Chapter 4

Start-Up Financing

Raising capital at any stage of a company's growth is challenging and requires creativity and tenacity, but these hurdles are especially difficult to conquer at the earliest stages of an enterprise's development, when the business model is still under consturction and the track record for success is minimal or non-existent. In this chapter, we'll take a look at *where* and *how* to raise capital at the seed level—when you're first organizing your business, or when it is in its earliest stages of growth.

In the chapters that follow, we'll look at funding strategies that are commonly used after a business has gotten past the start-up phase and has established a steady flow of customers and a reliable revenue stream, even if the company is not yet profitable. These include alternatives to raising capital in the early stages, private placements (a more organized and expanded method of angel financing for moderate-growth companies), commercial debt financing (once the business has assets in place to serve as collateral for the loan), and ways to acquire resources that you would have purchased if you had raised capital. Later in the book, we'll explore growth-financing strategies, such as seeking institutional venture capital (for rapidly growing companies that offer exceptional potential returns on investment) or raising capital by taking your company public with an initial public offering (IPO). Then we'll offer some creative alternatives to traditional financing as ways to grow your business. The main thing to understand is that no one plan fits all: The strategies that are available to—and useful for—a particular company depend mainly on that company's stage of development and the nature of its business. What works for a start-up retailer may not work for a 10-year-old manufacturer, and neither of those strategies may work for an early-stage technology or social networking business!

At the seed level, you are looking for capital to acquire the initial resources that you need to launch the enterprise, attract and hire employees, conduct research and development, acquire computer systems, and build initial inventory. The lines have blurred among what was once a relatively clear-cut demarcation between seed investors, angels, and venture capital (VC) funds. We now have microangels, crowdfunding, superangels, micro-VC funds, "normal" VC funds, and mega-VC funds, whose typical investment size and style start bleeding into the private equity fund area. Other funds are laser-targeted on a particular industry, region, or situation [such as management buyouts (MBOs) or turnarounds]. Start-up funding has even become the topic of a reality television show, *Shark Tank* (www.abc.go.com/shows/shark-tank.com), where hopeful entrepreneurs are given an opportunity to present their business plans to five self-made millionaires who may invest in their companies, and TechStars (www.techstars.org), where entrepreneurs compete for capital resources and support. During the first season of the show on Bloomberg television, a wide variety of concepts were presented, ranging from a plus-sized women's clothing line to a children's medicine dispenser to a mobile application that helps mitigate college sports recruiting violations. Clearly, early-stage investing is still motivated by two parts cash and one part love and passion and faith, since many of the ventures can and will fail and the investors hope to get as much emotional reward from investing as they do financial return.

I'm devoting the rest of this chapter to the likely sources of seed and early-stage capital described in Figure 4-1. Although this stage of your business is characterized by frustration, struggles, setbacks, and delays, if you are creative and aggressive in your search, there are many sources of cost-effective seed capital available that will let you maintain control and majority ownership of the business.

Figure 4-1. Matching Capital Needs to Likely Sources.

Stage of Growth	Amount Probably Needed	Most Likely and Affordable Source of Capital
Seed/Early-Stage	**$25,000 to $500,000** (depending on type of business)	**(a) Founder/Team:** Personal savings, credit cards, home equity line of credit, 401(k) and retirement account/pension/life insurance borrowing. (It is critical to demonstrate to investors in future rounds of capital that you have risked your own assets and have some "skin in the game.") **(b) External investors:** Family and friends, angels, vendors, customers, key employees, Small Business Administration (SBA) loan and loan guaranty programs, third-party loan guaranties, severance and downsizing payments, liquidation of stocks and bonds, networking, university and private incubator programs, venture-investor clubs, advances on inheritances, ACE-Net and other Internet/database angel/investor matching services, foundation grants, and economic development agencies.
Growth Stage	**$500,000 to $3 million** (depending on rate and method of growth)	Private placements, superangels, bands of angels, institutional venture capital, commercial lenders, venture leasing companies, strategic alliances and joint ventures, corporate venture capitalists, small business investment companies or minority enterprise small business investment companies.

Stage of Growth	Amount Probably Needed	Most Likely and Affordable Source of Capital
Mezzanine/Bridge	**$1 million to $5 million** (financing at this level is usually tied to a near-term initial public offering)	Merchant banks, investment bankers, private equity funds, institutional international investors, commercial banks, small securities offerings (via Internet)
Harvest	**$2 million to $20 million** (depending on exit strategy and founder's personal goals)	• Initial public offerings • Creative exit strategies (franchising, licensing, and so on) • Mergers and acquisitions

Financing the Business with Your Own Resources

The combination of your own financial investment and time investment ("sweat equity") is a prerequisite to obtaining capital from third-party sources. The capital markets expect you to put your own funds at risk before you ask others to risk investing in your business. This is often called the "straight-face test" because you are able to look a venture investor in the eye and demonstrate your own commitment to the new enterprise and your belief in its potential. If you have co-founders, all of you are expected to make this type of commitment. This is true even if the level of personal investment varies because of differences in the partners' financial circumstances or the degree to which a particular individual contributes a particular skill, recipe, knowledge, or relationship—the intangible, nonfinancial aspect of contribution.

Your initial capital may come from savings, 401(k) plan loans (where permitted) or withdrawals, home equity loans, a severance package in connection with downsizing, credit cards, or other sources as set forth here. Of course, this also violates the OPM (other people's money) rule: Wherever possible, use other people's money to invest in a risk enterprise. But in the world of new-venture financing, the OPM rule usually goes out the window unless you're a veteran entrepreneur with an established track record and can demand that others risk their capital without your investing your own funds in the enterprise.

If I Don't Have a Rich Uncle, Where Can I Get the Initial Seed Capital?

Traditionally, entrepreneurs have used their own savings and credit (credit cards, home equity lines of credit, and other such sources) to finance the prelaunch expenses and initial seed investment for their companies. If you don't have liquidity in your personal or retirement savings, you may be able to borrow against your 401(k) account, pension, or life insurance policies.

Only you can dictate what portion of your life savings you're willing to risk, and prudence should dictate some level of conservatism, which may vary depending on both your immediate cash needs and your short- to medium-term goals and needs. An individual with limited savings and two children nearing college age should be very careful with his savings and may want to reconsider whether this is the right time to launch a business venture at all. Conversely, a young couple with toddlers and one working spouse may decide that this is a perfect time to use their savings to launch a business. They know that they have a steady source of income from the working spouse and plenty of time to replenish their savings if the business venture is unsuccessful.

Family, Friends, and Fools

After exhausting the portion of your life savings and available credit lines that you have determined is appropriate to finance the start of your business, the next most likely source of capital is usually those who love and trust you, or the three "*F*s"—family, friends, and fools. Whether they're looking for an equity investment or a formal or informal loan, entrepreneurs often turn to old friends and family members, who typically provide capital on the basis of a relationship rather than on the basis of financial rewards.

If your family is anything like mine, however, you may want to reconsider this strategy. You will have to be prepared to provide business-plan updates at family dinners and to be reminded weekly of "who helped you get started." The benefits of this inexpensive capital may be outweighed by the costs in terms of family dynamics and by the complex emotions of guilt, despair, and frustration if the business fails and the family investment is lost.

