### Entrepreneurial Finance

Entrepreneurial Finance is the process of making financial decisions for new ventures. New ventures are inherently different from established ventures, as are entrepreneurs inherently different from conventional business managers. The financial decisions faced by each are starkly different as well.

Difference between New Ventures and Established Corporations

Entrepreneurs face very different finance challenges than that are faced by corporate managers.

In entrepreneurial finance, investment decisions and financing decisions are the same thing.

1. Corporations can sell financial claims in the market at market rates. They can also often fund projects through allocation of internally generated funds. New ventures, on the other hand, do not have a market for their financial claims, and thus must raise funds for projects from investors.

The result is that corporations can often finance projects with expectations of a positive net return on investment for which, a new venture would reject the same project unless they can raise investment.

Like-wise corporations can diversify their risk. Through risk management techniques, established corporations can shift project risks in order to reduce overall corporate risk. New ventures are usually typified by the entrepreneur bearing most of the risk himself/herself, undiversified.

2. Entrepreneurs have limited mechanisms by which they can signal and communicate their true intentions. This creates potential moral hazard and information asymmetry. In contrast, the public corporation has many formal, standard mechanisms by which information is communicated and incentives are aligned.

3. Portfolio Theory (valuation based on risk) does not apply to new ventures cleanly.

Given the different risk profiles, new ventures are difficult to accurately value. In practice, the value of most new ventures is largely derived as a function of the value of its options. Called "real options analysis", this approach applies options valuation techniques to real-world decisions. Venture capital firms are well known for applying sophisticated options valuation strategies to their portfolio of companies and decisions about if, when and how much to fund various financing rounds.

4. Real options analysis is a valuable technique for valuing the entire venture.

New ventures are illiquid by definition. They are closely held, private companies which have no explicit market value. The process of creating a market for investment in the new venture is known as creating liquidity, or achieving liquidity. Most venture capital firms plan their portfolio around expectations of liquidity events. Once liquidity is achieved, the firm's value can be harvested.

5. Liquidity is the only way in which new ventures return value to investors.

This leads to the final fundamental difference between corporations and new ventures: the entrepreneur. In an established corporation, the shareholders are the residual claimants. Incentives are aligned accordingly. But in a new venture -- one in which the entrepreneur is still participating -- the ultimate residual claimant is the entrepreneur herself. It is the entrepreneur who has undertaken disproportionate risk, undiversifiable risk, intangible risk in the form of personal sacrifice. It is therefore no surprise that it is the entrepreneur who finds herself necessarily driving valuation goals for the venture.

### Need for Financing

Any new venture needs financing and hence, entrepreneurs have to decide where to get funding from, how to invest, and how much to borrow. This article is concerned with the sources of entrepreneurial finance which the entrepreneur has access to. Indeed, one of the central preoccupations for entrepreneurs is where and from to get the funding in order to kick start their ventures and hit the ground running.

### Bootstrapping

This form of financing the ventures applies when entrepreneurs invest their own money, or offer stakes in their venture to individuals in return for their services, as well as includes other forms of financing such as delaying payments to partners, offering sweat equity to employees and other stakeholders etc. The important point to note about bootstrapping is that it can be actualized only when the entrepreneur does not need significant amounts of capital as all the methods mentioned above relate to investments that are limited in their capital mobilization. Another important aspect of this type of financing is that entrepreneurs typically offer equity in return for work done which is a non-monetized form of financing known as sweat equity.

### External Financing

This type of financing is the most common for entrepreneurs and this category includes all the types of financing mentioned subsequently. When compared to bootstrapping where the entrepreneur raises money either from internal sources or by offering equity in return for work, external financing often involves sourcing capital from external sources which are tangible and immediately monetized forms of financing. Apart from the types of external financing described below, private equity or equity to large investors in return for financing is often the norm for entrepreneurs.

