

Chapter 1

It Takes Money to Make Money

In This Chapter

- ▶ Determining your financial needs
- ▶ Understanding the difference between debt and equity financing
- ▶ Introducing bootstrapping

That old familiar saying states: “It takes money to make money.” Ask any business founder, entrepreneur, or top executive, and chances are that he or she will tell you that statement isn’t just a quaint old saying; it’s a fundamental truth of doing business today.

No business can operate without the money necessary to pay employees and vendors, and internal sources of cash aren’t always enough to keep a business going — especially for start-ups and fast-growing companies that tend to suck up cash far faster than it comes in from sales of company products and services. Sure, all the money in the world isn’t always enough to ensure business success — creating a successful business requires hard work, great ideas, dedicated and talented employees, and more than a little bit of luck — but at some point every business needs to raise capital to survive and to thrive.

For most businesses, the four major sources of capital are

- ✓ Founder’s or personal investment
- ✓ Internally generated cash
- ✓ Credit granted by vendors (trade credit)
- ✓ Customer advances
- ✓ Cash borrowed from lenders
- ✓ Cash from sale of an ownership stake (equity) in the business

In this chapter, we’ll discuss how to assess the financial needs of your company, focusing on the implications for your business of incurring debt versus offering equity. We’ll also consider how to put your financial plan into action and discuss a popular method of financing called bootstrapping.

Got Cash? Figuring Out How Much Money You Need

The first step in raising capital is understanding how much capital you need to raise. Do you need \$10,000, \$100 million, or something in between? Although you don't necessarily have to know this answer down to the last penny, you need to have a pretty good idea of where you need to end up, because the answer has a significant impact on determining what type of financing is appropriate for your needs and where you'll go to get it.



As you begin to get your arms around this magic number, be sure to focus on your long-term and short-term needs. Successful businesses anticipate their future cash needs, make plans, and execute capital acquisition strategies well before they find themselves in a cash crunch. When it comes to figuring out how much money you'll need, keep these three axioms in mind:

- ✔ As businesses grow, they often go through several *rounds* or stages of financing. These different rounds are often targeted to specific phases of a company's growth (for example, the *seed round* is applicable to start-up companies that are too early in their development to attract the attention of the larger venture capital firms) and, therefore, require different strategies and different networks of potential investors.
- ✔ Raising capital will be an ongoing issue for your business — you'll never have too much cash. In fact, company growth, acquisitions of other firms, and unforeseen problems can put a very real strain on your company's financial health. Plan for the capital acquisition process to become a way of life for you and your business.
- ✔ Capital never arrives as quickly as you think it will. It can take some time (from a few months to many, many months) from identifying the need for capital to the time you can actually raise it. Foreseeing your capital needs well in advance through periodic plan updates can avoid delays in getting your financing and growing your business.

Although you'll probably want to prepare full-blown financial documents to determine this number with a reasonable amount of accuracy (essential financial documents are covered later in this section), here's a quick and easy way to get a general idea of how much money you'll need to target in your efforts to raise capital.

1. Determine your projected sales.

How much money do you expect to take in this year? Your projected annual revenues are the starting point for determining how much capital you'll need to raise. You can determine your projected annual revenues by:

- Using your previous year's sales as a baseline and then increasing or decreasing the total by your estimated percentage increase or decrease in sales.
- Asking each one of your managers responsible for sales to provide you with an estimate of revenues for the year, and then totaling the results.
- Selecting a revenue target for the year based on a number that can realistically be achieved.

2. Calculate your start-up costs.

If your business is a new one, you'll need to estimate the one-time costs that can be attributed to start-up operations. Be sure to include the costs of things like:

- Beginning inventory and supplies.
- Advertising and promotion related to the start-up of your business.
- Capital expenditures for furniture, equipment, telephones, computers, fixtures, remodeling, and so forth.
- Deposits (for example, for building rent) and initial insurance coverage (often, for example, for worker's compensation insurance, the first year has to be paid in advance).
- Permits, licenses, and related fees.
- Professional fees including accountants, attorneys, consultants, and others.
- Unknowns (budget in an extra 25 percent or more to cover unexpected costs).

3. Tally up your recurring costs.

Every business has recurring costs, that is, expenses that are paid on a regular basis. Most of these costs are classified as overhead and include expenditures for:

- Rent.
- Utilities.
- Wages, salaries, and benefits.
- Phones and Internet access charges.
- Insurance and taxes.
- Office supplies.
- Loan payments.
- Office equipment leases.

