

## Funding Options

In a commercial a few years ago, baseball legend and philosopher Yogi Berra said “they give you cash, which is just as good as money.” In typical Yogi fashion, there is some wisdom behind the humor. The reality is that for start up companies, all money is not the same. How you get, what you can do with, and what it costs to receive money from investors is different than money from debt or grants or even revenue from customers. While a lot of publicity and effort over the last decade has focused on raising equity, particularly venture capital, entrepreneurs need to understand other funding options, including grants and debt. These sources of money also have subclasses which present unique options and costs for companies.

- An equity investment means someone is providing money in exchange for part ownership of a company. For private companies, investors buy stock directly from the company. Investors expect to receive many times their money back, usually when they sell their ownership stake in the future, or receive multiple dividend payments over time. Investors tend to win or lose along with the company.
- Debt is a loan of cash (or other asset) in exchange for a promise to pay back the principal by a scheduled time plus periodic interest payments. The lender, or bank, does not take ownership of the company, but does have rights to the assets of the company (and possibly assets of the founders) should the company default, or not make a scheduled payment.
- Grants usually are neither equity nor debt. They do not need to be paid back. Instead, government agencies, foundations or other organizations expect the work they fund to further their mission.

In general, many entrepreneurs’ goal is to increase the value of their piece their company. Some can maintain 100 percent ownership of their company and grow it large enough to satisfy their financial needs. This can be accomplished if the founder has a large enough savings account to fund the company’s growth by themselves, or if they can get loans or grants to fund the company’s growth. They may also be able to work with customers, vendors, suppliers, or other partners to manage cash flow to foster the company’s growth. Other entrepreneurs trade off control to investors for needed cash – and often advice, connections, leadership and/or skills – to grow their company beyond what they can fund through other means. By focusing on a growth strategy and financial plan that makes sense, all entrepreneurs can achieve the goal of increasing the size of their piece of the pie they create.

Some of the key issues to consider when deciding which kind of cash to pursue include:

- What you have in relation to what you need? Do you have personal savings, experience, industry and customer contacts?
- Do you have what *they* want? Does your company have reliable cash flow, collateral, strong credit history, a really big idea, an innovative research opportunity?
- What do you need the money for? Will you buy tangible assets, hire additional employees, develop new technologies, increase marketing expenditures?
- Are you willing to pay the price? Can you afford or accept cash payments, loss of control, bureaucracy?

## Debt

Debt actually takes many forms. Founders may accumulate personal debt by maxing out their credit cards, opening a home equity line of credit or getting a second mortgage on their home. Founders may also try to get a bank loan for their business. The challenge is that most banks don't lend to start up companies without an operating history and existing cash flow. Some banks may extend a loan if the founder offers a personal guarantee, which means their personal assets are offered as collateral. Debt also includes leases for equipment, offices, vehicles or other high-value items.

The main concern for lenders is getting their money back. Banks look for a number of factors in businesses before they will lend them money, including:

- Cash Flow - Will the company generate enough cash to make interest payments and pay back the principal?
- Credit - The company's or founder's credit history
- Collateral or Capital - Assets the founder can sell to pay off debt, or the bank would receive if the company fails to make required payments
- Confidence - Does the business plan make sense? Is it likely the company will succeed?
- Character - Founder's experience and trustworthiness, which indicates how likely the company will succeed enough to pay off the loan

- *A bank is a place that will lend you money if you can prove that you don't need it. – Bob Hope*
- *A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain. – Mark Twain*
- *If you owe the bank \$100 that's your problem. If you owe the bank \$100 million, that's the bank's problem. – Jean Paul Getty*

As long as you can get a loan and can afford to pay it off, debt allows you to leverage your investment to grow your company without sacrificing any control. You can make all the decisions and keep all the profits yourself. Like buying a car or house, once you pay off your debt and make your final financing or mortgage payment, you are free to do whatever you want with your company. The challenge for young companies is getting the loan and generating sufficient cash flow to make all the payments. As you can imagine, it would be hard for a person right out of college to buy a million dollar house or buy a luxury vehicle, despite the potential for riches they feel they have. Likewise, it is hard for a company that has no history to secure a large loan from a bank.

Examples of classes of debt:

- Short vs. long-term: Some lending sources specialize in short term loans or leases. Others focus on long-term debts. Knowing why you need to borrow money, and for how long, will help you identify appropriate lenders.
- SBA loans: The Small Business Administration (SBA) works with banks to encourage loans to small companies by offering a guarantee to the bank, essentially on the company's behalf. The bank loans the money to the small business and the SBA offers to pay off the debt if the company can't.

