Sources of Capital

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Debt or Equity Financing

- Debt financing - Obtaining borrowed funds for the company.
  - Asset-based financing; requires some asset to be used as a collateral.
  - Borrowed funds plus interest need to be paid back.
- Equity financing - Obtaining funds for the company in exchange for ownership.
  - Does not require collateral.
  - Offers investor some form of ownership position.

Debt or Equity Financing (cont.)

- Factors affecting type of financing:
  - Availability of funds.
  - Assets of the venture.
  - Prevailing interest rates.
  - All financing requires some level of equity; amount will vary by nature and size of venture.

Internal or External Funds

- Internally generated funds are most frequently employed; sources include:
  - Profits.
  - Sale of assets and little-used assets.
  - Working capital reduction.
  - Accounts receivable.
- Short-term internal source of funds:
  - Reducing short-term assets - inventory, cash, and other working-capital items.
  - Extended payment terms from suppliers.

Internal or External Funds (cont.)

- Criteria for evaluating external sources of funds:
  - Length of time the funds are available.
  - Costs involved.
  - Amount of company control lost.

Personal Funds

- Least expensive funds in terms of cost and control.
- Essential in attracting outside funding.
- Typical sources of personal funds:
  - Savings.
  - Life insurance.
  - Mortgage on a house or car.
- The entrepreneur’s level of commitment is reflected in the percentage of total assets that the entrepreneur has committed.

Family and Friends

- Likely to invest due to relationship with entrepreneur.
  - Advantages - Easy to obtain money; more patient than other investors.
  - Disadvantage - Direct input into operations of venture.
- A formal agreement must include:
  - Amount of money involved.
  - Terms of the money.
  - Rights and responsibilities of the investor.
  - Steps to be taken incase business fails.

Commercial Banks

- Types of Bank Loans (Asset based)
  - Accounts receivable loans.
  - Inventory loans.
  - Equipment loans.
  - Real-estate loans.
- Cash flow financing (Conventional bank loans)
  - Installment loans.
  - Straight commercial loans.
  - Long-term loans.
  - Character loans.

Commercial Banks (cont.)

- Bank Lending Decisions
  - Based on quantifiable information and subjective judgments.
  - Decisions are made according to the five Cs of lending- Character, Capacity, Capital, Collateral, and Conditions.
  - Review of past financial statements and future projections.
  - Questions are asked regarding ability to repay the loan.

Commercial Banks (cont.)

- "Bank Shopping" procedure:
  - Complete an application, which is a "mini" business plan.
  - Evaluate alternative banks.
  - Select one with a positive loan experience in the business area.
  - Set an appointment.
  - Carefully present the case for the loan.
  - Borrow the maximum amount possible.

Role of the SBA in Small-Business Financing

- The Small Business Administration (SBA) is primarily a guarantor of loans made by private and other institutions.
  - The 7(a) Loan Guaranty is the SBA's primary business loan program.
  - Proceeds can be used for:
    - Working capital.
    - Machinery and equipment.
    - Furniture and fixtures.
    - Land and building.
    - Leasehold improvements.
    - Debt refinancing (under some conditions).

Role of the SBA in Small-Business Financing (cont.)

- Eligibility criteria:
  - Repayment ability.
  - Five “C’s”.
  - Size.
  - Type of business.
  - Use of proceeds.
  - Availability of funds from other sources.
  - Owners of 20 percent or more are required to personally guarantee SBA loans.

Role of the SBA in Small-Business Financing (cont.)

- Maximum loan amount of $2 million.
- SBA's maximum exposure of $1 million.
- Maximum guarantee by the SBA is 50 percent.
- Interest rates are negotiated; subject to SBA maximums; pegged to the prime rate; may be fixed or variable.
- Guarantee 85 percent of loans of $150,000 or less.
- Guarantee 75 percent of loans above $150,000 to a maximum of $1 million.

Role of the SBA in Small-Business Financing (cont.)

- 504 loan program:
  - Provides fixed-rate financing to acquire machinery, equipment, or even real estate.
  - Maximum of the program is usually $1 million.
  - Loan can take various forms, including a Community Development Company (CDC) loan backed by a 100 percent SBA-guaranteed debenture.
- SBA Microloan – 7(m) loan program:
  - Short-term loans of up to $35,000.
  - Working capital, purchase of inventory, supplies, furniture, fixtures, machinery, or equipment.
  - Cannot be used to pay existing debts.

Research and Development Limited Partnerships

- Money given to a firm for developing a technology that involves a tax shelter.
- Major elements:
  - Contract - Liability for loss incurred is borne by the limited partners; tax advantages to both parties.
  - Limited partnership - A party that usually supplies money and has a few responsibilities.
  - Sponsoring company- Acts as the general partner; has the base technology but needs funds to develop it.

