

Writing The Business Plan

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What is a Business Plan

- Document used to raise money, obtain credit, perhaps recruit management or directors
- Explains the opportunity in the market, product or service, and potential profits for investors
- Document for public consumption but claims to be private and internal
- Real internal business plan different, not for circulation

Common Characteristics

- **Business writing: few or no adjectives**
 - What is difference between ‘good’ and ‘very good’?
 - Avoid hyperbole “unique opportunity with fabulous returns on investment”
 - Stick to facts
 - Don’t use BLSH
- **Anything longer than 25-30 pages before appendices is too long unless you are seeking to raise more than \$50 million**
- **Don’t need to go into technical details in body text**
- **Clean, organized document with TOC, page numbers and headers**

Key Elements of a Business Plan

1. Disclaimer*
2. Executive Summary
3. The Company
4. Market Analysis
5. Competitive Analysis
6. Marketing Plan
7. Management Team
8. Financial Projections
9. Other Appendices

1. Disclaimer

- Business plan must state that it is an internal document for management use only, not seeking to raise capital
- Strong SEC rules regarding raising capital
 - Disclosure
 - SEC registration
 - Blue Sky laws
- Legal document for raising of capital is a placement memorandum. Need to add 50 pages of boilerplate and risk factors.

1. Disclaimer

- Disclaimer language
 - Not a solicitation to sell securities
 - Internal document proprietary to management of the company
 - Financial projections and investor returns are not guaranteed, and were not prepared in compliance with SEC rules regarding disclosure.

2. Executive Summary

- From 3-5 pages long including a financial summary
- Should clearly detail the company, investment proposition, market opportunity, product, management qualifications
- By end of page 1 reader should be able to say what company is about

3. Company and Operations

- Describes the Company, past accomplishments, and the general business opportunity: be it product, service oriented.
 - How many years in operation, shareholding structure, form of incorporation, place of business.
 - Past accomplishments – what the company has done to this point.
 - Business opportunity: what is the product/service, how the Company has an ‘unfair’ business advantage to enter the market and beat competition.

3. The Company

- You must explain in this section that there is some kind of unique opportunity, be it technology, management team, market focus, business process and so forth, that makes this company a winner.
- Explain your ‘uniqueness’ and what advantage you have over competition. Try to avoid hyperbole.

3. The Company

- Explain the business model.
- This is your opportunity to talk about how the business will work (retail vs. wholesale, stores, distributors, dealers, production plant and capacity, etc.).
- Set up a chart with milestones for the opening of new stores, staffing goals, plant completion and production.

4. Market Analysis

- Market sizing and identifying key market segments and customers is crucial to business plan:
 - Identifies size of opportunity and sets boundaries for business
 - Used to set and justify revenue projections

4. Market Analysis

- Define the market that you are going after
- How large is it? What is the total consumption for the products/services you will be competing with?
 - Few companies serve all segments in their market: healthcare, transport, etc.
 - Look at demands and requirements for each market segment.
 - *Cite independent research.* Be able to back up your figures.

4. Market Analysis

- Sometimes difficult to narrow down segments, information hard to find
 - Companies do not publish financials based on subsidiaries or market
 - Example: insulin device is not for whole health care market, just diabetics. To claim market size is all of health care is not defensible.
 - Trade journals and other resources vital
 - People analyzing the plan will do their best to find this information. If you are wrong, you are dead.

5. Competitive Analysis

- Need not be overly detailed: simply a run down of the major competitors in your segment
- Be able to explain how each approaches the market, talk about their products, their relative strengths and weaknesses, and their market share
- Don't discuss competition in scornful or disrespectful manner – be objective as to how they stack up to you
- Only discuss direct competition – can go farther afield in appendices

6. Marketing Plan

- Explain how the Company will roll out their products and services, what the exact approach will be and why you believe it will be successful.
 - Remember the 4 P's of marketing: product, place, price and promotion.
 - Be able to detail how your plan will work and why - advantages in price, quality, features, etc.

6. Marketing Plan

- Chart is useful here – show the progress of marketing efforts on a timeline, with the budget and the media to be used.
- Show you understand how to market to these customers and explain why you believe it will be successful.

7. Management Team

- Include bios of all key managers and directors of the company
- Point out highlights of career
- Use text format – one or two paragraph description of career and qualifications
- Resumes presented upon request or in appendix

8. Financial Projections

- Technically, should be the first appendix.
- Begin with sources and uses of cash, financial summaries and metrics, then move onto projected Income Statement, Balances and Cash Flows.
- Sources and uses of cash – amount of debt and equity capital raised, assets being added, start-up losses, and other costs for which additional capital is needed (R&D etc.).
- Financial summaries should include Revenues, Gross Profit, EBITDA and Net Income.

