Chapter Three

Contents

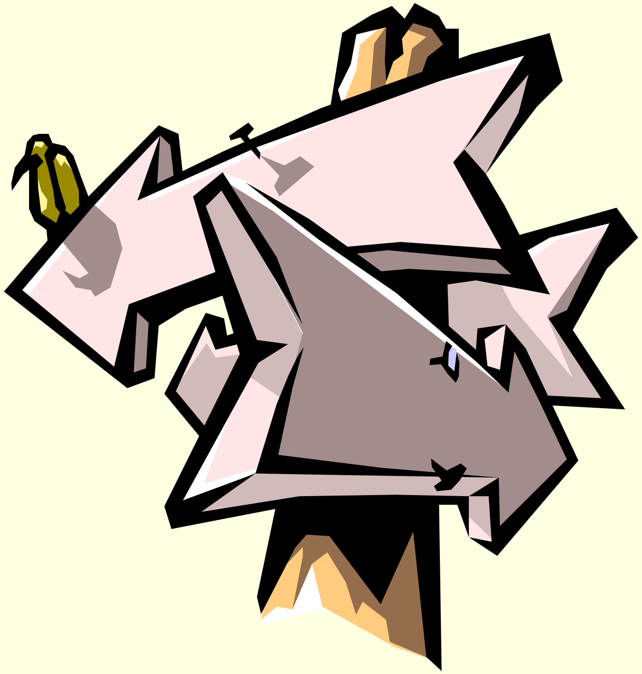
- Forms of Ownership
- Franchising
- Source of Finance

Choosing a Form of Ownership

- There is no one "best" form of ownership.
- The best form of ownership depends on an entrepreneur's particular situation.
- Key: Understanding the characteristics of each form of ownership and how well they match an entrepreneur's business and personal circumstances.

Factors Affecting the Choice

- Tax considerations
- Liability exposure
- Start-up and future capital requirements
- Control
- Managerial ability
- Business goals
- Management plans
- Cost of formation



Structuring the New Venture

- There exists a number of different business structures that differ in several important aspects.
- The most common Forms of Business Organization are:

- Sole proprietorship
- Partnership
- Corporation

Other Forms of Ownership

- S Corporation
- Limited Liability Company
- Joint Venture

Sole Proprietorship

A form of business organization in which an individual introduces his capital, use of his own skill and intelligence in the management of its affairs and is solely responsible for the results of its operation.

No distinction between the business

and

the individual's private affair

Advantages

- Simple to create
- Least costly form to begin
- Profit incentive
- Total decision-making authority
- No special legal restrictions
- Easy to discontinue

Disadvantages

- Unlimited personal liability
- Limited skills and capabilities
- Feelings of isolation
- Limited access to capital
- Lack of continuity

Cont'd

- *Example:* Photo studio, bookshop, bakeries, small town restaurants, retail stores, radio and watch repair shops,

- ***sole ownership*** *and* ***individual proprietorship***.

2. Partnership

- An association of two or more people who co-own a business for the purpose of making a profit.
- *Always* wise to create a partnership agreement.
- Best partnerships are built on trust and respect.

Types of Partners

- General partners
  - Take an active role in managing a business.
  - Have unlimited liability for the partnership's debts.
  - Every partnership must have at least one general partner.
- Limited partners
  - Cannot participate in the day-to-day management of a company.
  - Have limited liability for the partnership's debts.

Cont'd

- General partner in this partnership is treated exactly as in a general partnership.
- Limited partner has limited liability and is treated as an investor in the business.

Other Types of Partners

- **Secret partner**

  Takes an active role in managing a partnership but whose identities are unknown to the public..

- **Dormant or sleeping partner**

  Is neither known to the general public nor active in management. Others???

Advantages

- Easy to establish
- Complementary skills of partners
- Division of profit between partners
- Larger pool of capital
- Ability to attract limited partners
- Definite legal status
- Motivation of important employees
- Tax advantage over a corporation
- Flexibility

Disadvantages

- Unlimited liability of at least one partner
- Capital accumulation, Lack of continuity
- Difficulty in disposing of partnership interest
- Lack of harmony between partners
- personality and authority conflicts
- Partners bound by law

3. Corporation

separate legal entity from its owners.

- Types of corporations:
  - Domestic – a corporation doing business in the region in which it is incorporated.
  - Foreign – a corporation doing business in a region other than the region in which it is incorporated.
  - Alien – a corporation formed in country but doing business in another country.

Types of corporations

- Publicly held – a corporation that has a large number of shareholders and whose stock usually is traded on one of the large stock exchanges.
- Closely held – a corporation in which shares are controlled by a relatively small number of people.

Characteristics of Corporation

- **Separate legal entity**
  - It can sue or be sued.
  - It has the right to manage its own affairs.
  - Shareholders cannot be liable for the acts of the corporation.
- **Limited liability**

The assets and liabilities, rights and obligations incidental to the company's activities are of the company and not of its members.

