted to 115% of the loan amount. Disenchanted with the terms of the VD, they considered making a counter-offer. Since the firm didn't actually need to borrow money for the first year, Seo-yun suggested extending the drawdown date to 12 months following the close. Her proposal would maintain the total amount paid in interest at $0.62M. She was shocked to learn from the spreadsheet that the company's runway would only be extended by two months. Min-yun advised deferring principle payments until the very end, which would entail paying a $4M balloon payment as the loan's last installment.

According to this, the interest payment would remain at $33,000 for the duration of the loan. According to the spreadsheet, this would increase the runway by five months. However, the fact that the total interest payments would now be $1.2M was a drawback. Thus, the total amount of payments would be $5.2M, or 130% of the loan balance. Sadly, DK would have none of it, declaring that its offer was definitive and requesting that the business make a choice. Therefore, the two founders pondered if the transaction was worthwhile. They began to consider what the warrants' actual cost may be. They would only be worthwhile in the event of a successful withdrawal, of course. A friend of theirs who was quite knowledgeable in advanced finance said that the warrants would be worth around $0.3M. The founders added $0.3 million in warrant expenses to the $0.62 million in total interest payments to approximate the overall cost of VD, which came to $0.92 million. The founders started to question if undergoing the VD was indeed worthwhile. Everything hinged on what it would do for the business.

Before raising its next equity round, the business intended to purchase time for reaching the extra milestone. In the next round, the founder considered raising $20 million. They anticipated the next round to achieve a post-money value of $80M without achieving the extra milestone, but with it, it would approach $100M. Current shareholders would have their ownership interests reduced by 25% at the lower value and by 20% at the higher valuation. The founders calculated that there would be 5% less dilution as a result of the greater value. This was valued at $5M at a $100M price. They were aware that they couldn't reach the further milestone without the VD. Their preliminary estimates indicated that it would result in a gain of $5M at a cost of $0.92M if the VD permitted them to hit it for certainty. It would still be worthwhile even if it just boosted their odds of reaching the milestone by 20%. So they took DK up on his offer. They raised their next round at a value of $100 million, reached their goal on schedule, and celebrated with copious quantities of kimchi.

Enterprise Valuation using Debt vs Equity Value

For businesses without any debt, the valuation methods take equity-only funding into account. We go through how they may be changed to account for debt in this. Corporate finance is mostly concerned with the issue of how to value leveraged organizations. How to take taxes and risk into account is a topic of much discussion. However, as we've previously said, the majority of entrepreneurial endeavors place less significance on the debt tax shield. In regard to risk, we contend in 6 that it is challenging and rather arbitrary to discover acceptable risk discount variables for start-ups. Due to this and the fact that the majority of startups have very little debt, valuations often overlook debt. Debt may nonetheless become crucial for later-stage, bigger companies. Therefore, knowledgeable investors would wish to investigate the potential effects of its inclusion on valuation models. This section explains how debt may be taken into consideration when using the valuation techniques for entrepreneurial companies. There are several traditional corporate finance valuation methodologies available for leveraging existing organizations. These comprise the APV model, the leveraged Capital Asset Pricing Model, and the application of the WACC in the DCF model.

The contrast between enterprise value and equity value is essential to valuation models that include debt. Equity and debt values are added to get enterprise value, which is expressed as: enterprise value = equity value + debt value.

Changing the Methods of Valuation for Debt

On the assumption that debt and equity investors would eventually get the same risk-adjusted return, a valuation approach that calculates enterprise values is established. This may be done in three different ways. One is to adjust the VC approach. The other two strategies come from conventional corporate finance. An initial estimate of the exit value is used by the VCM. In order to do this, exit comparables must be used, which are valuations from similar IPOs or acquisitions. Depending on the comparable measure being used, they may be used to estimate equity or enterprise values. A measure should be used for equity valuation if it describes an equity-based multiple; if it characterizes the attributes of the business as a whole, it should be used for enterprise valuation. Consider the following three comparative metrics sales, EBIT, and net profits to demonstrate how this works. The first two metrics, which concentrate on business performance, should be utilized to calculate enterprise value. Sales volume should be mostly independent of debt level and depending on the firm as a whole. Interest and taxes are not included in EBIT or EBITDA. As a result, we may think about enterprise value without taking leverage effects into account. Instead, net profits are more suitable for assessing equity values since they are directly related to the pay of the stock holders[8], [9].

In order to calculate the exit value for the VCM, the enterprise or exit value of the similar companies is used, together with the necessary multiplier and the company's financial predictions. In either the form of an enterprise value or an equity value, this produces an estimate of the exit value. The comparison is stronger when similar businesses with comparable debt loads are used. The APV and the WACC are the two commonly used methods in corporate finance to account for debt. When using APV, one first calculates the enterprise value for an unlevered version of the business, assuming that it is fully funded by equity, and then calculates the value of the tax shelter. The DCF technique is often used to perform these calculations. The tax shield is often little for start-ups but might be significant for later-stage businesses. The second method of using debt in valuation entails discounting cash flows in the DFC model with a discount rate that takes into account the ratio of debt to equity and weighting each kind of capital's cost of capital. The WACC method is this[10], [11].

The enterprise-1evel cash flow risk when evaluating enterprise value and the equity-level cash flow risk when assessing equity value should be included in the discount rates utilized for these computations. The latter ought to be greater than the former in order to account for the increased risk from leverage. Corporate finance texts go into great length on how to modify betas and discount rates to take leverage into account. Given that there are no exact methods for determining what the appropriate discount rates should be in the first place, this is arguably less significant in our case. Overall, we avoid favoring one approach over another. We think that in certain situations, the enterprise model performs better than the equity value model, and vice versa. Use straightforward debt estimates for modest debt levels and concentrate on calculating the equity value after that. Finding suitable assumptions regarding the cost of debt, however, could become more difficult after a firm raises a sizable amount of debt. In this situation, estimating enterprise values when the cost of debt is automatically produced by the model may be preferable.

CONCLUSION

In conclusion, as feasible alternatives to conventional loan instruments, new forms of debt financing have gained popularity. They provide companies more flexible and diversified finance alternatives, enabling them to customize financing arrangements to suit their particular needs. Access to fresh investment options allows for the possibility of better returns for investors. However, it is essential for both investors and borrowers to carefully assess the risks, costs, and applicability of alternative loan arrangements. Businesses and investors may successfully navigate the shifting financial environment and improve their financing strategies by comprehending and using these alternate sources of loans.

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CHAPTER 22

EXITING INVESTMENTS: MAXIMIZING RETURNS AND OPPORTUNITIES

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ABSTRACT:

Exit Investment explores the crucial stage in the investment lifecycle where investors seek to exit their investment and realize their returns. This abstract delves into the various exit strategies available to investors, the factors influencing their decision-making, and the implications for both investors and investee companies. The abstract begins by discussing the importance of exit strategies for investors, highlighting that successful exits are essential for realizing investment gains and generating liquidity. It introduces several common exit strategies, including initial public offerings (IPOs), mergers and acquisitions (M&A), management buyouts, and secondary market sales. Each strategy offers distinct advantages and considerations based on factors such as market conditions, investor objectives, and the nature of the investee company.

KEYWORDS:

Acquisition, Buyout, Capital, Divestment, Initial Public Offering (IPO), Liquidity Event, Merger, Secondary Market.

INTRODUCTION

This looks at the methods through which investors sell their businesses, get cash, and realize a profit. We begin by looking at the initial motivations behind why investors seek an exit. The four most popular exit strategies are then covered: selling the firm to a financial buyer; selling the company to another running company via an acquisition; and shutting the company down. The company is then listed on a stock exchange through an initial public offering. We discuss the necessary planning, structure, and execution for each form of departure as well as the repercussions on the company's founders, investors, and shareholders. We conclude by putting out a methodology for determining which kind of departure is ideal for given company at what time[1].

The Value of Withdrawing from Investments

Whether the investment was profitable or not, it all ends ultimately. The investment cycle ends with exiting, which enables investors to acquire liquidity. As a result, the investors get the returns that prompted their initial investment.The business is either shut down or continues to run under new ownership.

Motives for Leaving : Investors' desire to see a return on their capital investment in the firm is the primary driver of exit strategies. This ought to eliminate the myth that a departure is motivated by the company's desire for capital for investment. When shareholders sell their shares to a third party, the proceeds go to the shareholders rather than the business. If a business needs extra finance, it may do it in the methods. Companies do, after all, sometimes obtain capital via initial public offerings, therefore in this specific instance two justifications may coexist The investors want to sell their shares at or after the IPO, and the firm needs to obtain capital. The fact that entrepreneurial businesses have shares that are non-liquid assets is a significant characteristic. As a result, it is difficult for a shareholder to locate a buyer quickly who would pay a price that is near to what may be thought of as a fair market value. Markets with high liquidity, like commodities or stock exchanges, have a large number of buyers and sellers. But this isn't the case for privately owned businesses, mostly because there isn't enough trustworthy data to determine a company's fair value. As a result, shareholders cannot anticipate selling their shares at a reasonable price immediately. Instead, they actively assist the business in finding a buyer at a situation known as a exit event or liquidity event[2].

Liquidity is desired by investors for a number of reasons. Due to the fact that they invest via fund vehicles, venture capitalists eventually have to liquidate the firms in their portfolio. They must repay their institutional investors' money after ten years. VCs often have the legal authority to demand that a business go public or find a buyer so they may sell their investment. Since their comparative advantage for generating value is at the early stages, angel investors also want to recover their money so they may make new investments. They could also wish to leave in order to lock in financial gains before pay-to-play provisions diminish them. Unexpected liquidity shocks or predicted liquidity demands affect family and friends. In order to support their continued operations, accelerators and other early-stage investors, who sometimes have modest interests in the firm, could also be keen to make a profit. Thus, despite having extensive time horizons, all of these investors eventually reach a moment when they are looking for a return on their investment. There is a strong justification for owning stock as long as investors are actively supporting the firm.

Holding stock offers the investors an incentive to participate in the firm, which improves its value. However, with time, the capacity to increase the value of the firm tends to deteriorate. For instance, an angel investor may have experience during the start-up phase, but after the business has advanced beyond that point, he may no longer provide value and will instead wait for the opportunity to sell his shares. At this point, it would be more cost-effective to sell his stock to a different investor who can add value, such as by assisting with the commercialization of the company's product [3]–[5]. When the present ownership restricts a company's commercial development and necessitates a change in ownership structure, this is another significant factor in pursuing an exit. A start-up may need access to more strategic assets as it expands, and these assets may only be available from certain new owners, whether they be corporate or financial purchasers. For instance, a business may need access to clients, distribution networks, production facilities, intellectual property, talent, or other crucial resources that it might readily get by being purchased by another business, usually a strong incumbent in an established market.

A sale to a financial buyer might be used to get investors with different value-adding capabilities than the company's present investors, or vice versa. The investors may sell their shares in either scenario and make more money than they would if they kept them. Market demand for entrepreneurial businesses varies, and astute investors are able to optimize their profits by exiting at the right time. This is particularly clear in the case of initial public offerings (IPOs), when astute investors may be able to timing the market and list the firm at the height of market values.4 With purchases, market timing may be useful for securing a transaction at a period when interest from purchasers is at its highest. The timing of departures also has a negative side, as some investors may take advantage of unfavorable insider knowledge about the company's future prospects. It's possible that the firm is overpriced if they opt to sell their shares. If buyers become apprehensive that sellers have such unflattering information about the firm, this might hinder the exit process. This is the standard lemons issue that we first ran across. The illiquidity of the shares of entrepreneurial enterprises might be further exacerbated by this kind of adverse selection issue.

DISCUSSION

Four Main Types of Exit

We focus on the four primary departure scenarios failure, IPO, acquisition, and sale to a financial bidder. In this section, we define them before analyzing their structure and the effects of each exit type on investors, entrepreneurs, and the firm itself. Going public, the first sort of departure, is sometimes seen as the most prestigious and professional. It entails putting a company's stock on the market so that investors may sell their shares to the general public and recoup their capital. The management staff often stays put. Entrepreneurs and managers may also get cash by selling some of their stock. Even while being a public corporation has significant administrative and financial repercussions, the firm nonetheless maintains its independence. Acquisition by a company is the second kind of departure. In this scenario, the startup no longer exists as a separate entity and is absorbed into the acquiring firm as a division. Selling their shares to the acquirer in exchange for money or more shares provides investors with a profit.

The management staff usually remains for as long as it takes to guarantee a seamless transfer, although they may thereafter depart. The selling to a financial buyer is the third kind of departure. The sale might be whole, which includes the holdings of all shareholders, or partial, which includes the ownership of only one or a few investors. A buyout is the term used for a complete exit whereas a secondary sale is used for partial exits. The business continues to be a privately owned, independent business in both situations. Selling their shares to the financial bidder allows investors to recoup their initial investment. With the exception of a management buy-in, when a new management team takes control, the management team normally remains in place [6]–[8]. Failure, or shutting down the company, is the fourth sort of departure. If the business has any unpaid debt, it could have to file for bankruptcy. If not, it simply sells its remaining assets and shuts down.

Over three quarters of all exits take place via purchases, making them the exit strategy of choice. IPOs, in comparison, make up fewer than 10% of transactions and are less frequent than financial sales. According to statistics on exit valuations, the overall value of IPOs and acquisitions in the United States is almost equal. The average exit value for IPOs is much greater than for acquisitions since there are far fewer IPOs than acquisitions. However, IPO valuations in Europe are far lower. In both the United States and Europe, the value of financial sales is the lowest of the three; this is also a reflection of the fact that they take place sooner in a company's growth than IPOs or acquisitions. Closures are not included in this data. Because closures are seldom advertised, obtaining them might be challenging. According to a National Venture Capital Association survey, up to 53% of all venture-backed businesses in the United States fail.6 According to academic studies by Hall and Woodward on U.S. VC investments made between 1987 and 2008, firms left in the following proportions: 37% were bought, 13% went public, and 50% failed.

Why Do New Businesses Fail?

Regarding the impact of entrepreneurial mindsets on success or failure, there are two schools of thought. According to the rational perspective, entrepreneurs often fail while making wise judgments because of the many risks that come with experimenting. According to the behavioral perspective, failure is really caused by entrepreneurs who are overconfident and overestimate their prospects of success too many entrepreneurs enter new markets, and as a result, many of them fail. University students are often invited to participate in well designed experimental games that accurately reflect the real-world environment by experimental psychologists in lab settings. The mystery of business failure is the subject of a research by Artinger and Powell. They enquire as to whether chances for entrepreneurship are particularly prone to overconfidence. This would contribute to explaining the high startup failure rates. The researchers created simulations of market entrance choices in the form of experimental games.

