Chapter 14

Build a Financial Plan

Objectives

14-1 Explain how entrepreneurs use their personal assets to start a business.

14-2 Discuss the sources of debt capital available to entrepreneurs.

14-3 Discuss the various sources of equity capital.

14-4 Describe the overall process of putting together the initial capitalization for a new business.

PERSONAL CONTRIBUTIONS

When setting out on their own, entrepreneurs must realize that the primary financial contributions will come from their own pockets. Some entrepreneurial pursuits rely heavily on the individual's talents and knowledge, while others require a sizable financial investment. All ventures require that entrepreneurs look first at what they can contribute in terms of abilities and money before looking to others for help. Securing the initial financing for a new business is often the straw that breaks the camel's back. It does not have to be, as long as the entrepreneur is determined and the business plan is well researched.

The Personal Resume

Your new business will be successful only if you have the personal skills to assume the responsibility of owning and managing it. A **personal resume** describing those skills helps to demonstrate that your background is suitable for the business you wish to start and should be part of your business plan.

A well-written resume, such as the one in Figure 14-1, includes the following information:

1. your name, address, telephone number, and e-mail address
2. a statement declaring your business objective and why you are qualified to achieve that objective
3. a chronological list of your work experiences, with a brief description of responsibilities and accomplishments for each position
4. a description of all formal education and training programs you have undertaken
5. a list of personal activities that indicate character and ambition, including community work, significant hobbies (particularly if they relate to the business), and awards and distinctions
6. three references—people who can attest to your achievements

If partners, investors, or family members will play important roles in the business start-up, their resumes should be included as well. The goal is to present a clear and complete picture of all the skills and expertise available to ensure the success of the new business. If your resume does not show this, you will have to earn the appropriate qualifications. This might mean taking related educational courses or working in the industry in order to gain knowledge and experience.

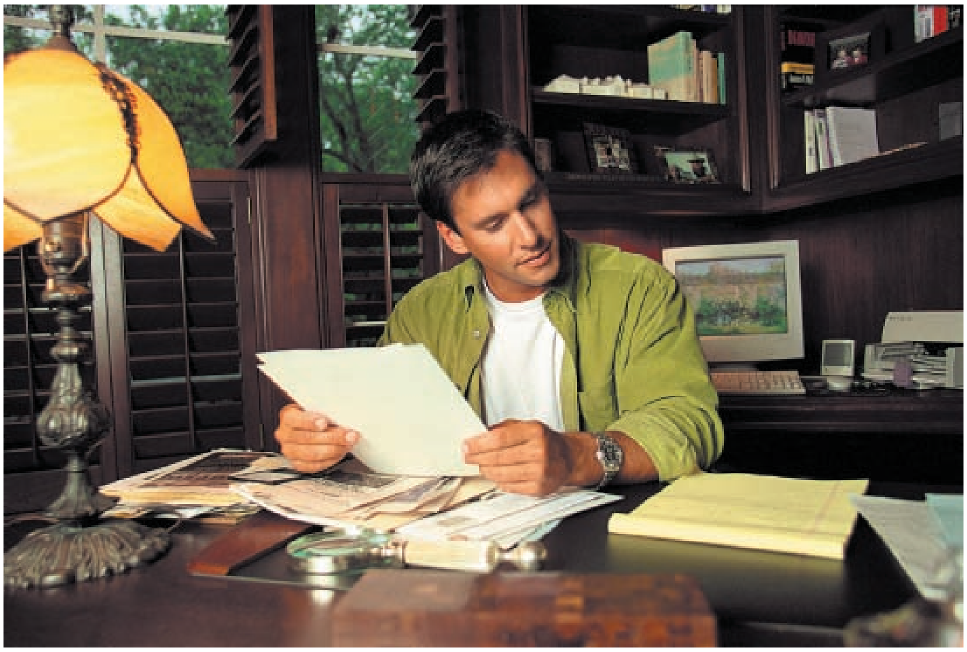
DIGITAL VISION

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FIGURE 14-1

Personal Resume

James L. Sullivan
111 Meredith Circle
Fort Walton Beach, FL 32548

Objective	To own and operate Precision Electronics Service Company and make use of management and vocational abilities.
Employment and Business Experience	Executive Airlines 1520 Locust Drive Atlanta, GA 33604 1983 – present Responsibilities: Supervised 10-person maintenance crew for charter aircraft carriers. Named 1990 Employee of the Year.
	Bureau of Land Management 907 Buena Vista Road Boise, ID 68745 1981 – 1983 Responsibilities: Repaired and installed radios. Supervised two employees.
Education	Marietta College Marietta, OH BA in Business Administration, 1981 GPA 3.2/4.0
	Vocational Technical Institute Twin Falls, ID Television Radio Repair Course, 1976
Community Activities	Fulton County Chamber of Commerce, Membership Committee South Metro YMCA Board of Directors Kiwanis Club, Treasurer
Hobbies	Ham radio operator, golf, model train collector
References	Mr. Milton Causey, Vice President Executive Airlines 1520 Locust Drive Atlanta, GA 33604 (404) 555-3440
	Ms. Phyllis Charles, Personnel Manager Executive Airlines 1520 Locust Drive Atlanta, GA 33604 (404) 555-3440
	Dr. William H. Hershey, Dean School of Business Administration Marietta College Marietta, OH 38973 (213) 555-6756

