* DO NOT BREAK EXAM SEAL UNTIL TOLD TO DO SO *

VENTURE CAPITAL
Professors Bernthal and Mendelson
Final Exam – Fall 2013
Friday, December 13, 2013 – 1:15 p.m.
3 hours (180 minutes)

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Write your **EXAM NUMBER** on the line above.

Honor Code Reminder: Under the Honor Code, the submission of any academic work constitutes a representation on the student's part that such work has been done and submission is being made in compliance with all applicable provisions of the Code.

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EXAM INSTRUCTIONS

1. You have two hours and forty minutes to complete this exam, plus a 20 minute grace period (180 total minutes). Please read these instructions carefully before proceeding.

2. There are 100 total points available. Points are split evenly 50/50 between two portions of the exam. Point values are next to each exam question. The weight of the point values provides an indication of the depth of analysis expected in a strong answer.

3. **If you're struggling to complete a question on time, you're advised to move on and then come back as time permits.**

4. Please stick as closely as you can to the basic structure set out in the questions. If necessary (e.g., if you believe a question is unclear or ambiguous), you may explain how you are interpreting a question or identify that you are making a key assumption concerning a fact. **That said, be careful not to stray in directions that are outside of the question's scope.**

5. Mark your answers with your exam number, not your name. If you are writing this exam by hand, write all answers in your Bluebook. If you are typing this exam, include all answers in your electronic responses. Do not rely on answers written on the exam booklet itself. **While you should provide your best analysis, please do NOT compromise your anonymity.**

6. **Work on this exam must be entirely your own. Any direct communications with others about the substance of the exam, whether in person or electronic, is strictly prohibited.** Subject to these limitations, you may use (1) hard copy materials, (2) soft or electronic materials (including those on your computer); and (3) a calculator or substitute.

7. At the conclusion of the exam, **DEPOSIT THE GREEN TEST BOOKLET INTO THE BOX** provided in the exam room. **DO NOT REMOVE THE GREEN BOOKLET FROM THE EXAM ROOM**.

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9. Relax, have fun, and good luck.

PART I: STARTUP BUFFCO
Take 80 minutes to read the fact pattern and complete your responses to Questions 1 – 7.
(50 total points)

Startup BuffCo (SB) is a corporation organized in Delaware. SB makes basketball coaching software that automatically generates powerful coaching drills and game plans based upon deep data analysis of team and individual statistics. The software works well. It is especially growing in popularity among NBA and Division I college programs where statistical data is extensive. Availability of a wealth of data makes the software's analyses more powerful. The software is less useful where less data is readily available, such as the high school and club levels.

In September 2003, SB raised $1 million from an angel investor, Rich Uncle Walseth (RUW). SB's sole founder, Ceal Barry, is CEO and SB is her first startup. Barry offered RUW the "same kind of stock that I own – common stock." RUW knew a lot about basketball, not so much about investing, and was happy to receive common stock and a $9 million pre-money valuation for his SB investment.

Startup BuffCo made progress after the Rich Uncle Walseth angel investment, however, additional fundraising was difficult. On the verge of going bust, in December 2005, SB raised $2 million from Boyle Ventures (BV) on a $6 million pre-money valuation. BV is a $50 million fund raised in 2003. The round was not syndicated and BV is the sole owner of the Series A preferred stock. BV received Series A preferred stock with a seat on the board of directors, standard protective provisions, and a 1x liquidation preference that is participating up to a 3x cap.

The lead general partner from BV, Burdie Halderson (BH), sits on SB's three-person board, along with the CEO founder Ceal Barry, and angel investor RUW. Boyle Ventures' cash infusion and Burdie Halderson's sage advice helped Startup BuffCo finally find its footing. CEO Barry, angel RUW, and BV to this day remain SB's only shareholders.

In June 2013, Startup BuffCo received a $10 million acquisition offer from Isiah Thomas Corp. (IT). IT offered to pay cash in exchange for all of SB's stock. SB rejected IT's acquisition offer.