Characteristics … cont’d

- Transferability of shares
  - *It is easy to transfer ownership in a corporation.*
- Perpetual existence
  - *Death, insanity, retirement and withdrawal of shareholders will not affect the company.*
- Common seal
  - *a common seal with the name of the company engraved on it, which is used as a substitute for its signature through its agents.*

Characteristics … cont'd

- Separation of ownership from management
  - *All shareholders, large in numbers, do not have the opportunity of managing the day-to-day activity of the corporation*.
- Supervision:
  - *A company is created by the legal process of incorporation. While it exists, it is subject to detailed regulation*
- It has a written constitution

Advantages

- Limited liability of stockholders
- Ability to attract capital
- Ability to continue indefinitely
- Transferable ownership
- Legal entity status
- Managerial efficiency
- Financial strength
- Scope of expansion is high

Disadvantages

- Lack of owner's personal interest
- Difficulty of formation/Cost and time
- Delay in decision making
- Lack of secrecy
- Oligarchy and fraudulent management
- Potential for diminished managerial incentives
- Potential loss of control by founder(s)
- Double taxation

Double Taxation* Example		
Corporate Income Tax	Corporate Earnings	$85,000
	Less Income Taxes Paid by Corporation (34% marginal bracket)	–10,900
	Earnings Available to Stockholders	$74,100
Individual Income Tax	Dividends to Stockholders	$74,100
	Less Personal Taxes Paid by Stockholders (28% marginal bracket)	–20,748
	Net to Stockholders	$53,352
*2010 income tax rates.		

Business Structure Comparison

	Proprietorship	Partnership	Corporation (S or C)	LLC
Best Suited for:	Single owner business where taxes or product liability are not a concern	Business with partners where taxes or product liability are not a concern	Single or multiple owner where company funded fringe benefits or liability protection are needed	Single or multiple owner business where limited liability is needed but wish to be taxed as a partnership
Type of Entity	Inseparable from the owner	Inseparable from owner but can have debt or property in his name	Separate legal entity	Separate legal entity
Main Advantages	-Inexpensive to set up -Few administrative duties	Inexpensive to set up Few administrative duties	-Limited liability -Company paid fringe benefits (C corp.) -Tax savings through income splitting (C corp.) -Capital may be raised by sale of stock	-Limited liability -Unlimited number of owners -Capital may be raised by sale of interests
Main Disadvantages	-Unlimited liability -No tax benefits -Business dissolves on owner's death	-Unlimited liability- also liable for partners' acts -No tax benefits -Dissolves on death or change of partner	-Can be costly to form -More administrative duties -S corp. limited to 35 shareholders	-Can be costly to form -More administrative duties
Taxes	-Owner is responsible -File Schedule C with	-Partners are responsible	-C corp. pays own -S corp. passes through to owners	-Usually taxed as partnership -Some states tax as corp.

The Nine Dots

Rules

You have to go

through all the dots.