Resume Do's and Don'ts A proper resume demonstrates your:

- self-image
- communication skills
- ability to achieve results
- direction and focus toward goals
- personal character, as evidenced by community activities, personal interests, and hobbies

You should avoid the following:

- excessive length (one page is sufficient in many cases)
- poor organization
- irrelevancies (include only significant information that gives evidence of your abilities)
- poor grammar, misspellings, typographical errors
- photos, fancy paper stock, or borders

References A proper resume offers as references people who can verify that what is represented is accurate. List two or three names with addresses and phone numbers, or state at the end of the resume that references are available upon request. It is customary to ask permission beforehand from people you would like to use as references.

It is important that your references be people who have witnessed the accomplishments listed on your resume. They should not be simply a list of friends or relatives. A potential lendor or investor expects to discuss with the references your career achievements, not whether you are pleasant to be around.

FUN FACTS

It has been reported that almost 25 percent of resumes exaggerate the education of the individual. In an increasingly competitive job market, there is greater pressure to pad credentials in order to get the attention of potential employers. Almost 50 percent of those who review resumes believe there is an increase in padding.

Ethics for ENTREPRENEURS

Bob High was preparing a resume to include with his business plan for a new restaurant. He was going to present the plan to his bank for consideration for a line of credit. Bob was on familiar terms with the bank personnel, who were aware of his successful career as a master chef. His career had been one of steady growth as he moved up the ladder of fine institutions. It was now time to venture out and open his own restaurant.

As he reviewed his resume, Bob was concerned that the bank might consider his lack of business experience a problem. He had entered the restaurant business after college, where he had been an English major. Since then he had enrolled in and successfully completed a number of cooking and restaurant programs, but he had not received any direct business training. Bob wondered if he should list business administration as his college major instead of English. After all, it was highly doubtful that the bank would request his college transcript.

Think Critically

1. What risk is Bob taking by changing his resume?
2. What other action might he take to satisfy the bank regarding his lack of business experience?

The higher the authority, the more credible the reference is. Previous supervisors or colleagues who have worked with you on career or community efforts make good references. Former instructors do too, since they have witnessed your educational achievements.

Net Worth

To determine your financial capabilities, use the method of calculation shown in the example in Table 14-1.

The format used to determine a person's financial worth is the same as that used in a business balance sheet, which will be discussed in Chapter 15. It lists the person's assets (owned property) on one side and liabilities (debts owed) on the other. The difference between the assets and the liabilities is the **personal net worth**.

TABLE 14-1 NET WORTH CALCULATION

ASSETS		LIABILITIES	
Cash on hand and in bank	$18,000	Notes payable to bank (auto)	$2,000
Government securities	6,000	Notes payable to others	0
Stocks and/or bonds	14,000	Accounts and bills due:	
Accounts and notes receivable	0	Credit cards	2,000
Real estate: lot	$10,000	Real estate mortgage (lot)	3,000
Automobile	8,000	Other debts	
Cash surrender value, life insurance	5,000	College loan	3,000
Other assets			
Personal belongings	16,000		
Certificate of deposit	6,000		
Total assets	**$83,000**	**Total liabilities**	**$10,000**

NET WORTH	
Total assets	$83,000
Total liabilities	$10,000
Net worth (total assets less total liabilities)	$73,000

Available Cash

Entrepreneurs must identify which of their assets can be turned into cash for financing the business and which assets can be used as collateral for borrowing purposes. The items listed in the assets column in Table 14-1 can help you identify which of your assets can be used in one of these ways.

Cash on Hand Cash on hand includes all money held in checking and savings accounts that is readily available upon request. One of the advantages of using personal savings to start a business is that the entrepreneur keeps more of the business's profits.

Entrepreneurs frequently seek financial assistance from family members. Any money offered by a family member should be included. If the money is an outright gift, it should be listed as cash on hand. If it is in the form of a loan, after the relative (or friend) reviews the business plan thoroughly and fully understands the risks, a personal note should be drawn up promising repayment after the business is firmly on its feet. The repayment note should appear on the personal net worth statement as notes payable to others. Entrepreneurs must be aware that they are required by the federal government to pay interest on such loans if they are to be considered legally enforceable.

Government Securities Savings bonds and treasury notes are two types of **government securities**. You may invest in the U.S. government by allowing it to use your money in exchange for repayment, including interest, at a later date. **Interest** is the payment made to lenders for the use of their money. Government securities can be redeemed for cash at federally insured financial institutions.

