**Entrepreneurship Essentials**
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**Lecture – 47**
**Funding New Venture – II**

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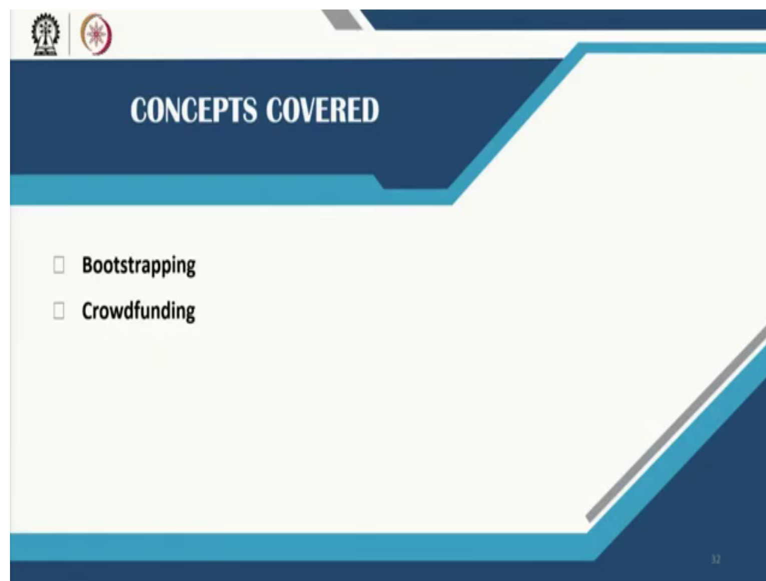


Hello, we will continue our discussion on Funding New Ventures. In this party in this session, we will be particularly discussing about bootstrapping and crowdfunding, but before we move on to bootstrapping; we will be explaining some key issues about funding in general. Particularly, when somebody gives you fund you gives them some kind of security. What security and what are the kind of securities we are going to discuss that.

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Security: In Two Contexts

| Securing a debt | Securitization of assets |
| --- | --- |
| • Hypothecation<br>• Mortgage<br>• Lien<br>• Pledge<br>• Guarantee | • A document holding the right on a property.<br>• A fixed deposit certificate<br>• A share certificate (equity & preference share)<br>• A bond certificate |

You offer assets as security to secure a debt so that the lender can liquidate the assets to recover the loan in the event you fail to repay as promised.
Lenders' motivation to extend the loan depends on the value and liquidity of the assets that you pledge.
Assets other than what is financed by the loan and offered as security is known as collaterals

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So, the term security is used in two context; one is security is a piece of paper that has an underlying asset meaning; that is an ownership of an underlying asset. You keep that with the lender or the giver of the money as a security to secure the money that they have given to you. So, that remains as a sec as a security with them. It may be say hypothecation meaning; whatever is stock you have bought or machines you bought with the money suppose you have bought a transporter maybe a bus or a truck and raising money from a bank.

So, you will write on a plate, this truck has is hypothecated to so and so bank. That shows that the bank has funded the purchase of the truck, they have given part of the money and the truck is in their name meaning; name of the bank. So, truck belongs to them, something like that. And then as you will repay all the loan that the bank has given the truck will come back

to your name, means; the name will be transferred to you or maybe they will release the lien on the with the r o c register of companies and the truck becomes yours.

Likewise, suppose you have a house building on a piece of land or maybe a an apartment also. So, the title deed can be given to the bank or the lenders wherein you mention that in case I default making payment as per schedule given to me, the bank will have the liberty to auction this property and realize the money. So, that also remains as a security similarly pledge, guarantee, lien suppose, you have a fixed deposit in your name you can put that deposit with the bank and you write that bank will write that this security is we register our lien on that security.

Now, some of the securities or some of these papers documents can actually be securities. Like suppose, you have a fixed deposit or say any suppose on a piece of paper, somebodies or say your house property. Now if house property is given to the bank. Now bank can hypothetically speaking, bank can give to another party that I have registered mortgage on this house so, you can keep this asset and give me some money. They are discounting your mortgage and getting some money for lending to another guy.

Suppose, you have raised an invoice on somebody it becomes a bill when somebody accept it and then you can actually bank will give you money for against that bill and then they will get, they will collect the bill collect the money and they will recover the money that they have given to you. So, some piece of paper can be securitize in that manner.

So, anything can be securitized like a title deed can be securitized. A fixed deposit; that is a security that is a piece of paper, but is the sec security and why lender wants this security because at some point of time if you default in making payment, if you default in keeping your promise they will liquidate that security and realize the money that is the objective.

