MODERN VENTURE FINANCING OPTIONS IN THE U.S.A.

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Abstract

This article involves discovering the prospective financing option in the United States of America. The main objective is to show how start-ups as well as the operating companies can obtain much needed capital sources in today's high competitive economic world. The article looks at self- financing, personal assets, retirement plans, entrepreneurs' assets as a way of getting financed and discusses the advantages and disadvantages of the options. This article will identify which financing options are most relevant at different stages of the firms.

Key words: venture financing, self-finance, investment, entrepreneur, business angels

JEL Classification Codes: G24

In the journey of starting a new business, every entrepreneur starts out in the same place: with an idea and a dream. The next step on the road to business success is figuring out where the money will come from to fund it. Self–financing is the number one financing method used during the early life cycle stages. The advantage of self –financing is it gives full control to entrepreneur over business (Cornwall J. 2008). It also shows bankers, lenders and investors that

entrepreneur is serious and confident. Most bankers and lenders are not interested in giving loans to startups. For this reasons, self-financing plays an enormous role in company's early life time.

Personal assets, such as savings accounts, equity in real estate, retirement accounts, vehicles, recreational equipment and collections are the most common initial source of business start – up money (Cornwall J. 2008). Thousands of successful businesses have been started on personal credit cards. While this is one of the most expensive ways to self-finance due to credit card interest rates, this remains one of the most popular resources for new entrepreneurs. Some life insurance policies offer the ability to borrow against the cash-value of the policy. These loans usually carry reasonable interest rates. Since the amount borrowed will be deducted from the death benefit, borrower does not have to pay it back (Cornwall J. 2008).

Retirement plans are another option. If the entrepreneur has retirement plan and is starting a part-time business, then he/she can borrow against this plan and start financing the new business. It's very common for such plans to allow you to borrow up to 50 percent of your vested account balance up to a maximum of $50,000. The interest rate is usually one to two percent above prime rate with a specified repayment schedule. The downside of borrowing from your 401(k) is that if you lose your job, the loan has to be repaid in a short period of time-often 60 days. ("Self-financing your business" Entrepreneur May 2013).

There are a number of benefits of going down this route. Firstly, using entrepreneur's assets is the easiest and quickest money to secure. Nobody has to be convinced and no approval process is required. Although using self-assets can take more time to start, it allows entrepreneur to have a full control on product or service (Cornwall J. 2008). If entrepreneurs seek outside financing, potential financiers want to see that owners are responsible enough to trust with their money. They will be more willing to invest if business owners do first.

Even though there are limited outside first-round financing sources, entrepreneurs should compare all the advantages and advantages of personal assets and outside investment. Using self-assets allow all of the profits and wealth go to the entrepreneur. At the same time, it avoids the difficulty of adding more shareholders. With more partners the entrepreneur has to grow a business larger to meet his personal goals for income and wealth plus those of the other partners.

There also some disadvantages of using entrepreneur's assets. First of all, limited funds might limit the growth of business. On the other hand, when entrepreneur used own assets then he/she is the only one at risk. If the venture fails, all of the consequences are the entrepreneur's to deal with. In addition, the entrepreneur may not have all of the skills, knowledge and experience needed to successful launch and grow the venture. However having professional investors involved in your business venture gives you access to valuable business advice and social capital.

Asking friends and families to invest is another common way that start-ups are funded. "Unfortunately in today's economy, in many cases, asking friends and family for money is the only way a small business startup can get funding," said Bob Shephard, director of community partnerships at the National Entrepreneur Center (NEC). According to the National Small Business Association, in 2013, 16 percent of business owners reported turning to friends and family for loans to cover their costs.