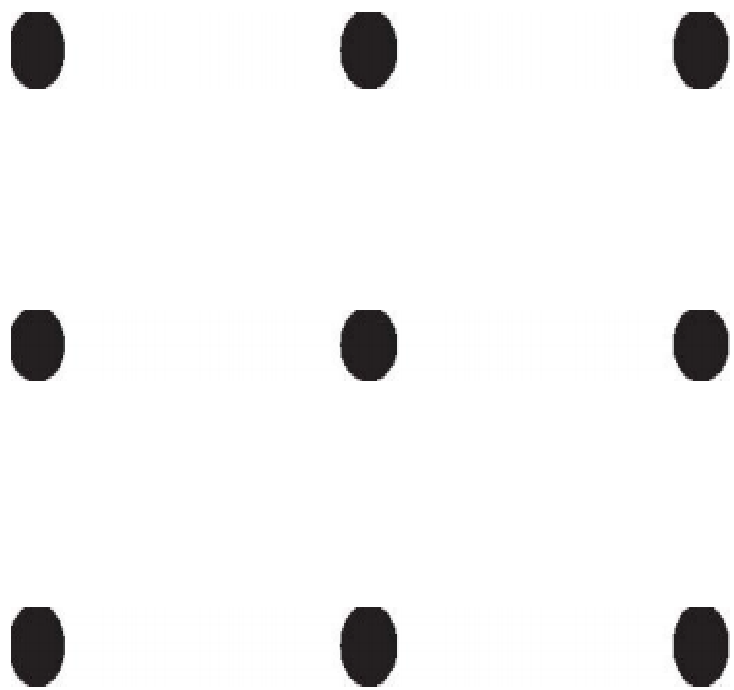
Use only 4 straight

lines

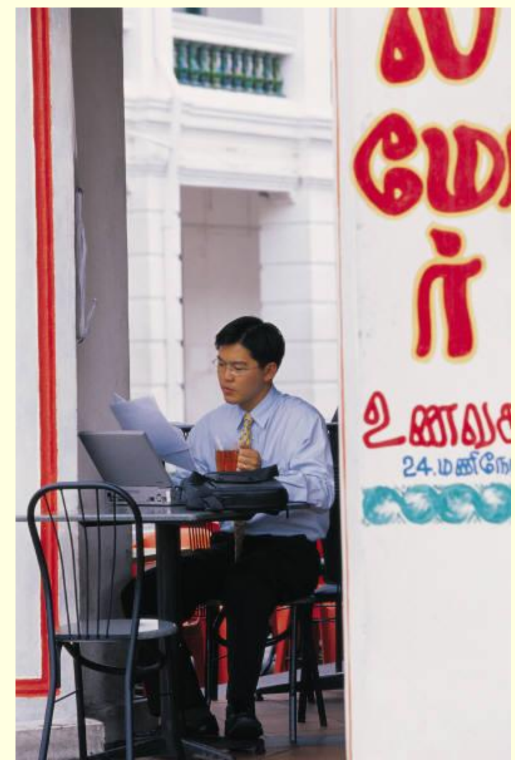
Next line should

start where the last

ends.



Franchising



Franchising

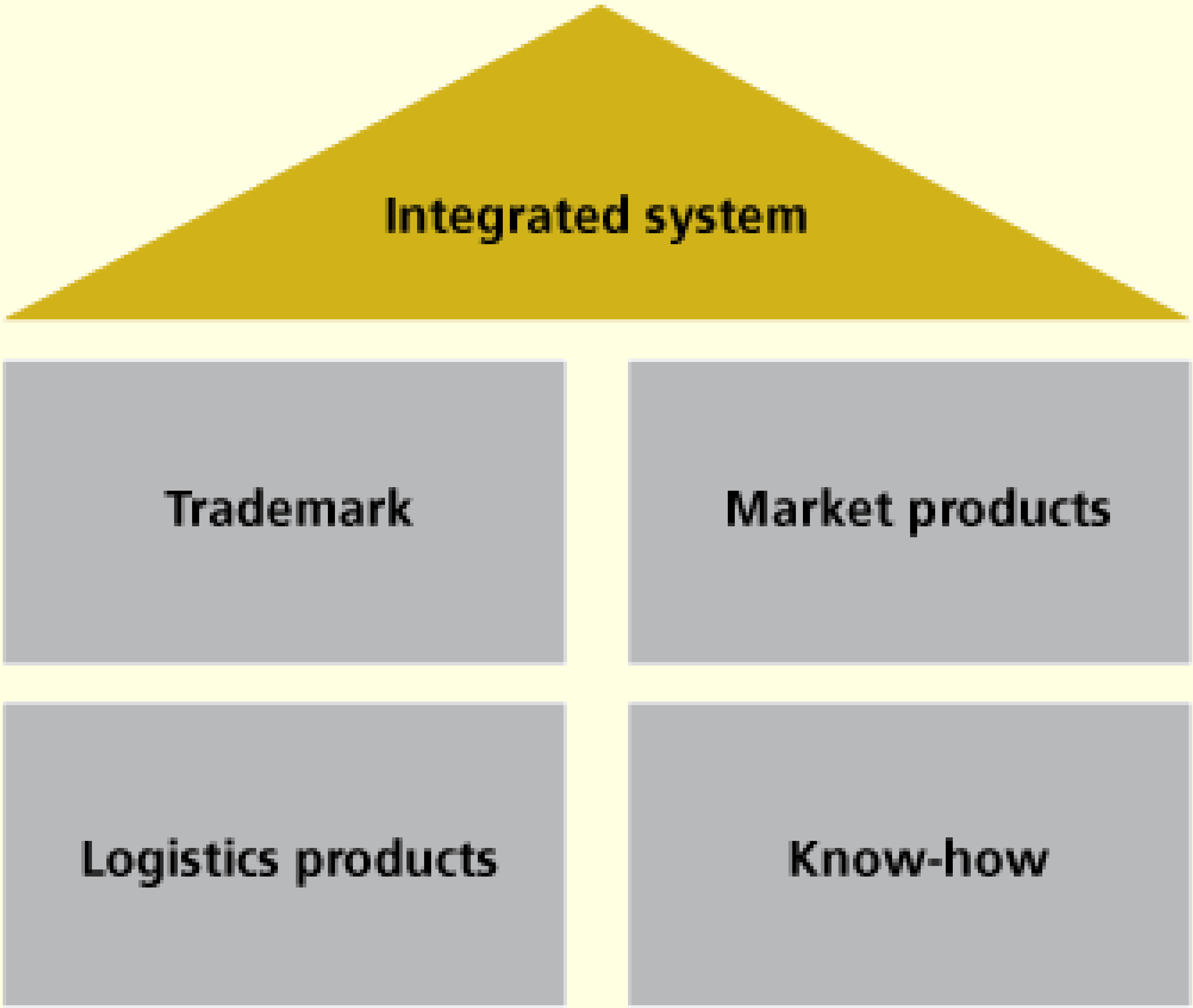
A system in which semi-independent business owners (franchisees) pay fees and royalties to a parent company (franchiser) in return for the right to become identified with its trademark, to sell its products or services.