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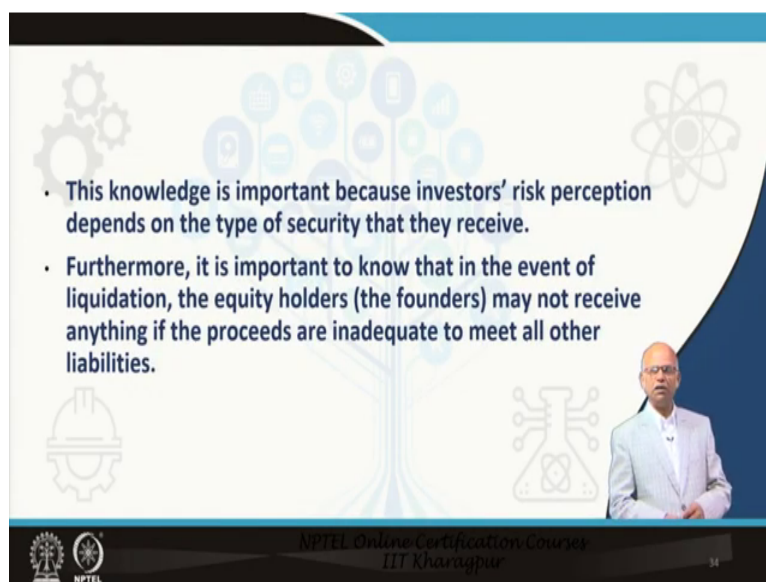


Now, why this discussion? This knowledge is important because, when you want to raise money from somebody. If you have some security with you and you think that you do not want to dilute your equity, you can raise money through loan because you foresee that there will be lot of cash flow moving forward. So, you can very easily repay the money that you want to borrow.

So, it would be better in that situation to borrow money, but then bank is going to ask for security. So, you should know what a security is what kind of things that they take as security. They take anything that can be liquidated. So, liquidity of anything is a good security. Suppose, you have fixed deposit or say life insurance policies with endowment meaning that at maturity you are supposed to get money or say some post office security, post office security in the form of say National Savings Certificates or something that you can keep with bank will create a lien and bank can easily recover money by liquidating them through a

standard process. So, if you are looking for money cash from bank as loan you need to understand what are security. So, that is it.

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Seniority of Sources (Nature) of Funds/
Seniority of Liabilities

- Seniority in the context of various types of sources of fund refers to the priority or order of payment (or repayment) in the event of liquidation of an enterprise.
- Seniority pertains to debt (loans, bonds, securities), preferred stock, various credits, and equity. Every security has relative seniority. Some securities such as bonds may be of same seniority, which is termed as pari passu.
- Say, based on court order, the assets of a company are being liquidated and the proceeds are to be distributed among all the creditors (banks and others).
- The senior most debt must be repaid before subordinated (or junior) debt is repaid.
- Preferred stock (preference capital) is senior to common stock (equity capi... which means that preference stock holders will be paid first. If anything i... left after paying to preference shareholders, only then equity shareholders will be paid.

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Now, security is on aspect. Now when you are trying to raise money from somebody, say investors say angel or V C or say high net worth individual or impact investor like will grow will be talking about that moving forward. So, when you are thinking of raising money, the other party who is going to give you the money they will think many things; one is how the valuation is going is going to go up, what kind of security you are going to offer them then what is the cash flow moving forward, what is going to give them the maximum benefit they want to look at that.

It is not just the benefit, but then what is the risk associated. Suppose, your investor invest in equity in the event of bankruptcy they will be the last party to receipt payment if anything is

left after paying all other creditors, particularly, secured creditors. So, if anything is left only then they will get the money. So, they are going to be mindful about that and think whether they are they would like to invest in equity or they would like to invest in secured debt. If it is secured debt you have to offer them some security whatever that is. So, there is always a trade off.

Now suppose a company goes into bankruptcy who are who are the party to receive the money for the first and then who next in the picking order. Who gets the money fast who gets money after that what is of order.

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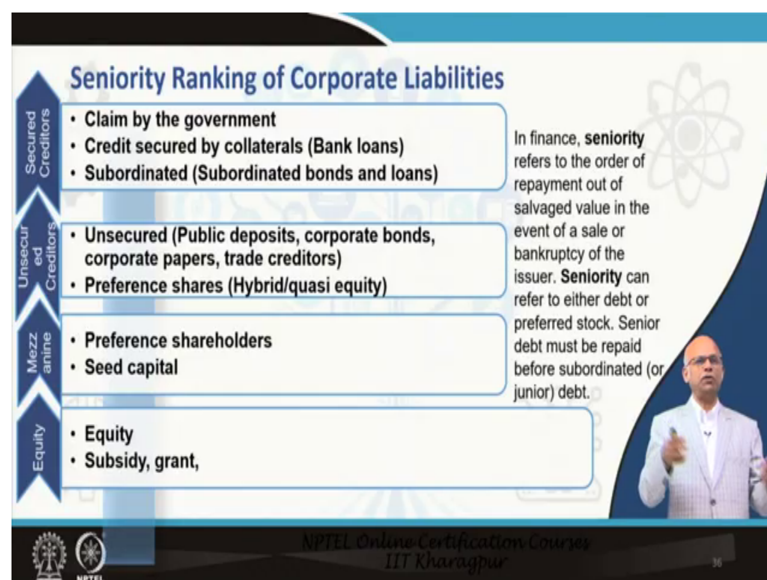


So, we will be talking about that. This is the order meaning from bottom to top. Meaning; the claim of the government suppose you have some pending tax liability or says sales tax or say goods and services tax liabilities still pending government will get the money fast.

