



# Creating a Financing Strategy for Your Business

*"It is not the critic who counts...credit belongs to the person who is in the arena,  
whose face is marred by dust and sweat and blood...whose place shall never be with  
those cold and timid souls who knew neither victory nor defeat" Theodore Roosevelt*

# Overview

- **Types and sources of financing**
- **Determining the right financing mix**
- **Equity, convertible debt, bank debt**
- **Funding gaps & issues**
- **Discussion**



**Without the right financing,  
businesses fail to grow to their  
potential and often die.**



# Five main types of financing

1)

“Earned” Money

- Generated from operations
- Few payback requirements

2)

Borrowed Money (Debt)

- Repaid over specified period of time plus interest
- Requires Cash Flow and Collateral

3)

Hybrid Money (Debt/Equity)

- Debt that may convert to equity
- Higher cost than typical debt

4)

Invested Money (Equity)

- Share of company (future earnings/capital gain)
- Ownership & control considerations

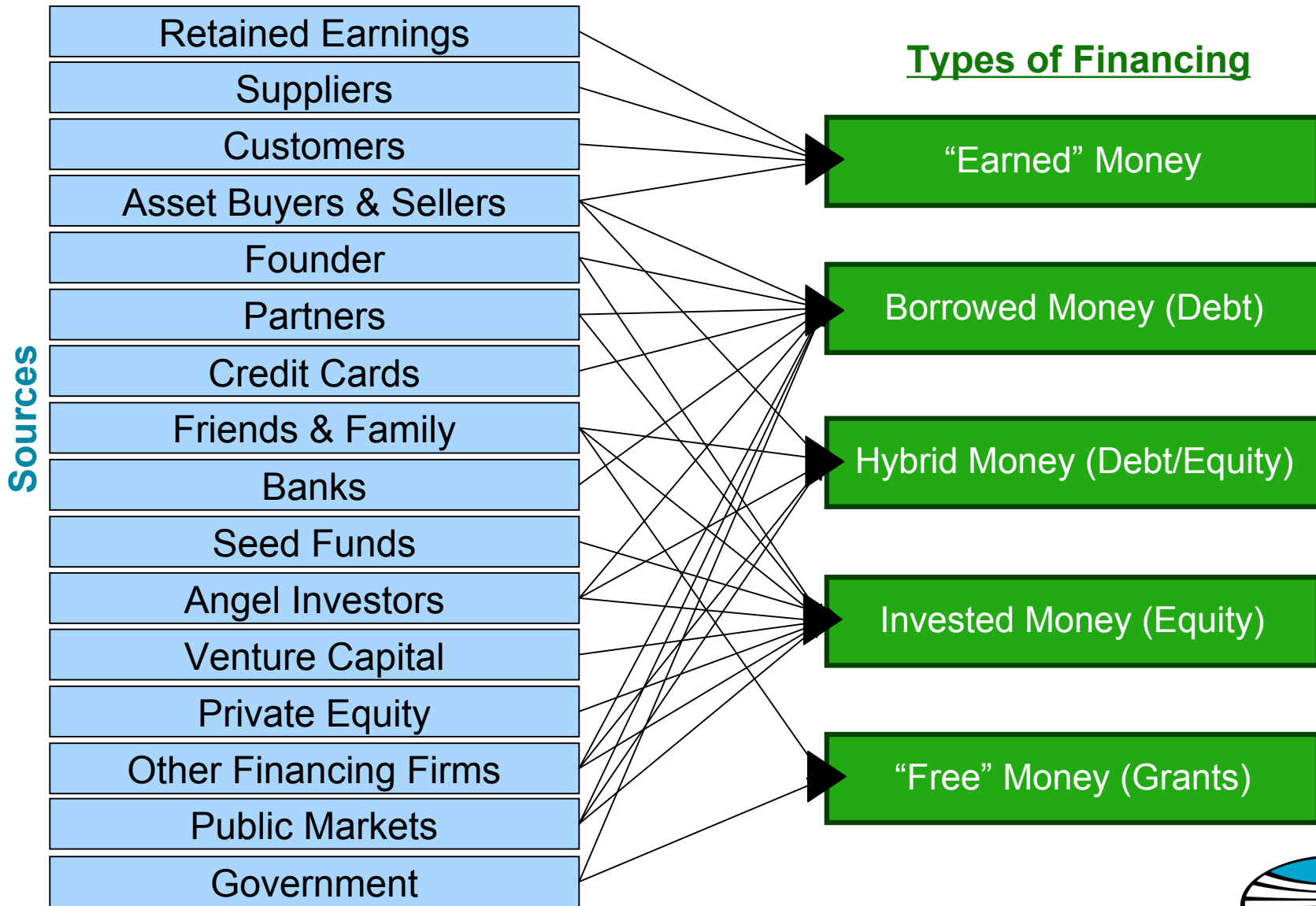
5)