Turning to old friends for money may also be unwise, particularly when the friend is investing in your new business based on trust and can't really afford to lose the money if things go south. Business loans and investments have ruined a lot of long-standing relationships over the years. The catch-22, of course, is that if things go very well, then your family and friends wind up arguing with you because you didn't give them a chance to participate. Again, you know your friends and family and their tolerance for risk, and only you can decide whether it will be advisable or appropriate to approach them for seed and early-stage capital.

If you decide to solicit friends and family as a source of capital, you must be very open and honest about the risks and rewards of the enterprise—and the risks are likely to be much more significant than the rewards in the early stages of the business. Make sure that they know that this is *not* like investing in the public stock market, where public reporting, a track record, and the availability of liquidity protect against downside risk. You should also put the terms of the investment arrangements in writing to formalize the transaction and to avoid confusion about the rights and responsibilities of the parties.

Family Business Offices

Many wealthy families have set up formal business offices, with financial managers handling investments, the review of proposals, reporting to family members, and related tasks. Different family business offices (or FBOs) will have different processes for evaluating prospective investments. Some are quite formal and are operated as quasi-venture capital funds with essentially one investor (the family), and others are very informal, with no clear-cut strategy or focus, or even a web site. Many FBOs will co-invest in or "piggyback" on transactions that are being considered by local angel groups or venture capitalists, and many rely heavily on their personal networks to generate deal flow. As of the fall of 2011, it was estimated that there are more than 3,000 FBOs in America; some may be U.S. offices of families abroad, and there may be many others that do not formally report their operations. Most of these FBOs are focused on wealth management and venture investment, *not* on running the underlying family business. Most of them have $100 million or more under management, and their investments include real estate, stocks and bonds, precious metals, and venture capital–style investments, either on a stand-alone or a syndicated basis.

Heaven on Earth—Finding an Angel Investor

Once you've demonstrated that your own funds are at risk and that you have exhausted your "emotional investors" (family, friends, coworkers, and others who love and trust you), it's time to begin your quest for an angel. If flying with angels isn't your cup of tea, then pay close attention to the other likely sources of seed and early-stage capital that are discussed later in the chapter.

The term *angel* originated on Broadway, where wealthy investors provided funds to aspiring directors to finance the production of a new musical or drama. The motivation for these investments included financial reward, but they were mainly driven by a love for the theater and the chance to develop friendships with aspiring actors, playwrights, and producers. The point was that these investors provided high-risk capital and were motivated by something more than money. Even today, playwrights, artists, producers, and musicians often rely on the altruism of others to advance their projects or careers; likewise, an aspiring entrepreneur must rely on something other than financial reward as an impetus for an investment. Your focus in meeting and presenting to angels must be more on what makes this *person* motivated to invest than on what internal rate of return (IRR) will be attractive to her wallet.

Beyond Broadway, angel investing has become a critical source of financing for seed and early-stage companies. From Arthur Rock in the early 1960s, whose angel dollars and capital-formation efforts helped launch companies such as Intel and Apple Computer, to cashed-out entrepreneurs such as Lotus founder Mitch Kapor, whose angel investments include RealNetworks and UUNET, to new-economy multimillionaires and Internet pioneers like Ted Leonsis of America Online, thousands of modern-day angels have played a key role in the launch, development, and financing of scores of early-stage companies, as well as provided mentoring and assistance to thousands of entrepreneurs. Some active entrepreneurs play the dual role of angel and active CEO, such as Tim O'Shaughnessy, who is the leader of Living Social and an angel investor in start-up 410 Labs, based in Baltimore. Interestingly, the investors in Living Social included former AOL CEO Steve Case. As of the date of publication, Living Social had raised $630 million in venture capital and was in the process of filing for its initial public offering (IPO).

Angels come in different shapes and sizes and often invest for very different reasons. Some are motivated by something much larger than financial return—a good thing, since it is hard to convince someone with a net worth of $125 million that *your* deal will make him rich. There are "checkbook angels," usually friends, neighbors, and others, who typically invest $5,000 to $25,000 on a passive basis, hoping to get in early on the next Yahoo!. Then there are "capital-A" angels, who typically invest $50,000 to $250,000 on a more active basis and who may insist on having some advisory or mentoring role as a condition of their commitment. Finally, there are the "superangels," the cashed-out multimillionaires and even billionaires who have the capacity and the guts to invest $500,000 to $2 million in an early-stage enterprise in a deal that may look more like a venture capital transaction (from a legal paperwork and control perspective) than like a deal made in heaven!

The recession led to a contraction in the angel investor market, but it has since started to spring back, and it remains a continually increasing source of seed funding. In 2008, angel investment dollars had decreased 26.2 percent from 2007 levels, signaling that these investors were significantly more cautious than they had been in prior years. In 2009, the contraction slowed, but continued, with an 8.3 percent decrease in the amount invested from 2008. Thankfully, this trend came to a halt in 2010, and the market began to rebound, with $20.1 billion in investments (a 14 percent increase over 2009).

The Importance of Angels

Although the business media tend to focus on the activities of the institutional venture capital firms, the amount of money that is invested in growing businesses by angels or private investors each year is much, much greater. Researchers at the Center for Venture Research at the University of New Hampshire estimate that 265,000 active angel investors are investing some $20 billion annually in 60,000 ventures. In contrast, institutional venture capital funding was estimated to be $10 billion—or half of that amount—in 2008. Angel investors have become a critical source of seed capital at a time when venture capital funds are leaning toward later-stage investments. The amount of money managed by venture capital (VC) firms has grown dramatically, from $2.3 billion in 1986 to more than $60 billion in over 800 VC firms in 2003, according to a study. By 2009, there were 2,624 reported venture capital financings, raising a total of $24.9 billion. But the number of ventures under management remains small because it takes as much time to research and manage a small investment as a large one. Thus, the average first-round investment by a venture capital firm is now about $5.6 million, eliminating many entrepreneurs who are looking for investments of as little as $50,000. The enormous success of the venture capital industry has opened a window of opportunity for angels or private investors looking for start-ups in which to invest.

Angels Versus Venture Capitalists

Before the second half of the twentieth century, American private equity investing was dominated by families and individual placements in emerging-growth opportunities. Wealthy families and individual investors provided start-up capital for companies such as Xerox and Eastern Airlines. The birth of the venture capital industry is generally considered to be the formation in 1946 of the first pooled and professionally managed fund, American Research & Development (ARD). As a limited partnership, ARD and other early funds offered a passive, diversified approach for investors in earlier-stage private companies.

Over the last 40 years, the VC fund model has become a centerpiece of the alternative-asset arena. Venture firms have grown larger, with more funds coming from large institutions, pension funds (which were permitted to make a limited amount of venture capital investments when the "prudent man" rules were revised in the 1980s), corporations, and endowments. Today only 20 percent of institutional venture capital is derived from individuals and families. Paid professionals—general partners of these limited-partnership vehicles—have taken over responsibility for searching, researching, negotiating, closing, monitoring, and developing exits for these types of investments.

Angel investing has grown significantly in recent years as the baby boomers near retirement with significant wealth. Angels also include cashed-out entrepreneurs who may have feathered their nests by selling their business or taking it public. Some angels provide capital to entrepreneurs as a type of quasi-philanthropy, a way to give something back to their communities by fostering local economic growth. Others are savvy private investors who are also helping entrepreneurs launch new businesses along the way. It is critical for an entrepreneur who is seeking angel investment to understand the angel's needs and motivations, then take steps to meet these needs. Maybe you're the son or daughter that the angel never had; maybe you remind her of herself when she was younger; or perhaps she just wants someone to coach. Maybe the angel has retired and needs to get out of the house and feel useful; maybe she has expertise and relationships that she wants to share; or maybe she's just bullish on your industry and is looking for a way to participate. It's your job to discover the reason and structure your relationship accordingly.