Then secured creditor will get the money like, if you have raised any money from bank as loan they have full security. Then if there is a subordinated bond or subordinated loan, suppose you have taken a loan and there you have offered the same security that you have offered to the bank, but this is subordinated. So, subordinated loan will become eligible only after you pay a fully to the secured creditor. Then if there are any unsecured creditor. Like say public deposit corporate bond is called CIPC corporate paper or trade creditors. These are this has no security so, they get the money now.

Then only after paying all their liabilities, all their claims; if any money is left then only you pay pre to preference shareholders. It may be different kinds of preference shares like hybrid like hybrid like part equity part no non convertible, but then unsecured loan. Then there may be pure preference shareholder without any hybrid or anything. Of course, there may be seed capital as well like say IIT, Kharagpur gives a seed capital for anybody who is incubated here, but then this is given as a soft loan. 3 percent interest, but it is a loan you have to repay.

So, IIT Kharagpur will get money if anything is left after paying all the above investors after paying to IIT Kharagpur if anything is left only then the equity shareholders will get money, subsidy and grant are not to be returned. So, the question does not come.

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## Types and Sources of Funds

- **Grant, subsidy, donations (no cost and no obligation to return).**
- **Seed money (Zero to low cost, vary from grant to debt)**
- **Equity (cost obligation: dividend & capital appreciation, no repayment)**
  - Founders/promoters, accumulated surplus (profit)
  - Investors
  - Friends & relatives
  - Public
- **Preference equity (Mostly hybrid in nature: mix of Debt and Equity)**
- **Unsecured loan** (mezzanine senior to equity but subordinate to secured debt)
  - Most costly
- **Debt, Trade creditors**
  - Long-term debt
    - Banks/financial institutions, private lenders, trade creditors, non-bank finance compa
  - Short-term debt
    - Mostly banks

Seniority

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## Example

A company defaults on payment to a creditor and the court orders liquidation. How the payment will be made and will there be anything for the equity holder? Suppose, the following is the list of creditors and their receivables.

| Creditors | Outstanding |
|---|---|
| Trade creditors | 200 |
| Unsecured loans | 300 |
| Bank loan | 1000 |
| Preference stocks | 500 |
| Loan on second lien (mortgage) | 200 |
| Total | 2200 |

| Liquidation proceeds: | | 1500 | 1300 | 2500 |
|---|---|---|---|---|
| Bank loan | 1000 | 1000 | 1000 | 1000 |
| Loan on second lien (mortgage) | 200 | 200 | 200 | 200 |
| Trade creditors | 200 | 200 | 100 | 200 |
| Unsecured loans | 300 | 100 | 0 | 300 |
| Preference stocks | 500 | 0 | 0 | 500 |
| Equity holders | | 0 | 0 | 300 |

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This is showing it in a in another order is an example. Suppose, your total outstanding money is say 2200 meaning; say if it is in 1000, then it is 22 lakh rupees. Trade creditor is supposed to get 2 lakh rupees, unsecured loan 3 lakh, bank loan 10 lakh, preference stock is 5 lakh, now loan to second lien or say subordinated loan is 2 lakh, total is 22 lakh and rest is equity.

Now suppose, there is a kind of a bankruptcy and bank has court has given order for liquidation who gets hot now suppose the outstanding loan with the bank is 1000 as shown at the left. Now suppose by selling all the assets the liquidator official liquidator who is in charge of liquidating the asset and pay the money to the secured creditor or all the creditors. Suppose, he realized he or she realizes only 1500 or 15 lakh rupees, 15 lakh rupees.

Then who gets what? If it is fifteen lakh bank will take all their dues that is 1000 or 10 lakh rupees in full then, whatever is left? After bank it will go to you have secondary or say

subordinated loan because they also have mortgage. So, they get their 200. Now after paying 10 lakh and 2 lakh to these lenders you are left with another 5 lakh it is in terms of 1000, 15 thous 100 means 15 lakh rupees.

So, you have 3 lakh rupees left. Trade credited is supposed to get 2 lakh. So, you now pay two trade creditors. Now what is left? Is only 1 lakh. Unsecured loan is 3 lakh rupees. So, now, this 3 lakh out of this 1 lakh or say whatever is left, money will be given to unsecured loan. So, unsecured lender will get only 1 lakh rupees. Nothing is left now. So, neither preference shareholder nor equity share holder will get anything. Suppose it is 13 lakh rupees then, bank will get in full then second secured creditor will gain get another 2 lakh they get their full money only 1 lakh will remain and that will go to trade creditors.

Now, if it is 25 lakh rupees, only then equity share holder gets something because everybody else is paid up fully only 3, 3 lakh rupees it is left equity shareholders get only this money.

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How to Fund Your Startup?

