Universität Zürich[UZH]

Department of Business Administration - Chair for Entrepreneurship

A Primer in Entrepreneurship

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Universität Zürich

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A Primer in Entrepreneurship

Part III Moving from an Idea to an Entrepreneurial Firm

Lecture 10
Getting Financing or Funding

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1. **The Importance of Getting Financing or Funding**

2. **Sources of Personal Financing**

3. **Preparing to Raise Debt and Equity Financing**

   3.1 Sources of Equity Funding

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4. **Creative Source of Financing and Funding**

Questions

? Why do most entrepreneurial ventures need to raise money in their early life ?

? What are the different sources of financing and funding ?

? How do entrepreneurs prepare to raise financing ?

…to be answered in today's lecture.

1 The Importance of Getting Financing or Funding

There are three reasons that most entrepreneurial ventures need to raise money during their early life.

Cash Flow Challenges	Inventory must be purchased, employees must be trained and paid, and advertising must be paid 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 it own.

1 The Importance of Getting Financing or Funding

Many entrepreneurs lack experience in raising capital.

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.

1 The Importance of Getting Financing or Funding

There are four alternatives for raising money for a start-up firm.

Personal Funds	**Equity Capital**
Debt Financing	**Other (Creative) Sources**

1 The Importance of Getting Financing or Funding

For each of the three common profiles of new ventures a specific type of financing or funding is appropriate.

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

2 Sources of Personal Financing

The seed money that gets a company off the ground comes from the founders' own pockets.

Personal Funds	Friends and Family	Bootstrapping
Involves both financial resources and sweat equity. Sweat equity represents the value of the time and effort that a founder puts into a firm.	Often comes in the form of loans or investments, but can also involve outright gifts, foregone or delayed com-pensation, or reduced or free rent.	Finding ways to avoid the need for external financing through creativity, ingenuity, thriftiness, cost-cutting, obtaining grants, or any other means.

2 Sources of Personal Financing

Because it is hard for new firms to get financing or funding early on, many entrepreneurs bootstrap out of necessity.

Bootstrapping

- Buying used instead of new equipment
- Leasing equipment instead of buying
- Minimizing personal expenses
- Sharing office space with other businesses
- Coordinating purchases with other businesses
- Obtaining payments in advance from customers
- Avoiding unnecessary expenses
- Applying for and obtaining grants

3 Preparing to Raise Debt or Equity Financing

Once a start-up's financial needs exceed what personal financing can provide, dept and equity are the two most common sources of funds.

Determine precisely how much money is needed.

Determine the type of financing or funding that is the most appropriate.

Develop a strategy for engaging potential investors or bankers.

3 Preparing to Raise Debt or Equity Financing

Determine precisely how much money is needed. → **Determine the type of financing or funding that is the most appropriate.** → Develop a strategy for engaging potential investors or bankers.

There exist two common alternatives for raising money.

- **Equity financing** means exchanging partial ownership in a firm, usually in the form of stock.

  Angel investors, private placement, venture capital, and initial public offerings are the most common sources of equity funding. Equity funding is not a loan—the money that is received is not paid back. Instead, equity investors become partial owners of a firm.

- **Debt financing** is getting a loan.

  The most common sources of debt financing are commercial banks and the Small Business Administration (through its guaranteed loan program).

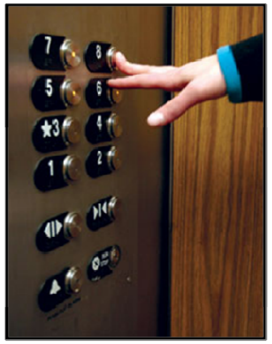
3 Preparing to Raise Debt or Equity Financing

Determine precisely how much money is needed. → Determine the type of financing or funding that is the most appropriate. → **Develop a strategy for engaging potential investors or bankers.**

The lead entrepreneurs in a new venture should prepare an elevator speech .

Elevator Speech It is a brief, carefully constructed statement that outlines the merits of a business opportunity.

Most elevator speeches are 45 seconds to two minutes long.



