2. Hail Cheeser!

A. Define the term overdrafts.	2

The withdrawal of an amount of money from a bank account that is greater than the amount currently in the account, in return for a fee.

B. Explain two appropriate forms of external finance that Manuel could use.	4

- <u>Loans:</u> The interest rate will likely be high compared to larger businesses, but he may be able to repay the interest because he expects a bump in sales at the new location.

- <u>Share capital:</u> He's already considering selling shares as a private corp, and this is money that doesn't need to be repaid. Floating shares on the stock market is not a realistic option at this point, so this should not be accepted. Venture capital and business angels are also forms of share capital that could reasonably be explained here.

- <u>Overdrafts:</u> It's quite possible that if demand really does jump the way that he expects, that overdrafts in the first few months may help him to get through any periods in which he needs more cash to pay his rent or get up and running.

- <u>Trade credit:</u> would help him with liquidity, but it may not be a ton of money that he gets from his suppliers. Still, if he's considering that retained profit and overdrafts may work, then it's reasonable to think that perhaps trade credit could allow him to start up the new location too.

- <u>Crowdfunding:</u> The student needs to be careful in how they describe this one, because there are different ways of doing it. In the US at least, the best known platform is Kickstarter, and a lot of new businesses there basically presell a good that customers will then receive if the firm gets enough funding to meet their goals and start producing. In the case of cheese, that doesn't make much sense, unless they get a gift card or something like that. Alternatively, Manuel could seek donations, use a platform for peer to peer business loans, or even sell shares of ownership through crowdfunding, though the latter then gets more complicated.

- <u>Business angels:</u> It's conceivable that an angel may be interested (if family/friends are interested in investing, then maybe it's not a stretch to suggest a business angel could be appropriate), but the case study just doesn't give an indication that he has a strong enough financial outlook that an angel would be interested in funding him. I'd want a good explanation from the student on this one.

I would not accept microfinance. It's not going to get him the amount of financing he needs, and if he grew up in a family that could afford foreign vacations and who could give him a business loan, then microfinance is not targeted at people like him.

C. Explain one advantage and one disadvantage of Manuel using internal sources of finance to open the new location.	4

Advantages may include:
- Manuel would retain full control (including profits) over his business
- It does not involve him paying interest to anyone, so it's the cheapest form of finance - It doesn't require him to go through lengthy procedures such as filling out loan applications or going to investor meetings to convince people to buy shares

Disadvantages may include:
- Realistically, he may not have the ability to do things like use retained profit (may not have enough), use his personal finance, or sell assets (doing this could really hurt his operations) - If he's investing his own money, he may just be increasing the potential for serious financial problems if business doesn't pick up the way that he expects
- Even if he could afford to use internal finance, external forms of finance would almost certainly be larger in value and thus better enable him to invest more into the business than he could on his own
- External finance could also come with someone else's expertise (family/friends who may have knowledge to share)

Accept other reasonable answers as appropriate.

D. With reference to Hail Cheeser!, explain the difference between profit and retained profit.	4

Profit is revenue minus costs. That profit then may be retained in the business or it may be distributed to owners of the business. *Retained profit* is profit that is left after all costs have been paid as well as any deductions for taxes and dividends. The remainder is then reinvested into the business.

E. As a small business, explain two challenges for Hail Cheeser! in getting funding to open a new location.	6

- He's betting on a big sales boost at the new location, but that is not a guarantee, so lenders and other financiers will want to look at his current profits, which do not seem impressive. His track record in business is also not long, and so he may not get debt or equity finance at all from an institution.
- To go along with this last point, the smaller and newer the business, the higher the interest rate a bank will typically charge, and that's assuming that a bank will even give him a loan in the first place.
- There are some forms of finance that are difficult or outright impossible for him because he is so small. For example, a business angel probably isn't going to want to even meet with him because the profit potential doesn't seem like it'd be high enough, nor would a VC firm (which isn't on the syllabus anymore, but I still think students should know about when we teach equity finance in general).
- He doesn't have much in the way of retained profit or personal savings to sink into the operation, and he probably doesn't have any assets that he can realistically sell. Manuel's profits are his income, and it's probably too hard for him to put the extra $15k he needs for the business into it out of his own savings, especially since most of it is in a retirement account.

