3.2 Sources of finance

External sources of finance: Equity finance

External sources of finance come from outside the business. They involve an external stakeholder taking a risk and investing in the business. External sources of finance can be grouped into three areas (see **Figure 1**):

- equity finance
- debt finance
- other sources of finance

The choice of external finance will depend on a large number of factors, such as the planned use of the money, the type and purpose of the business, the financial position of the business and the amount required.

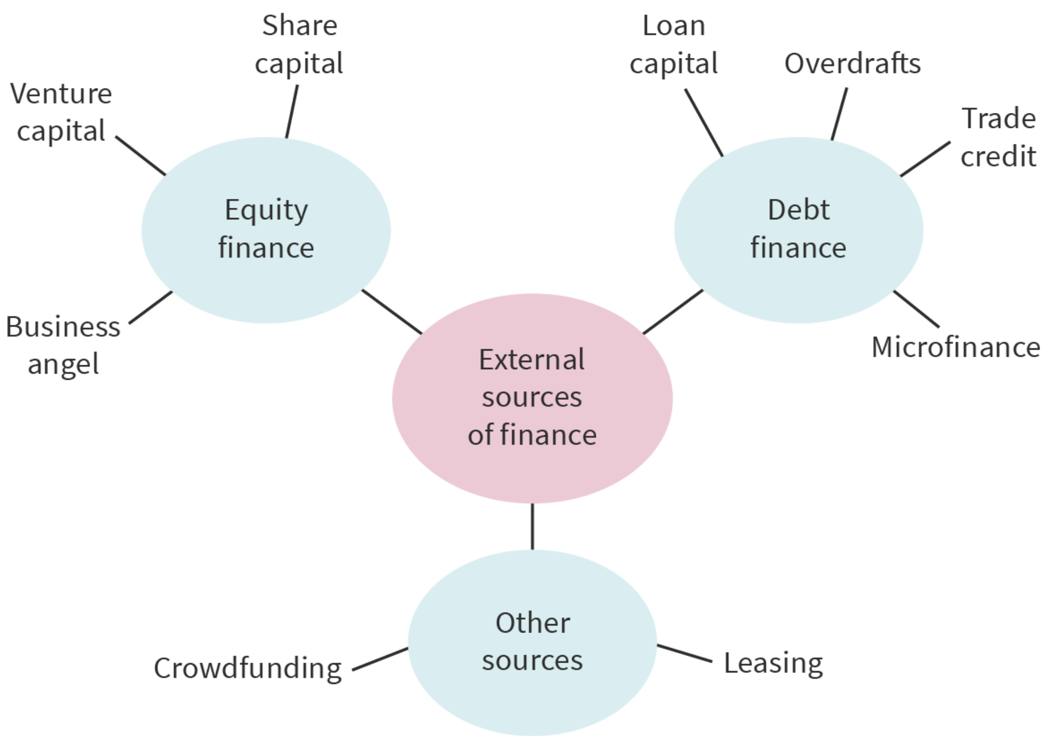

Figure 1. External sources of finance.

Equity finance

Equity finance is a type of funding where the provider receives part ownership of the business in exchange for the finance. Equity finance does not have to be repaid, and no interest is charged. Another advantage is that the risks associated with starting and growing the business are shared among multiple (or many) owners. However, the opportunity cost to the business of accepting equity finance is a loss of control and a loss of a portion of future dividends.

There are three broad categories of equity finance:

- business angel
- venture capital
- share capital

Business angel

A business angel is a successful, wealthy business person who invests their money into new businesses. Business angels provide funding to businesses who are not yet listed on a stock exchange. They often offer very early financing to a new business.

You may have seen business angels in a version of the reality TV show Dragons' Den, the idea for which originated in Japan in 2001. The show has spread to dozens of countries, but sometimes with a different name. In the show, entrepreneurs pitch their business ideas to a panel of business angels. If a business angel likes the business concept, they will invest in the business and offer their skills to help the business grow. In return for their investment and guidance, business angels require part ownership of the business and a portion of future profits. Obviously, most entrepreneurs do not pitch their ideas on reality TV. However, entrepreneurs seeking funding from a business angel will need to persuade the investor to invest, by presenting a solid business plan and showing a convincing personality.

Business angels often, but not always, seek high growth and large returns on the investment. However, it is also the case that a business angel serves as a mentor to entrepreneurs, sharing expertise and business contacts to help the new business succeed. These high expectations and close contact can be beneficial to the new business. However, there can be conflicts if the business angel wants the business to be set up or grow differently from the entrepreneur. It is therefore very important that both parties share the same values and objectives.

Theory of Knowledge

Entrepreneurs usually have to pitch their ideas to possible investors, as shown in **Figure 2**. To do this effectively, entrepreneurs have to provide factual details about the business to show that the business has a chance of success. But just as important is the emotional appeal – telling a good story about the business and coming across as likeable, energetic and reliable. In fact, many investors say that they invest more often in people than in business ideas.

