

CHAPTER 13

Sources of Financing:
Debt and Equity



Raising Capital

- Raising capital to launch or expand a business is a challenge.
- Many entrepreneurs are caught in a “credit crunch.”
- Financing needs in the \$100,000 to \$3 million range may be the most challenging to fill.



The “Secrets” to Successful Financing

- 1. Choosing the right sources of capital is a decision that will influence a company for a lifetime.**
- 2. The money is out there; the key is knowing where to look.**
- 3. Raising money takes time and effort.**
- 4. Creativity counts. Entrepreneurs have to be as creative in their searches for capital as they are in developing their business ideas.**

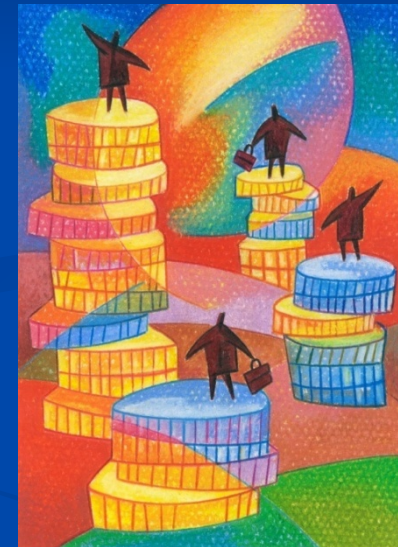
The “Secrets” to Successful Financing

(continued)

- 5. The Internet puts at entrepreneur’s fingertips vast resources of information that can lead to financing.**
- 6. Be thoroughly prepared before approaching lenders and investors.**
- 7. Entrepreneurs should not underestimate the importance of making sure that the “chemistry” among themselves, their companies, and their funding sources is good.**

Financing a Business

- **Entrepreneurs must cast a wide net to capture the financing they need to launch their businesses.**
- **Layered financing – piecing together capital from multiple sources.**



Three Types of Capital

In addition to the text

Capital is any form of wealth employed to produce more wealth for a firm.

- 1. Fixed** - Used to purchase the permanent or fixed assets of the business (e.g., buildings, land, equipment, and others).
- 2. Working** - Used to support the small company's normal short-term operations (e.g., buy inventory, pay bills, wages, or salaries, and others).
- 3. Growth** - Used to help the small business expand or change its primary direction.

Equity Capital

- Represents the personal investment of the owner(s) in the business.
- Is called *risk capital* because investors assume the risk of losing their money if the business fails.
- Does *not* have to be repaid with interest like a loan does.
- Means that an entrepreneur must give up some ownership in the company to outside investors.



Debt Capital

- **Must be repaid with interest.**
- **Is carried as a liability on the company's balance sheet.**
- **Can be just as difficult to secure as equity financing, even though sources of debt financing are more numerous.**
- **Can be expensive, especially for small companies, because of the risk/return tradeoff.**



Sources of Equity Financing

- Personal savings



Personal Savings

- The *first* place an entrepreneur should look for money.
- The most common source of equity capital for starting a business.
- Outside investors and lenders expect entrepreneurs to put some of their own capital into the business *before* investing theirs.



Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members



Friends and Family Members

- **After emptying their own pockets, entrepreneurs should turn to those most likely to invest in the business: friends and family members.**
- **Be careful! Inherent dangers lurk in family/friendly business deals, *especially* those that flop.**



Friends and Family Members

Guidelines for family and friendship financing:

- Consider the impact of the investment on everyone involved.
- Keep the arrangement “strictly business.”
- Prepare a business plan.
- Settle the details up front.
- Never accept more than investors can afford to lose.
- Create a written contract.
- Treat the money as “bridge financing.”
- Develop a payment schedule that suits both parties.
- Have an exit plan.



Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels



Angels

- **Wealthy individuals who invest in emerging entrepreneurial companies in exchange for equity (ownership) stakes.**
- **An excellent source of “patient money” for investors needing relatively small amounts of capital typically ranging from \$100,000 (sometimes less) to as much as \$5 million.**
- **Willing to invest in the early stages of a business.**

Angels

- **An estimated 258,000 angels across the U.S. invest \$26 billion a year in 57,000 small companies.**
- **Their investments exceed those of venture capital firms, providing more capital to 15 times as many small companies.**
- **Angels fill a gap in the seed capital market, specifically in the \$10,000 to \$2 million range.**



Angels

- **Average angel investment = \$50,000.**
- **Typical angel invests in 1 company per year, and the average time to close a deal is 67 days.**
- **52% of angels' investments lose money, but 7% produce a return more than 10 times their original investment.**
- **Angels can be an excellent source of “patient” money.**

Angels

The Challenge: Finding Them!

- **Network**
- **Look nearby: within a 50- to 100-mile radius**
 - **7 out of 10 angels invest in companies that are within 50 miles of their homes or offices.**
- **Informal angel “clusters” and networks**
 - **265 angel groups across the U.S.**
 - **Internet**



