



Indian Institute of Management Rohtak

Session 1&2

MDP on Entrepreneurship

**Gaining access to finances for
your startup**

By

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Many entrepreneurs complain that spending time on financing distracts them from their “real job”—building the business.

—Jeff Bussgang, founding general partner,
Flybridge Capital

Introduction

- many entrepreneurs prefer to focus on business building rather than on financing. Assembling a team, solving customers' problems, creating a product, and closing sales are the kinds of activities that many entrepreneurs report give the most energy and enjoyment
- raising capital either through VC financing or IPO is a core part of building a valuable business.
- Developing expertise in entrepreneurial finance should be thought of **not as a necessary evil but as a competitive weapon.**

Introduction

- The Nature of the Funding and Financing Process
 - 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.**

Why Most New Ventures Need Financing or Funding

Why Most New Ventures Need Financing or Funding

Cash Flow Challenges

Inventory must be purchased, employees must be trained and paid, and advertising must be paid for 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 its own.

Which features of a business determine the amount of cash that will be required to finance it?

Three major factors drive the amount of cash a business will require

- its underlying profitability;
- its asset intensity, which basically means the amount of assets (capital equipment and working capital) required to generate a dollar of revenue; and
- its pace of growth

Alternatives for Raising Money for a New Venture

Alternatives for Raising Money for a New Venture

Personal Funds

Equity Capital

Debt Financing

Creative Sources

Sources of Personal Financing

1 of 2

- Personal Funds
 - The vast majority of founders contribute personal funds, along with sweat equity, to their ventures.
 - Sweat equity represents the value of the time and effort that a founder puts into a new venture.
- Friends and Family
 - Friends and family are the second source of funds for many new ventures.

Sources of Personal Financing

2 of 2

- Bootstrapping
 - A third source of seed money for a new venture is referred to as bootstrapping.
 - Bootstrapping is finding ways to avoid the need for external financing or funding through creativity, ingenuity, thriftiness, cost cutting, or any means necessary.
 - Many entrepreneurs bootstrap out of necessity.

Examples of Bootstrapping Methods

Buy used instead of new equipment.

Coordinate purchases with other businesses.

Lease equipment instead of buying.

Obtain payments in advance from customers.

Minimize personal expenses.

Avoid unnecessary expenses.

Buy items cheaply but prudently via options such as eBay.

Share office space or employees with other businesses.

Hire interns.

Why might an entrepreneur choose to bootstrap a venture?

- Bootstrapping bypasses the early-stage dilution that is imposed by taking professional capital.
- Bootstrapping also dictates that the venture reach a cash flow positive state relatively quickly.
- Some ventures have an inherent business model that is amenable to this approach.
- Other ventures must consciously slow the rate of growth, or make other sacrifices, to stay cash positive and permit the bootstrapping strategy to work.

- In other cases bootstrapping slows down the growth of a venture—at its peril.
- In a case where there are network effects or first-mover advantages, the bootstrapping approach may limit the value-creation potential of the venture, or even doom it to failure.

What factors determine which of these sources of financing is more suitable for a particular entrepreneurial venture?

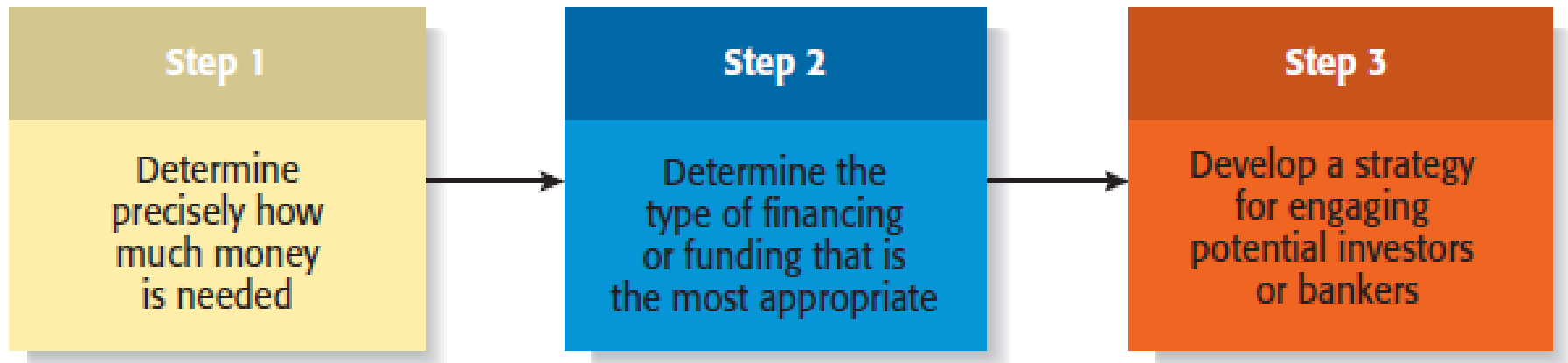
Debt versus Equity

- Of course, debt has the advantage of imposing no dilution on the venture. Because the “upside” return to the lender is limited to the interest rate, however, lenders will lend money only when the risk of losing their funds is perceived as very low.
- This is rarely the case in a high-potential startup

