

The Business of Software

An Overview of Financial Statements and Corporate Finance

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Overview

- Introduction
- Financial Statements
- Corporate Finance

Introduction

■ Business Case:

- Imagine you are Greg Wolfond in 1997 and you have a vision for transforming the way the world banks and invests in the post PC internet era.
- How will you finance your startup?

Financial Statements

- Financial Statements summarize business activity.
 - Provide a snapshot at a point in time (Balance Sheet - “Stock Accounts”) and a record of activity over a period of time (income Statement and Cash Flow Statement - “Flow Accounts”).
 - Accrual vs. Cash Accounting
- Financial Accounting (e.g. Audited Statements) vs. Managerial Accounting (e.g. detailed projections of revenues and expenses)
- Management Discussion and Analysis(M, D & A) is key to understanding what lies behind the numbers.
- Excellent examples of financial statements can be found in Annual Reports - often downloadable from corporate web sites.

Balance Sheet

■ Balance Sheet - "Stock Accounts"

- Law of Accounting Mass Conservation:
 - $\text{Assets} = \text{Liabilities} + \text{Equity}$
 - "The left side is financed by the right side"
- **Assets:** e.g. Cash & Monetary Assets, Accounts Receivable, Inventory, Prepaid Expenses, Fixed Assets
- **Liabilities:** e.g. Accounts Payable, Current Portion of Long Term Debt, Long Term Debt
- **Equity:** e.g. Pref. Shares, Common Shares, Deffered Stock Based Compensation
- Organized by claims on Bankruptcy: Debt, Pref. Shareholders, Common Shareholders, Suppliers, Employees
- Non Cash Items - e.g. Accounts Receivable, Prepaid Expenses, Accounts Payable

Income Statement

- Income Statement - “Flow Accounts”
 - Revenue “Top Line”
 - Expenses:
 - $\text{Cost of Goods Sold} - \text{Gross Margin\%} = \text{Rev} - \text{CGS} / \text{Rev}$
 - Sales & Marketing
 - General & Administrative
 - EBIT - Earnings (Loss) Before Interest and Taxes
 - Interest
 - Taxes
 - Net Income (Earnings Net of Interest, Taxes...)

Cash Flow Statement

■ Cash Flow Statement - “Flow Accounts”

- “Normalize” non-cash items such as depreciation, Accounts Payable, Accounts Receivable...
- **3 Sections:**
 - **Cash Flow From Operations** - often negative for a young high growth company
 - **Cash Flow From Investing** - In physical assets, investments in other companies or in securities
 - **Cash Flow From Financing** - Hopefully positive for a young company from rounds of private equity offerings, an IPO, Secondary Offerings

Financial Forecasting

- Work from assumptions about Revenue (pricing, volume, growth) and Expenses.
- Work from assumptions about how the company will be capitalized (funded). Most early stage companies go through several rounds of private equity financing and offer an “exit” to investors through an Initial Public Offering of their stock, a merger or by being acquired.
- Create a Model which logically captures the projected activity of the business. Use detail or summarize where relevant.
- Full Pro-Forma (Projected) Financial Statements can be created but minimally create a projected operating (I.e. Income) statement and a table showing financing activity, valuation and use of funds.

Corporate Finance

Sources of Financing

- Sources of Financing:
 - Suppliers and Customers - Many business finance themselves in part by “paying late and collecting early”
 - Lenders (Financial Institutions) - Secured Creditors (secure loans with collateral, such as Property, plant, equipment, inventory), Unsecured Creditors.
 - Instruments: Long Term Debt (Loans, Bonds), Short Term Debt, Operating Line, Debentures.
 - Private Risk Capital (Venture Capitalists, Other Investment Funds, Business Partners, Wealthy Individuals)
 - Instruments: Convertible debentures, Preferred Shares, Common Shares, Options, Warrants
 - Public Capital Markets: (Institutional Investors incl. Mutual Funds, Pension Funds, Insurance Companies etc..., Retail Investors, Day Traders)
 - Instruments: Stock

Corporate Finance - "Cost of Capital"

Risk / Reward

- "Cost of Capital" to the company is based on a risk / reward trade off to investors or lenders. The more risk an investor takes, the more reward, in the form of financial return is expected.
- T-Bills trade at the Risk Free Rate. A risk premium is added on top of that.
- As the risk increases, so does the required return:
 - T-Bill - e.g. 4%
 - Debt - e.g. 8% - 15%
 - Equity - e.g. 20% plus - depending on how risky the company is and the attributes of the shares. For Technology companies expected returns are **often 30%** at a minimum and investors hope for returns of **50%, 100% 300%, 500% 1,000's of %** over a time horizons ranging from one day (day traders) to many years (buy and hold long term investors.)

Valuation Methods

DCF, NPV, IRR

- **Discounted Cash Flow** - Future cash flows are discounted (opposite of compounding) using a chosen discount rate. The riskier (more volatile) the investment, the greater the **discount rate**, and therefore the lower the present value of the shares.
- **Net Present Value** (NPV) - Present Value of all cash inflows minus present value of all cash outflows. A range of appropriate discount rates are often used for best, medium and worst case scenario analysis.
- **Internal Rate of Return** (IRR) - rate of return that sets the present value of all cash inflows equal to the present value of all cash outflows.
- Although IRR is theoretically less accurate than NPV, it is often used because it is intuitive to think about what purchase price will create the desired rate of return given assumptions presented in the financial projections.

Valuation - Multiples

- Traditionally value company according to Actual (Fiscal Year, Trailing Twelve Months) or Forecast multiples of:
 - earnings
 - cash flow (EBITDA - Earnings Before Interest Taxes Depreciation and Amortization)
 - book value
- Technology Companies are now valued according to multiples of:
 - Sales!
 - Forecasted Sales!!
- Comparables - to multiples established for comparable companies. Private company discount (e.g. x .6) often used to compare a private to a public company.

Valuation in Reality

- In the final analysis, something is worth what a buyer will pay.
- Terms and structure can make a big difference in the “effective” valuation

Conclusion

■ Business Case Solution:

- Greg Wolfond will finance his company by offering equity to strategic partners including Sonera Corporation, Citicorp Strategic Technology Corporation, Bank of Montreal and Bank of America and to private equity investors
- The valuation will increase with each round of private equity financing
- Epilogue: 724 Went public on Feb. 2/2000 at \$98 / share and closed today, March 13, 2000 at \$284/ share implying a market cap (Implied valuation for the whole company) of over \$6.5 Billion

Conclusion

- Financial Statements - Stock vs. Flow, Accrual vs. Cash, Financial vs. Managerial, M,D & A
- Balance Sheet, Income Statement, Cash Flow Statement, Financial Projections
- Corporate Finance
 - Financing sources
 - Risk / Reward - Cost of Capital: Risk Free Rate + Risk Premium
 - Valuation - DCF, NPV, IRR, Multiples, Comparables, Private Company Discount, What a buyer will pay