COLORADO STATE UNIVERSITY

Lecture 7

Dr. Lauren Chenarides

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Rule No. 1 is never lose money.
Rule No. 2 is never forget Rule No. 1.

-Warren Buffett (Net worth = $149.4 Billion USD)

Lecture 7: Entrepreneurial Finance

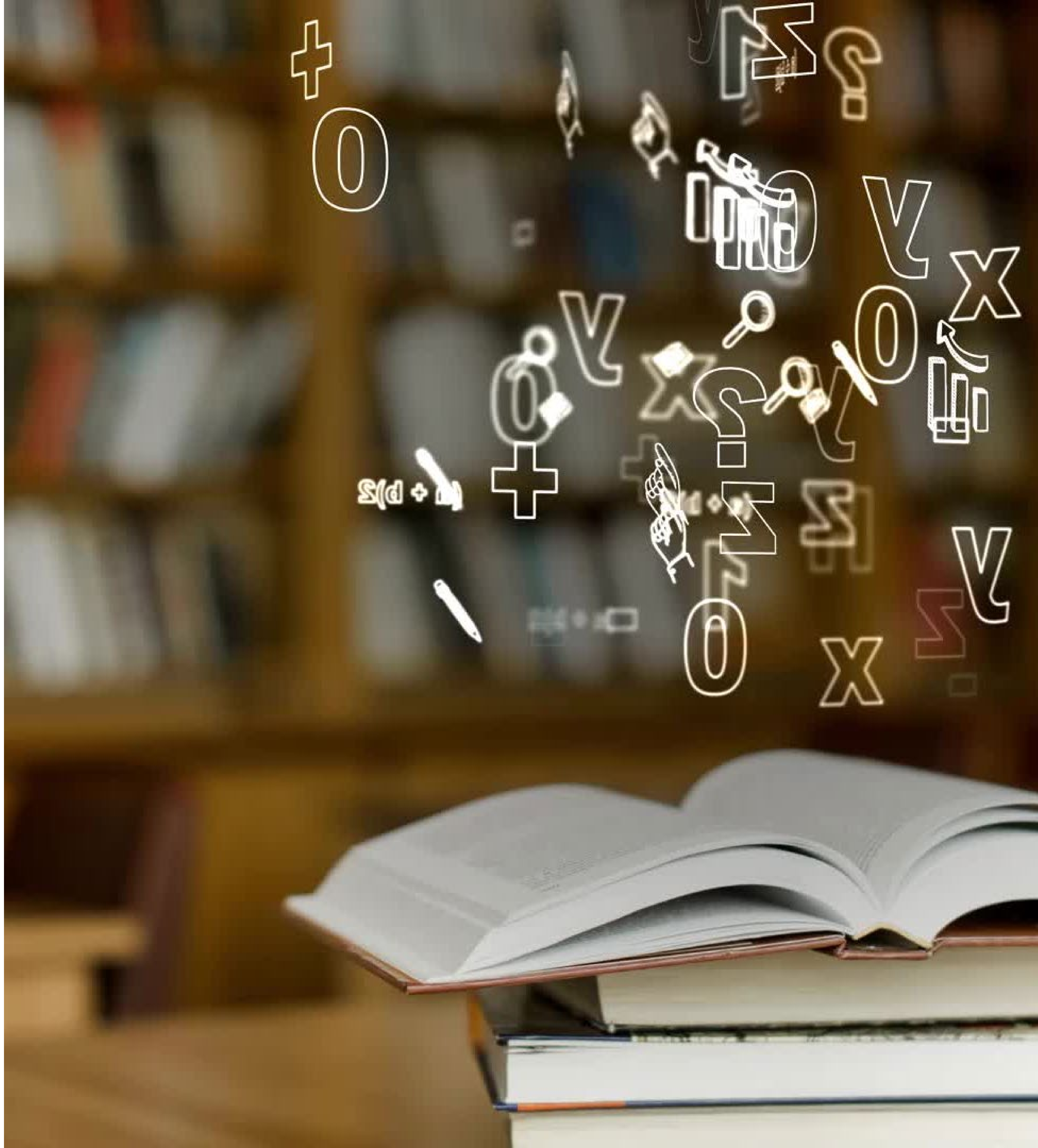
Textbook Reading (Quiz Basis)