8. Financial Projections

- Metrics are key measures of profitability, activity, and leverage.
- Present yearly statements first, then detailed monthly statements for first two years.
- Common size (percentile) statements are a nice touch – allow reader to see how the business changes as it grows and matures.

Other Appendices

- This is the place to add other information you think is vital:
 - News articles about the industry or especially your company
 - More technical discussion of any proprietary technology you have
 - Letters from key partners or customers
 - More detailed discussion of competition

Other: Risk Factors

- Do I need to add section on risk factors?
- Generally, no, unless the investment opportunity is risky in an unusual way.
- Disclaimer should cover you.
- Lengthy risk factor sections are the purview of the PPM and IPO.
- A lawyer might disagree with me, but he probably would then offer to write it for you for \$10,000.

Other: Exit Strategy

- Only include it in the business plan if there is a clear and reasonable exit strategy – if you have identified potential buyers, etc.
- May wish to discuss strategies for potential exit, but not state that company will do anything with certitude.

Other: Exit Strategy

- Professional investors know what private equity investing is and want to know management is interested in a profitable exit
- Info about IPOs and M&A activity is helpful, but any exit is likely to take place in 3-5 years, by which time market could change considerably

Other: NDAs

- Should you ask for people to sign an NDA to read the plan? Probably not.
- No proprietary technical information given in plan.
- Only confidential information that could be relayed in plan would be about business process or market segment. If these are the only competitive advantages then there are low barriers to entry – a sign not to invest.

Conclusions

- Remember, terse is best
- Executive summary is critical
- Business plan gets your foot in the door – do not expect to have someone read it and then send you a cashier's check
- Beginning of long investment process

Questions?



Davidson & Company LLC

- Business and strategic planning, corporate finance and investment banking
- Clients include: venture capital funds, private equity investors, investment banks
- Industries: electronic equipment, agribusiness, pharmaceuticals, leasing, timber, software and high tech, real estate, film and music
- Consulted in US, UK, Russia and Ukraine
- Extensive Big 5 and venture capital experience

Pro Forma Financial Statement Creation

Presented By:
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Strategic Planning and Financial Forecasting

- A strategic plan is essential to any business, not just one seeking capital
- Business planning process starts and ends with quantifiable goals expressed as pro forma financial statements
- Importance of this exercise cannot be underestimated

Financial Forecasting

- Easy way and hard way
- Easy way: income statement, no balance, 'direct' cash flows
- Hard way: create balance sheet and cash flow statement that meet GAAP
- The secret: the hard way is easier

Presentation

- Presentation is important
- Clean, simple P&L, Balance, Cash Flows
- Create summary pages and do your own metrics and financial analysis

Presentation

- Monthly is no more difficult than quarterly or yearly, allows more subtlety, can be presented in quarters or years
- Set up basic assumptions and format, then can cut and paste to create additional years
- Should present at least the first two years in months, then by year or year by quarter.

Due Diligence

- Do your homework
- Be able to support all your assumptions
- GIGO – garbage in, garbage out
- Financial model not just for presentation, but should be a useful and flexible tool for business and strategic planning

Due Diligence

- **Best resources for information: your competitors**
- SIC codes and public information
- See how their businesses work and understand them. Your business will probably run along a similar model unless part of your plan means changing the whole business model (business process vs. product superiority)
- **Critically important – market sizing, segmentation, competition products, services, prices and value**
 - Where do you fit in value chain?

Income Statement

**Basic US GAAP
format:**

Revenues

Less: Cost of Goods Sold

= Gross Profit

Gross Margin (%)

Less: Selling, General and Administrative

= EBITDA **

EBITDA Margin (%)

Less: Depreciation

= EBIT

Less: interest and other expenses

= Taxable Income

Less: income tax

= Net income

Net margin (%)

Revenue Projections – Key Factors

- Market sizing and segmentation – foundation for revenue projection
- Industry research & competitive products
- Who has market share
- Things to watch out for: plant capacity, market penetration, market segmentation, precedents for customer acceptance, competitor reactions
- Type of customer – Gov't vs. consumer, etc.

Revenue Growth

- No such thing as universal expected growth rate
- Glaring errors: business plans with more production than capacity and more sales than market segment
- Have cogent reasons for growth and be able to defend them coherently

Cost of Goods Sold

- Should have your own calculations as to what goods will cost
- Look at your product and competitors, and see how their prices line up in terms of quality or features

Gross Margin

- = gross profit/revenues
- Key profitability measure
- Business is either low volume high margin or high volume low margin (McDonald's vs. engineering)
- High margin businesses with huge volume growth rates are suspicious: 'too good to be true'
- Projecting gross margins out of line with industry standards raises questions

Selling, General and Admin

- Projections can be based on both fixed and variable assumptions.
- Primary fixed expenses: salaries, office expenses, rent, utilities, telephone, insurance, etc.
- Variables include sales commissions, marketing and advertising.

