**COMSATS University Islamabad, Virtual Campus**

**MGT403 Entrepreneurship**

**Lecture 20 Handouts**

**Types of capital and their resources**

**Raising Capital**

Capital is a crucial element in the process of creating new ventures; yet raising the money to launch a new business venture has always been a challenge for entrepreneurs. Raising capital to launch or expand a business is a challenge. At the start of the business, the capital required is known as “seed money”. Before starting business, it is important to identify that what choices you have to finance the business as it is observed that many entrepreneurs are caught in the “credit crunch.”

**The “Secrets” to Successful Financing**

1. **Choosing the right sources of capital for a business can be just as important as choosing the right form of ownership or the right location.** It is a decision that will influence a company for a lifetime, so entrepreneurs must weigh their options carefully before committing to a particular funding source.
2. **The money is out there; the key is knowing where to look.** Entrepreneurs must do their homework before they set out to raise money for their ventures.
3. **Raising money takes time and effort.** Sometimes entrepreneurs are surprised at the energy and the time required to raise the capital needed to feed their cash-hungry, growing businesses. The process usually includes lots of promising leads, most of which turn out to be dead-ends. Meetings with and presentations to lots of potential investors and lenders can crowd out the time needed to manage a growing company
4. **Creativity counts.** Entrepreneurs have to be as creative in their searches for capital as they are in developing their business ideas.
5. **The World Wide Web puts at entrepreneurs’ fingertips vast resources of information that can lead to financing; use it.** The Web often offers entrepreneurs, especially those looking for relatively small amounts of money, the opportunity to discover sources of funds that they otherwise might miss.
6. **Be thoroughly prepared before approaching potential lenders and investors.** In the hunt for capital, tracking down leads is tough enough; don’t blow a potential deal. Be ready to present your business idea to potential lenders and investors in a clear, concise, convincing way
7. **Entrepreneurs cannot overestimate the importance of making sure that the “chemistry” among themselves, their companies, and their funding sources is a good one.** Too many entrepreneurs get into financial deals because they needed the money to keep their businesses growing, only to discover that their plans do not match those of their financial partners.

**Layered Financing**

Rather than rely primarily on a single source of funds as they have in the past, entrepreneurs must piece together capital from multiple sources, a method known as **layered financing.** They have discovered that raising capital successfully requires them to cast a wide net to capture the financing they need to launch their businesses.

**Types of Capital**

Capital is any form of wealth employed to produce more wealth. It exists in many forms in a typical business, including cash, inventory, plant, and equipment. Entrepreneurs need three different types of capital, as follows:

1. **Fixed Capital** is needed to purchase a company’s permanent or fixed assets such as buildings, land, computers, and equipment. Money invested in these fixed assets tends to be frozen because it cannot be used for any other purpose. Typically, large sums of money are involved in purchasing fixed assets, and credit terms usually are lengthy. Lenders of fixed capital expect the assets purchased to improve the efficiency and, thus, the profitability of the business and to create improved cash flow that ensures repayment.
2. **Working Capital** represents a business’s temporary funds; it is the capital used to support a company’s normal short-term operations. Accountants define working capital as current assets minus current liabilities. The need for working capital arises because of the uneven flow of cash into and out of the business due to normal seasonal fluctuations.
3. **Growth Capital** unlike working capital is not related to the seasonal fluctuations of a small business. Instead, growth capital requirements surface when an existing business is expanding or changing its primary direction.

**Equity Capital** represents the personal investment of the owner (or owners) in a business and is sometimes called risk capital because these investors assume the primary risk of losing their funds if the business fails. To entrepreneurs, the primary advantage of equity capital is that it does not have to be repaid like a loan does. Equity investors are entitled to share in the company’s earnings (if there are any) and usually to have a voice in the company’s future direction. The primary disadvantage of equity capital is that the entrepreneur must give up some or sometimes even most of the ownership in the business to outsiders. To avoid having to give up majority control of their companies early on, entrepreneurs should strive to launch their companies with the smallest amount of money possible.

**Debt Capital** is the financing that a small business owner has borrowed and must repay with interest. Very few entrepreneurs have adequate personal savings needed to finance the complete start-up costs of a small business; many of them must rely on some form of debt capital to launch their companies. Lenders of capital are more numerous than investors, although small business loans can be just as difficult (if not more difficult) to obtain. Although borrowed capital allows entrepreneurs to maintain complete ownership of their businesses, it must be carried as a liability on the balance sheet as well as be repaid with interest at some point in the future.

**Sources of Equity Financing**

1. **Personal savings:**

It is the first place an entrepreneur should look for money. It is the most common source of equity capital for starting a business as outside investors and lenders also expect entrepreneurs to put some of their own capital into the business before investing theirs.

1. **Friends and family members:**

After emptying their own pockets, entrepreneurs should turn to those most likely to invest in the business: friends and family members. They should be careful as inherent dangers lurk in family/friendly business deals, especially those that flop.

