Introduction

ENTR467/667: Decoding Finance and Venture Capital for Entrepreneurs is designed to introduce prospective founders to the areas of finance which are particularly relevant in startup and quick-growth phases. In Part I, the course briefly discusses the role of the entrepreneur within capitalist economic systems; explores different risk tolerances and other behavioral issues; considers critical entrepreneurial dilemmas such as when to found, what kind of team to put together, and how to best finance an endeavor; carefully considers the issue of agency—along with the countless misalignments driven by it (which can wreck even the best opportunities); and, finally, encourages critical consideration of shareholder primacy vis-à-vis other stakeholders—a matter more-or-less taken as a given in finance, but challenged most everywhere else. In Part II, the course introduces some of the fundamentals of corporate finance with particular emphasis on financial statements and firm-level analysis of liquidity, leverage, asset management, and profitability; explores the sources of start-up capital with a special emphasis on bootstrapping techniques, angel investors, commercial banks and other asset-based lenders, venture capital, and an array of alternative sources; and, finally, outlines both the capital sources typically used to drive later-stage growth such as private and public equity as well as the strategies employed with IPOs, APOs, LBOs, and rollups receiving the most attention. In Part III, the course presents a detailed look at valuation at both the project-level and the firm-level—with traditional comparable and discounted cash flow (DCF) methods sharing the spotlight with more nuanced, real options-based alternatives. In Part IV, the course concludes with a critical review of corporate governance—typically defined as covering the mechanisms, processes, and practices by which a firm is directed and controlled—with special emphasis on small firms, small firms, and family businesses.

Grading and Assignments

Standard grading (A-F) will be used in this course. Additionally, the plus/minus system will be applied as follows:

- 93 < A
- 90 < A-
- 87 < B+
- 83 < B
- 80 < B-
- 77 < C+
- 73 < C
- 70 < C-
- 67 < D+
- 63 < D
- 60 < D-
- 50 > F

The final grade will be determined based on the completion of the following requirements:
Written Exercises (20%)  
Final Presentation (30%)  
Final Examination (50%)

I maintain the right to follow the grading scale set forth above; however, I have little interest in handing out poor marks. If students are committed and energetic about learning, I am confident that final course grades will pretty much fall into place.

Course Materials

ENTR467/667 does not require a primary textbook; however, the following texts are recommended:


A few scholarly, practitioner, and news-related readings are also suggested. Many of these selections are expressly noted in this syllabus; however, I occasionally will provide reading packets via Sakai which are to be considered TBD for the purposes of flexibility (as the winter session progresses, I may tweak readings to provide for a better fit with past conversations, current events, etc.)

Though by no means required, select chapters of the following textbooks can be quite helpful for students when it comes to taking some of the foundational material of this course a step further (both of these texts are often used in different 800-level courses offered by the Department of Finance):


Other supplemental materials (some are classics, others are contemporary, and some have simply caught my eye) are noted throughout the tentative schedule. These are absolutely not required readings, but will probably color my discussions to some extent on a weekly basis. Additionally, they serve as good resources for further consideration if a particular topic should happen to catch your interest, remain elusive after our in-class discussion(s), etc.

Sakai

On Sakai, you will find the following:

- A copy of the syllabus
- Links to all suggested readings (except for books)
- All exploratory notes
- Problem sets and answer keys
- Practice exams, supplements, and answer keys
My exploratory notes are presented in an outline form which should be filled out as the lecture/discussion proceeds on a weekly basis. To help ensure good attendance, I do not post completed exploratory notes on Sakai (only the outline) and I will not be swayed on this particular issue. If you are absent from a session, you will need to gather the missed information from a classmate.

N.B. Exploratory notes will be posted no later than the morning of class. Links to all readings will be posted at least one week ahead of their respective due dates. Please print out all notes and bring them with you (if you prefer, you may use your laptops or tablet devices for viewing, note-taking, etc. in class) as paper-handouts will not be provided.
PART I: INTRODUCTION AND RECURRING THEMES – ECONOMIC DYNAMISM, OPPORTUNITIES, AND SOURCES OF CONFLICT

