

# **FINANCING THE ENTREPRENEURIAL BUSINESS**

## **Administrative Details**

<b>Course</b>	Finance 374S – Entrepreneurial Finance
<b>Semester</b>	Spring 2014
<b>Classroom</b>	UTC 3.124
<b>Time</b>	T, H 3:30 – 5:00 pm
<b>Instructor</b>	Mark Jansen
<b>Office</b>	CBA 1.312J
<b>Phone</b>	(512) 887-2114
<b>Email</b>	<a href="mailto:mark@hpc3.com">mark@hpc3.com</a>
<b>Office Hours</b>	T, H 1:00 – 2:00 pm and by appointment
<b>Teaching Assistant</b>	TBA
<b>Prerequisites</b>	Finance 374S is a Restricted Course for students who are currently enrolled in the College of Business Administration. Prior completion of Finance 357 or Finance 357 H (grade=>B) is required.

## **Course Objectives**

This course intends to improve student understanding of how to value unlisted companies, how transactions can be financed, and how the financial valuation and deal structure can affect the development of the business, the management team and the shareholders. The course will provide a perspective of the financing process and the elements of deal making, including financial forecasting, and valuation methods. Students will develop a familiarity with various financing issues which must be addressed when starting or buying a business, from the points of view of both investor and entrepreneur.

The course combines lectures, cases, and guest speakers. Class discussions and assignments will engage, energize, and challenge students. While the instructor leads the process, students discover, articulate and develop most critical insights.

## **Teaching Approach and Case Preparation**

Individuals who value and finance unlisted firms frequently encounter ambiguity. There is an opportunity to learn from each deal and gradually build experience in the subject matter using case studies. To properly prepare, students will need to spend three to six hours of reading and preparation, including discussions with classmates. We will use the case method – a student-centered approach whereby students will drive the discussion of the case by identifying the problems and issues faced by the managers and formulating alternatives for solution backed by case facts and assumptions.

The case method will accelerate this process by exposing the student to a variety of deals. Students will analyze the situation, identify the key issues, and become more proficient at thinking through the possibilities and pitfalls of different financing and valuation methodologies. In some sessions, multiple cases will be discussed to contrast different approaches. Students should prepare and discuss all cases.

Much of the discussion will center on the question “why?” Good arguments will be supported with good facts, logic and analysis. Simply restating case facts like “the company’s revenues were \$100 million and profits were \$5 million” is not of value and uses precious airtime. We can assume everyone has read the case. A discussion of sales trends and explanations or solutions for these trends moves the class forward. By the same token, just throwing out an answer such as “I believe the company is worth \$10 million” is of little use without first telling which method you used, what adjustments and assumptions you made, and why you believe this to be a reasonable value.

Students who skim the reading right before class will not realize the benefits of the course. Students will learn by wrestling with the valuation and financing issues before class and developing a course of action. This experience, combined with the course discussion, will create the conditions necessary for students to move up the learning curve in the deal process. Working through and discussing the cases with your team is highly encouraged!

## **Course Policies**

### **Class Contribution**

Prepare each case thoroughly, and be prepared to initiate class discussion and to defend your conclusions. I will act as the moderator of the discussion. Do not look to me for “the answer”. Address your questions and answers to your fellow students, not to me. Hold up your hand and wait to be called on – do not blurt out a response. I monitor the participation throughout the semester and if you are not called on when you have your hand up, do not get discouraged as I may have reasons for directing the discussion to other students.

Rules of Engagement for Class Discussion:

- There is mutual respect between instructor and students, and among the students.
- Instructor and students come to class well-prepared
- Arrive on time and be prepared to participate.
- Electronic devices are closed and put away.
- Contribute ideas, assumptions, analysis, and personal experiences instead of simply presenting case facts.
- Participate and listen actively throughout class discussions.
- Speak concisely. Airtime is a scarce resource, do not ramble.
- Direct your comments to your classmates, not the professor.
- Respectfully challenge or support the arguments being made.
- Build on each other's comments and critique and debate different points of view.

Some of the points that I will use to grade class discussion are:

- Was the problem or issue clearly defined?
- Did you take a firm stand and back it with evidence?
- Did you outline your assumptions?
- Did you use the frameworks, valuation models and notes discussed in class?
- Did you explore the pros and cons of the strategic alternatives?
- Did you perform both qualitative and quantitative analysis?
- Was a plan of action presented along with implementation steps, timing and costs?
- How did you respond to your peer's questions about your solution?

