



Several topics are of primary importance to the firm. Growth management, for example, is crucial for new businesses, starting in the form of start-ups, with the aim of growing in a relatively short time.

The company crosses several stages during its life, from the early existence as a start-up to the maturity stage, eventually followed by the end of business. All these stages are peculiar and demand different plannings.

The intervention of multiple sources of early capital, like angels, venture capital, and private equity, allows newborn firms to access the capital that cannot be granted through ordinary channels, due to the initial stage of the business.

In this view, planning and forecasting has a crucial role in that it ensures the appropriate agenda for the corporation, with a global and medium–/long-term view about the business development.

Good management of all types of business must rely on appropriate methodologies for planning and forecasting, including both standard and advanced models, developed for management perusal.

Planning and forecasting involves both quantitative and qualitative approaches that can be used together to extract the best possible expectation about the future performance of projects and investments.

After studying this chapter, you will be able to answer the following questions, among others:

- What are the features of a start-up, and how does the company look in its early stage?
- What are the types of investors that intervene at the early stage of a company, providing the first sources of capital to the firm?
- How can the life cycle of the firm be described, and how is growth management handled?
- What is the importance of planning and forecasting for a series of projects?
- What type of models are available for planning and forecasting?

The first section of the chapter is dedicated to the growth management of early-stage business, from the start-up to the intervention of early-funding agents. The second section focuses on growth management and the life cycle of the company. The final section aims at introducing the topic of planning and forecasting and its role in investment decision.

12.1 The Birth of a Business

Learning Outcomes

- Define a business start-up and the first stage of a business.
- Define rights for equity purchase.
- Explain how rights can be converted into stocks.

12.1.1 Business Start-Up

It is quite difficult to give a fair valuation of a company in its early stage, due to the absence of history and the relatively high probability that the company will not survive the first stage.

The profitability of a firm is at the basis of its valuation, and the ability to generate cash flows is crucial as well as the uncertainty related to these cash flows. This is not the case of start-ups which in some cases have high values even if they are not generating consistent cash flows (Murray and Vidhan 2003).

It sounds like a contradiction of the paradigm of corporate value, which states profitability is the key to value. However, there are significant differences between a start-up and a more mature company.

A young firm in fact does not have significant investments in land, buildings, or other fixed assets and seems to derive the bulk of its value from intangible assets and human capital.

This is why when valuing young firms, the analysts prefer to abandon tradition valuation models, more focused on the presence of tangible assets, for new methods that can be used to justify investing in young firms.

The world of business is populated by young entrepreneurs trying to implement an idea and turn it into a successful company. In some sense, the entrepreneurs provide the energy for economic growth.

The most vibrant economies in the world are those where these young entrepreneurs actively promote their ideas in order to gather initial capital and support from experienced colleagues and other companies.

As mentioned above, at the beginning of any entrepreneurial adventure, there is an idea. In some cases, there is nothing more than that, and the entrepreneur is convinced that he or she can fill an unfilled need among consumers (Bodie et al. 2005).

In other cases, there is already something more than just the idea on the table, and the idea has been already converted in some product or service, with limited earnings and low visibility.

Still others have moved even further down the road to commercial success and have a market for their product or service, with revenues and the potential, at least, for some profits.

Any investor willing to put money in a start-up will be asking almost immediately about the value of the company. Most deals are lost at this stage, because the entrepreneur is not able to provide such information to the investor.

In most cases they have no answer or even quote a very large number that is not supported by adequate financial figures, thus convincing the investor that they don't even understand basic economics.

Early-stage companies face a very difficult challenge in determining their initial value and supporting it with good arguments. The company at the beginning owns very few assets and serves few customers, making the task even more difficult.

The founders need money but aren't ready to give up majority ownership, yet the investor needs to have ownership quantified to rationalize a traditionally high-risk investment.

The actions of the early-stage entrepreneur should be based on consciousness and realism. There is no point to claim a very high value if nobody then wants to invest in the idea.

According to the major consultancy firms, the rules for successful valuation and investment collection for start-ups can be summarized as a sequence of practical suggestions.

First of all, physical assets must be valued, at a fair value (asset approach). Start-ups generally have only few assets, so it is very important to include all of them in the valuation.

Sometimes founders forget to include all the computer equipment they bought or upgraded to get the business started. From this point forward, the valuation gets more subjective (Holton and Keating 1998).

Very often most of the value of a new business is in the idea and consequently in the intellectual property. Having filed patents and trademarks is a very positive step, even if their value is not certifiable, especially if you are only at the provisional stage.

The patenting of an idea gives an important push to the overall business and raises a lot the interest of the investors. Patents, Internet domain name, and some trademarks give a competitive head start.

At the early stage of a company, as well as at later stages, the value given by professionals and skilled employees is very important. In this respect, it is also important, when asking an investor for the right amount of money, to monetize the unpaid efforts of any executive or founder.

If, for example, the management team has successfully built a company like this before and has deep domain knowledge, a sizeable premium for "strength of the management team" should be added.

Existing customers and contracts also add value to the company and are proofs of the profitability of the business. The contracts not yet signed should be weighted by some probability. Also it is important to highlight any recurring revenues, like subscription fees, that don't have to be sold from scratch each time.

