8 : Sources of Capital for Entrepreneurial Ventures

EN 5106 – Fundamentals of Management and Entrepreneurship

Level III - Semester 5

Overview

- Entrepreneurs seeking to turn their innovative ideas into successful ventures often require various funding sources to fuel their business growth.
- The landscape of funding options is diverse, ranging from traditional avenues to newer, innovative models.
- The different sources of funding available to entrepreneurs, how they work and the pros and cons of those sources will be discussed here.

Intended Learning Outcomes

At the end of this lesson, you will be able to;

- Distinguish the forms of entrepreneurial capital
- Identify how informal investors differ from other parts of the funding community
- Differentiate among the different sources of funding available for entrepreneurs.

List of sub topics

8.1 Forms of Entrepreneurial Credit

8.2 Sources of Financial Capital

8.3 Informal Investors

8.4 Debt Financing

8.5 Equity Financing

8.6 Venture Capital Markets

8.7 Angel Investors

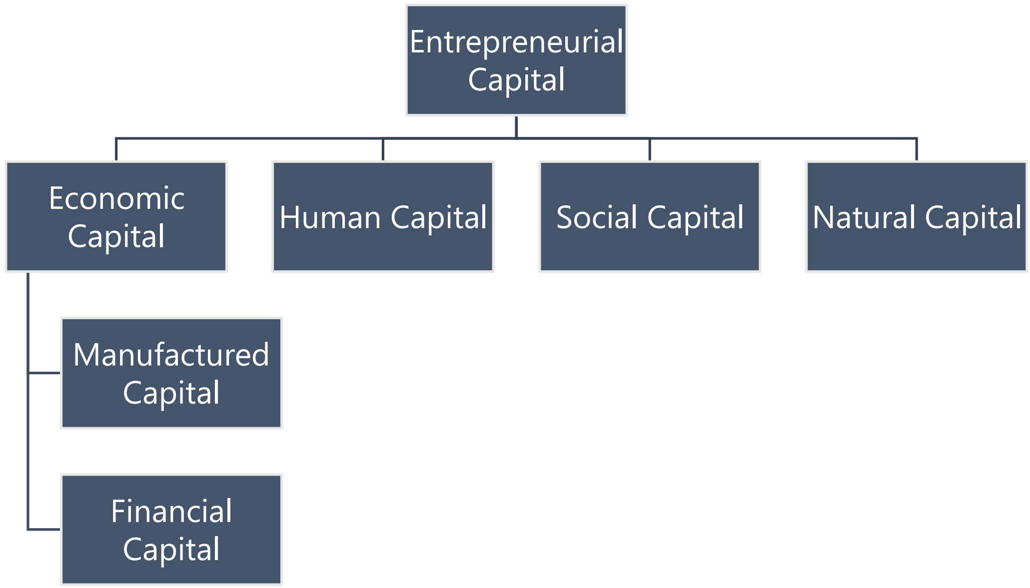
8.8 Peer to Peer Lending

8.9 Micro Credit

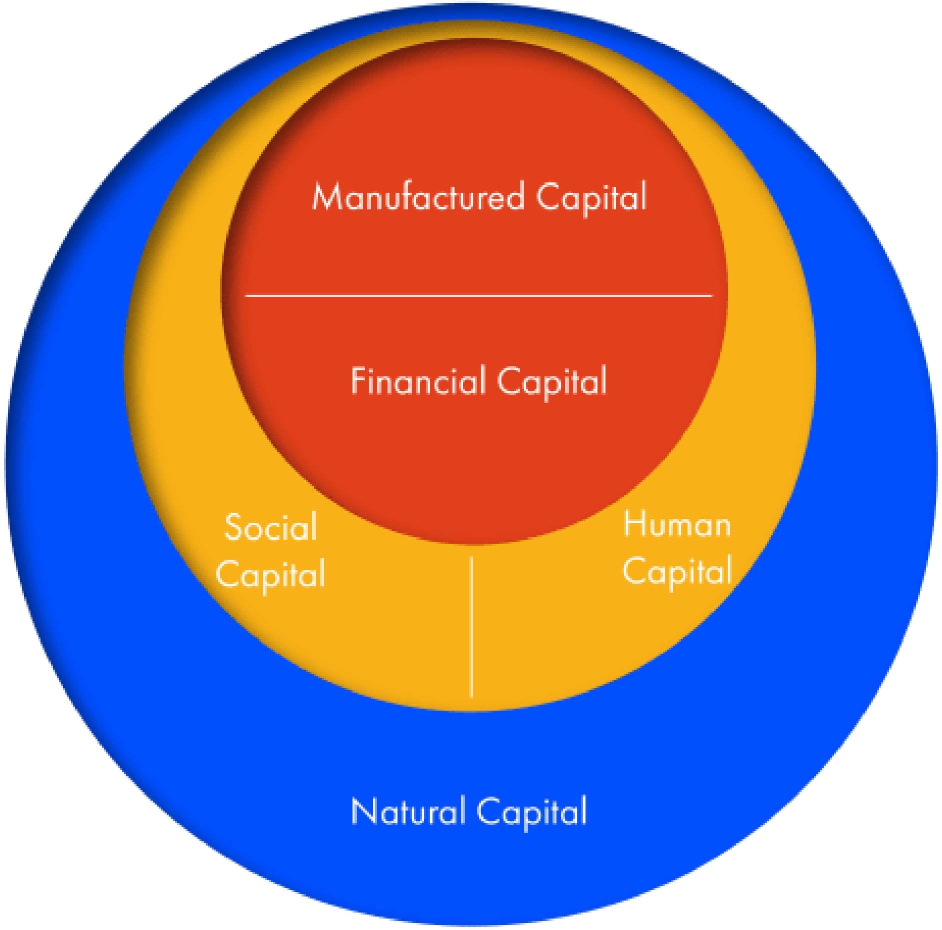
8.10 Crowdfunding

8.1 Forms of Entrepreneurial Capital

- Capital encompasses any resource, whether human-made or natural, utilized in the production of additional goods or services.
- Also known as "Factors of Production" or "Five Capitals".
- They are Categories of sustainable capital that are essential for enhancing the quality of our lives.
- Entrepreneurial Capital is 4 Folds:



8.1 Forms of Entrepreneurial Capital Cont…



[1] "The five capitals - A framework for Sustainability," Forum for the Future, https://www.forumforthefuture.org/the-five-capitals

8.1 Forms of Entrepreneurial Capital

- Economic Capital
  - Comprises both of financial capital and manufacturing capital.
  - Simply stating, Economic Capital is Money.
  - Main method by which entrepreneurs purchase the resources need for the manufacturing of goods and services.
  - Manufactured Capital is goods or assets that are needed in the production process.