The size of the investments that angels make varies depending on the type of investor, but angels typically invest anywhere from as little as $50,000 to more than $1,500,000. Since the recession, the amount invested by venture capital firms has fallen, leaving an increasingly large gap for angel investors to fill. However, it is important to understand that getting angel investing for your first round of financing (or "first sequence") has become increasingly difficult. This is not because the amount of money invested by angels has dropped in the past several years (although it has), it is because fewer angels are investing in first-sequence rounds of financing. In fact, first-sequence financing represented 45 percent of all angel investments in 2008, but this figure dropped to 30 percent in 2010. This drop has been attributed to a variety of causes: the need to increase investments in existing portfolio companies to keep them afloat, a cautiousness resulting from the recession, and the fact that more and more start-ups require less initial capital than before and have been finding more creative ways to get started. For entrepreneurs who are in search of angel investors for early-stage seed capital, there is an increasing need to be more competitive and prepared in seeking it out.

Profile of a "Typical" Angel

Generalizations about a group as diverse as the informal investor population are hazardous. Nevertheless, the data reveal a number of interesting characteristics. Despite the pitfalls, and as a starting point for discussion and further research, the following profile of the mythical "typical" angel is offered:

- Age 47
- Postgraduate degree, often technical
- Previous management experience with start-up ventures
- Invests between $50,000 and $100,000 in any one venture
- Invests approximately every two years
- Participates with other financially sophisticated individuals
- Prefers to invest in start-up and early-stage situations
- Willing to finance technology-based inventors when the technology and markets are familiar
- Limited interest in financing established, moderate-growth small firms
- Strong preference for manufacturing ventures, high technology in particular
- Invests close to home—within 300 miles and usually within 50 miles
- Maintains an active professional relationship with portfolio ventures, typically in a consulting role or by serving on the board of directors
- Not especially interested in diversification or tax-sheltered income as an investment objective

- Expects to liquidate an investment in five to ten years
- Looks for compound annual rates of return on individual investments, ranging from more than 50 percent from inventors to 20 percent from established firms
- Looks for minimum portfolio returns of about 20 percent
- Often will accept limitations on financial returns or accept higher risks in exchange for nonfinancial rewards
- Learns of investment opportunities primarily from friends and business associates
- Would like to look at more investment opportunities than the present informal system permits

The characteristics of different types of angels are given in Figure 4-2, and some of their perspectives on what they are looking for are given in Figure 4-3.

Almost half of all known angel groups have banded together to form a trade association called the Angel Capital Association (ACA). In 2009, the 5,632

Figure 4-2. Types of Angels.

1. ***Enthusiasts.*** (Older, more established investors, successful and with a short work schedule)
   - Invest $10,000 to $100,000.
   - Satisfied with making the deal.
2. ***Professionals.*** (Have another profession; invest in companies in their field because of knowledge and comfort factor)
   - Invest $25,000 to $200,000.
   - Paranoid investors—want to be hired by the company.
   - Main goal is to increase personal wealth.
   - Devote a lot of capital to risky, unproven ventures.
   - Instrumental in helping entrepreneurs past the family stage.
   - Both entrepreneur and angel need to complete their due diligence.
3. ***Micromanagers.*** (Serious, business savvy, built their own success)
   - Sense of self-entitlement because of successful ventures.
   - Like to share strategies and gain a seat on the board.
   - Invest $100,000 to $1 million if they "believe".
4. ***Corporate.*** (Most were senior managers at Fortune 500 companies)
   - Took early retirement or were laid off.
   - Main goal is profitability of investment.
   - Possess a minimum of $1 million capital and invest up to $200,000.

5. ***Entrepreneurial.*** (Currently own personal successful businesses)
   - More willing to take risk because of business and entrepreneurial attitude.
   - Enjoy personal fulfillment from helping fellow entrepreneurs in their ventures.
   - Devote from $200,000 to $500,000.
   - $20.1 billion invested in 2010, up from $17.6 billion in 2009.
   - 62,000 ventures funded in 2010, up from 57,000 in 2009.
   - 18.4 percent yield rate—abnormally high.

Figure 4-3. What Do Angels Really Want?

Here are some interesting perspectives from well-known angel investors:

"Angels are a unique blend of sophisticated private investor and mentor to entrepreneurs. They never have to write a check—they do it because it is in their blood and temperament to help entrepreneurs to create something new out of the ether. An angel looks at passion, drive, vision, the ability to network along with desire, as much as patents and finished product and cost of good sold. The higher the goal, the more we angels strive to become the 'systems integrators' of the new and innovative. We look for something compelling and special—in that we see hundreds of plans and invest in only several a year. Entrepreneurs should strive to exude confidence, passion, and drive—we are backing the jockey, not the horse, as the old saying goes."

—John May, New Vantage Partners, quoted in *Every Business Needs an Angel*

"I look for companies that solve problems in intelligent and friction-free ways and which break traditional boundaries."

—Ashton Kutcher, Hollywood actor and angel investor

"We're in a golden age of start-up innovation because the cost of starting a company has crashed through the floor. I want to see companies that leverage these efficiencies."

—Mitch Kapor, founder, Lotus Development

"I love hearing about other people's dreams. Tell me about your dreams and, like Pavlov's dog, I begin to salivate. Encouraging (and funding) people's dreams makes me happy, and I am good at it!"

—Whitney Johnson, Rose Park Advisors, columnist and angel investor angel investors who were participants in the ACA made 947 investments in 512 companies, providing $228.8 million to start-up ventures. The ACA member survey provides the basic demographics of its angel groups, reporting that:

- The average angel group invests in 3.8 companies.
- The average angel group investment is $241,528 per round.
- The median age of a group is three years.
- The average age of the investors in the group is 47.
- The average size of a group is 47.6 members, with a median of 37 members.

With that said, the ACA estimates that 17.5 percent of angel group members invest individually in each deal that is done as a group. More than 50 angel groups have formed nationwide as private, seed-round investing has begun to regain its popularity. Angels have a greater tendency to be drawn by the potential equity returns of funding new technology companies. As of the end of 2010, more than a million accredited angels have a total of $20 billion invested in more than 30,000 technology start-ups.

Finding an Angel

While you can find individual angels through referral from an accountant or attorney, angels are increasingly participating in a variety of networks.

Nonprofit angel networks. There are more than 50 loose-knit organizations nationwide through which investors learn about opportunities, attend programs on investing, and develop a sense of community. These networks are usually run by nonprofit entities, have tax-exempt status, and are oriented toward economic development. The greatest benefits come from community building among investors and creating a more efficient marketplace in which entrepreneurs can approach sources of capital.

Pledge funds. A more recent phenomenon involves pools of funds in which investors (anywhere from a handful to dozens) pledge a specific amount of money, to be invested in private equity transactions that are selected and managed by the group. Sometimes the group has a centralized paid staff; sometimes it is led and organized by a lead investor. These groups set legally rigorous standards, are focused, and are designed to profit from multiple transactions.

The club approach. In this model, investors place a set amount of money into a "club" account that is used like a venture fund to make investments that have been found and voted on by club members. These clubs can be staffed or unstaffed. More money can be accumulated than an individual can afford, and a more diversified fund can be created. Group dynamics are involved because each member must review potential opportunities in order to decide to "vote" for or against a deal.

