Entrepreneurship Essentials
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Lecture – 46
Finding New Venture - I

Hello and welcome. This week we are going to talk about Funding New Ventures, different sources of capital and why you need capital, then what are the advantages disadvantages of the capital, how to go about it.

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So, the beginning these are the list of sessions that we are going to have five sessions on first session is on: introduction general discussion then bootstrapping, crowdsourcing, incubation, acceleration.

Then we will talk about business angel, business venture capitalist, venture capital fund then debt funding government assistance, there are grants and other seed moneys etcetera.

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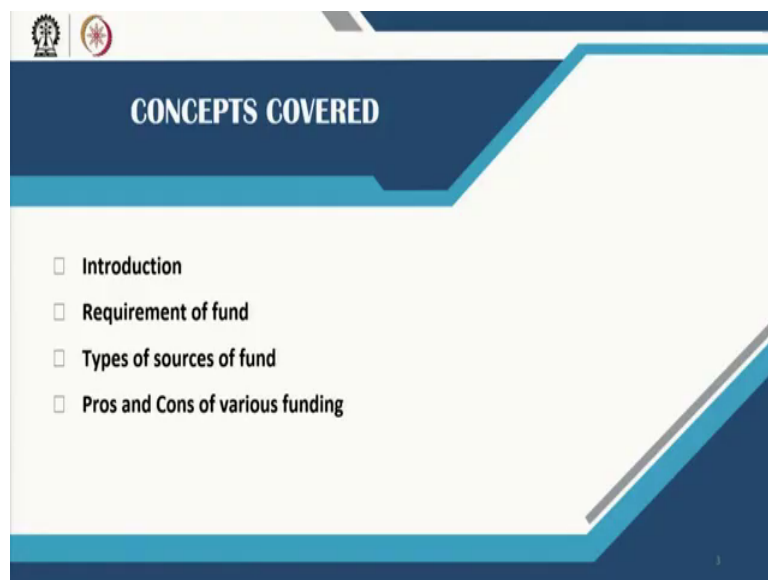

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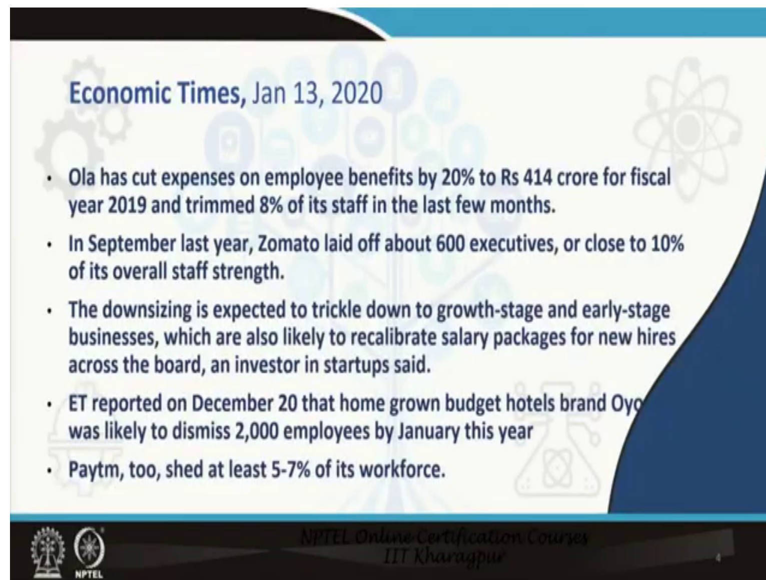

Today's session is introduction on general funding. Before we move on to that main topic, here is just a news item I just wanted to emphasize on this part.

We discussed earlier just look at the tragedy of people who are being fired when companies cannot really sustain with the existing number of employees. I mentioned earlier that before recruiting one should be absolutely sure that we really need this people for achieving growth, or we need to feel critical knowledge gap only then we should recruit.

Now one day's news tells us about, so many reduction of employees and they are all big names like Ola, like Oyo, like Paytm, who not Zomato and they are firing people because they these people are not necessary for their present operation. Now look at the disruption that you

caused to those people; look at the disruption that you go through because you know firing people brings in a different kind of fear psychosis among your existing employees.

And then chances are very high that some employees will think of even quitting with apprehension that anymore any point of time even they may be fired. So, firing is a very dangerous decision and avoidable decision that we should think before even hiring. I just wanted to emphasize on that point.

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This is an example when I talked about being cautious before hiring this is just to buttress that point.

