Topic 7 ▶ Financing the New Venture

LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Identify the nine common start-up costs that need to be considered when starting a new venture;
2. Identify various sources of funding for business venture; and
3. Apply the seven secrets of successful financing.

▶ INTRODUCTION

New ventures need financing. As new ventures are just starting off, they do not generate enough income to be able to pay for the up-front costs. Without sufficient funding, many brilliant ideas have met stumbling blocks and come to a sad end despite holding great potential. Therefore, this topic intends to shed some light on start-up costs, and alternative funding sources available to finance new start-ups. Finally, the topic closes with some guidelines on sourcing for funds.

7.1 START-UP COSTS

Figure 7.1: Start-up costs

Let us ponder Figure 7.1. Estimating your start-up costs will help you answer this question. Start-up costs are costs incurred in setting up a new venture. It may vary depending on the industry and the type of business, but listed below are common categories for most start-ups. Figure 7.2 illustrates the nine categories of start-up costs needed in new ventures.

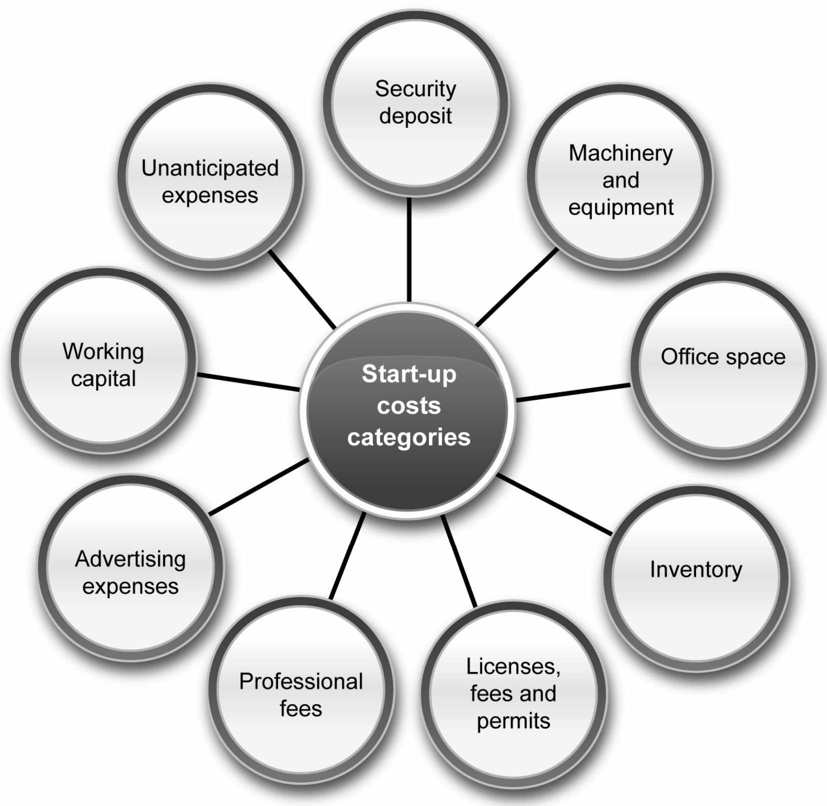

Figure 7.2: Start-up costs categories

These are just fundamental start-up costs that may need to be tailored to suit your business needs. Below are the details for Figure 7.2.

(a) **Security Deposits**

Lease deposits and **utility deposits** are common forms of security deposits. If you are renting a building for your new venture, you will be required to place a lease deposit with the landlord (usually amounting to two months rent). On the contrary, if you purchase the building instead, at least 10 percent of its price is required as a down payment for the purchase. In addition, utility service providers (electricity, water, telephone and so forth) also require you to put up deposits before service is connected.

(b) **Machinery and Equipment**

Depending on the type of business, the list of equipment required may vary. Computers, cash registers, fax machines and manufacturing machineries are but some of the equipment a new company may need to invest in.

