

CHAPTER 8: 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.