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The 'How' and 'When' of New Venture Funding

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Abstract—*For an entrepreneur who wants to take a business idea to the next level, one of the biggest challenges lie in securing investment for the growth of a company. Moreover, it is at the startup level that the capital is the riskiest. This paper examines the various financing options available to get a new venture funded, delving into the nitty-gritties of what kind of investors invest at what stage. By reviewing the literature, the paper reveals what type of funding is the most suitable and preferred from the entrepreneur's point of view as well as the investors' perspective.*

1. VENTURE FUNDING – AN INTRODUCTION

We need growth-oriented entrepreneurial ventures in the society. These ventures represent an important power in economy – they create innovations and dynamics, new jobs, income and, not least, wealth. Although growth-oriented entrepreneurial ventures can be found in all industry sectors and locations, there are some indications that the ventures with the highest growth potential are often characterized as knowledge-based and technology-driven – primarily based on intangible assets, opening in rapidly developing fields (Landstrom, et al., 2007).

One of the greatest challenges for new ventures is the ability to secure capital for investments that will allow the company to grow. All ventures will reach a point at which sufficient cash flow is necessary in order to go to the next level. It could be after a period of time or it could be because the venture is popular and the company is growing at a rapid rate due to demand (Gould, 2014).

In an interview, a very well-regarded VC explained the importance of financing for a venture as follows: "Venture financing acts as a CPR [cardiopulmonary resuscitation] for a new venture, without which it is difficult for a venture to survive (Aggarwal, et al., 2012).

The growth-oriented ventures are important in society, and venture capital is a significant vehicle for promoting their growth. The importance of venture capital makes it essential to understand the way the venture capital market operates, and how business angels and venture capitalists manage their investments (Landstrom, et al., 2007).

2. STAGES OF A VENTURE (BUSINESS MATURITY)

Funding for a venture comes in various forms and generally depends on the stage of development of the venture (McKaskill, 2009).

The Australian Bureau of Statistics' 2001 Special Article – Venture Capital Survey uses a multiple stage classification to describe business maturity. The definitions describe stages at which Angel or Venture Capital finance is invested.

- Seed: When the product is under development. Usually in business for less than 18 months.
- Early: The product is in pilot production. Usually in business for less than 30 months.
- Expansion: The product is ready and in the market. At this stage there is significant revenue growth.
- Late: This is when a new product is being developed after the one in market or product improvement of the existing one. There is continuing revenue growth.
- Buy out: [leveraged buy-out (LBO), management buy-out (MBO) or management buy-in (MBI)]: a fund investment strategy involving the acquisition of a product or business, from either a public or private company, utilizing a significant amount of debt.

Another common classification of stage of venture and the kind of financial requirement is given below.

Stage of Venture	Financing requirement
Seed Stage	Financing provided to research, assess and develop an initial concept before a business has reached a start-up phase.
Startup Stage	Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and are yet to generate a profit.
Expansion Stage	Financing for growth and expansion of the company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.
Replacement Capital	Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

Buy-out	The acquisition of a significant portion, majority control or 100% of businesses which normally entails a change of ownership. Funds are often used for expansion, consolidations, turn-arounds, and spinouts of divisions or subsidiaries.

Source: http://www.evca.com

3. SOURCES OF FINANCE

Entrepreneurs rely on different sources of capital in order to finance their ventures. Often an important source of capital is the entrepreneur's *own capital,* or personal savings (Aldrich 1999). A second source of capital may come from *informal investors,* often referred to (somewhat disdainfully) and collectively as the '3Fs' (family, friends, and fools) of new venture financing. Relatively speaking, the investment amount available or provided via these sources is limited, and these investors' expectations about a good return are set in an informal way (Harrison & Dibben 1997). Another source of funding, at the other end of the spectrum, is banks as providers of capital in the form of loans. However, banks do not wish to assume the high levels of risk associated with equity investing in entrepreneurial ventures.

However, the various forms of finance can be explicitly classified in two types - debt financing and equity capital (equity financing) (Gould, 2014).

Debt financing includes bank loans, personal and family contributions, and financing from other such agencies. Loans are often secured by some type of collateral in the company and are paid off over a period of time with interest. On the other hand, venture capitalists and angel investors provide funding in the form of equity capital. Both are given ownership in the company in exchange for money Pierce (2005).