- Bootstrapping (own sources including credit cards)
- Friends & Family
- Crowd-Funding/sourcing
- Startup competitions
- Impact Investors – Example: VillGro
- Incubators (mostly university based)
- Startup Accelerators (Surge by Sequoia Capital)
- Angel Investors
- Venture Capitalists
- Private Equity
- Bank Loans
- Advance/ Pre-payment from future customers
- Startup-Specific Credit Card: Example: LaghuUdhyami Card from IDBI
- Government Institutions – Example: DSIR, SIDBI, NABARD and MSME (NSIC)
- Indian government Startup Fu India Aspiration Fund (IAF), SIDBI SMILE, Mudra Fund
- Government grants: visit startupindia.gov.in

That is how money is distributed when a company goes into liquidation. So, depending on the picking order any investors will be will be kind of attracted or interested to invest in more senior security rather than less senior security light like equity share. Because, equity shareholder gets money only if anything is left after payment to all the others.

Now, what are the sources of money for funding your start up is very important. Starting you start with bootstrapping meaning; your own source of money wherever you have saved some money and kept maybe even your credit card, then comes family and friends. Most of the people most of the start up start with that if they exhaust their own money then look for parents and extended families. Then comes crowdfunding or crowdsourcing; finance in between like after crowdsourcing or maybe even before crowdsourcing there are many start up competition you can participate and get some money.

There are impact investors like will grow they are neither angel nor venture capitalist you call them venture capital, but then their investment pattern is very different. They are more of a social enterprise than a very commercial of venture capitalists.

So, impact investor; then there are incubators like say universities or any other so, IIT, IMS and other universities. Nowadays, even engineering colleges are encouraged by M H R D to open incubation cells where they will be giving some seed money and a space and other things, we will see that moving forward. Then there are start up accelerators; say search by sequoia capital is one of the accelerators in India. Why combinator combinator is perhaps one of the greatest accelerator then comes angel investors then, after angel investor you gain some traction more traction you become almost like cash positive or something at least you have acquired a lot of customers then comes venture capitalists.

After venture capitalist comes private equity their ticket size or fund size is very big they come only when you are in profit mostly. After that you look for bank loan; bank loan is not available when you are not really making profit mostly. Then you can actually use customers money they can give you advance prepay. Start up specific credit cards are available like Laghu, Udhyogi, Udyami card from IDBI, even other banks SIDBI, IDBI, it should be said be SIDBI S I D B I.

So, there are government institutions like DSIR, Department of Scientific and Industrial Research, Small Industry Development Bank of India, NABARD, then MSME, NSIC, I think NSIC is named as changed to MSME. So, all those also are there they give you some seed capital or some subsidy and then eventually they connect with connect you with other investors. SIDBI in particular is managers fund of funds they give money to many venture capital funds.

So, they also influences as decisions. Indian government, they have India aspiration fund SIDBI SMILE fund Mudra fund, there are many schemes at start up india dot gov dot in. So, you should visit them and learn more about it I will also present moving forward.

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So, impact fund, like I talked about will grow. Will grow gives you both grant as well as equity meaning; suppose they give you one crore rupees they will tell you that you do not have to repay 60 lakh rupees at all, just use that money and you convert the 40 lakh rupees that you give that we give you into equity not at today's rate, but when you raise money in the second round, in the next round whatever rate at which you give equity to investors you give us that.

And look at the data. When they complete at seventeen years they had 17.96 crore rupees of total investment. So many innovations, so many seed funding and job created and the present data is this.

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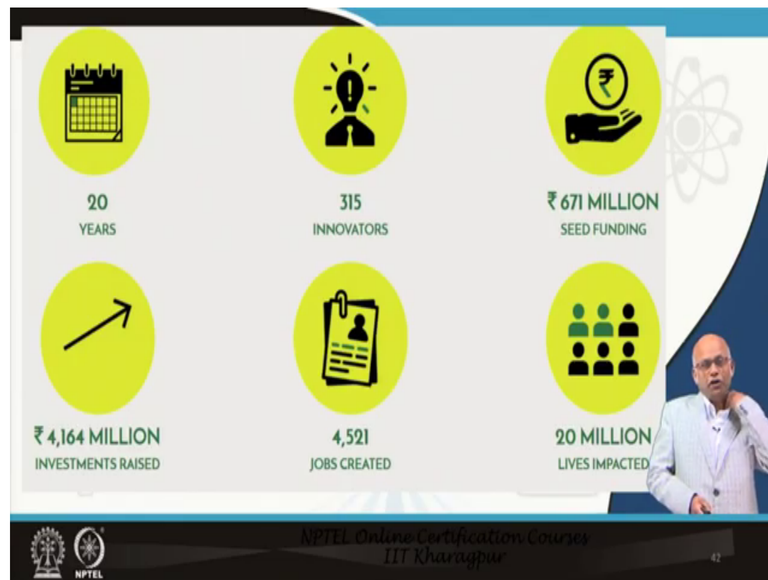


After 20 years they have 41 core rupees disbursed 315 innovation done so many million seed funding job creation etcetera. And they give money as grant as well that is the best part of it. So, imagine that a private party is giving you donations in terms of lakhs of rupees. So, big money and it is a wonderful social contribution by a private enterprise.

