EUREKA

EUREKA Information Booklet on

PRIVATE FINANCE

EUREKA GUIDE NAVIGATOR

➢ *This section provides an overview of the EUREKA Guide on Private Funding, and a short description of each of the Chapters that you can download here on the Eureka website.*

The Guide is set out in stand-alone Chapters in PDF format, and this 'Navigator' will help you identify which sections you need to consult to provide orientation on the topics or issues which you need more information on.

Purpose of This Guide

Many Eureka-supported projects encounter a "development gap" between the end of the R&D phase and the launch of a new product or process on the market. SMEs and project promoters often find themselves unable to meet the costs of commercialising the R&D and not knowing how to access external sources of private finance. The lack of appropriate funding when finance is required can jeopardise the commercialisation of the new technology, resulting in a reduced impact of the Eureka programme's support.

There are many different sources of private funding that can serve your needs, and it is important to be aware of each type of private finance and the implications of using it.

This guide is designed to help Eureka-supported technology projects, and especially SMEs without experience in private funding, that are seeking finance in order to commercialise their technologies. The information in this booklet will help them to better understand the various sources of external private funding available to them, to what extent they might be relevant for their needs, and how to access them.

How this guide will help you understand the often unfamiliar world of finance…

This guide seeks to help you understand the world of private finance by:

- Explaining the various types and sources of private financing
- Explaining the advantages and disadvantages associated with each kind, and their suitability to various stages of the life cycle of the business
- Explaining the investment criteria and requirements of investors and how to prepare a request for private funding
- Outlining the different sources of advice and assistance which can assist you in preparing a proposal for private funding

Having read the guide, you should be in a position to assess whether private financing is an option for your project, and how to go about raising it.

Every effort has been made to make the guide as simple and straightforward as possible. No prior knowledge of finance is necessary – the purpose of this guide is not to turn readers into financial experts, but to explain the basic concepts of private finance, how to raise private finance, and where to find assistance. A glossary of financial jargon is also provided.

Where to find what…

This guide has 11 easy-to-read chapters. An overview is set out below.

I Relevance of External Financing for Eureka-supported Projects

Looks at the different phases of development of technology-oriented firms and at what this means for these firms' financing needs.

II You and Your Financing Needs – 7 Questions To Ask Yourself

Seeks to put you, your technology project and your eventual financing needs in their wider perspective by asking some fundamental questions – such as your long-term vision for your project and why you may need external funds.

III Types of Private Finance

Explains what type of private funding exist, and explains the key differences between equity financing (investments) and debt financing (loans). It also puts you inside the mind of a banker and a venture capitalist, so that you can see how they view the world – and how they will view you and your project.

IV Sources of Private Finance

Outlines the numerous providers of loans and investment financing, and highlights some of their characteristics.

V Getting Your Business Plan Together

Explains why a good business plan is essential if you want to raise private funding, and provides some guideline on how to go about writing your plan.

VI The Investment Process

Takes you step by step through the process of raising private funding, and gives some general suggestions on sources of professional advice and assistance.

VII Moving Forward

Provides an answer to the questions of when and how your company should be financed, what different stages of investment there are and how you best prepare for contacts with the investors. Gives you insight on how and why to develop a capital-raising plan.

VIII Forming Alliances

Developing and leveraging partnerships could drive your business forward likewise. The best sources for financing could be your clients or your suppliers.

IX The Golden Rules of Raising Finance

Reminds you of the Do's and Don't's of raising private funding.

X Networks You May Need to Know

Provides contact details of organisations that could help you in your search for private funding.

XI Glossary

An overview of the terms financiers seem to love using. The Glossary will not only help provide you with summary explanations of terms used in the Eureka Information Pack, but also explain other terms that you may come across when seeking to raise financing.

I. RELEVANCE OF EXTERNAL FINANCING FOR EUREKA-SUPPORTED PROJECTS

1. Introduction

Approximately 1000 projects have already been completed under the EUREKA programme. Many of these projects resulted in high quality, novel technologies. EUREKA's work ends at the point where a project has been successfully completed and is ready to go to the market.

However, a good technology as such will not automatically guarantee commercial success. One of the key success factors going forward is having the required financial resources to build a successful business activity. Many of the companies involved in the EUREKA programme were supported financially by major industrial partners introduced to them through the EUREKA network. Others have obtained venture capital funding.

So, private finance may be needed in a wide range of Eureka-supported project situations, including:

- ❖ SMEs which want to commercialise technologies but whose economic base (i.e. assets owned) is insufficient
- ❖ Large companies or public and private research institutes that want to encourage the set-up of an independent spin-off company to commercialise a new technology
- ❖ Several companies who wish to set up a joint venture
- ❖ Executives in both large and small private and public R&D units who decide to start a business based on the innovation and experience gained.

Let us first have a look at the typical development path of a technology-based company and the financing needs that arise along the different stages of this path.

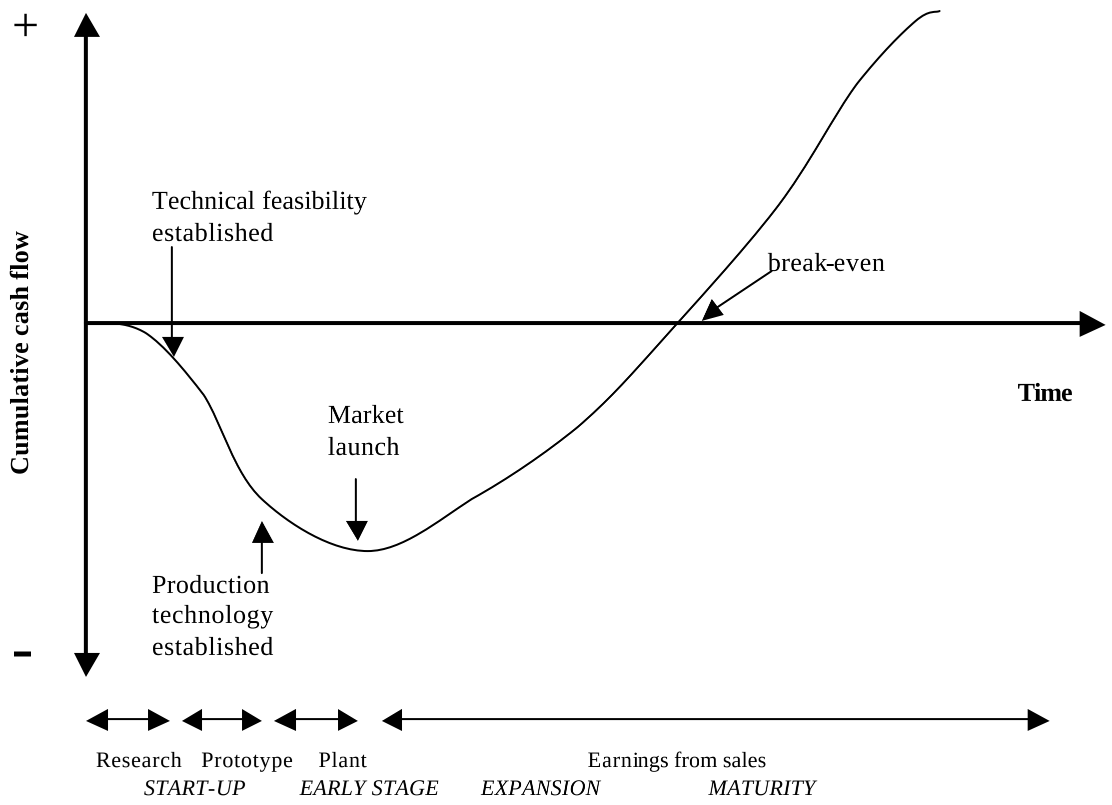
2. Financing Needs of Technology-based Companies

The table below outlines some of the financing issues that a young technology-oriented company is confronted with during the various stages of its development.

Development Stage	Financing issues for Technology-based Companies
Research & Development	No revenue generation capacity Finance needed to fund initial research.
Start-up	Significant capital needs and significant need for external finance. Funds may be also needed to finance working capital requirements (i.e. cash required to fund the day-to-day running of the business), market studies, development of a business plan, initial investments etc.
Early Stage	Strong expansion requires significant ongoing investment to finance it Funds may be also needed to finance working capital requirements Profits need to be reinvested to finance continued expansion

Continued Expansion	The company is now generating significant sales and has an often-positive cash flow. Increased capacity to finance new investment out of internal finance, but will need external finance if the requirements are large. This could be the case with fast-growing technology companies striving to make full use of high market potential in order to gain a strong position in this new market (especially where defensive strategies such as seeking patent protection are not considered to be nearly as effective).
Maturity	The company has established itself in the market, and continues to generate large sales volumes. Less relative expansion means increased positive cash flow.

