

Lecture 5: The Business of Capital

In 1976, **Steve Jobs** and **Steve Wozniak** were working on a little project in Woz's parents' garage. This project was a personal computer, including logic boards. Wozniak saw it as a fun hobby, but Jobs had already started thinking that there might be a business here. Jobs consulted someone from **Atari** (a big company back then) and built up a business plan.

The Beginning of Apple

Jobs and Wozniak realized they needed money to build a demo. However, they didn't have much. Wozniak sold his **HP calculator** for \$500, and Jobs sold his **Volkswagen** for \$1,300. With that \$1,800, they built the demo.

They then took it to a **computing club**, and people were enthusiastic. **Paul Terrell**, who owned a chain of electronics stores in the Bay Area, agreed to buy 50 units if they could build them. However, they still needed more money.

Securing Financing

They went to a high school friend's father, who lent them **\$5,000**. But when they approached a **bank**, they were turned down. Jobs' appearance didn't help much—long hair, unkempt, and smelling of his fruit diet. Still, they went to the **electronics supplier** and asked if they could get the parts on loan, showing them the commitment from Terrell. The supplier agreed. They built the computers and sold 50 units—this was the first transaction made as **Apple Computers**.

The Role of Capital in Business Creation

This story illustrates the importance of capital at every step of business creation. Without the **friends and family** financing and **vendor credit**, there would have been no Apple. And without the **line of credit** secured through **Mike Markkula** (former Fairchild Semiconductor engineer), Apple wouldn't have been able to scale.

In December 1980, Apple went public with an **IPO** at **\$14** per share. It opened at **\$22** and closed on the first day at **\$29**. Today, Apple is one of the **largest** and most successful companies in the world.

What is Equity?

Equity represents **ownership** in a company, and stock is a form of equity. In the early days, **Jobs and Wozniak** sold most of their shares, leaving them with only a third of the company. The majority was owned by venture capitalists.

Ownership in a corporation means you have **control**—51% of the shares control the company. Equity holders also have a **residual claim**, meaning they get what's left after all debts are paid.

Limited Liability and Stock Market Foundations

One of the most important concepts for stock markets to exist is **limited liability**. This means shareholders can't lose more than what they invested. Without this protection, stock markets wouldn't exist. Shareholders cannot be personally liable for company debts.

Raising Capital through Equity

Equity is a key way to raise capital for businesses, especially in the early stages. In the case of **Apple**, venture capital played a significant role. **Venture capital** is a form of **private equity** where investors provide funds to startups, typically in high-risk industries like tech and biotech.

Although venture capital involves high risks, successful investments can yield **exceptional returns**. Venture capitalists generally make around **10 investments**: five will fail, four will offer modest returns, and one will be a massive success. That one success compensates for the losses.

The Venture Capital Process

A venture capitalist's job is to **screen** companies and determine which ones have a chance of succeeding. They also provide valuable **guidance** and expertise to help the company succeed. For example, **Don Valentine** of **Sequoia Capital** helped **Jobs** and **Wozniak** build a business plan and brought in **Mike Markkula** as the CEO.

Venture capital is especially crucial in industries like **technology**, where success is uncertain but rewards can be massive. After raising venture capital, companies grow and develop their products, as Apple did with the **Apple I**.

Private Equity vs. Venture Capital

Private equity and **venture capital** are both forms of equity funding, but they differ in terms of the businesses they target.

- **Venture capital** invests in **startups**, with high risks but high potential for growth.
- **Private equity** invests in more **mature businesses**. These are often family-owned businesses looking to sell or expand. Private equity firms buy a significant stake, improve efficiency, and then either sell or take the company public.

Private equity funds generally target **businesses with established cash flow**, aiming to increase efficiency and profit.

Stock Buybacks and Their Role

Stock buybacks are when companies buy their own shares from the market. While some argue that stock buybacks manipulate stock prices, the reality is that **buybacks** are a way for companies to return **excess capital** to shareholders when no better investment opportunities are available.

Why buy back stock instead of paying a **dividend**? **Dividends** are taxed as regular income, while **capital gains** (from stock buybacks) are taxed at a lower rate. Therefore, stock buybacks are more tax-efficient.

The Role of Stock Markets

Stock markets allow businesses to raise **large amounts of capital** quickly by selling shares to the public. Going public through an **IPO** enables a company to scale rapidly. The stock market also provides **liquidity**, allowing investors to buy and sell shares with ease.

Stock markets democratize access to investments. **Ordinary people** can buy shares in companies like **Apple**, which was once only available to a select group of wealthy investors.

Capital Allocation Across the Economy

Stock markets facilitate the **allocation of capital** across industries. For example, when industries like the **Rust Belt** decline, capital is reallocated to emerging industries like **Silicon Valley**. This capital reallocation fosters innovation and growth.

The **decline in stock prices** signals to investors that a company may be in trouble, while **rising stock prices** indicate success. The stock market helps investors and businesses make better **capital allocation** decisions.

Stock Prices Reflecting Information

Stock prices reflect a **company's performance** and **future potential**. A falling stock price signals a problem, forcing managers to re-evaluate their strategies. For example, **IBM's** stock decline in the **1990s** forced the company to shift focus from **mainframes** to **services**.

IPO Pricing and Market Sentiment

The price at which a company goes public depends on the **market's expectations**. The investment bank that handles the IPO sets an initial price based on perceived value, but the market's reaction ultimately determines whether the price goes up or down. Typically, stocks rise after an IPO, but the real focus is on the company's performance over the next **six months**.

Corporate Taxes and Stock Buybacks

Corporate taxes often lead to **higher prices** for consumers and **lower wages** for employees. Lowering corporate taxes can benefit the economy by increasing wages and lowering prices.

Stock buybacks, while often criticized, are a sign that companies have **excess capital** with no better investment options. They are a way for companies to return capital to shareholders.

Conclusion

The financial system, particularly the role of **venture capital, private equity, and stock markets**, is crucial in raising capital, fostering innovation, and allowing companies to grow. While the process involves **high risk**, it offers the potential for **massive rewards** and fuels economic development across industries.