



1001

ACTIVITY

Finance & Investment – Lesson Plan

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ACTIVITY

LESSON PLAN

SUBJECT

Business Financing

OUTCOMES

Learners will be able to:

- List the two primary types of financing available to a business, and describe the benefits and drawbacks of each; list the various sources of financing;
- Identify the motivation behind each source of financing; and
- Explain which type of financing might be most suitable for a given business.

SKILL LEVEL

Middle School – High School – Post Secondary – Adult

PREPARATION

Review the introductory material with learners.

PROCEDURE

Summary

Review the overview on business financing options and sources. Be sure to also review the questions and answers, and discuss the key information in order to enable learners to complete the exercise. Once complete, instruct learners to follow the directions in the Student Edition. After completing the exercises, lead a discussion to review answers.

INSTRUCTOR



Business Financing – Types and Sources

Overview

There are two TYPES of financing available to most businesses: Debt and Equity. Debt is a loan that you must repay, usually with some amount of interest added. Equity, on the other hand, represents a purchase of ownership in a business. Each type of financing has its benefits and drawbacks, and not all businesses meet the requirements needed to obtain such financing.

There are also several SOURCES of financing, each with unique features, all of which should be considered when seeking business financing.

- Love Money** Money from family and friends. Could be debt or equity.
- Banks and Credit Unions** Normally offer debt, with some form of collateral required. Objective is to gain a reasonable rate of return by financing lower risk opportunities.
- Angels** Wealthy individuals who invest for financial or emotional reasons.
- Venture Capitalists (VCs)** Professional investors who seek out high growth companies in their early stages. Objective is to realize large capital gains.
- Mutual Funds** Professional investors who seek out various types of companies, but generally those that are stable and in later stages of growth. Objectives vary from capital gains to dividend income.
- Investment Banks** Act as brokers to connect people looking to invest with companies seeking financing. Investment banks normally only facilitate deals in the millions of dollars.
- Merchant Banks** Similar to Investment Banks, but often invest their own funds as well.
- Strategic Investors** Businesses that may have a strategic interest in the activities of another business (such as a partner or competitor). Objectives vary from direct financial return to strategic business benefits.
- Government** Invest for economic development reasons. Usually debt or grant financing.
- General Public** Often called retail investors. May invest for financial and/or emotional reasons. Private companies are significantly restricted from pursuing investment directly from the public. Most retail investors have their money managed by financial advisors or mutual fund managers.

DEFINITIONS
<p>Capital Gains The increase in value in an asset, like Stock.</p>
<p>Dividend A periodic distribution of part of the profits, which is paid by a company to its Shareholders.</p>
<p>Due Diligence Investigation conducted by an investor to determine the merits of a potential investment opportunity.</p>

Questions and Answers

(1) What are the benefits and drawbacks of equity versus debt financing, from an entrepreneur’s point of view.

	Debt	Equity
Repayment	Has to be repaid usually within 1 to 5 years, unless it is a long-term loan (such as a mortgage on a building), which could have a repayment term of 10 to 20 years, or more. Because a loan has to be repaid, the business must have sufficient cash flow to make scheduled payments. Many businesses, particularly startups, do not have strong enough cash flow to make loan payments right away.	Does not have to be repaid right away since the investor is purchasing an ownership position (shares) in the company. Often, equity requires payment of dividends, but dividends are only paid from a company’s profits – unlike debt, which has to be repaid whether a company is profitable or not.
Ownership	Generally does not include any ownership or decision-making involvement in a business.	By selling ownership in a business, an entrepreneur may also be giving up voting rights, which control the direction and decision making in a business. Some investors may also expect a seat on the board of directors, providing further influence on the company.
Risk	Creditors who provide debt financing can force a company into financial difficult and even bankruptcy if the company is not meeting its repayment obligations.	Unless a shareholder, or group of shareholders, has controlling interest in a company, their ability to force the company in a specific direction is limited.
Other	Debt weakens a company’s balance sheet, making it more difficult to raise additional financing in the future (until the debt is repaid or reduced).	When someone owns shares of a business, they may provide credibility and are often likely to encourage others to invest in that same business, making it easier for the company to raise additional financing.

(2) What is collateral and why does a bank require it, whereas investors such as Venture Capitalists do not?

Collateral is an asset (such as a house, car, equipment, etc.) that is pledged by a borrower to secure a loan or other credit. If the borrower cannot repay the loan as scheduled, then the collateral can be seized by the creditor and sold to cover losses. Banks use collateral to reduce or eliminate the risk involved in lending money. Generally, the lower the risk, the lower the return. Banks are structured to make thousands of low risk, low return investments. Venture Capitalists, on the other hand, focus their business on making only a handful of investments in high risk, high return business opportunities. Venture Capitalists don’t require collateral because the businesses they invest in often don’t have any, and they are purchasing equity ownership in the business, where the business itself acts as a type of collateral.

