Starting New Ventures 64-361.202

Chap 10. Getting Financing or Funding

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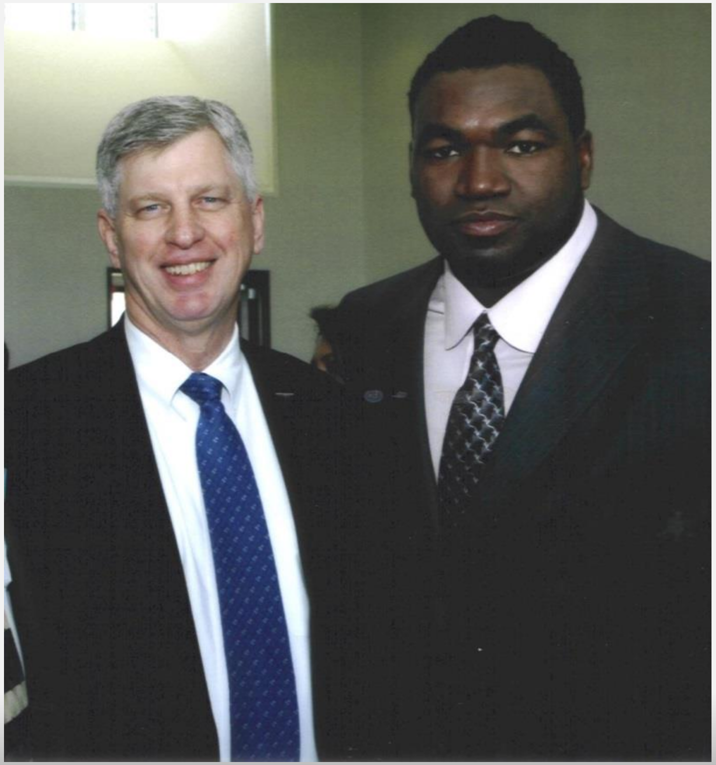
LVP with MVP



Indinero

- Online Financial service for small business people.
- Jessica Mah -Comp.Sci. UC Berkeley
  - Best advice: Be skeptical of all the advice you receive, even from people that seem successful and experienced.
- Andy Suh -Comp.Sci. UC Berkeley
- TechStars –no; Angel Funding -No
- Lightspeed Venture Partners -$35,000
- Y Combinator -$17,000 for 6% -but expertise more important
- Angel Investors -$1 million
  - Second try –patience and networking.

Financial Analysis

- How much money do you need?
  - Capital requirements
  - Break Even Analysis
  - Overall attractiveness of the investment
- Where to get the money?
- Financial Objectives and Ratio Analysis

Assess and Calculate Capital Requirements

Preparation	Estimation	Forecast	Conclusions
Required Resources How to identify: - Brainstorming - Process map - Do research - Talk to people with experience	Narrative Assumptions ↓ Estimate Expenses Start-up costs ↓ Estimate Demand	Sales forecast Break- even point	Cash requirements Break-even time to positive cash flow Cash Needs

Identify Required Resources

- Start-up resources include:
  - People (founding team, advisors, independent contractors)
  - Physical assets (equipment, inventory, office or plant space)
  - Financial (emergency fund)
- Complex Resources:
  - Utilitarian (i.e. patents)
  - Instrumental (i.e. industry contacts)
  - Intangible (i.e. organizational culture, tacit knowledge)

Use Process Map to identify resources

Marketing Efforts
People: entrepreneurs
Equipment: computer, phone, desk

Meet with Customer:
People: receptionists, entrepreneurs
Equipment: computer, phone, desk, TV/VCR

Do Work Contracted
People: entrepreneurs, associates
Equipment:
3 computers, 3 phones, 3 desks, TV/VCR, conference table, vidoe-conferencing capability

Deliver Services
People: entrepreneurs, associates
Equipment: portable projector, TV/VCR

Bill for Services, Payroll, AR/AP
People: bookkeeper
Equipment: computer, phone, desk

Outsource to CPA:
Audit books
Taxes

Narrative Assumptions

- An explanation of the sources of numbers for the forecast and the assumptions used to generate them.
- Example: Some typical assumptions might include
  - The inflation rate is 1%.
  - The cost of main ingredients will be constant over time.