(c) **Office Space**
Regardless of whether a property is leased or purchased, renovations may still be needed. You might need to build walls, add doors, build windows, add cubicles, do paint jobs and so forth. In addition, you need to furnish the office space with at least desks, chairs, cabinets, shelves and so on. Obviously, all these do not come free. Estimates for renovation, furniture's and fixtures can be obtained from the respective contractors and retailers to help determine the associated costs.

(d) **Inventory**
Inventories can consist of raw materials required for production or finished products that you will buy and resell to customers. Having inventory in hand is needed to assist businesses to keep up with orders. Estimates of this cost can be obtained from the suppliers of these items.

(e) **Licenses, Fees and Permits**
Starting a new establishment involves name registration, applying for business licence, health permit and so forth. In Malaysia, new business registrations will cost RM30 if the owner uses his own name as per identity card or RM60 if the business uses a trade name. On the other hand, fees and permits varies according to the type of business. For instance, an application for MSC status will involve a processing fee of RM2,000.

(f) **Professional Fees**
When starting off a new business, most entrepreneurs would seek the services or advice of professionals. For example, legal help will be roped in for advice on legal aspects of setting up a business. Consultants are hired to facilitate the setting up of their business operations or to conduct market research to determine the viability of their business idea. These expenses must also be taken into consideration.

(g) **Advertising Expenses**
People must be informed about a new start-up. This can be achieved through proper advertising programme. Realistic cost estimates must be made based on the advertising programme, the frequency, the screening timing, and the media used.

(h) **Working Capital**
It usually takes some time before a business venture can establish a reasonably good customer base. During this time, the income flow is not sufficient to cover the operational cost such as paying wages. Therefore, working capital is needed to serve as a cash reserve to pay for operational expenses until the income flow improves and is able to cover business

expenses. The working capital amount should be able to cover at least 3 to 6 months of expenses.

(i) **Unanticipated Expenses**

It is not possible to predict the future accurately. Therefore, new start-ups need to have a cash reservoir for unanticipated expenses that may arise during business operations. Experts suggest that it would be good to have an allocation of approximately 10 to 30 percent of total cost for unplanned expenses.

ACTIVITY 7.1

1. Using the common start-up costs categories discussed above as your guide, prepare a Start-up Costs Checklist for a new business venture you dream of setting up in the future.

2. "Be your own boss." Why do you think this keywords best describes people who ventures into entrepreneurship? What are the qualities an entrepreneur should possess when dealing with funding at early start up of new ventures? Discuss this in the MyLMS forum.

7.2 SOURCES OF FUNDING

Once you have estimated your expenses, the next step would be to determine how you are going to acquire funds for those expenses. There are many sources of funding available for entrepreneurial ventures. These alternatives can be generally grouped into two major sources of finance which are debt financing and equity financing. Figure 7.3 depicts a summary of these alternatives that can be used by entrepreneurs to finance their new ventures or even expansion of their existing venture(s). Each of these alternative sources will be discussed in detail in the subsequent sections.

