Entrepreneurship 6

Financial Resources for New Ventures: How to Get Them, How to Keep Them

"We all need money, but there are degrees of desperation."

--Anthony Burgess

Entrepreneurs face two key tasks wrt financial resources:

obtaining them and *managing* them well once they have them.

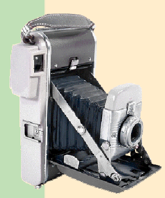
Basic Financial Statements

- Balance sheet
- Income statement (P&L)
- Statement of cash flow

snapshot of the company's financial standing at a particular *moment*.

=> it can change rapidly!

Balance Sheet



A picture of

- Assets—fixed and current
- Liabilities—long-term and current
- Owners' equity

- **Assets** include fixed assets (property, buildings, equipment & furniture) and current assets (cash and items that can be easily converted to cash).
- **Liabilities** include long term liabilities (loans, mortgages, etc.) and current liabilities (debts that are payable within one year).
- **Owner's Equity** consists of assets minus liabilities.

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Debt Ratio

- Determined from balance sheet
- A smaller number means greater financial health

$$\frac{\text{Total debt}}{\text{Total assets}}$$

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Income Statement

- **Profit & Loss statement**
- Reflects results of company's operations during a specific *period* of time
- Includes:
  - Net sales
  - Cost of sales
  - Operating expenses

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Profit Margin

$$\frac{\text{Net income}}{\text{Net sales}}$$

return on sales

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Statement of Cash Flows

- Shows changes in company's cash during a specific *period* of time
- Indicates
  - Operating activities- Deposits & debits (checks and withdrawals)
  - Investing activities - any purchases or sales of fixed assets (equipment, real estate, etc.)
  - Financing activities - cash raised during the period by borrowing money, selling stock, etc.

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Forecasting: Predicting the New Venture's Future Financial Outcomes

Projects the financial condition of the new venture

Proforma statements are made to help the entrepreneur project future profits, losses, cash flow needs, etc.

- Proforma balance sheet
- Proforma income statement
- Proforma statement of cash flows

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Information Asymmetry Problems

Entrepreneurs have information about their business that investors don't have. This creates three problems:

- Investors must make decisions on limited information
- Entrepreneurs can take advantage of investors
- Adverse selection when someone is unable to distinguish between two choices, one who has a desired quality and the other who does not

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Uncertainty Problems

- Investors must make judgments based on little actual evidence
- Entrepreneurs and investors disagree on value of new venture

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Solutions to Venture Finance Problems

- Self financing
- Contract provisions
  - Covenants
  - Mandatory redemption rights
  - Convertible securities
  - Forfeiture and antidilution provisions
  - Control rights
  - Vesting periods

Solutions to Venture Finance Problems

- Specialization
  - By industry
  - By development stage
- Geographically localized investing
- Syndication - Investors bring other investors on board as a group or syndicate to reduce the risk in the event the venture does not succeed

Capital Questions

- How much money do I need?
- Where should I get that money?
- What type of arrangements do I need to make to obtain that capital?

Start-Up Capital

How much do you need?

- 60% of all new ventures require less than $5,000 of capital to get started
- Only 3% require more than $100,000

(Source: U.S. Census Bureau)

Financial Analysis Tools

- List of startup costs and use of proceeds
- Proforma financial statements
- Cash flow statements
- Breakeven analysis

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Startup Costs

- All costs incurred to get the business off the ground
- Determine the capital you need
- Determine what you'll do with the capital once you get it

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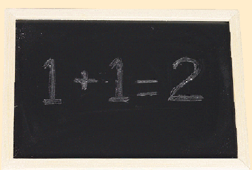
Two Proforma Lessons

- Profit and loss estimates depend on the quality of *sales* estimates.
- Profit and loss estimates depend on accurate estimates of *costs*.



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Income to Cash Flow

- Take your net profit and add back depreciation
- Subtract increases or add decreases in accounts receivable
- Subtract increases or add decreases in inventory
- Add increases or subtract decreases in accounts payable
- Subtract increases or add increases in notes/loans payable

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Improve the Flow

- Minimize accounts receivable
- Reduce the raw material and finished products inventory
- Control your spending
- Delay your accounts payable

Breakeven Analysis

- Calculate the amount of sales you need to achieve to cover your costs
- Determine the increase in sales volume you need to have in order to increase fixed costs

Calculate Breakeven Level of Sales

- Determine sales price (per unit)
- Estimate variable cost (per unit)
- Subtract variable cost from sales price to calculate contribution margin
- Estimate fixed costs
- Divide fixed costs by contribution margin

Debt vs. Equity

- Debt—financial obligation to return capital provided plus a scheduled amount of interest
- Equity—a portion of ownership received in an organization in return for money provided

Financing with Equity

New ventures tend to be financed by equity because

- New ventures have no way to make scheduled interest payments until they have positive cash flow
- Debt financing at a fixed rate encourages people to take risky actions

Debt Financing

- Debt guaranteed by the entrepreneur's personal assets or earning power
- Asset-based financing
- Supplier credit

Sources of Capital

- Savings
- Friends and family
- Business angels
- Venture capitalists
- Corporations
- Banks
- Asset-based lenders
- Factors
- Government programs

- **Commercial loans** – the borrower takes the whole loan amount out at one time and pays interest on the money borrowed.
- **Line of credit** – the entrepreneur draws up to a set amount of money at a particular interest rate, whenever it is needed.
- **Asset-based Lenders** – they provide financing by using the assets themselves as collateral for the loan.
- **Factors** – specialized organizations that purchase accounts receivable of a business at a discount.

  The new venture sells its accounts receivables to the factor for ninety plus percent of what they are worth and receives the cash value of those receivables immediately.

What Are Investors Looking For?

An excellent venture team with
- Motivation
- Passion
- Honesty
- Experience

What Are Investors Looking For?

An excellent business opportunity with
- Large market
- Product acceptance
- Appropriate strategy
- Protection of intellectual property
- Well-designed production plan
- Compelling product description
- Externally observable competitive advantage

Due Diligence

Investigation of
- The business
- The legal entity
- The financial records

Staging of Financing

Staging of financing allows investors to
- Minimize their risk and assess progress at milestones
- Gather more information over time
- Manage the uncertainty of investing

Venture Capital Method

- Consider business plan's forecasts
- Calculate price-earnings ratio
- Estimate terminal value
- Calculate *Net Present Value* of terminal value
- Specify portion of ownership by dividing investment amount by NPV of the terminal value

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Encouraging Investors

- Create a good impression
- Create a sense of urgency to generate momentum
- Frame ideas to make them more appealing
- Prepare a good business plan

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