FINANCING THE NEW VENTURE

- Gaining financial support is a critical success factor for the new venture.

Importance of getting Finance

- Launch the venture
- Manage the venture
- Grow the venture
- Survive the venture

- Cash flow challenges; secure human and operating resources at the initial stages before the firm starts generating cash
- Capital investments; this is usually needed to buy property, construct buildings and buy equipment.
- Lengthy product development cycles; need to pay up-front costs of lengthy product development cycles.

- Three core principles of entrepreneurial finance
  - More cash is preferred to less cash
  - Cash sooner is preferred to cash later
  - Less risky cash is preferred to more risky cash

Important sources of investment capital

- the entrepreneur’s own capital;
- Friends;
- Family/ relatives;
- retained capital;

- government funding;
- investment in other businesses;
- business angels; individuals who invested their personal capital directly in start-ups

- retail banking;
- corporate banking;
- venture capital;
- public flotation.

- Entrepreneurs may use a mix of these sources depending on the size and stage of the venture, the amount required and the risks involved.

Factors Affecting Financing

- Accomplishments and performance to date
- Investor's perceived risk
- Industry and technology

- Venture anticipated growth rate
- Venture age and stage of development
- Investor’s required rate of return or internal rate of return
- Amount of capital required and prior valuations of the venture

- Founders’ goals regarding growth, control, liquidity, and harvesting
- Relative bargaining positions
- Investor’s required terms and covenants

Information Asymmetry Problems

Entrepreneurs have information about their business that investors don't have. This creates three problems:

- Investors must make decisions on limited information
- Entrepreneurs can take advantage of investors
- Adverse selection

Uncertainty Problems

- Investors must make judgments based on little actual evidence
- Entrepreneurs and investors disagree on value of new venture
- Investors want collateral

Solutions to Venture Finance Problems

- Self financing
- Contract provisions
  - Covenants
  - Convertible securities
  - Forfeiture and anti-dilution
  - Control rights
  - Vesting periods

Solutions to Venture Finance Problems

- Specialization
  - By industry
  - Be development stage
- Geographically localized investing
- Syndication

Capital Questions

- How much money do I need?
- Where should I get that money?
- What type of arrangements do I need to make to obtain that capital?

Start-Up Capital

How much do you need?

- 60% of all new ventures require less than $5,000 of capital to get started
- Only 3% require more than $100,000

(Source: U.S. Census Bureau)

Financial Analysis Tools

- List of startup costs and use of proceeds
- Proforma financial statements
- Cash flow statements
- Breakeven analysis

Startup Costs

- All costs incurred to get the business off the ground
- Determine the capital you need
- Determine what you'll do with the capital once you get it

Proforma

- Project the financial condition of the new venture
- Estimate profit and loss
- Show financial structure of the business
- Allow investors to conduct ratio analysis

CIMITYM

Cash is more important than your mother.

Income to Cash Flow

- Take your net profit and add back depreciation
- Subtract increases or add decreases in accounts receivable
- Subtract increases or add decreases in inventory
- Add increased or subtract decreases in accounts payable
- Subtract increases or add increases in notes/loans payable

Improve the Flow

- Minimize accounts receivable
- Reduce the raw material and finished products inventory
- Control your spending
- Delay your accounts payable

Breakeven Analysis

- Calculate the amount of sales you need to achieve to cover your costs
- Determine the increase in sales volume you need to have in order to increase fixed costs

Debt vs. Equity

- Debt—financial obligation to return capital provided plus a scheduled amount of interest
- Equity—a portion of ownership receive in an organization in return for money provided

EQUITY CAPITAL

Inside Equity

- Equity finance represents ownership stake in the new venture. Initial equity mostly come from the:
- Founder
- Top management team
- Friends
- Family/Relatives

Advantages of Inside Equity

- Easy and quick source
- Less pressure
- Informal arrangements
- Less debt

Disadvantages if Inside Equity

- Risk of destroying personal relationships
- May encourage interference
- Force personal sacrifices

Outside Equity

This comes from investors who have no personal relationship with the venture beyond their investment and their concern for its profitability and protection.

Obtaining Risk Capital

- Three central issues to be considered
  - Does the venture need outside equity capital?
  - Do the founders want outside equity capital?
  - Who should invest?

- Different suppliers of investment capital are characterised along two primary dimensions:
  - the amount of money they are prepared to offer;
  - the level of risk they are prepared to take on.

