Financing a New Venture

A Canadian Innovation Centre How-To Guide



Financing a new venture

- New ventures require financing to fund growth
- Forms of financing include equity (personal, family & friends, VC, angel) and debt (generally family & friends, banks or government agencies)
- The amount of financing required is driven by the cumulative negative cash flow of the business
- The appropriate mix of financing vehicles changes with time and the life cycle of the venture
- The choice of financing vehicles is important, as it affects both control of the business and business strategy
- Securing financing is an almost continuous activity for high growth new ventures



Definitions

- **Equity:** shares in the company, issued to the founder or investors
- **Sweat equity:** investment by founders in form of labour
- Early-stage or seed financing: one of the first financings obtained by the company
- A, B or C round financing: levels of venture investments
- **IPO:** initial public offering on a public exchange
- **Private placement:** selling shares which can not be traded

- **Debt:** loans to the company, that carry a payback period and interest rate
- Convertible debentures: debt issued that can be converted to equity at a future date
- Liquidity event: selling the majority of shares in the business to provide a financial return to the investors (either through acquisition or IPO)
- Acquisition: when company is purchased by or buys another company

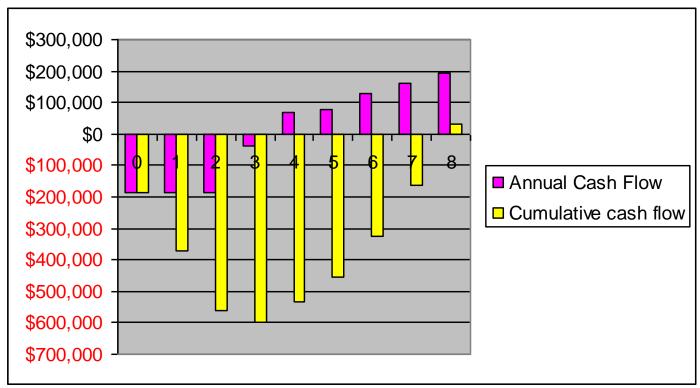


Importance of cash flows

- Most new ventures fail because they run out of cash
- Negative cash flow can be associated with money losing companies, or companies with very high growth rates
- Cash flows are cumulative, so total negative cash flow is total of all cash flows in previous periods plus negative cash flow in that period
- Companies must develop a plan to cover the maximum cumulative negative cash flow
- This plan can include various sources of finance (and a mixture of debt and equity) and can occur over time (to match the negative cash flow requirements)
- Biggest issue is not planning for negative cash flow and then running out of money



An example of a cumulative cash flows



"If annual sales growth is greater than gross margin, then the company will always be short of cash"

Eleven key cash flow drivers

Relationship with Cash Flow

1.	Sales Growth	usually negative
2.	Gross Margin % (Gross Profit/Sales)	positive
3.	Selling, General and Administration	
	(SGA) as % of Sales	negative
4.	Interest Expense	negative
5.	Non-cash Expenses	positive
6.	Income Tax Rate	negative
7.	Average Collection Period (ACP)	negative
8.	Inventory Conversion Period	negative
9.	Accounts Payable Period	positive
10.	Net Capital Expenditures	negative
11.	Owner's Withdrawals from Firm	negative

How much money should you raise and when should you raise it

- Your funding plan should show you know how to raise enough money to cover total cumulative negative cash flow
- Each source of funding must see other potential sources of funds, so that they know the company will not fail, and that they are not the only source
- When raising debt, actual timing is not that important, but you need to do it before you need the money (and raise it in tranches to meet negative cash flows not sit in bank account)
- When raising equity, first money raised is the most expensive
 therefore you should raise the minimum necessary to get you to the point where there is an increase in business value
- You should be prudent and not run out of money, this can be a fatal error (Remember everything takes longer than you expect and costs more)



What are the points at which company value increases?

These milestones are externally verifiable and can be used as points when already raised money can be issues, or subsequent rounds of finance obtained

- Proof of principle
- Prototype
- Strategic partner
- Patent issued or license granted
- First customer
- Distributor
- Third party validation



Reducing the initial amount required, and how much equity is given up

How to reduce investment required:

- Invest in stages
- Reduce amount spent
- Extended payment terms to suppliers
- Get up front payments from customers
- Create R&D consortium
- Leverage existing development work
- Obtain government grants

Potential downsides of less investment

- May reduce likelihood of success
- May increase time to market
- © CHE 2 May allow competitors into market space



Debt versus Equity financing

Debt

- Obtaining borrowed funds for the company
- Interest bearing instrument; loan
- Asset-based financing needs collateral
- Short-term borrowing for working capital
- Long-term borrowing for capital items
- Sacrifices cash flow for ownership control