Chapter 8. Sources of Capital for Entrepreneurs

Lecture Agenda

1. Review sources of capital

2. Investor activity



Chapter 8 Objectives

8.1 Explain the advantages and disadvantages of bootstrapping.

8.2 Differentiate between debt and equity as methods of financing.

8.3 Discuss commercial loans and social lending as sources of capital.

8.4 Explain initial public offerings (IPOs) as a source of capital.

8.5 Describe the special purpose acquisition companies (SPACs).

8.6 Discuss private placements as an opportunity for equity capital.

8.7 Describe the rise of crowdfunding as an increasingly potential source of funding.

8.8 Explain the market for venture capital.

8.9 Describe venture capitalists' evaluation criteria for new ventures.

8.10 Explain the importance of evaluating venture capitalists for a proper selection.

8.11 Describe the existing informal risk-capital market ("angel capital").

Sources of Capital

- Entrepreneurs must match their funding strategy to their stage of growth, risk tolerance, and control preferences.
- Sources
  - Commercial loans
  - Public offerings
  - Private placement
  - Convertible debentures
  - Venture capital
  - Informal risk capital
- Can be combination of sources
- Can be debt or equity

Sources of Capital

- Bootstrapping
- Debt Financing
- Equity Financing
- Crowdfunding
- Venture Capital
- Angel Financing

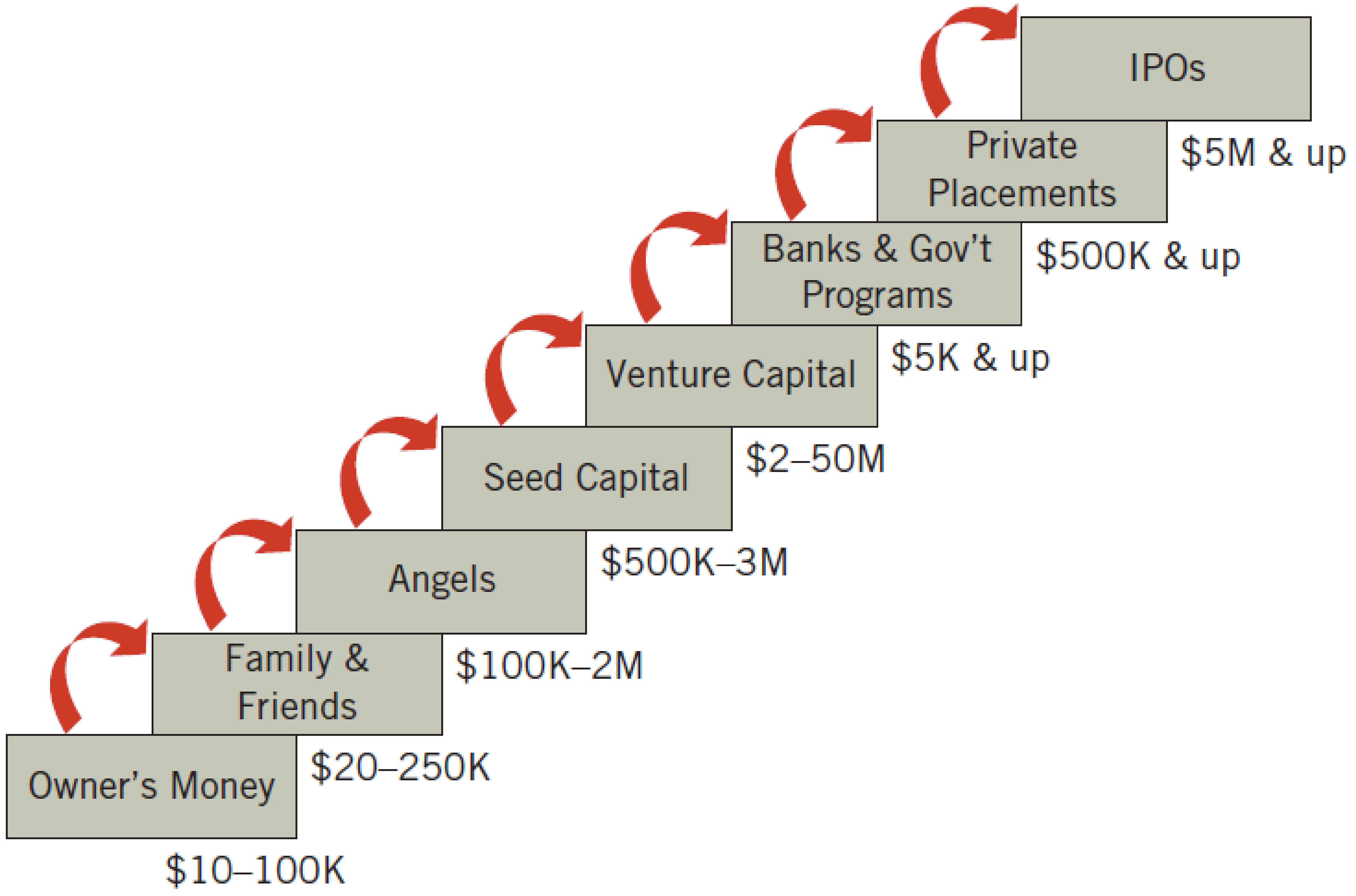
Connecting **Case Studies** to Sources of Capital