A good question can be worth as much as a good answer. Feel free to experiment with unorthodox solutions, which will be rewarded if you can defend them with logic and evidence.

### **Feedback**

I encourage students to offer suggestions on how to improve the course both for the existing semester and future ones. My goal is to optimize your learning experience so that you understand the important topics of the semester. Any suggestions for improvements are appreciated.

### **Honor Code**

All students must comply with University policies for conduct and academic honesty at all times during this course. Details of your responsibilities are described in McCombs School's policy statement on scholastic dishonesty. Any violations of these policies will result in referral to the appropriate administrative body. You should refer to the Student Judicial Services website at <http://deanofstudents.utexas.edu/sjs/> or the General Information Catalog to access the official University policies and procedures on scholastic dishonesty as well as further elaboration on what constitutes scholastic dishonesty.

### **Students with Disabilities**

The University of Texas at Austin provides upon request appropriate academic accommodations for qualified students with disabilities. For more information, please contact the Office of the Dean of Students at 512-471-6259, 512-471-4641 TTY.

### **Religious Holidays**

You must notify me of your pending absence at least 14 days prior to the date of observance of a religious holy day. If you must miss a class, an examination, a work assignment, or a project in order to observe a religious holy day, you will be given an opportunity to complete the missed work within a reasonable time after the absence.

## **Course Materials**

It will be assumed that students have, prior to the first class session, obtained at least a basic understanding of the financing instruments covered in the finance core courses. The notes covered in the course should be read and used as reference throughout the course. The readings are essential to preparing the written assignments.

### **Required reading:**

- Entrepreneurial Finance, 2011, Janet Smith, Richard Smith, & Richard Bliss, Stanford University Press, ISBN: 978-0-8047-7091-0.
- How to Buy a Business. <http://www.entrepreneur.com/article/79638>
- HBR Course Park is available for download at: <https://cb.hbsp.harvard.edu/cbmp/access/23628298>

### **Other recommended reading:**

- The Wall Street Journal may be read on a daily basis.  
<http://subscribe.wsj.com/semester>
- Management Buy-outs (Director's Guides), Institute of Directors  
<http://www.amazon.com/Management-Buy-outs-Directors-Guides-Institute/dp/0900939699>
- Smarter Ventures: A Survivor's Guide to Venture Capital Through the New Cycle, Katherine Campbell  
<http://www.amazon.com/Smarter-Ventures-Survivors-Venture-Financial/dp/0273654039>  
A useful perspective on the relationship between entrepreneurs and their investors
- Guerrilla Financing, Blackman and Levinson  
<http://www.amazon.com/Guerrilla-Financing-Marketing-Bruce-Blechman/dp/0395522641>
- Valuing A Business: The Analysis and Appraisal of Closely Held Companies, Shannon Pratt  
<http://www.amazon.com/Valuing-Business-5th-Edition-McGraw-Hill/dp/0071441808>
- The New Business Road Test: What entrepreneurs and executives should do before writing a business plan, John Mullins  
<http://www.amazon.com/The-Business-Road-Test-entrepreneurs/dp/027373279X>  
Provides a framework for assessing and shaping entrepreneurial opportunities
- Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – and What to Do About It, Josh Lerner  
<http://www.amazon.com/Boulevard-Broken-Dreams-Entrepreneurship-Failed/dp/0691154538>

## **Evaluation**

### **Individual Assignments 25%**

There will be five individual assignments at the beginning of the semester to familiarize students with the valuation methodology. Each assignment is worth 15 points.

### **Group Assignments 25%**

You will be randomly assigned to a team of 4 to 5 students after the 12th day of class. More details on the assignments will be provided during the semester. Your grade on the assignments will be computed in two parts. I will assign a grade to the team as a whole that represents my assessment of the team's overall performance across the semester with a maximum of 60 points. Each student will be given a budget of 15 points that can be used to reward team members for their contribution to the case write-ups. If someone from the team drops the course, the points from the individual that dropped are reallocated amongst the remaining team members. The sum of the team grade and the average of each individual's team member scores will be the student's grade for this component. The maximum score for this component is 75 points.

Most of the assignments will be case study write ups which will require you to render a valuation (or value range) of the firm. The cases generally deal with privately held companies with no secondary market for their debt or equity. This lack of liquidity and marketability generally decreases the value of private firms relative to public companies. Adjustments will also have to be made if the interest being valued is a minority or majority interest. Since many private firms manage the company to minimize taxes rather than maximize profits, earnings normalization may have to be made for excessive salaries, excess cash, and non-recurring income or expenses. Therefore, many assumptions will have to be made in your analysis and will probably lead you to the conclusion that valuation is as much art as science. If you are looking for "the number" you will get frustrated. We are trying to narrow the range of darkness by using different valuation models and hope to get some convergent validity and triangulation from these models to give a valuation range.