Estimate expenses and start-up costs

- All costs incurred to get the business off the ground
  - The cost of buying the equipment
  - The cost of buying the long-term assets (office space, etc.)
  - Working capital (the cost of keeping inventory, account receivable etc.)
  - Operational expenses (telephone, fax, travel, advertising etc.)
  - Production costs (material costs, labor costs, etc.)

Expenses & Start-up Costs

Variable Costs

- The costs of materials used to make the product
- The costs of labor used to make the product
- Commissions or other compensation based on sales volume
- Shipping and handling charges

Expenses & Start-up Costs

- Fixed or semi-fixed Costs
  - Utilities
  - Manager Salary
  - Advertising
  - Insurance
  - Interest
  - Rent
  - Depreciation

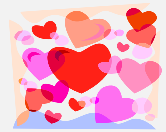
Why Most New Ventures Need Funding

Three Reasons Start-Ups Need Funding

Cash Flow Challenges	Capital Investments	Lengthy Product Development Cycles
Inventory must be purchased, employees must be trained and paid, and advertising must be paid for before cash is generated from sales.	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.	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 its own.

Sources of Capital

- Personal Savings
- Friends and family



- Bootstrapping
- Business angels

- Venture capitalists

- Corporations

- Banks
- The SBA Guaranteed Loan Program
- Leasing
- Government grants
  - Small business Innovation research

Sources of Personal Financing

- Savings
- Family and friends
  - (often called “friends, family, and other fools)
- Bootstrapping
  - Bootstrapping is finding ways to avoid the need for external financing or funding through creativity, ingenuity, thriftiness, cost-cutting, or any means necessary.
  - ILINC used this to get started by selling vapor-ware

Examples of Bootstrapping Methods

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

Preparing to Raise Debt or Equity Financing

- Debt—financial obligation to return capital provided plus a scheduled amount of interest
  - Debt guaranteed by the entrepreneur's personal assets or earning power
  - Asset-based financing
  - Supplier credit
- Equity—a portion of ownership receive in an organization in return for money provided
  - New ventures have no way to make scheduled interest payments until they have positive cash flow

Preparing to Raise Debt or Equity Financing

- Step 1: Determine precisely how much money the company needs
- Step 2: Determine the most appropriate type of financing or funding
  - Equity financing
  - liquidity event
  - Debt financing
- Step 3: Develop a strategy for engaging potential investors or bankers
  - Elevator pitch
  - Identify and contact the best prospects
    - Personal introduction is best
  - Prepare a complete business plan to close the deal

Elevator Pitch

1. 20 seconds: Describe the Opportunity or Problem that needs to be solved.
2. 20 seconds: Describe how your product or service addresses the opportunity or problem.
3. 10 seconds: Describe the qualifications of the team and yourself
4. 10 seconds: Describe your market

Remember: This is a pitch to INVESTORS not customers. End with a simple ask. “We are looking for an investment of $1 million for 50% of the company.”

60 seconds total: This is due for your proposal on November 19th

Sources of Equity Funding

Venture Capital

Business Angels

Initial Public Offerings

What Are Investors Looking For?

An excellent venture team with

- Motivation
- Passion
- Honesty
- Experience

What Are Investors Looking For?

An excellent business opportunity with

- Large market
- Appropriate growth strategy
- Compelling product description
- Competitive advantage

An Entrepreneur and Venture Capitalist –Starting Staples

WEDNESDAY, OCTOBER 31, 2012 THE BOSTON GLOBE B5

Business

Area's home prices rise, foreclosures fall

Values in metropolitan Boston advance a fifth consecutive month

By Jenifer B. McKim
GLOBE STAFF

The latest measures of the state housing market's recovery pointed in the right direction Tuesday, with foreclosures declining and home prices rising.