- Larger businesses might be able to get a higher credit limit on credit cards, but credit card companies are likely to look at Manuel's modest cash flow and only give him approval for smaller credit limits.
- He probably has fewer connections with financiers than a larger organization would.

Accept other reasonable answers as appropriate.

F. Recommend one of the sources of finance that Manuel is considering for his relocation to the waterfront market.	10

Students should show understanding of all three financial options, while making a clear recommendation for one based on the case study and logical analysis.

Arguments in favor of a <u>small business loan</u> may include:
- He's not giving up any equity, and as a result he not only retains all of his own profits, but he does not give up any decision making authority either.
- It would allow him to take out enough money that he probably wouldn't have to turn to another source for a while. If taking out overdrafts, for instance, he'd perhaps have to repeatedly go back for more, and he'd incur a fee every time, plus potentially really high interest rates. He also hasn't demonstrated that his retained profits are high enough at the moment, so there's a good chance that he'd have to delay the move until a time when retained profits are sufficient. With a loan, he could make the move sooner.
- There may be some kind of government entity like a Small Business Administration that he could go through that would give him access to cheaper loans than he could get on his own, as long as he meets the association's qualifications.

The major drawbacks for loans are that he needs to repay the money with interest, and the bank would also expect some kind of collateral from him, which could be a significant asset like a car or a home. This is all assuming that he could even get a loan, which is a very big question without a clear answer.

Arguments in favor of <u>personal savings and retained profits</u> + <u>overdrafts</u> may include: - He's not giving up any equity, and as a result he not only retains all of his own profits, but he does not give up any decision making authority
- He doesn't pay any interest on the use of personal savings or retained profits. - Doesn't have to go to any investor meetings or through the loan approval process, both of which can be very difficult and time consuming

There are several major drawbacks here though, especially that it's really not clear that he even has enough retained profit and personal funds to do this, so he's relying on increased retained profits from the new location, which may take time to materialize on a scale that is sufficient to fund the business and give him enough money to live on. He's going to face a 10% penalty in his retirement account, which is quite significant, and also a retirement account is probably investments, which may have lost value in the short time that he had them - he could easily be in a buy high, sell low situation in addition to the 10% penalty. The other huge drawback is that overdrafts are very expensive per dollar of overdraft. With most banks, he'd be hit with a fee, and then if he keeps the overdraft on his account for a while then he's also going to be paying a much higher interest rate than he would on a typical loan. This is thus very expensive finance.

Arguments in favor of reorganizing as a private limited company may include: - It could dramatically increase his ability to raise capital, particularly when compared with retained profits and overdrafts
- Shares are not a loan, so they do not need to be repaid
- Other investors may bring expertise or connections that he doesn't have on his own - It avoids the fees and withdrawal penalties mentioned in the second option, and he may find investors willing to fund him if a bank is unwilling to give him a loan, especially because it says he'd seek investment from friends and family.

The major drawback is that it would be time consuming to convince people to invest with him (if he's successful at all), and he'd be giving up a share of his already modest profits. He uses these profits as his personal income, and the more successful he is in business, the more money he'd eventually be giving up because those shares are a permanent part of the business unlike a loan that will be repaid. There's also the potentially awkward dynamic of doing business with friends and family, which can be a recipe for disaster with personal relationships.

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3. The Bagel Underground

A. Define the term trade credit.	2

An arrangement in which a business receives a good or service without paying up front or paying interest. The credit provider receives payment at a later date, such as 30, 60, or 90 days later.

