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4. Managing Finance

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Introduction

If entrepreneurship is defined as the relentless pursuit of an opportunity, and finance is defined as the study of the generation and allocation of cash, and risk to create value for the enterprise, then entrepreneurial finance refers to generating and managing cash and risk in order to create value in the relentless pursuit of opportunity.

Simply put, finance is management. Finance is a way of thinking about cash, risk and value. It helps to view problems from perspectives that concentrate on creating value. When viewed from the financial perspective, some decisions will turn out to be illogical or unfeasible, and so should be abandoned.

This unit focuses on the important topic of generating financing and managing those funds. It discusses sources of **personal financing**, which are all common in start-up firms. These sources include an entrepreneur using his or her personal funds, bootstrapping, and borrowing from friends and family.

The unit also addresses common sources of both **equity funding** and **debt financing** namely venture capital, initial public offerings, business angels, commercial banks and guaranteed loans. The unit also discusses concepts such as **financial projections** and **creating financial statements**. It identifies and discusses key success factors and common pitfalls. The unit concludes by identifying strategies for raising finance, and discussing briefly the notion of an **elevator pitch**.

Learning objectives

When you have successfully completed this unit you will be able to:

- Explain why most entrepreneurial ventures need to raise money at some point during their early life.
- Identify the sources of personal, equity and debt financing available to entrepreneurs.
- Present and discuss the concept of financial projections and financial statements.
- Identify the critical success factors and typical problems associated with financial plans.
- Outline a common strategy used by entrepreneurs to generate finance, namely the elevator pitch.

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1. Generating Finance

Before we begin our discussion on generating finance, it is imperative to state that cash is the most important financial resource. More cash is always better than less cash and cash on hand is better than cash due to arrive.

It is always better to focus on cash flow (i.e. the amount of cash coming into and spent by the business during a specific period of time) as opposed to profit and loss statements (i.e. revenue that a company receives from the sale of products minus invoices and expenses). Moreover, attention should be paid to the dynamic picture of cash flow (i.e. cash cycles, seasonality and note that today's investments are tomorrow's growth opportunities).

In short, cash management is critical, so you should never run out of cash.

Nevertheless, most companies, at one time or another, will have to generate finance in order to undertake initiatives such as establish the business, launch a new product, renew equipment, initiate international expansion etc. The three key reasons why most new firms need to raise money during their early life are:

Cash flow challenges
The business must pay its employees and purchase equipment and inventory before it can generate any cash from sales.

Cash investments
A small company typically does not have the ability to purchase sites, building facilities and equipment from the outset.

Long technology development cycles
Some technologies and products are under development for years before they generate any income. The up-front costs associated with development often exceed a firm's ability to fund these activities on its own.

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There are many options available to entrepreneurs to generate finance. Three key options include (a) personal finance (b) equity funding and (c) debt finance.

The sections below discuss these in more detail.

1.1 Sources of personal funding

The three main ways entrepreneurs generate personal funds are: (a) personal savings (b) friends and family and (c) bootstrapping.

Personal savings: In general, the founders of a company generate the seed money that gets a company off the ground by using their personal savings, mortgages, credit cards and life insurance policies.

Friends and family: Friends and family are the second source of funds for many new ventures. This form of contribution often comes as loans, investments or gifts.

Bootstrapping: Another source of seed money for new ventures is referred to as bootstrapping. Bootstrapping is the use of creativity, ingenuity, and any means possible to obtain resources other than borrowing money or raising capital from traditional sources.

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1.2 Sources of equity funding

Sources of equity funding are essentially comprised of (a) venture capital (b) business angels (c) initial public offering and (d) crowdfunding.

Venture capital
Venture capital, often called risk capital, refers to money provided by investors to start-up firms and small businesses with perceived long-term growth potential. It is used by funders to finance innovative companies by taking equity or a stake in the business. This is a very important source of funding for start-ups that do not have access to capital markets. Contrary to a banker who is looking for guarantees, the venture investor becomes an active partner of the firm and shares the risks of the business. Venture capital entails a high level of risk for the investor but also has the potential for above-average returns.

Business angels
A business angel is an individual who invests assets in a company with innovative potential. A typical business angel would be the former head of the company or senior executive who is able to invest between €5,000 and €20,000 per year, or an entrepreneur who has sold a company and who can invest amounts between €50,000 and €500,000. An angel also makes available to the contractor skills, experience, and networks of relationships as well as their time.

Initial public offerings
An initial public offering (IPO) is a company's first offer to sell stock to the public. It is a financial transaction conducted by a brokerage company and various people such as bankers, auditors and lawyers, which allows listing of a company on a stock exchange. IPO's are used to obtain new funds, decrease the cost of the capital, or to provide cash to existing shareholders. Participating in an IPO can be a complex exercise and it requires a good knowledge of the process and procedures.