- **Stirring the Lobster Pot**
  - and local equity financing
- **Crickets, Chitin, and Green Ink**
  - and trade credit
- **Culture of Love**
  - Peer-to-peer and
- **Dinr**
  - and early venture capital

Who Is Funding Entrepreneurial Start-Up Companies?

Financing Continuum

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



Personal and community funding (bootstrapping, social lending, angels) to **institutional and public markets (VC, private placements, IPOs)**

Source: "Successful Angel Investing," Indiana Venture Center, March 2008.

Choosing a Source of Capital

Stage / Condition	Capital Need	Control Preference	Risk Tolerance	Investor Expectation	Recommended Sources	Notes / Tradeoffs
	<$50K	Maintain full control	High personal risk	None or informal	**Bootstrapping, Friends & Family, Grants**	Fast access; may strain personal finances or relationships
	$50K–$250K	Moderate control sharing	Moderate	Moderate guidance	**Angel Investors, Crowdfunding (equity or reward)**	Angels bring mentorship; crowdfunding provides visibility
	$250K–$5M	Willing to share equity	Moderate to high	Professional oversight	**Venture Capital, Private Placements, SPACs**	High potential for scale; reduced control; formal governance
	$5M+	Public accountability acceptable	Low	High transparency	**Public Offering (IPO)**	Expensive and heavily regulated; strong liquidity and capital access
	Varies	Full control desired	Low	Repayment required	**Commercial Loans, Trade Credit, Accounts Receivable Financing, Factoring**	No equity dilution but increases financial obligations
	<$500K	Collaborative	Moderate	Social impact focus	**Crowdfunding, Program-Related Investments (PRIs)**	Emphasis on community engagement over profit

Sources of Capital

- Commercial Loans
- Peer-to-Peer Lending
- Trade Credit
- Accounts Receivable Financing
- Factoring

- Common Stock
- IPOs
- Private Placements

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Bootstrapping

- *Definition*: **Bootstrapping** is using or the operating revenues of the new company to build a new company.
- Why bootstrap?
  - Unwillingness of equity investors
  - Desire for autonomy
  - Lack of knowledge of other options

Advantages and Disadvantages of Bootstrapping

Advantages

– Cost: it is inexpensive

– Control: no external investors

– Concentration: can focus on business

Disadvantages

– Cash: may need more funds

– Equity: if more than one founder

– Risk: higher due to lack of funds

– Stress: due to money from friends and family

Sources of Capital

- Commercial Loans
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Debt Financing

- **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.

