



Entrepreneurial Financing

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This section of 10 pages includes discussions on the topics of:

- [Stages of Financing](#) (3 pages)
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Venture Associates is a firm with a long, successful history of its knowledge of entrepreneurial financing. It has consulted to and worked with hundreds of companies in practically all industry segments. These projects have ranged from initial conversations with prospective entrepreneurs in assisting them in their analysis of the viability of their project, all the way through the process of taking their companies public as well as advising on sellouts and mergers.

If you're exploring or have questions regarding the financing of your project, you're welcome to contact the firm via the following methods:



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For additional, in-depth information on the entrepreneurial financing subjects discussed in this section, please see the detailed tables of contents for the books written by James B. Arkebauer, founder of Venture Associates--click "[Books](#)".



Stages of Entrepreneurial Financing

Obtaining money for an entrepreneurial company is really pretty simple--it's just another sale. Your customer has something you want--their money. You have something they want, equity or a piece of the action of the potential growth of your enterprise.

The key, as in all sales, is to determine the right price and close the sale. To do that, you have to develop a financial marketing mindset. Just as you would prepare a marketing program to sell your product or service, you need to prepare a financial marketing program.

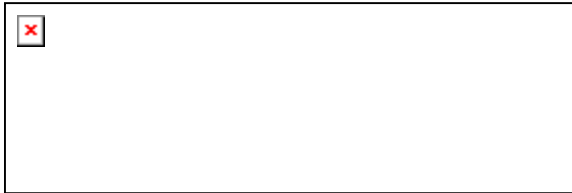
That means you prepare a business plan and develop and practice a verbal pitch, develop a marketing scheme, present the package, and close the sale. It takes intimate knowledge, unbounded enthusiasm, and a scuff-resistant ego.

Your business plan is going to show you how much money you will need, if it should be debt or equity, and at what stage or time period it's needed to accomplish what tasks.

By consulting with your peers, legal counsel, accountants and company consultant, you will have determined the most proper legal structure for your company as well as the proposed valuations. From this, you can then develop your financial marketing program which in turn will help you narrow in on the type of investor you will be seeking.

For seed and concept companies, this invariably means the entrepreneur starts with "family and friends" money, and then proceeds on to obtaining informal investor financing prior to attracting

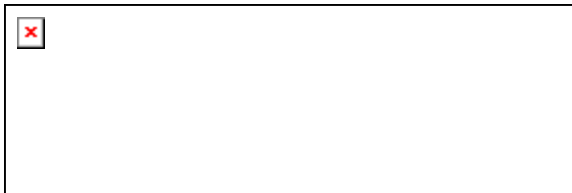
the interest of the more formal investors such as venture capital firms. It will be helpful if you understand the accepted "stages of growth" used by all financing sources.



Understanding the Stages of Entrepreneurial

Development

Prior to delving into the details of entrepreneurial financing, it's helpful to establish an understanding of the traditional stages of development for entrepreneurial companies. These are: Seed or Concept, Startup, First, Second, Third, and Harvest. They are briefly described with *Status, Tasks, and Financing* as follows:



Seed or Concept

Status. This is the wild-eyed, perhaps incurable, inventor stage. There is an idea, a concept, no management team, no prototype, and patentability has not been determined. No business plan, timetable, or market research has been assembled. Founder(s) may be technicians.

Tasks. To begin development of a prototype, assemble some key management, develop a business plan, assess market potential, structure the company, and assess patentability or proprietary standing.

Financing. Traditional venture capital firms have little interest in funding a company at this stage. The risk level is just too high, and the time for achieving a payout or harvest is not determinable. Personal savings or friend and family money funds this stage. It ends with the completion of a seed stage business plan and the formation of the company.



Start-up

Status. At least one principal person of the company is pursuing the project on a full-time basis. The prototype is being developed, the business plan is being refined, a management team is being identified, market analysis is being undertaken, and beta tests are being set up or initial customers are identified. More formal funding is being accomplished.

Tasks. Complete and test the prototype and obtain evidence of commercial interest. Assemble and identify an initial management team, finish the business and marketing plans, establish manufacturing and initiate sales.

Financing. Traditional venture capital firms may show an interest at this stage, assuming that a top-rated management team is assembled, patentability or proprietorship is proven, and marketability is demonstrated. Fundraising is a major effort at this stage and it may take from several months to a year or more.



First Stage

Status. The company is now a going concern. The product has proven manufacturable and is selling. If it's a service company, some customers have tried the service. The management team is in place, the company has experienced some setbacks, customers can confirm product usage, marketing is being refined, adjustments are being made in the business plan and the money raising efforts continue.