This graph illustrates this by showing a typical evolution path for the cash flow of a young technology-based company.



The positive and negative cash flow situations will vary in extent and duration, depending on the sector in which the business is active and its rate of expansion.

The Development Gap

We can therefore see that during the research and start-up phases no sales revenue is generated, yet the company has considerable expenditure outlays during the R&D phase, as it seeks to research and develop its technology, from design and testing through prototype to commercial process or product. Not to mention the cost of putting the embryonic company structure and organisation in place, such as a sales team, production, financial control etc. As the company is generating no sales revenue, it has a negative cash flow and therefore cannot internally finance the development of the company, even any expansion.

As the company moves through the early-stage phase, it begins generating revenue and eventually moves to a position where it is able to finance itself the day-to-day costs of trading, thus developing a positive cash flow. For very fast-growing companies, the cash flow situation may remain negative for a considerable period of time, as expansion costs continue to be higher than earnings.

Thus the relative inability of a company to meet its own financing needs will be greatest during the earlier stages of its life – in other words its need for external financing will be greatest during these early stages and during periods of rapid expansion.

Companies with low reserves of internal finance will need more external private finance than companies with strong balance sheets and significant levels of assets. Companies with low reserves of internal finance typically include:

- Companies developing and marketing innovative products and technologies
- Small and young companies
- Independent companies without large shareholders
- High-tech companies with expansive business or investment plans

Furthermore, the need for external finance has increased for the new technology-based firm operating in today's global market, due to increased competition and ever-shorter product life cycles, which do not allow innovative companies to finance investment and growth strictly from profits, reserves or own funds (e.g. entrepreneur's private money). External finance is needed more and more.

3. Is there still money out there?

Spectacular plunges in the value of shares on the stock market and the recent collapse of well-known high tech firms have given many investors food for thought. Entrepreneurs with bright ideas and valuable new technologies worry whether there is still enough money out there to finance their ventures.

For now, money is still aplenty; the steady stream of venture capital has not begun to dry up yet. In 2001, European venture capitalists invested € 12.2 billion, €4.1 billion of which in seed and start-up stages, and €8 billion in expansion stages. This was about 31% less than in the absolute top year 2000, but still considerably more than in 1999.

Thus, viewed over a horizon of 5 years, the amount of venture capital invested in European technology companies has continued to increase. The combination of novel quality technology, a sound business plan, and top quality management will continue to find money. The upward trend in venture capital looks set to continue.

II. YOU & YOUR FINANCING NEEDS - 7 QUESTIONS TO ASK YOURSELF

Before going about raising external finance it is important that you have clear answers to a number of questions. This chapter seeks to help you develop your own answers to these questions. These questions are important, as your position or situation may mean that certain sources are likely to be much more relevant. Again, it is important to ask yourself these questions BEFORE you go about raising external finance.

Q1 What do I want?

Before talking about finance needs and sources, the first step is to establish where you are. You could, for example, be:

- An entrepreneur or owner in an SME
- Senior executive or member of the management team in an SME
- Head of R& D department in an SME or larger company
- Executive in a public or private research institute
- Other

If you own or part-own a company or are considering setting up your own business venture it is worth taking time to reflect on **WHY you are (would I want to be) in business?**

Different types of motivation may drive you, such as:

- to be your own boss
- to create a successful and respected business
- generate substantial wealth for you and your associates
- the desire to see your new invention succeeded in the marketplace

Where do you see the business going over the next three years, five years? It is important to reflect on your long-term ambitions for the business before rushing off to seek funds to finance the next step up. Only you can answer this, and your reasons are very relevant when considering what kind of finance you could access.

Q2 Who owns the technology?

The technology, which has or is being developed, could be owned by:

- You / company / project consortium / university / other?

This question is important, because if you are not the sole owner (or about to become the sole owner) of the technology, then the owners - be they your employer or business associates or joint venture partners - need also to be involved in this process.

Q3 How can I develop the business?

What is the mission of your business, and what are your targets, in terms of sales, market share and profitability? What is the business seeking to do with the newly-developed technology?

What are the possibilities for bringing your technology to the market? Depending on your present situation, numerous possibilities exist, including:

- Commercialise it (in-house)
- Commercialise it in a new (spin-off) venture
- Commercialise it by entering in a joint venture
- Licensing its manufacture and/or sale
- Sell it
- Other

Q4 What do I need the finance for?

Do you need the extra money to invest in new assets (e.g. buildings, machinery, stock), finance a marketing campaign, or to supplement your working capital? For what period of time will you need extra finance? Depending on your financing need, some sources of finance will be more relevant than others.

Q5 Do I really need external finance?

Again, consider whether you need to seek external finance to meet your needs – *maybe your problem is not so much that you need extra cash, but that you need to better manage the cash you already have?* Ensure that you are maximising your internal sources of finance by:

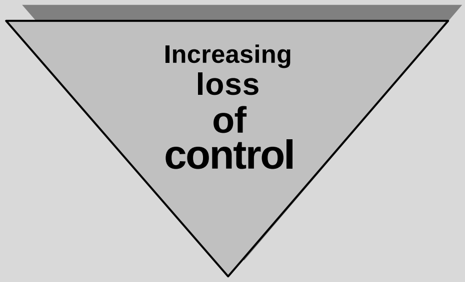
- Having strict credit control procedures in place
- Ensuring that good cash-flow forecasting systems exist
- Providing customers with incentives to encourage prompt payment
- Agreeing longer but fair payment terms with your suppliers
- Controlling carefully your overheads

Q6 What is my attitude to control?

How you view the prospect of taking in a partner in your venture and thereby giving up some control will strongly influence what type of finance you choose. Most people equate the sale of equity (shares in your business) with loss of control. However, allowing any third party to partly finance your business, be it equity or any other form of funding, will mean that they will be interested in ensuring that their investment is being properly managed to success and they will probably seek to influence the way that you run your business.

The table below shows the extent to which external influence changes according to the type of financing that is used.

- Own funds and improved internal controls
- Lease/Hire Purchase
- Grants
- Bank lending
- Sale of equity



It is also important not to look at the degree of control you cede to an outside party in isolation – while selling equity to a venture capital firm may involve a considerable loss of control for you, this must be weighed up against the many benefits, such as relevant business and management experience, strategic advice etc.

Q7 What finance is available?

Clearly, the terms on which finance is available to you will have a fundamental impact on your decision about which type and source of finance to use. In this respect, it is important not to accept the first offer you receive, but to 'shop around' and compare costs.

III TYPES OF PRIVATE FINANCE

- *In this section, we look at the 2 basic types of financing – debt and equity – and their key features, as well as some of the characteristics of the providers of each type of finance*

1. Equity Financing versus Debt Financing

Basically, investments break down into two forms - '**debt financing**' (i.e. lending) and '**equity financing**' (investment finance). Understanding the difference between lending and equity financing is key to financing your business in an optimal manner.

Debt Financing	Equity Financing
Debt financing refers to 'borrowed money', where a loan is made available, often by a bank, over a specified period (loan term) to a company or entrepreneur. In return, the borrower agrees to pay interest to the lender for being able to use the money, which is paid back either during or at the end of the loan term. Thus, the lender is rewarded by interest payments (in addition to the repayment of the loan amount itself). The amount borrowed is usually guaranteed (secured) by the business or personal assets of the borrower (e.g. entrepreneur's house).	**Equity financing** (also known as risk capital, private equity or venture capital), refers to the selling of a share in your business (equity stake) to a third party in return for their providing capital at full risk for you to grow your business. In contrast to loan financing, equity financing does not involve either repayment of the investment or interest rate payments, and the investment does not have to be guaranteed against your assets, as a bank loan is. The higher risk taken by the provider of equity capital is compensated for by the potentially high rewards of success, should the business prosper and grow.

It is important to understand that using one type of finance does not prevent you from using the other - debt and equity financing are often combined within an overall financing 'package' for a firm.

The Table overleaf summarises some of the key differences between Debt and Equity financing. **Section 2** describes the key Debt financing instruments, and the approach of a banker to lending. **Section 3** describes the basic types of Equity (venture capital) financing, and the approach of venture capital investor.