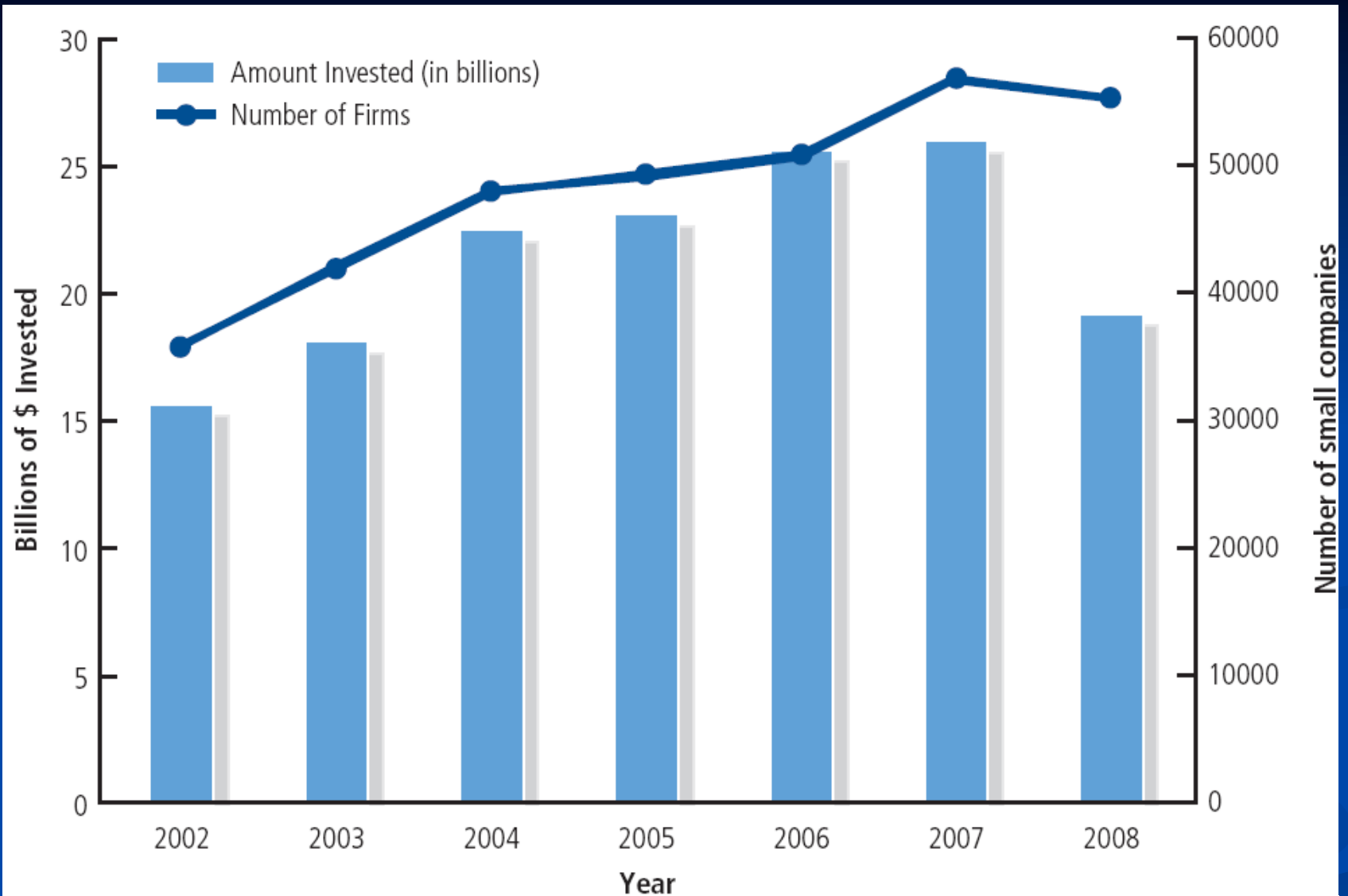


FIGURE 13.1 Angel Financing

Source: Center for Venture Financing, Whittemore School of Business, University of New Hampshire, www.unh.edu/cvr.

Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels
- Partners



Partners

- Giving up personal control
- Diluting ownership
- Sharing profits
- “For every penny you get in the door, you have to give something up.”



Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels
- Partners
- Venture capital companies