The valuation on cash flows can be done by using the methodologies encountered in the previous chapters. However, for a start-up the best methodology seems to be the DCF approach. The discount rate typically applied to start-ups usually varies between 30 and 60%, depending on maturity and the level of credibility attached to the financial estimates.

The key point is that valuing a business at its start is mostly about the ability to calculate an NPV of the potential future revenues. This is normally done in the form of a projection.

When the start-up is at a more mature stage, an interesting model that can be applied to its valuation is the multiple of discretionary earnings. If the company has at least 2 or 3 years of operations and managed to pass the breakeven point, the model applies.

It is then possible to estimate the company's valuation by just multiplying the EBITDA by some target multiple which can be read on some industry average tables or derived from scoring key factors of the business.

The average investor aims at getting back a return at least ten times their original investment. Roughly speaking, for a promising company, they will estimate a fair future value on a 5-year time span and then divide that figure by ten to arrive at the current valuation.

An effective way to impress any investor is to come prepared with a proper analysis of costs. In particular, when the business is being nonprofitable, such an analysis allows to measure the net value of the business by calculating how much it could cost for a new effort to replace key assets.

The replacement value can be used to estimate the current market value of a company, when the cost approach is implemented. The investors in fact tend to focus on the funds needed for an investment and its potential return (Kotler and Bloom 1975).

As mentioned many times, company valuation is an art more than a science. Also it was shown how sometimes it is so hard to get the right inputs for implementing the standard valuation model. In those cases, it is necessary to look at comparable firms.

The market approach is particularly important for early-stage firms, and it is possible to find online investor sites with the relevant information on recent funding activity. If the relevant information is not publicly available, one should ask a business advisor to query some investor friends.

In case a self-made valuation seems to be very difficult to reach, it is also possible to ask for professional service from valuation consultants who know how to get a feasible price for the company.

The size of the market is also important, in that it affects the growth projections of the business. When both market size and growth projection are high, the firm is obviously worth more.

There is a premium on the valuation price which is called goodwill, and it is usually set for start-ups on a target between \$500 million and \$1 billion, depending on the level of initial investment required.

Another important aspect of initial valuation is the correct analysis of the market in terms of competition. Competitors and barriers to new entries in the business can affect the potential profitability.

Investors in fact look for a big enough window of opportunity for a company to generate profits. In general, if there are more than three similar competitors, that's a bad sign and will negatively influence the valuation.

On the other hand, if it is possible to show to the investors that the market entails severe barriers to entry for possible competitors of the firm, this will raise the valuation, giving exclusivity to the business.

In summary, it is possible to conclude that start-up valuations always start with real financial data which you should be ready to provide. The analysis then extends into many subjective areas.

Most of the above approaches are indeed not very useful, if the investor is not keen to perceive the information given by them. In fact, their approach is usually very pragmatic, and most of the nuances will be ignored.

Rather than exact valuation, it is important to give the feeling of the potential of the business. Following all the above points gives a sense of credibility which is crucial besides the acceptance of them by the investor.

12.1.2 Rights

Previous chapters showed how the firm can obtain equity financing through multiple channels, once the start-up has come to a more mature stage. It is now important to also understand the meaning and use of rights issuance.

The issue of new shares reduces the proportion of equity held by the existing shareholders. This is why IPOs often contain a provision in the form of a preemptive right in the firm's articles of incorporation.

Such a provision obligates the firm to first offer any new issue of common stock to existing shareholders. In case the preemptive right is not included, the firm has a choice of offering the issue of common stock directly to existing shareholders or to the public.

The direct offering of new shares to existing shareholders is called a rights offering or privileged subscription. The firm issues rights to the shareholders, allowing them to buy a specific amount of new shares at a specified price, within a certain maturity. The terms of the rights offering are evidenced by certificates known as share warrants. The warrants are often traded on securities exchanges or on OTC markets.

The mechanics of the rights offering starts with financial management addressing several points like the price per share of the new issue, the number of shares to be issued, the limit of shares (if any) to be bought for each shareholder, and the likely effect of the rights on the existing shares (McGahan 2004).

The rights offer begins as a general cash offer, with the only difference lying in how shares are sold. Basically, the existing shareholders are informed that they own one right for each share of stock they own.

After that, the firm must specify what the proportion of rights per share is, so to determine how many rights are needed to buy one share. The rights must be exercised by filling out a subscription form and sending it, along with payment, to the institution acting as the firm's subscription agent.

Once the rights offer is made, besides doing nothing and letting the rights expire, the shareholder has two options. It is possible to exercise the rights and buy some of the target shares or place an order on the rights sold.

The right issue is offered to all the shareholders listed in the firm's records and can be fully or partially exercised.

In case rights are transferrable, the subscribed shareholders can sell them separately, either privately or on open market. A rights issue to shareholders is generally made as a tax-free dividend on a right-to-share ratio basis.

It must be underlined that, given that the exercise of rights with related sale of shares to the investor generates a cash inflow for the company, the rights issue can be considered as a source of capital in an organization.

Several issues must be addressed when issuing rights, including the engagement of a broker to manage the process, finding the right subscription price, determining the optimal rights-to-share ratio, and checking the effects of the offer on the current shares.

