Session 20

Activist Growth Investing: Be your own change agent

Test

1. In the traditional venture capital approach to valuation, you <u>forecast earnings in a future year</u>, <u>apply a multiple</u> to these earnings and discount it back to today at a <u>target rate of return</u> to get a value for the business. If you are the VC negotiating for a stake in the business, in return for the capital you are providing to it, which of the following combinations will you most likely to use in your valuation?
    a. Low forecasted earnings, low multiple of earnings, high target rate of return.
    b. Low forecasted earnings, high multiple of earnings, high target rate of return.
    c. Low forecasted earnings, low multiple of earnings, low target rate of return.
    d. High forecasted earnings, low multiple of earnings, high target rate of return.
    e. High forecasted earnings, high multiple of earnings, high target rate of return.
    f. High forecasted earnings, high multiple of earnings, low target rate of return.
2. In the traditional venture capital approach to valuation, you <u>forecast earnings in a future year</u>, <u>apply a multiple</u> to these earnings and discount it back to today at a <u>target rate of return</u> to get a value for the business. If you are the owner of the business negotiating with the VC about the portion of the business that you will give up in return for the capital you are providing to it, which of the following combinations will you be most likely to use in your valuation?
    a. Low forecasted earnings, low multiple of earnings, high target rate of return.
    b. Low forecasted earnings, high multiple of earnings, high target rate of return.
    c. Low forecasted earnings, low multiple of earnings, low target rate of return.
    d. High forecasted earnings, low multiple of earnings, high target rate of return.
    e. High forecasted earnings, high multiple of earnings, high target rate of return.
    f. High forecasted earnings, high multiple of earnings, low target rate of return.
3. Assume that a young business has been valued at $40 million, using the VC approach. The venture capitalist will be investing $10 million in the company to cover investing and operating needs for the future. What proportion of the company should he get in return?

   a. 20.00% of the company
   b. 25.00% of the company
   c. 33.33% of the company

4. When venture capitalists invest in young companies, which of the following services do they generally provide?
   a. Supply capital to meet the company's current needs
   b. Provide advice on operations and management
   c. Monitor the founder/managers of the company
   d. Facilitate access to other capital (debt and equity)
   e. Prepare for initial public offering or sale
   f. All of the above
5. The target rates of return demanded by VCs are much higher than the actual returns earned by VCs on their investments. Which of the following best explains the divergence?
   a. VCs consistently over value the companies that they invest in.
   b. VCs consistently under value the companies that they invest in.
   c. The earnings at young companies are generally much lower than initially projected.
   d. The earnings at young companies are generally much higher than initially projected.
   e. The failure rate among young companies is very high.

Solution

1. In the traditional venture capital approach to valuation, you <u>forecast earnings in a future year</u>, <u>apply a multiple</u> to these earnings and discount it back to today at a <u>target rate of return</u> to get a value for the business. If you are the VC negotiating for a stake in the business, in return for the capital you are providing to it, which of the following combinations will you most likely to use in your valuation?
    a. **Low forecasted earnings, low multiple of earnings, high target rate of return**.
    b. Low forecasted earnings, high multiple of earnings, high target rate of return.
    c. Low forecasted earnings, low multiple of earnings, low target rate of return.
    d. High forecasted earnings, low multiple of earnings, high target rate of return.
    e. High forecasted earnings, high multiple of earnings, high target rate of return.
    f. High forecasted earnings, high multiple of earnings, low target rate of return.

Explanation: If you are the VC, you want your estimate of value to be as low as possible (so that you can claim a higher percentage of that value). To accomplish that objective, you want to use low earnings and a low multiple (to get a low exit value) and a high target rate of return (to make the current value even lower).

2. In the traditional venture capital approach to valuation, you <u>forecast earnings in a future year</u>, <u>apply a multiple</u> to these earnings and discount it back to today at a <u>target rate of return</u> to get a value for the business. If you are the owner of the business negotiating with the VC about the portion of the business that you will give up in return for the capital you are providing to it, which of the following combinations will you be most likely to use in your valuation?
    a. Low forecasted earnings, low multiple of earnings, high target rate of return.
    b. Low forecasted earnings, high multiple of earnings, high target rate of return.
    c. Low forecasted earnings, low multiple of earnings, low target rate of return.
    d. High forecasted earnings, low multiple of earnings, high target rate of return.
    e. High forecasted earnings, high multiple of earnings, high target rate of return.
    f. High forecasted earnings, high multiple of earnings, low target rate of return.

Explanation: If you are the founder, you want your estimate of value to be as high as possible (so that you can give away a smaller percentage of that value). To accomplish *that objective, you want to use high earnings and a high multiple (to get a high exit value) and a low target rate of return (to make the current value higher).*

3. Assume that a young business has been valued at $40 million, discounting expected cash flows (after reinvestment needs) back at a risk-adjusted rate. The venture capitalist will be investing $10 million in the company to cover investing and operating needs for the future. What proportion of the company should he get in return?
    a. **20.00% of the company**
    b. 25.00% of the company
    c. 33.33% of the company

Explanation: The pre-money valuation is $40 million but the post money valuation is $50 million (since the $10 million will be a cash balance to be added to the DCF value). The owner will argue that the VC is entitled to only 20% of the value (10/50), but the VC will push back with 25% (10/40). The former is a fairer estimate.

4. When venture capitalists invest in young companies, which of the following services do they generally provide?
    a. Supply capital to meet the company's current needs
    b. Provide advice on operations and management
    c. Monitor the founder/managers of the company
    d. Facilitate access to other capital (debt and equity)
    e. Prepare for initial public offering or sale
    f. **All of the above**

Explanations: VCs are more than capital providers. They are management consultants, investment bankers and talent seekers.

5. The target rates of return demanded by VCs are much higher than the actual returns earned by VCs on their investments. Which of the following best explains the divergence?
    a. VCs consistently over value the companies that they invest in.
    b. VCs consistently under value the companies that they invest in.
    c. The earnings at young companies are generally much lower than initially projected.
    d. The earnings at young companies are generally much higher than initially projected.
    e. **The failure rate among young companies is very high**.

    Explanation: While VCs demand high target rates of return on every investment they make, many of their investments fail to make them any money (since the companies they invest in don't make it). The actual returns reflect this failure adjusted return.