3 Preparing to Raise Debt or Equity Financing

Why is it called an elevator's speech ?

If an entrepreneur stepped into an elevator on the 25th floor of a building and found that by a stroke of luck a potential investor was in the same elevator, the entrepreneur would have the time it takes to get from the 25th floor to the ground floor to try to get the investor interested in his or her opportunity.
This type of chance encounter with an investor calls for a quick pitch of one's business idea. This quick pitch has taken on the name "elevator speech."

3 Preparing to Raise Debt or Equity Financing

The elevator speech is a very brief description of your opportunity, product idea, qualifications.

Guidelines

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

3.1 Sources of Equity Funding

The firm's owners gain access to capital while they relinquish part of their ownership interest and may lose some control .

Business Angels

Venture Capital

Initial Public Offerings

3.1 Sources of Equity Funding

<u>Business Angels</u> 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;

… is interested in the start-up process.

The number of angel investors in the U.S. has increased dramatically over the past decade, partly because of the high returns some report.

Business angels are valuable because of their willingness to make relatively small investments. This gives access to equity funding to a start-up that needs just $50,000 rather than the $1 million minimum investment that most venture capitalists require.

i.e. www.businessangels.ch

3.1 Sources of Equity Funding

Venture Capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential.

Private Equity

Asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange (keyword: leveraged buyout)

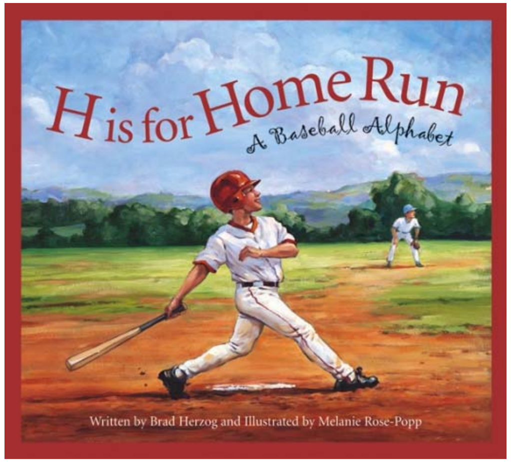
Venture Capital

Broad subcategory of private equity; refers to equity investments made for the launch, early development, or expansion of a business.

3.1 Sources of Equity Funding

Venture Capital: funds, or pools of money, are raised from wealthy individuals, pension plans, university endowments, foreign investors, and similar sources,

Venture Capital Firms are limited partnerships of money managers who raise money in "funds" to invest in start-ups and growing firms.



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.

3.1 Sources of Equity Funding

An <u>Initial Public Offering</u> is the first sale of stock by a firm to the public.

When a company goes public, its stock is typically traded on one of the major stock exchanges.

The first step is to hire an investment bank.

An investment bank is an institution, such as Credit Suisse First Boston, that acts as an underwriter or agent for a firm issuing securities.

The investment bank acts as the firm's advocate and advisor, and walks it through the process of going public.

3.1 Sources of Equity Funding

Initial Public Offering: There are four reasons that motivate firms to go public.

1. It is a way to raise equity capital to fund current and future operations.
2. An IPO raises a firm's public profile, making it easier to attract high-quality customers, alliance partners, and employees.
3. An IPO is a liquidity event that provides a means for a company shareholders (including its investors) to cash out their investments.
4. By going public, a firm creates another form of currency that can be used to grow the company.

