Small Business & Entrepreneurship Seminar Series

July 17, 2013
Session 3
Agenda

1. Financial statements
2. Financing models
3. Trends in startup funding
Disclaimer

- Neither the faculty/staff nor students of the Community Law and Business Clinic, nor the Wake Forest University School of Law, represent you in any capacity legal or otherwise. We are not your attorneys.

- Information in this presentation is not to be construed as legal advice, and does not take the place of a competent attorney.

- If you have legal issues, please retain and consult a licensed attorney.

- GET AN ACCOUNTANT
S wants to expand her jam business
- Assume that S is a **C corporation**

- How would she go about doing that?

- Some foreseeable costs:
  - Property
  - Manufacturing facility
  - Equipment
  - Marketing
  - Employees
  - Interest
  - Taxes
  - Raw materials

- $$$$$!
What is Finance?

- 2 principal uses:
  - The field dealing with the management of money within an organization or entity
  - The provision of funding for business startups or internal projects

- Includes:
  - Banking and banking activities
  - Investments
  - Credit and debt
  - Assets and liabilities
Capital Structure

- How a corporation finances its assets
- Corporations have two ways of raising money
  - Debt
  - Equity (stocks)
  - Okay, three: Hybrids
Debt (Leverage)

- Debt is money borrowed by one party from another, usually required to be paid back with interest at a later time
  - Bonds
  - Notes
  - Commercial paper

- Pros
  - Gains are magnified
  - Maintain ownership/control
  - Easier to plan for (known amounts)

- Cons
  - Losses are magnified
  - More expensive than equity
  - Cuts into cash flows (debt servicing)
  - Not easily accessible by startups
Leverage Example

- Buy house worth $100k
  - $90k loan from bank
  - $10k down payment

- House values go up 20%
  - $120k new house value
  - -$90k loan from bank
  - -$10k initial investment
  - = $20k profit

- House values go down 20%
  - $80k new house value
  - -$90k bank loan
  - -$10k initial investment
  - -$20k loss
Equity

- Equity is stock (partial ownership) in a company
- Money is raised by selling these shares to investors

Pros
- Lower risk
- Potentially cheaper
- No debt service; no need to pay back

Cons
- May be as expensive as debt with txn costs (underwriter fee: 5-7% gross)
- Less control over company
Initial Public Offering (IPO)

10,200,000 Shares

Ford Motor Company

Common Stock

Copies of the Prospectus may be obtained only from such of the underwriters, including the underwriters, as are registered or licensed dealers or brokers in securities in the State.
Sidebar: The financial regulatory environment

- Extreme complexity
- Ability of sophisticated actors to create significant asymmetries in knowledge
Strengthened but not simplified

Financial Stability Oversight Council
- Identify risks to the financial stability of the U.S. from activities of large, interconnected financial companies. Authority to gather information from financial institutions. Make recommendations to the Fed and other primary financial regulatory agencies regarding heightened prudential standards.

State Regulatory Authorities and AO’s
- Power to enforce rules promulgated by Bureau of Consumer Financial Protection

SEC
- Regulates securities exchanges: mutual funds and investment advisers. Examination authority for broker-dealers.
- Authority over security-based swaps, security-based swap dealers and major security-based swap participants.

CFTC
- Market oversight and enforcement functions.
- Authority over swaps, swap dealers, and major swap participants.
- Regulates trading markets, clearing organizations and interdealer brokers.

Office of the Comptroller of the Currency
- Focus on safety and soundness. Primary regulator of national banks and federal savings associations. Examination authority. Examines loan portfolio, liquidity, internal controls, risk management, audit, compliance, foreign branches.

Federal Reserve
- Focus on safety and soundness. Supervisor for systematically important financial institutions and their subsidiaries.
- Establishes heightened prudential standards on its own and based on Council recommendations.
- Examination authority.

