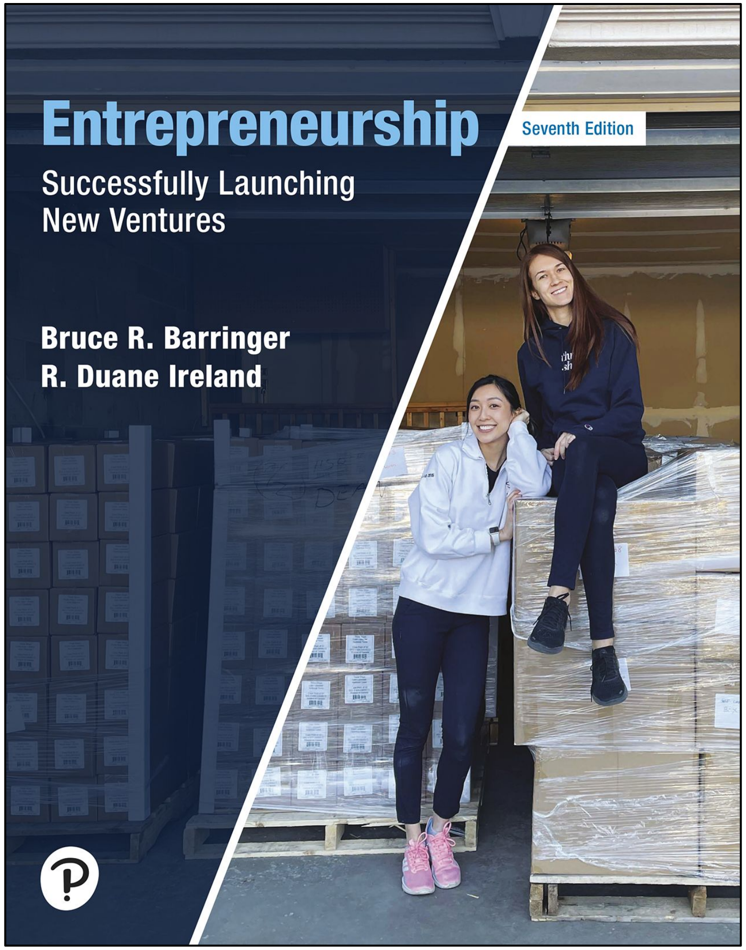
Entrepreneurship: Successfully Launching New Ventures

Seventh Edition



Chapter 10

Getting Financing or Funding

Learning Objectives (1 of 2)

10.1 Describe the importance of financing for entrepreneurial success.

10.2 Explain why most entrepreneurial ventures need to raise money during their early life.

10.3 Identify and describe the three sources of personal financing available to entrepreneurs.

10.4 Identify and explain the three steps involved in preparing to raise debt or equity financing.

10.5 Explain the three most important sources of equity funding that are available to the entrepreneurial firm.

Learning Objectives (2 of 2)

10.6 Describe common sources of debt financing entrepreneurial firms use.

10.7 Describe several creative sources of financing entrepreneurial firms may choose to use.

10.1 The Importance of Getting Financing or Funding

- Few people deal with the process of raising investment capital until they need to raise capital for their own firm.
  - As a result, many entrepreneurs go about the task of raising capital haphazardly because they lack experience in this area.
- The need to raise money surprises a number of entrepreneurs, in that many of them launch their firms with the intention of funding all their needs internally.
  - Because of this, it is important for entrepreneurs to understand the role of investment capital in a new firm's survival and subsequent success.

Figure 10.1 Three Reasons Startups Need Funding

Cash-Flow Challenges

Inventory must be purchased, employees must be trained and paid, and advertising must be paid for before cash is generated from sales.

Capital Investments

The cost of buying real estate, building facilities, and purchasing equipment typically exceeds a firm's ability to provide funds for these needs on its own.

Lengthy Product Development Cycles

Some products are under development for years before they generate earnings. The up-front costs often exceed a firm's ability to fund these activities on its own.

10.2 Why Most New Ventures Need Funding (1 of 2)

- Cash-Flow Challenges
  - If a firm operates in the red, its negative real-time cash flow, usually computed monthly, is known as its burn rate.
    - A company's burn rate is the rate at which it is spending its capital until it reaches profitability.

10.2 Why Most New Ventures Need Funding (2 of 2)

- Capital Investments
  - Although a venture's founders may be able to fund their firm's initial activities themselves, it becomes increasingly difficult for them to do so when it comes to buying property, constructing buildings, purchasing equipment, or investing in other capital projects.
- Lengthy Product Development Cycles
  - In some industries, firms need to raise money to pay the up-front costs of lengthy product development cycles.
    - For example, it typically takes between three and five years to develop an electronic game.