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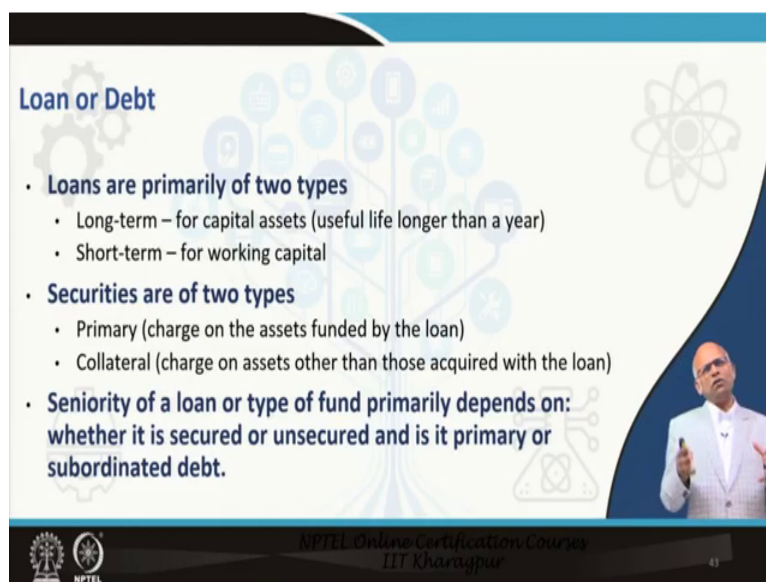


We talk about debt fund a little bit, but there will be a separate session all together about debt. Bebt comes with lab with lot of covenants. Covenants means conditionalities, debt can be long term can be short term. If you buy machinery then this is long term loan means to buy machinery banks give loan on a long term basis that is why called long term loan.

Because suppose you buy a computer also buy a machine that machine is supposed to be with you for maybe 15 20 years. So, bank will give you money which will be repayable for 7 years or 5 years depending on your cash flow that is long term money. But you need working capital on a daily basis. Today you need money tomorrow you may not require day after tomorrow you may require double that some. So, this is going to be a very fluctuating kind of requirement and bank will give you money as and when you need.

You need double the money there is money. So, that is why it is called working capital fund, because you meet working capital requirement with this, this is short term money. And then securities we discuss, but then security is can be two types; one is primary another is collateral. Primary securities are the securities or yeah in the form of the asset that is procured by the money that they give, like suppose you buy a machine. The machine per se will be hypothecated to the bank, you just merely on a piece of board you write that hypothecated to so and so bank that is all the security.

So, that people can see that you have borrowed money to buy this machine. So, if anybody wants to buy this machine from you, he or she will be mindful that bank has funded this, so the title is lying with the bank. That is the security, that is called primary security. Suppose, you use working capital money to buy some raw material again raw material remain hypothecated, because this is a this is an asset that you have created with the money that they have given, this remains as a primary security.

Now, your house has not been funded by bank, but you deposit the title deed of your house with the bank to secure these loans, this is called collateral. We have already discussed about seniority of the loan will not revisit that.

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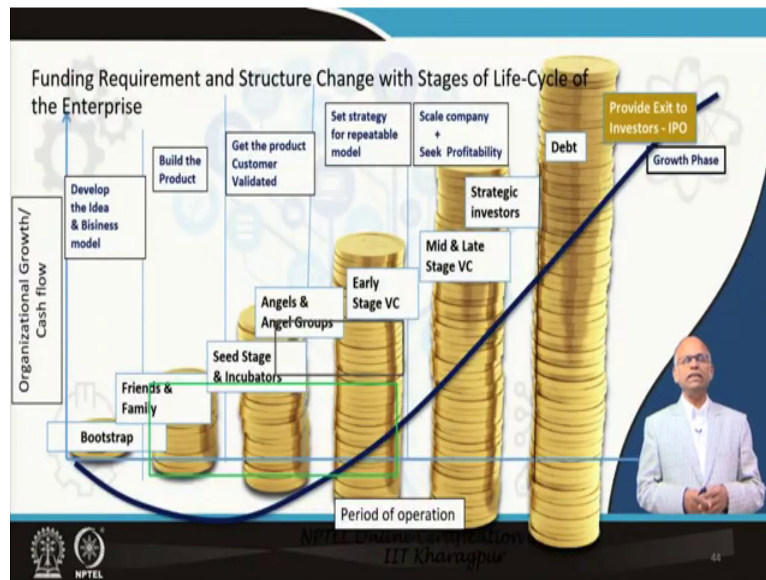


This is been already discussed in the previous session, but just to revisit at the beginning when you are at idea stage you bootstrap. Then comes friends and family, we showed the uncle coming in then seed stage when there are incubators like IIT Kharagpur and IIM s and many other universities including engineering colleges. After seed stage after incubation comes angel investors. In between somewhere if you are selected by an accelerator accelerators also give some a small amount of money in excess for equity. Then come early stage V C, whose this risk appetite is slightly more than mid and large latest is V C. So, V C also comes in between. Then comes large V C then a strategic investors or say private equity firm only after that normally people look for a debt and then exit.