As for the securities in an IPO, the rights can also be underwritten, with an underwriter taking care of the procedure, to guarantee that the funds sought by the company will be effectively raised.

The rest of the agreement is pretty standardized, and it is set out in a formal underwriting agreement. Typical terms of an underwriting require the underwriter to subscribe for any shares offered but not taken up by shareholders.

The underwriter at some point will have a right to terminate its obligations, if specific events occur. There could also be sub-underwriters that bear the risk of the issuance through a purchase of a portion of the shares (Porter 1980).

The rights often come with additional possibilities attached to them. For example, the so-called oversubscription privilege allows the investors to buy shares beyond the quantity allowed by the rights possessed, if there are still shares available.

The additional shares will be usually limited to a number that is not higher than the actual shares purchased through rights. In case the shares are not enough to fulfill all the oversubscription rights of the investors, additional shares will be distributed on a pro rata basis.

Example 12.1 Consider an investor having 1000 shares of some company for a total investment of 50,000 €. Stock price is therefore 50 €, and assume it did not change between date of purchase and date of rights issuance. If rights give a 1 to 1 subscription right, at an offer price of 25 €, the investor can buy additional 1000 shares of common stock at that price. By exercising the rights, he will pay 25,000 €

to buy the new shares, and the average cost of the total portfolio per share will then be.

$$\frac{(50,000 + 25,000)}{2000} = 37.5 \text{ €}$$

Although the price on the stock markets should reflect a new price of 37.5 €, the investor is actually not making any profit nor any loss. The right price will converge to an equilibrium price so as to match the new stock price. In many cases, the stock purchase right (which acts as an option) can be traded at an exchange.

Example 12.2 From the above example, consider the point of view of the company, which has 10,000,000 shares outstanding. Given the current price of 50 €, the total capitalization is 500,000,000 €.

If all the shareholders of the company choose to exercise their stock option, the company's outstanding shares would increase by 10,000,000, with a new market capitalization (given by the sum of old capitalization plus the cash received from investors exercising the rights) of.

$$500,000,000 + (25 \times 10,000,000) = 750,000,000 \text{ €}$$

The EPS of the investors would then be halved, if the company does not do anything with the raised money. On the other hand, if the equity raised by the company is reinvested, the EPS may be impacted depending upon the outcome of the reinvestment.

From a capital structure point of view, the issuance of rights offsets the dilution caused by the issue of new share. This is why generally the rights offering does not need to be approved by shareholders in case at least the 20% of outstanding shares is offered at a discount.

The investor can however have different reactions to a rights issue, because it sounds like choosing between either investing more cash into the share or being subject to the dilution of the existing shares.

For this reason, rights offering is not very popular among market participants, and it is usually used only as a last resource for the company, in case the investor demand is really insufficient for the company's needs.

There is no tax applicable to exercised rights, and the actual taxation is only on the sale of the security. The cost basis of the shares is "the subscription price plus the tax basis for the exercised rights." The holding period begins at the time of exercise, and if rights expire without being exercised, they don't count as a deductible loss.

12.2 Growth Management

Learning Outcomes

- Understand the life cycle of the firm.
- Define the short-term capital needs of the firm.
- Learn how to develop good short-term financial planning.

12.2.1 The Life Cycle of the Firm

Every company goes through several stages during its existence. Every step of the business life cycle involves different challenges involving different financing needs and sources.

Different strategies can be in fact associated to different possible future operations, for example, market penetration, customer retention, marketing, and business developing, among others.

It is therefore very important to know and understand the many different and consecutive steps that a company will have to make in order to grow and stabilize from a simple start-up to a well-established business.

Everything starts from an idea of an ambitious entrepreneur who thinks his innovation can be of interest for many people and therefore turn into a business. People in this stage want to start a business and like the idea of it, without committing to becoming entrepreneurs yet (Loughran and Ritter 2004).

The first step is to test the business idea, by conducting research on the industry sector of interest, and also grasp the feedback from family, colleagues, and friends. Also contacting industry specialists is a good idea. At this point the entrepreneur is able to determine whether the business idea is worth pursuing, and if so it will be the birth of your new business.

While surveying the market, it is important to test challenges as the idea profitability, the acceptance from the market. Also it is important to work on establishing a good business structure and find appropriate accounting management.

At a following stage, the business is tested, and the entrepreneur decides to start the related business. The work entails building the market and making the offers. There are no customers yet or just a few.

The company is legally formed, and it is an entity with full capacity. During this stage, products or services are tweaked according to the initial feedback from the first paying customers (if any) and market demand.

The business model must be created and shaped so as to guarantee a high profitability and meet the expectations from customers and investors. By adjusting the business model, it is possible to set the business on the right track.

At the growth stage, there is an already developed business plan, and revenues are growing. New customers and clients have been acquired, and the business is now running at a good pace, even if not at full speed yet.

The business line is clear, and there is no more doubt about its feasibility. Once the initial stage has passed, the generated revenues help pay for operating expenses and open up new business opportunities.

In the growth stage, it is not yet clear whether the business is generating net profits or losses. Competition in fact may prolong the breakeven point, especially when tuning is needed on the methodologies, sales and marketing model, and operation model. The main challenge is to deal with increased customers and revenues.

