Working Capital

Working capital represents a business's temporary funds; it is the capital used to support a company's normal short-term operations. Accountants define working capital as current assets minus current liabilities. New businesses need working capital to help fund day-to-day expenses until the time that the business reaches its breakeven point and has positive cash flow. The need for working capital in an existing business arises because of the uneven flow of cash into and out of the business due to normal seasonal fluctuations or timing differences between when business sells a product or service and when the customer actually pays for it. Credit sales, seasonal sales swings, or unforeseeable changes in demand create fluctuations in *any* small company's cash flow. Working capital normally is used to buy inventory, pay bills, finance credit sales, pay wages and salaries, and take care of any unexpected emergencies. Equity financing is the most common source of working capital for a start-up business. Investors expect working capital to help launch the business so that it can achieve its high growth potential and generate a return on investment over time. Lenders are the most common source of working capital for seasonal or other short-term needs in established businesses. Lenders expect repayment as soon as the cash comes into the business from normal operations.

Sources of Equity Financing

2.

Describe the various sources of outside equity capital available to entrepreneurs, including friends and relatives, crowdsourcing, accelerators, angels, corporations, venture capital, and public stock offerings.

Equity capital represents the personal investment of the owner (or owners) and any investment from outside sources in a business. Equity capital is sometimes called *risk* capital because these investors assume the primary risk of losing their funds if the business fails.

ENTREPRENEURIAL PROFILE: Dan Hanlon: Excelsior-Henderson Dan Hanlon's dream was to build a new motorcycle company that revived a classic brand called Excelsior-Henderson. At the age of 36, he launched his business and began raising money. During the 1990s, Hanlon raised more than $100 million in investments that helped build a state-of-the-art factory in Minneapolis-St. Paul, Minnesota, and fund the start-up expenses of the business. Early investments came from his family and friends. Eventually, the company raised money through a public offering of its stock. However, the business never was able to reach positive cash flow. Although Hanlon and his two cofounders were able to promote the concept of the business to investors and raise money, they were not as skilled at managing a growing business. Former employees said that they were micromanagers, unreceptive to suggestions from managers and employees, and unable to building a solid dealer network. In addition, they overbuilt what they needed for manufacturing, draining much of their capital. By the end of 1999, the company was down to its last million dollars, and the entrepreneurs were looking at various options to save it. In the end, however, the only option was to declare bankruptcy. "1999 was not a fun year. I started the year with a $20 million net worth and ended the year below zero," says Hanlon. "My brother Dave and his wife took a big hit. My mom and dad put in almost a third of their retirement savings." In addition, all of the shareholders in Excelsior-Henderson, many of whom were local citizens of the Twin Cities hoping to cash in on Hanlon's dream, lost all of the money they had invested in Excelsior-Henderson stock.[5]

If a venture succeeds, however, founders and investors share in the benefits, which can be quite substantial. The founders of and early investors in Yahoo!, Sun Microsystems, Federal Express, Intel, and Microsoft became multimillionaires when the companies went public and their equity investments finally paid off. To entrepreneurs, the primary advantage of equity capital is that it does not have to be repaid like a loan does. Equity investors are entitled to share in the company's earnings (if there are any) and usually to have a voice in the company's future direction.

The primary disadvantage of equity capital is that the entrepreneur must give up some—perhaps *most*—of the ownership in the business to outsiders. Although 50 percent of something is better than 100 percent of nothing, giving up control of your company can be disconcerting and dangerous. Many entrepreneurs who give up majority ownership in their companies or agree to the heavy-handed terms that professional investors insist on in exchange for equity capital find themselves forced out of the businesses they started! Entrepreneurs are most likely to give up more equity in their businesses in the start-up phase than in any other.

We now turn our attention to eight common sources of equity capital.

Funding from Founders

3.

Describe the seven sources of funding that the founders can contribute to their new businesses.

The *first* place entrepreneurs should look for start-up money is in their own pockets. It's the least expensive source of funds available! For the majority of start-ups, self-funding is the only source of funding available. Limited funding does not stop entrepreneurs from pursing their vision, however. The amount of capital required to launch new businesses is surprisingly small. For new businesses with employees, more than half of start-ups launch with less than $50,000. For those entrepreneurs who start their businesses with no employees (about 80 percent of all start-ups), almost half start with less than $10,000.[6]

ENTREPRENEURIAL PROFILE: Sharon Munroe: Little Green Beans After spending 21 years working in large corporations, Sharon Munroe decided it was time to leave the long hours and stress that come with a corporate career and open her own business. Munroe volunteered at a nonprofit thrift store and observed the strong demand for used children's products, so she launched a consignment store, called Little Green Beans, which specializes in children's clothing, toys, and accessories such as strollers and high chairs. As a first-time entrepreneur, she knew that she would have to self-fund her business start-up. She had carefully saved her money for several years in anticipation of launching a business. "When it's your savings, it's a bit scary to take such a big risk," says Munroe. "But it was a calculated risk where I wasn't going to just throw money at things and hope they worked. I knew where I was going to get a return on my investment." Monroe developed a carefully planned start-up budget that fit within the savings she had accumulated for her new business. She was able to lease a space in a high-traffic area, build out that space, buy the latest technology available for a retail operation, and pay for rent and other operating costs—all for about $20,000. Unlike most other retailers, she had no inventory costs because everything was sold on consignment. She invested the remaining $10,000 of her budget in marketing and public relations to ensure that her store would get off to a strong start. Monroe had a successful launch and needed no additional financing.[7]

Lenders and investors *expect* entrepreneurs to put their own money into a business start-up. If an entrepreneur is not willing to risk his or her own money, potential investors are not likely to risk their money in the business either. Furthermore, failing to put up sufficient capital of their own means that entrepreneurs must either borrow excessive amounts of capital or give up significant shares of ownership to outsiders to fund their businesses properly. Excessive borrowing in the early days of a business puts intense pressure on its cash flow, and becoming a minority shareholder may dampen a founder's enthusiasm for making a business successful. Neither outcome presents a bright future for the company involved. Using their own money at start-up allows entrepreneurs to minimize the debt their companies take on and to retain control of their companies' future.

There are seven common approaches used by entrepreneurs to self-finance part or all of their new businesses.[8]

PERSONAL SAVINGS A common source of start-up funding is to use savings accounts, cash from the sale of investments such as publicly traded stocks, and funds withdrawn from retirement accounts. This cash provides seed capital for buying equipment and funding working capital. Entrepreneurs also rely on personal savings to cover their own living expenses until the business generates enough cash flow to provide them with a paycheck. Entrepreneurs forgoing their paychecks during the start-up phase is known as **sweat equity**. However, entrepreneurs' personal expenses don't stop during the start-up phase, which is why they should have enough money saved to cover the early financial needs of their businesses and to pay their own living expenses for up to six months.

As we saw in Chapter 5, entrepreneurs often do not launch a business alone. They may take on partners as cofounders to both expand the capital base for the business and provide complementary skills and experience.

ENTREPRENEURIAL PROFILE: Lida Orzeck and Gale Epstein: Hanky Panky Lida Orzeck and Gale Epstein cofounded Hanky Panky in New York in 1977. Hanky Panky manufactures and sells women's lingerie through department stores such as Nordstrom and Lord & Taylor as well as in upscale boutiques. Key to the success of their business partnership for more than 30 years is that Lida and Gale are quite different; they bring complementary skills to the business. "Gail designs, and I don't," explains Lida Orzeck. "Gale appreciates my style and my eye, but she thinks of me as the woman on the street, which is a very important role to play. I'm more in charge of the business." Orzeck is in charge of sales, marketing, and operations. The two also have very different personalities. Epstein is the creative spirit. She is a vegetarian who would rather be riding horses in the country. Orzeck prefers life in the big city, with its fast pace and excitement. They have found that their differences make working together easier, more effective, and enjoyable. With its founders' complementary skills, Hanky Panky has grown to 150 employees and sells more than $50 million a year in merchandise.[9]

Before entering into any partnership arrangement, entrepreneurs must consider the impact of giving up some personal control over operations and of sharing profits with others. Whenever entrepreneurs give up equity, they run the risk of losing control over the business.

OTHER PERSONAL ASSETS An entrepreneur may already own some of the equipment necessary to run a new business, such as a computer, a smart phone, or a vehicle. Rather than spending precious cash to buy duplicates of these items, their personal assets can become a part of the investment the entrepreneur makes in the business. It is not uncommon for a business to grow out of a hobby or out of an area studied in school. In this case, the entrepreneur may already have some of the specialized equipment needed for the business. For example, Kurt Nelson and Tyler Seymour started their video production company, Just Kidding Productions, as they were nearing graduation from college. They had already purchased much of the video equipment and computers that they needed to launch their business while they were students. The partners assigned a fair market value to the equipment that each contributed into the business, and this counted as a part of their investment in the corporation they formed.

UNSECURED PERSONAL CREDIT As you will learn in Chapter 17, banks rarely provide loans to start-up businesses. However, an entrepreneur may be able to secure a personal loan through credit cards or a personal line of credit. Although many entrepreneurs use multiple credit cards to fund their businesses, doing so is a risky strategy. By using credit cards to fund a new business, entrepreneurs put their personal credit rating at risk if their businesses fail. In addition, they may be violating the terms of use from the credit card company, which often prohibits the use of a personal credit cards for business purposes.

ENTREPRENEURIAL PROFILE: Jane Poynter and Taber MacCallum: Paragon Space Development Jane Poynter and Taber MacCallum started their business while living in the experimental Biosphere 2 outside of Tucson, Arizona. They had been experimenting with self-sustaining ecosystems—basically mini-biospheres—while part of the crew was sealed within the experimental Biosphere 2. Once their time in Biosphere 2 was over, Poynter and MacCallum relied on student loans and credit cards to finance their new company, Paragon Space Development, which was based on the prototypes they developed during their time in the Biosphere 2. Fortunately, Paragon Space was able to sell its miniature biospheres to NASA, JAXA (the Japan Aerospace Exploration Agency), and other governmental agencies for various experimental projects. The partners were able to pay back the personal credit they used to fund the launch of Paragon Space Development.[10]

SECOND MORTGAGE ON PROPERTY If an entrepreneur owns a house or a condominium—and has equity in the property above the amount he or she borrowed through a primary mortgage—he or she can use the equity in the home to secure a second mortgage on the property to help fund a business start-up. A second mortgage, just like unsecured personal credit discussed above, is a personal credit obligation. If the business fails, the entrepreneur must personally pay off the balance of the second mortgage.

PLEDGING OTHER PERSONAL ASSETS If an entrepreneur owns personal assets, such as publicly traded stock, rental property, or an interest in a family trust, he or she can use the property as collateral to secure a loan for the business. This approach is not without risk; if the business fails and the entrepreneur is unable to repay the loan, the lender can seize the personal assets pledged as collateral to repay the loan.

WORKING A SECOND JOB Because the entrepreneur's living expenses are an important part of the cash necessary to launch a business, many new business owners continue working other jobs as they launch their businesses. This is known as "extending the runway" for the launch of the new business because it gives the start-up more time to succeed before the owner takes money out of the business to cover personal living expenses. Because entrepreneurs can do much of what they have to do during the start-up at any time of day, they often work paying jobs by day and work on their new businesses at night and on weekends. Even after their business launches, some entrepreneurs continue to hold a second job at night, such as waiting tables or bartending, to make ends meet. At some point, the business will demand too much time to allow one to also work a second job. Ideally, this occurs when the new venture is able to pay you a regular salary!