Commercial Loans

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

Peer-to-Peer Lending (P2P)

- *Definition*: **Peer-to-peer (P2P)** lending is money between unrelated individuals, or “peers,” without going through a bank.
  - Are often Internet-based sites that pool money from investors willing to lend capital at agreed-upon rates.
  - Fees are applied for brokering and servicing loans.
- Possible Dangers
  - Low funding success rate
  - Business plan disclosure to the public
  - No ongoing counseling relationship
  - Potential tax liability
  - Uncertain regulatory environment

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**
  - Sale of accounts receivable at discounted values.
- **Finance Companies**
  - Asset-based lenders that lend money against assets such as receivables, inventory, and equipment.

Debt Financing

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.
- Cash-flow problems can intensify because of payback responsibilities.
- Heavy use of debt can inhibit growth and development.

Sources of Capital

- Commercial Loans
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Equity Financing

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

Equity Financing (1 of 2)

- Money invested in the venture with **no legal obligation for entrepreneurs to repay the principal amount or pay interest on it**.
- Requires sharing the with the funding source.
- Much safer option for new ventures than debt financing.
- Owner must be willing to give up part of the ownership in return for funding.

Equity Financing (2 of 2)

- 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.
  - ______ is the most basic form of ownership; stock issues often are sold through public or private offerings.

Initial Public Offerings (1 of 2)

- “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.

Initial Public Offerings (2 of 2)

- “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.
- Advantages
  - Size of capital amount
  - Liquidity
  - Value
  - Image
- Disadvantages
  - Costs
  - Disclosure
  - Requirements
  - Shareholder pressure

Special Purpose Acquisition Companies

- **Special purpose acquisition company (SPAC)**
  - Formed to to merge with an existing company.
  - Growing industry with $80 billion raised in 2020 and $96 billion in 2021.
  - Raise IPO money, then have two years to complete acquisition or merger, or liquidate and return money.
  - IPO involves high cost, detailed disclosure, paperwork requirements, shareholder pressure for earnings.

The Story of Corteva's IPO

- **Corteva Agriscience** began as the agriculture division of **DowDuPont**, itself a 2017 merger between Dow Chemical and DuPont.
- The merger was designed as a temporary structure—a way to combine and then reorganize three distinct businesses:
  - Dow (materials science)
  - DuPont (specialty products)
  - Corteva (agriculture)
- The idea was to leverage short-term synergies (e.g., cost savings, scale) and then split into three independent, publicly traded companies, each focused on its core industry.

Formation and IPO

- June 1, 2019: Corteva officially spun off from DowDuPont and began trading on the New York Stock Exchange under the ticker “CTVA.”
- The separation made Corteva a standalone agriculture company, combining DuPont Pioneer (seeds and traits), DuPont Crop Protection, and Dow AgroSciences.
- At the time of the spinoff, Corteva had about 21,000 employees, operations in 140 countries, and roughly $14 billion in annual sales.