- Additional inventory purchases.
- Ongoing professional fees including accountants, attorneys, consultants, and others.
- Unknowns (budget in an extra 10 percent or more to cover unexpected costs).

Once you've determined the total projected sales, start-up costs (if applicable), and recurring costs, you can easily determine whether you'll be operating at a profit or loss, and how much financing you'll need to reach your goals.



So far, so good. But there's one more thing that the above projections do not consider: your needs for *working capital* — the cash you'll need to maintain your day-to-day operations. It does no good if your sales come in late in the first year. You must have the cash to keep operating until then. To accurately estimate your first year's capital needs, including *working capital*, you need to do a careful monthly cash flow projection — inflow and outflow. Here's how:

- ✔ Put your start-up expenses in month 0.
- ✔ Ramp your sales projection over the 12 months as conservatively as you feel you should. Then slip them by the number of days you expect your customers to take to pay you.
- ✔ Spread your expenses by month according to when you expect to pay them and be sure your inventory estimate ramps consistently with your sales forecast (Remember that you will have to have inventory on hand in advance of your sales).
- ✔ Next, compute your monthly net cash flow and run a cumulative net cash flow from month 0 to month 12. The first few months will probably show a negative cash flow and the cumulative negative amount will keep growing! At some month (hopefully) you'll start to see a positive cash flow.
- ✔ Look at the cumulative negative amount at that point on your spreadsheet. That's the *minimum* cash you will need to have to get your business started. This is a minimum only because things seldom happen exactly as you've planned, and especially not in the time frames that you usually expect.
- ✔ So add to this minimum the amount of "cushion" you estimate you will need for uncertainties. One way to do this is by recalculating your spreadsheet with your sales slipped 2 or 3 months. You really can't control how fast customers will buy and pay for your products! The best and most space-efficient way to express all of this is to show a simple spreadsheet with rows labeled: sales, cash receipts (customer payments), inventory payments, operating expense and purchases payments, net cash flow, cumulative cash flow. Columns will be month 0, 1,

2, and so on, and first year total. Call this “The Plan.” Then show a second (worst) case with the sales slipped to calculate the cash needed including the cushion.

Now you know how to calculate your real capital needs, which include the working capital you will need to operate until your business is cash positive. You’ve also now got a plan that you can use to see if you are on track on a month-to-month basis.



Before you turn to external sources of capital to meet your financing needs, make sure that you first exhaust all possible internal sources, including cutting costs, retaining profit, accelerating the collection of receivables, securing advances from customers, and selling off surplus inventory and fixed assets. Not only will maximizing your internal resources enable you to avoid taking on debt or diluting ownership in your company for as long as possible, it also will reduce the amount that you have to raise when you finally decide to seek capital from outside sources.

Getting Your Financial Ducks in a Row

If you’ve decided to seek capital — especially if you plan to seek debt financing or promote your business opportunity to outside investors — you need to have the following historical financial documents (for the past three to five years, depending on your lender’s requirements) ready to submit along with your loan applications:

- ✓ Balance sheets
- ✓ Cash flow statements
- ✓ Income statements

In addition to historical data, you’ll need detailed projections of your business’s projected financial activity for up to five years into the future. Specifically, this means forecasted income statements, balance sheets, cash flow statements, and capital expenditure budgets. Year one of the forecast needs to include monthly or quarterly projections, while subsequent years require quarterly or annual projections.



And be sure that your projections are in line with the amount of money that you’re requesting from your lenders or investors — significant discrepancies can cast doubt on either your competence or your honesty and neither outcome is seen as a positive enhancement of your ability to raise capital.

Primary sources for start-up capital

In its 2000 annual listing of the 500 fastest-growing small businesses in the United States, *Inc.* magazine (www.inc.com) found that companies on the list utilized three key sources of start-up capital:

- ✓ Personal assets: 92 percent
- ✓ Cofounder's personal assets: 36 percent
- ✓ Assets of friends and family: 33 percent

Venture capital comprised only 4 percent of start-up funds for *Inc.* 500 companies. The median amount of additional financing obtained after start-up was \$1,500,000, and, for 83 percent of *Inc.* 500 firms, the primary source of this additional financing was a bank line of credit.

Debt or Equity Financing: That Is the Question

When you get serious about raising capital for your business (and anytime you need cash, it's serious), consider two major avenues:

- ✓ **Debt financing means borrowing money for a fee.** Debt financing is ideal, for example, when you don't want to dilute ownership of your business in exchange for the cash you need. Of course, on the downside, you have to repay the full amount of the debt plus interest at some point in the future. If the debt exceeds your ability to pay it back on schedule, you may be forced to liquidate assets or go into bankruptcy.
- ✓ **Equity financing means selling a piece of your business in exchange for a cash investment.** Equity financing is great if you don't want an obligation to repay a lender, but, on the downside, you have to give up a portion of your ownership in the business. Give up too much ownership, and you may lose control of your business.

