# Financing Growth: A Practical Resource Guide for Small Businesses

**APRIL 2015**

## An Introduction to Capital Navigation Issues

Small business growth and long-term success depend on securing sufficient capital at critical times in the business life cycle. According to a recent National Small Business Association report (2014), more than 28 percent of small business owners are unable to obtain adequate financing.[1] A recent report from the *Pepperdine Private Capital Markets Project* (2015) finds that businesses that need capital and fail to secure it experience slower revenue growth, hire fewer employees than planned and reduce their employee numbers.[2] The barriers that small businesses face accessing capital are well documented. Small businesses need connections to a pool of readily available capital and the capacity to effectively compete for scarce resources.

The purpose of this report is to address a separate, but related issue that is often overlooked: Businesses need to find the "right" capital to support their growth. For example, they may benefit more from an infusion of capital from a non-traditional source than trading ownership shares for equity from a traditional venture capital firm. The explosion of new sources of capital (e.g., crowdfunding) further complicates this issue. Without at least a cursory understanding of the different types of available capital, small businesses may limit their search to known resources and thereby may not find the best capital for their growth requirements. In addition, finding the right capital match will help small businesses become more competitive. They will have a better chance of securing capital from a provider targeting their type of firm.

This report provides a practical and concise guide for small businesses that are exploring different sources of capital, and has a focus on emerging sources. It includes some insights into the relative advantages and disadvantages of alternative capital options, and successful case studies. Our intent was not to create a definitive guide on capital for small businesses, but rather to offer a compass for businesses that are trying to navigate the capital landscape.

We are especially interested in supporting urban small businesses poised for growth—firms that have been operating for at least one year and have likely already received their first infusion of capital. Our target audience is the entrepreneurs who have started companies in high-growth industries who are connected to incubators and accelerators. As such, we focus primarily on equity capital because it is essential for second stage growth and it is typically more difficult for small businesses to find comparative information on alternative sources of equity than for debt capital. The lending market has also been effectively covered in several national and local resource guides.[3] Although many emerging sources of capital target social enterprises, this report is focused on for-profit firms that do not self-identify as social enterprises.

The resource guide was informed by a thorough review of the literature on small business capital and interviews with key experts in the field, including leadership at financial organizations. The guide is divided into five sections:


- Traditional private-sector capital sources (private equity, venture capital and angel investors), p. 2;
- SBA programs, p. 5;
- Specialized opportunities (program related investments, community development venture capital and EB-5), p. 7;
- New sources of capital (revenue-based capital and crowdfunding), p. 10;
- Successful models for incubator and accelerator funds, p. 14.


Two visual executive summaries that highlight the comparative tradeoffs of the different sources follow.

**Figure 1: Capital Types by Business Growth Stage**

| SEED STAGE | EARLY STAGE | EXPANSION STAGE | LATE STAGE |
|---|---|---|---|
| Private Equity & | Venture Capital | | |
| Angel Investors | | | |
| SBIC | | | |
| | SBIR/STTR | | |
| | PRIs | | |
| CDVC | | | |
| | | EB-5 | |
| Revenue-based | Capital | | |
| Rewards-based | Crowdfunding | | |
| Equity-based | Crowdfunding | | |

## Traditional Private-Sector Capital Sources

Private equity, venture capital and angel investors are the traditional sources of private capital.

### PRIVATE EQUITY AND VENTURE CAPITAL

**Definition:** Private investors provide capital to a business in return for an ownership share.

**Size of Market:** Private equity invested $31.4 billion in companies in 2013 and venture capital invested $48.3 billion in 2014.[4]

**Best Fit:** While private equity funds often target larger companies in established industries, venture capital funds typically focus on smaller companies in high-growth industries that are considered too risky for other private equity players (e.g., high-tech companies). In 2014, the software industry captured the most venture capital dollars ($19.8 billion or 41 percent) and the highest number of deals (1,799).[5] Biotech, and media and entertainment were distant second and third industries. Venture capital is increasingly flowing to expansion stage funding and funding bigger deals.[6] Private equity funds are generally not interested in funding small businesses because of high underwriting costs relative to small investments with limited exit opportunities. However, businesses that have government contracts are more likely to obtain private equity and venture capital because the contracts mitigate some business risk.[7]

**Advantages:**

+ The primary advantage of these two sources of capital for small businesses is that they can provide substantial capital for business growth and opportunities for follow-on funding.
+ Through their ownership share (i.e., a board seat), private equity and venture capital providers are available to advise small businesses. In addition, some offer a range of management and advisory services built on proven track records that can be very valuable to inexperienced business owners.
+ Capital providers may also develop specific financial instruments and contractual clauses (e.g. stage financing) to create growth-oriented incentives for entrepreneurs.[8]
+ Finally, and perhaps most importantly, growing firms gain access to potential new customers, suppliers, and providers of specialized services through their capital providers' networks.

