Entrepreneurship

Getting Funding or Financing

Week 7

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The Importance of Getting Financing or Funding

- The Nature of the Funding and Financing Process
  - 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.
- Why Most New Ventures Need Funding
  - There are three reasons most new ventures need to raise money during their early life.
    - The three reasons are shown on the following slide.

Why Most New Ventures Need Financing or 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.

Alternatives for Raising Money for a New Venture

Personal Funds	Equity Capital
Debt Financing	Creative Sources

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.

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.

Examples of Bootstrapping Methods

Buying used instead of new equipment	Coordinating purchases with other businesses	Leasing equipment instead of buying
Obtaining payments in advance from customers	Minimizing personal expenses	Avoiding unnecessary expenses
Buying items cheaply but prudently via options such as eBay	Sharing office space or employees with other businesses	Hiring interns

Preparing to Raise Debt or Equity Financing

Step 1
Determine precisely how much money is needed

→

Step 2
Determine the type of financing or funding that is the most appropriate

→

Step 3
Develop a strategy for engaging potential investors or bankers

Preparing to Raise Debt or Equity Financing

Two Most Common Alternatives

Equity Funding	Debt Financing
Means exchanging partial ownership in a firm, usually in the form of stock, for funding	Is getting a loan

Preparing to Raise Debt or Equity Financing

Matching a New Venture's Characteristics with the Appropriate Form of Financing or Funding

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

Preparing An Elevator Speech

Elevator Speech

Purpose

- An elevator speech is a brief, carefully constructed statement that outlines the merits of a business opportunity.
- There are many occasions when a carefully constructed elevator speech might come in handy.
- Most elevator speeches are 45 seconds to 2 minutes long.

Preparing an Elevator Speech

Step 1	Describe the opportunity or problem that needs to be solved.	20 seconds
Step 2	Describe how your product 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

Sources of Equity Funding

Venture Capital

Business Angels

Initial Public Offerings

Business Angels

- Business Angels
  - Are individuals who invest their personal capital directly in start-ups.
  - The prototypical business angel is about 50 years old, has high income and wealth, is well educated, has succeeded as an entrepreneur, and is interested in the start-up process.
  - The number of angel investors in the U.S. has increased dramatically over the past decade.

Business Angels

- Business Angels (continued)
  - Business angels are valuable because of their willingness to make relatively small investments.
    - These investors generally invest between $10,000 and $500,000 in a single company.
    - Are looking for companies that have the potential to grow between 30% to 40% per year.
  - Business angels are difficult to find.

Venture Capital

- Venture Capital
  - Is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential.
  - There are about 800 venture capital firms in the U.S.
    - Venture capital firms are limited partnerships of money managers who raise money in “funds” to invest in start-ups and growing firms.
    - The funds, or pool of money, are raised from wealthy 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

- Venture Capital (continued)
  - Venture capital firms fund very few entrepreneurial firms in comparison to business angels.
    - Many entrepreneurs get 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” and so reject the majority of the proposals they consider.
    - Venture capitalists fund between 3,000 and 4,000 companies per year, compared to about 62,000 per year for business angels.

Venture Capital

- Venture Capital (continued)
  - An important part of obtaining venture capital funding is going through the due diligence process.
  - Venture capitalists invest money in start-ups in “stages,” meaning that not all the money that is invested is disbursed at the same time.
  - Some venture capitalists also specialize in certain “stages” of funding.

Initial Public Offering

- Initial Public Offering
  - 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

Reasons that Motivate Firms to Go Public

Reason 1	Reason 2
Is a way to raise equity capital to fund current and future operations.	Raises a firm's public profile, making it easier to attract high-quality customers and business partners.

Initial Public Offering

Reasons that Motivate Firms to Go Public

Reason 3	Reason 4
Is a liquidity event that provides a means for a company’s investors to recoup their investments.	Creates a form of currency that can be used to grow the company via acquisitions.

Sources of Debt Financing: Commercial Banks

- Banks
  - Historically, commercial banks have not been viewed as a practical source of financing for start-up firms.
  - This sentiment is not a knock against banks; it is just that banks are risk averse, and financing start-ups 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.

Other Sources of Debt Financing

- 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
  - Factoring is when a business sells its unpaid invoices to a third party (called a factor) at a discount to get immediate cash.

Other Sources of Debt Financing

- Peer-to-Peer Lending
  - Is a financial transaction that occurs directly between individuals or peers.
  - Prosper is the best know peer-to-peer lending network.
- Crowdfunding
  - A form of raising money that takes place, usually via the Internet, where people pool their money to support a start-up or other initiative, usually in return for some sort of amenity rather than loan.
  - Kickstarter is a popular online crowdfunding platform.

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