Innovation, Business Models and Enterpreneurship
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Lecture - 39
Managing Investors for Innovation

Welcome, friends. In our last session we discussed the role of incubators in the process of entrepreneurial journey. We discussed that incubators are very important support element in the journey of developing a startup into a sustainable business. We want to convert startups into organizations leaders of the industry and for that purpose initial support is very very required.

Now, normally in incubators we are providing support of variety of types we discussed that you provide physical space, you provide technological supports, you provide networking opportunities, you provide support related to mentorship, you provide assistance in the marketing activities and you also provide seed funds, but as the word is seed fund it means you are partially fulfilling the investment requirements of startups. But, depending upon the growth opportunity there may be much more requirements of an startup and for that purpose we need to see that what are the different sources from where investments for your innovation investments for your startup are possible.

And, in this session we are going to discuss the management of investment for innovation activity because funds are lubricants for running your business without funds without proper capital structure it is impossible to deal with your business activities. So, investment and many a times in countries like India or in various developing economies across the globe funds with the startups is a major challenge. So, this becomes an independent subject of interest that how to generate funds for the startups and in this session we are going to discuss this very aspect of this process.

Now, as we are discussing that these are the lubrications for a smooth running of business. So, it is said that finance is fuel to run the vehicle of innovation without proper cash flow in the organization the innovation journey cannot achieve its target. To achieve the target to achieve a free standing organization that objective you need to have adequate cash flow in the organization. And therefore, financing or managing investment, managing financial resources of the organization that is very very important.

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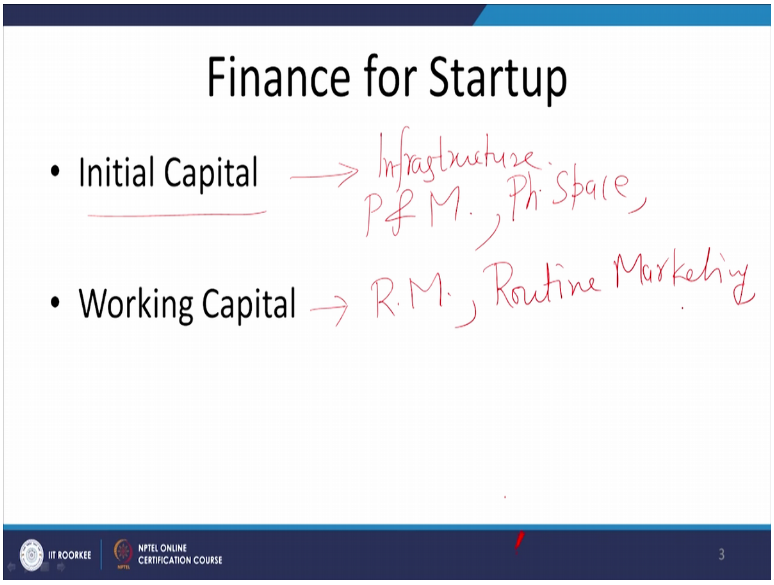

Now let us see; what are the different components of this whole discussion. There are two types of requirements related to finance. One is the financing requirement for developing initial capital. Here the meaning of initial capital is infrastructure you need this for plant and machinery, you need it for some type of developing the physical space, you need it for creating assets of your organization; assets which are of permanent nature, for developing those things you need this type of capital.

And, then you require working capital for raw material, you require working capital for your routine marketing activities, you require working capital for payment of regular monthly bills, electricity, telephone all these are pretty expenses, but these pretty expenses require some kind of cash flow. So, that is another important reason for thinking of management of finance for a startup.

Now, what are the sources of investment for a startup? Now, the first important source of financing your various requirement for a startup is you yourself. You have conceived an idea you want to develop a startup on this idea. So, obviously, you will fund your idea. So, the first important person who can fund your idea is self, you yourself.

