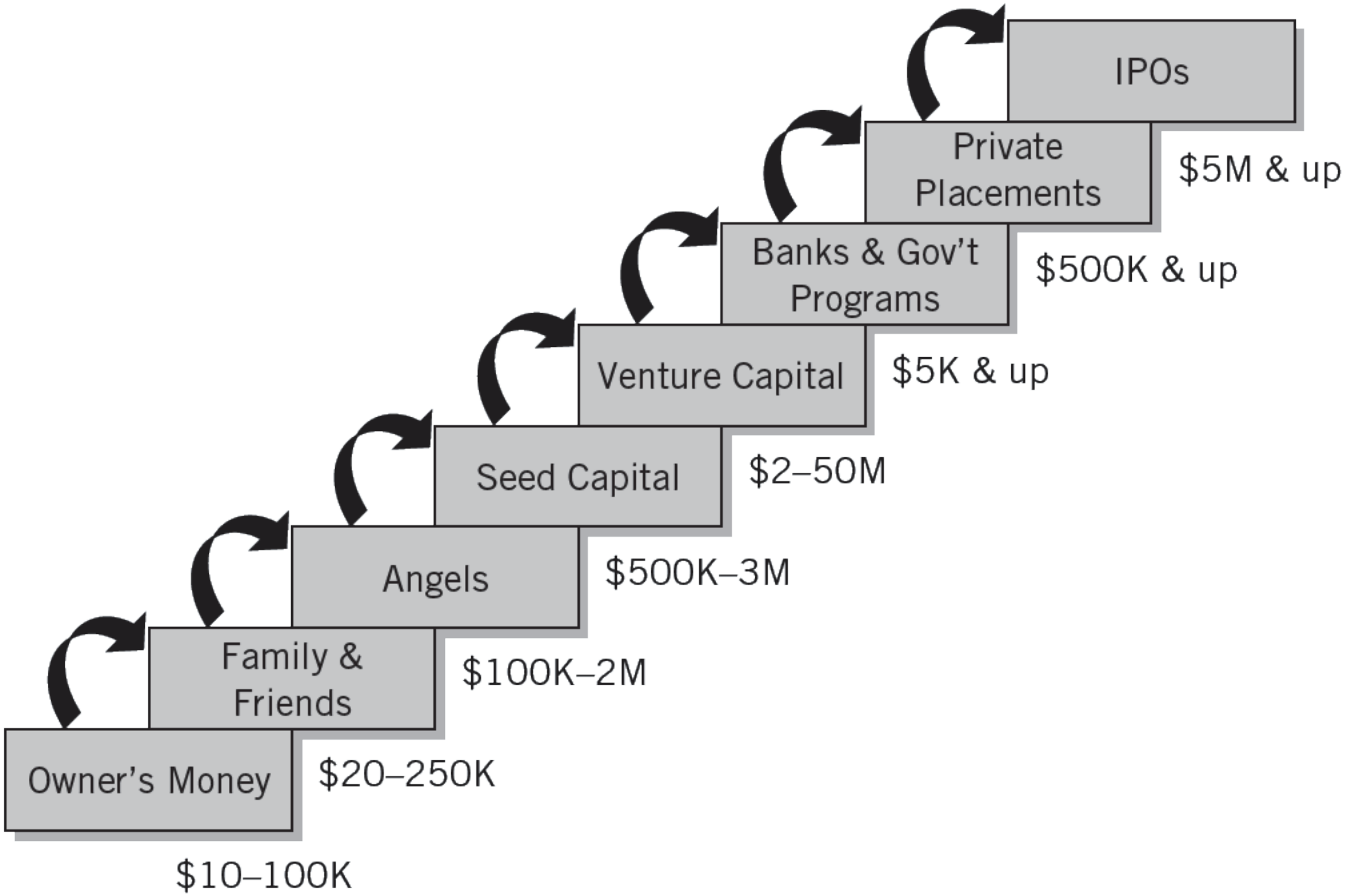
- SOURCES OF VENTURE CAPITAL FOR ENTREPRENEURS

Figure

Who Is Funding Entrepreneurial Start-Up Companies?

