

The background features a white area with a light gray dot pattern in the top-left corner. A diagonal line divides the image, with a solid orange triangle in the bottom-left and a large blue area in the bottom-right. The blue area contains a pattern of lighter blue dots. The text 'FINANCING THE VENTURE' is written diagonally across the center, following the line between the white and blue areas. The word 'FINANCING' is yellow, 'THE' is blue, and 'VENTURE' is orange.

FINANCING THE VENTURE

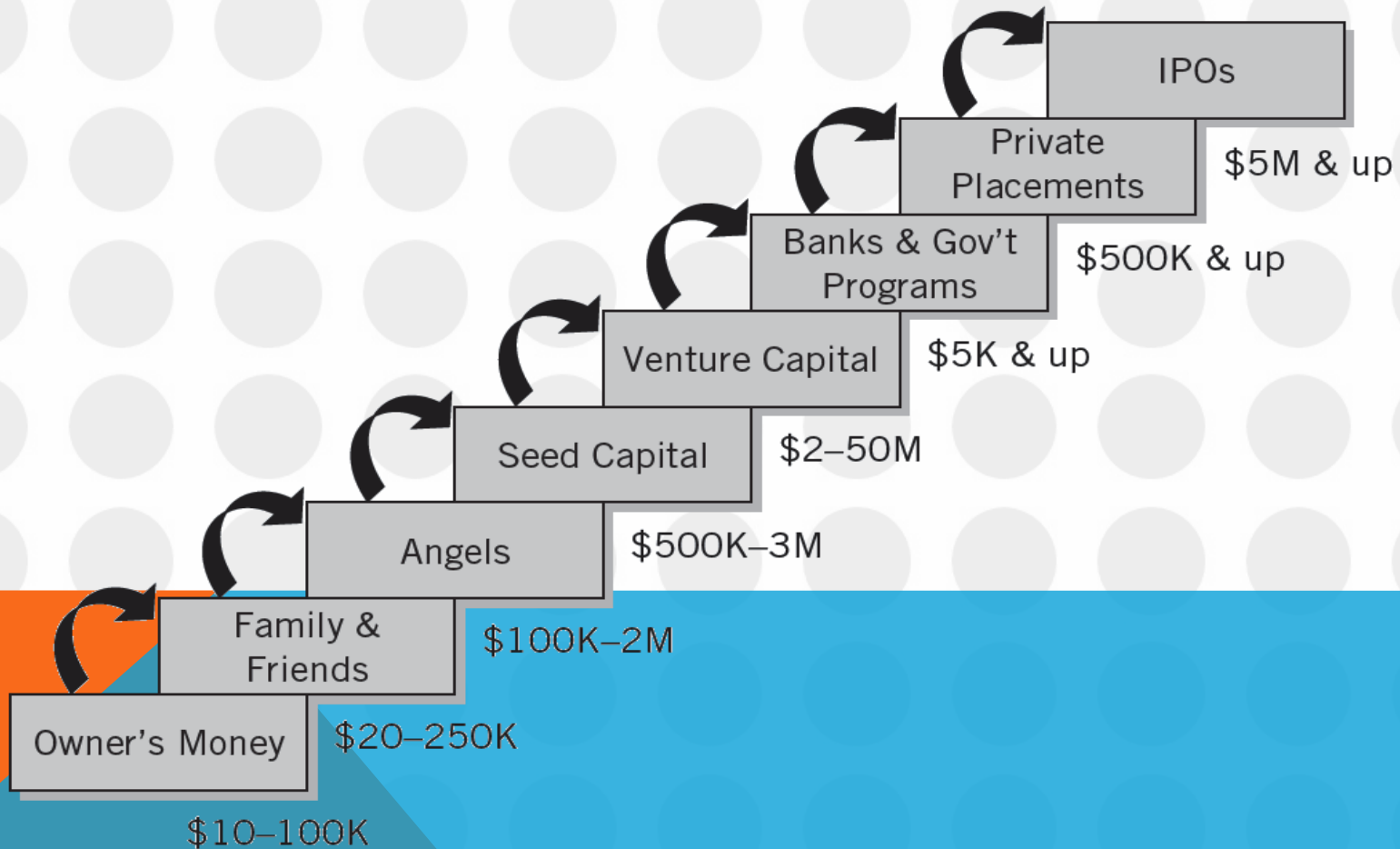
FIGURE

8.1

WHO IS FUNDING ENTREPRENEURIAL START-UP COMPANIES?

**Financing
Continuum**

The following diagram depicts the typical financing for start-up companies.



DEBT VERSUS EQUITY

Debt Financing

- Secured financing of a new venture that involves a payback of the funds plus a fee (interest for the use of the money).

Equity Financing

- Involves the sale (exchange) of some of the ownership interest in the venture in return for an unsecured investment in the firm.



