Objectives: Session 7 – Getting Financed

In this session you will use your startup costs and expenses from Session 7 to build a Startup Funding table. You will also learn about ways to finance a new business, and what works for what kinds of startups.

OVERVIEW

Many classes on starting a business talk about getting money from outside investors (venture capital). We will also talk about:

- Most startups are self-financed (called "bootstrapping"). A study made by Wells Fargo bank (2005) showed the average cost to start a business in the U.S. is $10,000.
- Owning a business yourself or having partners. If you can own it yourself, then you're probably better off, unless you want to have partners to reduce risk and to bring in know-how and experience.
- The amount of startup costs will depend on the business. For example, there may be little or no startup costs for a catering company or a portable lunch stand. The startup costs will be much higher for a high-end restaurant in a major urban location. The need for funding depends on these costs.
- Types of funding for a startup can depend on how much money is needed, whether the investor feels there is a good rate of return from their money, and whether the company agrees with the terms.
- More than 500,000 new businesses are started in the U.S. each year. Only about 5,000-6,000 receive venture capital per year.
- Angel investors must qualify according to the SEC rules. Research has shown there are more than 200,000 angel investors in the U.S.
- Getting funding from friends and family should be limited. There are a lot of legal restrictions. This type of funding might work for tens of thousands of dollars, in some cases hundreds of thousands.

DEFINITIONS

Angel Investor: A person who invests his or her own money in a startup business who meets the SEC guidelines.

Bootstrapping: Starting a business by yourself, with no outside investors, with or without bank loans, credit cards or other borrowed money.

Venture Capitalist (VC): A person or firm that makes business investments. A VC can also bring management and technical knowledge as well as money.

Business Valuation: What a business is worth. There are many ways to value a business, such as:

- Asset-based valuation
- Book value
- Adjusted book value
- Liquidation value

- Replacement value
- Earnings-based valuations.

VENTURE CAPITAL

"Venture Impact: The Economic Importance of Venture Backed

Venture capital (VC) is financial capital provided to early-stage, high-potential, and growth startup companies. The venture capital fund earns money by owning equity in the companies it invests in, which usually have a novel technology or business model in high technology industries, such as biotechnology, IT and software. The typical venture capital investment occurs after the seed funding round as the first round of institutional capital to fund growth (also referred to as Series A round) in the interest of generating a return through an eventual realization event, such as an IPO or trade sale of the company. Venture capital is a type of private equity.

In addition to angel investing and other seed funding options, venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value).

Venture capital is also associated with job creation (accounting for 2% of US GDP), the knowledge economy, and used as a proxy measure of innovation within an economic sector or geography. Every year, there are nearly 2 million businesses created in the USA, and 600–800 get venture capital funding. According to the National Venture Capital Association, 11% of private sector jobs come from venture backed companies and venture backed revenue accounts for 21% of US GDP.

It is also a way in which public and private sectors can construct an institution that systematically creates networks for the new firms and industries, so that they can progress. This institution helps in identifying and combining pieces of companies, like finance, technical expertise, know-hows of marketing and business models. Once integrated, these enterprises succeed by becoming nodes in the search networks for designing and building products in their domain.

BOOTSTRAPPING

Definition: To finance your company's startup and growth with the assistance of or input from others

Anyone who's started a business on a shoestring is adept at bootstrapping, or stretching resources--both financial and otherwise--as far as they can. But bootstrapping isn't limited to the startup state. It's a valid way for business owners to treat valuable resources at any stage of their business' growth.

Bootstrapping is one of most effective and inexpensive ways to ensure a business' positive cash flow. Bootstrapping means less money has to be borrowed and interest costs are reduced.

Looking for ways to bootstrap your business? Trade credit is one way to maximize your financial resources for the short term. Normally, suppliers extend credit to regular customers for 30, 60 or 90 days, without charging interest. However, when you first start your business, suppliers will want every order COD (cash or check on delivery) until you've established that you can pay your bills on time. While this is a fairly normal practice, in order to raise money during startup, you're going to have to try to negotiate a trade credit basis with suppliers. One of the things that will help you in these negotiations is having a written financial plan.

But using trade credit on a continual basis is not a long-term solution. Your business may become heavily committed to those suppliers who accept extended credit terms. As a result, the business may no longer have ready access to other, more competitive suppliers who might offer lower prices, a superior product, and/or more reliable deliveries.

Depending on the terms available from your suppliers, the cost of trade credit can be quite high. For example, say you make a purchase from a supplier who decides to extend credit to you. Terms the supplier offers are 2 percent cash discount within 10 days and a net date of 30 days. Essentially, the supplier is saying that if you pay within 10 days, the purchase price will be discounted by 2 percent. On the other hand, by forfeiting the 2-percent discount, you're able to use your money for 20 more days, and it will only cost you that 2-percent discount.

Factoring is another way to stretch your money. It involves selling your receivables to a buyer, such as a commercial finance company, to raise capital and is very common in industries, such as the clothing industry, where long receivables are part of the business cycle. Factors usually buy accounts receivable at a rate that ranges between 75 and 90 percent of face value, and then add a discount rate of between 2 and 6 percent. The factor assumes the risk, and task, of collecting the receivables. If your prices are set up to take factoring into account, you can still make a profit.

Customers can also help you obtain financing by writing you a letter of credit. For example, suppose you're starting a business manufacturing industrial bags, and a large corporation has placed an order for a steady supply of cloth bags. The major supplier that you'll source the material through is located in India. In this scenario, you obtain a letter of credit from your customer when the order is placed, and the material for the bags is purchased using this letter of credit as security.