Cont'd…

- Franchising: A legal arrangement by which one company allows its products, services, or business format to be used by others for a fee
  - Franchisee: A company or individual who pays for the legal right to use the product, service, or format of another.
  - Franchisor: A company that grants to another company or individual the legal right to use its product, service, or format.

Franchising Basics

- Franchisee gets the right to use all of the elements of a fully integrated business operation.
- Essence of what franchisees purchase from the franchisers: Experience.
- Key Question: What can a franchise do for me that I cannot do for myself?


Integrated system
Trademark
Market products
Logistics products
Know-how

Cont'd

- Businesses for which franchising works best have the following characteristics:
  - *Businesses with a good track record of profitability.*
  - *Businesses which are easily duplicated.*
- *Franchising offers franchisees the advantage of starting up quickly based on a proven trademark, and the tooling and infrastructure as opposed to developing them.*

Cont'd

- Two important payments are made to a franchisor:
  - (a) A royalty for the trade-mark and
  - (b) Reimbursement for the training and advisory services given to the franchisee

- *These two fees may be combined in a single 'management' fee*

The Franchising Relationship

Element	The Franchiser	The Franchisee
Site selection	Oversees and approves; may choose site	Chooses site with franchiser's approval
Design	Provides prototype design	Pays for and implements design
Employees	Makes general recommendations and training suggestions	Hires, manages, and fires employees
Products and services	Determines product or service line	Modifies only with franchiser's approval
Prices	Can only recommend prices	Sets final prices
Purchasing	Establishes quality standards; provides list of approved suppliers; may require franchisees to purchase from the franchisor	Must meet quality standards; must purchase only from approved suppliers; must purchase from franchisor if required.
Advertising	Develops and coordinates national ad campaign; may require minimum level of spending on local advertising	Pays for national ad campaign; complies with local advertising requirements; gets franchisor approval on local ads
Quality control	Sets quality standards and enforces them with inspections; trains franchisees	Maintains quality standards; trains employees to implement quality systems
Support	Provides support through an established business system	Operates business on a day-to-day basis with franchiser's support

Source: Adapted from *Economic Impact of Franchised Businesses: A Study for the International Franchise Association*, National Economic Consulting Practice of PriceWaterhouseCoopers, (IFA Educational Foundation, New York: 2004), pp. 3,5.

Types of Franchising

- Trade name
- Product distribution
- Pure (Business format)
- Others

Benefits of Franchising

- Management training and support
  - Start-up
  - Ongoing
- Brand name appeal
- Standardized quality of goods and services

Benefits …. Cont’d

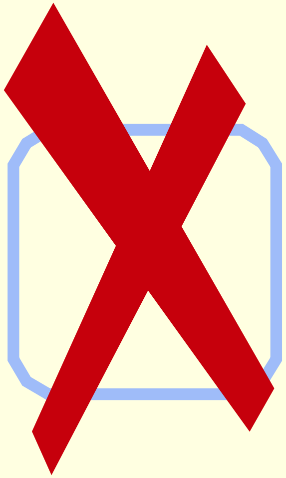
- National advertising program
  - Franchisees contribute 1 percent to 5 percent of sales
- Financial assistance
  - Some franchisers offer financial assistance to franchisees.

Benefits …. Cont'd

- Proven products and business formats
- Centralized buying power
- Site selection and territorial protection
- Greater chance for success

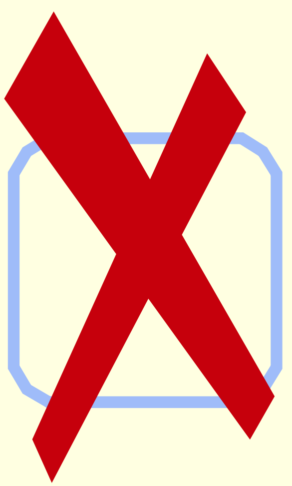
Drawbacks of Franchising

- Franchise fees and ongoing royalties
- Strict adherence to standardized operations
- Restrictions on purchasing
  - Approved suppliers only
  - Limited product line



Drawbacks …. Cont’d

- Contract terms and renewal
  - Average term = 10.3 years
- Unsatisfactory training programs
- Market saturation
- Less freedom
  - “Happy prisoners”



Ten Myths of Franchising

1. Franchises never fail.
2. open my franchise for less money than the franchiser estimates.
3. The bigger the franchise organization, the more successful I'll be.
4. I'll use 80 percent of the franchiser's business system, but I'll improve upon it by substituting my experience and know-how.

