



Why getting business funding early can do more harm than good

Description

A Harvard Business School [study](#) found that up to 75% of venture-backed companies fail. This is measured by companies that fail to produce a positive return for investors. This is to mean companies that fail to make more money than was ploughed into them. 30 to 40 per cent of those liquidate assets and investors lose all of their money.

This figure is significantly high, particularly in venture capital, where one assumes strict scrutiny. The question becomes why such a high number of good ideas fail. Even with the necessary funding to get them off the ground.

Though counterintuitive, the funding itself could be contributing to this failure rate. In this post, we look at some pitfalls entrepreneurs need to be aware of when getting early business funding.

Ignoring market feedback

As entrepreneurs, we often fall in love with our visions, often to a fault. This is actually a good thing though. Entrepreneurship is a hard gruelling journey, it's this passion that fuels the entrepreneur's efforts during the hard times.

The problem is when you fall in love with an idea it's hard to see the faults in it. With early business funding, the entrepreneur could push a flawed vision simply because they can finance these efforts. Bootstrapping a business gives you important feedback, what your market says.

When funding is limited, quick adjustments and pivots are made to factor in this feedback. Project abandonment is always on the board when things are not working. This may be a tough pill to swallow but important in any entrepreneurial journey.

The problem is, with enough funding, this feedback is often ignored. Money is poured into other avenues like advertising and PR to force the product on the market. Eventually, the cash flows run dry

and the flaws of the product, service or business model become too apparent.

Often too late to salvage the business. This is the importance of getting validation from the market that the business works before pouring funds into efforts to support it.

Too much early, unwise hiring

Talent has a large bearing on the success of any venture. The first members of the team, in particular, contribute the most to the success. These team members set the tone for future hires in the business.

The challenge lies in that talent does not come cheap. To keep costs under control, entrepreneurs have to find affordable talent that has a neck for multi-tasking and holding down many requirements in the business.

This requires entrepreneurs to find individuals that share their vision and are also building their reputation and skill, willing to sacrifice and invest themselves in the growth of the business for mutual benefit.

This is not an easy task, albeit a very necessary one. With early business funding, many businesses mistakenly chose to forego this step and higher established employees. A lot of them too.

Not only does this skyrocket fixed costs by way of salaries and put a strain on cash flows, but it's also a missed opportunity to align company talent with organizational culture. It brings individuals who feel accomplished and therefore come with their own values into the business.

This may overwhelm a small business, which has likely not built its own culture, causing it to lose its vision, ultimately its value proposition, which is the death of many businesses.

Moreover, these hires know they can find opportunities out there, so when tough times come, they bail. Roughing it up before business funding builds commitment and a sense of family in the early hires, and they'll likely be there to navigate the business through tough times.

Instead of seeking early business funding to hit up recruitment agencies, look for diamonds in the rough. Once polished, these are the gems that will bring your business success.

These early days are also particularly important for entrepreneurs to teach themselves multiple skills. These skills will give them the cross-sectional versatility necessary for business success.

Burying problems with money

From: Avinash on the Marketing<> Analytics Intersect Blog

The illustration above was published on the marketing and analytics intersect blog and illustrates the dangers of quick fixes. It simply shows that even though quick fixes take a little time, additional time will

be needed to fix the fix itself, making it take as long as a real fix.

In real life though, a quick fix and fixing the quick fix take longer than understanding the problem and putting a real fix. At times, the problems arising from a quick fix may not be fixable at all. No quick fix is more common than burying problems with money.

A lot of businesses are guilty of this crime.

For example, weâ??ve all seen industry giants try to cover a hit in their brand perception with some poor PR stunt that doesnâ??t fool anyone. After significant customer churn though, they inevitably try to address the root cause of poor customer relations, often too late to make a difference.

This challenge affects new businesses greater than larger ones. This is because;

1. New businesses suffer challenges more often
2. New businesses seldom have processes in place to deal with the numerous challenges they face.

With access to early business funding, entrepreneurs are tempted and often fail to resist the temptation to just buy the cheapest solution to the problem. These quick fixes compound the problem, surfacing later even more difficult to tackle, leading to business failure.

Entrepreneurs bootstrapping their businesses donâ??t have this privilege, to their own advantage. They invest in root cause analysis; find a real, often cheaper and longer-lasting solution.

That is after all what entrepreneurship is about; applying oneâ??s self to solving problems for a profit. Throwing money at problems is just a poor example of capitalism.

Shifting all focus to monetary returns

Put yourself in the shoes of an investor, how would you define business success? The most likely answer is the monetary return the business generated for your investment. Business success for your funders is not any different.

Profits, dividends, interest payments and capital growth quickly become the yardstick once an entrepreneur gets business funding. These factors also become the determinants of failure. Failure to reach thresholds regardless of any other factors constitutes a bad period.

With this blinkered view, liquidation may even be considered. But any entrepreneur knows that entrepreneurial success is far from black and white. Entrepreneurship is a gruelling journey where every little success is celebrated.

Patience is the most valuable currency when starting a new business and success can be achieved after many gruelling years.

With a shift to monetary returns caused by early business funding, entrepreneurs may become unnecessarily demotivated and business liquidation may be prematurely considered.

Missing the learning curve

Mistakes are very common in the early stages of a business. Early business funding can amplify these mistakes. Simple oversights can lead to irreparable damage. This is a lesson that became very apparent in a venture I was part of.