If your business needs to buy its facility, your initial costs may be high, but the building's cost can be financed over a long-term period of 15 to 30 years. The loan on the facility can be structured to make optimum use of your planned growth or seasonal peaks. For instance, you can arrange a graduated payment mortgage that initially has very small monthly payments with the cost increasing over the lifetime of the loan. The lower monthly payments give your business time to grow. Eventually, you can refinance the loan when time and interest rates permit.

Another advantage is that real estate appreciates over time and creates a valuable asset called equity. You can borrow against this equity--lenders often loan up to 75 or 80 percent of a property's appraised value. This also applies to any personal real estate you own. Home equity loans are a popular financing device for new business owners because there's often substantial equity tied up in a home, and the loans are easy to come by.

If you spend a lot of money on equipment, you may find yourself without enough working capital to keep your business going in its first months. Instead of paying cash for your equipment, the manufacturer can effectively loan you the money by selling you the equipment on an installment basis. This helps conserve your working capital while allowing you to use the equipment in your business.

Two types of credit contracts are commonly used to finance equipment purchases:

1. The conditional sales contract. The purchaser doesn't receive title to the equipment until it's fully paid for.

2. The chattel-mortgage contract. The equipment becomes the property of the purchaser on delivery, but the seller holds a mortgage claim against it until the amount specified in the contract is paid.

Leasing is another way to avoid financing the entire purchase of high-ticket items like equipment, vehicles, furniture, computers and even employees. With leasing, you pay for only that portion you use, rather than for the entire purchase price. When you're just starting out in business, it might make sense to shop around and get the best leasing arrangement possible. For example, you could lease a photocopier for several hundred dollars a month rather than financing the entire $3,000 purchase price, or you could lease your automobile or van instead of shelling out $25,000 or more for the full purchase price of the car.

There are many ways that a lease can be modified to increase your cash position. These modifications include:

- A down payment lower than 10 percent, or no down payment at all.
- Maintenance costs that are built into the lease package, thereby reducing your cash outlays. If you needed employees or a repairperson to do maintenance on purchased equipment, it would cost you more than if you had leased it.
- Extending the lease term to cover the entire life of the property (or use of the property for as long as you wish to use it).
- A purchase option that allows you to buy the property after the lease period has ended. A fixed purchase price can also be added to the option provision.
- Lease payments that can be structured to accommodate seasonal variations in the business or tied to indexes that track interest to create an adjustable lease.

Bootstrap financing really begins and ends with your attention to careful management of your financial resources. Be aware of what you spend and keep your overhead low. If you need to go the top-dollar route, make sure you can justify the expense. Don't choose an overly expensive office or location unless it's really going to pay off in increased sales. Take a look at secondhand furniture--if it works for your office, buy it. Barter for goods and services when appropriate. Buy on promotion, to take advantage of better prices offered for a limited time.

Keep a close watch on operating expenses. If interest rates are high, it won't take too many unpaid bills to wipe out your profits. At a 12-percent interest rate, carrying an unpaid $10,000 of bills will cost you $120 per month. Tight margins mean it's more costly to accumulate bills than increase production.

BUSINESS VALUATION

By Dana Griffin, Demand Media - *http://www.chron.com/*

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to effect a sale of a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and many other business and legal purposes such as in shareholders deadlock, divorce litigation and estate contest. In some cases, the court would appoint a forensic accountant as the joint expert doing the business valuation.

Standard and premise of value

before the value of a business can be measured, the valuation assignment must specify the reason for and circumstances surrounding the business valuation. These are formally known as the business value standard and premise of value. The standard of value is the hypothetical conditions under which the business will be valued. The premise of value relates to the assumptions, such as assuming that the business will continue forever in its current form (going concern), or that the value of the business lies in the proceeds from the sale of all of its assets minus the related debt (sum of the parts or assemblage of business assets).

Standards of Value

- Fair market value - a value of a business enterprise determined between a willing buyer and a willing seller both in full knowledge of all the relevant facts and neither compelled to conclude a transaction.
- Investment value - a value the company has to a particular investor. Note that the effect of synergy is included in valuation under the investment standard of value.
- Intrinsic value - the measure of business value that reflects the investor's in-depth understanding of the company's economic potential.

Premises of Value

- Going Concern - Value in continued use as an ongoing operating business enterprise.
- Assemblage of assets - value of assets in place but not used to conduct business operations.
- Orderly disposition - value of business assets in exchange, where the assets are to be disposed of individually and not used for business operations.
- Liquidation – value in exchange when business assets are to be disposed of in a forced liquidation.

Premise of value for fair value Calculation

- In use – If the asset would provide maximum value to the market participants principally through its use in combination with other assets as a group.
- In Exchange – If the asset would provide maximum value to the market participants principally on a standalone basis.

Business valuation results can vary considerably depending upon the choice of both the standard and premise of value. In an actual business sale, it would be expected that the buyer and seller, each with an incentive to achieve an optimal outcome, would determine the fair market value of a business asset that would compete in the market for such an acquisition. If the synergies are specific to the company being valued, they may not be considered. Fair value also does not incorporate discounts for lack of control or marketability.

Note, however, that it is possible to achieve the fair market value for a business asset that is being liquidated in its secondary market. This underscores the difference between the standard and premise of value.

These assumptions might not, and probably do not, reflect the actual conditions of the market in which the subject business might be sold. However, these conditions are assumed because they yield a uniform standard of value, after applying generally accepted valuation techniques, which allows meaningful comparison between businesses which are similarly situated.