Startup BuffCo's trajectory is trending well. It won't explode into a huge company anytime soon, however, it has a valuable product that is carving out its own niche. On December 10, 2013, SB received a $22 million offer from Knight Inc. (KI). KI offered $22 million cash in exchange for all of SB stock. The KI purchase offer is as follows:

- $2 million cash to SB payable upon closing.
- $15 million cash is subject to a three year earn out following closing of the acquisition. The earn out is based upon sales of SB's product. The sales number targets seem realistic based upon SB's current momentum and internal three year sales projections.
- $5 million cash to be set aside and held in escrow for five years to cover any intellectual property or tax claims that arise during the period following the acquisition. Balance of escrow to be paid to SB following five year escrow period.

<u>Question #1 (3 points)</u>

What percentage of Startup BuffCo did RUW own in September 2003, immediately after the angel investment?

Answer: 10% = 3 points

$1 million on a $10 million post money valuation.

<u>Question #2 (6 points)</u>

After the Series A round with Boyle Ventures, RUW was unhappy to learn about the price that BV paid for SB. RUW knows that you came through CU's Venture Capital class and now wants your advice. "What should I do differently in my next investment?" he asks.

Please advise RUW on _<u>two issues related to price</u>_ that he should address differently in his next angel investment.

<u>Answer: = 6 points total</u>

The Series A with BV is a down round. It also illustrates the angel paradox. BV is getting a better price and terms despite the fact that RUW came early at a time when risk was higher.

3 points where answer explains a steps RUW should do differently next time that directly improves an angel's position with respect to price. This includes:

(1) If the round is priced, get a lower valuation. If the round is done as debt, a conversion cap and discount can be used to achieve a better valuation upon conversion. Here, the SB angel round valuation was likely too high and should have been more realistic; and

(2) RUW should look for price based antidilution protection, either through a preferred stock arrangement or convertible debt that converts into preferred stock.

1.5 points for other ideas that are relevant but not as on-point. These could include:

(3) Seek structural protections, such as a right of first refusal to participate in a future stock issuance. Note that while this would help RUW get the benefit of a future purchase price, it is not as helpful as #1 & #2 above, which help guard against overpayment in the first instance.

<u>Question #3 (4 points)</u>

Startup BuffCo rejected IT's $10 million acquisition offer.

If it had been accepted, how much of the proceeds would Boyle Ventures have received from the IT purchase of Startup BuffCo?

Answer: $4 million = 4 points.

$10 M proceeds. Under Series A rights, BV gets liq pref = $2M. BV participates at 25% ownership up to 3x cap ($6M , inclusive of liq pref). 25% of $8M = $2 million.

$2 million liq pref + $2 million participation = $4 million.

Question #4 (8 points)

Assume Knight Inc.'s $22 million acquisition offer is accepted and SB gets a "best case" economic scenario. That is, SB gets the $2 million up front, the full $15 million earn out, and entire $5 million from escrow.

Under this best case scenario, how much of the $22 million would Boyle Ventures receive?

Answer: out of 8 points

$6 million.

$22 M deal. Under Series A rights, BV gets liq pref = $2M. BV can participate at 25% ownership up to 3x cap ($6M , inclusive of liq pref). 25% of $20M = $5 million. But including the liq pref, BV hits the 3x cap at $6 million.

If BV converts to common, then it owns 25% of the company. 25% of 22 million = $5.5 million. So BV will not convert.

Question #5 (12 points)

You are a scholar with alleged expertise in the world of early stage finance.

Use the following four concepts to explain why Knight Inc. would like to include the three year earn out and five year escrow provisions in its acquisition of SB: (i) *information asymmetry*, (ii) *agency costs*, (iii) *reputation,* and (iv) *use of time*.

Answer: out of 12 points. 3 points per concept.

Information asymmetry and agency costs are common problems of entrepreneurial finance. Reputation and use of time are two common solutions. Strong answers should analyze how these problems and solutions apply – or not – in view of the escrow and earn out provisions.