“Free” Money (Grants)

- For development of products providing benefit for specific constituency (typically government)



# Many sources of financing



# Not “One-size fits all”

Best mix depends on factors unique to each business

- Stage of development of your business
- Growth potential of your company
- Amount of financing needed
- Purpose for which you need financing
- Method & Timing for paying financing back
- Reputation / Finances of you and the team



# Stage of Development

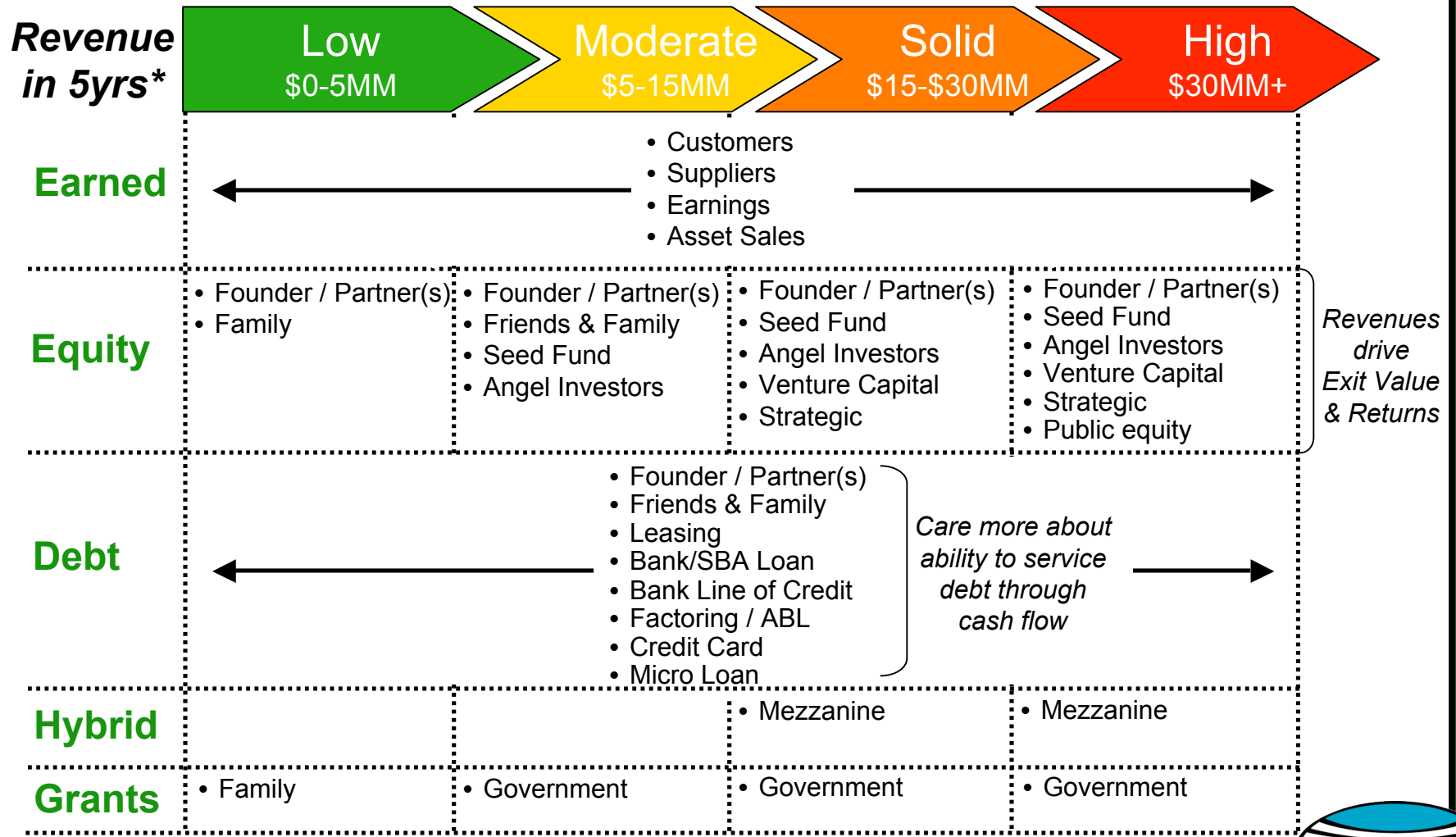
“Bootstrapping” is most common for early-stage companies

