CHAPTER 11 SOURCES OF CAPITAL

Debt or Equity Financing

- Debt financing - Obtaining borrowed funds for the company.
  - Asset-based financing; requires some asset to be used as a collateral.
  - Borrowed funds plus interest need to be paid back.
- Equity financing - Obtaining funds for the company in exchange for ownership.
  - Does not require collateral.
  - Offers investor some form of ownership position.

INTERNAL OR EXTERNAL FUNDS

- Internally generated funds are most frequently employed; sources include:
  - Personal funds
  - Accounts receivable.
  - Profits.
  - Sale of assets and little-used assets.
  - Working capital reduction.
- Sources of external funds include:
  - Family and friends
  - Commercial banks
  - Research and development limited partnership
  - Government grants
  - Bootstrap financing

PERSONAL FUNDS

- Least expensive funds in terms of cost and control.
- Essential in attracting outside funding.
- Typical sources of personal funds:
  - Savings.
  - Life insurance.
  - Mortgage on a house or car.
- The entrepreneur's level of commitment is reflected in the percentage of total assets that the entrepreneur has committed.

ACCOUNTS RECEIVABLE

- **Accounts receivable** loans are a **source** of short-term funding, where the borrower can use their **accounts receivables** as collateral to raise **funds** from a bank. The borrower still owns the **receivables** and is responsible for collecting from their **debtors**.

- **Accounts receivable** financing can take various forms, but the three major types are:
- Accounts receivable loans
- Factoring
- Asset-backed securities

FAMILY AND FRIENDS

- Likely to invest due to relationship with entrepreneur.
  - Advantages - Easy to obtain money; more patient than other investors.
  - Disadvantage - Direct input into operations of venture.
- A formal agreement must include:
  - Amount of money involved.
  - Terms of the money.
  - Rights and responsibilities of the investor.
  - Steps to be taken incase business fails.

COMMERCIAL BANKS

- Types of Bank Loans (Asset based)
  - Accounts receivable loans.
  - Inventory loans.
  - Equipment loans.
  - Real-estate loans.
- Cash flow financing (type of unsecured borrowing that is used for day-to-day operations of a small business)
  - Installment loans.
  - Straight commercial loans.
  - Long-term loans.
  - Character loans.

RESEARCH AND DEVELOPMENT LIMITED PARTNERSHIPS

- Money given to a firm for developing a technology that involves a tax shelter.
- Major elements:
  - Contract - Liability for loss incurred is borne by the limited partners; tax advantages to both parties.
  - Limited partnership - A party that usually supplies money and has a few responsibilities.
  - Sponsoring company- Acts as the general partner; has the base technology but needs funds to develop it.

RESEARCH AND DEVELOPMENT LIMITED PARTNERSHIPS (CONT.)

- Procedure
  - Funding stage - Establishment of contract; investment of money; documentation of terms and conditions, and scope of research.
  - Development stage - Sponsoring company performs actual research.
  - Exit stage - Commences when technology is successfully developed; sponsoring company and the limited partners commercially reap the benefits through either equity partnerships, royalty partnerships, or joint ventures.

RESEARCH AND DEVELOPMENT LIMITED PARTNERSHIPS (CONT.)

- Benefits:
  - Provides funds with minimum amount of equity dilution.
  - Reduces the risks involved.
  - Strengthens sponsoring company’s financial statements.
- Costs:
  - Expending of time and money.
  - Restrictions placed on technology can be substantial.
  - Exit from the partnership may be too complex.

GOVERNMENT GRANTS

- The Small Business Innovation Research (SBIR) program was created as part of the Small Business Innovation Development Act.
  - All federal agencies with R&D budgets in excess of $100 million must award a portion of their R&D funds to small businesses through the SBIR grants program.
  - Offers a uniform method by which each participating agency solicits, evaluates, and selects the research proposals for funding.

BOOTSTRAP FINANCING

- **Outside capital:**
  - Usually takes between three and six months to raise.
  - Often decreases a firm's drive for sales and profits.
  - Increases the impulse to spend.
  - Decreases the company's flexibility.
  - May cause disruption and problems in the venture.
- Bootstrap financing involves using any possible method for conserving cash such as:
  - Use of discounts for volume.
  - Frequent customer discounts.
  - Promotional discounts.
  - Savings through bulk packaging.