Figure 2. Entrepreneurs often have to pitch their business ideas to potential investors.
Credit: JohnnyGreig, Getty Images

In this blog post (https://www.ycombinator.com/blog/the-airbnbs), Paul Graham, one of the founders of venture capital company YCombinator talks about what YCombinator saw in the founders of Airbnb.

- Which is more effective when applying for an external source of finance – objective facts or appeals to emotion?

Venture capital

Venture capital refers to financing that pools resources from a group of investors to fund new businesses. The fundamental difference between venture capitalists and business angels is whose money is invested. Business angels are private individuals who risk their own money. Venture capitalists are companies that use the money from their clients to fund investments. The aim with venture capital is to help the new business grow so that the investors can later sell their stake at a higher price.

There are many news sources that specialise in business startups; some focused on specific countries or regions. If you are interested in learning more about large-scale startup funding, here are a few:

- TechCrunch Startups (https://techcrunch.com/startups/?guccounter=1) (https://techcrunch.com/startups/?guccounter=1) (Global)
- Disrupt Africa (https://disrupt-africa.com/) and Startup Africa News (https://startupafrica.news/)
- Contxto (https://contxto.com/en/) (Latin America)
- Sifted (https://sifted.eu/) (Europe)
- The Economic Times (https://economictimes.indiatimes.com/tech/startups) (India)
- Nordic Startup News (https://nordicstartupnews.com/) (Nordics)

Case study

Venture capital comes in many different forms. Some venture capital companies specialise in technology businesses. These tend to be businesses that are looking for fast growth and an initial public offering, where they can sell their shares to the public and earn large sums of money from their early investment. These venture capital companies are profit oriented.

An example of such a venture capital company is YCombinator (https://www.ycombinator.com). YCombinator specialises in providing equity finance at the seed stage, which is very early financing for new business ideas. YCombinator has developed a new financing model, where it invests 500 000 USD each in a large number of early-stage businesses, twice per year. For three months, YCombinator works with these businesses to refine ideas and prepare to seek funding from additional investors. One of YCombinator's most successful investments was in the company Airbnb.

YCombinator provides a free online Startup School (https://www.startupschool.org/) for entrepreneurs, in order to both support entrepreneurs as they start and to identify promising new businesses for their seed financing.

Other venture capital companies may focus on social enterprises. These venture capitalists are interested in making money from their investments, but are equally committed to meeting human needs and solving problems. These companies may be more patient. They are willing to forego fast growth and large returns to ensure the long-term sustainability of the business. They also want to ensure that the value created by the business is distributed widely among stakeholders. The kind of finance that these venture capitalists provide for social enterprises is called patient capital and is impact oriented.

An example of a venture capital business that focuses on social enterprises is the Acumen Fund (https://acumen.org/). The Acumen Fund invests money in young social enterprises around the world. It has investments in a diverse selection of sectors such as agriculture, education, energy, workforce development and financial inclusion. The Acumen Fund also provides education for social entrepreneurs through its Acumen Academy (https://acumenacademy.org/). Many of the courses provided by the Acumen Academy are free and cover a range of interesting and practical topics such as non-profit fundraising, storytelling for social change, designing for environmental sustainability and impact, along with many others.

Questions

1. Define equity finance. [2 marks]
2. Distinguish between the equity investment objectives of YCombinator and the Acumen Fund. [4 marks]

Exam tip

You should not face an exam question involving venture capital because this source of finance is not listed in the syllabus. However, this is a very important finance source for businesses, and you may see references to it in your research for the internal assessment or extended essay.

Share capital

Share capital is money that is raised through the issue of shares to new investors on a stock market. As you learned in Section 1.2.2 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/forprofit-commercial-enterprises-id-36509), privately held companies that wish to access large amounts of financial capital this way will ‘go public’ in an initial public offering (IPO), whereby the business sells all or part of the business to external shareholders for the first time. The initial public offering results in the company becoming a publicly held company (public limited company). As owners of the business, shareholders usually receive a portion of the profits earned, called a dividend.

Vast amounts of money can be raised using share issues. The largest ever IPO was from the Saudi Arabian oil company Saudi Aramco, which raised more than 25 billion USD in 2019. Of course, most IPOs do not generate this level of funds, but going public can generate large sums of money for the business to develop. Early investors, both business angels and venture capital companies, can also sell their shares at this point, often earning vast returns on their financial investment.

International Mindedness

Stock exchanges, where publicly listed company stocks are sold, are international in nature. While based in a particular country, stock exchanges typically have listings from companies based all over the world. To take the earlier example of BJYU's, the EdTech company is reportedly considering listing shares in the United States or in India.

Activity

Learner profile: Knowledgeable

Approaches to learning: Thinking skills (transfer)

Complete a table in which you outline the key characteristics of sources of equity finance. You could set up your table as shown here, and you could refer to **Table 1** in Section 3.2.1 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/internal-sources-of-finance-id-39255) (which outlines internal sources of finance) as an example.

Source	Length	Costs	Loss of control?	Suitable for
Business angel				
Venture capital				
Share capital				