Solutions to the 13 Biggest Finance, Management and Marketing Problems that Affect Entrepreneurs and Businesses

By

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The 13 Biggest Problems of Doing Global Business

1. **Focusing** – Knowing what business you should be in and then focusing on its operation
2. **Seeking advice and establishing the right organizational form and structure**
3. **Switching from an entrepreneur to a corporate entrepreneur – giving up some control**
4. **Attracting and retaining employees**
The 13 Biggest Problems of Doing Global Business (cont.)

5. Growing outside and choosing the right partner
6. Flexibility and Creativity – Making changes when needed
7. Building a lasting business
8. Market niching and customer focus
9. Going international successfully
10. Knowing how to successfully grow a business
11. Raising capital
12. Managing the cash flow
13. Valuing a business
Problem 1

Focusing
Aspects of the Entrepreneurial Process

**Identify and Evaluate the Opportunity**
- Creation and length of opportunity
- Real and perceived value of opportunity
- Risk and returns of opportunity
- Opportunity versus personal skills and goals
- Competitive environment

**Develop Business Plan**
- Title Page
- Table of Contents
- Executive Summary
  1. Description of Business
  2. Description of Industry
  3. Marketing Plan
  4. Financial Plan
  5. Production Plan
  6. Organization Plan
  7. Operational Plan
  8. Summary
- Appendices (Exhibits)

**Resources Required**
- Existing resources of entrepreneur
- Resource gaps and available supplies
- Access to needed resources

**Manage the Enterprise**
- Management style
- Understand key variables for success
- Identify problems and potential problems
- Implement control systems
- Develop growth strategy
Determining the Need for a New Product Idea

<table>
<thead>
<tr>
<th>Factor</th>
<th>Aspects</th>
<th>Competitive Capabilities</th>
<th>New Product Ideas Capability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of need</strong></td>
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<tr>
<td>Continuing need</td>
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<td>Future need</td>
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<td><strong>Timing of need</strong></td>
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<td>Demand cycle</td>
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<td>Position in life cycle</td>
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<td><strong>Competing ways to satisfy need</strong></td>
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<td>Modifying present way</td>
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<td><strong>Perceived benefits/risks</strong></td>
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<td>Utility to customer</td>
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<td>Appeal characteristics</td>
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<td>Customer tastes and preferences</td>
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<td>Buying motives</td>
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<td>Consumption habits</td>
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<td><strong>Price versus performance features</strong></td>
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<td>Price-quantity relationship</td>
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<td>Demand elasticity</td>
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<td>Stability of price</td>
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<td>Stability of market</td>
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<td><strong>Market size and potential</strong></td>
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<td>Market growth</td>
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<td>Threats to market</td>
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<td><strong>Availability to customer funds</strong></td>
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<td>Financing opportunities</td>
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## Determining the Value of a New Product Idea

<table>
<thead>
<tr>
<th>Value Consideration</th>
<th>Cost (in $)</th>
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<td><strong>Cash outflow</strong></td>
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<td>R&amp;D costs</td>
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<td>Capital equipment costs</td>
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<td>Other costs</td>
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<td><strong>Cash inflow</strong></td>
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<td>Sales of new product</td>
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<td>Effect on additional sales</td>
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<td>Salvageable value</td>
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<td><strong>Net cash flow</strong></td>
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<td>Maximum exposure</td>
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<td>Time to maximum exposure</td>
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<td>Duration of exposure</td>
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<td>Total investment</td>
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<td>Maximum net cash in a single year</td>
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<td><strong>Profit</strong></td>
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<td>Profit from new product</td>
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<td>Profit affecting additional sales of existing products</td>
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<td>Fraction of total company profit</td>
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<td><strong>Relative return</strong></td>
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<td>Return on shareholder’s equity (ROE)</td>
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<td>Return on investment (ROI)</td>
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<td>Cost of capital</td>
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<td>Present value (PV)</td>
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<td>Discounted cash flow (DCF)</td>
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<td>Return on assets employed (ROA)</td>
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<td>Return on sales</td>
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<td><strong>Compared to other investments</strong></td>
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<tr>
<td>Compared to other product opportunities</td>
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<tr>
<td>Compared to other investment opportunities</td>
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Problem 2
Establishing the Best Organizational Form
Corporate Organizational Forms in the U.S.