The authors remark that rational action should produce a symmetric pattern of either too many or too few enterprises entering a new market, depending on the market situation, to differentiate it from behavioral action. However, overconfidence should always result in excess entry that is, more businesses entering than could possibly survive in a competitive market. Next, the researchers define entrepreneurial markets as tiny markets with substantial uncertainty, categorizing markets according to two characteristics: size and uncertainty. The main conclusion is that economies with an entrepreneurial culture have higher barriers to entry than other markets. In markets with a high level of entrepreneurship, excess capacity may reach 250% and is typically 36%. Additionally, although the experimental individuals gained money in most market environments, they suffered significant losses in marketplaces that encouraged entrepreneurship. Additionally, the researchers discover that those who are less risk-averse and more self-assured are more inclined to explore new industries. They come to the conclusion that the high failure rates of entrepreneurial projects may be at least partially attributed to entrepreneurial overconfidence.

Decision to Leave

Exit is a choice, not an inevitable occurrence. The choice to quit may be seen as a sequence of options that the business must make at different phases of growth. There is always the option to continue in both good and adverse circumstances. Financially speaking, this entails either doing nothing, which is characteristic of negative circumstances, or providing further money, which ideally enables the business to achieve new milestones and raise its worth. This choice is supported by the real alternatives justification that we talk about in the context of phased financing. So, we may consider the option to depart as a trade-off between leaving, which would result in a known reward in the present, and refinancing, which would result in an uncertain return in the future.

When a corporation runs out of money and its investors are reluctant to risk further capital, the company must be shut down. Investors may still get any remaining assets at the time of closure, although often this is less than their original investment. The path's downward slope represents the adverse corporate result implied by the worst-case scenario. The ascending paths signify the exit outcomes' favorable character in the optimistic scenario. The choice for the positive scenario's departure is whether to keep supporting it in order to increase its value or to sell its shares through an IPO, acquisition, or finance sale. Investors decide to withdraw their money from an enterprise when doing so would result in a larger return than staying invested.

Exit Period

What decides when to leave? Three dominant factors are identified. First, as already said, investors' need for liquidity prompt them to push for a departure. Third, there is opportunistic market timing. Second, the financial environment of the firm varies throughout time, necessitating owner- ship changes at particular important intersections. We now take into account how various departure routes and corporate circumstances impact timing of exits. In the event of an IPO, the firm must first be developed enough to meet regulatory standards and pique institutional investors' interest. This normally demands a s and profi business plan along with many years of growth. Additionally, since investor interest in IPOs is often cyclical, IPO market circumstances are crucial. Consider a start-up that successfully prototyped its first product and now has to expand its manufacturing and sales department in order to scale up its operations. This is an example of an acquisition. At that scale-up stage, when the buyer's value of the start-up is greatest, is often the ideal moment to sell to a strategic buyer. Strategic buyers are not very interested in the firm prior to the scale-up stage since the product has not yet been tested. The strategic buyer can contribute little more value after the start-up has established a complete production and distribution network and won't consequently make an alluring offer. A different circumstance is when the acquirer is eager to take control of the technology early on, before it is evaluated, either because it may be beneficial or because it may be damaging to the incumbent.

External market-timing variables have two aspects for purchases. The desire for acquisitions by existing businesses or rival start-ups is first affected by industry cycles, innovation cycles, and the entry of rivals. Second, the interest of potential buyers in the firm is also influenced by company-specific characteristics. For instance, YouTube was bought by Google just 18 months after incorporation, while Instagram was acquired by Facebook only 16 months after its founding. External variables affect the date of the departure even if they are beyond the company's and its investors' control. Is it conceivable to postpone leaving indefinitely? That's an intriguing issue. In this scenario, the business would always be a privately owned corporation. This is the situation with family firms, whose shareholders primarily get dividends from them. Such an investment strategy without an exit is still essentially unheard of in entrepreneurial operations. A firm can only pay dividends after making a profit. Most investors would not be ready to tolerate the length of time between a start-up investment and a consistent stream of dividend payments. Therefore, exit continues to be an essential component of the funding strategy for entrepreneurial enterprises. Although departure is crucial to the entrepreneurial finance process, there has been a recent tendency to postpone exit for an extended length of time. This tendency really started to take off once the Great Recession of 2008 ended. It added a highly mythical animal, none other than the unicorn, to the corporate lexicon.

Rise of the Unicorns

Young, rapidly expanding businesses that are still privately owned and have a value of more than $1 billion are referred to be unicorns. They have multiplied in number in recent years.There were 232 unicorns worth at over $1,100B at the start of 2019.15The newest word in the dictionary is called a dedacorn, which is a unicorn valued at more over $10 billion. As of the beginning of 2018, the CB Insight report counted 17 of them. At the time, Uber, Didi Chuxing, MeituanDianping, Airbnb, and SpaceX had the greatest market values. In the U.S., 47% of unicorns were based, followed by China (30%), the UK (6%), India (4%), Germany (2%), and Israel (2%). There are also African unicorns. Jumia, an online retailer, became one in 2016 and had its initial public offering (IPO) on the New York Stock Exchange in April 2019. Internet software and services providers, e-commerce, and fintech were the three biggest groups. Unicorn popularity is due to a number of things.

The persistent dearth of IPOs is the primary motivator on the investor side. Since there aren't enough investment opportunities in the public markets for institutional investors who wish to diversify their portfolio with smaller, high-growth enterprises, they turn to the private markets. They are ready to tolerate more risk and less liquidity because they have a big desire for high-yield assets. Large financing rounds are required on the corporate side in order to take advantage of expansion prospects. This is especially true for IT businesses that want to dominate international markets, notably those in the United States, China, India, and the European Union. Scaling up remains pricey, despite the fact that creating new businesses has grown more affordable over time, which has increased the number of start-ups funded by angel and venture capital. Companies expanding globally often raise capital in rounds above $100M. For instance, Elon Musk's SpaceX received $351 million in a round in 2017. Chinese group-buying service company Meituan-Dianping raised $4 billion in the same year pretty much the same sum it had during its first public offering (IPO) on the Hong Kong stock market in September 2018.

Being a unicorn attracts much of attention from prospective employers, workers, clients, and suppliers. Therefore, pressure to hit the $1 billion valuation barrier is exerted on businesses by the desire to accomplish this apparent milestone. This may result in misleading manipulations. In 6.5, we demonstrate how improved downside protection might be exchanged for higher values, and 6.6 offers a concrete illustration. Using IPO ratchets in subsequent rounds is one technique to do this in the case of unicorns. These are an anti-dilution protection measure that raises the conversion rate of convertible shares in the event that the IPO price drops below a certain threshold. They boost values while also guaranteeing higher returns to investors in following rounds. Therefore, it should not be surprising that being a unicorn does not ensure that one will remain one. In December 2017, Apple purchased Shazam, a UK-based music recognition software provider, for around $400 million. In March 2017, Amazon paid $580 million to purchase the e-commerce platform firm Souq.com, which is located in Dubai. Both businesses had previously attained values of $1 billion.

Initial Public Offerings

The most prestigious exit for business owners and investors alike is often a listing on a stock market. This is due to the fact that IPOs often provide substantial financial gains. Additionally, it gives everyone engaged tremendous exposure and a halo of achievement. A corporation must go from being private to being publicly listed in order to become public.

Costs and Benefits

Going public has both benefits and drawbacks. For the firm and its stockholders, going public provides various advantages. The ability to cash in returns and diversify one's wealth is provided to investors and entrepreneurs in the first place. Astute investors can time the market to achieve higher returns. Public companies can use their shares to make acquisitions. Additionally, having a stock price gives the company important information about how investors view its performance. Increased liquidity and visibility enable businesses to acquire financial and nonfinancial resources to grow up. This is accomplished through reaching out to a larger range of lenders, workers, and strategic partners. Greater transparency and availability to investors decrease the company's cost of capital, which is reflected in the higher IPO value, cheaper costs for future secondary issues, and improved access to the corporate bond and loan markets.

There are significant direct and indirect expenses associated with going public. The need to provide information about the business, its technologies and products, its future plans, and, more broadly, the expenses of regulatory compliance, is one indirect cost. Investors need the information, yet rivals of the firm gain from its revelation. The whole senior management team is seriously sidetracked by the process of going public. A related issue is that a public firm is under pressure from investors and analysts to fulfill its quarterly profits objectives, which might impede entrepreneurial innovation. Being a public corporation exposes the company to hostile takeovers. Its capacity to take on risky long-term initiatives could be limited as a result. The evidence on whether publicly traded corporations find it challenging to undertake hazardous long-term investments is examined.

IPOs: Killing Innovation

Many CEOs complain about the pressure to fulfill their quarterly financial objectives, which they claim inhibits them from making longer-term investments. It has long been maintained that stock markets foster short-term decision making. This problem is especially important for technological start-ups that depend on protracted innovation cycles. The issue then becomes whether being public hurts business innovation. Stock market response to knowledge about a company's inventions might discourage exploratory ventures and favor less ambitious ones. What would these firms have done if they hadn't gone public? is a counterfactual that makes it difficult to provide an answer to this question. It is obvious that we cannot see such a counterfactual. A sample of businesses that went public might be contrasted with a sample of businesses that didn't. The analogy may not be accurate, however, since those who go public are probably different. They could perform better and be in the process of altering their company strategy. This issue is addressed in a research by Bernstein by contrasting firms that almost went public with those that really did. More specifically, the study examines all companies that file for an IPO and contrasts those that were successful in doing so with those that were not.

The research identifies those businesses who were unlucky and had to cancel their initial public offerings (IPOs) because the stock market unexpectedly turned cold in the two months after their filing. Those companies could be fundamentally very identical to those who successfully completed the IPO, with the important distinction being that the market slump prevented their IPO. As a result, they might be seen as a close representation of the counterfactual. Patents are used in the research to gauge invention activity. It finds that although the quantity of patents continues after an IPO, their quality declines. Additionally, following an IPO, creative inventors go from their company, and the surviving inventors create inferior patents. All of this shows that firms become less inventive after becoming public. But there's an intriguing twist to it. Public firms begin purchasing private start-ups after the IPO. According to the report, such purchases account for one-third of public businesses' patent portfolios five years following an IPO. This implies that corporations change their innovation approach after becoming public. They place less focus on developing inventions independently and instead buy them from the next crop of creative start-ups [9], [10].

Getting Ready For An IPO

A corporation must be ready in two key areas before deciding to go public. One goal is to develop into a completely autonomous business that can meet institutional investors' needs. The other is preparing to adhere to the many rules that are relevant to listed firms. Therefore, getting ready to go public requires a lot of time and work. The establishment of a fully functional corporate structure and a well-organized management team are prerequisites for the firm to be ready to handle demand from institutional investors. The hiring of an experienced chief financial officer to manage the listing process and the pressure from analysts and investors after the firm goes public is a crucial step in this preparation. The corporate counsel, who is in charge of the legal parts of the going public process, is another crucial individual. It could be necessary to reorganize the board of directors to include more independent members and form appropriate audit and remuneration committees. Professional venture capitalists may be able to contribute significantly to the professionalization process.

Along with effort and money, regulatory compliance is also necessary. A corporation must meet a strict set of listing standards in order to be listed. Usually, it must provide many years' worth of audited financial accounts. Being a publicly traded business exposes it to many legal, financial, and other compliance requirements, necessitating the use of suitable legal and accounting systems. To provide the necessary information, the organization must consequently establish systematic reporting methods. The business must make two crucial decisions after deciding to go public. The first is to go public with the business. While most businesses list in their native nation, others choose to do so. Most startup businesses in the US list on Nasdaq, however some choose the New York Stock Exchange instead. A firm may be able to attract a larger investor base, increase its worldwide awareness, increase its value, and improve the liquidity of its shares by listing overseas, which is expensive and time-consuming.

Lower market levels on several stock exchanges are reserved for new, rapidly expanding firms. To attract more specialist investors, they have less strict listing standards. Examples include the TSX-Venture of the Toronto Stock Exchange, EnterNext of Euronext, and the Alternative Investment Market of the London Stock Exchange. The second crucial decision is when to go public with the business. Public markets' interest in initial public offerings (IPOs) is very cyclical. Markets are referred to as hot when investors' interest in new issues is high and cold when it is low. Most IPO activity is concentrated in hot markets, and a company may need to wait years before a cold market turns hot again. As a result, investors occasionally rush a company to market when markets are hot, skipping the opportunity to wait for full development of the company. The five key elements of the IPO process are summarized here. The whole process takes several months, while the precise amount of time varies depending on how quickly regulatory filings are approved and how the firm responds to market circumstances. The first step is to choose the investment bankers who will oversee the entire process.

Investment bankers are regulated financial institutions that act as an intermediary between the company and stock market investors. They also deal with regulators during the IPO. The choice of investment bankers is crucial because they play a key role in generating interest in the offering, determining the issue price, and stabilizing the stock price after the IPO. The second step involves the investment bankers conducting due diligence on the company, which is the process of gathering information on the business, its financial situation, and its business prospects. The IPO prospectus, along with the audited financial accounts, is filed with the relevant regulator in the U.S., where due diligence is a requirement. The so called road show, which lasts for two or three weeks and involves company managers meeting institutional investors in financial hubs like New York, San Francisco, London, Hong Kong, or Tokyo to boost demand for the IPO, is the third step. The fourth step entails pricing the IPO and analyzing various other aspects of the offering. The final step is to execute the sale of securities and become a publicly traded company.

Job Creation Act

The 2012 Jumpstart Our Business Start-ups Act simplified several rules, adapting them to the needs of fast-growing start-ups. The Act's goal was to help job creation by facilitating access to capital markets for fast-growing start-ups. The U.S. securities regulation has strict provisions for companies that want to issue securities. the goal is to preserve investor confidence and maintain trans- parent financial markets. The IPO on-ramp idea, which lowers the disclosure and compliance expenses of the IPO process for start-ups with less than $1B in gross sales, is the cornerstone of the Act. It lessens the amount of financial information issuers must provide investors. The idea of full disclosure of all material facts is still in place, although issuers are only required to publish two rather than three years of financial history. Financial and management compensation analyses may be submitted more easily, and post-IPO disclosures are made more straightforward. The Sarbanes-Oxley and Dodd-Frank Acts' corporate governance rules are less onerous, and certain of its requirements are waived.

One innovative feature of the Act is that it enables startups to submit a security registration in confidence, preventing rival businesses from learning about any disclosure before issuance. The danger of releasing information before to reaching the securities markets is reduced as a result.40 Issuers are also permitted to get in touch with eligible investors prior to filing in order to gauge their interest in a securities offering. Specifically, during the quiet period between the registration of a security and its issue, investors are permitted to communicate. The outcomes of the JOBS Act have been mainly good, if somewhat disappointing, five years after its inception. The empirical data indicates that more businesses utilize the on-ramp to go public. There is, however, a worry that these issuers are of poorer caliber.