Information asymmetry refers to relevant data that one party has but the other does not. Here, SB

and CEO CB know much about the company that KI – despite diligence in the acquisition process – may not. This would include relevant information about the likelihood of intellectual property infringements, tax issues, SB's sales prospects, and other items about the company that may not surface in due diligence. Use of escrow and the earn out are a way to force SB, which possesses this information to the extent that it exists, to signal that it believes in the strength of SB. This helps overcome the lemons problem.

Agency costs refers to one party – an agent -- acting opportunistically at the expense of another – a principal. Here the post-acquisition concern is that SB's team would act opportunistically at the expense of KI. One version of this may be that, after sale of SB, Ceal would be financially "set" and de-motivated to continue working hard. The escrow and the earn out are a <u>way of using time</u> to diminish agency costs. By keeping the payment subject to escrow and the earn out, KI seeks to align incentives so that the SB team performs and acts in a way that is in KI's interest. This is a version of forcing Ceal to maintain "skin in the game" post acquisition.

Reputation can be a powerful response to problems of entrepreneurial finance. It works best, however, where observable behavior will be part of a repeat game. Here there are reasons for KI to believe that reputation does not resolve the problems of information asymmetry or agency costs. SB is unlikely to be involved in selling to KI again and, moreover, its entrepreneurs may not even launch another company. BV may have reputational constraints that KI can rely upon, however, it is unclear how worried BV is about doing business with KI in the future. Overall, the reputational constraints that operate in the VC world are less likely to effectively operate in this acquisition context. Where reputation is less effective as a constraint upon behavior, a party will look for greater explicit contractual protections. In this case, escrow and the earn out provisions may be understood to compensate for the diminished reputational constraints.

Use of time is a common response to the problems of entrepreneurial finance. Escrow and an earn out period are a way for the purchaser to buy itself additional time as a means to overcome information asymmetry and constrain agency costs. Additionally, the time value of money means that the purchase price here -- $22 million – looks better than it really is. Money tomorrow is less valuable than money today.

<u>Question #6 (12 points)</u>

You are Burdie Halderson. You must now evaluate whether to take the Knight Inc. deal. You recognize that the KI offer is likely a favorable one for Startup BuffCo and, moreover, you know that CEO Barry and angel Rich Uncle Walseth—who at this point just wants out of the investment—would like to accept.

Wearing your Boyle Ventures' general partner hat, do you want the KI deal to go through?

Why or why not?

Answer: I probably would like to stop this deal.

There are positives. I like that this is a deal for SB's stock rather than assets. I am ready to exit. The possible outcome is strong for CEO Barry and sideways for RUW. A great outcome for Barry may enhance my reputation in the startup community as someone startups should do business with. For BV, the best case scenario is a roughly 3x return over an 8 year investment (although, with the escrow, it is more accurately a 13 year investment). On a $50 million fund, the $4 million gain is not a fantastic IRR, but it is OK. It might be attractive enough depending on the company's future alternatives. And if my fund is already in a carry position, then I take 20% of whatever return is realized on SB. But there are two key problems.

First, we're not going to get most of the money immediately. Even worse, there is some chance we'll never see much of it. We might get the $2 million liq preference first, although a carve out for management is a possibility to watch out for. The remainder of BV's return, moreover, is subject to significant contingencies – earn out and escrow-related considerations – that are well outside of our control. The earn-out, for example, depends on SB's team continuing to do well and – further – KI's team supporting the product and sales. This makes us very nervous.

Second, the BV fund is from 2003. Assuming a 10 year fund, money is now due back to the LPs. BV probably has two one year extensions. But the three year earn out and five year escrow will go past the extensions. They would require LP consents. This is going to be a pain. And the timing will make the IRR on the KI deal even less attractive. In addition to this pain, there could be liability reps and warranties that lie outside the escrow – fraud, tax, IP, etc. Liability for a breach of contract could last past the life of the fund. Especially if liability for breaches are joint and several, then I may be uncomfortable with this exposure if there is a breach.

<u>Question #7 (5 points)</u>

Burdie determines that BV would like to reject the KI deal.