- LLC
- SC
- C Corporation
- Professional Corporation
- Not-for-Profit Corporation
- Hybrid Corporation
Stage 1 – Organizational Design

Shareholders

Board of Directors (Advisors)

President/CEO

Vice President Production
Vice President Marketing/Sales
Vice President Administration
Problem 3
Giving up Control
Corporate Entrepreneurship Formula

$$CE = CI + O + C^2$$

Where:
- $I$ = Level of Corporate Entrepreneurship
- $CI$ = Commitment to Innovation
- $O$ = Ownership
- $C$ = Creativity
- $C$ = Change
## Nine Steps to Transforming Your Organization

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
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</table>
| 1    | Establish A Sense Of Urgency  
- Examining market and competitive realities  
- Identifying and discussing crises, potential crises, or opportunities  
- Develop appropriate guidelines for time frame  
- Implementation must be achievable within the existing scope of organizational resources |
| 2    | Forming A Powerful Guiding Coalition  
- Assembling a group with enough power to lead the change effort  
- Encouraging and allow the group to work together as a team  
- Organize a team of established leaders who can implement and obtain buy-in of others and also work toward organizational goals without blocking tasks with personal agendas |
| 3    | Creating A Vision Of End Result  
- Creating a vision to help direct the change effort  
- Developing a strategic plan (mission, goals/objectives, strategies/tactics) for achieving that vision |
| 4    | Communicating The Vision  
- Using every vehicle possible to communicate the new vision & Strategies  
- Teaching new behaviors by example of the guiding coalition  
- Measuring progress toward the end goal must be visible and continually communicated to all |
| 5    | Selecting A Champion  
- Selecting a champion that can spearhead the transformation  
- Champion needs to be able to communicate the vision in a powerful way |
| 6    | Empowering Others To Act On The Vision  
- Getting rid of obstacles to change  
- Changing systems that undermine the vision & discourage risk taking  
- Rewarding creative thinking & implementation at any level  
- Acknowledge that employees are the ones responsible for achieving success |
| 7    | Planning For And Creating Short-Term Wins  
- Planning for visible performance improvements  
- Recognizing and rewarding employees involved in the improvements with more than token rewards  
- Stair step achievements: Winning small battles to “win the war”  
- Build in accomplishments which lead to the end goal and reward those that add value to that achievement |
| 8    | Consolidating Improvements & Producing Still More Changes  
- Using increased credibility to change systems, structures and policies  
- Hiring, promoting, and developing employees who can implement the vision  
- Giving employees the opportunity to initiate changes |
| 9    | Institutionalizing New Approaches  
- Articulating the connections between new behaviors and success  
- Developing the means to ensure leadership development and succession  
- Standardizing the process for all future change initiatives |

Corporate Entrepreneurial Environment

- Organization operates on frontiers of technology
- New ideas encouraged
- Trial and error encouraged
- Failures allowed
- No opportunity parameters
- Resources available and accessible
- Multidiscipline teamwork approach
- Long time horizon
- Volunteer program
- Appropriate reward system
- Sponsors and champions available
- Support of top management
Corporate Entrepreneurship Planning Guide

• Executive Summary
• Corporate Fit
  – Product fits into corporate goals
  – Customer base
  – Utilization of assets
  – Staff needs
  – Effect on business community
Corporate Entrepreneurship Planning Guide (cont.)

• **Product/Service Analysis**
  – Purpose of the product/service
  – Stage of development
  – Product limitation
  – Proprietary rights
  – Government approvals
  – Product liability
  – Related services and spin-offs
  – Production
Corporate Entrepreneurship Planning Guide (cont.)

• **Market Analysis**
  – Current market size
  – Growth potential of the market
  – Industry trends
  – Competition profile
  – Customer profile
  – Customer benefits
  – Target markets
  – Market penetration
Corporate Entrepreneurship Planning Guide (cont.)

- **Price and Profitability**
  - Price list
  - Sales estimate
  - Cost of product/service
  - Gross margin
  - 3-year operating expenses
  - 3-year operating statement
  - Start-up costs
  - Start-up expenses
  - Capital expenditures
Corporate Entrepreneurship Planning Guide (cont.)