Structure of the Spinoff

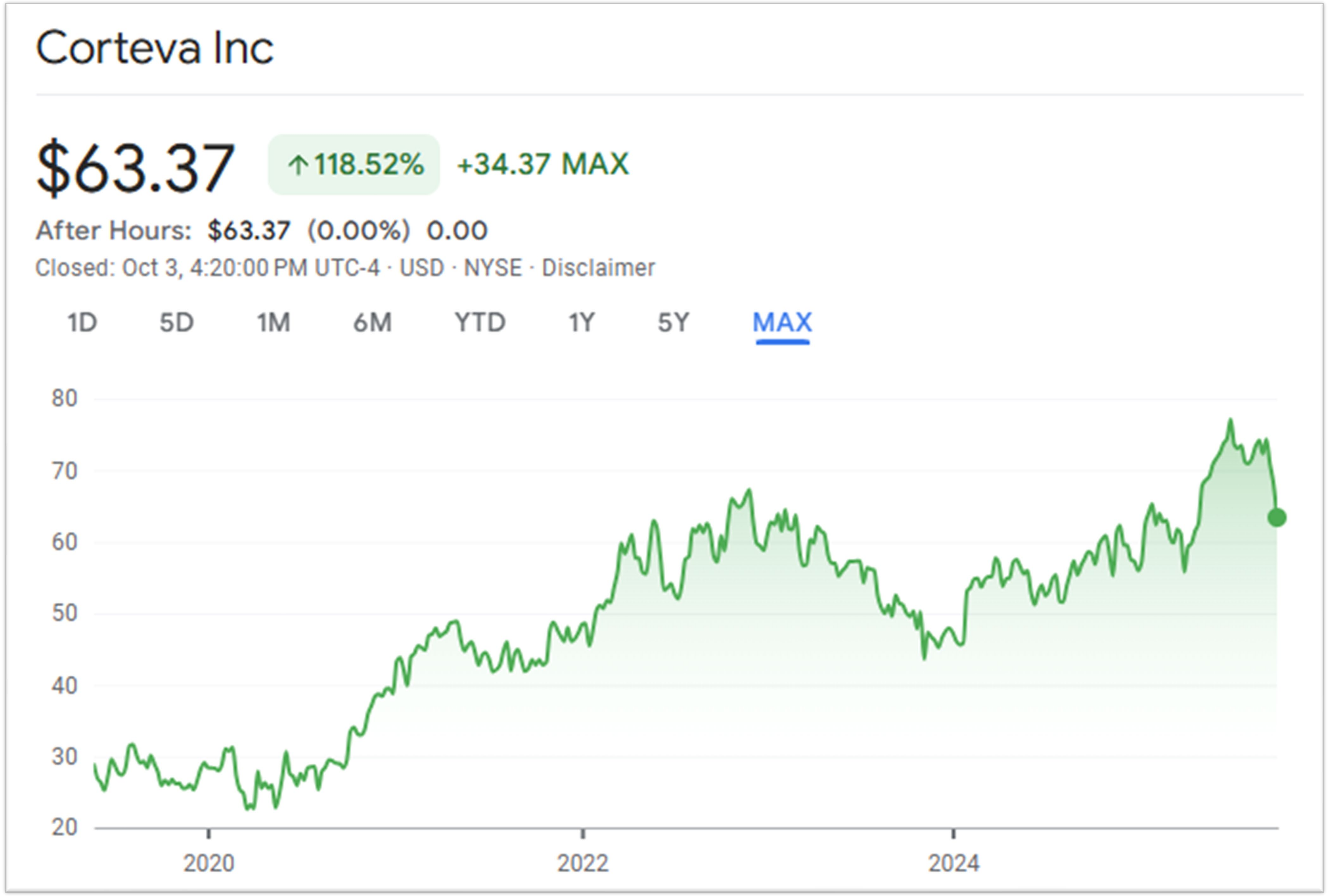
- The transaction was structured as a distribution of Corteva stock to existing DowDuPont shareholders, meaning they received shares in Corteva proportional to their DowDuPont holdings.
- This wasn't a traditional IPO where new shares are sold to raise capital. Instead, it was a tax-free spinoff, though Corteva became a publicly listed company through that process.
- Following the separation:
  - Dow Inc. focused on plastics and chemicals.
  - DuPont de Nemours, Inc. focused on specialty materials and electronics.
  - Corteva Agriscience focused on agriculture—seeds, crop protection, and digital solutions.

Rationale

- The logic behind the separation was that each company could:
  - Better focus on its own strategy and innovation pipeline.
  - Improve operational efficiency and capital allocation.
  - Attract investors who preferred a pure-play company (for example, investors focused only on agriculture rather than diversified chemicals).
- Corteva positioned itself as a “pure-play agriculture leader”, competing with firms like Bayer Crop Science (after Bayer acquired Monsanto), BASF, and Syngenta.

Post-Spinoff Performance

- Corteva has emphasized seed genetics (Pioneer brand), crop protection chemistry, and biological products, alongside digital agriculture platforms to help farmers make data-driven decisions.
- The company faced early headwinds in commodity markets and integration costs but has since strengthened its margins through innovation and cost discipline.