DEBT FINANCING

Commercial Banks

- Make 1-5 year intermediate-term loans secured by collateral (receivables, inventories, or other assets).
- Questions in securing a loan:
 1. What do you plan to do with the money?
 2. How much do you need?
 3. When do you need it?
 4. How long will you need it?
 5. How will you repay the loan?



DEBT FINANCING (CONT'D)

Advantages

- No relinquishment of ownership is required.
- More borrowing allows for potentially greater return on equity.
- low interest rates reduce the opportunity cost of borrowing

Disadvantages

- Regular (monthly) interest payments are required.
- Continual cash-flow problems can be intensified because of payback responsibility.
- Heavy use of debt can inhibit growth and development.

SOCIAL LENDING, OR CROWDFUNDING

Sources of Social Lending

- Are often Internet-based sites that pool money from investors willing to lend capital at agreed-upon rates.
- Match borrowers and lenders based on loan size, risk tolerance, and social familiarity (e.g., co-workers, fellow alumni, hometown residents, etc.).

Possible Dangers

- Low funding success rate
- Business plan disclosure
- No ongoing counseling relationship
- Potential tax liability
- Uncertain regulatory environment

TABLE

8.1

COMMON DEBT SOURCES

Debt Source	Business Type Financed		Financing Term		
	Start-Up Firm	Existing Firm	Short Term	Intermediate Term	Long Term
Trade credit	Yes	Yes	Yes	No	No
Commercial banks	Sometimes, but only if strong capital or collateral exists	Yes	Frequently	Sometimes	Seldom
Finance companies	Seldom	Yes	Most frequent	Yes	Seldom
Factors	Seldom	Yes	Most frequent	Seldom	No
Leasing companies	Seldom	Yes	No	Most frequent	Occasionally
Mutual savings banks and savings-and-loan associations	Seldom	Real estate ventures only	No	No	Real estate ventures only
Insurance companies	Rarely	Yes	No	No	Yes

OTHER DEBT FINANCING SOURCES

Trade Credit

- Credit given by suppliers who sell goods on account.

Accounts Receivable Financing

- Short-term financing that involves either the pledge of receivables as collateral for a loan or the sale of receivables at a discounted value (factoring).

Factoring

- The sale of accounts receivable at discounted values

Finance Companies

- Asset-based lenders that lend money against assets such as receivables, inventory, and equipment.

OTHER DEBT FINANCING SOURCES (CONT'D)

Equity Financing

- Gives investors a share of the ownership.
- ***Loan with warrants*** provide the investor with the right to buy stock at a fixed price at some future date.
- ***Convertible debentures*** are unsecured loans that can be converted into stock.
- ***Preferred stock*** is equity that gives investors a preferred place among the creditors in the event the venture is dissolved.
- ***Common stock*** is the most basic form of ownership and is often are sold through public or private offerings.

EQUITY FINANCING

Equity Financing

- Money invested in the venture with no legal obligation for entrepreneurs to repay the principal amount or pay interest on it.
- Funding sources: public offering and private placement

Public Offering

- “Going public” refers to a corporation’s raising capital through the sale of its securities on the stock markets.
- Initial Public Offerings (IPOs): new issues of common stock

PUBLIC OFFERINGS

Advantages

- Size of capital amount
- Liquidity
- Value
- Image

Disadvantages

- Costs
- Disclosure
- Requirements
- Shareholder pressure



PRIVATE PLACEMENTS

Regulation D

- Securities and Exchange Commission (SEC) regulations for reports and statements required when selling stock to private parties—friends, employees, customers, relatives, and professionals.
- Defines four separate exemptions, which are based on the amount of money being raised:
 - Rule 504a: placements of less than \$500,000
 - Rule 504: placements up to \$1,000,000
 - Rule 505: placements of up to \$5 million
 - Rule 506: placements in excess of \$5 million

PRIVATE PLACEMENTS (CONT'D)

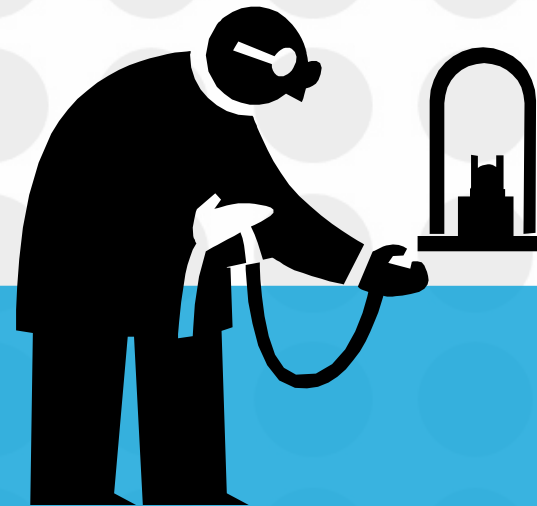
Accredited Purchaser

- Regulation D uses the term “accredited purchaser.” Included in this category are the following:
 - Institutional investors such as banks, insurance companies, venture capital firms.
 - Any person who buys at least \$150,000 of the offered security and whose net worth, including that of his or her spouse, is at least 5 times the purchase price.
 - Any person who, together with his or her spouse, has a net worth in excess of \$1 million at the time of purchase.

