

2006-255: STUDY OF ENTREPRENEURIAL BOOTSTRAPPING TECHNIQUES

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ASEE Abstract

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Financial bootstrapping is a little explored and understood area of entrepreneurial financing that needs to be investigated in an academic setting so that it may become a viable alternative for those who are planning their own start up ventures but do not have access to large amounts of traditional financing sources. The paper will focus on the techniques used in entrepreneurial start up firms to obtain forms of financing that are not the traditional debt loans or owner supplied capital. The paper will address the published data in the area of financial bootstrapping to assess where the academic community has progressed at this point in time in their understanding of the techniques. The paper will then draw conclusions of where future research needs to head in order to get a better understanding of this important financing technique.

Introduction

Financial bootstrapping is a technique used by many entrepreneurs to finance the business in the early startup phase when access to traditional forms of capital such as debt and equity are limited or non existent. Many entrepreneurs must rely on their own cunning and imagination to finance the business at the start. The entrepreneur is said to pull themselves up by the “bootstraps” when using creative techniques to finance the business.

Definition

Lynn Neeley defines bootstrapping as:

“ a variety of ingenious methods that find resources, maximize their efficient use, and minimize the explicit costs associated with using these means whether they are found inside the business, obtained from other people, or provided by other companies and organizations”³.

This definition is common throughout the literature in one format or another and will be used here as a basis for the paper. The key phrases in the definition are maximize use, minimize cost, and ingenious methods of finding resources. These attributes of an entrepreneur are born out of necessity due to their lack of access to traditional capital markets enjoyed by large or well established businesses. It is what helps set apart the entrepreneur from people who conduct business on behalf of large or well established companies. The entrepreneur is a risk taker by necessity as will be evident from a discussion of the techniques employed to find resources.

Influencing Factors on Financing Decisions

Entrepreneurs have factors that influence their financing choices which may be considered irrational by traditional corporate finance. The entrepreneur usually has personal property and securities at stake when financing their business. This may lead the entrepreneur to insert their own priorities, preferences, likes and dislikes into the financing decision³. The entrepreneur's attitude toward risk can also be a defining factor on the financing method. The use of external financing, such as bank debt, may be influenced by these attitudes⁴. This seems to help explain the entrepreneur's preference for internal sources of financing rather than external sources³.

Another deciding factor for the entrepreneur is their access to sources of capital which are generally limited due to the high risk, low collateral nature of a start up business. Most entrepreneurs are limited in their access to bank loans, long term debt markets, and equity markets. Due to the limited nature of their options, entrepreneurs have become creative in how they raise capital to start and run their businesses. The following commentary will outline the various techniques used by entrepreneurs to finance their businesses.

Bootstrapping Techniques

Owner's Assets

The entrepreneur has traditionally used their own assets such as marketable securities, real estate, and income from other sources such as a spouse or other employment, the foregoing of salary withdrawal, and the use of their homes to run the business³. These techniques are usually the first place the entrepreneur looks to raise capital for some good reasons. Those reasons include no dilution of ownership and maintained control of any future reimbursement at the entrepreneur's discretion. The techniques do lend themselves to high risk due to the fact that the sources are personal and can be lost if the business fails.

Personal Borrowing

Many start-up businesses have limited or no access to traditional bank lending due to their small size, limited collateral, and unproven business plans or expertise. "Banks and other lenders have not recognized most new businesses as unique entities because many or most new ventures have not been formed as corporations, the only business forms that have been recognized as unique entities"³. Most entrepreneurs resort to personal credit such as a second mortgage on their private homes, equity lines of credit, and use of personal credit cards.

Delaying Payables

A technique used for short term borrowing is taking a loan from your suppliers by delaying payments to them. The way it works is the supplier sends the raw material or service to the entrepreneur who can use it to generate a sale. If the sale is converted to cash and the payment has not been made to the supplier, then the entrepreneur is in essence taking a short term loan out from the supplier. This may be due more to the entrepreneur is short on cash and stretching their bill payment as long as possible until cash comes in. Other payables may be taxes and utilities and in some cases even employee salaries.

Minimizing Receivables

In order for the payables delay to have a maximum effect, the entrepreneur needs to collect their payments from customers as soon as possible. This creates a maximum “float” period which is the time between collection and payment. Some techniques that are used include targeting customers who have a history of paying quickly, obtaining prepayments, speed up invoicing processes, charge interest on overdue accounts, and selling the receivables to a third party⁴.