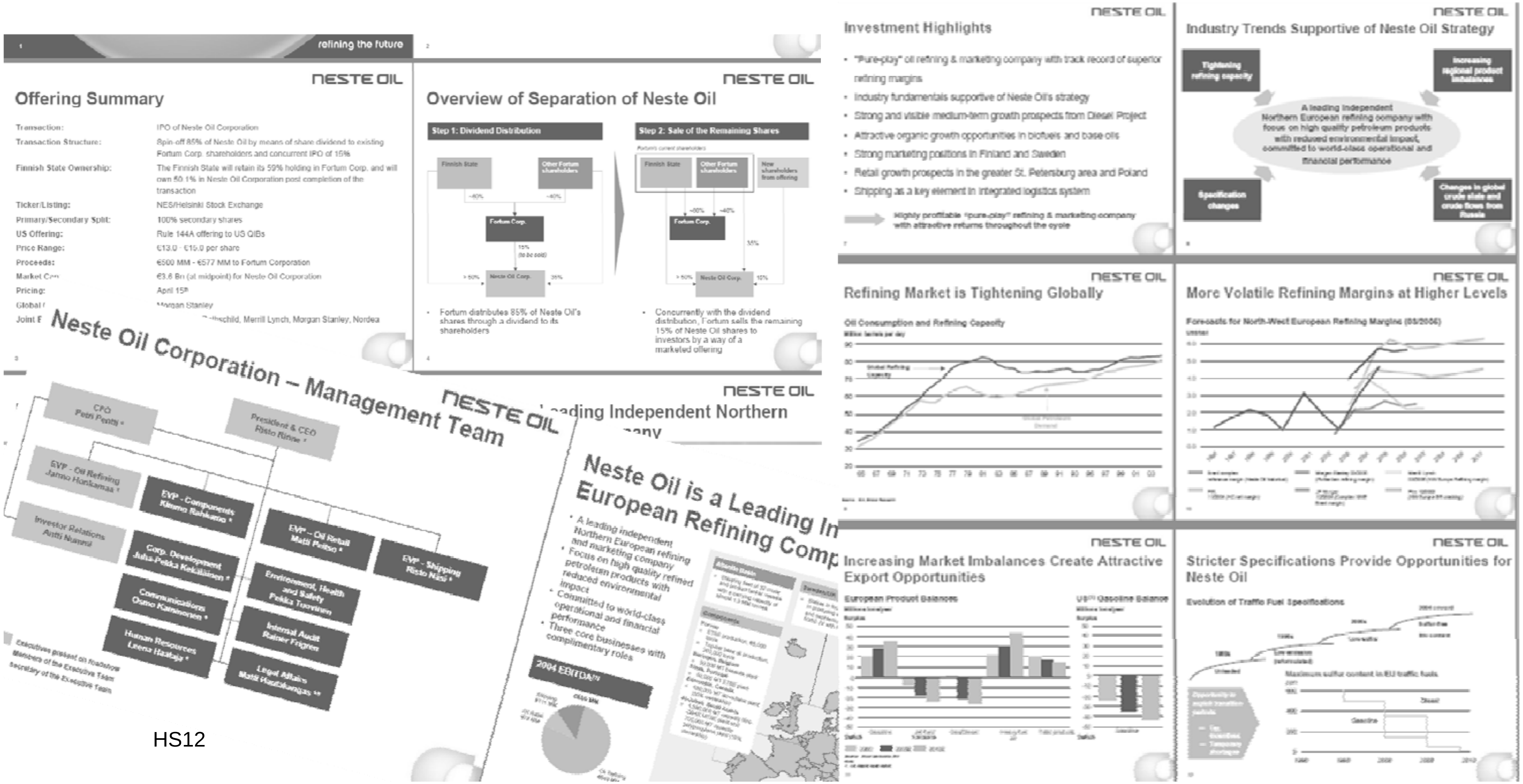
!

Although there are many advantages to going public, it is a complicated and expensive process.

3.1 Sources of Equity Funding

Initial Public Offering – An Example.

http://www.nesteoil.com/binary.asp?GUID=2681F4A6-B23D-494A-8920-30AF126FF021



3.2 Sources of Debt Financing

Debt financing involves getting a loan or selling corporate bonds.

There are two most common sources of debt financing available to entrepreneurs.

Commercial Banks

SBA Guaranteed Loans

3.2 Sources of Debt Financing

Commercial Banks

SBA Guaranteed Loans

Historically, commercial banks have not been viewed as practical sources of financing start-up firms.

This sentiment is not a knock against banks; it is just that banks are risk adverse, and financing start-ups is risky business.

http://www.cti-invest.ch/

There are two reasons that banks have historically been reluctant to lend money to start-ups.