Financing Continuum

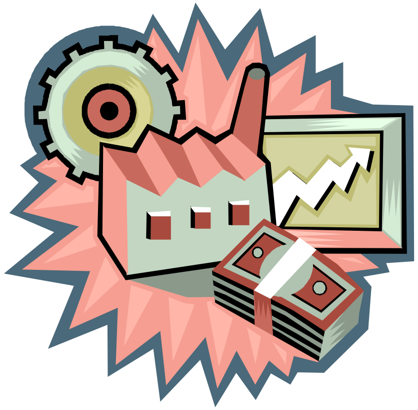
The following diagram depicts the typical financing for start-up companies.



Source: "Successful Angel Investing," Indiana Venture Center, March 2008.

Debt Versus Equity

- Debt Financing
  - Secured financing of a new venture that involves a payback of the funds plus a fee (interest for the use of the money).
- Equity Financing
  - Involves the sale (exchange) of some of the ownership interest in the venture in return for an unsecured investment in the firm.



Debt Financing

- Commercial Banks
  - Make 1-5 year intermediate-term loans secured by collateral (receivables, inventories, or other assets).
  - Questions in securing a loan:
    - What do you plan to do with the money?
    - How much do you need?
    - When do you need it?
    - How long will you need it?
    - How will you repay the loan?

Debt Financing (cont'd)

- **Advantages**
  - No relinquishment of ownership is required.
  - More borrowing allows for potentially greater return on equity.
  - During periods of low interest rates, the opportunity cost is justified since the cost of borrowing is low.
- **Disadvantages**
  - Regular (monthly) interest payments are required.
  - Continual cash-flow problems can be intensified because of payback responsibility.
  - Heavy use of debt can inhibit growth and development.

Table

Common Debt Sources

	Business Type Financed		Financing Term		
Debt Source	Start-Up Firm	Existing Firm	Short Term	Intermediate Term	Long Term
Trade credit	Yes	Yes	Yes	No	No
Commercial banks	Sometimes, but only if strong capital or collateral exists	Yes	Frequently	Sometimes	Seldom
Finance companies	Seldom	Yes	Most frequent	Yes	Seldom
Factors	Seldom	Yes	Most frequent	Seldom	No
Leasing companies	Seldom	Yes	No	Most frequent	Occasionally
Mutual savings banks and savings-and-loan associations	Seldom	Real estate ventures only	No	No	Real estate ventures only
Insurance companies	Rarely	Yes	No	No	Yes

Source: PricewaterhouseCoopers/National Venture Capital Association, MoneyTree™ Report, 2007.

Other Debt Financing Sources

- Trade Credit
  - Credit given by suppliers who sell goods on account.
- Accounts Receivable Financing
  - Short-term financing that involves either the pledge of receivables as collateral for a loan or the sale of receivables at a discounted value (factoring).
- Finance Companies
  - Asset-based lenders that lend money against assets such as receivables, inventory, and equipment.

Other Debt Financing Sources (cont'd)

- Equity Instruments
  - Give investors a share of the ownership.
    - ***Loan with warrants*** provide the investor with the right to buy stock at a fixed price at some future date.
    - ***Convertible debentures*** are unsecured loans that can be converted into stock.
    - ***Preferred stock*** is equity that gives investors a preferred place among the creditors in the event the venture is dissolved.
    - ***Common stock*** is the most basic form of ownership and is often are sold through public or private offerings.

Equity Financing

- Equity Financing
  - Money invested in the venture with no legal obligation for entrepreneurs to repay the principal amount or pay interest on it.
  - Funding sources: public offering and private placement
- Public Offering
  - "Going public" refers to a corporation's raising capital through the sale of securities on the stock markets.
    - Initial Public Offerings (IPOs): new issues of common stock

Public Offerings

- Advantages
  - Size of capital amount
  - Liquidity
  - Value
  - Image
- Disadvantages
  - Costs
  - Disclosure
  - Requirements
  - Shareholder pressure

Private Placements

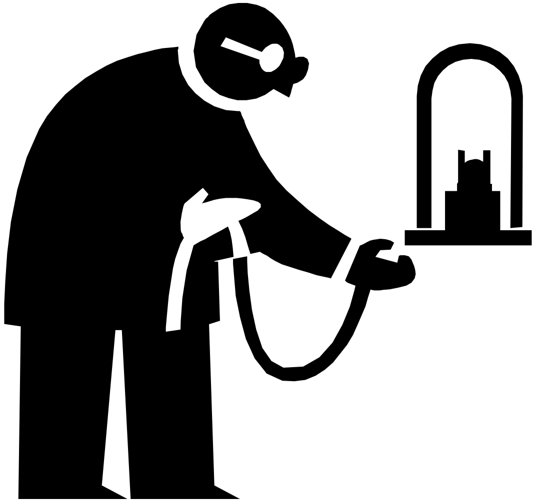
- Regulation D
  - Securities and Exchange Commission (SEC) regulations for reports and statements required when selling stock to private parties—friends, employees, customers, relatives, and professionals.
  - Defines four separate exemptions, which are based on the amount of money being raised:
    - Rule 504a: placements of less than $500,000
    - Rule 504: placements up to $1,000,000
    - Rule 505: placements of up to $5 million
    - Rule 506: placements in excess of $5 million