	Concept	Launch	Growth	Maturity
Earned		<ul style="list-style-type: none"> <li>• Customers</li> <li>• Suppliers</li> </ul>	<ul style="list-style-type: none"> <li>• Customers</li> <li>• Suppliers</li> <li>• Earnings</li> <li>• Asset Sales</li> </ul>	<ul style="list-style-type: none"> <li>• Customers</li> <li>• Suppliers</li> <li>• Earnings</li> <li>• Asset Sales</li> </ul>
Equity	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Friends &amp; Family</li> <li>• Seed Fund</li> </ul>	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Friends &amp; Family</li> <li>• Seed Fund</li> <li>• Angel Investors</li> </ul>	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Angel Investors</li> <li>• Venture Capital</li> <li>• Strategic Investor</li> <li>• Private equity</li> <li>• Public Equity</li> </ul>	<ul style="list-style-type: none"> <li>• Private Equity</li> <li>• Merger</li> <li>• Public Equity</li> </ul>
Debt	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Family</li> <li>• Micro Loans</li> </ul>	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Friends &amp; Family</li> <li>• Micro Loans</li> <li>• Leasing</li> <li>• Bank/SBA Loan</li> <li>• Bank Line of Credit</li> </ul>	<ul style="list-style-type: none"> <li>• Founder / Partner(s)</li> <li>• Friends &amp; Family</li> <li>• Leasing</li> <li>• Bank/SBA Loan</li> <li>• Bank Line of Credit</li> <li>• Factoring / ABL</li> </ul>	<ul style="list-style-type: none"> <li>• Company C.Card</li> <li>• Leasing</li> <li>• Bank Term Loan</li> <li>• Bank Line of Credit</li> <li>• Factoring / ABL</li> <li>• Asset Seller</li> <li>• Public Debt</li> </ul>
Hybrid			<ul style="list-style-type: none"> <li>• Mezzanine</li> </ul>	<ul style="list-style-type: none"> <li>• Mezzanine</li> </ul>
Grants	<ul style="list-style-type: none"> <li>• Family</li> </ul>	<ul style="list-style-type: none"> <li>• Government</li> </ul>	<ul style="list-style-type: none"> <li>• Government</li> </ul>	<ul style="list-style-type: none"> <li>• Government</li> </ul>