With the existence of information asymmetries and the apparent reluctance of lending institutions to give out loans to small business ventures with no reputation or adequate collateral, firms resort to the use of internal equity and methods that limit the use of external financing. Managers devote fifty percent of their time raising external funds during the fund-raising cycle. This makes cash flow out instead of flowing in (Timmons & Sanders, 1989; Landström, 1990).

4. VENTURE FINANCING BY EQUITY

In between the two extremes (i.e., an entrepreneur's own capital and informal investors on the one hand, and bank loans on the other), there are three major sources of equity finance available to entrepreneurs: (1) classic or professional venture capitalists (VCs); (2) business angels (BAs); and (3) corporate venture capitalists (CVCs). These three investor types differ according to the source of investment funds, typical scope and size of investments, primary motive(s) for investing, investment criteria, reporting requirements, and exit issues (Clercq, et al., 2006).

Venture Capitalists

Venture capitalists (VCs) invest outside equity from professionally managed pools of money. VCs raise funds from various parties (primarily institutional investors) who function as limited partners, in an investment pool referred to as a venture capital fund (Clercq, et al., 2006).

Business angels

Business angels are individuals who invest their own capital in new ventures. BAs are often either entrepreneurs (who have sold their companies and wish to invest their money) or retired senior executives of large companies (Clercq, et al., 2006). Business angels are individuals who offer risk capital to unlisted firms in which they have no family-related connections (Politis, 2008).

Corporate venture capitalists

Corporate venture capitalists (CVCs) are another source of equity finance for the entrepreneur. The CVC acts as a financial intermediary of a non-financial company (Siegel 1988). While CVCs are interested in equity growth on their venture investment, their primary interest is in securing strategic benefits for their parent operating company. CVCs seek to make money indirectly for their corporate parent by investing in ventures that add value to their parent (Clercq, et al., 2006).

Other forms of Venture Financing

Bootstrapping – Why and When?

Financial bootstrapping refers to "the use of methods for meeting the need for resources without relying on long-term external finance from debt holders and/or new owners" (Windborg & Landström, 2001).

The cost of an initial public offering (IPO) is high i.e. lawyers fees, underwriters, accountants, printers and regulators can run into 15 to 20 percent of a small offering. There are also costs as one sets up to comply with SEC requirements as well as directors' fees and liability insurance premiums (Timmons & Sanders, 1989). Bank loans require stringent audits, independent reviews to validate assets valued, which is probably done at carcass level. One also gives away valuable competitive information. The chance of information leaking out is an inherent risk hence doing one's own due diligence is preferred but at a cost. Bootstrapping methods are thus an alternative to external financing (Nanka-Bruce, 2009).

5. CROWD FUNDING

More recently, some entrepreneurs have started to rely on the Internet to directly seek financial help from the general public (the "crowd") instead of approaching financial investors such as business angels, banks or venture capital funds (Kleemann et al., 2008; Lambert and Schwienbacher, 2010). This technique, called "crowdfunding", has made possible to seek

capital for project-specific investments as well as for starting up new ventures (Schwienbacher & Larralde, 2010).

Crowd-funding is the financing of a venture by a group of individuals instead of professional parties (like, for instance, banks, venture capitalists or business angels). In theory, individuals already finance investments indirectly through their savings, since banks act as intermediary between those who have and those who need money. In contrast, crowd-funding occurs without any intermediary: entrepreneurs "tap the crowd" by raising the money directly from individuals. The typical mode of communication is through the Internet (Schwienbacher & Larralde, 2010).

6. BUSINESS ANGELS, VENTURE CAPITAL & CORPORATE VENTURE CAPITAL – WHY AND WHEN?

VCs, business angels and Corporate Venture Capitalists represent partially complementary and partially overlapping sources of finance. The complementary involves two dimensions—namely, the timing and amount of capital provided. Business angels tend to be more willing than VCs to invest at the very earliest stages; however, the amount of funding available for a single infusion is much larger from VCs and Corporate Venture Capital than from business angels. In general, VCs are more risk averse and prefer shorter investment horizons. Furthermore, business angels are more highly motivated by the intrinsic reward of their involvement in the management of the venture. Since Corporate Venture Capitalists emphasize technology and the line of the business of the venture, they make investments of varying size, often in conjunction with business angels and VCs. The strategic interest Corporate Venture Capitalists take in the venture means that they are often willing to pay higher prices for equity but also present a significant threat of using the venture's knowledge to create direct competition for the venture (Clercq, et al., 2006).

Business Angels rarely compete with Venture Capitalists for deals. Rather, they either invest in seed stage deals that they hope will develop into ventures that attract start-up financing from VCs, or they invest in ventures whose growth prospects are too small to be of interest to a VC.