B. Explain a benefit and a drawback of Andriy and Daniela using personal funds to finance part of their startup costs.	4

Benefits may include, but are not limited to:
- The main benefit is that they don't give up any interest or equity, which means that this form of finance is "free" in terms of not paying a direct financial cost to access it
- They have full control over the use of the money, unlike many other forms of finance in which the financier may have some control over how the money is spent
- The amount of money is flexible; if they want to put more or less money into the business at some point, they are free to do as long as they have the money
- Assuming that they have the money in relatively liquid accounts, there's no time lag between deciding they want/need the money and getting it

Drawbacks may include, but are not limited to:
- It's *their* money, from savings. Thus if the business doesn't go well, then they've lost their personal money that they could've used for anything else. That's quite risky. -

C. With reference to BU, explain the difference between share capital and loan capital.	4

Share capital is when a firm sells equity in its business; that is, it sells shares of ownership to investors in return for money. BU is not doing this. Loan capital is when a firm borrows money and pays interest on that borrowing. This is what BU is doing with the peer to peer lending platform. Its crowdfunding is, in this instance, in the form of loan capital.

D. With reference to BU, explain the difference between microfinance and peer to peer lending.	4

Peer to peer lending is not in the syllabus, but it is pretty clearly described in this case study, which is why I think this question is reasonable to ask. Peer to peer lending in this instance for BU is when people go through an app to lend to people as part of a portfolio of investments; these lenders are hoping to get a good return on their investment. Microfinance does sometimes get a return on investment for people who lend money, but that is very often not the point of the funding, and it's done as part of a social enterprise with individual lenders treating their loans like donations. Loans are very small scale and go to support entrepreneurs who could not get a loan through the traditional banking system. This is not BU's situation - there's no indication that they are unable to go through the banking situation, and the loan is probably not going to be "micro."

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E. Explain one other source of long term funding that Andriy and Daniela could use to finance the startup of BU.	4

- Share capital: As explained above, they could seek out investors.
- Angel investors: An investor may be willing to fund the ghost kitchen if they can be convinced that it's a viable business that will give them enough return on investment. - Leasing: By leasing a building rather than buying one (which they'd probably be doing anyway…) they could cut down on the amount of capital required up front. This wouldn't pay for everything though.

Do not accept:
- Retained profit: they haven't even started the business yet, so there *is* no retained profit.
- Sale of assets: again, without having started the business yet, there are no assets to sell unless we're talking about personal assets.
- Overdrafts: Because of the high fees and interest, and the likelihood that they wouldn't be allowed to take out an overdraft that's long enough, this should only be used for the short term.

F. Recommend whether BU should use crowdfunding through Andriy or Daniela's preferred methods.	10

Reasons in favor of peer to peer lending rather than selling bagels and other merchandise may include, but are not limited to:
- They're not making a promise to crowdfunders if they do this method. They're not guaranteeing that the loans will be repaid, or be repaid in a timely manner (typically there's no requirement of collateral with these loans, though students may not be expected to know that). However, with the sale of bagels and t-shirts and such, they're telling crowdfunders that they're going to deliver these things and thus need to follow through properly to make customers happy. These crowdfunders are people who will be customers, so they'll need to work hard to make them happy and leave a good impression.
- Making t-shirts and other merchandise is another time burden on the business, and it adds

costs as well. If anything goes wrong with the t-shirts or other things they've sold, then they need to make that right with the customers.
- They could potentially raise a lot more money this way, because they're not trying to get people (presumably locals) interested in the business itself, but rather the potential for interest payments. Thus, they could get lenders from a much wider area, potentially nationally or even internationally. All crowdfunders would care about is the safety of the loan and getting timely repayment.
- If Andriy's friend was able to get this funding in less time than a bank, then it's quite possible that BU could get this funding faster than through Daniela's method too.

Reasons in favor of selling bagels and other merchandise rather than peer to peer lending may include, but are not limited to:
- With the lending option, they'll have to pay interest, which may be more than they'd spend with Daniela's methods, especially if customers are largely choosing the bagel purchase option. With the bagel purchase option, it's basically interest free financing because they're just getting a pre-order and thus pre-funding of what they were already going to do.

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- It gets locals more excited about the business itself than in Andriy's method. She'd basically be getting demand before the business even opens. The shirts would also serve as promotional tools which could bring in more customers.
- Typically if they're not able to get enough people committed through this method to reach their funding goal, then the project doesn't go ahead and no money changes hands. In that sense it's very low risk, and if it doesn't work then they could always try another method.
- The cost of t-shirts, stickers, and other things could be far less than the donations that people are giving. Thus, this could be a pretty cheap way of raising money. Assume for instance that someone donates $25 and gets a t-shirt that only costs the business something like $5. When you bulk buy t-shirts and stickers, they're pretty cheap.