Upon receipt of a request from a client, we became too excited to do due diligence and scrutinize it. Who could blame us, we were excited, and it was a big break.

Luckily we didn't have the funds to fulfil the order, so we set out to find business funding for the project. It didn't take long for one of our potential funders to figure out the whole thing was a scam. In retrospect, the scam was pretty obvious.

Had we had a funder, we would have lost their money, burnt our reputations and entered into lifelong debt. The entire team learned a valuable lesson from that experience. Early business funding robs entrepreneurs of that important factor, a smooth ride on the learning curve.

A mistake like that would have completely dashed my enthusiasm for entrepreneurship as I imagine it would for many.

Foregoing early business funding allows entrepreneurs to make small manageable, recoverable mistakes. They can dust themselves off and try again without being daunted. Even the business is left in a position to continue after these small mistakes, as we did.

If the mistake is worth millions though, there is seldom hope for both the entrepreneur and the business.

Unsustainable asset acquisition

Excessive business growth can be as much of a threat to a small business as a complete lack of growth. Growth needs to be systemic and systematic for it to be sustainable in the long run.

No function should lack behind, otherwise, it buckles under the weight of the functions it supports. The failure of this function becomes imminent and soon after that, a domino effect follows that takes the rest of the organization with it. After all, any chain is only as strong as its weakest link.

Asset acquisition is the unchecked growth that often affects ventures that get early business funding. A number of factors propel entrepreneurs to go on an asset-buying spree.

The most common is that with sufficient capital in the coffers, the line between necessity and luxury becomes blurred. This lulls entrepreneurs into a false sense of justification for their purchases and the asset register quickly fills up.

However, with low asset utilization and performance ratios, these assets quickly become difficult to manage and maintain. In addition to diverting funds that could have been better used elsewhere, they put pressure on future cash flows.

Without access to or with limited business funding though, more organic growth is pursued. Assets grow in line with revenues they generate, purchased timely as needed. Their utilization and the return on investments in these assets are significantly improved allowing the business to achieve more success.

Higher cost of capital

In financial management, mainly three factors determine the risk premium of a firm:

1. The number of assets it owns, implicitly put up as collateral
2. The likelihood to generate cash flows to pay back the loan, as determined by the firm's profitability
3. The extent to which the firm is viewed as a going concern

The risk premium in turn determines the cost of capital. Lacking in these three areas increases the cost of capital for new firms.

This means seeking business funding early before getting a concept on the ground means paying more for capital. A good example is a junk bond. This is a bond issued by relatively unknown companies and hence pays a higher interest rate than its established counterparts.

Contrary to popular belief, junk bonds do not pay a higher premium because they are riskier, they pay it because they are perceived to be so. There is an important distinction here because some junk bonds come from very good investments.

This disadvantage means seeding a large share of equity or straining cash flows with large payments for small businesses. Instead, it's wiser for entrepreneurs to gain a little traction, prove their concepts and get fairer financing from investors.

This way the business funding benefits as opposed to straining the entrepreneur and the business.

Seeding operational control

In addition to seeding significant equity to secure funding, many investors may require entrepreneurs to seed operational control as well. This immediately grunts the funders rights to make decisions affecting the future of the business, even vetoing some of the founders' own.

This can be counterproductive. More often than not, funders are interested in maximizing the return on their investment above all else. They can't be blamed though, that's what they are in the

business of, maximizing returns.

It's, however, a different case for the entrepreneur though. Entrepreneurs are more invested in sustainability and growth for their businesses. Their businesses are more than money-making machines, they are a passion shared with the world.

Making a profit doesn't hurt, but for the founder, the return on their investment is more than just currency.

This can quickly lead to conflicting interests in the management of a business. This is a detrimental situation that few businesses can survive particularly small ones. Additionally, the nature of funding contracts puts the founder at a disadvantage and funders get their way.

In the process, businesses lose their visions, missions and value propositions in pursuit of short-term profitability. Before long they lose the essence of their existence and fade into obscurity. Failure usually follows shortly after.

Losing the ability to pivot

Many businesses today are not what they were set out to be. While for many it's a result of organic growth, for some it's a result of a complete change in strategy, pivoting. Changing circumstances make it important for businesses to stay flexible if they are to survive.

When an entrepreneur gets business funding though, this becomes very difficult. Business funding is for a particular purpose, the one an entrepreneur pitches to funders to get access to capital. When this purpose is changed, funders become uncomfortable.

After all, funders are not privy to the same vision, drive, and raw entrepreneurial instinct the founder has. Panic is a natural reaction and can be understood. Some business funding agreements may even expressly prohibit this shift.

As a result, entrepreneurs tend to stick to the original script to hold onto that precious capital. Even when it becomes clear the original path is not the wisest, they remain tethered to it. In any business, this is the shortest route to failure.

Entrepreneurs bootstrapping their operations are not bogged down by any such commitments though. At any given time, they can readjust, shift the fundamentals, put themselves in a better position to take advantage of opportunities and navigate threats.

So what does this mean for entrepreneurs?

It's important to remember that getting business funding early is not the enemy. Entrepreneurs just need to be aware of the challenges it comes with and avoid them.

More importantly, they need to appreciate there just could be an advantage to [starting a business with limited funding](#).

Because of this, lack of access to business funding should not stand in the way of entrepreneurs but motivate them to succeed.

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Author

mutconco