ENTREPRENEURIAL PROFILE: Brian Morgan: Adventure Life Brian Morgan traveled to Ecuador, Bolivia, and Peru to learn Spanish, trek in the shadow of volcanoes, and raft through the rain forest. After returning home to Montana, Morgan had an idea for a business that related to his experiences in South America. "I thought I could put a group of people together a few times a year and take them to Ecuador—show them the things that I found most spectacular," he says. He launched his business, Adventure Life, on a shoestring. He had only a couple of thousand dollars in savings, so he continued to work during the day at a software company. Morgan worked on Adventure Life evenings and weekends and used his limited start-up funding to print brochures and build a Web site. After a year of operations, the business was making enough to pay him a salary and cover all of its expenses. He was able to quit his job and focus on growing his business. Over the next 10 years, the company grew to more than $11 million in sales and sixteen employees.[11]

BOOTSTRAPPING As we saw in Chapter 8, because they are often unable to attract capital from outside sources, entrepreneurs bootstrap their companies. That is, the entrepreneur finds ways to accomplish all of the activities required to launch the business even though he or she has little or no money. It takes creativity, boldness, and a certain degree of brashness and moxie, but it works.

ENTREPRENEURIAL PROFILE: Johnny Earle: Johnny Cupcakes Johnny Earle was a struggling rock musician. To pay for his living expenses, he worked at a music store. One of his co-workers gave him many nicknames that were variations on his name Johnny. One of them, Johnny Cupcakes, somehow stuck. When Earle was ordering T-shirts for his metal band, he decided on a whim to get some shirts printed with his nickname Johnny Cupcakes. The shirts were a hit, and he was soon selling dozens each week out of the trunk of his car. Earle soon began to come up with creative designs for his T-shirts combining cupcakes with cultural icons, such as the Statue of Liberty holding a cupcake and a skull and crossbones with a cupcake in place of the skull. His T-shirt designs developed a strong following of loyal customers. Earle signed up with an inexpensive Web store called Merchline.com to sell his shirts and stored his inventory at his parents' house. The popularity of his T-shirt designs continued to grow. After eight years of bootstrapped growth, Johnny Cupcakes had reached almost $4 million in sales and employed 30 people.[12]

In the Entrepreneurial Spotlight

Bootstrapping a Technology Start-Up

Debbie Gordon worked in a series of jobs in the technology industry. In a job she held in 2002, the entrepreneur for whom she worked was facing serious cash flow challenges. He came to Debbie to ask whether she would be willing to loan the company $15,000 to make payroll. Rather than put her money at risk for her employer, Debbie decided to leave and explore possible start-up opportunities for herself.

Debbie had become intrigued by the success of eBay as an online auction site and was curious about the opportunities it might hold. She began experimenting with eBay by selling items that she liked to buy—particularly shoes. Debbie would buy large quantities of designer shoes at a local outlet store of an upscale retailer. She bought the shoes at a significant discount and then marked them back up to retail price, offering them for sale on eBay. Because the store offered a 30-day return policy, her inventory risk was almost nonexistent. She found the process not only fun but also financially rewarding.

Many of her friends saw her success selling shoes using the auction site and began asking her to help them sell things they no longer wanted on eBay. Debbie realized that there must be many more people just like her friends who would be willing to pay her to sell items on eBay. Between the end of 2002 and the middle of 2003, Debbie developed a business plan for her new venture, Snappy Auction. Her plan was to set up retail locations where people who did not want to sell items on their own through eBay could drop these items off and they would be placed on eBay and sold by the staff at these retail outlets. She would take a significant percentage fee based on the sale price of each item.

While developing her business plan, Debbie recognized that she would need help establishing and growing the venture and began to recruit a number of veterans with experience in the areas of business development, software consulting, marketing, and legal representation to assist her in formulating a business model with a clear value proposition. She bootstrapped their compensation by offering them equity in the business and delayed bonuses to offset what their salaries would be in the open market.

Debbie soon found herself fielding calls from complete strangers wanting to franchise Snappy Auction. She decided that franchising was a cost-effective way to grow her business. She could bootstrap expansion by having her franchisees pay for each new Snappy Auction outlet. However, pursuing such an option would require her to develop a formal franchise agreement. The Federal Trade Commission (FTC) requires all franchisees to create a Uniform Franchise Disclosure Document (UFDD), a document designed to provide potential franchisees with the important information they need to make fully informed decisions about investing in a franchise. Debbie found that hiring consultants to develop the UFDD would cost at least $100,000, which was beyond the funding she had available to invest in the business. Rather than try to borrow money or find an investor, she decided to bootstrap this part of her company by writing her own UFDD agreement. With FTC regulations in one hand and a copy of *Franchising for Dummies* in the other, Debbie completed her franchise agreement just in time for an franchising expo. The expo resulted in significant interest from potential franchisees, confirming Debbie's belief. Based primarily on word-of-mouth and press coverage, the franchising of Snappy Auction had begun in earnest. Snappy Auction would go on to sign 40 franchise agreements in 10 states by early 2005. At of the beginning of 2006, the number of signed franchise agreements would reach more than 100, with 50 of those locations up and running.

Snappy Auction's software system helps the salesperson determine an item's value based on market demand and even determine the best day to kick off bidding. Once again, Debbie used bootstrapping to develop her software platform. She had a software background and was able to find a software engineer to work with her. The software allowed Snappy Auction to provide an easy eBay interface to franchisees, giving her company a significant competitive advantage over other retail auction businesses that were entering the market.

Snappy Auction was already at a crossroads because of its rapid growth. Debbie wanted to continue to grow the business as aggressively as possible. People had been coming to her eager to invest in her successful business. Up until this point, she had been the only shareholder and had no long-term debt. She had financed all of her company's growth from her initial investment, bootstrapping, and the cash flow that Snappy Auction generated from its operations.

1. Bootstrapping was an essential ingredient in Snappy Auction's successful and rapid growth. What advantages did bootstrapping offer Debbie as she grew her company? What limitations can bootstrapping create?
2. Evaluate possible sources of equity financing that Debbie could have used if she had not bootstrapped. What would equity investors expected from their investment in Snappy Auction? Is Snappy Auction an attractive business model for outside investors? Explain.
3. What would you recommend to Debbie in terms of future financing of Snappy Auction's growth? Should she continue to bootstrap? Should she seek outside investments? Justify your recommendations regarding future financing for Snappy Auction and give details on how you might implement them.

Source: Based on Mark Schenkel, Jeffrey Cornwall, and Jane Finley, "Snappy Auction," *Entrepreneurship Theory and Practice* 36, no. 3 (2012).

Friends and Family Members

Although most entrepreneurs look to their own bank accounts first to finance a business, many do not have sufficient resources to launch their businesses alone. After emptying their own pockets, entrepreneurs should look to friends and family members who might be willing to invest in a business venture. Because of their relationships with the founder, these people are most likely to invest.

ENTREPRENEURIAL PROFILE: Gauri Nanda: Nanda Home Gauri Nanda had never really wanted to be an entrepreneur. Growing up, she had seen her parents struggle as small business owners. Nanda developed the first product for her business, Nanda Home, while attending graduate school at the Massachusetts Institute of Technology. The product was an alarm clock called Clocky that offered a unique way of waking up its owner. When the user presses the snooze bar, Clocky rolls off the table on its oversized wheels and finds a place to "hide" in the room. Clocky's mobile maneuvering forces the sleepy owner to get out of bed to turn off the alarm. Nanda had never intended her invention to become a business. It was simply a device she invented because of her own challenges with waking up for class on time. However, several tech bloggers discovered her product. The publicity, including being featured on national television news programs, convinced her that she should take advantage of the demand resulting from all the attention that Clocky had been getting. Nanda raised $80,000 from family members to launch her business. Because Nanda outsourced manufacturing, she was able to reach profitability without any additional outside investment beyond the funds from her family.[13]

The Global Entrepreneurship Monitor, a study of entrepreneurial trends across the globe, reports that family members and friends are the biggest source of external capital used to launch new businesses. Investments from family and friends are an important source of capital for entrepreneurs, but the amounts invested typically are small, often no more than just a few thousand dollars. In the United States, business founders and their family members investments in start-up businesses make up 36 percent of the typical start-up business's total capital.[14]

Investments (or loans) from family and friends are an excellent source of seed capital and can get a start-up far enough along to attract money from private investors or venture capital companies. Research by the Small Business Administration shows that 62 percent of start-up companies with employees and 59.6 percent of start-ups with no employees rely on personal and family savings to finance their businesses.[15] Inherent dangers lurk in family business investments and loans, however. Unrealistic expectations or misunderstood risks have destroyed many friendships and have ruined many family reunions. To avoid problems, an entrepreneur must honestly present the investment opportunity and the nature of the risks involved to avoid alienating friends and family members if the business fails. Smart entrepreneurs treat family members and friends who invest in their companies in the same way they would treat business partners. Some investments in start-up companies return more than friends and family members ever could have imagined. In 1995, Mike and Jackie Bezos invested $300,000 into their son Jeff's start-up business, Amazon.com. Today, Mike and Jackie own 6 percent of *Amazon.com*'s stock, and their shares are worth more than $8 billion![16]

Table 16.1 offers suggestions for structuring family and friendship financing deals.

Crowdfunding

Historically, securities laws limited who can invest in small businesses. Investing in entrepreneurial businesses has been the realm of those with the knowledge and financial ability to assume the risks that come with such investments. These investors are called **accredited investors**. A few creative entrepreneurs have raised money from investors who do not meet the requirements of accredited investors using a funding technique called **crowdfunding**. Crowdfunding uses the Internet to generate many small contributions from a large number of people to fund a business. Crowdsourcing has been used primarily to help raise money to support social causes, help fund struggling artists, or support local small business start-ups. The money received from crowdfunding was considered a contribution or a donation rather than an investment. In most cases, something nominal is usually offered in return for financial support. For example, a musician might show appreciation to contributors by giving each of them a free download of a new song. Likewise, an owner of a new restaurant may offer contributors a special discount. The contributions are motivated by the desire to help out the struggling musician or restaurateur. The most commonly used Web sites that promote traditional crowdfunding are Kickstarter and IndieGoGo.

ENTREPRENEURIAL PROFILE: Eric Migicovsky: Pebble Eric Migicovsky had tried to raise money from traditional equity financing sources for his new wristwatch, called Pebble, that pairs with smart phones via Bluetooth. However, he was unable to attract the funding he needed, so he decided to take the unconventional approach of mounting a Kickstarter campaign. Although his initial goal was to raise $100,000, Migicovsky was able to raise more than $10 million to help launch Pebble. In exchange for their contributions, Migicovsky promised contributors that they would have preference to buy Pebbles when the watches were introduced to the market. "I think our campaign was successful because people can actually imagine themselves using Pebble," said Migicovsky. "If we're building something people want, why don't we ask the people?"[17]

The Jumpstart Our Business Startups (JOBS) Act of 2012 significantly expands the use of crowdfunding as a means for raising equity investment for small businesses. Crowdfunding for small business no longer must treated as a contribution. Under the provisions of this bill, those who provide funding can become equity investors with ownership in the business. The JOBS Act opens up funding of start-ups to a much broader group of investors who do not meet the legal criteria to be considered accredited investors. To be eligible for crowdfunding, the business must have annual revenues of less than $1 billion. An eligible business can raise up to $1 million from a crowdfunding offering each year. There are limitations on how much individuals can invest in a crowdfunding deal that is based on their income and net worth. Using crowdfunding under the JOBS Act, *anyone* can invest some amount in a business start-up. Entrepreneurs are no longer limited to seeking funding only from accredited investors.[18]

Attracting investors through crowdfunding requires a different approach than an entrepreneur uses when pursuing more sophisticated and experienced investors. Unlike experienced investors who invest more in people than in their ideas, crowdfunding investors are attracted to compelling stories and business ideas they can see themselves using. Crowdfunding works through social media, so the people in an entrepreneur's existing network must be advocates and

TABLE 16.1 Suggestions for Structuring Family and Friendship Financing Deals

Tapping family members and friends for start-up capital, whether in the form of equity or debt financing, is a popular method of financing business ideas. In a typical year, some 6 million individuals in the United States invest in entrepreneurial ventures started by family members and friends. Unfortunately, these deals don't always work to the satisfaction of both parties. Chris Baggott, at the age of 31, quit his corporate job and bought a dry-cleaning store that he built into a chain with seven locations. He financed the business with a loan of $45,000 from his father-in-law, James Twiford Anderson, a physician. Anderson also cosigned a $600,000 bank loan for his son-in-law. However, the business soon fell on hard times, falling well short of Baggott's projections. Baggott was unable to meet his loan obligations. To try to find out what was going on, the bank went straight to Baggott's father-in-law, who would then call Baggott to get answers. "He'd call us and say, 'What the heck is going on here?'" says Baggott. "And then he'd have to write a check to cover it from his own funds." Eventually, Baggott had no choice but to sell his business. His father-in-law lost tens of thousands of dollars on the venture. "It was painful," says Baggott, who felt that the business failure strained the relationship with his father-in-law.

