Alternative Sources of Finance

Alternative Sources of Finance: Basics

Meaning: **Funding** channels **beyond conventional bank lending** and public capital markets.

Why needed: Startup funding, growth, innovation, infrastructure and diversification.

Equity: Angel investment, VC, PE.

Debt: Private credit.

Platform-based: Crowdfunding.

Purpose-based: Infrastructure and social-impact financing.

Startup funding: Umbrella covering multiple funding sources.

Indian ecosystem: SIDBI, Startup India, FFS, SEBI, NABARD, NIIF.

Debt vs Equity Financing

Core concept: **Equity = ownership; Debt = borrowing**.

Equity: No compulsory repayment or fixed interest; dividends/capital gains for investors; ownership dilution.

Debt: Principal repayment + interest; no ownership dilution; increases financial risk.

Major advantage: Equity reduces repayment pressure; debt preserves ownership.

Major disadvantage: Equity dilutes control; debt creates fixed repayment obligations.

Key terms: **Leverage** = use of debt; **Gearing** = debt-equity relationship; **Collateral** = security for loan; **Dilution** = reduced ownership percentage.

Debt vs Equity Financing (cont)

Interest is generally **tax-deductible** subject to tax rules; **dividends** are **not deductible business expenses**.

Angel Investment

Core concept: **Wealthy individuals invest their personal money in early-stage startups**.

Stage: Pre-seed, seed and early stage.

Form: **Equity or convertible instruments**.

Returns: **Capital appreciation** through startup growth or exit.

Additional support: **Mentorship**, expertise and business networks.

Pre-seed: Funding at the idea/concept stage.

Seed funding: Initial capital to develop a product or prototype.

Exit: Investor realises returns through sale, acquisition or IPO.

Angel investors take **high risks** because startups have uncertain survival and returns.

Key distinction: Angel = individual's own money; VC = professionally managed investment fund.

Venture Capital

Core concept: **Professionally managed funds** invest **pooled capital** in high-growth, high-risk startups.

Stage: Seed, **early-stage and growth-stage** businesses.

Form: **Equity / equity-linked instruments**.

Returns: **Capital appreciation** through eventual exit.

Venture Capital (cont)

Process: **Pitch** → **Due diligence** → **Valuation** → **Term sheet** → **Investment** → **Monitoring** → **Exit**.

Due diligence: Detailed examination before investment.

Valuation: Estimated worth of the startup.

Term sheet: Preliminary document outlining investment terms.

Portfolio company: Company in which the fund invests.

Follow-on investment: Additional investment in an existing portfolio company.

Dry powder: Committed but uninvested capital.

Unicorn: Privately held startup valued at **USD 1 billion or more**.

Exit: Sale of investment to realise returns.

Funding rounds: **Series A** → **Series B** → **Series C** and subsequent rounds. - **Series A**: Scaling a business model with initial market traction. - **Series B**: Expanding operations and market reach. - **Series C** onwards: Larger expansion, acquisitions or preparation for an exit.

Stages of VC Financing

Stage Purpose

> Seed Develop idea, prototype and proof of concept

> Startup Product development and initial marketing

> Early stage Begin commercial production and sales

> Growth stage Expand operations, market share and capacity

> Late stage Scale operations before IPO or acquisition

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Private Equity (PE)

Core concept: Investment in **privately held companies**, generally **established** businesses.

Form: **Equity / equity-linked instruments**.

Objective: Improve company value and exit at a profit.

Involvement: Management, governance, restructuring and strategic decisions.

Major types: **Buyout, LBO, Growth Capital, Distressed Investment, Minority Investment**.

Important keywords
- **Buyout**: Acquisition of a controlling stake.
- **LBO**: Leveraged Buyout, Acquisition financed substantially through borrowed funds.
- **Growth Capital**: Funding expansion of established businesses.
- **Turnaround**: Reviving a struggling business.
- **Value Creation**: Increasing business value through operational/strategic improvements.
- **Exit**: Sale, acquisition or IPO.

Startup Funding

- Core concept: **Capital raised by startups to develop, launch, operate and expand**.
- Funding lifecycle: **Bootstrapping / Pre-seed → Seed → Early stage → Growth → Late stage**.
- Sources: Own funds, Friends & Family, Angels, VC, Bank Loans, Government Grants, Crowdfunding, Incubators/Accelerators.

Important keywords
- **Bootstrapping**: Using personal funds / internally generated revenue.
- **Incubator**: Supports early-stage startups with mentoring and infrastructure.
- **Accelerator**: Fixed-duration programme to speed up startup growth.

Startup Funding (cont)

- **Burn Rate**: Rate of cash consumption.
- **Runway**: Time available before cash runs out.
- **Product-Market Fit**: Product satisfies genuine market demand.
- **Bridge Financing**: Short-term funding until the next funding round or financing event.
- **Valuation**: Estimated worth of the startup.

Formula: **Runway = Available Cash ÷ Net Monthly Burn Rate**.

Key distinction: **Incubator nurtures; accelerator speeds up growth**.

Recall trick: **Startup funding = Funding needs across the entire business lifecycle**.

Crowdfunding

- Core concept: Raising funds through **small contributions** from a **large number of people**, usually via **online platforms**.

Four types
- **Donation-based**: No financial return.
- **Reward-based**: Product / reward in return.
- **Equity-based**: Shares / ownership.
- **Debt-based**: Loan repayment with interest.

Advantages: Wider access to capital, market validation, publicity and reduced dependence on traditional finance.

Risks: Funding target may not be met, fraud, platform fees, IP exposure and regulatory concerns.

Important keywords
- **All-or-nothing**: Funds released only if target is achieved.
- **Keep-it-all**: Amount raised retained even if target is missed, subject to platform terms.

Crowdfunding (cont)

- **P2P Lending**: Direct lending through an online intermediary platform.
- **Funding Target**: Amount campaign aims to raise.

Private Credit

Core concept: Loans provided by **non-bank lenders** / private funds directly to businesses.

Returns: **Interest and fees**.

Features: Privately **negotiated terms**, flexible structures; secured or unsecured loans.

Major types: Direct Lending, Mezzanine Financing, Distressed Debt, Venture Debt, Unitranche Financing.

Important keywords
- **Covenants**: Conditions imposed on borrowers.
- **Collateral**: Assets pledged as loan security.
- **Senior Debt**: Higher repayment priority.
- **Subordinated Debt**: Lower repayment priority than senior debt.
- **Mezzanine Debt**: Hybrid debt with equity-like features.
- **Venture Debt**: Loans to startups, often VC-backed.
- **Credit Spread**: Additional yield over a benchmark for credit risk.
- **Unitranche Financing**:Combines senior and junior debt into a single loan facility

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