Amounting the IPO

The investment bankers, together with the management and board of directors of the firm, set the price for an IPO. How many shares to issue and at what price are the two key considerations in pricing. The amount of money a corporation hopes to raise will be its aim. This is low if the firm listings just to let current investors to sell their shares, but high when the company needs money for investments. Stock markets typically require companies to float a minimum percentage of their shares, so the total number of shares to be offered, called free float, is determined first. Given the total number of shares offered, the amount actually raised depends on the offer price, which is set at a later stage. While the company formally makes the decision, in practice it is the investment bankers who set the price. To set the price, the investment banker provides an initial estimate of the market's appetite for the company's shares, typically using the method of exit comparables. This is expressed as a range within which the final price is expected to fall, and it gets updated as information comes in along the process. The final offer price is set the day before the IPO.

With fixed price, investors know the price before the IPO is executed, so there is a risk of deteriorating market conditions, which may lead to a failed issue; consequently, the price is typically set cautiously low. With book-building, the price is set to clear the market, giving the investment bank no discretion regarding the allocation of shares. With auctions, the price is set to clear the market. In the popular press, underpricing is frequently portrayed as a success because there are positive returns on the first day of trading. Investors who buy shares at the offer price clearly appreciate this practice, but it is effectively a cost for the company. If the shares were priced closer to their market price, then the company would raise more money for. The underpricing conundrum has been explained in several ways. Some popular hypotheses are based on asymmetric information: investors worry about overpaying for a firm they don't fully understand. To entice them, a low offer price is necessary. This is a variation of the winner's curse or the lemons conundrum. When insiders sell substantial blocks of shares, this problem becomes very apparent.

Setting Up the IPO

An IPO necessitates a number of choices in addition to the price per share. One has to do with the ratio of primary to secondary shares. Primary shares are those that the firm has just issued in order to raise money. Existing shares are what pre-IPO investors refer to as secondary shares. New investors are wary of large secondary offers made by insiders because they worry that they could include unfavorable insider knowledge. Another instance of the same issue may be seen here. Companies must also determine whether the shares sold during the IPO will have the same voting privileges as the shares now owned by the investors and founders. Some of the most successful entrepreneurial organizations that went public have decided to issue dual-class shares, offering founders a chance to manage the company by owning shares with dual voting rights. This is known as a dual share structure. In contrast to most other nations, the United States, Switzerland, Scandinavia, and the Benelux region all often issue dual-class shares. Dual-class shares, according to technology businesses, provide their visionary founders independence. One of the things I feel incredibly grateful we have is this corporate structure where, at the end of the day, it's a controlled firm, said Mark Zuckerberg, who in 2018 had 60% of Facebook's voting rights. The whims of short-term stockholders do not control us.

We can really design these products and decisions with what is going to be in the best interest of the community over time51 But this argument is deba. Even if visionary founders are crucial to a company at the time of the IPO, this may change over time. Many founders relin- quish leadership to professional managers, even if the company proves successful and keeps growing. Those who don’t often get in trouble. For example, when in 2018 Facebook faced some scrutiny over privacy issues, critics pointed to Mark Zuckerberg’s dual role as CEO and chairman of the board. They argued that lack of oversight had contributed to the company’s troubles. More generally, dual class shares encourage entrenchment, insulating management from the discipline of the market for corporate control. The wedge between ownership and voting rights can weaken incentives for shareholder wealth maximization. The empirical evidence suggests that the larger the wedge, the more likely are wasteful acquisitions and investments. Companies with dual-class shares also do not invest more in R&D or in intangible assets. A recent study finds that firms with dual-class shares achieve higher IPO valuations that a comparable set of companies with single-class shares. However, this advantage fades over time. Such evidence would support allowing ‘sunset’ provisions that force multiple-vote shares to convert into standard ones over time.

CONCLUSION

In conclusion, as the climax of an investor's attempts to monetize their investment, exit investment is a crucial stage in the investment lifecycle. Investors may increase the likelihood of successful exits by carefully weighing the various exit methods, analyzing market circumstances, and aligning with investor goals. A well-thought-out exit strategy may help investee firms develop, add value, and take advantage of new financing possibilities. The exit process and achieving mutually beneficial results depend on effective cooperation and communication between investors and investee firms.

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CHAPTER 23

TALES FROM THE VENTURE ARCHIVES: ALIBABA'S IPOS

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ABSTRACT:

Tales from the venture archives alibaba's IPOs explores the fascinating journey of Alibaba Group, one of the world's largest e-commerce companies, through its initial public offerings (IPOs) on the Hong Kong Stock Exchange and the New York Stock Exchange. This abstract provides an overview of Alibaba's IPOs, highlighting the strategic decisions, challenges, and outcomes associated with these landmark events. The abstract begins by introducing Alibaba Group and its rise as a global e-commerce powerhouse. It highlights the significance of Alibaba's IPOs, which marked major milestones in the company's growth trajectory and had far-reaching implications for the global investment community.

KEYWORDS:

Alibaba Group, Banks, Dual-Class, Initial Public Offering (IPO), Investment, Market Capitalization, Structure.

INTRODUCTION

Alibaba Group Holding Limited, which takes its name from the children's story from One Thousand and One Nights, is probably the most successful Chinese technology start-up to date. Alibaba, which was founded in 1999 by Jack Ma, became China's market leader in e-commerce and related fields including cloud computing, artificial intelligence, and electronic payments. The firm floated its shares on the Hong Kong Stock Exchange in November 2007 after numerous rounds of venture capital. The business raised HK$13.1B at the offer price of HK$13.50. On the first day of trade, Alibaba's shares increased from HK$13.50 to HK$30, representing a more than 50% undervaluation. The stock price peaked at HK$39.50 before dropping to HK$5 in 2008. Alibaba stunned the financial markets in February 2012 when it said it would delist its shares from the Hong Kong Stock Exchange and repurchase all outstanding shares at the initial share price of $13.50. At the time, its stock price was hovering around $10. The company was going through certain strategic adjustments at the time, which were anticipated to have a detrimental effect on its short-term financial performance.

According to Jack Ma, taking Alibaba.com private will allow our company to make long-term decisions that are in the best interest of our customers and that are also free from the pressures that come with having a publicly listed company. Less than 1,000 nights after delisting its shares from the HKSE, Alibaba relisted its shares in September 2014, this time on the NYSE. The offer price was initially set at $68 but increased to over $94 on the first trading day. The sum raised was $25 billion, making it the biggest IPO to date. The value at IPO was over $230 billion. Why did the business go from the HKSE to the NYSE? Alibaba desired a dual-class share structure in which 30 important individuals controlled the board of directors for the business. The NYSE regulations permitted this arrangement, but the one-share-one-vote rule that the HKSE had implemented after Alibaba's 2007 IPO prohibited it. The stock price has risen nicely by early

2019, going beyond $150. The story is not over yet. The HKSE made the decision to amend its listing rules in December 2017 to permit dual-class share offerings, licking its wounds from the loss of Alibaba. Alibaba submitted a secret listing to the HKSE in June 2019 that would enable them to raise up to $20 billion. Overallotment options, sometimes known as Green shoe options, are another consideration when structuring IPOs.

These options enable the underwriters to purchase more shares at the offer price typically up to 15% and resell them in the days after the IPO in order to maintain market values. If the offering is underpriced, the underwriter's option might be highly profitable. All significant shareholders enter into lock-up agreements with the underwriters at the time the IPO is planned. These prohibit pre-IPO stockholders from selling their shares for a certain amount of time after the IPO, often six months. The objective is to maintain orderly trading after the IPO in order to prevent significant stock price movements. Consider Lyft's post-IPO stock performance, which was adversely impacted by significant short sells and sparked discussion over the design of its lock-up agreements, to see the significance of lock-ups. From a business standpoint, going public is expensive. There are numerous financial expenses. The listing costs that must be paid to the stock exchange come first. Typically, they are stated as a function of the IPO's total raised funds.

The business will also have to pay yearly listing costs after the IPO. The costs paid to the underwriter come in second. Investment banks nearly always charge 7% of the total amount raised during an IPO in the United States. These commissions typically vary between 3 and 5% on stock exchanges in Europe and Asia. Underpricing, which occurs when the firm raises less money in the IPO than its market value should permit, is the third expense. A direct listing is an additional, more affordable and discrete method of becoming public. In this instance, the firm does not raise any additional capital since it does not sell any new shares after listing its existing ones on the stock market. The business is not required to send out a road show or employ an underwriter. Investors, company founders, and employees may sell their shares to the general public as of the day of listing. Smaller businesses have often been linked to direct listings. When Swedish music streaming service Spotify made the decision to list its shares directly on the NYSE in 2018, this situation altered. The firm was valued at $26.5 billion as a result of the successful IPO [1].

DISCUSSION

After the IPO

Investors have the option to either sell their shares on the open market or hold onto them for a little longer after the end of any lock-up period. Their aspirations for the future prosperity of the firm heavily influenced their choice. Selling in bulk at the conclusion of the lock-up period might lower the share price since the market interprets it as a warning. Therefore, knowledgeable investors progressively sell their shares over time. Investors who hold board positions must determine when to step down. To guarantee a seamless transition to a bigger board with members chosen by institutional investors, some VCs leave their positions prior to the IPO, while others hold off until after the IPO. Some people never seem to want to leave Arthur Rock, an early Apple Computers investor, remained on the board for more than ten years after the IPO [2].

For founders and management, the change to a public firm has significance as well. They may now get some liquidity, just like investors. However, the market keeps a watchful eye on their stock transactions. Their share transactions must be declared, and selling sizable stakes especially when done suddenly can have a detrimental impact on prices. Many founders choose to keep sizable interests and continue to be involved in the business. Some people continue to serve as CEO or another executive position for an extended period of time. In fact, one reason founders often choose an IPO over an acquisition is the chance to keep their current position. Others choose to retire and engage in comfortable activities like rearing chickens. However, many choose to continue their involvement in the entrepreneurial process by becoming serial entrepreneurs, board members, or angel investors.

Acquisitions

The most frequent method of exiting an entrepreneurial enterprise is via acquisition. It serves as a crucial conduit for existing businesses to acquire ideas for commercialization. According to a research by Arora, Cohen, and Walsh, start-ups account for the majority of the inventions that U.S. manufacturing businesses launched between 2007 and 2009 thus, acquisitions are financial transactions with a strategic goal. One of the three primary upside exit strategies is acquisition. Due to the less noticeable cycles of acquisitions compared to IPOs, a departure is also an option during market downturns. They are also less costly, with investment bankers receiving the majority of the fees for their work as financial consultants and due diligence. Acquisitions need less exposure of private information than going public, which is crucial for businesses with significant trade secrets. Potential buyers anticipate having access to more in-depth and private information than is provided to the authorities overseeing the stock market. Acquisitions result in the founders losing their autonomy and control. They either depart or join a bigger firm when their company is taken over by the acquirer [3].

Strategic Goals

An entrepreneurial venture that is a possible acquisition target faces a trade-off between build or sell Building requires going alone and raising additional funding with the goal of eventually going public. For example, the start-up may have to develop a fully-fledged sales and marketing organization, attract a complete management team, or negotiate international distribution deals. Focusing on the last row of the evaluation matrix, which specifically identifies the three strategic challenges of sales, operations, and organization, incumbents can offer an established sales team, market access, marketing know-how, and brand. On the production side, established companies already have many established supply relations, some of which the start-up may be able to leverage. An established company similarly faces a build or buy trade-off. It can decide to enter the market by itself, replicating the investments of the entrepreneurial company by developing similar products and services. There are three problems with the build option. First, it may not be easy to replicate what the entrepreneurial venture is offering, let alone improve on it. This is not merely a technical challenge, but also an organizational challenge of getting employees within the established company to adopt the new ideas and approaches that were developed by the entrepreneurial company. Second, building takes times. Time to market can be of great importance in a competitive environment, and the established company risks being late to market [4].

Third, the decision to build or buy affects the competitive landscape. From an acquirer's perspective, a benefit of buying is to eliminate the target company as a competitor. In this context, it is worth noting that most acquisitions of entrepreneurial companies do not come within the radar of antitrust authorities. Typically, the acquired companies are too small, or the markets too young, to attract their attention. Additionally, it can be challenging to integrate the start-up into the established company without killing its entrepreneurial spirit. Integration requires what management scholars refer to as absorptive capacity, which is the capacity to evaluate the technology, assimilate it into the buyer's organization, and develop it profitably. Some acquisitions are referred to as acquihires, and the first one was reportedly Dodgeball, a New York-based social location service acquired by Google in May 2005, hiring founders Alex Reinsert and Doug Jaeger. Active acquihires include Facebook and Yahoo!, as well as unicorns like Dropbox, Pinterest, and Airbnb. Most targets are young, small start-ups that face competition from established companies. Acquihires are seen as a tool in the competition for talent because they bring in a large number of talented people all at once, allow a team that works well to stay together, and appeal to recruits because they convert income into capital gains, which have lower tax rates. Acquihire critics point out their costs because the new hires may only stay for their lock-up period typically a year[5], [6].

Acquisition

Seasoned practitioners often say that companies are bought, not sold. Getting an acquisition offer is far from trivial and requires preparation. Thus, getting acquired is rarely a coincidence; instead it is the outcome of a strategic plan to generate interest among potential acquirers. The objective here is subtle. On the one hand, the start-up wants to configure itself so that it can easily be bought and integrated into the acquiring company. For example, a software start-up can specialize its product to a particular platform of a potential acquirer. On the other hand, too much specialization makes the start-up overly dependent on one potential acquirer and reduces its bargaining power. The start-up must therefore craft its strategy so as to remain an attractive target, without becoming beholden to any one acquirer. Some acquirers have prior strategic relationships with the companies they ac- quire. These could be supplier relationships, licensing arrangements, or strategic alliances. In some cases, the strategic relationship is accompanied by an investment by the established corporation. An equity stake gives the potential acquirer a toehold in the start-up company and ensures privileged access to company information [7], [8].

The start-up only needs one acquirer in the end, but having multiple potential bidders greatly boosts its negotiating power; however, there is a risk that by courting a second potential buyer, the start-up risks losing the interest of the first one. In some cases, the entrepreneurial venture openly engages with multiple potential buyers, and in other cases it prefers to keep negotiations confidential. Investment bankers can also play a significant role in the process. Buyers must also develop what is referred to as absorptive capacity in order to find targets, close deals, and integrate seamlessly. For large technology companies like Alibaba, Cisco, or Google, acquisitions are at the center of their R&D strategy. They maintain teams of specialists who constantly search for acquisition targets and then have the financial and human resources in place to make the deals [9].

Creating an Acquisition Structure

The price paid by the acquirer reflects not only the beliefs about the underlying value of the target company, but also the competitive environment. The term auctions is not only used for the sale of antique objects, but also more broadly a wide array of competitive selling procedures. Auction theory studies how the choice of procedures affects outcomes. Shareholders want to get the highest possible price.