Tasks. To achieve market penetration and initial sales goals, reach close to breakeven, increase productivity, reduce unit costs, build the sales organization and distribution system.

Financing. At this stage, traditional venture capital firms are interested in investment--in fact, it's their most preferable stage. Financing is needed to get the production bugs worked out and to support initial marketing efforts.



Second Stage

Status. Significant sales are developing as are assets and liabilities. The company is sporadically achieving breakeven, and cashflow management becomes critical. Second-level management is being identified and hired. Export marketing is being explored and more sophisticated management systems are being put into place.

Tasks. To obtain consistent profitability, add significant sales and back orders, expand sales from regional to national, identify international marketing plans, and obtain working capital to expand marketing, accounts receivable, and inventory.

Financing. More sophisticated and second-round venture capital financing comes into play at this stage. The founders and investors are forming plans for the harvest



Third Stage (also Mezzanine Stage)

Status. All systems are really go and the potential for a major success is beginning to be apparent. Snags are being worked out in all areas from design and development of second-generation products; to marketing and distribution; to management and all its applied systems.

Tasks. To increase market reliability, begin export marketing, put second-level management in place, begin to "dress up" the company for harvest.

Financing. At this stage, the company may need to obtain "bridge" or "mezzanine" financing to carry increased accounts receivable and inventory prior to harvest. There is a great amount of pressure to prove second- and third-generation products, increase profitability records, improve the balance sheet, and firmly establish market share and penetration.



Stage Four: Or is the Harvest Near?

The end may be near for entrepreneurial companies. The company is sifting and sorting out its options including going public, being acquired, selling out, or merging. What started out as a dream has become an entrepreneurial reality. The next challenge is to start all over again, but this time with a pocketful of dollars.

With an understanding of the stages of development of entrepreneurial companies, we can delve into the various types of entrepreneurial financing.

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Types of Entrepreneurial Financing

Entrepreneurial managed companies are constantly on the search for new capital and it is seldom easy to come by. Top entrepreneurs understand that raising money is a way of life.

Experienced entrepreneurs realize that the financing of companies is done in stages and that they have to be flexible in identifying the latest trends in financing. Many first-timers erroneously believe that they can successfully generate sufficient cashflow on a near-term basis, then bootstrap their way to financial success. This doesn't work in today's fast-moving business climate, especially in many medium and high-tech areas. This section discusses this fact and other potential problems. The next section offers many solutions for the sourcing of financing.

There Are Several Types of Financing: Debt and Equity

Contrary to the dreams of many startup entrepreneurs, initial financing can be the hardest part of launching their new business. There are many popular misconceptions that an idea, a startup team, and a preliminary business plan will get them in the venture capitalist door. They expect to exit, happily, with the check in hand. They don't realize that traditional venture capital-venture capital funds that are supported by institutional investors-only finance a fraction of a percent of the new companies started each year. They are not cognizant of the fact that 90 percent plus of startup money comes from private sources and its up to the individual entrepreneur to identify and sell their project to these financing sources. It's tough, tough work.

The first thing to do is to put together a business plan to use as a fundraising tool (see Business Planning). Second is the actual raising of the financing, or financial marketing. Each alternative to raising money requires a different approach to the business plan. Financing never happens quickly; it is never simple. In fact, it is usually quite painful and exasperating. Entrepreneurs can find themselves chasing down blind alleys if they don't prepare properly.

There are a number of sources of financing and a variety of forms of capital. Some are used to finance seed or startup companies while others are used for expansion. Start-ups are usually limited to the type of financing they can get, like personal savings used as equity or personally secured subordinated debt. On the other hand, companies with a proven track record have a much larger choice of financing alternatives--such as banks, venture capital firms, or public offerings.

What all entrepreneurs soon discover is that there are several factors that they must constantly reckon with, in pursuit of the elusive dollar. These are:

- the dilution of equity ownership,
- potential restrictions on daily operating flexibility, and
- debt-imposed constraints on future growth.

These factors are touched on in this section.



Your Two Basic Choices for Financing

For all intents and purposes, the entrepreneur has two basic choices when considering financing: debt or equity, pledging a part of one's soul or giving away a piece of it. Commonly, one does both.

In simple terms, debt is borrowed money secured in some fashion with some type of asset for collateral. Equity, on the other hand, is contributed capital, usually hard dollars. Debt may be secured by a personal signature only, and equity can also be in the form of a contributed asset.

But most often new businesses require long-term debt or permanent equity capital to support major expansion and anticipated rapid growth. The advantage of borrowing is that it is a relatively simple process to arrange. It does not take a great deal of time and does not dilute equity ownership. The disadvantages are that it is a high-risk strategy as far as company growth is concerned, in that incurring debt subjects the company to a firm obligation, usually including the principals as cosigners. A downturn in business or an increase in interest rates could result in the inability to service debt payments with the consequences being that the co-signers have to personally pay the company's debt.