**Disadvantages:**

– Only a small percentage of firms successfully obtain private equity and venture capital (some estimate that it may be less than one percent, even for established companies).[9] As one expert that we interviewed said, "there is a lot of venture capital chasing only the best startups." It is a very competitive market with high rates of rejection.

– Most private equity and venture capital lending happens in Silicon Valley. In 2014, Silicon Valley attracted 48 percent of all U.S. venture capital dollars and 32 percent of deals. The New York metro was a distant second (10 percent of dollars and 11 percent of deals).[10]

– Several studies show that minority, women and foreign-owned businesses face even greater challenges and are less likely to secure private equity and venture capital.[11]

– Firms in non-traditional venture sectors (e.g., food service) are generally not considered attractive investments.

– It is not patient capital. For some businesses, the timeline from product development to a procurement pipeline can take longer than the ten years required by private equity and venture capital.

– The due diligence process is time consuming and expensive, especially for small business owners that are new to the process.

– Small businesses have higher opportunity costs associated with obtaining this type of equity. Time spent by the entrepreneur cultivating relationships with investors and negotiating deals means less time spent on business operations, which potentially hurts business growth in the process. Private equity and venture capital deals can take six to 12 months to close.[12]

– Another primary disadvantage is a loss of ownership and, therefore, control. An entrepreneur's diminished control has ramifications not only for the entrepreneur but for the city and state in which they are located. Outside investors may decide to move the firm, creating a loss of income and jobs for its current location and limited returns from early stage local support.

Some equity funds have unique missions and drive positive social and environmental change. **THE BAY AREA EQUITY FUND** is a $75 million Double Bottom Line (DBL) private equity fund. It seeks to deliver market-rate returns while supporting social and environmental improvement in low-income Bay Area neighborhoods. Investments focus on rapidly-growing technology companies, firms that supply consumer products and services, and health care companies that provide benefits to residents in target neighborhoods. Since its close in June 2004, the fund has been helping its portfolio companies implement tailored DBL programs in their communities.[13]

**Figure 2: Navigating Capital Sources by Tradeoffs**

| | TYPES OF CAPITAL | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Relinquish Ownership and Control, Gain Significant Growth Capital | Private Equity & Venture Capital | Angel Investors | SBIC | CDVC | EB-5 | | | |
| Retain Full Ownership, but Gain Modest Amount of Capital (<$1M) | SBIR/ STTR | PRIs | Revenue-based Capital | Rewards-based Crowd-funding | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Targeted Industries and/or Geographic Concentration | Private Equity & Venture Capital | Angel Investors | SBIR/ STTR | | | | | |
| No Significant Industry or Geographic Concentration | Angel Investors | SBIC | PRIs | CDVC | EB-5 | Revenue-based Capital | Rewards-based Crowd-funding | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| High Cost of Capital | Private Equity & Venture Capital | Angel Investors | SBIC | CDVC | Revenue-based Capital | | | |
| Modest or Free Capital | SBIR/ STTR | PRIs | EB-5 | Rewards-based Crowd-funding | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Access to Mentors, Advisory Services | Private Equity & Venture Capital | Angel Investors | SBIC | SBIR/ STTR | CDVC | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Access to Supply and Customer Networks | Private Equity & Venture Capital | Angel Investors | SBIC | SBIR/ STTR | CDVC | | | |

## ANGEL INVESTORS

**Definition:** Like private equity and venture capital funds, angel investors provide capital to a business in return for an ownership share. Unlike private equity and venture capital funds, angel investors are individuals who invest their own money in companies.

**Size of Market:** Angels invested an estimated $25.8 billion in 2014.[14]

**Best Fit:** Early to late stage funding. Like venture capital, angel investors seem to be gradually moving away from seed funding to later stage investing.[15]

**Advantages:**

+ Angel investing continues to expand and includes unaccredited investors, meaning there are significantly more potential investors than with other alternatives, including those found in an entrepreneur's personal network of friends and family.
+ Angel investors can provide more patient capital than private equity or venture capital, since they do not need to provide returns to their own investors.
+ The capital is flexible and includes small and large loans.
+ Through the angel's ownership share (i.e., a board seat), small businesses can draw on the advice of angel investors. Many angel investors are former entrepreneurs and their business experience can be very valuable to entrepreneurs.[16] An academic study of angel investments finds that small businesses funded by angel groups have improved survival, exits, employment, patenting, and financing than businesses rejected by these groups.[17]
+ Angel investors may be motivated by more than profit and may thus be persuaded by different criteria than the standards needed to convince traditional private equity and venture capital. Some entrepreneurs that were rejected by traditional venture capital firms may have a better chance with angel investors, especially if the angels are unaccredited.

