

## ON THE NOT SO SIMPLE STEPS INVOLVED IN STARTING A BUSINESS VENTURE<sup>1</sup>

### I. BECOMING A CAPITALIST I: GETTING STARTED

Suppose that you had stumbled upon a cool idea likely to please some of your fellow human beings. To do so, you will produce and sell to them a new product or service that no one had ever thought of before.

Starting such a venture will make you a capitalist -- one of the creative, risk taking people who dream of getting rich by pleasing their fellow human beings. Jeff Bezos founder of Amazon.com, is but one of many such entrepreneurial men and women to come out of Princeton; but his is a truly classic case of an idea that seems off the wall at first but then survives, thanks to the tenacity of its creator.

Having a multitude of such creative, risk-taking people, supported financially by an equally-risk taking cadre of venture capitalists who are willing to take a chance on the,, is one of those things making the American economy the envy of the world. Microsoft, Amazon.com, Yahoo.com, Google, e-Bay, Starbucks and many, many more relatively young American companies that now dominate their global markets all started this way.

For some reason, much of Europe lacks that powerful source of economic energy – although, of course, not Asia, where risk-taking and entrepreneurship have become a highly respected way of life as well.

#### A. Your Financial Plan

To launch your new venture, you will, first of all, need some up-front financing.

You can cobble it together from you're your own savings, from your parents, or from some of your family's well-to-do friends.

You may also be able to secure some debt-financing – e.g., a revolving line of credit at a bank. In return for a periodic fee, the bank lets you borrow automatically up to a certain amount from it. The expectation is that you will pay back these instant loans as cash comes in, so that you will always have a little cushion between what you owe at any point in time and the maximum credit line extended to you. The fee is paid on top of any interest on loans, even if you have not drawn on any credit at all. The financial flexibility this standby credit offers is worth a monthly fee.

Another way to borrow is to lease space and equipment you may need rather than buying it. For start-ups, leasing is a great financial contract.

If you do not have access to private venture capitalists willing to invest in your idea, you may have access to public assistance. Specifically, you may belong to a category of Americans whom the government is committed to help through loans from the *Small Business Administration (SBA)* or some other agency tasked with furthering your category's economic opportunities. Some entrepreneurs get started that way.

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## B. Your Business Plan

Potential investors in your venture naturally will want to know what your so-called “business plan” is for the venture, and who else is willing to risk their money on your idea, and how much.

A business plan must provide credible details on (1) the product being produced, (2) the “value proposition” of the product, (the price you plan to charge for it relative to the value it brings to the customers, (3) the “marketing strategy” ( including the probable market for your new product, competition and “go to market” strategy), (4) the management resources committed to the company and your ability to attract the properly skilled labor required for the production of the product, (5) the plan for accessing any additional technical and marketing resources to execute the business plan, and finally, (6) the financial projections. You will provide information on all six aspects of your proposed venture in prose and formatted according to accepted industry protocols.

Of these six tasks, the *marketing strategy* will be the most challenging and the most crucial. Everything else depends on your being able to sell what you produce. Too many entrepreneurs fall wax romantic over their own ideas and blithely assume that everyone else will think likewise. In fact, outsiders may be quite skeptical at first about the merits of you’re a new product. Therefore, it will be wise to enlist some credible professional advice on your marketing strategy.

The *financial projections* are conveyed in the so-called “pro-forma” financial statements which are fairly standard and a major tool of communicating with prospective investors. They will include detailed assumptions on pricing, labor and manufacturing costs, operating margins, working capital needs, overhead costs, outside consultants and directors, and maintenance related capital expenditures, among other things. There are four main components of the *financial projections*:

1. **The Pro-Forma Cash Flow Statement:** This statement should show, on a quarterly or even monthly basis for the first year, and annually thereafter for the first, say 5 years, what cash will flow into your venture and for what purpose cash was spent by your venture. The statement is fundamental, because cash is the lifeblood of a business venture. Your cash-flow statement should be fairly detailed, so that investors can see exactly where you expect the money to come from and on what particular items you will spend it. They may want to question the wisdom of some of your proposed outlays – for example, a lavish floor space or number of sales representatives needed to bring the product to market.
2. **The Pro-Forma Statement of Financial Position (“Balance Sheet” in the vernacular:** This statement is a relatively detailed listing of all of the valuable concrete things or financial contracts or patents to which your firm has legal title. These items are called “assets.” The statement also includes a detailed listing of all of the debts your business owes. They are also called “liabilities.” By definition, a firm’s “net worth” is the difference between the dollar value of all of the assets it owns minus the dollar value of all of the liabilities it owes. Because a firm’s Net Worth = Assets – Liabilities (all in dollar values), from which follows the famous accounting identity:

$$\boxed{\$Assets = \$Liabilities + \$Net\ Worth}$$

This accounting identity explains why the *Statement of Financial Position* is called the “**Balance Sheet**” in the vernacular.