- Debt investors favor businesses with “hard” assets, which can serve as collateral, and steady, predictable, proven cash flow, which can serve as the basis for paying back the loan.
- Ventures without these properties will be forced to rely on equity financing, unless personal assets and loan guarantees can be used to back the loan.

Preparing to Raise Debt or Equity Financing

1 of 3



Preparing to Raise Debt or Equity Financing

2 of 3

Two Most Common Alternatives

Equity Funding

Means exchanging partial ownership in a firm, usually in the form of stock, for funding.

Debt Financing

Is getting a loan.

Preparing an Elevator Speech

1 of 2

Elevator Speech

Purpose

- An elevator speech is a brief, carefully constructed statement that outlines the merits of a business opportunity.
- There are many occasions when a carefully constructed elevator speech might come in handy.
- Most elevator speeches are around 60 seconds long.

Preparing an Elevator Speech

2 of 2

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

Sources of Equity Funding

Venture Capital

Business Angels

Initial Public
Offerings

Preparing to Raise Debt or Equity Financing

3 of 3

Matching a New Venture's Characteristics with the Appropriate Form of Financing or Funding

Characteristics of the 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

Business Angels

1 of 2

- 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.
 - The number of angel investors in India has increased dramatically over the past decade.

Business Angels

2 of 2

- Business Angels (continued)
 - Business angels are valuable because of their willingness to make relatively small investments.
 - These investors generally invest between \$10,000 and \$500,000 in a single company.
 - Are looking for companies that have the potential to grow between 30% to 40% per year.
 - Business angels are difficult to find.
 - Although angel investment comes with its issues of high-interest expectations and lesser investments as compared to Venture capitalists; it is important to remember that **Google, Yahoo, and even Alibaba were a result of Angel investing.**

Venture Capital

1 of 3

- Venture Capital
 - Is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential.
 - Venture capital firms are limited partnerships of money managers who raise money in “funds” to invest in start-ups and growing firms.
 - The funds, or pool of money, are raised from wealthy individuals, pension plans, university endowments, foreign investors, and similar sources.
 - The investors who invest in venture capital funds are called limited partners. The venture capitalists are called general partners.

Venture Capital

2 of 3

- Venture Capital (continued)
 - Venture capital firms fund very few entrepreneurial firms in comparison to business angels.
 - 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.
 - A distinct difference between angel investors and venture capital firms is that angels tend to invest earlier in the life of a company, whereas venture capitalists come in later.

Venture Capital

3 of 3

- Venture Capital (continued)
 - An important part of obtaining venture capital funding is going through the due diligence process.
 - Venture capitalists invest money in start-ups in “stages,” meaning that not all the money that is invested is disbursed at the same time.
 - Some venture capitalists also specialize in certain “stages” of funding.
 - **Private Equity**

Table

Main Differences Between Business Angels and Venture Capitalists

Main Differences	Business Angels	Venture Capitalists
Personal	Entrepreneurs	Investors
Firms funded	Small, early-stage	Large, mature
Due diligence done	Minimal	Extensive
Location of investment	Of concern	Not important
Contract used	Simple	Comprehensive
Monitoring after investment	Active, hands-on	Strategic
Exiting the firm	Of lesser concern	Highly important
Rate of return	Of lesser concern	Highly important

Initial Public Offering

1 of 3

- Initial Public Offering
 - An initial public offering (IPO) is a company's first sale of stock to the public. When a company goes public, its stock is traded on one of the major stock exchanges.
 - Most entrepreneurial firms that go public trade on the NASDAQ, which is weighted heavily toward technology, biotech, and small-company stocks.
 - An IPO is an important milestone for a firm. Typically, a firm is not able to go public until it has demonstrated that it is viable and has a bright future.

Initial Public Offering

2 of 3

Reasons that Motivate Firms to Go Public

Reason 1

Is a way to raise equity capital to fund current and future operations.

Reason 2

Raises a firm's public profile, making it easier to attract high-quality customers and business partners.

Initial Public Offering

3 of 3

Reasons that Motivate Firms to Go Public

Reason 3

Is a liquidity event that provides a means for a company's investors to recoup their investments.

Reason 4

Creates a form of currency that can be used to grow the company via acquisitions.