• Angel investments may be less time consuming and unaccredited angel investors will typically require less due diligence.

**Disadvantages:**

– According to the 2015 *Pepperdine* report, angel equity has the highest average costs of capital, with expected annual returns in the range of 25-30 percent.[18] However, since they also invest at early stages, with higher risks, angel capital may not be more expensive when compared to private equity and venture capital making similar investments.

– As with private equity and venture capital, angel investing is concentrated in a few industries (software, healthcare, retail, biotech, IT and industrial/energy captured 80 percent of angel investments in Q1Q2 2014).[19]

– Since angel investors by definition do not have access to a larger fund of capital, they may not have the resources available for multiple rounds of funding.

– Angels who want to play highly active advisory roles may potentially interfere with business operations.[20] Conversely, while some angel networks include management and advisory services for entrepreneurs, individual investors do not have to provide this level of support.

– As individuals, angels do not always offer firms the same level of access to new customers, suppliers or specialized services as private equity or venture capital firms.

**Context:** Traditionally, angel investors have been high net worth individuals, many of whom are entrepreneurs themselves, who provide critical seed funding to businesses that may have difficulties finding capital elsewhere. Angel investing, however, continues to evolve and now also includes investors who are not necessarily high net worth individuals, although many still have business experience.[21] Angel investors include both accredited and unaccredited investors, but the accredited investors provide the majority of capital.[22] Angel investors often participate in semiformal networks that make deals with subgroups of members.[23] These groups may provide some level of technical assistance to the businesses in which they invest.

### Figure 3: Private Capital Market Rates of Return

| | 1st quartile | Median | 3rd quartile |
|---|---|---|---|
| PEG ($25M EBITDA) | 24.3% | 25.0% | 28.8% |
| PEG ($50M EBITDA) | 22.3% | 25.0% | 26.3% |
| VC (Seed) | 23.0% | 33.0% | 48.0% |
| VC (Startup) | 23.0% | 33.0% | 38.0% |
| VC (Early Stage) | 23.0% | 28.0% | 38.0% |
| VC (Expansion) | 19.0% | 25.0% | 33.0% |
| VC (Later Stage) | 18.0% | 25.0% | 33.0% |
| Angel (Seed) | 15.0% | 30.0% | 35.0% |
| Angel (Early Stage) | 21.3% | 25.0% | 35.0% |
| Angel (Expansion) | 21.0% | 25.0% | 35.0% |
| Angel (Later Stage) | 17.5% | 25.0% | 30.0% |

**Source:** Adapted from Everett, C. R. (2015). *Pepperdine Private Capital Markets Project: 2015 capital markets report*. Pepperdine University Graziado School of Business and Management, p. 5.

**Note:** PEG = Private Equity Group and VC = Venture Capital

**MAINE ANGELS**, an angel network in Portland, Maine, established in 2003, comprises a group of over 65 accredited private equity investors who invest in and mentor early stage companies from diverse sectors: "Our goal is to make sound investments in promising New England entrepreneurs with an emphasis on Maine businesses."[24] It uses a team approach to deal evaluations. After every presentation by an entrepreneur, members who are interested in the proposal form a working group with a designated "deal lead." The members work collaboratively through the due diligence process, leveraging the group's expertise and connections, and negotiate a deal for all members to consider. Once due diligence is complete and deal terms have been established, each member individually chooses whether or not to invest.[25] Some deals also include capital from strategic partners. Individual angel investments range from $10,000 to over $100,000 and total deals range from $35,000 to $710,000. As of the end of 2014, Maine Angels had invested more than $13 million in 56 companies.[26] According to a 2014 ranking of angel groups by CB Insights, Maine Angels ranked number one in the U.S. in terms of follow-on funding, with over 80 percent of all businesses going on to raise additional capital.[27] Prominent companies associated with Maine Angels include ezCater, a Boston-based internet company that connects businesses to local restaurants and caterers for group ordering,[28] and Jamhub, a Whitinsville, MA-based electronics company that offers music sound solutions.[29]