After a while, the growth may become much faster, to establish a phase of expansion for the company. The business is ready to expand and spread its roots into new markets and distribution channels.

The fairly huge volume of sales generates significant cash inflows that help expand the operations in order to capture a larger market share. The rapid growth stage takes advantage from the proven sales model, marketing model, and operations model set forth from your growth/survival stage. Increasing market competition is crucial at this stage (Quinn and Cameron 1983).

A further stage can be defined of cruising and comes when the entrepreneur is finally able to fully unleash the potential of the business, by having achieved the targets of growth set in the previous stage.

The business is now running at full speed, and all the teamwork and support for the daily operation is put in place. All employees and management can now focus on their core competencies, or if they don't, they have a specific plan in place to get those resources.

The final stage is at maturity of the business, when the market has been dominated for several years and no more or little growth is still possible. The option at that stage is therefore to take a step back toward the expansion stage or to think of a possible exit strategy.

Every stage of the business life cycle brings new or pre-existing challenges. Solutions that may have worked for one stage may not work in another stage, which is why you should always adjust your business plan and operations accordingly.

Every stage is characterized by the need of specific sources of capital, to help face the challenges for the business. It is therefore very important to have proper accounting management, in order to constantly monitor the finances.

The monitoring of the financial situation of the company is also a good way to understand at what stage the company currently is. Details about the current situation of the company can help to face current challenges and forecast the upcoming ones.

The entrepreneur can undertake several actions to promote the business. They can speak in public or publish books. Other planned solutions can involve the sale of the brand or franchise, if the old business model is not valid anymore.

After the last stage is initiated, the natural end of the company comes naturally as a final closure. There can be several reasons for the entrepreneur to put an end to the adventure and various possible actions to be undertaken.

For example, there might be a loss of demand due to a competitor unexpected boost in market share, resulting in the loss of revenue due to lost market share. Also, it can happen that a company may lose important workers or managers.

In general, such a series of unexpected downturns can push the business backward of many of the above analyzed stages. It may also hamper their ability to deliver solutions to their customers or clients.

In some cases, the entrepreneur is just interested in a new adventure and decides to sell the business to start another. It is a choice, and some entrepreneurs specialize in multiple businesses. For some others it just happens, for many possible reasons.

Moving through stages is also possible. Sometimes the business is maybe at growth stage, but new opportunities arise, and new funding allows for significant changes that bring the business back to previous stages and start again (Rink and Swan 1979).

Much more difficult is to move forward skipping one or more of the stages, unless a very lucky coincidence happens that brings unexpected resources and visibility to the business and accelerates its progression.

It is hard for a serial entrepreneur to be identified in a stage, given that the companies he is running are probably not synchronized on the same stage. Businesses are at different levels of growth.

The individual businesses may have different needs than the entrepreneur, and it is usually the case that a company brand is disjointed from the entrepreneur's brand. It will then be necessary to separate what the business needs for growth versus what the entrepreneur needs for growth.

12.2.2 Short-Term Financial Planning

Companies need to meet budget and investment goals. This is why they develop short-term financial plans, which have a higher degree of certainty compared to long-term plans. Such plans can be therefore amended as financial and investment goals change.

Short-term cash flows of many companies are heavily hit by the elements of their working capital. These elements generally include raw or finished inventory, debtors, creditors, and cash.

There are cases where the variability in working capital creates large deficits that put the business at risk. Differences in cash cycles and account payables determine the above mentioned discrepancies. Recall that the accounts payable cycle is the time a company takes to pay for its inventories and the cash cycle is the time debtors take to pay for products.

Cash shortages occur for different reasons, like aggressive marketing policies allowing debtors to delay payments. Such a policy could be harmful to the finances of the firm, in some cases (Delurgio 1998).

In case of severe cash shortages, it becomes necessary to proceed to a cash flow forecast, in order to estimate the total cash flow collection and payment during each period, in different scenarios, from the worst case to the best.

The analysis involves knowing the difference between the total collections and total payments to ascertain whether there is a deficit in any quarter of the year. For each cash inflow and outflow item, you must account for all relevant increases and decreases.

The shortage in short-term funds can be covered through other short-term measures. For example, current liabilities can be increased, through negotiation of longer payment terms. Also the sale of certain unwanted assets and discounts to encourage debtors to make quicker payments are useful tools.

The short-term planning and forecasting begins with the estimation of future cash flows (FCF) of the firm. The analysis allows to determine whether a surplus or a deficit of cash will occur in the near future (Dickinson 2005).

Moreover, the management of the firm needs to assess whether the imbalance will be temporary or permanent, in order to determine what the impact on the firm's long-term financial decisions will be. Overall, short-term planning focuses on the cash surplus/deficits that are temporary. Short-term analysis is usually done at quarterly intervals.

One of the factors that affect the short-term cash of a firm is seasonality, defined as the seasonal tendency of cash flows to be high due to high sales in some months and low due to low sales in other months.

Some businesses generate so much cash during the favorable months that they are able to carry them during the bad months, therefore not experiencing any emergency in terms of cash flows.

Seasonality brings up two main issues. First of all, if it is true that the sale price follows the sales proportionally, the same is not true for the costs, which remain stable over time.