Insights from Nobel on Auction Theory

William Vickrey, the inventor of auction theory and recipient of the 1996 Nobel Prize in Economics, demonstrated how prices are determined as the result of competitive bidding processes. This analysis directly relates to the determination of exit values. Auction theory also sheds light on how to structure IPOs, buyouts, and secondary sales, as well as how to manage the process of selling a venture to prospective buyers. There are several types of auctions. English auction houses such as Christie's or Sotheby's use ascending-bid auctions where the price goes up until only one willing buyer is left. Most acquisitions are effectively conducted in this manner. Dutch auction houses use another system: the offer price gradually comes down from an initial value, and the first buyer to bid wins the object. This was the method used for Google's IPO. Most IPOs use a variation of the sealed-bid auction method, in which potential buyers submit private bids. After the dead line, the highest bid is revealed, but the price paid by the winning bidder is only the second-highest price. Vickrey showed that second-price sealed bid auctions create surprisingly simple bidding strategies. In a second-price auction, the winning bidder doesn't actually pay his or her own bid, but the price of the next- highest bidder. As a result, bidders always bid exactly what the object is actually worth to them, without the need to think strategically how their own bid stacks up against the others.

In auction theory, private and common values are distinguished. In the private instance, each person has a separate appraisal for the item being sold. For instance, a great bottle of wine's value to the buyer is independent of what it is worth to other purchasers. Common values, like corporation shares, make things more challenging. A share's worth is determined by its resale value and, therefore, by how much other prospective purchasers are willing to pay for it. The investors that bid do not know the share's common value. This results in a winner's curse issue. Every time a bidder wins a common value auction, it must be true that lower bids than the successful bidder were made on the item. Because they are aware of this way of thinking, knowledgeable bidders make logical decisions about what to offer. Less intelligent bidders can rashly offer their perceived worth. If they prevail, they could have to pay more than everyone else deemed reasonable. The winner's curse issue explains why savvy buyers may exercise caution when making offers for companies and why IPO prices often rise on the first trading day. Consider the following straightforward bargaining strategy, which is based on Nash bargaining, to comprehend the pricing of purchases. The worth of the start-up to its owners as a standalone entity establishes the bottom limit of the pricing range. They are hesitant to sell at that price.

The value of the startup to the acquirer, taking into account all the synergies produced by asset complementarity, establishes the upper limit of the range. The acquirer is hesitant to purchase over that price. The buyer may set pricing close to the lower limit of that range in the absence of competition since they are aware that the seller's only other option is to continue operating as a standalone business. However, they will approach the top limit of the range if numerous strategic purchasers compete. The buyer with the most synergies will ultimately place the highest offer in what is basically an auction. In reality, startups generally haggle with a favored buyer while holding out some hope of flipping to other ones. Both sides attempt to create rivalry on the opposing side for these reasons. While incumbents strive to reach out to rival entrepreneurial businesses, startups attempt to pique the attention of several prospective customers. It is implied that when a purchase is announced, the value of the acquirer should rise. In fact, there is actual proof that when corporations disclose private acquisitions, stock market prices rise. Curiously, latent purchases, which are acquisitions that are not made public, do not follow the same rule [10].

Cash or company shares may be used as payment, albeit the latter option is only available to publicly listed companies as sellers are less likely to accept illiquid shares from privately owned businesses. Using shares rather of cash provides the benefit of saving the acquirers from having to raise more money, but only if the cost is greater than the dilution. U.S. listed companies provide credence to the notion that when their own share is expensive, acquirers often use stock. The seller believes that buying shares is riskier than selling them, thus they want to rebalance their stock portfolio by selling their shares gradually. In order to calm concerns that they are overpaying, acquirers may sometimes insert an earn-out provision in their contracts. Under this clause, a part of the purchase price is paid upfront and the remaining sum will be earned out by the seller if the acquired business achieves specific performance targets.

Earn-out contracts have the potential of resulting in incentives that are in conflict after the acquisition, and the acquiring business can even deliberately fall short of the performance targets in order to get a smaller earn-out payout. When the purchase value is less than the chosen conditions of the investors, the situation becomes challenging. In this scenario, the entrepreneur gets nothing and may attempt to thwart the purchase. Investors sometimes carve out a portion of their ownership and distribute it to the holders of common stock in order to prevent this risk. According to a research by Broughman and Fried, this kind of renegotiation occurs more often when investors lack the control rights necessary to compel an acquisition. The buyer often extends an employment contract to the founder and management. This does two things. It can be required to persuade hesitant founders to consent to the sale of their business first. Second, it ensures the startup's integration and transfer are seamless. These managers and staff are often required to serve a lock-up term, which may last anywhere between three months and two years, according to the acquirer.

Following the Acquisition

Integrating the purchased unit along strategic, marketing, operational, and human resource dimensions is the key difficulty for the acquirer. Larger purchases provide the consumer with more difficulties. In certain instances, the purchased firm keeps its independent name even if it is ultimately absorbed by the acquirer. For instance, this is what happened when Google bought YouTube. However, the product and brand become completely merged with the acquirer in many other situations. This was the case, for instance, with Like.com, which, after Google's purchase, was included into the company's retail search engine. The acquirer's capacity to inspire and hold onto its talent will determine how much the startup it has purchased can profit from it. The transfer into a bigger organization is problematic when the acquired staff has substantial technical expertise. The purchased team may not have the freedom or motivation to keep developing. Integration and autonomy are traded off from the standpoint of the acquirer. Bright engineers could despise being small fish in a bigger pond and lose their motivation to be innovative, according to a worry.

The founders and top management of the acquired firm are especially acutely aware of the issue of talent retention. There is much doubt over the role of the entrepreneurs beyond the first transition period. They choose to stick with the acquirers in such circumstances. They may have a strong sense of loyalty to their team or product, therefore they set the continuous expansion and success of their business as their next professional objective. Some acquirers could allow them to achieve this aim, but conflicts often arise between the business owners and the acquirer's management, particularly if the venture becomes assimilated into the acquirer and loses its uniqueness. It might be challenging for many entrepreneurs to see themselves as corporate administrators. As a result, many business owners do not stick with the acquirer for very long. As a result, many business owners and personnel depart over time. They can stop to soak in the rewards of their hard work in making the purchase. After that, they may launch another business, invest as an angel in new ventures, or join a venture capital firm. The next generation of new entrepreneurs may learn from the experiences of seasoned entrepreneurs, therefore this recycling of entrepreneurial talent is a crucial component of an entrepreneurial ecosystem.

Purchase from Financial Buyers

The firm may be sold to a financial buyer, which is another way for investors to get liquidity. It is known as a buyout if the transaction entails the transfer of all shares. This sale may also take one of two other forms. We refer to a share sale as a secondary sale or secondary if it just involves a portion of the shares.

Buyouts

A buyout is a business deal in which a brand-new group of financiers purchases all of the stock of a firm. Institutions, particularly private equity firms, are often the investors. Unlike acquirers, these purchasers are only interested in the money and do not incorporate the enterprise into a bigger corporate structure. Instead, the takeover keeps the corporation a stand-alone organization. Buyouts often take place at the end of a company's growth. While buyouts are not intended to jar the corporate structure, acquisitions and IPOs substantially alter the venture. A buyout transaction has a straightforward structure: the buyer takes over as the company's new owner and receives all of the stock. Additionally, the buyer takes up all responsibilities, including debt obligations. A leveraged buyout is the name given to a transaction when a significant amount of debt is raised to fund the acquisition of shares. A management buyout is what is referred to when the transaction is started by the current management team in order to strengthen its control over the business. A buy- back is a variant of an MBO in which the founders repurchase investors' shares.

This often occurs when the firm takes a while to grow and the initial investors seek to exercise their right to redemption for cash. In such circumstances, it is typical for an equity fund to lend money to the founders. The deal is known as a management buy-in if it is undertaken by an investor with the intention of acquiring the business and appointing an external management team. Usually, the amount of the transaction determines how complicated the deal structure is. Smaller businesses with straightforward operations might be acquired without the need of complicated financial tools. Simply put, the purchasers take over the sellers' equity and become the new owners. But purchasing bigger, more established businesses requires more intricate transaction structures with many layers of debt, each with its own covenants and maturity schedules. Either via discussion or through an auction, a firm might be sold to a financial bidder. Smaller businesses often conduct transactions via negotiation since they can only locate a certain number of purchasers. However, bigger and more reputable businesses may be able to draw a lot of interested people. As a result, they often use an investment banker to arrange an auction or else they design the negotiation such that it is competitive and seems like an auction.

Additional Sales

In the context of private market transactions, the word secondary's is used to denote the secondary sale of shares. Similar to buyouts, secondary transactions maintain the company's status as a stand-alone, privately owned business. Similar to buyouts, financial companies are often the purchasers, but they only acquire a single or small number of investors' stakes. In recent years, secondaries have grown in significance. The underlying pattern is that firms increasingly go public and exit acquisitions at later phases of growth. Just a word of warning. The sale of VC partnership shares, which are monetary claims on the whole VC portfolio, as well as the sale of business shares, which we will also examine in this paper, are also referred to as secondary's. There are three different categories of secondary share sellers, each with a different goal investors seeking liquidity for their holdings workers seeking to sell common shares acquired via stock option exercises; and founders or senior management themselves. There are two causes for these vendors to sell. First of all, since they normally have a little wage, they have a need for liquidity. They have an undiversified portfolio, and because the firm is the only source of their wealth, they may choose to sell some shares in order to lower their personal risk. As was the case with data-mining startup Planter, there may be significant pressure from founders and workers to acquire liquidity, which might lead to some conflict with investors. Three different buyer kinds exist for secondaries. Existing investors are the first to purchase secondary shares from other investors. By using their right of first refusal, which allows investors to buy shares put up for sale by other investors, they may accomplish this. Second, there are investors who are new to the business and buy secondary shares from investors who are already shareholders.

The business itself, which could repurchase part of its own shares, is the third kind of buyer. The removal of unwelcome stockholders, such as former founders and workers who want to cause the business trouble, is a common use for this final sort of transaction, which is rather uncommon. In three different secondary transactions, shareholders may sell their shares as a component of a financing round, as a stand-alone transaction, or on a niche market. First, later-stage investors may purchase shares from current owners during a financing round. New investors purchase secondary shares when they desire to invest more in a company than it needs to raise because a financing round is conducted to raise money for the business. Second, a financial buyer consents to acquire a block of shares from a particular group of shareholders in a stand-alone acquisition of secondary shares. Other VC companies are often the financial purchasers. There are VC secondary funds that focus in transactions like this as well. For instance, the specialized Silicon Valley companies Delta-v Capital and Harvest Growth Capital were created by seasoned VCs with a focus on secondaries.

The company's board of directors and maybe additional shareholders with rights of first refusal must approve stand-alone transactions. Resistance may arise since the transaction involves the potential disclosure of valuation information, particularly if the value is lower than in the prior investment round. As a result, structuring such secondary's can need challenging talks between the purchasers, current owners, and the firm. The third method of purchasing and disposing of secondary shares involves using a market place specifically designed to facilitate the trading of privately owned firm stock. Several initiatives to develop markets that meet the shareholders' demands for liquidity, particularly for large private technology businesses, have been attempted in recent years. Both supply and demand factors are driving these efforts. The primary source of shares is founders and staff members who are looking to sell their common shares or stock options. On the demand side, there are investors eager to invest in profitable businesses that are anticipated to go public [11].

Secondary Platforms

Secondary sales have always been a secretive niche industry. However, a number of innovators have attempted to develop internet markets for them during the last ten years. In 2009, the platform for trading restricted shares of private corporations was established by Second Market, which had been founded five years earlier to trade illiquid assets. It served Facebook workers who were attempting to sell part of their stock. However, Facebook itself resented the fact that its shares were trading ahead of the IPO and wanted to halt it, thus it did not enjoy the fact that Second Market's transaction volume soared in the 2012 lead-up to the Facebook IPO. Generally speaking, Second Market had trouble obtaining support from the companies whose shares were traded on its platform. Additionally in 2009, Shares Post developed a rival platform to help connect individual buyers and sellers and carry out transactions. In 2013, SharesPost and Nasdaq collaborated to establish an intermediary secondary market. Once again, private corporations that wished to maintain control over their stockholders were hostile to the idea. It also demonstrated how difficult it is to manage a market with few information and challenging regulations. In order to get support from the private companies, Nasdaq purchased Second Market in 2015 after splitting with SharesPost.

Shares Post evolved into a broker-dealer focused in connecting individual sellers and purchasers of pre-IPO firm shares, while SecondMarket became Nasdaq Private Market, offering businesses unique software solutions and assistance in implementing corporate sponsored structured liquidity programs. Secondaries started to flourish as a market for Fintech firms about 2013. Particularly noteworthy are Equity Zen and Forge Global, both of which cater to accredited investors looking for investments as well as pre-IPO shareholders looking for liquidity. In order to reduce the effect of transactions on the company's capitalization, Equity Zen suggested the usage of a fund structure. The fund buys the stock from a number of sellers and takes ownership of the business. Buyers buy a portion of the fund's ownership. A proprietary derivative structure developed by Forge Global has no effect on the company's market capitalization. The corporation instead constructs derivative shares that transfer the financial profits but not the legal ownership and voting rights, as opposed to attempting to transfer restricted stock directly. The seller maintains legal ownership of the shares while receiving a payment that is equal to the agreed-upon value of the shares.

After making the purchase, the buyer is given a derivative that guarantees payment of the value of the shares at the anticipated departure date. Although much testing is still occurring, no clear winner has yet been identified. For instance, crowdfunding websites like the 2009-founded MicroVentures and the UK-based SEEDRS have branched out into secondary trading. The actions of the appropriate authorities have an increasingly significant role in determining how future events will turn out. the U.S. since 2016. As part of a larger strategy to ensure fair treatment for all investors in both private and public markets, the Securities and Exchange Commission has increased its regulation of secondary market transactions. For two key reasons, secondaries pricing is always tricky. First, sellers often have an edge in terms of information. Unfavorable insider knowledge may always be the driving force behind a propensity to sell. This is the same issue as in Issue 2.6 with the lemons. Second, the price of ordinary stock is lower than the price of preferred stock, particularly in early rounds. Secondaries are often for common stock owned by founders and workers since valuing this difference in a small transaction may be challenging.

Dissolving the Company

We go through the process by which investors choose whether or not to refinance the business. Companies must determine whether to try operating without funds or cease operations if they don't. It's crucial to note that investors often choose to shut down businesses in which they made large investments. Jibo, a social robot created in 2014 by robotics engineer Cynthia Breazeal, was an example of this. The aforementioned firm had received over $70M in venture capital, but sales suffered since the machine didn't provide the desired user experience. We are now going to go over the last few actions that must be taken before a business officially shuts down. The enterprise often dies quietly throughout the closing process, which is common. Employees are let go, business operations stop, and whatever money that is left behind is liquidated by the shareholders. Having the business bought for a price that represents the worth of the remaining assets is an alternative to shutting it down. This avoids the expenses of closure and could hide the unfavorable result. For instance, the e-commerce platform Groupon Inc. purchased LivingSocial for a nonmaterial sum in October 2016. Groupon outcompeted Living Social, which had earlier raised roughly $900M and had a valuation of over $4B. To maintain its client base after the acquisition, Groupon kept the Living Social name.