The nation's largest and oldest impact investment angel group, **INVESTORS' CIRCLE**, was established as a nonprofit in 1992 in Chicago and is now headquartered in Durham, North Carolina. Its mission is to promote the transition to a sustainable economy by increasing the flow of capital to early stage enterprises that are addressing social and environmental challenges.[30] The organization was recently ranked by the annual Halo Report as one of the 10 most active angel groups in the U.S., with over $190 million being invested in 290 enterprises since its inception, including $8.5 million invested in 32 enterprises in 2014.[31] To do this, the organization connects entrepreneurs and investors face-to-face at national pitch events and local network meetings. Investors' Circle offers three national "Beyond the Pitch" events a year, where 10-15 companies pitch to their large network of nearly 200 angel investors. Historically, nearly 50 percent of entrepreneurs at the national events have received funding after their presentation.[32] Investors' Circle also has local networks in six regions around the country that meet regularly in Boulder-Denver, Boston, New York, Philadelphia, Raleigh-Durham and San Francisco. Prominent companies associated with Investors' Circle include Social Imprints, the go-to promotional printer for top Silicon Valley companies[33] and the advanced lighting firm Luxtech.[34]

## SBA Programs

The federal government plays an important role in funding the growth of small businesses, with several agencies providing grants and contracting opportunities.[35] In this report we focus on U.S. Small Business Administration (SBA) programs because it is their mission to support the growth of small businesses, including ensuring that they have sufficient access to capital. The SBA does not directly serve small businesses, but rather works with intermediaries. While the SBA is best known for its role as a guarantor of a variety of commercial loan products deployed through financial institutions, the agency also facilitates the deployment of equity and debt capital to small businesses through other federal agencies and private-sector partnerships.[36] For the purposes of this report, we highlight the three primary SBA programs that facilitate the deployment of equity capital to small businesses: the Small Business Investment Company (SBIC) program, the Small Business Innovation Research (SBIR) program, and the Small Business Technology Transfer (STTR) program.

### THE SBIC PROGRAM

**Definition:** The SBIC program partners with privately-owned, professionally-managed investment funds to facilitate the flow of capital to U.S. small businesses. Although the program allows its funds to make equity investments, most SBICs provide debt financing. The SBIC is essentially a "fund-of-funds" program that deploys capital on a matching basis to funds across the U.S. that in turn provide capital to small businesses.

**Size of Market:** At the end of 2014, there were 299 active SBICs. In FY2014, the SBIC program deployed $5.5 billion,[37] which ultimately financed 1,085 small businesses, over 26 percent of which were women, minority, or veteran-owned or in low to moderate income areas. Of the $5.5 billion in financing, $955.6 million was in the form of equity investment and an additional $1.03 billion was invested as hybrid mezzanine capital.[38]

**Best Fit:** The average SBIC investment in a small business was $2.4 million in 2014, and 21 percent of 2014 investments were to companies that were less than two years old. Over the past five years, SBIC investments were made in 48 states, with 28 percent flowing to manufacturing firms and 15 percent to professional services.[39]

**Advantages:**

+ SBICs operate in much the same way as a traditional private equity or venture capital firm. Entrepreneurs may not even realize they are seeking funding from an SBIC. As such, they share many of the same advantages as private equity and venture capital.

- + SBICs provide financing to small businesses in a broader set of regions and industries than venture capitalists. They also target minority and women-owned businesses and small businesses in underserved areas.[40]
- + The program's stability through the business cycle is another advantage: Even as private capital became scarce after the financial crisis in 2009, SBIC total financing actually increased every year between 2009 and 2014.[41]

**Disadvantages:**

- − SBICs share many of the same disadvantages as private equity and venture capital, including the competitiveness of their funding.
- − The amount of equity invested by SBICs each year is extremely small relative to traditional private equity and venture capital providers, and a substantial portion of available funds go to underserved businesses and geographies, making SBIC capital potentially unsuitable for many firms with conventional needs.

**Context:** Founded in 1958 for the purpose of expanding the availability of risk capital to entrepreneurs, many of the first private equity firms were SBICs and many of the country's most successful companies benefited from the program including Apple, Intel, and America Online. SBICs are licensed and regulated by the SBA, but the SBA does not exert any control over SBIC decisions about which small business to provide with capital. The SBA does not directly fund SBICs, but instead uses a funding mechanism that allows SBICs to access low-cost, government-guaranteed debt from public markets.[42] The SBA provides a guarantee that can be up to a 2-to-1 match of funds raised privately by the SBIC (with a 1:1 ratio and $50 million cap for Early Stage SBICs).[43]

The majority of SBICs provide debt capital to small businesses and equity is typically part of a larger financing packing that is primarily debt capital. SBA is open to licensing new early stage equity funds through its Early Stage Initiative, which was launched in 2011. Funds licensed as Early Stage SBICs may access leverage in an amount equal to the lesser of $50 million or a 1:1 match with private capital.[44] There are currently five Early Stage SBICs.