Sources of Debt Financing

Commercial
Banks

Commercial Banks

- Banks
 - Historically, commercial banks have not been viewed as a practical source of financing for start-up firms.
 - This sentiment is not a knock against banks; it is just that banks are risk averse, and financing start-ups is a risky business.
 - Banks are interested in firms that have a strong cash flow, low leverage, audited financials, good management, and a healthy balance sheet.

Other Sources of Debt Financing

1 of 2

- Vendor Credit
 - Also known as trade credit, is when a vendor extends credit to a business in order to allow the business to buy its products and/or services up front but defer payment until later.
- Factoring
 - Is a financial transaction whereby a business sells its accounts receivable to a third party, called a factor, at a discount in exchange for cash.

Other Sources of Debt Financing

2 of 2

- Peer-to-Peer Lending
 - Is a financial transaction that occurs directly between individuals or peers.
 - The loans are facilitated by online firms such as Funding Circle, Lending Club, and Dealstruck.
 - Be sure to watch out for high interest rates, usually between 12 percent to 25 percent.

Creative Sources of Financing or Funding

Crowdfunding

Leasing

SBIR and STTR
Programs

Other Grant
Programs

Strategic Partners

Crowdfunding

1 of 2

- Crowdfunding
 - Crowdfunding is the practice of funding a project or new venture by raising monetary contributions from a large number of people (the “crowd”) typically via the Internet.
- Two Types of Crowdfunding Programs
 - Rewards-based crowdfunding allows entrepreneurs to raise money in exchange for some type of amenity or reward.
 - The most popular rewards-based crowdfunding sites are Kickstarter, Indiegogo, and RocketHub.

Crowdfunding

2 of 2

- Two Types of Crowdfunding Programs (continued)
 - Equity-based crowdfunding helps businesses raise money by tapping individuals who provide funding in exchange for equity in the business.
 - The catalyst for the beginning of equity-based crowdfunding was the JOBS Act, which was passed in April 2012.
 - It appears that equity-based crowdfunding will be confined to entrepreneurs raising money from accredited investors.
 - Equity-based crowdfunding sites include Funders Club, Crowdfunder.com, and Circle Up.

Leasing

1 of 2

- 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 that it enables a company to acquire the use of assets with very little or no down payment.

Leasing

2 of 2

- Leasing (continued)
 - Most leases involve a modest down payment and monthly payments during the duration of the lease.
 - At the end of an equipment lease, the new venture typically has the option to stop using the equipment, purchase it for fair market value, or renew the lease.
 - Leasing is almost always more expensive than paying cash for an item, so most entrepreneurs think of leasing as an alternative to equity or debt financing.

SBIR and STTR Grants

1 of 4

- 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.

SBIR and STTR Grants

2 of 4

- SBIR Program
 - The SBIR Program is a competitive grant program that provides over \$1 billion per year to small businesses in early-stage and development projects.
 - Each year, 11 federal departments and agencies are required by the SBIR to reserve a portion of their R&D funds for awards to small businesses.
 - Guidelines for how to apply for the grants are provided on each agency's Web site.

SBIR and STTR Grants

3 of 4

- SBIR Program (continued)
 - 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.
 - Historically, less than 15% of all Phase I proposals are funded. The payoff for successful proposals, however, is high.
 - The money is essentially free. It is a grant, meaning that it doesn't have to be paid back and no equity in the firm is at stake.
 - The small business receiving the grant also retains the rights to any intellectual property generated as the result of the grant initiative.

SBIR and STTR Grants

4 of 4

SBIR Three-Phase Grant Program

TABLE 10.5 Small Business Innovation Research: Three-Phase Program

Phase	Purpose of Phase	Duration	Funding Available (Varies by Agency)
Phase I	To demonstrate the proposed innovation's technical feasibility.	Up to 6 months	Up to \$150,000
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 2 years	Up to \$1 million
Phase III	Period in which Phase II innovations move from the research and development lab to the marketplace.	Open	No SBIR funding available; however, federal agencies may award non-SBIR-funded follow-on grants or contracts for products or processes that meet the mission needs of those agencies, or for further R&D.

Other Grant Programs

- Private Grants
 - There are a limited number of grant programs available.
 - Getting grants takes a little detective work.
 - Granting agencies are low key, and must be sought out.
- Other Government Grants
 - The federal government has grant programs beyond the SBIR and STTR programs.
 - The full spectrum of grants available is listed at www.grants.gov.
 - Be careful of grant-related scams.

Strategic Partners

1 of 2

- Strategic Partners
 - Strategic partners are another source of capital for new ventures.
 - Many partnerships are formed to share the costs of product or service development, to gain access to particular resources, or to facilitate speed to market.
 - Older established firms benefit by partnering with young entrepreneurial firms by gaining access to their creative ideas and entrepreneurial spirit.