- Plan for Further Action
  - Pitfalls
  - Positives
  - Needed capital
  - Role of corporate entrepreneurial manager
  - Business plan
  - License potential
  - Corporate partners
  - Proprietary rights
  - Corporate staff
  - Corporate entrepreneurship executive board
Characteristics of a Corporate Entrepreneurial Leader

• Help people feel that they are important parts of a whole
• Assume that all human beings have the capacity for excellence and growth
• Undo the damage of employees feeling under-valued and under-appreciated
• Emphasize the rewards of self-motivation and self-improvement through work
• Establish a vision that empowers caring for the people and the product
• Combine the goals of the organization with the goals of the people in it
Characteristics of a Corporate Entrepreneurial Leader (cont.)

• Help employees learn how to manage change
• Demonstrate that new ways of doing things are workable
• Encourage new ways of doing things
• Manage by walking around (MBWA)
• Keep the bureaucrats out of the way of productive people
• Fail their way to success
• Develop a well-orchestrated purposeful disorganization
Problem 4
Attracting and Retaining Employees
Compensation Options and Analysis

Total Employee Reward Package

- **Economic**
  - Cash
    - Salary
    - Overtime
    - Bonus
  - Stock
    - ESOP
    - Dividend Re-investment Program
  - Pension
    - Retirement
    - Health
  - Risk Program
    - Life/Health
    - Personal Accident
  - Vacation
    - Holidays
    - Personal Days
  - Working Hours
    - Office Location
    - Parking
  - Medical
    - Dental

- **Non-Economic**
  - Environment
    - Living
      - Climate
    - Working Environment
      - Safety
    - Social Environment
      - Peer Group
    - Schooling
      - Safety
  - Communication
    - Variation In Work and Surroundings
  - Transportation
    - Maintenance of Working Environment and Equipment
  - Cultural Facilities
    - Quality of Life

**Source:** Adapted from material of Gerard Torma, Director of Compensation and International Human Resources, Nordson Corporation.
Problem 5
Choosing the Right Partner
Key Factors in Evaluating a Firm

- One-person management
- Poor corporate communications
- Few management tools being used
- Insufficient financial controls
- Highly leveraged--thinly capitalized
- Variations and poorly prepared financial statements
- Sales growth with no increase in bottom line
- Dated and poorly managed inventory
- Aging accounts receivable
- No change in products or customers
Favorable Circumstances for Licensing

- Company lacks capital, managerial resources, knowledge, or commitment to a foreign market.
- Company wants to test viability of a market.
- Technology is not central to company’s core business.
- Strong possibility of acquiring new technology.
- Market too small to warrant any other activity.
- Laws of country restrict other options.
- Risk of nationalization in country too great.
- Licensee could become a future competitor.
- Rapid rate of technological change.
Problem 6

Being Flexible and Creative
The Product Planning and Development Process

Idea Stage

Evaluate Laboratory development

Concept Stage Evaluate

Product Development Stage Pilot production run Evaluate

Test Marketing Stage Semi-commercial plant trials Evaluate

Introduction

Growth

Maturity

Decline

Commercialization stage – product life cycle

Number of product ideas

Amount of investment
Creativity and Problem-Solving Techniques

- Brainstorming
- Reverse brainstorming
- Synectics
- Gordon method
- Checklist method
- Free association
- Forced relationships
- Collective notebook method
- Heuristics
Creativity and Problem-Solving Techniques (cont.)