- Factoring: For companies with existing sales and accounts receivables, factor companies pay you up front a portion of your accounts receivable (what your customers owe you). You get the cash now in exchange for a fee, or discount on the total amount eventually due. With “recourse” factoring, you are responsible for actually collecting from your customers and you have to pay the factoring company even if your customer doesn’t pay you. Non-recourse factoring means the factor company collects the debts owed and you aren’t responsible if your customer never pays.

## Equity

Investment capital can come from many sources. Entrepreneurs often spend money from their savings account or cash out part of a retirement account to pay for their startup expenses. If there are two or more founders, the team may be able to put more money in collectively than a single entrepreneur. Many times, one partner will be the brains and sweat behind the company and the other will provide the money. Some companies will hire early employees by offering stock in the company in lieu of a salary until cash is available. These employees thus become part owners in the company too.

Beyond the start up team, potential investors often fall into one of these categories:

- Friends and family – People who know you and want to help you succeed. Many times the investment arrangement is informal. While this is definitely simpler and cheaper to set up, companies should go through much of the same process before selling shares to a relative as they would to a professional investor.
- Angels – Wealthy individuals who invest in high-risk start up companies. Angels are the first “strangers” to invest in a company. Angels may be retired entrepreneurs or active executives at other companies.
- Venture Capital – VC funds are multi-million dollar pools of money that are run by professional managers responsible for generating high returns to their investors. VC funds usually focus on specific industries and stages of companies. A single venture capital firm may raise many funds that are in various stages of their operating life cycle. Typically, funds only operate for 10 years, which means that they spend the first three or four years investing in companies, work the next three or four years to help those companies grow, then need to get their money out of all their investments by the end of the fund’s life.
- Private Equity Funds – Similar to VCs, but often larger and more likely focused on buying companies, not investing in them.
- Public Offering – “Going public” means selling shares on a public market, such as NASDAQ or the New York Stock Exchange. Many ambitious entrepreneurs see this as the end goal, but the initial public offering (IPO) process is very costly, complicated and competitive and running a public company can be much more difficult than running a private one.

Selling shares of your company to others is not a trivial matter. It can change the direction and make-up of a company. It means sharing the risk and rewards with others. It also means asking others to share with risk with you. You will need to follow regulations set forth by the federal Securities and Exchange Commission (SEC) and your state (the Alaska Securities Act is administered by the Division of Banking, Securities and Corporations, a division of the

Department of Commerce, Community, and Economic Development). Therefore, raising money will likely require the advice of attorneys, accountants and other professional advisors.

Investors are partners in your business, although they may be “silent” partners. Typically, if company fails, you don’t have to pay back investors. They, like you, will lose the amount they invested, but not more.

## Grants

The closest thing to “free money” may be grants because they do not have to be paid back and do not take any control away from the owners. Many private foundations only provide grants to non-profit organizations; for-profit companies are ineligible. Some foundations and many government agencies do provide grants to for-profits. One major federal grant program is called the Small Business Innovation Research/Small Business Technology Transfer (SBIR/STTR) program. This program is designed to fund early-stage feasibility and prototype development by small companies. There are two major types of grants available:

- “Traditional” grants – Money available to fund broad topics that support the agency’s mission. Federal agencies that offer these sorts of grants include: National Institutes of Health (NIH), National Science Foundation (NSF), Department of Commerce, Environmental Protection Agency (EPA), Department of Agriculture (USDA), and the Department of Education. For example, the EPA wants to control air pollution and has several ideas of how to do this. It leaves it up to companies to propose specific research to be done within these parameters. As you can imagine, these agencies want to see the resulting work be commercially successful, but don’t have any interest in buying the resulting technology or product that is developed themselves.
- “Contract” grant – Money to fund specific topics of need to the agency. Agencies like the Department of Defense, NASA, and Homeland Security essentially pay small companies to develop products the agency wants to buy. An employee of the agency – possibly the person in charge of buying the potential end product – reviews the proposals and makes the funding decision. These grants not only provide cash for R&D, but also practically line up a major customer who wants to buy from you.

The federal agencies listed above, as well as many others, have a number of grant programs available, not just the SBIR/STTR. The funding priorities are often rather obvious – if you are developing a reliable, clean, and affordable energy technology, you might want to target the Department of Energy. Others may not be as obvious – the Department of Defense is a major supporter of breast cancer research. The good news is that every agency has a website that can help you find relevant opportunities. The bad news is that every agency has a different website with myriad pages across countless programs. Another option is to visit [www.grants.gov](http://www.grants.gov), which should list every federal grant opportunity available.