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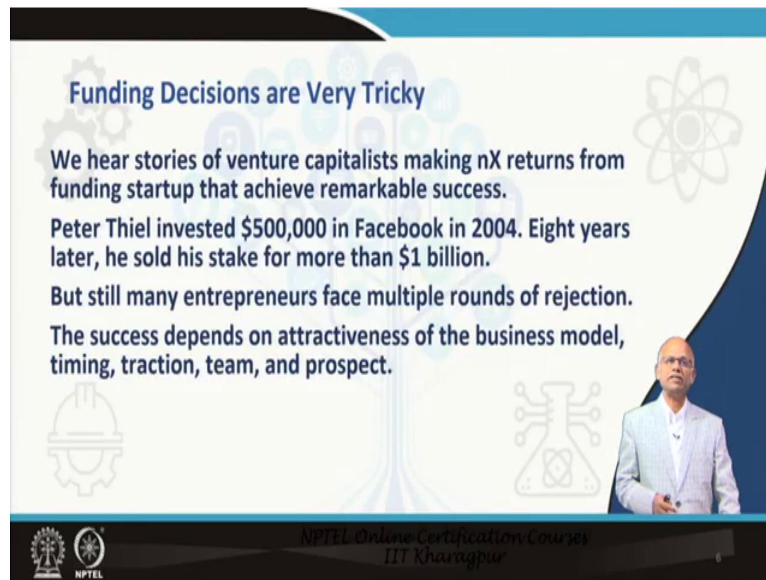

Now, we should understand that capital is the lifeblood of a new venture. We have already seen empirical evidence that about 60, 70 percent of the companies die because of several reason that risk leads to the reasons lead to shortage of capital or run out of money. Even if the reason may be that customers are not buying their product that is why they are shutting down and many have and many occasions.

It so, happens that the growth is not happening and then companies run out of money. So, running out of money is a very important issue in start of success and start of failures. So, we should be we should be knowledgeable about where to get money how to get money when to raise money etcetera. So, capital will ensure that we sustain for a longer time and success will come at some point of time, but if you fail to raise money at a certain point of time even though business is going good maybe you are burning cash, but we need cash to run the show.

So, at any point of time we run out of money and we have to call it quit even though business has potential and funding decisions are very tricky. Suppose you raise a lot of money at the early stage, then you give a different kind of a feelings to your employees to your executives that there are a lot of money and they start spending money you run you burn lot of cash which is unnecessary.

Like many companies they realized after the failed that they actually unnecessarily spent so much money that was avoidable and they failed because they did not avoid those expenses and then eventually, they died. And this kind of habit of spending overspending comes when you get too much of money.

So, too much of money is not at all good just like too little money will not let you move forward too much of money is equally dangerous. It also leads to failures more number of failures perhaps than running out of cash. So, decisions to raise capital and then how much to raise or is very important. Particularly, suppose you are at the very early stage of start up, now you just may be registered a company and developing a product you attempted to ask for money.

And if there is opportunity you will be you know going on giving presentations after presentations. That perhaps should be avoided and you should always try to move ahead with your development process as far as possible and as far as practicable. Because raising money has many implication: the first implication that is that you are going to dilute your equity.

Dilution of equity is not so much of a curves, but then you have to save equity for raising more money moving forward, if you dilute it significantly at the early stage there then there will be very little equity to prove to offer to your future investors, to your employees and then eventually you will find that whatever equity is left with you it does not make you motivated to run the show.

You also need to have adequate percentage of equity holding. So, that your value goes up otherwise why you will do business. So, you should always try to move ahead without raising money and then try to run the show without really external assistance.

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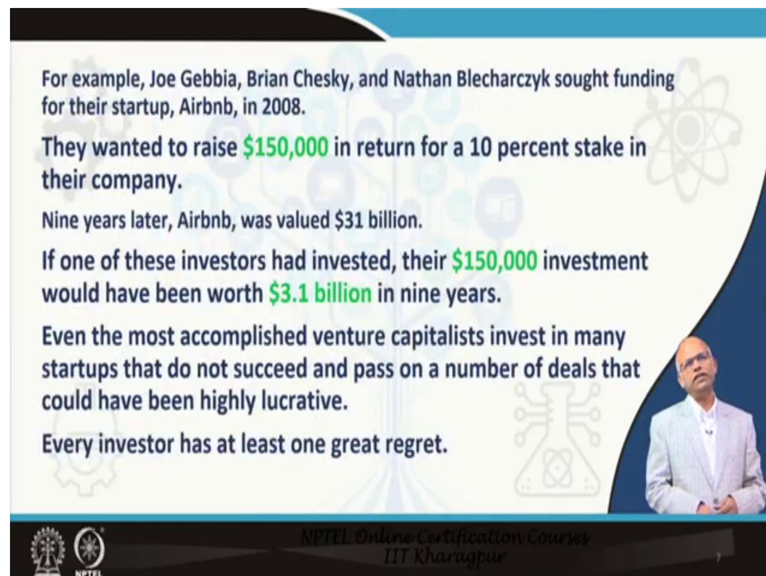

We hear lot of a stories about you know venture capital is making something like 100 times their investment and whatnot.

