Professional Issues in IT

Financing a Startup Company

Week 4

What is the Startup Company?

A startup company is an entrepreneurial venture which is typically a newly emerged, fast-growing business that aims to meet a marketplace need by developing a viable business model around an innovative product, service, process or a platform.

Why Startup company needs Capital?

- Capital is the money or assets which are invested to start/run any business
- Startup company needs capital because:
  - Need to buy equipment and machineries
  - Need to pay for salaries, rent, renovations, advertising, marketing, stationaries, travelling, interest on loans etc.
  - Product or service design/development takes time, human resources, and financial resources.
  - Customers pay late (time vary between 1 to 3 months in case of commercial customers such as other companies)

The Business Plan

- First Step in raising the money is to prepare the business plan
- It is a document which is prepared to explain the plans to potential funders. The document contains the description of:
  - Company operations
  - Technical feasibilities of the products and services
  - Expertise of founders
  - Potential target markets
  - Market size
  - Assessment of competitors
  - Prediction of financial performance of the company

Sources of Finance

- Government Organizations
- Non-government Organizations
- Types of Finance
  - Grants
  - Loans
  - Equity Capital

Grants

- A *grant* is a sum of money given to the company; while the company is obliged to demonstrate that it has been used for the purposes for which it was given, it is not intended that the grant should ever be paid back to the organization which gave it.
  - Grants are available from local and national funders (sources)
  - The availability of grants depends upon government policies, location, operation, type, and employment generation perspectives of the company
  - Grants are usually intended to provide the capital investment (typically for initial setup of premises and furnitures)
  - Subject to a number of conditions
  - Limited to a certain proportion of capital

Loans

- A sum of money lent to the company; interest is payable on it, at a rate that maybe fixed or variable, and the loan is ususally for a fixed period of time.
- The company has to payback
- If fails, the lender is entitled to recover from the sales of the company assets.
- In most cases, security (in the form of guarantees or assets) is needed
- Loans could be devided into overdrafts and long-term loans.

Overdrafts

An overdraft is the most flexible form of loan. Overdrafts are offered by banks; they allow a company (or an individual) to spend more money than is in its account, up to a specified maximum. Interest is only payable on the amount actually owed and the rate is normally comparatively low; it is usually fixed at a certain number of points above the bank base lending rate, the precise figure depending on the bank's view of the credit-worthiness of the borrower. While overdrafts are the most flexible and usually the cheapest way to borrow, there is a price to be paid. A bank can withdraw overdraft facilities without warning, possibly for reasons of general policy that have nothing to do with the borrower. Many small companies have been forced into liquidation unnecessarily as a result of such action by banks.

Long-term loans

- Long-term loans are usually made for a fixed period at a fixed rate of interest. The borrower receives the capital (the amount of the loan) at the start of the period of the loan and is committed to paying interest on that amount throughout the period of the loan. Provided the borrower pays the interest on time, the lender cannot call in the loan. The borrower must repay the capital at the end of the period.

Soft Loans

- It is a loan on terms that are less onerous than those that prevail for commercial loans.
- Soft loans are usually only available to start-up companies
- Interest rates may be lower than commercial interest rates
- Security is not demanded.

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- Usually channeled through banks and commercial financial institutions.

Equity Capital

- *Equity capital* is money paid to the company in exchange for a share in the ownership of the company, as described in the previous chapter.
- If a company looks to have good prospects but needs to raise more capital, it will usually need to resort to business angels or venture capitalists.
- Business angels are wealthy individuals who provide equity capital for start-up companies and small firms that are seeking to grow rapidly.
- Venture capitalists are companies whose business is investing in small companies with high growth potential.

Gearing

- *Gearing or leverage* is the relationship between loan capital and equity capital.
- Lenders are safe but gets fixed return
- Shareholders are at risk but gets flexible returns
- A highly geared company acquires investments from shareholders which in turn results in the loss of lenders interest or intention to invest in the companies.