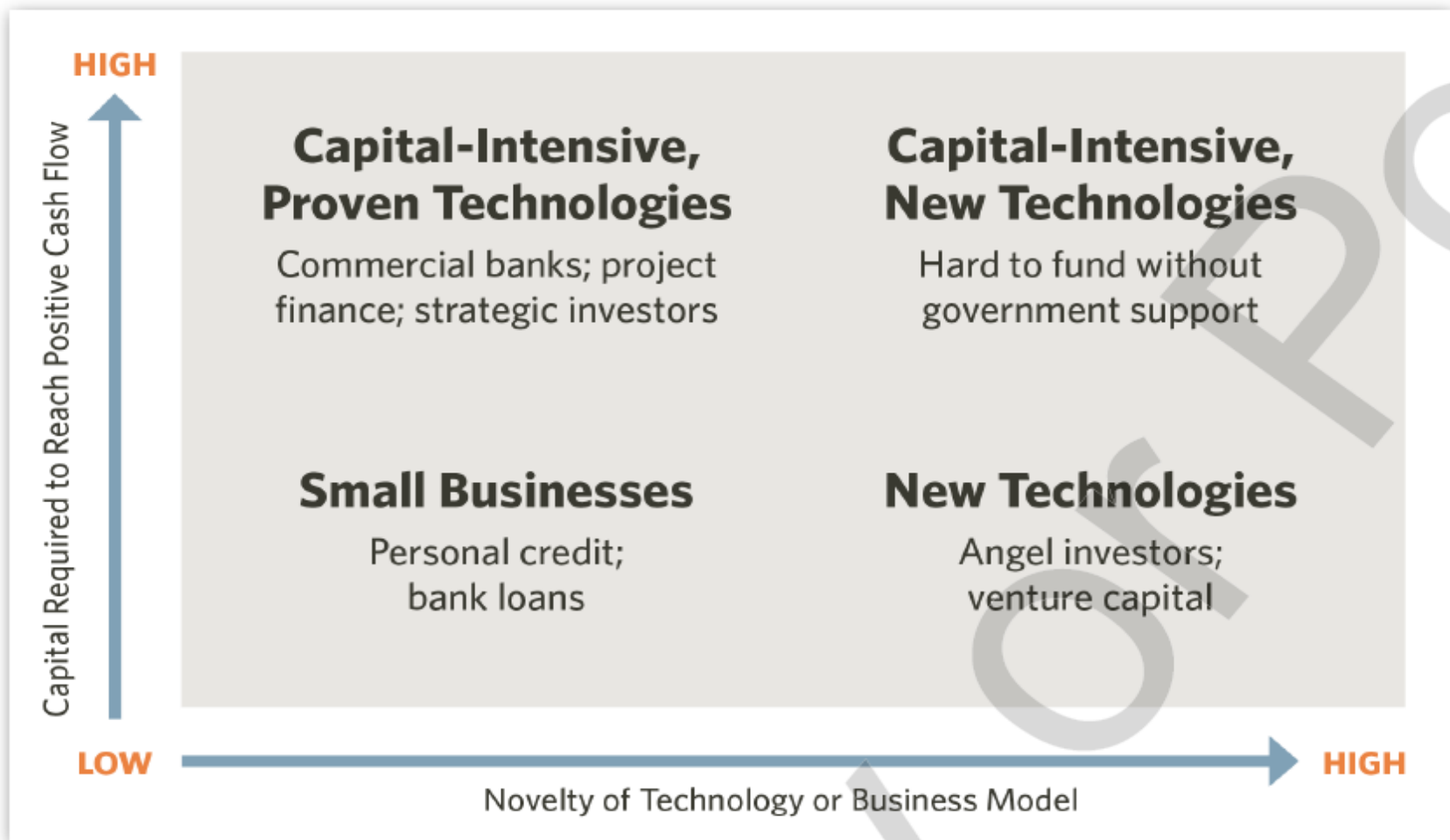
Strategic Partners

2 of 2



- Biotech firms often partner with large drug companies to conduct clinical trials and bring new products to market.
- The biotech firms benefit by obtaining funding from their partners, and the partners benefit by having additional products to sell.

Which factors determine the type of investor that is a good fit with a particular venture?