Ten Myths …. Cont’d

5. All franchises are the same.
6. I don’t have to be a hands-on manager. I can be an absentee owner and still be very successful.
7. Anyone can be a satisfied, successful franchise owner.

Ten Myths of …. Cont'd

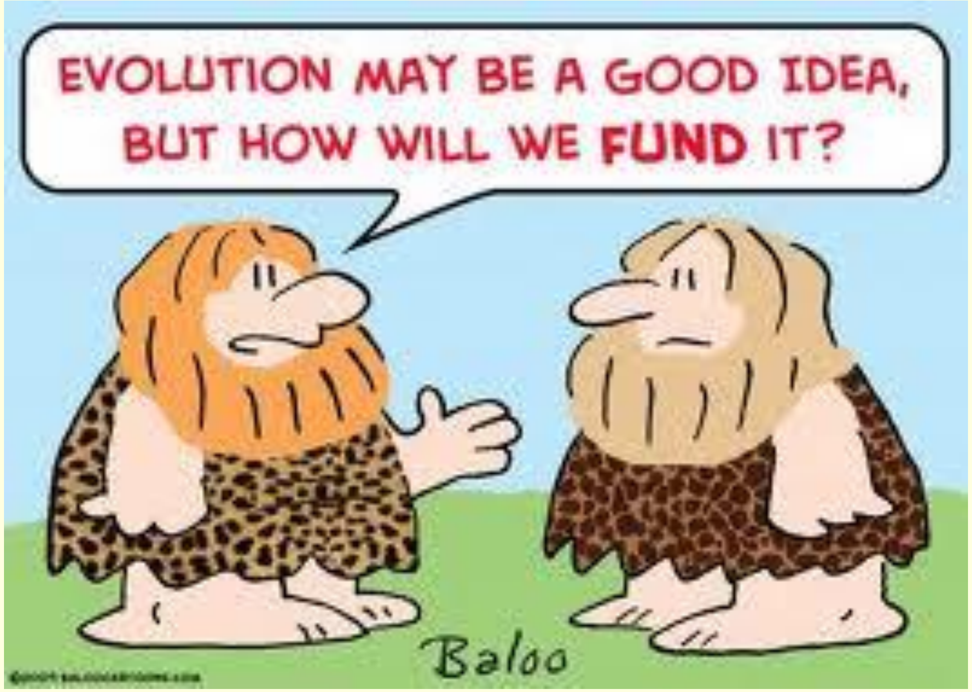
8. Franchising is the **cheapest** way to get into business for yourself.

9. The franchiser will **solve my business problems** for me;

10. Once I open my franchise, I'll be able to run things the **way I want to.**

In Ethiopia …

Sources of Funds: Equity and Debt



Financing Ventures

- *How will you finance your business?*
  - *Where do you find the money?*

    (Source of Capital)

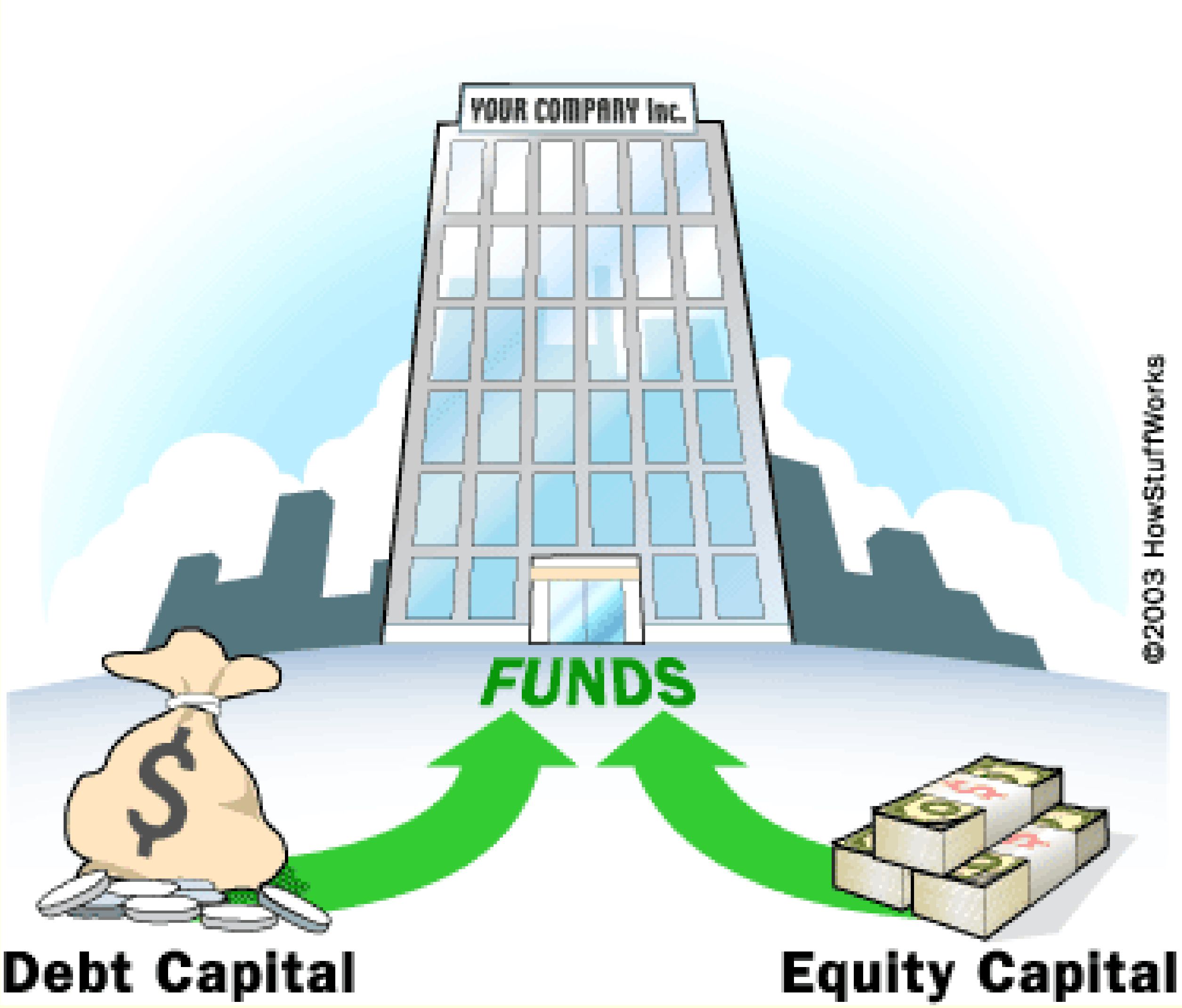
What is capital?