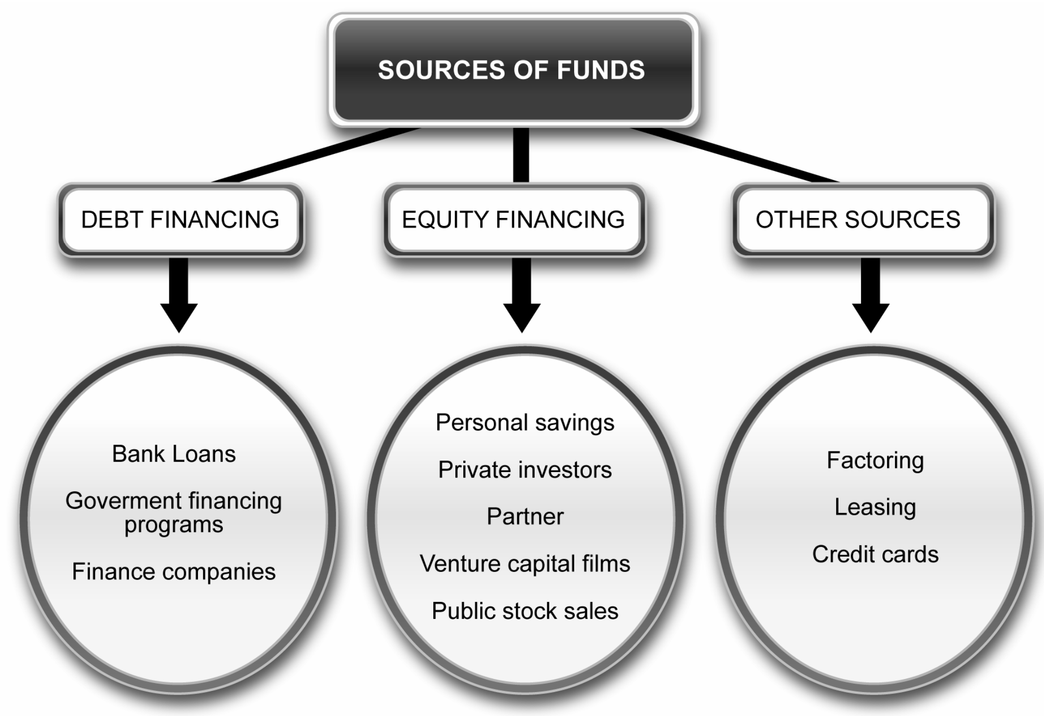

Figure 7.3: Alternative sources of funding

7.2.1 Debt Financing

Debt financing is financing that must be paid back with interest. It is stated as a liability in a company's balance sheet. Fundamentally, the basic characteristics of debt financing are presented in Figure 7.4.

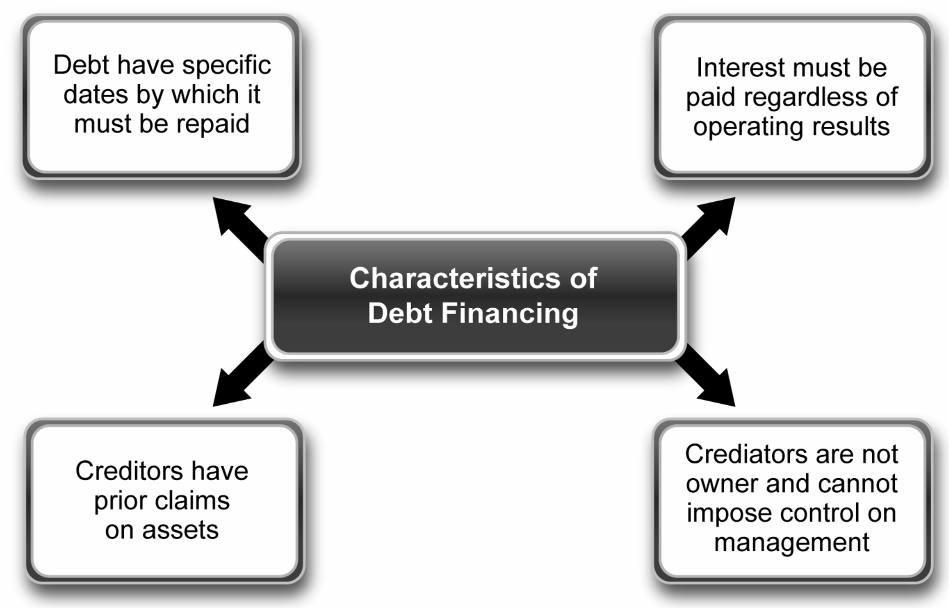

Figure 7.4: Characteristics of debt financing

There are numerous sources of debt financing as depicted by Figure 7.5.