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4. Lato

A. Define the term asset.	2

Property, whether tangible or intangible, that a firm owns that is of financial value.

B. Define the term leasing.	2

When a firm rents the use of an asset over a period of time.

C. With reference to Lato, explain the difference between internal and external sources of finance.	4

Internal finance comes from resources the firm already has, such as personal funds, sale of unused assets, and retained profit. For Lato, only the second two would be logical, and the sale of assets is actively being considered by the CFO. External finance uses financial resources that come from outside the organization. In the case of Lato that would be the share capital that they are considering raising, but it could also include any of the other forms of external financing that are on the syllabus yet not mentioned in the case study.

D. Other than its headquarters and production plants, suggest one other asset that Lato could sell, and a downside of selling that asset.	4

Answers may include, but are not limited to:

- Intellectual property such as brands, trademarks, copyrights. The downside here is all of these help the firm earn money, and selling them would help competitors.
- Machinery and other equipment that isn't necessary for the firm. The downside is that it's realistically hard to find such assets that wouldn't hurt their ability to operate, and even if they did, they would get a depreciated value for them.
- Any land it owns. The downside here is that they probably don't even have any, and any that they did would probably be associated with the buildings on that land, so it's hard to separate the two. Obviously selling land with buildings means a downsizing of their operations or having to lease it back, which would cost them more in the long run.

E. Explain why the use of personal funds would not be appropriate as a source of finance for Lato.	4

Personal funds are for sole traders. No one who owns shares of a company is going to put their own money into the business without getting shares in return, because then they'd be funding the firm in a way that benefits other people without those people having to contribute financially.

F. Explain why Lato may choose to sell a building it owns and then lease it.	4

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There is an immediate need for cash, which selling their building would satisfy. However, unless they're going to downsize their operations by closing a plant or pulling out of markets, then they still need those buildings to operate. Leasing those buildings would allow operations to continue while giving the firm the cash that it needs right now.

G. Recommend whether Lato should sell assets or raise share capital to improve its financial position.	10

Reasons for selling assets may include, but are not limited to:
- As mentioned above, there's an immediate need for cash, which the sale of assets would give them.
- If their demand has been flat or declined, as in the case of in-line skates, then it may be necessary to find ways of cutting costs and downsizing operations if Lato doesn't have enough confidence that demand will rebound enough. The CFO wanting to shut down a production plant is an indication that this firm is in a long term decline that cannot be supported by its existing level of physical assets.
- Raising money this way doesn't dilute the value of outstanding shares like share capital would. Investors already aren't happy, and selling shares could further decrease the price of the shares.
- Selling assets doesn't necessarily mean that they can't use those assets anymore; as we see in the case of the HQ, it could allow them to continue operating while getting the cash

they need now. This could possibly be done with their manufacturing plant too.

Reasons for raising share capital may include, but are not limited to:
- Raising shares is free money, in the sense that it does not need to be repaid. This is an advantage over the sale of assets particularly in the case of the sale and leaseback, because the leasing would cost the firm more over time than owning it.
- Selling their assets may look like more of a desperate move, so it may hit the share price by more than selling more shares would.
- There is an important rise in demand in at least some cities, so they may be on the verge of increasing their sales and so would not want to be selling assets at this point. - Along with the rise in demand goes the idea that the CEO wants them to try to take advantage of that by spending more on marketing. Shareholders may be willing to support this, or new investors willing to buy shares if they see that potential to take advantage of the situation given their strong brand name.

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5. Dishes

A. Define the term business angel.	2

An individual (probably wealthy) who invests their money in a firm in order to get equity; that is, a share of ownership.