### Angel Investors

We often hear the term Angel Investor spoken by entrepreneurs or mentioned in the business press. Angel Investors as the name implies are literally and metaphorically the Knights in Shining Armour to the entrepreneurs as they not only invest their own monies but are also known to guide the entrepreneurs in actualizing a successful business model. Indeed, Angel Investors are also known to invest in new ventures as a means of doing good for society as well as to share their wealth with new and up and coming entrepreneurs who they (The Angel Investors) think have a game changing idea. Moreover, Angel Investors in many cases are successful entrepreneurs themselves and hence, mentor the new entrepreneurs in the same way managers and role models mentor promising employees. It is also the case that in recent years, Angel Investors have invested nearly three times the amount of money as raised through venture capitalists.

### Venture Capitalists

Venture capitalists differ from Angel Investors in the sense that while the latter invest their own money and often do so for giving back to society, the former invest in new ventures with capital that their professionally managed investment firms have accumulated from private investors. In other words, venture capitalists often act as representatives of individuals and trusts with capital to spare and do so for profit oriented purposes rather than the for fun investments by Angel Investors.

Further, venture capitalists need a compelling business model and its presentation by the entrepreneurs as they are in the business of investing for profit and hence, need to generate returns on their capital.

### Buyouts

This type of financing happens when the entrepreneur sells his or her stake in the venture to individual or a group of investors. However, buyouts are also used to refer to instances when private equity firms pick up stakes in new ventures where the majority stake is still with the entrepreneur. Moreover, buyouts are latter stage investments which mean that by the time the buyouts happen, the venture is already into its growth phase or in the process of being on the road to profitability. Having said that, it must be noted that buyouts also happen when the investors realize that ventures have good assets which can fetch returns as well as have the potential to grow and generate value in the future. Buyouts can also be hostile meaning that the entrepreneur might be forced to give up his or her stake in cases where the private equity or the other investors decide that a change of ownership would be good for the venture. Finally, buyouts happen when the venture is also in the process of winding up as some investors might want to pick up assets on the cheap and sell them off piecemeal.

### Entrepreneurial Ecosystem

All of us are endowed with skills, abilities, and capabilities. However, the reason why some of us are so successful whereas others languish is mainly due to the way in which these traits are nurtured, encouraged, and enabled. For instance, we need to go to the right schools, have supportive families, and be mentored at all stages of our lives so that we do not make any missteps or commit blunders and mistakes that would prove detrimental to our progress. In other words, talent has to be nurtured if it has to flourish. In the same manner in which this happens in our individual lives, entrepreneurs too need enabling and empowering environments which not only ensure that their game changing ideas are translated into actionable pursuits but also ensure that these entrepreneurs have the necessary ecosystem in which they can thrive and prosper. In short, the entrepreneurial ecosystem comprises of the all the stakeholders including government, bureaucracy, funders, and consumers.

### The Example of Bangalore

The reason why Bangalore became a hotspot for innovation and global corporations in IT is that it offered a serene and salubrious environment (including the weather) in terms of readily available pool of talent, an unobtrusive government which unlike the Indian way of interfering in business did its best to keep out of the Indian IT industry and its growth, enabling laws and tax breaks that encouraged companies to reap the benefits, and most importantly, a thriving culture of innovation that was long the characteristic of the city before the IT industry made it its home. Indeed, all these factors ensured that Indian entrepreneurs such as the founders of now global brands like Infosys, Wipro, TCS, and other companies have an enabling and empowering entrepreneurial ecosystem which made them thrive and prosper.

### The Original Silicon Valley

Of course, the blueprint for this ecosystem originated in the Silicon Valley of California in the United States wherein global behemoths such as Apple, Google, and Microsoft in addition to Facebook and thousands of other startups found that the entrepreneurial ecosystem there was eminently suitable for them to start their companies and prosper. Indeed, the fact that Silicon Valley is thriving despite the recession is an indicator of how the region has moved beyond the vicissitudes of the market and carved its own niche as a place where entrepreneurs can thrive. Further, China that has emerged in recent years as an entrepreneur’s dream come true has followed the footsteps of Silicon Valley and has indeed, done better than it on many counts such as minimal governmental interference and maximum benefits which prove to be the right nourishment for businesses and entrepreneurs to thrive.

