Financing Alternatives Overview

This financing alternative primer contains an overview of the different ways that an entrepreneur can raise capital to fund their new business. Raising capital to fund a business is one of the most important steps in setting up a new business for success. It is important for entrepreneurs to understand their different options and the pros and cons of each alternative.

This document details the nine most popular methods by which entrepreneurs raise capital for their startup businesses. It discusses the benefits and potential pitfalls of each so that entrepreneurs can make well-informed decisions when deciding how to raise money.

This guide is a starting point for entrepreneurs who want to learn about their different options and determine which ones fit their situation best. However, this guide is by no means a complete reference. There is a large amount of information available on each alternative, and before making a final decision, it is important for an entrepreneur to do their own research and consult others when needed.

Disclaimer

These documents were created and vetted by students and supervising attorneys at the University of Pennsylvania Law School's Entrepreneurship Legal Clinic applying Pennsylvania law. They are intended to educate and inform the early stage start-up. As such, they are designed to be simple and accessible and may omit terms or language relevant to your specific circumstances. Please carefully read through the documents and any instructions and annotations included therein.

You acknowledge that your use of these documents does not create an attorney-client relationship between you and the Clinic or you and the individual members of the Clinic and does not constitute the provision of legal advice or other professional advice. You should seek advice from a licensed attorney before using or relying on these documents. Additionally, none of the documents created constitute tax advice. By using and relying on these documents, you assume all risk and liability that may result.

Early Stage Financing Alternatives Primer

Bootstrapping	Founders typically self-finance the start-up by contributing their own personal assets.
Credit Cards	Founders use credit card loans to finance the business.
Seed Financing	
A) Friends And Family	Founders receive equity investments or zero (or low) interest loans or grants from friends and family.
B) Angel Investing	Wealthy individuals and groups with an interest in the ethos or industry of the company will make hybrid equity and equity investments in the company.
C) Grants	Non-profit companies that have achieved 501(c)(3) status receive grants.
Venture Capital Financing	More mature early stage companies receive equity investments from venture capital firms.
Online Lending	Lenders provide small loans to early stage companies through online applications.
Crowdfunding	Companies receive funding from a number of individuals by creating an online campaign.
Bank Loans	Very mature early stage companies may receive low interest secured loans from commercial banks or bank-like entities.

1 Bootstrapping

The founders of the company self-finance the company at the idea stage of the company's life cycle. Founders bootstrap by contributing any assets they have that the company can utilize or by liquidating any non-cash assets and contributing them to the company along with any available cash.

Pros: Bootstrapping has the primary benefit of allowing the founders to maintain control over the company and receive all of the benefits of any earnings that accrue to the company. Additionally, bootstrapping allows the founders to maintain control over the company's ownership and operations.

Cons: If the founders do not have large pools of capital to contribute to the company, then the company's ability to grow will likely be limited. Additionally, the founders' capital may receive higher risk-adjusted returns by being invested elsewhere.

---

2 Credit Cards

Credit cards can provide business owners easy access to funds on very short notice. A business owner can apply for and use a personal credit card or a credit card that is tailored for small businesses.

Pros: Small business credit cards are generally easy to get approved for and have high credit lines, which can supply the entrepreneur with large amounts of capital. Additionally, small business credit cards will usually have mileage perks and discounts for office supply purchases.

Cons: Interest rates on credit cards are substantially higher than those on a traditional bank loan, and late payments can hurt the business owner's credit score, which will hurt future chances of obtaining a line of credit from a bank.

---

3 Seed Financing

Seed round investing occurs before a company goes to venture capitalists for financing. Seed investments come from friends and family, angel investors, and grants (for non-profit entities). These investments frequently take the form of informal loans, convertible notes (see our Convertible Notes Overview), simple agreements for future equity (convertible notes without a maturity date and/or accruing interest), and convertible preferred stock. Seed rounds typically raise $50,000 to $1 million (see our Seed Financing Kit).

Seed Financing—Friends and Family. Investments from friends and family are one of the most common forms of seed financing at the early stage of a company's growth. Friends and family investments come in a variety of forms, including informal loans and equity investments.

- **Pros:** Friends and family investment provides the benefit that friends and family will typically have a close, personal relationship and personal interest in the founders' success, and therefore will be more forgiving and less aggressive in negotiations.

- **Cons:** Friends and family may not be sophisticated and may not understand the risks inherent in investing in an early stage company. If the company struggles, friends and family may be less understanding of these struggles than more sophisticated investors. Additionally, friends and family introduce a personal element that can complicate decisions, because what would normally be simple business decisions may become personal matters.

Seed Financing—Angel Investors. High net-worth individuals or small and informal venture capital-like groups frequently provide capital to early stage companies by investing in convertible notes and convertible preferred equity. Angel investors frequently have a special philanthropic interest in the industry or type of business of the company.