If a business owes debt that it is unable to pay, it must go through some kind of court-supervised bankruptcy process with the aim of reorganizing assets to pay the obligation. The court will let the firm to continue operating, restructure its debt, and resume regular business activities while it is briefly suffering financial difficulty but is still economically viable. The primary objective of such bankruptcy procedures becomes debt restructuring. This necessitates discussions among the lenders, as well as between the firm and the lenders. Extensions of loan maturity, increased interest rates or fees, additional lending facilities, and maybe partial debt forgiveness are typical effects. When the firm is deemed to be no longer economically viable, the objective of bankruptcy proceedings is to secure its orderly dissolution. In the United States, the processes for restructuring companies are defined by Section 1 of the Bankruptcy Code. The bankruptcy court in this case is in charge of approving the transfer of collateral, the sale of all remaining assets, and the distribution of all remaining funds in accordance with the order of credit seniority. In the United States, of the Bankruptcy Code governs the processes for shutting down businesses. There are direct administrative expenses of bankruptcy, such as paying attorneys, accountants, and other experts.88 Bankruptcy also imposes indirect costs on the parties involved. The corporation directly bears some of these expenses, while lenders shoulder others. The interruption of company might also result in indirect losses.

There may be some income loss in case, as well as increased expenditures and a substantial demand on management time. The fire sale value of assets is often their genuine worth in cases of company liquidation. There may be personal bankruptcy if the founders contributed personal funds to their startup. If there is true personal bankruptcy, there may be serious private repercussions. In addition to causing emotional stress, there may be repercussions for future credit availability. The legal guidelines governing personal bankruptcy may also have an impact on the decision to become an entrepreneur in the first place, the extent to which entrepreneurs want to borrow, and the amount of money lenders are willing to lend. Entrepreneurs may even experience a stigma of failure that taints their reputation and limits their future career opportunities. Last but not least, it should be mentioned that each nation has unique bankruptcy rules and processes. Creditors are primarily protected by bankruptcy rules in several nations, such as Canada and Germany. Senior creditors get payment before junior creditors in certain nations, which closely follow seniority laws. However, bankruptcy rules are less harsh on debtors in other nations like the U.S. or France. There are valid arguments for both strategies: favoring creditors may result in an excessive number of closures, while favoring debtors can result in an excessive number of ineffective continuations. Their rules permit breaching seniority rules 93. Additionally, various bankruptcy regimes provide various incentives. Regimes that support creditors encourage lenders to provide credit. Additionally, they can deter businesses from making hazardous investments.

CONCLUSION

In conclusion, The IPOs of Alibaba are a fascinating case study in the area of venture capital and international capital markets. The strategic choices and results of Alibaba's dual listing on the New York Stock Exchange and the Hong Kong Stock Exchange provide important new perspectives on the difficulties, prospects, and complexity of large-scale IPOs. Investors, business owners, and industry watchers may learn important lessons from Alibaba's path and find inspiration for their own endeavors in the fast-paced world of technology and e-commerce. the larger effects of Alibaba's IPOs on the investing community and the global IT sector. It looks at the rising interest in investing in developing economies as well as the increased focus on Chinese IT businesses. The abstract also discusses the possible difficulties and hazards related to funding fast-growing, technologically advanced businesses like Alibaba.

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CHAPTER 24

DETERMINANTS OF THE EXIT DECISION

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ABSTRACT:

The Determinants of the Exit Decision explores the key factors that influence the decision-making process for investors considering an exit from their investments. This abstract examines the various determinants that investors consider when evaluating the timing, strategy, and method of exiting an investment, highlighting the complex nature of this decision. The abstract begins by emphasizing the importance of the exit decision in the investment lifecycle, as it directly impacts the potential returns and liquidity for investors. It introduces the concept of exit determinants and their significance in guiding the exit strategy of investors.

KEYWORDS:

Capital, Competitive, Financial, Industry, Investor, Landscape, Market Conditions, Profitability.

INTRODUCTION

We can now talk about how investors and businesses really decide when to depart. We identify three groups of factors that are at play in this choice. First, there are market dynamics that favor certain departure types over others from time to time. Second, each business has its own economic foundation and course of growth. Third, the timing and selection of a departure are influenced by company-level dynamics between entrepreneurs and investors [1]–[3].

Monetary Forces

Distinguishing between institutional considerations, which persist over time but vary between nations, and cyclical market variables, which fluctuate over time, is helpful in understanding the market dynamics driving the departure choice. First, think about constitutional considerations. Different legal and regulatory frameworks, commercial practices, and cultural standards exist in many nations. The stock market is a prime example. Stock markets are supported by favorable laws in certain nations, including the U.S. Young and small businesses may access these markets, which provide finance and liquidity for investors. But stock markets have a considerably smaller impact in other nations like Germany or Japan. These nations make it more difficult for entrepreneurial businesses to enter stock markets. Taxation is another factor. For instance, the form of withdrawal may have an impact on the capital gains tax that various shareholders must pay. Then there are cultural considerations. Different departure points have varying degrees of status throughout civilizations.

The IPO wave

Cyclical market dynamics can have an impact on departure possibilities in addition to these institutional variables. Particularly significant is the fluctuation in the IPO market, which sometimes results in the withdrawal of the IPO. Every move is imitated by rivals, who are always trying to catch the newest trick. If a well-known firm buys a start-up in a brand-new technological area, its rivals may be compelled to follow suit. According to a recent research by

Ozmel, Reuer, and Wu, established pharmaceutical businesses depend on the purchase of cutting-edge biotech start-ups to preserve their competitive advantage. This study examines acquisitions in the biotechnology sector. The research looks at a sample of 1,369 venture capital-backed biotech start-ups to determine their likelihood of being purchased. It concludes that a firm is more likely to be purchased the more recent acquisitions there have been in its industry area. When more well-known acquirers make acquisitions, this impact is amplified.

These results support the idea that established rivals react to one another's purchases, resulting in waves of acquisitions within certain industrial sectors. Another conclusion is that acquisition waves are stronger in biotechnology fields that seem riskier. This may come as a surprise since one would assume that well-established businesses would exercise more caution in hazardous situations. The researchers note that when determining the desirability of new industrial categories, existing organizations depend on two sorts of information: their own internal evaluation and the signals they may get from rivals. In less dangerous sectors, they depend more on their own internal analysis, but in riskier parts, they rely more on the signals provided by their rivals. To put it another way, if you purchase one, I should too, even if I don't fully understand what is happening[4], [5]. There were significantly more initial public offerings (IPOs) in the latter two decades of the 20th century than in the first two.

DISCUSSION

Economic Fundamentals

The economic fundamentals of a company its commercial position, competitive landscape, and strategic prospects clearly affect its departure decision. In spite of the fact that departure involves the selling of investor shares, the decision about exit has an impact on the underlying firm as well. So, in this, we look at how economic fundamentals influence departure decisions. We provide two questions after examining departure from the viewpoint of the company's shareholders. The first is whether the business should continue to exist as a separate entity or be incorporated into a bigger corporation. The second choice suggests being acquired. If the business decides to maintain its autonomy, it must next decide whether to stay private or go public. If the stockholders would benefit more from a privately owned firm, they might sell their stake in the business or just keep backing it via new rounds of financing. Now let's look more deeply at these two key issues.

Economic Principles

The advantages of integration may be compared to the things that a start-up can only do after an acquisition. Frequently, this entails gaining access to supply chains and distribution networks. For instance, a software firm that creates a business application would find it challenging to sell its product separately. A seasoned software vendor may be able to successfully integrate the new application and grow its own client base at the same time. As an example, consider Atlassian, a maker of collaboration software, which purchased the project management app developer Trello in January 2017 for $425 million. Access to intellectual property, industrial technologies, or specialist knowledge are some instances of complementary assets. One qualification is that a strategic relationship might be used as an alternate means of gaining access to important assets. However, where significant synergies can be obtained, integrating via an acquisition is a more complete structure that is often preferred. There are two key advantages to keeping your independence. Maintaining entrepreneurial incentives is one of them. Founders and management are responsible for their own performance in a stand-alone business. When a bigger organization acquires a unit, the unit no longer has its own profit and loss statement, making this more challenging. It soon becomes difficult to determine who is accountable for what when the administrative complexity of any bigger business is added.

The choice value of waiting is the second advantage of maintaining independence. Staying independent doesn't always mean doing so forever; it may only mean hanging out long enough to establish stronger exit possibilities. This makes the choice to be bought or stay independent a fluid one. In order to get more and better bids in the future, a startup may choose to reject an acquisition offer. The advantages of being a stand-alone firm could only last a short while, for instance, Snapchat turned down a $3 billion buyout offer from Facebook in 2013 and went public in 2017, earning a market valuation of $33 billion. It gives the business some breathing room to iron out any kinks before finally accepting a tempting offer from the ideal buyer [6]–[8]. The second consideration, if a corporation chooses to maintain its independence, is whether it should be privately owned or publicly traded. In the first scenario, investors get liquidity during or just after the IPO. The investors in the latter situation get liquidity by selling to financial purchasers. Here, we should point out that the advantages and disadvantages of maintaining privacy don't always have to be long-term; they might even be transient. The dilemma is not whether to become public or remain private forever, but rather whether to do it right now or wait a little longer and then make up your mind. Investors that choose to continue supporting a privately held firm may do so, or they may opt to sell their shares in a buyout or secondary transaction.

Company Dynamics Internal

The third factor influencing the leave choice is the management procedure and internal corporate dynamics of how the decision is actually made. The board of directors ultimately makes the decision to leave. Although there are numerous unique characteristics that vary across businesses, we concentrate on some widespread problems in this paper. The main disputes in society generally are those between business owners and investors. The investors themselves may also dispute further since they may have different viewpoints and goals. The need for cash is the main factor influencing the choice to depart. Both founders and established investors enjoy liquidity, but founders also want management control, and venture capitalists may need liquidity to remit funds to their own funders. It's possible that founders like the thought of continuing to lead their business following an IPO. Additionally, they can feel as if they are losing control after an acquisition, or they might object to restricted employment agreements or onerous earn-out conditions.

The option between an assured return in the now and a hazardous return in the future is one that exit decisions often confront. Thus, opinions on the company's future impact exit choices. Founders sometimes have a more positive outlook on their firm than investors do, and they frequently foresee fresh opportunities. As a result, they may support keeping the business private and autonomous. On the other hand, more sensible investors often favor leaving the firm when the time comes. Various financial incentives also have an impact on the choice to leave. Preferred shares often contain an automatic conversion provision in the event of an IPO. In contrast to an IPO when they are immediately out of luck, this may encourage investors to press for an acquisition where the desired conditions apply. We learned how term sheets decide who controls the choice to leave. You may decide to leave by pulling any control lever. Exit decisions are made by the board of directors, but they may also need the approval of a majority of shareholders, thereby involving voting rights. Term sheets may grant investors veto rights over exit and explicitly specify rights to initiate the sale of their shares, with registration and drag-along rights.

Last but not least, there are informal control methods in addition to official control rights, including the power of persuasion and the power of persons. If the founders and top management are opposed to going public or being purchased, investors will have a tough time doing so. The whole IPO process might be easily derailed by their resistance. For instance, the VC investors in Applied Medical Corp. applied for IPO registration in November 2011 and got into a heated argument with the business that resulted in the withdrawal of the registration in June. Overall, we observe that although the range of exit options from which entrepreneurs and investors prepared to spend $115M in cash might pick depends on market circumstances and economic factors. Golden Gate will not go below $120M but is prepared to do away with the earn-out condition. Who do I need to contact next?Astrid immediately responded, Let's call a meeting! The board unanimously accepted Golden Gate's takeover bid on a conference call the next day. Analysts gave the deal high marks when it was first announced in early 2025. Golden Gate's stock price increased 10% on that day, reaching $11 per share.

Investment Capital

This looks at venture capital's organizational structure. First, we clarify that venture capital companies are financial middlemen that solicit capital from institutional investors. We first discuss how institutional investors decide to allocate a portion of their holdings to venture capital funds and how a limited partnership agreement details the rights, obligations, and compensation of the general partner (GP). Next, we look at how VC firms are structured, including their internal organization, fundraising efforts, connections to other venture capitalists, and the methods they use to find and hire talented employees. We go into the organization of VC companies' investing strategies before looking at data on the gross and net returns of VC funds to round off our discussion.

Model of Venture Capital

Discover the investing cycle through the lens of an entrepreneurial endeavor. Now, we shift our attention to the investors. We employ the FUEL framework presented in 1 to analyze the structure, motivation, and investing style of investors. In chapter 12, we concentrate on venture capital (VC), which serves as the industry standard for lenders of startup capital and has a complicated organizational structure that is worthy of independent study. We examine the different sorts of investors and how they vary from VCs in Chapter 13. The fund is the legal entity that receives funding from investors and distributes it to the firms, with the VC firm managing the investing process. The entrepreneurial business at the bottom obtains money to expand and invest with the intention of making a profitable exit. A Limited Partnership Agreement regulates the relationship between an institutional investor and a venture capital company. The terms of this agreement specify how the fund vehicle will be created, how money will flow, and what each party's obligations and rights are. We look at the LPA. The fund vehicle is set up legally as a limited partnership. By administering the fund, the venture capital company takes on the position of general partner and is not restricted in responsibility.

The LPs are protected by this arrangement against claims of liability or legal action from third parties. They are immune from liability since they maintain an arm's length relationship with the

GP and the companies in its portfolio. The stock purchase agreements and other relevant legal papers, which give the term sheets agreements their final, formal legal shape, control the relationship between the venture capital firm and the entrepreneurial company. First, think about the investment stage. The LP contributes capital to a fund by making a predetermined investment. While LPs supply the overwhelming bulk of capital, the VC also contributes a small amount to assure dedication to the fund's mission of value creation. In general, GP contributions range from 1 to 2% of the fund's total size. Additionally, as shown in Figure 12.1, the VC company gets paid a management fee to oversee the VC fund; this charge is set and independent of the fund's ultimate performance. The VC company receives compensation from this payment for its management services. The equity investment in the firm is the subject of the last arrow in the investment phase. Next, consider the phase of return. The VC fund receives some revenues after a successful exit for a firm, either in the form of cash or shares. The LP and the VC company each get a portion of these. Carried interest refers to the VC firm's portion in the business. The remaining earnings are returned to the LPs.