### Components of an Entrepreneurial Ecosystem

Thus, for the actualization of an enabling and empowering entrepreneurial ecosystem, there need to be venture capitalists who would fund the startups and angel investors who persist with the ventures despite initial hiccups. Next, the government has to have laws and policies that would encourage entrepreneurs by giving them tax breaks, benefits, and land and facilities including roads, infrastructure such as international airports and the like so that global investors flock to these ecosystems. Further, the bureaucracy should not throw spanners in the works of the entrepreneurs through meaningless rules and regulations and instead, must speed up the decision-making process as well as implement single window clearances. Moreover, there must be a talent pool of skilled and employable workers who would staff the startups and ensure that when they take off, the ventures have the necessary people to drive their businesses.

### Why the Chinese are racing ahead?

Therefore, after considering the factors which go into making an enabling and empowering entrepreneurial ecosystem, it is clear that unless these aspects are taken care of, the inventors, and the entrepreneurs would take their business elsewhere. Indeed, if the example of China is anything to go by, it is that it has stolen a march over India on many of these aspects as not only does it offer the right ecosystem, it also ensures that the entrepreneurs are treated as heroes and heroic figures who are no less important than the politicians and other personalities who are regularly feted by society. In short, the lesson for any country is that global capital is country blind and region blind and just as the early bird catches the worm, the regions and the countries that are at the forefront of the race to attract global capital would win in the end.

<https://www.managementstudyguide.com/entrepreneurial-finance.htm>

## Debt vs Equity Financing

Outside financing for small businesses falls into two categories:

**Debt financing** involves borrowing a fixed sum from a lender, which is then paid back with interest.

**Equity financing** is the sale of a percentage of the business to an investor, in exchange for capital.

Before you seek capital to grow your business, you need to know where to find debt vs equity financing, which of the two types you qualify for, and how to weigh the pros and cons of each.

Types of debt financing

Debt financing comes in many forms from many types of organizations, they include:

* Secured lines of credit from banks or other financial institutions: Though harder to get, this type of financing has low interest rates, and lets you draw down only as much cash as you need, in any given period.
* Term loans from banks or alternative lenders like Bond Street: These provide the full amount of capital upfront and require regular payments over a fixed amount of time.
* Credit cards from banks, credit unions, savings and loans, and other financial institutions: You borrow money that must be paid back with interest after a grace period.
* Invoice or receivables financing from financial companies: When you need cash on hand, this form of financing fronts capital at a discount, for income you would receive later.
* Merchant cash advance from MCA companies: This loan product is tailored to businesses which receive the bulk of their revenue via credit cards. The lender takes a fixed percentage of your daily credit card receipts.

### **Types of equity financing**

Equity financing typically comes from three sources:

* Friends and family (or other small investors): These private investors put a relatively small amount of money into your business in exchange for relatively small pieces of the pie.
* Angel investors: Also generally private individuals or associations, these investors in return for investment, are sometimes looking for a large ownership percentage.
* Venture capital firms: These firms publicly invest millions of dollars into very promising startups.

Equity financing is most appropriate for high-risk technology and innovation startups, with the potential to generate a huge return on investment, as well as businesses in very cyclical industries that do not have a steady cash flow. Venture capitalists have demanding criteria; they typically seek to invest in companies with ambitious plans, like market domination or global reach. Investors of every type will carefully study your business plan for a strong background and management team, a demonstrated need for your product or service, a clearly defined pricing and sales strategy, preparation for competition, and realistic financial projections.

