
Financing Stages for Start-up Businesses

A start-up business presents a higher risk investment than a mature business. The mature business has assets for collateral and a known cash flow that allows investors and lenders to assess business risk. By its nature, the risk profile of a start-up business is much more difficult to assess.

The importance of focusing on early stage and expansion stage financing and the various phases within each stage is to understand the unique business and financing characteristics at each of these phases.

Early Stage Financing

Seed Financing Phase

The seed phase, also known as the pre-commercialization stage, is the proof-of-concept stage in which a business idea is tested for its viability. At this stage, the basic research may have been completed, but the commercial capabilities are not yet proven. Generally, a formal business entity has not been formed because the decision of whether to move forward with creating a business has not been decided.

During the seed stage, the entrepreneur generally requires relatively small amounts of financing to conduct business feasibility studies, develop prototypes, evaluate market potential, protect intellectual property, and investigate other aspects of the business idea.

At the end of the seed financing phase, the entrepreneurs make the decision of whether to move forward with a commitment to create a business (often called the go/no go decision).

Pre-launch Financing Phase

The pre-launch phase occurs after the decision has been made to move forward with the creation of a business. In this phase, the foundation for the business is created. The development of a detailed business plan explaining how the business will be

created and function is critical at this time. This phase usually requires substantially more funding than the seed state. Depending on circumstances, angel investors may be interested in providing funding at this stage.

Often the first step in this phase is to create a legal entity for the business. The legal entity will define the boundaries of how the business will operate. Then the business founders may search for and acquire land and facilities in which to operate the business. Along with this, is the acquisition of equipment and other assets needed for business operations. During this phase, the business will often hire management and investigate all regulations that must be met and licenses that must be obtained. The business founders, along with the newly hired management team, will need to finalize the development of distribution and marketing relationships along the business' supply chain.

Start-up Financing Phase

During the start-up phase, also known as the launch phase, production is initiated and sales occur. It is characterized by hiring employees and establishing the products in the marketplace. Financing for the start-up phase involves bridge financing from the time the pre-launch phase is funded until operations commence, sufficient working capital for the smooth operation of the business, funding of any losses during the start-up phase and contingency funds in case of an unexpected interruption in the start-up process. Funding for the pre-launch stage and the start-up phase may occur at the same time.

First-Stage Financing Phase

First-stage financing, also known as the ramp-up phase, is the final phase in early stage financing. It is characterized by ramping up production and sales. Ramping up the business by increasing sales is an indication of success because the company's business model is being validated.

Business volume may be approaching breakeven and profitability is within sight. If the company achieves profitability in the start-up phase or shows clear signs of being able to achieve profitability in the ramp-up phase, venture capitalists may be interested in financing this phase.

From a strategic perspective, the ability to accelerate the ramp-up momentum into growth may catapult the company into its growth stage, in which it establishes profitability and is able to finance its operations from internal resources.

Expansion Stage Financing

Second-Stage Financing Phase

This financing follows first-stage financing and provides working capital for the initial expansion of a business that is producing and shipping product and has growing accounts receivable and inventories. Although the company has made progress, there are instances in which it may not yet be profitable.

Third-Stage or Mezzanine Financing Phase

This is provided for major expansion of a company that has an increasing sales volume and is profitable. These funds are used for further plant expansion, marketing, working capital, or developing an improved product.

Bridge Financing

Bridge financing involves filling a time gap between when an expenditure is made and returns are generated. For example, government grants often involve bridge financing because the grant will not pay directly for the purchase of an asset (e.g., equipment) but will reimburse the company after the purchase is made. So, bridge financing fills the time gap from the time the expenditure is made (equipment is purchased) and the company is reimbursed by the grant for the purchase of the equipment.

Bridge financing may occur in any of the financing phases outlined above. It is usually provided by commercial banks.

For more information on business development, including contracts and agreements, visit the [Ag Decision Maker website](http://www.extension.iastate.edu/agdm/vdstart.html), www.extension.iastate.edu/agdm/vdstart.html.

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