

FIN 303 Hybrid - Professor Dow

Finance in the Business Plan

What is a business plan?

- Goals for the business.
- Strategy for achieving those goals.

Every business should have a plan, from a small family restaurant that wants to generate a steady income, to Google with their plans for world domination. A business plan should have explicit goals so the company knows what it wants to achieve and can evaluate whether it is achieving it. It also should have an explicit strategy for achieving those goals.

For small businesses, the business plan will focus in more on the operational details of the company and practical issues such as working capital management. For large companies, strategic issues will be more important. In this presentation, we'll focus more on small business and leave large-company capital structure questions for a later lecture.

Why make a plan?

- Serves as a checklist for the planning you'll need to do.
- Convince investors that your company will be successful.

It's helpful for a business to have a written business plan. First, a business plan serves as a checklist to make sure you've thought about all aspects of the business including the financials and long-term strategy. In addition, if you're looking for outside investors, they'll want to see a detailed financial plan that shows how you'll generate enough money in the future to generate a return on their investment.

Parts of a Business Plan

- Description of the company, management and product
- Market Analysis
- Strategic Plan
- Financial Projections

A business plan is typically split into three or four major parts. The first part will provide an overview of the company, the track record of the management and a detailed description of the operations of the company and the products or services it is selling. The plan will also have a market analysis which identifies the competitors and the direction the market might take in the future. The strategic plan will identify the strengths and weaknesses of the company along with opportunities and threats and then the actions the company will take to insure it has a strong market position. Finally, the plan will have both historical financial data and projections for the future. The financial projections are the focus of this presentation.

Finance in the Business Plan

- Historical financial statements
- Pro forma financial statements
- Financial ratios and analysis

The financial plan will generally provide three kinds of information: (1) historical financial statements, (2) estimates of what the financial statements will look like in the future (known as pro forma financial statements) and (3) some analysis of the financial information including appropriate financial ratios. You should be familiar with financial statements from your financial accounting class and we will discuss the use of financial ratios in a later presentation.

It's important to recognize that the financial part of a business plan is designed to provide answers to specific questions. For example, if you are presenting your business plan to a bank in order to get a loan, the bank will want to know how much you want to borrow and they will want to see evidence that your business will generate enough money to repay the loan in the future. This information should be clearly presented in your financial plan.

Pro Forma Financial Statements

- Pro forma financial statements are projections of what will happen in the future.
- Forecasting the future is complicated!
- Be explicit about assumptions.
- Sensitivity analysis

Pro forma statements are projections of what will happen in the future. They have the same form as historical financial statements but the numbers are estimates made by the company. Forecasting the future is complicated so forecasts will never be perfect, but they should be reasonable and informed estimates of what the company things will happen. Potential investors may challenge the forecasts so the company should be able to show how they derived the numbers and be able to defend their assumptions. As part of this, the assumptions used should be clearly shown as part of the pro forma financial statements.

Forecasts of the future are always dependent on a number of assumptions and these assumptions are never certain. Sensitivity analysis is the practice of seeing how your conclusions are affected if you change your assumptions. For example, if you constructed you financial statements assuming that sales are going to grow by 10% per year it would be useful to know what would happen if sales only grew by 5%. If the company can show that they still would be able to make their interest payments with 5% growth, it would make investors more confident about lending them money.

The capital budget

- Balance sheet
- Assets needed
 - Too much or not enough
- How financed?
 - Equity
 - Debt
 - Bootstrapping

One of the most important items in the financial plan is past and expected future capital spending. Dollar amounts would be summarized on the balance sheet but, depending on the business, there may also be more detailed descriptions of capital expenses. The plan would lay out how much would be spent and when the spending would occur. Outside investors would want to examine the plan to make sure you're not trying to raise more money than you need (after all, the more money you raise now, the more you'll have to come up with to repay the investors in the future). Depending on the business, they'll also want to be sure that the company is raising enough money so it doesn't find itself short and having to return to investors to ask for more. In some situations (such as with venture capital) companies are funded in stages with the company given enough money to prove itself, and once it does that, it can return to the same investors to get additional funds to finance further growth.

One of the things that investors will look at is how the funds are raised. Will the company mostly be borrowing money or is it looking for equity investors? For small businesses, outside investors will want the owner to make a significant investment in the company with their own money to have "skin in the game". In this way, the owner has an incentive to work hard to make the company successful because if the company fails, they'll lose their own money in addition to the investors' money.

The plan will also want to show how much of the funding for the company will come out of "bootstrapping", that is, using income generated by the company to fund future expansion. Part of the purpose of a financial plan is to check for the reasonableness of the assumptions. In this case, is it likely that the firm will be able to generate enough cash early on to fund needed investment in the future or could it find itself short.

Income statement

- Forecasts of:
 - Sales
 - Revenue
 - Costs
 - Earnings

The pro forma income statement will include forecasts of sales, revenue, costs and earnings. For investors, the bottom line is the amount of future earnings as that will be determine whether their investment in the company can provide an acceptable return, or in the case of a bank loan, whether the company will be able to repay the loan. Even though earnings are the bottom line, investors will look closely at the assumption the plan makes about sales, revenue and costs as these together will determine earnings. Business owners tend to be optimistic about the amount of sales and revenue and so the business plan should provide a justification of the numbers used and some analysis of what would happen if sales turned out to be lower than expected.

Cash Budget/Working Capital Management

- What is working capital?
- Cash budget
- Inventory management and the cash conversion cycle

Working capital is the money used to support the day-to-day operations of the business. For example, a company might have to pay cash up front to buy materials to manufacture their product before they sell it. If they offer credit, they may not receive the proceeds of their sales until some time after the sale. A start-up business might also need cash to pay employees early on before the company becomes a stable business that can generate enough cash on its own. In addition to asking for money to fund capital purchases, a new company will need investors to provide funds for working capital.

The amount of funds needed will be determined by the cash budget. This estimates the cash inflows and outflows on a monthly, weekly or daily basis. The difference between cash outflows and inflows will determine the necessary working capital.

The cash conversion cycle follows the operations of the business from the acquisition and holding of inventory through sales and finally to the collection of payments. Small businesses especially should show in some detail how they will efficiently manage inventory and the cash conversion cycle to avoid requiring excess working capital. This will be discussed in more detail in a later presentation.

Financial Ratios

- Financial ratios
 - Summarize financial information
 - Put numbers into context
- Later presentation goes through ratios in detail.

Financial ratios are a way of summarizing large amounts of financial information and putting them in context by expressing one value relative to another. For example, saying that a company has annual interest costs of \$200,000 doesn't tell us very much in itself. Expressing interest costs relative to earnings is better since earnings measures the company's ability to pay those interests costs. A \$200,000 interest expense is not much for a company with earnings of \$20,000,000 but would be a serious problem for a company with earnings of \$150,000.

A financial plan will typically include a few key financial ratios to provide some analysis of the company's financial situation. We will study financial ratios in detail in a later presentation.