Applied material makes up a notable portion of this course; however, the first three lectures are decidedly theoretical in nature (with a heavy dose of anecdotes to drive home the primary ideas). Though entrepreneurship as an academic discipline continues to lack generally accepted cumulative or unified theory of its own (as the definitions of entrepreneurship and the entrepreneur remain subject to vigorous debate, perhaps this should not be too surprising) and has historically focused more on describing (as opposed to predicting) entrepreneurial phenomena, the entrepreneurship literature does pull from the theoretical wells of other well established disciplines including economics, sociology, psychology, business management, strategy, industrial organization, accounting, and finance, among others. Theory, regardless of its reputation for being dry, prescribes behavior—in an entrepreneurial context, it tells us what entrepreneurs should do. But, why not just study what entrepreneurs do? The overwhelming majority of them fail. There is certainly room in the classroom for anecdotes, rules of thumb, and war stories, but theory neither can nor should be crowded out entirely.
“Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary...[and the] fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates...[which incessantly revolutionize] the economic structure from within, incessantly destroying the old one, incessantly creating a new one.” - J. Schumpeter, Capitalism, Socialism and Democracy (1947)

Economics is more-or-less dominated today by the synthesis of neoclassical and Keynesian economics—a fact which, in all likelihood, colored your introductory economics courses. Interestingly enough, however, the concept of profit—the driving force behind the capitalist system—has no place in the neoclassical tradition due to the assumption of perfect competition (which drives equilibrium and, therefore, eliminates profits). In such a world (which empirically does not seem to be too similar to our own), scant attention need be paid to the entrepreneur. Though such theoretical parsimony certainly has value, alternative frameworks exist which not only include the entrepreneur, but identify the role as being critical to the dynamic and (sometimes paradigmatic) change inherent to capitalist systems.

Lecture Notes:

Syllabus and Discussion of Course Content
8_28_18_Part_1 (The Entrepreneurial Environment)

Suggested Readings:


Additional Readings of Note:

Gartner, W., 1988, “‘Who is an Entrepreneur?’ is the Wrong Question,” American Journal of Small Business 12(4): 11-32.


“There is no such thing as a ‘resource’ until man finds a use for something in nature and thus endows it with economic value.” – P. Drucker, “Purposeful Innovation and the Seven Sources of Innovative Opportunity” (1985)

“Fundamentally, in a system where the knowledge of the relevant facts is dispersed among many people, prices can act to coordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan.” – F. Hayek, “The Use of Knowledge in Society” (1945)

“It has been shown in a number of psychological studies that people suffer a wishful thinking bias, that is, they overestimate the probability of success of entities that they feel associated with.” – R. Shiller, “Bubbles, Human Judgment, and Expert Opinion” (2001)

Within or without “the perennial gale of creative destruction” (Schumpeter 1945), entrepreneurs seek out opportunities, materially innovative or otherwise, for profitable exploitation—whether by creating inefficiencies, eliminating them, some combination of the two, or via some other mechanism(s) entirely. Empirically, we know that the overwhelming majority of entrepreneurs fail; therefore, it makes sense to ask the question: why do people actually seek out and attempt to exploit entrepreneurial opportunities if the outcome is predictably bad? Neoclassical economic theory has little to say about this question given the assumption that participants are strictly rational, self-interested, utility-maximizing agents (“Homo economicus”)—an assumption that spills over into the core of financial theory and serves as a driver of market efficiency (an equilibrium condition). But, are real life human beings really such automatons? Certainly not. Though the implications are debatable, humans are emotional and prone to logical errors—in matters both mundane and critical. Accordingly, the fundamental tenants of behavior are appropriate for consideration.

Lectures:

9_4_18_Part_1 (Sources of Entrepreneurial Opportunities)
9_4_18_Part_2 (Risk Preferences and a Departure from Homo Economicus)

Suggested Readings:


Additional Readings of Note:


“Founders are usually convinced that only they can lead their start-ups to success...[success, however, makes] founders less qualified to lead the company and changes the power structure so they are more vulnerable. ‘Congrats, you’re a success! Sorry, you’re fired,’ is the implicit message that many investors have to send founder CEOs.” - N. Wasserman, “The Founder’s Dilemma” (2008)

“Moralists tend to have a low opinion of self-interest. They are scandalized by economists’ postulate of universal self-interest which they ‘consider to be an implied slur on human nature.’ Typically, they view self-interest as an impulse to be controlled or transcended. It [is] the serpent that must be expelled if we are to regain Eden.” - I. Maitland, “The Human Face of Self-Interest” (2002)

“The faults of the burglar are the qualities of the financier.” - G. Bernard Shaw (1905)

When to found? What kind of team? What type of financing? What can happen when goals and/or risk tolerances are not aligned across principals and agents? The entrepreneurial world is rife with conflict—and not just between competing firms; indeed, entrepreneurs frequently find themselves (fiercely) at odds with their business partners and/or investors due to a particularly potent mix of asymmetric information, misaligned interests, and perverse incentives. Oftentimes, entrepreneurs want one thing and their financial benefactors another. Understandably, the end result of such misalignment can be disastrous for one or more parties. A full understanding of the mindset of different partners (counterparties) and recognition of potential sources of conflict is critical for both entrepreneurs and capitalists.

