# Chapter Readings, Lecture Notes, Videos-3

Ch 13- Sources of Financing; Equity and Debt

Section IV. Putting the business plan to work: sources of funds

Chapter 13. sources of financing: debt and equity

****Part 1: Learning Objectives****

1. Describe the differences between equity capital and debt capital.
2. Discuss the various sources of equity capital available to entrepreneurs.
3. Describe the process of “going public.”
4. Describe the various sources of debt capital.
5. Describe the various loan programs available from the Small Business Administration.
6. Describe the various federal and state loan programs aimed at small businesses.
7. Explain other methods of financing a business.

****Part 2: Class Instruction****

****Introduction****

New ventures need money. Raising those funds is one of the initial challenges for entrepreneurs. As capital markets rise and fall, the search for financing can be an uncertain journey.  Some of the keys to successful financing include these seven steps:

1. Choosing the right sources of capital.
2. The money is out there; the key is knowing where to look.
3. Raising money takes time and effort.
4. Creativity counts.
5. The Internet puts at entrepreneurs’ fingertips vast resources of information that can lead to financing. Use it.
6. Put social media to work to locate potential investors.
7. Be thoroughly prepared before approaching potential lenders and investors.
8. Entrepreneurs cannot overestimate the importance of making sure that the “chemistry” among themselves, their companies, and their funding sources is a good one.
9. Plan an exit strategy.
10. When capital gets tight, remember to bootstrap.

Rather than relying primarily on a single source of funds, entrepreneurs use ***layered financing***, a technique of raising capital from multiple sources.  ***Capital*** is any form of wealth employed to produce more wealth.  Entrepreneurs have access to two different types of capital: equity and debt.

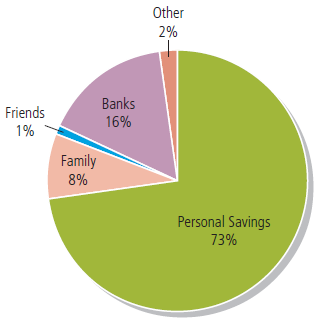
****Equity Capital vs. Debt Capital                         LO 1****

***Equity capital*** represents the personal investment of the owner(s) in a business. It is sometimes called risk capital.  The primary advantage is that it does not have to be repaid like a loan does.  Equity investors share in the company’s earnings and usually have a voice in the company’s future direction.  The primary disadvantage is that the entrepreneur must give up some, or even most, of the ownership.  To avoid having to give up control, entrepreneurs should strive to launch new companies with the least amount of money possible.

***Debt capital*** represents the financing that entrepreneurs borrow and must repay with interest.  Although borrowed capital allows entrepreneurs to maintain complete ownership, debt must be carried as a liability on the balance sheet, and it must be repaid with interest in the future.  Because lenders consider small businesses to be greater risks, they require higher interest rates on loans.  The cost of debt financing often is lower than that of equity financing, as investors demand greater returns than lenders.  Unlike equity financing, debt financing does not require entrepreneurs to dilute their ownership interest in their companies.

****Sources of Equity Financing                     LO 2****

The *first* place entrepreneurs should look for star-up money is in their own pockets.  They often rely on ***bootstrapping***, which is a process in which entrepreneurs first tap their personal savings and use creative low-cost start-up methods to launch their businesses.

Refer to Figure 13.1, Sources of Financing for Typical Start-Up Businesses.

In addition to personal savings, the following are potential sources of equity financing:

****Friends and Family Members.****

After emptying their own pockets, entrepreneurs look to friends and family members as their relationship with the entrepreneurs make them likely to invest.  They are often more patient than outside investors and less like to meddle in the operations of the business.  The amounts of money they invest are typically small in comparison to other kinds of investors.  Consider the potential ramifications and consequences on personal relationships before using this source. Unrealistic expectations or misunderstood risks have destroyed friendships and relationships with family members.  Refer to the Hands On… How To, Structure Family and Friendship Financing Deals.

***Accredited investors*** are people who have the knowledge and financial ability to assume the risks that come with investing in a business.  They must have a sustained net worth (excluding their primary residence) of at least $1 million or annual income of at least $200,000.

***Crowdfunding*** is a method of raising capital that taps the power of social networking and allows entrepreneurs to post their elevator pitches and proposed investment terms on specialized Web sites and raise money from ordinary people who invest as little as $100.

