SESSION 2: THE STRUCTURE OF A BUSINESS

A Financial Balance Sheet

Assets		Liabilities	
Value of investments you have already made as a company over your history. Their value is updated to reflect their current cash flow potential.	**Assets in Place**	**Debt**	Lenders, both short and long term, get first claim whatever cash flow is generated by the firm.
Value of investments you expect the company to take int the future. This value rests on perceptions of the opportunities you see for the firm.	**Growth Assets**	**Equity**	Equity investors get whatever is left over, after meeting the debt obligations.

Assets in Place

- The assets in place reflect investments that a business has already made. The investments were made in the past, but the value that is attached to them is your estimate of what they will generate for you in the future.
- With this definition, you can see that the value of assets in place can be
  - Significantly lower than what you originally invested, if their earnings power has deteriorated.
  - Significantly higher than what you originally invested, if their earnings power has improved.
  - About what you invested, if the earnings power has stagnated.

Growth Assets

- Growth assets reflect the value of investments that you expect a business to make in the future.
- That value is measured by the “excess returns” you expect to generate on future investments.
- The value of growth assets will be
  - Higher, if you are in a business where you access to lots of investments that generate excess returns
  - Lower, if you are in a business that either has very few investments or low or zero excess returns
  - Negative, if you are in a business with bad investments and you make them anyway.

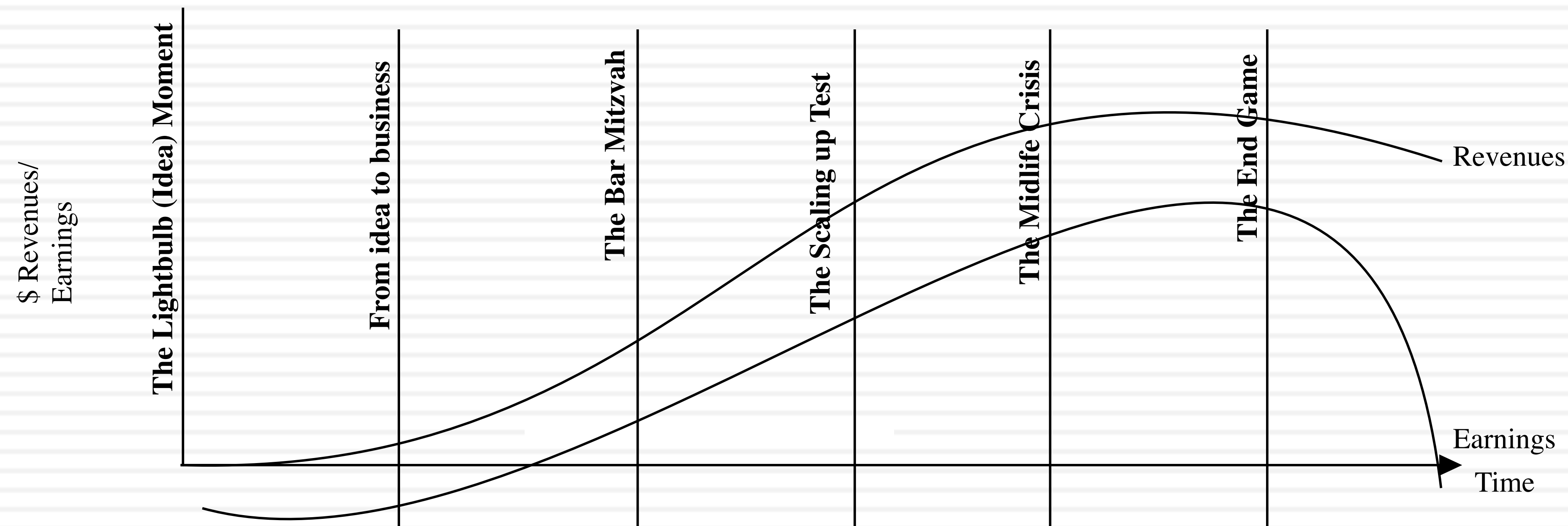
Debt

- You have the choice of borrowing money to fund some or a big part of your value.
- There are three characteristics that set debt apart from equity:
  - Contractual commitments to make payments to the lenders (interest & principal)
  - Failure to meet these commitments can result in you going out of business or losing your equity stake
  - In much of the world, the tax law is tilted to give you a benefit when you borrow