So which approach is better for *your* company? The answer to that question varies depending on the goals that you have for your business, the ability of your firm to repay its debt, the amount of money needed, and many other factors. Each approach has its good points and its bad.



Many companies utilize a combination of both kinds of financing, maintaining a balance between the two. A business with a line of credit, automobile leases, and an assortment of trade credit and short-term loans (all forms of debt financing) may, for example, look to venture capitalists for an infusion of cash to fuel expansion, offer stock options to its employees, or float an initial public offering (IPO) of its stock (equity financing options).

Different flavors of debt financing

A company that doesn't use debt financing at one time or another is rare. You can find plenty of different ways to use debt to fuel your business. Although we cover the various forms of debt financing in great detail in Chapters 2 and 7 (and additional comments sprinkled throughout the book), here are some of the more common types, just to give you a taste of what's available:

- ✓ Short-term commercial loans
- ✓ Long-term commercial loans
- ✓ Home equity loans
- ✓ Working capital lines of credit
- ✓ Leasing
- ✓ Credit cards
- ✓ Accounts receivable financing
- ✓ Inventory financing
- ✓ Corporate bonds
- ✓ Letters of credit



Be careful about the extent to which you use debt financing in your business. Too much debt piled up against your available assets creates an unfavorable *debt-to-equity ratio* (which reflects upon your ability to repay your debt and can provide a clear warning sign to potential lenders — generally a debt-to-equity ratio in excess of 1 is considered bad). Not only that, but putting your company too far in debt overextends your resources, making it more difficult to weather a downturn in sales or unexpected events that impact your business in a negative way.

Different flavors of equity financing

If your company is fast-growing, innovative, and produces terrific products or services, you may find that people aren't interested in just purchasing what you sell, they're also interested in purchasing a piece of your business. Although the make-money-fast days of the recent explosion (and subsequent implosion) of dot-com firms seem to be behind us — taking with them a boom in IPOs — plenty of investors still are looking for good opportunities to put their money to work.

Here are some of the more common ways that you can raise equity capital from investors:

- ✓ Angel investors
- ✓ Family and friends
- ✓ Founder's capital
- ✓ Initial public offerings
- ✓ Strategic investors
- ✓ Strategic partners
- ✓ Venture capital



Keep in mind, however, that equity financing is considerably different than debt financing, and in many ways it can be far more intrusive to your business. Here are some of the things you need to consider before committing to an equity financing plan:

- ✓ Unlike debt that can be paid off (for example, by getting a new bank), it is very hard to reverse (that is, pay off) an equity investment. The investor will want a lot more money than he put in because of the risk he assumed. So you should generally look at raising equity as an irreversible event. Being cautious is understandable! You'll be living with these investors and their expectations for a long time.
- ✓ Equity investors will want to know how, how much, and when they will get their money back. You'll need answers to these questions — that's some of what this book is about. (See Chapters 15 and 16 for more about exit strategies in IPOs and Mergers)
- ✓ Don't forget that most start-ups go through several rounds of new equity investors. You can't give away a lot of the equity early on or you'll have too little left for the later rounds — or you'll be faced with losing control of your company in those future rounds (and losing control of your exit strategy, too).

Looking for financing in all the right places

If you look hard enough, you can find the cash that you need to start up your business or fuel its growth almost anywhere. This book covers all these different sources and more in considerable detail.

To give you a taste of what's to come, here are some of the more common sources for business financing:

✓ **Self-funding:**

- Personal savings (See Chapter 2)
- Credit cards (See Chapter 2)
- Trade credit (See Chapter 5)
- Employee stock ownership plans (ESOPs)
- Home-equity loans (See Chapter 7)
- Bartering (See Chapter 5)
- Customers (See Chapter 5)

✓ **Private resources:**

- Angel investors (See Chapter 4)
- Friends and family (See Chapter 3)
- Private equity offering (See Chapter 10)
- Strategic alliances (See Chapter 16)
- Mergers (See Chapter 16)

✓ **Commercial funding:**

- Investment banks (See Chapter 14)
- Commercial banks (See Chapter 7)
- Savings and loan associations (See Chapter 7)
- Credit unions (See Chapter 7)
- Venture capital firms (See Chapter 11)
- Leasing firms (See Chapter 13)

✓ **Government financing programs:**

- Small Business Administration (SBA) loans (See Chapter 9)
- Small Business Investment Companies (SBICs) (See Chapter 9)



Plenty of sources of financing are available to those who seek them. The key is obtaining the kind of financing that is right for your company in an amount sufficient to ensure that you meet your goals. As hard as it may be to believe, one thing is worse than no financing at all: Financing that doesn't meet your needs or that gets you and your business into financial trouble.