CEO angels. In this situation, a small venture fund, usually a limited partnership, is created by investors drawn from a specific business community. They provide assistance as well as capital to chosen companies, which are usually from the same field. Members of the group may take on general partnership responsibilities, or professional managers can be employed. This model is very similar to the traditional venture capital model, except that the investments are more focused and the limited partners are more active in helping to find opportunities and providing hands-on assistance to the companies chosen.

Active angels. In this model, angels propose to play a more active role in the growing company once funds are committed. Some angels in this model are really looking for full- or almost full-time employment with the companies in which they invest.

Hybrid Approaches to Angel Investing

The growth of social networking has inspired some hybrid approaches to angel investing. For example, the founders of Venture Hacks (www.venturehacks.com) launched AngelList.com in early 2010, with the support of the Kauffman Foundation, and by July of 2011, the entrepreneur-angel social networking site had claimed responsibility for 8,000 introductions, 400 investments, and 8 acquisitions, and that is just one type of data that gets reported by the community (http://angel.co/). Investors have included some of the world's top venture capital firms and angel investors, including Kleiner Perkins and Andreessen Horowitz, Mitch Kapor and Dave Morin. Fast-growth start-ups such as Uber, Yipit, Wanderfly, BranchOut, and many more have been successfully matched up with their ideal investors on this web site, which serves as a cross between the dating service Match.com and the social networking phenomena Facebook and LinkedIn.

Another hybrid model is Lightbank (www.lightbank.com), which looks a bit like a hybrid of a venture accelerator, an angel group, and a traditional venture-capital firm. The Lightbank team, led by veteran entrepreneurs Eric Lefkofsky (the co-founder of Groupon) and Brad Keywell, has launched 5 companies, invested in more than 20 start-ups, and raised more than $1.2 billion to invest in more companies. Lightbank provides strategic expertise, access to its networks, and technology support and infrastructure to its portfolio companies. It looks for start-ups with great teams, disruptive technologies, and large, addressable target markets. Interested entrepreneurs apply online to demonstrate that they have a game-changing idea for investment consideration by initially answering a few simple (but insightful) questions:

- What is your brilliant idea?
- Who are your people?
- Why should we be interested?
- How are we going to make money together?
- Where can we reach you?

You can also submit an attachment (such as PowerPoint slides, an executive summary, or a business plan) of up to 10 MB to support your business model and communicate your vision. If your idea makes it through the initial screens and filters, you'll be invited to Chicago to pitch the team in person and possibly play them at Ping-Pong. Really.

Asking an Angel to Dance

From a practical perspective, it's just as important for you to perform due diligence and prequalify your prospective funding sources as it is for the angel to scrutinize your business plans and evaluate your management. In addition to the regional or national angel networks mentioned earlier, there are a number of online resources that can direct entrepreneurs to private investors. You should also attend venture and trade fairs and forums (see Figure 4-4). Networking through friends and associates—getting out there and talking to as many people as possible—is still the best way to find an angel. Remember, dancing is, in the end, a person-to-person activity.

You can also find potential angels through networking in business and venture groups, private investor clubs (which usually have organized monthly presentations by entrepreneurs to potential prequalified angels), venture capital networks, incubators, industry trade associations, university and fraternity/sorority alumni

Figure 4-4. Where to Find an Angel.

ANGEL FUNDS AND CLUBS

Active Angel Investors
c/o New Vantage Group
402 Maple AVE West
Vienna, VA 22180
(703) 255-4934
www.activeangelinvestors.com/index.htm

Mid-Atlantic Angel Group
www.magfund.com

ARC Angel Fund
885 3rd Avenue, 20th Floor
New York, NY 10022
www.arcangelfund.com

AngelList.com
http://angel.co

ANGEL NETWORKS

Angel Investment Network
www.midwestinvestmentnetwork.com

Investor's Circle
165 11th Street
San Francisco, CA 94103
(415) 255-6844
www.investorscircle.net

Minority Angel Investor Network
Building 100 Innovation Center
Suite 200
S. 13th ST & Constitution AVE
The Navy Yard
Philadelphia, PA 19112
(215) 564-6857
www.minorityangelinvestornetwork.com

Rain Source Capital
1600 University Avenue West
Suite 401
St. Paul, MN 55104
(651) 632-2140
www.rainsourcecapital.com

ONLINE RESOURCES AND SERVICES
A wealth of information about angels, or informal private equity, exists on the Web. Here are a few of the most comprehensive resources.

Venture Funding Network
www.venturefundingnetwork.com

Mid-Atlantic Venture Association
www.mava.org

The Angels' Forum
www.angelsforum.com

SBIC Program
www.sba.gov/content/sbic-program-0

Technology Capital Network at MIT
www.thecapitalnetwork.org

Angelsoft
www.angelsoft.net

Go BIG Network
www.gobignetwork.com

FundingUniverse
www.fundinguniverse.com

TheFunded
www.thefunded.com

Angel Capital Association
www.angelcapitalassociation.org

VENTURE FORUMS

Baltimore-Washington Venture Group
c/o Dingman Center for Entrepreneurship
The Robert H. Smith School of Business
University of Maryland
College Park, MD 20742-1815
(301) 404-2144
www.rhsmith.umd.edu/Dingman

Charlottesville Venture Group
P.O. Box 4547
Charlottesville, VA 22905
(434) 231-5255
www.cville-venture.org

Florida Venture Forum
2121 Ponce de Leon BLVD
Suite 720
Coral Gables, FL 33134
(305) 446-5060
www.floridaventureforum.org

New York Venture Group
347 West 57th Street
Suite 4C
New York, NY 10019
www.unifx.com/nyvg.html

VENTURE FAIRS

Angel Venture Fair
held at: 140 South Broad Street
Philadelphia, PA 19102
(215) 563-6500
www.angelventurefair.com

Mid-Atlantic Venture Fair
c/o Mid-Atlantic Venture Association (MAVA)
1600 Tysons BLVD
Suite 575
McLean, VA 22102
(703) 506-9300
www.mava.org

The Gathering of Angels
#4 Hawthorne Circle
Santa Fe, NM 87506
(505) 982-3050
www.gatheringofangels.com

MATCHING SERVICES AND ONLINE BROKER-DEALERS

Garage Technology Ventures
502 Waverley ST
Suite 300
Palo Alto, CA 94301
(650) 838-0811
www.garage.com

Virginia Center for Innovative Technology
www.cit.org

meetings, social and country clubs, and virtually any other place where semiretired and cashed-out entrepreneurs may hang out. Angels may invest alone or as a group through clubs and networks ("bands of angels"), and while many won't individually consider a deal that requires more than $50,000, a growing number of very-high-net-worth individuals ("superangels") will invest $500,000 or more of their own money and help you identify other potential investors. These superangels also bring respect and credibility to a new business because others respect their expertise and industry knowledge.

As I mentioned earlier, you've got to do your own due diligence on each angel you consider. Remember that the relationship is akin to that with a spouse or parent—so you have to be sure that you can get along personally with the individual. You'll also need to define your nonfinancial expectations and have a meeting of the minds on these issues. A good angel offers you (and your business) a lot more than money, and you need to reach an agreement regarding how much of the angel's time will be available for advice, coaching, and mentoring, and also what doors the angel is expected to open on your behalf. Ideally, your angel should have a diverse (and current) network, deep industry experience, and significant company-building experience, in addition to being a source of seed capital. The angel-entrepreneur relationships that don't work out over the years often fail because of misunderstandings about the nonfinancial aspects of the relationship.