B. Explain one reason why short-term sources of finance would not be suitable for Dishes' plans to upgrade its offices.	2

Short term sources of finance, such as overdrafts, trade credit, and crowdfunding do not typically offer a firm the larger sums of money that they will need to upgrade their offices, nor do they typically offer financing at affordable rates. Overdrafts are one of the most expensive forms of finance and should only be used when a firm needs money quickly that it will likely be able to pay back fairly quickly; that's not the case with an office building. Trade credit doesn't even help with an office expansion, except for maybe some of the supplies that go in the office. Crowdfunding doesn't make sense for a large meal delivery app - it's already grown past the stage in which people might crowdfund it. Dishes needs to be able to pay off its expansion costs over a longer time period.

C. Explain two other forms of finance that may be available to a small independent restaurant owned by a sole trader that would not be available to Dishes.	2

Answers may include:

- Personal funds: Because Dishes is a large company with investors, putting their personal funds is off the table. For a small sole trader though, this is likely one of their primary sources of finance.
- Crowdfunding: People may combine to fund a new small business, but they would not do so for a large and established business.
- Microfinance: This depends on how small the business is, what the context is, etc, because this is really for funding small businesses in situations where there is poverty and/or lack of access to the banking system. None of that is the case with Dishes.

D. Explain the difference between how Dishes has raised share capital so far versus raising it through an initial public offering.	4

So far they've raised money through business angels and venture capital firms (VC is no longer on the syllabus, but I still think it's a really important form of finance for students to know about, and you can see that I've explained it in the text). Both of these forms are private investments and do not allow the general public to put their money into the firm, unless they go through venture capital firms, where they'd get indirect access to early stage companies. If they did an initial public offering, then the business angels and VC firms would probably cash out and exit their equity positions in the firm. The general public would be able to invest in Dishes if they had an IPO.

E. Recommend whether Dishes should attempt to raise additional capital through share capital or through loan capital.	10

Advantages of venture capital and business angels may include, but are not limited to: - Unlike loans, it doesn't need to be repaid
- They will not need to pay dividends until they are profitable, and even then it's not necessarily the case that they'd make regular dividend payments to investors in the short term
- These investors may also have expertise, connections, and other guidance for Dishes. They often take a pretty active role in the firm, and that would definitely be the case in this situation because investors own 75% of the company.
- Over the last 30 years (at least in the US and Europe), venture capital finance has become readily available, giving young firms the ability to raise much more money in private equity financing than they used to be able to, thus giving them the capital that the stock market allows, without the hassle of going public or the interest payments that loans require. *This is of course not something that students can be expected to know.*

Disadvantages of venture capital and business angels may include, but are not limited to:: - These investors firms can really steer the company's decision making, and this is clearly a concern for Ana
- Investors may pressure Ana and Nikola to go public before they would like to, because they would see a quicker return on their investment. Venture capitalists in particular do not tend to keep equity stakes in companies after an IPO - they want to take the firm to the IPO stage and get a high return on investment.
- Ana and Nikola only have around 25% equity; if they went through another round of VC financing, it's likely that it would result in them having even less control of the firm, to the point where it's even easier for them to lose control of strategic decision making or simply be pushed out in favour of new management.

Advantages of loan capital may include, but are not limited to::
- No equity share is given up. This is a particularly good thing given how much equity the co-founders have already given up.
- Interest rates are low, so now may be the best possible moment to take on debt, particularly if they have a good return on capital employed
- Lenders do not have a voting voice in the business
- Ana wants to do a bond in particular, which the case study notes could have a lower interest rate than a traditional bank loan. Something that the students wouldn't know is that this can also be a form of *ongoing* finance - they could continue issuing bonds as long as

investors are willing to buy them.

Disadvantages of loan capital:
- Interest payments must be met, regardless of profit. Otherwise, they will enter default, and various things can happen that are really harmful, including a bank seizing assets (if they do a bank loan instead of bonds), and the long term inability to borrow more.
- Ana wants to raise debt capital through bonds rather than the bank and there's no guarantee she'll be able to do so. This involves convincing a lot of investors rather than just one bank. It's probable that they could issue a bond given their size, but it's not guaranteed.
- If they do end up going through the bank instead of bonds, they may not have enough collateral to secure a long term loan