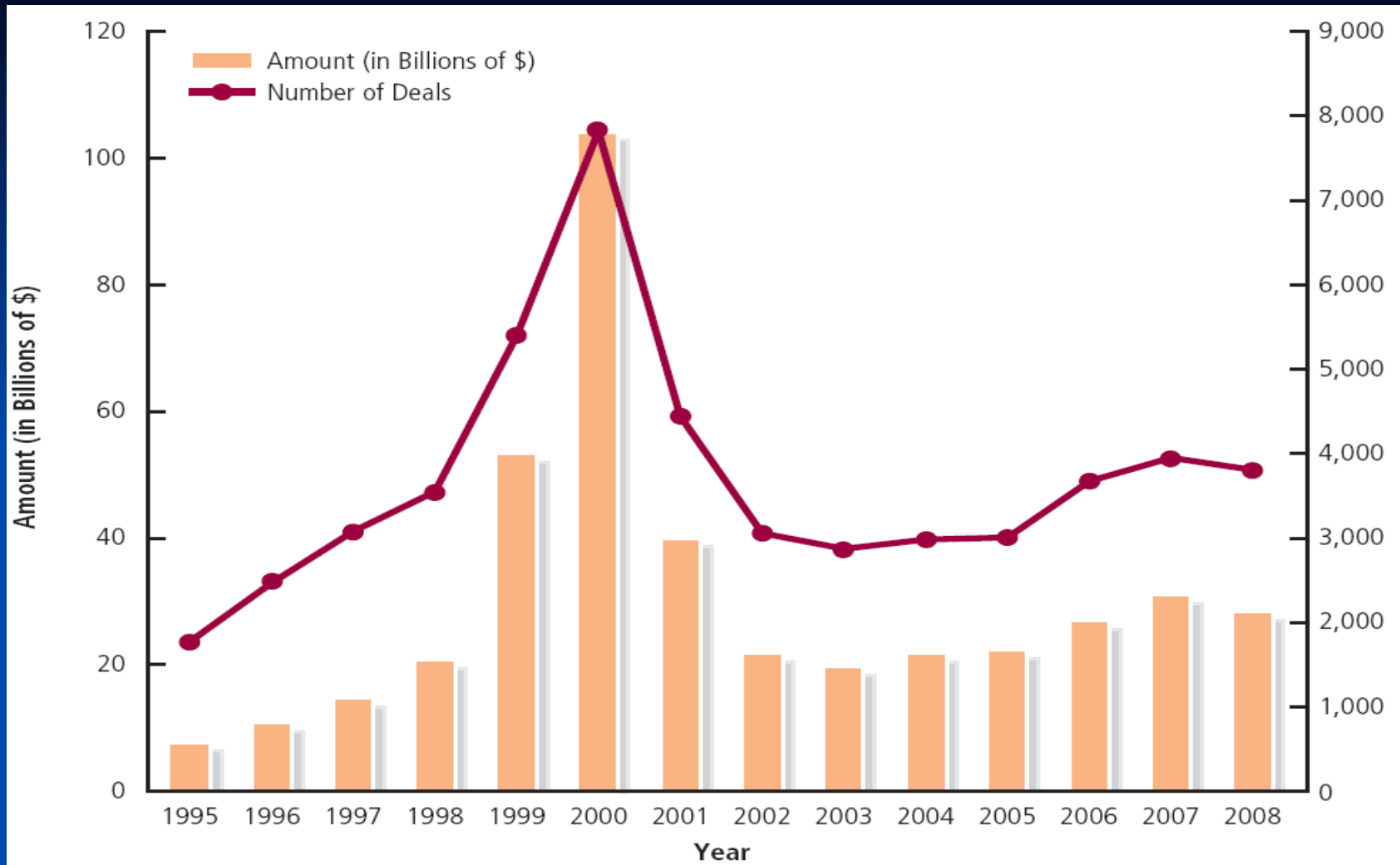


FIGURE 13.2 Venture Capital Funding

Source: Based on PriceWaterhouseCoopers <http://www.pwcmoneytree.com>.

Venture Capital Companies

- More than 740 venture capital firms operate across the U.S.
- Most venture capitalists seek investments in the \$3 million to \$10 million range
- Target companies with high-growth and high-profit potential.
- Business plans are subjected to an *extremely* rigorous review - less than 1% accepted.

The Business Plan Funnel

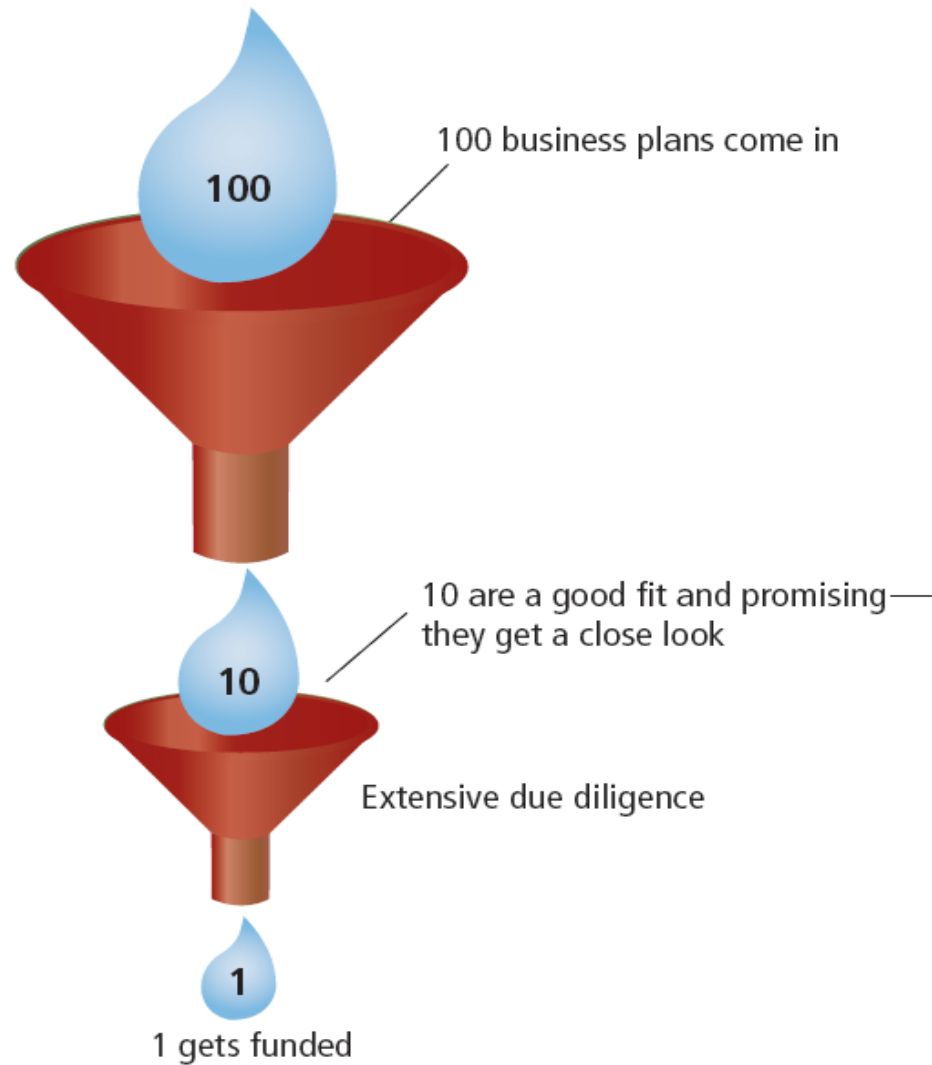


FIGURE 13.3

The Business Plan Funnel

Source: Venture Impact: The Economic Importance of Venture Backed Companies to the U.S. Economy, Fourth edition, National Venture Capital Association, 2007, p.10.

Venture Capital Companies

(continued)

- Most often, venture capitalists invest in a company across several stages.
- On average, 98% of venture capital goes to:
 - Early stage investments (companies in the early stages of development).
 - Expansion stage investments (companies in the rapid growth phase).
- Only 2% of venture capital goes to businesses in the startup or seed phase.