Private Placements (cont'd)

- Accredited Purchaser
  - Regulation D uses the term "accredited purchaser." Included in this category are the following:
    - Institutional investors such as banks, insurance companies, venture capital firms.
    - Any person who buys at least $150,000 of the offered security and whose net worth, including that of his or her spouse, is at least 5 times the purchase price.
    - Any person who, together with his or her spouse, has a net worth in excess of $1 million at the time of purchase.

Investors

- "Sophisticated" Investors
  - Wealthy individuals who invest regularly in new and early- and late-stage ventures and are knowledgeable about the technical and commercial opportunities and risks of the business in which they invest.



The Venture Capital Market

- Venture Capitalists
  - Are valuable and powerful source of equity funding for new ventures that provide:
    - Capital for start-ups and expansion
    - Market research and strategy
    - Management-consulting, audits and evaluation
    - Contacts—customers, suppliers, and businesspeople
    - Assistance in negotiating technical agreements
    - Help in establishing management and accounting controls
    - Help in employee recruitment and employee agreements
    - Help in risk management and with insurance programs
    - Counseling and guidance in complying with government regulations

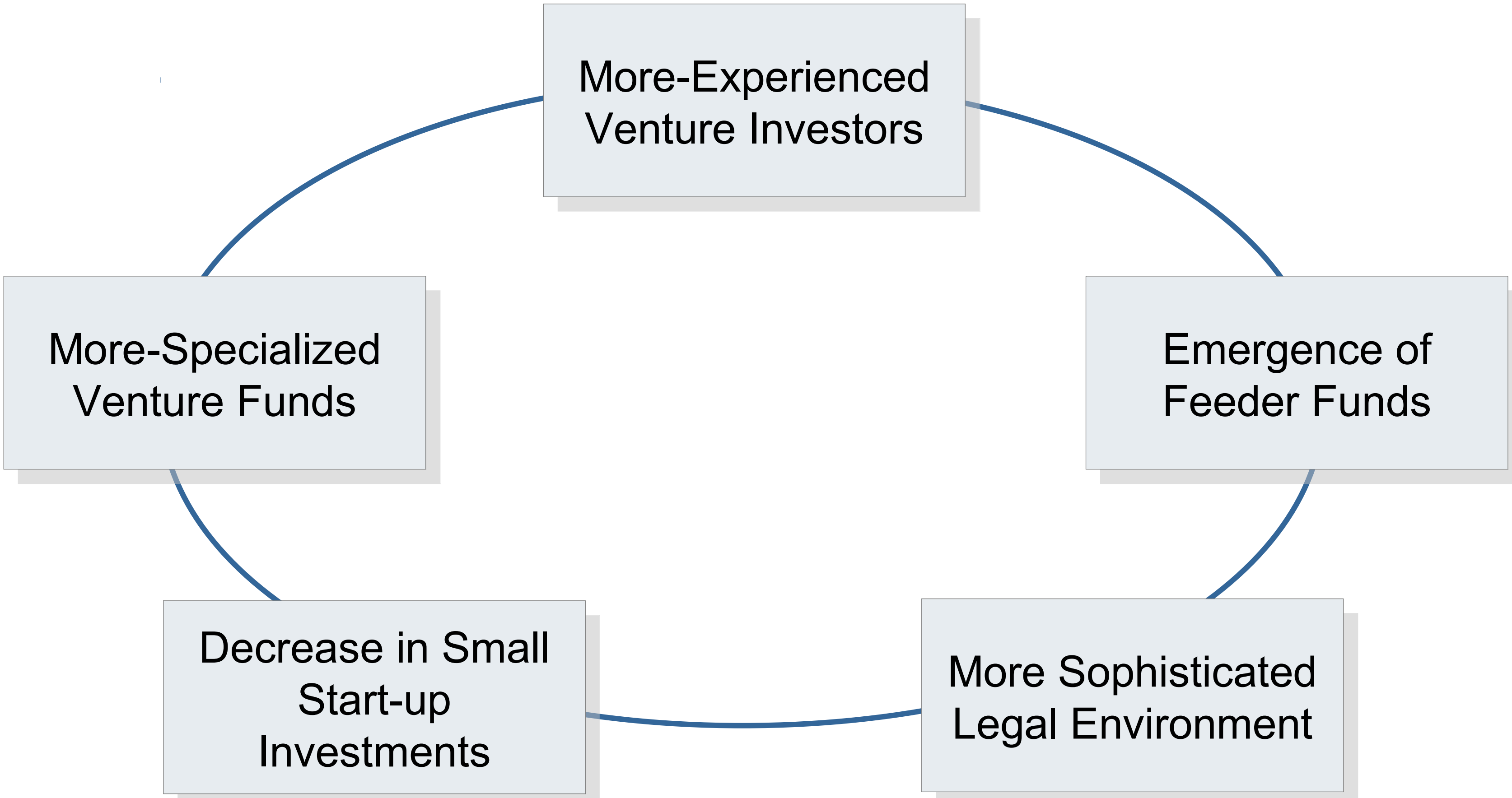
Table

Venture Capital Investments Comparison by Stages

Stage	Amount	Deals
Expansion	$10.8 billion	1,235
Later Stage	$12.2 billion	1,168
Early Stage	$5.2 billion	995
Start up/ Seed	$1.2 billion	415

