Newer Sources of Finance

Many new businesses fail because the proprietors do not have enough cash to last them through the critical first few months of trading while their sales revenues are only just starting to build up. Before you begin trading, you need to make sure you have enough money to set up the business and cover your initial running costs. If you or your business partners don't have enough money yourselves, you will need to approach other sources of finance.

1. Banks

Banks offer a variety of finance options, services and introductory offers to business start ups. Banks can provide finance in the form of an overdraft, whereby they agree to let you withdraw more money than you actually have in your business account. Your bank will set a maximum level for your overdraft.

You only have to pay interest on the amount you are overdrawn, so overdrafts can be a good option if you only need small amounts of extra cash at certain times during the month or year. However, the interest you pay is often higher than the rate for a loan.

2. Personal savings

Personal savings and money raised from friends and family are the most common forms of finance for start ups. Friends and family may be prepared to help you start your business by offering you a loan, particularly if you cannot get one from a bank. This may be on preferential or 'soft' terms, including the possibility of an interest-free loan. If you opt to pay interest there will be tax implications for both parties. However, personal relationships may be affected if your business does not do as well as planned and you are unable to repay the loan on time or in full.

3. money raised from friends and family

Relatives or friends may also consider investing money in your business in return for a share of its ownership, even if they act as a 'sleeping partner'. However, they need to understand that they will be risking their capital and that returns are not guaranteed, so they should invest only

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what they can afford to lose. This type of investment also has implications relating to the legal status of your business.

4. Angel Investors

This category refers to retired company executives or wealthy individuals who make direct investments in startups and small firms.

These investors are typically leaders in their respective fields. They contribute by means of their network of contacts and experience and also provide their technical and management knowledge.

However, you should know that in exchange for their investments, angel investors might monitor your startup management practices and might want a say in your business.

5. Business Loans

Business loans are the most common source of funding, not only for startups but also for small and medium-sized businesses.

Banks and other financial institutions offer many types of business loans in return for regular interest payments. They will need you to have a solid business plan in place. Your plan should show potential and have numbers to back it up.

Having a good idea is not enough; you need to have evidence to support it. In some cases, banks might ask you for something as collateral, but every situation is different. If you don’t offer collateral, they might charge you a higher rate of interest but this will help you in avoiding bad credit too.

6. Venture Capital

This funding source is ideal for tech-based startups that have a high growth potential in communications, information technology, or biotechnology.

The venture capitalists basically invest in your startup in exchange for equity, so you have to share ownership with an external party. Venture capitalists also expect a high return on investment once the business is properly established.

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Always look for venture capitalists who have a background in your business's industry and can bring relevant knowledge and experience.

7. Incubators

This term refers to a university, company, or any organization that is willing to provide you with resources for your startup. These resources could include office space, laboratories, marketing, consulting, cash, or anything else you might need.

What do incubators ask for in exchange? They are aware that you are in a vulnerable position, so they will typically demand equity. The reason why they see a lot of potential in your ideas and want to earn profit from it in the future.

8. Crowd funding

As the name indicates, crowd funding refers to getting funds from a crowd, i.e., the general public. Entrepreneurs typically use this option when developing a product that's essential to people and not available elsewhere.

There are crowd funding websites that enable members of the public to pool their funds to help various causes. Every member can contribute as little as $10, and the money can go a long way if many people add to it. Use a good crowd funding platform, and advertise your cause to get more people to contribute.

Startups can use any of these sources of finance to launch their operations and offer quality products and services to people.

9. Grants and Subsidies

Bringing innovations to light is not always easy. As a result, some government agencies provide support to budding businesses.

Access to this funding allows you to cover different expenses, such as marketing, research and development, equipment, salaries, and improvement in productivity.

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Technically, governments give grants to startups unconditionally and you don't have to repay them. But you cannot use the grant money for any other purpose, or you will be vulnerable to legal action.

Once a government source has provided you with funding and you fulfill the terms of the program, that agency might offer you additional funding in the future.

Venture Capital

Startup companies with a potential to grow need a certain amount of investment. Wealthy investors like to invest their capital in such businesses with a long-term growth perspective. This capital is known as venture capital and the investors are called venture capitalists. Such investments are risky as they are illiquid, but are capable of giving impressive returns if invested in the right venture. The returns to the venture capitalists depend upon the growth of the company. Venture capitalists have the power to influence major decisions of the companies they are investing in as it is their money at stake.

Features of Venture capital

The following are the features of venture capital:

1. It is basically **financing of new companies** which are finding it difficult to go to the capital market at their early stage of existence.
2. This **finance can also be loan-based or in-convertible debentures** so that they carry a fixed yield for the providers of venture capital.
3. Those who provide venture capital **aim at capital gain due to the success achieved by the concern** that borrows.
4. It is a **long-term investment** and made in companies which have high growth potential. The provision of venture capital will bring rapid growth for the business.

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5. The venture capital provider will also **take part in the business of borrowing concern** whereby, the venture capital financier not merely confines to finance, but also provide managerial skill.

6. Not all the capitalists will experience high risk. But venture capital financing **contains risks**. But the risk is compensated with a higher return.

7. Not much of technology is involved in venture capital; it **involves financing mainly small and medium size firms**, which are in their early stages. With the assistance of venture capital, these firms will stabilize and later can go in for traditional finance.

Types of Venture Capital Funding

1. Seed Capital

If you're just starting out and have no product or organized company yet, you would be seeking seed capital. Few VCs fund at this stage and the amount invested would probably be small. Investment capital may be used to create a sample product, fund market research, or cover administrative set-up costs.

