

Financing Entrepreneurial Ventures

- *What investors want?*
- *What is their basis of evaluation of a firm?*
- *What are the different sources of capital and how they compensate for risk?*
- *Why do venture capitalists demand such high return?*
- *Why equity financing may or may not be appropriate for certain businesses?*

Corporate Value Fundamental

At the end of the day, investors



Corporate Value Fundamental

At the end of the day, investors want to get their money back



Corporate Value Fundamental

At the end of the day, investors want to get their money back along with a healthy return.



Corporate Value Fundamental

Therefore, the heart of corporate valuation



Corporate Value Fundamental

Therefore, the heart of corporate valuation is how much future cash a firm can generate.



Corporate Value Fundamental

$$\text{Value} = \text{NPV}(\sum \text{future cashflows})$$



Corporate Value Fundamental

$$\text{Value} = \text{NPV}(\sum \text{future cashflows})$$



EXPECTED

Corporate Value Fundamental

A mature company



- Predictable future cash flows
- No anticipated changes in their environment

Corporate Value Fundamental

CASH

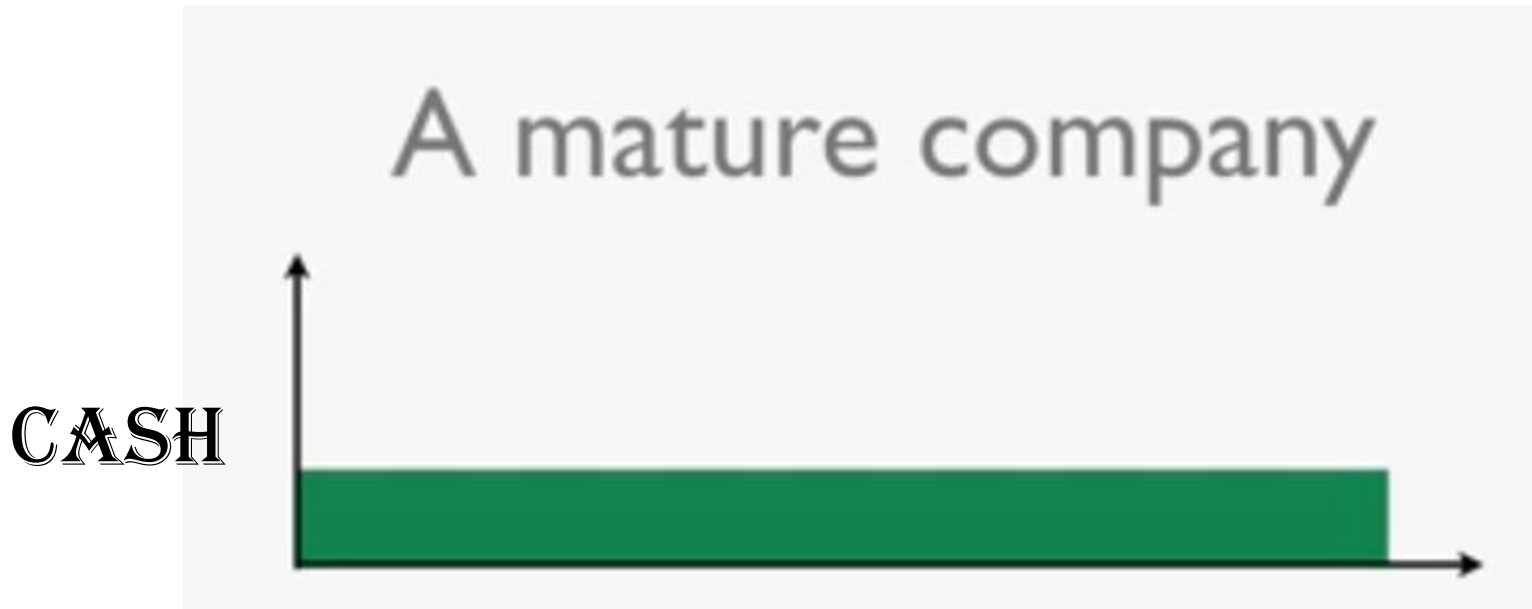
A mature company



TIME



Corporate Value Fundamental



TIME



Corporate Value Fundamental

A high-growth company



Corporate Value Fundamental

A high-growth company

CASH



TIME



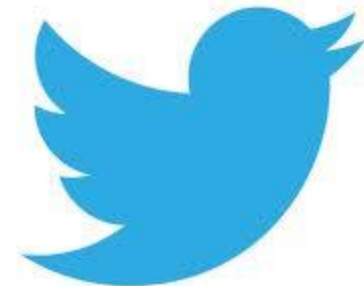
Corporate Value Fundamental

A high-growth company

CASH



TIME



Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
Bank	Very low	P+1	Collateral
Lease	Low	P+5	Collateral, industry focus
Mezzanine	Medium	P+15	Convertible debt
Angel	High	20-40	Equity, board, management
Venture Capital	High	40+	Equity, board, ratchet
Friends & Family	?	?	Their love for you

* Annualized return expressed as a percentage

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
Bank	Very low	P+I	Collateral

With **bank financing**, you go directly to a **bank** and apply for a loan.