So, we should be like very careful about all those matrix. Say for example, some company like say Peter Thiel invested 5 lakh dollar, just 5 lakh dollar in Facebook at the early stage. And eventually after 8 years he sold this stock for 1 billion dollar. So, he converted 5 million dollar into 1 billion dollar. So, perhaps many people had this opportunity to invest 5 lakh dollar in Facebook, but they could not make a decision to whether to invest or not to invest.

Now, somebody invested he lift the benefit. Now, there are many occasions when Peter Thiel invested maybe another 5 lakh in number of companies and then it actually did not return anything. So, investment from that point of view from investors point of view and from a start-up point of view, this decisions are very tricky. And then success depends on many factor, it is not just the business model it is the attractiveness of the business then the team the traction that you have achieved.

So, depending on that you will be helping your investors to make a decision. If you are too much at a early stage even they will feel this is too risky a business. Look let us look at more tricky issues and with examples; like Airbnb approached to many investors with their business plan for only 1,50,000 dollar in excess for 10 percent of the equity. Many investors sent a regret later that, sorry we are we would not be able to fund and rest of the investors did not even bother to send a reply, not even a regret later.

And then someone if someone has would have invested say 1,50,000 dollar at the time I said in 2008 when the company was just in the formatting stage. Nine years down the line that person would have made 3.1 billion dollar for the 10 percent equity. In fact, at today's valuation 10 percent of Airbnb is about 40 billion dollar Airbnb is a wonderful success a story, but then when they approached to so many people.

If they approached to any of us perhaps we would have thought the same way that this is not a business that can be funded. Because, they expected people to visit inside the visit and a stay with an a stranger that has no kind of acquaintance with them, they do not know anything about that culture there the kind of people that they are. Even today without suppose Airbnb does not exist, you ask anybody offering this business that offering this opportunity that somebody can go to some country say in Iraq, Iran or say Turkey or some other country.

And then stay with a with a homeowner perhaps most of the people will say no way, but then Airbnb had this leap of faith they had some hypothesis and eventually they enacted a success a story companies valued now 40 billion dollar. Many venture capitalists miss this kind of opportunity many venture capitalist fund this kind of businesses and then they burn their

finger this is such a tricky thing; that is why we should be we should always put our self in the shoes of investors.

And then think what kind of comfort what kind of confidence that we are giving to the investor only then we can actually think of expecting a positive response from investor.

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There are different kinds of means money comes in different forms meaning that they invest in both equity, in preference shares, they also give debt, the some of them give grant as well. Now, if you get equity from founders point of view this may be good this may be may not be good depending on whether you are interested in diluting your equity whether the cash flow is good enough to raise money in term in the form of debt and then repay and then save the equity.

So, there are lot of trade-off between dilution and cash flow and then repayment etcetera; for making the decision as to in which format you want the money. At the same time investors may not be interested to give you the money in that format; most investors prefer to give convertible give money in the form of convertible preference shares, not even debt.

So, there is always a trade-off here again. Equity investment gives owners ownership to investors. If somebody invest in equity he become he or she becomes part owner. Preference equity share is kind of a mezzanine capital meaning that it has both features of equity and features of debt. Debt is nothing but loan that you take and pay interest and after some period of time you repay the loan.

So, you have to repay if you do not repay the lender will take you to court and then there will be bankruptcy; decree against you. Then grant is the most attractive part of the capital you get it free; grant is normally given by government because government has the prerogative and the responsibility to promote industry. So, they always try to try to entice entrepreneurs with subsidy with margin money with seed capital etcetera. Just imagine that that we have two Tata group of companies in India, or two Reliance industries group in groups in India.

The economy will be at least say 10 percent larger compared to what we have today, but how this happened some entrepreneurs took the plunge they invested the risk money and then gradually they have grown they have now reliance gives employment direct and indirect employment to maybe 10 lakh people or even more Tata same story; and then their contribution to our GDP, our government income is collusion if you if we have 10 says groups of companies our GDP will almost double.

So, government has a responsibility to nurture earliest as company. So, there someday some of them become Reliance some of them become Tata group of companies.