Debt Vs Equity Financing – Some Key Distinctions

Debt Financing	**Equity Financing**
1. No loss of ownership	1. Loss of ownership
2. Repayment (of loan) & interest charges	2. No repayment and no interest
3. Need to provide security on the loan	3. Risk–taking business partner
4. Lender may impose financial discipline to ensure repayment schedule is met	4. Will want to have say in how business is run; often by a seat on the board of directors
5. Unlikely to provide much management advice	5. Advice & support can be significant

2. Debt financing

A. Debt Financing Instruments

Debt financing can take numerous forms. The most common lending instruments are:

Debt financing: main instruments

- Overdrafts
- Loans
- Bank guarantees
- Leasing and Hire Purchase
- Factoring

Overdrafts

An overdraft is a flexible lending instrument whereby the borrowing company can withdraw money at will, up to an agreed limit. Overdrafts are best used to finance short-term variations in working capital, or to make short-term purchases, such as stock.

Loans

Money can be lent on a short term, medium-term and long-term basis. Such loans are called term loans, as the money is lent for a certain period.

Guarantees

Guarantees are sometimes provided by government and public agencies to assist viable businesses that lack sufficient security to obtain debt financing.

Both Leasing/Hire Purchase and Factoring are discussed in the glossary.

B. Understanding the Banker's Approach

Banks are in the business of accepting money on deposit from others and lending this money on to others. They are the main providers of loan finance for both individuals and companies. The different types of banks, such as retail banks and merchant banks, are discussed in Chapter IV.

A bank makes the majority of its profit on what is referred to as the *net interest income*, which is the difference between the interest they pay on money 'borrowed' from depositors (e.g. saving accounts) or other bankers and the interest they receive on money lent to borrowers. Very little of the asset base of a bank consists of shareholders' funds, or equity. Now, suppose an entrepreneur cannot repay on a loan and the entire loan amount is lost. For the bank this has a number of consequences

- ❖ As the bank still has to repay its depositors, the loss decreases the already narrow equity portion of its balance sheet
- ❖ As the bank is allowed to lend money only in proportion to its equity, the loss reduces its ability to lend
- ❖ In order to make up the lost loan principal, the bank must earn the full net interest margin on many new loans

This is why ……..

- ❖ Bankers do NOT like high-risk loan propositions.
- ❖ Loans must be repaid.
- ❖ Security in support of a loan is often sought 'just in case'.

Let us have a closer look now at some key success factors in obtaining a loan.

C Getting The Bank To Lend – Important Success Factors

Bankers often make assessments of loan requests using simple checklists, such as the checklists shown below:

The 5 C's Checklist	
❖ **C**haracter of borrower ❖ **C**apacity to repay ❖ **C**ollateral (security)	❖ **C**apital provided (debt/equity ratio) ❖ **C**onditions (product, industry, economy)

Character of the Borrower

Research suggests that bankers form an impression of an individual quickly and tend to stay with this impression. Therefore, you need to impress at the first meeting.

Capacity to repay

Will this individual's company be able to pay back the loan? This is one of the key questions a banker will be asking himself, as he listens to you across the table. You will have to show clearly to the bank how your company is going to be able to generate the cash necessary to pay interest on the loan and repay the loan amount. This will be done using your business plan – which is the subject of Chapter V.

Conditions

What are the conditions in which the business will operate, in terms of products and markets, strategy and competition? What is it that makes this business a viable proposition?

Capital Provided

How does the requested loan amount compare with the company's liquidity, and is other finance being requested from elsewhere and in which amount?

Collateral

Another key question that the banker will ask - *if this company finds itself unable to repay the loan, what can my bank do to recover the loan?* Banks need at least one and preferably two alternative sources of repaying the loan, other than cash flow.

Finally, some useful tips for increasing your chances of obtaining loan finance…

Making a favourable impression on your banker…

- Project an air of confident professionalism
- Dress conservatively, be on time, be prepared to provide documentary evidence to support your arguments
- Remember that while finance is the language of the banker, few entrepreneurs speak it – if you can, you will have a real competitive advantage
- Be honest – bankers hate surprises

Chapter IV looks at the sources of debt finance, in particular bank lending.

3. Equity Financing

- *This section looks at the different venture capital instruments available for financing an entrepreneurial business.*

A key consideration when seeking to approach a venture capital provider is the stage of development of your company, as this is probably the most important investment criterion of venture capital providers. This is reflected in the fact the key investment stages correspond closely to the equity financing instruments available to entrepreneurs.

All businesses will have some form of equity financing. Initially it is the money invested in the business by the entrepreneur or by family and friends. Some expand the equity financing by selling shares to wealthy investors, and a few raise equity from formal venture capital companies.

A. Equity Financing Instruments

This section describes briefly the key Equity financing instruments

Seed (Seedcorn) Capital Financing

Seed capital is financing provided to allow a business concept to be developed. This might involve the production of prototypes and additional research, prior to bringing the product or service to the market.

Start-up Capital Financing

Financing provided to firms for use in product development and initial marketing. Companies benefiting from this financing would be those that are being set up or that have been in business for a short while but have not sold their products commercially.

Other Early Stage Financing

Capital provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales.

Expansion (or Development) Financing

Financing provided to fund the growth and expansion of an established company which is breaking even or trading profitably. Funds may be used to finance increased production capacity, product development, provide additional working capital, and/or marketing.

Mezzanine (or Bridge) Financing

A debt instrument that bridges a gap in time between earlier rounds of venture financing and a liquidity event, usually a refinancing, an acquisition or an initial public offering. Generally structured as subordinated debt with warrants with a term of not more than 3 years. This facility is expected to be deployed very quickly with little due diligence on the part of the lender. Therefore, it is priced fairly aggressively with the lender seeking a return in the 30% to 40% range.

Management Buy-out (MBO)

Financing provided to enable current operating management and investors to acquire an existing product line or business.

Mezzanine Debt

Mezzanine debt is loan financing which is between secured loans and equity insofar as it is either unsecured or it has a second claim on the borrower’s assets in the event of a default. It also refers to the financing to fill the void between equity and senior secured debt. It is particularly useful in financings for buyouts, recapitalisations, acquisitions, and growth where there is a capital need beyond what the senior secured lender is willing to provide and more than the equity provider can afford or is willing to invest.

Venture lending

Venture lending essentially entails lending to companies that don't generate cash but that should, given adequate time, have sources of capital available to them, usually from venture capital funds. A venture loan would take the form of a bridge facility, bridging the period of time it takes to get a full equity round completed.

Explanations of other less relevant equity-financing instruments (Management Buy-in, Secondary Purchase, Turnaround Financing, and Preference Shares are contained in the glossary.

B. Understanding the Equity Investor's Approach

Equity investors will not invest money into a company, until they are convinced that there is a reasonable probability that the potential financial returns measure up to the risks. Equity financing has the highest level of risk, and the equity investor will therefore seek high returns on the investment, compared to other forms of financing. By investing money in your business, equity investors are risk-sharing partners in that their success depends on the success of your business. Therefore, they will only be attracted to investment opportunities that offer well-above average returns on investment.

This means, as a general rule, is that a venture capitalist expects to get a return of between five and ten times their initial investment, over a period between 3-7 years. An ideal scenario for a venture capitalist is one where the company will grow very rapidly and float an initial public offering (IPO) of its shares on the stock market within five years of the first venture capital investment.

Because of the uncertainty and higher risk of early-stage and start up investments, the expected return on investment will be correspondingly greater. The return on investment sought can up to 80% for seed capital investments and up to 60% for start-up investments, compared to 25% for companies that are almost ready to seek a flotation on the stock exchange.

There are a number of key things that a venture capitalist will look for in an investment opportunity, but amongst the most important are:

What the equity investor looks for in a company

- Outstanding leadership ability on part of the entrepreneur
- General track record of entrepreneur and management team
- Market with potential for sustained growth where you can gain a protected position
- Ability of management to exploit this potential and control the company through the growth phases
- A sound business plan which demonstrates clearly why the business will provide the high return on investment sought by the equity investor
- Venture capitalists are concerned about how they will realize liquidity and receive value for their investment. Therefore, does your company have the possibility of growing quickly and becoming an attractive acquisition target or IPO candidate?

IV PRIVATE FINANCE - SOURCES

- *This section provides you with an overview of the various **providers** of private finance for businesses.*

The main sources of Private Financing relevant to technology-based companies are:

Private Financing: main sources

- Government funds
- Founder's Funds
- Family, Friends and Fools
- Banks
- Business Angels
- Venture Capital Companies
- Corporate Venture Capital
- Corporations
- The Stock Market

1. Government Funds

While public sources of finance are not the subject of this guide, it is worth noting that government agencies can be an important source of funding, especially during the R&D and start-up phases and often comes in the form of grants. Although grants may be attractive in that they represent 'free money', they can often have non-financial constraints such as administrative reporting requirements and employment creation requirements. Your national EUREKA office can provide further information in the area of public funding.