****data from 2007**

Recent Developments in Venture Capital



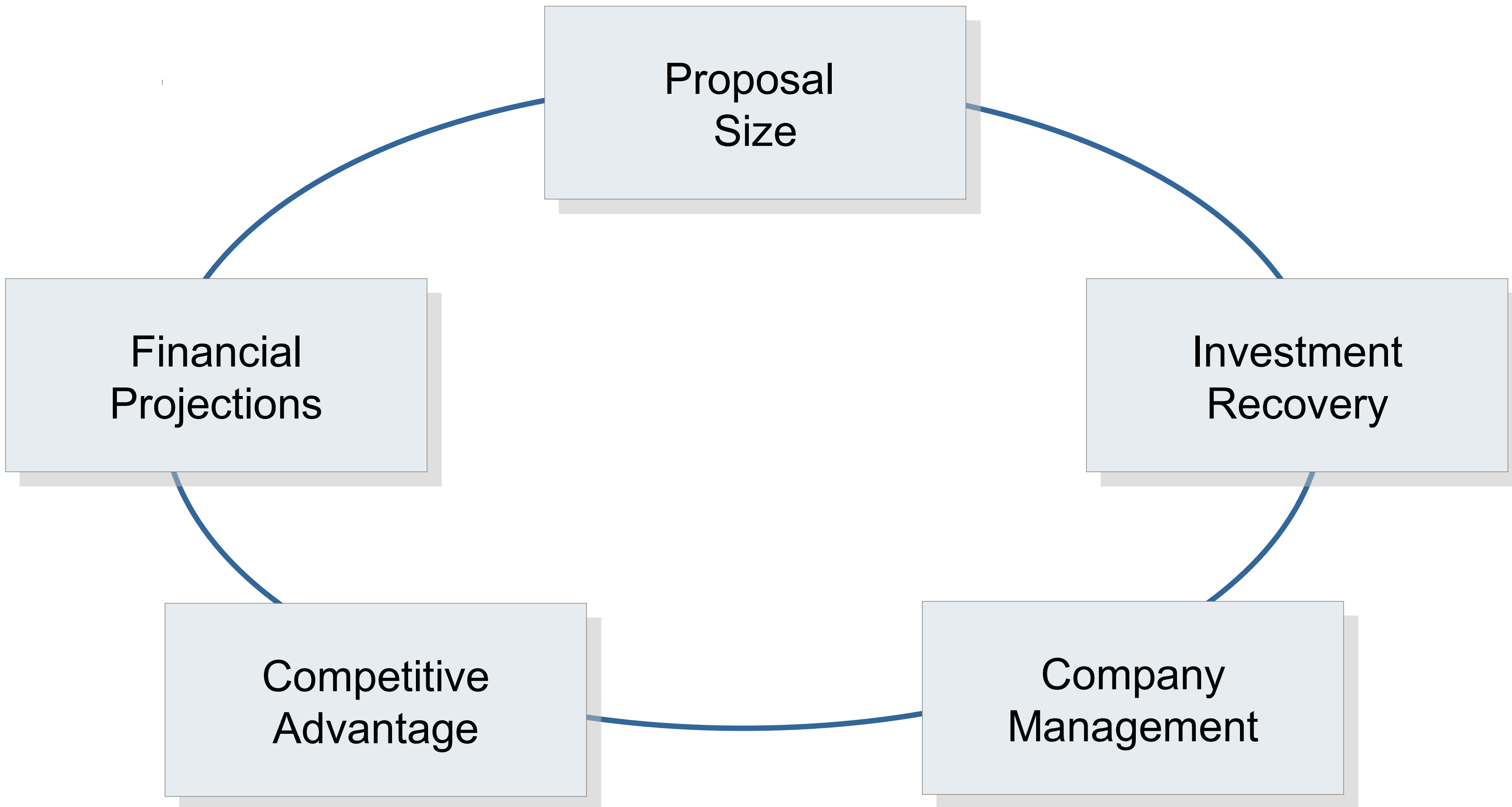
Investment Agreement Provisions

- Choice of securities
  - Preferred stock, common stock, convertible debt, and so forth
- Control issues
  - Who maintains voting power
- Evaluation issues and financial covenants
  - Ability to proceed with mergers and acquisitions
- Remedies for breach of contract
  - Rescission of the contract or monetary damages