Minimal Asset Cost

Techniques used here attempt to acquire the use of assets at a minimum cost to the entrepreneur. These may include the buying of used equipment, the use of temporary employees or sharing of employees with another business, using business incubators for office space, and using government resources to assist with expertise and advice. The entrepreneur is mainly concerned with preserving as much capital as possible while still providing a high quality product or service.

Another option available to the entrepreneur is equipment leasing. Leasing is a tool where the user pays for the usage of the assets but does not take ownership of the asset. By leasing, the lessor (entrepreneur) transfers the risks of equipment ownership to the leasing company and can therefore focus on using that equipment as a productive tool to grow the business. There are many advantages for leasing, some are:

Free-up working capital: Leasing allows a small business to purchase the equipment needed today while making affordable payments over future months, hence reserving capital. Also, leases can be off-balance sheet structures according to FASB113, therefore a liability does not appear as debt on their financial statements, so the business stays attractive to lenders such as banks.

Staying ahead of technology: Leasing enables the entrepreneur to acquire equipment quickly and upgrade the equipment at any point in time during the life of the lease to avoid equipment obsolescence.

Customized solutions: Leasing allows the entrepreneur to structure the business financing needs around the unique business environment the entrepreneur is managing within, whether it is limitations in cash flow, or cyclicalities of the business. For instance, a lease structure can allow for step-up payment leases, step-down leases, balloon payments, Skipped Payment Lease, Deferred Payment Lease, 90 or 120 Days Same as Cash, or \$1.00 buyout.

Tax Advantages: The IRS does not consider an operating lease to be a purchase, but a tax-deductible overhead expense.

100% Financing: Most common leases will finance the cost of equipment and costs of installation and maintenance, therefore preserving more cash for the business.

There are three types of leases: 1) Fair Market Value Purchase Option (FMV) - has the lowest monthly payment of a standard lease with flexible purchase options at lease end. A Fair Market Value lease is the preferred option for businesses who are interested in avoiding equipment obsolescence. At the end of lease, the lessor has the options of: Returning the equipment, or purchasing equipment for the Fair Market Value, or extending the lease under a new lease renewal. 2) 10% Purchase Option –the entrepreneur’s monthly payments would be lower than a \$1 Buyout Lease, but higher than the Fair Market Value option. And, at the end of the lease, the business owner can choose to purchase the equipment for 10% of the original cost or return the equipment, 3) 1\$ Purchase Option – the business owner would choose this type of lease, if interested in owning the equipment at lease end. The monthly payments are higher than the FMV, since the lessor will end up owning the equipment at the end of the lease term for \$1.

Other Borrowing

This may include borrowing from friends or family and employing friends and family at reduced or no cost to the company. Sometimes the entrepreneur will give ownership rights to the relatives and friends in exchange for the early input of reduced cost labor or capital. The entrepreneur may also borrow physical asset such as equipment or even barter for equipment when possible. Entering into equipment sharing agreements with other small businesses may also be employed as a form of borrowing.

Conclusion

It is clear from the literature that there are reasons beyond the control of the entrepreneur that necessitate creative financing techniques to be used. It is assumed that entrepreneurs would prefer to use traditional financing techniques such as bonds and stock issues or traditional bank loans but these forms of financing are generally unavailable. There has been some research in the field of entrepreneurial financing techniques, but more remains to be discovered. One industry that has garnered a lot of attention is the software industry. In a study conducted by Harrison, Mason and Girling, they looked at the correlation between studies conducted in Northern Ireland, Scotland and Massachusetts where both studies used the same questionnaire to assess the techniques used by the different entrepreneurs in each general region¹. From the studies, they were able to determine that cultural background seems to play a role in how much risk an entrepreneur is likely to take. This led to help determine the type of financing they were likely to use.

It seems logical to study this group of entrepreneurs due to the fast pace of the industry and the number of firms that have started in the last 25 or so years. This gives the researchers access to the original start up entrepreneurs in many instances and includes techniques that have been currently used. Some questions that remain are: can the results be inferred to all software companies? Can the results be inferred to other industries outside of software? Are there connections between types of financing used and the business cycle of the firms? Is there a link between information and business savvy of the entrepreneurs and the type of financing being used? All of these questions and many more seem to be the next logical step for the study of bootstrap financing and will be explored as the techniques become better understood and recognized by researchers.

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