Crowdfunding
Crowdfunding is the use of small amounts of capital from a large number of individuals to finance a business venture. Instead of collecting investments from one source, crowdfunding platforms allow entrepreneurs to gather investments from a large group of smaller investors. Investments can start as low as 10 euros. Crowdfunding makes use of the easy accessibility of vast networks of friends, family and colleagues through social media websites like Facebook, Twitter and LinkedIn to get the word out about a new business and attract investors.

Crowdfunding has the potential to increase entrepreneurship by expanding the pool of investors from whom funds can be raised beyond the traditional circle of owners, relatives and venture capitalists. Popular crowdfunding platforms include www.kickstarter.com (international) and www.crowdaboutnow.com (The Netherlands).

1.3 Sources of debt finance

Debt finance can be generated from commercial banks and guaranteed loans.

Commercial banks
A commercial bank is a bank that accepts deposits, makes business loans, and offers related services. Historically, commercial banks have not been viewed as practical sources of financing for start-up firms as they are risk averse, and financing new ventures is risky business. Furthermore, lending to small firms is not as profitable as lending to large firms. In many instances, it is simply not worth a banker's time to do the due diligence necessary to determine the entrepreneur's risk.

Guaranteed loans
A guaranteed loan is a loan offer by a government agency. The agency undertakes to repay a loan in case the borrower defaults.

2. Financial Projections

Planning for the future is vitally important for a new venture. Whatever a business is trying to achieve, it is almost impossible to be successful if its managers do not have a clear idea of what their business is going to be like in the future. Central to this is the concept of financial projections.

Simply put, a financial projection is an estimate or forecast of future revenues and costs.

Projected financial statements reveal the likely financial outcomes of a particular action. They can be used to allocate resources in a more efficient and effective manner.

Financial statements (or financial reports) are formal records of a business' financial activities. These statements provide an overview of a business' financial condition in both the short and long term. Projections should include key financial ratios and comparisons relative to competitors' and/or industry averages. Financial projections should answer the following questions:

- How will the business perform financially?
- What will the company's cash position be?
- What will the company's financial position be?

There are three basic financial statements, namely:

A projected profit and loss account
This is often referred to as the income statement. It tells you how well the business is doing in terms of sales, costs and profitability. Normally it is produced for an accounting period of a year, but often it is produced on a monthly basis so that the performance of the business can be monitored and any corrective action can be taken.

A projected balance sheet
A balance sheet or 'statement of financial position' is a summary of the value of all the assets, liabilities and ownership equity in an organisation. It shows a company's financial condition on a given date. Of the three basic financial statements, it is the only statement which applies to a single point in time, instead of a period of time. A company's balance sheet has three parts: assets, liabilities and shareholders' equity. The difference between the assets and the liabilities is known as the net assets of the company.

A projected cash flow statement
Cash flow is determined by taking your inflows of cash (cash you're receiving) and subtracting your outflows of cash (cash you're paying out). It is important to most lenders because it provides an indication of whether you will have enough cash to pay your suppliers, vendors, and other creditors on time.

When taken together, these statements or reports should provide a good view of the current and future performance and position of the company.

3. Key Success Factors & Common Pitfalls

Financial projections should be consistent with the venture's overall strategy. The process of developing such statements will help demonstrate whether the strategy is financially feasible. It should also indicate the amount of outside financing necessary to support the execution of the venture's strategy.

Financial projections should adopt a five-year approach. They should be monthly for the first two years and quarterly for the remaining three years. They should avoid any assumptions and include any historical financial information.

All financial projections should include a list of significant assumptions. They should also consider all financial obligations involved in bringing the product or service to the marketplace. This may include the cost of new employees, additional physical space, purchasing support materials and services and increases in inventory and accounts receivable. Deviations from historical trends should also be highlighted and finally, all assertions and assumptions should be supported with valid data. It is good practice to identify what data you have and also be clear about what you don't know.

While most entrepreneurs will attempt to create comprehensive financial projections or plans, many errors are made. A synthesis of the literature and best practice reveals that the common mistakes include:

- Too much ink is wasted on numbers and too little focuses on information that really matters.
- Often the numbers do not support the company's strategy or the key drivers of the venture's success or failure.
- Few entrepreneurs correctly anticipate how much capital and time will be required to accomplish objectives.
- Many financial projections are wildly optimistic.

4. Strategies for Raising Finance

You have learned that raising finance can come in many different forms and so it is important to go through all the options before choosing which one to use. The decision about which option is most suitable will depend on the nature of the business, its level of maturity, the level of profitability, the financial structure of the business, and the aspirations of the owner-manager.

Young start-up companies normally access funds in the form of venture capital in order to develop and grow.

A key strategy used by entrepreneurs to raise funds from venture capitalists is called the elevator pitch.

An elevator pitch is a very brief overview of your product, service, technology or project and the benefits associated with it.

The name reflects the fact that an entrepreneur can deliver an elevator pitch in the time-span of an elevator journey (i.e. between thirty seconds and two minutes). The term is typically used in the context of an entrepreneur pitching an idea to a venture capitalist to receive funding.

