Exploratory Note 10

Bootstrapping Resources

**INTRODUCTION**

Procuring adequate financing for a start-up and/or rapidly growing business venture is critically important; indeed, no matter how good an idea may be, successful execution is highly unlikely in the absence of sufficient capital. Over the course of three notes this evening, we consider a fairly wide range of non-institutional sources of capital for start-up firms with particular emphasis on the following: loans and/or investment from friends and family (and fools), customer prepayments, vendor financing, deferred employee compensation, angel investment, receivables financing, leasing, and traditional bank financing.

**FUNDING – A FEW PRELIMINARY QUESTIONS**

Before we delve into the sources of capital, a handful of questions—some of them touched upon, albeit briefly, before—are in order:

How much financing is required? How should an entrepreneur go about making this determination?

Equity or debt? Wat are the trade-offs?

Is raising more money always better than raising less? Why or why not?

Does starting a business with limited resources (bootstrapping) necessitate different growth strategies relative to well-capitalized ventures?

In subsequent discussions, we will consider firms that are well-capitalized; however, this evening is focused almost exclusively on firms which are resource-constrained.

**BOOTSTRAPPING A BUSINESS – FROM DEFINITION TO STRATEGY**

Many of you have likely heard of the term ‘bootstrapping’ before. In finance, bootstrapping has several meanings depending on the context: econometric models frequently employ statistical bootstrapping techniques; leveraged buyouts (LBOs) are regularly referred to as bootstrapped deals; and startups oftentimes bootstrap resources to get off the ground. It is, of course, the latter context which is particularly germane to our discussion this evening, though LBOs will be discussed in a subsequent session.

For startups, what does it mean to pursue a bootstrap strategy when it comes to funding?

When bootstrapping a startup, timing of payments is critical. Amar Bhide’s *Harvard Business Review* article, “Bootstrap Finance: The Art of Startups,” argues a handful of points (from which I have selected several) of strategic interest:

* Get operational quickly.
* Look for quick break-even, cash-generating projects.
* Keep growth in check.
* Focus on cash, not on profits, market share, or anything else.
* Cultivate banks before the business becomes creditworthy.

Some of these points may seem counter-intuitive at first; however, they are of critical importance to resource-light operations.

**BOOTSTRAPPING A BUSINESS – SOURCES OF FINANCING**

Sources of bootstrap capital are numerous, but include: personal, friends, and family (and fools); customer prepayments; vendor financing; and deferred employee compensation.

***Personal, Friends, and Family (and Fools)***

What are some of the personal sources of funding that are frequently utilized by entrepreneurs to get things off the ground?

Consider money from friends and family. What are the benefits? What are the risks? Is it worth going this route?

How about the other category that I have derisively labeled fools?

***Customer Prepayments***

Regardless of firm size, an often-viable source of funds is customer prepayments. How do customer prepayments work? Consider the effect on working capital.

From what types of customers might prepayment be expected?

***Vendor Financing (Extended Terms)***

Similarly, vendor financing is a viable source of financing for many firms. What is vendor financing? How does it work? Consider the effect on working capital.

***Deferred Employee Compensation***

For many firms, employee compensation is the single largest use of cash. It is sometimes possible to defer employee compensation—thereby mitigating the cash burn of a firm at critical moments. How does it work?

**BOOTSTRAPPING A BUSINESS – THE CASH CONVERSION CYCLE**

Several of the bootstrapping techniques outlined above are useful because of their effect on the cash conversion cycle:

CCC = DIO + DSO – DPO

Cash Conversion Cycle = Days Inventory Outstanding + Days Sales Outstanding – Days Payables Outstanding

Thinking back to last week, what is DIO? Under resource-constrained circumstances, do we want DIO to be higher or lower?

What is DSO? Again, under conditions of constrained resources, do we want a higher number or lower number?

How about DPO? Why is DPO subtracted?

What is the effect of the bootstrapping resources discussed above on the cash conversion cycle equation?

**CONCLUSIONS**

Not all startups are the same; however, the overwhelming majority of businesses are formed with less-than-desirable resource levels. Techniques such as those outlined above can be extraordinarily helpful when it comes to making ends meet without the support of institutional investors.