Prior to 2012, contributions to entrepreneurs through crowdfunding were considered to be donations rather than true investments.  However, the Jumpstart Our Business Startups (JOBS) Act of 2012 expands the use of crowdfunding as a means for raising equity investment by eventually allowing people who do not meet the legal criteria to be an accredited investor to be considered as true investors in a business.  To be eligible for crowdfunding, the business must be under $1 billion in revenues, and can raise only $1 million through crowdfunding.  When the law is fully implemented, there will be limitations on how much each individual can invest, which will be based on their income and net worth.

Attracting investors through crowdfunding requires a different approach than attracting traditional investors.  Entrepreneurs should seek advice from financing experts to develop a long-term financing plan in this circumstance.  Refer to Hands On… How To, Crowdfunding.

****Accelerators.****

***Accelerator programs*** are offered by some communities and universities to offer new entrepreneurs a small amount of seed capital and a wealth of additional support.  They are designed to move entrepreneurs from the idea stage to a point when the business has a proven story and a strong business model that can be pitched for more significant funding.

****Angels.****

***Private investors (angels)*** are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies. They are accredited advisors, often with significant industry experience, who fill a specific equity financing gap before venture capital firms and institutional investors are interested.  This is the fasted-growing segment of the small business capital market; angels typically invest $100,000 to perhaps $5 million.  The average investment is $350,000.  Refer to Figure 13.2, Angel Financing.

Angels look for a qualified management team, a business with a clearly defined niche, market potential, a competitive advantage, a sizable customer base, and an exit strategy.

The major challenge for an entrepreneur is to find angels.  Networking is the key through local friends, attorneys, bankers, stockbrokers, accountants, other business owners, and consultants.  Today there are angel networks and angel capital funds (superangels), many of which have Web sites.  The Angel Capital Association is a professional association whose members are angels.  Angels may be willing to wait as long as 7 years before exiting a company, and earn their returns (typically 20 to 50 percent) through the increased value of the business.  Angels typically purchase 15 to 30 percent ownership in the business.

****Venture Capital Companies.****

***Venture capital companies*** are private, for profit organizations that purchase equity positions in young businesses that they believe have high-growth and high-profit potential. The firms that receive venture capital typically produce annual returns of 300 to 500 percent within five to seven years for the venture capital companies.  Refer to Figure 13.3, Venture Capital Funding.

* Policies and Investment Strategies.

Investment and size screening – The average venture capital firm’s investment in a small company is $7.5 million and investments range from $100,000 to $5 to $25 million. About one in 1,000 businesses in the United States receive venture capital.  Refer to Figure 13.4, The Business Plan Funnel.

Ownership and control – Most venture capitalists prefer to purchase ownership in a small business through common stock of convertible preferred stock.  Venture capital firms are not passive investors: they may purchase a controlling share of a company, leaving its founders with a minority share of ownership; may join the boards of directors of the firm; and even take over the management of the firm.

Stage of investment – Venture capital companies commonly seek out companies in the early or rapid-growth stage. They often invest over time across several stages of a firm’s growth, where their investments often total $10 million to $15 million or more.

Advice and contacts – In addition to the money they invest, they provide management advice and access to valuable networks of contacts of suppliers, employees, customers, and other sources of capital.

Investment preferences – Venture capital funds increasingly are focusing their investments in specific industries, such as technology, biotechnology, or other specialty niches. They prefer to invest in firms that have advanced beyond the stage when angels invest.  Refer to Figure 13.5, Angel vs. VC Investments.

* What Venture Capitalists Look For.

Two factors make a deal attractive to venture capitalists: high returns and a convenient and profitable exit strategy.   In addition, they look for the following:

* Competent management
* Competitive edge
* Growth industry
* Viable exist strategy
* Intangible factors such based on the venture capitalist’s sense of fit and potential. For example, a solid sense of direction, strategic planning process, and the chemistry of the management team.
* Corporate Venture Capital. Large corporations, both U.S. and foreign, finance and invest in small companies for strategic and financial purposes.  Examples include Google, BMW, Comcast, and Amazon.  The right corporate partner may also share technical expertise, distribution channels, and marketing know-how, and provide introductions to important customers and suppliers.

****Public Stock Sales (“Going Public”)                   LO 3****

One method of raising large capital is to sell shares of stock, known as “going public.” An ***initial public offering*** (IPO) is a method of raising equity capital in which a company sells shares of its stock to the general public the first time. Refer to Figure 13.6: Initial Public Offerings (IPOs), to note the fluctuation in the number of IPOs from 1983 to 2011.  It is an effective method of raising large amounts of capital, but can be expensive and time-consuming with regulatory nightmares.  Once a company has made an IPO managers must consider the impact of their decisions not only on the company, but also on shareholders and the value of their stock.