Single-family home values in the Boston area were up 0.7 percent in August, compared with July, marking the fifth consecutive month of increases, according to the S&P/Case-Shiller Home Price Indices. It monitors repeat home sales and is considered by many in the industry to be the best indicator of the nation's real estate market.

The price improvement locally is in keeping with national numbers reflecting a healthier housing market. Over the last year, Boston-area home prices rose by an average of 1.7 percent, Case-Shiller said. Values increased 2 percent during the same period in the 20 US metro areas the index measures.

David M. Blitzer, chairman of the index committee at S&P Dow Jones Indices, said the strong numbers reflect numerous housing indicators that have all turned positive, including an increase in the number of new single-family houses being built, more home sales, and a drop in mortgage default rates.

"The sustained good news in home prices over the past five months makes us optimistic for continued recovery in the housing market," Blitzer said.

Foreclosure numbers released Tuesday also provided a boost for the Massachusetts real estate market.

HOUSING, Page B7

Gauging the gains

S&P/Case-Shiller tracks the sales and resales of single-family homes across 20 metro areas in the United States. The indexes had a base value of 100 in January 2000. For example, a current value of 150 translates to a 50 percent appreciation rate since January 2000.

SOURCE: S&P/Case-Shiller

STAPLES

AN UNEASY START

Staples revolutionized the office supply business, but its success was far from guaranteed. Mitt Romney's testimony in its founder's divorce case reveals insight into its rocky beginnings.

Tom Stemberg and Mitt Romney earlier in their careers and in August at the Republican National Convention (above).

By Beth Healy
GLOBE STAFF

It was early 1987, and Mitt Romney was shopping. And he was angry.

He was walking the aisles of Staples, a little-known retail store his firm had bet $1.5 million on so far, and picking up office supplies. Then he waited in line at the checkout counter — for far too long.

To Romney, then chief executive of a fledgling investment firm called Bain Capital, it confirmed what friends had told him: A superstore with low prices was a good idea, but the lines took forever, the credit card machines weren't working, the staff was "surly." With just a few stores open since its launch in Brighton, Staples already had big problems.

"I was shopping there myself and found it a frustrating experience," Romney would later say.

Staples went on to revolutionize the way office supplies were sold, and its founder, Tom Stemberg, would become a loyal political backer for Romney in his run for the presidency. But two-decade-old court documents unsealed last week offer a new glimpse into the early days of the start-up, revealing a rocky beginning long before Staples became a polished bullet point on Romney's resume as a businessman and job creator.

The filings, released at Norfolk Probate and Family Court at the request of the Globe, portray a retailer riddled with operational problems and contentious board fights, and shed light on Romney as a hard-nosed investor, leaning sternly on an entrepreneur for results.

Stemberg, a former supermarket executive, believed the inefficient business of small stationers could be improved so companies could buy office supplies in large volume. He hoped to launch a chain of big stores.

STAPLES, Page B7

Boston Globe on the Funding of Staples

- Opening Line: “It was early 1987, and Mitt Romney was shopping. And he was angry. He was walking the aisles of Staples, a little-known retail store his firm had bet $1.5 million on so far, and picking up office supplies. Then he waited in line at the check-out counter -- for far too long. To Romney, then CEO of Bain Capital, a superstore with low prices was a good idea, but there were big problems.”

- Venture Capitalists see their job as driving the entrepreneur to greater heights. They are not usually gentle about it!

- They also describe the difficulty of setting a value for the company - and how the founder always thinks it is much higher than the venture capitalist does!

Boston Globe on the Funding of Staples

- “It was a very difficult and painful process,’’ Romney would recall while testifying on Stemberg’s behalf. “We found Tom difficult to deal with from a negotiating standpoint.” …….
- Stemberg and his lawyer were driving a tough bargain, trying to keep “a very large portion” of the company for the founder, while Bain and the other investors were “of course thinking we should take a large portion of the company.”