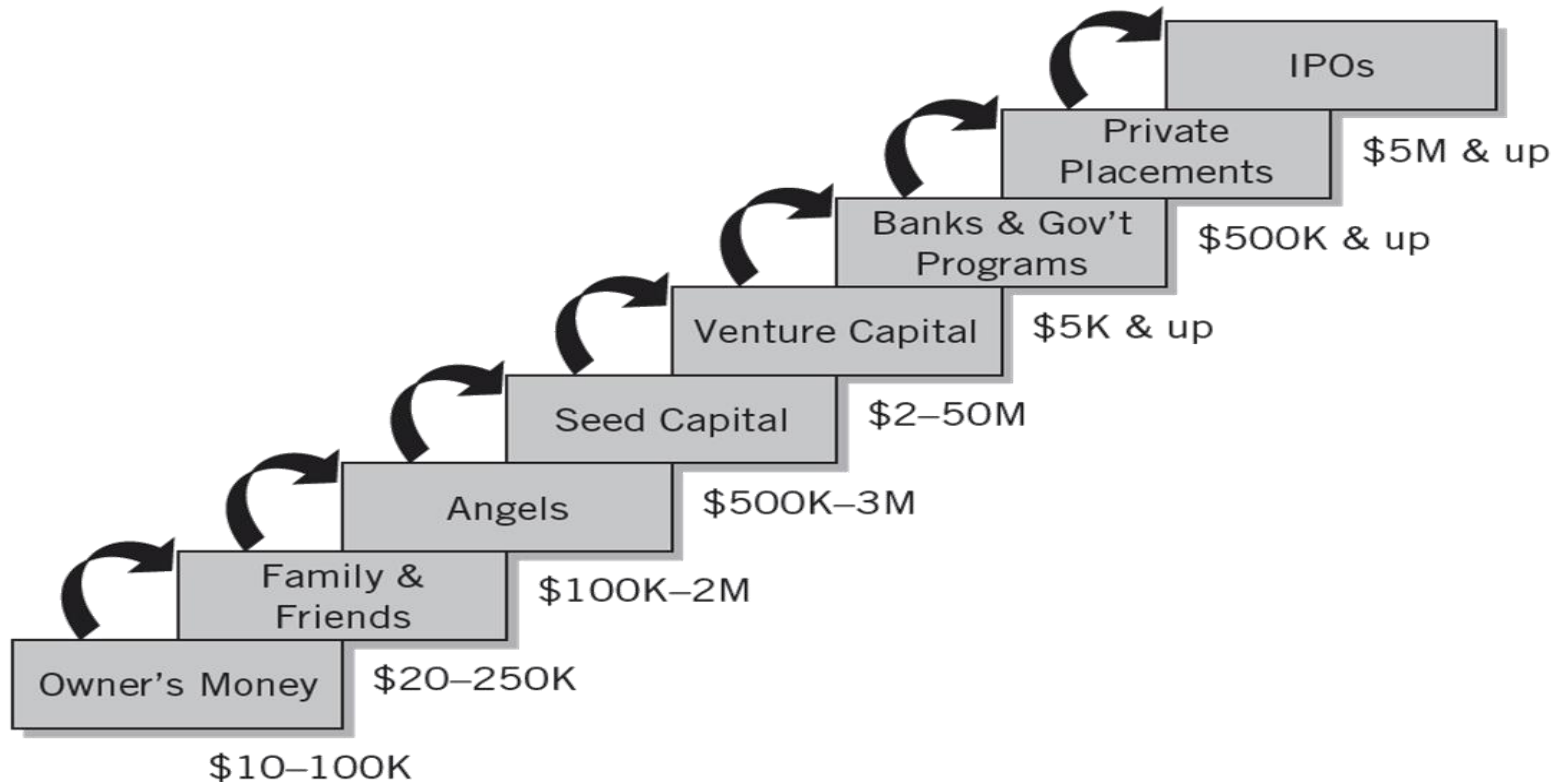
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- The two dimensions that drive a financing source's appetite are the amount of capital required to reach cash flow positive (i.e., the amount of financing a venture will ultimately require) and the degree of risk inherent in the start-up

Who Is Funding Entrepreneurial Start-Up Companies?

Financing Continuum

The following diagram depicts the typical financing for start-up companies.



Ten Criteria Most Frequently Rated Essential in New-Venture

Criterion	Percentage
Capable of sustained intense effort	64
Thoroughly familiar with market	62
At least ten times return in five to ten years	50
Demonstrated leadership in past	50
Evaluates and reacts to risk well	48
Investment can be made liquid	44
Significant market growth	43
Track record relevant to venture	37
Articulates venture well	31
Proprietary protection	29

Returns on Investment Typically Sought by Venture Capitalists

Stage Of Business	Expected Annual Return on Investment	Expected Increase on Initial Investment
Start-up business (idea stage)	60% +	10–15 × investment
First-stage financing (new business)	40%–60%	6–12 × investment
Second-stage financing (development stage)	30%–50%	4–8 × investment
Third-stage financing (expansion stage)	25%–40%	3–6 × investment
Turnaround situation	50% +	8–15 × investment