Lessons Learned from Corteva

- Corteva's spinoff is a modern example of how **corporate restructuring and public offerings** can unlock shareholder value by allowing focused, standalone companies to pursue growth in specialized sectors.
- It demonstrates the **strategic use of equity markets** to reconfigure large conglomerates—an alternative to traditional IPOs or mergers.
- It also illustrates how **public listings can be used not only to raise capital but to redefine corporate identity** in response to market and investor expectations.

Private Placements

- Another method of raising capital is through the private placement of securities (e.g., stocks or bonds).
- The Securities and Exchange Commission (SEC) provides a **Regulation D**, which allows smaller firms to sell stock through **Direct Public Offerings (DPO)**
- Regulations dictate reports and statements required when selling stock to private parties—friends, employees, customers, relatives, and professionals.

Sources of Capital

[redacted]

[redacted]

- Commercial Loans
- Peer-to-Peer Lending
- Trade Credit
- Accounts Receivable Financing
- Factoring

[redacted]

- Common Stock
- IPOs
- Private Placements

[redacted]

[redacted]

[redacted]

Crowdfunding (1 of 3)

- *Definition*: **Crowdfunding** seeks funding for ventures by raising monetary contributions from a large number of people, usually via the Internet.
- Three Principal Parts:
  - The __________ proposes the idea and/or venture to be funded.
  - The __________ who support the idea.
  - A moderating __________ (the "platform") that brings the parties together to launch the idea.

Crowdfunding (2 of 3)

- Two Distinct Forms:
  - **Rewards Crowdfunding**—The entrepreneur seeks a target amount of funding to launch a business concept without incurring debt or sacrificing equity and, in return for the donation, the entrepreneur provides some type of gift or incentive.
  - **Equity Crowdfunding**—The entrepreneur shares equity in the venture, usually in its early stages, in exchange for the money pledged.

Crowdfunding (3 of 3)

- Potential concerns:
  - Reputation
  - Intellectual property (IP) protection
  - Donor dilution
  - Investor management
  - Public fear
- Benefits:
  - Funding
  - Profile
  - Marketing
  - Engagement
  - Feedback

Value of Crowdfunding

- Crowdfunding is dispersed geographically and focused on leisure, retail, and consumer products.
- New legislation allows up to $50 million in crowdfunding, up from $1 million.

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The Venture Capital Market

- *Definition*: **Venture Capitalists** are valuable and powerful sources of equity funding for new ventures.
- They 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

Recent Developments

- After decline in 2008, in 2021, **venture capital invested about $330 billion in the United States**, largely in the Internet, health care, telecommunications, and software.
- Such investments dropped in 2022 and 2023 due to inflation and over-valuations in earlier years.

VC Funding Increasing in Early-Stage Startups

- Becoming more likely to invest in early-stage businesses:
  - More ease and efficiencies to launch a venture
  - Increase in incubators and accelerators
  - Lower infrastructure costs with cloud-based computing
  - Shorter product cycles
  - Can now sell to global consumers
  - Equity crowdfunding
  - College graduates more sophisticated with technology

Venture Capitalists’ Objectives

- Focused on return on investment.
- Weight risk and potential return
- Measure product/service and the management
- Return expectations vary based on market potential, management’s investment in company.
- Annual goal of 20 to 30 percent is common.

Venture Capitalist System of Evaluating Product/Service and Management

Status of Product/Service — Riskiest

Level 4 Fully developed product/service Established market Satisfied users	4/1	4/2	4/3	4/4
Level 3 Fully developed product/service Few users as of yet Market assumed	3/1	3/2	3/3	3/4
Level 2 Operable pilot or prototype Not yet developed for production Market assumed	2/1	2/2	2/3	2/4
Level 1 Product/service idea Not yet operable Market assumed	1/1	1/2	1/3	1/4
	Level 1 Individual founder/ entrepreneur	**Level 2** Two founders Other personnel not yet identified	**Level 3** Partial management team Members identified to join company when funding is received	**Level 4** Fully staffed, experienced management team

Riskiest

Status of Management

Source: Stanley Rich and David Gumpert, *Business Plans That Win $$$* (New York, NY: Harper & Row, 1985), 169.