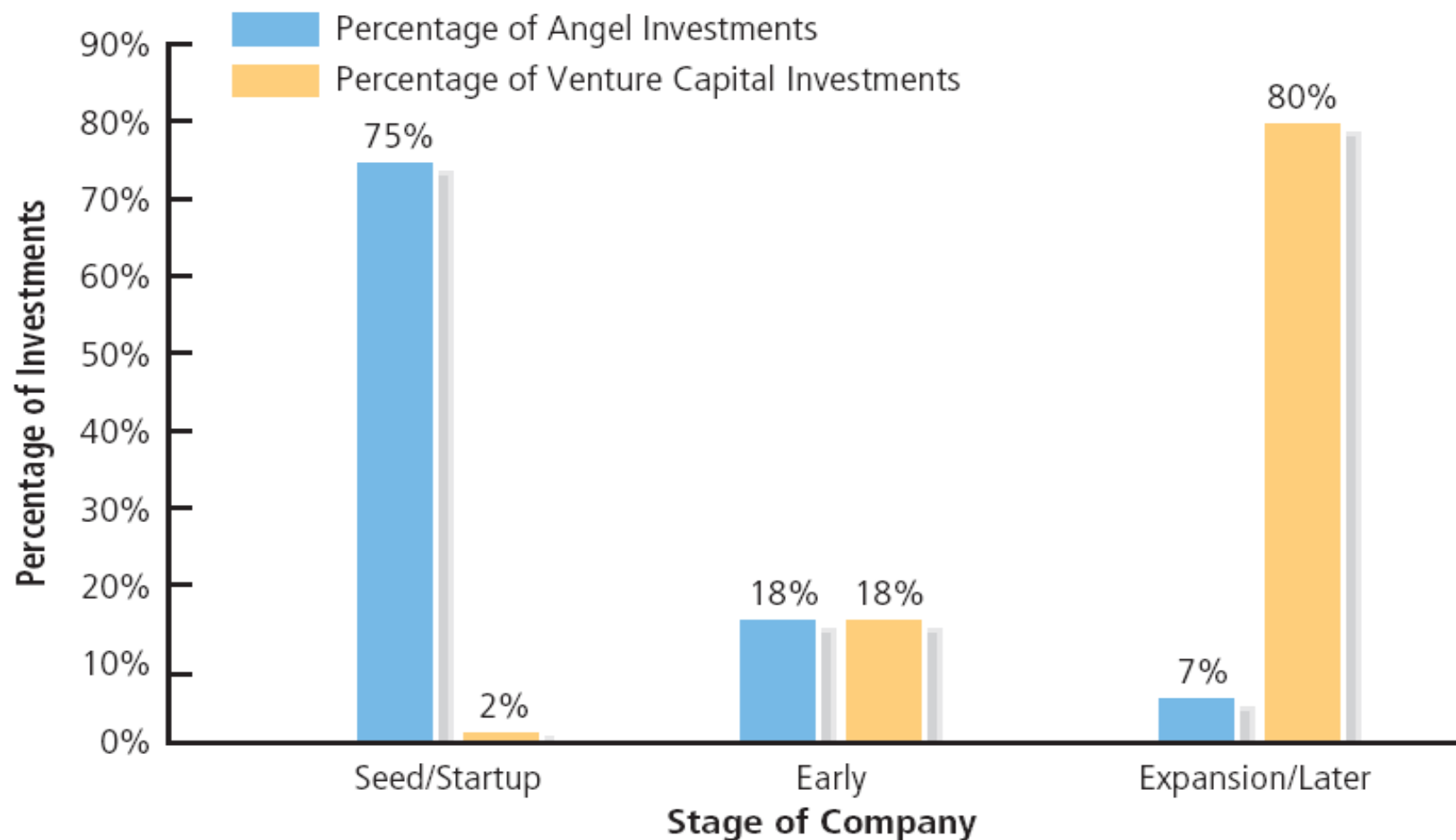


FIGURE 13.4 Angel Investing and Venture Capital Investing

Source: Robert Wiltbank and Warren Bocker, *Returns to Angel Investors in Groups*, Angel Capital Education Foundation, <http://www.kauffman.org/Details.aspx?id=1032>, and PWC Moneytree Report, Pricewaterhouse Coopers, <https://www.pwcmonnneytree.com/MTPublic/nc/index.jsp>.

What Do Venture Capital Companies Look For?

- **Competent management**
- **Competitive edge**
- **Growth industry**
- **Viable exit strategy**
- **Intangibles factors**