For local grants, talk to a local economic development commission or state economic development agency. They may also help you identify other grant programs available to companies in your area. The USDA, for example, has special grants available for companies that can increase employment in distressed economic areas.

Major competitive grant programs provide not only funding, but credibility to winning companies that can also be leveraged in discussions with investors. Also, the funding organization may provide contacts, resources, or other direct assistance to help you sell the product you develop.

While there are many benefits to grants, there are several things to consider before applying for grants, such as:

- Agencies may have very specific requirements – geographic, use of funds, who actually gets the money, partnership requirements, etc. You need to read the fine print.
- Each award is limited in scope. You may have very limited freedom in how you progress in your development or research.
- Many agencies run at the speed of government, not startup businesses. It can take months to apply for a grant, months to learn if you won, then even more time before you can start. After that, it may take months before you get paid.
- Because most public agencies need to announce how they use tax payer money and nearly all grant agencies want the public to know what they are doing to further their mission, they may publish some information about your company. It is usually not very detailed, but may take your company out of “stealth mode” and give competitors a hint about what your company is doing.
- Some grants require matching funds. This means that in order to get the grant, the company needs to contribute some proportion of resources necessary to complete the project. This may come from the company’s own capital or from equity investors. The money doesn’t go to the granting organization; the grant is just not intended to be the sole source of funding to the company for the relevant work.

## Crossovers

In addition to the various forms of equity, debt and grant, there are a number of financing options that are essentially a combination of two.

- Investor loan guarantee – Investors can offer a guarantee on a loan, or cosign the loan. They won’t have to part with any cash as long as you make the payments. You may agree to give them a small piece of the company or pay them some cash to compensate them for taking the risk with you. But, if your company falters, they will be liable for payments. If this happens, they likely will take a significant percentage of the company in exchange for bailing it out.
- Angel debt – Very similar to traditional debt, but the lender is an individual. This is common when a company is unable to get a loan from any bank or other financial institution. A wealthy individual may loan the company money in exchange for a high interest rate. Because the lender is an individual, they can be more flexible than a bank on terms, such as timing.
- Zero interest or forgivable loans – Some state or local agencies may offer a “grant” that is expected to be paid back in five or seven years. In this regard, it is much like a loan. But, no interest may ever be charged to the amount provided. Also, the agency may not ever call the loan due – if you can’t pay it back, they don’t foreclose on your property. In this regard, it is much like a grant. The difference is that if you can pay it back, you are obligated to do so.

- Convertible debt – Convertible debt is a loan that can be converted to equity at a set rate. Convertible notes allow a company to pay back lenders if they can or offer stock instead if they can't. The lenders can get paid a nice interest rate or, if they think the company will become very valuable, forgo the immediate payout and let their money ride as stock. Conversion may be at the option of the company, the debtor/investor, at a given point in time, or when a specific event occurs. Often this is used by companies that expect to raise equity more than once and the conversion is triggered when a subsequent round of investment is made.

## Customers and Partners

The ultimate success of any company depends on its ability to generate revenue from customers. It makes sense that customers may also help many companies get started. Depending on your business, it may be practical to start small by selling some products or services to generate revenue. If you can make a small profit on each sale, then you can slowly grow the business over time. Or, if it is costly for you to make your product or deliver your service, customers may be willing to pay some money up front, and at milestones along the way so you don't have a huge investment and time lag before receiving payment.

Sometimes, just the mere fact that you are able to sell your product or service to real customers and generate real revenue will help you raise equity or debt to embark on a major expansion or product extension later. As mentioned above, a reliable operating history reduces the risk for banks and investors.

Also, as long as you have some cash coming in, you may also be able to get support from vendors or suppliers. They may have flexible payment plans that help maximize your cash flow to help your company grow (and help their business with you grow). In other words, if your accounts receivable period is shorter than your accounts payable (i.e. you get paid faster than you have to pay others), you may have sufficient cash to pay off debt or fund growth internally.

## Conclusion

There are a number of options to fund a company build on a solid business plan. Many won't make sense for your company. Others are a natural fit, although not necessarily a sure thing. In any case, it is important to do your homework and understand all the benefits, costs, tradeoffs, restrictions, similarities and differences. Regardless of the funding source(s) you pursue, you need to be able to provide sufficient information so they can answer these same key questions:

- Will the company do what it says it will do?
- Will this company provide me what I want in exchange for my money?
- Can the management team/founder lead the company to success?
- Will this company use my money wisely and effectively?
- Is this the *best* company to give my money?