Equity

- Obtaining funds for the company in exchange for ownership
- No collateral required
- Investors share in the profits of the venture
- Issue of control when ownership is diluted
- Canadian SME's prefer debt financing over equity financing by a large margin



Alternative sources of financing

- Self
- Family and Friends
- Suppliers and trade credit
- Commercial banks
- Government loan programs
- Strategic partners
- Angel investors
- Venture capitalists
- Other government programs



Sources of equity finance over lifecycle

- Third Stage Expansion
- Acquisition
- •IPO
- Second Stage Expansion
- Private Placement
- Institutional Venture Capital



- First Stage Expansion
- Some Venture Capital
- Bank Financing
- Business Start-up
- Angels
- Government programmes



- Self
- Family and friends

Time

Importance of personal funds

- 2/3 of start-ups use personal savings
- 3 of 4 most common financing strategies involve personal guarantees
- Least expensive source of funds and most control
- Essential to attracting outside funding
- Personal funds invested are a sign of commitment by the entrepreneur sources are: savings, life insurance, investments, mortgage, credit cards, lines of credit



Commercial Banks and their loans

Commercial banks are the most frequently used source of short-term funds

- accounts receivable loans
- inventory loans
- equipment loans
- real estate loans

- lines of credit
- installment loans
- SRED loans
- contract financing



Government funds

Business Development bank of Canada (BDC)

- Offers financial products, consulting services, and venture capital to SME's
- Loans have less stringent requirements, more flexible repayment, and use viability as main funding criteria

NRC – IRAP

Grants for R&D but some are repayable

Revenue Canada

- Refunds 35-40% of eligible R&D expenses
- Refund in the form of cash (can be collateralized)

Export Development Corporation

- Accounts receivable insurance
- Contract and working capital financing

Small business loan

Administered by banks on up to \$150,000 for eligible fixed assets
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Angel Investors

- Angel investors are wealthy individuals investing their own money
- They are motivated not only by a financial return but a desire to help others and have an impact
- There are approximately 200,000 in Canada
 - They have an average age of 47, net worth of C\$1.36 million,
 - Most have previous entrepreneurial experience
 - Invest about once per year and reject 97% of applications
 - Average investment is \$110,000
 - 53% of investments are made within 50 miles of their home
 - Compatibility with owners of business is critical given that investment firm is illiquid
 - Importantly they see their role as complementing that of the entrepreneurs and their team



Angel Investment decision making process - Informal

"The only thing more difficult than finding an angel is successfully negotiating a deal with one"

- As they are only accountable to themselves, it is difficult to say in a specific instance what are the criteria for success.
- However research in the decision making process has led us to conclude the following factors can increase the chance of a successful investment:
 - Prepare properly and know you plan and your numbers in advance
 - Find them through a referral and screen them for fit
 - Make sure you have thought out how much money you need and what you will use it for
 - Be prepared to negotiate and understand what you will have to give up to engage them (and the benefits of this)
 - Have references ready they will find a way to check them



Venture Capitalists (VCs)

- Firm of professionals who manage pool of equity capital on behalf of other investors (I.e. pension funds)
- The firm is paid both on the basis of funds invested and successful exists Management expense and profit
- Each fund has investment time horizon, which affects their decision making as well as areas of specialization
- While some VCs invest in businesses at all stages of development other specialize (seed or mezzanine)
- At time of investment need to understand liquidity event
- Importantly they see their role as replacing the entrepreneurs and their team if necessary



Venture Capital decision making process - More formal

- VCs are accountable to investors and therefore need to both justify their investment decision making process and demonstrate it fits within the mandate of the fund.
- Research in the VC decision making process has led us to conclude the following factors can increase the chance of a successful investment:
 - Prepare properly and know you plan and your numbers in advance
 - Find them through a referral and ensure you meet their investment criteria
 - Think out how much money you need and when, what you will use it for and what you could do if you had more
 - Be prepared to negotiate and understand what you will have to give up to engage them along with all the detailed terms in a VC contract
 - Have references (often customers) and other legal documents ready they will want to check them



Angels versus VCs

- Angels make about 30 times as many investments as VCs
- Angels tend to invest in smaller amounts or syndicate for larger investments
- Angels tend to become much more involved with their seed ventures often working alongside entrepreneur
- VCs can not spend as much time with seed companies, but are usually well linked to follow on financing
- Over 70% of VC investments are subsequent to an Angel investment



How much will you have to give up?