10.3 Sources of Personal Financing (1 of 2)

- Personal Funds
  - The vast majority of founders contribute personal funds, along with sweat equity, to their ventures.
    - Sweat equity represents the value of the time and effort that a founder puts into a new venture.
- Friends and Family
  - Friends and family are the second source of funds for many new ventures.

10.3 Sources of Personal Financing (2 of 2)

- Bootstrapping
  - A third source of seed money for a new venture is referred to as bootstrapping.
  - Bootstrapping is finding ways to avoid the need for external financing or funding through creativity, ingenuity, thriftiness, cost cutting, or any means necessary.
  - Many entrepreneurs bootstrap out of necessity.

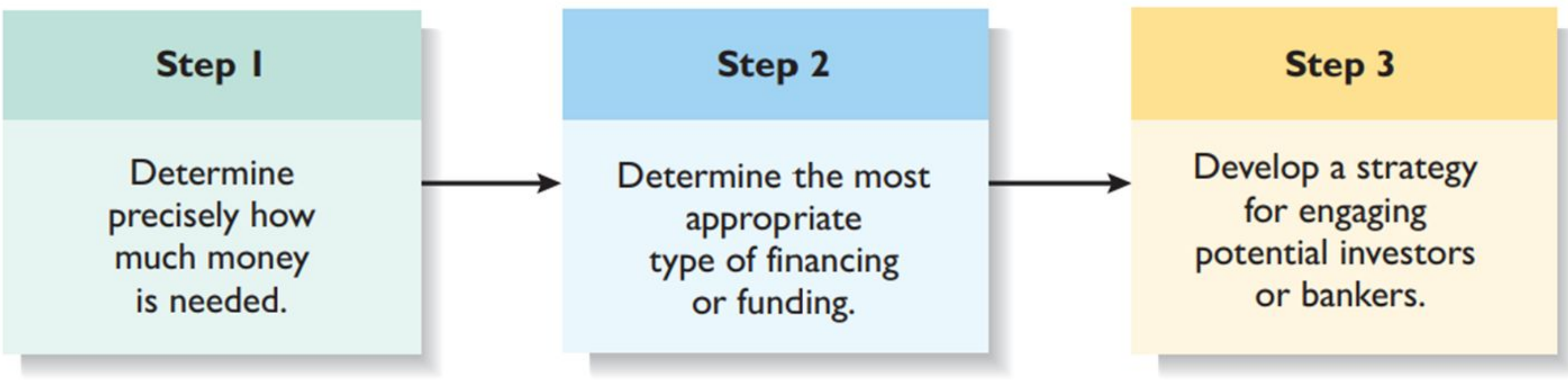
Table 10.1 Examples of Bootstrapping Methods (1 of 2)

- Buy used instead of new equipment.
- Coordinate purchases with other businesses.
- Lease instead of buying equipment.
- Obtain payments in advance from customers.
- Minimize personal expenses.
- Avoid unnecessary expenses, such as lavish office space or furniture.

Table 10.1 Examples of Bootstrapping Methods (2 of 2)

- Buy items cheaply, but prudently, through discount outlets or digital platforms like Facebook Marketplace rather than at full-price stores.
- Share office space or employees with other businesses.
- Hire interns.

Figure 10.3 Preparing for Debt or Equity Financing



10.4 Preparing to Raise Debt or Equity Financing (1 of 2)

- Equity and debt financing are the two most common alternatives for raising money.
  - Equity financing (or funding) means exchanging partial ownership of a firm, usually in the form of stock, in return for funding.
    - Equity funding is not a loan—entrepreneurs do not pay back the money received from this funding source. Instead, equity investors become partial owners of the firm.
- Debt financing is securing a loan.
  - Commercial bank and SBA guaranteed loans are the most common sources of debt financing.

Table 10.2 Matching an Entrepreneurial Venture's Characteristics with the Appropriate Financing or Funding Source

Characteristics of the Venture	Appropriate Source of Financing or Funding
The business has high risk with an uncertain return: Weak cash flow High leverage Low to moderate growth Unproven management	Personal funds, friends, family, and other forms of bootstrapping
The business has low risk with a more predictable return: Strong cash flow Low leverage Audited financials Good management Healthy balance sheet	Debt financing
The business offers a high return: Unique business idea High growth Niche market Proven management	Equity

10.4 Preparing to Raise Debt or Equity Financing (2 of 2)

- Developing a strategy for engaging bankers or investors involves preparing an elevator speech (or pitch).
  - An elevator speech is a brief, carefully constructed statement that outlines the merits of a business opportunity.
  - Most elevator speeches are around 60 seconds long.