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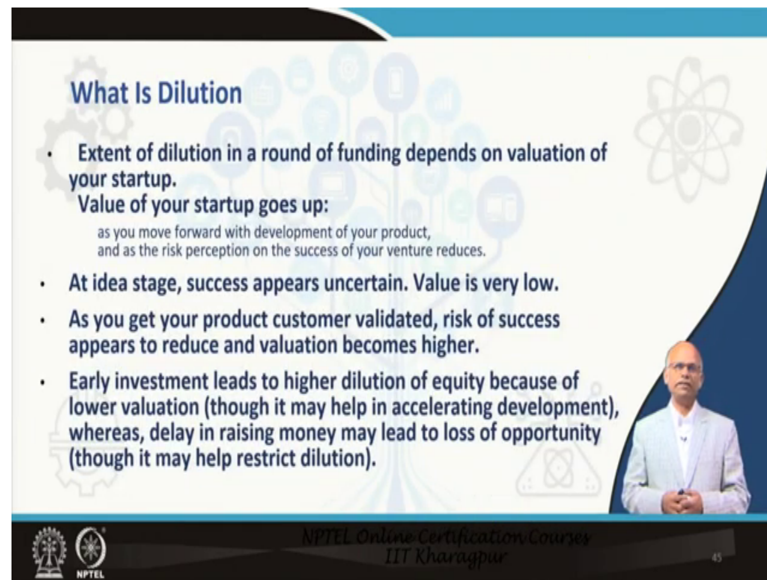


We have given an example about dilution. So, will not spend a lot of time, but one should understand that as you raise money and if you raise money in terms of equity, you dilute your own holding of the equity. As you move forward you create more and more value your dilution becomes less and less.

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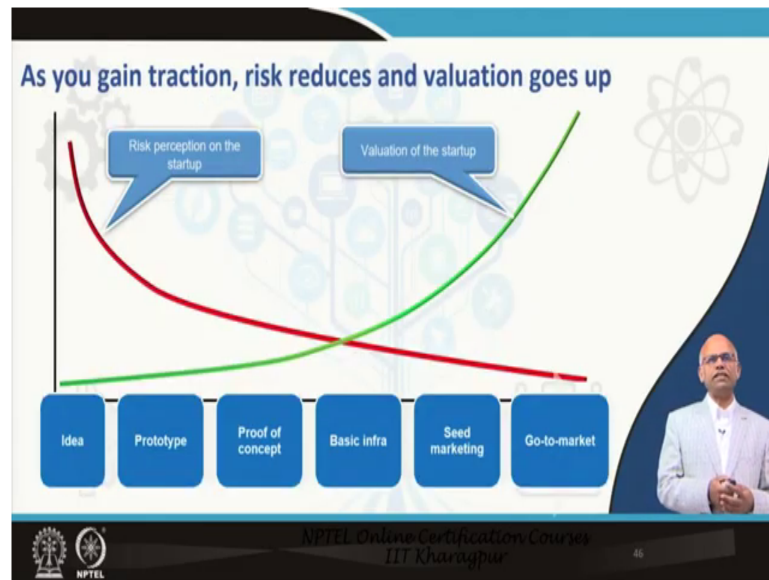


So, let us understand that with some example. So, this is just to show that you are moving forward from idea to prototype to go to market. The risk perception about your company to the investors are going down whereas, valuation valuations at different stages is going up. Because, now the chart chances of failure it is reducing. This is given with an example here.

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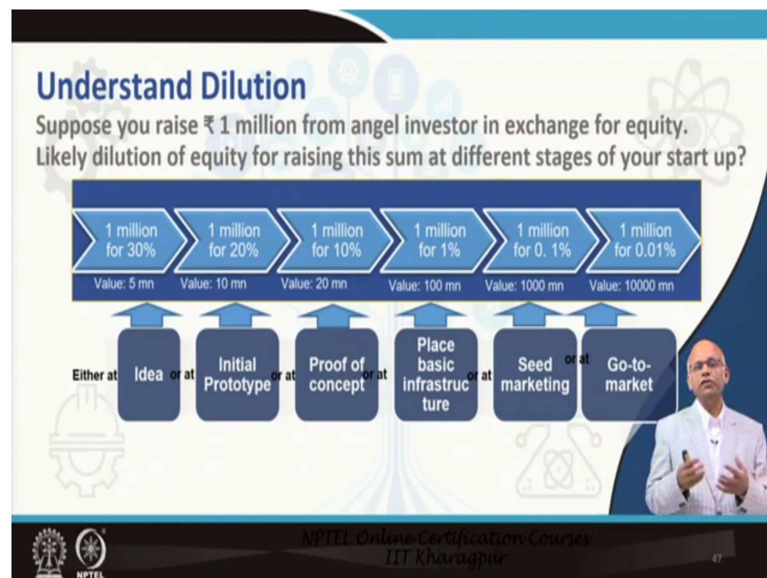


Suppose, you are looking for 10 lakh rupees, 10 lakh makes a million rupees. You want 1 million rupees from investor at idea stage investors is going to tell you that your idea may not actually translate into a business. So, if I have to give you 10 lakh rupees, I need 30 percent of the equity. So, you postpone you do not raise the money. Suppose you raise the money when you have the prototype ready. Now the same investors may tell you that I can give 10 lakh rupees if you give me 20 percent, because now I see that there is a prototype and it looks like promising.