The basic rule is simple:

- Decide how much money you need now \$X
- Decide how much the company is worth now \$Y
- Assume that post investment the company is worth
 \$(X + Y) remember the money goes into the company not to the entrepreneur

The percentage you have to give up is X/(X+Y)

If you need \$300K and your company is worth \$500K before the investment, then after the investment it is worth (X+Y) = 800k

The investor wants \$300k/\$800k or 37.5%



Valuing the company

For new ventures there are three basic ways to value company (lowest to highest):

- Market price of similar company's stock (P/E ratio) based on profit forecast in 3 – 5 years
- Net present value (NPV) of cash flows, assuming positive
- Strategic value, based on assumptions of value firm brings to an acquirer (in reality this is most important in Canada as 80% of funded firms are acquired)

Market price of similar company's stock

- Create a 5 year profit and loss pro-forma
- Identify profit in year 5 (example \$1 million)
- Select industry sector based on stock exchange indices
- Look at either industry average or most similar company P/E ratio from that sector
- Multiply your forecast by that number
- i.e. Industry P/E 15, so your value would be \$15m

Net present value of free cash flow

With the free cash valuation approach, the firm's value equals the present value of cash flows that will ultimately flow from the firm to the debt holders and shareholders who finance the firm.

These cash flows are expected to arise from

- 1) normal operation of the firm
- 2) liquidation of redundant assets and be reduced by investments in new assets needed to maintain and grow operations.

Calculating discounted cash flows

- How do we calculate the value today of money in the future
- They depend on interest rates
- If interest rates are 10%, then \$100 now is the same as \$110 in the future (ignoring taxes) \$100 * (1 + 0.1) = \$110
- Similarly \$110 / (1+0.1) = \$100
- For 2 years we use (1+.1)*(1+.1) = \$121

Problems with discounted cash flows

•	Very dependent on year you	Year	9 years	10 years
	chose as final year	1	-\$500	-\$500
•	Very dependent on interest rates	2	\$0	\$0
		3	\$300	\$300
•	Assumptions can be changed to	4	\$600	\$600
	significantly change business value	5	\$1,000	\$1,000
		6	\$1,700	\$1,700
		7	\$3,000	\$3,000
•	Doesn't reflect that distant	8	\$4,500	\$4,500
	earnings are much more risky	9	\$7,000	\$7,000
		10		\$10,000
		NPV @ 5%	\$12,019	\$18,158
		NPV @ 15%	\$5,926	\$8,398



Determining value based on strategic acquisition

- Difficult to come to any real number
- Simplest way is to create a model based on first valuation method (from year 5 comparable) - this creates the lower valuation
- Then create a revised model based on how the earnings would change if the company was now owned by the strategic acquirer (I.e. how much would the profit increase under new ownership)
- Increased value calculated based on higher profit this creates the higher valuation
- Actual valuation will be between these limits and be a function of negotiating power

A shortcut method of valuation often used by Venture Capitalists

- Investors often look at values based on how they will achieve their required returns
- If the investor requires an annual return of 30% on each investment, then they need to work backwards from the liquidity event.
- For example if they invested \$1 million now, then they would multiply this by the required interest rate and the number of years to calculate their exit percentage. This means they would want to get back \$2.2 million.
- Assuming the firm was worth \$5 million in year 5, then they would want \$2.2/\$5 or 40% of the company now



Another Example

- A startup firm estimates it will earn \$2M after taxes on sales of \$10M.
- The firm needs \$1.0M now to reach that goal in 5 years.
- A similar firm in the same industry is selling at 15 times earnings.
- A VC firm is interested in investing in the deal and requires a 50% compound rate of ROI.
- What % of the firm will have to be given up to obtain the needed capital?



Simple Calculation

- Future value = 2m * 15 = 30m
- Current value of \$30 m in 5 years at 50% interest is: $30\text{m/}(1.5)^5 = \$3.9 \text{ million}$
- Only worth this after investment of \$1 million
- Shares = 25.6%

Issues considered by the investor

- Strength of the business plan
- Does it seem likely to fail?
- Can I make my required rate of return?
- What are Agency issues in working with the entrepreneur (entrepreneur's behaviors, information asymmetry)?
- Issues around moral hazard and adverse selection
- Possibility of introducing behavioral controls into the relationship (perhaps by direct participation)
- Transaction costs associated with the introduction of controls



Showing the investor a return

- Remember that if you want an investor, you have to show them a specific exit strategy (sometimes more than one)
- Identify potential acquirers or provide some evidence of whether an IPO is possible
- Show that you understand issues around subsequent finance rounds
- Explain which types of industry players might see value in your business and if possible provide evidence of their acquisition activity
- Explore how targeting specific acquirers might affect your business strategy



Financing a New Venture: Take-Aways

- It is important to raise enough money to cover the total cumulative negative cash flow
- Try to reduce the amount needed through careful management of expenses and cash flow
- Personal funding is the most common and least expensive form of financing
- Debt financing doesn't involve reducing control as equity financing does
- Remember that if you want an investor, you have to show them a specific exit strategy (sometimes more than one)