- Scientific method
- Kepner-Tregoe method
- Value analysis
- Attribute listing method
- Morphological analysis
- Matrix charting
- Sequence-attribute/modification matrix
- Inspired (big-dream) approach
- Parameter analysis
Problem 7
Building a Strong Company
<table>
<thead>
<tr>
<th>Company</th>
<th>Core Values</th>
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<tbody>
<tr>
<td><strong>3M</strong></td>
<td>• Innovation; “Thou shalt not kill a new product idea”</td>
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<td>• Absolute integrity</td>
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<td>• Respect for individual initiative and personal growth</td>
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<td></td>
<td>• Tolerance for honest mistakes</td>
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<td>• Product quality and reliability</td>
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<tr>
<td><strong>American Express</strong></td>
<td>• Heroic customer service</td>
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<td>• Worldwide reliability of services</td>
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<td></td>
<td>• Encouragement of individual initiative</td>
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<tr>
<td><strong>Ford</strong></td>
<td>• People as the source of our strength</td>
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<td>• Products as the “end result of our efforts” (we care about cars)</td>
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<td></td>
<td>• Profits as a necessary means and measure for our success</td>
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<td></td>
<td>• Basic honesty and integrity</td>
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<tr>
<td><strong>General Electric</strong></td>
<td>• Improving the quality of life through technology and innovation</td>
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<tr>
<td></td>
<td>• Interdependent balance between responsibility to customers, employees, society, and shareholders (no clear hierarchy)</td>
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<td>• Individual responsibility and opportunity</td>
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<td>• Honesty and integrity</td>
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</table>
## Central Concepts of the Mission Statements of Selected U.S. Companies (cont.)

<table>
<thead>
<tr>
<th>Company</th>
<th>Mission Statements</th>
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</thead>
</table>
| Marriott         | • Friendly service and excellent value (customers are guests); “make people away from home feel that they’re among friends and really wanted”  
                   | • People are number 1—treat them well, expect a lot and the rest will follow        
                   | • Work hard, yet keep it fun                                                        
                   | • Continual self-improvement                                                       
                   | • Overcoming adversity to build character                                          |
| Procter & Gamble | • Product excellence                                                               
                   | • Continuous self-improvement                                                      
                   | • Honesty and fairness                                                             
<pre><code>               | • Respect and concern for the individual                                          |
</code></pre>
<table>
<thead>
<tr>
<th>Wal-Mart</th>
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<tr>
<td>• “We exist to provide to our customers”—to make their lives better via lower prices and greater selection; all else is secondary</td>
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<tr>
<td>• Swim upstream, buck conventional wisdom</td>
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<td>• Be in partnership with employees</td>
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<td>• Work with passion, commitment and enthusiasm</td>
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<tr>
<td>• Run lean</td>
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<tr>
<td>• Pursue ever-higher goals</td>
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</tbody>
</table>
Problem 8
Focusing on a Market Niche and Customer
## Market Segmentation Techniques by Type of Market

<table>
<thead>
<tr>
<th>Segmentation Criteria</th>
<th>Consumer</th>
<th>Industrial</th>
<th>Government</th>
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</thead>
<tbody>
<tr>
<td>Demographic</td>
<td>age, family size, education level, family life cycle, income, nationality, occupation, race, religion, residence, sex, social class</td>
<td>number of employees, size of sales, size of profit, type of product line</td>
<td>type of agency, size of budget, amount of autonomy</td>
</tr>
<tr>
<td>Geographic</td>
<td>region of country, city, size, market density, climate</td>
<td>region of country</td>
<td>federal, state, local</td>
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<tr>
<td>Psychological</td>
<td>personality traits, motives</td>
<td>degree of industrial leadership</td>
<td>degree of forward thinking</td>
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<tr>
<td>Benefits</td>
<td>durability, dependability, economy, esteem, enhancement of earnings, status from ownership</td>
<td>dependability, reliability of seller and support service, efficiency in operation or use, enhancement of firm’s earnings, durability</td>
<td>dependability, reliability of seller and support services</td>
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<tr>
<td>Volume of Use</td>
<td>heavy, medium, light</td>
<td>heavy, medium, light</td>
<td>heavy, medium, light</td>
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<tr>
<td>Controllable Marketing Elements</td>
<td>sales promotion, price, advertising, guarantee, warranty, retail store purchased service, product attributes, reputation of seller</td>
<td>price, service, warranty, reputation of seller</td>
<td>price, reputation of seller</td>
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</tbody>
</table>

## Market Grid Examples for the Services of a New Commercial Bank for the Industrial Market

<table>
<thead>
<tr>
<th>Type of Business</th>
<th>Insurance and real estate</th>
<th>Construction</th>
<th>Wholesale trade</th>
<th>Utilities</th>
<th>Transportation</th>
<th>Service Industries</th>
<th>Retail trade</th>
<th>Manufacturing</th>
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<tbody>
<tr>
<td>Commercial loans</td>
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<td>Checking accounts</td>
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<td>After-hours depository</td>
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<td>Bank-by-mail</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
Problem 9