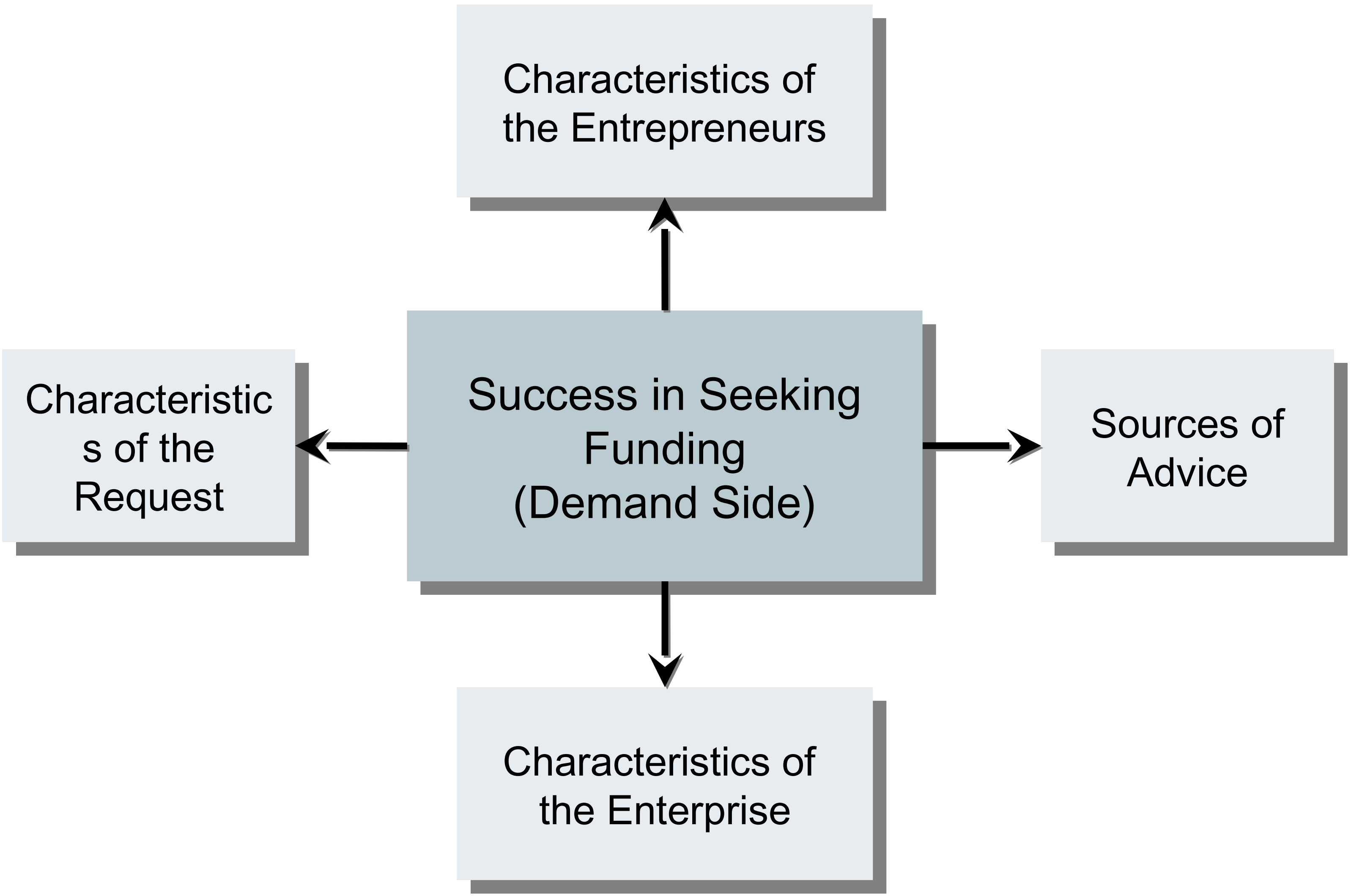
Dispelling Venture Capital Myths

- Myth 1: Venture capital firms want to own control of your company and tell you how to run the business.
- Myth 2: Venture capitalists are satisfied with a reasonable return on investment.
- Myth 3: Venture capitalists are quick to invest.
- Myth 4: Venture capitalists are interested in backing new ideas or high-technology inventions – management is a secondary consideration.
- Myth 5: Venture capitalists need only basic summary information before they make an investment.

Venture Capitalists and Business Plans



Factors in Successful Funding of Ventures



Figure

Venture Capitalist System of Evaluating Product/Service and Management

Status of Product/Service

Riskiest

Status of Product/Service				
Level 4 Fully developed product/service Established market Satisfied users	**4/1**	**4/2**	**4/3**	**4/4**
Level 3 Fully developed product/service Few users as of yet Market assumed	**3/1**	**3/2**	**3/3**	**3/4**
Level 2 Operable pilot or prototype Not yet developed for production Market assumed	**2/1**	**2/2**	**2/3**	**2/4**
Level 1 Product/service idea Not yet operable Market assumed	**1/1**	**1/2**	**1/3**	**1/4**
	Level 1 Individual founder/ entrepreneur	**Level 2** Two founders Other personnel not yet identified	**Level 3** Partial management team—members identified to join company when funding received	**Level 4** Fully staffed, experienced management team

Riskiest

Status of Management

Source: Stanley Rich and David Gumpert, *Business Plans That Win $$$* (New York: Harper & Row, 1985), 169.
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Table

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

Source: W. Keith Schilit, "How to Obtain Venture Capital," *Business Horizons* (May/June 1987): 78. Copyright © 1987 by the Foundation for the School of Business at Indiana University. Reprinted by permission.

Table

Factors in Venture Capitalists' Evaluation Process

Attribute	Level	Definition
Timing of entry	Pioneer	Enters a new industry first
	Late follower	Enters an industry late in the industry's stage of development
Key success factor stability	High	Requirements necessary for success will not change radically during industry development
	Low	Requirements necessary for success will change radically during industry development