Successful Entrepreneurs Use Combinations

Unlike oil and water, debt, equity, self-funding, and external funding do mix well. In fact, it's an entrepreneurial secret. *The best managed companies mix their financing sources and choices.* Which to use, and when, becomes a matter of individual option, although there are some pretty well established precedents. Founders' personal investments, including both personal assets and family and friends' equity and loans, are usually what finances concept or seed stage companies.

Development or Start-Up stage companies commonly seek funding from private placements, early-stage venture capital firms, and various grants from both foundations and government sources.

Early/First-stage or production companies may receive financing from bank loans, leasing companies, and research and development partnerships (for incremental product development). Strategic partnerships are often entered into at this stage with potential customers, suppliers, and manufacturers.

Companies at the next stage of ramping up (**Second Stage**), which is full-scale production and expanded marketing, often receive additional dollar injections. These come from second and larger rounds of traditional venture capital, larger companies that are looking for product distribution opportunities, institutional investors, more venture leasing companies (for manufacturing equipment), and additional strategic partners (often seeking secondary manufacturing and distribution rights both domestically and for foreign countries).

After this stage, the entrepreneuring company has some heavy choices to consider. Here is where the harvest point (**Third and Forth Stage**) is a natural if the plan has been to build a company and then sell out. They still need more money (what's new), but their choices are a lot broader: more venture capital, bridge or mezzanine financing while going public, being acquired (perhaps by one of the earlier-stage strategic partners), or selling out to a cash-rich company.

So Debt or Equity?

If we're saying that entrepreneurs use combinations, how do we distinguish which and when? The use of debt almost always requires that some equity has come in first. A rough rule of thumb is that a dollar of early stage equity can support a dollar of debt, if there is some additional security to further back the debt.

Lenders feel that a start-up has little ability to generate sales or profits. Consequently, the lender wants to have their debt secured, and even then, they feel that the asset value will be decreasing with time and there's always the possibility that management may not be up to the company-

building challenge at hand.

This debt will most likely be short-term debt (one year or less) to be paid back from sales. Short-term debt is traditionally used for working capital and small equipment purchases. Long-term borrowing (one year or maybe up to five) can be used for some working capital needs, but usually is assigned to finance property or equipment that serves as collateral for the debt.

While commercial banks are the most common source of short-term debt, there are more choices for long-term financing. Equipment manufacturers provide some, as does the Small Business Administration (SBA), various state agencies, and leasing companies. More examples are given in the following section.

It's true, entrepreneurs can finance start-ups with more debt than equity, but there are some distinct disadvantages. As an example; if they negotiate extended credit terms with several suppliers, this restricts their flexibility to negotiate prices. Heavily leveraged (i.e., debt-financed) companies are constantly undercapitalized and will experience continuing cashflow problems as they grow. Paying close attention to strained cashflow requires a lot of management time be diverted from company operations. It also affects the balance sheet, making it difficult to obtain additional equity or debt.

On the other hand, there is one big positive in using debt. Debt doesn't decrease or dilute the entrepreneur's equity position and it provides nice returns on invested capital. However, if credit costs go up, or sales don't meet projections, cashflows really get pinched and bankruptcy can become reality.

Top entrepreneurial companies use varying combinations of debt and equity. They determine which is the most advantageous for the particular stage of growth they're financing. Their aim is to create increasingly higher valuations or profit structures.

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Sources of Financing

Financing an enterprise can be both confusing and exasperating. If you're a beginner in the subject, you may feel lost in not knowing the "lingo." If you have years of experience, you may find yourself needing a "refresher." The following section sets out some sources for finding money and is meant to spark your thinking process. Entrepreneurs need to be creative, but sometimes we need a jumpstart to help us get going.

Equity Types and Sources

PERSONAL

- Savings

- Credit Cards

- Sell Assets (boats, hobby equip)

- 2nd Mortgage

FAMILY &; FRIENDS

- Personal Investments - They invest because they know you and TRUST you

- Debt (convertible) or equity

- Acquaintances

ANGELS

Individual private investors are commonly and affectionately known as "angels." Along with family and friends, they provide the vast majority of start-up funding for entrepreneurial companies. They may invest in either debt or equity or combinations.