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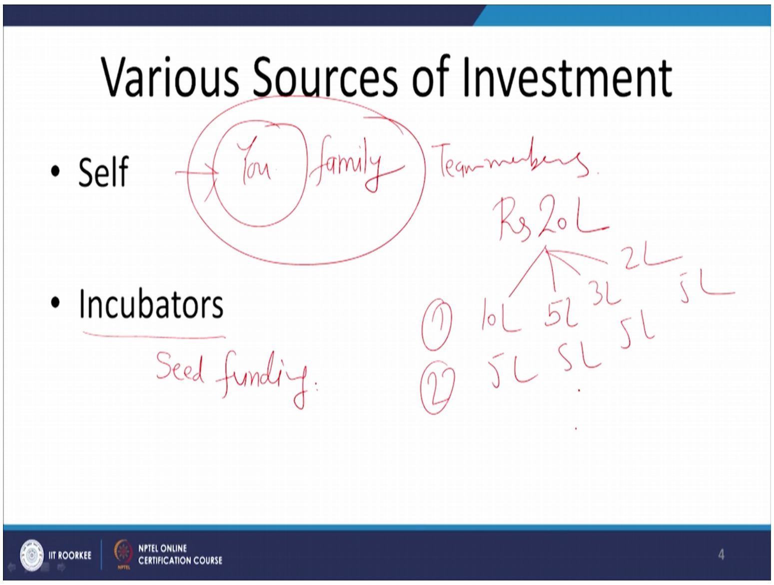

And, then you can also enlarge the meaning of self, means your family can also be the part of self. So, your family can also become self then you can also invite because we have discussed many a times that innovation is a team activity. So, when innovation is a team activity your 2, 3, 4 friends have joined you in this journey of entrepreneurship; so your team members.

I need 20 lakh for my startup. This is my initial projection that for 1 year I will require 20 lakh rupees and we are four friends. So, we can divide these 20 lakh rupees that I am pulling to 10 lakhs and one friend is pulling 5 lakhs, another is pulling 3 lakhs and one is pulling 2 lakhs or we all are equal partner in this. So, these are the examples of self that how you can generate funds for your requirement within your own control.

Then, you can go to incubators also, where you are actually going for some kind of mentoring activity, some kind of coaching some kind of other support and side by side you also get seed funding. It is very important to understand that most of the incubators are within university or educational institutions and their primary purpose of those incubators is not to provide funds, rather their primary purpose is to add value to your idea, to provide a support and in that support system funding is one part.

Now, if you feel that your idea is excellent, your idea does not require your product does not require any kind of mentoring or coaching and you are approaching incubator just for the purpose of investment then probably you are wrong, because if you go to IITs incubator, if you go to NITs incubator, if you go to IIMs incubator they are for a specific value addition into your ideas, into your products for helping you to develop more robust technologies more robust business models. So, you need not means you should not confuse that incubators are a kind of bank or other traditional lending agencies where you can get funds easily.

So, seed funding is available, no doubt in that, but seed funding is not the primary objective of incubators are there for providing you support of variety of types and in that variety of types seed funding is or financing is one of the support it is not the only way. So, we need to understand that some of the very initial our primary requirements can be supported by the incubator. But, later on we need to see that how we leverage our presence in an incubator to generate higher level of fundings. You must have heard in newspapers or in different media reports that such incubator oh sorry such startup has received, series one funding, series two funding, series three funding.

So, now, we need to leverage those types of activities that if I am an incubatee in xyz incubator then how I can get more funding from investors which are available in the market. So, in this session we are going to discuss only that particular part that you have limited capacity as an individual. So, that is self.

And, similarly incubators are also having a limited support under variety of a schemes our incubators are working and as per the mandate of a scheme one incubator can support some time up to 5 lakhs, sometime up to 10 lakhs, sometime up to 20 lakhs, sometime up to 30 lakhs depending upon the type of funding is available to incubator. Accordingly, incubator will distribute that money in the form of seed funds to various incubators available to it.

So, incubators funds are very limited. They are only there to give you some kind of oxygen so that you can survive, but on the basis of that support system when you are taking oxygen artificially you need to generate your own investment opportunities, so that you can attract investors, you can get funding from prospective investors in your venture.

So, therefore, we talk of next stage of investments and next range of investments we have two very traditional methods of funding these are debt financing and equity financing we all understand the meaning of debt and equity and both these methods are available to our start-ups. You can attract investors or means first you need to decide whether you want to have equity financing for your startup or you want to have debt financing for your startup.

So, when to have debt financing when to have equity financing if you think from the startups point of view and when you think from the investors point of view when to put your money in the form of debt and when to put your money into form of equity these are some of the very tricky questions. There cannot be any yes or no type of answer. Many a times it works on our intuition, many a times it work on our ability to understand company's profile and we will discuss these things in more detail.