Moreover, the net working capital changes are more pronounced. Tracking seasonalities in the firm can bring to light patterns of occurrence giving the firm ample time to secure financial help during a deficit period.

Negative cash flows occur when there are specific circumstances that hit the firm and the cash flows get a temporary negative sign for some reason. The phenomenon relates to seasonality, and it creates temporary short-term cash needs. A common industry example of a negative cash flow shock is if a piece of machinery breaks and must be replaced.

On the other hand, positive cash flow shocks are also possible, and even if it is something desirable, it creates a short-term financing imbalance. A new expansion can create increased revenues but may create deficits beforehand due to increases in marketing expenses and capital expenditures.

Capital markets are not perfect, and they are characterized by frictions like transaction costs and other sources of disequilibrium. Firms can increase their value by adopting a policy that minimizes transaction costs.

According to the matching principle, the firm should finance its short-term cash needs with short-term debt and long-term cash needs with long-term sources of funds. The principle comes into play in the above situation which requires matching the maturities of the assets and liabilities.

The concept of permanent capital indicates the amount of capital a firm must keep investment in short-term assets in order to grant continuity to its daily operations. It is therefore a description of a long-term type of investment.

Following the matching principle, the firm should finance this long-term debt with long-term financing. This long-term financing would have lower transaction costs than short-term sources of funds.

The other type of working capital is the temporary working capital, calculated as the difference between the current level of short-term investments and the permanent

working capital needs. It represents short-term needs and should, as the matching principle states, be funded by short-term debt.

Another choice for the firm is to implement aggressive financing policies, by financing almost all the working capital needs through short-term borrowing. Even if this gives an advantage in terms of term structure rates, there are some issues related to it.

The short-term debt savings is in fact mostly offset by the risk that the firm will have to refinance the debt in the future at a higher rate. This results in the rise of the equity cost of capital in order to offset any benefit from the lower borrowing rate.

Such a policy is useful in case the market is not perfect, and there are agency and transaction costs. The short-term debt is in fact less sensitive to the firm's credit quality than the long-term debt.

It follows that the value of the short-term debt is less affected by the actions of the management or the information hitting the market. The funding risk is therefore lower, and the company should be able to refinance itself with external capital.

Opposite to the aggressive financing policy, a firm can also adopt a conservative financing policy. Such a policy implies that no short-term financing is used; it is just used very sparingly to meet peak seasonal needs.

Short-term financing for a firm primarily comes in the form of bank loans, especially when the business is small. Bank loans start with the signing of a promissory note, stating the amount of the loan, the maturity, and the interest rate.

The simplest form of loan is the single, end-of-period payment loan, which requires the firm to pay an interest on the amount borrowed and the principal all together in a lump sum at the end of the borrowing period.

The interest stated can be either a fixed or variable rate. A variable rate is usually compared against the prime rate. The prime rate is the rate banks charge their most creditworthy customers.

Another popular bank loan is the line of credit, which does not represent a proper loan but the possibility for a firm to borrow any amount up to a stated maximum. The firm can then choose to draw upon the limit of credit offered, when needed. Firms use lines of credit to finance seasonal needs. An uncommitted line of credit is an informal agreement that does not legally bind the bank to provide the funds.

In a committed line of credit, there is a binding legal agreement obligating the bank to provide funds to the firm regardless of the financial condition of the latter. There are provisions about restrictions to be fulfilled by the firm (Hopp and Spearman 2001).

A revolving line of credit is a committed line of credit, which a company can use as needed, that is a solid commitment for a longer period of time. A revolving line of credit with no fixed maturity is called evergreen credit.

A bridge loan is a type of short-term loan which is commonly used to cover a gap of funding in the short run, until the firm can arrange for a long-term loan. There is a fixed discount rate, and the borrower must pay the interest in advance.

Loans are always accompanied by some fees that are related to the origination and the stipulation of the agreement. Commitment fees are associated with a committed line of credit increase of the effective cost of the loan to the firm.

A loan origination fee has to be paid for the credit checks and legal fees related to the origination of the loan. The firm pays this fee at loan initiation, which reduces the amount of usable proceeds that the firm receives, resulting in an additional interest charge.

Sometimes the bank requires a compensating balance requirement, to reduce the loan proceeds available to the firm. The firm is assumed to own a percentage of the loan amount in an account at the bank.

Most banks require that this balance be held in a non-interest-bearing account, but others allow the balance to be held in an account that pays a small amount of interest to offset pay of the interest expense of the loan.

Commercial paper represents a popular source of short-term funding, in the form of unsecured debt normally used by large firms. It is a normally cheaper source of short-term capital compared to the bank loans.

Direct paper involves the firm selling the security directly to the investors, while the dealer paper is sold to investors in exchange for a spread (fee) for their services. This spread reduces the proceeds that the issuing firm receives, resulting in a higher cost.

Business can get short-term financing with a secured loan, a type of corporate loan in which specific assets are pledged as collateral.

Pledging of account receivables is another option for the firm, where the lender screens the invoices representing credit sales of the borrowing firms. The lender can then decide to accept them as a collateral to the loan and give it.

The amount lent to the firm usually corresponds to some percentage of the value of the accepted invoices. If the borrowing firm's customers default on their bills, the firm is still in debt to the lender (Harrigan and Porter 1983).