The dollar values of assets, liabilities and net worth are calculated on the initial founding of the company and thereafter as of the end of a so-called “fiscal period,” be it a month, a quarter or a year. It is a momentary snapshot. Many companies choose the calendar year as their fiscal year; but a company can choose any other period as its fiscal year and then stick with it – for example, from July 1<sup>st</sup> to June 30<sup>th</sup>, or from October 1<sup>st</sup> to September 30<sup>th</sup>.

In your business plan, you will include pro-forma statements of financial positions for, perhaps, the next 5 years, probably on a more frequent basis (quarterly) for the first year.

3. **Pro-Forma Income Statement:** The “accounting income” of a business firm for a given fiscal period is formally defined as the difference between the “revenues” earned in that period minus the “expenses” incurred in that period. One can think of “revenue transactions” in a particular fiscal year as those that, taken by themselves, would increase a firm’s net worth. Typical revenue transactions are sales of output. Similarly, one can think of “expenses” as those transactions that, by themselves, decrease the firm’s net worth. Typical expense transactions in a particular fiscal year are the use of raw materials in production, rental payments on equipment and floor space, payments for energy, salaries and wages of employees, and payment of interest on debt and any other cash outlays made, or liabilities incurred, to support the year’s revenue transactions.

Note that not all cash inflows in a given year represent “revenues” for that year. Suppose, for example, the firm borrows \$100,000. That will increase its assets by \$100,000 (namely, cash on hand) but also its liabilities, by the same amount. Net worth is not touched by this transaction. Therefore it does not constitute a revenue transaction. On the other hand, if we sell 10,000 widgets @ \$10 cash per widget, then this transaction would increase the asset “cash” by \$100,000, not increase any liability, and therefore, viewed by itself, increase net worth by \$100,000. (The fact that we had to give up the widgets will be recognized by the accountant separately).

Similar reasoning applies to expenses. You should not worry too deeply about this aspect of the problem, as it involves financial accounting and lies beyond the compass of this course. Here we just give you the general idea.

Income statements are written for entire fiscal periods – a month, a quarter or a year. In your business plan, you will offer pro-forma income statements for the next 5 years, perhaps on a quarterly basis for the first year.

4. **The Cap Table:** This statement details the proposed securities to be sold to outside investors and the “initial capital structure,” by which is meant the structure of equity financing and (if used) debt financing used to get the venture launched and sustained in its initial phase.

The Cap Table is a summary description of the financing’s terms and conditions, and the prospective stakes held by the founder-owners of the new company and the rest of the management team, many of whom will agree to work for low cash wages in return for an ownership stake in the venture. The cap table also lists how much of the total ownership stake would be reserved for future employees, who will get access to them through stock options or outright stock grants.

A stock option is a piece of paper entitling its owner to purchase a specified number of shares of a company’s common stock (usually 1 share or a 100 shares) at a specified

“striking price,” regardless of what the actual price of the share is. Thus, if you hold an option entitling you to buy 1 share of ACME, Inc. stock at \$40 per share, and the stock currently sells at \$70 per share, you can “exercise” your option by buying the share at \$40 and then immediately resell it for an immediate gain of \$30. That gain, alas, is taxable at ordinary income tax rates. Alternatively, you could just hold on to the share you bought, hoping it will rise further in value.

Typically the founders would be entitled to ownership in the form of common stock. They are ownership certificates, usually printed up in large numbers (perhaps millions), with each certificate representing a tiny stake in the venture. The venture capitalists who also have invested in the company would own a different security, one that ranks higher than the common stock, thus giving these outside investors the right to get their money back before the founders/management can take out any money (other than their agree-upon salaries and wages).