Pros of equity financing:

* For new businesses with no revenue or those which are yet to attain profitability, equity financing can be your best if not only option.
* Investors take on almost all the risk; they receive their returns only if the business succeeds
* No percentage of your revenues will be diverted to pay loans.

Cons of equity financing:

* You give up a percentage of your business.
* Investors may have control over key decisions and influence the culture of the company.
* Landing investment can be a full-time effort, and reporting to investors regularly can take precious man-hours.
* Investors or “equity partners” usually do not expect a return on their investment for 3-5 years, but they often exit after 5-7 years.

Pros of debt financing:

* Can be used by almost any kind and size of business.
* You retain ownership of your business, which means you will not have to share profits long-term.
* You know when you need to repay.
* There are a range of options (different kinds of loans, credit cards, lines of credit, etc.).
* Interest on the debt can be deducted from the firm’s tax return.
* Interest rates on loans are usually lower than the return on equity investments.

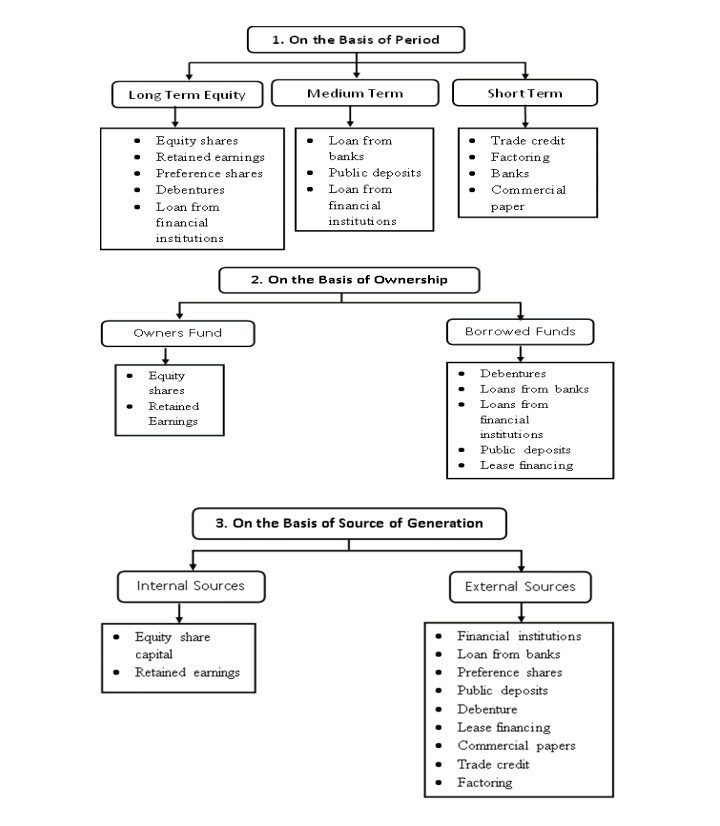
Cons of debt financing:

* Requires repayment of both principal and interest whether business is good or bad.
* Debt is an expense and expenses prevent you from reinvesting your revenue in the business.
* There’s always a risk. Defaulting will cost you the assets (or personal guarantee) you pledged as collateral.
* Lenders may restrict what you use the money for or whether you can look for more financing elsewhere.

|  | DEBT | EQUITY |
| --- | --- | --- |
| **Requirements** | Profitability, collateral | High growth potential & reach |
| **Effort** | Many options; time on application | May take months to find and pitch investors |
| **Ownership** | Keep 100% ownership | Giveaway percentage of ownership |
| **Rates** | Interest may be high; payment begins almost immediately | No pressure to make early returns, but returns are generally higher than interest on debt |
| **Predictability** | Predictable repayments | Unpredictable exit |
| **Oversight** | Minimal oversight | Investors need reporting, may get involved in decision-making |
| **Cash flow** | Payments deplete cash flow | No payments means investing cash straight into business |
| **Lender’s stake** | Often little stake in your success | Very invested in your success |

## Sources of Funds (and their classifications)

Business simply cannot function without money, and the money required to make a business function is known as business funds. Throughout the life of business, money is required continuously. Sources of funds are used in activities of the business. They are classified based on time period, ownership and control, and their source of generation.