Educational capability	High	Considerable resources and skills available to overcome market ignorance through education
	Low	Few resources or skills available to overcome market ignorance through education
Lead time	Long	An extended period of monopoly for the first entrant prior to competitors entering the industry
	Short	A minimal period of monopoly for the first entrant prior to competitors entering this industry

Source: Dean A. Shepherd, "Venture Capitalists' Introspection: A Comparison of 'In Use' and 'Espoused' Decision Policies," *Journal of Small Business Management* (April 1999): 76–87; and "Venture Capitalists' Assessment of New Venture Survival," *Management Science* (May 1999): 621–632. Reprinted by permission. Copyright 1999, the Institute for Operation Research and the Management Sciences (INFORMS), 7240 Parkway Drive, Suite 310, Hanover MD 21076 USA.

Table

Factors in Venture Capitalists' Evaluation Process (cont'd)

Attribute	Level	Definition
Competitive rivalry	High	Intense competition among industry members during industry development
	Low	Little competition among industry members during industry development
Entry wedge mimicry	High	Considerable imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, a franchisee
	Low	Minimal imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, introducing a new product
Scope	Broad	A firm that spreads its resources across a wide spectrum of the market—for example, many segments of the market
	Narrow	A firm that concentrates on intensively exploiting a small segment of the market—for example, targeting a niche
Industry-related competence	High	Venturer has considerable experience and knowledge with the industry being entered or a related industry
	Low	Venturer has minimal experience and knowledge with the industry being entered or related industry

Source: Dean A. Shepherd, "Venture Capitalists' Introspection: A Comparison of 'In Use' and 'Espoused' Decision Policies," *Journal of Small Business Management* (April 1999): 76–87; and "Venture Capitalists' Assessment of New Venture Survival," *Management Science* (May 1999): 621–632. Reprinted by permission. Copyright 1999, the Institute for Operation Research and the Management Sciences (INFORMS), 7240 Parkway Drive, Suite 310, Hanover MD 21076 USA.