- Capital is the amount of cash and other assets owned by a business.
- Capital can also represent the accumulated wealth of a business, represented by its assets less liabilities.
  - Capital can also mean stock or ownership in a company.

Types of Capital

- Fixed - used to purchase the permanent or fixed assets of the business (e.g., buildings, land, equipment, and others).
- Working - used to support the small company's normal short-term operations (e.g., buy inventory, pay bills, wages, or salaries, and others).
- Growth - used to help the small business expand or change its primary direction.

Debt Capital and Equity Capital



Equity Capital

- Represents the personal investment of the owner(s) in the business.
- Is called *risk capital* because investors assume the risk of losing their money if the business fails.
- Does *not* have to be repaid with interest like a loan does.

Debt Capital

- Must be repaid with interest.
- Is carried as a liability on the company's balance sheet.
- Difficult to secure as equity financing,
- Can be expensive, especially for small companies, because of the risk/return tradeoff.

How will you finance your business?

- *What Is Financing* ?
  - Means of obtaining the resources to purchase an item, then paying back the loan in a set time period.
  - Financing is typically categorized into two fundamental types: debt financing and equity financing.

Cont'd

- Debt financing:
  - Means borrowing money that is to be repaid over a period of time, usually with interest.
  - Can be either short-term or long-term
  - The lender does not gain an ownership interest in your business. In smaller businesses, personal guarantees are likely to be required on most debt instruments

Cont’d

- Equity financing
  - Describes an exchange of money for a share of business ownership (without having to repay a specific amount of money at any particular time)
  - The major disadvantage to equity financing is the dilution of your ownership interests and the possible loss of control that may accompany a sharing of ownership with additional investors.

Advantages to equity financing:

- It's less risky than a loan because you don't have to pay it back,
- You tap into the investor's network, which may add more credibility to your business.
- Investors take a long-term view, and most don't expect a return on their investment immediately.
- There's no requirement to pay back the investment if the business fails.

Disadvantages to Equity financing:

- Require returns that could be more than the rate you would pay for a bank loan.
- The investor will require some ownership of your company and a percentage of the profits.
- You will have to consult with investors before making big (or even routine) decisions -- and you may disagree with your investors.
- In the case of irreconcilable disagreements with investors, you may need to cash in your portion of the business and allow the investors to run the company without you.