**Guidelines for family and friendship financing:**

Following factors should be mainly considered for family and friendship financing:

* Consider the impact of the investment on everyone involved.
* Keep the arrangement “strictly business.”
* Settle the details up front.
* Never accept more than investors can afford to lose.
* Create a written contract.
* Develop a payment schedule that suits both parties.
* Have an exit plan.

1. **Angels:**

Frequently, the next stop on the road to business financing is private investors. These private investors (“angels”) are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies.

**Patient money** is the investors’ willingness to make a financial investment in a business with no expectation of turning a quick profit. Instead, the investor is willing to forgo an immediate return in anticipation of more substantial returns down the road. The typical angel:

* Invests in companies at the seed or startup stages.
* Accepts 10 percent of the proposals presented to him.
* Makes an average of two investments every three years.
* Has invested an average of $80,000 in 3.5 businesses.
* 90 percent are satisfied with their investments.

1. **Partners**

Partners may bring in capital, expertise and complimentary skills. Partners may be general partners (with unlimited liability) or sleeping partners (with limited liability).

1. **Corporations**

It has been estimated that about 20 percent of all venture capital investments come from corporations and about 300 large corporations across the globe invest in start-up companies.Corporate partners may share marketing and technical expertise.

1. **Venture capital companies**

Venture capital companies are private, for-profit organizations that assemble pools of capital and then use them to purchase equity positions in young businesses they believe have high growth and high-profit potential. Many venture capitalists focus their investments in specific industries with which they are familiar. Venture capitalists typically purchase between 20 percent and 40 percent of a company but in some cases will buy 70 percent or more.

Most often, venture capitalists invest in a company across several stages. On average, 98 percent of venture capital goes to:

* Early stage investments (companies in the early stages of development).
* Expansion stage investments (companies in the rapid growth phase).
* Only 2 percent of venture capital goes to businesses in the startup or seed phase.

Venture Capital Companies mainly look for: competent management, competitive edge, growth industry, viable exit strategy & for other intangible factors.

1. **Public stock sale**

Initial public offering (IPO) refers to situation when a company raises capital by selling shares of its stock to the public for the first time. There are several advantages and disadvantages which associated with company’s decision of “going public”.

**Advantages of “Going Public”**

* Ability to raise large amounts of capital.
* Improved corporate image.
* Improved access to future financing.
* Attracting and retaining key employees.
* Using stock for acquisitions.
* Listing on a stock exchange.

**Disadvantages of “Going Public”**

* Dilution of founder’s ownership.
* Loss of control.
* Loss of privacy.
* Reporting to the SEC.
* Filing expenses.
* Accountability to shareholders.
* Pressure for short-term performance.

**Sources of Debt Capital:**

* **Commercial banks**

Commercial banks are the very heart of the financial market for small businesses, providing the greatest number and variety of loans to small companies. Banks tend to be conservative in their lending practices and prefer to make loans to established small businesses rather than to high-risk start-ups. It usually offers:

1. **Short-term loans,** extended for less than one year, are the most common type of commercial loan banks make to small companies. These funds typically are used to replenish the working capital account to finance the purchase of more inventories, boost output, finance credit sales to customers, or take advantage of cash discounts. There are several types of short-term loans. Business owners use **commercial loans** for a specific expenditure to buy a particular piece of equipment or to make a specific purchase, and terms usually require repayment as a lump sum within three to six months.
2. **Lines of credit,** one of the most common requests entrepreneurs make of banks and commercial finance companies is to establish a commercial line of credit, a short-term loan with a pre-set limit that provides much-needed cash flow for day-to-day operations.
3. **Intermediate and Long-Term Loans,** banks primarily are lenders of short-term capital to small businesses, although they will make certain intermediate and long-term loans. Intermediate and long-term loans, which are normally secured by collateral, are extended for one year or longer and are normally used to increase, fixed- and growth capital balances. Small companies often face a greater challenge qualifying for intermediate- and long-term loans because of the increased risk to which they expose the bank.
4. **Asset based lenders** are usually smaller commercial banks, commercial finance companies, specialty lenders, or divisions of bank holding companies that allow small businesses to borrow money by pledging otherwise idle assets, such as accounts receivable, inventory, or purchase orders, as collateral. This method of financing works especially well for manufacturers, wholesalers, distributors, and other companies that have significant stocks of inventory or accounts receivable.
5. **Vendor financing (trade credit)**

Many small companies borrow money from their vendors and suppliers in the form of trade credit. Because of its ready availability, trade credit is an extremely important source of financing to most entrepreneurs. When banks refuse to lend money to a start-up business because they see it as a high credit risk, an entrepreneur may be able to turn to trade credit for capital. Getting vendors to extend credit in the form of delayed payments usually is much easier for small businesses than obtaining bank financing.

1. **Equipment suppliers**

Most equipment vendors encourage business owners to purchase their equipment by offering to finance the purchase. This method of financing is similar to trade credit but with slightly different terms. Usually, equipment vendors offer reasonable credit terms with only a modest down payment, with the balance financed over the life of the equipment (often several years).