Venture Capitalists' Screening Criteria

Venture Capital Firm Requirements

- Must fit within lending guidelines of venture firm for stage and size of investment
- Proposed business must be within geographic area of interest
- Prefer proposals recommended by someone known to venture capitalist
- Proposed industry must be kind of industry invested in by venture firm

Nature of the Proposed Business

- Projected growth should be relatively large within five years of investment

Economic Environment of Proposed Industry

- Industry must be capable of long-term growth and profitability
- Economic environment should be favorable to a new entrant

Proposed Business Strategy

- Selection of distribution channel(s) must be feasible
- Product must demonstrate defensible competitive position

Financial Information on the Proposed Business

- Financial projections should be realistic

Proposal Characteristics

- Must have full information
- Should be a reasonable length, be easy to scan, have an executive summary, and be professionally presented
- Proposal must contain a balanced presentation
- Use graphics and large print to emphasize key points

Entrepreneur/Team Characteristics

- Must have relevant experience
- Should have a balanced management team in place
- Management must be willing to work with venture partners
- Entrepreneur who has successfully started previous business given special consideration

India -Update

Government has created a large pool of funds for helping startups. However, no one seems to know the process for startups to get access to these funds

- <https://letsventure.com/for-startups>
- <https://www.startupindia.gov.in/>
- <https://www.sumhr.com/top-list-angel-investors-india/>
- <https://angel.co/india/investors>

Venture Capital in India

Industry	No. of Deals	Aggregate Deal Value (\$mn)
Internet	187	4493
Telecom	95	386
IT-Software	89	162
Business Services	30	338
Healthcare	30	191
Food & Agriculture	27	183
Consumer Discretionary	26	68
IT-Other	17	89
Industrial	15	150
Cleantech	11	106
Semiconductors & Electronics	3	6
Real Estate	2	-

Venture Capital in India

Portfolio Company	Industry	Investment Stage	Investor(s)	Deal Size (\$mn)
Flipkart Internet Private Limited	Internet	Unspecified Round	eBay Inc., Microsoft, Tencent	1400
One97 Communications Limited	Internet	Secondary Stock Purchase,	Softbank Capital	1400
MakeMyTrip Pvt. Ltd.	Internet	PIPE	Ctrip.com International, Ltd., MIH Internet Africa Pty Ltd	330
OYO Rooms	Internet	Unspecified Round	Greenoaks Capital, Lightspeed Venture Partners, SB Investment Advisers, Sequoia Capital	250
One97 Communications Limited	Internet	Unspecified Round	Alibaba Group, SAIF Partners India	200

Venture Capital in India

- VC industry in India is in healthy state, with more than \$120 billion fund deployed in India till date.
- The 4,000-plus enterprises that have been funded by the industry ,
- around 1,847 enterprises that have been listed on the NSE over 23 years and 5,500 on the Bombay Stock Exchange

Financial Tools for Entrepreneurs

Financing Needs and Cumulative Cash Flows

- Before beginning to raise money, entrepreneurs must understand their capital requirements.
- These capital needs will depend on estimates of machinery investment, the number of personnel required at different stages of the business, wages and benefits per employee, the rate of customer uptake, revenue per customer, and similar factors.
- Entrepreneurs will need to consider these cash dynamics annually or even monthly and should conduct multiple scenario analyses (e.g., $\pm 50\%$ of projections)

Revenue Assumptions

Initial Customer Base	100
Lifetime Customer Revenue	\$1,000
Up-Front Revenue	25.0%
Average Customer Tenure	38

Balance Sheet Assumptions

Net Working Capital (% of Sales)	20.0%
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Variable Cost Assumptions