Family and friends are still one of the best sources, entrepreneurs tend to raise money from relatives, colleagues and other people they know well (The Wall Street Journal 2010). While some startups are financed with capital borrowed from financial institutions, getting a bank loan can be next to impossible, especially for people with little or no collateral, a bad credit rating and no prior business experience. Even if loan is approved, chances are the interest payments will make it difficult for entrepreneur to generate a profit. While borrowing from

family and friends might seem a great alternative to borrowing from banks, it has definitely own advantages and disadvantages. Usually, friends-and-family financing is informal. Entrepreneurs mostly don't have to write a business plan beforehand. There are clear benefits to approaching family or friends for a loan or investment rather than conventional sources. Generally, they will be flexible. Friends or family may offer loans without security or accept lower security than banks. They may also lend funds interest-free or at a low rate. Most family loans are interest free. You pay back what you borrowed and nothing more (Elaine P. 2012).

Another advantage of borrowing from family or friends is if business doesn't go well, chances are your relatives will be understanding, whereas other creditors will do everything possible to ensure that you live up to your contractual obligations (Elaine P. 2012). For both loans and investments, friends and family may allow you a longer period than formal lenders to repay the loan or start making returns on their investment. In addition, family members who invest will want to see it succeed, so much so that they will probably do anything they can to help. Banks on the other hand are in the business of lending and won't provide entrepreneur with any assistance whatsoever, other than the initial loan.

There are also drawbacks of borrowing from family members or friends. Borrowing from family and friends may be detrimental to your self-esteem. Many people who depend on others for financial support feel bad about the fact that they are not fully self-sufficient. This lack of confidence can hurt your business (Jane S. 2009). Business owners that borrow from relatives are often pressured into listening to suggestions and advice that may not always be sound.

Aside from self–financing and family and friends, there are outside options for financing a new venture. Business angels are wealthy individuals who are willing to invest in early-stage ventures and in exchange receive a share of any financial rewards (Leach, 2012, p. 108).

Business angels are an attractive way to finance a start-up venture. They provide the financing and in return the entrepreneur is willing to share the later profits. Angels have historically been a primary source for startup capital (Morrow, 2013). Since the funding is often informal, many statistics fall short of what is actually being lent. However, the Center for Venture Research reported that $22.9 billion was funded by angel investors in 2012 and was spread between 67,030 ventures that year (Morrow, 2013).

Once an entrepreneur's personal funds are exhausted, and they have sought out financing through friends and family, they must continue to look for sources of financing. Business angels are sought after while the company is still in the early start up stages and moving through the survival stage (Leach, 2012, p. 108).

There are advantages to seeking finance through a business angel. Most business angels have a great wealth of business knowledge. They don't just offer financial assistance, they can help contribute their expertise and skills to grow the business (Ramadani, 2012). This can increase the growth potential of a firm.

Business angels investments range from $50,000 to $500,000 or more (Hall, 2012). This can boost the financial standing of a venture in one shot. Often taking the venture into a more serious level and pushing past the start – up stage. With a large capital influx, an entrepreneur may be able to raise funds from one business angel instead of needing to piece meal the financing through several sources.

A combined advantage and disadvantage is the return of partial ownership in exchange for funding. This is an advantage initially in that unlike other types of debt there are no immediate needs for repayment. The funding can all be used and not needed to allocate back for interest payments. However, at some point the investors will want to see profits and the

entrepreneur will be liable for that. Business angels are investors and an entrepreneur needs to realize that they will want to get a return on their investment (Morrow, 2013). It also lessens the profit return to the entrepreneur, as they will have a lower ownership percentage in the company.

Probably the two biggest disadvantages to business angels are successfully finding one, and getting matched up with one. Most entrepreneurs find angels through word of mouth (Morrow, 2013). This means a lot of networking and a lot of time to find a business angel. It may be harder to find an angel then the entrepreneur thinks.

There are now more angel groups or bands, where several business angels work together to capitalize on high – growth business. Even using one of those, the founder of Capital Growth Inc. said that it is like dating, "Angel forums are a great place to meet people, but the right match isn't always the person you meet the first time" (Morrow, 2013). So even if an entrepreneur can find a group of angels that have interest in their venture, they may have difficulty finding an actual angel who wants to fund their particular business.