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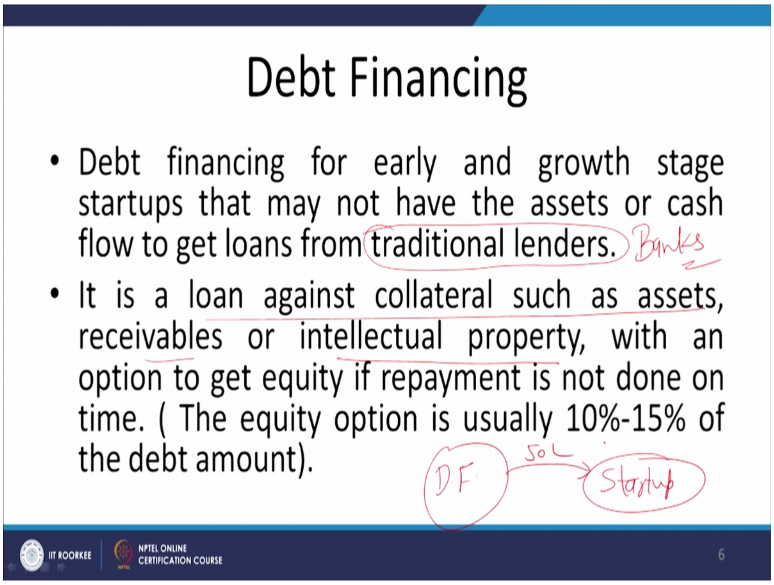

Debt financing for early and growth stage startups that may not have the assets or cash flow to get loans from traditional lenders. Now, traditional lenders we all know one type of traditional lender that is commercial banks. So, banks are also financing different type of business organizations.

Recently in our country lot of cue and cry is there over NPS is non performing assets of banks because banks have given the funds banks have landed the money to some of the corporates where they are not able to recover their loans and these are debt financing, where you are giving loans to some organization and you are anticipating not anticipating you have agreed that you will repay this loan at the rate of this much interest.

But, because of poor understanding of those organizations banks are not able to recover those loans from some of the corporates in India. So, those funds for bank are now NPA nonperforming assets, banks are not getting anything on those assets in the form of loans given to loans given by the bank.

So, in the case of startups because you do not have any assets you do not have a regular stream of cash flow. So, for you it is very difficult to convince a traditional banker, a traditional lender to finance you. So, in this case there is a provision which is now coming in India and this provision is it is this debt financing is coming in India, where it is a loan against collateral such as assets receivables or intellectual property with an option to get equity if repayment is not done on time means those companies which are involved in debt financing.

So, if I am giving you are owning a start up and if I am a company which is involved in debt financing and this is start up. Now, if I am giving you let us say some 50 lakh rupees. So, this 50 lakh I am giving not on the basis of your previous cash flows, not on the basis of physical assets you have, but I am giving this 50 lakhs on the basis of collateral it is like intellectual property.

So, we discussed in last few sessions you remember about intellectual capital, intellectual assets, intellectual property. So, now, you can understand if I have some patents with me. So, this debt financing is possible on the basis of those patents because this person, this organization understand the value of intellectual property.

Then, I have some kind of receivables that and these receivables are in future that this much market I am going to cover in next 4 years, 5 years. So, accordingly these companies can give me funding in the form of loans and then there is an option that if I am not able to repay this money within the given time frame so, this loan can be converted into equity also.

So, it is not going to become non performing asset like it is becoming nowadays in case of various commercial banks, but it will become part of equity in my startup after a particular date and then the normal prevalent rule is that that the equity option is around 10 to 15 percent of the debt amount. So, that is the in between you can negotiate between the startup and the debt financier that what will be the equity option.