Table 10.3 Guidelines for Preparing an Elevator Speech

Step 1 Describe the opportunity or problem that requires a solution.	20 seconds
Step 2 Describe how your product or service meets the opportunity or solves the problem.	20 seconds
Step 3 Describe your qualifications.	10 seconds
Step 4 Describe your market.	10 seconds
Total	60 seconds

10.5 Sources of Equity Funding

- The three most common forms of equity funding are:
  - Business Angels
  - Venture Capital
  - Initial Public Offerings

Business Angels (1 of 4)

- Are individuals who invest their personal capital directly in startups.
- The prototypical business angel is about 50 years old, has high income and wealth, is well educated, has succeeded as an entrepreneur, and invests in companies that are in the region where he or she lives.
- Individual angel investors generally invest between $5,000 and $150,000.

Business Angels (2 of 4)

- Many well-known companies, including Apple and Google, received their initial investment from one or more angel investors.
- Research shows that there were 363,460 active angel investors in 2021. In 2021, angels invested $29.1 billion in ventures.
- Many angels are motivated by more than financial returns: they enjoy the process of mentoring a new startup.

Business Angels (3 of 4)

- Most angel investors remain fairly anonymous and are matched up with entrepreneurs via referrals.
  - To find a business angel, an entrepreneur should discreetly work his/her network of acquaintances to see if anyone can make an appropriate introduction.
  - An advantage that college students have in regard to finding business angels is that many judge college or university-sponsored business plan or business model competitions.

Business Angels (4 of 4)

- There are organized groups of business angels.
- These groups typically consist of 10 to 100 angel investors in a local area that meet regularly to listen to business plan presentations.
  - An example of an angel group is the Central Texas Angel Network (CTAN) located in Austin, TX.
  - It is a relatively large angel group, with 110+ angel investors with expertise in multiple sectors.
  - The process the network follows to vet investment opportunities is explained on the CTAN website.

Venture Capital (1 of 6)

- Venture capital is money that is invested by venture capital firms in startups and small businesses with exceptional growth potential.
- In exchange for their investment, venture capitalists receive an equity position in the firms in which they invest.

Venture Capital (2 of 6)

- Venture capital firms are limited partnerships of money managers who raise money in “funds” to invest in startups and growing firms.
- The funds, or pools of money, are raised from high-net-worth individuals, pension plans, university endowments, foreign investors, and similar sources.
- The investors who invest in venture capital funds are called limited partners. The venture capitalists are called general partners.

Venture Capital (3 of 6)

- Because in the past venture capitalists have funded high-profile successes such as Google, Facebook, Spotify, and Uber, the industry receives a great deal of attention.
- In fact, venture capitalists fund a small percentage of startups.
- Many entrepreneurs become discouraged when they are repeatedly rejected for venture capital funding, even though they may have an excellent business plan.
- Venture capitalists are looking for the “home run.” The result is that they do not fund the majority of the business plans they receive and review.

Venture Capital (4 of 6)

- Still, for firms that qualify, venture capital is a viable alternative to equity funding.
- An advantage to obtaining this funding is that venture capitalists are extremely well connected in the business world and can offer a firm considerable assistance beyond funding.
- An important part of obtaining venture capital funding is going through the due diligence process, which refers to the process of investigating the merits of a potential venture and verifying the key claims made in the business plan.

Venture Capital (5 of 6)

- Firms that prove to be suitable for venture capital funding should conduct their own due diligence to make sure they end up with a venture capital firm that is a good fit.
- They should ask the following questions before accepting funds from a particular venture capital firm.
  - Do the venture capitalists have experience in our industry?
  - Do they take a highly active or passive management role?
  - Are the personalities on both sides of the table compatible?

Venture Capital (6 of 6)

- They should ask the following questions before accepting funds from a particular venture capital firm (continued):
  - Does the firm have deep enough pockets or sufficient contacts within the venture capital industry to provide follow-on rounds of financing?
  - Is the firm negotiating in good faith in regard to the percentage of our firm they want in exchange for their investment?