INVESTORS

“Sophisticated” Investors

- Wealthy individuals who invest regularly in new and early- and late-stage ventures and are knowledgeable about the technical and commercial opportunities and risks of the business in which they invest.



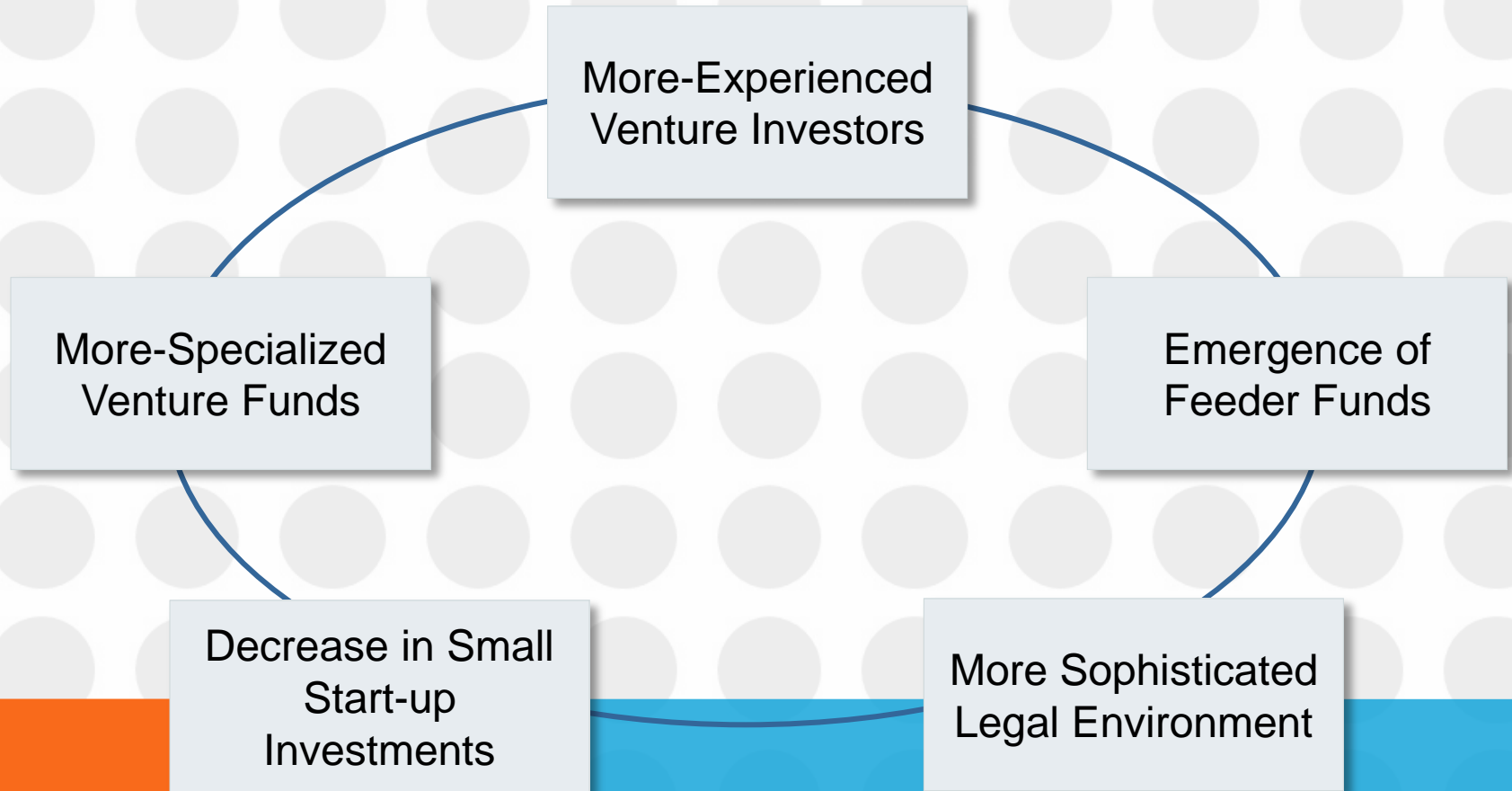
THE VENTURE CAPITAL MARKET

Venture Capitalists

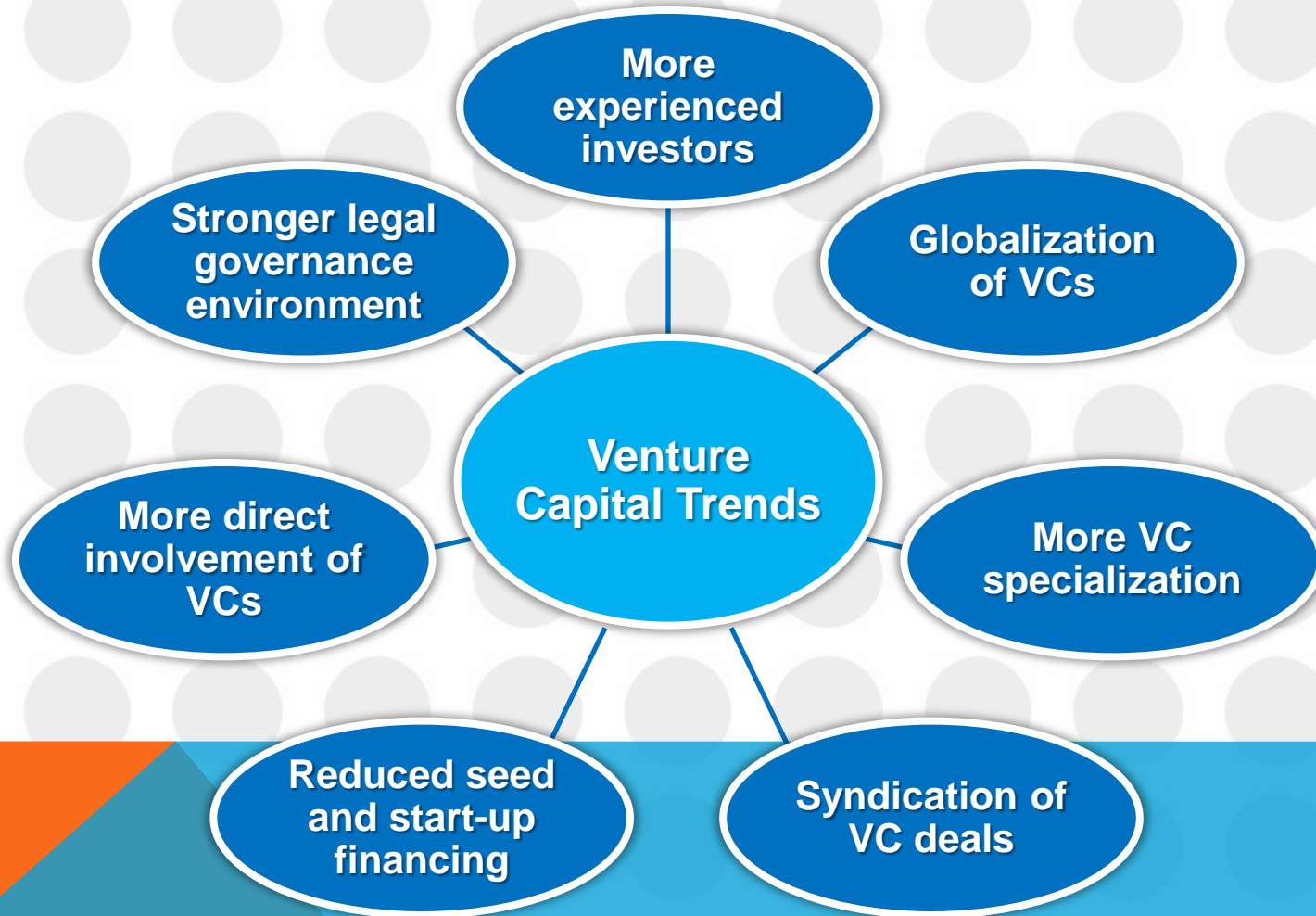
- Are valuable and powerful sources of equity funding for new ventures who provide:
 - Capital for start-ups and expansion
 - Market research and strategy
 - Management-consulting, audits and evaluation
 - Contacts—customers, suppliers, and businesspeople
 - Assistance in negotiating technical agreements
 - Help in establishing management and accounting controls
 - Help in employee recruitment and employee agreements
 - Help in risk management and with insurance programs
 - Counseling and guidance in complying with government regulations

Stage	Amount	Deals
Later Stage	\$1.8 billion	178
Early Stage	\$2.3 billion	364
Start up/Seed	\$134 million	80