- Human Capital
  - Human resources
  - Factors needed for good human capital are well-being of individuals, their knowledge, abilities, intellectual contributions, motivation, creativity and capacity for interpersonal connections.

8.1 Forms of Entrepreneurial Capital

- Social Capital
  - The value generated by the societal network an entrepreneur has created.
  - Guided by the tendencies that emerge within these networks to engage in actions for each other.
  - The efficiency of individuals and groups is influenced by these social connections.

- Natural Capital
  - Collection of natural ecosystems used by entrepreneurs to create goods or services.
  - These cannot be reproduced with human intervention.
  - This is a sustainable source of capital.

- The most important form of capital for entrepreneurs is financial capital.

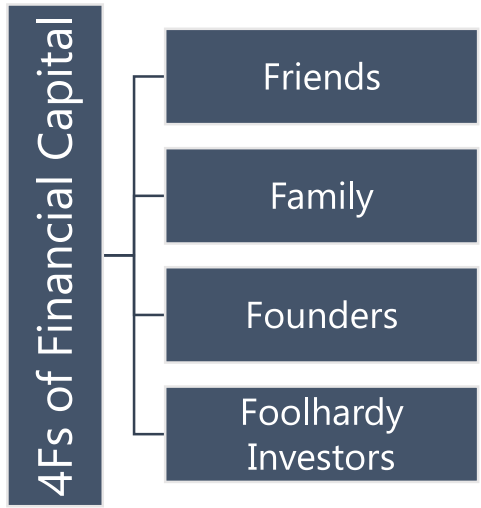
8.2 Sources of Financial Capital

- There are various sources of Financial capital for entrepreneurs.
- They advance up a hierarchy of financial capital sources as their ventures progress.
- The degree of risk and the phase of the company's growth are factors that determine the suitable sources of funding for entrepreneurs.
- The quickest and easiest method to get capital is to get it from family, relatives and friends.
  - It is important to explain what is in it for them.
  - Money from family is considered equity, which is better than debts.
  - Make sure to avoid misunderstandings.

- Some other common sources of financial capital are; informal investors, debt and equity financing, venture capital, angel investors, microcredit, crowdfunding and lending.

8.3 Informal Investors

- Most of the financial capital of a business come from the 4Fs;



- In reality, without informal investment, there would be scarcely any new ventures.
- Statistics are very high in the world on the percentage of adults who have informally invested on a business that is not their own.
- Some examples of the informal investors are; close family relatives, friends and neighbours, workmates etc.