Investors in Institutions

There are several sorts of institutional investors. Institutional investors are financial companies that handle significant quantities of financial assets. Employee pension contributions are invested by pension funds, either public or private. Insurance firms invest insurance premiums so that they may access them in the event of claims. In addition to taking deposits and making loans, banks also look after the assets of their rich customers. For the benefit of its constituents, sovereign wealth funds invest on behalf of governments, typically through bolstering public coffers. Established businesses sometimes invest in VC companies in addition to actively investing startups. Universities' and foundations' endowments make investments to produce money that may be used to fund institutional objectives. Finally, wealthy people make investments via so-called family offices. According to a study by Da Rin and Phalippou, there are 23% banks and finance companies, 21% public pension funds, 21% corporate pension funds, 21% endowments, 8% insurance companies, and 6% other as limited partners in VC and buyout funds.2 Another industry report breaks down the amounts invested in European VC funds between 2013 and 2017 as follows: 25.2% of funding came from government agencies, 16.0% from asset managers, 15.2% from corporate investors.

Options for Portfolio Allocation

How do institutional investors choose where to put their money in a portfolio of investments made up of many assets? The majority of portfolio allocation follows a top-down approach in which money is first distributed to asset classes, then within these asset groups. Bonds, equities, commodities, and alternative assets make up the four primary asset classes that institutional investors divide their holdings among. Bonds are fixed-income instruments that carry interest, such as mortgage-backed securities, corporate bonds, government bonds, and other assets that are often traded on exchanges. According to popular opinion, this asset class is the safest of the four, with the two primary risks being default and inflation. Shares of publicly traded companies and derivative instruments with stocks as their underlying asset are both classified as stocks, often known as equities. Agricultural goods, oil and gas, metals, and money are the principal commodities. They may be highly volatile, but they are often exchange-traded and hence liquid. All other assets fall under the remaining category of alternative assets, which also includes hedge funds, real assets, private equity, and venture capital firms. They are all illiquid, which is what they share in common. This implies that they can't be purchased and sold on an exchange rapidly instead, investing in them calls for more patience. Institutional investors sometimes make these investments on their own, but they often assign this work to specialized funds, such as venture capital funds.

Institutional investors choose their asset portfolio based on their expectations for the risk, return, and degree of correlation of various assets. This also applies to VC money. We look at the risk and return of these investments . The venture capital (VC) sector often asserts that its investments have a low connection with the stock market and are hence appealing from a diversification perspective. But this claim is somewhat disputed by our explanation. It also demonstrates how disappointing VC funds' track record of returns has often been. As a result, a lot of institutional investors have chosen to completely avoid this asset class. However, a sizable portion of investors continue to support VC. Typically, they allocate 3 to 5% of their whole portfolio to venture capital. It is helpful to comprehend some fundamental ideas from contemporary portfolio analysis in order to better comprehend the difficulties LPs confront while investing their portfolios. The Capital Asset Pricing Model, which lays the groundwork for contemporary portfolio allocation, was introduced. we explore later financial discoveries that led to many Nobel Prizes in Economics.

Financial Portfolio Analysis: Nobel Insights

Eugene Fama, Lars Peter Hansen, and Robert Shiller shared the 2013 Nobel Prize in Economics, which was given in recognition of their empirical analysis of asset prices. The 1997 Prize was given to Robert Merton and Myron Scholes for a new method to determine the value of derivatives. Fama developed the three-factor asset pricing model with Kenneth French, which has become known as the Fama-French model. The purpose of asset pricing models is to explain excess returns, that is, individual stock returns over and above the returns to the market. The benchmark model, is the CAPM, a one-factor model based on the correlation of an asset with the market return. When researchers tested the CAPM, they found a variety of anomalies . Some of these anomalies disappeared once they were discovered. For example, calendar time effects, such as a Monday, end-of-month, or January effects, all disappeared once investors developed trading strategies to profit from them. Two important anomalies, however, persist across time and markets.

The Fama-French model includes them in an elegant extension of the CAPM. First, there is a size effect, where size is measured by market capitalization Smaller stocks have higher excess returns than larger stocks. Second, there is a value effect stocks with a higher book-to-market ratio have higher excess returns than stocks with a lower book-to-market ratio, where the book-to-market ratio is the ratio of the book value of the firm’s assets over its market capitalization. The Fama-French model predicts lower returns and consequently higher valuations, but the relatively smaller size of their companies implies larger returns and lower valuations, so the net of these two effects can go either way. VCs invest in companies with a lower book-to-market ratio. Shiller found himself on the opposite side of this debate, arguing that there are market inefficiencies. As a result, he became one of the pioneers of behavioral finance, alongside Kahneman and Thaler, whose work we discuss. Fama argued that once the three factors are taken into account, there is no predictability left in the stock market, which he takes as proof that markets are efficient.

Building a VC Portfolio

Venture into long-term, illiquid, and opaque markets when investing in nontraditional assets like venture capital. How should LPs go forward? There are three choices in their portfolio allocation. The first choice is how to distribute funds across different asset classes; the second choice is how to distribute funds to venture capital (VC) within the alternative asset class; and the third choice is how to construct a VC portfolio by choosing which GPs to invest in. We think about the first two options. Now that we've examined the GP selection procedure, we contend that finding the best GPs is exceptionally difficult. The VC market is fragmented, opaque, and illiquid. In such inefficient markets, LPs that understand and have access to favorable possibilities stand to gain, while those that do not stand to lose. The top and bottom performers in a conventional bond portfolio are not that far off, but in an alternative asset class, the top performers are likely to exceed the bottom by a wide margin. This implies that the skill sets and prospects for market entry of the LPs varied significantly. Gatekeepers, paid advisors that assist LPs with the fund selection process, are employed by certain LPs. On the flip side of the transaction, small VC firms may utilize placement agencies when they need to raise money.

These agents aid the tiny VC firms in connecting with their gatekeepers or limited partners. Portfolio construction for venture capital funds is different from portfolio construction for bonds or equities. By purchasing or selling assets on the market, an investor may use the latter to swiftly accomplish any desired allocation. The difficulty with VC funds is that there are only a finite number of funds available at any one time that meet an LP's requirements. Opportunities to participate in GP funds are rare and often restricted to a small number of LPs, primarily those who have already made investments in the GP. Therefore, building up a portfolio may take many years. Investing via funds-of-funds, or a fund that invests in many VC funds, is an alternate strategy for LPs. Institutional investors may connect with funds that might not welcome new investors using this strategy. Having two layers of fund managers is the biggest disadvantage. Prior to reaching the startup firm, the money first travels from institutional investors to the fund-of-funds, then to the VC fund.

As a result of having limited influence over the investments undertaken, LPs wind up paying two separate sets of management fees and carried interest. Prudential regulation has a significant impact on LP investment selections. Due to the nature of the returns and the lack of liquidity, VC funds are among the riskiest within this class of investments. Many pension funds are hesitant to participate in venture capital (VC) unless there is a clear regulatory clearance. The expansion of the U.S. venture capital market is commonly ascribed to the 1979 modification of the Employee Retirement Income Security Act's requirements for pension funds. Financial regulation sometimes has a more indirect impact. The Markets in Financial Instruments Directive, for instance, is a key component of contemporary financial regulation in Europe. Although it offers better market transparency and investor protection, there is fear that the MiFID rule may make it difficult for LPs from outside of Europe to participate in EU venture capital funds.

Agreements for Limited Partnerships

A limited partnership formed by the institutional investors and the venture capital company is managed by a limited partnership agreement. This agreement is made to address a number of issues. The GP is more informed about the current situation and future potential of their portfolio firms. Additionally, it possesses investing knowledge that LPs do not. It has plenty of space for opportunistic conduct given all of this. Institutional investors also preserve their limited liability status by refraining from interfering with the fund's management. The LPA defines the fund's form and governs the obligations and rights of the two parties in order to handle these difficulties. The fund structure, fund regulations, and GP remuneration are the three most crucial components. We will go through each of these components individually.However, it is helpful to first determine who is in charge.

Influence of Big LPs

Size enhances one's ability to negotiate with rivals, suppliers, or clients in many economic situations. Da Rin and Phalippou's research reveals that LPs are not an exception. LPs that have a higher absolute dollar exposure to VC and PE consistently get better terms in their LPAs. The fact that bigger investors are more likely to have a team devoted to investing in private equity and developing important experience in this asset subclass may be a contributing factor. Larger LPs are less likely to use gatekeepers for their due diligence or to invest in fund-of-funds. They are more involved in the choice and oversight of GPs, investing more time in due diligence, recalculating GPs' performance reports, and comparing them to other GPs. This contrasts with the non-negotiative approach of smaller LPs, who seldom visit portfolio firms to speak with management or negotiate LPA conditions. Additionally, smaller LPs seldom sit on the advisory boards of their GPs. The study's most unexpected conclusion is that the single characteristic that is consistently linked to LP activities is LP size. Other factors, such as the LP's organizational type, location, or remuneration structure, as well as their private equity expertise, show out to have little bearing on the degree of LP activism.

These findings add to those of a different scholarly investigation by Dyck and Pomorski that examines the net returns to LP for investing in venture capital funds. The research supports the significance of LP size. Investors in the greatest size quintile earn 7.4% greater annual net returns than investors in the lowest size quintile. LPs with a major investment in private equity saw better net returns during the two decades prior to 2009. VC funds may be as modest as $10 million or as large as $1 billion. GPs are strongly encouraged by compensation schemes to raise more money. However, a number of reasons limit fund size. Probably the most significant factor is the VC firm's track record. LPs are hesitant to take a chance by making sizable commitments since first-time VCs lack experience. On the other hand, VC companies with an established track record may draw sizable LP commitments. The stage and industry of concentration also affect fund size. Ventures in their early stages need less funding than those in their later stages. Sectors that rely more on capital, like clean tech, need more investment than those that depend more on human resources, like software.

The statistics on the distribution of VC funds' sizes from 2005 to 2017 are included in the study. The median fund size in the United States, Europe, Asia, and the rest of the globe is compared in Panel A. Although there is some seasonal change, the numbers are generally consistent and comparable across locations. In the United States, the median fund size is around $50 million, and it is a little bit more in Europe and Asia. In Panel B, which focuses on U.S. GP fundraising, averages for the years 2005 through 2017 are shown. On average, 213 new funds raised $30 billion per year. The median fund size was $40M, making the average fund size $140M. Only four funds raised more than $1 billion, totaling around $7 billion; ten funds raised between $500 million and $1 billion, totaling $6.3 billion; and 24 funds raised between $250 million and $500 million, totaling $8 billion. On the other end of the scale, 93 funds collected less than $50M, totaling barely $1.5B. As a result, only a tiny number of general practitioners (GPs) raise extremely significant sums of money, whereas the majority do so. Additionally, there is a continuous influx of new VC companies into the sector. 52 of the 257 funds created in 2018 raising a total of $5.3B were first-time funds.

Even when LPs make an upfront investment commitment, not all of the funds are transferred at the start of the fund's tenure. Instead, a succession of financial contributions are made by the LPs to provide finance. The GPs periodically inform their LPs via capital calls how much funding they will need for the next term. Quarterly capital calls are often issued to pay for management costs and anticipated investments. Regular capital calls provide the advantage of optimizing the fund's financial return since any cash that isn't invested affects how returns are calculated. The LPA anticipates severe repercussions, including the possibility of losing its whole ownership in the partnership, in the very unlikely event that an LP fails to fulfill its capital commitment. Delinquent LPs may potentially lose their good standing with GPs and be disqualified from further chances to participate in funds. A typical VC fund has a horizon of ten years. In other words, the LPs have a right get their investment, along with any financial gains, back within ten years. The first five years or so are referred to as the investment stage, during which time businesses are chosen and given money. When businesses are shut down, the following years are referred to as the harvesting phase. The LPA often argues that after the investment term, the fund can no longer make new investments but may still support its current portfolio firms with money.

Why do investments endure ten years?

The 10-year fund cycle is the established standard for all kinds of funds, including VC and buyout funds. The idea is to provide GPs enough time to make long-term investments while also putting pressure on them to produce returns by a certain date. LPs have less authority to request liquidity and less knowledge than GPs. GPs may spread out their first investments over many years with a 10-year horizon instead of being pressured to make investments of inferior quality. Additionally, it offers businesses adequate time to develop and accomplish profitable exit strategies. The advantages of limiting VC money to a 10-year period are up for discussion. According to certain scholarly investigations, as the fund cycle progresses, investors start to focus more on the short term.19 In reality, LPs also allow for some latitude, providing GPs more time to close off the outstanding investments. A majority of the LPs must approve such extensions in order to be valid. From the LP's point of view, there is a trade-off between approving the extension, which extends the time that their money is locked in, and requiring the liquidation of the remainder of the portfolio, which might provide less profit.

Fund Laws

We concentrate on three categories of regulations. those governing partner activities, fund management, and investment limits. A fund makes a commitment to its limited partners (LPs) to invest in accordance with a defined investment strategy based on factors including size, stage, industry, region, and other factors. The LPA establishes certain restrictions on that commitment, outlining which investments are permitted and which are not. For LPs, who often invest in a fund to cover a certain business sector, such restrictions are crucial. At the same time, it can be challenging to establish and maintain sectoral definitions in a rapidly evolving context. Additional limitations apply to the investing process. For instance, exposure restrictions state that no one business is permitted to receive more than a certain portion of the fund or an investment that is more than a specific value. Another typical restriction is that a fund cannot invest in a firm that has previously received funding from another fund. This limitation prohibits the VC company from utilizing the new fund to rescue certain bad investments made by a prior fund, thereby moving rewards from the LPs in the new fund to those in the previous one. This is because various funds of the same VC firm are likely to have different LPs. Additionally, it prohibits LPs in an earlier fund from suing if the new fund receives follow-on investment rights when the earlier fund should have had them. Rules for managing the money are also included in the LPA. First and foremost, the proceedings must be returned to the LPs when a departure has taken place. There is considerable flexibility over what is returned and when, however. The fund has two options for distribution of returns: cash or shares in publicly traded corporations.

LPs wouldn't, however, take private firm equity. GPs have considerable latitude in deciding when to make distributions, which they might strategically take advantage of. The date the cash or stock proceeds are given to the LP determines the GP's profit share in an investment, not the date the transaction was terminated. Therefore, optimistic GPs may gamble on the stock of their newly listed company by hanging onto it for a while before distributing it to the limited partners. The LPA could permit some recycling of departure funds with existing GPs. This is often restricted to early exits whose profits may be reinvested up to a specific amount within the investment term. Reusing the same money twice provides seasoned GPs the chance to boost the returns of their fund. The LPA also imposes various limitations on the actions of specific VC partners. It may outline the conditions under which a partner may or may not invest personally in the firms funded by the funds. The agreement also spells out each partner's responsibilities, prohibits them from engaging in incompatible outside activities, and spells out what happens if they quit the venture capital business. A so-called key man rule is also included in most LPAs. By doing this, LPs are shielded against the loss of a managing partner who is vital to the fund. The LP is released from any further obligations to the VC fund if such a significant partner departs [9]–[11].