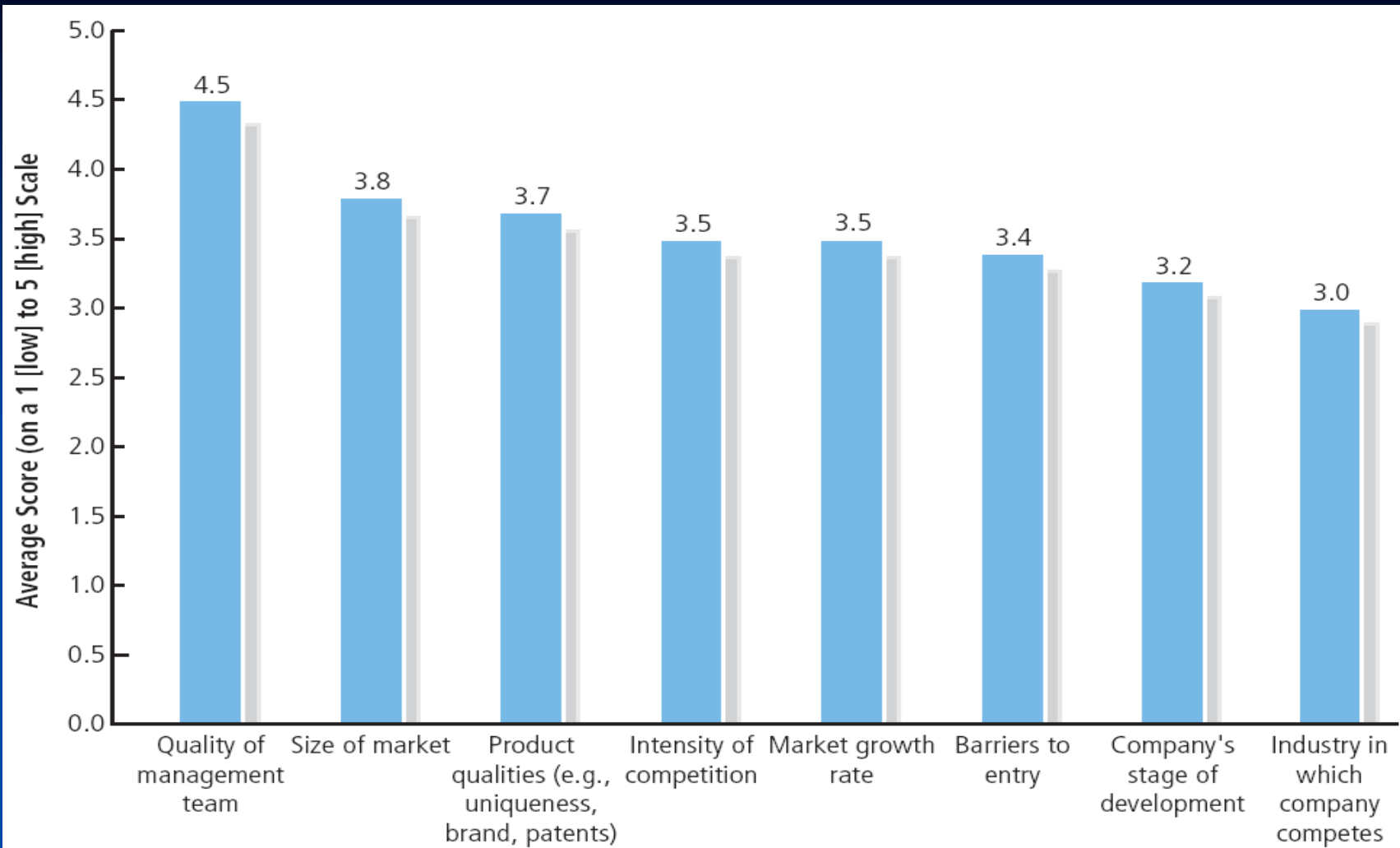


FIGURE 13.5

Which Factors Are Most Important to Venture Capitalists?

Source: Dee Powers and Brian E. Hill, Venture Capital Survey, The Capital Connection, <http://www.capital-connection.com/survey-value.html>.

Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels
- Partners
- Venture capital companies
- Corporate venture capital



Corporate Venture Capital

- About 300 large corporations across the globe invest in start-up companies.
- Approximately 6 to 8% of all venture capital invested is from corporations.
- Capital infusions are just one benefit; corporate partners may share marketing and technical expertise.



Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels
- Partners
- Venture capital companies
- Corporate venture capital
- Public stock sale – “going public”



Going Public

- **Initial public offering (IPO) - when a company raises capital by selling shares of its stock to the public for the first time.**
- **Since 2000, the average number of companies making IPOs each year is 173.**
- **Few companies with less than \$25 million in annual sales make IPOs.**



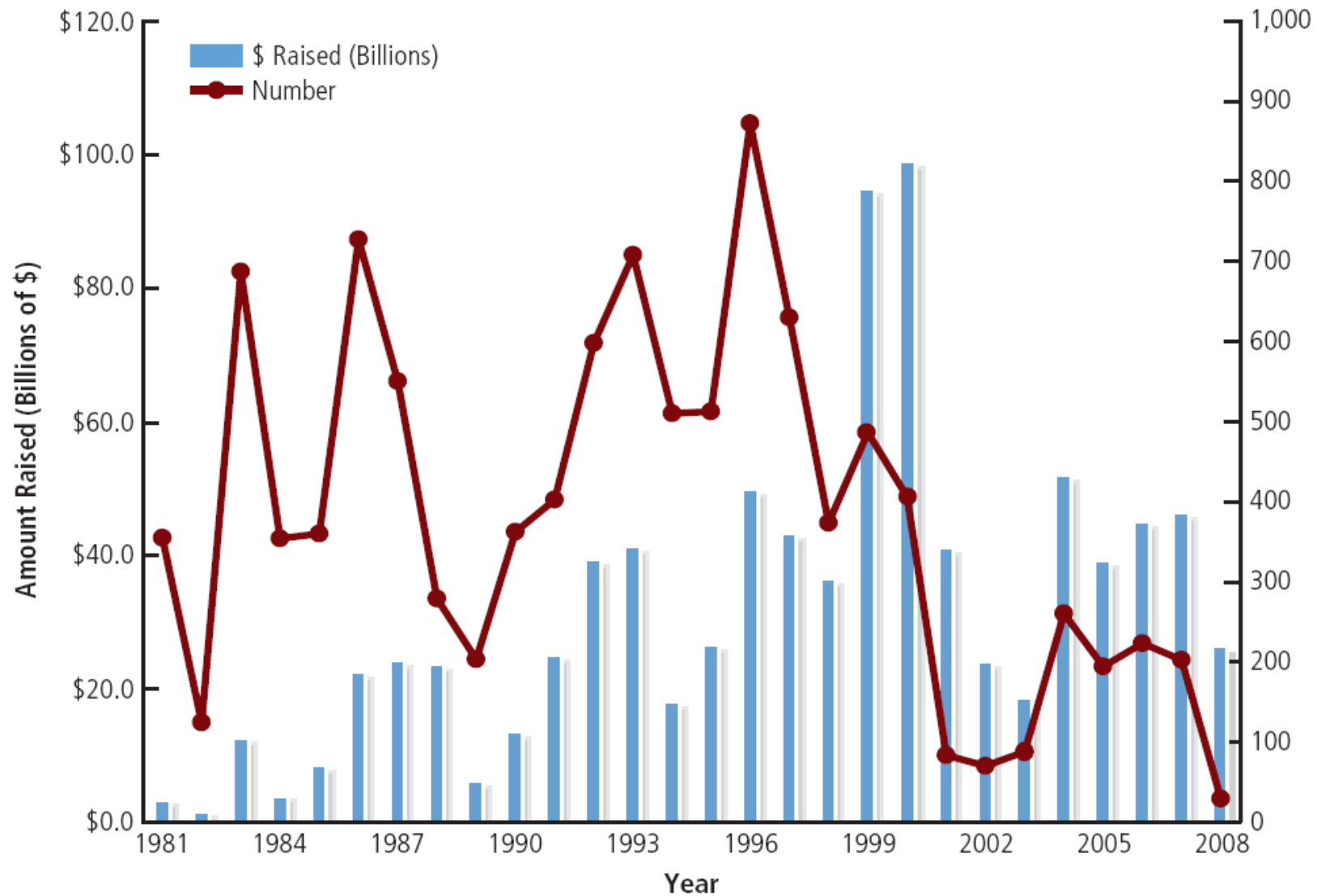


FIGURE 13.6 Initial Public Offerings (IPOs)

Source: Thompson Financial Securities Data.