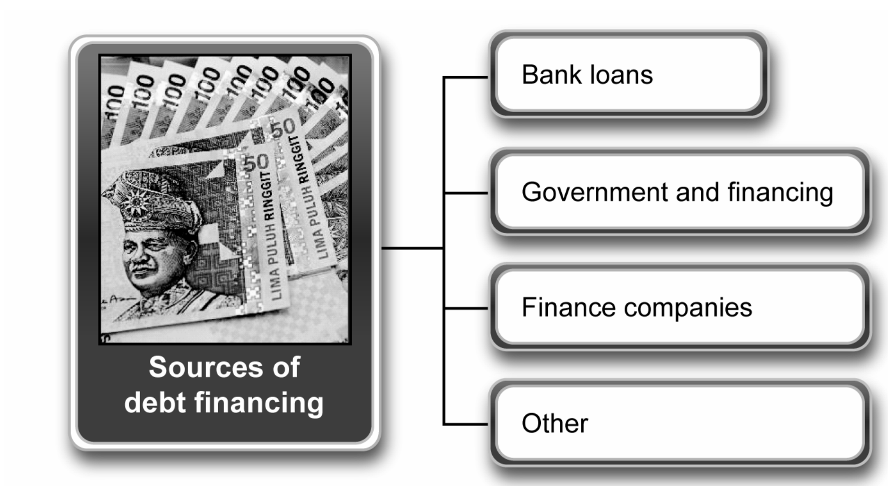

Figure 7.5: Sources of debt financing

Now, let us look at each of the sources in more detail.

(a) **Bank Loans**

The commercial banking system is always relied upon as a source of credit for small businesses. Short-term loan such as commercial loans and line of credit, and longer term loans such as instalment loans are but some of the products available for business funding. When giving out loans, banks tend to rely upon provisions for instance, whether there is a market for the business, the value of the collateral, the credit record of the applicant, the ability of the business to repay the loan, the knowledge and capability of the business owner or manager, and of course the macro factors such as the general economic situation of the country.

However, not all commercial banks welcome small and medium business entrepreneur as customers. The primary reason underlying the denial of assistance is the lack of collateral and pristine track record. Measures have been taken to develop banks specifically to nurture and support the Small and Medium Enterprises (SME) (Figure 7.6). The SME Bank or *Bank Perusahaan Kecil dan Sederhana Malaysia Berhad* (http://www.smebank.com.my/start-up.asp) is one such example. This bank is the effort of the Government of Malaysia to lend a helping hand for the SMEs in the country.

Figure 7.6: SME Bank
Source: http://www.niaganews.com/thumbnail.php

(b) **Government Financing Programmes**

The government has a variety of financing programmes for small businesses. The range of financial assistance rendered aims to help SMEs improve their workforce, develop products or technology, promote their product or services and restructure their debts. The financial assistance programs executed through various government bodies are summarised in Figure 7.7. For detailed information about the schemes and funds provided by these government agencies, visit SME info at – http://www. smeinfo .com.my/index.php?ch=2&pg=3&ac=62#fa.