Lecture Notes:

9_11_18_Part_1 (Founders’ Dilemmas)
9_11_18_Part_2 (Agency – Theory and Implications)
9_11_18_Part_3 (Shareholder Primacy – Theory and Implications)

Suggested Readings:


Additional Readings of Note:


Friedman, M., 1962, Capitalism and Freedom, University of Chicago.


PART II: INTRODUCTION TO FINANCIAL STATEMENTS (AND ANALYSIS), SOURCES OF CAPITAL FOR EARLY-STAGE FIRMS, EXIT STRATEGIES, AND CAPITAL STRUCTURE

Stepping away from theoretical foundations, the next six lectures, though certainly not blind to theory, are materially more applied in nature. What does an income statement tell us? How about a balance sheet? Is a given project appropriate for bank financing? What about for venture capital financing? Is growth always connected to value? What exit options are available? Questions such as these are of fundamental importance to early-stage firms; in fact, scholarship has yielded strong evidence that startups which develop financial statements, implement better financial controls, adequately fund their operations from appropriate sources, and plan strategically are much more likely to survive. But, financial literacy is by no means ubiquitous amongst entrepreneurs. To the contrary, entrepreneurs are oftentimes shockingly unaware of even the basics—a fact which can and does drive unrealistic (and oftentimes absurd) projections, insufficient (frequently non-existent) controls, and ultimate failure.
“[The evidence] indicates that growth and the adoption of management systems reinforce each other as companies transition through their first ‘growth crisis.’ We also find evidence informative to the empirical regularity found in early-stage startup firms where founders are replaced as CEOs more often than expected. We find that CEOs with lower adoption of MCSs are more likely to be replaced. Overall, the evidence supports the relevance of these systems to the growth of startup firms beyond their initial stage.”

“Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.”
– Warren Buffett

Sound decision-making in an entrepreneurial context demands organized and timely financial data. Not all startup firms will be concerned with the same financial measures—firms with high-growth potential, for instance, may be willing to sacrifice short- and medium-term profitability for long-term value while firms with lesser opportunities are likely to be more myopic. For firms with outside funding, the importance of financial statements increases even further as they constrain managerial action, mitigate asymmetries, and establish a foundation for performance evaluation, among other things. A general understanding of the basic financial statements, methods of analysis, and practice when it comes to drafting them is a must for all entrepreneurs.

Lecture Notes:

9_18_18_Part_2 (Financial Statement Analysis)
9_18_18_Part_3 (Pro Forma Development)

Suggested Readings:

PriceWaterhouse Coopers.
Rigoglioso, M., 2005, “Smart Startups Don’t Wait to Set Up Accounting Systems,” 
Insights by Stanford Business.

Additional Readings of Note:

Accounting Studies 17: 119-54.
Ballantine, J., F. Cleveland, and C Koeller, 1993, “Profitability, Uncertainty, and Firm 
Interdependence on the Perceived Usefulness of Management Accounting 


September 25, 2018 - Traditional Sources of Capital for Early-Stage Firms: Bootstrapping Resources, Angel Investment, and Commercial Banks and Other Asset-Backed Lenders

“Venture capital financing is the exception, not the norm, among start-ups. Historically, only a tiny percentage (fewer than 1%) of U.S. companies have raised capital from VCs...[but] less venture capital doesn’t mean less start-up capital. Non-VC sources of financing are growing rapidly and giving entrepreneurs many more choices than in the past. Angel investors—affluent individuals who invest smaller amounts of capital at an earlier stage than VCs do—fund more than 16 times as many companies as VCs do, and their share is growing.” - D. Mulcahy, “Six Myths About Venture Capitalists” (2013)

“Bootstrap financing is a variety of ingenious methods that find resources, maximize their efficient use, and minimize the explicit costs associated with using resources whether they are found inside the business, obtained from other people, or provided by other companies and organizations.” - L. Neeley

Though venture capital (VC) seemingly gets most of the attention, the overwhelming majority of entrepreneurial ventures in the United States will never secure VC investment. A plethora of alternative funding sources exist, however, which are much more readily obtainable—though they all yield their own trade-offs, challenges, and risks—for the cross-section of startups and fast-growing firms: loans and/or investment from friends and family (and fools), customer prepayments, vendor financing, deferred employee compensation, angel investment, receivables financing, leasing, and traditional bank financing, to just name a few.