Successful IPO Candidates Have...

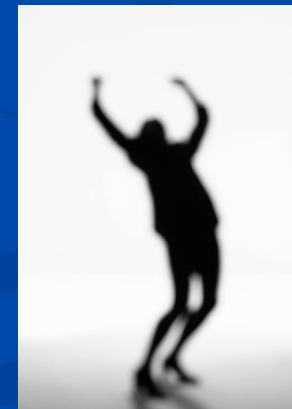
- Consistently high growth rates
- Strong record of earnings
- 3 to 5 years of audited financial statements that meet or exceed SEC standards
- Solid position in a rapidly-growing industry:
Average company age is 14 years
- Sound management team with experience
and a strong board of directors



Advantages of “Going Public”

In addition to the text

- Ability to raise large amounts of capital
- Improved corporate image
- Improved access to future financing
- Attracting and retaining key employees
- Using stock for acquisitions
- Listing on a stock exchange



Disadvantages of “Going Public”

In addition to the text

- Dilution of founder’s ownership
- Loss of control
- Loss of privacy
- Reporting to the SEC
- Filing expenses
- Accountability to shareholders
- Pressure for short-term performance
- Timing

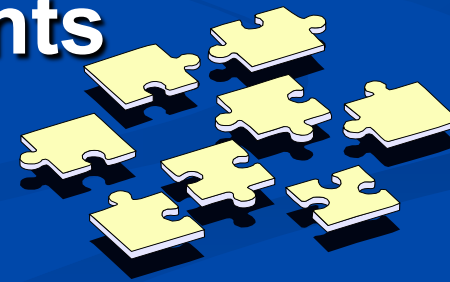


Timetable for an IPO

| Time | Action |
|---------|---|
| Week 1 | Conduct organizational meeting with IPO team, including underwriter, attorneys, accountants, and others. Begin drafting registration statement. |
| Week 5 | Distribute first draft of registration statement to IPO team and make revisions. |
| Week 6 | Distribute second draft of registration statement and make revisions. |
| Week 7 | Distribute third draft of registration statement and make revisions. |
| Week 8 | File registration statement with the SEC. Begin preparing presentations for road show to attract other investment bankers to the syndicate. Comply with Blue Sky laws in states where offering will be sold. |
| Week 12 | Receive comment letter on registration statement from SEC. Amend registration statement to satisfy SEC comments. |
| Week 13 | File amended registration statement with SEC. Prepare and distribute preliminary offering prospectus (called a "red herring") to members of underwriting syndicate. Begin road show meetings. |
| Week 15 | Receive approval for offering from SEC (unless further amendments are required). Issuing company and lead underwriter agree on final offering price. Prepare, file, and distribute final offering prospectus. |
| Week 16 | Company and underwriter sign the final agreement. Underwriter issues stock, collects the proceeds from the sale, and delivers proceeds to company. |

The Registration Process

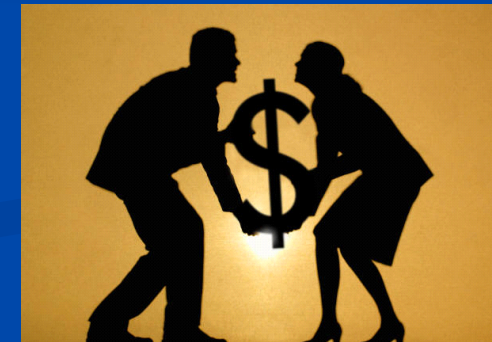
- Choose the underwriter
- Negotiate a letter of intent
- Prepare the registration statement
- File with the SEC
- Wait to “go effective” and road show
- Meet all state requirements



Sources of Equity Financing

(continued)

- Personal savings
- Friends and family members
- Angels
- Partners
- Venture capital companies
- Corporate venture capital
- Public stock sale – “going public”
- Simplified registrations and exemptions



Simplified Registrations and Exemptions

Goal:

**To give small companies easy
access to capital markets with
simplified registration
requirements**

Simplified Registrations and Exemptions

- Regulation S-B
- Regulation D (Rule 504): Small Company Offering Registration (SCOR)
- Regulation D (Rule 505 and 506): Private Placements
- Section 4 (6) Private Placements
- Intrastate Offerings (Rule 147)
- Regulation A

Sources of Debt Capital

- **Commercial banks**
 - **Lenders of first resort for small businesses**
 - **Average micro-business loan = \$7,400**
 - **Average small business loan = \$181,000**
 - **Study: 12% of entrepreneurs receive bank loans to start their businesses.**



Sources of Debt Capital From Commercial Banks

- **Short-term loans**
 - Home Equity Loans
 - Commercial Loans
 - Lines of Credit
 - Floor planning
- **Immediate and Long-Term Loans**
 - Installment Loans
 - Term Loans



Six Common Reasons Bankers Reject Small Business Loans

In addition to the text

- 1. *“Our bank doesn’t make small business loans.”***

Cure: Before applying for a loan, research banks to find out which ones seek the type of loan you need.

- 2. *“I don’t know enough about you or your business.”***

Cure: Develop a detailed business plan to present to the banker.

Six Common Reasons Bankers Reject Small Business Loans

(continued)

In addition to the text

3. *“You haven’t told me why you need the money.”*

Cure: Your business plan should explain how much money you need and how you plan to use it.

4. *“Your numbers don’t support your loan request.”*

Cure: Include a cash flow forecast in your business plan.

Six Common Reasons Bankers Reject Small Business Loans

(continued)

In addition to the text

5. ***“You don’t have enough collateral.”***
Cure: Be prepared to pledge your company’s assets – and perhaps your personal assets – as collateral for the loan.

6. ***“Your business does not support the loan on its own.”***
Cure: Be prepared to provide a personal guarantee on the loan.