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Expenses before going to market:

Startup Expenses	₹ '000
Early salary	100
Market research	40
Prototyping	500
Design of logo, etc.	30
Traveling	25
Legal expenses	60
Trial expenses	200
Advert. & Promo	100
Rent	60
Utilities	20
Website & hosting	20
Internet data plan	10
Telephone bill	5
Insurance	10
Consumables	20
(Prel. & Preop.)	1200

Assets:	
Current assets	
Cash	50
Inventory	500
Other current assets	100
Long term assets	
Machinery	200
Computer	120
Software	50
Interior decoration	10
Furniture & Fixure	50
Preliminary & Preop.	1200
Sub total	1630
Total expenses	3480

Funding	₹'000
Liabilities	
Accounts payable	100
Other curr	50
Friends & Relatives	500
Long-term liabilities	0
Sub-total	650
Equity	
Owners	2000
Investors	0
Crowdsourcing	830
Sub-total	2830
Loan fund	0
Total funding	3480

That is why all those supports are there now suppose you think of approaching to an investor. Now that I have just registered your company and then you need some money then you need to know the purpose of this money.

Why you need the money what are the kind of expenses that you need to incur moving forward for which you need money unless you have a clear idea you will not know how much money you need or if the question is thrown back to you why do you need this money then you will be blabbering; I need money for prototyping and then perhaps you will not find many items ready in your mind.

You need money for many purposes like start-up expenses like say; registering a company, early salary like you need some people when you are building a prototype market research then you need design, a logo, travel, legal expenses, trial expenses, advertisement and

promotion little bit of that rent, utilities etcetera. So, these are the expenses that is normally incurred even before perhaps registering a company or before you go to market at least your before your product is ready and you are ready to go to market you incur all those expenses.

And the sum total of them is referred to as preliminary and preoperative expenses. Preliminary and preoperative expenses, these expense remain in your balance sheet as an asset as long as you do not write it off. If you remember financial statement lectures we treated this preliminary preoperative expenses as an asset and we amortized them meaning that we use them up every year small a small portion that is how we amortized them.

And then eventually it is supposed to become 0 some means moving forward we want to write it off. So, that becomes part of our balance sheet if you remember the balance sheet on your right; normally, we have a either a T shaped balance sheet or a column single column balance sheet.

If it is T shaped then let left side will be asset like current asset includes cash, inventory other current assets, long term asset or noncurrent asset will be machinery, computer software, interior, furniture, preliminary preoperative then the total asset. These assets have been funded by equity and liabilities. So, equity and liability comes on the liability side and these are the sources of money that funds all of this.

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For what purposes a startup requires money?

Once you are ready with you product, you need major amount of fund to

- Create infrastructure.
- Working capital.
- Sales promotion.
- Brand building.
- Logistics.
- Post sales service.
- Employee benefits.

- Website/app development
- Team hiring
- Legal and consulting services for your startup
- Licenses and certifications
- Marketing and Sales
- Office space and other admin expenses

So, you prepare this kind of a balance sheet to understand where do you stand. Let us move forward once you are ready with a prototype; now you want to go to market then you need a different kind of kind of expenses to be incurred. Like say, you create infrastructure like maybe buy buying machinery buying a building factory shade or something you need working capital you need working capital to buy raw material, prepare goods in process and then prepare finished goods receivables etcetera.

You make sales promotion because now, you are ready with a product. So, you have to promote your product beg build brand requires lot of money set up logistic and then for maintenance or post sales service you have to have a separate division, employee benefit and many more things. So, you need money for that.

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So, depending on at what stage you are you are going to prepare a requirement of money based on all these items which you think that you need. Among sources of money the one very significant item is equity capital equity capital is the money that founders bring in and investors also invest in equity capital reserves and surplus is the accumulated profit.

So, let us focus on equity capital and how it changes owner’s structure or percentage holding. Now look at this left side is asset right side is say liabilities equity and liabilities.

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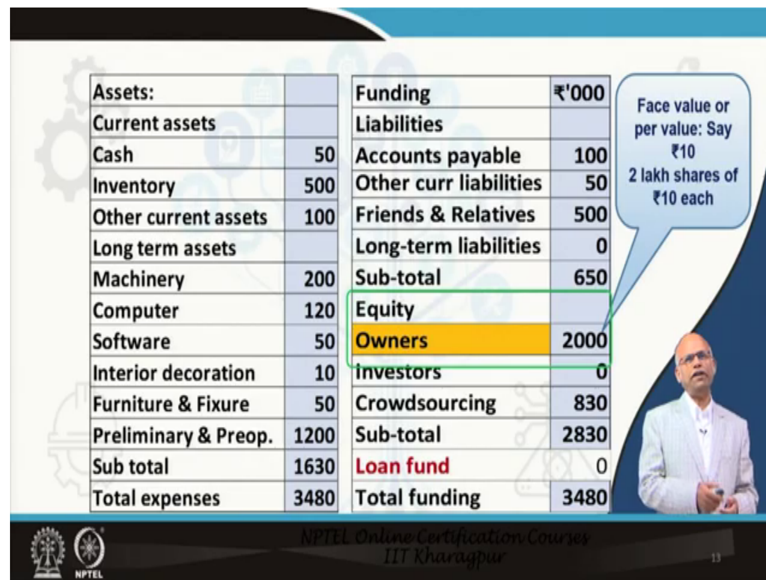