RECENT DEVELOPMENTS IN VENTURE CAPITAL



RECENT DEVELOPMENTS IN VENTURE CAPITAL



INVESTMENT AGREEMENT PROVISIONS

Choice of securities

- Preferred stock, common stock, convertible debt, and so forth

Control issues

- Who maintains voting power

Evaluation issues and financial covenants

- Ability to proceed with mergers and acquisitions

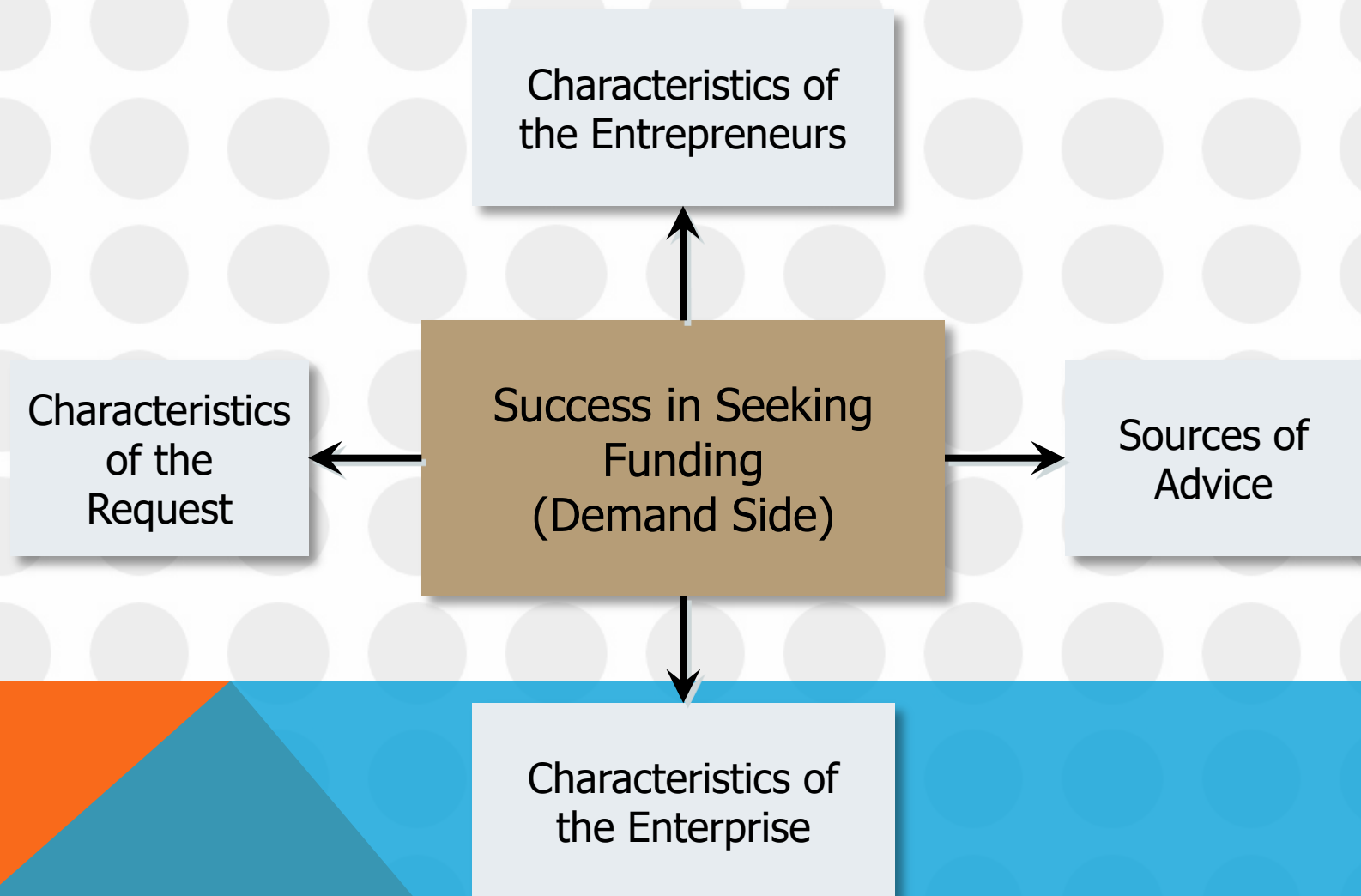
Remedies for breach of contract

- Rescission of the contract or monetary damages

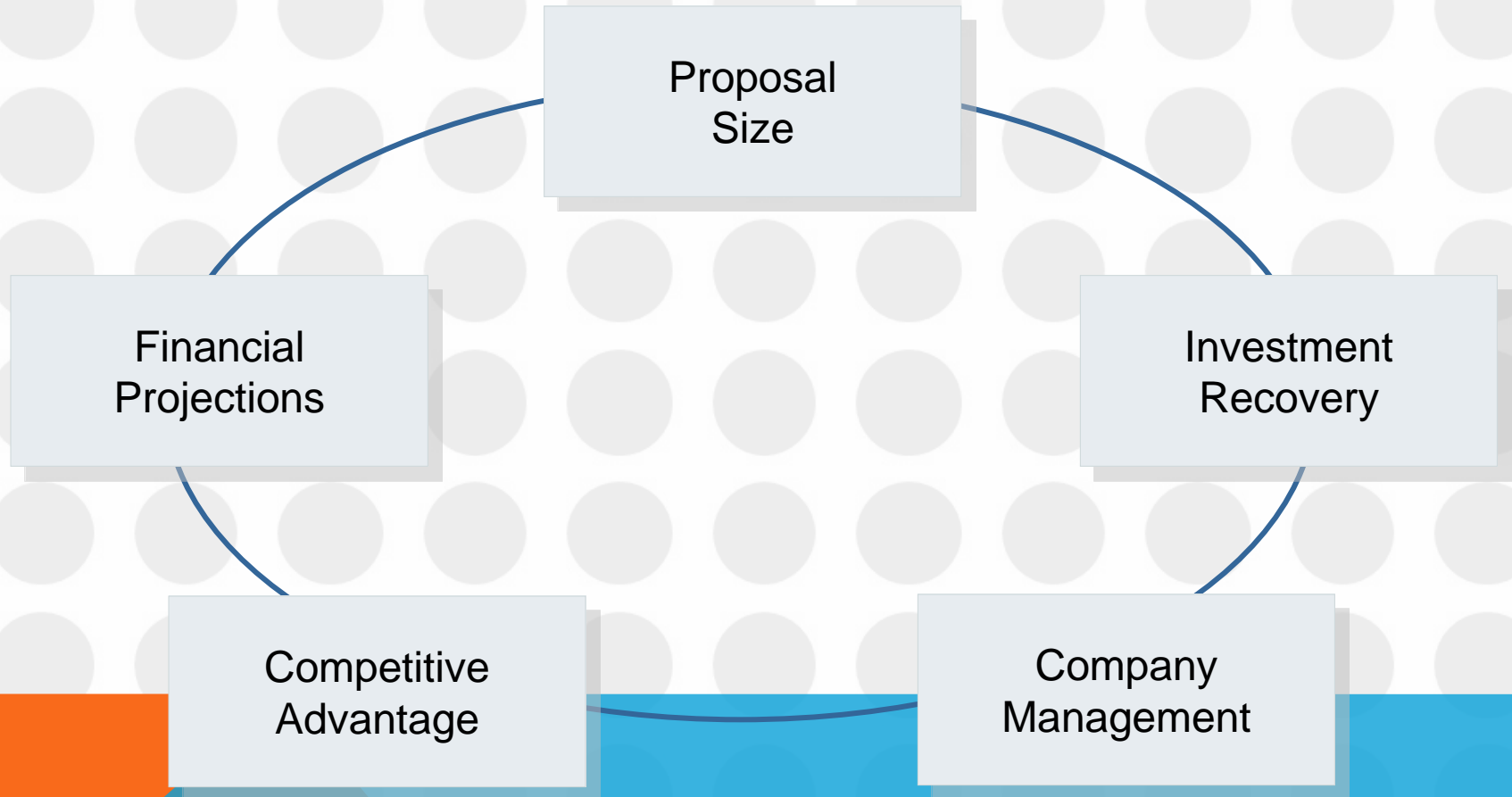
DISPELLING VENTURE CAPITAL MYTHS

- Myth 1:** Venture capital firms want to own control of your company and tell you how to run the business.
- Myth 2:** Venture capitalists are satisfied with a reasonable return on investment.
- Myth 3:** Venture capitalists are quick to invest.
- Myth 4:** Venture capitalists are interested in backing new ideas or high-technology inventions—management is a secondary consideration.
- Myth 5:** Venture capitalists need only basic summary information before they make an investment.

