Creating and Managing Entrepreneurial Ventures

New Venture Financing
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FEUNL
New Venture Financing
Funding options for early-stage companies

• Do not found yet: stay at University
• Government Funding
• Founders
  – Personal savings, second mortgages, credit cards
• Family
• Friends
• Angel investors
• Angel circles
• Early-stage venture capitalists
Seed Funding: the “bootstrapping”

• Founders
  – Use your own assets (garage companies)
  – Cash: Accumulated savings; credit card (not recommended)
  – Take a second mortgage on your home

• Friends and Family
  – Are they ideal investors? (what if it goes wrong?)
    • Would you like to have your mother in law as an investor?
  – Can they provide collateral for a loan? (what if it goes wrong?)
  – Can they open any doors? Where: banks, VC’s; customers; suppliers

• Crowdfunding?
  – How may a crowdfunding investor monitor and add value?
  – Perverse incentives?
Seed Funding

• Suppliers
  – Negotiate credit terms (pay at the last allowed date)
    • What if they demand letters of credit?
  – Make them see you as a strategic partner
  – Do you want them as an investor?

• Under which terms?
  • How will potential future investors (VCs?) react?

• Customers
  – Make them see you as a strategic partner
    • In other words, convince them to pay fast or to finance your purchases
  – Do you want them as an investor?
Seed Funding

- Internally-generated cash-flow
  - At initial stages do not concentrate exclusively on R&D, etc - Try to generate cash-flow from sales of services

- Cash-management
  - At early stages cash is a very scarce commodity: save-it
    - Limit your costs to the absolute minimum
      - Starting with your own salary
    - Negotiate generous paying terms with suppliers
    - Don’t sell on credit, unless you have no other choice
    - Minimise your inventory; be as “just in time as possible”
  - One day you’ll have to decide which bills not to pay
    - Be careful to avoid harming strategic relationships or/and bankruptcy or even personal liability
Seed Funding: Debt

- Asset-based lending
  - Leasing vs buy
    - Flexibility: if you lease is easier to abandon the (bad) investment
  - Inventory financing
    - Typically via short-term credit lines secured by inventory
    - Better keep inventory under strict control and make sure you’re not selling on credit…
- Factoring of receivables
- Other credit lines
  - Typically they are short-term and with covenants attached
  - You may be required to pledge your own assets and other forms of personal guarantees. Are you willing to take that risk? Do you fully understand the consequences?
Is bank credit an alternative at early-stages?

• Companies lacking track-record may fail to attract traditional unsecured bank loans due to their high-risk

• Some bank lending possible, but:
  – Increases your firm’s (and yourself’s) bankruptcy risk
  – Imposes an extra cash-outflow: interest payments
  – May hinder future growth prospects

• Bank guarantees sometimes possible, especially letters of credit to support imports
  – Remember that defaulting on them is more dangerous that delaying a supplier’s payment

• Debt should be avoided by firms facing:
  – High risk; High growth prospects; high “burn rate”
Why don’t startups get bank financing?

“A bank is a place that will lend you money if you can prove that you don’t need it.”

— Bob Hope
Later Stages

• At startup and future rounds, the required amounts of finance substantially increase, demanding the participation of “deeper pockets” more sophisticated investors. Typically:
  – Business Angels (at startup)
  – Venture Capital Funds
  – Venture debt
  – Corporate strategic investors
  – Banks (especially at later stages)
Angel financing - who are these angels?

• High net worth individual who invests a portion of his wealth in startup companies aiming at profiting at exit
  – They are a very diverse (risk-prone) group
  – Typically invest on industries they understand
  – Tend to invest in very early-stages
  – Use terms and conditions much more “informal” than those of venture capital firms
    • Typically invest in straight equity
  – May contribute with connections and advice
    • Being shareholders they have incentive to promote company value
    • May even source for later rounds (VC, banks, etc)
  – Some are successful entrepreneurs themselves
• Usually organised in Angel Circles
Angel types

- Relevant entrepreneurial experience
- Relevant industry experience

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Angels vs VC

• Advantages of Angel financing
  – Simpler investment structures (equity)
  – Often pay more than professional VC’s
  – More available for small amounts of funding
  – Minimal due-diligence and deal negotiation

• Disadvantages
  – Inadequate when large amounts of capital are required
  – VC-backed firms seem to outperform angel-backed
    • Size and/or more professional/”hands-on” VC approach (do VC’s outperform angels at selecting their investments?)
  – Handling information to a large group of individuals
Venture Capital
What is venture capital?