Lecture Notes:

- 9_25_18_Part_1 (Bootstrapping Resources)
- 9_25_18_Part_2 (Angel Investment)
- 9_25_18_Part_3 (Commercial Banks and Other Asset-Based Lenders)

Suggested Readings:

- The Handbook of Financing Growth (Chapter 5:69-118; Chapter 6: 203-300)

Additional Readings of Note:


October 2, 2018 - Traditional Sources of Capital for Early-Stage Firms: An Introduction to Venture Capital

“While very few companies receive VC funding, a very large fraction of start-ups that make it to the public company stage are venture capital-funded...[c]onsistent with this success, venture capital has fueled many of the most successful start-ups of the last thirty years. Four of the twenty companies with the highest market capitalization in the U.S. – Microsoft, Apple, Google, Cisco – have been funded by venture capital. A large number of other highly valuable companies – Gilead, eBay, Amazon, Yahoo, Amgen, Adobe, Celgene, Starbucks, Genzyme, Juniper, Symantec, Stryker, Intuit – were VC-funded.” – S. Kaplan and J. Lerner, “It Ain’t Broke: The Past, Present, and Future of Venture Capital (2009)

Many entrepreneurs want venture capital; however, comparatively few are familiar with the nuances of the VC industry and its participants. How do venture capitalists think? What is their business model? How do they operate? Are they abusive towards entrepreneurs? What else besides money do they bring to the table? Certainly, not all venture capital firms think and/or operate the same way, but as an asset class there is much that is generalizable.

Lecture Notes:

10_2_18_Part_1 (Introduction to the VC Industry and its Participants)
10_2_18_Part_2 (VC Value Added and the Monitoring of Portfolio Firms)
10_2_18_Part_3 (VC Returns)

Suggested Readings:

The Handbook of Financing Growth (Chapter 5:122-51)
Venture Capital (Chapters 1-3, 5)

Additonal Readings of Note:


October 9, 2018 - Traditional Sources of Capital for Early-Stage Firms: An Introduction to Venture Capital (Part II)

“A VC typically signals its intention to invest by offering a term sheet to the potential portfolio company. The company responds by signing the term sheet, rejecting it completely, or negotiating changes to some of the provisions...[although] few term sheet provisions have binding consequences if they are not followed, the document still serves as an anchor for all future negotiations between the parties.” – A. Matrick and A. Yasuda, Venture Capital & The Finance of Innovation (2011)

“Investments are of two kinds, safe and venturous. The former tend to maintain the status quo of industry. They are based on ‘past performance’ records and the belief that the current routine of earnings will continue. Venturous investments, on the other hand, are founded on faith in future accomplishments, on inventions yet to be made, on growth and earnings only promised...[the] Du Pont policy of expansion under which a ‘safe’ investment in a going enterprise was almost immediately supplemented by a ‘venturous’ investment aimed at discovery, improvement and new growth—hence new employment and new profits—was at once one of the oldest principles of industrial progress and one of the newest.” – W. Dutton, Du Pont: One Hundred and Forty Years (1942)

Per Gifford (1997), term sheets are designed to do the following: commit capital while preserving the abandonment option (a type of real option), align the goals of venture capitalists and entrepreneurs by tying compensation to long-term value, and preserve mechanisms by means of which to force the distribution of rewards in the future. The typical end result of such negotiations (if they are successful): a VC position in convertible preferred stock—a security type which gives the holder unique and (oftentimes) powerful rights over the holders of common stock. Now, the overwhelming majority of VC investments are by VC funds; however, existing corporations have historically played a notable role when it comes to financing innovation and other entrepreneurial activities—yielding a completely different set of issues, contractual and otherwise, worthy of consideration.