Suppose you say no; sir, I am not going to raise money at 20 percent, I do not want to dilute so, let me work further. So, you work further, you make a proof of concept kind of a minimum viable product customers have already validated that product and you kind of are more confident, then you approach to the same investor for 10 lakh rupees. The investors tell you that we can give you want a 10 lakh rupees or 1 million rupees in exchange for 10 percent

because now we have made some progress. You do not take the money even now move forward.

Now, you have kind of you have placed basic infrastructure for manufacturing, you are ready to go to market. As you move forward the same investors will be ready to give you same 1 million rupees for less and less percentage holding or percentage equity in your company. In the process your dilution goes down and becomes less and less. At idea stage your dilation will be seventy percent whereas, at go to market stage it is hardly any dilution. It is your dilution is 0.01 percent so, you will continue to hold 99.99 percent.

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- Consider two scenarios: A. Say you plan to delay the fund raising till the point B hoping that the cash flow will follow the brown dotted line.
- But if your burn rate is more than you expect, your cash flow may actually follow the red dotted line.
- B. Suppose you raise fund at point A. With more fund at your disposal, you move in an accelerated pace and things may take a positive turn.

A

B

Two points of entry of investor

Dilution: Say 20%

Early phases of a start-up

Loss of opportunity

Dilution: Say 40%

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So, as you move forward you dilute less. That does not mean that you should wait up to go to market to raise money, because your dilution is less it is not the case. Because at any point of time if you raise money, the chances of failure also go down because you have the money to hire people to make faster prototype called rapid prototyping. So, chances of early success increases. So, one should understand that as well.

Suppose you take money at a stage A. So, you have you immediately press into action and then success hits success comes and then you kind of move along the green line. So, all [FL], but suppose you delay that process and you raise money at point B. Now you struggle up to point B, you burn a lot of cash now you slog more and then eventually you may become successful. You may not become successful, you may follow either the brown line or the red

line. So, when you are borrowing when you are postponing the decision you have to be mindful about that as well otherwise it will be loss of opportunity.

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So, whether it is dilution of 40 percent or 20 percent, decision should be yours when you are ready for money. You are ready when you have a promising concept. You have validated with early customers or if you think that with some money you can go to the next stage immediately

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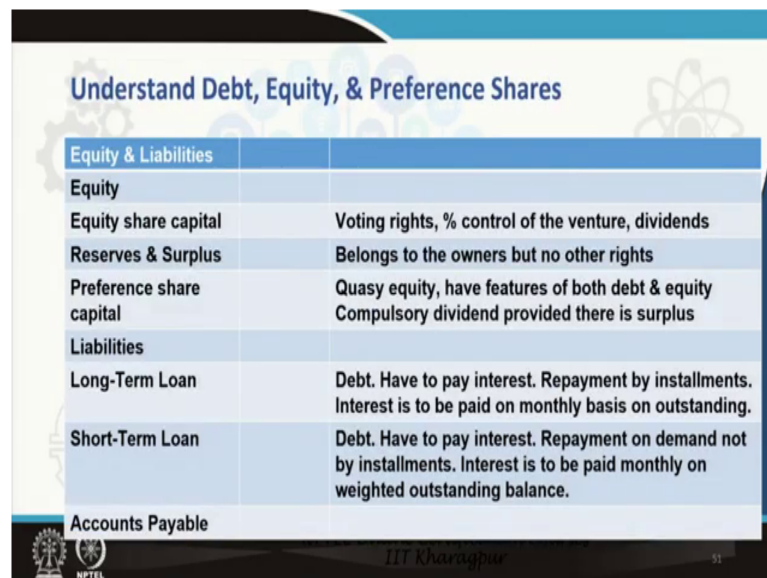


Understand debt, understand equity, understand preference share. Suppose you think of equity share. Equity share capital has voting right it gives control on the venture and it is it makes you eligible for dividend. So, from your point of view, it is dilution from investors point of view they get voting right, they will have a say on the management of the company. So, you cannot do anything and everything, but if they give you a loan they do not have this voting right. So, control over the venture is related whether it is equity share or something. Reserves and surplus as you know belongs to the owner.

So, whatever money whatever profit you are accumulating will belong to the shareholders. So, if somebody invest in equity share, you they become eligible for that. Let us move forward.

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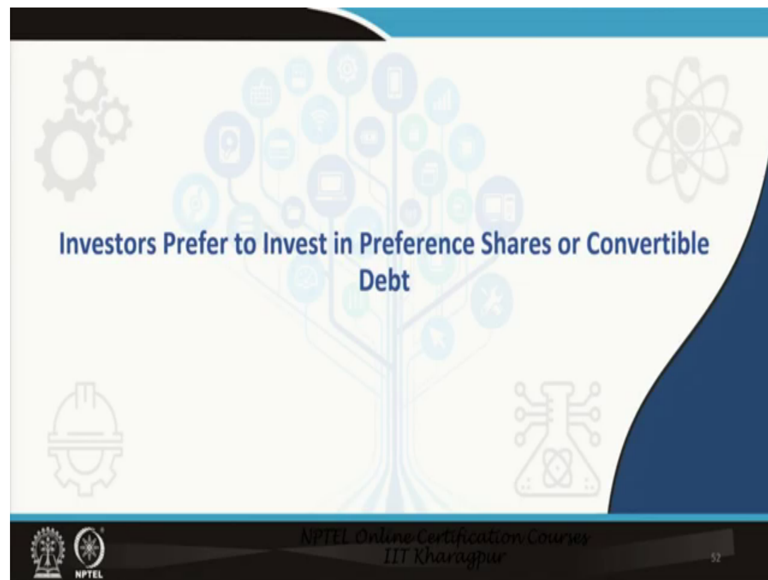