Asset-Based Lenders

- **Businesses can borrow money by pledging as collateral otherwise idle assets – accounts receivable, inventory, and others**
- ***Advance rate* – the percentage of an asset's value that a lender will lend.**

Asset-Based Borrowing

- Discounting accounts receivable
- Inventory financing



Other Sources of Debt Capital

- **Vendor financing (trade credit)**
- **Equipment suppliers**
- **Commercial finance companies**
- **Saving and loan associations**
- **Stock brokers**



Other Sources of Debt Capital

(continued)

- **Credit unions**
- **Private placements**
- **Small Business Investment Companies (SBIC)**
- **Small Business Lending Companies (SBLCs)**



Federally Sponsored Programs

- **Economic Development Administration (EDA)**
- **Department of Housing and Urban Development (HUD)**
- **U.S. Department of Agriculture's Rural Business (USDA) - Cooperative Service**
- **Small Business Innovation Research (SBIR)**
- **Small Business Technology Transfer programs (STTR)**
- **Small Business Administration (SBA)**

SBA Loan Programs

- Patriot Express Program
- CommunityExpress Program
- 7(A) Loan Guaranty Program
 - Average 7(a) loan = \$183,000

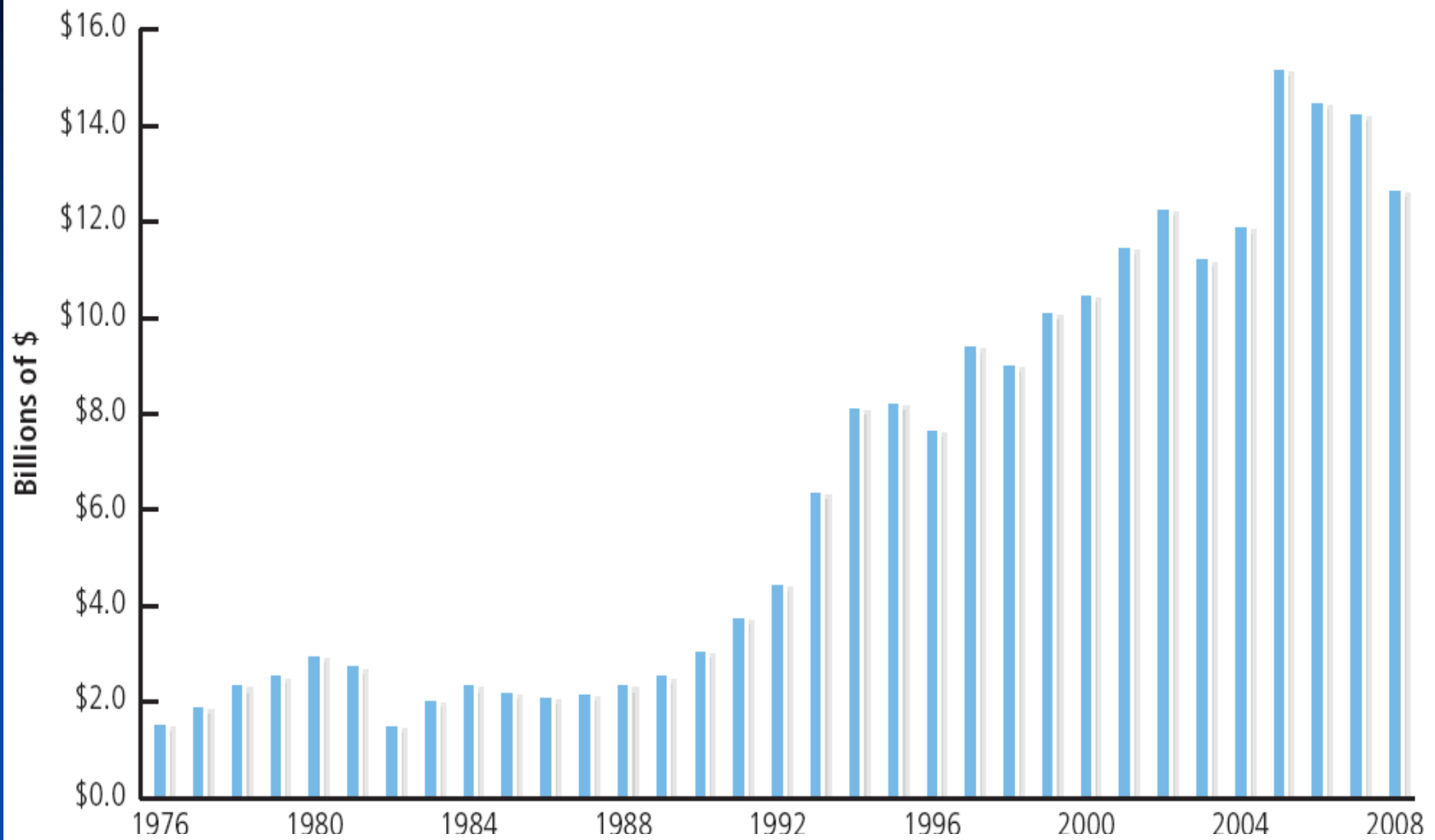


FIGURE 13.7 SBA 7(A) Guaranteed Loans

Source: U.S Small Business Administration.

SBA Loan Programs

- Patriot Express Program
- CommunityExpress Program
- 7(A) Loan Guaranty Program
 - Average 7(a) loan = \$183,000
- Section 504 Certified Development Company Program
- Microloan Program
 - Average microloan = \$13,000

SBA Loan Programs

(continued)

- **The Capline Program**
- **Loans involving international trade**
 - **Export Working Capital**
 - **International Trade Program**
- **Disaster Loans**

State and Local Loan Programs

- ***Capital Access Programs (CAPs)*** –
Designed to encourage lenders to make loans to businesses that do not qualify for traditional financing
- ***Revolving Loan Fund (RLFs)*** –
Combine private and public funds to make small business loans

Internal Methods of Financing

- **Factoring Accounts Receivable – selling accounts receivable outright**
- **Leasing – assets rather than buying them**
- **Credit cards**