Can BV stop the deal? If so, how?

Answer: Yes, BV can probably stop the deal.

Most important, BV has "standard" protective provisions." This would likely include the ability to stop any company sale of substantially all its assets. BV can reject the sale under its Series A preferred rights.

Additionally, KI would likely want a "clean" transaction. On an as converted basis, BV is a minority shareholder. But even if BV cannot block the sale, the threat of dissenter's rights -- and

a subsequent lawsuit – would likely chill KI's enthusiasm for the acquisition.

The Board is less likely to block the sale. Burdie lacks the Board of Director votes since CEO Barry and angel Rich Uncle Walseth each want to take the deal. Moreover, Burdie has a fiduciary duty as member of the Board of Directors to vote the best interests of the company. Even Burdie thinks this is a good deal for Startup BuffCo.

To block the sale, Burdie should have another BV general partner exercise the protective provision that requires Series A consent to approve the sale of the company. Alert CEO Barry. She may be able to recut the KI deal so as to cash BV – and potentially, RUW – out today in exchange for a lower acquisition price.

PART II: THE *ACCESS* PROJECT
Take 80 minutes to read the fact pattern and complete your responses to Questions 8 - 11. (50 total points)

Nestled within south-central-west-north Eurasia, roughly the size of the Front Range of Colorado, is the sovereign country of Bernthalistan. The country's approximately 10 million English-speaking citizens enjoy a favorable lifestyle due to natural resource-rich lands. But the country's leaders know that their economic future is dicey due to the foreseeable exhaustion of their natural resources. The government and private sector leaders have determined that a vibrant startup ecosystem is the best way to secure long term growth and prosperity.

Bernthalistan is fortunate to have several world-class technical universities, most of which are in Mendelville, which also is known as the small country's traditional economic center. There exists a small but growing startup community located in Mendelville, including a handful of active local early-stage-only VC firms. The legendary arts scene in certain historic locations, including Gerding City and Weiserton, attracts poets, travelers, musicians, and other artistic types. Due to its lovely beaches and great weather, Bernthalistan also boasts international outposts of several large accounting and legal firms scattered throughout the country.

Bernthalistan's leaders – private sector, government, and academic – wish to massively accelerate activity of the country's startup ecosystem. Despite its relatively small population, the government hopes to become an outsized world player—similar to Israel—in the world's innovation economy. They want home grown startup success as well as to become a world destination for innovation and investment. After much deliberation, the country settled on the following:

1. The country shall adopt Delaware corporate law in its entirety.

2. The country shall democratize the funding of startups by allowing crowd funding without restrictions. In other words, so long as crowd funding rules are followed, any company issuer can raise money from any investor without additional securities laws limitations.

3. In exchange for this freedom, all companies raising money must use a government-created crowd funding software platform called *Access*. And

4. All funding must be done as equity. Bernthalistan doesn't like debt and doesn't want to become the next Iceland or Greece.

Access is a crowd funding platform much like Kickstarter or AngelList. Companies raising money present their idea, their management team, and references on the *Access* website. In addition, fundraising companies must provide detailed financial projections, a full business plan, and a Private Placement Memorandum that states how much money the company seeks to raise. *Access* provides a standard format for each of these company disclosures. So long as a fundraising company follows the prescribed standard format and provides truthful information, there is a "safe harbor" that protects the company against future investor lawsuits. Expert investors hired by *Access* get direct exposure to the management team and conduct in-person due diligence conversations. These due diligence sessions are recorded and posted on the *Access* site. Potential investors—individuals and VCs alike—review the companies and, if they wish, offer terms to the company.

Financing offers are visible to both company and other potential investors. This is intended to create an eBay-like auction experience that the government hopes will maximize the terms to the company. The company then chooses which deal it wants to take, if any. Once a deal is struck, *Access* then automatically generates standard document forms based on the deal terms agreed to.