2. Founder's Funds

Founders and entrepreneurs will have put in all the finance that they are able to afford. In addition to investing any available finance, the entrepreneur(s) can also make non-financial contributions (e.g. taking little or no salary) – the so-called "**sweat equity**"! It is important that the founder makes a significant contribution, as potential investors will expect this as proof of his/her commitment to the venture.

3. Family, Friends and Fools

This source of finance is referred to as the **3 Fs**: Family, Friends, and Fools: the brother-in-law, neighbour, colleagues, who invest (small) amounts of funds in a starting business. It is all about limited amounts of money from people who have an emotional bond with the entrepreneur. The extent to which a start-up entrepreneur depends on these sources is generally underestimated – this so-called 'love money' tends to be very important in getting many business ventures off the ground.

While there are advantages to maximizing the amount of money from own funds, such as no dilution of ownership, these must be weighed against the very personal commitment you undertake towards family and friends. This would mean not risking what you cannot afford to lose and not asking your family and friends to do so. While a potentially important source of funds at the outset, family and friends cannot be relied upon for follow-up rounds of finance.

4. Banks

Banks have been a traditional source of financing for businesses, providing a significant amount of their financing needs. In addition to debt financing, banks provide numerous other services to companies, including guarantees, deposit holding, worldwide transactions facilities, and sometimes provide financial services such as insurance and risk management.

Banks may be divided into **two main types**:

- **Commercial or retail banks** provide a full range of retail banking products and services to the general public and the business community, and are the type found in your local town or village.
- **Investment banks**, on the other hand, do not provide retail-banking services; rather they serve as intermediaries between issuers of shares and the investing public. The investment bank underwrites the stock offering (i.e. they agree to buy all the public shares at a set price) and resells them to the general public, making their profit on the difference (spread) between the purchase price and the selling (public offering price). Investment bankers may also work as advisors or intermediaries with companies that decide to float on the stock exchange.

5. Business Angels

Venture capital firms are often thought to be the main source of equity financing for new and young business entrepreneurial ventures, but this is in fact not the case. The main source of 'classic venture capital' - small amounts of high-risk early-stage equity – is the informal venture capital market. This is comprised of Business Angels, which are individuals of high net worth, the majority of whom are self-made with substantial business and entrepreneurial experience, and who are prepared to invest directly in entrepreneurial businesses.

Typically, business angels tend to invest locally in business sectors in which they have some experience. Individually, their investments may be quite small - around € 50.000 - but in syndication, considerably larger sums may be available. They make quick decisions. In the UK alone, it is estimated that some € 2 billion is available for investment by private individuals, The investment pool of Business Angel finance for Europe is estimated between 10 and 20 billion euro. This is substantially more than is available for the early-stage investment sector from formal venture capital sources.

Business angels are becoming more and more important as a source of private equity. They can fill up the equity gap left by the bank finance that is often inappropriate, and by the formal venture capital that is concentrating on later stage and larger businesses.

In addition to the finance they make available, business angels are value-added investors who can bring the significant benefits of their business know-how, industry experience and contacts to your business venture. While business angels, like venture capital firms, are the first and foremost motivated by the prospect of a high return on their investment, they also tend to be attracted by the opportunity to be closely involved in guiding the development of the business. They will therefore tend to seek to have a 'hands-on' involvement in the company through a position on the board, consultancy work, or even through working on a part-time basis.

Finding business angels is not easy, as most of them prefer to remain anonymous. You can maximise your chances of finding one by searching locally. Other potential paths to identifying business angels include successful entrepreneurs familiar with your sector, participating in networking organisations such as business clubs and professional associations, business angel networks, lawyers, accountants, and venture capitalists.

6. Venture Capital

Venture capital is one of the most relevant sources of finance for innovative companies to fund their growth. Venture capitalists may be generalist or specialist investors depending on their investment strategy. Venture capitalists can be generalists, investing in various industry sectors, or various geographic locations, or various stages of a company's life. Alternatively, they may be specialists in one or two industry sectors, or may seek to invest in only a localized geographic area.

Venture capitalists seek investments in companies with high-growth possibilities, and usually are not interested in investing amounts below € 500.000. They invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (seed capital), or may provide capital to start up a company in its first or second stages of development (early stage investing), or provide financing to help a company grow beyond a critical mass to become more successful (expansion stage financing).

7. Corporate Venture Capital (Corporate Venturing)

Corporate investors provide equity to a company that is not yet listed on a stock exchange, both for the strategic benefits that equity deals can provide as well as the financial gains that can supplement operating earnings. Corporate investors cite two major investing objectives: financial return and a window on technology. Despite the strong financial draw, however, strategic interests are the foremost driver of corporate venture capital activity.

The general characteristics of corporate venture capital are very similar to venture capital.

8. Large Corporations

Large companies may in some instances represent a potentially important source of equity financing for bringing R&D projects to the market. This would obviously be the case where the R&D project is owned by a large company which wants to commercialise it itself, but also where there is no formal or informal connection with the company. For example, a large corporation might take an equity stake due to its having strategic interests in seeing that the technology is commercialised (e.g. wanting to have a 'window' on developments). Such corporations are potential buyers of a new business venture.

9. The Stock Market

Another way for a company to raise finance is to sell shares (stocks) on the stock market, through an initial public offering (IPO). This will mean that shares in the company are offered for sale to the public. The concept is exactly the same as venture capital, the main difference being that the market is a public equity market instead of a private equity market.

Selling shares on the stock market is however only an option for mature companies, and is not relevant therefore to new or very young companies.

Having looked at the various instruments and sources of debt and equity financing, we have seen that in order to seek any external financing, the first step is to develop a business plan. This is discussed in Chapter V.

V. GETTING YOUR BUSINESS PLAN TOGETHER

- *This section explains the importance of the business plan and provides advice on writing one - and how to present it to investors…*

1. The Importance of a Business Plan

Even if you do not intend to raise outside capital, the business plan is vital. It provides you with a clear map, with milestones against which progress can be measured and evaluated. You have to think through all aspects of the business, from product development to customer service. Writing a business plan will force you to examine in detail the basic assumptions on which the viability of your proposed venture is built.

Furthermore, a business plan is indispensable if you are seeking external finance for the business, as you will need to set out a convi ncing argument to justify the lender or investor supporting your venture. Business plans are sales documents, selling your business idea, product, service, you and your track record to a potential financier. The business plan is the point of departure for prospective investors to begin their due diligence in order to ascertain the various risks and potentials of the project.

The next paragraph outlines the key components of a quality business plan. It is essential that your plan address each of these areas before you approach an investor.

It is not a good idea to have someone else write your business plan for you. Investors want to learn about you, not discover how well others can write for you. Ask a friend with relevant business experience, or ideally your professional adviser or accountant, to reviewing the draft business plan. Be as professional in preparing the business plan as you are in running your business!

2. The Business plan

This section sets out the key elements that should be included in a professional business plan.

O. Executive Summary

This is the most important section that you can be certain will be read. It's therefore your best opportunity to capture the reader's imagination and interest, persuading him that it is worth reading on. It should be short and focussed (2-3 pages in length) and include the key details from the structure below. Pay particular attention to communicating why the business will be a success and where it is unique.

1. The product or service

Give a precise description of what the product or service is and what it will be used for. Add a realistic statement of your products unique or distinctive advantages and how they will be translated into benefits for your customers.

2. Management team

A well-balanced, experienced management team, led by an entrepreneur with strong leadership ability is essential. Describe the special abilities each member brings to the business venture, and emphasize management's previous track record in running, or being involved with, successful businesses. You could also consider using non-executive/independent directors as members of the team; their input from a "stand-back" position can be extremely valuable. Put detailed CV's in an appendix.

3. Markets & Competition

It is essential to convince your investor or lender that there is genuine market for your product or service. You might first provide a general description of the market (estimated size, history and likely future developments…) and then focus on your target segments. Good competitor analysis is crucial: who are the potential competitors? On what basis do they compete? How does your product compare with those already available? How do your potential customers see the competition?

4. Marketing

Now you need to show how you will reach the market you just described. Explain how you produce the products or provide the service, and how the business will operate on a day-to-day basis. What is the target price, how is it set? What mix of promotion tools? How will you sell and distribute your product or service?

5. Operations & Logistics

Explain how you produce the products or provide the service, and how the business will operate on a day-to-day basis (how each key task will be done, in which manner and why and by whom).