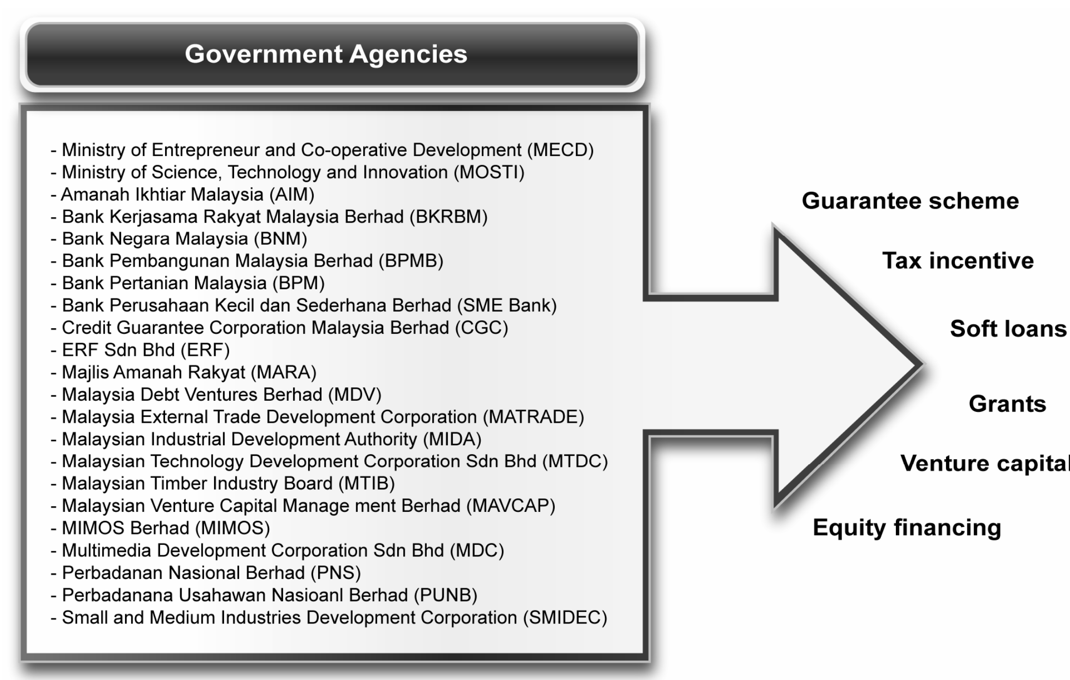

Figure 7.7: Financial Assistance provided by Malaysian Government Bodies
Source: www.smeinfo.com.my

(c) **Finance Companies**

Commercial finance companies are an alternative source of debt financing when loan applications of new ventures are rejected by commercial banks. Finance companies are primarily interested in financing high risk business ventures and tend to charge higher interest rates as compared to commercial banks.

(d) **Other Sources of Debt Financing**

There are several other options for debt financing which are not very popular. However, they may also be considered in times of need. For example, there are **asset based lenders** who are willing to provide loans to entrepreneurs with a condition that idle assets such as inventory or accounts receivables to be pledged as collaterals. **Trade credit** is another option with which entrepreneurs can extend their credit in the form of delayed payment. Entrepreneurs can also turn to **insurance companies**, **stock brokerage houses**, or **credit unions** for loans.

7.2.1 Equity Financing

Equity financing is obtained through investment made by investors in exchange for ownership. Unlike debt financing, it does not have to be paid back with interest. Instead, investors receive dividends based on the company's performance. Equity capital is also referred to as risk capital because the investors bear the risk of losing their investment if the business fails. Figure 7.8 encapsulates the basic characteristics of equity financing.