- **Pros:** Angel investors will typically be able to provide more capital than friends and family in amounts that would still be too small for a venture capital firm to finance. Therefore, angel investors often serve as a bridge between the friends and family round of capital raising and the venture capital rounds. Angel investors sometimes have experience, expertise, and connections and can provide valuable guidance to the company.

- **Cons:** Angel investing is a risky form of investing. Therefore, angel investors frequently will seek high returns on their convertible notes and convertible preferred stock, along with seeking clearly defined exit plans for their investments, such as initial public offerings or acquisitions.

Seed Financing—Grants for Non-Profits. Foundations will fund nonprofit organizations that qualify for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. Nonprofits can also obtain federal or state grants, as well as grants from other nonprofit or corporate companies.

- **Pros:** Nonprofits can receive generous amounts of money through grants and are more likely to receive grants in the future once they are approved for an initial grant.

- **Cons:** The application process is lengthy. Significant research is necessary in order to find the appropriate grant, and the competition is fierce. The number of nonprofits that receive grants compared to how many apply is very low.

---

4 Venture Capital

After seed round financings, early stage companies may raise capital from professional venture capital firms, private equity firms, and venture capital arms of large corporations. Companies raise capital in a series of rounds. In the first round (Series A), venture capital firms will make investments almost exclusively through convertible preferred equity, and the documents used will be highly standardized. In Series A financings, companies typically will raise between $3 and $5 million. Later round investments—Series B to E—can raise anywhere from $5 million to $100 million.

Pros: Raising capital from venture capitalists provides access to significantly larger amounts of capital than any other alternatives for early stage companies. Additionally, venture capital firms frequently have significant experience and industry connections and can provide valuable business guidance.

Cons: Venture capital investors will frequently impose a number of requirements on the company because of the risky nature of their investment. These requirements may include veto rights over major decisions like changing organizational documents, declaring and paying dividends, changing the size of the board of directors, and issuing securities senior to the venture capital firm's investment. Venture capital firms will also frequently require that they be paid special dividends, require anti-dilution provisions, require seats on the board of directors, and seek a number of other rights that can hamper the capital structure and operational mobility of the company.

---

5 Online Lending

Founders of the company can apply for small business loans from online lending services. The application process is usually a lot simpler than applying for a bank loan, and the funds are therefore usually delivered to the borrower much more quickly. Kiva is an organization that is involved with online lending. They enable people to lend money to low-income and underserved entrepreneurs via the Internet.

Pros: The funds are available relatively quickly and lenders can sometimes make decisions within hours of receiving the application.

Cons: These types of loans are more susceptible to fraud, and there won't always be someone available to assist the founders of the company in filling out the loan application. Filling out the application incorrectly can potentially lead to being charged higher rates.

---

6 Crowdfunding

Using the Internet, a company's founders will find people to back the company's efforts with each person investing a small amount. The founders can choose either to give investors rewards or products in return, or to give small equity shares. Examples of popular websites that allow small business owners to campaign for their business are Kickstarter, GoFundMe, and Indiegogo. Before choosing a website, it is important to do some research on the different options because some websites are better for small projects (as opposed to equity funding).

SEC Intervention: The SEC used to allow only accredited investors to fund startups. Under the new rules, even people with annual income or net worth that is less than $100,000 are able to invest (capped at a maximum of five percent of their yearly income or net worth). This has helped startups raise money more easily because they can draw upon a larger pool of investors. It also helps entrepreneurs who were previously unable to attract the attention of high net worth individuals.

Pros: Founders can reach many investors using this method, and signing up on any of these websites is relatively simple.

Cons: Some sites require a company to raise their full goal in order to receive any money. Frequently, there are processing fees and charges for a percentage of total money raised. Other costs include marketing and compliance costs, taxes and manpower. There are also IP considerations. Patent trolls can find your idea and steal it if you aren't properly protected; you also may infringe on another company's idea without realizing it.

---

7 Bank Loans

Commercial banks usually will not lend to early stage companies without personal guarantees or pledges of personal assets from the founders. There are, however, banks that exist to lend to early stage companies once they have secured venture capital investments. Any early stage loan will very likely be

an asset-based loan, where the bank secures the loan by taking collateral over the assets of the company. This requires a fairly clean balance sheet and assets that the bank can secure as collateral.

Pros: The interest rates on asset-based loans from commercial banks are typically low compared to more junior investments like convertible notes and convertible preferred equity. Additionally, the founders will not have to give up any ownership or control over the company's major decisions.

Cons: The bank will impose covenants on the company, restricting its operations. Additionally, the credit agreement with the bank may be difficult to negotiate and will be heavily favored towards the bank. Furthermore, the bank will have the right to seize the assets securing its loans if the company defaults on its obligations under the agreement.