Equity

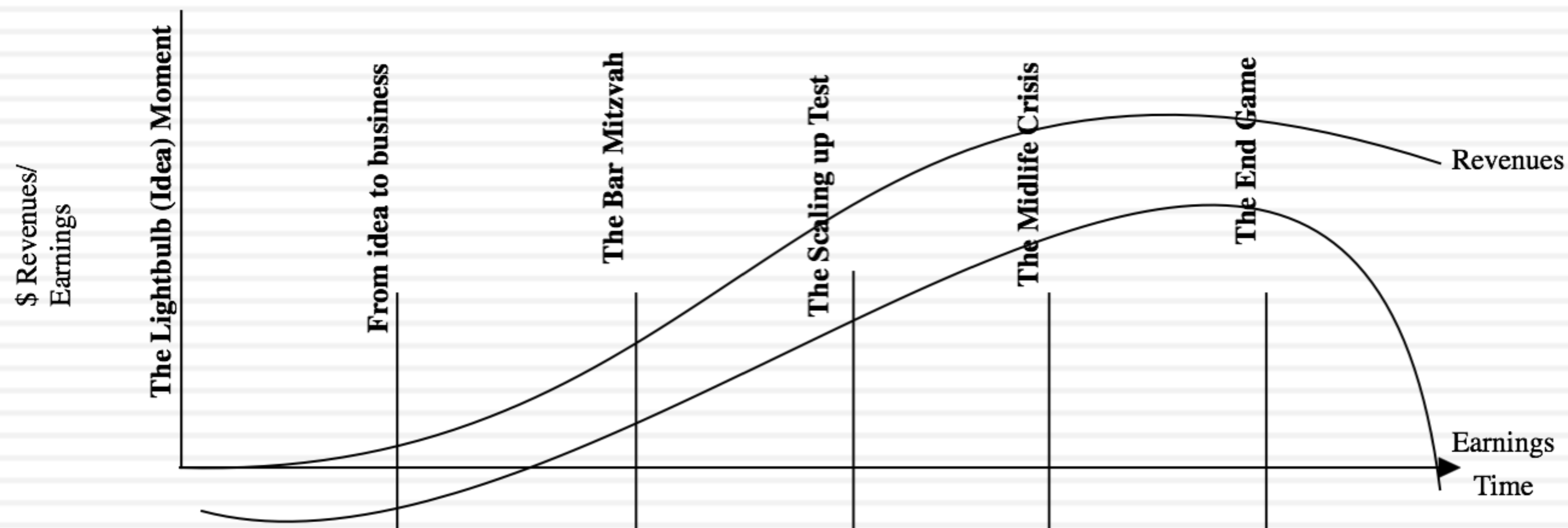
- Equity is a residual claim. If you are the sole owner of a business, you are entitled to lay claim on whatever cash flows are left over after every one else has been paid their contractual dues.
- The Dividend Claim: If you are the stockholder in a public company, the managers have the discretion to decide how much of the cash flows are paid out to you as dividends.

The Corporate Life Cycle



Growth stage	Stage 1 Start-up	Stage 2 Young Growth	Stage 3: High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
Description	Have an idea for a business that meets an unmet need in the market.	Create a business model that converts ideas into potential revenues & earnings	Build the business, converting potential into revenues.	Grow your business, shifting from losses to profits	Defend your business from new competitors & find new markets	Scale down your business as market shrinks.