Going International
Methods for Doing Global Business

- **Exporting**
  - Indirect Exporting
    - Foreign purchaser in a local market
    - Export management firm
  - Direct Exporting
    - Independent foreign distributors
    - Overseas sales office

- **Non Equity Arrangements**
  - Licensing
  - Partnering Agreements
  - Turn-key Projects
  - Franchising
  - Management Contracts

- **Direct Foreign Investment**
  - Minority Interests
  - Joint Ventures
  - Majority Interests
Problem 10
Growing Your Business
Growth Cycle of a Venture

Start-Up | Early Growth | Rapid Growth | Failure | Maturity | Innovation or Decline

YEARS
Problem 11

Raising Capital
## Alternative Sources of Financing

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Length of Time</th>
<th>Cost</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Fixed Rate Debt</td>
<td>Floating Rate Debt</td>
</tr>
<tr>
<td>Short-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Self</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Family and Friends</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Suppliers and Trade Credit</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Commercial Banks</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Government Programs</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Private Equity Placements</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Public Equity Offerings</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Angel Financing</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Venture Capital Financing</strong></td>
<td>X</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# Bank Loans

## Bank Lending Decisions

<table>
<thead>
<tr>
<th>Character</th>
<th>Collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity</td>
<td>Conditions</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
</tr>
</tbody>
</table>

## Types of Bank Loans

<table>
<thead>
<tr>
<th>Accounts Receivable Loans</th>
<th>Character Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment Loans</td>
<td>Installment Loans</td>
</tr>
<tr>
<td>Inventory Loans</td>
<td>Long-term Loans</td>
</tr>
<tr>
<td>Real Estate Loans</td>
<td>Straight Commercial Loans</td>
</tr>
</tbody>
</table>
Private Equity Market
(Enterprise Capital)

Individuals
- Individuals
- Angel Groups (networks)
- Angel Funds
- Family Offices

Venture Capital Firms
- Private Venture Capital Firms
- Small-Business Investment Companies (SBIC)
- Industry Sponsored Venture Capital Firms
  - Banks and other financial institutions
  - Nonfinancial companies
- Regionally Oriented Venture Capital Firms
- University Sponsored Venture Capital Firms

Private Equity Firms
- Limited Partners
- General Partners
Problem 12
Managing the Cash
Example Statement of Cash Flows

(For the Year Ended December 31, 2002
Amounts is thousand dollars)

Cash flows from operating activities:
Receipts:
Collections from customers 244
Interest received on notes receivables 8
Total Cash Receipts 252

Payments:
To Suppliers (120)
To Employees (53)
For Interest (14)
For Income Tax (10)
Total Cash Payment (197)
Net Cash Inflow from Operating Activities 55

Cash Flows from Investing Activities:
Acquisition of small equipment (10)
Acquisition of machinery (150)
Net Cash Outflow from Investing Activities (160)

Cash Flows from Financing Activities:
Proceeds from Issuance of Long Term Debt 70
Proceeds from Bank Loan 20
Net Cash Inflow from Financing Activities 90

Net Decrease in Cash (15)
Cash Balance December 31, 2001 20
Cash Balance December 31, 2002 5
# Days in the Cash Cycle

<table>
<thead>
<tr>
<th>Area</th>
<th>Calculation</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days in Raw Materials Inventory</td>
<td>Average Raw Materials Inventory Cost of Raw Materials</td>
<td>X 365 Days</td>
</tr>
<tr>
<td>Days in Work in Process Inventory</td>
<td>Average Work in Process Inventory Cost of Goods Sold</td>
<td>X 365 Days</td>
</tr>
<tr>
<td>Days in Finalized Goods Inventory</td>
<td>Average Finalized Good Inventory Cost of Goods Sold</td>
<td>X 365 Days</td>
</tr>
<tr>
<td>Days in Accounts Receivable</td>
<td>Average Accounts Receivable Credit Sales</td>
<td>X 365 Days</td>
</tr>
<tr>
<td>Days in Accounts Payable</td>
<td>Average Accounts Payable Cost of Goods Sold - Labor</td>
<td>X 365 Days</td>
</tr>
</tbody>
</table>
# Cash Flow Statement Changes