Investment bankers who underwrite public stock offerings typically look for established companies with these characteristics:

* Consistently high growth rates
* Scalability
* A strong record of earnings
* Three to five years of audited financial statements that meet or exceed Securities and Exchange Commission (SEC) standards
* A solid position in a rapidly growing industry
* A sound management team with experience and a strong board of directors

The Registration Process.  This is a coordinated effort that requires a team of professionals, including company executives, an accountant, a securities attorney, a financial printer, and at least one underwriter.  The registration process alone is a required, time-demanding – and potentially expensive – task that involves these steps:

* Choose the underwriter. A ***managing underwriter (investment banker)*** is a financial company that serves two important roles: helping to prepare the registration statement for an issue and promoting the company’s stock to potential investors.
* Negotiate a letter of intent. A ***letter of intent*** is an agreement between the underwriter and the company about to go public that outlines the details of the deal.
* Prepare the registration statement. The ***registration statement*** is the document a company must file with the SEC that describes both the company and its stock offering and discloses information about the risk of investing.
* File with the SEC. The Division of Corporate Finance can take 30-45 days to review the application, and can require the company to make revisions.
* Wait to go effective. While waiting for the SEC’s ruling, the underwriters are building a syndicate of other underwriters who will market the company’s stock. During this quite period of time the company must refrain from publicity and providing information about the potential IPO.
* Road show. A ***road show*** is a gathering of potential syndicate members sponsored by the managing underwriter for the purpose of promoting a company’s IPO.
* Sign underwriting agreement. On the last day before the registration statement becomes effective, the company signs the formal underwriting agreement.  At this meeting the underwriters receive their shares to sell, and the company receives the proceeds of the offering.
* Meet state requirements. In addition to satisfying the SEC’s requirements, a company must also meet the securities laws in all states in which the issue is sold.  These state laws (or “blue sky” laws) vary drastically among states.

Nonpublic Registrations and Exemptions.  The SEC allows several exemptions from this full-disclosure process for small businesses. Simplified registrations and exemptions enable smaller companies easier access to capital markets through some recently improved options for small businesses. A ***limited private stock offering*** allows entrepreneurs to sell stock through a limited private offering to accredited investors, corporations and trust, and insiders to the business.

The SEC has established simplified registrations and exemptions through what is known as Regulation D (Ruel 504, 505, and 506):

* Regulation D – minimize the expense and time required to raise equity capital by simplifying or eliminating the requirement for registering the offering with the SEC.
* Rule 504 is the most popular of the Regulation D exemptions because it is the least restrictive. It allows a company to sell shares of its stock to an unlimited number of investors without regard to their experience or level of sophistication.  There is a cap of $1 million in a 12-month period on the amount of capital a company can raise.
* Rule 505 has a higher capital ceiling (up to $5 million), but cannot have more than 35 nonaccredited investors, provide no advertising of the offer, and more has stringent disclosure requirements.
* Rule 506 imposes no ceiling on the amount that can be raised, but most companies that make Rule 506 offerings raise between $1 million and $50 million in capital. Like Rule 505, it limits the issue to no more than 35 nonaccredited investors, and prohibits advertising the offer.  There is no limit on the number of accredited investors, however.

****Sources of Debt Financing                                   LO 4****

Debt financing involves funds that small business owners borrow and must repay with interest. Borrowed capital allows entrepreneurs to maintain complete ownership but it must be carried as a liability on the balance sheet as well as be repaid with interest.  Because small businesses are considered to be greater risks than bigger corporate customers, they must pay higher interest rates.  Most small firms pay well above the ***prime rate***, which is the interest rate that banks charge their most creditworthy customers. The cost of debt financing is lower than that of equity financing because investors demand greater returns on their investment than lenders.

There is an astounding range of credit options varying greatly in complexity, availability, and flexibility.  Refer to Figure 13.7, Small Business Financing Strategies.

****Commercial Banks.****

Commercial Banks provide the greatest number and variety of loans to small companies, but prefer to lend to established small businesses rather than to high-risk start-ups.  Before making a loan, the bank will scrutinize the firm’s financial reports to project its position in the future, they want proof of the stability of the company’s sales and its ability to generate adequate ash flow sufficient to repay the loan, collateral to secure the loan or an SBA guarantee.  Smaller banks tend to be more small business friendly than bigger banks.  Banks and other lenders require entrepreneurs to sign personal guarantees for any loan; this means that if the business does not repay the loan then the entrepreneurs agrees to personally repay the loan.  In essence, bankers look for three sources to repay a loan: sales sufficient to repay, the entrepreneur’s personal guarantee, and collateral that could be sold to repay the loan. Refer to Hands On… How to for a list of seven common reasons banks turn down loan requests.