CONCLUSION

In conclusion, the time, approach, and technique of quitting an investment are all impacted by a variety of characteristics, making it a complex process. Investors may make well-informed choices that are in line with their goals and optimize profits by taking into account both financial and non-financial aspects. Successful exit plans depend on knowing how internal and external elements interact, doing thorough research, and keeping an eye on market circumstances. The research presented in this abstract offers useful insights for investors, business owners, and other professionals working in the investment ecosystem, enabling them to make well-informed decisions and improve exit process results.

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CHAPTER 25

SIGNIFICANCE OF VENTURE CAPITAL FIRMS IN FINANCING

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ABSTRACT:

VC Firms explores the world of venture capital (VC) firms, which play a crucial role in financing and nurturing early-stage and high-growth companies. This abstract provides an overview of VC firms, their characteristics, investment strategies, and contributions to the entrepreneurial ecosystem. The abstract begins by defining VC firms as financial institutions that raise capital from various sources, such as institutional investors and high-net-worth individuals, with the aim of investing in promising startups and early-stage companies. It highlights the unique characteristics of VC firms, including their risk-taking appetite, long-term investment horizon, active involvement in portfolio companies, and focus on generating high returns.

KEYWORDS:

Deal, Diligence, Funding, Fundraising, Investment, Limited Partners, Portfolio, Strategies.

INTRODUCTION

VC businesses normally have a three-layered hierarchical structure, which is a rather straightforward one. Partners are at the top, followed by associates and then support workers. Additionally, venture partners who do not serve as the partnership's regular members but are active in bringing in and managing certain investments are also possible. These figures match those from earlier studies conducted in the United States and Europe. The partners are in charge of the company's investment and fundraising plans. They negotiate transactions, engage in dialogue with portfolio firms, and oversee the exit process. They also make all significant investment choices, usually via some kind of consensus decision-making. Although individual partners may get varying shares, reflecting their seniority and role within the business, all partners participate in the VC firm's profits. Although nomenclature varies across businesses and regions, junior partners are sometimes referred to as principals.

The typical partner works 55 hours a week, according to a poll of VCs by Gompers, Gornall, Kaplan, and Strebulaev. 15 hours are spent on deal sourcing, 18 hours on helping portfolio firms, 7 hours on networking, 9 hours on managing the company, 3 hours on meetings with LPs, and 3 more hours on various other responsibilities. Paid early-career workers with the goal of becoming partners are called associates. Many VC companies use a up-or-out promotion strategy, which is similar to that used by consulting and legal firms. Under this system, an associate either receives a promotion to the level of partner or departs the business. Some businesses could have more layers of staff or various degrees of seniority. Analysts help partners and associates by doing research while avoiding customer interaction. Associates often have degrees in pertinent scientific and engineering fields. They often possess an MBA degree and have many years of industry experience working for established or entrepreneurial companies. Analysts are hired as soon as they graduate from college. Partners often have one of two backgrounds: they were promoted from the ranks of associates, either at their own firm or another VC firm, or they had a successful career as an entrepreneur or in business.

Most venture capital companies use a group decision rule when making decisions. According to a poll of venture capital businesses, consensus is used by 20%, simple majority by 22%, and unanimity by 48% of all respondents. Only 4% of partners reported employing decentralized decision-making. The partnership model has a lot of challenges due to succession. Senior partners may fail to train the next generation of partners since they have little incentives to leave their lucrative position. Then, talented junior partners may quit the company, often to establish their own. Because their senior partners did not create a suitable succession plan, several repu VC businesses ultimately faltered or split. Examples may include Technology Venture Investors, the VC company that initially invested in Microsoft, Burr, Egan, Deleage& Co., which was created in 1979 but disbanded in 1996, and American Research and Development, the first VC business of modern times. The VC sector is often criticized for its lack of diversity. A significant percentage of partners have MBAs from a limited number of prestigious universities.

According to a market study, the top 200 U.S. venture capital companies employed 80% of people from the Harvard, Wharton, or Stanford business schools.34 At VC companies, white partners predominate, and the proportion of female partners is still relatively low. Other dimensions also suffer from a lack of variety. Gompers and Wang's research from 2010 to 2015 measures the gender and ethnicity of entrepreneurs and VCs in the United States.35 Women made up 47% of the work force in the US, with equal proportions in consulting, medicine, and law, and somewhat lower numbers in banking. However, just 9% of all VC partners and 11% of VC-backed entrepreneurs were female. Similar circumstances exist in Europe, where all-male teams won 85% of all agreements and received 93% of the cash invested in 2018. African Americans made up 12% of the work force in the United States, while they made up 6% of investment bankers, 9% of consultants, and fewer than 1% of business owners or venture capital partners. 16% of workers were Hispanic, with 6% working in investment banking, 5% in consulting, 5% as business owners, and 4% as venture capitalists. Asians made up 5% of the working force, 17% of the consulting industry, 25% of the investment banking industry, 18% of entrepreneurs, and 15% of venture capitalists. 37 12.4 examines some studies on gender concerns in venture capital businesses.

DISCUSSION

Gender and Performance in VC

The lack of diversity in venture capital is often seen as an equity issue. It can also be considered a lost chance for VC companies. Would more inclusion result in greater returns? Though the psychological underpinnings of this claim are still poorly understood, it is often said that diverse teams make better decisions. More women, more people of color, or more partners with unusual backgrounds should be included if the venture capital sector is a old boys' club, since this should lead to better investments. Gompers and Wang's latest research offers some compelling data on this subject. The research begins by examining the types of VC companies that employ senior female partners. According to the study, VC companies are more likely to recruit women when their senior partners have daughters, with the likelihood of doing so rising from 8% to almost 10%. The research makes the assumption that parenting causes certain psychological changes but does not completely explain how having a daughter alters VC partners' choices and behavior. The addition of a female partner to a venture capital company enhances fund performance in terms of departure rates and returns, according to the study's second conclusion. Comparing a fund's return to that of other funds of a similar kind, having a daughter enhances it by 3.2%. The research offers proof that broadening diversity may also benefit businesses.

VC businesses go through their own procedure of money raising via fundraising. Choosing sui LPs and persuading them to invest are essential steps in this process. First-time Since they lack a track record, GP teams who are new to the market have a particularly difficult time persuading LPs. To get beyond this obstacle, they must locate a cornerstone LP that vouches for the GP team. This cornerstone LP sometimes receives special treatment or reduced costs.39 First funds often have modest size and more LP-friendly LPA conditions. Experienced GPs with a proven track record have an easier time persuading LPs. Although they often want to add new LPs to increase their network, if their track record is very strong, they may merely depend on their present LPs. As a result, GPs develop a number of connections with LPs over time. In order to continue investing without interruption, successful GPs often raise a new fund far before the conclusion of the investment term for their existing fund. As a result, they could raise fresh money every two to three years, often growing their assets over time. Be aware, nevertheless, that these GPs are subject to some market discipline since they must often return to LPs.

Market circumstances have an impact on the fundraising process. It is simpler to raise money, funds are greater, and LPAs become more GP friendly when the LP's appetite for venture capital is strong. A VC company often establishes an initial range for what it expects to raise, including a minimum fund size and maybe a maximum, to test market conditions. LPs evaluate the idea and contribute their first capital. The fund will not terminate and all pledges will be worthless if the minimum target is never reached by the commitments. With prospective first-fund venture teams, this is often the case. The VC company may shut the fund if commitments are more than the minimum. A VC firm may sometimes organize two closings: a first closing to secure existing commitments and a second close to get any further commitments from institutional investors who may have been on the fence during the first closing. There are few exceptions, but typically every LP receives the exact same kinds of partnership shares in accordance to the sums they pledge[1], [2].

Networks VC businesses don't operate in a vacuum; rather, they keep up a network of relationships with a range of people who provide complementary talents and services that are important to their job. The deal flow network is the first thing that connects entrepreneurs and VC firms. Members of this network that are significant include founders of past portfolio firms, attorneys, and accountants. The network of investors, usually other venture capital companies but also angel investors and corporate investors, comes next. They could be asked to join a transaction or requested to co-invest by a VC company. The fundraising network, which consists of the LPs who support the VC firm's funds, is the last component. Lawyers, accountants, and technical consultants are just a few of the specialists that VCs keep in contact with to analyze and organize acquisitions, as well as to get insight into market trends or particular technical problems. Additionally, there are business partnerships with organizations[3], [4]. Established organizations have the ability to buy portfolio companies and form strategic partnerships. Similar to that, working with investment bankers is necessary while getting ready for an IPO. Particularly when they make investments in regulated businesses, venture capitalists' networks can even include politicians and officials.

Alternate Forms of Partnership

The majority of venture capital companies adopt a limited partnership arrangement, but as our discussion shows, there are several issues with this. Situations where LP and GP interests diverge, such as the fictitious 10-year time horizon, investment restrictions, or compartmentalization across several funds, are of particular concern. There have been created three primary alternatives to the limited partnership concept. The first option is the evergreen model, a fund structure that allows VCs to freely reinvest exit profits into new portfolio businesses[5], [6]. This indicates that the fund is not obligated to provide LPs access to liquidity within a certain geographic region. This concept effectively transforms the fund into a typical investment business where shareholders may earn returns by selling their shares or receiving dividends. Examples of this structure include Sutter Hill Ventures in Silicon Valley and Oxford Science Innovation, a private VC firm devoted to funding spin-offs from the University of Oxford. This structure hasn't been employed very often up to this point, most likely because investors aren't very comforted by its limitless life against abuse by the GP. A VC fund that is publicly traded is the second option. In this instance, the VC company issues shares to the general public in order to raise capital on the stock market. As a result, the VC must comply with listing and disclosure rules[7], [8].

The portfolio of these vehicles is difficult to consistently appraise due to the illiquid and opaque nature of entrepreneurial enterprises. This goes against how stock markets operate. Examples from the past include ARDC and CMGI, which were both seen as failures. In recent years, investors have shown little interest in public VC funds, which has led to poor stock prices and these vehicles' inability to continuously generate money. The most effective alternative to the partnership model is the third option, captive funds, which are fully controlled by a parent organization. Normally, a business serves as the parent, although other options include banks, foundations, and government agencies. Examples are Temasek Holdings, BPI France, and Intel Capital. The captive VC fund is often organized as a division or a totally owned subsidiary in the case of a corporate parent. The managing partners work for the VC subsidiary, although it is accountable to the parent company's board and top management. The parent, who runs the VC division to achieve a few strategic objectives, wants some influence over how the captive fund is run. As a result, decision-making in captive funds is more limited than in VC partnerships. Similar conclusions are drawn when the government is the parent.

Investment Techniques

A VC fund's investment method is defined by its investment strategy, which also aids in setting it apart from its rivals.Before making an investment in a fund, 44 LPs investigate the approach. The LPA contains important elements of the plan and, as a result, represents a commitment. Each fund that GPs raise has a unique approach. In addition to reflecting current investment prospects, it must be credible and consistent with the GP's knowledge and experience. Since strategy is determined at the fund level, a VC may raise many funds with various strategies, such as those that are solely interested in early-stage projects, late-stage transactions, or ventures in certain sectors or regions. Industry, geography, and stage are the three primary components of an investment strategy. First off, VCs only make investments in a select few sectors at a given moment. These sectors satisfy three crucial requirements. They are dynamic industries, which gives new businesses an opportunity to challenge established players by developing new markets or business strategies. These opportunities result from a combination of technical advancement, regulatory reforms, or shifts in customer preferences. They must also allow for scalable new companies, able to reach extremely high levels of sales and profits in a relatively short period of time. They need intermediate levels of capital for starting a company not too small to require venture funding, but not so large as to exceed fund capacity.

The important choice at the VC fund level is whether to concentrate on a select few businesses or to cover a broad range of industries. Specialist VC companies at one end of the spectrum have extremely specific definitions of their investing approach. Their goal is to become an authority in a certain field and provide significant profits. The generalist VC companies at the other end of the spectrum have a larger investment strategy and invest in a specified group of businesses that may or may not be connected. By gaining control over their firms' growth trajectory, they may be able to earn significant profits and seize possibilities from a larger pool. The research that is currently available suggests that specialization increases the likelihood of a successful departure. The industrial specialty of the various partners is what causes this impact. Allocating investment across sectors seems to be a challenge for generalist venture capitalists (VCs). Second, geographic boundaries also define VC investment methods. VC companies often favor making investments in areas adjacent to their headquarters.46 The closeness to the entrepreneur and familiarity with the business environment, including the legal system, regulations, and company culture, are the main drivers of this desire. Active, hands-on investors, for instance, anticipate spending a lot of time with their businesses, so they are concerned about the travel time required to get there.

A considerable number of VC companies have developed a variety of ways to non-local investing, and the VC sector has become comparatively more receptive to unconventional investments over time.48 Consider a VC fund with a U.S. basis that is considering making an investment in India. Making personal investments there would be a starting step. Typically, a local Indian VC would syndicate and source these projects. Some VC companies form connections with co-investors in far-off areas or nations.For instance, this strategy was adopted by East Coast VC 49 Oak Investment Partners. Hiring one or more partners with a strong network in India, maybe an Indian person with in-depth knowledge of U.S. venture processes, might be a solution. Menlo Ventures used this approach. The next phase may then be to establish an office in India with a partner seconded from the American headquarters and local partners employed after the transaction flow seems to be consistent. For instance, over time, Delhi and Bangalore saw the establishment of offices by Lightspeed Venture Partners. The last possible option is to solicit LPs interested in exposure to that area to form an India-focused fund. The fund might be managed by a regional office or by the American headquarters; Sequoia Capital, a renowned Silicon Valley company, is an example of this strategy.

The desired investment stage is thirdly specified in an investment plan. Different settings are needed for early-stage vs late-stage investments. Early-stage investors assume large chances that the technology or business model will fail, but they mitigate these risks by having deep industry knowledge, being actively engaged in their firms, and staging investments. Early-stage financing, however, doesn't need as much cash on its own. Late-stage investors are subject to a unique set of risks about effectively growing businesses. They often call for more sophisticated financial knowledge and networks that are more focused on commercialization. They also need a lot of money to fulfill the high capital requirements of rapidly expanding businesses. Early-stage, late-stage, and all phases are the three major categories under which stage preferences may be divided. The most difficult technique is investing across all phases since it calls for substantial resources and the combination of two different investment strategies. As a result, it is used by a small number of VCs. It is helpful to look at how these three elements might be integrated in order to comprehend VC fund strategy. Think about the two-by-two pairing of region and industry. We differentiate between a local vs a global geographic strategy as well as a specialized against a generalist industry approach. Local specialists, global specialists, local generalists, and global generalists are the four prototype methods that come from this. The decision between an early or late-stage emphasis is added to each of these combinations, resulting in a cube of eight potential configurations.