Office of Financial Research
- Office within Treasury, which may collect data from financial institutions on behalf of Council.
- No examination authority.

FDIC
- Focus on protecting deposits through insurance fund: safety and soundness; manage bank restructurings.
- Examination authority: orderly liquidation of systemically important financial institutions.

Bureau of Consumer Financial Protection
- Focus on protecting consumers in the financial products and services markets. Authority to write rules, examine institutions and enforce. No prudential mandate.

FINRA
- Regulates brokerage firms and registered securities representatives. Writes and enforces rules. Examination authority over securities firms.

This chart assumes these activities are conducted in a systematically important bank holding company (SIB).

1. The Council, through Office of Financial Research, may request reports from systematically important BHCs.
2. FDIC may conduct exams of systematically important BHCs for purposes of implementing its authority for orderly liquidations, but may not examine those in generally sound condition.
3. The Dodd-Frank Act expanded the FDIC’s authority when liquidating a financial institution to include the bank holding company, not just entities that house FDIC-insured deposits.

Note: Green lines from SEC and CFTC represent enhanced authority over existing relationships.
BREAK
Types of Financial Statements

- **Balance sheet**
  - One-time snapshot of assets and liabilities
  - Assets = liabilities + shareholders’ equity

- **Statement of cash flows**
  - Cash generating activities through operations, financing and investment
  - Measures ability of company to generate cash from normal operations

- **Income statement/statement of activities (NP)**
  - Measure of profitability during given period
  - How revenue transforms into net income

- **Statement of retained earnings**
  - Amount retained by company rather than given as dividends
Balance Sheet

Assets = Liabilities + Stockholders' Equity

- Property tax bill due to CALPOWER $14,500
- TekMax invoice for disk drive parts delivered $12,000.00
- Promises to pay to Tioga Bank $2,000.00 plus interest

Stockholders' Equity

- Contributed capital
- Retained earnings
  - Reinvested earnings
Statement of Cash Flows

\[ +/ - \text{Cash Flows from Operating Activities (CFO)} \]
\[ +/ - \text{Cash Flows from Investing Activities (CFI)} \]
\[ +/ - \text{Cash Flows from Financing Activities (CFF)} \]

Change in Cash
Income Statement

Revenues - Expenses = Net Income
Financial Statement Exercises

- Find the total assets
  - $1,209,300
- Find total liabilities
  - $790,069
- What is the debt/equity ratio?
  - Debt (liabilities) = $790,069
  - Equity = $419,231
  - D/E ratio = ~1.88
    - Good or bad?
      - Capital intensive industries have higher D/E ratios
- What is the net cash provided (used) by operating activities?
  - Is this good or bad?
Common Financial Ratios

**Short-Term Solvency, or Liquidity, Ratios**

- **Current ratio** = \( \frac{\text{Current assets}}{\text{Current liabilities}} \)
- **Quick ratio** = \( \frac{\text{Current Assets} - \text{Inventory}}{\text{Current liabilities}} \)
- **Cash ratio** = \( \frac{\text{Cash}}{\text{Current liabilities}} \)

**Days’ sales in receivables** = \( \frac{365 \text{ days}}{\text{Receivables turnover}} \)

**Total Asset Turnover** = \( \frac{\text{Sales}}{\text{Total assets}} \)

**Capital intensity** = \( \frac{\text{Total assets}}{\text{Sales}} \)

**Profitability Ratios**

- **Profit margin** = \( \frac{\text{Net income}}{\text{Total assets}} \)

**Long-Term Solvency, or Financial Leverage, Ratios**

- **Total debt ratio** = \( \frac{\text{Total assets} - \text{Total equity}}{\text{Total assets}} \)

**Debt-equity ratio** = \( \frac{\text{Total debt}}{\text{Total equity}} \)

**Equity multiplier** = \( \frac{\text{Total assets}}{\text{Total equity}} \)

**Times interest earned ratio** = \( \frac{\text{EBIT}}{\text{Interest}} \)

**Market Value Ratios**

- **Return on Assets (ROA)** = \( \frac{\text{Net income}}{\text{Total Assets}} \)