# Growth potential over 5 years

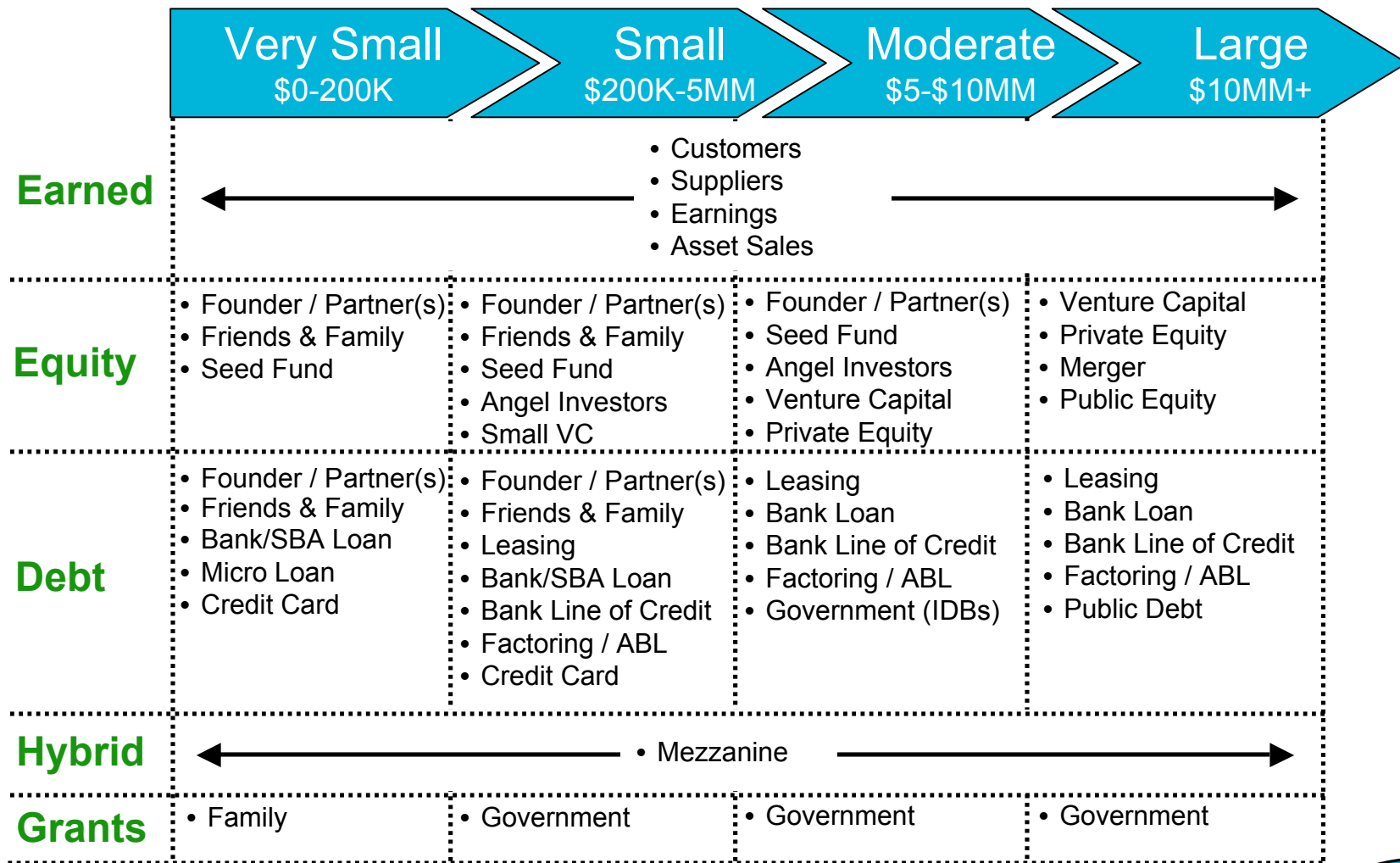
Particularly impacts type of equity funding



\* Industry and profit potential are also important factors in assessing financing options