<table>
<thead>
<tr>
<th>Cash from Operating Activities</th>
<th>+</th>
<th>Cash from Investing Activities</th>
<th>+</th>
<th>Cash from Financing Activities</th>
<th>=</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income adjusted for:</td>
<td></td>
<td>a. cash used to buy long term assets</td>
<td></td>
<td>a. cash from sale of stock</td>
<td></td>
</tr>
<tr>
<td>a. Noncash expenses or revenues</td>
<td></td>
<td>b. cash from sale of long term assets</td>
<td></td>
<td>b. cash used to purchase stock</td>
<td></td>
</tr>
<tr>
<td>b. gains or losses on sales of long term assets</td>
<td></td>
<td>c. cash from long term debt (loan)</td>
<td></td>
<td>c. cash from long term debt (loan)</td>
<td></td>
</tr>
<tr>
<td>c. changes in current assets or liabilities</td>
<td></td>
<td>d. cash used to pay off long term debt (loan)</td>
<td></td>
<td>d. cash used to pay off long term debt (loan)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>e. payments of cash dividends</td>
<td></td>
<td>e. payments of cash dividends</td>
<td></td>
</tr>
</tbody>
</table>

Net income adjusted for:
- Noncash expenses or revenues
- Gains or losses on sales of long term assets
- Changes in current assets or liabilities

Cash used to buy long term assets
Cash from sale of long term assets
Cash from sale of stock
Cash used to purchase stock
Cash from long term debt (loan)
Cash used to pay off long term debt (loan)
Payments of cash dividends

= Change in Cash
The Cash Cycle

1. Send Invoice to Customer
2. Collect Cash from Customer
3. Collect Accounts Receivable
4. Send Invoice to Customer
5. Ship Product
6. Receive Order from Customer
7. Finished Goods Inventory
8. Work in Progress Inventory
9. Raw Materials Inventory
10. Purchase Materials

Finished Goods Inventory
Work in Progress Inventory
Raw Materials Inventory
Purchase Materials
Collect Cash from Customer
Send Invoice to Customer
Ship Product
Receive Order from Customer
Accounts Receivable
Problem 13
Valuing a Business
## Methods for Valuation of a Venture

<table>
<thead>
<tr>
<th>Method</th>
<th>Description/Explanation</th>
</tr>
</thead>
</table>
| Fixed price                                 | • Two or more owners set initial value.  
  • Based upon what owners “think” business is worth.  
  • Uses figures from any one or combination of methods.  
  • Common for buy/sell agreements.                                                               |
| Book value (known as balance sheet method)  | 1. **Tangible book value:** Set by the business’s balance sheet. Reflects net worth of the firm. Total assets less total liabilities (adjusted for intangible assets).  
  2. **Adjusted tangible book value:** Uses book value approach. Reflects fair market value for certain assets. Upward/downward adjustments in plant and equipment, inventory, and bad debt reserves. |

**Tangible book value:**
- Set by the business’s balance sheet. Reflects net worth of the firm. Total assets less total liabilities (adjusted for intangible assets).

**Adjusted tangible book value:**
- Uses book value approach. Reflects fair market value for certain assets. Upward/downward adjustments in plant and equipment, inventory, and bad debt reserves.
## Methods for Valuation of a Venture (cont.)

