Venture Capital

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WHAT'S COVERED

In this lesson, you will learn about venture capital funding and how it works. Specifically, this lesson will cover:

1. Defining Venture Capital

Venture capital is a method of financing a business start-up in exchange for an equity stake in the firm. The risk of investment loss and the potential for future payout are both very high. As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. Return is earned when the business is sold to another owner or it "goes public" with an initial public offering (IPO). The venture capitalist can then "exit" by selling his shareholdings in the company.

Due to their risky nature, most venture capital investments are done with pooled investment vehicles. Investors combine their financial contributions into one fund, which is then used to invest in a number of companies. This way, investors are diversifying their portfolio and spreading out risk. Venture capitalists are gambling that returns from successful investments will outweigh investments lost in failed ventures.

Venture capitalists are selective in their investments. Innovative technology, growth potential, and a well-developed business model are among the qualities they look for. Growth potential is the most important quality, given the high risk a VC firm assumes by investing. The priority for VC firms is high financial return and a successful exit within three to seven years.

Venture funding is most suitable for businesses having large upfront capital requirements that cannot be financed by debt or other alternatives. These characteristics usually best fit companies in high-tech industries, which explains the venture capital boom of the late 1990s. The technology firms of Silicon Valley and Menlo Park were primarily funded by venture capital. These industries saw a surge in public interest that eventually generated large returns for VC firms.

> EXAMPLE Facebook is one example of an entrepreneurial idea that benefited from venture capital financing. The Menlo Park-based firm has seen immense success since its launch in 2004. Unfortunately for Facebook's venture capitalist investors (Accel Partners, Greylock Partners and Meritech Capital), the IPO has not performed as well as expected.

HINT

A VC firm's contributions often extend beyond financial funding. To increase the likelihood of high returns, it is in the venture capitalists' interests to nurture their investments. Any guidance and expertise venture capitalists offer to start-up firms can be instrumental to success.

TERM TO KNOW

Venture Capital
Money invested in an innovative enterprise in which both the potential for profit and the risk of loss are considerable.

1a. Advantages

Pursuing venture capital financing may not be appropriate for most start-up companies. It is important to weigh the benefits of receiving abundant resources against the costs of losing autonomy and ownership.

Advantages of venture capital include the fact that:

- It has an ability for company expansion that would not be possible through bank loans or other methods. This is essential for start-ups with limited operating histories and high upfront costs.
- Repayment of VC investors isn't necessarily an obligation like it would be for a bank loan. Rather, investors are shouldering the investment risk because they believe in the company's future success.
- Venture capitalists provide valuable expertise, advice and industry connections. A stipulation of many VC deals includes appointing a venture capitalist as a member of the company's board. This way, the VC firm has intimate involvement in the direction of the company.
- Venture capital is also associated with job creation (accounting for 2% of US GDP), the knowledge economy, and is used as a proxy measure of innovation within an economic sector or geography.

1b. Disadvantages

There are also disadvantages of venture capital:

- Securing a VC deal can be a difficult process due to accounting and legal costs a firm must shoulder.
- The start-up company must also give up some ownership stake to the VC company investing in it. This results in a partial loss of autonomy that finds venture capitalists involved in decision-making processes.
- VC deals also come with stipulations and restrictions in the composition of the start-up's management team, employee salary and other factors.
- With the VC firm literally invested in the company's success, all business operations will be under constant scrutiny. The loss of control varies depending on the terms of the VC deal.

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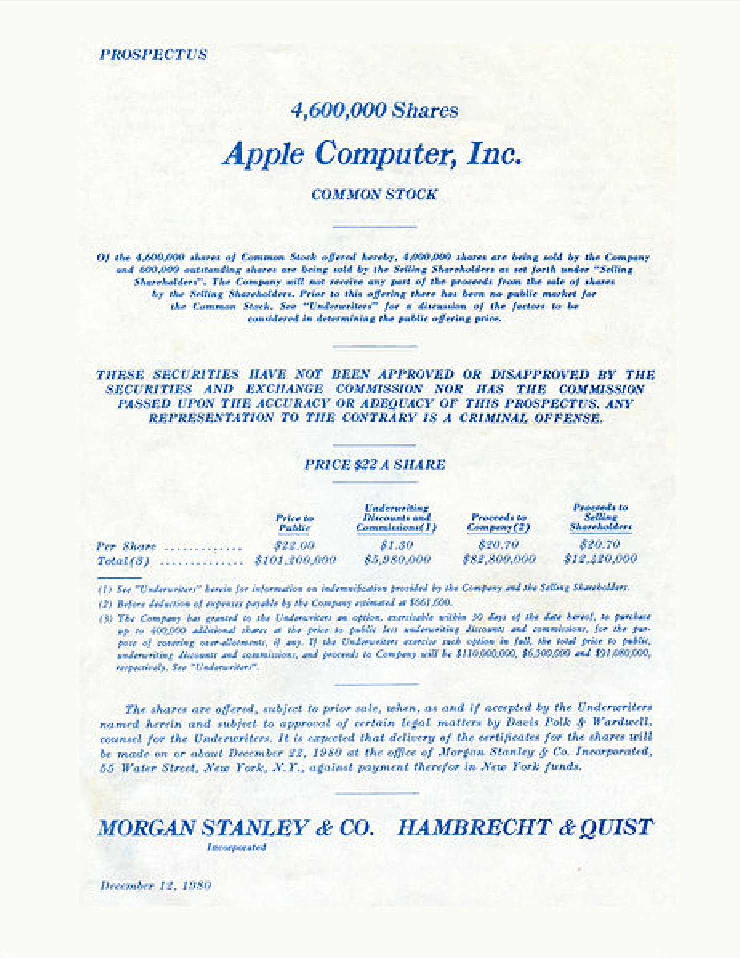
2. IPOs

An **initial public offering (IPO)**, also known as a stock market launch, is the first time a private company's shares are sold to the general public on a securities exchange. Allowing the general public to take up equity stakes in the company transforms it from being privately traded to publicly traded. If the company was venture-backed, the VC firms often gain their returns from IPO yields. Usually, the VC exits investments within a short time (one to three years, normally) after the IPO is concluded, either by distributing the shares to VC fund investors or selling them off on the market.

