CHAPTER 18
FINANCING START-UP AND GROWTH

Author's Note

Finding money for a new venture or a growing one is always a topic of great interest to students. If the first question they typically ask is, "Where will I find an idea for a business?" the second is certainly, "Where will I find the money to get started?" With that in mind, the purpose of this chapter is to give students an optimistic yet realistic view of sources of money at the start-up stage and then at the growth stage. The premise is that, if the new venture makes it through the start-up phase, many more financial resources become available.

For start-up financing, the chapter focuses on bootstrapping techniques, recognizing that the average new venture cannot attract professional capital. We believe that finding a way to start with the least amount of capital possible and giving up little or no equity, gives the entrepreneur a chance to build a venture to the stage where he or she has more clout when seeking growth funding.

The chapter also looks at valuing a business, an important skill that will be needed should the entrepreneur wish to sell the venture or if buying a business is the entry strategy to business ownership.

Learning Objectives

This chapter will give students an understanding of:

- Why it's important to start the money hunt with a plan
- How start-ups are financed
- How to finance growth
- Methods for valuing the business

Supplementary Lecture Material

Venture Capital Has Fallen on Hard Times

Everything cycles but, in recent times, venture capital funds have suffered from poor investments in dot coms and technology. In 2002, the level of venture capital funding reached lows not seen since 1997. In the first quarter of 2002, VCs invested about $5.1 billion in young companies for 495 financing rounds, only 19 rounds more than the same period in 1997.

With merger activity in decline, the Nasdaq trending downward, and successful IPOs almost a memory, total VC funding is down 26 percent, 72 percent lower than the level of funds commited to investing in the fourth quarter of 2001. In the first quarter of 2002, only four VC-backed companies managed to go public, raising $345 million. Compare that with the fourth quarter of 1999 when 77 companies went public and raised $7.4 billion.

While all this may sound like doom and gloom, there is actually a bright side. VC portfolios are becoming smaller and healthier, so the industry in general is moving toward more efficiency. The decline in venture investing is also a signal that the limited partners that invest in the VC funds are exerting more control over the goals of the fund. Some of the billion-dollar funds like Kleiner Perkins

Caufied & Byers have found that their limited partners have changed the game, reducing the amount the fund is able to invest. What this means to entrepreneurs who, by the nature of their start-ups typically seek venture capital, is that the VCs are looking far more critically at the investment, and the entrepreneur is under far more pressure to prove that he has a compelling story and a realistic execution plan.

Source: Ari Weinberg, "Venture Capital on the Rocks," Forbes, April 30, 2002.

Films to Rent

Silicon Valley: 1970s – 1990s

Silicon Valley is a place without the normal business rules, where risk has been the culture since this high-tech area of northern California was born. Using high-tech entrepreneurs, the film discusses the entrepreneurial spirit and the challenges of funding high-tech start-ups.

www.films.com
Item: **BVL9083**
Format: **VHS**
List Price: **$89.95**

Cases Relevant to This Chapter

Franchising a Dying Business

Overnite Express

Earthlink.net: The Journey to Recognizing an Opportunity

Alcoholes de Centroamerica, S.A. de C.V.

Wizards of the Coast

Answers to Issues to Consider

1. *How does bootstrap financing fit into the strategic plan of a new venture?*

   Bootstrapping is a critical part of a new-venture strategy because, at the earliest stages of the venture, it is difficult to raise capital from outside investors or debt financing sources.

2. *What is the role of angels as a source of new venture funding?*

   Angels are typically former entrepreneurs who comprise the informal risk-capital market. They are more likely to invest in early stage ventures than are professional venture capitalists. They generally take an interest in mentoring the entrepreneur, and they usually stay with the venture longer than would a VC.

3. *At what stage of venture development do venture capitalists typically become involved, and why?*

   Venture capitalists typically become involved at the second-round financing of high-growth ventures because the business now has a small track record and proven performance; therefore, a lot of the risk of start-up has been reduced. Some VCs, however, do provide funding at the seed stage for high-tech ventures that hold particular promise for a big hit.

4. *Why are commercial banks not usually a reliable source of new venture financing?*

   Commercial banks are highly regulated and do not like to take risk. Therefore, they like to see a track record of positive cash flow so they can feel comfortable that the entrepreneur can pay off any loans they issue.

5. *Why should a private offering be used as a capital-raising vehicle before a public offering is used?*

   Often a private offering is used first because, to complete it, a growing venture is not required to have a great many assets or credit references, which it would need for bank financing, or a lengthy track record. The entrepreneur does not have to file with the SEC if the venture qualifies under the rules of Federal Regulation D, so it's easier and less expensive for smaller companies to sell stock.

6. *For what kind of business would private venture capital be a logical financial strategy for growth? Why?*

   Businesses that need at least $2 million in capital and are high-growth companies with intellectual property and a defined exit strategy or liquidity event within five years are the best bets for a VC investment.

7. *How can strategic alliances be used to help grow the business?*

   Strategic alliances can be used to structure deals with suppliers or customers that will help reduce expenditures for marketing, raw materials, or R&D. They can help a new or growing business to move into the market more rapidly and provide expertise that the entrepreneur doesn't have.

8. *What are some things that should be done to prepare for a public offering before the year of "going public"?*

   To prepare for a public offering, the entrepreneur should spend the year prior to the offering talking with others who have gone through the process, reading, and putting together the team that will see the company through it. Another way to speed up the process and add to its potential success is to start running the private corporation like a public corporation from the beginning; that is, doing audited financial statements and keeping good records.

9. *In approaching a venture capitalist, how can the entrepreneurial team deal from a position of strength?*

   The entrepreneur should approach a VC through a referral from someone who knows the VC and be prepared to show that the business will achieve high growth and return the VC enough gain on his or her investment to make up for all the average or mediocre-performing investments in his or her portfolio.

10. *What are the key components in valuing a new or growing venture?*

    The key components are earnings, assets, going concern value, liquidation value, investment value, intrinsic value, and fair market value. Today some nonfinancial yardsticks are also important: the experience level of the management team, the innovative level of the firm's distribution channels, the nature of its relationships in the industry and with customers, the company's ability to be fast and flexible, and the amount and kind of its intellectual property.

Suggestions for Experiencing Entrepreneurship

1. *Define a venture concept that interests you. Then develop a timeline and financial strategy for the venture.*

   Students should consider at what points their particular venture will likely require capital and the events that will trigger that need. Then they need to determine the types of capital that are appropriate for a particular stage in the venture's evolution.

2. *Interview a venture capitalist or an angel (preferably both) to learn their expectations when they are reviewing business plans for new ventures.*

   Encourage students to do both so that they can compare and contrast the needs and requirements of each. Students often talk about needing venture capital to start a business. Interviewing a venture capitalist is one way to dispel the notion that venture capital is a primary source of funding for most businesses.