<table>
<thead>
<tr>
<th>Method</th>
<th>Description/Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Multiple of earnings</strong></td>
<td>• Net income is capitalized using a price/earnings ratio (net income multiplied by P/E number).</td>
</tr>
<tr>
<td></td>
<td>• 15% capitalization rate is often used (equivalent to a P/E multiple of 6.7, which is 1 divided by 0.15).</td>
</tr>
<tr>
<td></td>
<td>• High-growth businesses use lower capitalization rate (e.g., 5%, which is a multiple of 20).</td>
</tr>
<tr>
<td></td>
<td>• Stable businesses use higher capitalization rate (e.g., 10%, which is a multiple of 10).</td>
</tr>
<tr>
<td></td>
<td>• Derived value is divided by number of outstanding shares to obtain per-share value.</td>
</tr>
<tr>
<td><strong>Price/earnings ratio (P/E)</strong></td>
<td>• Similar to return on investment approach.</td>
</tr>
<tr>
<td></td>
<td>• Determined by price of common stock divided by after-tax earnings.</td>
</tr>
<tr>
<td></td>
<td>• Closely held firms must multiply net income by an appropriate multiple, usually derived from similar publicly traded corporations.</td>
</tr>
<tr>
<td></td>
<td>• Sensitive to market conditions (prices of stocks).</td>
</tr>
</tbody>
</table>
## Methods for Valuation of a Venture (cont.)

<table>
<thead>
<tr>
<th>Method</th>
<th>Description/Explanation</th>
</tr>
</thead>
</table>
| Discounted future earnings (discounted cash flow) | • Attempts to establish future earning power in current dollars.  
• Projects future earnings (5 years), then calculates present value using a discounted rate.  
• Based on “timing” of future income that is projected.                                                                                                                                                                                                                                                                                                                                                                                                         |
| Return on investment (ROI)                  | • Net profit divided by investment.  
• Provides an earnings ratio.  
• Need to calculate probabilities of future earnings.  
• Combination of return ratio, present value tables and weighted probabilities.                                                                                                                                                                                                                                                                                                                                                                                     |
| Replacement value                           | • Based on value of each asset if it had to be replaced at current cost.  
• Firm’s worth calculated as if building from “scratch.”  
• Inflation and annual depreciation of assets are considered in raising the value above the reported book value.  
• Does not reflect earning power or intangible assets.                                                                                                                                                                                                                                                                                                                                                  |
Methods for Valuation of a Venture (cont.)

<table>
<thead>
<tr>
<th>Method</th>
<th>Description/Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidation value</td>
<td>• Assumes business ceases operation.</td>
</tr>
<tr>
<td></td>
<td>• Sells assets and pays off liabilities.</td>
</tr>
<tr>
<td></td>
<td>• Net amount after payment of all liabilities is distributed to shareholders.</td>
</tr>
<tr>
<td></td>
<td>• Reflects “bottom value” of a firm.</td>
</tr>
<tr>
<td></td>
<td>• Indicates amount of money that could be borrowed on a secured basis.</td>
</tr>
<tr>
<td></td>
<td>• Tends to favor seller since all assets are valued as if converted to cash.</td>
</tr>
<tr>
<td>Excess earnings</td>
<td>• Developed by the U.S. Treasury to determine a firm’s intangible assets (for income tax purposes).</td>
</tr>
<tr>
<td></td>
<td>• Intent is for use only when there is no better method available.</td>
</tr>
<tr>
<td></td>
<td>• Internal Revenue Service refers to this method as a last resort.</td>
</tr>
<tr>
<td></td>
<td>• Method does not include tangibles with estimated useful lives (i.e., patents, copyrights).</td>
</tr>
</tbody>
</table>
Methods for Valuation of a Venture \textit{(cont.)}

<table>
<thead>
<tr>
<th>Method</th>
<th>Description/Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>• Needs a “known” price paid for a similar business.</td>
</tr>
<tr>
<td></td>
<td>• Difficult to find recent comparisons.</td>
</tr>
<tr>
<td></td>
<td>• Methods of sales may differ—installment vs. cash.</td>
</tr>
<tr>
<td></td>
<td>• Should be used only as a reference point.</td>
</tr>
</tbody>
</table>
Steps in Valuing Your Business and Determining Investors’ Share

1. Estimate the earnings after taxes based on sales in the fifth year.
2. Determine an appropriate earnings multiple based on what similar companies are selling for in terms of their current earnings.
3. Determine the required rate of return.
4. Determine the funding needed.
5. Calculate, using the following formulas

\[
\text{Present Value} = \frac{\text{Future valuation}}{(1 + i)^n}
\]

where:

- future valuation = total estimable value of company in 5 years
- \( i \) = required rate of return
- \( n \) = number of years

\[
\text{Investor’s share} = \frac{\text{Initial funding}}{\text{Present value}}
\]