

Financing the Corporation: An overview

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ABSTRACT

This article focuses on how to finance a corporation. One of the greatest challenges for new ventures is the ability to secure capital that will allow the corporation to grow. There is no magic formula, and the management team will need to evaluate and assess which options are beneficial for the company. Each business will need to weigh the pros and cons of each option in order to determine what would be best. There are two options that these businesses may consider. The two types of financing — debt financing and equity capital — are explored. The role of commercial banks, the Small Business Administration, angel investors, and venture capitalists is introduced and discussed.

Keywords: *Angel Investors, Capital; Commercial Banks, Cure Period, Debt Financing, Equity Capital, Financial Institutions, Investments, Pro-rata Rights,; Small Business Administration; Startup, Venture*

Introduction

Corporations believe in the success of their dream, and they expect their ventures to take off and expand. One of the greatest challenges for new ventures is the ability to secure capital for investments that will allow the company to grow. All projects will reach a crossroad where 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 was so popular and the company is growing at a rapid rate due to demand. Regardless of the situation, the company's management team will need to determine when and how they will invest in the future through, for example, purchasing new equipment, hiring new staff or putting more money into marketing initiatives. Raising money can be a difficult task if the company has not established a reputation or is still new. When determining the amount of capital needed, the decision makers must

analyze the situation and decide how much and what type of capital is required. Since the situation is not the same for all businesses, there is no magical formula. Some businesses may only need short term financing for items such as salaries and inventory; whereas, other businesses may need long term financing for major items such as office space and equipment. Each business must develop a customized plan that will meet its unique needs. Securing capital is a choice made after weighing the pros and cons of various options. There are three popular sources for obtaining funding for new ventures: borrowing from financial institutions, partnering with venture capitalists, and selling equity and possession in order to obtain a share of the revenue (Goel & Hasan, 2004). All financing options can be classified into two categories debt financing and equity capital.

1. Debt financing for companies with quick and significant growth potential.
2. May include bank loans, personal and family contributions and financing from agencies such as the Small Business Administration. Loans are often secured by some type of collateral in the company and are paid off over a period of time with interest.
3. On the other hand, venture capitalists and angel investors provide funding in the form of equity capital.
4. Pierce (2005) offers some advice which may be of assistance when assessing which option may be best for the company. Some of the tips include:
5. A Small Business Administration program may not be the best option if the company needs less than \$50,000.
6. Debt financing is often less expensive and easier to obtain than equity capital.
7. Financing the venture via debt entails the responsibility of making monthly payments regardless of whether the business has an affirmative cash flow.
8. Equity investors assume that there will be very little return during the beginning stages of the profession, but need additional research about the business' development. In addition, they assume that the company will definitely succeed in achieving the aforementioned aims and objectives.
9. Debt financing is often offered to all forms of corporations. However, equity capital tends to be reserved
10. Angel investors tend to invest money in companies that are within a 50 mile radius, and the amounts of funding tend to be in the range of \$25,000 and \$250,000. Angel investors may be companions, relatives, customers, suppliers, financial experts or even competitors.
11. It is difficult to secure venture capital funding, even in a good economy.

Option of Financing

Debt financing and equity capital options both require the financial professionals of an organization to complete detailed documentation prior to the award of financing. The finance team should be prepared to produce quarterly balance sheets, background information on the company and projections.

Debt Financing: Debt financing occurs when a firm advancing its capital through the means of selling bonds to individuals or institutions that are willing to invest. In exchange for the money lent, the investors become creditors and expect to be repaid with interest on the debt that was incurred.

Commercial Banks: A corporation that receives deposits, offers business loans, and other similar services. Though commercial banks give their services to individual citizens, they usually invest more of their efforts to lending money to and taking deposits from companies.

If the company cannot finance the expansion through personal investments, the management team will need to develop a business plan that meets the criteria for

potential lenders. Commercial banks may be the first choice, especially if the owner has a relationship with a specific lender. Since traditional lenders tend to be conservative, good rapport and an established relationship will be beneficial when applying for a loan. According to the University of Maine's Cooperative Extension, a 1980 Wisconsin study of smaller corporations discovered that 25% of the companies that underwent the interview process were denied at first, but 75% of them was approved when they submitted their proposal to another group. It is important for potential borrowers to understand the mindset of potential lenders. Most lenders tend to focus on five important factors when deciding whether or not to extend credit, and business owners need to be prepared to address them. The five factors are:

1. **Character** — what are your personal characteristics? Are you ethical and have a good reputation? Will you do everything possible to pay the loan back?
2. **Capacity** — will your business be able to generate sufficient cash flow to pay the loan back? Do you have access to other income?
3. **Collateral** — do you have collateral to cover the loan in the event the venture does not perform well? Is there a qualified individual willing to co-sign on the loan?
4. **Conditions** — have you researched the environment to see if there are any circumstances that could negatively impact your business (i.e. nature of product, competition)? How will you deal with these situations if they arise?
5. **Capital** — what are you personally willing to invest in the venture? Most lenders are not willing to invest in ventures if you have not made a major investment in the future of the project. Why should they invest in the venture if you are not willing or able to?
6. **Equity Capital:** Money invested in a business by owners, stockholders or others who share in profits.
7. **Venture Capitalists:** A term that defines an investor that gives capital to start-up companies or offers support to small corporations hoping to expand. Capitalists, however, lack any form of access to public funding.

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 technical ventures.

Funding may be invested throughout the company's life cycle with funding being provided at both the beginning and later stages of growth. Venture capitalists may invest at different stages. Some firms may invest before the idea has been fully developed while others may provide funding during the early stages of the company's life.

However, there is a group of venture capitalists who specialize in assisting companies when they have reached the point when the company needs financing in order to expand the business.

Angel Investors

Angel or Angel Investor defines an individual who offers capital to startup businesses in need of added value. Angel investors often boost the companies' financial worth due to their connections and expertise in the field. Many firms receive some type of funding prior to seeking capital from venture capitalists. Angel Investors have been identified as one source that entrepreneurs may reach out to for assistance (Gompers, 1995). "In a nationwide survey of more than 3,000 individual angel investors conducted by the Angel Capital Association, more than 96 percent predict they'll invest in at least one new company in 2007. Also, 77 percent expect to invest in three to nine startups, and five percent think they'll fund 10 or more new companies" (Edelhauser, 2007). This is good news for future entrepreneurs with a dream.

Including angel investors in the early stages of financing could improve the changes of receiving venture capital financing. Madill, Haines and Rlding (2005) conducted a study with small businesses and found that "57% of the firms that had received angel investor financing had also received financing from venture capitalists. Firms that did not receive angel" investing in the early stages (approximately 10% of the firms in the study) did not obtain venture capital funding (Madill, et. al., 2005, "Abstract"). It appears that angel investor financing is a significant factor in obtaining venture capital funding. Since obtaining venture capital tends to be difficult, businesses can benefit from the contacts and

experience of angel investors in order to prepare for a venture capital application and evaluation. The intervention of an angel investor may make the company appear more attractive to the venture capitalists.

Regardless of how a company decides to finance the venture, it will have to make an agreement that is beneficial to the investor since they are the ones providing the money. Therefore, it is important to select a choice that benefits the business in the long run. Initial decisions may set the tone for future deals. Advani (2006) has provided some recommendations to consider when determining what will work best. These suggestions include:

1. **Don't give pro-rata rights to your first investors.** If your first investor is given pro-rata rights, chances are your future investors will want the same agreement. It would be wise to balance the needs of your early investors to protect their stake in the company with how attractive the company will be to future investors.
2. **Avoid giving too many people the right to be overly involved.** If too many people are involved, it could create a bureaucracy and make it difficult for decisions to be made in a timely manner. In addition, the daily tasks of a business may be prolonged due to the need for multiple authorization signatures.
3. **Beware of any limits placed on management compensation.** Some investors may place a cap on the earning potential of senior management personnel. This type of action could create a problem with human resource needs such as attracting and hiring quality talent to run and grow the business.

4. **Request a cure period.** Many investors will request representation for every legal agreement to protect themselves if the management of a company is not in compliance with laws, licenses, and regulations that govern the operation of the business. Although all parties may have good intentions, errors do occur. If a "cure period" is added to the financing agreement, the entrepreneur will have the opportunity to find a solution to the problem within a given period of time (i.e. two to four weeks).
5. **Restrict your share restrictions.** Having unrestricted shares is often a good negotiating factor with future investors. Therefore, it would be wise to evaluate any requests to restrict the sale of shares owned by the founders and/or management team.

Types of Corporate Venturing

The first corporate venture funds appeared in the mid-1960s, which was approximately 20 years following the first formation of the institutional venture capital funds (Gompers, 2002). "Since that time, corporate venturing has undergone three boom-or-bust cycles that closely track the independent venture capital sector" (Gompers, 2002, p. 2). It has been found that many corporations will consider entering the business venture market when the independent sector starts to show hints of achievement and prosperity (Gompers & Lerner, 1998).

