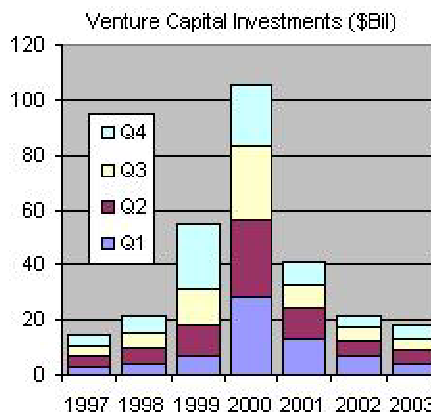
ALTERNATIVES TO VENTURE CAPITAL FUNDING

Venture capital is a proven, professional way to fund a fast-growing business. However, it is not the only source of capital for emerging businesses and it's not appropriate or optimal for many situations. This paper summarizes six types of financing sources for small and medium-sized enterprises and discusses how to choose which is most appropriate.

Understanding Venture Capital

Entrepreneurs often focus on venture capital without comparing its advantages and disadvantages with financing alternatives. They seek advice only from the venture capital (VC) community who coach them on structuring their business to fit a VC model. This reminds me of the saying, "If all you have is a hammer, then everything looks like a nail." The business is made to fit the tool (venture capital) rather than choosing the best tool for the needs of the business. Before discussing alternate funding tools, let me summarize the key characteristics of venture capital. VC funding is:

- **Proven and professional.** There are many firms (e.g. Intel, Apple Computer, Amazon) that succeeded using VCs and rewarded investors, founders, and consumers in the process. Venture capitalists typically bring both financial experience and industry contacts to the companies they fund.
- **Fast and risk tolerant, but not cheap.** Many startups that quickly grew to join the Fortune 500 used venture capital to get there. VCs are willing to take much greater risks than bankers. To pay for risk, however, VCs expect a return of 25-60%--much higher than bank loans. If your business is a "sure thing", then venture capital is expensive.
- **Focused on a 3-5 year exit strategy.** VCs typically spend their first four years investing the money from their investors, and try to cash out in ten years. Thus VCs seek investments that grow quickly and can be sold 3-5 years later. VC interest in particular business depends, among other things, on an assessment of how well this business can be sold in 3-5 years. If you don't want to sell in 3-5 years, it's best to look at alternative funding.
- **Not always available.** VC funding is generally not available for slow growth industries. It is generally for larger opportunities (exit valuation of more than $20-$100 million and funding needs of over $2-$5 million) because most VC funds are too large to manage small investments, but there are some smaller funds. Even for high-growth businesses, venture capital is cyclical, sometimes there's plenty and sometimes the well is dry, as shown below (sources: http://www.ventureeconomics.com and http://www.pwcmoneytree.com).



VCs are clustered in regions (Silicon Valley, Massachusetts) and industries (telecom, biotech, electronics) and less accessible to other sectors of the economy (retail, automotive, manufacturing).

Financing Alternatives

Because of these limitations and costs, I found it useful to review the five alternatives below (in order) with entrepreneurs before pursuing venture capital.

1. Fund from operations

Existing operations is first place to look for funds. It may be possible to "tune" the business to reduce cash needs or generate more cash from existing customers. Any money found this way is better than free--it has with no financing cost, it can reduce future financing cost, and (because many businesses are valued at a multiplier of earnings) increases the value of the business. If this is a startup, the first year month-by-month operating and cash projections show how well an entrepreneur has thought through his business, optimized elements that generate cash, planned new investment burn rate and identified contingencies.

2. Interested partners

This category includes a laundry list of items that are the closest thing I know to "free money" including:

- **License part of your solution**. You may be able to enlist others to exploit parts of the market. For example, biotech companies like Genentech license their new processes and drugs to major pharmaceutical companies and Ballard Power Systems licensed their fuel cell technology to the major automotive companies.

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- **Launch Customers.** Do you have any customers who are willing to fund your R&D to get the product? Many software products were developed as part of a consulting contract.

- **Vendor financing.** How much can your suppliers of equipment and facilities provide?

- **Research grants.** Small Business Innovation Research (SBIR) grants and other "gifts" that don't need to be repaid are available from various sources. For example, see: http://www.acq.osd.mil/sadbu/sbir/

- **Sweat equity.** There may be people willing to work for stock options, reducing up-front cash.

3. Fund it yourself

After exhausting the possibilities of funding from (1) operations and (2) partners, the next place to look is in the mirror. If you have money and believe in your business, the best place these funds is to invest it in yourself because: (a) it's beneficial not to have to answer to creditors; and (b) the return on your investment should be higher than other places where you could invest your money.

4. Debt financing

In today's low interest world, debt is a low-cost capital source. Home equity loans are one source costing less than 5% in some cases. SBA (Small Business Administration) loans are another source. You can also finance your equipment, facilities, and receivables at rates lower than venture capital. Even with VC funding, the venture capitalists will maximize debt to minimize their investment, so you might as well take this step yourself first.

5. Friends, family and angels

Having exhausted alternatives 1-4 the next place to turn is to people who know and trust you. Friends and family are more likely to loan risk money and likely to charge less because you are more bound to pay them back than you would someone with whom you only have a business relationship.

Friends and family financing can also be a precursor to venture capital. In this case, it is often debt convertible to shares at the lender's option. The "friends" may be rich people you are introduced to--typically called "angel investors".

There are legal requirements that must be met and contracts and statements must be in the right form when using this type of funding. One should consult an expert to ensure that you are "legally compliant."

Comparing the alternatives

The following table above gives an overview of the major differences between the six types of funding:

	Operations	Partners	Self	Debt	Friends	VC
Size of investment	Varies	Varies	Small (~$100K)	Varies	Small (~$100K)	$2-20M
Cost of capital	Free	Free to 10%	Free to 5%	5-10%	8-12% + option	25-60%
Risk tolerance	Not applicable	Not applicable	Varies	Low	Varies	High
Financials	Company	Not applicable	Company	Bank/ company	Friends/ company	Audited
Emergency control	Owners	Owners	Owners	Bank	Friends	VCs

Note:

- "Financials" means the detail and standards to which financial reports must be produced and how broadly they must be shared. Audited financials can be a burden on a small firm.

- "Emergency control" means who controls the firm in a financial emergency such as bankruptcy.

- The six funding alternatives aren't mutually exclusive. It is best to get as much as you can from each of the lowest cost sources first. You can also mix these, by, for example, using your friends and family to co-sign your bank debt.

- It is important to have access to more funds than your plan needs in case your forecast is optimistic.

- Lots of capital is no substitute for a good business. It is important to have a good idea, a good business model, and a good management team.

Conclusion

This paper is only an overview. The following are references to let you explore this topic further.

- Blum, Laurie. *Free Money for Small Businesses and Entrepreneurs.* John Wiley and Sons. Fourth edition © 1995.

- Green, Charles. *Financing the Small Business.* Adams Media Corporation © 2003.

- Lorenz-Fife, Iris. *Financing Your Business.* Prentice-Hall © 1997.

Please contact me if you would like additional info.

About the Author

Bert Vermeulen owns Corp21, a company that supports, incubates and advises businesses, entrepreneurs, and inventors around the world. For more information, see http://www.corp21.com.