6. Financial projections

Provide a realistic assessment of sales, costs and cash flow and demonstrate the business's growth prospects (for a three-year or longer period). State and justify the bases and assumptions used in the projections. Be aware that bankers and venture capitalists will be able to identify where you have 'reverse forecasted' to arrive at projections merely designed to impress them.

7. Indicate the purpose, amount and type of finance

State how much finance is required, and what it will be used for. For lending you need to show how the loan will be repaid and in the case of equity investments how you expect the venture capital investor to make a return. Include an implementation schedule - what are the deadlines for capital expenditure, obtaining orders, production?

8. Provide different scenarios for financial projections (sales, costs and cash flow)

Ask the appropriate "what if?" questions to ensure that key factors and their impact on the financing required are carefully assessed. For example, what if sales decline by 25% or supplier costs increase by 30.5%, or both? How does this impact on the profit and cash flow projections? Is the company still a viable proposition?

Some other points to bear in mind…

Business Plan Writing Tips

- Make the plan readable
  When writing, write to hold the reader's interest; do not bore him with unnecessary detail. Use charts and graphics to illustrate and amplify complicated information.
- Keep the plan realistic
  Do not be too optimistic; highlight challenges and show how they will be met.
- Correct level of detail
  Too lavish a document might suggest unnecessary waste and extravagance, and a lack of focus on the part of the entrepreneur. Confine technical details, quantitative data, reference lists to an appendix
- Don't make ambiguous, vague, or unsubstantiated statements
  Let realistic market and sales projections drive the assumptions underlying the financial spreadsheets, rather than the reverse.
- The numbers matter, but so do the economics…
  Your financial projections should not be centered on whether or not you can build a profitable-looking spreadsheet. Rather, you need to focus your efforts on showing how you create a profitable and sustainable business.

First Impressions Are Important !

Banks and venture capitalists receive credit applications or requests for capital every day and fairly or unfairly, their choice of opportunities to consider will be based on their first impression of the Business Plan. Make sure therefore that it is attractively written and presented, with a strong executive summary.

Many small business organisations, consultancies, banks and venture capital organisations publish booklets on producing business plans, which may be of help to you.

3. Pitching Your Business Plan to Investors

While your business plan is the most important document in preparing your venture, there are two other elements of utmost importance if you want to raise interest in the financiers' community.

A. The elevator pitch

What would you do if you found yourself in an elevator with a financier whom you have been trying to meet? How will you tell him or her exactly what he or she needs to know about your venture in order for you to capture his or her interest? Remember you only have 60 seconds!

A good elevator pitch contains the following elements:

- What is the problem that your product or service solves?
- What is the value or benefit it delivers?

- Why is it important and exciting?
- What have you accomplished and what do you need to make your company a success?
- Who are you and how can you be contacted?

A good pitch takes time and effort to build. Write and refine until you have the perfect one. Remember you can only once make a first impression!

B. Business plan presentation

Investors back persons, not pieces of papers so you have to be prepared to present your business plan in one-to-one or one-to-many meetings. As your sales pitch, the presentation will get your idea across clearly and succinctly. An effective presentation consists of 12 to 15 simple concise slides with a clear story line containing the following sections:

- Summary
- Company and team
- Market
- Strategy
- Competition and risks
- Investment considerations: status, time line, use of funds
- Recap

Tips from the trenches….

- Keep it short and to the point
  Brevity requires effort -- you must think hard about the essentials of your message and ruthlessly cut away the unnecessary details.
- Solve a problem
  Avoid sounding like a solution in search of a problem
- Stress the opportunity and lay out the benefits
  How will your business benefit your customers?
- Make it tangible
  Don't talk in abstractions, don't get lost in details.
- Show your passion and commitment.

VI. THE INVESTMENT PROCESS

➢ *This section looks at the process of finding investment, and relates mainly to the process of seeking equity financing.*

Generally speaking the process of raising external finance, from the time your business plan has been prepared to when external finance has been obtained and put in place, can take anything from one month to one year. In general the process will be shorter where loan financing is sought, whereas the higher risk involved in equity financing will mean that a greater and more detailed level of checks will be made.

1. Overview of the Investment Process

1. First contact

After you have selected appropriate target investors, you send them a letter enclosing the **Executive Summary** from the Business Plan. The objective here is to attract the interest of the target and obtain an interview. If possible, obtain a personal introduction from someone that is well-known to the investor like a director or founder of one of their portfolio companies, a lawyer who has worked with them on deals and who knows you well…

2. Initial enquiries and interviews

Where the investor is sufficiently interested in proceeding further, they will then meet the entrepreneur and management team to discuss the business plan in detail. During these discussions the venture capital firm will be assessing the viability of the venture and the abilities of the management team.

3. Examination of the Business Plan

If the management team has been successful in the first two stages, the fund managers will now examine the Business Plan very carefully – especially the financial projections. They may make some preliminary enquiries about the technology but their main concerns will be the cash flow forecasts and the potential returns. There will certainly be follow-up meetings between the investor and the managers at this stage.

4. Initial Negotiation of Terms of the Deal

If the potential investor decides that the opportunity is worth pursuing, they will commence discussions of the terms of a deal with you. The key elements that will be involved in these negotiations are discussed in this chapter, and include *valuing the business*, *establishing your financial commitment* to the venture, and *agreeing a financing structure* for the venture.

Once agreement has been reached on a proposed deal, the venture capital investor will send you an *Offer Letter*, which will set out the general terms of the investment, subject to the due diligence review. The Offer Letter demonstrates that a venture capital firm is seriously considering investing in your business.

5. Due diligence

All being well, the fund managers will now proceed to make a thorough evaluation of the plan. This process, known as "due diligence" means taking nothing for granted, but checking all aspects of the business. The potential investors will almost certainly require additional meetings during this time and the whole process will take several weeks - even months.

6. Final Negotiation and completion

At this point, if all the preceding work has led to a decision to invest an offer will be made to the Company. The investors will decide how much of the equity they want to buy and what it is worth to them. Normally, no venture fund will want to buy more than around 35% and it may well be less, depending upon the value they put on the firm.

7. The Investment

Venture capital companies make equity investments but according to circumstances, they may offer loans in addition to equity. This might be done if the deal did not justify a high valuation, so additional funds could be made available as loans. These loans might be convertible to equity under some conditions to be agreed.

2. More Details on the Process

A. Identify Investors

Once you have prepared your business plan and had it reviewed by a professional adviser (e.g. your accountant, or a consultant), the first step in the process is to identify suitable investors who you can target in your effort to seek equity financing.

Some advice on approaching investors:

- Target investors whose investment focus matches your business venture (in terms of sector, geographical area, and investment stage) –otherwise you risk wasting your time and theirs. It is generally better to seek equity finance within your own country, as most venture capitalists prefer to invest within their own country.
- Do not contact too many firms (no more than five) – this gives you an opportunity to revise the business plan if your first contacts prove unsuccessful, as well as avoiding that your business opportunity becomes too well known.
- Details of contact addresses and co-ordinates of venture capital firms can be obtained from membership directories of your national venture capital and business angel associations and/or the European Venture Capital Association. See Section IX for more information and addresses

Once you have identified venture capitalists with relevant investment foci, then you can send them a letter with a copy of your business plan. You should find that you receive an initial indication from the Venture Capital firm on your business plan within a week or so of receipt - either a prompt "no" or a request for further information or for a meeting with you. If you do not receive a quick "no", find out the reasons for the rejection - you may have to make revisions to your business plan, or team, or carry out further market research before approaching other potential investors.

B. Initial negotiation of an acceptable offer

Where the investor, following examination of the business plan and discussions with you, decides that the opportunity is worth pursuing, they will begin discussing the terms of a deal with you. A number of key issues and tasks will be dealt with at this stage:

- Arriving at a value for the business
- Establishing your financial commitment to the business
- Agreeing the financing of the investment

Valuing the business

There are different methods – such as calculating the price-earnings by which the investor may seek to place a value on the business. Depending on the stage of business, however, these valuations can often be merely prospective, and serve as a basis for discussion. For some early-stage companies, the valuation process is often more an art than a science. However it is useful for setting out the borders of the negotiating area.

Your financial commitment to the investment

In addition to agreeing a value for the business, it will be important that you (and your team) show that you are willing to invest some of your own capital to demonstrate personal financial commitment to the venture. If not, the investor will ask why should they risk their money (and that of their investors) if you are not prepared to risk your own. As a general guideline, an investor would expect that you (and your management team) invest the equivalent of one year's salary each in the venture, or approximately 10% of the capital to be invested in the company.