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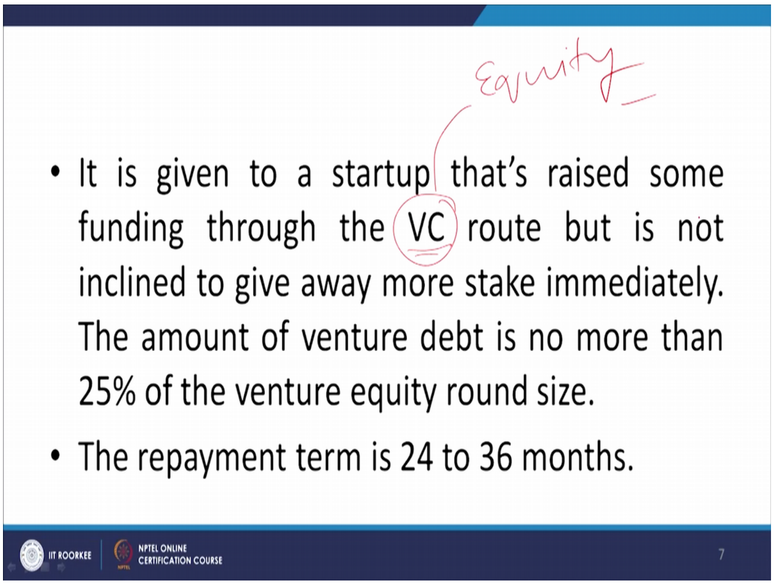

So, debt financing is normally given to a startup that has raised some funding through the venture capital route, but is not inclined to give away more stake immediately when this venture capital is the route where you give equity to investor.

Now, debt financing is not done at the first level. The first level you get funding in the form of equity you have your company your startup. So, first few investments first few series of investments in your startup are normally done by the venture capitalists in the form of equity and then when you have already received 1 or 2 rounds of equity funding then you get the debt financing and you particularly take this route of debt financing because you are not willing to give more stake.

Because, when I have a company where the calculation of present value of my company is 40 lakhs and I am the only owner. I have 100 percent equity. So, I am the owner of entire 40 lakhs. Now, you become my partner, 5 percent partner so, my equity remains 95 percent and you become 5 percent partner in my organization, in my company.

So, there may be a possibility that I do not want to reduce my equity less than 75 percent. So, if by initial rounds of funding my equity has already reduced to 75 percent, 25 percent equity is now available with venture capitalist. So, and I do not want to reduce my equity less than 75 percent. So, in that case I will like to go to debt financing I will not go further investments by the venture capitalist because the further investment by venture capitalists will reduce my equity to less than 75 percent or any other value 75 percent is just an example. It can be 60 percent, it can be any other value.

So, what I do in that case, we raised the money to debt financing. Normally, in the debt financing the repayment period is 2 to 3 years and after 2 to 3 years we will convert this debt finance into the equity if it is not repaid. Some of the because particularly in India very recently in 2017 and 2016, all of a sudden there is a surge in debt financing and some of the companies which were involved in venture capitalist activity have developed separate debt funds.

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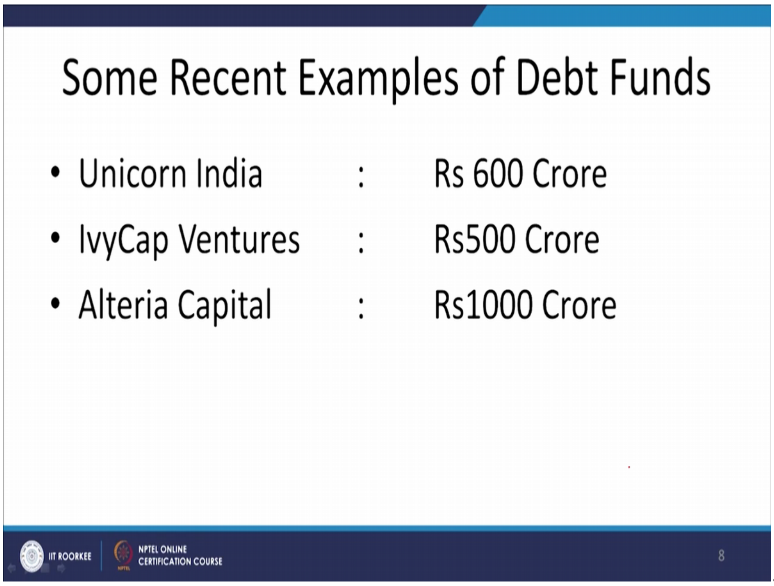

Like Unicorn India it has developed a debt fund of 600 crores just for debt financing of startups. IvyCap Venture that is another very important name in equity financing of startups. So, they also came with a debt fund of 500 crore rupees Altaria capital it has developed a debt a debt fund of 1000 crore rupees. So, these are some of the very recent examples which all have developed in last one and a half years.