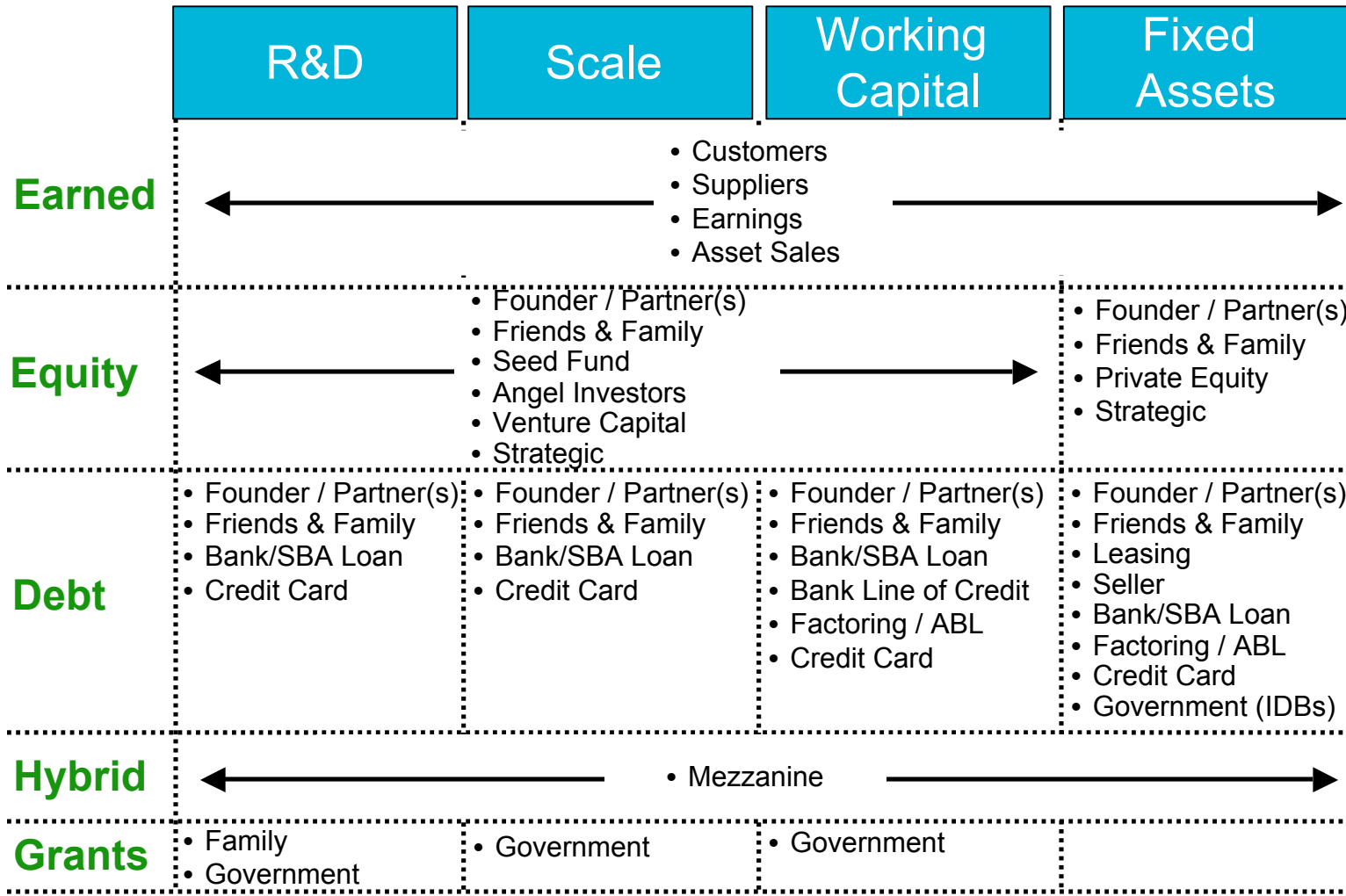


# Amount of Funding



# Purpose

Match type of funding to use of funds



# Method and Timing of Payback

## “Earned” Money

- Few payback requirements

## Borrowed Money (Debt)

- Installments of principal and interest
- Paid over time (max around 5yrs for most)

## Hybrid Money (Debt/Equity)

- Installments or accrual of interest and/or principal
- On exit for portions of debt converted to equity

## Invested Money (Equity)

- Share of company on exit

## “Free” Money (Grants)

- Few payback requirements
- Required performance / delivery of R&D



# You and the Team

- **Personal relationship with lenders / investors?**
- **Integrity / reputation?**
- **Past successes / industry expertise?**
- **Personal financial statement / collateral?**
- **Credit history / score? (Personal & Business)**
- **Amount of “skin in the game”?**



# Angel Equity

## Valuation & Returns “Rules of Thumb”:

- \$1-3MM pre-money for start-up, expect 1X sales at exit
- \$250k-\$2MM round, \$15-75k per angel per deal
- Required risk adjusted annual rates of return:
  - **Seed:** 80%+ (19X+ assuming 5yrs)
  - **Start-Up:** 50-70% (8-15X)
  - **First Stage:** 40-60% (6-10X)
  - **Second Stage:** 30-50% (4-8X)

## Other Considerations:

- “Smart” or “Dumb” money?
- Other Terms:
  - Liquidation preference
  - Redemption
  - Anti-dilution
  - Pre-emptive rights
  - Board seats, etc.