Type of Financing Structure

Regarding the type of financing structure, you must be prepared to give up a significant portion of the equity if you want to secure the financing. This does not usually involve a venture capital firm taking a controlling interest in the company, but invariably it will be more than you might wish.

There are various ways in which the deal can be financed, including equity only, equity plus debt and/or mezzanine finance and or preference shares (see glossary). The investor will put forward a proposed structure for consideration by you, on which you can seek the advice of your professional adviser. It is unlikely that the investor will agree to finance all the financing needs at this stage, rather he/she will agree rounds of finance, where further equity is invested when the business meets agreed targets at the various stages of the development course that has been mapped out in the business plan (remember that business plan you're meant to be writing ?!) – this is called stage financing.

Other negotiating points may include agreeing the number of votes assigned to the investor's shares, and whether the investor requires a seat on the Board of Directors.

C. The Due Diligence Process

As mentioned above, due diligence is about the investor backing up initial impressions of the business plan and you with solid evidence to support (or contradict) their current views. External consultants may be used to assist in this part of the process – for example chartered accountants may be brought in to report on the financial projections of the business plan, and maybe examine your management information system (where the company exists already).

For the venture capital investment process, due diligence means a rigorous investigation and evaluation of an investment opportunity before committing funds. This process includes review of its management team, business conditions, projections, philosophy, and investment terms and conditions.

The verification process consists of checking the accuracy of the business plan, audited accounts, and management accounts; getting replies to warranty and other standard questionnaires; patent searches; and technical studies. Unpublished accounting information and subjective information are equally important; these data are collected by calling customers, suppliers, lawyers, and bankers, and by checking trade journals. Due diligence emphasizes understanding and quantifying the *risk* of the proposed deal, rather than the upside.

As an entrepreneur, you should provide maximum cooperation to the due diligence process and not withhold any information which you think the potential investors should be aware of before arriving at their decision. Since trust is a paramount factor in the investment process, withholding valuable information will almost certainly blow up the deal.

It would be a very wise thing to call in experienced professional advisors to help you through the due diligence process.

D. The Costs

Although it is true that a venture capital investment does not entail interest payments or other significant outflows from a company, there will be considerable costs in making the investment.

The table below outlines some of these costs:

The Investor's Costs

- Due diligence expenses, technology checks, patent searches, market information, company's warranties (ownership of technology and patents; track record, etc)
- Management time and costs
- Contract negotiations
- Articles of Association
- Shareholders' Agreement
- Taxes and miscellaneous costs

Although these are mainly costs incurred by the investor in checking out the investment opportunity, it is usual for them to be recovered from your company, together with a fee for the management time involved. There are so many variables that it is impossible to quantify just how much these costs will amount to, but there are estimates which indicate the total costs may be about 5% of the deal itself for medium and large investments. The percentage may be greater for small deals.

However, the costs are not billed to your company directly but are included in the investment.

E. Completion

Following completion of a satisfactory due diligence, the terms of the deal can be finally negotiated and agreements in principle can be drawn up by the lawyers. Ensure that you understand the legalities of these documents by having your adviser explain them to you.

Well, that's the essence of the investment approach! The next section provides an overview of the role of professional advisers in helping you through the process of raising external finance.

3. The Role of the Professional Adviser

In any 10 commandments on being a good entrepreneur, the first and last should be "You can't do everything yourself!" And this is as true for raising finance as it is for most aspects of the new business venture.

Professional advisers can play an important part in the process of raising private finance. Your financial adviser in particular can contribute throughout the process, and where you are seeking to raise finance from a venture capital firm, you will need to hire a lawyer.

The role of the financial adviser

Your financial adviser can provide valuable help throughout the process of raising finance, providing accounting, tax, and business planning advice to you.

- ❖ Initial appraisal of your outline business and financial plan
- ❖ Advising you on the preparation of a detailed business plan
- ❖ Carrying out specialised business planning work, e.g. financial modelling and sensitivity analysis.
- ❖ Identifying potential providers of finance and helping you present your plan to them
- ❖ Providing tax-related advice on how to gain maximum benefit from the tax system and minimise your tax liability
- ❖ In the case of equity finance, providing assistance in negotiating the terms of an equity deal with your investor, and reviewing the key documents (e.g. Offer Letter etc.) with your lawyer.

The role of the lawyer

Where you are seeking to raise equity finance, the assistance of a lawyer becomes necessary. The key roles of the lawyer in the process of securing equity finance are:

- ❖ Reviewing the Offer Letter
- ❖ Negotiation the terms of the investment agreement with the investor's lawyer.
- ❖ When you are setting up a company, drawing up the articles of association which govern the constitution of the company, the activities it is legally authorised to undertake, and the powers of the shareholders and directors – for Eureka projects seeking private financing, it is likely that the project structure will need to be adapted to a business entity.

In the case where you raise finance from a venture capital firm, it will have its own lawyer involved throughout the process and if other venture capital firms (e.g. in the case of syndication) or a bank are involved they too will have their lawyers present. While the investment approach of business angels is less formal, they too will normally involve a lawyer, and you should do likewise.

Generally, you will pay the costs of all professional advice. In most cases the venture capital firm will increase the funding it provides to take these costs into consideration, so that you do not have increased cash commitments, although your stake in the company may be slightly smaller as a result. It is important, before you enter into discussions, to agree who will be liable for which costs before the work begins.

VII MOVING FORWARD

- *This section provides orientation on the questions of when and how your company should be financed, what different stages of investment there are and how you best prepare for contacts with the investors.*

When should you look for financing? What is the right time to initiate the process? In what phase should your business be? How much money do you need? Should you get it all at once or in stages? The answers to these fundamental questions will help shape your approach.

This chapter is divided into 4 sections:

- *Assessing where you are*
- *Putting together a plan for raising finance*
- *Different types of investors for different stages of growth*
- *Contacting investors*

1. Assessing where you are

When should you look for financing? What is the right time to initiate the process? In what phase should your business be? How much money do you need? Should you get it all at once or in stages? The answers to these fundamental questions will help shape your approach.

When you consider timing funding your company, be sure to think of two issues:

- When do you absolutely need the money to come into your bank account?

  The best time to raise capital is when you don't really need it. The worst possible time is when you are (almost) out of cash.

- How linked is your company's upcoming sales and profit performance to the current economic climate?

  Your timing for pitching a deal might be tied directly to when your cash flow looks its best, or when you land the biggest account you have ever serviced. The issue here is whether outside economic news plays a significant part in your company's positioning and performance when asking for funds.

2. Put together a capital-raising plan

Besides a business plan and a good management team (see chapter V: Putting together a business plan), you will need an additional plan called a capital-raising plan. Companies spend a lot of time developing their product and their business plan. However, you need to spend as much time thinking about how to raise capital as you do about the product and service that you are trying to provide. How much is needed, how long will it last and where will you get it are the main questions entrepreneurs should ask.

How much money do you need?

A common mistake that entrepreneurs make in their search for finance is either raising too little or too much money. If you don't raise enough money, and subsequently need to request additional finance, the process will be tighter and the cost will be much higher. On the other hand, if you ask for too much, it may dilute your ownership and control more than is necessary.

Investors often provide capital in stages rather than in one lump sum. These stages are often related to specific business-plan milestones or performance objectives like revenues, customer levels, profits, recruitment of team members etc. The critical hurdles a company has to take in this respect are positive cash flow and break-even cash flow because these will determine how much money you need and when you are going to need it. Breaking the investment into stages also protects the investor against mismanagement and protects you against premature dilution of ownership.

All sources of capital, regardless of whether they are business angels, venture capitalists or commercial lenders, will want to know that you have taken time to determine the amount of capital needed to implement your business plan. Thinking through the financial components means budgeting and forecasting.

Budgeting

In this section of your capital-raising plan you should address how much money you will need to implement your business plan and why. You should also demonstrate when the various capital levels are required, to allow your investors to invest in stages. Also include a part on how you will use the money and why you believe that this expenditure is necessary for the company at this stage. It is best to draw up different scenarios reflecting different funding levels because you might not raise the exact amount of the money you require.

Forecasting

Financial projections demonstrate that you have considered the impact that the capital injection will have on growing your business by predicting what the company's sales, costs, profits, etc will be in different points in the future, if the capital is raised and the business plan executed properly. Here also, present your projections in three cases: best – expected – and worst case to demonstrate that you have conducted sensitivity analysis for the forecasting process. Be realistic: unrealistic projections may impair credibility on a first impression.