Another type of loan is the factoring of accounts receivables in which the firm directly sells its receivables to the lending entity, in exchange of the amount due from customers, who are instructed to then pay to the new creditor.

If the deal is arranged with recourse, the lender can seek payment from the borrower should the customers default on their bills. When the deal is without recourse, the lender's claim on the borrower's assets in the event of a default is limited to only explicitly pledged collateral.

A floating lien is an agreement where the full value of the firm's inventory is used as a collateral for the loan. It represents the riskiest form of loan from the point of view of the lender in that the value of the inventory is reduced as inventory is sold. Therefore, this type of loan bears a higher interest rate than the next two discussed. A trust receipt loan is also pledged by the firm's inventory, but in case of sale of the inventory, the proceedings are forwarded to the lender in repayment of the actual loan.

12.3 Planning and Forecasting

Learning Outcomes

- Learn the basic planning rules.
- Explain how planning are forecasting.
- Define and explain the strategic planning process.

12.3.1 Basic Planning Rules

Planning is an important component of good management and governance. It helps keep the company in line with the needs of the community and contributes to organizational stability and growth.

The firm must establish a basis for monitoring the progress of the business, focusing on results and impact. Good planning allows an organization to look into the future in an orderly and systematic way from a governance perspective.

Through strategic planning, the board sets policies and goals to guide the organization, providing the executive managers with a clear focus for program implementation and agency management.

Many organizations are forced by the investors to set priorities, organize work, and assess progress through an annual program of some kind. Most groups find it practical to define objectives for a 12-month period and to design strategies and programs to meet them.

Organizations can define their vision about the future operations of the business through a detailed plan, so as to determine systematically how to reach targets, understand obstacles, and figure out ways to overcome them (Doyle 2008).

Planning relies on organizational stability, and some confidence in the future of the business is needed. It must be the case that the key staff and its board leadership will continue to be affiliated with the organization, so that they have the time to plan.

In an unstable organization, the management may end up being fully employed in the operations, which means that they would be using every minute to carry out functions required for survival.

The agreement on some kind of planning starts from the consensus about the mission statement and the organizational goals of the company, which are a crucial basis for long-term planning.

Planning is sometimes difficult when the organization is very young or the leadership is new, therefore lacking a sense of the community and the understanding of the broader external environment.

In general, the longer the term of the planning, the more stable the organization should be, with the involvement of an organized, serious effort which takes time and energy.

Long-range planning is defined as the process used by the management of a company to determine the corporate objectives. It gives a view of how the company should look at the end of a specified period of time.

The planning horizon normally ranges from 3 to 5 years, and the period is filled with a series of multi-year goals and objectives, defining what the organization wishes to accomplish.

Goals are defined in terms of program development, tasks, and the timeline for achieving them. Long-range planning is based on forecasts of future environmental and internal conditions and plans how the organization can function within them.

Compared to operational short-term planning, the long-term planning is necessarily less precise and specific. It is developed as a more general framework with much wider objectives.

Operational planning in fact generates a work plan with detailed annual objectives, tasks, methods, timelines, and responsibilities. It is then focused on specific objectives and timelines rather than general strategic planning.

Some differences also exist between long-term planning and strategic planning, with the latter being a comprehensive process stating goals to achieve and how to reach them. Included are measurable goals which are realistic and attainable but also challenging.

Strategic planning implicitly states that future aspects of the business can be created or influenced by the firm. It is an ongoing process of self-examination, done by challenging difficult choices and prioritizing tasks (Hill and Jones 2010).

Strategic planning is therefore different from both short-term planning and long-term planning in that it is a dynamic and evolving process, taking into account the internal and environmental changes that affect the business.

It is a tool for organizing the business based on projections of the desired future, and it is necessary in order to define the road map of an organization from the actual point to a range of years in the future.

The plan must be simple, written, clear, and based on the real current situation and have enough time allowed to give it time to settle. It should not be rushed. Rushing the plan will cause problems.

As a plan, it must resemble all the thoughts and ideas of those who develop it and be flexible and practical, in order to be open to changes when needed. It should follow up after discussions and meetings about the overall structure of the document.

The implementation part is also important, and every unit within the organization should accept the plan, agree to its direction, and implement specific actions. Employees must work with team spirit in order to effectively and efficiently implement a plan.

12.3.2 The Process of Strategic Planning

The strategic planning process can be defined by many different models and involves several action steps. One approach assumes a cooperative effort between board and staff.

A strategic planning committee of board members and staff can be formed, for the effort. The following part of the section describes the several steps involved in strategic planning, along with some suggested approaches for carrying out each step. Frequently, some of the steps occur before the strategic planning retreat. First of all, there must be an agreement on the process, through a board meeting or other formal happening with key employees and external stakeholders.

Such a preliminary meeting aims to develop an understanding of the nature of strategic planning and the potential value added to the firm. Common goals and strategies are set in order to resemble a common vision.

Doing strategic planning comes at a cost, given the amount of resources involved, from staff to time. On top of that, one should consider the opportunity cost of the use of time for productive operations.

It would be quite difficult or unwise to enter into a strategic planning process if the business is in crisis or is financially or organizationally unstable and until the immediate problems and needs have been successfully addressed.