Criteria for Evaluating New-Venture Proposals

- Major Categories of Venture Capitalist Screening Criteria:
  - Entrepreneur's personality
  - Entrepreneur's experience
  - Product or service characteristics
  - Market characteristics
  - Financial considerations
  - Nature of the venture team

Table

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

Source: Reprinted by permission of the publisher from "Criteria Used by Venture Capitalists to Evaluate New Venture Proposals," by Ian C. MacMillan, Robin Siegel, and P. N. Subba Narasimha, *Journal of Business Venturing* (winter 1985): 123. Copyright © 1985 by Elsevier Science Publishing Co., Inc.

Table

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 defendable 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

Source: John Hall and Charles W. Hofer, "Venture Capitalists' Decision Criteria in New Venture Evaluation," *Journal of Business Venturing* (January 1993): 37.

Venture Capitalist Evaluation Process

- Stage 1: Initial Screening
  - This is a quick review of the basic venture to see if it meets the venture capitalist's particular interests.
- Stage 2: Evaluation of the Business Plan
  - This is where a detailed reading of the plan is done in order to evaluate the factors mentioned earlier.
- Stage 3: Oral Presentation
  - The entrepreneur verbally presents the plan to the venture capitalist.
- Stage 4: Final Evaluation
  - After analyzing the plan and visiting with suppliers, customers, consultants, and others, the venture capitalist makes a final decision.

Table

Essential Elements for a Successful Presentation to a Venture Capitalist

TEAM MUST:
- Be able to adapt
- Know the competition
- Be able to manage rapid growth
- Be able to manage an industry leader
- Have relevant background and industry experience
- Show financial commitment to firm, not just sweat equity
- Be strong with a proven track record in the industry unless the company is a start-up or seed investment

MARKET MUST:
- Have current customers and the potential for many more
- Grow rapidly (25% to 45% per year)
- Have a potential market size in excess of $250 million
- Show where and how you are competing in the marketplace
- Have potential to become a market leader
- Outline any barriers to entry

PRODUCT MUST:
- Be real and work
- Be unique
- Be proprietary
- Meet a well-defined need in the marketplace
- Demonstrate potential for product expansion, to avoid being a one-product company
- Emphasize usability
- Solve a problem or improve a process significantly
- Be for mass production with potential for cost reduction

BUSINESS PLAN MUST:
- Tell the full story, not just one chapter
- Promote a company, not just a product
- Be compelling
- Show the potential for rapid growth and knowledge of your industry, especially competition and market vision
- Include milestones for measuring performance
- Show how you plan to beat or exceed those milestones
- Address all of the key areas
- Detail projections and assumptions; be realistic
- Serve as a sales document
- Include a strong and well-written executive summary
- Show excitement and color
- Show superior rate of return (a minimum of 30% to 40% per year) with a clear exit strategy

Source: Andrew J. Sherman, Raising Capital, 2nd ed. AMACOM Books, 2005; p.175.

Informal Risk Capital

- Business Angel Financing
  - Wealthy individuals in the United States are looking for investment opportunities.
    - They are referred to as “business angels” or informal risk capitalists.
- Types of Angel Investors
  - Corporate angels
  - Entrepreneurial angels
  - Enthusiast angles
  - Micromanagement angels
  - Professional angels

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

Source: Mark Van Osnabrugge and Robert J. Robinson, *Angel Investing* (San Francisco: Jossey-Bass, 2000), 111. This material is used by permission of John Wiley & Sons, Inc.

