Finances

Chapter-5

CS449-Professional Issues in Information Technology

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Chapter Outcome

After reading this chapter you should:

- *understand why start-up companies need capital;*
- *know what is required in a business plan;*
- *understand the different ways in which capital can be raised & the advantages & disadvantages of each.*

Introduction

Fresh graduates in computing are often tempted by the idea of setting up their own company. They might decide to use their skills in website design and programming to offer services to small organizations.

They may have ideas for a software package or computer game. However modest the group's initial ambitions, it is likely that they will need some money to start the venture.

To work on a product or a project, money is needed for the operating costs before you get paid. The bigger the project, the longer it gets to get paid.

WHY CAPITAL IS NEEDED?

- It is very difficult to start any commercial venture without having some money in hand, because your customers will not be willing to pay you until you have provided them with the service or the product they are buying.

- You, however, have to buy the things you need to make the product or to provide the service, and you have to live while you are making or doing it.

WHY CAPITAL IS NEEDED?.....

If you are setting up a company to build websites, you are likely to need much more money.

First, because your customers are likely to be other companies, it will take you longer to get paid.

In normal commercial practice, invoices for services are issued at the end of a month to cover the work that has been done during the month.

WHY CAPITAL IS NEEDED?.....

A client is unlikely to pay an invoice within less than one month of receiving it. Two months is more likely with commercial clients and three months is not uncommon.

Some large companies are notorious for not paying invoices for as much as 6 or even 12 months.

The result is that you need enough cash in hand to be able to live for at least three months.

Additional money will be needed for the expenses of starting the company.

WHY CAPITAL IS NEEDED?.....

The sum of money needed is likely to be even larger if you want to develop a package.

During development, there will be no revenue coming into the company.

For this period cash will be needed for:

Salaries, however small, for the founders and for any other staff they may need to employ;

Rent, utilities like lighting of the premises used;

WHY CAPITAL IS NEEDED?.....

Equipment and consumables;

Costs of advertising and marketing the products;

Miscellaneous expenses like:

- company stationery
- or travelling;

Interest on any money borrowed.

WHY CAPITAL IS NEEDED?.....

While it is often possible to carry out the early stages of development in the founders' spare time, working from their homes.

This is not usually satisfactory once commercial sales have started.

However successful the development of the packages, it will take some months before sales reach a level sufficient to cover the company's ongoing costs, so, even after development is complete, more cash will be needed.

The Business Plan

The first step in raising the money is to produce a business plan.

You can try and convince potential investors to invest in your company/ product using the business plan.

- It Consists of Objectives/ description of company, technical feasibility, technical expertise.
- It provides the description of the market, size of the market, assessment of competition.
- It also includes budgets, cash flow predictions, and projected balance sheets and profit and loss accounts.

The Business Plan….

With a good business plan, you will be able to convince people who might be willing to lend you money or invest money in your company.

It is a mistake to think of a business plan as a prediction of what will happen when and if you succeed in starting your company.

It should be seen more as a scenario that demonstrates that your company has a reasonable chance of success.

The attempt to produce a business plan will often show that what a new company is trying to do has very little chance of succeeding.

(Possible) Sources of Finance

Government policy in the UK strongly encouraged the growth of small companies and due to that there are many possible sources of funding.

These can all be grouped under three headings:

- grants
- loans
- sale of equity

Many other countries have similar policies, but there are big differences between countries in the way that the policies are implemented .

Grants

A *grant* is a sum of money given to the company which should demonstrate that it has been used for the purposes for which it was given.

The grant is given with the intention that it is not to be paid back to the organization which gave it.

Grants are only available from government & EU sources or, very occasionally, from charities.

They are also limited to a certain proportion of the money spent on a particular development and are conditional upon the remainder being raised from other sources.

Grants….

These grants are usually:

- intended to assist with capital investment, typically investment in premises and equipment;
- subject to a number of conditions, in particular the raising of capital from other sources;
- limited to a certain proportion of the capital investment that the company can prove it has made.

This means that they are often of limited usefulness to small software companies, whose investment more usually takes the form of employees’ time.

Loans

While grants are undoubtedly very helpful, their effect on company finance is short term.

The major sources of finance are *loans* and the *sale of equity*.

A loan is a sum of money lent to the company; interest is payable on it, at a rate that may be fixed or variable, and the loan is usually for a fixed period.

The company has to pay back the loan eventually &, if it goes into liquidation, the lender is entitled to recover the loan from the sale of the assets of the company.

Loans….

In most cases, security is required for the loan.

In other words, the company agrees that if it fails to make repayments, the lender is entitled to sell some of the company’s assets in order to make up for the shortfall.

It is in the same way that, if you borrow money to buy a house and then fail to keep up the repayments, the lender can sell the house to recover the loan.

Overdrafts

It is usual to divide loans into *overdrafts* and long-term loans.

An overdraft is the most flexible form of loan.

Overdrafts are offered by banks; they allow a company (or an individual) to spend more money than is in its account, up to a specified maximum.

Interest is only payable on the amount actually owed and the rate is normally comparatively low;

Overdrafts....

A bank can withdraw overdraft facilities without Warning.

It is possibly for reasons of general policy that have nothing to do with the borrower.

Many small companies have been forced into liquidation unnecessarily as a result of such action by banks.

Long term Loans

In contrast, *long-term loans* are usually made for a fixed period at a fixed rate of interest.

The borrower receives the capital (the amount of the loan) at the start of the period of the loan and is committed to paying interest on that amount throughout the period of the loan.