Initial Public Offering (1 of 3)

- An initial public offering (IPO) is a company's first sale of stock to the public. When a company goes public, its stock is traded on one of the major stock exchanges.
- Most entrepreneurial firms that go public trade on the NASDAQ, which is weighted heavily toward technology, biotech, and small-company stocks.
- An IPO is an important milestone for a firm. Typically, a firm is not able to go public until it has demonstrated that it is viable and has a bright future.

Initial Public Offering (2 of 3)

- Firms choose to go public for several reasons.
  - First, it is a way to raise equity capital to fund current and future operations.
  - Second, an IPO raises a firm's public profile, making it easier to attract high-quality customers, alliance partners, and employees.
  - Third, an IPO is a liquidity event that provides a mechanism for the company's stockholders, including its investors, to cash out their investments.
  - Finally, by going public, a firm creates another form of currency that it can use to grow the company.

Initial Public Offering (3 of 3)

- The first step in initiating a public offering is for a firm to hire an investment bank (an institution that acts as an underwriter or agent for a firm issuing securities).
  - An investment bank must satisfy several stipulations to assure the SEC that the offer is legitimate.
  - During the time the SEC is investigating the potential offering, the investment bank issues a preliminary prospectus that describes the public offering.
  - After the SEC approves the offering, the investment bank issues the final prospectus, which sets a date and issuing price for the offering.

10.6 Sources of Debt Financing

- There are two common types of loans.
  - Single-purpose loan: a firm borrows a specific amount of money that it must repay in a fixed amount of time, with interest.
  - Line of credit: there is a borrowing “cap” and borrowers can use the credit at their discretion.
- Obtaining a loan allows the entrepreneur to maintain ownership of their firm and deduct interest payments on their loans from their taxes.
  - However, loans must be repaid, and often come with strict conditions.

Commercial Banks (1 of 2)

- Historically, commercial banks have not been viewed as a practical source of financing for startup firms.
  - This sentiment is not a knock against banks; it is just that banks are risk averse, and financing startups is a risky business.
    - Banks are interested in firms that have a strong cash flow, low leverage, audited financials, good management, and a healthy balance sheet.
    - Although many new ventures have good management, few have the other characteristics, at least initially.

Commercial Banks (2 of 2)

- The good news is that despite these historical precedents, some banks are starting to engage startup entrepreneurs.
- When it comes to startups, some banks are rethinking their lending standards and are beginning to focus on cash flow and the strength of the management team rather than on collateral and the strength of the balance sheet.
- Entrepreneurs should follow developments in this area closely.

SBA Guaranteed Loans (1 of 2)

- The SBA Guaranteed Loan Program
  - The most notable SBA program available to small businesses is the 7(A) Guaranty Program.
  - The program operates through private-sector lenders who provide loans that are guaranteed by the SBA.
  - The loans are for small businesses that are unable to secure financing on reasonable terms through normal lending channels.
  - Almost all businesses are eligible to apply for an SBA loan.

SBA Guaranteed Loans (2 of 2)

- Size and Types of Loans
  - The SBA can guarantee as much as 75% on loans up to $5 million and 85% for loans of $150,000 or less.
  - An SBA guaranteed loan can be used for almost any legitimate business purpose.
  - Although SBA guaranteed loans are utilized more heavily by existing small businesses than startups, they should not be dismissed as a possible source of financing.

Other Sources of Debt Financing (1 of 3)

- Online Lenders
  - There is a group of online lenders, including OnDeck, Kabbage, Fundbox, and Prosper that provide loans to businesses.
  - Depending on the company, loans are available from $2,000 to $2 million.
  - Interest rates are normally higher than charged by a commercial bank, so it is advisable to check the terms carefully.

Other Sources of Debt Financing (2 of 3)

- Peer-to-Peer Lenders
  - Peer-to-peer lenders underwrite borrowers but don’t fund the loans directly.
  - Instead, they act as intermediaries between borrowers and individuals or borrowers and institutional investors.
    - Lending Club is an example of a peer-to-peer lender.
  - The thing to watch when considering peer-to-peer loans is the annual percentage rate, which in many cases is high.

Other Sources of Debt Financing (3 of 3)

- Vendor Credit
  - Also known as trade credit, is when a vendor extends credit to a business in order to allow the business to buy its products and/or services up front but defer payment until later.
- Factoring
  - Is a financial transaction whereby a business sells its accounts receivable to a third party, called a factor, at a discount in exchange for cash.