* Annualized return expressed as a percentage

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
Bank	Very low	P+I	Collateral
Lease	Low	P+5	Collateral, industry focus

Lease financing is one of the important sources of medium- and long-term **financing** where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.

* Annualized return expressed as a percentage

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
Bank	Very low	P+I	Collateral
Lease	Low	P+5	Collateral, industry focus
Mezzanine	Medium	P+15	Convertible debt

Mezzanine financing is basically **debt** capital that gives the lender the rights to convert to an ownership or equity interest in the company if the **loan** is not paid back in time and in full. It is generally subordinated to **debt** provided by senior lenders such as banks and venture capital companies.

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
Bank	Very low	P+I	Collateral
Lease	Low	P+5	Collateral, industry focus
Mezzanine	Medium	P+15	Convertible debt
Angel	High	20-40	Equity, board, management

An **angel investor** is an **investor** who provides financial backing for small startups or entrepreneurs. **Angel investors** are usually found among an entrepreneur's family and friends. The capital they provide can be a one-time injection of seed money or ongoing support to carry the company through difficult times.

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
--	----------------	-------	-------------------------

Venture capital financing is a type of **financing** by **venture capital**. It is private equity **capital** provided as seed **funding** to early-stage, high-potential, growth companies (startup companies) or more often it is after the seed **funding** round as a growth **funding** round (also referred to as series A round)

Venture Capital	High	40+	Equity, board, ratchet
Friends & Family	?	?	Their love for you

* Annualized return expressed as a percentage

Sources of Capital

And how they compensate for risk

	Risk tolerance	Cost*	Compensating mechanisms
--	----------------	-------	-------------------------

Monies, usually in the form a loan, that a business owner gets from either family members or friends in order to help finance their startup or growing business .

Friends & Family	?	?	Their love for you
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* Annualized return expressed as a percentage

Venture Capitalists

Why such a high rate?

Result	How many	Amount invested	Amount returned
Home run	1	\$1,000	\$15,000
Life style	2	\$2,000	\$2,000
Dogs	7	\$7,000	\$0
Totals	10	\$10,000	\$17,000

A \$10,000 investment that returns \$17,000 in five years yields 11.2% compound annual return.

Putting it into practice

What VC or Angel funding does to your business.

Example 1: A restaurant

2011

2016

Putting it into practice

What VC or Angel funding does to your business.

Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value*	150,000	
Investment	125,000	
Equity %	45%	

2016

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Firm Value: Assume 3x EBITDA

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Firm Value:

= Assume 3x EBITDA

= $3 * 50,000 = 150,000$

Firm Value: Assume 3x EBITDA

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Investors put up \$125K



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Total value of the firm
after investment:
 $275K = 150K + 125K$

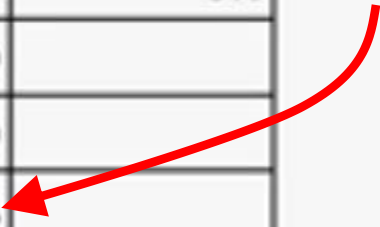
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Investment	125,000	
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$$45\% = 125K / (150K + 125K)$$


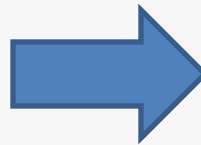
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Firm Value		
Investment		
Equity %		

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Investment		
Equity %	45%	

A firm value of \$275K (\$150K + \$125K) needs to grow 5X to satisfy VCs.

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COGS		35%
Gr. Margin		65%
G&A		50%
R&D		0%
S&M		10%
EBITDA		5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

$$1375K = 275K * 5$$

Putting it into practice

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Example 1: A restaurant

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Revenue	1,000,000	100%
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Gr. Margin	650,000	65%
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G&A		50%
R&D		0%
S&M		10%
EBITDA		5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Reverse engineering the figures!

Putting it into practice

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R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue		100%
COGS		35%
Gr. Margin		65%
G&A		50%
R&D		0%
S&M		10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

$1,375,000 / 3 = 458,333.33$: roughly 458,000

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

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Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS		35%
Gr. Margin		65%
G&A		50%
R&D		0%
S&M		10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

$$9,160,000 = 458K / .05$$

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS		35%
Gr. Margin		65%
G&A		50%
R&D		0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



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Gr. Margin		65%
G&A		50%
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S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Putting it into practice

What VC or Angel funding does to your business.

Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS		35%
Gr. Margin		65%
G&A	4,580,000	50%
R&D	0	0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS		35%
Gr. Margin	5,954,000	65%
G&A	4,580,000	50%
R&D	0	0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS	3,206,000	35%
Gr. Margin	5,954,000	65%
G&A	4,580,000	50%
R&D	0	0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Putting it into practice

What VC or Angel funding does to your business.
Example 1: A restaurant

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS	3,206,000	35%
Gr. Margin	5,954,000	65%
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R&D	0	0%
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Firm Value	1,375,000	
Investment		
Equity %	45%	

900% growth

Putting it into practice

What VC or Angel funding does to your business.