What to Look for in Investors

- Seek investors who:
  - Are considering new financing proposals and can provide the required level of capital
  - Are interested in companies at the particular stage of growth
  - Understand and have a preference for investments in the particular industry

- Seek investors who:
  - Can provide good business advice, moral support, and has contacts in the business and financial community
  - Are reputable, fair, and ethical and with whom the entrepreneur gets along
  - Have successful track records of 10 years or more advising and building smaller companies

- Attitude
  - Be wary if getting through to a general partner in the investment firm is an ordeal
  - Be wary if the investor thinks he or she can run the business better than the lead entrepreneur or the management team
- Over commitment
  - Be wary of lead investors who indicate they will be active directors but who also sit on the boards of six to eight other startup and early stage companies or are in the midst of raising money for a new fund

- Inexperience
  - Be wary of dealing with venture capitalists who have:
    - No operating, hands-on experience in new and growing companies
    - A predominantly financial focus

- Unfavorable reputation
  - Be wary of funds that have a reputation for early and frequent replacement of the founders
  - Be wary of those who have more than one-fourth or the portfolio companies are in trouble or failing to meet projections in their business plans

Presenting Information to Possible Investors

- A concise presentation should include the following:
  - What is the market opportunity?
  - Why is it compelling?
  - How will/does the business make money?
  - Why is this the right team at the right time?
  - How does an investor exit the investment?

Angel Investors

- Who are angel investors?
  - Most are self-made entrepreneur millionaires
  - Many are in their 40s and 50s
  - Most are well educated
  - They are sometimes reached through personal acquaintances

- Advantages
  - Relative accessibility
  - Size of investment pool
  - Individuals may be in a position to lend their positive reputations to the venture to attract additional funds

- Disadvantages
  - They sometimes lack the business expertise that would help the entrepreneur when advise in needed
  - Sometimes they may suffer from the inability to invest more money
  - Sometimes private investors tend to be over protective of their investment

Venture Capital

- This is capital that comes from professionally managed pools of investor money. Instead of wealthy individuals making investments one at a time and on their own, they pull their funds with other like minded people and hire professionals to make the investment and related decisions.

- Advantages
  - Often able to bring additional money on the table when needed
  - They also provide additional advice based on experience and important industry contacts for the firm

- Disadvantages
  - May lead to the dilution of ownership
  - Interference in company affairs
  - Loss of control

Going Public

- Advantages of going public
  - To raise more capital with less dilution than occurs with private placements or venture capital
  - To improve the balance sheet
  - To reduce or eliminate debt (thereby enhancing the company's net worth
  - To obtain cash for pursuing opportunities that would otherwise be unaffordable

- To access other suppliers of capital and to increase bargaining power
- To improve credibility with customers, vendors, key people, and prospects
- To achieve liquidity for owners and investors
- To create equity incentives for new and existing employees

- Disadvantages of going public
  - Requirements to conform to standard accounting and tax practices
  - Increased accountability
  - Lack of operating confidentiality
  - Demand from dividends from stakeholders
  - Lack of operating flexibility

DEBT FINANCING

Sources of Debt Capital

- Trade credit
- Commercial banks
- Finance companies
- Factors
- Leasing companies

Trade Credit

- Trade credit—the ability to buy goods and services and have 30, 60, or 90 days to pay for them
  - Major source of short-term funds for small businesses

Commercial Banks

- Common types of financing involving the use of a bank
  - overdrafts
  - Term loans
  - mortgages and equipment loans
  - Plant improvement loans

Commercial Finance Companies

- Frequently lend money to companies that do not have positive cash flow
- Will not make loans to companies unless they consider them viable risks; usually more accepting of risk than are banks

Criteria for loan evaluation

- Character; type of person you are
- Capital; the amount of money you have personally invested in the business
- Capacity; your management ability
- Collateral; security you are providing or pledging
- Circumstances; nature of product, stage of competition etc.
- Coverage; insurance coverage that will protect the lender in the event of the death of the borrower.

- Advantages of debt financing
  - You maintain control and ownership of the business
  - Interest and other cost are tax deductible
  - Inflation results in repayments of cheaper amounts.

- Disadvantages
  - Procedure for accessing loans can be cumbersome and difficult
  - High interest rates
  - Risks that future profits will not cover repayment
  - Must share financial and other confidential information
  - Lender may impose certain restrictions on borrower.

Factoring

- Factoring—a form of accounts receivable financing where the receivables are sold, at a discounted value, to a factor
  - The factor buys the client's receivables outright, without recourse, as soon as the client creates them, by shipment of goods to customers
  - Cash is made available to the client as soon as proof is provided (old-line factoring) or on the average due date of the invoices (maturity factoring)

Leasing Companies

- Leasing companies—leases common and readily resalable items such as automobiles, trucks, typewriters, and office furniture to both new and existing businesses
  - Up front payment required
  - Interest may be more or less than other forms of financing, depending on the equipment leased, the credit of the lessee, and the time of year

Sources of funds for entrepreneurs and small firm owner-managers in Ghana

- The venture capital fund
- MASLOC
- The commercial banks, e.g. ADB
- Money lenders
- NGO’s
- Credit unions
- Banks