Stocks The certificates representing ownership in a corporation are called stocks. Publicly traded stocks are normally bought and sold through stockbrokers, licensed agents who buy and sell stocks on stock exchanges such as the New York Stock Exchange or the NasDaq Stock Exchange. If you wish to buy stock in a corporation, you can learn the price per share by checking with a stockbroker or clicking on the stock quote icon on most major Internet search sites. There is also a complete listing of stocks, bonds, and government securities in most major newspapers or financial news media, such as the *Wall Street Journal*. The stockbroker places a buy order through the exchange to find a seller. Discount trading brokerage firms offer direct trading through their web sites at reduced trading commission fees. Buyers of publicly listed stocks are always available, although the selling price is never guaranteed until the transaction is actually made. To sell stock, thereby converting it to cash, individuals place a sell order with their stockbroker. The completion of the sale normally takes only a few days, and the seller receives his or her cash at that time.

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Bonds Like government securities, **bonds** are contracts of indebtedness issued by corporations or governmental units that promise payment of the principal plus interest at a specified date, or **maturity date**. An individual holding a bond can redeem it at any time for cash, although it loses some of its original value if it is exchanged before the maturity date.

Profit Sharing and Pension Plans Many individuals have accumulated investments in profit sharing and pension plans with current or former employers. Often these investment plans are held by the company until the individual leaves the company. Entrepreneurs who have worked for such companies and plan to resign and pursue a business start-up can consider these investment plans as money available to start a business. They should be aware, however, that money withdrawn before a specified date or age may be subject to taxes and/or penalties.

Insurance Policies Another source that can be considered available funds is the cash value of a life insurance policy. **Whole life insurance** policies serve as investments for their owners. Over a period of time, premium payments accumulate and the policy acquires a cash value because the insurance company uses a certain portion of the premium payments to make investments. As these investments grow, the cash value of the policy grows as well. Whole life policies allow the owner either to redeem the cash value at any time or to borrow against the policy at a very attractive interest rate. The policyholder must be aware, however, that any money taken out or borrowed against the policy will decrease the amount of money distributed at the time of death.

Assets Not Considered Available Cash Automobiles are not usually considered sources of available cash because they are needed for transportation. Other assets may include personal belongings, such as furniture and jewelry, but these are also not usually counted as available assets. Homes are not considered readily available cash assets because they are used as residences and cannot be sold on short notice.


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DEBT CAPITAL

The primary financial contribution for a new business comes from the entrepreneur's personal savings and investments. You must take a careful look at your financial resources and how much of those resources you are willing to contribute to the business venture. Although it is important to show confidence in an idea by investing personal resources, it would be foolish to risk *all* your financial assets.

After you have identified all possible sources of personal wealth, it may be clear that your business plan will require more investment capital than you have available. You may find it necessary to turn to outside sources for financial help in the form of loans, also called **debt capital**.

It is imperative that you set aside enough money to provide for personal emergencies. You should also keep in reserve enough to cover several months' living expenses in case the business venture does not work out as planned. Determining the amount of money necessary to open a business will be discussed more thoroughly in Chapter 15.

Friends and Relatives

Establishing trust is usually a requirement for borrowing money. Who trusts the entrepreneur more than friends and relatives? In many cases it is encouragement from these people that prompts the idea to start the business in the first place.

Most people use family money, if it is available, during the start-up phase of a new business. Friends and family may be willing to lend more money than other sources would, and they often allow more time for repayment. In addition, they probably do not scrutinize the business plan as closely as other lenders would, and they are usually more understanding during times of hardship.

If you accept an offer of a loan from friends or family, a formal agreement should be signed by all parties stating the duration and the interest rate to be paid. If there is no signed personal note, the Internal Revenue Service will not recognize it as a debt and you will not be able to deduct interest payments as a business expense. A signed agreement will also assure the lender of repayment as promised. If payment must be delayed in the future, it is fairly easy to draw up a new agreement.

A word of caution regarding borrowing money from friends or family: They may feel that since you used their money, you should also take their advice. A good rule to follow is not to ask for help from family or friends, but if it is offered, do not turn it down.

Borrowing Against Collateral

Some assets that are not easily converted into cash can be used as collateral against which to borrow. This is true if the lender believes that the assets can be converted to cash at a future date in the event the borrower defaults on the loan.

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Home Equity The equity in one's home or other real estate is an excellent source of collateral because the real estate market is considered reasonably stable. **Home equity** is the difference between the money owed (mortgage) on a home and its appraised value. For instance, the equity of a home with an appraised value of $150,000 and an outstanding mortgage loan of $100,000 is $50,000. A lending institution might lend money against a certain portion of this equity by holding the house as collateral. In the event the borrower cannot pay back the loan, the lender has the right to force the sale of the house to recapture the money owed. To make sure the loan is well secured, or collateralized, the lender will usually loan only up to 80 percent of the equity in a home to protect itself in case the real estate market experiences a slump. In the example above, the borrower could borrow up to $40,000—or 80 percent of the home equity of $50,000—if he or she were willing to place the home as collateral against a loan that would finance the new business. Since a home is often considered a precious investment, a decision to borrow against it should be made only after very careful deliberation.