### THE SBIR & STTR PROGRAMS

**Definition:** The SBA facilitates the deployment of capital from 11 federal agencies through the SBIR and STTR programs to support small business engagement in federal research and development (R&D) that has the potential for commercialization.[45] The SBIR program requires agencies to set aside 2.6 percent of their extramural R&D budgets for grants and contracts to small businesses. The STTR program requires federal agencies to set aside 0.35 percent of their extramural R&D budget to facilitate cooperative research agreements between small businesses and U.S. research institutions (e.g., universities).[46] Each agency independently extends solicitations for small businesses to meet their requirements.[47] Many small firms use the grants in lieu of early stage growth capital.[48]

**Size of Market:** In 2012, the latest available data, the SBIR program awarded $2.2 billion and the STTR program awarded $263 million respectively, for a combined total of just under $2.5 billion[49] in outlays supporting 6,169 businesses. Approximately 15 percent of funds went to women-owned businesses and approximately 5 percent of funds went to minority-owned or disadvantaged businesses.[50]

**Best Fit:** Early stage funding for high-tech companies with complex products or services.

**Advantages:**

- + The major advantage of these programs is that federal agencies do not take an ownership stake or intellectual property rights in the companies that participate in the program and grants provide zero-cost capital.
- + The solicitations are competitive, but acceptance rates are likely higher than the less than one percent associated with private equity and venture capital.
- + SBIR/STTR drive financing to small businesses in a broader set of industries than private equity and venture capital.
- + For companies developing a technologically complex product or service that is deemed too risky for angels and venture capitalists, SBIR/STTR may be an effective funding channel.
- + Many states have SBIR experts in state SBDC organizations who can provide valuable guidance to companies, including grant searches enabling entrepreneurs to focus on solicitations most likely to align with their company's development needs.
- + Some states provide SBIR matching funds and gap funding to support projects.
- + Studies find that SBIR-funded ventures exhibit faster revenue and employment growth along with a greater likelihood of follow-on venture capital funding than comparable firms that do not receive SBIR funding.[51]

**Disadvantages:**

- Given the three-stage funding process, these programs are initially suited only for early stage funding.
- The grants and contracts are not relevant to small businesses across all industries. The vast majority of funding comes from the Department of Defense and Homeland Security agencies.[52]
- Working directly with government agencies rather than intermediaries in the case of SBIC or conventional private equity providers can be a bureaucratic and time consuming process.
- While the federal agencies may provide technical advisory services, they do not offer the same level of management and advisory services provided by private equity and venture capital funds.
- Likewise, they may not offer firms the same level of access to new customers, suppliers or specialized services as private equity or venture capital firms.

**Context:** The purpose of these programs is to create jobs, stimulate technological innovation, strengthen the role of small businesses in meeting federal R&D needs, and increase private sector commercialization of innovations derived from federal R&D. Federal agencies with extramural R&D budgets that exceed $100 million are required to participate in the SBIR and STTR programs. The SBA serves as the umbrella organization that provides policy and programmatic oversight for the program.

Each program provides funding to small businesses in three phases. In phase one, the Feasibility Study or Prototype phase, small businesses are eligible to receive a grant up to $150,000. In phase two, the R&D phase, businesses may receive up to $1 million in grants or contracts. In phase three, the Commercialization phase, small businesses must seek private sources of funding, though some federal agencies may provide non-SBIR funded R&D or production contracts for products, processes or services intended for use by the U.S. Government.[53] Small businesses must start with phase one and successfully meet all requirements before applying for additional phases. Many notable American companies have benefitted from participation in these programs, including Qualcomm, the world's leading provider of wireless technology and services. As a tiny firm providing contract R&D services to the government in 1985, the first capital that the company received was phase one and two SBIR funding of $1.5 million from the Department of Defense and the NSF.[54]

## Specialized Opportunities

Program Related Investments (PRIs), Community Development Venture Capital (CDVC) and EB-5 capital are more specialized than the alternatives discussed above but could provide the right capital for qualified businesses.