8.4 Debt Financing

- Debt financing refers to the method of raising capital by borrowing funds, typically through loans or other forms of credit, with an obligation to repay the borrowed amount along with interest within a specified period.
- New businesses primarily rely on commercial banks as their main provider of debt financing.
- Commercial Banks
  - While debt financing can be a valuable tool for business expansion, it also comes with the responsibility of timely repayment.
  - Certain banks may extend unsecured short-term loans. But the majority of bank loans are backed by tangible assets such as fixed assets, receivables, and inventory, or other valuable assets.
  - Offers businesses the advantage of gaining access to substantial capital without diluting ownership.

8.4 Debt Financing Cont…

- Interest rates on bank loans vary based on factors such as the creditworthiness of the borrower, prevailing market conditions, and the terms of the loan.
- Advantages :
  - Does not have to give up the ownership of the company.
  - Interest paid on debt is often tax-deductible, resulting in lower taxable income, reducing the overall tax burden.
  - Fixed or predictable repayment structure.
  - As repayments are made, the business retains its profits and any returns generated from its operations.
  - Successfully managing and repaying debt obligations can enhance a business's creditworthiness. This can, in turn, lead to improved terms for future loans and better access to financing options.

8.4 Debt Financing Cont…

- Disadvantages:
  - Obligation to make regular interest payments.
  - If a business is unable to meet its debt obligations, it may lead to bankruptcy or financial distress.
  - Businesses may need to pledge assets such as property, equipment, or accounts receivable to receive the debt where at a failure to repay the lender can seize the asset.
  - High levels of debt might be viewed negatively by investors and stakeholders, affecting the market perception of the company.
  - If the debt carries variable interest rates, the business is exposed to interest rate fluctuations.

8.4 Debt Financing Cont…

- Other debt financing sources:
  - Trade Credit - Short-term financing arrangement between businesses where a seller allows a buyer to delay payment for goods or services received.
  - Accounts Receivable Financing - Business using its outstanding accounts receivable (unpaid invoices from customers) as collateral to obtain financing from a lender.
  - Factoring - Business selling its accounts receivable (unpaid invoices) to a third-party financial company, known as a factor.
  - Hire Purchase - Allows a business to acquire and use an asset, typically a high-value item like a vehicle or equipment, without making the full payment upfront. Instead, the buyer pays for the asset in installments over an agreed-upon period.
  - Financing Companies - Lenders that are asset-based, who may offer loans that commercial banks avoid.

8.5 Equity Financing

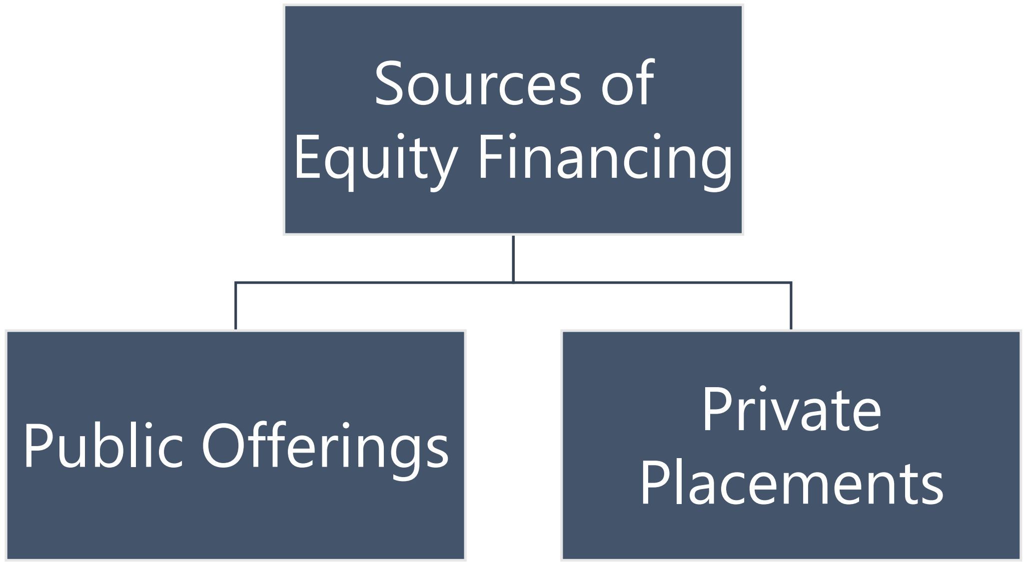
- Method of raising capital for a business by selling ownership shares to investors in exchange for funds.
- Unlike debt financing, equity financing involves selling a portion of the company to investors.
- This approach allows businesses to secure funding without incurring debt.
- Provides investors with ownership stakes, making them shareholders in the company.
- Equity investors assume a level of risk, as the value of their investment is tied to the performance of the business.
- Equity investors often expect a return on their investment through exit strategies such as the sale of the company, a merger or acquisition, or the company going public.