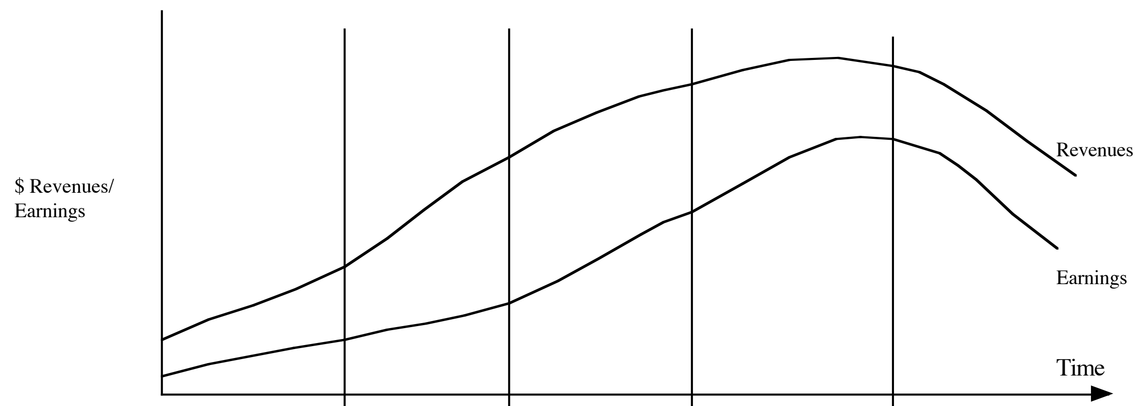
The Asset Side across the Life cycle



Growth stage	Stage 1 Start-up	Stage 2 Young Growth	Stage 3: High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
Assets in Place	None	Very low	Building substance	Becoming larger	Primary component	All & Declining
Growth Assets	All & Unproven	Most and first proof	Most of the value	Scaling down	Tough to find	What growth assets?

The Financing Side

Financing Choices across the life cycle

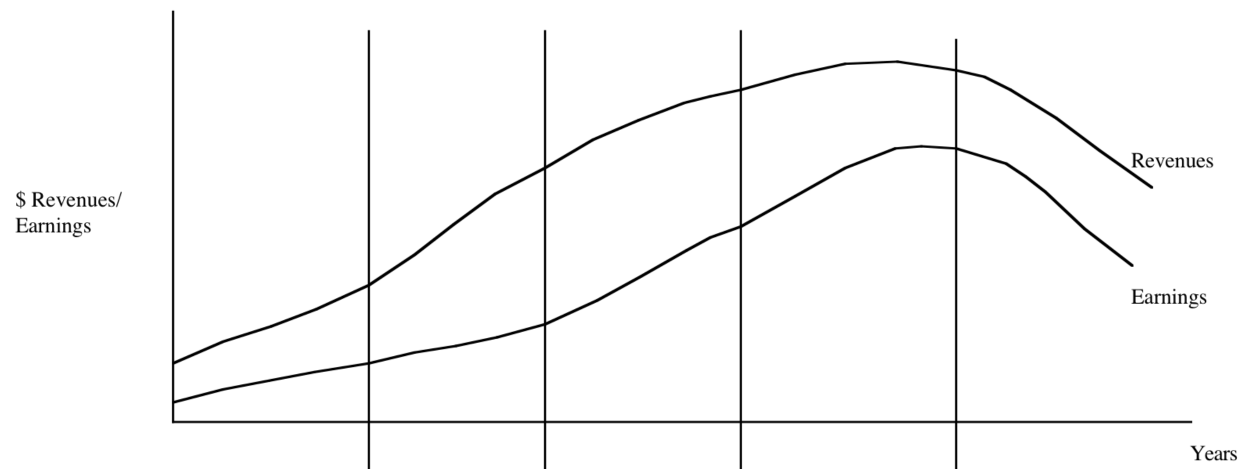


External funding needs	High, but constrained by infrastructure	High, relative to firm value.	Moderate, relative to firm value.	Declining, as a percent of firm value	Low, as projects dry up.
Internal financing	Negative or low	Negative or low	Low, relative to funding needs	High, relative to funding needs	More than funding needs
External Financing	Owner's Equity Bank Debt	Venture Capital Common Stock	Common stock Warrants Convertibles	Debt	Retire debt Repurchase stock
Growth stage	Stage 1 Start-up	Stage 2 Rapid Expansion	Stage 3 High Growth	Stage 4 Mature Growth	Stage 5 Decline

Financing Transitions: Accessing private equity → Inital Public offering → Seasoned equity issue → Bond issues

The Harvesting Side

Figure 10.7: Life Cycle Analysis of Dividend Policy



External funding needs	High, but constrained by infrastructure	High, relative to firm value.	Moderates, relative to firm value.	Low, as projects dry up.	Low, as projects dry up.	
Internal financing	Negative or low	Negative or low	Low, relative to funding needs	High, relative to funding needs	More than funding needs	
Capacity to pay dividends	None	None	Very low	Increasing	High	
Growth stage	Stage 1 Start-up	Stage 2 Rapid Expansion	Stage 3 High Growth	Stage 4 Mature Growth	Stage 5 Decline	Years