Angels or Devils—You Be the Judge

In the rough-and-tumble world of new-venture investing, one common myth is that angels—because they invest in part for nonfinancial reasons—are somehow kinder and gentler in the way they structure deals. While it may be true that few angels want seven inches of legal documents to govern their deals, they also will not tolerate a cocktail-napkin or handshake deal. They didn't amass their wealth by being pushovers, and the same holds true in their venture investing. Be prepared for some tough one-on-one negotiating over risk, control, and rewards with a sophisticated angel who has a first-rate advisory team. These high-paid advisors usually view their mission as protecting their wealthy client from bad deals or transactions that haven't been carefully thought out or properly structured. For more information on the advantages and disadvantages of attracting an angel investor, see *Every Business Needs an Angel* by John May and Cal Simmons (Random House, 2001).

Understanding Angel Investment Club Criteria

Each angel investment club has its own processes and criteria for the decision-making process, and some of these vary by region. Set forth here are the "10 investment commandments" of the California-based The Angels' Forum (www.angelsforum.com), which made its first investment in 1998 and remains an active investment club today.[1]

1. *Management:* Thou shalt invest in good management that demonstrates an ability to execute the business plan rapidly, provide sound cash management, raise additional cash, lead the organization, and adjust the business plan where necessary. Thou shalt seek leaders with industry expertise who are driven and charismatic.
2. *Board of Directors:* Thou shalt invest only in companies where the majority of the board is composed of strong outsiders, who possess solid business experience in the industry and/or in the stage of the company. Said directors shall push the company to execute the business plan rapidly within cash constraints and shall have also have the ability to recognize the need for a CEO change and act swiftly in implementing it. Thou shalt seek Directors with good contacts for initial customers and/or raising capital.
3. *Business Plan:* Thou shalt seek business plans that effectively address the technology, customer acquisition, and competitive challenges, to establish the business with realistic gross margins, unit volume, and return on capital invested.

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4. *Access to Capital:* Thou shalt identify and establish relationship with sources of capital with a history of investing in like kinds of businesses in the amounts needed for the company. Thou shalt work with these co-investors for the betterment of the company and all investors.
5. *Product Need:* Thou shalt invest in companies that have an in-depth knowledge of their customers' usage habits and needs (through to the end user). Thou shalt forsake all those "nice to have" products or services and save thy resources for "must haves."
6. *Sustainable Differentiation:* Thou shalt invest in companies that have advantages such as patents, first-mover position, world-class technologists, proprietary processes, and/or key customers under contract.
7. *Market Size and Trajectory:* Thou shalt invest in companies that have large and/or rapidly growing markets or can realistically create such markets. Thou shalt invest in companies with a low risk of market loss to alternative technologies.
8. *Technology Risk:* Thou shalt have sufficient technical expertise at the table, or through thy trusted contacts, to evaluate all product and technology claims before committing thy resources.
9. *Investment Execution Risk:* Thou shalt have established the ability to influence key company decisions, create and link milestones to capital rounds, and seek early customer learning, as through use of prototypes. Thou shalt receive a fair valuation on thy investments and not release investment funds until the full round is raised. Thou shalt stay involved and work with companies to assist—aggressively if necessary—in their success. Thou shalt invest only in those companies that provide a clear exit strategy for thy investment.
10. *Investment Evaluation Risk:* Thou shalt ask tough questions of the company, listen to the market, and discuss the company with other investors. Thou shalt always speak the truth with thy fellow Members and be loyal in voicing any opposition or apprehensions, now and forever and ever.

Other Sources of Seed and Early-Stage Capital

Let's assume that your personal funds or credit lines are limited, either your friends and family have no money or you don't want to ask them for it, and angel investors are not for you—what alternatives do you have? There's still hope for finding money at the early stages. In fact, over the past several years, there has been something of a groundswell in the creative financing area: With options such as microloans, incubators, accelerators, and crowdfunding, there are a variety of ways to finance your project with nontraditional sources of capital. In the realm of high-probability/low-cost capital-formation options, consider the following creative sources.

Incubators

Often it is very difficult for a company to meet the initial capital requirements that come with starting up. In these cases, what is called an *incubator* can prove to be very helpful. Many angel investors and cashed-out entrepreneurs look to and start up business incubators to find potential investments and mentoring opportunities. These types of organizations are interested in getting a firm past the often tough start-up phase that so many businesses fail to survive. They can help to defray or eliminate some of the initial costs that many start-up firms face. It is for these reasons that about 87 percent of the firms that have gone through a business incubator stay in business once they graduate, according to the University of Michigan.

There are a number of areas in which incubators typically provide assistance to young firms. The first of these is physical office and storage space. Most entrepreneurs do not have the space to run a business efficiently from their home or place of residence, but buying or renting space from which to operate the business can be too costly and make the venture seem unattractive to many potential entrepreneurs. It is not uncommon for an incubator to provide flexible space and leases at very low rates to the new firm.

Entrepreneurs of start-up firms may also receive support in several other ways. Discounts on fee-based support services like fax and copy machine access, bookkeeping, telephone answering, secretarial assistance, meeting rooms, and libraries can help tremendously in reducing the cost of a new venture. These services involve many key day-to-day tasks that must be completed to ensure that the company can run smoothly. While these services can be vital to a firm's survival, many entrepreneurs who are not affiliated with an incubator may choose to attempt to do them on their own or forgo them completely to avoid the costs.

Employee-focused services are also a common part of many businesses' cost structures. Providing health insurance, life insurance, and other such services can be quite costly to the firm. Incubators can frequently get group rates for many of these services that can bring down their price and make them affordable to the business owner.

In addition to providing their own money, incubators can help entrepreneurs find additional funding. Insight into how and where money can be obtained on terms favorable to the entrepreneur is a main reason many individuals contact an incubator. Incubators also tend to know many wealthy individuals or angel investors who may express an interest in investing in the venture.

Incubators can provide much more than money to a firm. They offer business advice on many levels. They have had a hand in growing many businesses, and they are very knowledgeable about the challenges that often arise. They have lots of experience to share with entrepreneurs on how to grow their business, make it self-sustainable, and make it profitable. The voice of experience can be just as valuable as the services and capital that an incubator brings to the firm, if not more so.

As a result of years of helping small businesses grow, incubators are able to build up an impressive list of contacts. An incubator can introduce the entrepreneur to a large number of individuals who may be beneficial to the company. People who are well versed in a specific industry, can provide technical assistance, create and maintain strong supply chains, provide funding, and offer any number of value-adding insights can help a start-up take off.

Information on a number of business incubators is given in Figure 4-5.

University and Private Incubators

Many universities have established business incubators, both to foster entrepreneurship and to assist in the "birthing" of new businesses and ideas. These incubators offer shared resources, on-site advisors, cooperative research and development, and the natural synergies of having entrepreneurs with different ideas all at the same venue. A more recent trend is the "private incubator," often established by cashed-out entrepreneurs who offer their expertise as well as the physical facilities to foster business growth and development.

Advantages of Business Incubators

- Greatly increase the likelihood of survival for start-up firms
- Create jobs in the community, helping to retain individuals who might otherwise leave the area because of lack of job opportunities

Figure 4-5. Incubator Resources.