### **Attendance and Case Discussion 25%**

I expect students to participate in each session's discussion, and will grade each student's contribution to others' learning after each and every session. To assist me in this process, please **display a name card** at every session. If your name card is not displayed, I will assume you expect no credit for contributing to the session. If you are by nature a quiet person, please come talk to me and I'll help bring you into our class discussions. Please note that the quality of what you contribute to these discussions (whether a thoughtful question, some astute analysis, or some other meaningful contribution) will count far more than the quantity of your remarks. More 'noise' does not necessarily equal a higher score. A maximum score for class participation is 75 points.

Each student team (see group assignments) will select a (different) speaker for each case discussion. The pool of speakers (for each session) will be "cold called" to open and close each class. The student should take the point of view of the protagonist in the case. A good opening would begin by taking a firm stand on the solution to the problem and defending it with logic and numerical analysis. Openings should include: (1) defining the problem; (2) answering the questions; (3) developing strategic alternatives; (4) presenting a solution; and (5) providing an action plan for implementation. An opening can take anywhere from five to fifteen minutes. This is where the discussion begins and others are encouraged to support or challenge the assumptions and conclusions your classmates are making. Openings and closings have a disproportionate weighting and since there are more students than openings and closings, you must remain fully engaged and participate in each case discussion. The grade of the group leader will reflect on the team.

### **Individual Case Exam 25%**

You will have two exams. The first will be an in-class exam on February 27<sup>th</sup>. You will receive a case study at the end of class on February 25<sup>th</sup> and will have time to prepare notes and other materials for the exam. The exam questions will be distributed to you in class on February 27<sup>th</sup>. You will submit your solutions to the questions plus any four single-side pages of supporting analysis that you did on the case. This will be individual work without collaboration or discussion for a maximum score of 30.

The second exam will be a take-home case exam that will be distributed to you on March 20<sup>th</sup>. You will submit the case, your written analysis and spreadsheet work electronically on March 27<sup>th</sup>. This will be individual work without collaboration or discussion for a maximum score of 45.

### **Grading**

Submissions will be graded to a mean score across the class of approximately 85. Once all submissions are in at the end of the term and the grades, including class contribution grades, have been totaled, letter grades will be assigned by ranking students from the top to the bottom of the class. Grades of A and A- will be given to not more than 50% of the class. Student work will be graded by assessing the quality of the work to determine the number and proportion of B, C, D, and F grades given. There is no required distribution for the bottom half of the grades, though generally the combined proportion of C, D and F grades will not exceed 20% of the class.

<b>Date</b>	<b>Topic</b>	<b>Reading</b>	<b>Description</b>	<b>Assignment</b>
1/14 1/16	<b>Introduction</b>	Ch. Preface, 1, 2 HBR: Introductory Note on the Case Method	Course Introduction New Venture Financing – Types of entrepreneurship, stages of new venture development, business plans, sources of financing, information issues, term sheets	Parallel 6
1/21 1/23	<b>Financial Modeling</b>	Ch. 6	Methods of Financial Forecasting: Revenue – Forecasting for established companies, forecasting for new companies, fundamental analysis, incorporating uncertainty	6.2, 6.3, 6.5, 6.7, 6.9 Dayva
1/28 1/30	<b>Cash Flow Modeling</b>	Ch. 7	Methods of Financial Forecasting: Integrated – Cash conversion cycle, working capital, developing assumptions, financial modeling for start-ups, incorporating uncertainty	7.1, 7.5, 7.9 Wind Zero
2/4 2/6	<b>Investment Assessment</b>	Ch. 8	Assessing Financial Needs – Sustainable growth, Break-even analysis, planning for rapid growth, scenario analysis, staged investing	TBA
2/11 2/13	<b>Valuation I</b>	Ch. 9, 10 HBR: Note on Cash Flow Valuation Methods: Comparison of WACC, FTE, CCF and APV Approaches HBR: Note on the Theory of Optimum Capital Structure	New Venture Valuation – Myths, discounted cash flow, RADR, CEQ, relative value, venture capital method, rates of return Valuation in Practice – Continuing value, multiples, estimating risk free, market risk premium & beta, applying RADR & CEQ, advantages & disadvantages of RADR & CEQ	TBA
2/18 2/20	<b>Valuation II</b>	Ch. 11 HBR: Valuation Techniques HBR: Small Company Finance: What the Books Don't Say HBR: Note on Valuing Control and Liquidity in Family & Closely Held Firm HBR: Note on Valuing Private Businesses HBR: Corporate Valuation and Market Multiples	The Entrepreneur's Perspective on Value – Undiversified investors, partial-commitments, valuing partial commitment with RADR & CEQ	Central Circuit Breaker
2/25	<b>Real Options</b>	Ch 4, 5.8, 5.9	New Venture Strategy - Strategic planning, financial strategy, real vs. financial options, expansion & abandonment options, decision trees, game trees, game theory	
2/27	<b>In Class Exam</b>			
3/4	<b>Deal Structure</b>	Ch. 12	Deal Structure – Outside investors, contracts, proportional risk sharing, asymmetric risk & return, subsidized investors, active investors, implementation & negotiation, informational issues	Wind Zero
3/6	<b>Contract Design</b>	Ch. 13 HBR: Organizing the Enterprise: Which Form is Best for You? HBR: Note on Angel Financing HBR: Note on Private Equity Securities	Value Creation & Contract Design - Staged investing, signaling beliefs, alignment of interests, valuation-based contracting. Legal entities	
	<b>Spring Break</b>			