8.5 Equity Financing Cont…

- Equity financing is particularly attractive for businesses with high growth potential or those in industries requiring substantial upfront investment.
- It fosters a long-term partnership between investors and entrepreneurs, as both parties work together to drive the success of the business.
- Other ways for Equity Financing:
  - Loan with warrants - Lender provides a loan to an entrepreneur with the added feature of receiving warrants as part of the agreement.
  - Convertible Debentures - Unsecured loans that can be converted into shares.
  - Preferred Shares - Equity that provides investors with a preferred position over creditors in the event of the venture's dissolution
  - Common Shares - Form of ownership which carry the right to vote for the board of directors.

8.5 Equity Financing Cont…

- Two Sources of Equity Financing:



- Public Offerings
  - Also known as Initial Public Offering (IPO)
  - The process by which a private company becomes a publicly traded company by offering its shares to the general public for the first time.
  - Marks the transition from private ownership to public ownership.

8.5 Equity Financing Cont…

- Advantages of Public Offerings:
  - Can raise a large amount of capital
  - Liquidity
  - Stronger company image

- Disadvantages of Public Offerings:
  - High cost of the process
  - Disclosure of company affairs to public
  - Extensive involvement of paperwork

8.5 Equity Financing Cont…

- Private Placements
  - Sale of securities directly to a selected group of investors, rather than through a public offering in the open market.
  - Commonly used by startups with the intention of growth and expansion seeking to raise capital without going through the more extensive regulatory requirements associated with a public offering.
  - Private Placement Memorandum (PPM) is the comprehensive document that provides investors with all the essential information required to make well-informed investment decisions.

8.5 Equity Financing Cont…

- Advantages of Equity Financing
  - Can raise a large amount of capital at once
  - No interest payments are included
  - No obligation to repay the capital

- Disadvantages of Equity Financing
  - Capital is only available in large amounts
  - Has to dilute the ownership of the company
  - Investors might need to acquire the firm in a future date

8.6 Venture Capital Markets

- Venture capital (VC) is a form of private equity financing that provides funding to high-potential, early-stage, and emerging companies with significant growth prospects.
- Offers a full range of financial services including:
  - Capital for business
  - Market strategy development
  - Management consultation
  - Developing social connections
  - Assistance in negotiations
  - Assistance in employee recruitment

8.6 Venture Capital Markets Cont…

- There are five stages in Venture Capital Financing;

Seed Financing
- Initial funds for a business concept

Startup Financing
- Provided when product development is completed

Early Stage Financing
- Funding for expanding the market for the developed product

Expansion Financing
- Funding for growth and increased production

Late Stage Funding
- Pre-initial public offering investments

8.6 Venture Capital Markets Cont…

- The most common objective of Venture Capitalists is Return on Investment.
    - They invest a significant amount of time assessing the risk associated with a venture in comparison to its potential returns.

- Some factors that venture capitalists consider upon evaluating new proposals are:
    - Market entry time
    - Stability of the product
    - Knowledge of the entrepreneur
    - Preparation time
    - Rivalry among competitors
    - Entry strategy
    - Extent of the business
    - Industry expertise

8.6 Venture Capital Markets Cont…

- Venture Capital Firms **DO NOT**:
  - Control the company
  - Give directions on how to run the company
  - Get satisfied with a low return on investment
  - Invest through quick decisions
  - Help entrepreneurs with less management expertise just because he/she has a good idea
  - Make decisions based on small amount of details on the firm

8.7 Angel Investors

- Angel investors are individuals who provide financial support to early-stage startups and entrepreneurs in exchange for equity or ownership in the company.
- Angel investors are often entrepreneurs themselves or successful business professionals who have a keen interest in supporting innovative ideas and emerging companies.
- Unlike traditional venture capitalists, angel investors typically invest their own personal funds, bringing not only capital but also valuable industry experience, mentorship, and networking opportunities to the table.
- The relationship between angel investors and entrepreneurs is often more personal compared to traditional funding sources, as angels are not only investing their money but also leveraging their expertise and network to contribute to the success of the startup.

8.7 Angel Investors Cont…

- Angel investors typically lack prior connections with entrepreneurs and often adopt an impartial stance when evaluating whether to make an investment.