3. Different types of investors for different stages of business growth

As stated above, investors prefer to invest in stages. Different stages of business development also correspond to different type of investors. Where to look for money thus depends on where you are.

The table overleaf gives an overview of which investor type is most appropriate at a given stage of the company. For more information on the development stage of your company see Chapter I Relevance of External Financing for Eureka-supported Projects. For more information on the different instruments of equity financing, you should turn to Chapter III

Types of Private Finance. Of course, models simplify reality and in the real world, there may be more or less stages.

Business stage	
Key highlights	
Sources of Finance	
Types of Finance	

Business stage	**Research and business plan development** *"from nothing to a business "plan"*	**Start-up** *"from business plan to legal entity"*	**Convincing first customers** *"from prototype to product"*	**Extending customer base** *"from early adopters to early majority"*	**Maturity/Harvest** *"… to prosperity"*
Key highlights	Concept, Research, Project Plan, Design specification Business Plan Development	Legal entity creation	Marketing	Accelerated growth	Growth, profit
Sources of Finance	Founders, Public sector, Friends, Family and Fools	Business Angels, Management Team, Venture Capitalists, Corporate Venture Capitalists	Management Team, Venture Capitalists, Corporate Venture Capitalists	Management Team, Venture Capitalists, Banks, Corporate Investors	Management Team, Venture Capitalists, Mezzanine Providers, Banks, Institutional Investors
Types of Finance	Seed Capital Seed round	Start-up capital First Round	Early stage capital Second Round	Expansion Capital (Equity), Loans Third, fourth round…	Loans, Mezzanine, Equity (Later stage) Trade sale, IPO, Buy Out, Merger & Acquisition,

4. Contacting Investors

The next step is contacting investors. It is important to note that **different investors need to be approached differently**, and this section provides some guidance on approaching business angels and venture capital investors.

Finding Business Angels

Angel investors can be very difficult to identify and contact. They do not want to be deluged with business plans. Most of them rely upon networks of trusted friends and businesses associates to identify investment opportunities and are more likely to invest in business proposals that come from these sources. Obtaining referrals is the best start in contacting. Entrepreneurs can maximize their chances of finding business angels by

- searching locally. Business Angels tend to invest in a limited regional action radius.
- looking for successful entrepreneurs who are familiar with your industry and market
- participating in networking organisations as business clubs, industry and professional associations,…
- using "gatekeepers" such as lawyers, accountants and professional advisers. Chances are high they will know someone who might have an interest in investing in your business.
- getting in touch with Business Angels Networks.

You find a list of useful organisations and their addresses in Section X Networks you may need to know

The importance of **personal chemistry** between an entrepreneur and business angel investor cannot be underestimated. Business Angels are both investor and entrepreneur. As they want to be involved in running the company, you and your angel must be sure you can really work well together.

Identifying and contacting venture capitalists

Entrepreneurs often have mixed views towards venture capitalists. They welcome the money and management support but they fear the loss of control and restrictions that investors place on a company. To achieve balance between the needs of the venture capitalists and the needs of your company, you must understand the process of obtaining venture capital financing. Section VI The Investment Process deals with the venture capital investment process.

Some tips on approaching venture capitalists…

Don't blindly send your business plan to any venture capitalists whose contact details you have identified. This will only lead you to waste precious resources and generate lots of frustration and disappointment.

Do

- Research the venture capital industry to match the characteristics with the investment criteria of your company.

- Seek to make contact with prospective investors through a respected referral such as a lawyer, accountant or professional adviser who has a personal contact to VCs – this will help you to make the most of your chances.

You find a useful list of organisations and their addresses in Section X Networks your may need to know. Try to narrow your search to those venture firms that already have a core understanding of the dynamics of your sector.

VIII. Forming Alliances

- *This section looks at how you can make your business stronger and your money go farther by designing and implementing partnerships and alliances with other organisations*

Unlike the past few years, only smart and strong companies did well in 2001 and will prosper in the years ahead. The capital markets for small and medium sized companies now and over the next few years will not be as accessible or as affordable as they were in 1999 and early 2000. Therefore, your plans to set up and grow your business should be more creative and one way of doing this is to place strong emphasis on creating and leveraging partnerships and alliances.

Partnerships aren't just a much-talked-about trend; they're the best alternative for many companies that find themselves either shut out of traditional financing deals or unwilling to go with the equity valuations or interest charges required to make those deals happen.

Your clients or suppliers as source of finance ?

Be open to those business arrangements that don't always necessarily involve an exchange of cash. Sometimes the access to a client's or supplier's facilities, equipment and his or her expertise can be just as valuable.

Alternatively, you can negotiate short payment terms for your clients (e.g. 10 days) and long payment terms for your suppliers (e.g. 3 months). This will have a positive effect on your cash flow and thus diminishes your company's need for capital.

Leverage your (first) customer(s) to build your business

Finding the first customer for a new technology is a difficult matter. Many start-up entrepreneurs are caught up with the chicken-or-egg situation: potential customers want to see your track record in serving other customers before jumping on board. It is common human behaviour to expect people to choose to do business with companies that have already established a good reputation.

A solution to this chicken-or-egg situation could be to form a tactical alliance with your first customer in order to accelerate the formation of your product or service. By doing this, you can use your first customer as an ersatz incubator: it provides you with the resources needed like office space, use of machinery, access to distribution channels, joint marketing efforts and so forth. Also, by having your initial financing coming from your first client, you find out quite easily whether your product is going to be useful.

During the late 90s, many of these alliances emerged on the Internet. It started with the one between Netscape and Yahoo where the former sent traffic to the latter so the latter could help people find valuable sites and thus create more demand for the former's products. This way they helped create each other 's products, brand and market.

Effective use of PR and media

If you are too small to have substantial marketing, advertising, telesales, or name recognition, you can create impact for your business by partnering with companies who have brand recognition and who will co-market or custom-brand your joint efforts.

Building partnerships to strengthen your business

Before you enter in partnerships, whether strategic or tactical, you should answer the following questions:

- What do you want to accomplish with this alliance?
- Why do you want to accomplish this, and what benefits do you expect?
- What do you bring to the alliance?
- What do you need from your alliance partner?
- What are your criteria for choosing the right partner?

Once these questions are answered, you can start to identify potential partners and start building relationships with them. And keep in mind what a good alliance ought to be: a win-win for all parties.

IX RAISING FINANCE – THE GOLDEN RULES

➢ *This section sets out key points to remember when raising private funding*

Know why you want to raise finance

If you are setting up a new business, or own an existing one, ask yourself what do you want out of the business and when do you want to realise your wealth? Are you, for example, willing to open the ownership of your business venture to private investors in order to increase the growth potential? Review the 7 key questions in Chapter II. Once you know why you want to raise finance, it will be easier to see which type(s) of finance would best suit your needs. So if you decide, for example, that you do not necessarily wish to retain complete control of the business venture, equity financing becomes an option you can explore.

Know how much money you need – and why

It is worth remembering that it is better to raise too much finance than too little. Even the most thorough business plan is ultimately just a plan, and plans can go wrong! The actual sales may only be 50% of what you forecasted and may take twice as long to realise. This is why it is important to ask yourself the 'what if' questions when developing your business plan and undertaking sensitivity analysis to check the consequences of any deviations from your key assumptions and financial projections.

Plan ahead

Raising finance can take time, so try and plan ahead and anticipate when you will need the money. This will help to ensure that you have allowed yourself sufficient time to find the finance provider that is right for you or take on board suggested modifications to the business plan – or even just negotiate properly the deal. Remember – the best time to raise finance is when you least need it! As private funding may be provided for different stages of the business development you will need to be constantly planning ahead.

Own the plan

Prepare the business plan yourself – this will allow you to develop the necessary mastery over all aspects of the business plan and thus to present and sell your idea more effectively. Your accountant or friend can help – but the business plan must be **yours**. Moreover, if it is not yours, it cannot capture your personal motivation and reflect what you really want from business or life over the coming years. And when planning, be realistic more than optimistic.

Keep asking yourself the simple questions

What's unique about my business – why has nobody thought about doing it before? Why will a customer prefer my product or service, pay the price I want to charge, and buy from me instead of a competitor? How much will it cost to produce? Why would a stranger be willing to lend money or invest in the business?

XI. GLOSSARY OF TERMS

About this Glossary

The world of finance has its own language, and financiers love using this jargon…!

To help you along, this Glossary is to provide summary explanations of terms used in the Eureka Information Pack, as well other terms that you may come across when seeking to raise financing.