• VC is capital devoted to high-risk investments
  – Typically, recent firms with innovative (uncertain) projects
  – Because risk is too high, expected returns must be consistently high (average: 30%-60%)
    • VC investors expect, on average, a very high return
    • VC investors anticipate that a high percentage (2/3) of their investments will be liquidated or generate negative returns
    • Therefore, the few highly successful projects must generate extremely high returns (> 300%)
    • Thus, prices paid by VC investors must be low enough to generate expected IRR’s consistent with these goals
The organisation of VC investments

• Typically, VC (and PE) firms are partnerships who make no direct investments
  – (general) Partners are experienced on the type of investment they will be responsible for
    • Sector, regional or corporate finance experts

• Investments are made through VC Funds
  – General partners create, manage and liquidate funds
  – VC funds are funded by investors (limited partners)
Size and growth potential

- VC firms will only invest if the target has reached a minimum size and has the potential to grow to (at least) a certain minimum size:
  - Fixed-costs associated with each deal mean that below a certain break-even size it is not (for the general partners) profitable to invest
  - This rules-out most seed financing
  - Firm must grow in order to add sufficient value and generate the required rate of return
  - There is a minimum size to allow for an IPO
    - Cost dilution, liquidity float, etc
The Business Plan Funnel

100 business plans come in

10 are a good fit and promising —
they get a close look

Extensive due diligence

1 gets funded
Due - diligence

• The purpose is to determine the attractiveness, risks and issues regarding a transaction
  – Knowledge gained in the process helps to structure deal
• Issues:
  – Background – what are people’s *real* motivations?
  – Products and services, how well developed are they?
  – What is the market, growth, competition, etc
  – Technology; how much innovative and proprietary?
  – Strategy, marketing?
  – Organisation and management
  – Financial history, financial management, cash-flow prospects
“I call my invention ‘The Wheel,’ but so far I’ve been unable to attract any venture capital.”

FORBES • November 1, 2004
Value added by VC investing

• Focus: Selecting investments based on the general partners’ field of expertise (industry; stage; regional; etc) / 1-hour flight rule

• Deal structuring
  – Structuring deals in such a way to make sure all parties have the right incentives (contracts)
  – Making sure that VC’s position is protected: paid the “right price”; anti-dilution provisions; shareholder’s agreement; invested on the right type of securities (convertible, etc)

• Advice

• Connections
  – Potential customers, suppliers, strategic partners
VD deals are very complex

- VC’s invest in preferential shares
  - Means they have preferential rights
  - Typically they protect themselves against downside
    - "anti-dilution" protection
  - They may force you to repay their shares under special "liquidation events"
  - The way the proceeds from the sale are shared depends on how much value was created
  - They typically demand control of the Board of Directors, veto power on critical decisions
DOGBERT, VENTURE CAPITALIST

I'LL INVEST UP TO FIVE MILLION DOLLARS IF YOU'LL AGREE TO SOME STANDARD CONDITIONS.

I WILL BE CHAIRMAN OF THE BOARD AND OWN 99% OF THE COMPANY. YOU WILL WORK FOR FREE AND WASH MY CAR TWICE A WEEK.

CAN I MOW YOUR LAWN INSTEAD OF WASHING YOUR CAR?

YOU'RE A TOUGH BARGAINER, BUT I PREFER MULTIMEDIA DEVELOPERS FOR MY GARDENING NEEDS.
Harvesting

- Harvesting the investment may be achieved in different ways:
  - IPO
  - Trade sale
  - Management buy-out (MBO)
  - Redemption of securities
  - Sale to another venture capitalist (or Private Equity)
  - Write-off
When to harvest?

• Typically, harvest has to occur within a specific time period
• Theoretically, the harvesting process begins even before the investment is approved (looking for alternative way-outs)
• The ideal timing would happen when the company has reached the “right-size” to be an IPO and/or acquisition candidate and the stock market is particularly “hot”
• In principle, after 4/5 years the VC should evaluate whether or not the IPO route makes sense and/or start looking for potential private buyers.