Research and Development Limited Partnerships (cont.)

- Procedure
  - Funding stage - Establishment of contract; investment of money; documentation of terms and conditions, and scope of research.
  - Development stage - Sponsoring company performs actual research.
  - Exit stage - Commences when technology is successfully developed; sponsoring company and the limited partners commercially reap the benefits through either equity partnerships, royalty partnerships, or joint ventures.

Research and Development Limited Partnerships (cont.)

- Benefits:
  - Provides funds with minimum amount of equity dilution.
  - Reduces the risks involved.
  - Strengthens sponsoring company's financial statements.
- Costs:
  - Expending of time and money.
  - Restrictions placed on technology can be substantial.
  - Exit from the partnership may be too complex.

Government Grants

- The Small Business Innovation Research (SBIR) program was created as part of the Small Business Innovation Development Act.
  - All federal agencies with R&D budgets in excess of $100 million must award a portion of their R&D funds to small businesses through the SBIR grants program.
  - Offers a uniform method by which each participating agency solicits, evaluates, and selects the research proposals for funding.

Table 11.2 - Federal Agencies Participating in Small Business Innovation Research Program

- Department of Defense (DOD)
- National Aeronautics and Space Administration (NASA)
- Department of Energy (DOE)
- Department of Health and Human Services (DHHS)
- National Science Foundation (NSF)
- U.S. Department of Agriculture (USDA)
- Department of Transportation (DOT)
- Nuclear Regulatory Commission (NRC)
- Environmental Protection Agency (EPA)
- Department of Education (DOED)
- Department of Commerce (DOC)

Government Grants (cont.)

- Phase I
  - Awards up to $100,000 for six months of feasibility-related experimental or theoretical research.
- Phase II
  - Awards are up to $750,000 for 24 months of further R&D.
  - Money is used to develop prototype products/ services.
- Phase III
  - Does not involve direct funding from the SBIR program.
  - Commercialization of technology through funds from private sector or regular government procurement contracts.

Government Grants (cont.)

- Procedure
  - Solicitations describing areas for funding are published by government agencies.
  - Proposal is submitted by a company or individual.
  - Screening of received proposals.
  - Evaluation of proposal on a technological basis.
  - Granting of awards based on potential for commercialization.
  - Research findings are owned by the company or individual, not by the government.

Government Grants (cont.)

- The Small Business Technology Transfer (STTR) program was established by the Small Business Technology Transfer Act of 1992.
  - Agencies that participate in the STTR program:
    - Department of Defense (DOD).
    - Department of Energy (DOE).
    - Department of Health and Human Services (DHHS).
    - National Aeronautics and Space Administration (NASA).
    - National Science Foundation (NSF).
  - The procedure for obtaining a STTR award is the same as for the SBIR award.

Government Grants (cont.)

- Other Government Grants
  - Available at the federal, state, and local levels.
  - The federal and some state governments provide training grants to companies locating in and/or hiring in labor surplus areas.
  - Many of the states and cities in the United States also have grant incentive programs.
  - Grants are also available in many countries and cities throughout the world.

Private Placement

- Types of Investors
  - Investor can influence nature and direction of the business.
  - May be involved in the business operation.
  - Entrepreneur needs to consider degree of involvement.
- Private Offerings
  - A formalized method for obtaining funds from private investors.
  - Faster and less costly.

Private Placement (cont.)

- Regulation D contains:
  - Broad provisions designed to simplify private offerings.
  - General definitions of what constitutes a private offering
  - Rule 504:
    - Sale of up to $500,000 of securities to any number of investors in any 12-month period.
    - No general advertising/ solicitation through public media.

Private Placement (cont.)

- Rule 505:
  - Sale of $5 million of unregistered securities in the private offering in any 12-month period.
  - No general advertising/ solicitation through public media.
  - Additional information must be disclosed if issuance involves unaccredited investors.
- Rule 506:
  - Sale of unlimited number of securities to 35 investors and an unlimited number of accredited investors and relatives of issuers.
  - No general advertising/ solicitation through public media.

Bootstrap Financing

- Outside capital:
  - Usually takes between three and six months to raise.
  - Often decreases a firm's drive for sales and profits.
  - Increases the impulse to spend.
  - Decreases the company's flexibility.
  - May cause disruption and problems in the venture.

Bootstrap Financing (cont.)

- Bootstrap financing involves using any possible method for conserving cash such as:
  - Use of discounts for volume.
  - Frequent customer discounts.
  - Promotional discounts.
  - “Obsolescence money”.
  - Savings through bulk packaging.
  - Consignment financing.