Sources of Funds: Equity and Debt
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. Creativity counts. Entrepreneurs have to be as creative in their searches for capital as they are in developing their business ideas.
4. The World Wide Web puts at entrepreneur’s fingertips vast resources of information that can lead to financing.

5. Be thoroughly prepared before approaching lenders and investors.

6. Entrepreneurs should not underestimate the importance of making sure that the “chemistry” between themselves, their companies, and their funding sources is a good one.
Three Types of Capital

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

- **Fixed** - used to purchase the permanent or fixed assets of the business (e.g., buildings, land, equipment, etc.)
- **Working** - used to support the small company’s normal short-term operations (e.g., buy inventory, pay bills, wages, salaries, etc.)
- **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.
Sources of Equity Financing

- Personal savings
- Friends and family members
- Angels
- Partners
- Corporations
- Venture capital companies
- Public stock sale
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 the entrepreneur to put some of her own capital into the business before investing theirs.
Friends and Family Members

- After emptying her own pockets, an entrepreneur should turn to those most likely to invest in the business—friends and family members.
- Survey: 10% of business owners turn to family and friends for capital.
- Careful!!! Inherent dangers lurk in family/friendly business deals, especially those that flop.
Guidelines for Family and Friendship Financing Deals:

- Consider the impact of the investment on everyone involved. Keep the arrangement “strictly business.”
- Settle the details up front.
- Create a written contract.
- Treat the money as “bridge financing.”
- Develop a payment schedule that suits both parties.
Angels

- Angels - private investors who back emerging entrepreneurial companies with their own money.
- Fastest growing segment of the small business capital market.
- An excellent source of “patient money” for investors needing relatively small amounts of capital – often less than $500,000.
Angels

- Key: finding them!
- Angels almost always invest their money locally and can be found through “networks.”
- The typical angel accepts 30% of the proposals presented to him and has invested an average of $131,000 in 3.5 businesses.
Corporate Venture Capital

- 30% of all venture capital investments come from corporations.
- About 900 large corporations across the globe invest in start-up companies.
- Capital infusions are just one benefit; corporate partners may share marketing and technical expertise.
Venture Capitalist Companies

- More than 3,000 venture capital firms operate across the United States.
- Most venture capitalists seek investments in the $3,000,000 - $10,000,000 range in companies with high-growth and high-profit potential.
- Business plans are subjected to an extremely rigorous review – less than 1% accepted.
Venture Capitalist Companies

- Most venture capitalists take an active role in managing the companies in which they invest.
- Many venture capitalists focus their investments in specific industries with which they are familiar.
- Most often, venture capitalists invest in a company across several stages.
What Do Venture Capital Companies Look For?

- Competent management
- Competitive edge
- Growth industry
- Viable exit strategy
- “Intangibles”
Going Public

- Initial public offering (IPO) - when a company raises capital by selling shares of its stock to the public for the first time.
- Typical year: about 550 companies make IPOs.
- Few companies with sales below $10 million in annual sales make IPOs.
Advantages of “Going Public”

- 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”

- 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
The Registration Process

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

- 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 Debt Capital

- Commercial banks
Commercial Banks

...the heart of the financial market for small businesses!

- **Short-term loans**
  - Commercial loans
  - Lines of credit
  - Floor planning

- **Intermediate and long-term loans**
  - Installment loans and contracts
Sources of Debt Capital

- Commercial banks
- Asset-based lenders
Asset-Based Borrowing

- Discounting accounts receivable
- Inventory financing
Sources of Debt Capital

- Commercial banks
- Asset-based lenders
- Trade credit
- Equipment suppliers
- Commercial finance companies
- Saving and loan associations
Sources of Debt Capital

(continued)

- Stock brokerage houses
- Insurance companies
- Credit unions
- Bonds
- Private placements
- Small Business Investment Companies (SBICs)
- Small Business Lending Companies (SBLCs)
Sources of Debt Capital

(concluded)

**Federally Sponsored Programs:**

- Economic Development Administration (EDA)
- Department of Housing and Urban Development (HUD)
- U.S. Department of Agriculture’s Rural Business-Cooperative Service
- Local Development Companies (LDCs)
- Small Business Innovation Research (SBIR)
- Small Business Technology Transfer programs
- Small Business Administration (SBA)
Small Business Administration
Loan Programs

- Low Doc Loan Program
- SBABExpress Program
- 7(A) Loan Guarantee Program – the most popular SBA loan program
- CAPLine Program
- International Trade Programs
  - Export Working Capital Program
  - International Trade Program
SBA Loan Programs

- Section 504 Certified Development Company Program
- Microloan Program
- Prequalification Loan Program
- Disaster Loans
- 8(A) Loan Program
State and Local Loan Programs

- **Capital Access Programs (CAPs)** – now offered in 22 states and are designed to encourage lenders to make loans to businesses that do not qualify for traditional financing.

- **Revolving Loan Fund (RLF)**s – combine private and public funds to make small business loans.
Internal Methods of Financing

- Factoring - selling accounts receivable outright
- Leasing assets rather than buying them
- Credit cards