As mentioned above, not all businesses are ready for a long-term type of plan. In some cases, a good short-term plan to drive the company until the point of affording a longer plan could be the solution.

Only when strategic planning seems to be the right solution can the steps involved in implementing be considered. Processes and responsibilities for each step have to be established (Grullon et al. 2002).

It is common in medium–large-size firms to create strategic planning committees or task forces, with selected participants. The members must be committed to the process and willing to employ enough time to the planning effort.

Managers at different levels are usually included in the coordinating group, sometimes together with some representative of the support staff. In some cases, the group may also include representatives of stakeholders or older managers.

The strategic planning process may also be supported by external forces, and the group may decide to hire consultants to help with the preparation of the document. When internal staff is involved, their workload is normally adjusted to take the new task into consideration.

One of the first moves to make is to scan the environment in which the business operates. The relationship between an organization and the external environment it operates in is of crucial importance for the right development of the business.

The scan usually includes identifying and assessing opportunities and threats in the external environment. On top of that, there is an internal component to assess organizational strengths and weaknesses, in a process called SWOT analysis.

Both threats and opportunities must be identified in the target community and the broader environment. This allows to adopt flexibility in the management of the business, so as to face every issue properly.

Issues to be considered include the trends in the community and the political and technological forces. Also demographical and social changes, as well as the economical trends, are important to look at.

The needs of the community must be the focus of a careful observation, given that these needs have to be addressed by new products and services. This process allows

to identify potential clients and beneficiaries of the organization's services and advocacy.

It is also important to consider the opportunities and the challenges related to the selection of fund providers, as well as keeping an eye on competitors operating in the same environment, which could compete for funding as well.

The exploration process is normally sorted by using marketing tools like interviews, focus groups, distance surveys, and informal discussions with clients and other community residents.

About the internal part of the analysis, the strengths and weaknesses of the organization must be carefully assessed. In order to do so, a number of components or approaches may be included.

The various aspects of evaluation of the internal performance include the human resources and the methods and practices, together with the outcomes achieved. When hard data are not available, a perceived performance can be partially determined through asking clients and stakeholders.

Identifying the critical factors of success for the business is also very important, even if such a task is normally not included in a strategic plan. It is about forecasting what factors will be important for the future development of the firm.

Factors like the relationship with the outside community, the available resources, and the planned strategies, as well as the managerial structure and the employees' behavior, can make a difference.

The organization might want to review or formalize organizational values and operating principles. Some organizations have written values and principles which guide their decision-making and their ongoing activities.

There are normally key issues arising from an analysis like the one described above. They could be specific strategic issues or issues to be addressed by setting priorities in terms of time and importance.

When there is no overall agreement about what to prioritize, it is useful to explore the issue priorities to identify opportune choices. In order to do that, for example, the board and staff might be asked to identify strategic issues from the environmental scan.

Issues can be many and involve the need to assess specific needs of a part of the community or the community as a whole. There could be also the need to expand the community of reference.

In particular, the choice could be to expand from the neighborhood to the entire city or county. Agreement would be also needed on whether the organization should consider merging with another group.

The first three steps should lead to an overall agreement about the issues or choices to be considered and decisions to be made as part of the strategic planning process.

After those steps, the organization is then ready to develop a strategic planning retreat agenda and schedule a retreat or a series of shorter meetings.

The overall agreement must be there also for the corporate values and mission, and the consensus about the rationale for the organization to exist should be full. The goals and outcomes, as well as contracts and grants, should be clearly defined.

The strategic plan should start from common organizational core values, a community vision, and the clearly stated mission of the company. These values, mission statement, and vision usually appear as an integrating part of the whole strategic planning session to be reviewed by the strategic planning committee or task force before the board's approval.

The vision about the community should lead to the development of a shared vision for the business, by assuming that such a vision may be dependent upon a shared vision of what society should become.

The process goes through defining the perspective of where the company wants to be in a few years and after that defining the strategies to be used to get there. The perspective should involve both broad terms and specific descriptions.

The task can also be assigned to diverse small groups, and the approach is useful, and then the board is illiterate or uncomfortable to speak the same language, being a multiethnic entity.

In this case the groups can pretend they want to be able to communicate the major corporate accomplishments to external people, in a few years from now. They can then share their vision with the full group and use it to develop a shared vision.

In doing so the small groups can put themselves into the shoes of either stakeholders or managers of any level, to develop statements about the company as they would envision in some years. The single visions are then merged into an aggregate one.

The common vision about the organization must be translated into key goals, in the form of statements describing the company. The goals can cover a wide range of categories like program, resources, relationships, and institutional development.

There must also be an agreement about the strategies to use to achieve the goals. Current and new programs must be emphasized, and the strategies should relate to specific goals in the list. The board needs to provide a broad view to guide this effort, while the planning group or staff can do much of the detailed analysis.

One possible approach is to look at the SWOT analysis results and use them to identify changes to be made in the current strategies. This could involve the identification of new strategies as well as changes in the priorities.

It is normal that the planning group presents several possible scenarios to the board, leaving to the top managers the decision about which one to use. Based on the decisions made using these scenarios, strategies will be determined.

