Entrepreneurial Finance
Agenda

- Describe critical issues in venture financing
- Describe the difference between entrepreneurial and conventional finance
- Crafting financial strategies
  - Debt or equity
  - To raise money or not
The entrepreneur’s Achilles' heel

- More cash preferred to less cash
- Cash sooner preferred to cash later
- Less risky cash preferred to more risky cash

! Become adept at understanding and reviewing your financial issues

! Always link strategic to financial aspects decisions to each other
Financial myopia

- A combination of self-delusion and
- Not understanding the complex dynamics and interplay between financial management and business strategy
Beyond collect early, pay late

- What is most likely going to happen?
- When?
- What can go right along the way?
- What can go wrong?
- What has to happen to achieve our business objectives and increase or preserve our options?
Ongoing financial vigilance:

- Financial consequences and implications of business decisions eg pricing, volume, policy changes
- How can we measure & monitor changes in our financial strategy & structure
- Clear & accurate metrics to define cash conversion cycle, especially timing of cash commitments ahead of sales receipts
Ongoing financial vigilance:

- What does growth mean? Require outside equity or debt? How much capital if we grow x%?
- If growth faster/slower than x% what impact on cash flow, profitability, return on assets, shareholder equity?
- How much capital does growth require? Internal finance? External sources? What is a reasonable mix of debt & equity?
Ongoing financial vigilance:

- What if?? 20% more than planned? Or 20% less than planned?
- What focus & priorities? Cash flow and break even for product lines?
- Pricing, volume, costs? How sensitive are cash low and net income to increases/decreases to price, variable costs, volume?
- How do financial ratios compare to industry?
Value creation
- Community
- Shareholders
- Customers
- Employees
- Suppliers

Slicing the value pie
- Allocating risk and returns
- Cash-risk-time

Covering risk
- Debt: take control
- Equity: stage commitments
Corporate finance uses theories of finance:
  › Capital asset pricing models
  › Efficient market hypothesis
  › Portfolio theory

Global financial meltdown provides evidence that neat theories do not mean there is a single answer to financial management.
Corporate finance vs entrepreneurial finance

- Cash flow is king
  - Accrual based accounting, earnings per share, creative use of tax accounting can be opinion or manipulated and misleading.

- Time critical financing
  - Can be shorter, more compressed, optimum timing changes rapidly, can be more volatile.

- Capital markets
  - Private are imperfect, inaccessible, unorganised, invisible, but improving through associations and angel investor groups.
  - Underlying assumptions of capital markets do not apply even at initial public offering, rational models suffer limitations.
Corporate finance v entrepreneurial finance

- **Emphasis**
  - Capital is least important factor, need best deal and backer with value add in terms of wisdom know-how, counsel, help

- **Strategies**
  - Staged commitments
  - Refuse excess capital if valuation unattractive or likely to change

- **Downside of cash crisis**
  - Personal implications for entrepreneur
  - Emotional loss, personal guarantees are common
Corporate finance v entrepreneurial finance

- Risk-reward relationship
  - Typical high risk = high reward, low risk=low reward not typical in entrepreneurship, opposite is often true

- Valuation methods
  - 10 year forecasts using capital pricing methods, discounted cash flow forecasts irrelevant or misleading because dynamic, erratic historical and prospective growth curves
Corporate finance v entrepreneurial finance

- Conventional financial ratios
  - Can be misleading when applied to private companies – may own multiple companies & move cash and assets around
  - Different tax goals
  - Important value and equity builders may be off balance sheet or hidden assets eg excellent management team, know-how

- Goals
  - Create value over long term, not focus on next quarter results
  - Value built at expense of short term earnings
  - Heavily self financed = reduced accounting earnings
Determine capital requirements

- Opportunity – leads and drives business strategy
- Business strategy drives financial requirements
- Financial requirements drives financial structure – sweat the details
- Financial structure drives financial strategy
- Feedback loops, parallel processing, iterative work
Determine capital requirements

- Free cash flow (or operating working capital) determines external financing requirements, relative bargaining power and financing choices
  - Cash burn rate – $xx per day
  - Time to OOC (out of cash) – in 90 days
  - TTC (time to close & clear check) – how long it will take to get the financing (cash) you need
Fund-raising critical variables

Availability of financing affected by:

- Accomplishment & performance to date
- Perceived risk
- Industry & technology
- Venture upside potential & anticipated exit timing
- Venture anticipated growth rate
- Venture age and stage of development
- Investor ROI
- Amount of capital required & venture valuations
- Founders growth, control, liquidity, harvesting goals
- Relative bargaining position
- Investor’s terms and covenants
Fundraising options

- **Debt** (requires collateral, pay interest, involves a level of risk)
  - Short term debt – 1 year or less
  - Longer term borrowings

- **Equity financing**
  - Fills non-bank gaps
  - Preserves ownership (maybe)
  - Lowers the risk of loan defaults
New venture financing

- Difficult to get debt
  - No track record
  - Need substantial collateral

- Lender sees
  - Little proven capability to generate sales, profits, cash to pay off short & long term debt or sustain profitable operations long term
  - Underlying asset value may erode - need evidence of strong management & equity capital

- Existing venture – more attractive risk for expansion capital
See page 433
- Bootstrapping
- VC is a time bomb
- Playing small is making money
- Crowdfunding
Summary

- Critical issues in venture financing
  - Financial know-how, issues, analysis
- The difference between entrepreneurial and conventional finance
  - Slice the pie and manage/cover risk
- Crafting financial strategies
  - Capital requirements, fund raising strategies, harvest strategies