Chapter XIV

Company Valuation and Financing

Alice asks the Red Queen for directions, The Queen answers, “That depends on where you want to go.” And in another line, the Queen observes, “Now, here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!”

From Alice in Wonderland (Humes, 1997)

There is been much written on the period between Netscape going public on August 9, 1995, and NASDAQ peaking at 5,048.62 on February 29, 2000. March 10 of that year, by the way, was the worst day to buy stocks in 70 years (Berenson, 2004). This was not a normal period and this chapter will not attempt to explain it.

Our goal is to understand the effect of the financing process on the emerging company. Venture capitalists (VCs) and investment bankers are a big part of that process. They are in the background but affect the company’s behavior every day. “How to succeed” would not be complete without a basic understanding of their motive and behavior.

For background, an overview of the venture capital and investment banking process is provided. What is the owner’s unique perspective and how does this

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affect the company? How is the value of the emerging company determined? And finally, what are some important lessons from inside the boardroom?

The Venture Capital Process

VCs receive money from investors and purchase shares of emerging companies. Like a mutual fund they diversify by investing in many companies. The typical VC portfolio may have 10 or more than 100 companies in it. In good days, you needed only one company to be a winner. It would provide an extraordinary return and make up for many failures. But during the Internet bust no level of diversifying could insulate VC portfolios from large losses. The public, by far, were the biggest losers and watched as over a trillion dollars of accumulated value disappeared. VCs and investment bankers set the stage for much of this loss, one of the greatest in the history of the stock market.

Despite this period, the VC system remains an essential part of the innovation infrastructure that we are fortunate to have. Previously banks financed infrastructure changes like the railroad and provided this capital formation role. Today great universities, innovative minds and unrelenting spirit, combine with the VC system to create, nurture, and produce new technology.

On a Short Leash

Contrary to what most people believe, the real client of the emerging company is not the customer, it’s the VC investors since it is there money being spent in the early days. As a result, managers in small companies are frequently less independent than their mature company counterparts. Management teams that do not satisfy the investors are quickly and easily replaced.

On the positive side, senior board members can play a critical role in advising and guiding the emerging company. The well-connected VC can steer the company towards early customers and alliances. They do not just provide money; they provide “smart” money. As important, a prestigious VC firm lends credibility. They help overcome customer concerns over the financial stability of the emerging company.

In the early days of the software company “anchor” customers are also highly visible and have great influence over the direction of the company. After all, they
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