Table

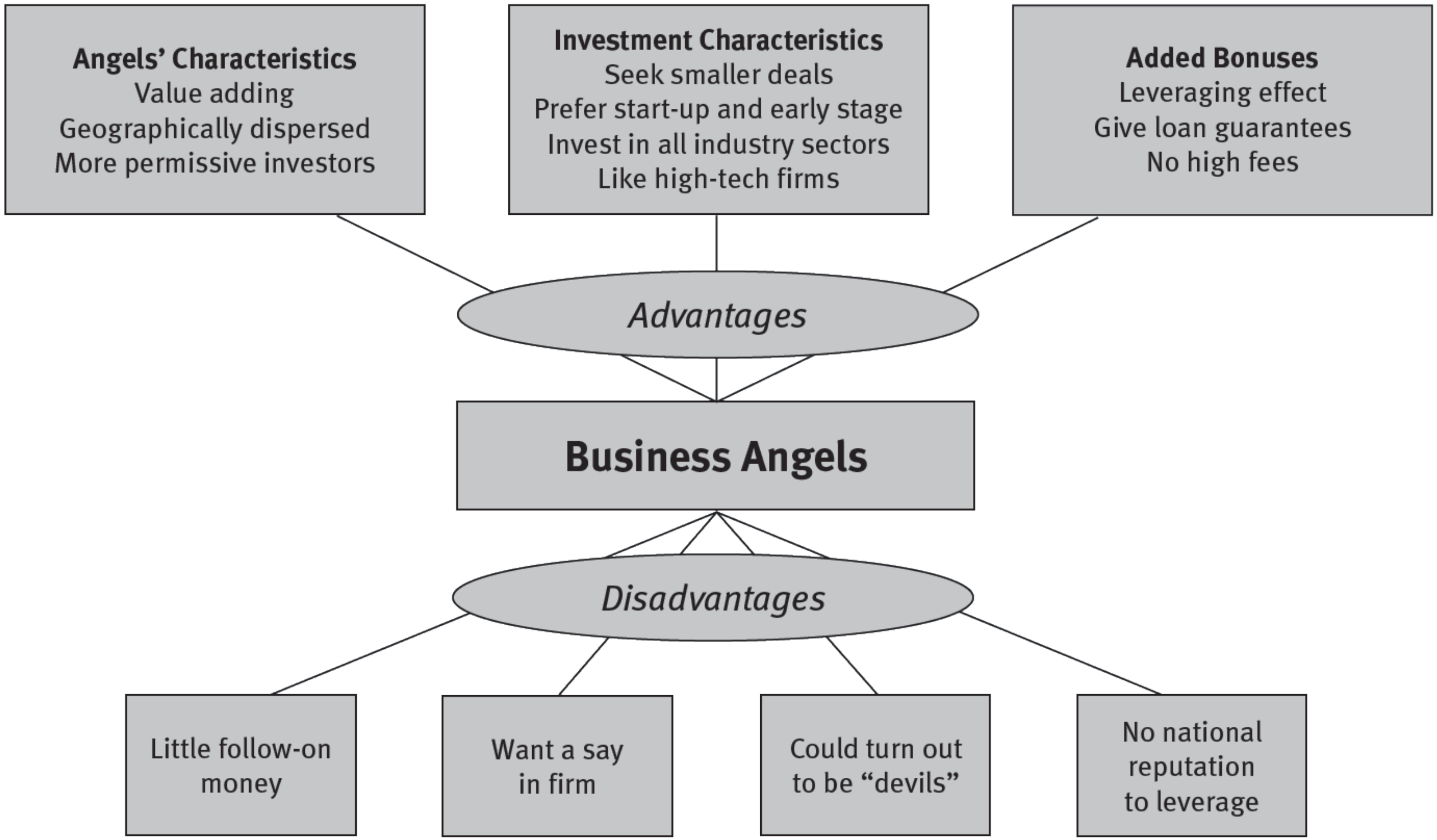
"Angel Stats"

Typical deal size	$250,000
Typical recipient	Start-up firms
Cash-out time frame	5 to 7 years
Expected return	35 to 50% a year
Ownership stake	Less than 50%

Source: William E. Wetzel, University of New Hampshire's Center for Venture Research, and the Indiana Venture Center, 2008.

Figure

The Pros and Cons of Business Angel Investments



Source: Mark Van Osnabrugge and Robert J. Robinson, *Angel Investing* (San Francisco: Jossey-Bass, 2000), 64. This material is used by permission of John Wiley & Sons, Inc.

Key Terms and Concepts

- accounts receivable financing
- accredited purchaser
- angel capital
- business angel
- debt financing
- equity financing
- factoring
- finance companies
- informal risk capitalist
- initial public offering (IPO)
- private placement
- Regulation D
- sophisticated investor
- trade credit
- venture capitalist