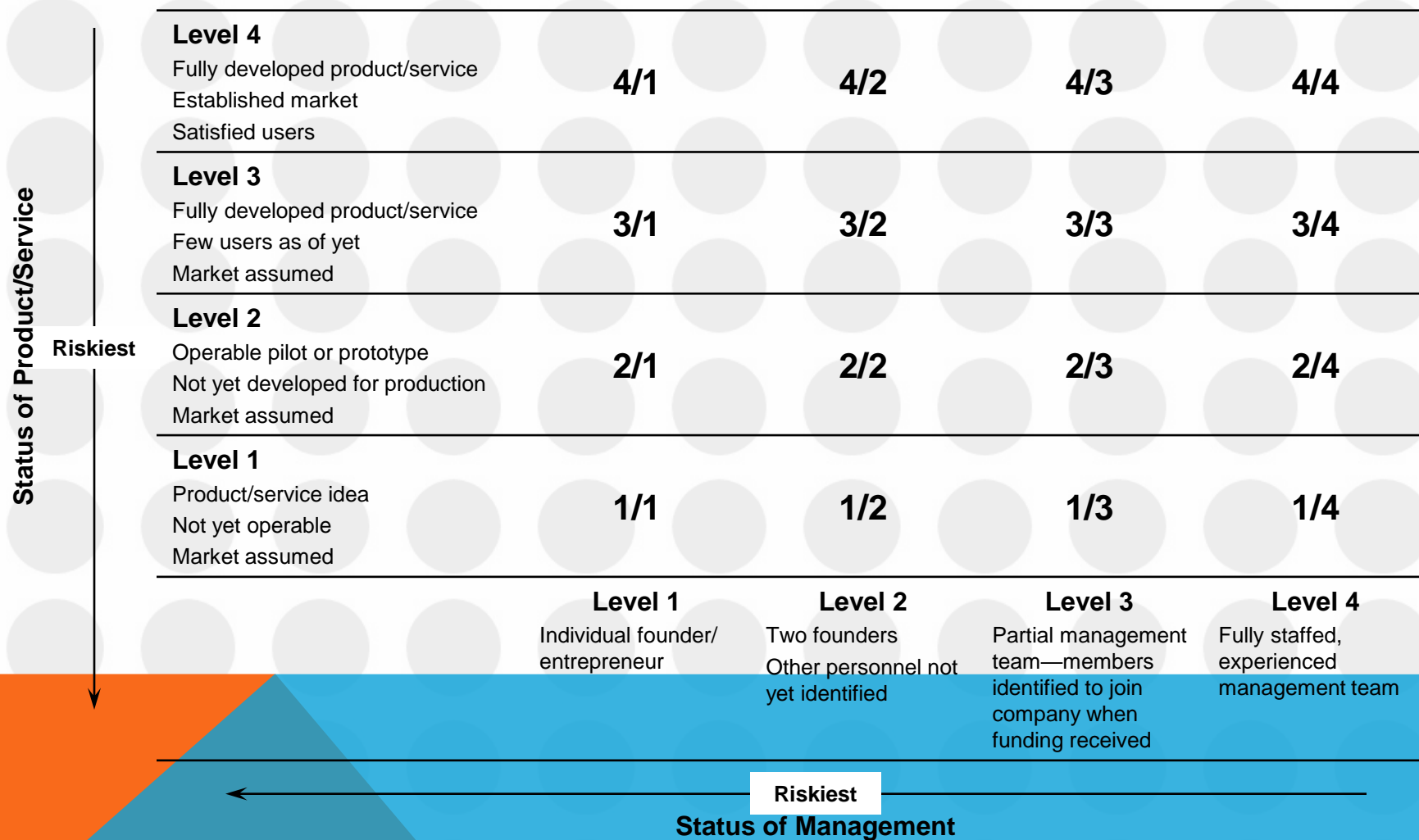
FACTORS IN SUCCESSFUL FUNDING OF VENTURES



VENTURE CAPITALISTS AND BUSINESS PLANS



VENTURE CAPITALIST SYSTEM OF EVALUATING PRODUCT/SERVICE AND MANAGEMENT



RETURNS ON INVESTMENT TYPICALLY SOUGHT BY VENTURE CAPITALISTS

Stage Of Business	Expected Annual Return on Investment	Expected Increase on Initial Investment
Start-up business (idea stage)	60% +	10–15 × investment
First-stage financing (new business)	40%–60%	6–12 × investment
Second-stage financing (development stage)	30%–50%	4–8 × investment
Third-stage financing (expansion stage)	25%–40%	3–6 × investment
Turnaround situation	50% +	8–15 × investment

TABLE

8.4

FACTORS IN VENTURE CAPITALISTS' EVALUATION PROCESS

Attribute	Level	Definition
Timing of entry	Pioneer	Enters a new industry first
	Late follower	Enters an industry late in the industry's stage of development
Key success factor stability	High	Requirements necessary for success will not change radically during industry development
	Low	Requirements necessary for success will change radically during industry development
Educational capability	High	Considerable resources and skills available to overcome market ignorance through education
	Low	Few resources or skills available to overcome market ignorance through education
Lead time	Long	An extended period of monopoly for the first entrant prior to competitors entering the industry
	Short	A minimal period of monopoly for the first entrant prior to competitors entering this industry

TABLE

8.4

FACTORS IN VENTURE CAPITALISTS' EVALUATION PROCESS (CONT'D)

Attribute	Level	Definition
Competitive rivalry	High	Intense competition among industry members during industry development
	Low	Little competition among industry members during industry development
Entry wedge mimicry	High	Considerable imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, a franchisee
	Low	Minimal imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, introducing a new product
Scope	Broad	A firm that spreads its resources across a wide spectrum of the market—for example, many segments of the market
	Narrow	A firm that concentrates on intensively exploiting a small segment of the market—for example, targeting a niche
Industry-related competence	High	Venturer has considerable experience and knowledge with the industry being entered or a related industry
	Low	Venturer has minimal experience and knowledge with the industry being entered or related industry

CRITERIA FOR EVALUATING NEW-VENTURE PROPOSALS

Major Categories of Venture Capitalist Screening Criteria:

- Entrepreneur's personality
- Entrepreneur's experience
- Product or service characteristics
- Market characteristics
- Financial considerations
- Nature of the venture team

Venture Capital Firm Requirements

- Must fit within lending guidelines of venture firm for stage and size of investment
- Proposed business must be within geographic area of interest
- Prefer proposals recommended by someone known to venture capitalist
- Proposed industry must be kind of industry invested in by venture firm

Nature of the Proposed Business

- Projected growth should be relatively large within five years of investment

Economic Environment of Proposed Industry

- Industry must be capable of long-term growth and profitability
- Economic environment should be favorable to a new entrant

Proposed Business Strategy

- Selection of distribution channel(s) must be feasible
- Product must demonstrate defendable competitive position

Financial Information on the Proposed Business

- Financial projections should be realistic

Proposal Characteristics

- Must have full information
- Should be a reasonable length, be easy to scan, have an executive summary, and be professionally presented
- Proposal must contain a balanced presentation
- Use graphics and large print to emphasize key points

Entrepreneur/Team Characteristics

- Must have relevant experience
- Should have a balanced management team in place
- Management must be willing to work with venture partners
- Entrepreneur who has successfully started previous business given special consideration

VENTURE CAPITALIST EVALUATION PROCESS

Stage 1: Initial Screening

- This is a quick review of the basic venture to see if it meets the venture capitalist's particular interests.

Stage 2: Evaluation of the Business Plan

- This is where a detailed reading of the plan is done in order to evaluate the factors mentioned earlier.

Stage 3: Oral Presentation

- The entrepreneur verbally presents the plan to the venture capitalist.

Stage 4: Final Evaluation

- After analyzing the plan and visiting with suppliers, customers, consultants, and others, the venture capitalist makes a final decision.

TEAM MUST:

- Be able to adapt
- Know the competition
- Be able to manage rapid growth
- Be able to manage an industry leader
- Have relevant background and industry experience
- Show financial commitment to firm, not just sweat equity
- Be strong with a proven track record in the industry unless the company is a start-up or seed investment

PRODUCT MUST:

- Be real and work
- Be unique
- Be proprietary
- Meet a well-defined need in the marketplace
- Demonstrate potential for product expansion, to avoid being a one-product company
- Emphasize usability
- Solve a problem or improve a process significantly
- Be for mass production with potential for cost reduction

MARKET MUST:

- Have current customers and the potential for many more
- Grow rapidly (25% to 45% per year)
- Have a potential market size in excess of \$250 million
- Show where and how you are competing in the marketplace
- Have potential to become a market leader
- Outline any barriers to entry

BUSINESS PLAN MUST:

- Tell the full story, not just one chapter
- Promote a company, not just a product
- Be compelling
- Show the potential for rapid growth and knowledge of your industry, especially competition and market vision
- Include milestones for measuring performance
- Show how you plan to beat or exceed those milestones
- Address all of the key areas
- Detail projections and assumptions; be realistic
- Serve as a sales document
- Include a strong and well-written executive summary
- Show excitement and color
- Show superior rate of return (a minimum of 30% to 40% per year) with a clear exit strategy

INFORMAL RISK CAPITAL

Business Angel Financing

- Wealthy individuals who are looking for investment opportunities.
 - They are referred to as “business angels” or informal risk capitalists.

Types of Angel Investors

- Corporate angels – are senior managers who have been laid off with generous severances or have taken early retirement.
- Entrepreneurial angels – most prevalent type of investors , most of these individuals own and operate highly successful businesses.
- Enthusiast angles – they are simply like to involve in deals. Mostly are age 65 or older, independently wealthy from success in a business they started.
- Micromanagement angels – are very serious investors. Some of them were born wealthy, but the vast majority attained wealth through their own efforts.
- Professional angels – The term *professional* in this context refers to the investor’s occupation, such as doctor, lawyer, accountant, etc.

Typical deal size	\$500,000–\$850,000
Typical recipient	Start-up firms
Cash-out time frame	5 to 7 years
Expected return	35% to 50% a year
Ownership stake	Less than 50%

Pros

1. Angels engage in smaller financial deals.
2. Angels prefer seed stage or start-up stage.
3. Angels invest in various industry sectors.
4. Angels are located in local geographic areas.
5. Angels are genuinely interested in the entrepreneur.

Cons

1. Angels offer no additional investment money.
2. Angels cannot offer any national image.
3. Angels lack important contacts for future leverage.
4. Angels may want some decision making with the entrepreneur.
5. Angels are getting more sophisticated in their investment decisions.

KEY TERMS AND CONCEPTS

accounts receivable financing

accredited purchaser

angel capital

bootstrapping

business angel

crowdfunding

debt financing

direct public offering (DPO)

equity financing

factoring

finance companies

informal risk capitalist

initial public offering (IPO)

private placement

Regulation D

social lending

sophisticated investor

trade credit

venture capitalist