### PROGRAM RELATED INVESTMENTS (PRIs)

**Definition:** A PRI is an investment that is treated as a grant, made by foundations to nonprofit or for-profit organizations, including small businesses.[55] It may take the form of a loan, line of credit, cash deposit, bond or equity investment: "Depending on the purpose and scope of the investment, a PRI may be relatively simple (such as a working capital loan to a nonprofit organization or a cash deposit in a community bank) or complex (such as an equity investment in a for-profit enterprise)."[56]

**Size of Market:** In 2007, the latest available data, $734 million was invested in PRIs.[57] Although the number of PRIs being made and the dollar amounts invested have been steadily increasing, they are still underutilized by foundations. According to a recent report by the Lilly Family School of Philanthropy,[58] less than one percent of U.S. foundations have made PRIs. The Gates Foundation, the Ford Foundation, the Erich and Hannah Sachs Foundation, the Skoll Foundation, and the Annie E. Casey Foundation are some notable examples of foundations that have successfully used PRIs. New IRS guidance in 2012 has generated greater interest in PRIs because it expands potential uses of PRIs for direct investment in small businesses.[59] For example, the Gates Foundation nearly quadrupled its PRI budget allocation from $400 million in 2009 to $1.5 billion in 2015.[60]

**Best Fit:** PRIs are best suited for businesses that create jobs in underprivileged areas or that advance science or promote environmental preservation. A recent article indicates that PRIs have the potential to fill the "idea-to-impact" gap between academic research and commercialization by funding ventures considered too risky, requiring too much capital, and requiring too much time for ramp up (more than 10 years) for modern venture capitalists.[61] For example, life sciences and biotechnology firms that have the potential to improve health globally may qualify, as exemplified by the Gates Foundation's recent $52 million investment in CureVac, a company developing technologies to fight cancer.[62] PRIs can be and have been used for first, second and third rounds of funding.

**Advantages:**

+ Since they are treated as debt, a significant advantage of PRIs is that it allows entrepreneurs to retain full ownership over their company.

+ PRIs can be a source for long-term, patient capital. There are no regulated limits on the size of PRIs—they range from small loans to multi-million dollar capital investments—and there are no limits on repayment terms.[63]
+ PRIs fund ventures considered too expensive, too long-term, and too risky for traditional venture capitalists whose funders expect returns within 10 years.
+ They may provide lower-cost capital because foundations are interested in impact as well as financial returns.
+ PRIs are used to finance small businesses across diverse industries and geographies.

**Disadvantages:**

- The primary disadvantage of PRIs is that the market is relatively small (less than one hundred foundations currently deploy PRIs annually) and many foundations target their funding geographically. As one expert on PRIs explained, "most small businesses should not spend their time trying to secure a PRI—it may not be fruitful as there is not yet an accessible touch point to many PRI-makers."
- Crucial intermediaries, such as lawyers and accountants, may lack the experience and resources to effectively evaluate and facilitate investment.[64]
- Foundations will likely not provide technical advisory services nor offer the same level of management and advisory services provided by private equity and venture capital funds.
- Likewise, they may not offer firms the same level of access to new customers, suppliers or specialized services as private equity or venture capital firms.
- The decision process may be lengthy, especially at foundations that do not have a track record with PRIs. They may also ask for additional documentation. As one expert stated, "it is a slow yes or no with PRIs, which isn't helpful for most small businesses that need an answer quickly."

**Context:** Foundations use PRIs as another tool to achieve their mission. Because they are expected to be repaid, with some return, they stretch foundation endowments further. Foundations are not allowed to use PRIs for the sole purpose of generating income, which sets them apart from other types of equity investments. To prove that the investment was made for reasons beyond solely future income, foundations can cite the timeline for drawing financial returns or the perceived market returns, or regulatory risk of the investment in question, among other qualitative variables.[65]

**THE HERON FOUNDATION** is a recognized leader in mission-related investing. They have over 51 investments (as of early 2015) with a direct investing strategy focused on strengthening growth stage enterprises through both PRI and non-PRI investments, while also employing the full range of other financial tools in their portfolio.[66] These include bonds, private equity funds and public equity that expand reliable employment and economic opportunity for the disenfranchised.[67] In 2012, Heron embarked on a strategic shift to focus their investments on opportunities that, above all, "add jobs to the economy and help combat persistent poverty and unemployment."[68] In 2013, they invested their largest direct debt PRI to date ($5 million).[69]

As one example of this new strategy, in 2012, the Heron Foundation made a $1 million Series C preferred equity investment in Ecologic Brands.[70] Ecologic Brands, headquartered in Oakland, California, is a new entrant to the packing industry that creates biodegradable packaging out of recycled materials.[71] The company, whose customers include major brands like Safeway and Seventh Generation, is a double bottom line company that emphasizes workforce development and environmental goals.[72] Interestingly, this investment was not a PRI, but nonetheless allowed Ecologic Brands to upgrade its manufacturing plant in Manteca, California, a city with significantly higher unemployment than the national average, which will create 138 new manufacturing jobs in Manteca.[73]