10.7 Creative Sources of Financing and Funding

- Crowdfunding
- Leasing
- SBIR and STTR Grant Programs
- Other Grant Programs
- Strategic Partners

Crowdfunding (1 of 2)

- Crowdfunding is the practice of funding a project or new venture by raising monetary contributions from a large number of people (the "crowd") typically via the Internet.
- Two Types of Crowdfunding Programs
  - Rewards-based crowdfunding allows entrepreneurs to raise money in exchange for some type of amenity or reward.
  - Kickstarter and Indiegogo are the most popular rewards-based crowdfunding sites.

Crowdfunding (2 of 2)

- Equity-based crowdfunding helps businesses raise money by tapping individuals and investors who provide funding in exchange for equity in the business.
- The catalyst for the advent of equity-based crowdfunding was the JOBS Act, which was passed in April 2012.
  - Examples of equity-based crowdfunding sites include SeedInvest, AngelList, and WeFunder.
- On average, successful crowdfunding campaigns raise $28,656.

Leasing (1 of 2)

- A lease is a written agreement in which the owner of a piece of property allows an individual or business to use the property for a specified period of time in exchange for payments.
- The major advantage of leasing is that it enables a company to acquire the use of assets with very little or no down payment.
- Leases for facilities and leases for equipment are the two most common types of leases that entrepreneurial ventures undertake.

Leasing (2 of 2)

- Most leases involve a modest down payment and monthly payments during the duration of the lease.
- At the end of an equipment lease, the new venture typically has the option to stop using the equipment, purchase it for fair market value, or renew the lease.
- Leasing is almost always more expensive than paying cash for an item, so most entrepreneurs think of leasing as an alternative to equity or debt financing.

SBIR and STTR Grants (1 of 4)

- SBIR and STTR Programs
  - The Small Business Innovation Research (SBIR) and the Small Business Technology Transfer (STTR) programs are two important sources of early-stage funding for technology firms.
  - These programs provide cash grants to entrepreneurs who are working on projects in specific areas.
    - The main difference between the SBIR and the STTR programs is that the STTR program requires the participation of researchers working at universities or other research institutions.

SBIR and STTR Grants (2 of 4)

- SBIR Program
  - The SBIR Program is a competitive grant program that provides over $2.5 billion per year to small businesses for early-stage and development projects.
  - Each year, 12 federal departments and agencies are required by the SBIR to reserve a portion of their R&D funds for awards to small businesses.
  - Guidelines for how to apply for the grants are provided on each agency’s website.

SBIR and STTR Grants (3 of 4)

- SBIR Program (continued)
  - The SBIR is a three-phase program, meaning that firms that qualify have the potential to receive more than one grant to fund a particular proposal.
    - In 2022, 18 percent of SBIR proposals received funding, which is about average for the previous five years.
  - The payoff for successful proposals, however, is high.
    - The money is essentially free. It is a grant, meaning that it doesn’t have to be paid back and no equity in the firm is at stake.
    - The small business receiving the grant also retains the rights to any intellectual property generated as the result of the grant initiative.

Table 10.5 Small Business Innovation Research: Three-Phase Program

Phase	Purpose of Phase	Duration	Funding Available (varies by Agency)
Phase I	To demonstrate the proposed innovation's technical feasibility.	Up to 6 months	Up to $150,000
Phase II	Available to successful Phase I companies. The purpose of a Phase II grant is to develop and test a prototype of the innovation validated in Phase I.	Up to 2 years	Up to $1 million
Phase III	Period in which Phase II innovations move from the research and development lab to the marketplace.	Open	No SBIR funding available; however, federal agencies may award non-SBIR -funded follow-on grants or contracts for products or processes that meet the mission needs of those agencies, or for further R&D.

SBIR and STTR Grants (4 of 4)

- STTR Program
  - Is a variation of the SBIR for collaborative research projects that involve small businesses and research organizations, such as universities or federal labs.
  - The STTR program requires the company to have a partnering research institution.
  - More information about the SBIR and STTR can be obtained at www.sbir.gov.

Other Grant Programs

- Private Grants
  - There are a limited number of grant programs available to entrepreneurs.
  - Getting grants takes a little detective work.
  - Granting agencies are low key, and must be sought out.
- Other Government Grants
  - The federal government has grant programs beyond the SBIR and STTR programs.
  - The full spectrum of grants available is listed at www.grants.gov .
  - Be careful of grant-related scams.

Strategic Partners

- Strategic partners are another source of capital for new ventures.
- Many partnerships are formed to share the costs of product or service development, to gain access to particular resources, or to facilitate speed to market.
- Strategic partnerships that capture these types of benefits can help new ventures lessen their need for funding or financing.

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