Lecture Notes:

10_9_18_Part_1 (Understanding Term Sheets)
10_9_18_Part_2 (Preferred Stock – Basics and Conversion)
10_9_18_Part_3 (Corporate VC Activities: Startups, Spinoffs, Internal Projects, and Employee Contracting)

Suggested Readings:

The Handbook of Financing Growth (Chapter 5: Pages 166-67)
Venture Capital (Chapter 8-9)

Additional Readings of Note:


October 16, 2018 - Alternative Sources of Capital for Early-Stage Firms, Later-Stage Options (and Strategies), and a Contrarian View of Growth

“I went to the bank and proposed that they lend money to the poor people. The bankers almost fell over.” – M. Yunus, Nightly Business Report (2005)

“At the federal program, a foreigner who invests $500,000 — and in some instances, $1 million — in a project that will create at least 10 jobs can apply for a green card...[and in] the last four years, the program’s popularity has surged. In fiscal year 2010, 1,885 visas were issued. But by fiscal year 2013 that figure jumped 354 percent to 8,564, according to government data. Last year, the entire annual allotment of 10,000 visas had been claimed by August — before the end of the fiscal year in October.” – J. Satow, New York Times (2015)

Though the first quotation above from Muhammad Yunus may seem a bit out of place, many entrepreneurs who attempt to obtain traditional financing will experience a similar result. Banks do not make money by saying no; however, in the post-2008 world, upstarts and other more aggressive market participants would be excused for thinking otherwise. But, a variety of alternative sources, many of them non-dilutive, exist that are worthy of consideration including: crowdfunding, visa-based options, grants, and owner financing of acquisitions, among others. Of course, firms do not remain startups forever; therefore, planning must begin early for later-stage growth—thereby necessitating an understanding of both the different capital sources and strategies available to high-growth firms in relatively more mature stages. Sources of later-stage growth capital include private equity, mezzanine, and public markets. Later stage growth strategies include an array of organic and acquisitive options including IPOs, APOs, LBOs, rollups, and strategic sales. Lastly, while entrepreneurs are often obsessed with growth (and for good reason as it is generally a good thing), it is important to keep in mind that growth and value are not always positively linked—a statement well supported by the frequent successes of restructure and distress-oriented investors.

Lecture Notes:

10_16_18_Part_1 (Alternative Sources for Early-Stage Firms)
10_16_18_Part_2 (Later Stage Options – Sources and Strategies)
10_16_18_Part_3 (Growth and Value – A Contrarian View)

Suggested Readings:

The Handbook of Financing Growth (Chapter 5: Pages 152-65; 169-202)
Crowdfunding and EB-5 Packet
Additional Readings of Note:


“How do firms choose their capital structures?...The answer is we don’t know...we do not know how firms choose the debt, equity, or hybrid securities they issue.” – S. Myers, American Finance Association Presidential Address (1984)

“The two Modigliani-Miller theorems hold good, irrespective of individual differences between shareholders’ valuations of risk, leverage effects, durability of loans, etc. The logic of the theorems rests in fact upon the assumption of perfect markets, namely that a shareholder can always, through his own borrowing or lending, compose his asset portfolio as he sees fit and that he can, without costs, give it the composition he desires with respect to risk, leverage, etc. If for instance the risk level of a firm’s assets is increased, the shareholders can neutralize this by lowering the risk of other assets in their portfolios.”

“External equity financing is undeniably important for high-growth companies needing financing beyond their debt capacity. However, contrary to the current focus in the literature on external equity finance for high-growth companies, internal finance and financial debt are the most frequently used financing alternative.” – T. Vanacker and S. Manigart, “Pecking Order and Debt Capacity Considerations for High-Growth Companies Seeking Financing (2010)

Precise funding sources aside, does capital structure—a firm’s mix of equity and debt—actually matter? If so, is there an optimal capital structure which will maximize shareholder value? Questions like these have interested both academicians and practitioners for quite a long time: Modigliani and Miller (1958), for instance, set the groundwork for a simple but powerful debt tradeoff theory (which was a major contributing factor to Modigliani’s 1985 and Miller’s 1990 Nobel Prize awards) while Myers and Majluf (1984) present an alternative, asymmetric information-based theory. Though these and other efforts, related or otherwise, have done much to improve our understanding of capital structure and its importance, as the evidence attests, much work remains to be done—especially for startup firms.