There are two basic differences between the VC and the angel. First, the VC contributes not only capital but also effort, which helps in the successful implementation of the project. In contrast, the angel contributes only capital (Chemmanur & Chen, 2014).

In a study conducted by Chemmanur & Chen with one of the objectives to develop a theoretical analysis of the different roles played by venture capitalists and angels in funding private firms, it was found out that venture capitalists could add value to the firm by exerting effort, which, together with the entrepreneur's effort, increased the chance of project success; the angel was unable to add significant value (Chemmanur & Chen, 2014).

7. WHAT IS VENTURE CAPITAL?

Venture capital is usually available for start-up companies with a product or idea that may be risky, but has a high potential of yielding above average profits. Funds are invested in ventures that have not been discovered. The money may come from wealthy individuals, government-sponsored Small Business Investment Corporations (SBICs), insurance companies, and corporations. It is more difficult to obtain financing from venture capitalists. A company must provide a formal proposal such as a business plan so that the venture capitalist may conduct a thorough evaluation of the company's records. Venture capitalists only approve a small percentage of the proposals that they receive, and they tend to favor innovative technological ventures (Gould, 2014).

Venture capital, also referred to as 'risk capital', is an investment, in the form of equity, made in a new or untried technology or high risk ventures, promoted by a technically or professionally qualified entrepreneur where the venture capitalist expects the enterprise to have a very high growth rate, provides management and business skills to enterprise, expects medium to long-term gains, and does not expect any collateral to cover the capital provided (Pandey, 1996).

In most cases, the venture capitalist becomes part owner of the new venture. Some investments are structured as debt to equity participation, often reserved by a covenant for a future buyout. Venture capital investment criteria usually include a planned exit event (an IPO or an acquisition), normally within three to seven years (Nath & Saha, 2008).

8. SIGNIFICANCE OF VCS

Venture capital firms act as intermediaries between investors and entrepreneurs. They add value by bridging the gap between these actors and through hands-on involvement in their ventures, and thereby represent a vital part of innovation systems in a knowledge economy. Due to the rapid growth of venture capital in many OECD (Organization for Economic Co-operation and Development) countries the past decade one has witnessed an increase in private-sector investments in R&D, not as direct support of R&D but as the financing of high-risk and fast-growing knowledge-intensive enterprises (Langeland, 2007).

The economic impact of VC is much greater than any other form of financing because venture-backed companies have outperformed non-venture-backed companies, even those considered the top business entities in their respective countries (Subhash, 2009).

Indeed, recent decades have seen venture capital become increasingly important to most advanced economies' innovation systems, as well as to a growing number of emerging economies (Bruton, Fried, and Manigart 2005;

Ahlstrom and Bruton 2006). Venture capital backing is especially important in high technology sectors, where uncertainties are great and ventures often require substantial financial support before being able to sustain themselves on internally generated revenues (Berglund, 2011).

9. CONCLUSION

The reality is that most businesses require risk capital. There is an increasing number of private investors. Governments and public service institutions have been challenged to initiate efforts that will serve to bring (private) investors closer to entrepreneurs. Portfolio firms are also advised to put more emphasis on decision to accept VCs and/or angels as co-owners and also decide carefully on the resources they wish to acquire as well as carry out their own due diligence (Nanka-Bruce, 2009).

The study highlights the most suitable, different types of financing options available at different stages of ventures' developments as described below (Technopolis Group, 2009):

Type of Investor	Characteristics	Stage of venture
Informal Investors	'Friends and Family' providing a mixture of debt and equity to family members, colleagues and friends. Unprofessional investment with limited added value and returns.	Early stage¸ small-scale investment, but very substantial in terms of the total amount of early stage investment.
Business Angels	Informal venture investment that is increasingly important to early stage investment. Covers a wide range of activities, some BA money is 'smart money' with significant added value.	Early stage, and geographically widely spread. Increasingly undertaking investment that was previously undertaken by VC.
Venture Capital	Professional investors, who provide 'smart money' and significant value added for firms.	From seed to exit. Focus on high-tech sectors that can deliver the very high returns that the structure of VC funds requires.
Private Equity	Professional investors who provide risk capital for existing assets.	Later stage investment.
Corporate Venture Capital	This involves equity investment by funds associated with large corporate enterprises that invest in order to access strategically important technologies.	CVC typically invest in biopharmaceuticals, software and ICT sectors.

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