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*“Business is never so healthy as when, like a chicken, it must do a certain amount of scratching for what it gets.”*

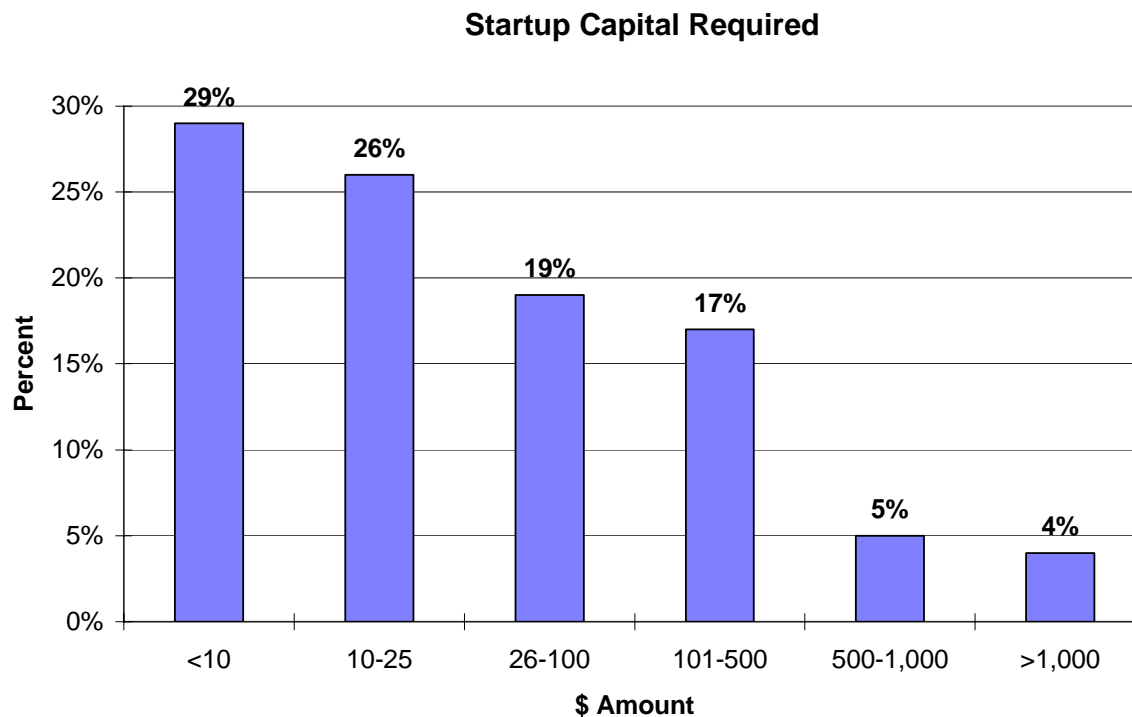
- Henry Ford

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## Sources of Finance

**Successful entrepreneurs often must become tireless fund raisers.** In startup or in early stage ventures, finding additional equity capital may take half an entrepreneur’s time.

Typical amounts of startup capital required (\$ 000's):



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- Most new ventures need at least some equity capital invested before debt financing makes any sense. **Debt financing is dangerous** (bankruptcy risk) unless and until the new business is up, running and making money.
  - **For most startups, the big issue is finding enough equity capital.** Then finding more as the young business grows.
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### Sources of Equity Capital

Sources of Capital -- Private Companies	Startup Stage	Growth Stage
Founders' Own Savings	Yes	Maybe
Friends and Family	Yes	Yes
Angels (Wealthy Individuals)	Yes	Maybe
Professional Venture Capital Investors	Yes	Yes
Small Business Investment Companies	Maybe	Yes
Corporations	No	Maybe
Employee Stock Ownership Plans	No	Maybe
Public Stock Offering	No	Yes
Personal and Business Associations	Maybe	Maybe
Commercial Banks (Debt)	No <sup>1</sup>	Yes
Savings & Loans (Debt)	No	Maybe
Life Insurance Companies (Debt)	No	Maybe
Commercial Credit Companies (Debt)	No	Yes
Factors (Debt)	No	Yes
Leasing Companies (Debt)	Maybe	Yes
Federal Government Programs	Maybe	Yes
State Government Programs	Yes	Yes
Research & Development Grants	Maybe	Maybe
Tax Shelters	Maybe	Maybe
Private Foundations	Maybe	Maybe
Joint Ventures	Maybe	Yes
Supplier Financing	Maybe	Yes
Money Just Laying There On The Sidewalk	No	No

### Stages of Financing

- o **It often is in founders' best interest to raise equity capital in stages, over time.** With the passage of time and the achievement of tangible results, the difficulty and cost of finding money declines. For example, a business with at least some sales is no longer a "startup" -- it is an "early stage" company. Early stage companies attract about five times more venture capital investors than startups!
- o Finding money in the range of \$500,000 to \$1 million is the toughest size category. This range is too small for most VC firms and too large for most "friends & family".

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<sup>1</sup> Banks may lend to startups under unusual circumstances -- when the owners simultaneously invest a lot of equity capital and adequate collateral (other than a racehorse) is available.