**Period Basis Sources**

On the basis of the period, the different sources of funds can be classified into three parts. Which are:

* Long-term sources fulfil the financial requirements of a business for a period more than 5 years. It includes various other sources such as shares and debentures, long-term borrowings and loans from financial institutions. Such financing is generally required for the procurement of fixed assets such as plant, equipment, machinery etc.
* Medium-term sources are the sources where the funds are required for a period of more than one year but less than five years. The sources of the medium term include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.
* Short-term sources: Funds which are required for a period not exceeding one year are called short-term sources. Trade credit, loans from commercial banks and commercial papers are the examples of the sources that provide funds for short duration.

Short-term financing is very common for the financing of present assets such as inventories and account receivables. Seasonal businesses that must build inventories in terms of future prospects of selling requirements often need short-term financing for the interim period between seasons. Wholesalers and manufacturers with a major portion of their assets used in inventories or receivables also require a large number of funds for a short period.

## Ownership Basis Sources

On the basis of ownership, the sources can be classified into Owner’s funds and Borrowed funds. Owner’s funds mean funds which are procured by the owners of a business, which may be a sole entrepreneur or partners or shareholders of a business. It also includes profits which are reinvested in the business. The owner’s capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business.

This capital forms the base on which owners gain their right of control of management in the business. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk. Equity shares and retained earnings are the two important sources from where owner’s funds can be obtained.

Borrowed funds refer to the funds raised with the help of loans or borrowings. This is the most common type of source of funds and is used the majority of the time. The sources for raising borrowed funds include loans from commercial banks, loans from financial institutions, issue of debentures, public deposits and trade credit.

These sources provide funds for a specific period, on certain terms and conditions and have to repay the loan after the expiry of that period with interest. A fixed rate of interest is paid by the borrowers on such loans. Often it does put a lot of burden on the business as payment of interest is to be made even when the earnings are low or when the loss is incurred. These institutions don’t take into consideration the activities of business after the loan is given. Generally, borrowed funds are provided on the security of some assets of the borrower.

## Generation Basis Sources

The way of classifying the sources of funds is whether the funds are generated from within the organization or from external sources of the organization. Internal sources of funds are those that are generated inside the business. A business, for example, can generate funds internally by speeding collection of receivables, disposing of surplus inventories and increasing its profit. The internal sources of funds can fulfil only limited needs of the business.

Whereas, External sources of funds are the sources that lie outside an organization, such as suppliers, lenders, and investors. When a large amount of money is needed to be raised, it is generally done through the external sources. External funds may be costly as compared to those raised through internal sources.

In some cases, business is required to mortgage its assets as security while obtaining funds from external sources. The issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources of funds commonly used by business organizations.

**Funding options for startups in India**

**1) Bootstrapping your startup business:**

Self-funding, also known as bootstrapping, is an effective way of startup financing, specially when you are just starting your business. First-time entrepreneurs often have trouble getting funding without first showing some traction and a plan for potential success. You can invest from your own savings or can get your family and friends to contribute. This will be easy to raise due to less formalities/compliances, plus less costs of raising. In most situations, family and friends are flexible with the interest rate.

Self-funding or bootstrapping should be considered as a first funding option because of its advantages. When you have your own money, you are tied to business. On a later stage, investors consider this as a good point. But this is suitable only if the initial requirement is small. Some businesses need money right from the day-1 and for such businesses, bootstrapping may not be a good option.

Bootstrapping is also about stretching resources – both financial and otherwise – as far as they can.

### 2) Crowdfunding as a funding option:

Crowdfunding is one of the newer ways of funding a startup that has been gaining lot of popularity lately. It’s like taking a loan, pre-order, contribution or investments from more than one person at the same time.