**PRIME COALITION**, a nonprofit organization in Boston established in 2014, facilitates philanthropic investments to mitigate climate change.[74] Its launch is being supported by eight philanthropic families—foundations and family offices. It was created to increase awareness about PRIs, especially their use as capital providers for small businesses, and to expand the adoption of PRIs. PRIME helps foundations with traditional venture investor competencies like due diligence, deal sourcing, and the structuring of terms.[75] The organization, which is funded solely through grants, supports foundations in the deal-making process but does not take any ownership stake or revenues from the deals. PRIME may also act as a fiscal intermediary where the philanthropic organizations give PRIME a recoverable grant and PRIME extends a recoverable grant to the small business.[76]

The organization is targeting two PRI investments annually in 2015 and 2016. They are in the process of closing their first deal, which includes three mission-oriented families—two foundations and one angel investor—investing $500,000 in seed capital. PRIME is focused on businesses positioned to significantly reduce greenhouse gas emissions and that may become attractive to traditional follow-on investors, but which struggle to raise traditional venture capital because of their high risk and long technology development timelines.[77]

## COMMUNITY DEVELOPMENT VENTURE CAPITAL (CDVC)

**Definition:** CDVC funding is provided by mission-driven venture capital funds that invest in small businesses in underserved communities to create good jobs for low-income people.

**Size of Market:** According to the CDVC Alliance, 75 funds are currently operating in the U.S., providing $2.4 billion annually to small businesses.[78] The CDVC Alliance maintains a list of active funds.[79] Five percent of funds are invested in seed stage businesses, 76 percent in series A, and 13 percent in series B.[80]

**Best Fit:** Early and growth stage funding for small businesses that generate jobs in low-income communities. CDVC funds have been invested in companies across a broad set of industries, including software/IT services, consumer products, manufacturing, cleantech, restaurant/hospitality services, business services, and healthcare services.[81] CDVC is most often invested in regions with limited access to venture capital and in industries outside of the high-tech venture capital mainstream. In many deals, though, CDVC capital is invested with traditional venture capital and in these cases it is more likely to be invested in traditional venture capital industries.[82]

**Advantages:**

+ CDVC funds operate in much the same way as traditional private equity or venture capital firms. Entrepreneurs may not even realize they are seeking funding from a CDVC. As such, they share many of the same advantages as private equity and venture capital.
+ It provides capital to more diverse industries and regions, including those areas that do not have robust venture capital markets.
+ Organizations that provide CDVC combine the expertise, networks, and resources of a traditional venture capitalist with the desire to invest in companies that are making a positive social or environmental impact.
+ An advantage of CDVC is its flexibility and the ability of CDVC funds to make smaller investments under $3 million.[83] More than 80 percent of CDVC investments are under $3 million.[84]

**Disadvantages:**

– CDVC shares many of the same disadvantages as private equity and venture capital, including the competitiveness of their funding.

– The amount of equity invested by CDVCs each year is extremely small relative to traditional private equity and venture capital providers and a substantial portion of available funds go to underserved businesses and geographies, making this capital potentially unsuitable for many firms with conventional capital needs.

– A recent study finds that CDVC capital may not be as effective as traditional venture capital in driving growth and may be associated with a lower probability of successful exits than traditional venture capital.[85]

**Context:** CDVC funds were first created in the 1970s and expanded through CDCs and CDFIs, but did not gain more widespread use until the 1990s.[86] CDVC funds are venture capital funds that self-identify as such based on their mission; there is no federal government designation or definition.[87] Other than their mission, they operate like traditional venture capital funds and seek market-rate financial returns. Their funds are backed primarily by banks (30 percent) followed by government funds (23 percent),[88] which typically include a mix of SBA and CDFI funds and state and local government funding.[89] Not all CDVC funds are certified as CDFIs, although the CDVC Alliance encourages this to happen so they are eligible for CDFI funds.[90] Most CDVC funds are established as for-profit limited partnerships with 10-year lives and traditional venture capital structures, which is not a great match with the CDFI Fund certification process.[91] In terms of mission, CDVC funds operate like CDFIs, but they often don't apply for CDFI status.[92] While some CDVC funds are nonprofit, the more common structure is an association between a for-profit fund and a nonprofit affiliate that provides technical assistance (e.g., mentoring and workforce development).[93]