The business plan is the most crucial document in starting the new venture. You may think that this statement is so obvious as to be a condescending remark. One wishes the geniuses who ran the hundreds of ill-fated *dot.com* ventures in the late 1990s had understood this obvious requirement as well. They did not. These failed *dot.coms* tend to have this in common: they lacked a credible business plan and were, instead, based on romantic lyrics that were swallowed up by eager and ignorant investors that were feeding on “Greater Fools Soup”. The “Greater Fools Theory” of investing holds that even smart and fully informed investors will buy vastly overpriced financial securities on the belief that there will always be a “greater fool” onto which such paper can be foisted at an even higher price. (In many areas of the country, the real estate market now operates in that mode.)

Particularly disturbing in the later 1990s was that the investment bankers and financial analysts, who, in theory, are to function as the ever vigilant watchdogs over our capitalist order, not only bought the fables gushing forth from eager *dot.com* entrepreneurs – or pretend to buy them – and eagerly promoted this junk to private investors.

### **C. Your Capital Expenditure Plan**

You must estimate what floor-space and capital equipment will be needed to support your venture in the early years and describe these requirements to outsiders as well. At this stage, you will probably wish to rent as much of that floor-space and equipment as you can, which, in our wondrous economy, means virtually all such fixed inputs.

Renting rather than owning these fixed assets, as they are called, may be more expensive per unit of capacity and time period; but you will not be saddled with owning such assets and can write the rental contract so that you can easily return rented assets if the marketing plan was too optimistic. To be sure, canceling renting contracts prematurely usually brings with it stiff financial penalties. Even so, renting still remains a more flexible way to procure required structures and capital equipment. That flexibility is worth some extra expense at this stage of your venture, when the risks are high and financial capital to buy structures and equipment outright is expensive. (Don’t forget, you give up sizeable chunks of your business to procure financial capital from venture capitalists).

The capital expenditure plan can be made part of the Business Plan or developed as a separate document. I would favor the latter to convey that you have given it much thought. Often it is simply made part of the detailed assumptions used to make the previously described financial projections.

## D. Legal Counsel

You will also need to provide potential investors in your venture assurances (1) that your product does not infringe on any patents held by others, (2) that you will not run afoul of any federal, state or local ordinances – e.g., environmental laws or local zoning laws or relevant labor laws, and (3) that the securities being offered properly convey title and are in conformity with securities laws.

There is no way around it: you would run enormous risks starting a new venture without the advice of legal counsel. If you do not have money to pay for that counsel, perhaps the lawyer(s) will accept an equity position in your venture instead. Many lawyers have an entrepreneurial streak in them. Ideally, though, it is probably best to pay them their proper fees, if there is the cash to do so.

## II. BECOMING A CAPITALIST II: MEZZANINE FINANCING

Now suppose you have successfully run your business for a few years and you would like to expand it. The profits you have made and retained in the business – rather than paying it out to yourselves and the other investors – have not accumulated enough capital to finance the planned expansion. You can then look around for later-staged growth capital, also called “mezzanine” financing. A mezzanine, as you know, is a sub-floor in a building between to main floors.

Mezzanine financing is supplied by so-called “private equity firms.” They tend to be partnerships, rather than publicly traded companies. The partners themselves are savvy investment people who really understand the businesses they invest in. Typically they invest their own money in this way, along with that of other wealthy individuals or institutions (such as university endowments and employee pension funds). To procure such outside moneys, the private equity firms establish funds that have a name and will try to collect, say, \$200 million or so before the fund gets closed to additional investors. It is then invested by the partners on behalf of themselves and the outside investors. In return for their work, the partners get a management fee (a percent of the invested funds) and share in the profits they have earned for the outside investors.

After a private equity firm has invested mezzanine capital in your ongoing firm, one or more of the partners will take a continuous interest in how you run the business, and typically become members of the Board of Directors watching over your firm. They are both, friends and your own business consultants, and hard task masters, watching vigilantly over your so-called “burn rate,” that is, the rate at which you spend cash on hand, and for what purposes. They will help you and goad you to nourish your business along, sometimes making connections to other friends and business partners that can be helpful to you. Most often, they will have control over major decisions, such as capital spending over established minimums, financing events, and the sale of the business.