Projecting S,G & A

- Payroll and staffing: have a list of major officers and expected compensation: CEO, CFO, CTO, CIO
- Accounting: controller, staff accountants
- Sales and marketing people
- Administrative staff
- Sales commissions: look at industry standards
- As company expands, so will payroll

Projecting S,G & A

- Rent: budget 400 sq. ft./office employee
- Telephone/internet: \$150/month/employee is reasonable
- Office expenses and supplies - \$50/month/employee
- Computer leases: \$35-\$50/month/employee

Projecting Marketing Expenses

- Marketing and advertising expenses: should vary with revenues
- Look at industry standards in terms of marketing \$ spent as opposed to revenues
- In early stages (first two years) you should know what you are going to spend and why
- Projecting revenue growth without increases in marketing expenditures is hard to support

Marketing As Growth Driver

- Common method of forecasting growth : marketing \$ spent per customer obtained
- Although this is not totally inaccurate, it can be scattershot
- Failure of dot.coms with Super Bowl ads
- Using a % of revenues to project marketing budgets is more accepted
- Have a coherent strategy

EBITDA

- Earning Before Interest, Taxes, Depreciation, and Amortization
- Roughly equals operating cash flow
- Finance guys love this number – you should learn to love it as well

Depreciation

- Calculated from fixed assets and capitalized expenses on the balance sheet
- Basic definitions: office equipment and furnishings, plant and mfg., capitalized R&D
- Easiest to use straight-line depreciation
- Computer and software – 3 years, office furnishings – 7 years, plant and mfg – 5 years, R&D – 5 years (or check)
- Approximate 4.5 years – 54 months straight line for all assets
- After year 3 new capex should equal depreciation

Interest Expense

- Calculated from bank debt on balance sheet
- Interest rates fluctuate – check with your local bank for small business loans
- Err on side of conservatism – your company isn't going to be AAA rated

Taxes

- Figure most often used: 40%
- New tax laws may lower corporate tax rate – ask your accountant
- Start-up losses turn into tax shields – a real asset that you need to track for use against future profits
- If you are raising outside capital you will probably have to have a C-corporation, not a pass-through S corp or LLC.

Projecting the Balance Sheet

- Easier to do than you think
- Only hard parts – projecting fixed assets, debt and equity capital
- Fixed assets, capital structure is key homework for the business plan anyway
- Working Capital projections are easy

US Balance Sheet Format

Assets

Current Assets:

Cash

Accounts Receivable

Inventory

Other Current Assets

=Total Current Assets

Fixed and Long-Term Assets

Gross PP&E

less: accumulated
depreciation

=Net PP&E

Other Long-Term

Assets

Total Assets

Liabilities & Owner's Equity

Current Liabilities

Trade Payables

Other Short-Term Liabilities

=Total Current Liabilities

Long-Term Debt

Other Long-Term Liabilities

Total Liabilities

Owner's Equity

Paid-In Capital

Retained Earnings

=Total Owner's Equity

Total Liabilities and Owner's Equity

Balance Sheet

- Why 'balance'? Because $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.

Cash

- In projecting balance sheet, use cash as a plug
- $\text{Liabilities} + \text{owner's equity} - (\text{all assets except cash}) = \text{cash}$
- This will track with the cash flow statement
- Keep debt and equity at 0 initially, and cash will show you exactly how much cash you need to raise and when

Working Capital Calculations

- Working capital is current assets and current liabilities
- Easiest and most accurate method – use multiples from the income statement
- Expressed in days of sales, days of cost of goods sold, or days of cash costs
- Ratios gained from competitors published financial information

Working Capital Calculations

- Example: Accounts Receivable (expressed in days of sales)
- Day of sales = yearly sales figure/360 or monthly sales figure/30
- Company projects sales of \$12 million for year
- Industry terms are net 45 days
- $\$12 \text{ million} / 360 = \$33,333$ sales per day
- Average 45 day terms means $33,333 * 45 = \$1.5 \text{ million}$ projected accounts receivable on end of year balance
- As sales go up, AR on Balance will also increase

Working Capital Calculations

- Other categories:
- Inventory – expressed in days of cost of goods sold (COGS)
- Trade payables – expressed in days of COGS
- Other short-term liabilities – days of S,G,&A expenses