And, therefore, this trend of debt financing because startups are not when you have received some of the investment in the form of equity it means you are now getting a reputation in the market and when you are getting a reputation because your next series of investments depends upon your performance and now your name is also available with the investors.

So, they are looking to invest in your organization because you are a sure bet for them you are going to give higher returns on their investments. So, more and more investors because as you move ahead it is very difficult to get series one funding series a funding because the first investor convincing first investor is the toughest task, but convincing third, fourth, fifth investor is relatively easier.

So, investors are reading once you are having a good track record but at that time you will not like to dilute your equity and therefore, you go for the debt financing. In India now we are having a positive entrepreneurial ecosystem and therefore, more and more startups are getting succeed. They are getting successful in attracting good investment.

But, the question of how much equity to be given to the investor is also coming parallely. Therefore, these startups are looking for debt financing and therefore, these types of debt funds are created by the organizations because more and more startups are looking for debt financing which is not diluting their equity.

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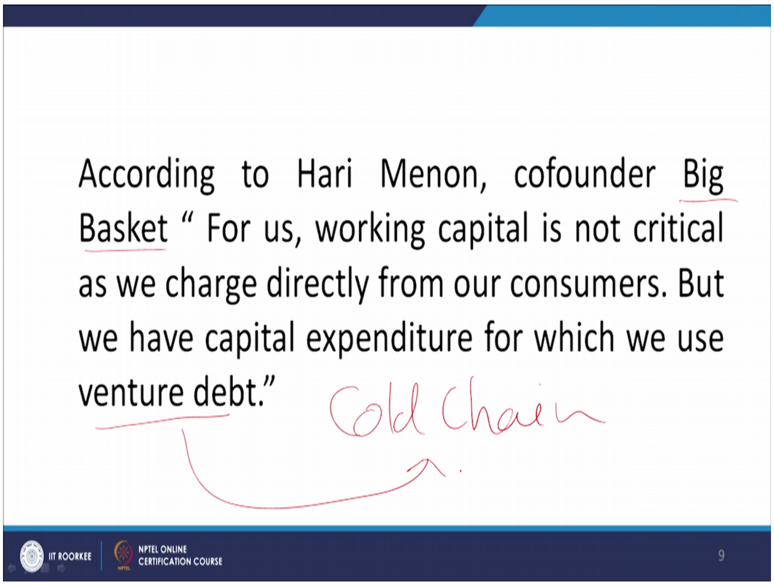

Just to add what I said, one of the very popular startup in India nowadays, is Big Basket. So, the co founder of Big Basket Hari Menon in one of the interview he mentioned that for us working capital is not critical as we charge directly from our consumers. So, they are charging with from the customers. So, therefore, they are having a very good cash flow for their working capital, but we have working capital, but we have capital expenditure for which we use venture debt.

So, they have developed actually Big Basket developed cold chain because they use in food and food related items in their supply chain. So, using this venture debt they have developed large number of cold chain solutions across the country and which is one of the reason of their success. And, using the venture debt they have developed this cold chain.

And, praising the cold chains praising the venture debt they have mentioned that working capital they are able to meet with the regular sale of their products. They have already received three series of equity funding and now they are using this debt financing for developing or for scaling of their infrastructure.

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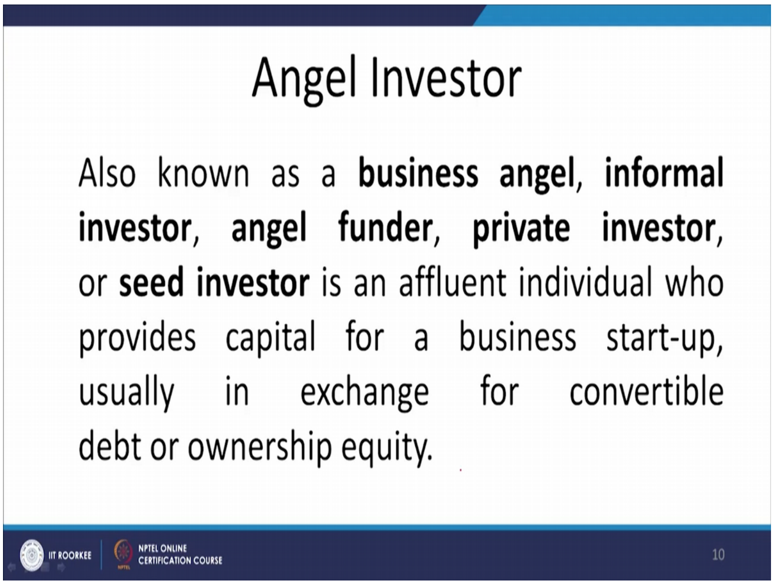