Customer Acquisition and Setup Cost	\$100
Recurring Customer Cost	\$1

Fixed Cost Assumptions

Monthly Fixed Costs	\$200,000
Annual Fixed Cost Growth Rate	10.0%

Customer Growth Assumptions

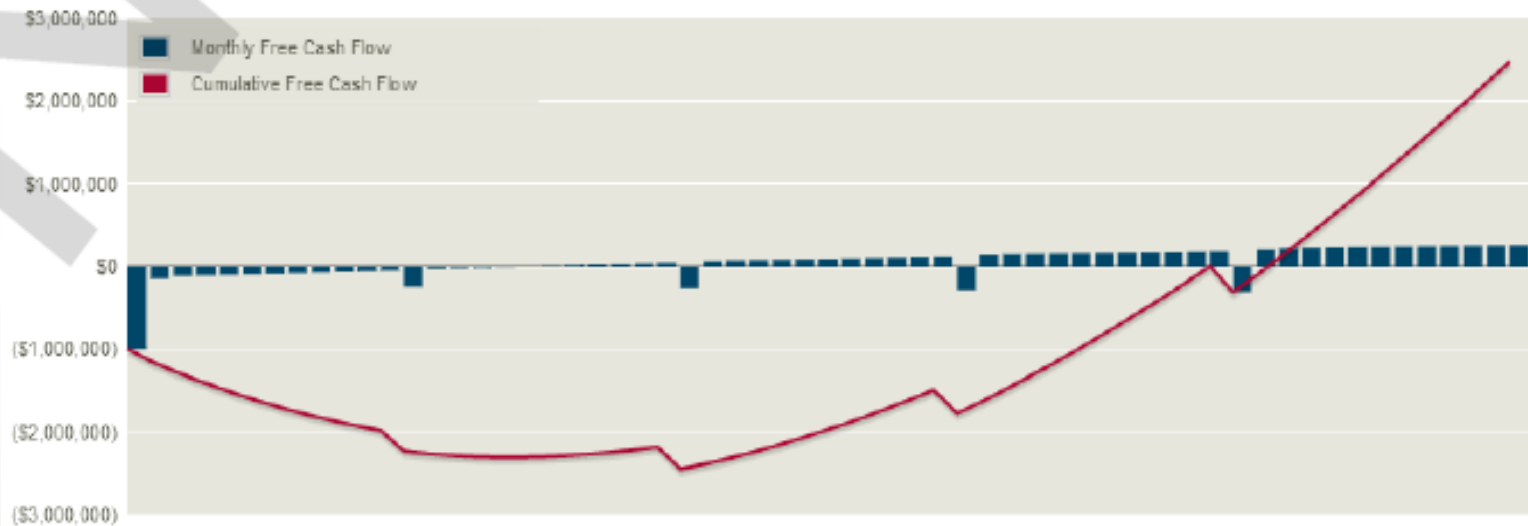
New Customers Per Month in Year 1	500
New Customers Per Month in Year 2	600
New Customers Per Month in Year 3	700
New Customers Per Month in Year 4	800
New Customers Per Month in Year 5	900

Capital Expenditure Assumptions

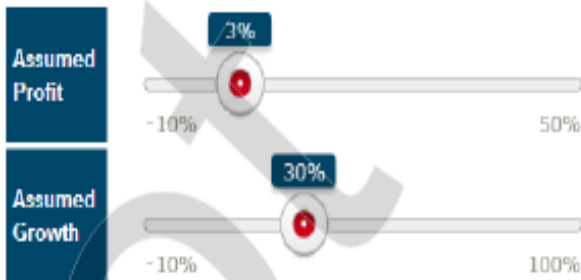
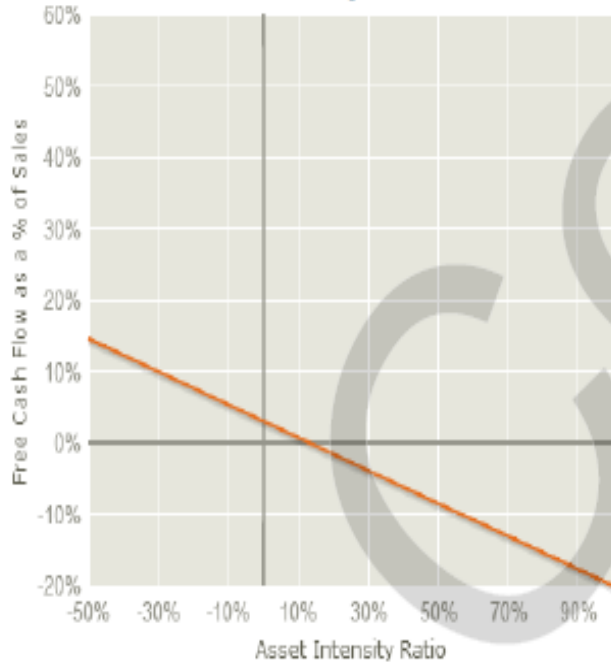
Initial Capital Expenditure	\$1,000,000
CapEx Required for Year 2 (Month 12)	\$200,000
CapEx Required for Year 3 (Month 24)	\$300,000
CapEx Required for Year 4 (Month 36)	\$400,000
CapEx Required for Year 5 (Month 48)	\$500,000