**Stages of Financing** (Continued)

- o In a classic venture company, founders seek new equity financing in connection with the achievement of clear milestones. Reaching each milestone increases the chance of success, lowers risks for investors, and increases the market value of the company:

Venture Milestone	Amount Invested	Type of Investor	New \$ % Own	Post-Money \$ Valuation	Founder % Own	Founder \$ Value
Initial Seed Startup	\$ 25,000	Founder	100%	\$ 25,000	100%	\$ 25,000
Product R&D	75,000	Family	35%	215,000	65%	140,000
Product Testing	150,000	Friends	15%	1,000,000	55%	550,000
Shipping Product	300,000	Angel	10%	3,000,000	50%	1,500,000
Expansion Round	2,000,000	VC Firm	33%	6,000,000	33%	2,000,000
Late Stage Round	5,000,000	VC Firms	25%	20,000,000	25%	4,000,000
Go Public (IPO)	10,000,000	Public	20%	50,000,000	20%	10,000,000

- o In the above example, the founder owns less of the company after each new round of financing (dilution.) But the VALUE of the founders' remaining stake increases.
- o **Elapsed time from "Seed" to the IPO might be 5-7 years**, sometimes longer.
- o Founders cannot finance some small businesses in stages (such as a restaurant or a retail store), at least not the first unit. Founders, friends & family must finance the first unit in one shot. Once the first unit is up, running and making money, then professional VC equity investors may take an interest.

**Founders' Own Savings**

- o **The first place Founders should look for startup money is in their own pockets.** It's the cheapest source (in terms of retaining ownership control.) The Commerce Department says 67% of all business owners launched their business 100% with their own money.
- o **Professional investors like to see founders' money invested.** Among other things, this creates a downside financial risk for management, not just an upside. Trying to raise equity, when you yourself have not invested a penny, can be nearly impossible.
- o **Even a relatively small \$ amount invested by founders will greatly strengthen their bargaining position** -- when raising additional sums from other investors.
- o **Bootstrap Financing** -- often includes using credit cards and home equity lines of credit to raise money to start the business. This approach, of course, increases the chances of personal bankruptcy should the business fail...

### Friends & Relatives

- Next to one's own savings, friends and family are the most likely sources of startup equity capital. The Census Bureau reports that founders source 10% of the capital required for small business startups in this way.
- **Friends & family invest in people.** People whom they know and trust. This is not so different from what professional venture capitalists try to do.
- **Inherent dangers lurk in these waters.** *"Here be dragons."*
- Many family and friendship relationships have foundered on the rocks of unrealistic expectations and misunderstood risks. **Some preventative measures:**
  - ◆ Explain the risks openly and honestly to everyone.
  - ◆ No one should invest more than they can afford to lose.
  - ◆ Keep the arrangement strictly business.
  - ◆ Settle the details up front.
  - ◆ Create a written contract.
  - ◆ Make sure there is an agreed, reasonable "exit."

### Angels

- **Angels are wealthy individuals**, often entrepreneurs themselves, who invest their own money in startups and early stage ventures.
  - **Typical size range: \$250,000 to \$500,000.** Some 80% of angel financing is for amounts of less than \$500,000.
  - Public data on Angels is very poor. Private investors who invest in private companies, leads to *very private* information.
  - **Angels are the largest source of outside capital for startups.** Annual investment by angels in the U.S. may exceed \$40 billion -- 3 to 5 times more money invested than by professional venture capitalists. And in 20 to 30 times more companies!
  - **Angels tend to be passive investors** (but not always). They often do not seek control or participation in management of the business. Angels may not want to be a director.
  - **Angels tend to invest locally** (50 to 100-mile radius) and tend to invest in businesses they understand. E.g., an angel who became wealthy in retailing may prefer startups in the same industry.
  - Sounds great, eh? So where is a list of angels in my area? Go fish! Networks and contacts. Ask friends, family, lawyers, accountants, stock brokers for introductions.
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## Venture Capital