****Short-Term Loans.****

Short-term loans are those that are intended to be less than one year, are the most common type of commercial loan banks make to small companies. These loans are typically used to replenish working capital to finance the purchase of inventory, boost output, finance credit sales to customers, or take advantage of cash discounts.  There are several types of short-term loans.

* Home equity loans
* Commercial loans (or “traditional” bank loans)
* Lines of credit. A ***line of credit*** is a short-term bank loan with a preset limit that provides working capital for day-to-day operations.
* Floor planning

****Intermediate- and Long-Term Loans.****

These types of loans are normally secured by collateral and are extended for one year or longer. The typical uses include constructing buildings, purchasing real estate and equipment, expanding a business, and other long-term investments.  Installment loans and term loans are examples.

* Installment loans are used by entrepreneurs to purchase equipment, facilities, real estate, and other fixed assets. Repayment of the loan is set to coincide with the length of the equipment’s usable life.
* A ***term loan*** is a bank loan that imposes restrictions (covenants) on the business decisions an entrepreneur makes concerning the company’s operations. These loans are typically not secured by collateral when there is a high probability of repayment.  Typical kinds of covenants include limits on owners’ salaries, prohibit further borrowing without bank permission, or maintenance of certain financial ratios.

****Consider using You Be the Consultant: “The Never-Ending Hunt for Financing” at this point.****

****The Small Business Administration (SBA) Loan Guarantee Programs                              LO 5****

The SBA works with local lenders (both bank and nonbank) to offer many other loan programs designed to help entrepreneurs who cannot get capital from traditional sources.  The SBA does not actually lend money to entrepreneurs directly; instead entrepreneurs borrow money from a traditional lender, and the SBA guarantees repayment of a percentage of the loan in case the borrower defaults.   Because the SBA assumes most of the credit risk, lenders are more willing to consider riskier deals.  SBA loans often have a longer term than traditional bank loans, and need less collateral.  Refer to Table 13.1, SBA Loan Program Overview.

SBA programs include:

* ***7(A) loan guaranty program*** is an SBA program in which loans made by private lenders to small businesses are guaranteed up to a ceiling by the SBA. It is the most popular SBA program.  Refer to Figure 13.8, SBA 7(A) Guaranteed Loans.
* Section 504 Certified Development Company Program is designed to encourage small business to purchase fixed assets, expand facilities, and create jobs. Three lenders play a role in every 504 loan: a bank, the SBA, and a certified development company (CDC).  A ***certified development company*** is a nonprofit organization licensed by the SBA and designed to promote growth in local communities by working with commercial banks and the SBA to make long-term loans to small businesses.
* Microloan Program. About three-fourths of small businesses need less than $100,000.  ***Microloans*** are made through an SBA program aimed at entrepreneurs who can borrow amounts of money as small as $100 up to a maximum of $50,000.  This is the single largest source of funding for microenterprises, provided by about 180 authorized lenders that are nonprofit intermediaries.  Micro loans do not carry SBA guarantees, but lenders’ standards are less demanding than on conventional loans.

Other SBA Loan Programs.

* SBA*Express* Program
* Small Loan Advantage and Community Advantage Loan Programs
* ***The CAPline Program*** is an SBA program that makes short-term capital loans to growing companies needing to finance seasonal buildups in inventory or accounts receivable.
  + ****Export***Express***Program**** is an SBA loan program that offers quick turnaround times to small companies that are developing or expanding their export initiatives.
  + ***Export Working Capital (EWC) Program*** is an SBA loan program that is designed to provide working capital to small exporters.
* The ***International Trade Program*** is an SBA loan program for small businesses that are engaging in international trade or are adversely affected by competition from imports.
* ***Disaster Loans*** are an SBA loan program that makes loans to small businesses devastated by some kind of financial or physical loss.