The following suggestions can help entrepreneurs avoid needlessly destroying family relationships and friendships:

- **Keep the arrangement strictly business.** The parties should treat all loans and investments in a business-like manner, no matter how close the friendship or family relationship, to avoid problems down the line. If the transaction is a loan exceeding $13,000, it must carry a rate of interest at least as high as the market rate; otherwise, the Internal Revenue Service may consider the loan a gift and penalize the lender.
- **Validate the business plan.** Seek business counseling from outside experts, such as a local SBDC (Small Business Development Center) or a SCORE (Service Corps of Retired Executives) chapter, to test the strength of the business plan before you present it to family members.
- **Educate "naive" investors.** Family members and friends usually invest in a business because of their relationships with the founder, not because they understand the business itself. Take the time to explain to potential investors the basics of the business idea, how it will make money, and the risks associated with investing in it.
- **Never accept more than investors can afford to lose.** No matter how much capital you may need, accepting more than family members or friends can afford to lose is a recipe for disaster—and perhaps financial hardship or even bankruptcy for the investors. Brian Scudamore, founder of 1-800-Got-Junk?, was unwilling to take money from family members even when his business was in danger of failing (it did not) because of a lack of cash. "My dad could have given me the money. However, I didn't want him to worry that things weren't going well . . . I wanted to show dad that I could do it myself, even if that meant stretching things a bit too far. Also, taking money from him would cause problems if things went sour."
- **Create a written contract.** Don't make the mistake of closing a financial deal with just a handshake. The probability of misunderstandings skyrockets! Settle all of the details of the deal up front in a formal agreement. Putting an agreement in writing demonstrates the parties' commitment to the deal and minimizes the chances of disputes from faulty memories and misunderstandings. If it is an equity agreement, create a formal shareholder agreement. If the money from family is a loan, use a formal promissory note.
- **Treat the money as "bridge financing."** Although family and friends can help you launch your business, it is unlikely that they can provide enough capital to sustain it over the long term. Sooner or later, you will need to establish a relationship with other sources of capital if your company is to grow. Consider money from family and friends as a bridge to take your company to the next level of financing. Have an exit plan for family members to show them how they will get their equity investment, plus a fair return, out of the business.
- **Develop a payment schedule that suits both the entrepreneur and the lender or investor.** Although lenders and investors may want to get their money back as quickly as possible, a rapid repayment or cash-out schedule can jeopardize a fledgling company's survival. Establish a realistic repayment plan that works for the parties without putting excessive strain on the young company's cash flow.
- **Keep everyone informed.** Entrepreneurs should keep investors informed about the company's progress, its successes and failures, and the challenges it faces. Investors will want to know both good news and bad news. Hold regular formal meetings with family investors.

Sources: Based on Alison Stein Wellner, "Blood Money," *Inc.*, December 1, 2003, *www.inc.com/magazine/20031201/gettingstarted.html*; Jenny McCune, "Tips for Feud-Free Financing from Friends and Family," *Bankrate*, July 24, 2000, *www.bankrate.com/brm/news/biz/Capital_borrowing/20000724.asp*; Paul Kvinta, "Frogskins, Shekels, Bucks, Moolah, Cash, Simoleans, Dough, Dinero: Everybody Wants It. Your Business Needs It. Here's How to Get It," *Smart Business*, August 2000, pp. 74–89; Alex Markels, "A Little Help from Their Friends," *Wall Street Journal*, May 22, 1995, p. R10; Heather Chaplin, "Friends and Family," *Your Company*, September 1999, p. 26; Nicole Carter, "How to Get Your Family to Invest Without Drama," *Inc.*, June 19, 2011, *www.inc.com/guides/201106/how-to-get-drama-free-funding-from-parents.html*; Noam Wasserman, *The Founder's Dilemmas* (Princeton, NJ: Princeton University Press, 2012), p. 259.

Source: CartoonStock.

"I call my invention 'The Wheel', but so far I've been unable to attract any venture capital."

lend credibility to a broader network of potential investors.[19] Although the JOBS Act significantly broadens the pool of people who can invest in small businesses, it also creates new challenges for entrepreneurs who use crowdfunding. The use of crowdfunding may complicate future fund-raising if an entrepreneur uses layered financing, so entrepreneurs should seek advice from financing experts to develop a long-term financing plan. Crowdfunding creates a large number of owners all of whom have a certain set of expectations and may require time and attention from the entrepreneur. If adding one additional partner increases the complexity of running a business, imagine what a crowd of partners can do to complicate an entrepreneur's life!

Accelerators

Inexperienced entrepreneurs have difficulty finding early-stage seed funding. The first-time entrepreneur doesn't have the credibility to attract professional investors and typically doesn't have the personal wealth necessary to provide personal funding. To help bridge this gap in funding, many communities and universities have established **accelerator programs** that offer new entrepreneurs a small amount of seed capital and a wealth of additional support. Accelerator programs help move entrepreneurs from the idea stage to a point when the business has a proven story and a successful business model that they can pitch for more significant funding. "An accelerator takes single-digit chunks of equity in externally developed ideas in return for small amounts of capital and mentorship," says Paul Bricault, cofounder of Amplify, a Los Angeles–based accelerator.[20] Accelerators offer a structured program that lasts from three months to one year. A select group of entrepreneurs, typically 10 to 20, are invited to participate as a group in an accelerator program. The accelerator provides entrepreneurs with about $15,000 to $25,000 in seed capital, gives them temporary space to work on their businesses and their pitches, and connects them with a team of mentors, each of whom gets a small share of equity in the business in return for their guidance. All of this requires the entrepreneur to give up 6 to 10 percent of the ownership in the business. At the end of the program, the accelerator hosts a large pitch event. Local angel investors and venture capitalists are invited to hear accelerator participants pitch their business ideas. Investors who are interested can join the mentor team as investors in businesses that "graduate" from the accelerator program. There are private accelerators located in most major cities, and a growing number of universities, such as the Arizona State University program highlighted in the "Entrepreneurship in Action" section in this chapter, have accelerator programs to assist student and alumni entrepreneurs.

Two of the largest accelerator programs are Y Combinator and TechStars. Although accelerators do provide small investments, the most important contribution they offer is the coaching and mentoring from angel investors and experienced entrepreneurs. "Most angel investors have a couple of coffee-shop meetings, write a check, and then cross their fingers," explains David Cohen, founder of the global accelerator network called TechStars. "At TechStars, investors and mentors actually work with the companies for three months. At the end of that time, you've become part of the team—and you know whether or not you want to invest more."[21] The Techstars accelerator program reports that 70 percent of its participants receive subsequent funding after going through its program. An amazing 94 percent of businesses launched through the Y Combinator accelerator program receive additional funding.[22]

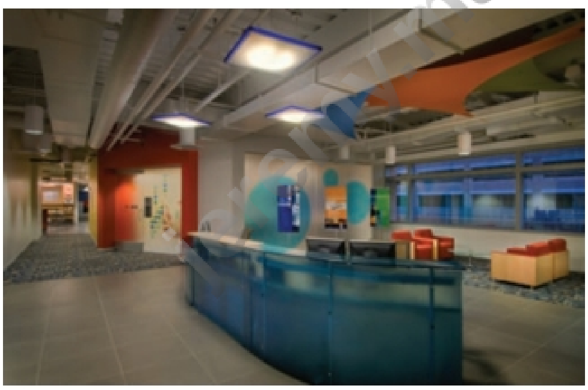
ENTREPRENEURIAL PROFILE: Ben Stucki: Dalo Ben Stucki was an experienced software engineer and app developer and noticed that app developers had only one option for developing new apps—using their computers. He recognized that developers were not happy about having to lug their computers around when working with clients on new apps. He determined that there was a need in the market for software that would allow app developers to use their iPads or other tablets to develop new apps. "Many in our market want to work on mobile devices," said Stucki. "When you go to a client meeting, you don't really bring your laptop anymore. It's an iPad or a tablet." However, Stucki did not have the business experience necessary to secure funding for his new product, so he entered JumpStart Foundry, an accelerator that is part of the TechStars network. JumpStart Foundry provided Stucki with a space to work and seed capital. However, most important for Stucki, JumpStart Foundry provided mentors who had both investment and start-up experience. During the summer that he was in the accelerator program, Stucki worked on both developing his software and his business skills. After leaving the program at the end of the summer, he was able to raise $400,000 in capital from a venture capital firm and two angel investors, allowing him to hire his first employee, build his business, and begin to sell his product.[23]

Entrepreneurship in Action

Launching a Business in a University Accelerator

SkySong is a 43-acre technology park in Scottsdale, Arizona, developed by Arizona State University (ASU). SkySong will eventually include more than 1.2 million square feet of office, research and retail space; multifamily residential units; a hotel; and a conference center. One of the programs within SkySong is ASU's Edson Student Accelerator. Edson provides teams of student entrepreneurs from across the ASU campus with up to $20,000 in seed funding, office space for one year within SkySong, training and coaching, and an intensive mentoring program. The Edson accelerator program gives student entrepreneurs the opportunity to develop their innovative ideas and launch viable businesses. The program accepts student entrepreneurs pursuing any enterprise, large or small, for-profit or not-for-profit, domestic or global. Each year teams of aspiring student entrepreneurs submit written proposals to apply to become part of the accelerator program. It is a highly competitive process. The written proposals go through two rounds of judging. The finalists are invited to make presentations on their proposals to a panel of judges. Applications for a recent accelerator cohort included 340 start-up teams that included more than 1,000 ASU students from all university disciplines. Those 340 applicants were narrowed down to the top 30, who then pitched to an independent panel of judges comprised of local business leaders and successful entrepreneurs. The judges then chose the top 20 companies to receive funding and support from the Edson program. Brent Sebold, a venture manager at SkySong, says that helping entrepreneurs build the right team that can successfully transform the idea into a business that generates revenues and creates new jobs is the value of an accelerator program.

Three of the five finalists for *Entrepreneur* magazine's College Entrepreneur of 2011 participated in the Edson Student Accelerator program, including the winner of the award, Gabrielle Palermo. Palermo is COO and cofounder of a business called G3Box, which sells medical clinics made out of converted steel shipping containers to nonprofits and nongovernmental organizations. "I wasn't thinking I would be running a business while I was in college," said Palermo. The idea for the business came


Source: ASU SkySong.


Source: ASU SkySong.

Skysong, Arizona State University's Innovation Center

(continued)

Entrepreneurship in Action *(continued)*

from a challenge posed by professors in one of her engineering classes. The challenge was to come up with a use for the numerous used shipping containers abandoned at ports around the world. The professor teamed Gabrielle Palermo with classmates Billy Walters, Susanna Young, and Clay Tyler. "The team's thinking immediately turned to ways to convert the containers into something that could help people," says Palermo. Their idea from the class project soon evolved into their start-up business.

G3Box solves two problems: It uses freight shipping containers that are left to rust in ports around the world, and it addresses the problem of inadequate medical facilities in rural areas. "For every seven containers we sell, we can donate a free maternity clinic," Palermo says. Shipping containers are ideal because they are durable, available all around the world, and can be made mobile, allowing access to remote locations. When converting the shipping container into clinics, G3Box must include an electrical power system, a ventilation/air-conditioning system, usable clinic space, and access to potable water.

G3Box is developing a prototype clinic to address maternal mortality in rural Africa, which has one of the highest maternal mortality rates in the world. In Malawi, Africa, for every 100,000 live babies born, 1,200 women will die. Most of these deaths, due to hemorrhage, sepsis, and hypertensive diseases, are preventable when there is access to quality medical facilities and educated health care administrators. "After the first clinic is set up, we will be able to tailor their designs for the future clinics based on the feedback from the villagers," says cofounder Susanna Young.