- **The venture capital fund business is booming.** In 2000, VC firms raised over \$80 billion in new money, compared to \$44 billion in 1999 and just \$3 billion in 1991.
  - VC funds raise their money from ultimate money sources such as pension funds, insurance companies, banks, wealthy individuals, and foreign investors. Professional investors manage VC funds. Investors compensate the Managers mainly by giving them a share of the capital gains from the fund's investment portfolio.
  - In a typical VC fund, the professional managers (partners) put up 1% of the money and take up to 20% of the profits, if any.
  - **Venture capitalists are highly concerned about their investment track record** and their general reputation. They need a good track record to raise money for their next fund. They need a good reputation to attract new investment opportunities.
  - **There are over 1,200 VC funds listed in industry directories**, such as *Pratt's Guide*. Far from being all the same, major differences characterize VC funds.
  - **VC funds have their own strategies and criteria.** Most are very small in staff size. A \$100 million VC fund probably has 3-5 partners, at most.
  - Some **VCs specialize** by industry or stage of development. Some specialize by region (especially smaller funds.) Some want 51% or more ownership, others will take a minority stake. Some will syndicate (share the deal with other outside investors.) Some prefer to be the only VC in the deal. Most are ethical and honest; a few are not.
  - Most VC funds prefer investment amounts of \$1 million or more. Large funds may have a minimum of \$5-\$10 million. **Little deals take as much time as bigger ones.**
  - **At least 80% of all VCs (by amount of money under management) will NOT invest in startup companies**, except under unusual circumstances. These VCs prefer ventures that have at least some revenues.
  - VCs list their criteria, including minimum and maximum investment amount, in industry guidebooks. It is not hard to find dozens of VCs whose criteria fit your venture, so long as you are not a raw startup.
  - **What is difficult -- is to get the VC to read your business plan.** VCs think they are very busy people. They receive hundreds of proposals each year. Your Plan must be very good indeed to attract any attention. The Summary must be especially good, because that is all most VCs will read.
  - Before sending your plan, phone the VC firm. You probably won't be able to reach a partner; an assistant will answer. Ask the assistant who in their firm handles your type of opportunity (region, industry, stage.) Send your Book to that person. Wait two weeks. Next send a fax saying you intend to phone the VC. Wait a day or two. Then call the VC -- after 5:30PM -- to increase the chance s/he will pick up their own phone.
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### Other Alternatives

Own savings, friends & family, angels and VC firms together account for over 90% of the equity capital invested in startup and early stage companies. There are many other sources as well, but this Lecture Note discusses these only briefly.

### The Public

- o **“Going Public” (IPO) isn’t for many businesses.** Less than 20,000 U.S. companies are publicly traded -- less than one-tenth of 1%. Going public mostly is for big ventures with a market value of \$100 million or more. Selling stock to the public in any form is difficult for startup and early stage ventures. There are many rules and regulations.
- o **SEC Regulation S-B:** Simplified registration procedures (new in 1992) makes it easier for companies with a market value of \$20-\$50 million to sell stock to the public.
- o **Small Company Offering Registration (SCOR):** Available in 46 states, allows very small stock offerings (\$1 million or less) to be sold to the public with little red tape and associated costs. Founders can advertise SCOR offerings -- which can apply to startup or early stage companies. If one offers less than \$500,000, no audited financial statements are required.
- o **SEC Regulation A:** Similar to a SCOR, but up to \$5mm can be raised with registration costs running in the area of \$75,000 to \$125,000. Main advantage: stock may be offered over the internet.
- o **SEC Regulation D;** Rules 504, 505 and 506, and Section 4(6): **These are registered private placements** alternatives and are the legal forms of raising money from friends, family, angels and VC firms.
- o States all have securities laws, with Delaware law being one of the most favored. **Check with your local state securities lawyer before you sell any kind of stock to small investors, and before you sell stock in excess of \$5 million.**

### Corporations

- o Large corporations sometimes invest in ventures, especially in biotech and other high tech industries. Outside of biotech, corporations have not been successful in venture capital investments, in general. Their goals are different from financial investors.
  - o **One inherent problem is a conflict-of-exit.** When a venture succeeds, the corporation probably will want to buy it all for itself, at a low price. Other investors in the deal will want to sell it all, at the highest possible price.
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**Small Business Investment Companies (SBIC's)**

- o Created by an act of Congress in 1958, SBICs are licensed and regulated by the federal government through the Small Business Administration (SBA.) SBICs offer equity and debt financing, mostly for expansion stage venture companies.
- o **SBICs have declined as a source for venture finance in recent years.** They prefer to lend debt with an equity kicker. If you are lucky, there may be a good SBIC in your area. New government regulations have put some life back into this sector. It is worth a look, if your venture has earnings and can pay interest expense.
- o About 100 special SBICs finance minority-owned businesses.
- o The SBA itself may guarantee 75% of the amount of a loan made by local banks. The SBA also has many other loan programs (from \$10,000 to \$500,000.) Write for their information and ask which local firms are part of their system.

**Government Assistance**

If you startup cannot raise money anywhere else, or if you fit certain criteria, consider government sponsored programs:

- o Economic Development Administration (EDA) -- finances ventures in depressed areas.
  - o Farmers Home Administration (FmHA) -- any venture in rural areas (no cities nearby.)
  - o Department of Housing (HUD) – finance for inner city ventures.
  
  - o Connecticut -- Works Loan Guarantees -- 40% first loss guarantees on bank loans.
  - o Connecticut -- URBank -- Small business loans to \$500,000.
  - o Connecticut -- CT Business Development Corp. -- SBA linkage.
  - o Connecticut -- SBA programs -- full range. Chase and First Union in New Haven.
  - o Connecticut Innovations -- technology transfer developments in:
    - o Advanced marine applications
    - o Advanced materials
    - o Aerospace
    - o Applied optics and microelectronics
    - o Biotech
    - o Computer applications
    - o Energy & environmental services
    - o Medical products/instruments
    - o Telecommunications
  
  - o New Haven -- Small Business Counseling -- (203) 782-4390.
  - o New Haven -- SCORE (Service Corps of Retired Executives) -- (203) 865-7645
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