Small Business Technology

More and more businesses are paying their bills via electronic fund transfer. The debtor sends payments to the vendor over the Internet, and these payments are automatically subtracted from the business checking account. Paying this way speeds up transactions and improves the business's cash flow. Payers can also wait until the last possible day to pay and still receive early payment discounts. Many small businesses use automatic deductions to pay bank notes. The bank debits the business account for monthly installment payments. The entrepreneur saves time preparing and mailing the payment and is less likely to miss the due date.

Investments Instead of selling their investments and using the cash to finance the start-up, many entrepreneurs decide to use their investments as collateral. This can be a good idea particularly if the investments are expected to grow at a rate equal to, or higher than, the interest cost of borrowing against them. Just as in the case of home equity, the lender will loan only a certain portion of the market value of the investment to protect against a downward turn of the market. For example, stock you own might have a collateral value of 70 percent of its current market value. You could place $10,000 of that stock with a lender as collateral and receive a $7,000 loan. The stock remains in your name but is in the lender's possession until the loan is paid.

Cash can be used for collateral when it is placed in a **certificate of deposit** with a bank. A certificate of deposit, or CD, is money that is deposited for a specified period of time (six months, one year, or longer) and cannot be withdrawn without penalty. The interest rate is higher than on a standard savings account, and the longer the duration of the CD, the higher the interest rate. When a CD is used as collateral, the bank keeps control over it until the debt is paid. It is important to note that during the time stocks and/or CDs are held by a lender, the interest payments on the CDs and dividends on the stocks continue to be paid to the borrower.

Commercial Banks

Most entrepreneurs think of commercial banks when it comes to borrowing funds. They have a bank they deal with on a regular basis and are inclined to begin their quest for funds there. However, you may find that your bank is not able or willing to meet your business needs. Banks are very aware of the risks of loaning money to a new business start-up—remember, the majority do not survive past five years. Since they have a responsibility to their shareholders, banks normally do not offer start-up loans unless there is suitable cash or stock collateral available from the borrower. You should investigate and shop around for banks to help, but do not be surprised if you are not welcomed with open arms.

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Before approaching a bank for funds, you should understand the various types of financing available. The following seven types of loans are the most common:

1. **Traditional Loans** This type of loan is normally short-term (less than one year's duration) and often unsecured (no collateral required). Traditional loans may not be available to new business owners.
2. **Line of Credit** There are two types of line-of-credit financing. The **regular line of credit** allows business owners access to a preapproved, prearranged amount of money for a specific period of time, usually one year. The **revolving line of credit** also allows business owners access to a certain amount of money, but it provides an option for renewal at the end of the original term.

The interest rate for a line of credit is usually 1.5 to 3 percent above the **prime rate of interest**. The prime rate is the publicly stated rate that major commercial banks charge their most creditworthy business customers for short-term loans. In most cases interest is charged only on the amount drawn, but the bank may charge a fee (1.5 to 2 percent of the total line) for reserving the funds.

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A business owner who needs extra cash several times during the year may be able to save time and money by obtaining a line of credit. Once a line of credit is approved, loans of this amount are automatic. No additional paperwork or approvals are required up to the preapproved amount. A line of credit helps business owners through the highs and lows that can occur over the course of a year. If a retail business has a dip in sales in October, it may not have the money to stock up on inventory for the busier Christmas season. A line of credit can provide the funds to increase inventory when sales are slow.

3. **Installment Loans** Entrepreneurs often use installment loans to finance equipment. The term of the loan is based on the expected life of the asset purchased. If you purchase an expensive piece of equipment, such as a computer system, it is likely that your business will not generate enough profit to pay for it in one year. If the loan is spread out over several years, however, the computer will add enough value to the business to justify its expense.

   The interest rate on installment loans is based on the bank's cost of funds and is usually 2 to 4 percent higher than the prime rate of interest. Installment loans for business equipment are handled in the same manner as installment loans for personal assets. They are often obtained through the private lending division of the bank rather than the commercial lending division. It is common for the bank to request that the equipment serve as collateral for the loan.

4. **Mortgage Loans** Mortgage loans are given to businesses that have property to serve as collateral for the loan. Two types of mortgage loans are usually available to entrepreneurs. The first is a loan on new property, such as a building that houses the business. For this type of loan, the building becomes collateral. The maximum amount of the loan is determined by the value of the property. Many commercial banks will approve a loan of up to 90 percent of the appraised value of the building.

   The second type of mortgage uses property that is already owned and listed on the personal financial statement, such as the owner's residence, as collateral. This is known as an **equity loan**. The maximum amount for this type of loan is determined by the amount of equity the owner has in the secured property—that is, the appraised value of the property less the existing debt. As with home equity loans, many banks will approve a loan up to 80 percent of the equity amount.

   Acquiring a mortgage loan may require payment of closing costs, including loan origination fees, appraisal fees, and other fees. Interest rates for these loans vary. Some are based on the prime lending rate, others on the treasury bond interest rate.

5. **Accounts Receivable Financing** This type of loan is available to accounts receivable businesses, which permit their customers to charge merchandise or services. If an entrepreneur has accounts receivables worth $10,000—in other words, customers owe the business $10,000—then the loan is based on that amount. Banks will loan a business up to 85 percent of the total face value of its accounts receivable if the business's debtors are deemed good credit customers. As the receivables come in, payments are forwarded to the bank. The interest rate for this type of financing is often higher than that for other types of loans.
6. **Inventory Financing** If you choose this type of financing, the inventory that is held by your business is used as collateral for the loan. Banks will probably require that the value of the inventory be at least double the amount of the loan. This type of loan is available only when you have paid for the inventory. Banks are sometimes reluctant to use inventory as collateral because if the entrepreneur defaults and they end up in possession of the inventory, they often do not have a way of reselling it.


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7. **Sales Contracts** Some entrepreneurs own businesses that sell products or services on a contractual basis. For example, Michael Jacob owns a small furniture manufacturing plant in North Carolina. He recently obtained a contract with a large chain of retail furniture stores. He will supply them with 8,000 entertainment centers over a period of three years. Michael's company has never had such a large order, and he does not have enough equipment or employees to produce the merchandise. To meet his contractual obligation, he must buy four new machines and add six new employees. He does not have enough money on hand to cover these costs. The contract is with a well-known business, so he can take the contract to the bank and request a loan based on the value of the contracted sales. Most banks are receptive to this type of request as long as the purchaser has a sound business reputation.

Trade Credit

A company that supplies merchandise to a business can provide a source of working capital known as **trade credit** to that business. Vendors provide trade credit as a way of enticing sales and meeting competition. Typically trade credit gives the business 30 to 90 days to pay for merchandise. Effective use of trade credit can be a valuable cash flow tool. Purchasing goals and plans will be discussed in Chapter 16.

Another form of trade credit is **factoring**. In many industries there are companies that, in effect, buy an entrepreneur's accounts receivable at a discounted amount, then collect the amount due from the purchaser. For example, if ABC Company is owed $5,000 by Smith Brothers, the factor will pay ABC $4,500 for that receivable and assume the liability for the $5,000 balance due.

Equipment Vendor Loans

Equipment vendors often allow entrepreneurs to lease equipment or buy it on credit. The vendor usually requires a down payment of 25 to 50 percent of the cost of the equipment. The balance is paid in installments over a specified period, thereby making it possible for businesses to use profits from the use of the equipment to cover their costs. The equipment that is being financed is the collateral for the loan. In the event of default the equipment vendor takes back the equipment. Usually equipment vendors offer a larger line of credit on the equipment they sell than banks do because they can resell the equipment if they are forced to take back ownership because of a loan default.

A large part of the cost of starting a new business is often the purchase of equipment. When vendors allow entrepreneurs to lease or buy on credit, they provide a reduction in immediate expenditures and, therefore, an increase in working capital.

FUN FACTS

Did you know that such well-known companies as Nike, Apple, FedEx, AOL, Ben & Jerry's Ice Cream, Intel, and Compaq received initial financing support from a federal agency such as the SBA?

Credit Cards

Almost everyone is bombarded with invitations to apply for credit cards. Many credit card companies charge excessive interest charges and should be avoided. However, there are companies that offer more competitive rates—although usually higher than direct bank-loan rates—and these cards may be considered for short-term credit for business purposes. Some companies offer cash advances to card holders, although generally at higher rates than for direct purchases.

If a new business is in need of short-term credit, there is nothing wrong with using a credit card as long as the finance charge is fair and the amount charged is not part of the long-term capitalization plan of the business. Often these cards can be used to purchase inventory before credit is arranged between the entrepreneur and the vendor. The entrepreneur can use a personal credit card or, better yet, apply for a bank credit card in the name of the business.

State and Local Business Development Funds

Most states and many communities have funds available for business start-ups. An example of this type of funding at the state level is the Colorado First Customized Training Program. This program, which began with the passage of a law in 1984, provides money to new businesses for employee training. An example at the local level is the Allentown Economic Development Commission in Allentown, PA, which provides loan assistance to qualified small businesses.

The purpose of these assistance programs is to help create businesses that will bring jobs to an area and thus increase the community and state tax base. They are not handouts, but they do offer very appealing low-interest loans with attractive payback terms. Not all businesses qualify for these programs—manufacturing and technology-based companies are most favored.

Small Business Administration

As you have learned, the Small Business Administration is a federal agency established in 1953 to aid the development of small businesses. One of its primary purposes is to provide financial assistance to small business owners.

The SBA's loan guarantee program is for small business owners who are unable to obtain financing through a bank or other private lending source. The maximum amount of the loan guarantee is 90 percent, and the maximum amount that can be borrowed is $750,000. If a loan request is approved, the SBA guarantees the lender that in the event the borrower cannot repay the obligation, the SBA will use funds appropriated by Congress to pay the guaranteed portion of the loan. SBA "contact banks" include most commercial banks. The same bank that denies the entrepreneur a loan may be quite helpful in assisting the same entrepreneur to apply for an SBA guarantee, as it relieves the bank of much of the loan risk.

The SBA also has a smaller program designed to assist small businesses in their operations. The 7(m) Micro Loan program provides short-term loans of up to $35,000. These loans are designed to provide existing small businesses with working capital for purposes such as inventory, supplies, or other operational expenses.

Very few groups of business owners qualify for direct loans from the SBA. They include businesses that employ the handicapped, promote energy conservation, or are being started in communities of great need.

It should be noted that the government is not in the business of giving handouts to small businesses. SBA programs are designed to assist in financing, not to provide free money. There is a very limited budget set aside in the Small Business Innovation Research (SBIR) program to provide grants to small businesses for innovative research and development in the areas of public assistance and government contracts. Applications and information about the program are available at local SBA offices or through the SBA Internet website.

Information regarding SBA loans is easily obtained at participating banks, Small Business Development Centers at local colleges or chambers of commerce, or by visiting a regional Small Business Administration office.

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EQUITY CAPITAL

Equity capital is the money invested in a business by the owner or owners. This might include the owner's personal savings or investment by others, such as private investors, venture capitalists, stockholders, investment bankers, or partners.

Entrepreneurs who need additional funds and wish to finance their business entirely through equity capital need investors. If they want people to invest in their business, they may be required to provide a substantial portion of the needed capital themselves. Many potential investors consider the amount of money you are willing to invest an indicator of how dedicated you are to the new venture. However, if the business is one that involves a truly innovative idea, someone may be willing to invest the entire amount needed.

Private Investors

Entrepreneurs may be able to obtain financial assistance from people who are willing to take a gamble and invest in a sound business plan. These **private investors** often have a personal association with the entrepreneur or learn of the opportunity through contacts in the local community. Since they are generally not professional investors, most have a conservative investment philosophy and may not be willing to finance businesses that involve high risk. A personal banker, lawyer, or accountant may be able to provide a referral to such a source.

Taking private investors can be accomplished through the sale of stock. As discussed in Chapter 4, selling stock in your company means giving up a portion of the ownership in exchange for needed funds. It can be done when you start the business or after it is established, perhaps to expand the business operation. Selling stock this way is not the same as public offerings through a major stock exchange, which is how large businesses trade and sell stock.

Figure 14-2 is an example of a cover sheet for a private stock offering to investors. The cover sheet is usually supported by a formal business plan that further explains the intent and goals of the business attempting to raise capital.

FIGURE 14-2

Cover Sheet of a Private Stock Offering

Number ______________ Offeree ______________

PRIVATE PLACEMENT MEMORANDUM

Unique Expectations, Inc.
2196 Cheshire Bridge Road
Atlanta, GA 30303

THESE ARE SPECULATIVE SECURITIES. SEE "RISK FACTORS." THE SECURITIES ARE SUBJECT TO CERTAIN RESTRICTIONS ON TRANSFER. THERE IS NO MARKET FOR THEM AND NO MARKET LIKELY TO DEVELOP. CONSEQUENTLY, THEY WILL NOT BE READILY TRANSFERABLE.

	Price to Purchaser 1	Proceeds to Corporation 2
Per share	$50	$50
Total	$2,000,000	$2,000,000

THE OFFERING

The Company hereby offers to sell **40,000** of its authorized Common Stock having a par value of $1 per share. Upon completion of this offering, there will be **75,000** of such shares outstanding.

The offering price is **$50.00** per share, with minimum investment of **$50,000.00** per investor. If any investor desires to purchase more than **1,000** shares, he/she may do so, provided the additional investment is in increments of **$5,000.00.**

The full amount of each subscription shall be due and payable upon the Company's acceptance of a stock subscription agreement signed by the investor.

The Company believes that it should not attempt to conduct the business described herein until such time as it shall have received a minimum of **$500,000.00** in payment for shares of Common Stock offered hereby. Therefore, until **$500,000.00** has been received, all monies paid to the Company for the offered shares will be deposited in a special escrow account at Capital City National Bank for the benefit of the subscribers and will be held in that account until the required minimum amount has been raised, and if less than **$500,000.00** is raised, the escrowed funds will be refunded to the subscribers without interest.

The Global ENTREPRENEUR

In Europe, businesses receive financial support from the European Investment Bank (EIB), which serves as a financing institution for the member countries of the European Union. Its goal is to foster business development and create closer ties among EU nations through economic growth. In 2003, the EIB was instrumental in providing over 35 billion euros in financing to European businesses.

Think Critically

1. Find out more about the European Investment Bank and compare it to what you have learned about the Small Business Administration.
2. Do you believe that trade agreements reducing trade barriers among members of the European Union have added to the need for the EIB? Why?

Venture Capitalists

Financial assistance from **venture capitalists** should generally be considered only as a last resort. Venture capitalists are professional investors who seek larger, high-risk business investment opportunities. They rarely invest in small start-ups, preferring established businesses and/or businesses that have the potential for an extremely high return on investment.

Venture capitalists often insist on being involved in the management of the business. They usually require agreements that allow them to take full control of the business if it is not meeting their expectations. Profit becomes the highest priority, often overriding the entrepreneur's ideas about product quality or how the business should be run. Accepting venture capital is often a matter of accepting that it is better to own a significantly reduced portion of the business than no business at all.

Investment Banks

Investment banks specialize in bringing together entrepreneurs who need funds and individuals or groups that have money to invest. The latter include, for example, insurance companies and pension fund administrators. Most major metropolitan areas have investment banks. Entrepreneurs in other areas may not have access to this funding source.

Partnerships

Entrepreneurs may seek a partner or partners for one of two reasons: to increase the business's capital or to acquire expertise in areas unfamiliar to them. The percentage of ownership is usually based on the percentage of the total capital each partner invests. A partnership agreement should be drawn up that clearly shows the amount invested by each partner. Many entrepreneurs prefer to form a corporation and share the stock in the same proportions as in the intended partnership.

CREATE A FINANCIAL PACKAGE

It is not uncommon for the finished business plan to require more money to implement it than is available. Sometimes this is—or should be—the inhibitor that stops or delays a business start-up. It can also be a challenge to the entrepreneur's determination, creativity, and confidence.

In most cases, initial capitalization of a start-up business comes from a number of sources discussed in this chapter, starting with the entrepreneur's personal savings. An example is an entrepreneur who, after reviewing all sources of personal wealth, comes up with half the funds required. She may visit the bank for start-up capital but will likely be turned down unless she can offer ample collateral that can be easily converted to cash. She turns next to family and friends. If she is reluctant to make a direct request, her enthusiasm for the idea may generate an offer of a loan or investment money. Next, she explores the industry for assistance in the form of equipment loans and trade credit. She may consider using a personal or business credit card for a small portion of the money. Once most of the funds are in place, another trip to the bank, with a business plan that includes a strong personal resume and a complete market and financial analysis, might be in order. The same bank that would not give her a start-up loan may be willing to grant a short-term line of credit once it ascertains that she has put together her initial capitalization and will soon be making deposits on a regular basis.

As you consider sources of additional funds, keep in mind that the best source is the one that fulfills your business's particular needs at the lowest cost. Cost can mean either monetary loss or ownership reduction, which forces you to give up a portion of your interest in the business.

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You must be knowledgeable about the various financial sources and how each could serve your business. Take the time to determine the true cost—in both money and ownership—of capital obtained from each source. Choose alternatives as well, since your first choice may not be available. For example, if you don't have enough capital to purchase inventory, you should probably try to make use of trade credit or seek a short-term loan from a bank. If you need equipment, you might consider equipment vendors or banks.

Financing a business start-up carries undeniable risks. You must be willing to show confidence in your idea by taking the largest risks and hoping others will follow your lead.

Chapter Review

Ship in a BOTTLE

Financial Considerations

The initial cost of researching his business idea had not been a problem for Fred. He had paid for the initial samples, about $500, out of his savings. He had covered the cost of the first trade show and basic supplies the same way. However, when the idea had grown to the point of designing brochures, creating a web site, and stocking inventory, Fred realized he would need to create a financial plan.

His initial estimates of his expenses were:

inventory	$4,500
brochure	2,000
web site design and setup	1,800
computer upgrade	1,100
immediate trade show expense	2,300
supplies	450
miscellaneous	500
Total	$12,650

These figures were only a start-up projection. Fred knew he would have to do a full 12-month projection as well, but that could wait until after he had a better feel for the new enterprise. His initial plan was to finance the first three months' activity himself and then look further down the road and decide if 12-month and long-term capitalization plans were needed, based on the initial trial.

Fred went to work on phase one. He had already spent over $2,000 of his personal savings at this point, which left only $3,000 in his savings account. He completed a personal net worth statement that showed some clear deficits. In addition to the $3,000 he had a stock and bond portfolio of $5,000. He had a whole life insurance policy, but it was only two years old and had no loan value yet. Outside of these tangible listings there was nothing else he could use in the business. He needed his car, and his personal belongings were not items he could sell. The small amount of equity in his home was out of bounds, as he did not believe in putting up everything he owned to pursue his dream. He and Jeanie had two personal credit cards, each with $5,000 credit available. He decided to take his business plan to Bill Barron at First National Bank for advice.

Fred and Bill had known each other for a number of years, and Fred was confident that Bill would give him solid direction. After reviewing the business plan, Bill suggested a two-tier financing plan.

"This idea has great potential, Fred, but as you admitted, it's too early to go full speed. I'd advise you to stay the course and see where you stand in another three months. You have the $3,000 in savings and $5,000 in stock. You can sell the stock, or the bank can loan you $4,000 against it as collateral. I think you can find the rest of the $12,650 in trade credit with Johann on inventory purchases, or, if necessary, use one of your credit cards for a short-term loan. If the business keeps developing over the next three months, you might have enough history to qualify for at least a line of credit with our bank. Once we see that the business can support short-term

continued

credit, the door will be open to discuss a longer-term financing plan to build this business into a full-function import business with unlimited potential."

Leaving the bank, Fred felt good. He called Johann and requested 90-day payment terms on the $4,500 merchandise order. Johann agreed on the condition that Fred pay $1,000 in advance. Having reduced his $12,650, three-month need to $9,150, Fred could now move ahead with his plan.

Think Critically

1. Are there other ways that Fred could have solved his financial dilemma?
2. Why is the banker willing to work with Fred in three months, but not now?
3. If you were Fred, would you sell your stock and bonds, or borrow against their value?

Summary

When putting together a business plan, entrepreneurs must look first at what they can personally contribute to the endeavor. Calculating personal net worth is part of this process. Sources of personal contributions include cash on hand, government securities, stocks and bonds, profit sharing and pension plans, and insurance policies.

If it is necessary to seek other financial sources, a personal resume should be included with the business plan. A personal resume gives an overview of the skills and leadership capabilities of the person who will manage and operate the business. A resume should be prepared for each person actively involved in the proposed new business.

Entrepreneurs must also provide evidence of financial capability. A personal net worth calculation shows what financial resources can be used for the business. It indicates the amount of readily available cash and any assets the entrepreneur owns that can be used as loan collateral.

If the entrepreneur does not have the needed financial resources, he or she must turn to borrowing money, called debt capital, or attracting investors, who supply equity capital. In either case a sound financial plan must be prepared that demonstrates the business's ability to pay back the debt or achieve sufficient profits to share with investors.

The entrepreneur has many financial sources to choose from. Debt capital is available from friends and relatives, commercial banks, supply vendors, equipment vendors, personal credit cards, state and/or local business development funds, and the SBA. Equity capital is available from personal savings, private investors, venture capitalists, partners, investment bankers, and sale of stocks, bonds, or government securities.

Matching financial sources to business needs is very important. The entrepreneur should remember that the best source of financing is the one that fulfills the business's needs at the lowest cost. It is not uncommon for the entrepreneur to use many different sources to arrive at the total capitalization needed for a new business start-up.

Chapter Review

A Case in POINT

Too Soon to Expand

Eleanor War was so pleased with the success of her ladies' fashion boutique after one year that she began looking for a second location. She quickly found an opportunity in a neighboring community.

She thought it would be much easier to open and operate the second store than the first. She had learned a great deal in a year and had established good credit with all her suppliers. She saw no reason to go through all the financial planning she had done for the first store. She could order all the inventory on credit and would not have to pay for it for 30 to 60 days. By then she would have sold enough to pay for the first orders. She also knew that the fixture and equipment manufacturers would give her a note for most of her purchases since she had been paying on time for the first store's fixture and equipment note. She was so confident that she opened without a cash reserve for operating expenses.

It didn't work. Business started at a very slow pace. After the first month, Eleanor had sold barely enough to cover her operating expenses, let alone the initial inventory bills and monthly fixture note. At the end of 60 days she was in serious trouble. She was forced to stock the new store with inventory from her other store because she could not order from her suppliers until she paid for the initial inventory shipments. This, of course, hurt business at the original store. Eleanor had overestimated the success of the second store. She wondered what she should do.

Think Critically

1. What did Eleanor fail to do before opening her second store?
2. What should she do at this point?
3. What will happen if Eleanor fails to correct the situation immediately?

Vocabulary Builder

Write a brief definition of each word or phrase.

1. bonds
2. certificate of deposit
3. debt capital
4. equity capital
5. equity loan
6. factoring
7. government securities
8. home equity
9. interest
10. investment banks
11. maturity date
12. personal net worth
13. personal resume
14. prime rate of interest
15. private investor
16. regular line of credit
17. revolving line of credit
18. trade credit
19. venture capitalist
20. whole life insurance

Review the Concepts

21. Why is a personal resume important to a business plan?
22. What information should a personal resume include?
23. How is a person's net worth calculated?
24. What is the difference between stocks and bonds?
25. What types of financing options are available from commercial banks?

Critical Thinking

26. Approximately how much money would a bank be willing to lend as a home equity loan on a house with an appraised value of $150,000 and an outstanding mortgage of $90,000?
27. Why would an individual use stocks as collateral to borrow against, rather than selling them?
28. What is the net worth of an individual with the following assets and liabilities? How much money do you believe this person could raise for business purposes?

ASSETS	LIABILITIES
Cash, savings $3,500	Home mortgage $80,000
Stocks, bonds $8,400	Automobile loan $8,200
Automobile $12,400	Accounts payable $2,400
House $165,000	Student loan $2,800
Personal belongings $26,000	

29. Make a list of all potential sources of capital, both debt and equity, describing the advantages and disadvantages of each.

Project

Build Your Business Plan

Your hypothetical business plan has now progressed to the point where you need to start thinking about acquiring capital. Begin this process by doing the following:

1. Prepare a net worth calculation (hypothetical or real), indicating which funds could be invested in a business operation.
2. Develop a list of all possible funding sources in your community. Include both debt capital and equity capital sources.
3. Rank the funding sources based on the type of business you are planning. The first source on the list should be the one you consider your best choice for financing.