1. Work with a small team of your classmates to develop a plan to create an accelerator program on your campus. Make sure to develop a plan that fits within the mission and resource constraints of your school. If your school already has an accelerator program, what are the similarities and differences between your program and the program at ASU?
2. Evaluate possible equity funding options for G3Box as it prepares to leave its one-year stay in the accelerator program.
3. What tips can you offer the G3Box team before they approach the sources of financing you have listed?
4. Assuming that you have the financial means to invest in a small company, would you invest in G3Box? Explain. If so, what questions would you ask before investing?

Sources: http://skysong.asu.edu; Mary Shinn, "Engineering Classes Help Students Reach Out," Statepress.com, September 12, 2010, *www.statepress.com/2010/09/12/engineering-classes-help-students-reach-out*; Stacie Spring, "3 ASU Student Businesses Up for Entrepreneur Prize," *Ahwatukee Foothills News*, February 12, 2012, *www.ahwatukee.com/news/business/article_52964369-7515-550b-8af1-4057486e6bdf.html*; Carolyn Horwitz, "Meet the Entrepreneur of 2011 Award Winners," *Entrepreneur*, December 21, 2011, *http://www.entrepreneur.com/article/222469*; Maria Muto-Porter, "An Inside Look at Arizona State University's SkySong Incubator," *Young Entrepreneur*, May 17, 2012, *www.youngentrepreneur.com/blog/an-inside-look-at-arizona-state-universitys-skysong-incubator*.

Angels

After they dip into their own pockets and convince friends and relatives to invest, some entrepreneurs still need even more money for seed and early growth capital. At this point, entrepreneurs often turn to private investors. These private investors, known as **angel investors**, are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies. Angel investing has a long history of supporting successful start-ups. For example, Alexander Graham Bell, inventor of the telephone, used angel capital to start Bell Telephone in 1877. More recently, companies such as Google, Facebook, Apple, Starbucks, Amazon, and the Costco relied on angel financing in their early years to finance growth.

In many cases, angels invest in businesses for more than purely economic reasons (often because they have experience and a personal interest in the industry), and they are willing to put money into companies in the earliest stages (often before a company generates any revenue), long before venture capital firms jump in. Angel financing is ideal for companies that have outgrown the capacity of investments from friends and family but are still too small to attract the interest of venture capital companies.

ENTREPRENEURIAL PROFILE: Elizabeth Thorpe: Posh Brood Based on her experience as a mom trying to plan vacations for her own family, Elizabeth Thorpe decided that there was a need for a Web site that offered family-friendly choices on where to stay. Thorpe's business, Posh Brood, targets young, upscale families with incomes of $150,000 to $300,000. She started the business with a personal investment of $20,000, but her ability to build a sizable following of customers and the publicity from several very favorable reviews in the media attracted interest from investors. Posh Brood is a certified travel agency that generates revenues primarily through commissions paid by hotels. Thorpe built relationships with large hotel chains, such as Omni Hotels and Resorts, and established relationships with Expedia.com and Travelzoo. She chose to work with an angel investor to fund her business rather than seek a large investment from venture capital firms. The angel invests $12,000 each month to cover Posh Brood's payroll for five employees and other operating expenses. Thorpe believes that this approach to financing gives her time to fully develop her business model and determine the best growth path for Posh Brood over the long term.[24]

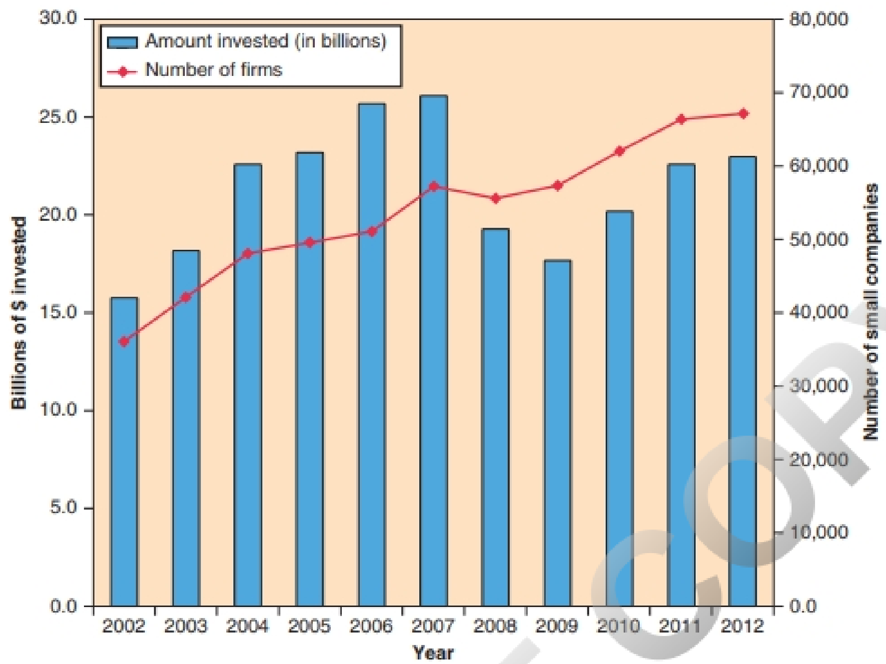


FIGURE 16.2
Angel Financing

Angels are a primary source of capital for companies that have the potential for significant growth in the start-up stage through the growth stage. The Center for Venture Research at the University of New Hampshire estimates that more than 268,000 angels invest $22.9 billion a year in more than 67,000 small companies, most of them in the start-up phase (see Figure 16.2).[25] Angels invest almost as much money in small companies as do venture capital firms, but they put it into nearly 18 times as many companies as do venture capital firms. Because the angel market is so fragmented and, in many cases, built on anonymity, we may never get a completely accurate estimate of its investment in business start-ups. However, experts concur on one fact: Angels are a vital source of equity capital for small businesses.

Angels fill a significant gap in the seed capital market. They are most likely to finance start-ups with capital requirements in the $10,000 to $2 million range, well below the $5 million to $25 million minimum investments most professional venture capitalists prefer. Because they invest in earlier stages of a business, angels also tolerate risk levels that would make venture capitalists shudder. In fact, 52 percent of angels' investments lose money, returning less than the angels' original investment. The potential for investing in big winners exists as well; 7 percent of angels' investments produce a return of more than 10 times their original investments.[26] In general, angel investors hope to realize a return of 10 times their original investment for seed stage funding, eight times their investment for a start-up business, and from three to five times their investment for funding in business seeking growth capital.[27]

Lewis Gersh, an experienced angel investor, says that out of 10 companies that an angel invests in, five will fail, two will break even, and two will return two to three times the original investment. Just one company out of 10 will produce a significant return, "which means that every one of them has to have the potential of being a home run," says Gersh. Most angels consider a "home run" investment to be one that results in a return of 10 to 30 times the original investment in five to seven years, somewhat lower than the returns that venture capital firms expect.[28] One angel investor, a retired entrepreneur, says that of the 31 companies he has invested in, "more than half have gone under, but four were home runs, returning 25 times my investment. The others gave me a small return or at least some of my money back."[29] Angel financing is important because angels often finance deals that venture capitalists will not consider.

ENTREPRENEURIAL PROFILE: Angelo Nunez and Cary Williams-Nunez: Prime Time Boxing Angelo Nunez and Cary Williams-Nunez combine the Baby Boomer Generation's interest in keeping in shape with nostalgia for boxing that can be traced back to the *Rocky* movies that were popular during their youth. Prime Time Boxing offers members boxing lessons as a path to fitness. The success of the company's first three Prime Time Boxing locations led the owners to seek angel funding to expand their business to additional locations. They plan to buy existing gyms and convert them to Prime Time Boxing gyms using the funds raised from angel investors. Although their existing locations are profitable, they need $500,000 in growth capital from angel investors to fund their expansion goals for their company.[30]

Because angels prefer to maintain a low profile, the real challenge lies in *finding* them. Most angels are seasoned entrepreneurs themselves; on average, angel investors have founded 2.7 companies and have 14.5 years of entrepreneurial experience. They also are well educated; 99 percent have college degrees. Research also shows that 88 percent of angel investors are men (their average age is 57 years) who have been investing in promising small companies for nine years. The typical angel invests an average of $50,000 in a company that is at the seed or start-up growth stages and makes an investment in one company per year.[31] The average time required to close an angel financing deal is 67 days.[32] Angels accept 14.5 percent of the investment proposals they receive.[33] When evaluating a proposal, angels look for a qualified management team ("We invest in people," says one angel), a business with a clearly defined niche, the potential to dominate the market, and a competitive advantage. They also want to see market research that proves the existence of a sizable and profitable customer base.

Because angels frown on "cold calls" from entrepreneurs they don't know, locating them boils down to making the right contacts. Asking friends, attorneys, bankers, stockbrokers, accountants, other business owners, and consultants for suggestions and introductions is a good way to start. "Angels are more likely to invest in a company that was referred to them by someone they know and trust," says Marianne Hudson, director of the angel initiative at the Kauffman Foundation.[34] Networking is the key. Angels almost always invest their money locally, so entrepreneurs should look close to home for them—typically within a 50- to 100-mile radius. Angels also look for businesses they know something about, and most expect to invest their knowledge, experience, and energy as well as their money in a company. In fact, the advice and the network of contacts that angels bring to a deal can sometimes be as valuable as their money!

Angel investing has become more sophisticated, with investors pooling their resources to form angel networks and angel capital funds, dubbed "super-angels," that operate like miniature versions of professional venture capital firms and draw on their skills, experience, and contacts to help the start-ups in which they invest succeed. Angel networks are affiliations of independent angel investors. The network carefully screens potential deals before they are presented to the angel investors. Most networks have a team that works with entrepreneurs to improve their business plans and polish the pitches of those entrepreneurs who make it through the initial screening. Each angel investor makes an individual decision about whether to invest in each deal presented to the group. Membership fees from the angels and sponsorships paid by local professional organizations, such as law firms, accounting firms, and commercial banks, support the operating costs of the angel network. Angel super-funds go one step further and pool money from a group of angels to directly invest in deals. A committee of angels participating in the super-fund or staff hired to manage the pool of investment capital picks the companies in which the super-fund invests. Veteran angel investor Mike Maples operates Floodgate, a super-angel fund that manages $35 million in angel capital and invests between $250,000 and $1 million in promising start-ups, including Twitter and Digg.[35]

Today, more than 300 angel capital networks operate in cities of all sizes across the United States (up from just 10 in 1996) with as many operating in other countries.[36] Entrepreneurs can find angel networks in their areas with the help of the Angel Capital Association's directory (*www.angelcapitalassociation.org*). With the right approach, an entrepreneur can attract more money and a larger network of advisers from an angel capital group than from individual investors. The typical angel capital group has 44 members who invest $1.77 million each year in 6.3 companies on average.[37]

ENTREPRENEURIAL PROFILE: Stephanie Hanbury-Brown: Golden Seeds Golden Seeds's angel investor network of 250 members is the fourth-largest angel group in the United States. Its focus is on investing in women-led businesses. "It's very difficult for any entrepreneur to get capital, and it's even harder for women," says Stephanie Hanbury-Brown, founder of Golden Seeds. Members of the Golden Seeds angel network include both men and women, but the majority of members are women. So far, members of the network have invested approximately $34 million in 42 promising companies. "The top three things we look for are a great entrepreneur, a great entrepreneur, and a great entrepreneur," says Hanbury-Brown. "We back the jockey over the horse, unlike some venture capitalists who are OK backing the idea or the technology." Golden Seeds makes investments in multiple industries, including technology, consumer goods, life sciences, and media. The group has locations in New York, Boston, Philadelphia, and San Francisco. "I like investing in people who really know a particular industry and maybe worked at a corporation within a particular industry," says Hanbury-Brown. "And while they were there, they identified a real gap and need in the marketplace. Those people are in a really good position to know where the future of the industry is going and how they can disrupt that course."[38]

Angels are an excellent source of "patient money," often willing to wait five to seven years or longer to cash out their investments. They earn their returns through the increased value of the business, not through dividends and interest. For example, more than 1,000 early investors in Microsoft Inc. are now millionaires, and the original investors in Genentech Inc. (a genetic engineering company) have seen their investments increase more than 500 times.[39] Angels' return-on-investment targets tend to be lower than those of professional venture capitalists. Although venture capitalists shoot for 60 to 75 percent returns annually, angel investors usually settle for 20 to 50 percent (depending on the level of risk involved in the venture). A study by the Kauffman Foundation reports that the average return on angels' investments in small companies is 2.6 times the original investment in 3.5 years, which is the equivalent of an annual 27 percent internal rate of return.[40] Angel investors typically purchase 15 to 30 percent ownership in a small company, leaving the majority ownership to the company founder(s). They look for the same exit strategies that venture capital firms look for: either an initial public offering or a buyout by a larger company.