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Now, this means these are the source of funding. So, you look at equity, suppose we have just populated with some data. So, owners have invested 20 lakh rupees suppose this is in 1000 at the top you fund you see triple 0 omitted means this is expressed in terms of 1000, 2000; 1000 that means, 20 lakh rupees.

So, owners invested 20 lakh rupees in this business. Now, normally owners investment are in terms of some securities call equity share; that means, every money that you invest or the total money that you invest represent some number of shares. Usually shares are of rupees 10 each that is called face value or per value. It can be 1 rupee, it can be 10 rupee, it can be 100, 1000, 1 lakh, there is no there is no fixed rule it is not it is not a fixed amount.

So, you can have anything as face value suppose you have ten rupees as face value and if you have invested 20 lakh rupees; that means, you have invested in 2 lakh shares of rupees 10

each that makes 2 lakh into 10 is equal to 20 lakh rupees. Now total founder say there are three founders they have invested 20 lakh rupees. So, they have invested in 20 lakh shares precisely.

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Equity Holding

Equity & Liability		
Equity capital – fully paid-up equity capital	Consisting of 2 lakh equity shares of face value ₹ 10 each.	Total equity capital: ₹ 20 Lakh i.e. 2 L shares
Co-founder A holds	50,000 shares	50,000/2,00,000 = 25% holding
Co-founder B holds	80,000 shares	80,000/2,00,000 = 40%
Co-founder C holds	70,000 shares	35%
		Total 100%

So, let us move forward now suppose co-founders are ABC. A invested in 50,000 shares; that means, 50,000 multiplied by 10; that means, 50 lakh rupees. So, 50 lakh rupees or say 50,000 shares. Either you divide 50 lakh rupees by 20 lakh or you divide 50,000 shares by 2 lakh shares is a total number of shares, so your holding becomes 20 per 5 percent. C invested 80,000 in 80,000 shares; that means, invested 8 lakh rupees 80,000 into 10. And the total equity capital is 20 lakh.

So, either divide 8 lakh by 20 lakh or divide 80,000 by 2 lakh number of shares his share holding is 40 percent. Similarly, cofounder C holds 35 percent of the equity.

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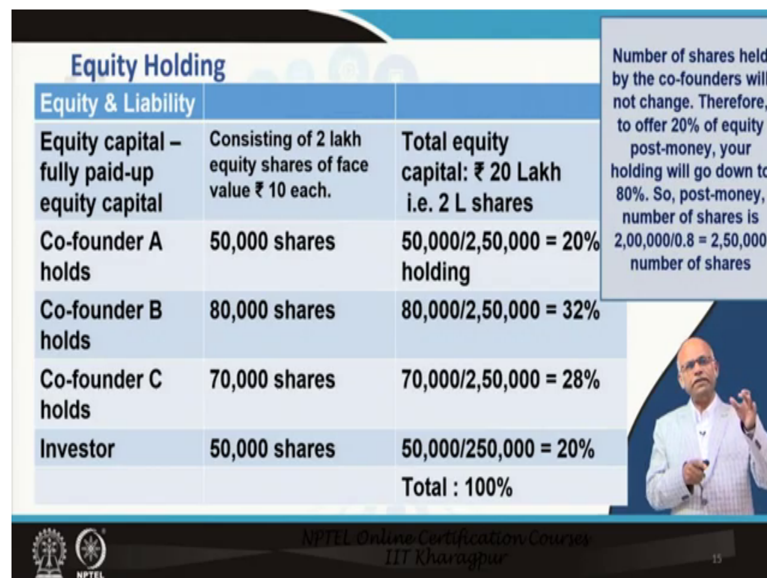

Now, suppose you invite someone some investor you need some 5 lakh rupees of investment from somebody.

So, that somebody came in and then it may or may not be 5 lakh rupees, but you are giving that somebody 20 percent share, suppose. Suppose, that somebody is bringing 1 crore rupees at some point of time; you may need investment. And somebody is investing 1 crore rupees; now that somebody demanded that you must give me 20 percent of the equity.

So, how many shares make 20 percent? The 1 crore rupees that he or she brings has no relation with number of equities that he or she gets. It is the percentage holding that determines now if that investor tells us that they want 20 percent equity; that means, post

money meaning after investment their shareholding will be 20 percent your shareholding means combine holding of three cofounders will be 80 percent.