## III. BECOMING A RICH CAPITALIST III: GOING PUBLIC IN AN “IPO”

Now suppose you have “grown your business,” as the jargon goes, and by now you have a flourishing business ready to be sold to the general investing public – e.g., regular mutual funds, hedge funds, institutional money managers or individual investors. Typically with the aid of an investment banking firm, you will organize a so-called “initial public offering” or IPO.

As already noted earlier in the section on “The Cap Table,” even before that step, you had issued ownership certificates to yourself, to your closest co-workers, who took these certificates in lieu of cash compensation, and to the outside investors, both original and mezzanine. In *total*, you might have issued, say, 5 million of such certificates. They are also called “stock certificates” or simply “shares of stock.”

In an IPO, those who now hold shares of stock in the still private venture will sell a certain fraction of them to the general investing public, with the help of an investment banking firm that may form a “syndicate” with other investment bankers and retail the stocks through their networks of brokers. The investment bankers will prepare all of the documentation requires for such a sale (including a “prospectus” which describes the business in fine detail, includes financial statements, and highlights the potential risks faced by the firm, so that investors are fully informed). The firm will have gotten a formal charter for the proposed, publicly traded company, usually from the State of Delaware which specializes in serving corporations in that way. You may even have registered your hitherto privately held company in stat state. All of these proceedings will be closely supervised by the federal Securities and Exchange Commission (SEC), which will make sure that all statements you make in the prospective are true, that you have not withheld pertinent information, and that the sale of the securities to the public will take place in a fair and orderly manner.

Particularly important these days is that you comply fully with the Sarbanes-Oxley (SOX) requirements. SOX was introduced to Congress a few years back by Senator Sarbanes and Congressman Oxley, in the wake of the financial accounting scandals that had driven so much of the stock-market bubble in the late 1990s. The strictures on financial reporting imposed by SOX can be excruciating. (If your parents are business executives, mention casually at dinner that you are a great fan of SOX 404 and wish there were more such requirements. Dinner will stop early that day, I can assure you, and you will be sent to your room. If your parents are not business executives or accountants, of course, they will think you are talking about a baseball team, which generally like to be known by the color of their socks.

Suppose of the 5 million shares of common stock you had issued earlier, you, the founder, owned 500,000. Your colleagues on the management team would own other chunks of the stock. The outside investors, you will recall, may own similar securities, but priority over yours.

Your firm will sell a total of 3 million of the 5 million shares in this IPO. Your investment banker advises you to offer the shares to the market at a price of \$70 a share. At that price, the bankers tell you, the issue will sell quickly into the market, and you won't face the embarrassment of having a large block of unsold shares on your hands. That is never an image-enhancing circumstance.

If public investors agree that the stock is worth at least \$70 per share, they will snap up the offering quickly. Included in the 3 million shares are 300,000 of your own. Figure it out. You are now a multi-millionaire, at least on paper. Alas, for you, usually the management team cannot sell any of the shares it owns for at least 180 days after the date of the IPO – the so-called “lock-up” period, and there may be other restrictions on such sales imposed by the venture capitalists. Your *Porsche* will have to wait.

Many times in the 1990s, the investment bankers put too low a price an initial offering price on shares in an IPO, and their market price shot up quickly thereafter. It helped the bankers to sell the issue quickly through their network of brokers. Knowing that quick and almost certain profits could be made in the hours and days just after the IPO, the investment bankers (through their brokers) would allot a certain number of shares at the unduly low prices to each of their business and personal friends, among them politicians whose favors they needed. These lucky ones then could make hundreds of dollars of profits in one or two days, without lifting a finger. (What a way to purchase the good will of politicians!) The lucky ones also included the CEOs of still private or already public companies, who promised in return for such quick profits, once again off the record, that they would use the kindly bankers handing them these sure and quick profits, should their own companies' sell newly issued bonds and stocks in the market, even if that might not have been in these interests of these firms' shareholders. The SEC now frowns upon this practice, which is considered unfair. As far as I know, the SEC has made it much more difficult to bestow such favors on friends and favored business partners.

In any event, here's the final deal: Some time after the IPO, when you will be a millionaire – initially on paper, eventually in cash – you will receive a friendly visit from Princeton University's

Development Office, reminding you of what a great place Princeton is, forever should be, and certainly was for you. You will be tithed appropriately. That is only fair. After all, you have learned all you know, and so much more, in *Economics 100*, not even to speak of *English 101*, which helped you write the lucid prose in your business plan.