

Part 10. Small Business Finance and IPOs

In the last section, we looked at how large corporations raised money. In this section, we will examine some of the financing issues facing small and start-up businesses. What makes a business small? For our purposes, it is not the amount of sales or the number of employees, it is the amount of money you want to raise. If you only need to raise \$20,000 it wouldn't make sense to list your company on the New York Stock Exchange. Because of this, small businesses have different options when it comes to financing. Actually, the options they have are limited for two reasons, the small amount of money they need, and the lack of information available.

The small amount of financing

Say that you had a quick business venture that only needed an initial investment of \$1,000. It wouldn't make sense to issue stocks and bonds; the cost of doing so would be hundreds of thousands of dollars. In fact, it really wouldn't make sense to get a bank loan. If the bank charged an interest rate of 10% it would only get \$100 for the year, hardly worth the time it would take to evaluate the loan and handle all the paperwork. Raising funds at this level is typically done either by saving or by borrowing from friends and family. Alternatively, an individual might borrow by using credit cards, which are offered by institutions that specialize (through credit cards) in making small, short-term loans, usually at very high interest rates.

As the amount of the needed funds gets larger, the options increase. At a certain point, banks would become an option. Some banks specialize in making loans to small businesses while other banks only deal with large companies (and some banks make all types of loans).

Risk and limited information

Starting a business is a risky venture. You can misjudge the market and find that business is less than expected, or a company can fail simply due to bad luck. When investors provide funds to your company they are putting their money at risk, so they are very concerned to know how much risk they face. What makes this difficult is that the investors lending the money usually have less information than the people borrowing the money. They don't know if you are reliable.

Example: Your Uncle Louis and Uncle Fred are both considering starting their own businesses. Uncle Fred is very responsible and has a good business opportunity. Uncle Louis is not very responsible, but he is very optimistic about his opportunities. From the bank's point of view, both of these seem like reasonable candidates for loans on the surface, but they don't know if the individuals are responsible and so a good risk. The bank *knows* that they don't know, so they would be very reluctant to make any loan. They wouldn't be willing to lend to Uncle Louis, but they also wouldn't lend to Uncle Fred, because they don't know if he is correctly representing the risks. Uncle Fred is forced to rely on friends and family for funding because they have the information about his business opportunity.

Financing from Banks

The key issue for the bank is whether your company will have the cash to pay back the loan. Getting the loan is a process of convincing the bank of that. Indeed, banks are institutions that

specialize in collecting and evaluating information about business and individuals. The bank will check your credit history and look at your final assets. Part of the process is you trying to convince the bank that you have a good business idea that will generate enough cash to repay the loan. This is largely done through a business plan.

Trade Credit

Up to this point, we have not made much of a distinction between long-term and short-term financing. Generally, a company will try to use long-term financing to fund long-term projects and short-term financing for short-term needs. If you are getting funding to buy a building that you will use over the next ten years, you do not want to arrange a sequence of one-year loans because of refinancing risk.

Short-term financing generally involves small amounts of money that will be repaid within the year. Often, it is not worthwhile to make repeated trips to the bank or to borrow a small amount long-term (particularly if the amount needed to borrow is expected to change over time). Other forms of financing can be used. For example, you need to buy \$10,000 worth of inventory that you will sell over the next month. You could get a one-month loan for the \$10,000, but a better plan may be for the supplier to give you the inventory now with an agreement that you pay them in one month. The supplier is offering you trade credit, which is one type of short-run financing.

The Financing Decisions: Equity or Debt

The principles used by large corporations when deciding on the mix of equity and debt also apply to small businesses. Using leverage can increase the expected return, but it also increases the amount of risk. Because of this, businesses with large amounts of risk tend to use relatively more equity financing. However, there are other factors that can be very important for small businesses.

Say that you are starting a small restaurant and need \$30,000 initial capital. You have \$15,000 of your own money but need to raise an additional \$15,000 from your Aunt Lenora. Aunt Lenora can invest in your restaurant in two basic ways. She can give you the \$15,000 as a loan, where you promise to repay that amount, plus interest, at a certain time in the future. Alternatively, Aunt Lenora can join you in this business by becoming part-owner. She gives you the \$15,000 and in return gets half ownership in the business and half of all profits. Our basic understanding of leverage says that by borrowing from Lenora we are on the hook for our debt, and that can be risky, but if we share the risk by making Lenora our partner, our expected returns will be lower and Lenora will get a large share of the gains when we hit it big. But there are some other considerations as well.

The definitions of equity and debt can get blurred.

In the small business world, the financial relationships implied by equity and debt can sometimes be unclear. Defaulting on the loan to Aunt Lenora will have some extra costs for you, particularly when going to the family reunion.

And even if your business is structured as a corporation, you may not get the full benefits of limited liability. A bank may want you to pledge personal collateral for the loan. Collateral are assets that would be given to the bank if you fail to repay the loan. Collateral provide some insurance to the bank if you can't repay the loan. It also provides you with a greater stake in the

future of the company; making you work harder to make sure that the company will be a success so that the bank will be repaid.