(3) How does “emotion” play a role in an Angel investor’s investment decisions?

Angel investors will often invest for emotional reasons which have nothing to do with money, such as:

- The excitement of owning part of a company.
- The fulfillment of helping another company through the challenges of business startup and success. Challenges which they may have personally experienced on their own road to success.
- To foster local economic development associated with the creation of a new company and new jobs in a community.
- A personal interest in the subject matter the company is pursuing. For example, a baseball fan investing in a baseball team; an avid sailor investing in a boating company; etc.
- To support a company that is propagating a shared set of views and beliefs (political, religious, philanthropic, etc.) through its activities. For example, a company that develops materials related to a specific religious faith will attract investors that have similar religious views.
- To influence the direction and decision making within a company. For example, a family owned business that wishes to maintain family control; investors who wish to keep a company from moving its operations; groups who wish to influence environmental policies; etc.

**(4) What type of criteria do Venture Capitalists look for?
What type of companies might qualify?**

There are many Venture Capitalists, each with their own investment objectives and requirements. But there are a basic set of criteria that most tend to share.

High Rate of Return (“Upside”)	A company must be focused on increasing its value significantly. Generally, expected rates of return range from 30% - 100% per year.
High Risk (“Downside”)	Venture Capitalists understand that in order to generate a high rate of return, they must take on high financial risk. The companies they choose to invest in are at early growth, often do not have tangible assets, and as a result there is significant risk if the business opportunity is not realized.
High Revenue Growth	A company must be expected to reach revenues of \$30 million - \$100 million within 5 years or so.
Exit Strategy	An exit strategy defines how an investor will get their money out of a company. With high growth companies, this is usually through an Initial Public Offering (IPO) or by being acquired by a larger company. Venture Capitalists are interested in capital gains, as opposed to dividend income.
High Financial Need	A company must be seeking a significant amount of growth financing. Often this is at least \$1 million - \$10 million. The rationale is that a company that is not seeking a significant amount of growth capital likely won’t realize the high revenue growth needed to justify an investment. In addition, the amount of due diligence needed is the same regardless of the size of the investment, consequently, small investments tend to be considered too inefficient.
Other	There are many other features that Venture Capitalists look for, including defensible business model, limited market risk, barrier to entry, experience of the management team, etc.

(5) Why does government use investment financing to spur economic development?

All businesses need financing in order to start, operate, and grow. Some need a small amount of financing, while others may need tens of millions of dollars. In any event, the more financing that is available the more likely that new businesses will be started, and existing businesses will attempt to grow. When that happens, more money comes into a community, is spent in the community, and more jobs are created. As a community increases its jobs and the income of its citizens, the more prosperous it becomes.

Activity**(6) Suggest a type and source of financing for each of the following businesses.**Larry's Lounge Chairs

Larry is an entrepreneur. He manufactures comfortable lounge chairs, which are sold in furniture stores in his community. Larry wants to grow his business from \$1 million per year in revenue to \$4 million, within the next 5 years. He needs \$500,000, has strong cash flow, no debt, owns his building and equipment, and eventually wants to pass on the business to his daughter to run.

Larry should consider debt financing from a bank, credit union, or other source. His strong cash flow may be sufficient to service new debt. His desire to keep the business in the family limits his ability and desire to attract equity investors. He may also consider angel financing if he can structure it properly.

Techwinmac

A startup company that has been researching and developing a new technology that they believe will revolutionize how cell phones are manufactured. They have patented their process and are about to begin commercializing it. They have no revenues as of yet, but project they could achieve \$50 million within 4 years. They need \$5 million to do so.

Venture Capital equity financing or a strategic investor are the only options that can provide such an amount of financing without need for immediate repayment. They do not have cash flow or tangible assets to qualify for debt financing. Angel equity financing may be an option as well, as a bridge to the Venture Capital stage.

Bookwork Books

A privately owned publishing company founded over 50 years ago. Revenues are \$300 million and the company is profitable. Management wishes to grow revenue to \$500 million within 5 years, and is seeking \$50 million financing to do so.

The company should consider an initial public offering. The public equity markets can provide a large amount of financing, and the company's successful track record should be able to attract sufficient funds.

BUSINESS FINANCING

Types and Sources

OVERVIEW

You will be introduced to the two primary types of financing available to a business, and the various sources of financing.

OUTCOMES

Upon completion of this activity, you should be able to:

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PROCEDURE

Summary

Review the overview on business financing options and sources. Answer the questions that follow.

Name

Score

Date

STUDENT



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Other		

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