

Starting a New Venture

Topics to be Discussed

- Classification of Business Activity
- Classification of Legal Organization
- Characteristics of Legal Organizations
- Financing Business Operations
- Bonds
- Equity Securities
- Advantages and Disadvantages of Issuing Bonds vs. Stock

Classification of Business Activity

Manufacturing Activity

Product Handling Activity

Wholesaler - engaged in the business of selling to retailers or jobbers rather than consumers. Generally sells goods in large quantities.

Retailer - engaged in the sale of small quantities directly to the consumer

Service Activity

Classification of Legal Organizations

Sole Proprietorship

- ☛ one owner
- ☛ owner provides capital of the business and usually directs activities of business

Partnership

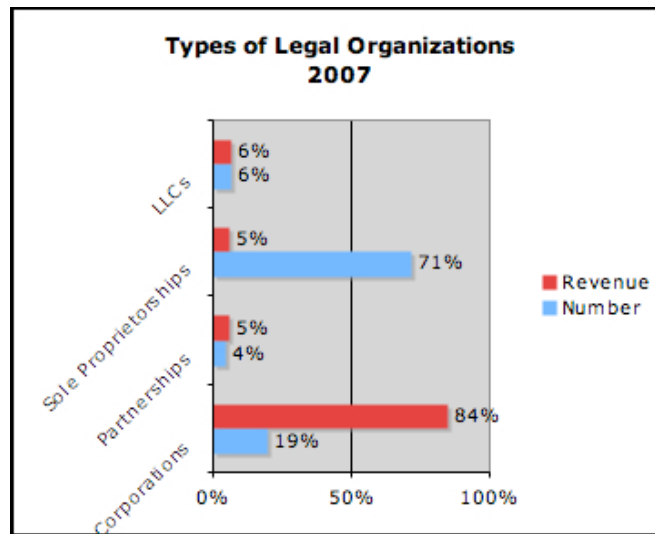
- ☛ two or more owners
- ☛ contractual arrangement
- ☛ partners provide capital and usually direct activities of business

Corporation

- ☛ in 1819, Chief Justice Marshall described a corporation as

. . . an artificial person, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly only incidental to its very existence.

- ☛ this definition implies that
 - corporation is a separate legal entity, separate and distinct from the natural persons who are its owners
 - a corporation is created by an act of a sovereign state
 - a corporation has only those powers given it by the state and either expressed or implied in its charter
- ☛ additional factors
 - a legal entity, separate and distinct from its owners
 - ownership evidenced by shares of stock
 - capital usually provided by many stockholders
 - hired managers usually direct activities of business



Characteristics of Legal Organization

Characteristic	Sole Proprietorship	Partnership	Corporation
Liability of Owners			
Mutual Agency			
Taxation			
Ease of Capital Assembly			
Transferability of Ownership			
Ownership Serves As Collateral			
Continuity of Existence			
Government Intervention			
Expense of Starting Business			

Financing Business Operations

Short Term - 5 years or less

- ☛ bank loan
- ☛ promissory note
 - an unconditional written promise by one party (maker) to pay another party (payee) a definite sum of money at some fixed or determinable future date.

Long-Term

- ☛ equity (ownership) financing
- ☛ debt financing

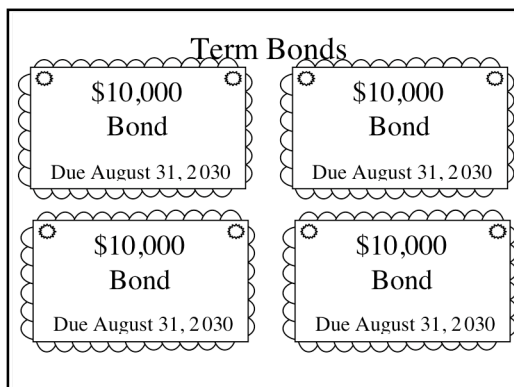
Bonds

A bond is a written unconditional promise wherein the borrower promises to pay a specific sum at a determinable future date together with interest at a stated rate and at stated dates

- ☛ bonds differ from some other forms of debt because they are placed in the hands of numerous public investors rather than channeled directly to a single lender
- ☛ usual denomination, \$1,000+

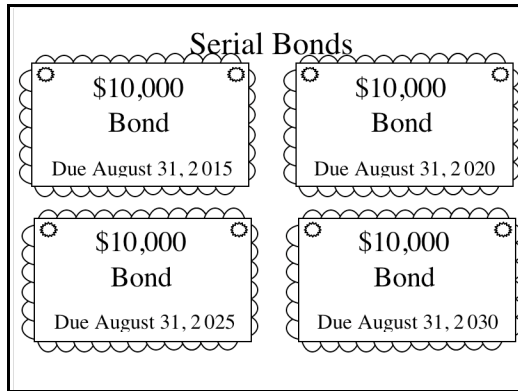
The terms of the borrowing are contained in a master contract between the corporation and the bondholders. This master contract is known as the bond indenture.

At the time of arranging for the bond issue, the borrowing corporation selects a bond trustee -- a bank or trust company -- to hold the bond indenture and to act as an independent third party to protect the interests of both the borrower and the lenders.