Now, another type of financing option is the equity financing and when we talk of equity financing one of the very simple word which is very popular in the domain of innovation and business model entrepreneurship, a start up system is angel investor. Now, angel investors are also known by the names of business angel, informal investor, angel funder, private investor or seed investor.

Now, these are the alternative names and the meaning of angel investor is that these are high net worth individuals. They are very affluent people. Those who have surplus money available with them and they provide capital for a business startup usually in exchange of convertible debt or ownership equity.

So, these people are high net worth individuals and they put their money into business, expecting higher returns on their choices, on their selection. It is very likely if startup succeeds so, their investment if it is in the form of ownership equity, it may increase by that much time and if it fails so, it may feel miserably also. So, both things are there.

So, lot of risk is involved if you become angel investor. But, anybody cannot become angel investor for that purpose you need to be a very affluent person having you should be a cash rich person then you can become angel investor.

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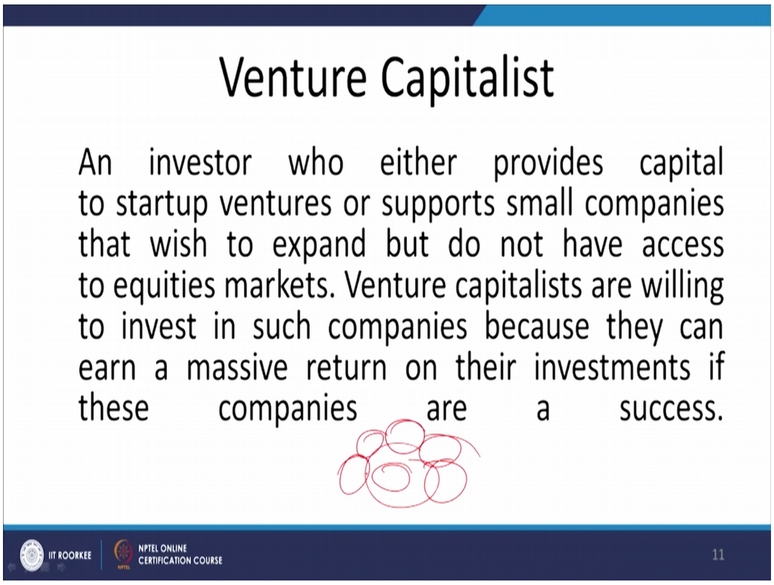

Then another type of a investor is venture capitalists VC's that is also very very popular word. Nowadays because whenever we talk of a startup, whenever we talk of innovation, whenever we talk of incubators so, the first thing that I am into incubator and I am looking for VC's. I am looking for VC's, why I am looking for VC's because I need funds. So, VC's are considered to be very important source of investment in your startup and when VC's invest in your startup then probably you can get debt financing, that is the sequence.

So, these are investors who either provides capital to startup ventures or supports small companies that wish to expand, but do not have access to equities market. Venture capitalists are willing to invest in such companies because they can earn a massive return on their investment if these companies are a success.

Now, the difference between venture capitalist and the angel investor is one. Angel investors are actually investing their own money they are themselves very rich while VC may not be themselves very rich, I can be a VC, because in VC we are pooling the money of various people. So, various people come together they pool their money maybe one 1 lakh if 100 people are there if I am able to get support from 100 people and each of them is giving me 1 lakh rupee. So, I have a total fund of 100 lakh rupees. Now, with these 100 lakh rupees I can invest some money in different startups and the expectation is that to get high return on my investment.

So, venture capitalists are actually the fund managers. They have funds from many individuals and then they evaluate the proposals of startups and provide funds to those startups.