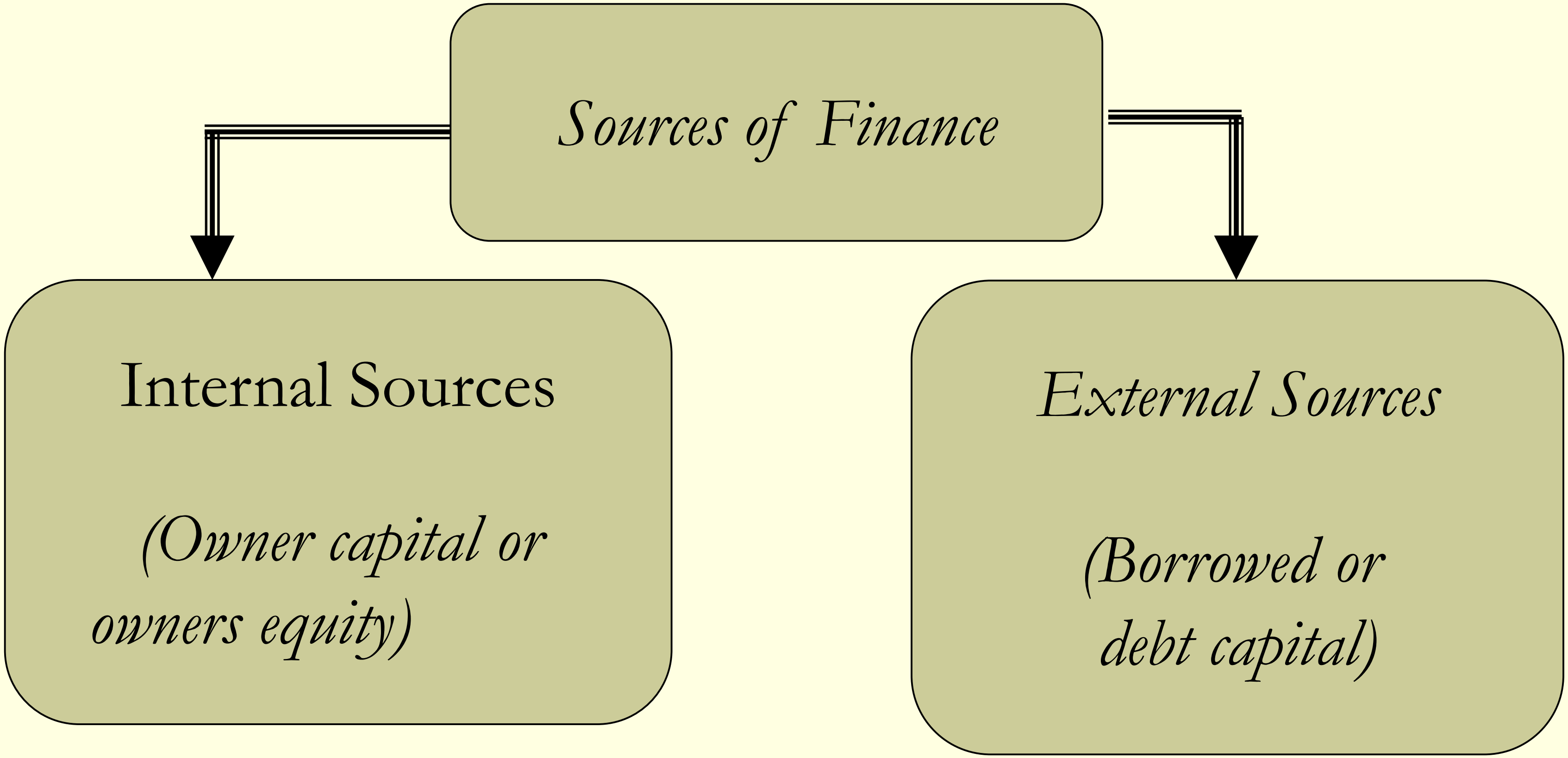
Advantages to Debt financing:

- The bank or lending institution (such as the Small Business Administration) has no say in the way you run your company. The business relationship ends once the money is paid back.
- The interest on the loan is tax deductible.
- Loans can be short term or long term.
- Principal and interest are known figures you can plan in a budget (provided that you don't take a variable rate loan).

Disadvantages to debt financing:

- Money must paid back within a fixed amount of time.
- Debt can make it difficult for a business to grow because of the high cost of repaying the loan.
- Assets of the business can be held as collateral to the lender.

Sources of finance



Sources

Internal Sources

- ✓Personal saving
- ✓Friends and relatives
- ✓Partners
- ✓Public stock sale (going public)

Cont'd

External Sources

- ✓ Commercial banks
- ✓ Trade credit
- ✓ Equipment suppliers
- ✓ Credit unions
- ✓ Insurance companies

The "Secrets" to Successful Financing

1. Choosing the right sources of capital is a decision that will influence a company for a lifetime.
2. The money is out there; the key is knowing where to look.
3. Raising money takes time and effort.
4. Creativity counts. Entrepreneurs have to be as creative in their searches for capital as they are in developing their business ideas.

