

Example of essay on preferred stock and the vc method

[Business](#), [Company](#)



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Question 1

Series A investment is the preferred stock issued to a venture capitalist during the first round by a portfolio company. This preferred stock is convertible to common stock for example during the issue of an IPO or when the company is on sale. Normally this happens in the range of \$6m to \$10M and finances the company for a range of six months to two years. This finance is for product development, marketing and branding, new employee hiring and any other crucial commercial undertakings.

EBV calculations

Pre-financing valuation: 5 million dollars

New money: 10 million dollars

Post money valuation: \$100 Million

Total shares diluted: 6 million shares

Original purchase price: 0. 83 dollars

Pre financing

post financing

Common

16, 000, 000 shares

16, 000, 000 shares

Series A

6, 000, 000 shares

10, 000, 000 shares outstanding shares

Exit strategy

25% profitability with valuations of 500, 000, 000 dollars

$0.25 \times 100,000,000 = 25,000,000$

Funds; $100,000,000 \times 0.02 \times 10 = 2,000,000$

Interest = $400,000,000 \times 0.2 = 80,000,000$

Deductions add up to: 82 million dollars

These calculations reveal that the exit strategy is very sensitive since the venture capitalist will have to share the profitability of five years with the interest and the annual fee of the funds invested. The 500 million exit valuation is a projected figure which cannot be established with much certainty considering the uncertainty involved in the portfolio companies and the securities exchange markets as well as their regulations.

Question 2

Calculations

Pre financing valuation: 6, 000, 000

New finances:

Pre finances

post financing

Common stock

10, 000, 000

10, 000, 000

Series A

5, 000, 000

Outstanding shares

10, 000, 000

15, 000, 000

Investment recommendation

Original purchase price for CP

$6,000,000/5000000 = 0.83$ dollars

Expected probability of success 25%

$6,000,000 * .25 * 3 = 4.5$ million dollars

Funds increase to 10.5 million dollars within three years

The exit strategy therefore is sensitive in that within the three years the stock valuation will have increases since the aggregate purchase price will be almost a third of the original purchase price.

Question three

The standard venture capital process has five steps; the seed stage, the startup stage, the second stage, the third stage and the bridge stage.

The seed stage

The seed stage is involved in funding the portfolio company with the seed finds. The venture capitalists have approached the prospect company for the idea of funding. The capitalist convinces the investors that the investment into the prospect company is worthwhile with a presentation of the feasibility

study conducted both economically and technical. The investors and the venture capitalist make a decision on whether to undertake the investment or not.

The rational for this step is to assess the level of risk involved. Normally, the level of risk is very high and the investment is most likely to be lost due to the high level of uncertainty in every factor considered. So the investors and the venture capitalist meet and establish measurable results of the risk of losing the investment and causes of the risks.

The startup stage

In this stage the investment idea that has qualified for investment is now allowed for consideration both in its aspects and expected returns. A plan is therefore prepared that guides the investment process and a team to run the venture is also selected by the venture capitalists. A development of the prototype project for the investment is also done in this stage. The main decision here is made by the venture capitalist who demands whether the project is favorable as well as feasible and whether to continue with the next necessary steps does make the decision.

The second stage

In this stage the investment idea has now been transformed into actions that have already been predetermined. Here the portfolio Company with the help of the venture capitalist can now make an encounter the market environment and the competitors afresh equipped with the new investment strategy and funds in place. The goal in this stage is to try to gain a percentage of the market share. The investment also targets to manage the

costs involved and tries to reach the break even for this particular venture. This is the most decisive stage in the venture process.

The third stage

This is also referred to as the expansion stage whereby the capitalist and the portfolio company harness their capabilities and try to expand the market share gained in the former stage. For this to improve, the market campaign and branding of the investment products is done. A SWOT analysis is done to try and analyze the company's improvement and strategy. Measures to reduce the costs or restructuring the internal organization are also done. The main aim of this last stage of the venture capital process is to try and create an exit strategy for the venture capitalist. This involves the investors and the venture going public. This is normally done through an issuing of an initial public offer (IPO). At this stage the market share achieved gives the venture several opportunities to choose from for the venture to go public; one is the hostile takeover, or merging with an interested company, keeping of competition or eliminating them. The investment is repositions in the market either by venturing into a new market segment. A follow up strategy is also established to make sure that the investment products or services are able to get new customers and venture into new markets or a segment in the same market.

Question 4

The use of convertible bonds to fund companies has several pros and cons

Pros

The method delays the dilution of the common stock and so even the earning to be received per share is also delayed. The company also gets the funds in the current period and the prices are set later.

The company becomes more flexible to enable the changes it needs to implement in its strategic operations. This is because this method of finances is fast and also very cost effective. Normally, the portfolio company can delay the issues from the board and the shareholders and focus on them when the holders of the notes convert their shares to equities. The investors also benefit since they have priority since they hold a superior position in the structures of the company's capital.

The bond can be offered and issued at a lower rate in coupons compared to the straight bonds. This is because the high figure of converting the bonds ensures that the yield is lower therefore the feature for converting is a sweetener

Cons

The conversion is also a cause of diluting the control of the company in addition to diluting the earnings per share as well as the securities. This is because the voting control shifts from the original to the new owners who have purchased the convertible securities.

Along period of financing the company through this means may put the company in a restricted position. This may cripple its autonomy and the control in other investment programs.

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