Alabama Business Incubation Network (ABIN)
1020 Ninth Avenue, SW
Bessemer, AL 35022
(205) 481-2101
E-mail: bessemerincubator@yahoo.com

Arkansas Business Incubator Manager Association
c/o GENESIS Technology Incubator
1 University of Arkansas Engineering
Research Center
Fayetteville, AR 72701
(501) 575-7227

Colorado Business Incubator Association (CBIA)
c/o Alcott Administrative Services
2738 S. Newton Street
Denver, CO 80236
(303) 934-9117

Illinois Small Business Development Center
c/o Illinois Department of Commerce and Economic Opportunity
500 E. Monroe
Springfield, IL 62701
(309) 837-4684
www.commerce.state.il.us/dceo

Louisiana Business Incubator Association (LBIA)
7117 Florida BLVD
Baton Rouge, LA 70806
(225) 218-1100
www.lbia.org

Maryland Business Incubation Association
c/o Maryland Technology Development Center
9700 Great Seneca Highway
Rockville, MD 20850
(240) 832-3612
www.mdbusinessincubation.org

Mississippi Business Incubator Association
c/o Mississippi Development Authority
P.O. Box 849
Jackson, MS 39205
(601) 359-3593
E-mail: jbrandon@mississipi.org

National Business Incubation Association (NBIA)
20 East Circle DR #37198
Athens, OH 45701
(740) 593-4331
www.nbia.org

Business Incubator Association of New York State, Inc.
P.O. Box 95
Albany, NY 12201
(518) 689-0553
http://bianys.com

Oklahoma Business Incubator Association
c/o Pioneer Technology Center Business Incubator
900 N. Stiles AVE
Oklahoma City, OK 73104
(405) 377-2220
(405) 809-3553
www.okbia.org
E-mail: bonniec@pioneertech.org

Pennsylvania Incubator Association (PIA)
c/o Corry Industrial Center
1524 Enterprise RD
Corry, PA 16407
(814) 664-3884
E-mail: rnovo@corryidc.org

Texas Business Incubator Association
9600 Long Point Road
Suite 150
Houston, TX 77055
(713) 932-7495
www.tbiaonline.org

Wisconsin Business Incubator Association
2320 Renaissance BLVD
Sturtevant, WI 53177
(262) 898-7524
www.wbiastate.org

- Target low- to moderate-income groups
- Place fledgling businesses together, allowing tenants to participate in joint problem solving, support others facing similar problems, exchange information, and discuss mutual commercial interests

Disadvantages of Business Incubators

- Require long start-up time (but the community can be working with entrepreneurs during the start-up period to provide business planning and assistance)
- Carry high start-up cost
- Demand a continual operating budget
- May never become self-supportive
- Most businesses started in an incubator do not grow to be large businesses
- Existing businesses may not be supportive because of fear of competition

Accelerators

After the dot-com bubble burst, the incubator model lost popularity, and many incubators disappeared between 2003 and 2009. Over the past few years, however, an alternative form of incubator has begun to pop up: the accelerator. While sharing some characteristics with incubators, accelerators are a new utility used to achieve business growth and have proved fruitful for several start-ups. Accelerators typically provide start-ups with mentoring, expertise, a small amount of financing (typically about $20,000), and connections to angel and venture capital in exchange for equity (typically about 7 percent). Unlike incubators, accelerators are not conducive to allowing a business to grow slowly. They are usually based on a boot-camp model to get businesses going in a few months. Many companies that are chosen to take part in an accelerator are successful in finding further rounds of financing through the venture capital connections that they made during the program.

Many established businesses have a desire for rapid growth. After a certain point in their life, however, most firms experience a growth slowdown. While some companies are satisfied with their position in the market, others want to jump-start their growth. Some angel investors and angel investor groups provide business accelerators that cater to these companies. Many angels who are not affiliated with the accelerators will also look to them for potential investment opportunities. With the help of an accelerator, a firm can get its growth onto the fast track to a degree that it was not previously able to achieve.

Business accelerators differ from incubators in that they are much more focused on in-depth technical training, software, marketing, and Web presence. In addition, accelerator programs are typically for-profit, whereas incubators are mostly nonprofit organizations. Companies will choose a business accelerator when the most basic functions of a business are intact and there is a need for more of an emphasis on communication technologies and the development of an Internet presence.

In-depth technical training is important to many accelerator programs. Business owners and key employees are taught the skills they need to be able to use and maintain complicated software and develop technologies to maintain a competitive edge. Database, bookkeeping, and inventory tracking software are just some examples of technology that businesses need to be able to use to accelerate their growth.

Marketing is another aspect of most accelerator programs. If a business wants to increase the number of units it sells or increase its customer base, marketing is an obvious choice. A business accelerator will teach firms how to identify their target market and who is most likely to buy their product. It can even help a firm discover how to break into other markets and demographics. Companies will learn how to improve their sales skills and leverage affordable marketing tools to achieve the greatest impact.

Web presence is one thing that has been proven to stimulate business growth in the past. A larger presence on the Internet leads to more exposure in an increasingly digital business landscape. Use of the Internet can streamline many sales and marketing functions. Simple programs such as Facebook and LinkedIn can be used to increase sales calls, while more complex but easy-to-use ordering systems allow customers to make purchases faster and more easily.

While business accelerators can be very useful in getting a business on the fast track, they do have some drawbacks. Most accelerator programs are a service in exchange for fees. If the company does not derive more value from the accelerator program than it puts in, then its participation in the accelerator could be detrimental to it.

Also, businesses in accelerator programs are looking to grow and increase sales. While most of these companies are in stable financial positions, some may have seen the growth and increased sales promised by most accelerators as the only way for the company to survive. It is possible that these companies are in the red and are merely looking for a way to save a sinking ship.

Companies in accelerator programs may also have an inexperienced management team that has difficulty dealing with high growth. Even though this is what accelerator groups are set up to help with, not all accelerators are created equal. The quality of the accelerator program itself should be evaluated to determine the expectations for the health of the companies coming out of it.

Unexpected growth should not always be considered a drawback. Accelerator programs prep businesses to grow. Most of the time, these companies will be ready to take on the increase in growth with little interruption to their normal business activities. If a business is growing rapidly and cannot handle the growth, an angel investor with experience in the industry may be the best thing for the company. The investor should be able to determine whether the company needs help in handling growth and whether he can help before he provides the firm with any money.

Figure 4-6 provides information on a number of business accelerators.

Advantages of Business Accelerators

- Provides expertise, (typically) facilities, and shares the intellectual resources of several other entrepreneurs in the program
- Gives funding to help grow the business and living expenses for the entrepreneurs during the start-up phase
- Allows entrepreneurs to make connections with investors for future rounds of financing

Disadvantages of Business Accelerators

- Must sacrifice equity, so a careful cost-benefit analysis must be completed to discover whether the capital being infused and the other resources offered are really worth the ownership stake that is being given up, or whether there is a cheaper way to achieve business growth
- Typically have to relocate to the site of the accelerator if there isn't one in your area
- Usually must give up other responsibilities to focus on the program
- Not all accelerators are created equal—thoroughly investigate the programs available before you choose one

Figure 4-6. Business Accelerators and Incubators.