Implied Values

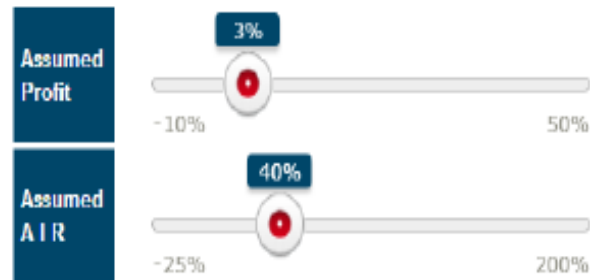
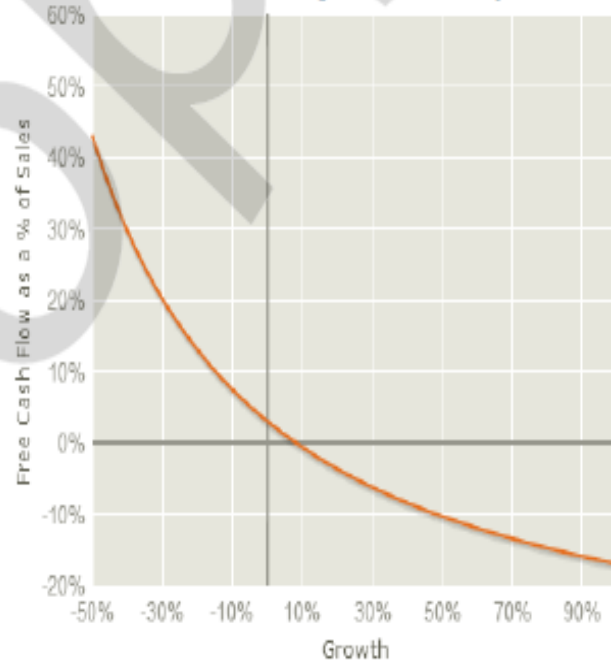
Implied Monthly Customer Retention Rate	97.2%
Implied Upfront Customer Revenue	\$250.00
Implied Monthly Recurring Customer Revenue	\$20.83
Implied Monthly Fixed Cost Growth Rate	0.8%
Implied Cash Conversion Cycle (Days)	73.0



FCF as a Function of Asset Intensity Ratio
for a Given Profit Margin and Growth Rate



FCF as a Function of Growth
for a Given Profit Margin and Asset Intensity Ratio



Case: How Venture Capitalists Evaluate Potential Venture Opportunities

Key questions

- How do you evaluate potential venture opportunities?
- How do you evaluate the venture's prospective business model?
- What due diligence do you conduct?
- What is the process through which funding decisions are made?
- What financial analyses do you perform?
- What role does risk play in your evaluation?
How do you think about potential exit routes?

Evaluating potential venture opportunities

1. Large market opportunity in fast-growing sector
 - Explosive growth – difficult for others to catch up and for incumbents to respond
 - \$100 to \$300 M revenue stream within five years
 - Market potential needs to be > \$500M to get 25% market share

Evaluating potential venture opportunities

2. Competitive advantage – as unfair as possible
 - Network effect like eBay or operating system lock-in like Microsoft
 - Usually based on difficult engineering problem that takes years to solve
 - Patents OK, but competitors work around them

Evaluating potential venture opportunities

3. Team

- Strong technical founder for technical problem + a sales-oriented entrepreneur
- Founder understands thrusts of technology and industry dynamics around it
- Entrepreneur drives other parts of the business and sells the vision to investors
- Vision, execution, sales, and entrepreneurship

Evaluating potential venture opportunities

4. Other factors

- How much pain does the customer feel, and how much will he pay to solve it?
- Market opportunities (2 types)
 - Replacement for existing product: better, faster, cheaper
 - New-to-the-world product with less market certainty and greater risk

Evaluating the business model

- Two kinds of investments opportunities
- First is a company capable of executing better or offering a better version of an existing product or service – market is proven
- Second, completely new markets or business models where they *think* they understand their bets: e.g., Friendster or Webvan

Due diligence

- VCs hire professors and technical experts to meticulously study a new **technology**. Too hard to be done? Or are they asking the right questions?
- Determine **customers'** real needs and their willingness to pay
- **Industry** experts about the idea, team, market, and market need
- **Entrepreneur and team** – call references and blind references
- Some firms require 2 general partner sponsors and a devil's advocate to raise objective questions

Financial analysis?

- Revenue and expense models
- VCs look at expense model first to determine break-even point $[FC/(VR-VC)]$
- Create their own revenues models – not top-down, but bottoms-up, which becomes a fraction of the top-down estimate in the business plan

Role of risk

- Consider technical, competitive, and market risks before investing in a company
- Track milestones around product, first beta customers, first revenue customers

Potential exit routes

- Market cap > \$200 M,
- + Revenues > \$60 - \$80 M
- = large enough market for an exit
- Plus consideration of likely acquirers
- IPO always most profitable exit