Strategic Investments Through Corporate Venture Capital

Large corporations are in the business of financing small companies. Today, about 15 percent of all venture capital deals involve strategic investments by corporations. The average investment that large corporations make in small companies is $3.5 million, an amount that represents 8.4 percent of total venture capital investments.[41] Approximately 300 large corporations across the globe, including Intel, Motorola, Cisco Systems, Chevron, Comcast, Nokia, UPS, and General Electric, have venture capital divisions that invest on average $2.2 billion a year in young companies, most often those in the product development and sales growth stages. The large companies are looking not only for financial returns from the small companies in which they invest but also innovative products that can benefit them. Young companies get a boost from the capital injections that large companies give them, but they also stand to gain many other benefits from the relationship. The right corporate partner may share technical expertise, distribution channels, and marketing know-how and provide introductions to important customers and suppliers. Another intangible yet highly important advantage that an investment from a large corporate partner gives a start-up is credibility, often referred to as "market validation." Doors that otherwise would be closed to a small company magically open when the right corporation becomes a strategic partner.

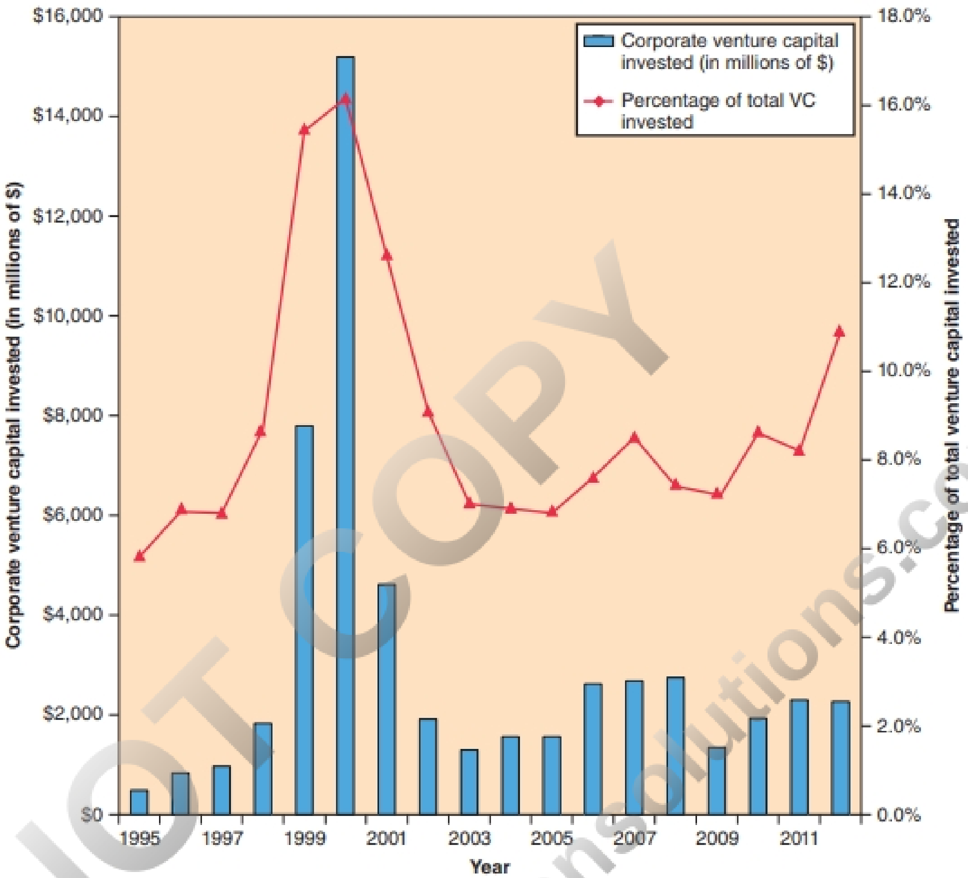
Foreign corporations also are interested in investing in small U.S. businesses. Often, these corporations are seeking strategic partnerships to gain access to new technology, new products, or access to lucrative U.S. markets. In return, the small companies that they invest in benefit from the capital infusion as well as from their partners' international experience and extensive network of connections. Figure 16.3 shows recent trends in corporate venture capital.

ENTREPRENEURIAL PROFILE: Cisco Systems Since its inception, Cisco Systems's venture capital fund has invested more than 100 technology start-up companies. In addition, the Cisco venture capital fund leverages its funding by investing in regional venture capital funds that have a focus on technology investments around the globe. Cisco looks for more than just product fit in their investments. "The best way to think of our research and development organization is that, to some extent, it's a collection of tribes," says Guido Jouret, chief technology officer of Cisco's emerging technologies group. "We have business units focused on their own products, with their own competitors and their own partnership alliances. When it comes to acquiring new technologies, Cisco has a 'simple and rigorous checklist' for evaluating opportunities. In addition to proving its technology is beneficial to Cisco in both the short and long term, a company should have a corporate culture that blends seamlessly with Cisco." For example, Cisco's venture fund invested $100 million in Insieme, which develops software for cloud computing and networking. With its investment, Cisco also has the rights to acquire Insieme outright for an additional $750 million in the future. Cisco executives recognize that not all research and development can come from inside their company and that strategic investments broaden Cisco's development of new and innovative products.[42]

FIGURE 16.3

Corporate Venture Capital

Source: Based on PriceWaterhouse-Coopers MoneyTree Report.



In the Entrepreneurial Spotlight

Funding Does Not Ensure Success

Christopher Cashman founded Protez Pharmaceuticals in 2003 using a creative financing plan. In exchange for 25 percent of the stock of Protez, Influx Pharmaceuticals agreed to give Protez some promising new drugs that it was not able to bring to market because of its commitment to several other new drugs. To develop these drugs, Protez received $3.3 million in government grants that Influx had been awarded. Protez also received an $800,000 investment from a small corporate venture capital division of a London-based drug company. Protez Pharmaceuticals's mission was to engage in the discovery and development of new antibiotics for difficult-to-treat infections, particularly those tied to infections in hospitals, using the technology they received from Influx.

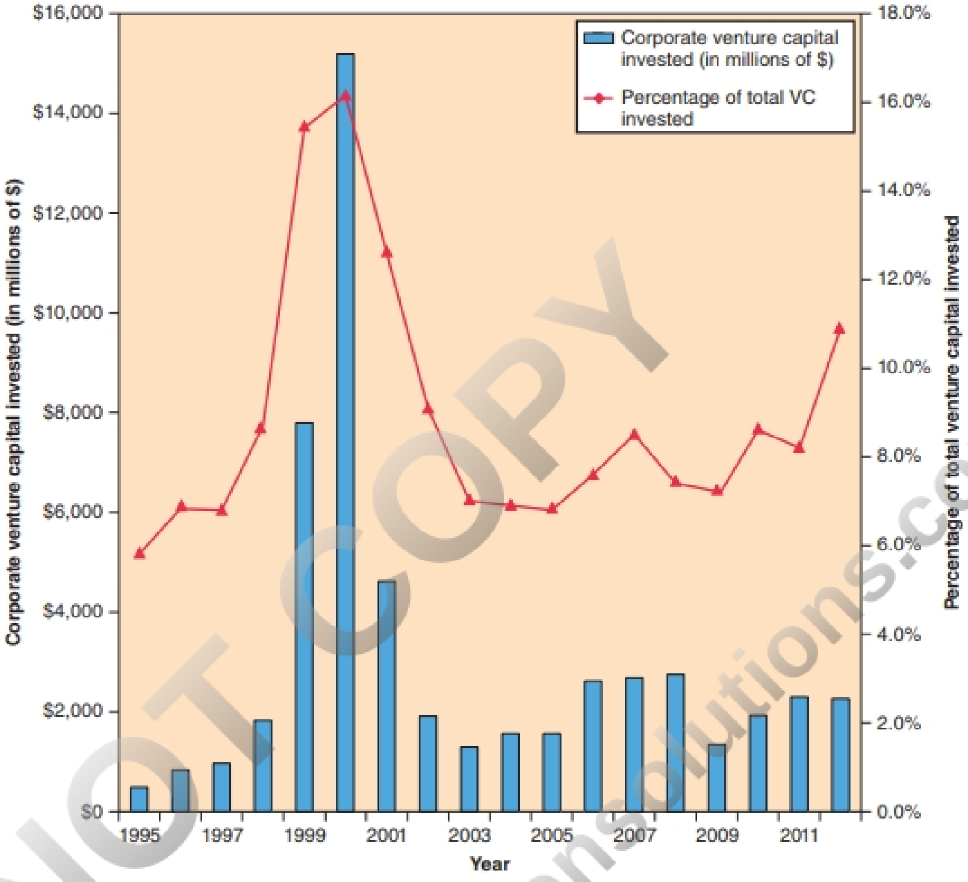
In 2005, Cashman raised $800,000 in seed funding from an angel capital network, Robin Hood Ventures, and another $250,000 from Innovation Philadelphia, a nonprofit economic development organization that serves the Philadelphia metropolitan region. His pitch to investors was that Protez was working on four different drug technologies, each of which could represent an annual market of $250 million to $500 million. The most promising of the four was known as Compound Y, a broad-spectrum antibiotic first developed in Japan.

Based on the progress Protez was making, Cashman quickly began pursuing a substantial B round of funding that he hoped would raise another $15 million. Cashman pitched to investors that $10 million would be enough to get Compound Y through Phase I clinical trials and that the full $15 million would take the drug all the way through Phase II. To be approved by the U.S. Food and Drug Administration, drugs must go through three phases of human trials: Phase I establishes safety and dosage, Phase II measures efficacy in a limited population, and Phase III measures efficacy in a broader population. Protez's monthly burn rate (the amount of negative cash flow each month) was $190,000. Cashman expected Protez's burn rate to double over

FIGURE 16.3

Corporate Venture Capital

Source: Based on PriceWaterhouse-Coopers MoneyTree Report.



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Only two years later, just as Compound Y was entering Phase II clinical trials, Protez announced that there was an agreement for Novartis to acquire the company. As optimistic as Cashman was about Protez, even he was surprised that the company was purchased so early in its development. Under the terms of the agreement, Novartis agreed to acquire Protez for up to $400 million in cash. The first $100 million was paid at closing. Novartis tied the remaining $300 million investment in Protez to meeting certain clinical milestones, regulatory approvals, and commercial targets. Protez became a stand-alone subsidiary of Novartis, maintaining its operations in Pennsylvania. The sale of Protez was Robin Hood Venture's biggest exit to date. Robin Hood investors could have ultimately reaped as much as 15 times their investment if the entire $400 million was paid out. Cashman's optimism soared.

Just two years later, however, Novartis made a stunning announcement about Protez. Officials at Novartis said that the company discontinued the development of Compound Y (now known as PZ-601) after observing a "high rate of adverse events" in testing the drug for patients with skin infections. Novartis closed Protez's headquarters and laid off its 16 employees. The former owners of Protez Pharmaceuticals never saw the $400 million payday they hoped for when Novartis bought the company. "There has not been, and there will be, no milestone payments made from the previously announced $300 million in potential milestones," says Sarah Kestenbaum of Novartis. Even without the additional $300 million, the company's former owners received a fourfold return on their investment from the $100 million in cash paid at the time of the acquisition.