So, 50,000 plus 80,000 plus 70,000 means 2 lakh share will now represent 80 percent of equity. So, the total number of shares is now going to be 2 lakh divided by 80 percent because you have 2 lakh shares and that is going to be going to represent 80 percent. So, total equity becomes 2,50,000 shares deduct 2,00,000 from there that you are holding you get 50,000 shares.

So, investors have to be given 50,000 shares they will hold 50,000 shares out of 2,50,000 shares. So, they hold 20 percent, but they brought in 1 crore rupees. So, that has no relation how much holding they get.

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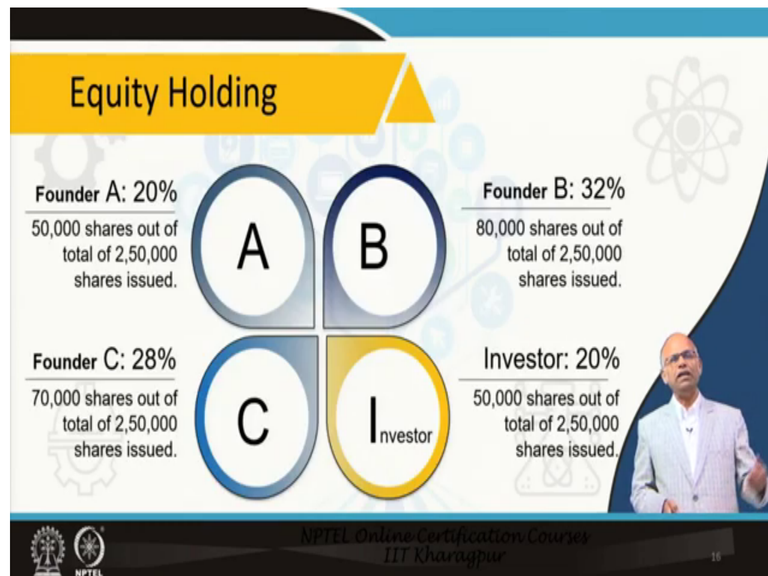

So, understand this very clearly. Now, this is just presented in different format. So, A hold 20, B hold 32, C hold 28 invest and investor get 20 percent. How is it so? Because, now the total number of equity shares at 2,50,000, you three continue to hold 50,000, 80,000, and 70,000 divided by 2,50,000. So, your shareholding has gone down from the previous structure.

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An Investor Can Invest in Equity, Preference Shares, Debt, Grant.

Seniority of Creditors

- If a company goes into liquidation, the sales proceeds of all its assets are distributed among all creditors and equity holders.
- Secured creditors are served first.
- Next are unsecured creditors and employees.
- Preference shareholders
- Stockholders are paid last.

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Now, an investor can as I said bring equity in preference share debt share and what are the consideration for this. We will be talking about that moving forward I am just introducing that there is something called seniority of creditors. Suppose investors bring in money in terms of equity or preference share or debt then suppose there is a liquidation event whatever that is maybe a bankruptcy.

Or maybe you are selling your company the debt holders get their money first. If anything is left then it goes to preference shareholder. After paying of all the money to preference

shareholders claim if anything is left then only equity shareholders get money. So, now, you understand that any investor ordinarily would prefer to invest in debt rather than shares either equity or preference, but then if the bring in debt their top line also is limited like if the company valuation goes up their value does not go up.

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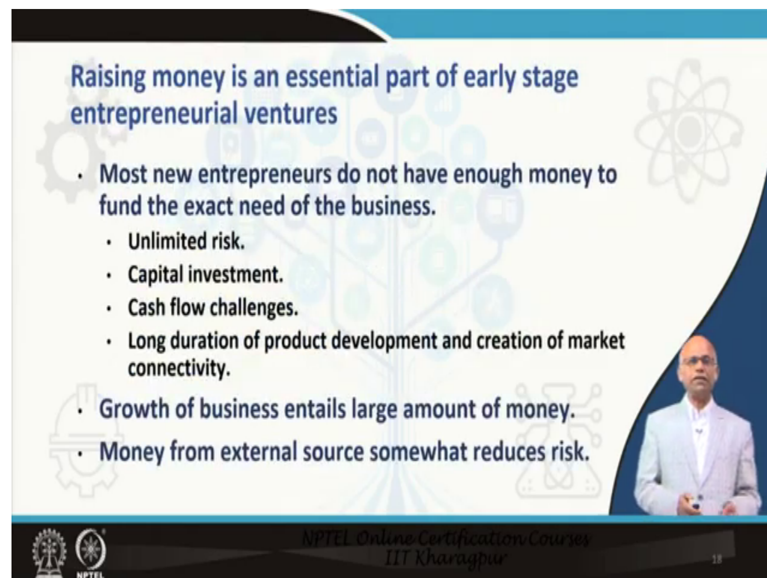

So, we are going to discuss that moving forward. So, suppose most of the new entrepreneurs they think that we need money immediately, but then the risk they should understand that at the if you are at a very early stage investors will think that this is unlimited risk.