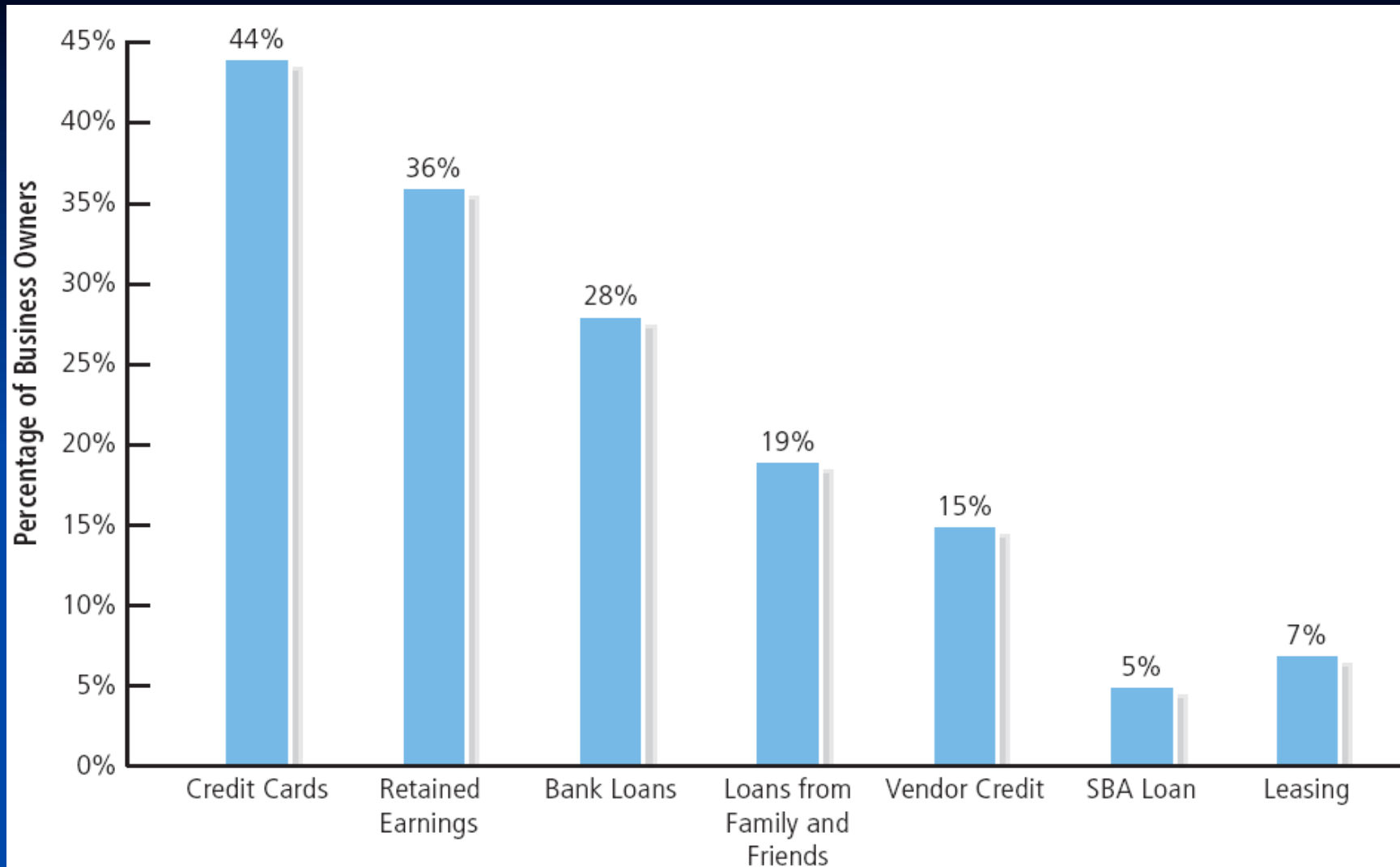


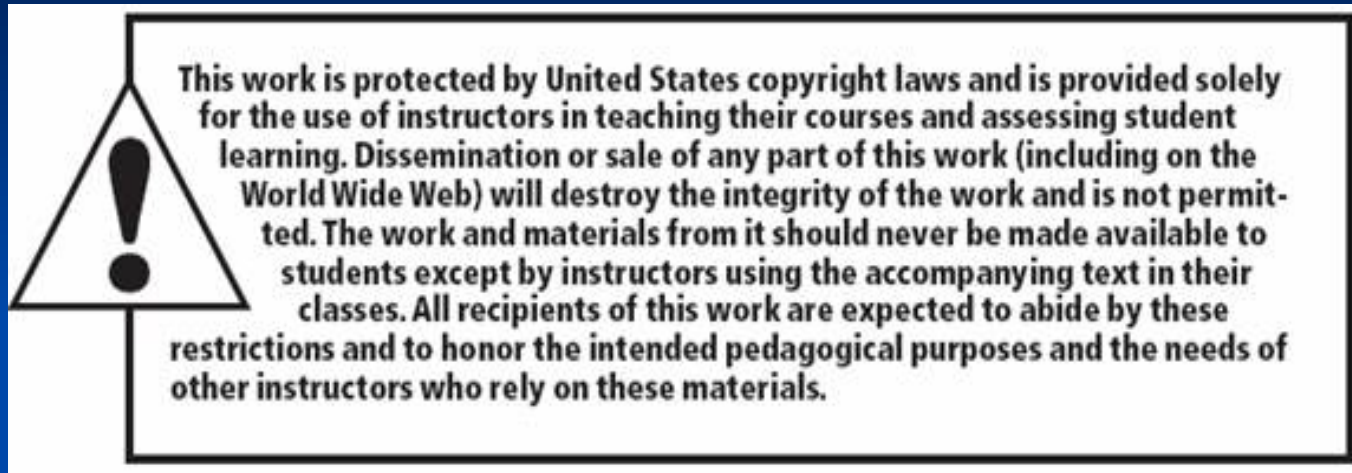
FIGURE 13.8 Where Do Small Businesses Get Their Financing?

Source: Based on 2008 Survey of Small and Mid-Sized Businesses, National Small Business Association, Washington, DC, 2009.

Conclusion

- **Capital is key for entrepreneurs.**
- **In the face of a capital crunch, business' s need for capital has never been greater.**
- **Sources of capital may include**
 - **Family and Friends**
 - **Angel Investors**
 - **Initial Public Offering**
 - **Traditional Bank Loan**
 - **Asset-based Borrowing**
 - **Federal, SBA Loans, and others**





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