Debt financing or equity financing? Some questions to ask

To decide whether debt financing is right for you, first ask these questions:

- ✓ Will your company's cash flow support repayment of the debt?
- ✓ Will your company qualify for debt financing?
- ✓ Will the amount of cash acquired through debt financing be sufficient to meet the company's needs?
- ✓ Will the additional debt endanger your company's credit rating?
- ✓ Will your company be able to comply with the loan terms and conditions?
- ✓ What kinds of collateral or personal guarantees does the lender require?

To decide whether equity financing is right for you, first ask these questions:

- ✓ Are you willing to lose some amount of control in how the company is operated?
- ✓ Are current owners willing to dilute their ownership interests?
- ✓ Is the company attractive to potential investors?
- ✓ Do the company's financial reporting systems support accurate and timely reporting of financial data?
- ✓ Are you willing to share in the future profits and equity growth of the company?
- ✓ Are you willing to share trade secrets and confidential company plans and information with potential investors?

Bootstrapping

Before you run out and begin your search for capital, you may want to consider an approach that many businesses — particularly start-ups and small businesses that may not yet qualify for loans or be able to attract venture capital — have used with more than a little bit of success. It's called *bootstrapping*. It means finding money and resources by any means possible, including begging, borrowing, bartering, sharing, and leasing everything a company needs.

In short, bootstrapping is guerrilla financing.

So, who bootstraps? Many companies do. In fact, some estimates put the total at 75 to 85 percent of all start-up businesses. Three fundamental rules for effective bootstrapping are

- ✓ **Hire as few employees as possible.** For many companies, employees are the greatest expense. When you add up salary, benefits, overtime,

and other employee-related expenses, it doesn't take long for any budget to feel the pinch. Bootstrappers avoid this pinch by hiring (and paying) as few employees as possible.

- ✔ **Lease, share, and barter everything you can.** No, you don't have to pay cash for everything that you need for your business to run. Many companies share facilities, equipment, and even employees with one another to spread out their respective costs. An increasing number of firms also have discovered the wonderful world of *bartering*, the trading of goods and services to other companies in exchange for the goods and services that are needed. See Chapter 5 for an in-depth discussion of bartering.
- ✔ **Use other people's money.** Why use your own money when someone else will let you use his or hers? We're not talking about getting a loan, we're talking about convincing a vendor to allow you to pay 30 or 60 or even 90 days after you receive your goods from them. Or, on the other hand, obtaining payment from your customers before you deliver their goods or services. In each case, you have an opportunity to use someone else's funds to your advantage — for a while, at least.

Bridgepath.com: Bootstrapping their way to success

When Bridgepath.com — the first competitor-to-competitor Internet exchange for permanent and temporary staffing firms — was formed in San Francisco in 1997, the founders decided to turn to bootstrapping to finance their company's start-up. Bridgepath.com's approach may not be for everyone, but it worked for the founders. The result? Bridgepath.com (www.bridgepath.com) was able to raise almost \$1 million in venture capital after a year of bootstrapping.

The company's bootstrapping techniques included

- ✔ Bartering with vendors in exchange for services. The company's accountant, for example, accepted help with designing and implementing a Web site in lieu of cash payment.
- ✔ Negotiating with four different long-distance telephone companies until striking the best deal possible, saving thousands of dollars for the company.
- ✔ Asking employees to bring in spare furniture to furnish their offices, and utilizing abandoned furniture. The result? The cost of furnishing each of the company's offices was kept to \$50 or less.
- ✔ Convincing vendors to accept delayed payment for goods and services provided to the company.
- ✔ Paying employees lower than average wages in exchange for stock options.



Some of the more common approaches to bootstrapping are

- ✓ Seeking funds from friends and family.
- ✓ Getting a home-equity loan.
- ✓ Offering equity to employees and vendors in lieu of salary or cash payments.
- ✓ Bartering for goods and services.
- ✓ Tapping your credit cards.
- ✓ Convincing vendors to accept extended payments.
- ✓ Starting your business part time while working a full-time job.
- ✓ Getting an extra job.
- ✓ Working from home or in your garage.
- ✓ Sharing offices with another company.
- ✓ Encouraging customer financing (deposits and early payments).
- ✓ Looking for angel investors.
- ✓ Pooling founders' savings.