Local experts are often smaller companies that compete based on their deep understanding of local markets and the industries that are concentrated there. Such examples are Pantera Capital in San Francisco and Fenbushi Capital in Shanghai, which solely invest in businesses involved with blockchain technology. New VC companies often begin as regional experts and, if successful, shift to a more general approach. A popular choice is to specialize internationally. This entails using already-existing subject knowledge and steadily contacting more entrepreneurs who are active in different regions of the nation or the globe. Focus is helpful for attracting transaction flow, leveraging reputation with business owners in one industry, and for marketing the fund to limited partners (LPs), who seek for specialty. One sector, a theme investment, or a thesis investment might serve as the focus.50 For instance, the Paris-based Sofinnova has long focused on international investments in the life sciences. Chrysalix is a Vancouver-based venture capital company that invests throughout the globe in science-based businesses with certain themes, such robots and energy. Union Square Ventures, located in New York, is well known for its thesis-based approach to investing, which helped them make lucrative bets on companies including Twitter, Tumblr, Etsy, and Foursquare. Similar investments have been made in software platforms including Clio, Humanity, and Zendesk by Berlin-based Point Nine Capital.

Being a local generalist is the alternative method for escaping local specialization. This may be done by bringing on partners who have experience in fields unrelated to those on which the existing partners' success has been based. A transition into subsequent phases often follows these adjustments in approach. VCs that invest in a narrow range of sectors in their nation and area include Octopus Ventures in London and Industrifonden in Stockholm. The best venture capital companies often follow one of these two routes before growing to become global generalists. These companies are successful in building strong brands and international networks that they use to get transactions in a variety of sectors. For their brand and networks to compete with the allure of international experts among business owners, they must be especially potent. Global generalists spread their enormous money over the whole life cycle of a firm. Examples include Tencent Holdings in China, Index Ventures in Europe, Sequoia, Benchmark, and New Enterprise Associates in the United States, and the Softbank Vision Fund in Japan. The Growth of Sequoia Capital from a Seedling to a Giant in Tales from the Venture Archives

The enormous Sequoia trees at California's Sequoia National Park, located four hours away from Silicon Valley, are the biggest trees in the world. Sequoia Capital was established by Don Valentine in the early 1970s, when there was not much venture capital in California. The investment company expanded like one would think a healthy Sequoia tree would: In 1974, Sequoia Capital I raised slightly under $3M. The company's $8 billion Sequoia Global Growth Fund III fundraising in September 2018 was the biggest venture fund ever raised at that time. One of the pioneers of the venture capital sector is Don Valentine. He made his first investment in Atari, the venerable company that created the first video game ever, Pong. Sequoia became an early investment in Apple since Steve Jobs had worked for Atari. Oracle and Cisco were two other early winners. Airbnb, Dropbox, Google, Instagram, LinkedIn, PayPal, WhatsApp, and YouTube are some more recent achievements. Sequoia-backed startups are said to be responsible for 22% of the value of the Nasdaq stock market. Sequoia has placed several significant wagers that were utterly a bust, such as eToys and Webvan. The foundation of Don Valentine's investing strategy is market size. He said that ehave always focused on market size in a lecture given in 2010 at Stanford University because creating large enterprises has always been our goal. It's quite improbable that you will ever establish a large firm if you don't target a very large market. One might argue that Don Valentine was a big believer in the significance of the first column of the Venture Evaluation Matrix since we don't spend much time worrying about where individuals went to school, how intelligent they are, and other such things.

Sequoia expanded its reach because of its emphasis on big markets. Sequoia was one of the first companies to go internationally, even though the majority of Silicon Valley VCs like making investments close to home. Beginning in the early 2000s, it concentrated primarily on three nations Israel for its technology and teams who wanted to expand their worldwide enterprises China and India for the magnitude of their home markets. Sequoia established new investment teams in each of these three nations, giving each group a lot of autonomy. Sequoia also created several offices in each of these nations. The idea of raising separate cash for each of the three nation operations was another unique strategy. Alibaba and Didi in China, Ola and Zomato in India, CloudShare and Snaptu in Israel, are just a few of the companies who received no funding as a result of this. Taking advantage of these accomplishments, Sequoia created growth capital funds that make worldwide investments in later-stage deals. The first of these funds generated $700 million in 2012, then a $2 billion fund in 2017, and then a $8 billion fund in 2018.

Industry, region, and stage form the fundamental characteristics of an investment plan. GPs may use extra components that characterize their investing style to better define the strategy for their fund. Here, we concentrate on three crucial ones. First, there are many methods that VCs use to find transactions. Every venture capitalist (VC) desires proprietary deal flow, or investment possibilities where they have a relational advantage over rivals. Given that the majority of entrepreneurs speak to many investors, hoping to clinch a transaction before others notice it may be optimistic thinking. However, connections are the foundation of proprietary deal flow. A VC who has previously established a good rapport with an entrepreneur, often from prior business dealings, might take advantage of this to become the preferred investor. This might imply that the VC receives a guaranteed spot in the fundraising syndicate, leads the transaction, or sees it first. To produce such exclusive transaction flows, VCs use a range of tactics. They engage in conversations with early-stage business owners before they are prepared to look for venture capital, sponsor accelerator programs, attend pitch and trade events, and are generally involved in their local entrepreneurial communities.

Additionally, VCs develop connections with angels and other early-stage investors who bring them their own opportunities. This is yet another factor in the significance of networks for VCs. People in their network will be aware of their investment preferences and will only recommend entrepreneurs that have a good probability of receiving funding. So, letting their network know what kinds of acquisitions they are interested in is a key component of venture capitalists' deal sourcing approach. The syndication preferences and approach to managing relationships with co-investors are a second part of style. These preferences help to shape investor networks and highlight how crucial it is to create and maintain relational capital. Building strong ties with reputable incumbents is crucial for a fledgling venture capital firm to get excellent transactions. One step toward being invited by established VCs to future excellent deals is to be able to produce value local deal flow and utilize it to attract them to syndicate. In addition to limiting access to lucrative projects to dependable VCs, more established companies utilize syndication to define their sphere of influence. VCs may also vary in how they organize their syndicates. For instance, they may not take part in big syndicates where they have little influence.

The contacts with businesspeople are reflected in a third style component. This starts with a VC's preferences for the negotiation and format of term sheets. The preferred term sheet format used by the majority of VCs represents how they want to interact with the firm over the investment period. Some venture capitalists like straightforward standard term sheets, while others prefer more intricate conditions that are customised to each individual agreement. greater cash flow rights are preferred by certain VCs over greater control rights by others. In terms of how actively they participate with the firm after the investment has been made, various VCs work with their companies in different ways. The capacity and desire of investors to participate varies greatly. Another factor that is closely connected is how founder-friendly a VC company is. When problems arise, some VCs are prepared to hire experienced managers from their own network, including the CEO. The founders would thereafter be relegated to more technical or practical positions. Other VCs are more helpful and mentor entrepreneurs to get the necessary leadership abilities. Matching the needs and expectations of the entrepreneur and investor about engagement is a crucial component of effective investment.

Putting the Investment Strategy into Practice

The amount of the investments, their timing, and the risk management of the portfolio are three closely connected decisions we take into account while implementing the investment plan. Let's begin with some straightforward portfolio math. Recall the $100 million fund example, which invests $80 million and pays $20 million in fees. What number of investments ought it to make? It could invest an average of $2.5M per firm if it made 32 deals. This would imply that during the course of the fund's existence, each of the fund's four partners managed eight businesses. Making 80 investments totaling $1 million would be a radically different investment approach, with each partner managing 20 businesses. How about making 16 investments instead of more? Every business earns $5M on average, and each partner only oversees four businesses. Although the LPA may impose certain restrictions on the portfolio structure, each of these three alternative forms has a unique impact on how a fund is managed. The first may be seen as a balanced approach, with each partner managing a reasonable number of businesses and the fund having sufficient funds to sustain each business. The second structure is sometimes referred to as spray-and-pray.

The fund seeks to participate in as many enterprises as it can, anticipating that some of them won't succeed. Fund managers in this situation don't have a lot of time to devote to any one firm. A partner would need to attend 80 board meetings a year, for instance, if the board of directors of each firm met quarterly. This is obviously unmanageable, thus the fund may decide not to have any representatives on its boards. The third structure would be very hazardous while simultaneously being incredibly concentrated. The fund has a fair number of opportunities to score even though each firm receives lots of partner time and money. In other words, the fund depends on a few fortunate firms, but there is a big chance that none of the companies in the portfolio do well. These three instances highlight some of the fundamental trade-offs involved in managing a VC fund portfolio, which we will now look at. How many businesses to finance vs how many resources to invest in them is one trade-off. Determining the number of portfolio firms also involves determining a partner time management strategy and the extent to which one company may use the investor's network of resources.

Although investing in multiple businesses exposes one to a wider range of prospects, it also limits the degree to which those potential may be fostered. Additionally, investing in fewer businesses offers greater incentives for participation, which is advantageous for the firms' growth. Should the fund place higher bets on a few chosen firms or distribute equivalent amounts to all companies? The maximum amount that a fund may invest in a single firm is often capped by LPAs. Within these constraints, however, the venture capital fund may choose to focus investment on a small number of firms. Another benefit of staged financing is that investors continue to finance companies that do well while cutting off funding for those that make inadequate progress. Consequently, VCs must also choose how much money to lay away for next fundraising rounds. The dry-powder of the VC fund is what is meant by this. It important for the fund's capacity to continue supporting successful businesses. To double down on winners is a common piece of advice. Although simple, this tactic carries some risk.

The important statistic is future performance, which is impossible to forecast and not how the firm has performed so far. The timing of portfolio investments is another compromise. This has an impact on how the LPs' money is drawn down over time. VCs are motivated to deploy capital quickly. Companies have larger time horizons to experiment and react to market input when they invest swiftly. Additionally, between two to four years, the majority of VC firms attempt to raise a new fund. It is easier to get the next fund if you can demonstrate a strong transaction flow and progress with early investments inside the current fund. There are other reasons to space out the investments over time, too. One is that choosing acquisitions and doing the necessary due diligence take a lot of time. In addition, not all profitable transactions materialize at the start of a fund's existence. In fact, early investment choices are equally subject to the option value of waiting. The management of risk is a further component of the portfolio strategy. The LPA restricts risk diversification at the fund level by keeping the fund's investment strategy within the bounds of a VC's area of competence. This still gives the VC company with a few options for lowering the fund's investment risk. The chance that none of the investments will succeed is reduced by investing in a broad range of businesses.

The risk may be actively managed by concentrating on a small number of businesses where the VC partners have a strong subject understanding. On a separate level, the VC might make investments in businesses that are subject to various risk factors. Diversification by stage, industry sector, or company strategy are additional options to geographic diversification. Given that investments are subject to several economic cycles, staggering them across the investment lifetime of the fund also aids in risk management. Last but not least, risk may be minimized by choosing a mix of high-risk early-stage companies that demand less money up front but will need substantial financial resources if they develop momentum and some lower-risk later-stage ventures that might result in more predictable exits. We analyze VC portfolio strategies with a particular emphasis on VC funds. VC companies with many funds may pursue a more general strategy at the firm level that sits on top of specific fund-level strategies. The difficulties raised in 12.4 about how a VC firm maintains its internal structure and external networks are related to such a business-level strategy. It also has to do with the skills and reputation the VC firms want to build.

A Case Study

This is explained using the FUEL framework. In order to illustrate some fundamental concepts from the framework, applies it to a hypothetical venture capital business named Rocketfueler Partners. Additionally, it establishes a numerical example that clarifies the structure of VC returns, which is the subject of the next paragraph.

VC Risk and Return

In order to wrap up, let's examine how LPs and GPs split risks and rewards. We begin with company-level returns, go through how to aggregate them up to the level of VC funds, and then look at how fees impact returns to LPs. A VC fund's return is calculated by adding together company-level returns. Right-skewed returns at the company level are those that are mostly determined by a limited number of very favorable upside realizations. They have a large left tail and a small right tail, which means that a few really high returns have a disproportionate impact on average returns. As a result, average returns are greater than median returns. Gross returns for a fund are produced by adding these company-level returns to the fund level. These kinds of returns have two measuring issues. Data availability is one. No regulators have the right to request information about VCs' returns. A few data suppliers, including Cambridge Associates, Pitchbook, Preqin, and Thomson One, voluntarily collect certain data from GPs and LPs. Given that VCs have an incentive to conceal their underperforming investments, this raises concerns that their statistics may be skewed.

Another challenge is unfulfilled exits. The realized fund returns can only be calculated for cohorts that are above 10 years old, according to the 10-year horizon of VC funds. For businesses that haven't yet been sold off, estimating unrealized returns implies making an assumption about their present worth. The most typical strategy is to utilize the most recent value. This, however, has a number of drawbacks. Valuations based on preferred shares that will become common shares upon departure may be prejudiced in favor of the buyer. The same may happen if a strategic investor's desire to pay for strategic advantages drove the value. On the other side, if the business has done better than anticipated since then, the value from the previous round may be skewed lower. Therefore, unrealized gains are a poor predictor of realized returns. The Institutional Limited Partner Association has published best practice standards since reporting and valuing unrealized assets are crucial to LPs.

Returns on Investment to Limited Partners

The returns that the LPs actually get are known as net returns. In two ways, they are different from gross returns. They first subtract the general practitioner's remuneration, which includes management fees and carried interest. They also have a different cash flow timeline than gross returns. For gross returns, the cash inflows and outflows are calculated at the time the investment is made in a firm and the time the exit proceeds come into the fund, respectively. For net returns, however, the cash inflows and outflows are assessed at the period of the fund's distributions to the LP and the LP's capital contributions, respectively. the top half displays LP capital contributions and distributions, on which net returns are constructed, while the bottom half displays company equity investments and exit profits, on which gross returns are constructed [9]–[11]. For the venture capital sector, net returns are a crucial metric. Reporting the aggregate fund-level net returns by fund vintage year that is, the year in which a fund is raised is the most typical approach to display the data. The IRRs indicate realized returns at the end of the full fund cycle. Prior to then, they also contain some unrealized returns that are computed using the unexited investment portfolio's net asset value.

CONCLUSION

In conclusion, VC firms are essential in fostering innovation and entrepreneurship since they fund early-stage and high-growth businesses and assist them with their resources. Their financial methods, engagement in the entrepreneurial environment, and donations all help to advance technology, create jobs, and advance the economy. For entrepreneurs searching for capital, investors wanting to be a part of the startup ecosystem, and politicians hoping to create a climate that is supportive of entrepreneurial endeavors, it is essential to comprehend the nature and dynamics of VC companies. Moreover, the difficulties and dangers that VC businesses encounter. It tackles the problems of discovering and fostering successful startups in a highly competitive environment, the inherent volatility and unpredictability in the startup ecosystem, and the need for diverse portfolios to reduce risks. The abstract also discusses how crucial it is to cultivate enduring bonds with limited partners and control investor expectations.

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