FINANCING STRATEGY

Entrepreneurship: Starting and Operating a Small Business, 3/e
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FINANCING STRATEGY

UNIT 3 • SHOW ME THE MONEY: FINDING, SECURING, AND MANAGING IT

Performance Objectives

After this lecture, you should be able to complete the following Performance Objectives

1. Explore your financing preferences.
2. Identify the types of business financing.
3. Compare the pros and cons of debt and equity financing.
4. Identify sources of capital for your business.
5. Understand stocks and bonds as investment alternatives.

10 Going It Alone versus Securing Financing

Financing – the act of providing or raising funds (capital) for a purpose.
Ways to obtain capital for a business:
1. Obtain gifts & grants
2. Borrow money (debt)
3. Exchange a share of the business for money (equity)

10 How often Do Small Businesses Really Fail

Creditor – person or organization that is owed money.
20 -25 percent of businesses were closed during the first eight years of business because of bankruptcy. The other 75 – 89 percent were terminations because:
- Business that were sold to new owners
- Businesses that changed operations
- Closed when the owners retired or moved on to other businesses.

10 What Is the Best Type of Financing for you and Your Business

Risk Tolerance – the amount of risk or threat of loss that an individual is willing to sustain.
Three ways for a business to raise the capital to grow:
1. Finance with earnings
2. Finance with equity
3. Finance with debt

10 Gifts & Grants

Don’t stake your business on these Gifts
- Cash, free facilities & equipment, unpaid labor from friends & family, & forgiveness of debts
- Tax abatements - legal reduction in taxes.
- Tax credits – direct reduction of taxes.

Grants
- Primarily for research & commercialization
- Difficult to get for low-tech, start-ups

Gifts & grants do not require repayment
One challenge that you may face is determining what type of debt financing to pursue and preferences and the options available to you. Your lenders will want to know what you own, what you owe, and what your business finances are.

Debt Financing: Pros and Cons

Pros:
- Lender has no say in operation of business
- Loan payments are predictable
- Lenders do not share business profits

Cons:
- If loan payments are not made, lender can force business into bankruptcy
- If business is not incorporated & defaults, lender can take house & other possessions of owner
- Loan payments increase fixed costs, lower profit

Available in many forms
- Commercial loans
- Personal loans
- Leases
- Bonds

Promissory Note – a loan document that is a written promise to pay a specific sum of money on or before a particular date.

Principal – the amount of a loan before interest and fees are added.

Leveraged – financed by debt, as opposed to equity.

Default – the result of a borrower failing to meet the repayment agreement on a debt.

Equity Financing: Pros & Cons

Equity means that, in return for money, an investor will receive a percentage of ownership in a company.

Equity Financing: Pros & Cons

Equity Advantages:
- If business does not make profit, investor does not get paid.
- There are no required regular payments in the form of principal or interest, and dividends for common shareholders are distributed at the discretion of the board of directors.
- The equity investor cannot force the business into bankruptcy in order to recoup the investment.
- Equity investors have an interest in seeing the business succeed and may offer helpful advice and valuable contacts.

Equity Disadvantages:
- If give up too much ownership, entrepreneur can lose control of business to equity holders.
- Even with small amounts of equity, investors may interfere with the business via unsolicited advice and/or continuous inquiries.
- Equity Investor takes more risk, wants higher returns
- Entrepreneur must share profits with equity investors

Having an Excellent Business Plan
How Capital Sources Read Your Business Plan
Family & Friends

Where & How to Find Capital That Works for You
Financial Institutions & Dimensions of Credit

Bankers operate on the principles of the Five C’s of credit:
1. Collateral
2. Character (credit history, credit reporting agency)
3. Capacity (debt service)
4. Capital
5. Conditions

Community Development Financial Institutions (CDFIs)

- Community Development Banks
- Community Development Credit Unions
- Community Development Loan Funds
- Community Development Venture Capital Funds

Venture Capitalists & Angels

Venture capitalists – an investor or investment company whose specialty is financing new, high-potential entrepreneurial companies and second-stage companies.
- Venture capitalists typically reap the return on their equity investments in one of two ways:
  1. By selling their percentage share of the business to another investor through a private transaction, or
  2. By waiting until the company goes public and trading their ownership shares for cash by selling them.

Venture Capitalists
- Policy loan (a loan made against an insurance policy with cash value).
- Vendor Financing
  - Float (the time between a payment transaction and when the cash is actually in the payee’s account.)

Other Creative Financing

Federally supported investment companies (SBICS, MESBICS, New Market Venture Companies)
- Financing for Rural/Agricultural Businesses
- Youth Financing
- Self-Funding: Bootstrap financing
  - Bootstrap financing – funding a business by creatively stretching existing capital as far as possible, including extensive use of the entrepreneur’s time.

Accessing Sources through Online Networking

The internet is an important extension to your options for networking.
You can search for angels and connect with other entrepreneurs online. Use search engines such as: Google, Bing, Excite, and Yahoo! to find Websites such as Entrepreneurs’ Organization.
Investors Want Their Money to Grow: Can You Make It Happen?

Three Categories of financial investments:
1. **Stocks**—shares of company ownership (equity)
2. **Bonds**—loans (debts) made to companies or government entities for more than one year.
3. **Cash**—Savings accounts, Treasury bills, or other investments that can be liquidated (turned into cash) within 24 hours.

*The higher the reward an investment offers, the greater the risk.*

**How Stocks Work**

Share - a single unit of corporate stock.
Shares of stock represent a percentage ownership in a corporation.
Public corporations sell stock to the general public to raise capital.
Prices of stocks reflect investors’ opinions about business performance & value.
Traded on stock exchanges.

**How Bonds Work**

Interest bearing certificates that corporations & governments issue to raise capital.
Lower risk & return expected than with stocks.
A form of debt financing with a guaranteed rate of return to investors.

**Bonds**

Securities – investment instruments representing ownership in an entity (stock) or debt (bond) held by an investor.
Maturity – the date at which a loan must be repaid, including when a bond must be redeemed by the issuer.
Face Value – the amount of a bond, also known as par, to be repaid by a corporation or government at its maturity date.
Par – the face value of a bond (typically $1,000) and the stated value of a stock.
Premium – (regarding bonds) the amount above par for which a bond is trading in the market.
Discount – (regarding bonds) the difference between a bond’s trading price and its par value when the trading price is below par.

**KEY TERMS**

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<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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</thead>
<tbody>
<tr>
<td>angel investor</td>
<td>Par personal guarantee</td>
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<tr>
<td>bootstrap financing</td>
<td>policy loan</td>
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<td>premium</td>
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<td>principal</td>
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<td>promissory note</td>
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