****Non-Bank Sources of Debt Capital.****

* Asset-Based Lenders. Asset-based lenders allow businesses to borrow money by pledging collateral, such as accounts receivable and inventory. Asset-based lenders may be small commercial banks, commercial finance companies, specialty lenders, or divisions of bank holding companies.  The ***advance rate*** is the percentage of an asset’s value that a lender will lend.
* Discounting Accounts Receivable. A small business pledges its account receivable as collateral; the lender advances a loan against the value of approved accounts receivable.
* Inventory Financing.
* Purchase Order Financing.
* Vendor Financing.
* Equipment Suppliers.
* Commercial Finance Companies.
* Saving-and-Loan Associations.
* ***Margin loans*** are loans from a stockbroker that use the stocks and bonds in the borrower’s portfolio as collateral.  A ***margin (maintenance) call***occurs when the value of a borrower’s portfolio drops and the broker calls the loan in, requiring the borrower to put up more cash and securities as collateral.
* ****Credit Unions**** are a nonprofit financial cooperative that promotes saving and provides loans to its members.
* Private Placements. This involves selling debt to one or a small number of investors, usually insurance companies or pension funds.  This is a hybrid between a conventional loan and a bond.
* ***Small Business Investment Companies (SBICs)*** are privately owned financial institutions that are licensed by the SBA and use a combination of private capital and federally guaranteed debt to provide long-term venture capital to small businesses.

****Other Federal and State Programs                    LO 6****

****Economic Development Administration (EDA).****

The Economic Development Administration (EDA) offers loan guarantees to create new business and to expand existing businesses in areas with below- average income and high unemployment.

****Department of Housing and Urban Development (HUD).****

This agency does not extend loans or grants directly to entrepreneur.  However, the Urban Development Action Grants are extended to cities and towns that, in turn, lend or grant money to entrepreneurs to start small businesses that will strengthen the local economy.

* S. Department of Agriculture’s Business Programs and Loans. The Department of Agriculture’s loan program is open to all businesses and is designed to create nonfarm employment opportunities in rural areas that are underserved.  Various programs help fund projects that create or preserve quality jobs and/or promote a clean rural environment. The Rural Development Rural Business Services (RBS) does not make direct loans to small businesses, but will guarantee bank loans.
* Small Business Innovation Research Program (SBIR). The federal government awards cash grants or long-term contracts to small companies that want to initiate or to expand their research and development efforts. There are three phases in the grant process: proof of concept, prototype development, and commercialization.
* The Small Business Technology Transfer Program (STTR). This program helps companies to use the vast reservoir of commercially promising ideas that originate in universities, federally funded R&D centers, and nonprofit research institutions.
* State and Local Loan Development Programs.
  + ***Capital Access Programs (CAPs)*** is a state lending program that encourages lending institutions to make loans to businesses that do not quality for traditional financing because of their higher risk.
  + ***Revolving loan funds*** is a a program offered by communities that combine private and public funds to make loans to small businesses, often at below-market interest rates.
  + ***Community development financial institutions (CDFIs)***are community-based financial institutions that designate at least a portion of their loan portfolios to otherwise “unbankable” business owners and aspiring entrepreneurs.

****Other Methods of Financing                    LO 7****

****Factoring Accounts Receivable.****

A ***factor*** is a financial institution that buys a business’s accounts receivable at a discount.

****Leasing****.

Companies can lease most any kind of asset rather than purchase these assets. It avoids down payments, may help cash flow, and may offer great flexibility.

****ROBS.****

Many small businesses use ***Rollovers as Business Startups*** as a means of using retirement savings to fund their businesses.

****Merchant Cash Advance.****

A ***merchant cash advance*** is an arrangement in which the provider of the merchant cash advance prepurchases credit and debit card receivables at a discount.

****Peer-to-peer Lending.****

***Peer-to-peer loans*** are web-based vetting platforms that create an online lending community of investors who provide funding to creditworthy small businesses.  Examples include Lending Club, Prosper, and Fundations.

***Loan brokers*** specialize in finding loans by looking to a wide network of lenders.

****Credit Cards.****

Credit cards are a source of financing for entrepreneurs that may not be able to find other options. A study by the Kauffman Foundation reports that 7 percent of the capital for start-up companies comes from credit cards and 58 percent of new businesses rely on credit cards to finance operations in their first year of business. Credit cards may be the entrepreneur’s only choice for financing.

Advantages of credits cards include:  source of easy-to-access funds that is quickly available; flexible repayment options; attractive short-term alternative to financing.

Disadvantages of using credit cards include: high interest rates, particularly expensive to use to get access to cash versus making purchases, and can be difficult to get out of the pattern to use for financing operating expenses.

****Conclusion****

Entrepreneurs use both debt and equity as source of capital, and must understand the advantages and disadvantages of each of the many available sources as they relate to their particular business.  Start-ups have the most difficulty finding financing, while well–established small businesses have a somewhat easier time.  The Great Recession made it difficult for even successful entrepreneurs to get financing.

****Part 5: Case Studies****

The following text cases may be used for lecture and assignments for topics presented in this chapter.

* Case 8: SocialToaster
* Case 10: InQuicker