**ROE** = \( \frac{\text{Net income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} \)

**Asset Management ratios**

- **Inventory Turnover** = \( \frac{\text{Cost of goods sold}}{\text{Inventory}} \)

**Days’ sales in inventory** = \( \frac{\text{Cost of goods sold}}{\text{Inventory}} \)

**Receivables Turnover** = \( \frac{\text{Cost of goods sold}}{\text{Inventory}} \)

**Market Value Ratios**

- **Inventory Turnover** = \( \frac{\text{Cost of goods sold}}{\text{Inventory}} \)

**Price earnings ratio** = \( \frac{\text{Price per share}}{\text{Earnings per Share}} \)

**EV multiple** = \( \frac{\text{Enterprise value}}{\text{EBITDA}} \)
BREAK
Startup Financing

- Sweat equity
- Family and friends
- Government grants/loans
- Crowd-funding
- Angel investors
- Venture capital/Private equity
- Mezzanine investors (usu. debt)
- IPO
- Bank loans
Types of Seed Funding

- Sweat equity – personal assets and WORK to grow and increase value of company
- F&F - Selling portions of the company to friends and family
  - Exception in the securities regulations allows this
- Grant money – CDCs, municipalities, SBA grants/loans, etc.
- Crowdfunding – raising capital in small amounts from many people
  - New regulatory changes (JOBS Bill) is set to allow crowd funding
Angel Investors

- Usually affluent individuals, groups or networks
- Provides capital for convertible debt or equity stake in company
- Early-stage investors
- Fills “valley of death” between F&F and venture capital
Venture Capital

- Pooled investor money managed by professionals
- Invests in growth (high-potential) startups
  - Often only invest in startups with IP holdings
- Obtains ownership stake (equity) in company
- Also called growth funding round, or Series A, B, C, etc. funding
Initial Public Offering

- Money raised from the public at large
- More securities regulations are required due to publicly traded status
- Usually for established businesses only
Initial Public Offering (IPO)

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Cash Management in Startups

- Valuation
  - Not linear
  - Requires concrete stages of growth/milestones
  - Investment amounts/terms/rounds based on valuations

- Burn rate
  - How much cash a startup goes through in a given period of time
  - Trim expenses where possible, but not to the detriment of long-term growth/health

- Business can be profitable and still run out of cash!

- Cash is king in the startup world
Cash Management, cont.
Cash Management, cont.

Diagram:
- Valuation axis
- Cash Out Date
- Time axis
- Post-Money Valuation
- Pre-Money Valuation
- $'s in the Bank
- Series A raised
Startup Financing

Takeaways

- Process can be complex
- Most new businesses **FAIL**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent Failed</th>
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<tbody>
<tr>
<td>Year 1</td>
<td>25 %</td>
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<tr>
<td>Year 2</td>
<td>36 %</td>
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<td>Year 9</td>
<td>69 %</td>
</tr>
<tr>
<td>Year 10</td>
<td>71 %</td>
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</tbody>
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- Knowing the financial side of business is vital to success
Trends in Startup Financing

- Crowd funding – going straight to the people
- Lower costs for the average startup
- More startups (especially due to poor job market)
- More IP-based investing
- Founders may retain more power
S has several distribution deals and wants to move from the small commercial kitchen into her own processing facility.

Where should she go for funding?
Finance Takeaways

- Know:
  - where the money is coming from
  - when/if/how it needs to be paid back
  - what you’re giving away

- Do you need an accountant?
  - YES!
Conclusion

- Financing a business can be complex, but is essential to its growth and profitability

- Understand:
  - The steps in the financing process
  - The financial ramifications of funding
  - The financial statements and position of your company

- Consult your attorney or accountant for more information