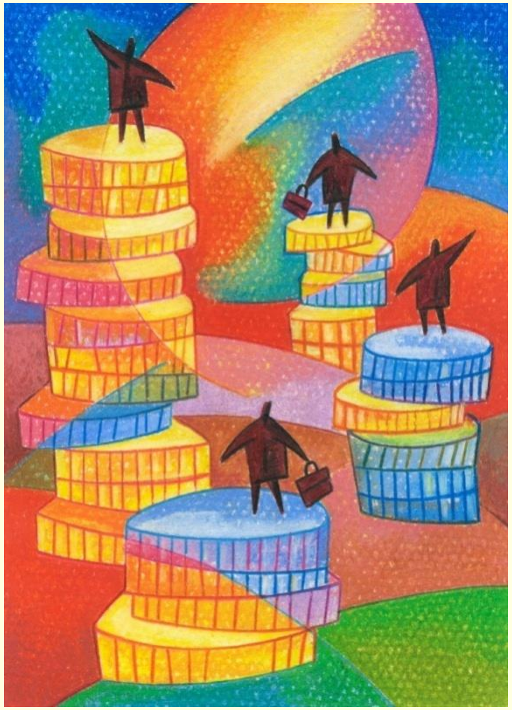
Cont’d

5. The World Wide Web puts at entrepreneur’s fingertips vast resources of information that can lead to financing.
6. Be thoroughly prepared before approaching lenders and investors.
7. Entrepreneurs should not underestimate the importance of making sure that the “chemistry” among themselves, their companies, and their funding sources is a good one.

Layered Financing

- Entrepreneurs must cast a wide net to capture the financing they need to launch their businesses.

- Layering – piecing together capital from multiple sources.



Sources of Equity Financing

- Personal savings
- Friends and family members
- Partners
- Corporations
- Venture capital companies
- Public stock sale

Personal Savings

- The *first* place an entrepreneur should look for money.
- The most common source of equity capital for starting a business.
- Outside investors and lenders expect entrepreneurs to put some of their own capital into the business *before* investing theirs.

Friends and Family Members

- After emptying their own pockets, entrepreneurs should turn to those **most likely to invest** in the business: friends and family members.
- Careful!!! Inherent dangers lurk in family/friendly business deals, *especially* those that flop.

Friends and Family Members

- Guidelines for family and friendship financing:
  - Consider the impact of the investment on everyone involved.
  - Keep the arrangement "strictly business."
  - Settle the details up front.
  - Never accept more than investors can afford to lose.
  - Create a written contract.
  - Treat the money as "bridge financing."
  - Develop a payment schedule ,Have an exit plan.

Commercial Banks

...the heart of the financial market for small businesses!

- Short-term loans
  - Commercial loans
  - Lines of credit
  - Floor planning
- Intermediate and long-term loans
  - Installment loans and contracts

Cont'd

- Banks provide unsecured and secured loans. But to secure a bank loan, an entrepreneur typically will have to answer a number of question
  - *What do you plan to do with the money (credit facility)?*
  - *How much do you need?*
  - *When do you pay back?*
  - *After how long will you need it?*
  - *How will you repay the loan?*

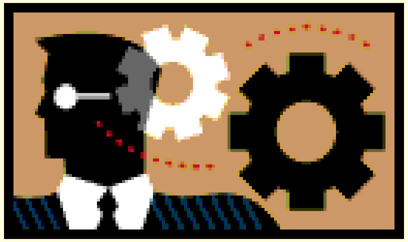
Cont'd

- Due to different reasons banks are **more cautious** in lending money since they cannot afford to incur more bad loans.

- Most bankers refer to the five Cs (Criteria) of credit in making lending decision.

Five Cs

***C**apital*



***C**apacity*

***C**haracter*

***C**ollatral*

***C**ondition*

Cont'd

- Capacity: The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan.

- Capital: is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail. In some cases, it may need to be at least 25% of the total amount needed to start your business.

Cont'd

- Conditions: Will the money be used for working capital, additional equipment, or inventory?
- Character is the general impression you make on the potential lender or investor. The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company.

Cont'd

- Collateral: or "guarantees" are additional forms of security you can provide the lender. If for some reason, the business cannot repay its bank loan, the bank wants to know there is a second source of repayment. Assets such as equipment, buildings, accounts receivable and in some cases inventory

Asset-Based Borrowing

- Businesses can borrow money by pledging as collateral otherwise idle assets – accounts receivable, inventory, and others
- *Advance rate* – the percentage of an asset's value that a lender will lend.

Cont'd

- Discounting accounts receivable

- **Inventory financing**

Internal Methods of Financing

- Factoring - Selling accounts receivable outright.
- Leasing - assets rather than buying them
- Credit Cards

Going Public

- Initial public offering (IPO) - when a company raises capital by selling shares of its stock to the public for the first time.

Successful IPO Candidates

- Consistently high growth rates
- Strong record of earnings
- 3 to 5 years of audited financial statements that meet or exceed standards
- Solid position in a rapidly growing industry
- Sound management team with experience and a strong board of directors

Advantages of "Going Public"

- Ability to raise large amounts of capital
- Improved corporate image
- Improved access to future financing
- Attracting and retaining key employees
- Using stock for acquisitions
- Listing on a stock exchange

Disadvantages of "Going Public"

- Dilution of founder's ownership
- Loss of control
- Loss of privacy
- Filing expenses
- Accountability to shareholders
- Pressure for short-term performance
- Timing