- “It was very clearly our intent to [reward] Tom handsomely if the company did spectacularly well. On the other hand, we did not want Tom to receive any reward if he were to turn out to be not an effective chief executive officer,” Romney said in his testimony.

Boston Globe on the Funding of Staples

- Indeed, such contentious face-offs are common, said Todd Dagres, a Boston venture capitalist whose deals have included Akamai Technologies and Twitter.
- "The one thing that is an absolute rule is, the most successful entrepreneurs I've dealt with have been the most challenging,'' said Dagres of Spark Capital.
- "Based on how successful Staples and Stemberg were, and Mitt has been, I would be shocked to learn if it was anything different."

Boston Globe on the Funding of Staples

- As we discussed in class, it always comes down to this point: The entrepreneur thinks he/she has creating something incredibly valuable.
- The venture capitalist hopes this is correct, but approaches the situation with more skepticism.
- Besides, if the entrepreneur IS correct, then the VCs want to make sure they capture as much of the wealth created as they can!

- In the end, it comes down to making a deal that fairly recognizes the potential value created while providing adequate reward to the investors taking the risks. The only way to do that is through negotiation. It is not a science.

Venture Capital

- Venture Capital
  - Staging of financing
  - Specialization
    - By industry
    - By development stage
  - Geographically localized investing
  - Syndication
    - Share risk
    - Better investment decision
    - Diversify portfolio

Business Angels

- Business Angels
  - 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, and is interested in the start-up process.
  - Business angels are valuable because of their willingness to make relatively small investments.

Sources of Debt Financing

- Commercial Banks
  - Historically, commercial banks have not been viewed as practical sources of financing for start-up firms.
    - Banks are interested in firms that have a strong cash flow, low leverage, audited financials, good management, and a healthy balance sheet.

Get a Bank to Say "Yes"

- Our bank doesn't make small business loans
- I don't know enough about you or your business
- You haven't told me why you need the money
- Your numbers don't support your loan request
- You don't have enough collateral
- You business does not support the loan on its own

SBA Guaranteed Loans

- The SBA Guaranteed Loan Program
  - Approximately 50% of the 9,000 banks in the U.S. participate in the SBA Guaranteed Loan Program.
  - The program operates through private-sector lenders who provide loans that are guaranteed by the SBA.
  - The SBA can guarantee as much as 85% on loans up to $150,000 and 75% on loans over $150,000.
- The 7(A) Loan Guaranty Program
  - The most notable SBA program available to small businesses.

Creative Sources of Financing or Funding

Leasing

Strategic Partners

Small Business Innovation Research Grants

Leasing

- Leasing
  - 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 to allow use of assets with little or no down payment.

Government Grants

- SBIR and STTR Programs
  - 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 main difference between the SBIR and the STTR programs is that the STTR program requires the participation of researchers working at universities or other research institutions.

Government Grants

Small Business Innovation Research (SBIR): Three-Phase Grant Program

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.

Happy Ending

Remember-Financial Objectives and Ratios

- Profitability
  - Is the ability to earn a profit.
  - <u>Net Profit on Sales Ratio</u> - Measures the firm's profit per dollar of sales revenue.
  - <u>Net Profit to Equity Ratio</u> - Measures the owner's rate of return on the investment in the business.

Remember -Financial Objectives and Ratios

- Liquidity ratios- *Tell whether or not a small business will be able to meet its short-term obligations as they come due.*
  - Current ratio = current assets/current liabilities
  - Quick ratio = (current assets – inventory)/current liabilities

Remember- Financial Objectives and Ratios

- Stability - Is the strength and vigor of the firm's overall financial posture.
- Leverage Ratios - *Measure the financing provided by a firm's owners against that supplied by its creditors*
  - Debt Ratio - Measures the percentage of total assets financed by creditors rather than owners.

Remember- Financial Ratio Analysis

- Determine whether it is meeting its financial objectives
- Comparing a Firm's Financial Results to Industry Norms
  – Comparing a firm's financial results to industry norms helps it determine how it stakes up against its competitors and if there are any financial "red flags" requiring attention.