"The [PZ-601] program termination is a reminder of how difficult the drug-development business is," says Barbara S. Schilberg, CEO of BioAdvance. "We look forward to seeing the members of the team find new opportunities in the region where they can use their entrepreneurial talent." They did find new opportunities as well. Three former Protez executives quickly moved on to launch a life sciences company called VenatoRx Pharmaceuticals, which began work on new antibacterial compounds to treat infections funded by a three-year, multi-million-dollar grant from the National Institutes of Health. Christopher Cashman was named to the board of directors of JDP Therapeutics, Inc., a specialty pharmaceutical company.

1. How typical is Protez's success in raising capital? How typical is the eventual demise of Protez even after it had been successful raising funds and negotiated an exit through its sale to Novartis? Explain.
2. Venture capitalists often view failure in previous deals to be at least as valuable as success when looking to invest in the teams that are leading entrepreneurial start-ups. Do you agree with this perspective? Explain. Discuss why the former Protez executives were able to move on so quickly to new endeavors after Protez was shut down.
3. Do you consider the demise of Protez to be a failure? Explain.

Sources: Jim Melloan, "Mr. Cashman, You're On," *Inc.*, July 1, 2005, *www.inc.com/magazine/20050701/cashman.html*; "Protez Pharmaceuticals to Be Acquired by Novartis," *Drugs.com*, June 4, 2008, *www.drugs.com/news/protez-pharmaceuticals-acquired-novartis-8264.html*; John George, "Novartis shutters Protez," *Philadelphia Business*, September 20, 2010, *www.bizjournals.com/philadelphia/stories/2010/09/20/story2.html?page=all*; "JDP Therapeutics, Inc. Appoints Christopher M. Cashman to Board of Directors," *Prweb.com*, June 18, 2010, *www.prweb.com/releases/JDP_Therapeutics/Pharmaceuticals/prweb4159384.htm*.

Venture Capital Companies

4.
Describe the types of businesses that attract venture capital financing and explain the criteria that venture capitalists use to decide on their investments.

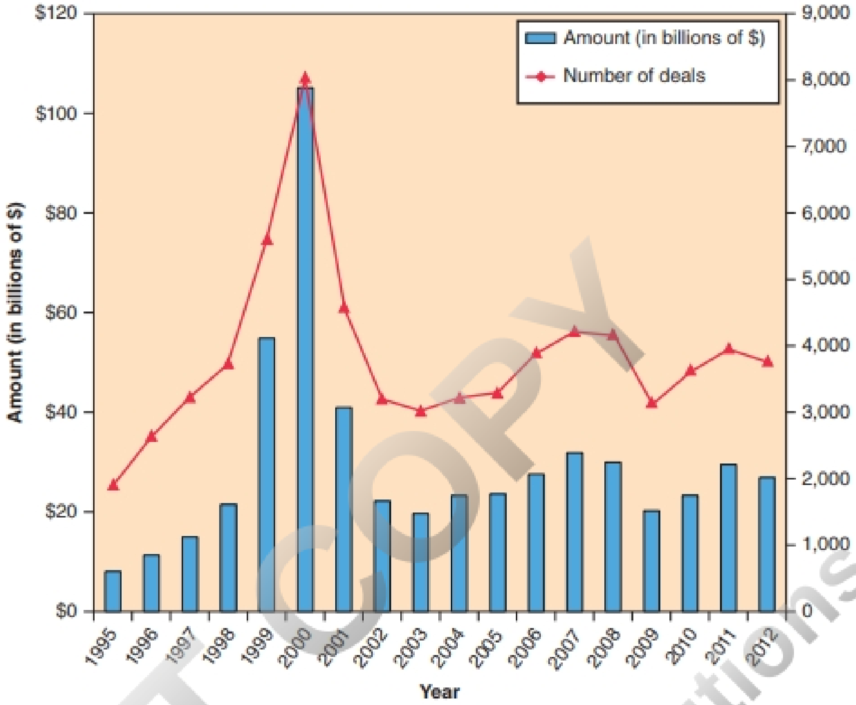
Venture capital companies (VCs) are private, for-profit organizations that raise money from investors to purchase equity positions in young businesses that they believe have high growth and high profit potential, producing annual returns of 500 to 1,000 percent over five to seven years. More than 400 active venture capital firms operate across the United States today, investing in promising small companies in a variety of industries (see Figure 16.4). Companies in California's Silicon Valley and Boston's high-tech corridor attract 38 percent of all venture capital investments.[43] Some colleges and universities across the nation have created venture funds designated to invest in promising businesses started by their students, alumni, faculty, and others. Business schools at the University of Michigan, the University of Maryland, the University of North Dakota, Cornell University, and, in a joint venture called the University Venture Fund, the University of Pennsylvania, Brigham Young University, the University of Utah, and Westminster College operate venture capital funds that are comanaged by students, faculty, and sometimes professional venture capitalists.[44]

Venture capital firms, which provide funding for only 38 out of 100,000 of all start-up companies in the United States, have invested billions of dollars in high-potential small companies over the years, including notable businesses such as Apple Computer, Microsoft Inc., Intel, and Outback Steakhouse.[45] Although companies in high-tech industries such as communications, computer software, energy, medical care, and biotechnology are the most popular targets of venture capital, a company with extraordinary growth prospects has the potential to attract venture capital, whatever its industry.

FIGURE 16.4

Venture Capital Funding

Source: Based on PriceWaterhouse-Coopers Money Tree Report.



The opinions of entrepreneurs and venture capitalists often differ when it comes to the growth potential for their start-up businesses. The typical venture capital firm receives about 1,100 business plans each year. "It's rare that an unsolicited business plan shows up on the doorstep and becomes funded," says Bryan Stolle with Mohr Davidow Ventures. "We have large networks of trusted colleagues and advisors, and we have more brought to us through those networks than we can handle or deal with."[46] For every 100 business plans that the average venture capital firm receives, 90 of them are rejected immediately because they do not match the firm's investment criteria or requirements. The firm conducts a thorough due diligence investigation of the remaining 10 companies and typically invests in only one of them. That is only 1 percent of the deals they consider! Undoubtedly, every entrepreneur who submits a business plan to venture capitalists is convinced that their business was worthy of funding, but very few ever see any investment. Table 16.2 offers a humorous look at how venture capitalists decipher the language of sometimes overly optimistic entrepreneurs.

A traditional venture capital firm seeks funding for several separate funds managed within the firm. Investment in the venture funds comes from wealthy individuals, corporations, pension funds, endowments, foundations, and insurance companies. Each fund has a cap for the amount of investment and a defined period of time that the fund will invest in high-potential businesses. As each fund nears the end of its defined time of operation, the venture capital management team seeks to liquidate all investments made from that fund so that the investors in the fund can be paid and realize a return on their initial investment. A few venture capital firms, known as evergreen funds, do not put a defined life on their funds and simply pay out returns to their investors over time as companies they invest in reach an exit event, such as an acquisition or public offering.

Policies and Investment Strategies

Venture capital firms usually establish stringent policies to govern their overall investment strategies.

INVESTMENT SIZE AND SCREENING The average venture capital firm's investment in a small company is $7.2 million. Depending on the size of the venture capital company and its cost structure, minimum investments range from $100,000 to $5 million. Investment ceilings, in effect, do not exist. Most firms seek investments in the $5 million to $25 million range to justify the cost of screening the large number of proposals they receive.

TABLE 16.2 Deciphering the Language of the Venture Capital Industry

By nature, entrepreneurs tend to be optimistic. When screening business plans, venture capitalists must make an allowance for entrepreneurial enthusiasm. Here's a dictionary of phrases commonly found in business plans and their accompanying venture capital translations.

Exploring an acquisition strategy—Our current products have no market.

We're on a clear P2P (pathway to profitability)—We're still years away from earning a profit.

Basically on plan—We're expecting a revenue shortfall of 25 percent.

A challenging year—Competitors are eating our lunch.

Considerably ahead of plan—Hit our plan in one of the last three months.

Company's underlying strength and resilience—We still lost money, but look how we cut our losses.

Core business—Our product line is obsolete.

Currently revising budget—The financial plan is in total chaos.

Cyclical industry—We posted a huge loss last year.

Entrepreneurial CEO—He is totally uncontrollable, bordering on maniacal.

Facing challenges—Our sales continue to slide, and we have no idea why.

Facing unprecedented economic, political, and structural shifts—It's a tough world out there, but we're coping the best we can.

Going to market with a freemium model—We don't know how we are going to make money, but we are going to start by giving our products away.

Highly leverageable network—No longer works but has friends who do.

Ingredients are there—Given two years, we might find a workable strategy.

Investing heavily in research and development—We're trying desperately to catch the competition.

Limited downside—Things can't get much worse.

Long sales cycle—Yet to find a customer who likes the product enough to buy it.

Major opportunity—It's our last chance.

Niche strategy—A small-time player.

On a manufacturing learning curve—We can't make the product with positive margins.

Passive investor—Someone who phones once a year to see if we're still in business.

Positive results—Our losses were less than last year.

Refocus our efforts—We've blown our chance, and now we have to fire most of our employees.

Repositioning the business—We've recently written off a multi-million-dollar investment.

Selective investment strategy—The board is spending more time on yachts than on planes.

Solid operating performance in a difficult year—Yes, we lost money and market share, but look how hard we tried.

Somewhat below plan—We expect a revenue shortfall of 75 percent.

Expenses were unexpectedly high—We grossly overestimated our profit margins.

Strategic investor—One who will pay a preposterous price for an equity share in the business.

Strongest fourth quarter ever—Don't quibble over the losses in the first three quarters.

Sufficient opportunity to market this product no longer exists—Nobody will buy the thing.

Too early to tell—Results to date have been grim.

A team of skilled, motivated, and dedicated people—We've laid off most of our staff, and those who are left should be glad they still have jobs.

Turnaround opportunity—It's a lost cause.

Unique—We have no more than six strong competitors.

Volume sensitive—Our company has massive fixed costs.

We don't measure our success by financial results—We are not sure whether this business model will ever result in profits.

We're iterating like crazy right now—We are no closer to a real product now than we were six months ago.

Window of opportunity—Without more money fast, this company is dead.

Work closely with the management—We talk to them on the phone once a month.

A year in which we confronted challenges—At least we know the questions even if we haven't got the answers.

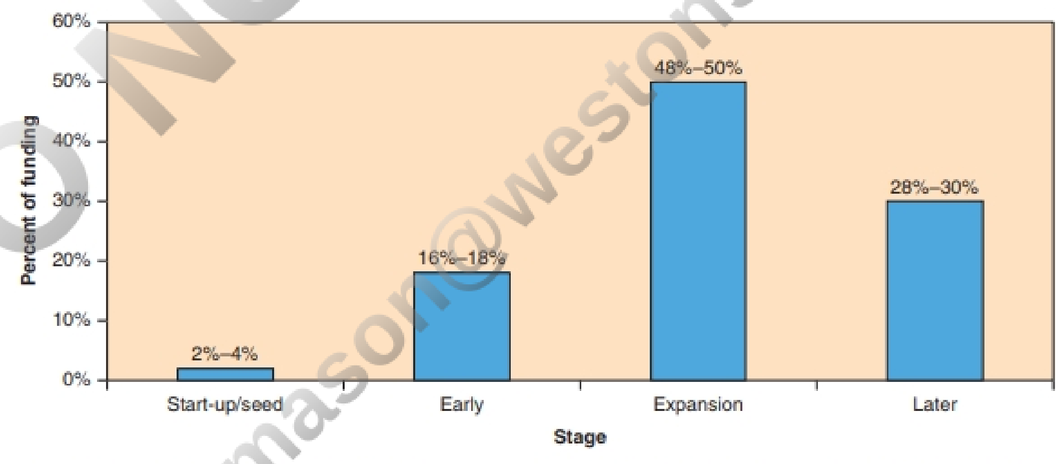
Sources: Based on Scott Herhold, "When CEOs Blow Smoke," *e-company*, May 2001, pp. 125–127; Suzanne McGee, "A Devil's Dictionary of Financing," *Wall Street Journal*, June 12, 2000, p. C13; John F. Budd Jr., "Cracking the CEO's Code," *Wall Street Journal*, March 27, 1995, p. A20; "Venture-Speak Defined," *Teleconnect*, October 1990, p. 42; Cynthia E. Griffin, "Figuratively Speaking," *Entrepreneur*, August 1999, p. 26; Tom Ruhe, "The Most Pervasive, Pernicous Offense," *Wall Street Journal*, July 10, 2013, http://blogs.wsj.com/accelerators/2013/07/10/thom-ruhe-the-most-pervasisve-pernicious-offense/; Kevin Rouse, "Actual Things That Came Out of Humans Mouths at Day One of TechCrunch's Disrupt SF Conference," *New York*, September 9, 2012, http://nymag.com/daily/intelligencer/2012/09/techcrunch-jargon.html.