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 to 15 × investment
First-stage financing (new business)	40% to 60%	6 to 12 × investment
Second-stage financing (development stage)	30% to 50%	4 to 8 × investment
Third-stage financing (expansion stage)	25% to 40%	3 to 6 × investment
Turnaround situation	50% +	8 to 15 × investment

Source: Adapted from W. Keith Schilit, "How to Obtain Venture Capital," *Business Horizons* (May/June 1987): 78.

Criteria for Evaluating New-Venture Proposals (1 of 3)

- Factors that are used in the evaluation of new ventures:
  - Timing of entry
  - Key success factor stability
  - Educational capability
  - Lead time
  - Competitive rivalry
  - Entry wedge imitation
  - Scope
  - Industry-related competence

Criteria for Evaluating New-Venture Proposals (2 of 3)

- 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

Criteria for Evaluating New-Venture Proposals (3 of 3)

- Success acquiring funding related to:
  - Entrepreneur (education, experience, age)
  - Enterprise (stage, industry type, location)
  - Request (amount, business plan, capital source)
  - Source of advice (technology, business plan, funding)

Evaluating the business plan:

- Proposal size
- Financial projections
- Investment recovery
- Competitive advantage
- Company management

Venture Capitalists’ Screening Criteria

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 5 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
- 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
  - A quick review is done of the basic venture to see if it meets the venture capitalist's particular interests.
- Stage 2: Evaluation of the Business Plan
  - A detailed reading of the plan is done 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 stakeholders, the venture capitalist makes a final decision.

Discussion Activity 7-1

- *Shark Tank* is a television show where entrepreneurs pitch their business ideas to a panel of investors—called "sharks"—who are seasoned venture capitalists, CEOs, or founders of successful companies.
- Each shark invests their own money in exchange for equity or other terms they negotiate during the pitch.
- The show mirrors a **venture capital pitch process**: entrepreneurs present their concept, demonstrate market potential, and negotiate valuation and deal terms—all under time pressure.

Shark Tank: Evaluating Venture Capital Pitches

Evaluating the Venture Capitalist

Suppose you are the founder – it's just as important to **evaluate the funder**.

- Does the venture capital firm in fact invest in your industry?
- What is it like to work with this venture capital firm?
- What experience does the partner doing your deal have, and what is their clout within the firm?
- How much time will the partner spend with your company if you run into trouble?
- How healthy is the venture capital fund, and how much has been invested?
- Are the investment goals of the venture capitalists consistent with your own?
- Have the venture firm and the partner championing your deal been through any economic downturns?

Sources of Capital

- Commercial Loans
- Peer-to-Peer Lending
- Trade Credit
- Accounts Receivable Financing
- Factoring

- Common Stock
- IPOs
- Private Placements

Informal Risk Capital: Angel Financing

- Business Angel Financing or **Angel Capital**
  - Wealthy individuals looking for investment opportunities.
  - Referred to as “business angels” or informal risk capitalists.

Types of Angel Investors

- Corporate angels
- Entrepreneurial angels
- Enthusiast angels
- Micromanagement angels
- Professional angels

“Angel Stats”

Typical deal size	$250,000 to $600,000
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%

Source: Jeffrey Sohl, University of New Hampshire’s Center for Venture Research, 2011; and the Halo Report, 2011.

Pros and Cons of Dealing with Angel Investors

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.

Source: Jeffrey Sohl, University of New Hampshire's Center for Venture Research, 2011; and the Halo Report, 2011.

Summary: Choosing the Right Source of Capital

- Early Stage → Bootstrapping → Friends & Family → Angels / Crowdfunding
- Growth Stage → Venture Capital / Private Placement
- Mature Stage → SPAC or IPO
- Ongoing Needs → Debt or Trade Credit

Bottom Line: The “right” capital isn’t just about *how much* you raise—it’s about what you give up, what you gain, and how well it fits your growth path.

Summary

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