Loans are usually provided by banks or similar institutions. Even if a soft loan is available as part of a government initiative, it will usually be channeled through a commercial bank

Equity Capital

Equity capital is money paid to the company in exchange for a share in the ownership of the company.

The founders of a new company often find the initial capital from their own resources or from friends and family, but few are able to continue raising capital in this way.

If a company looks to have good prospects but needs to raise more capital, it will usually need to resort to *business angels* or *venture capitalists*.

Business Angels

Business Angels are wealthy individuals who provide equity capital for start-up companies and small firms that are seeking to grow rapidly.

They are usually interested in investing in firms operating in areas of which they have some experience and, as well as providing capital.

They will usually expect to offer advice on management and other business issues.

Venture Capitalists

Venture capitalists are companies whose business is investing in small companies with high growth potential. They are only interested in fairly substantial investments, from, say, £500,000 upwards.

If the company is already operating, the shares issued to business angels or venture capitalists will usually be new shares, taken from the difference between the issued capital and the authorized capital.

The new investors will probably be paying substantially over the par value of the shares.

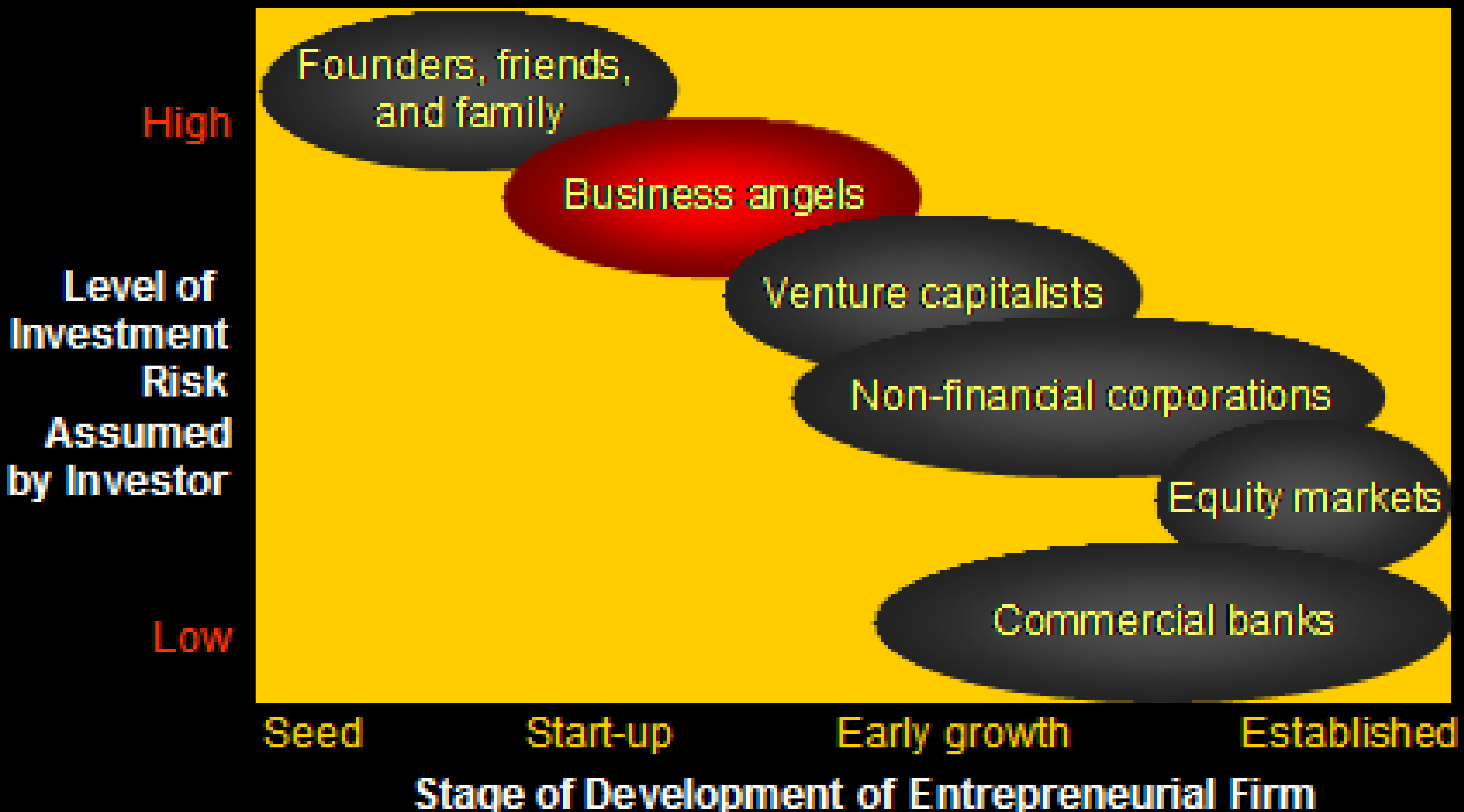
Angel investors vs Venture Capitals……

- Angel investors bridge the gap between building the initial product and building the company.

- Both business angels and venture capitalists aim to make money by helping the company to expand and become successful and then selling their shares at a profit.

Providers of Finance throughout the Evolution of the Entrepreneurial Firm

The Role of Business Angels



Gearing

- The relationship between loan capital and equity capital in a company is known as *gearing* or *leverage*.

- If a company closes, the investors will lose their money, but lenders don't (usually).

- But, investors also stand to make more if the company picks up.

- If there is higher gearing, most of the companies profits may end paying the interests.

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