The selected strategies should add value to the reach for goals and should be appropriate. Moreover, they should be feasible and acceptable in terms of their fit to the ideas of managers and stakeholders.

There is also a cost-benefit trade-off that must be addressed, and the benefits from applying a strategy should be to justify the costs in time and other resources. Related to timing, it is important that the strategy implementation is done at the right time, given the environmental conditions.

All the above steps lead to the completion of a preliminary draft resembling the results of the newsprint and notes from the retreat, the results of the environmental scan, and other relevant materials. Once a draft has been prepared, the next step can begin.

The implementation begins after all the objectives have been addressed. A specific work plan is needed which recognizes that strategies must reflect current conditions within the organization and its environment.

Detailed objectives are then uncommon to develop in a plan. It is usually the case for 1 or 2 years, and then the planning becomes more dynamic. However, some action plans are needed. Annual program objectives should be time-based and measurable. The annual plan may be a part of the strategic plan or may be an annual addendum to it.

Developing objectives and annual work requires input from both the board and employees. The staff usually takes a major responsibility for program-related goals and objectives once the board has defined goals and objectives related to governance.

The written strategy must be then finalized summarizing the decisions taken in the strategic planning process. The output of each major step should be included, and the format is normally free.

The final step is the monitoring and the eventual modifications of the strategy, due to changes in the external environment or the company itself. Progresses should be regularly monitored, and strategies should be revised if needed.

12.4 Summary

The genesis of a business normally starts from the early-stage start-up status and then continues like explained in previous chapters through several types of investment sources and companies.

On the other side, once the capital is set, there is also the opportunity for investors to benefit from rights issued by the company, in the form of options that allow old and new investors to purchase shares of the capital.

The management of growth of the firm is itself an interesting task, because it covers several stages of the firm's life and implies the understanding of the actual status of a company.

Several stages correspond to several times of the company's life, from birth to maturity, and the related management should be fitting the situation of either strong growth, or steady state, or decline of a business.

Planning is an important component of good management and governance. The firm must establish a basis for monitoring the progress of the business, focusing on results and impact.

Several stages are involved in planning and forecasting for firms. The strategic plan should start from common organizational core values, a community vision, and the clearly stated mission of the company.

The process goes through defining the perspective of where the company wants to be in a few years and after that defining the strategies to be used to get there.

Problems

1. What are the facts that affect the valuation of a young firm?
2. What type of assets are the most valuable ones for start-ups?
3. What is the role of stakeholders in the value of a start-up?
4. Describe the typical preemptive provisions contained in an IPO.
5. Describe the process for rights offering.
6. Consider an investor with 10,000 shares of some company for a total investment of 750,000 €. Stock price is therefore 75 €, and assume it did not change between date of purchase and date of rights issuance. If rights give a 1 to 1 subscription right, at an offer price of 37.5, the investor can buy additional 1000 shares of common stock at that price. What will be the average cost of the total portfolio per share after exercising the rights?
7. Consider the point of view of the company in exercise 1, which has 25,000,000 shares outstanding. Given the current price of €75, what is the new capitalization of the firm?
8. Describe the stages in the life of the firm.
9. Explain how short-term financial planning differs from long-term planning.
10. Describe the factors that affect the short-term cash of a firm.
11. What are the various types of loan available to finance short-term corporate cash needs?
12. Explain the features that good planning and forecasting should have.
13. What are the typical factors that affect financial planning?

References

- Bodie Z, Kane A, Marcus AJ (2005) *Investments*, 6th edn. McGraw-Hill, New York
- Delurgio S (1998) *Forecasting principles and applications*. Irwin/McGraw-Hill, New York
- Dickinson V (2005) *Firm life cycle and future profitability and growth*. Working paper. School of Business, University of Wisconsin, Madison
- Doyle P (2008) *Value-based marketing: marketing strategies for corporate growth and shareholder value*. Wiley, New York
- Grullon G, Michaely R, Swaminathan B (2002) Are dividend changes a sign of firm maturity? *J Bus* 75(3):387–424
- Harrigan KR, Porter M (1983) End-game strategies for declining industries. *Harv Bus Rev* 61(4):111–121
- Hill C, Jones G (2010) *Strategic management theory: an integrated approach*. Cengage Learning, Mason
- Holton WJ, Keating B (1998) *Business forecasting*. McGraw-Hill, New York
- Hopp WJ, Spearman ML (2001) *Factory physics*, 2nd edn. Irwin/McGraw-Hill, New York
- Kotler P, Bloom P (1975) Strategies for high market-share companies. *Harv Bus Rev* (6):53
- Loughran T, Ritter JR (2004) Why has IPO Underpricing changed over time? *Financ Manag* 33(3):5–37
- McGahan A (2004) How industries change. *Harv Bus Rev* 82(10):86–94
- Murray FZ, Vidhan KG (2003) Testing the pecking order theory of capital structure. *J Financ Econ* 67:217–224

-
- Porter M (1980) *Competitive strategy: techniques for Analyzing industries and competitors*. The Free Press
- Quinn RE, Cameron K (1983) Organizational life cycles and shifting criteria for effectiveness. *Manag Sci* 29:33–51
- Rink DR, Swan JE (1979) Product life-cycle research: a literature review. *J Bus Res*:219–247