Venture Capitalists (VCs) are more formal than business angels. They are individuals who join an organized venture capital firm to raise and distribute funds to new and growing ventures (Leach, 2012, p. 25). This type of capital is often sought after in the second round of financing during the rapid – growth stage. It is used by entrepreneurs to support working capital and expansion (Leach, 2012, p. 26). This may be the next step in financing after using business angels in the start – up stage and then moving on to hyper growth.

The advantage to venture capitalists is the ability to use outside funding to support rapid growth. It is similar to business angels in that a return is expected, but immediate interest payments are not required like debt.

Another advantage of venture capitalists is that an entrepreneur can obtain large sums of funding if they can match up. Recently, a venture capitalist gave $30 million to fund a PhD program (Dolan, 2013). These kinds of large sums would be hard to obtain through a bank or other loan option.

As with business angels, it may be hard to get a venture capitalist on board with the venture. Many studies have been conducted to try to determine what causes a VC to take on a project. It does again seem to be partially a matter of networking. A VC is more likely to fund the venture if they have a social connection with the founders (McGinn, 2012). So it takes time to develop these relationships that can fund the venture. However, the primary influencers on a VC have been found to be the potential for return and the founders' experience. So while it may be hard to obtain VC financing, if the business plan is solid there is potential for raising large capital amounts.

Another disadvantage is that venture capitalists have lowered funding in certain sectors. Particularly, the clean technology industry has seen a decrease in venture investments recently. This is due to high profile blowups and bankruptcies (Hull, 2013). So if the venture is in a certain industry that are higher risk, it may have trouble securing financing from venture capitalists.

As a venture begins to thrive and enter the survival stage, depending on business needs and success, the entrepreneur may require additional capital for expansion. Other capital needs may surface as requirements of additional property, plant and equipment to satisfy an increase in demand, or warehouse space to facilitate buildup of product through the use of working capital to prepare for cyclical sales peaks and valleys. At this stage, the firm has established a trajectory of success with at least two-to-three years' worth of history demonstrating a track record of financial stability and growth which, incidentally, will be required by first round financing providers such as Small Business Investment Companies (SBIC's) through the Small Business Administration (SBA) or commercial lending banks. Large corporations, through Corporate Venture Capital (CVC) business

units, will also be attracted to invest in small businesses with strategically complementary products, sound management and solid growth potential. Finally, firms will also make use of working capital through trade credit with vendors or advanced payments from customers.

Local or regional commercial lenders providing traditional bank loans are the primary source of capital for small businesses (Mullen, 2012; Sherman, 2012). Bank loans come in various forms, typically identified by the term of the note. Short term notes have a period of less than a year. These loans are typically issued in the form of a promissory note and may be secured by accounts receivable or inventory (Sherman, 2012). Some firms may utilize operating lines of credit where a credit facility is approved and funds may be borrowed as needed in the form of draws or tranches. Funds borrowed through lines of credit are usually paid within one-to-three years and have either fixed or variable rates based on the date the tranche is funded. Interim financing is also offered by banks providing loans with maturities from three to five years. Interim loans are usually utilized for purchases of furniture, equipment, fixtures or other operating capital. Finally, long term loans, having terms exceeding five years, but typically not longer than twenty, will primarily be used for acquiring real estate, with the building or land used by the lender as collateral (Sherman, 2012).

In addition to banks, wealthy individuals, corporations and institutional investors make funds available to venture capital (VC) firms who funnel capital to various types of business based on their industry, stage of business life cycle, or geographic location (Sherman, 2012). Large corporations will also form business units to manage Corporate Venture Capital (CVC) which is allocated to companies whose strategy aligns with the business needs of the corporation (Sherman, 2012).

Venture capital deals are typically structured as purchases of preferred stock, but can also take the form of a convertible debenture which starts as debt with the option to convert to equity,

or as debt securities with warrants which enable the venture capitalist to retain creditor status while having the ability to purchase common stock (Sherman, 2012). Common stock may also be purchased, however in the early stages this option is not usually selected by venture capitalists as there are no special rights as are afforded to preferred equity positions (Sherman, 2012).