Y Combinator
320 Pioneer Way
Mountain View, CA 94041
www.ycombinator.com

Launch Pad Ignition
643 Magazine ST
Suite 102
New Orleans, LA 70130
www.launchpadignition.com

SPARK Business Accelerator
201 S. Division
Suite 430
Ann Arbor, MI 48104
www.annarborusa.org/business-accelerator

SproutBox
Bloomington, IN
http://sproutbox.com

TechStars
Locations: Boston, Boulder, Seattle, NYC
www.techstars.com

Dreamit Ventures
PMB 263
North Bryn Mawr AVE
Bryn Mawr, PA 19010
www.dreamitventures.com

Capital Factory
Austin, TX
www.capitalfactory.com

MassChallenge, Inc.
One Marina Park Drive, 14th Floor
Boston, MA 02210
(888) 782-7820
http://masschallenge.org

NYC SeedStart
Six MetroTech Center
Brooklyn, NY 11201
(707) 469-3669
www.nycseedstart.com

American Family Insurance Business Accelerator Business Program
www.amfambusinessaccelerator.com

IBM SmartCamp
(Multiple locations)
www.ibm.com/ie/smarterplanet/smartcamp

Excelerate Labs
820 West Jackson BLVD
Suite 700
Chicago, IL 60661
www.exceleratelabs.com

Houston Tech Center
410 Pierce ST
Houston, TX 77002
www.houstontech.org

Launchpad LA
Los Angeles, CA
www.launchpad.la

Jumpstart Foundry
Nashville, TN
http://jumpstartfoundry.com

OCTANe LaunchPad
Orange County, CA
www.octaneoc.org/home/launchpad

Gangplank
260 South Arizona AVE
Chandler, AZ 85225
http://gangplankhq.com

AlphaLab
2325 East Carson ST
Pittsburgh, PA 15203
www.alphalab.org

Portland Ten
Portland, OR
www.portlandten.com

Betaspring
One Davol Square
Providence, RI 02903
http://betaspring.com

Silicon Valley Association of Startup Entrepreneurs Seed Program
Redwood City, CA
www.svase.org

The Startup Project
San Francisco, CA
www.startupproject.org

Berkeley Ventures
727 Allston Way
Berkeley, CA 94710
www.berkeleyventures.com

Tech Wildcatters
2700 Fairmount ST
Dallas, TX 75204
http://techwildcatters.com

Bizdom U
Detroit, MI
www.bizdom.com

NEXTSTART
135 South Main ST
Suite 600
Greenville, SC 29601
www.nextstart.org

The Awesome Inc. Experience
348 East Main ST
Lexington, KY 40507
www.awesomeinc.org/the-awesome-experience

Lightspeed Venture Partners Summer
2200 Sand Hill RD
Menlo Park, CA 94025
www.lightspeedvp.com/summerfellowships

Startup Utah
Utah
www.startuputah.com

LaunchBox Digital
Washington, DC
www.launchboxdigital.com

BetaFish
Wilmington, DE
http://betafishde.tumblr.com

The Founder Institute
(Multiple locations)
www.founderinstitute.com

Peer-to-Peer Lending, Microloans, and Crowdfunding

The financial crisis has had at least one interesting side effect: the rise of alternative and increasingly creative forms of financing. During the economic recession, and continuing to today, credit and other traditional forms of start-up financing became more difficult to obtain. As a result, entrepreneurs began looking to newer, less-traditional forms of raising capital that cut out the financial intermediaries (banks, for instance) that are typically present in the process.

Peer-to-peer (also known as person-to-person or P2P) lending is a process of borrowing directly from individuals; in most instances, the lender and the borrower never meet. There are a variety of ways this happens, but generally, the process is relatively simple: The borrower registers on one of the many peer-to-peer web sites (see Figure 4-7) and is then matched up with a number of lenders who are interested in investing based on the borrower and the interest rate, among other things. The P2P industry has been growing rapidly over the past few years: In 2005, there was $118 million in outstanding P2P loans; by 2011, that number had reached more than $500 million. P2P web sites make a profit by charging the borrowers an interest rate (usually 2 to 5 percent) on top of what the lenders require. The overall success rate of getting a loan through a P2P process is about 10 percent. Certain web sites, such as Kiva, specialize in small loans (or microloans) for entrepreneurs.

In addition to the peer-to-peer phenomenon, there are several institutions that specialize in providing microloans to entrepreneurs. The U.S. Small Business Administration (SBA), for instance, has a microloan program under which eligible entrepreneurs can borrow up to $50,000 to finance their business. Most of the entrepreneurs that take advantage of this program borrow about $13,000 for start-up costs, such as inventory, overhead, and the like. Microfinancing

Figure 4-7. Crowdsourcing and P2P Resources.

PEER-TO-PEER LENDING	MICROFINANCE AND MENTORING	CROWDFUNDING
Lending Club www.lendingclub.com	**ACCION USA** 115 East 23rd Street, 7th Floor New York, NY 10010 (212) 387-0377 www.accionusa.org	**Startup Addict** www.startupaddict.com
Prosper www.prosper.com	**Small Business Administration** Microloan Program 409 3rd ST, SW Washington, DC 20416 (704) 344-6640	**ProFounder** www.profounder.com
Peer-Lend www.peer-lend.com	**Kiva** Kiva Microfunds 3180 18th Street, Suite 201 San Francisco, CA 94110 (828) 479-5482 www.kiva.org	**Kickstarter** www.kickstarter.com
Microloan www.microloan.com	**Startup America Partnership** www.startupamericapartnership.org	**Indie GoGo** www.indiegogo.com
	Samuel Adams Brewing the American Dream (888) 661-2337 www.samueladams.com/btad	

has become more popular recently because new ventures are requiring less financing than in previous years. In fact, according to data gathered by the Panel Study of Entrepreneurial Dynamics (PSED), solo entrepreneurs have had median start-up costs of only $6,000, while team ventures have had expected start-up costs of about $20,000. Besides financial institutions and governmental entities that provide microloans, many businesses have programs to help fund start-ups with smaller loans. Samuel Adams, for instance, has teamed up with ACCION USA (a provider of microloans) to create the Brewing the American Dream program. The Brewing the American Dream program provides loans of from $500 to $25,000 to fund entrepreneurs in the food and beverage industry. In addition to the loan, the program also provides business education seminars and "speed coaching" events to help the business owner turn the loan into a successful venture.

In the same vein, one creative funding source that has evolved in recent years is crowdfunding. Crowdfunding (or crowd financing), like P2P, involves getting individuals to pool their resources to finance a project without a typical financial intermediary. Unlike P2P, however, the lenders (also known as "crowdfunders" or "backers") often do not engage in crowdfunding strictly for financial gain. In fact, the "lenders" often actually act more like donors. In a typical transaction, an entrepreneur can go onto a crowdfunding web site, propose the amount needed for the project, and, if the amount pledged is met by backers, receive the funds. Usually, the backers receive something in return, like a product from the business (a DVD or CD from the film or album produced, for instance) but not their money back, if the project is funded, so the funds are not donations in the strict sense. In fact, studies show that for the majority of backers, the reward is the main motivator of their monetary pledge. Crowdfunding sites generally make a profit by taking a small percentage (about 5 percent) from the projects funded before the money goes to the entrepreneur.