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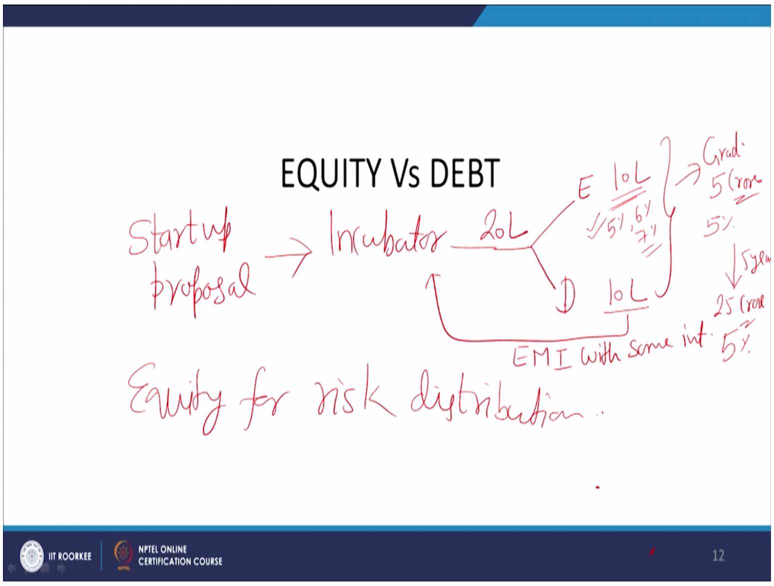

Now, the last question in managing investment is equity versus debt; how much equity, how much debt.

Now, when you are having a proposal a startup proposal so, you are first going to incubator. Now, incubator is giving you funds like let us say 20 lakh rupees. Now, in this 20 lakh rupees incubator we will divide this funding to you in two parts, equity component and debt component.

Now, maybe let us say it is divided 50 – 50 percent. So, 10 lakh goes for the equity and 10 lakh goes for the debt. Now, this debt of 10 lakh you will return to incubator in the form of equated monthly instalments and with some interest. So, that you will return back to incubator and this 10 lakh is the equity component in your capital.

Now, when you are graduating from the incubator and your valuation and this is also negotiable that this equity of 10 lakh when you are getting the support from incubator you will negotiate that you are going to give 5 percent, 6 percent or 7 percent equity against this 10 lakh. So, maybe you agree on 5 percent.

Now, your company is valuated when you are graduating at 5 crore rupees. So, the incubator has 5 percent equity in this 5 crore now when you are graduating after two years from the incubator your company your this incubator has an equity of 5 percent in this. Now, when the valuation is made after 5 years now, your valuation is 25 crore and in this 25 crore again the equity of incubator is 5 percent.

So, you can understand how this equity is same equity is there, but the value of that equity over a period of time is increasing. Now, in this case when I know that my idea is risk proof, my proposal is risk proof I will not like to give much equity to my investors that is the rule of thumb. When I am sure that my idea is going to be a sure short hit then I will not like to give equity to investors then I will like to have more and more debt funding.

But, when I feel that there are lot of risk involved in my idea and in that case I will like to use equity for risk distribution because when equity is there. So, investors become my partner when equity is there investors become my partner and I will like to use my partners for distribution of risk. All my partners will share some percentage of risk that is a liability that is a liability.

So, when my business proposal is already under some kind of fluid situation, when it is already not very sure short hit then I have some doubts about my business proposal and in that case if I take debt financing so, I am further adding liabilities to my business which is not desirable. So, when I want to have distribution of risk I go for equity, but when I have that my business is very sure and, I want to have just money to support my business activities or my scaling activities in that case I go for debt financing.

So therefore, you see when a traditional business goes to a bank for financing so bank so that traditional business never say that you are taking equity in my business. The traditional lenders give you loan because the business is going on a very steady path. There is no risk involved therefore, in that kind of system more and more debt financing is them and when you have risk involved in your business you will like to have equity in that case.

So, that is how you can decide equity versus debt in the financing issues related to your startup solid idea, solid market plan, solid business proposal, solid business model go for debt financing. If you have doubts about your business proposal, if you have doubt about your marketing activities, if you have doubt about your business model then go for equity financing because this will reduce the risk element on you. So, that is all about managing investment for the innovation activities.

Thank you very much.