*Angels provide 90% (\$26B)  
seed & early equity capital  
<1 in 20 start-ups get angel \$  
<1 in 500 start-ups get VC \$  
<1 in 25 angel deals get VC \$*

*Current valuation issues  
reducing these ratios*



# What is Convertible Debt?

- Debt that converts to equity (many flavors)
- Above market interest rate (paid or accrued)
- Conversion typically at discount of 5-30% (may increase over time)
- Can also include warrants of 20-40%
- Other protections:
  - Prevent pre-payment
  - Specified payment if change of control
  - Cap on additional debt
  - Maximum conversion valuation, etc.



# Convertible Debt Pros & Cons

## Pros:

- Can postpone valuation discussion
- Cheaper documentation - makes sense for capital raises <\$500k
- More collateral if significant IP - worth what without the company?
- Protection from down round - but risk is low if initial pre money \$1-3MM
- Useful as bridge when round is <60 days away and valuation is clear

## Cons:

- Puts investors and entrepreneurs on opposite sides for next round
- Entrepreneur in worse position if investor expected to lead next round
- Investors sell off upside - dollars used to increase value of company
- May not adequately price-in downstream financing risk
- Future investor may re-negotiate
- Affects company's balance sheet
- May decrease team motivation if discount increases

*May bridge gaps  
in valuation  
(for now)*



# Government

## Attempts to fix market failures to fund small businesses

### Small Business Administration (SBA)

- Guarantees debt provided by banks to qualified small businesses
- Various loan programs (sba.gov) - 7(a) loans of \$50k-\$2MM
- Need cash flow and personal guarantees from all owners >20%

### Small Bus. Innovation Research (SBIR) & Technology Transfer (STTR)

- Agencies with >\$100MM R&D budgets have required SBIR programs
- Phase I <\$100k, Phase II (SBIR) <\$750k, Phase II (STTR) <\$500k
- grants.gov for more info

### Other

- Industrial Development Bonds (IDBs)
- Small Business Investment Company (SBIC)
  - Supplements private financing
  - AOL, Apple, FedEx, Intel, Staples, Sun Microsystems
  - None in SC, approx 18 in NC

*Free or cheap  
money!  
(If you can get it)*



# Bank Debt

## What they look at:

- **Personal financials** - cash position (banks want deposits)
- **Business financials** - Cash Flow, BS & IS, Investor backing, etc.
- **Ongoing** - monthly reports (AR & Inventory will impact LOC)

## Ratios / Covenants:

- **Cash Flow** =  $(\text{Net Income} + \text{D\&A}) / \text{Debt Payments} = >1.2:1$
- **Liquidity** =  $\text{Cash} / \text{Total Debt} = >0.1$  or may specify min \$
- **Leverage** =  $\text{Total Debt} / \text{Net Worth} = <3:1$

## Protective Provisions:

- **Personal guarantees**
- **Veto over capitalization changes, etc.**
- **Insurance & audit requirements**



# Funding Gaps

- **Concept to Launch (<\$0.5 million)**
  - More seed funds emerging e.g. SC Launch, Next Start, Shotgun, YCombinator, TechStars etc.
  - Uneconomical to do Series A Preferred if raising <\$0.5MM
- **\$1-5 million in investment**
  - VC Funds too big to do small deals (median fund >\$150MM)
  - Some boutique VCs emerging
  - More syndication happening among angel groups
- **Expected revenues <\$15 million in 5 years**
- **Low-tech and capital intensive ventures**



# Other Issues

- **Downstream financing is biggest risk for seed & early stage investors like SC Launch**
- **Few experienced technology angel investors locally**
  - Most local angels made money in traditional industries
- **Few local tech entrepreneurs with “big wins”**
  - Investment dollars follow success
- **Bad economy**
  - Risk averse banks and investors
  - Disparity in valuation expectations / requirements

*Need to “go big” with ideas and teams  
that are attractive for investors beyond Greenville*



## **“Cash is King”**

**Understand the options**

**Develop a thoughtful & realistic plan**

**Get funding before you need it**

**Get more than you think you need**

**Spend smart**



**Logan Metcalfe**

**logan@arenaconsulting.net**

**864.238.8072**