Accountant's report

A report prepared by a registered auditor on a company's historical financial information for publication in a prospectus or similar investment advertisement.

APR

The annual percentage rate is a rate of interest that every financier must quote and must calculate in the same way, so that meaningful comparisons can be made.

Base rate

The rate of interest which forms the basis for the charges for bank loans and overdrafts or deposit rates for commercial banks. Rates of interest charged by the banks on much of their lending to customers are set at margins over their own base rate: the size of the margin depends on the nature and status of the customer.

BIMBO (Buy in management buy-out)

A management buy-in which involves some incoming management

Bridge financing

Short-term venture capital financing for a company which expects to go public within approximately one year

Burn rate

The requirement rate of a company for cash in order to continue operating

Business angel

A private equity investor, usually with a business background who is able to make a small scale equity investment (typically around € 50,000) and also supply some hands-on expertise to assist in the running of the business.

Business Angel network (BAN)

A private or semi-public body whose aim is to match entrepreneurs looking for equity with Business Angels. BAN operates either at regional or national level.

Business plan

A plan setting out the objectives of the business and how they are to be achieved

Cash flow

The difference between the company's cash receipts and its cash payments in a given period.

Cash burn rate

The negative real time cash flow of a company, usually computed monthly

Compilation

The preparation of financial statements from primary records for organisations without the knowledge, expertise or resources to prepare financial statements themselves,

Development funding/capital

Venture capital provided after a company has become established to fund an expansion of the business.

Divestment

The disposal of a business or business segment.

Earn-out

A formula for calculating sale proceeds to be paid to a disposing management which relates an element of the proceeds to future earnings.

Equity

A shareholding in a company.

Eureka

EU research programme aiming to promote European industrial cooperation in market oriented R&D projects (mainly products and processes) for advanced civilian technology applications.

Exit

The route by which a venture capitalist realises their original investment, usually as a result of flotation or corporate purchase.

Factoring

There are many different types of factoring arrangements. An arrangement can be either confidential or disclosed to customers. Typically it involves the purchase of the trade debts owed to a business by a factoring company. This provides short term financing and may include the administration of the business' sales ledger by the factor who will be responsible for credit control and the despatch of statements,

Because factoring involves the sale of the business' debtors it is only suitable for financing working capital and is normally most suitable for growing businesses. The cost will be more than an overdraft but your business may save money, for instance by not having to employ a credit controller. (See also invoice discounting).

Flotation (see also IPO)

Term used to describe the entry of a company to the stock market, whether by an offer for sale, placing or introduction.

Forecast

A statement of management's best expectation of the most likely financial results made for a current (or unexpired) accounting period, or for a future accounting period.

Gearing

The total borrowings of a company expressed as a percentage of shareholders funds. Also known as the leverage or debt: equity ratio.

Grant

Whether or not grant finance is available will depend on factors such as where the business is located, whether it will create jobs and the purpose of the investment. Grants are normally preferable to other forms of finance. However there can be costs in complying with the terms and conditions of the grant and you should research these carefully.

Improve controls

This is likely to be a cheap form of finance. However, there will be costs such as having to employ a competent credit controller or giving up some of your own time to carry out this task.

Incorporated

Organised as a limited company.

Institutional investor

An investor investing other than in a private capacity - normally a financial institution such as an insurance company

Investigation

The analysis of the operating and/or financial aspects of a business; the objective being to produce a report that will help or support the decision making process

Invoice discounting

A similar arrangement to factoring, but confidential - the customer should be unaware that the invoice has been discounted. The business usually retains responsibility for running the sales ledger and collecting debts.

IPO – Initial Public offering

Method of exit by which the buy-out is floated on the stock market, usually allowing management and institutions to realise some of their investment and also allowing new funds to be raised for the company to replace borrowings and/or redeeming preference shares

IRR – Internal Rate of Return

A basis by which to measure investor returns, being effectively the compounded annual rate of return on their investment, including interest, dividends and realisation profits. it is used, for example, by venture capitalists to measure achievement and in such cases the IRR is greatly affected by the timing of exit.

Lease/HP

Leasing or HIP (renting an asset for most of its useful life) can be a good way to finance an asset if your business lacks security or there are tax reasons to do so. Remember however that lease and HP companies will only enter into contracts with credit-worthy businesses.

A lease will normally cost you more than a loan or overdraft and involves a regular monthly commitment, but there may be tax advantages which make this a cheap way to finance an asset. Remember to compare the quoted APR, which each company must calculate in the same way.

Leveraged buy-out

Similar to a management buy-out or buy-in but without the same degree of direct equity participation by the managers. The term 'leverage' is another name for gearing, and is used to indicate the substantial levels of borrowing taken on by the acquisition vehicle to finance the acquisition, which is typically secured on the assets of the business being purchased.

Lessor

A person who leases out property or assets.

Liquidity review

An investigation of a company experiencing severe cash flow problems to determine the factors which have caused the cash flow problems and to assess the continued viability of the business

Management buy-in

An arrangement whereby a team of outside managers purchase a business, with funding provided by a group of financial backers.

Management buy-out

An arrangement whereby the management of a company purchases the business, with funding provided by a group of financial backers. Normally the managers put up a relatively small sum to finance the deal but gain a disproportionately large share of the equity if all goes well.

Mezzanine finance

A form of finance falling between equity and debt. It is a flexible form of funding, typically used in a management buy-out to achieve the desired overall risk/return profile for investors. Frequently unsecured, it usually bears interest at a higher rate than secured loans and often carries an option to give the lender a stake in the equity

Newco

A newly formed company set up as an acquisition vehicle, for example, in a management buy-out.

Overdraft

A flexible form of bank lending. Clearly the key advantage of an overdraft is that you only pay for the funds you use and this makes it suitable for funding working capital. Typically the rate of interest payable will be between 3% and 7% over the bank's base rate, depending on the level of risk. Note also that arrangement fees can have a substantial impact on the cost of an overdraft. The interest charged and any arrangement fee for an overdraft are negotiable. The chief disadvantage of an overdraft is that it is theoretically repayable on demand and this is another reason why it is only suitable for financing assets which can quickly be turned into cash.

Preference shares

Are part of the equity capital of a company, but do not dilute the level of management's control (which is determined according to the level of ordinary share capital held). A number of categories exist:

Cumulative - the dividends ascribed to the shares accumulate if they are not paid out, and are payable before dividends due to the ordinary shareholders.

Participating - the dividend holder has the right to receive a dividend based on the level of profits.

Redeemable - the preference share capital is repaid at an agreed date or when the company is sold or achieves a stock market listing.

Convertible - the preference share capital can be converted into ordinary share capital at the option of the venture capital firm e.g. prior to the sale or flotation of the business.

Prospectus

A document offering shares or debentures in a company to the public for subscription or purchase.

Ratchet

An incentive arrangement whereby a number of trigger points for future profits are set such that the managers get a bigger share of the equity if the company performs well and a lesser share if it performs badly.

Retention of title

The retention by a seller of goods of legal title to the goods until they have been paid for, even though possession of the goods is given to the buyer before that time

Seed Capital

See Venture capital. In particular seed capital is the term given to providing finance for the development of ideas into products.

Sensitivity analysis

Analysis of the sensitivity of predicted results to changes in the underlying assumptions.

Syndication

A group of individuals (business angels) or companies (like venture capitalists) which has combined forces to undertake a project that would not be feasible to pursue alone

Term Loan

A loan for a fixed amount with a fixed repayment schedule normally from a bank. It is most suitable for funding fixed assets and core borrowing. Although the interest rate may be slightly less than on an overdraft there is no opportunity to flex the amount of financing. When the level of financing required is likely to go up and down it is important to choose a form of finance which does not require you to pay for funds you are not using. Therefore a term loan is suitable for fixed assets, but not for working capital. The key advantages of a term loan are that you know when the repayments are and can budget accordingly and the APR may be lower.

Trade Sale

The sale of an equity share of an investee company to another trading group or company.

Unincorporated

A form of business which is not a company; normally a sole trader or a partnership.

Venture capital

The concept of adding value to investments by participating in the management and offering advice. A wider definition would be risk investment in unquoted companies with high growth potential. Venture capital can be broadly subdivided into seed or start up capital (used to bring a research idea to the development stage), second round finance for young companies (used to expand the range of products) and development capital for established companies (used to develop an alternative product or expand through acquisition).

Working capital

The cash resources a company needs to operate as a going concern on a daily basis. Such resources may be internally generated in the form of retained profits or proceeds of sales of assets or provided externally by shareholders, trade creditors and bankers or other financial institutions

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