The debt or equity decision is a joint decision by you and the lender

Could you raise all \$30,000 by borrowing from Aunt Lenora and then use your own money for something else? It's possible, but Aunt Lenora might not be willing to lend you her money if you are not putting your own money at risk at the same time. If you didn't use your money, it might indicate that you don't have confidence in this business venture, which is a bad sign to outside investors. Also, the more you have at stake in the business, the harder you will work and the better the prospects for Lenora to get repaid. Outside investors in small businesses like to see the owners make substantial equity investments of their own into the business.

This is an issue for large corporations as well, although it works indirectly. If a corporation uses too much debt, this will increase the risk that the bondholders will not be repaid, which means that they will demand a higher interest rate. The use of debt can increase the cost of debt to the company.

Giving up control

One of the assumptions of corporate finance is that the equity owners of a company do not have any particular attachment to the company, aside from the returns they expect to get. This is often not true for small businesses. If I am running my own restaurant, I may be reluctant to bring in partners if they are going to interfere in how I run my business. Because of this, the owners of many small businesses will avoid equity financing, particularly if they would have a minority stake. They may strongly prefer to keep ownership and control for themselves, or at least to keep it within their family.

Private Placement

Sometimes mid-sized companies will want to issue small amounts of equity or debt, but not enough to justify issuing securities in major stock or bond markets. An option is to sell equity or debt to a few individuals or institutional investors. This is called private placement because the securities are sold to specific investors and not sold in security markets to the general "public".

Start-Up Companies and Venture Capitalists

While small companies can usually raise sufficient funds from banks, and large companies have access to the entire range of capital markets, new mid-size companies can find themselves caught in the middle, not fitting well with either traditional bank finance or with raising funds in public markets. This is a particular problem for start-up companies in very risky businesses, such as computer technology. For these companies, an alternate source of financing has developed, called venture capital.

Venture capitalists provide funds to a company when it is first starting up. They do this by taking an equity stake in the company rather than by making a loan. To see why this matters, we will go through a short numerical example.

We begin with five start-up companies, each company requiring \$1,000,000 of initial financing. If a company fails, the investors will lose all their money. However, if a company is a success,

the company will be worth \$12,000,000. Only 1 out of 5 companies will make it, the rest will go bankrupt. The problem is that we don't know which company will succeed. The only way to find out is to try.

The venture capitalist will provide all the funding for the companies, \$5,000,000 in total, and by agreement will own half of each company. Four out of the five companies fail, but one company succeeds. The venture capitalist's share of that company is worth \$6,000,000, which gives the venture capitalist a 20% return.

Compare that result with a bank that charges 20% interest on loans to each of the start-up companies. The bank provides \$5,000,000, four companies go bankrupt and do not repay the loan, while the one company that does succeed repays \$1,200,000 (the principal plus the interest on the loan). The bank loses money! To get a 20% return, the bank would have to charge an interest rate equal to 500%!

While this example oversimplifies the problem a bit, it makes an important point. When there is a substantial uncertainty about returns, debt contracts are a bad source of financing from the investor's point of view. Debt contracts share the downside risk (when a company goes bankrupt) but do not share in all the upside gains when a company hits it big.

Because of the high risk involved, venture capitalists follow several guidelines:

- 1) They look for projects with the possibility of a large upside (which will compensate for the high risk)
- 2) They fund a number of different projects to diversify risk.
- 3) They use equity funding so that they share in the upside risk.

The venture capitalist process proceeds in a number of stages. In the first stage of the process, an individual with a new idea will develop a business plan for their prospective company and pitch it to various venture capitalists. If a venture capitalist agrees to pursue the idea, they will make an initial contract. The founder of the company brings their idea (plus some personal funds to signal commitment) while the venture capitalist will provide money and business experience. They agree to split ownership of the company. Usually the amount of cash provided by the venture capitalist is enough to get the company started with its concept but usually not enough to get it fully to market, and certainly not enough to fund its growth over the company's lifetime.

After the first round of funding runs out, the company will have to return to the venture capitalist to get additional funding. The point of this is to allow the venture capitalist to cut its losses. The kind of company a venture capitalist deals with can be very speculative; they don't know if the idea will work, and there is no way to determine that except to try. Financing in stages allows the company to try out its idea while limiting the financial risk to the venture capitalist. This gives us a fourth guideline:

- 4) They fund the company in stages.

The final part of the venture capital process is when the company looks like it will be successful. At this point, there is a shift to long-term funding from the broader capital market.

The IPO

The **Initial Public Offering** (or IPO) is when shares of the company are offered to the public for the first time. While there are several ways to handle an IPO, the most common way is to use an investment bank. The investment bank acts as an advisor to the company helping it to determine an initial value for its shares (remember the section on valuation). The investment bank will buy the newly issued shares and resell them to the public. Once the shares are publicly available in the market, anyone can buy them and the price will fluctuate with investor demand.

The IPO performs two roles. First, it allows the company to use the larger capital market in order to raise additional funds. Often, companies having an IPO still need significant capitalization in order to expand and prosper. Traditional equity markets can provide that funding at a lower cost than venture capitalists.

The IPO also allows the founders of the company and the venture capitalists to cash out by selling their existing shares in the market. The venture capitalists can use the money to fund new start-up companies. For the founders, this is the point that their initial idea makes them rich!