This is how crowdfunding works – An entrepreneur will put up a detailed description of his business on a crowdfunding platform. He will mention the goals of his business, plans for making a profit, how much funding he needs and for what reasons, etc. and then consumers can read about the business and give money if they like the idea. Those giving money will make online pledges with the promise of pre-buying the product or giving a donation. Anyone can contribute money toward helping a business that they really believe in. Crowd funding it can also generate interest and hence helps in marketing the product alongside financing. It is also a boon if you are not sue if there will be any demand for the product you are working on. This process can cut out professional investors and brokers by putting funding in the hands of common people. It also might attract venture-capital investment down the line if a company has a particularly successful campaign.

Some of the popular crowdfunding sites in India are - Indiegogo, Wishberry, Ketto, Fundlined and Catapooolt.

### 3) Get an angel investment in your startup:

Angel investors are individuals with surplus cash and a keen interest to invest in upcoming startups. They also work in groups of networks to collectively screen the proposals before investing. They can also offer mentoring or advice alongside capital.

Angel investors have helped to start up many prominent companies, including Google, Yahoo and Alibaba. This alternative form of investing generally occurs in a company’s early stages of growth, with investors expecting a upto 30% equity. They prefer to take more risks in investment for higher returns. Angel Investment as a funding option has its shortcomings too. Angel investors invest lesser amounts than venture capitalists.

Here is a list of popular Angel Investors in India – Indian Angel Network, Mumbai Angels, Hyderabad Angels.

### 4) Get Venture Capital For Your Business:

This is where you make the big bets. Venture capitals are professionally managed funds who invest in companies that have huge potential. They usually invest in a business against equity and exit when there is an IPO or an acquisition. VCs provide expertise, mentorship and acts as a litmus test of where the organisation is going, evaluating the business from the sustainability and scalability point of view.

A venture capital investment may be appropriate for small businesses that are beyond the startup phase and already generating revenues. Fast-growth companies like Flipkart, Uber, etc with an exit strategy already in place can gain up to tens of millions of dollars that can be used to invest, network and grow their company quickly.

However, there are a few downsides to Venture Capitalists as a funding option. VCs have a short leash when it comes to company loyalty and often look to recover their investment within a three- to five-year time window. If you have a product that is taking longer than that to get to market, then venture-capital investors may not be very interested in you.

They typically look for larger opportunities that are a little bit more stable, companies having a strong team of people and a good traction. You also have to be flexible with your business and sometimes give up a little bit more control, so if you’re not interested in too much mentorship or compromise, this might not be your best option.

Some of the well known Venture Capitalists in India are – Nexus Venture Partners, Helion Ventures, Kalaari Capital, [Accel Partners](http://www.accel.com/), Blume Ventures, Canaan, Sequoia Capital and Bessemer Ventures.

### 5) Get Funding From Business Incubators & Accelerators:

Early stage businesses can consider Incubator and Accelerator programs as a funding option. Found in almost every major city, these programs assist hundreds of startup businesses every year.

Though used interchangeably, there are few fundamental differences between the two terms. Incubators are like a parent to to a child, who nurture the business providing shelter tools and training and network to a business. Accelerators so more or less the same thing, but an incubator helps/assists/nurtures a business to walk, while accelerator helps to run/take a giant leap.

These programs normally run for 4-8 months and require time commitment from the business owners. You will also be able to make good connections with mentors, investors and other fellow startups using this platform.

In India, popular names are Amity Innovation Incubator, AngelPrime, CIIE, IAN Business Incubator, Villgro,Startup Village and TLabs.

### 6) Raise funds by winning contests:

An increase in the number of contests has tremendously helped to maximize the opportunities for fund raising. It encourages entrepreneurs with business ideas to set up their own businesses. In such competitions, you either have to build a product or prepare a business plan. Winning these competitions can also get you some media coverage. We, at ProfitBooks benefitted a lot when we were regional finalists in Microsoft BizSparks in 2013 and won Hot100 Startup Award in 2014.