So, they will try to dilute your equity more. In the previous example, if you are very much at an early stage if they bringing in 1 crore rupees, they will ask for 90 percentage of equity something like that. Because, they will think that my money is going down the drain, but if I

get majority holding maybe I can take care of the management etcetera. More importantly if there are one million ideas at the beginning.

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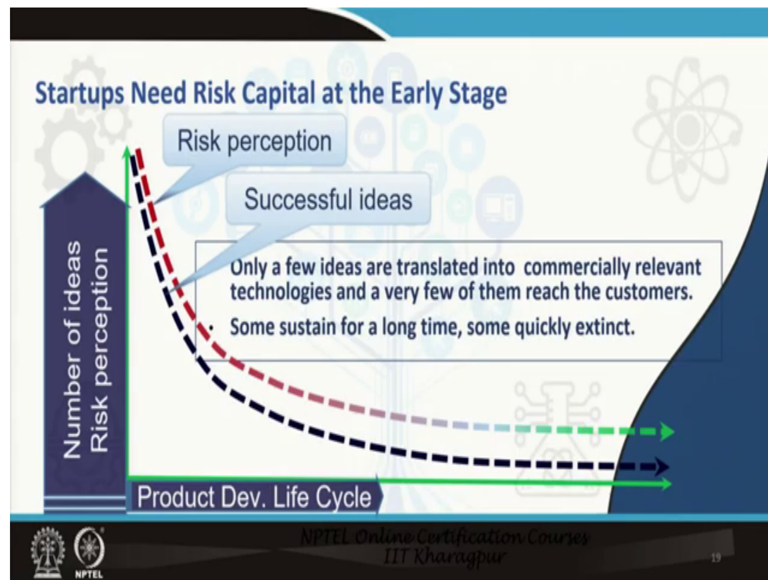

Then as they move forward at the move forward by building new TECNA; means developing the idea into say some kind of prototype or something ideas fall on the wayside; meaning that they become untenable they do not become successful. So, gradually very few number of ideas actually sustain at the end. So, risk perception at the beginning is very high because failure rate is very high whereas, when other later stage you have a prototype it is customer validated chances of failure is less.

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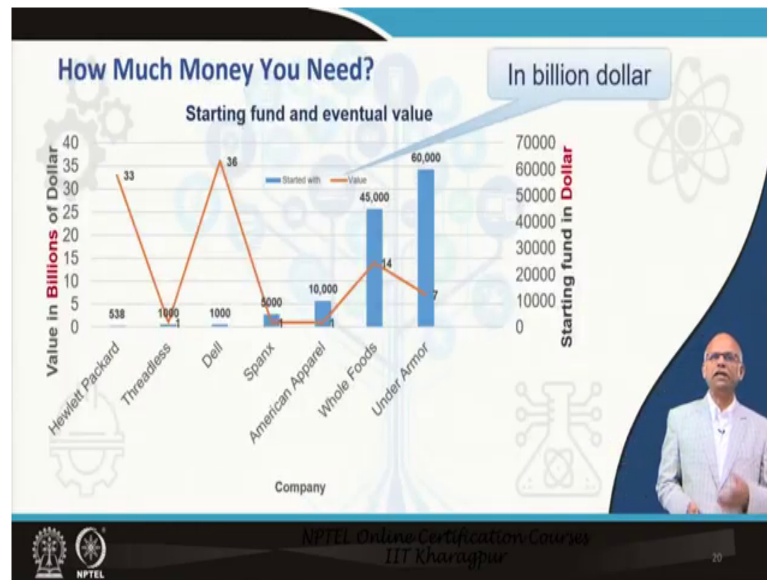

And you get more money this slide shows how much money you need. Sometimes we think that you tell somebody why do not you start a business you say I do not have a crore of rupees. So, how can I start a business look at this example Hewlett Packard has started their business at 538 dollar and their evaluation is 33 billion dollar. Threadless started business with 1000 dollar valuation is 1 million dollar. Dell started at 100 dollar valuation is 36 billion dollar valuation are all billion dollar.

So, look at this graph and this amount of money that they started with you find no correlation at all you do not need billions of rupees or crore of rupees to finally, make a billion dollar company.