<u>Question #8 (15 points)</u>

Set aside location considerations for this question. Ignoring issues of geography, if you were a startup CEO, do you like the *Access*-based fundraising approach as compared to the traditional / U.S. approach that we've primarily focused upon in the VC course? Or, alternatively, would you prefer the more traditional / U.S. approach? What notable advantages and drawbacks of Benthalistan's *Access* system inform your analysis?

The key here is that a strong answer should identify the pros and cons of the *Access* system relative to the U.S. approach from the perspective of the CEO. Either answer can receive full credit.

There are at least four relevant factors from the vantage point of the entrepreneur, which include:

1. **Transaction costs.**

    a. ***Access* saves on "search" costs – that is the costs for an entrepreneur to find an investor, and vice-versa. Instead of taking a ton of meetings, the company puts its materials on the site and then wait until it picks one, then engages personally. This saves significant time for which an entrepreneur can instead focus on the building a company, rather than financing. And lower search costs could potentially lower the cost of capital, as it reduces the VC's costs. No flying all around the country. A startup might not need 6 months to raise money.**

    b. **The standardized disclosure forms could save on costs of disclosure. Note, however, there is a PPM required, which could involve more costs than the U.S. system where entrepreneurs stay with accredited investors. So this may be a pyrrhic savings, as it may nonetheless be more disclosure than a Reg D / Rule 506 type exemption would require.**

    c. ***Access* probably requires faster time to get to agreed upon terms. The standardized documents could be a big help, especially on legal fees. Of course the downside to this is limitations on the ability to make trade-offs and use private ordering to tailor a contract to individual circumstances.**

    d. **The safe harbor provision has some attraction as it may save on litigation costs over the long term. Overall, adoption of Delaware law is also attractive, as it enhances predictability and clarifies that private contracting – and use of preferred stock – will be allowed. One attraction of Delaware, however, is the specialized business courts. These are not necessarily included in this proposal.**

2. **Impact on price and valuation.**

    a. **It is not clear how this will work out from the vantage point of the entrepreneur. The eBay-like auction goal could have the intended effect of immediately generating bidding competition, resulting in higher valuations for startups.**

    b. **Yet transparency also could lead to collusion and lower valuations. Bidders can see one another's terms.**

    c. **The prohibition on debt limits my options. While it depends on the discount and cap amount, some startup insiders generally view debt as more entrepreneur-friendly than a priced equity round. The *Access* system revoves this option.**

3. **Information disclosure and leakage.**

    a. **Everyone can see my secrets, including my local and international competitors. Even seeking investors almost becomes tantamount to giving out investor's information rights to everyone on *Access.***

    b. **I worry about picking an investor, then engaging in personal diligence and that sending a signal to the market that there is something very wrong with my company.**

    c. **Standardized docs are not tailored. As such, they could overlook something. If this becomes a regular risk, then investors would require some premium to cover potential hidden risks due to standardized disclosure, which would involve higher costs.**

4. **Relationship with VC / investor community**

    a. **Yes, *Access* saves on the cost for a VC to learn about the company, but this still does not save me from having to do some diligence on the VC. I'd rather talk to a lot of investors, not just one, so that I can do diligence with whom I'm "married" to the next decade.**

    b. **Post investment involvement from a VC is important. Will *Access* diminish the post-investment involvement?**

    c. **An entrepreneur may have concerns about angering potential future investors. If similar terms are presented, then transparency means that an investor knows that the entrepreneur chose the other VC b/c of professional preference, not terms.**

<u>Question #9 (15 points)</u>

RealDeal, a Bernthalistan-based startup, is currently part of Stan-i-Stars, part of TechStars' Global Accelerator Network, and the leading accelerator program in Bernthalistan. RealDeal possesses intellectual property in proteomics—the study of proteins—that may revolutionize health care. In particular, RealDeal's software platform enables health care providers to conduct an affordable but accurate analysis that detects changes in a human's proteins. This analysis makes possible the early detection of many human diseases and ailments. Proteomic research is predicted to explode over the next 5-15 years. If so, RealDeal's software could be the market leader.

RealDeal posted on *Access* and received many offers. In the end, they've narrowed their options down to two.