You need to make your project stand out in order to improve your success in these contests. You can either present your idea in person or pitch it through a business plan. It should be comprehensive enough to convince anyone that your idea is worth investing in.

Some of the popular startups contests in India are NASSCOM’s 10000 startups, Microsoft BizSparks, Conquest,NextBigIdea Contest, and Lets Ignite.

### 7) Raise Money Through Bank Loans:

Normally, banks is the first place that entrepreneurs go when thinking about funding.

The bank provides two kinds of financing for businesses. One is working capital loan, and other is funding. Working Capital loan is the loan required to run one complete cycle of revenue generating operations, and the limit is usually decided by hypothecating stocks and debtors. Funding from bank would involve the usual process of sharing the business plan and the valuation details, along with the project report, based on which the loan is sanctioned.

Almost every bank in India offers SME finance through various programs. For instance, leading Indian banks –Bank Of Baroda, HDFC, ICICI and Axis banks have more than 7-8 different options to offer collateral free business loans. Check out the respective bank sites for more details.

### 8) Get Business Loans from Microfinance Providers or NBFCs

Microfinance is access of financial services to those who would not have access to conventional banking services. It is increasingly becoming popular for those whose requirements are limited and credit ratings not favoured by bank. Similarly, NBFCs are non-banking Financial Corporations are corporations that provide Banking services without meeting legal requirement/definition of a bank. Some of the microfinance companies in India are - Annapurna Microfinance Pvt Ltd, Arohan Financial Services Pvt Ltd, Asirvad Microfinance Pvt Ltd, Bandhan Financial Services Pvt Ltd, BSS Microfinance Pvt Ltd, Cashpor Micro Credit, Disha Microfin Pvt Ltd, Equitas Microfinance Pvt Ltd, ESAF Microfinance and Investments Pvt Ltd, Fusion Microfinance Pvt Ltd, Grama Vidiyal Micro Finance Ltd, Grameen Financial Services Pvt Ltd

### 9) Govt Programs That Offer Startup Capital:

The Government of India has launched 10,000 Crore Startup Fund in Union budget 2014-15 to improve startup ecosystem in India. In order to boost innovative product companies, Government has launched ‘Bank Of Ideas and Innovations’ program. Government backed ‘Pradhan Mantri Micro Units Development and Refinance Agency Limited (MUDRA)‘ starts with an initial corpus of Rs. 20,000 crore to extend benefits to around 10 lakhs SMEs. You are supposed to submit your business  plan and once approved, the loan gets sanctioned. You get a MUDRA Card, which is like a credit card, which you can use to purchase raw materials, other expenses etc. Shishu, Kishor and Tarun are three categories of loans available under the promising scheme. Also, different states have come up different programs like Kerala State Self Entrepreneur Development Mission (KSSEDM), Maharashtra Centre for Entrepreneurship Development, Rajasthan Startup Fest, SIDBI – Small Industries Development Bank Of India also offer business loans to MSME sector.

### 10) Quick Ways To Raise Money For Your Business

### There are few more ways to raise funds for your business. However, these might not work for everyone. But they can help get quick funds.

Product Pre-sale: Selling your products before they launch is an often-overlooked and highly effective way to raise the money needed for financing your business. Remember how Apple & Samsung start pre-orders of their products well ahead of the official launch? It’s a great way to improve cashflow and prepare yourself for the consumer demand.

Selling Assets: It can help you meet your short-term fund requirements. Once you overcome the crisis situation, you can again buy back the assets.

Credit Cards: Business credit cards are among the most readily available ways to finance a startup and can be a quick way to get instant money. If you are a new business and don’t have a ton of expenses, you can use a credit card and keep paying the minimum payment. However, keep in mind that the interest rates and costs on the cards can build very quickly, and carrying that debt can be detrimental to a business owner’s credit.