Characteristics of bonds

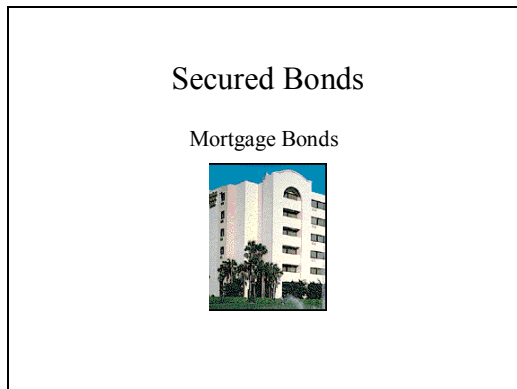
- ☛ maturity of bonds
 - term bonds – all the bonds of a particular bond issue mature on the same date



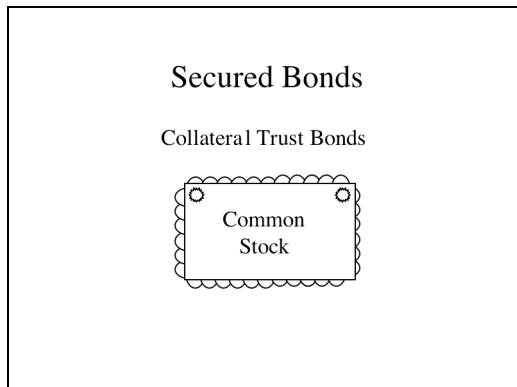
- serial bonds – all the bonds of a particular bond issue mature in installments

☛ secured vs. unsecured bonds

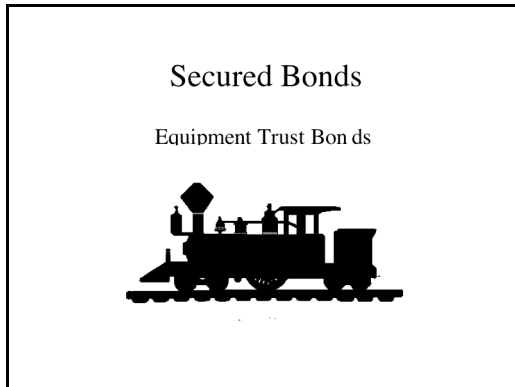
- secured bonds



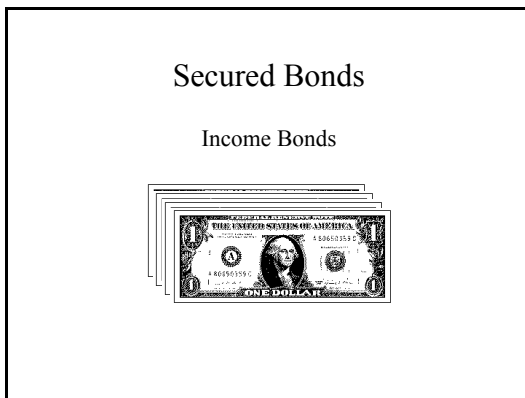
⇒ mortgage bonds - the investor's protection rests upon the pledge of the real assets (such as real estate) of the corporation. If the company defaults (fails to pay interest or repay principal) the bondholders may foreclose the mortgage and take over the pledged property.



⇒ collateral trust bonds - this financing procedure pledges a portfolio of securities, held in trust by a commercial bank, as protection for the holders of these debt instruments



⇒ equipment trust bonds - pledges machinery, such as the working equipment the corporation normally employs in its everyday operation, as collateral for the loan



⇒ income bonds - promises to pay interest only when, as, and if earned by the corporation

⇒ guaranteed bonds - debt securities backed by another party, e.g., a strong corporation might guarantee the securities of their lesser-known subsidiary

- unsecured bond - debenture

- ☛ callable bonds - at the option of the issuer, the bond may be retired, prior to maturity, at a designated price
- ☛ convertible bonds - at the option of the holder of the bond, the bond may be converted into another type of security such as common stock
- ☛ manner of interest payment
 - registered bonds - bondholder of record will receive interest
 - coupon (bearer) bonds - bearer of bond interest coupons will receive interest

Equity Securities

Types of Stock

- ☛ common stock
- ☛ preferred stock



Values assigned to stock

- ☛ par value
- ☛ no-par stock, with stated value
- ☛ true no-par stock (no par, no stated value)

Basic Rights of Stockholders

- ☛ right to vote
- ☛ right to share in earnings
 - form of compensation
 - ⇒ *cash dividends* - paid at the discretion of the management of the corporation
- ☛ right to share in assets upon liquidation
- ☛ preemptive right - the right to maintain present percentage ownership interest by having first opportunity to acquire any new issuances of stock of the same class

Characteristics of stocks

- ☛ callable stock - at the option of the issuer, the stock may be retired at a designated price
- ☛ convertible stock - at the option of the holder of the stock, the stock may be converted into another type of security e.g., preferred stock convertible into common stock
- ☛ redeemable stock - at the option of the holder of the stock, the stock may be redeemed for cash
- ☛ cumulative preferred stock - if any dividends have been omitted on preferred stock in the past, they must be paid out to preferred shareholders first, before common shareholders can receive dividends (alternative: non-cumulative preferred stock)
- ☛ participating preferred stock - in addition to paying a stipulated dividend, the preferred stock holder has the right to participate with the common stockholder in additional distributions of earnings under specified conditions.

Advantages and Disadvantages of Issuing Bonds vs. Stock

Advantages of Issuing Bonds

- ☛ to the corporation
 - interest is tax deductible; dividends are not
- ☛ to the current owners
 - if the company can earn a higher rate of return on borrowed funds than the cost of borrowing funds, additional benefits will accrue to the current stockholders. (financial leverage, trading on the equity)
 - present owners retain current ownership percentage without an additional investment on their part while still raising funds for the corporation

Disadvantages of Issuing Bonds

- ☛ to the corporation
 - interest must be paid; dividends need not be paid
- ☛ to the current owners
 - if the company return on investment is less than the cost of the additional funds, the current stockholders will suffer a reduction in their earnings