Venture capitalists often judge the quality of an idea on the basis of the quality of its elevator pitch, and will ask entrepreneurs for the elevator pitch to quickly weed out bad ideas. In reality, a venture capitalist will normally afford an entrepreneur more than thirty seconds to pitch their idea — they may in fact stretch to ten minutes. If you are lucky enough to get ten minutes with a venture capitalist, you should consider including the following key points in your pitch:

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1

Define the problem and determine exactly who is experiencing this pain. Use graphs, pictures or better still describe a problem scenario or usage case.

2

Present the solution. This is an overview of the product or service offering that will solve the problem. Use photos, screen shots, briefly list the features and benefits. Remember to be clear about the status of product development.

3

Profile of the company. Be specific. For example:

- State the year it was founded
- Identify the number of employees (full-time and part-time)
- State the date the product was launched
- Determine the number of beta users and number of paying customers
- Mention the names of any channel partners
- List any certification received
- Determine the number of patents filed
- Mention any press coverage or awards

4

Determine the market size. Identify the total potential target market, show the different segments and explain how you prioritise the segments. If you must use third party figures, cite the source.

5

Present your sales strategy. Specify how you sell your product. If you sell directly, identify (a) How many sales people are needed? (b) How long does it take to close a deal? (c) Who is the key decision maker? If you use a channel, determine (a) Who are the partners? (b) How many are required? (c) How are the territories divided?

6

Describe your revenue model. This should include both revenue and cost drivers. If you're part of a network dealing with brokers, value added resellers, or wholesalers, each member of the value chain will require a share of the revenues. A graphical representation of how this is allocated can give investors a clear understanding of the profitability of the business.

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7

Determine your competition. Be sure to present all your competitors. They may be direct competitors or indirect competitors. In other words, you should identify and summarise existing alternatives (other technologies or types of products) that are offered.

8

Present your management team. Identify all members of the management team and their position in the venture. Also identify all members of the advisory board and their areas of expertise.

9

Present your (five year) financial projections and assumptions. Be specific. You should list the following:

- In 2020, €? per sale
- In 2020, number of customers
- 2020 market share: ?%
- In 2020, ?% from new sales; ?% from recurring
- Clearly determine which market you are serving
- State that figures do not consider future product extensions

10

Determine your funding requirements. Again be specific and consider the following:

- Prior Funding: €? from founders, €? from outside investors, €? grants
- Current Round: Seeking €? million (€? raised)
- Use of Funds: Finish v 2.0 Prototype, launch in ??? market, file patents
- Future rounds: Series B of €? million expected in early 2010
- Exit Strategy: Acquisition (list potential buyers)

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Remember, your pitch must be must be succinct. You should stick to ten minutes at most. It should be easy to understand so don't spend too much time on the technology. Also, remember that investors are sensitive to exaggeration. They know that 700 customers is not equal to 680 beta users and 20 paying customers; so don't inflate your numbers. Your pitch must also be tempting — investors want to make money, so be sure to sell the value of your idea.

Furthermore, be aware of the figures the investors want and remember that your figures must add up. Finally, remember that investors are looking for the following attributes in a technology or venture:

- Outstanding team with prior experience
- A good fit between the investor and the firm
- Unique value proposition as opposed to another 'me too' product offering
- Good return on investment
- Realistic assessment of risks
- Detailed and realistic financial plans
- Exit strategies within 4 to 7 years

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Review

Young start-up companies need access to finance, normally in the form of venture capital, in order to develop and grow.

The three key reasons why most new firms need to raise money during their early life are:

- Cash flow challenges
- The need to make cash investments for the fledgling business
- Long technology development cycles

This unit discusses how new firms facing a number of potential options might effectively raise funds at early stages, especially when a firm is small or has not yet developed a marketable product.

You learned that **financial projections** are a critical element of managing the money in a business. A financial projection is an estimate or forecast of future revenues and costs.

The unit provided a brief introduction to the three basic financial statements:

- profit and loss
- balance sheet
- cash flow statements

Options for financing the start-up include: (a) personal financing, (b) equity funding and (c) debt financing.

The three main ways entrepreneurs generate personal funds are (a) personal savings (b) friends and family and (c) bootstrapping.

Sources of equity funding are essentially comprised of (a) venture capital (b) business angels and (c) initial public offering.

The unit also addressed the critical success factors and typical problems associated with financial plans. Finally, the unit explained briefly how to prepare an elevator pitch. An elevator pitch is a very brief overview of your product, service, technology or project and the benefits associated with it.

Self-Assessment Questions

1. Why do most entrepreneurial ventures need to raise money?
2. Identify the sources of personal and debt financing available to entrepreneurs.
3. What is bootstrapping? Provide some examples of how entrepreneurs bootstrap to raise money or cut costs. In your opinion, how important is the art of bootstrapping for an entrepreneurial firm?

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