1. As mentioned previously, banks are risk-adverse. In addition, banks frequently have internal controls and regulatory restrictions prohibiting them from making high-risk loans.

2. Lending to small firms is not as profitable as lending to large firms. In many instances, it is simply not worth a banker's time to do the due diligence necessary to determine the entrepreneur's risk profile.

3.2 Sources of Debt Financing

Commercial Banks

SBA Guaranteed Loans

While these loans typically are not available to start-ups, they are an important source of funding for small businesses in general.

Approximately 50 percent of the 9,000 banks in the United States participate in the SBA Guaranteed Loan Program.

The most notable SBA program available to small businesses is the **7(A) Loan Guarantee Program**. This program accounts for 90 percent of the SBA's loan activity. Almost all small businesses are eligible to apply for an SBA guaranteed loan.

The SBA can guarantee as much as 85 percent (debt to equity) on loans up to $150,000, and 75 percent on loans of more than $150,000.

4 Creative Sources of Financing and Funding

Because financing and funding are difficult to obtain, particularly for start-ups, entrepreneurs often use creative ways to obtain financial resources.

Leasing

Strategic Partners

Small Business Innovation Research Grants

4 Creative Sources of Financing and Funding

- **Leasing**
- Strategic Partners
- Small Business Innovation Research Grants

A lease is a written agreement in which the owner of a piece of property allows an individual or business to use the property for a specified period of time in exchange for payments.

The major advantage of leasing is that it enables a company to acquire the use of assets with very little, or no, down payment.

The two most common types of leases that new ventures enter into are leases for facilities and leases for equipment.

4 Creative Sources of Financing and Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

Strategic partners are another source of capital for new ventures. Indeed, strategic partners often play a critical role in helping young firms fund their operations and round out their business models.

Biotechnology, for example, relies heavily on partners for financial support. Biotech firms, which are typically fairly small, often partner with larger drug companies to conduct clinical trials and bring products to market.

4 Creative Sources of Financing and Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

The Small Business Innovation Research (SBIR) and the Small Business Technology Transfer (STTR) programs are two important sources of early-stage funding for technology firms.

These programs provide cash grants to entrepreneurs who are working on projects in specific areas.

The STTR Program is a variation of the SBIR for collaborative research projects that involves small businesses and research organizations, such as universities and federal laboratories.

4 Creative Sources of Financing and Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

The SBIR Program is a competitive grant program that provides more than $1 billion per year to small businesses for early-stage and development projects.

Each year, 10 federal departments and agencies are required by the SBIR to reserve a portion of their research and development funds for awards to small businesses.

4 Creative Sources of Financing and Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

The SBIR is a three-phase program, meaning that firms that qualify have the potential to receive more than one grant to fund a particular proposal.

Phase	Purpose of Phase	Duration	Funding Available (varies by agency)
Phase I	To demonstrate the proposed innovation's technical feasibility.	Up to six months	\$75,000–\$100,000
Phase II	Available to successful phase I companies. The purpose of a phase II grant is to develop and test a prototype of the innovation validated in phase I.*	Up to two years	\$300,000–\$750,000
Phase III	Period in which phase II innovations move from the research-and-development lab to the marketplace.	Open	No government funding involved. At this point, businesses must find private funding or financing to commercialize the product.

4 Creative Sources of Financing and Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

It is a grant, meaning that it doesn't have to be paid back, and no equity in the firm is at stake.

Historically, less than 15 percent of all phase I proposals are funded, and about 30 percent of all phase II proposals are funded.

The payoff for successful proposals, however, is high. The money is essentially free.

Do you know the answer ?

?! Why do most entrepreneurial ventures need to raise money in their early life ?

?! What are the different sources of financing and funding ?

?! How do entrepreneurs prepare to raise funding ?

...test yourself.

References

Barringer, B. and D., Ireland (2008): Entrepreneurship - Successfully Launching New Ventures, Pearsons Prentice-Hall.

Outlook

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- recognizing opportunities and generating ideas
- feasibility analysis
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- developing an effective business model

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- unique marketing issues
- Intellectual Property
- challenges of growth
- strategies for firm growth
- franchising

next week