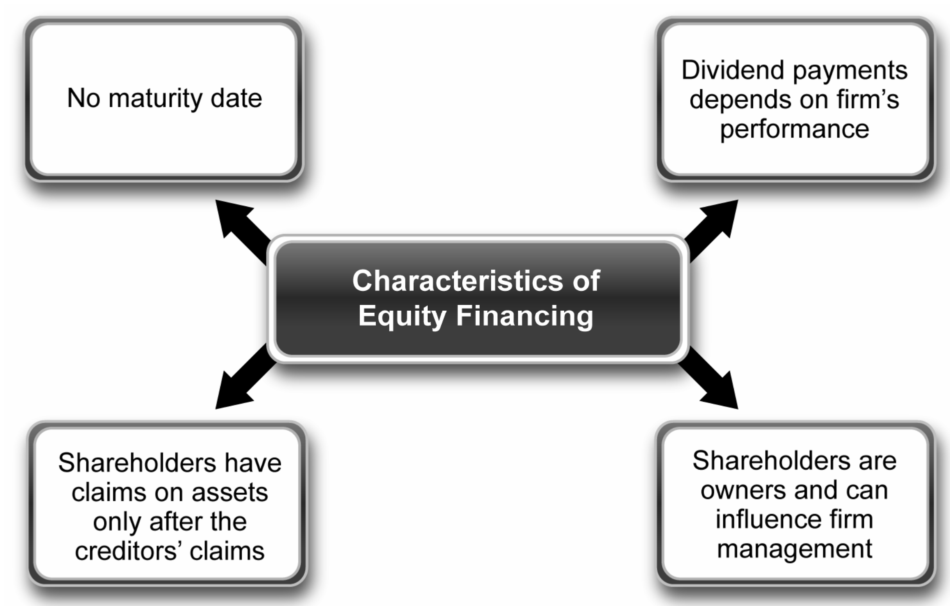

Figure 7.8: Characteristics of equity financing

Table 7.1 below discusses the numerous form of equity capital.

Table 7.1: Numerous Forms of Equity Capital

Forms	Descriptions
Personal Savings	Personal savings is a common form of equity financing and is usually the first place entrepreneurs look for funding. In fact, most investors and lenders would expect to see entrepreneurs devote some of their own money to the business before investing theirs.
Private Investors	**Friends** and **family members** are often more than willing to come forward to provide financial assistance. However, it is important to take note that failed business ventures may strain these relationships. It is always better to settle the details up front, create a written contract, and prepare a payment schedule that should go well with both parties. **Angels** are another form of private investors. These wealthy individuals back up emerging entrepreneurial ventures with their own money and harbour hopes of earning high profits when the ventures become successful. The only challenge is finding them. Here, networks of resourceful contacts play an important role.
Partners	Forming partnerships allow accumulation of additional resources. Entrepreneurs who come together as partners will pledge to jointly contribute to their venture in terms of funding, knowledge or activities and share the risks and rewards of running a business. There are two types of partners – active partners and sleeping partners. (i) **Active partners** are dynamically involved in managing the business and have unlimited liability, meaning that their personal assets are subject to attachment and liquidation to pay for the business debts. (ii) **Sleeping partners** (also known as silent partners) contribute capital for a business but relinquish any management responsibility, and unlike active partners, sleeping partners' shares of losses are limited to the amount of their invested capital.

Table 7.1 *(Continued)*

Venture Capital Firms	Venture capital firms are companies that invest money in small businesses operating in particular industries, in which they are familiar with and have high growth and profit potentials. Venture capital firms also look for business with competent management and competitive edge. In return, they expect a significant ownership interest in the business, which is typically 20 to 40 percent of a company. Since they risk a considerable amount of money, most business proposals are subjected to rigorous reviews and selection process.
Public Stock Sales	A company can also raise capital by selling shares of its stock to the public. Stock sales can be public (stocks sold to everyone through the stock market) or private (stocks sold to specific individuals). Going public paves the path for large amount of capital. However, the founder must be prepared to accept dilution of ownership and loss of control.

7.2.2 Other Methods

Below are the other sources of funding.

(a) **Factoring**

In most cases, a company's cash is trapped in the form of accounts receivable – credit extended to customers for purchases made. These are assets as the money will be received in the future. However, in times of need, a company may require money immediately and cannot wait for the payment to be received on the due date, in the future. Cash crunch can be reduced by using factoring.

> Factoring involves the selling of account receivables at a lower price than the face value of the account.

This allows the entrepreneur to have access to cash quickly and allow the buyer to make a decent profit when the account is settled in the future.

(b) **Leasing**

Purchasing assets such as equipment or machinery are expensive and most new start-ups may not have the necessary funds to do so. Therefore, new start-ups can resort to leasing these assets at the initial stages to reduce the need for additional funding. In analogy, this is similar to finding a house to live in. If you cannot afford to purchase a house, you can rent one instead.