Lecture Notes:

10_23_18_Part_1 (Modigliani and Miller – Trade-off Theory)
10_23_18_Part_2 (Myers and Majluf – Pecking Order Theory)
10_23_18_Part_3 (Applications, Industry Differences, and Conflicts)

Suggested Readings:

The Handbook of Financing Growth (Chapter 4 – pages TBD)


Additional Readings of Note:


PART III: PROJECT AND FIRM VALUATION UNDER CONDITIONS OF CERTAINTY AND UNCERTAINTY

Though not traditionally defined this way, a firm is a collection of projects--without projects, either current and/or expected, a firm has neither purpose nor foundation for value. The decision-making process dealing with project selection is known as capital budgeting and, needless to say, firms which make better capital budgeting decisions outperform, on average, those which do not. The next three lectures are designed to introduce you to the valuation of such projects and, by extension, firms under conditions of both certainty and uncertainty.
October 30, 2018 - Traditional Capital Budgeting Decision-Making Tools for Startup and/or Growing Firms: Payback, Accounting Rate of Return (ARR), Net Present Value (NPV), and Internal Rate of Return (IRR)

“As manufacturers make critical decisions about whether to acquire CIM [Computer-Integrated Manufacturing] equipment, they must avoid claims that such investments have to be made on faith alone because financial analysis is too limiting. Successful process investments must yield returns in excess of the cost of capital invested. That is only common sense. Thus the challenge for managers is to improve their ability to estimate the costs and benefits of CIM, not to take the easy way out and discard the necessary discipline of financial analysis.”

“Bluntly stated, the willingness of managers to view the future through the reversed telescope of discounted cash flow analysis is seriously short-changing the futures of their companies.” – R. Hayes and D. Garvin, “Managing As If Tomorrow Mattered” (1982)

Entrepreneurs and financial managers have an array of tools available to assist in making optimal capital budgeting decisions. One of these tools, net present value (NPV), is theoretically superior to the others; however, practitioners tend to use alternatives like payback period, internal rate of return (IRR), or even nothing at all instead of NPV. Such empirical evidence might suggest a lack of knowledge in the business community, but such an explanation would be incomplete. Though introductory textbooks on corporate finance continue to hold NPV in high regard (and for good reason), it too has shortcomings—in both implementation and design.

Lecture Notes:

10_30_18_Part_1 (Incremental Cash Flows)
10_30_18_Part_2 (Payback, Accounting Rate of Return, Net Present Value, and Internal Rate of Return)
10_30_18_Part_3 (Scenario and Sensitivity Analysis)

Suggested Readings:


Additional Readings of Note:


“Real-options analysis rewards flexibility and that’s what makes it better than today’s standard decision-making tool, ‘net present value.’ NPV calculates the value of a project by predicting its payouts, adjusting them for risk, and subtracting the investment outlay. But by boiling down all the possibilities for the future into a single scenario, NPV doesn’t account for the ability of executives to react to new circumstances, for instance, spend a little up front, see how things develop, then either cancel or go full speed ahead.” – P. Coy, Business Week (1999)

Net Present Value (NPV) is undoubtedly a powerful tool; however, it is dependent upon the rather dubious assumption of certainty. As reality, of course, is rarely quite so predictable, there is an opening for an alternative: real options analysis (ROA) or real options valuation (ROV). Whereas NPV assumes that once a project is accepted it will be pursued until completed no matter what happens, ROV recognizes that many projects are inherently flexible—that they present entrepreneurs and/or managers with multiple decision nodes. Depending on the project and the uncertainty of its cash flows, there may, for instance, be value to waiting, expanding, contracting, or even abandoning a project entirely. Interestingly enough, these real options have value which is quantifiable, at least to an extent, upfront using options pricing models.

Lecture Notes:

11_6_18_Part_1 (Real Options - Logic)
11_6_18_Part_2 (Real Options - Valuation)

Suggested Readings:

Damodaran

Additional Readings of Note:


“Leaving aside tax factors, the formula we use for evaluating stocks and businesses is identical. Indeed, the formula for valuing all assets that are purchased for financial gain has been unchanged since it was first laid out by a very smart man in about 600 B.C. (though he wasn’t smart enough to know it was 600 B.C.). The oracle was Aesop and his enduring, though somewhat incomplete, investment insight was “a bird in the hand is worth two in the bush.” To flesh out this principle, you must answer only three questions. How certain are you that there are indeed birds in the bush? When will they emerge and how many will there be? What is the risk-free interest rate (which we consider to be the yield on long-term U.S. bonds)? If you can answer these three questions, you will know the maximum value of the bush ¾ and the maximum number of the birds you now possess that should be offered for it. And, of course, don’t literally think birds. Think dollars. Aesop’s investment axiom, thus expanded and converted into dollars, is immutable. It applies to outlays for farms, oil royalties, bonds, stocks, lottery tickets, and manufacturing plants. And neither the advent of the steam engine, the harnessing of electricity nor the creation of the automobile changed the formula one iota – nor will the Internet. Just insert the correct numbers, and you can rank the attractiveness of all possible uses of capital throughout the universe.”