Example 1: A restaurant

900% growth

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

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R&D	0	0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Can the physical plant grow to accommodate # of meals? Does firm generate enough gross margin to make growth investments? Are there enough customers to support 900% growth?

Putting it into practice

What VC or Angel funding does to your business.

Example 2: A software company

2011

Revenue	1,000,000	100%
COGS	50,000	5%
Gr. Margin	950,000	95%
G&A	150,000	15%
R&D	250,000	25%
S&M	400,000	40%
EBITDA	150,000	15%
Firm Value*	450,000	
Investment	125,000	
Equity %	22%	

2016

Revenue		100%
COGS		5%
Gr. Margin		95%
G&A		15%
R&D		25%
S&M		40%
EBITDA		15%
Firm Value		
Investment		
Equity %		

* Assume 3X EBITDA (although this may be low for high margin, high growth companies).

Putting it into practice

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Revenue		100%
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EBITDA		15%
Firm Value		
Investment		
Equity %	22%	

A firm value of \$575K (\$450K + \$125K) needs to grow 5X to satisfy VCs.

Putting it into practice

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Firm Value	450,000	
Investment	125,000	
Equity %	22%	



2016

Revenue		100%
COGS		5%
Gr. Margin		95%
G&A		15%
R&D		25%
S&M		40%
EBITDA		15%
Firm Value	2,875,000	
Investment		
Equity %	22%	

$$2875K = 575K * 5$$

Putting it into practice

What VC or Angel funding does to your business.
Example 2: A software company

2011

Revenue	1,000,000	100%
COGS	50,000	5%
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Reverse engineering the figures

Putting it into practice

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Revenue		100%
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G&A		15%
R&D		25%
S&M		40%
EBITDA	958,000	15%
Firm Value	2,875,000	
Investment		
Equity %	22%	

2,875,000/3=: roughly 958,000

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Investment	125,000	
Equity %	22%	



2016

Revenue	6,386,000	100%
COGS		5%
Gr. Margin		95%
G&A		15%
R&D		25%
S&M		40%
EBITDA	958,000	15%
Firm Value	2,875,000	
Investment		
Equity %	22%	

$$\sqrt{6,386,000 = (958,000 / .15)}$$

Putting it into practice

What VC or Angel funding does to your business.

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Revenue	6,386,000	100%
COGS		5%
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R&D	1,596,000	25%
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Revenue	6,386,000	100%
COGS		5%
Gr. Margin		95%
G&A	957,000	15%
R&D	1,596,000	25%
S&M	2,554,000	40%
EBITDA	958,000	15%
Firm Value	2,875,000	
Investment		
Equity %	22%	

Putting it into practice

What VC or Angel funding does to your business.

Example 2: A software company

2011

Revenue	1,000,000	100%
COGS	50,000	5%
Gr. Margin	950,000	95%
G&A	150,000	15%
R&D	250,000	25%
S&M	400,000	40%
EBITDA	150,000	15%
Firm Value	450,000	
Investment	125,000	
Equity %	22%	



2016

Revenue	6,386,000	100%
COGS		5%
Gr. Margin	6,069,000	95%
G&A	957,000	15%
R&D	1,596,000	25%
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✓ Growth is over 600 percent

Putting it into practice

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S&M	2,554,000	40%
EBITDA	958,000	15%
Firm Value	2,875,000	
Investment		
Equity %	22%	

What physical plant? Geography doesn't limit customers. And tons of gross margin flexibility.

Putting it into practice

What VC or Angel funding does to your business.

Example 1: A restaurant

900% growth

2011

Revenue	1,000,000	100%
COGS	350,000	35%
Gr. Margin	650,000	65%
G&A	500,000	50%
R&D	0	0%
S&M	100,000	10%
EBITDA	50,000	5%
Firm Value	150,000	
Investment	125,000	
Equity %	45%	



2016

Revenue	9,160,000	100%
COGS	3,206,000	35%
Gr. Margin	5,954,000	65%
G&A	4,580,000	50%
R&D	0	0%
S&M	916,000	10%
EBITDA	458,000	5%
Firm Value	1,375,000	
Investment		
Equity %	45%	

Can the physical plant grow to accommodate # of meals? Does firm generate enough gross margin to make growth investments? Are there enough customers to support 900% growth?

Lessons

- *Investors want their money back with a healthy return.*
- *Value is in the eye of the beholder.*
- *Understand the potential sources of capital available to your venture and write your business plan accordingly.*

Thank You For Listening!

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References

- *Source: Alex Glassy (2011).*
- *Financing Entrepreneurial Ventures.*
- *<http://www.youtube.com/watch?v=L7CbYBylYRQ>*