In a normal year, VCs invest in only 3,700 of the nearly 28 million small businesses in the United States! The venture capital screening process is *extremely* rigorous. The typical venture capital company invests in less than 1 percent of the business plans it receives. According to the Global Entrepreneurship Monitor, only about one in 1,000 businesses in the United States attract venture capital during its existence.[47] The average time required to close a venture capital deal is 80 days, slightly longer than the time required to complete angel financing.[48]

OWNERSHIP Most venture capitalists prefer to purchase ownership in a small business through common stock or convertible preferred stock. Although some venture capital firms purchase less than 50 percent of a company's stock, it is not uncommon for others to buy a controlling share of a company, leaving its founders with a minority share of ownership. Entrepreneurs must weigh the positive aspects of receiving needed financing against the disadvantages of owning a smaller share of the business. "Would you rather have 80 percent of a company worth zero or 50 percent of a company worth $500 million?" asks a partner at one venture capital firm.[49]

STAGE OF INVESTMENT Most venture capital firms invest in companies that are either in the early stages of development (called early-stage investing) or in the rapid-growth phase (called expansion-stage investing); few invest in businesses that are only in the start-up phase (see Figure 16.5). According to the Global Entrepreneurship Monitor, only one in 10,000 entrepreneurs worldwide receive venture capital funding at start-up.[50] About 97 percent of all venture capital goes to businesses in the early, expansion, and later stages.[51] Most venture capital firms do not make just a single investment in a company. Instead, they invest in a company over time across several stages, where their investments often total $10 to $25 million or more.

ENTREPRENEURIAL PROFILE: Bismarck Lepe, Belsasar Lepe, and Sean Knapp: Ooyala Ooyala allows creators of video content to deliver their content across all types of formats and devices. Founded by a group of former Google employees, Bismarck Lepe, Belsasar Lepe, and Sean Knapp, Ooyala received $77 million in funding from venture capitalists over five major rounds of



__Start-up/seed__ – This is the initial stage in which companies are just beginning to develop their ideas into products or services. Typically, these businesses have been in existence less than 18 months and are not yet fully operational.

__Early stage__ – These companies are re ning their initial products or services in pilot tests or in the market. Even though the product or service is available commercially, it typically generates little or no revenue. These companies have been in business less than three years.

__Expansion stage__ – These companies' products or services are commercially available and are producing strong revenue growth. Businesses at this stage may not be generating a pro t yet, however.

__Later stage__ – These companies' products or services are widely available and are producing ongoing revenue and, in most cases, positive cash ow. Businesses at this stage are more likely to be generating a pro t. Sometimes these businesses are spin-offs of already established successful private companies.

FIGURE 16.5

Venture Capital Funding by Stage

financing. Sierra Ventures, a California venture capital firm, was the first venture capital firm to invest in Ooyala and was the only investor in Ooyala's Series B investment round of financing. Sierra Ventures also participated with other venture capital firms in all three subsequent rounds of fund-raising that followed its initial investment. Mark Fernandes, managing director of Sierra Ventures, serves on the board of Ooyala as a representative of Sierra's sizable investment in the company.

ADVICE AND CONTACTS In addition to the money they invest, venture capital companies provide the small companies in their portfolios with management advice and access to valuable networks of contacts of suppliers, employees, customers, and other sources of capital. One of their goals in doing so is to strengthen the companies in which they have invested, thereby increasing their value. Former National Basketball Association star David Robinson's company, Admiral Capital Group, recently invested in Centerplate, an event catering business that focuses on sports venues, and plans to use his network of contacts to help the company expand, particularly into professional basketball events.[52]

CONTROL In exchange for the financing they receive from venture capitalists, entrepreneurs must give up a portion of their businesses, sometimes surrendering a majority interest and control of its operations. Most venture capitalists prefer to let the founding team of managers employ its skills to operate a business *if* they are capable of managing its growth. However, most venture capitalists join the boards of directors of the companies they invest in or send in new managers or a new management team to protect their investments. The term sheets they negotiate often include the right to determine the CEO. In other words, venture capitalists are *not* passive investors! A study of new business ventures by Harvard professor Noam Wasserman reports that only half of the companies' founders were in the CEO position after three years and that the likelihood of a founder being replaced increases significantly after a company receives capital from outside investors, especially venture capitalists.[53]

Some venture capitalists serve only as financial and managerial advisers, whereas others take an active role managing the company—recruiting employees, providing sales leads, choosing attorneys and advertising agencies, and making daily decisions—which can cause friction with the founding entrepreneur(s). The majority of these active venture capitalists say they are forced to step in because the existing management team lacked the talent and experience to achieve growth targets.

ENTREPRENEURIAL PROFILE: Jason Brown: Cotton Comfort Jason Brown was just 26 years old when a group of venture capitalists offered to invest $5 million in Cotton Comfort, a small chain of clothing stores he had launched at age 20. He gave up 46 percent of his company in exchange for the capital investment and the investors' experience. Brown says that the venture capitalists pushed him to grow the company too fast, and when the economy slowed, Cotton Comfort ran out of cash and folded. "I was too young to know that my job was to listen to what the VCs had to say but to know that they had only a chapter out of the novel of understanding about my business," says Brown, who went on to launch two more successful businesses.[54]

As Jason Brown learned, a common complaint among entrepreneurs who accept venture capital is that their investors push too hard for too much growth too soon.

INVESTMENT PREFERENCES Venture capital funds are larger, more professional, and more specialized than they were 20 years ago. As the industry grows, more venture capital funds are focusing their investments in niches—everything from information technology services to biotechnology. Most venture capital firms also focus their investments within a specific geographic region. Some will invest in almost any industry but prefer companies in particular stages, including the start-up phase. Traditionally, however, only about 2 to 4 percent of the companies receiving venture capital financing are in the start-up (seed) stage, when entrepreneurs are forming a company or developing a product or service. Most of the start-up businesses that attract venture capital today are in the biotechnology, software, energy, and medical device industries.

COMPETENT MANAGEMENT Attracting venture capital takes more than just a good idea; it requires a management team that can transform an idea into a viable business. Venture capitalists believe in the adage "Money follows management." To them, the most important ingredient in the success of any business is the ability of the management team. They are looking for a team of managers who share the same vision for the company and have the experience and the ability to make that vision a reality. "The team is more important than the idea," says Jason Mendelson of the venture capital firm The Foundry Group. "Always has been, always will be. So you can have the cure for cancer but a crummy team, and it will fail. If you have a great team and kind of a medium idea, you can usually do OK."[55] From a venture capitalist's perspective, the ideal management team has experience, managerial skills, commitment, and the ability to build effective teams.

COMPETITIVE EDGE Investors are searching for some factor that will enable a small business to set itself apart from its competitors. This distinctive competence may range from an innovative product or service that satisfies unmet customer needs to a unique marketing or research-and-development approach. It must be something with the potential to make the business a leader in its field.

GROWTH INDUSTRY Hot industries attract profits—and venture capital. Most venture capital funds focus their searches for prospects in rapidly expanding fields because they believe the profit potential is greater in these areas. Venture capital firms are most interested in young companies in industries that have enough growth potential to become at least $100 million businesses within three to five years. Venture capitalists know that most of the businesses they invest in will flop, so their winners have to be *big* winners.

VIABLE EXIT STRATEGY Venture capitalists not only look for promising companies with the ability to dominate a market, but they also want to see a plan for a feasible exit strategy, ideally to be executed within three to five years. A recent study by the National Venture Capital Association reports that the number one factor that venture capitalists say creates a nonfavorable environment for venture capital is difficulty achieving successful exits.[56] Venture capital firms realize the return on their investments when the companies they invest in either make an initial public offering or sell out to a larger business. For instance, Dell recently purchased Equallogic, a company that developed highly efficient network data storage solutions for businesses, for $1.4 billion, creating a handsome payout for Equallogic's three founders and the venture capital companies that had invested in it. Paula Long, Peter Haden, and Paul Koning started Equallogic in the Haden's attic in 2003, and within three years, its sales had increased from $492,000 to more than $100 million.[57] "If your vision is to run a company and hand it over to your kids, VC funding is out of the question," says Mike Simon, CEO of LogMeIn, Inc., a remote software company that has raised $20 million in capital, half of it from venture capital firms.[58]

INTANGIBLE FACTORS Some other important factors considered in the screening process are not easily measured; they are the intuitive, intangible factors the venture capitalist detects by gut feeling. This feeling might be the result of the small firm's solid sense of direction, its strategic planning process, the experience and chemistry of its management team, or a number of other factors.

ENTREPRENEURIAL PROFILE: Ofer Raz and Hod Fleishman: GreenRoad In 2003, Ofer Raz and Hod Fleishman launched GreenRoad, a company whose software helps companies and individuals improve driving habits, reduce collisions, improve fuel economy, and reduce vehicle operating costs, and quickly realized that their company would require a significant investment to capitalize on the market opportunity that lay before it. The duo estimates that the cost of vehicle crashes in the United States alone is $235 billion and that 90 percent of all crashes are the result of driver behavior. Their subscription-based service provides real-time feedback and driver coaching and is designed to reduce those costs and save lives by improving drivers' behavior. Customers who use the company's technology (including Ryder, Ericsson, TMobile, LeFleur Transportation, and others) typically reduce the number of crashes by 50 percent and fuel consumption and emissions by up to 10 percent. After pitching their idea to many venture capital firms, Raz and Fleishman have received $42.5 million in financing across three rounds. Venture capitalists were impressed with the experience of the management team that Raz and Fleishman had assembled, the company's fast growth, and the size of the potential market. Representatives from the venture capital firms hold five of GreenRoad's board seats, but the company has the capital it needs to support continued research and development, product innovation, and a more concentrated sales and marketing effort.[59]

Despite its many benefits, venture capital is not suitable for every entrepreneur. "VC money comes at a price," warns one entrepreneur. "Before boarding a one-way money train, ask yourself if this is the best route for your business and personal desires, because investors are like department stores the day after Christmas—they expect a lot of returns in a short period of time."[60]

Public Stock Sale ("Going Public")

5.

Explain the process, advantages, and challenges of making an initial public offering.

In an **initial public offering** (IPO), a company raises capital by selling shares of its stock to the general public for the first time. A public offering is an effective method of raising large amounts of capital, but it can be an expensive and time-consuming process filled with regulatory nightmares (see Table 16.3). In the past, "going public" was a more common strategy for small businesses seeking to raise capital than it is today. However, since 2001, there has been a significant drop in the number of public offerings. This is because of the dot-com crash in 2000 and the enactment of the Sarbanes-Oxley Act in 2002, which imposed much tighter regulatory control over and increased costs for publicly held companies. "The big VC companies now sort of have a chokehold on the distribution and they're not letting companies go public unless they have very, very large revenues and prospects for big market caps," explains Frank Quattrone, cofounder and CEO of Qatalyst Partners, a technology-focused investment bank.[61] Figure 16.6 shows the trend in the number of IPOs and the amount of capital raised.