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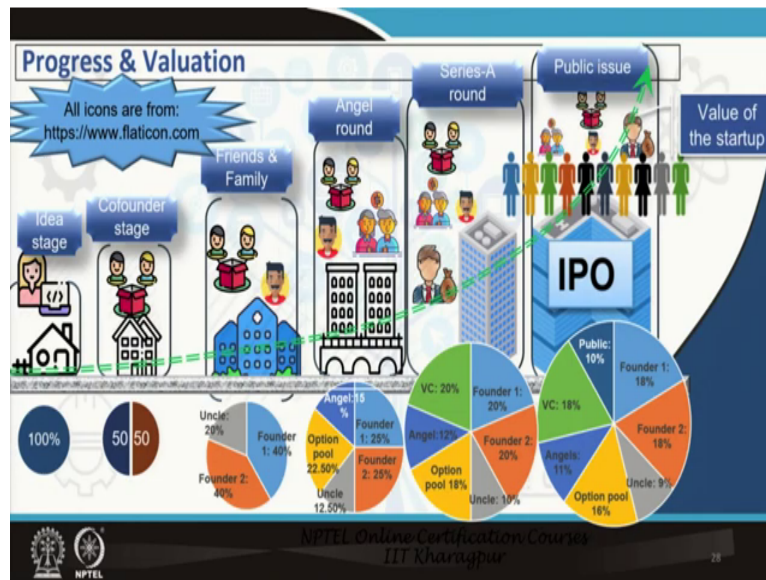

And to drive from the point about risk perception about the kind of investment that you should look for at different stages I have this slide. So, you start with say at idea stage you have your own money.

So, this is all bootstrapping your own source then as you move forward you bring a cofounder he or she brings in some money. So, you are still on your own then you think of inviting maybe your uncle or somebody, friends and relatives. Let us consider that you invited your uncle and he chipped in some money at the idea stage you had 100 percent holding at two co-founder stage you have 50 holding now your uncle has chipped in.

So, he is going to demand some holding so, two co-founder founders hold 40 percent each uncle hold 20 percent hypothetically. Now, as you move forward now you approach to angel because you need more money you have already built a prototype now you want to go to

market so, you need lot of money. Now angel said we can bring in 1 crore rupees 2 croreth whatever 1 million we need 15 percent holding 15 percent of the equity.

Now, all your holding goes down founders who had 40 percent each now become 25 uncle have 12.5 and you prepared an option pool for employees like a soap like employee is a stock option you prepare a separate pool you keep that reserved for employees maybe 22.5 percent that is a condition that angel may stipulate.

Then you move forward you need more money lot of money so you approach to venture capitalist they say we need 20 percent your holding goes down, and your valuation goes up. As the valuation is the orange colour line dotted line that you just follow it is going down finally, you need lot of money and you want to reward all your investment by making your share liquid. So, you want to go for a public issue so now, public will be holding ten percent all others holding will go down significantly.

And then lot of there are a lot of shareholders with IPO it is a success complete success a story your valuation is going through the roof and everybody reap reaps the benefit.

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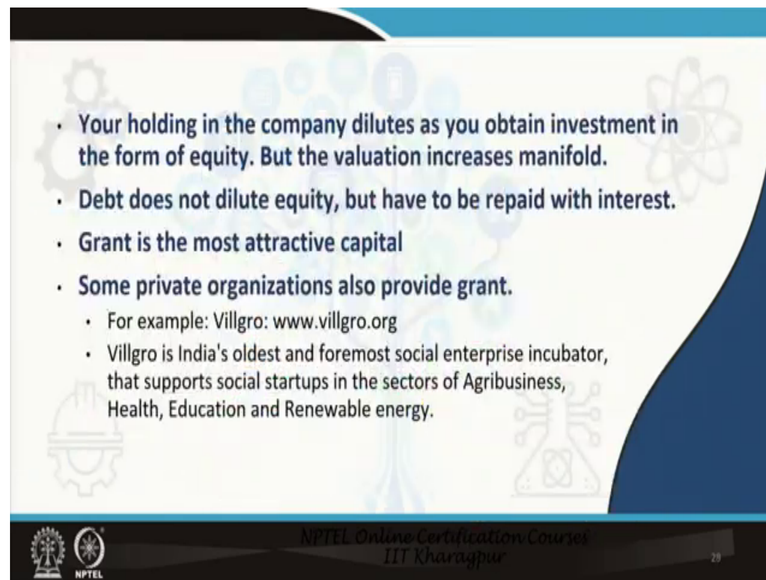

So, as I said your holding goes down some private organizations also provide grant like I was talking about grant. Some private organization like Villgro they give grant as money. We will talk about that in the next session.

Thank you for up.