(c) **Credit cards**
Small businesses also rely on credit cards to finance their business (Figure 7.9). It is becoming a popular alternative as credit card companies are usually not concerned about how you spend your money, as long as the bills are settled. In fact, customers are given the option to extend their credit by paying a minimal amount from their monthly bills and the remaining amount will incur a certain percentage of interest charge. Although this option seems convenient, it is a risky way to finance a business and it must be used with caution.

Figure 7.9: Credit card

It is not possible to identify which financing option is better than the other. One must carefully consider several factors such as:

(a) Costs of financing (interests, fees, dividends, and other possible charges)

(b) Time period of financing – long term or short term?

(c) Need for ownership control – are you willing to relinquish control?

SELF-CHECK 7.1

1. In what situations do you think debt financing would be preferred over equity financing? Discuss.
2. What factors do you think would influence a lender or investor to finance a business venture?

7.3 SECRETS OF SUCCESSFUL FINANCING

Table 7.2 describes some guidelines an entrepreneur may follow in order to be successful in financing their new venture.

Table 7.2: Guidelines in Financing New Ventures

Guideline	Description
Viable idea	Ensure you have a viable business idea in hand. The business venture must hold great potential for high profit and growth.
Creativity counts	Be creative! Creative business ideas and methods of searching for funds could get you the right sources of capital.
Be meticulous	Be meticulous in your preparation before approaching lenders and investors. Being thoroughly prepared reflects how serious you are with your venture and highlights your planning and management skills. This will boost the confidence of lenders and investors to finance your business venture.
The importance of networking	Build your network and contacts with resourceful people. You would be surprised how these contacts could help match your needs with someone out there who is looking for an opportunity to invest.
Maintaining good credit records	Lenders and investors want to know they can trust you with their money.
Provide explanation	Always explain how much money you need and how you plan to spend the money. Investors and lenders want to know whether their money would be put to good use.
Be confident	Finally, be confident! If you are not confident with your own business idea, it would be difficult to convince others to believe in it and finance it.

ACTIVITY 7.2

1. SMEs are always at a disadvantage when sourcing for funds. Do you agree? Why?
2. Ahmad plans to start an electronic manufacturing facility. He intends to rely solely on his RM15,000 savings to fund the start-up and fuel the growth of his firm. Is Ahmad being realistic? Justify your answer.
3. What are the potential obstacles for an entrepreneur seeking financing?

SUMMARY

- Start-up costs estimates determine how much fund you need to source for.
- Start-up costs include common categories such as inventory, machinery and equipment, office space, security deposits, licence, fees, permits, professional fees, advertising fees, working capital and unanticipated expenses.
- Start-up costs vary according to the type of business and industry. Therefore, the start-up costs checklist needs to be tailored accordingly.
- There are two major sources of financing – debt financing and equity financing.
- Debt financing is financing that must be repaid with interest. It includes financing by commercial banks, government agencies, finance companies and other sources such as trade credit, stock brokerage, asset based lender and so forth.
- Equity financing involves investment in exchange for ownership. Major sources of equity financing includes personal savings, private investors such as family, friends or affluent investors known as angels, partners, venture capital firms, and going public with stock sales.
- Other internal methods of financing that helps urgent financing needs includes factoring, leasing, and credit cards.
- When selecting the financing option, one must consider factors such as the cost of financing, time frame, and the desire for ownership control.
- It is recommended that the entrepreneurs seeking financing from lender or investors be thoroughly prepared, provide a detailed report on how much fund is needed and how it would be spent, confident with their business idea,

creative, maintain a clean credit record, and build networks with resourceful others. These are the success factors that influence successful financing.

KEY TERMS

Bank loans	Leasing
Credit cards	Partners
Debt financing	Personal savings
Equity financing	Private investors
Factoring	Start-up costs
Finance companies	Stock sales
Government financing	Venture capital firms