Fixed Assets

- Know and list what you need for operations
- Remember capacity constraints – as business ramps up, plant may need to be added
- Include all office furniture, software and equipment
- Leased computers are usually off balance sheet

Fixed Assets

- Depreciation occurs every day – must be accounted for for each period and then added to accumulated depreciation
- Net fixed assets = gross fixed assets less accumulated depreciation
- Good practice - after year 3 capital expenditures should equal depreciation expense for period
- Addition of office personnel means more computers, furniture, phones, etc. These also need to be accounted for

Debt and Long-Term Liabilities

- Key part of your business plan – structure of capital
- Debt vs. equity?
- Start-ups have a hard time securing reasonable debt – no history, no collateral
- Be realistic: high interest rates paid monthly, balloon payments after 12 months

Equity Capital

- Start with no debt or equity, and by now your balance should show you almost exactly how much cash you need (the missing plug)
- Retained earnings from prior period + net income for this period less dividends paid = new retained earnings
- Don't project dividend payments unless company already pays dividends regularly or the shareholders are demanding them

Cash Flow Statement

- Exceptionally easy to do
- If you have income statement and balance sheet, you have cash flow statement already
- Don't need to generate any new numbers or make any new assumptions

Cash Flow Statement

Net income

Add back depreciation expense

Changes in working capital accounts

= **cash flow from operations**

Changes in fixed assets and other long-term investments

= **cash flow from investing**

Change in long-term debt

Change in paid-in capital

Less dividends

= **cash flow from financing**

Cash flow from operations + cash flow from investing + cash flow from financing

= net change in cash

Beginning cash + net change in cash

= ending cash

Cash Flow From Operations

- Investors want to know when cash flow will turn positive – they usually mean cash flow from operations
- “when will business be able to support own expansion?”
- Net income + depreciation expense plus working capital requirements
- Depreciation is a non-cash expense – needs to be added back

Changes in Working Capital

- All figures needed already projected on balance sheet
- If accounts receivable or inventories are growing, you are USING cash
- If Payables are growing, you are GAINING cash
- Prior period current assets less current period current assets (from balance sheet)
- Current period current liabilities less prior period current liabilities (from balance sheet)

Cash Flow From Investing

- Means purchases of fixed assets and R&D
- Can also mean investments in subsidiaries, stock market, or bonds
- Look at balance sheet – if gross fixed assets increases, then have used cash
- $\text{Prior period gross fixed assets} - \text{current period gross fixed assets} = \text{CFI}$

Cash Flow From Financing

- Tracks increases and decreases in debt and equity paid-in capital
- NOT retained earnings
- If you raise new debt or equity, you have positive CFF
- If you pay down debt, you have negative CFF
- From balance: current period LTD less prior period LTD plus increase in PIC = CFF

Total Cash Flow

- Cash Flow From Operations
- Plus Cash Flow From Investments
- Plus Cash Flow From Financing
- = Net Change in Cash
- Cash at beginning of period + net change in cash = cash at end of period (on balance)
- Check – this calculation should equal figure on balance. If not, you are forgetting something somewhere and need to hire a financial consultant

Main Metrics

- Nice to add a schedule with ratios investors want to see
- Liquidity Ratios: measure short term viability
 - Current ratio = current assets/current liabilities
 - Quick ratio = cash plus accounts receivable/current liabilities
 - Net working capital = Current assets – current liabilities

Main Metrics

- Activity Ratios: measures use of assets
 - Inventory turnover = $\text{cost of goods sold} / \text{inventory}$
 - Collection period = $\text{accounts receivable} / \text{sales per day}$
 - Fixed asset turnover = $\text{sales} / \text{net fixed assets}$
 - Total asset turnover = $\text{sales} / \text{total assets}$

Main Metrics

- Leverage: measures indebtedness
 - Debt ratio: $\text{total liabilities} / \text{total assets}$
 - Debt to equity ratio: $\text{long-term debt} / \text{owner's equity}$
 - Times Interest Earned = $\text{EBIT (EBITDA} - \text{depreciation)} / \text{interest expense}$
 - Cash coverage ratio = $\text{EBITDA} / \text{interest expense}$

Main Metrics

- Profitability:
 - Gross Margin = gross profit/sales
 - Net Margin = net income/sales
 - Return on Assets = net income/total assets
 - Return on Equity = net income/owner's equity

Questions?



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- Clients include: venture capital funds, private equity investors, investment banks
- Industries: electronic equipment, agribusiness, pharmaceuticals, leasing, timber, software and high tech, real estate, film and music
- Consulted in US, UK, Russia and Ukraine
- Extensive Big 5 and venture capital experience