Aside from external cash infusions, businesses may opt to work with suppliers who will provide trade credit terms. Many suppliers will sell goods and services on credit to facilitate and incentivize movement of their product. This benefits the entrepreneur by deferring the required cash outlay, while increasing the sale ability of the product offered by the supplier. In addition, prepayments are sometimes negotiated into contracts when there is a large upfront capital outlay required or when there is a lengthy manufacturing process involved. A firm may require a down payment of fifty or thirty three percent of a sale, then turn around and use the funds to procure supplies or inventory to complete the sale. For many firms, trade credit is one of the most common, easily accessed sources of capital.

With so many funding options available for first-round financing, entrepreneurs must examine their business needs and weigh the advantages and disadvantages of utilizing various sources of capital. Depending on the type of business, or industry, ventures will lean more towards equity financing or debt financing. Some entrepreneurs may wish to retain full decision making powers, while others need flexibility regarding cash outlays to investors. Firms that create a tangible product tend to use debt financing, whereas businesses based in research and development or intellectual property that are less tangible in nature tend to obtain funding through equity stakeholders. There are many factors that must be looked at to determine the proper capital structure which will optimize business growth while yielding sufficient benefits for the entrepreneur.

Prior to seeking financing, the entrepreneur must formulate a solid case to attract the attention and establish the trust of those who have the cash (Mullen, 2012). There should be sufficient collateral available to secure loans, or owner infused equity to indicate the entrepreneur's level of commitment. The plan should well thought out and forecast cash requirements and repayments without being too rosy when projecting cash receipts generated through sales. The timing of capital sourcing is also critical. The entrepreneur should not seek funding when cash is already depleted; this shows poor planning on the part of the owner, and creates doubt in the mind of the financier (Sherman, 2012). When creating a plan, the benefits and impediments must be carefully analyzed to ensure the entrepreneur gains the greatest advantage from the capital source.

One of the primary intrinsic benefits of owning a business is having control over all the decisions and management of the business and seeing the venture succeed. For this reason, many entrepreneurs will seek financing in the form of a business loan as it allows the owner to retain full control over the business (Sherman, 2012). Other advantages of using bank financing are that the terms can be flexible to suite business needs by structuring notes to be short, medium or long term, and cash outlays are straight forward and easy to budget (Mullen, 2012). Another primary advantage is that interest payments are typically lower and have the added benefit of being tax deductible. Downsides to borrowing include loan prepayment penalties, un-flexible payment schedules which don't mesh well with cyclical cash cycles, and collateral requirements (Mullen, 2012); all of which increase the risk of the business owner. Because of collateral requirements, companies which focus on production of tangible assets, with reduced managerial discretion and flexibility are better suited to take on a business loan (Brewer III & Genay, 1996).

For entrepreneurs that require more flexibility and time, and don't mind sharing the spoils, venture capital sources may be the better alternative. Benefits of tapping into VC include

larger quantities of capital, access to the experience, network and resources of the VC, and flexibility with respect to cash outlays as payments are distributed from business profits (Brewer III & Genay, 1996). Because of the additional risks to the VC, they will typically require a larger rate of return, as compared to interest charged by banks, and they retain ownership rights. Obtaining VC requires greater resources up front with regard to time and legal expenses (Mullen, 2012). Other disadvantages include high levels of scrutiny, as well as additional administrative and accounting costs associated with higher levels of regulation (Mullen, 2012). Those that are able to secure VC will benefit from a much greater upside potential (Brewer III & Genay, 1996). Ventures which are built upon research and development and require flexibility to shift funds between projects are much more likely to attract and obtain non-debt financing.

Conclusion

Whether capital is obtained through self-financing, business operations, banks, or venture capitalists, obtaining and managing capital for a new business is as critical as running the business. The plan for capital management must be well thought out with built in flexibility and alternatives identified in advance to account for unforeseen circumstances. Entrepreneurs that manage capital wisely will have a much greater chance of turning their ideas into reality and achieving their dream.

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