IN CONTEXT

This is the Initial Public Offering (IPO) Prospectus for Apple Computer Inc. in December 1980.



PROSPECTUS

4,600,000 Shares

Apple Computer, Inc.

COMMON STOCK

Of the 4,600,000 shares of Common Stock offered hereby, 4,000,000 shares are being sold by the Company and 600,000 outstanding shares are being sold by the Selling Shareholders as set forth under "Selling Shareholders". The Company will not receive any part of the proceeds from the sale of shares by the Selling Shareholders. Prior to this offering there has been no public market for the Common Stock. See "Underwriters" for a discussion of the factors to be considered in determining the public offering price.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

PRICE $22 A SHARE

	Price to Public	Underwriting Discounts and Commissions(1)	Proceeds to Company(2)	Proceeds to Selling Shareholders
Per Share	$22.00	$1.30	$20.70	$20.70
Total(3)	$101,200,000	$5,980,000	$82,800,000	$12,420,000

(1) See "Underwriters" herein for information on indemnification provided by the Company and the Selling Shareholders.

(2) Before deduction of expenses payable by the Company estimated at $661,600.

(3) The Company has granted to the Underwriters an option, exercisable within 30 days of the date hereof, to purchase up to 400,000 additional shares at the price to public less underwriting discounts and commissions, for the purpose of covering over-allotments, if any. If the Underwriters exercise such option in full, the total price to public, underwriting discounts and commissions, and proceeds to Company will be $110,000,000, $6,500,000 and $91,080,000, respectively. See "Underwriters".

The shares are offered, subject to prior sale, when, as and if accepted by the Underwriters named herein and subject to approval of certain legal matters by Davis Polk & Wardwell, counsel for the Underwriters. It is expected that delivery of the certificates for the shares will be made on or about December 22, 1980 at the office of Morgan Stanley & Co. Incorporated, 55 Water Street, New York, N.Y., against payment therefor in New York funds.

MORGAN STANLEY & CO. Incorporated   HAMBRECHT & QUIST

December 12, 1980

A total of 5 million shares were offered to the public for $22 each. The total outstanding shares after the offering were 54,215,332. The company's officers, directors, and major shareholders held 32 million shares and the rest were held by the company for stock options, plans, and other needs. Apple's valuation after the IPO was over $1 billion. (54 million shares at $22.)

TERM TO KNOW

Initial Public Offering (IPO)

A type of public offering where shares of stock in a company are sold to the general public.

2a. Advantages

Going public can also have benefits for the company, including:

- Increasing exposure, prestige, and public image
- Enlarging and diversifying the equity base
- Enabling cheaper access to capital, which is particularly important for high growth companies
- Allowing owners of the company to cash in on their efforts in a very lucrative way (if the IPO is successful)
- Attracting and retaining better management and employees through liquid equity participation

2b. Disadvantages

IPOs are not without cost to the company. Disadvantages to completing an initial public offering include:

- Legal, accounting and marketing costs associated with the process
- Requirement to disclose financial and business information
- Meaningful time, effort and attention required of senior management
- Risk that required funding will not be raised
- Public dissemination of information which may be useful to competitors, suppliers, and customers.

2c. Registration Rights

Prior to agreeing to provide capital, venture capitalists contract for privileges including**registration rights**, which ensure their ability to sell shares into the public capital markets, thereby safeguarding their future returns. Prior to selling shares on the stock exchange, companies must register these shares with the Securities and Exchange Commission. The registration rights agreement between the company and the venture capitalists requires the company to register the offering of shares by venture capitalists under certain conditions.

These conditions may be in the form of:

- *Demand rights:* Require the company itself to prepare, file, and maintain a registration statement on behalf of the investors' shares, so that investors can actually initiate a public offering and sell their shares.
- *Piggyback rights:* Require that the VC investors' shareholdings are included in a company-initiated registration so that the investors can sell their shares when the company initiates a public offering.

BIG IDEA

The number of each type of demand or piggyback rights, the percentage of investors necessary to exercise these rights, allocation of expenses of registration, the minimum size of the offering, the scope of indemnification and the selection of underwriters and brokers are all areas of potential negotiation in the registration rights agreement.

TERM TO KNOW

Registration Rights
A contractual agreement specifying conditions for registering shares of stock with the SEC prior to selling them on a security exchange.

SUMMARY

In this lesson, you learned about why venture capital is an attractive option for companies with high upfront costs. **Venture capital is defined** as financing that is provided to high risk endeavors in exchange for an equity stake in the company. There are **advantages** to venture capital funding beyond receiving the capital itself, but there are also **disadvantages** because it comes with increased oversight and scrutiny.

Venture capitalists often generate the return on their investment when a company grows and issues an **IPO**, or public sale of stock. IPOs also come with their own set of**advantages** and **disadvantages**, but to safeguard their investment, venture capitalists contract for **registration rights**, which ensures their ability to sell their shares into the public capital markets.

Best of luck in your learning!

TERMS TO KNOW

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