<b>Wk</b>	<b>Topic</b>	<b>Reading</b>	<b>Description</b>	<b>Assignment</b>
3/18	<b>Rollups</b>	HBR: Consolidation of Highly Fragmented Service Industries HBR: Note on LBO Capital Structure		Project DialTone
3/20	<b>Franchising</b>	HBR: Note on Franchising HBR: Note on Buying a Franchise	Guest Speaker: Randy Murphy	World Wrapps
3/25 3/27	<b>Case Exam</b>	Take Home Case Exam		
4/1	<b>Management Buy-Outs</b>	Entrepreneur: How to Buy a Business HBR: Technical Note on LBO valuation HBR: Technical Note on LBO Valuation (B)	Management Buy-Outs Guest Speaker: Salvador Alanis	Brazos Partners the Comark LBO
4/3	<b>Debt vs. Equity and giving up shares.</b>	HBR: Note on the Financial Perspective: What Every Entrepreneur Should Know HBR: Why Entrepreneurs Don't Scale	Debt vs. Equity and giving up shares. Valuing IP	Clarion Optical
4/8	<b>Bootstrap Finance</b>	HBR: Bootstrap Finance: The Art of Startups	Founder Choices	Lather, Rinse, repeat: FeedBurner's Serial Founding Team
4/10	<b>Venture Capital</b>	Ch. 3 CP: Valuation Issues in Start-Ups and Early-Stage Companies: The Venture Capital Method HBR: How Venture Capitalists Evaluate Potential venture opportunities HBR: Note on Valuation of Venture Capital Deals	Venture Capital - Types of private equity funds, how funds are structured, raising private equity funds, how funds work, calculating carry, private equity returns, fund of funds Guest Speaker: Michael Falcon	How Venture Capitalists Evaluate Potential venture opportunities
4/15	<b>M&amp;A</b>	HBR: Note on Mergers and Acquisitions and Valuation HBR: Evaluating M&A Deals –Equity Consideration HBR: Note on Sum-of-the-Parts Valuation	Stock as currency Break-up value	Interco
4/17	<b>Bankruptcy</b>	HBR: A Managerial Primer on the U.S. Bankruptcy Code	Guest Speaker: Steven Shang	Amazon.com: The Brink of Bankruptcy
4/22	<b>International</b>	HBR: Valuing Cash Flows in an International Context	International Investments	David's Paradise
4/24	<b>Funding High Growth</b>	HBR: Note on Managing the Growing Venture HBR: Five Stages of small Business Growth	Guest Speaker: Clayton Christopher	Alfin Fragrances, Inc.
4/29	<b>Choice of Financing</b>	Ch. 14	Choice of Financing - Financing alternatives, considerations, financial decision process, cumulative financing needs, organizational structure, reputation & relationships, financial distress	Wrightlines Air Service
5/1	<b>Exit</b>	Ch. 15 HBR: Company Sale Process HBR: Note on the Initial Public Offering Process	Harvesting - Liquidation events, IPO's, underwriting, trade sales, valuing private transactions, MBO's, ESOP's, the harvesting decision Guest Speaker: Sam Goodner	Carlton Polish