What they look like:

90% male, ages=40-60, masters/advanced degrees, prior start-up experience, income \$100-\$250k, invest 2 ½ yr, \$25k-50k per deal-\$130k tot, seldom invest in more than 10% of a deal, they seek 20% compounded per annum returns, they expect to hold their investment for 5-7 yrs, prefer manufacturing and product companies, they like to invest in technology they know, prefer start-up, dislike moderate growth, like a consulting or board of advisor position with the company, they like invest with others and prefer to invest close to home (50-300 miles), their motivation is a high rate return, learn about deals from friends, 30% from accountants or attorneys, they would like to see more deals, and they refer deals to other private investors.

Where to find them: network-network-network

Ask for referrals, use calling card file, spread the word--"have plan/will travel" anybody, anytime, anyplace. Make contact with attorneys, accountants, management consultants, customers, employees, doctors, dentists, investment bankers (pay fees) Networking is hard work.

How to present to them:

Need one page brief (2-4 page) executive summary, and full business plan. Most important, one minute pitch, 3 minute pitch, 15-20 minute presentation with visuals. Objective is to get one-on-one with investment decision maker.

For more information on Angels see: [NetNews](#)

EMPLOYEES

Many entrepreneurs overlook the possibility of obtaining investment in either debt or equity from their existing and prospective employees.



VENTURE CAPITAL

Venture capital investment firms have some very tough qualifications for their investments.

- Top Management Team
- Very Fast Growth (minimum zero to \$20 million in 4-5 years)

- Large Market Potential (\$50-\$100 million plus revenues)

- Larger Capital Needs
- Tough Due-diligence

INVESTMENT BANKERS

x

- Function as Agents
- Can find dollars from many different sources

x

x

- Can assemble unique investment structures

x

- Can ID strategic partners
- Good experienced deal makers

MERCHANT BANKERS

Basically same as Investment bankers except frequently supply some of their own money.

STRATEGIC PARTNERS/ALLIANCES

x

- Advances - royalty/licenses, R&D, manufacturing, distributing, marketing

x

x

- Equity - options/warrants
- Debt - subordinated/convertible

Debt Types and Sources

BANKS-S&Ls-Credit Unions

Place secured short, or medium-term loans

What they Finance	What they look for
Working capital	Need some Equity
Lines of Credit	Personal Guarantees
Accounts Receivable	
Plant & Property	

COMMERCIAL FINANCE COMPANIES

What are they?

assets based lenders, more aggressive than banks

How do they differ from banks?

quicker processing, higher rates

What do they finance?

receivables, some inventory

LEASING FIRMS

x

Types, equip, VCs

How to use them

SBA

Large variety of programs

Basic programs

Approved lenders (Money Store)

Examples of lessor known

Low Doc

Handicap Assistance

What they finance

Plant & property

GOVERNMENT SOURCES

BDCs

SBICs

MESBICs

SBIRs

Grants - local, state, federal, private, foundations

(\$100 Billion annually)

Farmers Home Administration

Export-Import Bank

Incubators

Industrial Development Bonds

Enterprise Zones

SUPPLIERS

Floor planning

Extended Terms

Special discounts

EQUIPMENT MANUFACTURERS

Lease programs in place

Extended terms

FACTORS - deep discounts

Raw materials

Finished inventory

Accounts receivable

SOURCES of FINANCING HINTS

There are many "source guide books" and listings available. Good libraries have numerous listing books for banks, venture capital firms, asset based lenders, investment and merchant bankers, leasing firms, commercial lenders, factors, venture capital clubs, and "Million Dollar Directories" for determining strategic alliances. There are several CD-ROM and diskette providers of financing source databases. You should also inquire with your city, county and states' departments of economic development. See your local Small Business Administration (SBA) for information on their many programs.

Finally, see the "Sources of Everything" appendix in "The McGraw-Hill Guide to Writing a High-Impact Business Plan" book.

A Final Financing Note

The secret to successful entrepreneurial financing is that it takes COMBINATIONS !
Combinations of debt and equity and different time periods in the ongoing life of any enterprise.

And the secret to successfully operating a entrepreneurial company is to pay constant, unrelenting attention to:

Cashflow

Accounts Receivable

Accounts Payable

Inventory Control

For additional, more detailed information on the preceding entrepreneurial financing methods, click "[Books](#)."

For information on Private Offerings, click "[Private Offerings](#)".

For information on Going Public, click "[Going Public](#)".

VENTURE ASSOCIATES CONSULTING

The principals of Venture Associates have a great deal of experience in developing, writing and producing documents and in obtaining entrepreneurial financing. If you would like to discuss the availability and costs for services, please make contact via the following information:

Our Services include:

• Business Plans and Planning	• Private Offerings(SCOR/Reg D)
Reverse Mergers (Shells)	Market Research
Capital Sourcing	Strategic Partnering
Leveraged Buyouts	Going Public



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