Although the need for bootstrapping tends to go away as a business grows and becomes more established — and therefore becomes more attractive to conventional lenders and investors — any company, no matter how big or how small, can benefit by applying bootstrapping techniques in its day-to-day financial activities. One of the greatest dangers as businesses become more established is the growth of *overhead* — the costs of facilities, administrative personnel, equipment, utilities, office supplies, furniture, and so forth — at a rate far faster than the growth of a company's sales. This is a recipe for poor profits, sluggish growth, and loss of competitive edge. Bootstrapping can help keep your company lean and mean while keeping overhead in check and profits high.

Choosing a path

Personal and business factors drive your capital needs, and you'll need to recognize this in a very personal way. If, for example, you are in a manufactured product business, you will need more capital than someone starting a professional services business. The fact that you need more capital means that you will have devote more of your time dealing with the issues surrounding the quest for capital.

Starting from scratch

Starting a business from nothing is the dream of many people, but it is, without a doubt, one of the most difficult things you can do. The rewards — mental and financial — can be tremendous, but ask anyone who's already been down this path, and he or she will tell you that it's anything but easy. According to small business Web site AllBusiness.com (www.allbusiness.com), the majority of successful entrepreneurs start with small sums of money, often \$5,000 or less. In fact, the average start-up cost for companies listed on the most recent *Inc.* 500 list of fast-growing small businesses was only \$25,000, and roughly half of those businesses were started at home.

AllBusiness.com cites five ways to start a thriving business without spending a lot of cash:

- ✔ **Keep your day job — for now.** You may be able to start your business by working on it during weekends and evenings. That way, you can afford to experiment with different versions of your business until you find one that seems likely to succeed. Also, it's far easier to get some of your initial credit set up when you are still employed with a steady income. Ideally, you can get your business on track and accrue a healthy backlog of orders before you quit your job.
- ✔ **Work part-time.** Try shifting from full-time to part-time work when you start your business. Such a move makes the most sense in the early stages of your new venture, when you need to devote more time to finding customers and delivering products and services to them.
- ✔ **Go from two incomes to one income for a time.** If your spouse is employed, his or her income (and benefits such as medical

insurance) may cover basic living costs long enough for you to start your firm. This may mean creating a new spending plan for your family, but adhering to new budget guidelines for a few months is a small price to pay for long-term success.

- ✔ **Turn your employer into a client.** You may be able to start your new business as a consultant or supplier to your old firm.
- ✔ **Get creative about financing.** You may be the best source of financing for your new business. For one thing, you won't charge yourself interest. So begin your search for start-up cash by rummaging around in your personal treasury. Be wary of tapping into retirement accounts; you probably can't afford to risk those funds. Instead, design a budget that boosts your savings rate and sets that money aside in an account for your new business.

If you need money right away, you also can consider borrowing money from family members and friends. But don't borrow more than you're willing and able to repay over time in the event that your business doesn't work out. Alternatively, some family members or friends may be willing to risk their money in exchange for an equity stake in your business.

Credit cards are a tempting — but expensive — source of starting capital. If you resort to them for cash, your business plan needs to include a specific schedule for paying back that money within a year or so.

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If you are a very private person — and you would prefer not to have other people meddling in your finances — you should first go down a path of bootstrapping, moving towards slow and conservative growth using bank lines of credit. As your business gets larger (and your capital needs increase), you might consider a subsequent private placement of equity, and then a sale of your company through a merger.

If, on the other hand, you are *not* concerned about privacy *and* want to grow as fast as possible, you should go the venture capital path to an initial public offering (IPO). Conversely, the professional services start-up may well be able to grow rapidly without raising equity capital — an equity event — to the consternation of the founder who wants to find a rationale to make his investment liquid.

Things quickly get more complex when you consider a founder who wants to grow to an IPO as soon as possible, but who is an inveterate recluse. The mismatch between personal inclinations (behavior), personal goals, business model needs, and financing realities is one of the most important issues for a company and its founder. There are ways to handle almost every mismatch, and proper planning can overcome almost any obstacle.



Luck can account for a few good financing outcomes, but far more positive results have occurred when a goal, strategy, and plan were in place. If you want to sell as an exit strategy, for example, then first think about who would want to buy you and why. Then make your company irresistible to them. Much of this does not require calculations, just common sense and back-of-the-envelope calculations.