Option 1: Comes from an investor named Spittny Bears. Bears is an angel investor and is offering $1m dollars with simple 1x liquidation preferences with no participation. She would like the right to attend board meetings but doesn't need a board seat. She has asked for standard protective provisions, a 1% option pool, and a $6m dollar pre-money valuation. Bears is new to Bernthalistan, having recently retired there from Boulder, Colorado, where she was a therapist to the large and growing population of hypomanic personalities (which, it turns out, was a very lucrative practice).

Option 2: Comes from a local venture capitalist, Fiona VC. Fiona VC is offering a $1m dollar round at $5m dollar post-money valuation. Fiona VC would like 1x liquidation preference with a 3x cap. They require a board seat, standard protective provisions, and a 22% option pool. The lead general partner on the deal from Fiona VC, who is affectionately known throughout the country by the nickname "One Eye", is something of a legend. One Eye was a pioneer in Bernthalistan's startup scene. She is widely credited as the country's first venture capitalist and her 25-year investment track record is excellent. Fiona VC is well-known in the area and is viewed as a "go-to" choice for entrepreneurs. Their funds have been very successful over the last two decades.

Which offer should RealDeal choose? What are the pros and cons of the two offers?

Answer: This is a smart vs. dumb money dilemma. Answer depends on what RealDeal prioritizes. If reputation, strategic assistance and future connections are prioritized, then Option 2 is likely the better choice for RealDeal. If money and deal terms are prioritized, then Option 1 is the better choice.

1. **Smart vs. Dumb money**

    a. **One-eye as a GP, and Fiona as a VC firm, represent smart money. Hsu highlights the certification value to a startup of an investment from a reputable VC. The transfer of reputational capital to RealDeal could be attractive.**

    b. **One-eye will take a board seat. Startups are thin and need tacit knowledge. The advisory functions performed by One-eye could be powerful – strategic advice, supplier and customer connections, attracting executive talent, etc. Proteomic research taking 5-15 years would benefit from sage early stage advice.**

    c. **Indications here – e.g., 1% option pool, no background in investing -- are that SB is dumb money. Of course the hypomanic experience could be valuable. accelerator**

SB may be good at dealing with entrepreneurs due to prior profession. But SB is retired. How hard will she work for the company? Another line of analysis is that RealDeal may be able to combine SB's investment with help from Stan-i-Stars. If CEO thinks that the accelerator's outside help is sufficient, then maybe VC funding can wait.

2. **Deal terms.**

    a. **All else equal, return is better on SB's offer, due to higher valuation and lower option pool.**

    b. **SB offer's pre-money valuation is $6M; Fiona's pre-money is $4M. SB will take only 1/7 of the company. Fiona will take 1/5, after a large option pool is implemented, too.**

    c. **Effective valuation from the perspective of RealDeal's prior shareholders is even more disparate than the pre-money indicates. The option pool will almost certainly be pre-investment. As a result, RealDeal's prior shareholders will suffer this dilution. There is a 21% swing between the two offers with respect to option pool. This effectively means that, from the perspective of the prior shareholders, Fiona's offer is 1/5 lower than its premoney valuation suggests, at least relative to SB's offer.**

    d. **SB's offer involves fewer controls – namely, she does not need a Board seat. Note, however, that the protective provisions in the hands of an angel may cause more concern than the control provisions in the hands of an experienced VC. SB is an unknown investor. She's new and reputation might not matter. And of course the Board involvement of One-eye may be very attractive. And Fiona VC is an established VC with proven record and reputational constraints.**

    e. **Fiona VC option pool is scary high. To be sure, some options will be needed to recruit high level talented employees. But 22% . . . will they replace CEO? As CEO, I need to think about the Founder's Dilemma type issues and be eyes-wide-open that Fiona VC may be including high options to create an alternative for another CEO down the line.**

    f. **Something is weird with Fiona VC 3x cap / precedent. If they are so good, then why are they asking for this this?**