Large corporations have shown an interest in venture capital investing over the years, and they tend to use many different means to achieve their clever and budgeting aims for venture capital investments.

Gomper (2002) described three of these models, which are internal corporate venture group, dedicated external fund, and passive limited partner in a venture. What is involved with these three models? Some organizations will create an internal corporate venture group to assess venture capital options and invest successfully. Other corporations will put investment capital in a loyal fund that exists as a separate entity external to the organization. Finally, there are real venture funds that offer businesses the chance to be acquiescent, limited partners and perform diverse investments in ambitious corporations.

Funding

In order to avoid a "backlash of no cash," a business may determine that selling shares of equity would be the best way to secure working capital. This alternative could alleviate some of the stress associated with starting a new venture and provides the company an opportunity to grow at a quicker rate. However, the business will be required to give the investors some control and profits. Angel investors may want to take a role in the company, but the venture capitalists will probably want to remain in the background as a silent partner. If the venture is not successful, the investor loses. Therefore, angel investors and venture capitalists will probably require a higher return on investment than a conventional lender since the risks are greater.

Trends in Financing

New ventures will continue to grow, and corporate management teams will need to look to the trends when determining how to finance. During the last couple of years, the availability of financing and the cost of options have changed. Advani (2006) provides a list of trends that will assist corporations in getting funding for new

ventures. The trends for start up financing in 2007 are:

1. **Angel investing will continue to grow.** “There are about 250,000 angel investors in the United States investing in approximately 50,000 small companies each year,” and this number will continue to grow as angel investing becomes more popular (Advani, 2006). One reason for the growth may be the proposed tax incentives that will be provided to high net worth investors who privately invest.
2. **Valuations and investment terms are good.** “The yield rate on angel investments, (the rate at which investments presented to angels result in funding), increased from 10 percent in 2003 to 23 percent in 2005. Pre-launch startup valuations involving first-time corporations have escalated to more than \$5 million. However, they should stabilize at \$2 million to \$3 million in the future” (Advani, 2006).
3. **Business credit scores will supplement personal credit scores.** Credit cards remain the most used form of capital for companies wanting to finance their debt. In the past, credit card companies made decisions based on the owner's personal credit history. Today, many companies are using credit data on the business to make decisions. Business credit information may be collected from data banks such as the Small Business Financial Exchange (SBFE). Banks and other lenders utilize the information on the companies in conjunction with their supported instructions for
- businesses. Nearly every one of the top 20 banks in the United States are using this method.
4. **Getting \$50,000 in funding continues to be difficult.** According to the Global Corporationship Monitor, the average amount of start-up capital used by small businesses in industrialized countries is \$53,000 (Advani, 2006, 6). Unfortunately, most corporations cannot secure \$50,000 in credit card financing, and angel investors are usually not interested in companies where they are the only investor in businesses with insufficient working capital. In addition, programs, such as the Small Business Administration's Micro loan Program, are facing cuts so they aren't being marketed by SBA lenders. However, nonprofit micro lenders may be able to fill the gap. In the past, these lenders were not able to compete with banks, but they are considering forming an alliance to more effectively convert credit bureau protocol to include performance of micro loans in credit scores. This action may make this option more attractive to corporations and small business owners.
5. **Low credit scores are not considered harmful to financing anymore, but patient capital remains a significant obstruction to potential success.** In the past, if a potential corporation did not have a high credit score, credit options were limited. Many used the equity in their homes in order to get a good rate. But, Internet lenders and non-traditional one-on-one lenders have

developed alternatives for businesses without high credit scores. Although the cost of the capital may be higher for those without a good credit score, options exist. Unfortunately, the lack of patient capital and long-term financing choices for companies with sub-prime credit presents problems. The interest rates that these companies charge can be very high and businesses may not be able to generate earnings while paying these rates.

Conclusion

Corporations believe in the success of their dream, and they expect their ventures to take off and expand. One of the greatest challenges for new ventures is the ability to secure capital for investments that will allow the company to grow. All projects will reach a crossroad where 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 was so popular and the company is growing at a rapid rate due to demand. Regardless of the situation, the company's management team will need to determine when and how they will invest in items such as purchasing new equipment, hiring new staff and putting more money into marketing initiatives. Raising money can be a difficult task if the company has not established a reputation or is still new.

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