So, investors sometimes prefer or mostly investors prefer to invest in preference share or convertible debt. Meaning that; the invest in debt and in future that they have the opportunity to convert that into equity. So, that they reap the benefit of equity, but in between if your company comes bankrupt, then they at least save their money because debt had high seniority.

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Salient Distinctions between Preference Shares and Common Equity Shares

Preference Shares (PS)

- Dividends are paid before paying to common equity holders.
- Dividends are accrued and paid when surplus is generated.
- Rate of dividend is fixed.
- Convertible preference shares may be converted to equity shares.
- PS holders do not have voting rights in management decisions.
- PS may be redeemed.
- In case of liquidation or bankruptcy, PS holders are paid before CES. Limited upside.

Common Equity Shares (CES)

- Dividends are paid out of surplus/net profit after paying to preference share holders.
- Varies with surplus and declaring such dividend is prerogative to BoD.
- Dividends are paid out of surplus and is never accrued for paying in future.
- A company may buy-back CES.
- CES holders participate in management through their right to vote on resolutions.
- The entire surplus after meeting other liabilities is distributed among CES holders. Unlimited upside.

Distinction between preference share and communicative. If investors are preferring preference share why so. So, let us look at this why it is better than equity share common equity. Equity share also is known as common equity share see for preference share there is a fixed dividend stipulation. Suppose, investors are giving you money in the form of preference share they will say that you have to pay may a dividend at the rate of 5 percent, 6 percent, 10 percent or something.

Only difference is that this dividend it just payable. You can pay this year you can pay next year or year after next year, it will keep on accumulating, but you have to pay that. You have to pay a fixed amount meaning the it will be determined at the time of money give at the time of giving the money this dividend accrued and paid moving forward when you make profit. If you are not making profit they will not ask for it and it is fixed.

Preference share may or may not be convertible they may say that this is convertible they may say this is not convertible. If it is convertible at some point of time all their money will be converted into equity at a predetermined rate or at a condition and at a rate which will be conditional to some event happening. In case of liquidation or bank corrupt bank guaranty bankruptcy preference shareholders gets preference over equity share holder. In case of equity share dividend is prerogative to the management they may or may not declare dividend.

And the rate of dividend varies with the level of comfort or with the with their own plan as to how much should be the dividend it is not fixed and dividend is not carried forward. If dividend is paid this year fine otherwise, forget about it. There will be no carry forward dividend. Sometimes a company can buyback communicative share to increase or to give benefit to the shareholders and increase founders equity holding. So, suppose now investors hold 20 percent you buy back that 20 percent, the entire 100 percent will be belong to the founders.

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**Equity Funds**

money is invested in the business in exchange of part ownership

- Exit through IPO or acquisition
- Cost: No interest, dilution
- Part ownership
- Mentoring and supervision
- Security: No security

**Debt Funds**

borrow money, which is paid back overtime with interest

- Repayment
- Cost: Interest and charges
- No ownership
- Covenants
- Security: Charge on assets plus collaterals
- Claim on assets senior to the common share holders

**Government grant** – No cost, in some cases no dilution, non-returnable
**Hybrid securities** (preference share/stock/capital) – Features of both equity and debt
**Convertible** bond/stock/

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The surplus; entire surplus belongs to the founder; obviously, the shareholders the owners. Now difference between equity fund and debt fund is more significant. Equity fund if somebody has invested in equity of your company. If they want to exit from your company IPO is the route or maybe some somebody else acquire your company and then they acquire the holding of the investors as well, that is also another liquidation event.

Then, in case of debt the exit is repayment; suppose you borrow the money rather than taking in terms of equity. So, you have to repay the money and you have to pay interest. There is no dividend payment to the debt holder there is no question of dividend you do not have to pay dividend to them and they do not have any ownership. They cannot come and tell you why are you doing this, you do that, something like that anything. No business issues are discussed with the lenders. So, they have no control over how you manage the company.

So, but then there are some covenants like they may say that your inventory holding is too high you must pay interest in time, you must pay the instalment on principle in time etcetera. At the same time; they may also stipulate security both primary as well as collateral. Whereas, for equity there is no question of security and then they get their claim fast in case of liquidation because they are senior.

While discussing that let us also discuss that government grant comes absolutely without any conditionalities. You just have to give a utilization certificate at the end of utilizing the money that is it. Then there are hybrid security which has both equity and debt features like preference capital. Sometimes they are convertible sometimes they are not likes say bond.

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So, we will discuss about bootstrapping in the next session.

Thank you very much, we will close it here.