3. **Follow on Funding**

    a. **Proteomic research is said to take 5-15 years. This means that additional funding will likely be needed. As an established fund, Fiona VC may be a better candidate for this than SB. Moreover, Fiona VC will likely have additional contacts to help build a future syndicate for a larger round.**

    b. **A potential downside of deal with Fiona VC is uncertain time to exit. Assuming a standard 10 year fund, Fiona VC may pressure RD to exit earlier than it would like.**

Question #10 (8 points)

Access emerges as a winner. Companies and investors use it on a widespread basis. Fiona VC now needs to raise a new fund. LPs of Fiona VC argue that the traditional "2 and 20" structure is too rich of a deal since, given *Access*' success, VCs no longer have to hunt deals out for themselves. If all the companies are on the website, they observe, shouldn't the fees be lower?

Are the LPs correct? Explain why or why not.

Probably not. Of course, the LP's view has some merit. VCs work hard to generate proprietary deal flow. *Access* should save some "search" costs – that is the costs for an entrepreneur to find an investor, and vice-versa. Lower search costs could potentially be savings that the LP points to in arguing for lower fees.

This line of analysis is overall a red herring, however, for several reasons. The LP's perspective here overstates the importance of "hunting deals." It understates the other functions VCs perform as specialized intermediaries in solving the common problems of entrepreneurial finance.

1. **Diligence costs are not fully mitigated. Team matters. A VC still needs to conduct diligence on the people involved. Good VCs will likely do their own diligence in addition to the *Access* diligence.**
2. **2% fees are a "loan" against carry. Fees get paid back to LPs before a VC receives carry. Fees also allow a VC to focus on active involvement with portfolio companies prior to exit. Post-investment monitoring is critical, ranging from board activity and assistance in exits. *After the Term Sheet.* This is time intensive work.**
3. **Reputation and attracting the best entrepreneurs remains important. *Hsu.* VCs are still "competing" for deals on the site. So they'll still need to do a lot of activities to win deals.**
4. **Finally, if they look at themselves as global players, they'll need to pay their VCs market rates, which are world-wide, or risk losing them.**

At the end of the day, an LP is paying for access to high quality sushi – viz., individuals who are able to exploit information gaps. Perhaps *Access* creates a more efficient asset class. But investing in the *Access* era is likely to remain marked by high levels of uncertainty, info assym, agency costs, and transaction costs. *Yale.* If the LPs are unwilling to pay a high caliber VC's fees, Fiona VC will be likely to just find another LP.

Question #11 (12 points)

You are an advisor to the city of Mendelville's mayor, Mason Jendelson (MJ). MJ is under considerable national pressure to collaborate with other cities—especially Weisertown and Gerding City—as part of Bernthalistan's innovation economy efforts. MJ dabbles in some of the economic geography literature. He is especially fond of Richard Florida's line that the world is "spiky" and not flat. Surveying other parts of Bernthalistan, Jendelson knows that his city has a head start and is already the nation's startup leader.

Jendelson tells you, "The world is not flat. I am not the President of Bernthalistan. My job is to serve the citizens of Mendelville. I want Mendelville to be the next Silicon Valley. Building up Weisertown and Gerding City will just dilute our advantage and give them a chance to take the lead. "

Use concepts from the Venture Capital course to advise MJ as to whether it is in Mendelville's best interests to freeze out Weisertown and Gerding City and instead focus on Mendelville.

Answers here may vary, however, course themes on economic geography suggest that the Mayor is probably misguided and would be better served to attempt to collaborate and create a regional entrepreneurial network. This is a small geographic area – roughly the size of the Front Range – and a regional network is probably the better strategy than a freeze out of WT and GC. Relevant precedents and concepts include (1) agglomeration economies (Marshall); (2) economies of scale and scope; (3) network effects (Saxenian and horizontal networks); (4) Florida and the 3Ts (talent, technology, tolerance); (5) Glaeser's work on cities; (6) Blank's history of Silicon Valley; and (7) Saxenian's discussion of cross-regional advantage (*New Argonauts*).

****END OF EXAM****