2. Startup Capital

At this stage, your company would have a sample product available with at least one principal working full-time. Funding at this stage is also rare. It tends to cover recruitment of other key management, additional market research, and finalizing of the product or service for introduction to the marketplace.

3. Early Stage Capital

Two to three years into your venture, you've gotten your company off the ground, a management team is in place, and sales are increasing. At this stage, VC funding could help you increase sales to the break-even point, improve your productivity, or increase your company's efficiency.

4. Expansion Capital

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Your company is well established, and now you are looking to a VC to help take your business to the next level of growth. Funding at this stage may help you enter new markets or increase your marketing efforts. You should seek out VCs that specialize in later stage investing.

5. Late Stage Capital

At this stage, your company has achieved impressive sales and revenue and you have a second level of management in place. You may be looking for funds to increase capacity, ramp up marketing, or increase working capital.

6. Bridge Financing

You may also be looking for a partner to help you find a merger or acquisition opportunity, or attract public financing through a stock offering. There are VCs that focus on this end of the business spectrum, specializing in initial public offerings (IPOs), buyouts, or recapitalizations. If you are planning an IPO, a VC may also assist with mezzanine or bridge financing – short-term financing that allows you to pay for the costs associated with going public.

A key factor for the VC will be risk versus return. The earlier a VC invests, the greater are the inherent risks and the longer is the time period until the VC's exit. It follows that the VC will expect a higher return for investing at this early stage, typically a 10 times multiple return in four to seven years. A later stage VC may be seeking a two to four times multiple return within two years.

Advantages of Venture Capital

1. Opportunity for expansion of the company

Venture Capital provides the company with an opportunity to expand. This would not have been possible through other methods like bank loans. Bank loans require collateral and there is an obligation to repay the loan. However, in venture capital, the investors themselves are ready to take the risk as they believe in the company's long-term success. Therefore, venture capital financing is beneficial for start-ups with high initial cost and limited operating history.

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2. Valuable guidance and expertise

Besides capital financing, venture capital is also a source of valuable guidance, expertise, and consultation. A member from the venture capital firm is usually appointed to the board of the start-up company. This allows the active involvement of the venture capitalist in the company's decisions. As venture capitalists have experience in building and expanding start-ups, their expertise and guidance can prove to be beneficial. They can help with building strategies, technical assistance, resources, etc. in order to make a business successful.

3. Helpful in building networks and connections

Venture capitalists have a huge network of connections in the business community. These connections could be advantageous for the start-ups to grow and become successful. They can help the start-up to enter into alliances with potential customers or business houses.

4. No obligation for repayment

There is no obligation to repay the venture capitalist investors if the start-up fails or shuts down. Hence, venture funding is essential for start-ups. It does not leave the start-up with the burden to pay back as is the case with bank loans.

5. Venture capitalists are trustworthy

VC's are strictly regulated by regulatory bodies. For instance, In USA, VC's are regulated by U.S Securities and Exchange Commission. They are subject to similar regulations as any other form of private securities investments. Also, know-your-customer (KYC) and anti-money laundering regulations may apply since a large number of venture capital funds are provided by depository institutions and banks. It's a rarity to see a VC perform an unscrupulous activity.

6. Easy to locate

It is very easy to find and locate VC within minutes, investors, as they are documented in various directories. This reduces the time, efforts and money involved in searching venture funding. One can find a VC quickly and efficiently. For instance, you can get a huge list of venture capital firms by typing on any search engine.

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Disadvantages of Venture Capital

1. Dilution of ownership and control

Venture capitalist provides huge capital to the start-ups in return for a stake in the equity of the company. If the start-up succeeds, then it helps them earn tremendous amounts of profit. VC's usually become a part of the Board. They actively participate in the company's decision-making. VC's will want to protect their investments. If there is a difference of opinion between the VC and the start-up founder, then things can get chaotic. Any major decision requires the consent of investors.

2. Early redemption by VC's

A VC may decide to redeem the investment within 3 to 5 years. Their primary focus is to earn capital gains. Venture capital may not be suitable for an entrepreneur whose business plan will take a longer time to provide liquidity.

3. Long and complicated process

The start-up company's owner should first present a detailed business plan. Thereafter, the VC analyses the business plan in detail. Then, a one-on-one meeting is conducted to discuss the business plan in detail. Later, if the VC agrees to go ahead with the funding then due diligence is done to verify the details. If the due diligence is found satisfactory then only the VC will offer a term sheet. Therefore, venture capital funding is often found to be a lengthy process.

4. Vc's take a long time to decide

Venture Capital funding involves a huge amount of risk. So, VC's usually takes lots of time to decide whether they want to undertake investment or not. Venture funding may be a great source of availing funds for the start-ups. However, the long wait before receiving the funds is a huge drawback.

5. Approaching a vc can be tedious

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A lot of investment opportunities through uninvited emails overburden the VC's. Due to this a lot of business proposals go unnoticed. One of the ways to approach the VC is through a mutual connection.

6. May require high return on original investment

Some VC's require high ROI within the next three to five years of investment. If your start-up will need more time to generate high ROI, then opting for VC may not be the right choice. As expectation of higher ROI may cause a high level of stress.

7. May release the funds from time to time

Because venture funding involves a huge amount of capital, the VC may not release all the funds at the same time. Most of the contracts require the start-up company to reach certain milestones in order to receive the funding, which they originally requested. This creates undue pressure on the start-up company.

8. May lead to under-valuation

Venture Capitalists are in a hurry to sell off their equity stake. Therefore, they may pressurize the owner of the company to list the company. This untimely listing of the company could result in under-valuation of the company's shares. This could prove to be a disadvantage for the company's owner.

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