Once a company makes an IPO, *nothing* will ever be the same again. The company is no longer under the exclusive ownership and control of the entrepreneur. The entrepreneur typically retains some ownership and may play a significant management role. However, responsibility and control rests in the hands of the board and the management team they put in place to represent the interests of *all* the stockholders of the company.

ENTREPRENEURIAL PROFILE: Paymaxx and CompuPay The high cost of regulatory compliance dissuades many potential companies from going public. Paymaxx, founded in 1991, became one of the largest payroll provider companies in the United States, and the fast-growing company was considering an IPO to acquire the capital necessary to fuel its growth. Its founders made an abrupt U-turn in their plans when they discovered the cost of complying with the Sarbanes-Oxley Act, choosing instead to sell the company to a larger payroll processing company, CompuPay.[62]

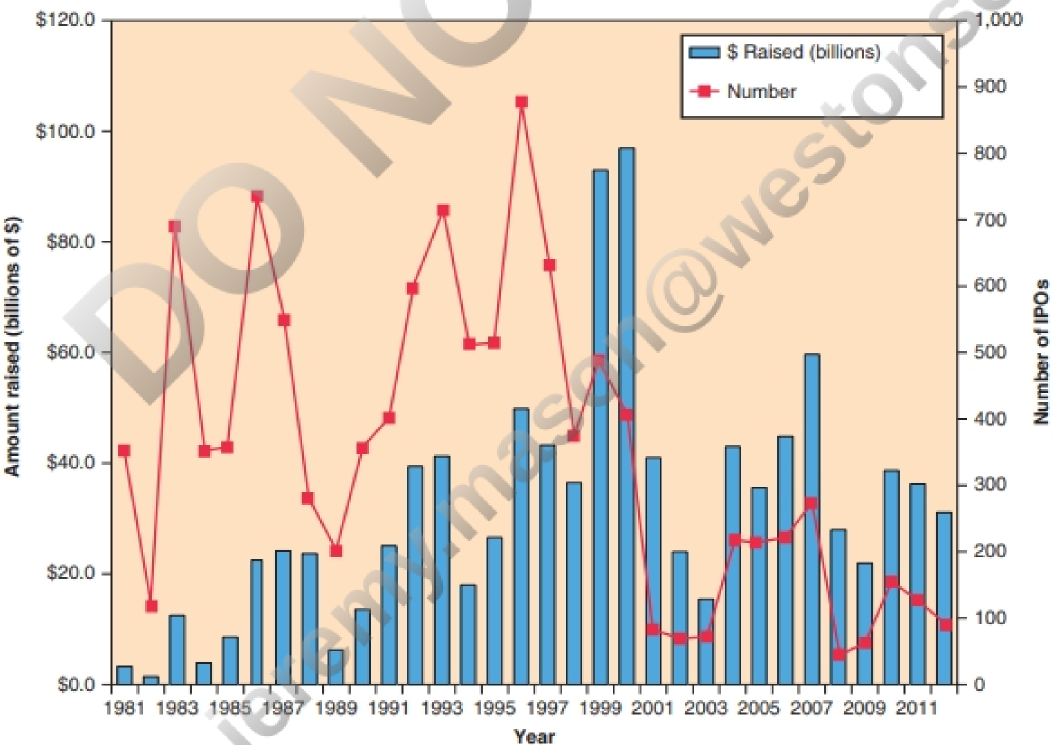


FIGURE 16.6

IPOs

Source: Based on Renaissance Capital's IPO Home, *www.ipohome.com*.

TABLE 16.3 **The IPO Process**

Taking a company public is a complicated, bureaucratic process that usually takes several months to complete. Many experts compare the IPO process to running a corporate marathon, and both the company and its management team must be in shape and up to the grueling task. Making an IPO requires a coordinated effort from a team of professionals, including company executives, an accountant, a securities attorney, a financial printer, and at least one underwriter. Typically, the entire process of going public takes from 60 to 180 days, but it can take much longer if the issuing company is not properly prepared for the process. The key steps in taking a company public follow:

- **Choose the underwriter.** The single most important ingredient in making a successful IPO is selecting a capable **underwriter** (or **investment banker**). The underwriter serves two primary roles: helping to prepare the registration statement for the issue and promoting the company's stock to potential investors. The underwriter works with company managers as an adviser to prepare the registration statement that must be filed with the Securities and Exchange Commission (SEC), promoting the issue in a road show, pricing the stock, and providing after-market support. Once the registration statement is finished, the underwriter's primary job is selling the company's stock through an underwriting syndicate of other investment bankers it develops.
- **Negotiate a letter of intent.** To begin an offering, the entrepreneur and the underwriter must negotiate a **letter of intent**, which outlines the details of the deal. The letter of intent covers a variety of important issues, including the type of underwriting, its size and price range (usually between $10 and $20 per share), the underwriter's commission, and any warrants and options included. The underwriter establishes an estimated price range for the company's IPO in the letter of intent but does not set the final price until the day before the offering takes place. Depending on demand for the company's shares, the condition of the market, and other factors, the actual price may be outside the estimated range. Since 2001, 65 percent of IPOs have sold within or above the estimated ranges listed in their SEC filings.[63]

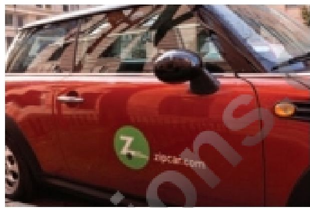
  There are two types of underwriting agreements: firm commitment and best effort. In a **firm commitment agreement**, the underwriter agrees to purchase all of the shares in the offering and then resells them to investors. This agreement *guarantees* that the company will receive the required funds, and most large underwriters use it. In a **best efforts agreement**, the underwriter merely agrees to use its best efforts to sell the company's shares and does not guarantee the company will receive the needed financing. The managing underwriter acts as an agent, selling as many shares as possible through the syndicate. Most letters of intent include a **lock-up agreement** that prevents the sale of insider shares, those owned by directors, managers, founders, employees, and other insiders, for 12 to 36 months. The sale of these shares early in a company's public life could send negative signals to investors, eroding their confidence in the stock and pushing its price downward.
- **Prepare the registration statement.** After a company signs the letter of intent, the next task is to prepare the **registration statement** to be filed with the SEC and the prospectus to be distributed to potential investors. These documents describe both the company and the stock offering and disclose information about the risks of investing. It includes information on the use of the proceeds, the company's history, its financial position, its capital structure, the risks it faces, its managers, and many other details. The statements are extremely comprehensive and may take months to develop.
- **File with the SEC.** When the registration statement is finished (with the exception of pricing the shares, proceeds, and commissions, which cannot be determined until just before the issue goes to market), the company officially files the statement with the SEC and awaits the review of the Division of Corporate Finance. The division sends notice of any deficiencies in the registration statement to the company's attorney in a comment letter. The company and its team of professionals must address all of the deficiencies noted in the comment letter and prepare an amended registration statement. Finally, the company files the revised registration statement, along with a pricing amendment (giving the price of the shares, the proceeds, and the underwriter's commission).
- **Wait to go effective.** While waiting for the SEC's approval, the managers and the underwriters are busy. The underwriters are building a syndicate of other underwriters who will market the company's stock. (No sales can be made prior to the effective date of the offering, however.) The SEC also limits the publicity and information a company may release during this quiet period (which officially starts when the company reaches a preliminary agreement with the managing underwriter and ends 90 days after the effective date).
- **Road show.** The purpose of the **road show** is to promote interest among potential underwriters in the IPO by featuring the company, its management, and the proposed deal. The managing underwriter and key company officials barnstorm major cities such as New York, Boston, San Francisco, Chicago, Los Angeles, and sometimes foreign cities such as London and Hong Kong at a grueling pace. Company executives often make presentations to stockbrokers and institutional investors in two or three cities a day for two to four weeks.
- **Sign a formal underwriting agreement.** On the last day before the registration statement becomes effective, the company signs the formal underwriting agreement. The final settlement, or closing, takes place a few days after the effective date for the issue. At this meeting, the underwriters receive their shares to sell and the company receives the proceeds of the offering.
- **Meet state requirements.** In addition to satisfying the SEC's requirements, a company also must meet the securities laws in all states in which the issue is sold. These state laws (or "blue sky" laws) vary drastically from one state to another, and the company must comply with them.

Few companies with less than $25 million in annual sales manage to go public successfully. It is extremely difficult for a start-up company with no track record of success to raise money with a public offering. Instead, investment bankers who underwrite public stock offerings typically look for established companies with the following characteristics:

- Consistently high growth rates.
- Scalability. Institutional investors want proof that a company can maintain or improve its efficiency as it experiences the strain that rapid growth imposes.
- High profit potential. Strangely enough, profitability at the time of the IPO is not essential; since 2001, 47 percent of companies making IPOs have had negative earnings.[64]
- Three to five years of audited financial statements that meet or exceed SEC standards. After the Enron and WorldCom scandals, investors are demanding impeccable financial statements.
- A solid position in a rapidly growing industry. In 1999, the median age of companies making IPOs was four years; today, it is twelve years.[65]
- A sound management team with experience and a strong board of directors.

The biggest advantage of an IPO is the capital infusion that the company receives. Since 2001, the average IPO has raised $310 million for the issuing company.

ENTREPRENEURIAL PROFILE: Robin Chase: Zipcar Zipcar cofounder and CEO Robin Chase developed a sound business model for new kind of car rental company. Zipcar offers a fleet of Mini Coopers, Beetles, and Priuses, which are popular with the company's target market of young customers. Zipcar's rental cars are parked at various reserved locations in the urban areas and college campuses where it operates. Zipcar follows a membership model that allows its customers to reserve cars by the hour or day with gas, parking, maintenance, and insurance included. Members have automated access to Zipcars using an access card that enables them to unlock the door where the keys are already inside. Although cofounder Chase was strong on the initial vision for the company, she was unable to get Zipcar to profitability and was unsuccessful in raising badly needed financing. Thus, the board, which was made up of Chase and four outside investors, decided it was time to find a new CEO. "While we all think Robin did a fabulous job starting the company, the sense at the board level was that we needed a different type of manager for the next stage," explains Jill Preotle, a board member. The board hired Scott Griffith as the new CEO. Griffith had experience with two start-up ventures—one very successful and one that failed. Over the next seven years, Griffith led Zipcar through several rounds of venture capital financing totaling $56 million. In June 2010, Zipcar announced that it had filed a registration statement with the SEC relating to a proposed IPO. In April 2011, Zipcar announced that it raised $174.3 million through its IPO, which was 27 percent higher than its most optimistic forecast.[66]



Zipcar.
Source: © B Christopher/Alamy.

Securing capital to launch or to expand a small business is no easy task. However, entrepreneurs who understand the equity funding options that are available and are prepared to go after them stand a much better chance of getting the financing they seek than those who don't.

Chapter Review

1. Explain the differences between the two types of capital small businesses require: fixed and working.
   - Capital is any form of wealth employed to produce more wealth. Two forms of capital are commonly identified: fixed capital and working capital.
   - Seed capital is used for the start of a new business. Growth capital is money used to fund the significant expansion or change in the business model of an existing business. Both seed and growth capital can be used to fund fixed and working capital needs.
   - Fixed capital is used to purchase a company's permanent or fixed assets. Working capital represents the business's temporary funds and is used to support the business's normal short-term operations.

2. Describe the seven sources of funding that the founders can contribute to their new businesses.
   - Funding from the founding entrepreneur is the most common sources of funding for a new business.
   - The founders of a new business rely on a variety of forms of self-funding to finance the launch: (1) using personal savings to fund the business and to support the living expenses of the entrepreneur as the business gets started, (2) contributing personal assets to the business such as computers and vehicles, (3) taking out unsecured personal loans, (4) taking out a second mortgage on the entrepreneur's home, (5) pledging personal assets such as investments to secure a business loan, (6) working a second job while starting the business, and (7) using various