While crowdfunding has mainly been the domain of the entertainment industry, many for-profit and nonprofit new ventures in other industries have been making headway and successfully funding projects via crowdfunding. For instance, BeerBankroll (a member-managed brewery and pub) received $2.5 million using crowdfunding. While this is an atypical example, it goes to show that creative forms of financing can be useful for financing entrepreneurial ventures—subject to certain caveats. For more information on the process, look at some of the leading web sites that facilitate the process, such as Kickstarter (www.kickstarter.com), IndieGoGo (www.indiegogo.com), and Sellaband (www.sellaband.com); some also use Facebook and Twitter to manage their own campaigns, as well as the resources in Figure 4-7.

Advantages of Peer-to-Peer Lending and Crowdfunding

- Eliminates the use of banks and other financial intermediaries.
- May provide lower interest rates than traditional forms of borrowing (and no monetary repayment or interest is typically expected in the case of crowdfunding).
- Provides alternative forms of financing.
- The borrower can appeal to the lenders/backers on a personal level and tell her "story" to convince them to invest.
- Much of the red tape and paperwork required for a traditional bank loan can be avoided.
- Funds are typically dispersed to the borrower quickly, usually within 10 days.
- Entrepreneurs can raise funds without sacrificing equity.

Disadvantages of Peer-to-Peer Lending and Crowdfunding

- Most loan requests are not met—the funding success rate is about 10 percent in the case of P2P.
- The borrower still has to pay a percentage fee to the P2P company (and give a reward in the case of crowdfunding).
- During the recession, many borrowers defaulted, making lenders in the P2P arena more cautious.
- The regulatory future of P2P is uncertain: The SEC has determined that the promissory notes issued to lenders by P2P companies are "securities" and subject to federal regulation, and both the SEC and the Consumer Financial Protection Bureau (created under Dodd-Frank) are in the process of determining how the P2P industry should be regulated.
- Crowdfunding may also run afoul of securities regulations, depending on the structure of the transaction.
- The equivalent of the entrepreneur's business plan is released to the general public.
- The entrepreneur will not receive the advice, involvement, and expertise that other types of investors (such as angels or VCs) may provide.
- Lenders and backers will not be involved in future rounds of financing, and the amount that entrepreneurs can raise in the initial funding is limited.
- In the case of crowdfunding, there are tax implications—the amount received in exchange for the gift is "income" and is taxed accordingly.

As of the final printing of this third edition (early 2012), Congress and the SEC were still holding hearings and formulating guidelines as to how crowdfunding would be regulated as a strategy for private enterprises.

Economic Development Agencies

The U.S. Department of Commerce's Economic Development Administration (EDA) was established by Congress to generate jobs, help retain existing jobs, and stimulate industrial and commercial growth in economically distressed areas of the country. EDA assistance is available to rural and urban areas of the nation that are experiencing high unemployment, low income, or sudden and severe economic distress. The EDA works in partnership with state and local governments, regional economic development districts, public and private nonprofit organizations, and Native American tribes. EDA programs include public works, urban development, economic adjustment, research and evaluation, economic development districts, local technical assistance, national technical assistance, trade adjustment assistance, university centers, and redevelopment centers (see Figure 4-8).

Customer Financing

No one (besides you) is more interested in your success than your customers, and they may be willing to provide funds or other resources to facilitate your launch. In addition to equity, your customers may want some type of partial or full exclusivity for a given product or service, and they can play an expanded role in influencing how the product will be offered, distributed, or packaged. For example, a group of retailers may be interested in an early-stage software company

Figure 4-8. Economic Development Contacts and Resources.

Brownfield's Home Page
U.S. Environmental Protection Agency
www. epa.gov/brownfields

Bureau of the Census
U.S. Department of Commerce
www.census.gov

Bureau of Labor Statistics
U.S. Department of Labor
www.Stats.bls.gov

Center of Excellence for Sustainable Development
U.S. Department of Energy
www.smartcommunities.ncat.org

Economic Development Administration
U.S. Department of Commerce
1401 Constitution AVE, NW
Suite 7800
Washington, DC 20230
(202) 482-5081
www.eda.gov

Environmental Justice Home Page
U.S. Environmental Protection Agency
www.epa.gov/environmentaljustice

International Economic Development Council
www.iedconline.org

National Association of Development Organizations
www.nado.org

National Governors Association
www.nga.org

Northeast-Midwest Institute
www.nemw.org

Office of Solid Waste and Emergency Response Home Page
U.S. Environmental Protection Agency
www.epa.gov/aboutepa/oswer.html

Rural Development
U.S. Department of Agriculture
www.rurdev.usda.gov

Trade Adjustment Assistance Program
www.taacenters.org

University Economic Development Association
http://universityeda.org

U.S. Environmental Protection Agency Home Page
www.epa.gov

whose product, once finished, could streamline their inventory-management systems. In some cases, the customers may form a consortium or buying group to invest in the company. Customers with a vested interest in a business are likely to stay long-term, offer free expertise, and lead to new customer referrals.

An alternative to an equity investment would be for the customers to prepay for the product or service in exchange for a discount or other benefits. These customer-financing arrangements can be especially useful if the business requires large up-front development costs, such as companies in the software industry, where targeted licensees/customers could provide early-stage financing in exchange for perpetual, royalty-free, and unlimited rights of use of the end product.

Vendor Financing

This form of early-stage financing is fast becoming one of the most popular methods that small businesses use to acquire the resources they need in order to grow. Statistics from the Equipment Leasing and Finance Association, based in Washington, D.C., show that vendor financing leapt from a seldom-used sales option to a $13 billion a year industry between 1992 and 1998, and by 2010 the equipment leasing and vendor financing industry had reached $518 billion (www.elfaonline.org).

Vendor financing can be obtained through companies of all sizes, from small suppliers to large corporations. The firms listed in Figure 4-9 are finance companies owned by major manufacturers. The trade associations listed in the figure can provide information about vendor financing and help you find a vendor that meets your needs.

Usually business owners select the equipment or supplies that they need and then apply for financing through a vendor that offers such arrangements. Some businesses work in reverse, first locating a vendor that offers financing and then selecting equipment from that vendor. Most vendors will prepare the documents in-house, even though financing is a transaction separate from the lease or purchase of the equipment and may be handled by an outside company.

Vendors may also be a useful source for other resources that you would otherwise be raising money to obtain, such as research and development, advertising and promotion, and even customer referrals. Typically, larger vendors in a wide variety of industries offer formal programs, have large budgets for customer support and services, or focus on smaller, emerging-growth companies that may mature into larger customers. Talk to your largest vendors, and shop competitively for the

Figure 4-9.	Vendor Financing Resources.

Canon Financial Services
(office equipment)
(800) 815-4000
www.cfs.canon.com

Equipment Leasing and Finance Association
(all types of equipment)
(202) 238-3400
www.elfaonline.org

GE Capital
(all types of equipment)
(800) 553-7287
www.gecapital.com

HP Financial Services
(high-tech equipment)
(888) 215-8868
www8.hp.com/us/en/hp-financial-services/index.html

IBM Global Financing
(IBM products and services)
(877) 426-2223
www-03.ibm.com/financing/us/index.html

IKON Financial Services
(office products)
(610) 296-8000
www.ikon.com

John Deere Financial
(agricultural and construction equipment)
(800) 356-9033
www.deere.com/en_US/jdc/

Oracle Credit Corp.
(computers and software)
(650) 506-7000
www.oracle.com

products and services that they may be in a position to offer. You'll be pleasantly surprised at how many larger companies have targeted the small-business customer as a high priority and have resources ready to offer you at little or no cost.

Additional Resources:

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