How much is a company actually worth? Practitioners, with academic support, typically look at recent transactions, (public) comparables, and discounted cash flow (DCF) methods—while those with more sophistication will often include the role of real options. Regardless, the end result is a wide range of possible valuations. More precision would certainly be desirable in most instances, but companies are not like houses or other easily valued assets.

Lecture Notes:

11_13_18_Part_1 (Comparables, Discounted Cash Flow, and ROA Approaches)
11_13_18_Part_2 (The Berkus and Risk Factor Summation Methods)

Suggested Readings:

Venture Capital (Chapters 11-12)

Additional Readings of Note:


PART IV: CORPORATE GOVERNANCE

Per Shleifer and Vishny’s influential survey article (1997), “[c]orporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” Others would, of course, define it differently—with heavy emphasis on the policies, processes, and customs by which an institution is directed on behalf of the relevant stakeholders. Regardless of perspective, there is no denying the important role of corporate governance. Empirically, strong corporate governance is associated with superior stock returns and weak corporate governance with inferior stock returns. Theoretically, this is problematic (why are firms with strong corporate governance seemingly underpriced to begin with—hence the outperformance), but practically speaking, it is invaluable.
November 27, 2018 - Corporate Governance: A Primer

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” - A. Shleifer and R. Vishny, “A Survey of Corporate Governance” (1997)

“Once parted with their money, neither initial nor subsequent investors necessarily have much to offer the firm in terms of special ability: as ‘[t]heir investment is sunk and nobody—especially the managers—needs them[,]’” - A. Shleifer and R. Vishny, “A Survey of Corporate Governance” (1997)

Few research programs in finance are as active as corporate governance. Providing insight on a wide range of corporate financial issues including, but not limited to, board activities, executive compensation, and succession, corporate governance is of both academic and practical significance: How much should a corporate CEO be paid? How much influence should a board wield? How many members should sit on a corporate board? How large should the audit committee be? How should executive change be prepared for and effected? These questions, and others, are at the core of corporate governance.

Lecture Notes:

11_27_18_Part_1 (The Board of Directors)
11_27_18_Part_2 (Executive Compensation and Succession)

Suggested Readings:


Additional Readings of Note:

Bainbridge, S., 2011, Corporate Governance After the Financial Crisis, Oxford University Press.


“When things are going well, everyone feels like they’re on the same side of the table. When things are going not so well, it’s a different story. This is the reality of the startup-investor relationship. It’s not an easy relationship by any means. The relationship is made more challenging by the fact that it goes through an early honeymoon period shortly after an investment is made. Everyone is happy and excited. But then the real work begins. And the real difficulties.” – B. Yoskowitz, “Four Ways to Align Interests Between Startup Founders and Investors” (2010)

“The governance of a family business is more complicated than for non-family owned companies because of the central role of the family that owns and typically leads the business. In a family business, the business, the family, and the ownership group all need governance.” – J. Davis, “Governing the Family-Run Business” (2001)

“[Business] owners credit their advisory boards with cutting costs; helping with product development; introducing them to valuable clients, investors, and suppliers; and eliminating the sense of isolation that can come with running your own business. Most crucial, an advisory board makes a chief executive answerable to a third party.” – A. Gardella, “How to Create an Advisory Board” (2010)

Management and ownership succession, compensation, and employee motivation, among other things, are critical to the operation of smaller firms. Add in a family component, rapid growth, or a combination of the two, and these issues can quickly create havoc. Though much of corporate governance focuses on the decisions and makeup of the board of directors (and for good reason), many smaller firms rely on advisory boards to assist in the development and maintenance of their governance structures.

Lecture Notes:

12_4_18_Part_1 (Corporate Governance – Startups, Small Firms, and Family Businesses)
12_4_18_Part_2 (The Role of Advisory Boards)

Suggested Readings:


Additional Readings of Note:


