BUS 314: Resourcing New Ventures

A Course Overview

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Spring 2020

Contents

1 Introduction

- Innovation creates productivity which creates growth (market, economic, organizational, etc.)
- **New business venture:** Organization/entity with a purpose to fulfill, desired outcome, and risk to manage
  - Fuel for a venture: Idea, market need/interest, financial capital, audience, supporters, human capital (team/passion), management
- Become a learning organization
- People buy into ideas they believe they helped to create
  - Create shared context so everyone is communicating and emotionally invested
- Kaizen: Businses philosophy of continual improvement
- Application interface: How a product integrates with other products in the user's life
- Buyer interface: How a product informs and is purchased by a buyer
- **Product-market fit:** Being in a good market which accepts the product
  - Does not imply growth
- **Go to market fit:** Consistent alignment between messaging, marketing, and sales to capture customers in a timely basis with urgency
- **Market alternative:** Other methods of solving the problem which are not competitors
- **Competitive alternative:** Competitor attempting to solve the same problem
- **Objectives & Key Results (OKR):** Organizational management technique where objectives and measurable key results (KPIs) are set
  - E.g. Objective: Increase revenue; key result: increase amount of monthly subscriptions by 30%
- **Due diligence:** Investigation into an entity after preliminary negotations (i.e. after signing the term sheet)
  - **Corporate records:** Entity documentation (e.g. directors' and stockholders' meeting minutes)
  - **Charter documents:** Official entity documentation (e.g. certificate of incorporation, designation, or rights, bylaws)
  - Business plan and financials
  - Intellectual property
  - Material agreements
  - Disputes and litigations

2 Pitch Frameworks

- Positioning statement:
  - For (target customers)
  - Who (have a certain problem)
  - Our product is a (description)
  - That provides (unique breakthrough capability)
  - Unlike (competition)
  - Our product/solution (has a competitive differentiation)
- Components of a pitch:
  - Market story: Description of the problem and job in the context of the market
    * Define the market
    * Examine trends
    * Address problems
    * Understand alternatives
    * Define an ideal solution to discuss inevitability
  - Company story: Description of solution and competition, and the relative positioning
    * **Four Question Framework (4QF):** What problem is being solved, for whom, why better than the alternative, and why now?
    * What you belive in the company
    * How the company helps users
    * Trigger phrases: Phrases which imply underlying beliefs and thoughts
  - Economic story: Description of the business model and return on investment
    * Business model
    * Financials/unit economics
    * Cpitalization structure/plans
- **Situation Complication Resolution:** Framework
  - Situation (what): Current situation accepted as fact
  - Complication (so what): Reason why there is a problem which needs action
  - Resolution (now what): Action(s) required to solve the problem
- **Sequoia pitch:** Pitch framework by Sequoia Venture Capital
  - **Company purpose:** Define company in a single sentence
    * Communicate mission
    * Don't list features
  - **Problem:** Customer pains and current methods of addressing, and shortcomings
  - **Solution:** Unique and compelling value proposition, eventual goal
    * Discuss relevant trends

- **Why now:** Statement of why it is the right time for the product to enter the market
- **Market potential:** Identify customer and market
- **Competition/alternatives:** Direct and indirect competitors, and differentiation
- **Business model:** Discussion of the company will survive and thrive financially
- **Team:** Discussion of the founders and key team members
- **Vision:** What is the goal in several years

3 Financials

3.1 Basics

- Measures:
  - **Stock measure:** Current value held at a given time
  - **Flow measure:** Change in a value over time
- **Liability:** Obligation to a creditor
- **Asset:** Tangible resource held
- **Equity:** Assets which may have liabilities attached
  - Equation: Value of equity = assets - liabilities
- **Revenue/income:** Money generated
  - **Sales/operating revenue:** Money generated from operations
  - **Non-operating revenue:** Money generated which is not from an operation (e.g. investment interest)
- **Expense:** Money spent
  - **Cost of Goods Sold (COGS):** Direct cost of production (e.g. materials, labor)
  - **Non-manufacturing/Operating expense:** Expense not directly associated with productions (e.g. employee benefits)
- **Profit:** Difference between total revenue and total expenses
- **(Financial) capital:** Funds available to be used for production
  - **Working capital:** Assets available to pay off liabilities (difference between total liabilities and total assets)
- **Accounts Receivable:** Revenues which are agreed but have not yet been received
  - Are assets

3.2 Balance and Income Sheet

- **Balance sheet:** Stock measure which contains information about assets, liabilities, equity
  - Represents the value of all assets and their method of financing (debt/equity) at a point in time
  - Used to:
    - Examine liquidity
    - Determine financial flexibility
  - Basis for return on equity/assets, DSO, inventory turnover, etc.
    - **Days Sales Outstanding (DSO):** Average number of days to collect payment after sale
      - Ideal when low
  - Total assets is equal to total liabilities plus stockholders' equity
  - Example: See figure 1
- **Income statement:** Flow measure which contains revenues, expenses, profit/income

Example Company
Balance Sheet
December 31, 2019

ASSETS	
Current assets	
Cash	$ 2,100
Petty cash	100
Temporary investments	10,000
Accounts receivable - net	40,500
Inventory	31,000
Supplies	3,800
Prepaid insurance	1,500
Total current assets	89,000
Investments	36,000
Property, plant & equipment	
Land	5,500
Land improvements	6,500
Buildings	180,000
Equipment	201,000
Less: accum depreciation	(56,000)
Prop, plant & equip - net	337,000
Intangible assets	
Goodwill	105,000
Trade names	200,000
Total intangible assets	305,000
Other assets	3,000
Total assets	$ 770,000

LIABILITIES	
Current liabilities	
Notes payable	$ 5,000
Accounts payable	35,900
Wages payable	8,500
Interest payable	2,900
Taxes payable	6,100
Warranty liability	1,100
Unearned revenues	1,500
Total current liabilities	61,000
Long-term liabilities	
Notes payable	20,000
Bonds payable	400,000
Total long-term liabilities	420,000
Total liabilities	481,000
STOCKHOLDERS' EQUITY	
Common stock	110,000
Retained earnings	220,000
Accum other comprehensive income	9,000
Less: Treasury stock	(50,000)
Total stockholders' equity	289,000
Total liabilities & stockholders' equity	$ 770,000

The notes to the sample balance sheet have been omitted.

Figure 1: Example of a Balance Sheet

- Represents the change in financial impact of operations over time
- Used to:
  - Evaluate past financial performance
  - Predict future cash flows
- Does not analyze:
  - Cash flow
  - Currently available funds
- Basis for gross/operating/net margin
- Example: See figure 2

3.3 Financial Ratios

- Categories of ratios:

Sample Products Co.
Income Statement
For the Five Months Ended May 31, 2019

Revenues & Gains	
Sales revenues	$100,000
Interest revenues	5,000
Gain on sales of assets	3,000
Total revenue & gains	108,000
Expenses & Losses	
Cost of goods sold	75,000
Commissions expense	5,000
Office supplies expense	3,500
Office equipment expense	2,500
Advertising expense	2,000
Interest expense	500
Loss from lawsuit	1,500
Total expenses & losses	90,000
Net Income	$ 18,000

Figure 2: Example of an Income Statement

- **Profitability ratio:** Proportional difference between profits over time or against other entities (e.g. gross vs. net margin)
- **Activity ratio:** Measure of efficiency of use of assets (e.g. DSO)
- **Liquidity ratio:** Measure of the ability to pay its liabilities when due (e.g. current ratio)
- **Coverage ratio:** Measure of the ability to meet financial obligations (e.g. months of cash burn in bank)

- Ratios:
  - The greater, the better
  - **Gross (profit) margin:** Difference measure which is the sales revenue minus cost of goods sold
    - Represents how efficiently a company creates its product
  - **Operating margin:** Ratio measure which is (sales revenue minus operating costs) divided by sales revenue
    - Less than the gross margin
    - Represents how efficiently a company absorbs operating costs
  - **Net (profit) margin:** Ratio measure which is net income divided by sales revenue
    - Less than the operating margin
    - Represents baseline of how much revenue per dollar is translated into profit

- **Return on assets:** Profitability measure which is (asset turnover times profit per asset)

3.4 Cash Flow

- Consume cash when you:
  - Increase assets (e.g. buying equipment)
  - Decrease liabilities (e.g. paying back a loan, paying a supplier faster)
- Generate cash when you:
  - Decrease assets (e.g. reducing inventory/accounts receivable)
  - Increase liabilities (e.g. getting a loan)
  - Issue equity (e.g. sell shares)
- No effect on cash when you:
  - Change depreciation estimates
- **Cash flow statement:** Flow measure which contains operating, investing, and financing cash flow and the business activity which generated it
  - For each line item, information contains: Source, amount, difference
  - Example: See figure 3

3.5 Balanced Scorecards

- **Scorecard:** Perspective to view the health of an entity which has both a goal and an entity
  - **Measure:** Method of quantifying a value
  - **Goal:** Qualitative objective
- 4 scorecards:
  - **Financial perspective:** Financial health
  - **Customer perspective:** Customer interest and retention in the product
  - **Internal business perspective:** Ability to efficiently and effectively deliver product
  - **Learning/growth perspective:** Ability to innovate and continually create value

3.6 Miscellaneous Concepts

- Operating expenses do not include cost of goods sold
- **Insolvency/bankruptcy:** State where the value of the assets are less than the value of the liabilities
- Goodwill: Additional money paid in a purchase above valuation
- Profit can be manipulated by changing estimates/assumptions such as:
  - Amortization of assets over longer/shorter periods of time
  - Cpitalizing R&D so it does not appear on the income statement
- **Unit economics:** Revenue or profit from one unit of a product/service
  - Example of application: Number of units which must be sold to cover fixed costs
  - Examples of metrics: Monthly active users (MAU), active revenue per user (ARPU)

Paul's Guitar Shop Statement of Cash Flows For the Year Ended December 31, 2015	
CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$ 12,950
Adjustments to reconcile net income to	
net cash provided by operating activities:	
Depreciation on fixed assets	2,000
(Increase) decrease in current assets:	
Accounts receivable	(300)
Inventory	(39,800)
Prepaid expenses	(1,000)
Increase (decrease) in current liabilities:	
Accounts payable	49,000
Accrue expenses and unearned revenues	1,450
NET CASH PROVIDED BY OPERATING ACTIVITIES	24,300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101,000)
NET CASH USED IN INVESTING ACTIVITIES	(101,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10,000
Proceeds from long-term debt	99,500
Payments on long-term debt	-
NET CASH PROVIDED (USED) IN FINANCING ACTIVITIES	109,500
NET INCREASE (DECREASE) IN CASH	32,800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	$ 32,800

Figure 3: Example of a Cash Flow Statement

- **Triple Buttom Line (3BL/TBL):** Measurement system across social, environmental, and financial aspects

3.7 Equity

- Multiple rounds of share distribution
- **Intellectual property:** Concept, knowledge, and technology which is the property of an entity (person, company, etc.)

4 Teams and Human Resources

- **Intellectual property:** Idea, concept, or creation owned by an individual or entity
  - Employees list prior inventions on a contract
- **Non-soliciation clause:** Legally binding clause which states an employee cannot leave a company and actively recruit their previous employees
- **Non-disclosure agreement (NDA):** Legally binding clause which states an employee cannot publish confidential information revealed to them by an entity
- **Non-compete clause (NCC):** Legally binding clause which states an employee cannot work in competition against an entity for a given amount of time

5 Capitalization Structure

5.1 Introduction

- **Capitalization structure:** Distribution of debt and equity in a company
- **Venture capital:** Private equity funding provided to startups at early funding rounds
- **Stock/share:** Equity in an entity
- **Vesting:** Gradual transfer of legal ownership of equity
  - **Cliff:** Period of time until which no shares vest
  - **Accelerated vesting:** Ability to increase the speed at which shares vest
- **Security:** Order of reimbursement of assets during liquidation
  - In order of most security to least security:
    - Debtors
    - Preferred shareholders
      - Series B shareholders
      - Series A shareholders
    - Common shareholders
- **Pre-money valuation:** Valuation of a company before funding
- **Post-money valuation:** Valuation of a company after funding
  - Equation: Pre-money valuation + value of funding
- **Valuation:** Perceived balance of risk and reward
- **Pro-rata ownership:** Ability to maintain a certain percentage of ownership of the company by being given the option to purchase more shares upon any dilution
- **Term sheet:** Formal document between an investor and investing company containing terms on which investment occurs
  - May have legally binding provisions (e.g. confidentiality)
  - Not legally binding; does not imply a closed deal
- **Key control terms:** Contract terms to manage risk
  - E.g. Protective provisions, anti-dilution provisions
  - **Drag-along rights:** Contract term where a majority of voters can override the minority
  - Control provisions exist for voting, which can be majority or super majority
- **Investment memo:** Confidential internal documentation about a decision on a potential investment

5.2 Common Stock

- **Common stock:** Stock which has claim to assets/dividends, and gives voting rights
- Does not have a participation cap
- Calculation of common stock liquidation:

$$\begin{aligned}\text{Common stock liquidation} \;&=\; \text{Percent of ownership} \times \\ &\qquad (\text{Total liquidated} \;-\; \text{Preferred stock liquidation})\end{aligned}$$

5.3 Preferred Stock

- **Preferred stock:** Stock which has higher claim to assets/dividends than common stock, but has no voting rights
  - Convertible to common stock at a 1-to-1 ratio
- **Series A round:** First significant round of venture capital financing
  - **Series A stock:** Preferred stock generated during the Series A round
- **Series B round:** Second significant round of venture capital financing
  - **Series B stock:** Preferred stock generated during the Series A round
- Investors can follow the rules for preferred stock, or convert it to common stock which removes the rules
- **Liquidation preference:** Term on preferred stock which provides guaranteed investor protection by returning liquidated proceeds first if a venture fails
  - Calculated as a multiple of the investment
  - Above 1x is unreasonable
  - E.g. Given an investment of \$1M, a liqudation preference of 2x, and a liquidation of \$5M (at least greater than \$2M), the investor is guaranteed a return of \$2M
- **Participation cap:** Maximum amount of liquidated proceeds received from preferred stock, relative to the investment
  - E.g. Given an investment of \$1M and a participation cap of 3x, the maximum amount received upon liquidating the preferred stock and participating is \$3M
- **Participating (preferred) stock:** Preferred stock which receives liquidated proceeds (investment times liquidation preference) first, then continues to receive a percentage of common stock
  - Calculation of participating preferred stock liquidation:

$$\begin{aligned}\text{Participating preferred liquidation} \;=\; & MAX(\\ & \quad MIN(\\ & \qquad \text{Investment} \;\times\; \text{LiquidPref} + \\ & \qquad \text{ParticipatingPrefStockPercent} \;\times\; \text{TotalLiquidated}, \\ & \qquad \text{Investment} \;\times \text{PartCap} \\ & \quad), \\ & \quad toCommon(\text{PrefStock}) \\ &)\end{aligned}$$

- **Non-participating (preferred) stock:** Preferred stock which receives liquidated proceeds (investment times liquidation preference) but does not receive a percentage of common stock
  - Calculation of non-participating preferred stock liquidation:

$$
\begin{aligned}
\text{Non-participating preferred liquidation } = MAX(&\\
&MIN(\\
&\quad \text{Investment } \times \text{ LiquidPref },\\
&\quad \text{Investment } \times \text{PartCap}\\
&),\\
&toCommon(\text{PrefStock})\\
)&
\end{aligned}
$$

- Steps to calculate exit value for a given investor with preferred shares:
  - Calculate the value of liquidating common shares:
    * Change the class of shares from preferred to common, keeping the percentage the same
    * Multiply the percentage of common share by the liquidation amount
  - Calculate the value of liquidating preferred shares:
    * Take the original investment
    * Multiply it by the liquidation preference
    * Cap it by the liquidation amount
    * If participating, add the participating value:
      · Take the liquidation amount
      · Remove the preferred share liquidation
      · Multiply it by the percentage of preferred shares
      · Add this to the preferred share liquidation amount calculated above
    * Apply the participation cap:
      · Multiply the original investment by the participation cap
      · Cap the liquidation amount above by this amount
    * Take the larger value of this vs. the value of liquidating common shares
- **Participation right:** Term where investors receive additional returns according to cap table percentage upon liquidation
- Avoid:
  - **Redemption right:** Term which provides investors with the ability to withdraw the investment
  - Milestone/tranching-based financing: Ability to hold back investments until a certain date or milestone
  - Reciprocal contract

5.4 Stock Options

- **Stock option:** Right to buy common stock (at a discounted rate)
  - Rate to purchase is set when first issued
  - Not stock/shares, so they cannot vote

- Can be converted to common shares
- Will vest over time

- Stages in the capitalization table:
  - Reserved
  - Allocated
  - Vested
  - Exercised
- **Exercise/strike price:** Discounted price at which a share can be bought using a stock option

5.5 Stages

- **Startup:** Venture which has not yet received Series B funding
  - Financing from equity (initial investors), customers, employees (who will work for equity and lower salary)
- **Scaling:** Venture which has received Series B funding but is not yet public or having private equity
  - Financing from equity, debt, and customers
- **Mature:** Venture which is stable, being public or having private equity
  - Financing from equity, debt, and customers