- Differences between Angel Investors and Venture Capitalists:
  - Angel investors often engage in individual part-time investment activities, while venture capital typically originates from a company or fund with full-time managers and a board of directors. This latter approach involves formal analysis and structured investment procedures.

  - Angel Investors generally support businesses at their startup, while venture capitalists' support is more suitable towards the growth and expansion of the business.

8.7 Angel Investors Cont…

- Types of Angel Investors

Corporate Angels	• Previous senior managers who have retired early
Entrepreneurial Angels	• Owners of successful businesses who are also entrepreneurs
Enthusiast Angels	• Older successful entrepreneurs who likes to invest as a hobby
Micro-management Angels	• Serious entrepreneurial investors who would use the strategies that worked for them in their company on the business
Professional Angels	• Investors who like to invest in a company which sells a product or service where they have prior professional experience on

8.7 Angel Investors Cont…

- Advantages of Angel Investors
  - Provide early stage funding
  - Provide expertise and mentorship
  - Offer flexible terms and conditions
  - Help build up network
  - Make quicker investment decisions

- Disadvantages of Angel Investors
  - Have lesser capital to invest
  - Some investors can be overly interfering
  - High risk of failure in early stage startups

8.8 Peer to Peer Lending

- Peer to Peer Lending (P2P Lending) is a form of online lending that connects individual lenders directly with borrowers.
- In this decentralized lending model, traditional financial intermediaries like banks are bypassed, and the lending and borrowing transactions occur through online platforms.
- How Peer to Peer Lending operates:
  - Occurs through an online platform where borrowers and lenders can create their profiles.
  - Borrowers list their loan requirement on the platform with details.
  - Lenders select the borrowers they would like to invest on by looking at the loan listings.
  - Loan approval takes place after risk assessment and the cash is disbursed.
  - Borrowers do the repayment according to the agreed interest rates.

8.8 Peer to Peer Lending Cont…

- Advantages of Peer to Peer Lending
  - Easier access to funding
  - Quick and convenient process
  - Different types of borrowers are allowed to register with the platform

- Disadvantages of Peer to Peer Lending
  - Borrowers defaulting
  - Regulations for P2P lending are still upcoming
  - Limited assurance for lenders

8.9 Micro Credit

- Microcredit, also known as microfinance, is a financial service that involves the provision of small loans, typically to individuals in low-income communities, who lack access to traditional banking and financial services.
- The aim of microcredit is to empower individuals to start or expand small businesses, generate income, and improve their overall economic well-being.

- Features of Micro Credit
    - Small amount loans
    - Targeted at the underserved
    - Entrepreneurs are focused
    - Flexible repayment terms are agreed upon

8.9 Micro Credit Cont…

- Advantages of Micro Credit:
    - Financial inclusion
    - Poverty alleviation
    - Local economic growth
    - Community building

- Disadvantages of Micro Credit:
    - High interest rates
    - Borrowers becoming over indebted

8.10 Crowdfunding

- Crowdfunding is raising small amounts of money from a large number of people to fund a business.
- It leverages the collective contributions of a diverse group of individuals, often facilitated through online platforms.
- How crowdfunding works:
  - Entrepreneurs create a detailed campaign on the online crowdfunding platform.
  - Entrepreneurs set a financial target they wish to achieve and their deadline through the campaign.
  - Promotional activities for the campaign are carried out.
  - Interested parties start funding the campaign.
  - If the campaign reaches or exceeds its financial goal, the funds are transferred to the entrepreneur. Funding parties receive the promised rewards, equity, interest, or other agreed-upon benefits.

8.10 Crowdfunding Cont…

- Advantages of Crowdfunding:
  - Businesses that has to struggle with funding, can get access to a secure mode of funding.
  - Promotes market validation for the product.
  - High engagement with community.
  - Flexible funding models.

- Disadvantages of Crowdfunding:
  - No guarantee of success for the campaign.
  - Has to pay a fee for the platform.
  - Crowdfunding is subject to regulatory frameworks that vary by jurisdiction.

Summary

Forms of Entrepreneurial Capital

- Economic Capital
  - Manufactured Capital
  - Financial Capital
- Human Capital
- Social Capital
- Natural Capital

Sources of Financial Capital

- common sources of financial capital are; informal investors, debt and equity financing, venture capital, angel investors, microcredit, crowdfunding and lending
- Informal Investors – 4Fs

Different types of sources of Financial Capital

- Informal investors, debt and equity financing, venture capital, angel investors, microcredit, crowdfunding and lending
  - How they work
  - Advantages and disadvantages