**SJF VENTURES**, a venture capital partnership established in 1999 with offices in Durham, North Carolina, New York City and San Francisco, is a leading impact investor representing a portfolio of over 40 high growth companies. SJF provides initial equity financing of $1 million to $5 million and leads or participates in syndicates of larger rounds.[94] SJF Ventures focuses on companies in the resource efficiency, energy and infrastructure, health and wellness and education sectors.[95] It looks for not only the usual qualities in investments – management teams with deep domain expertise, strong customer validation, and explosive growth opportunities – but also an interest in making a positive impact on society through their work.[96] In February 2015, for example, SJF was part of a syndicate of investors in a Series C round for Civitas Learning, an Austin-based company that helps more than 2.3 million students navigate college through a predictive analytics platform.[97] The company had previously raised a Series A round of funding in 2011 for $4.1 million and a series B round in 2013 for $8.7 million. For its next round of funding the company looked to a syndicate led by ReThink Education that included SJF Ventures in 2014-15. In January, 2015, Civitas Learning raised $16.2 million in Series C funding from this group of investors.[98]

### THE EB-5 IMMIGRANT INVESTOR PROGRAM

**Definition:** The EB-5 Immigrant Investor program, administered by United States Citizenship and Immigration Services (USCIS) and housed within the Department of Homeland Security (DHS), was created by the Immigration Act of 1990 to create jobs in high poverty and high unemployment areas using foreign capital. It does this by facilitating the issuance of an EB-5 visa to an immigrant investor who makes a significant investment of their own funds in a commercial enterprise that creates at least 10 full-time jobs.

The minimum investment requirement for EB-5 is set at $1 million, or $500,000 if the project is located in a targeted employment area (TEA), defined as a rural area or an area with an unemployment rate of at least 150 percent of the national average.

**Size of Market:** The EB-5 program has the potential to channel up to $5-10 billion annually to economically distressed areas. In FY2014, an estimated $2.6 billion was invested in EB-5 projects.[99]

**Best Fit:** Many EB-5 projects are large real estate development deals. However, the growth in regional centers and increased interest in the EB-5 program has led to new deals involving smaller businesses. When the EB-5 program was first started the capital was often used for smaller projects such as restaurants and retail businesses.

**Advantages:**

+ It can be a relatively low cost of capital since most investors are interested in the visa status as the primary benefit from their investment.
+ Investors have some ownership obligations, but typically do not exert the same control over the business as traditional venture capitalists.
+ It provides capital to a diverse set of industries in regions that do not have robust venture capital markets (including inner cities).
+ It is flexible capital that can be invested in small amounts ($500,000 or $1 million per investor).

**Disadvantages:**

– The primary disadvantage of EB-5 is that the market is relatively small. Smaller deals, especially when they are in smaller cities, typically find it difficult and costly to attract EB-5 investors since it requires global connections.

– The EB-5 program is complex and it may be difficult or costly to hire crucial intermediaries, such as lawyers and accountants. In addition, application materials need to include economic modeling that shows ten jobs created for each immigrant investor to gain approval.

– EB-5 capital is not patient capital; there is an expectation that most capital will be returned to investors after five years.

– Projects that use EB-5 funding can take more than one year to gain approval from the federal government.

– Since EB-5 investors are individuals and do not have access to a larger fund of capital, they may not have the resources available for multiple rounds of funding.

– EB-5 capital typically does not include management and advisory services for entrepreneurs, nor does it offer the same level of connections to potential new customers, suppliers, and providers of services.

**Context:** The investors and the project are subjected to scrutiny and must meet several criteria, including securities regulations, before the visas ultimately are granted. Most EB-5 projects are brokered by regional centers. These centers pool funds from multiple investors to support economic development within a defined geographic area. As of June 2014, 579 regional centers had been approved by USCIS. The government does not release any aggregate data on regional center activity, but a recent report finds that 60 of the regional centers operate in more than one state and the states with the most regional centers operating within their boundaries are California, Florida, Texas, Washington, and New York. Every state has at least one regional center with the authority to operate there.[100]

## New Sources of Capital

The explosion of innovative startups and scarce capital is driving the growth of new sources of capital, which disrupts the traditional pathways that small businesses have used to obtain growth capital.

### REVENUE-BASED CAPITAL

**Definition:** Revenue-based capital, which is also referred to as royalty-based capital, has characteristics of both debt and equity, and can be structured to be treated by the IRS as either debt or equity. Typically, companies pay a fixed percentage of top-line revenues monthly, quarterly or annually until the original investment plus a return is paid back to the investor. For example, revenue-based debt terms could define monthly payments of three percent of revenue until 1.5 times the initial investment is returned.

**E3 CARGO TRUCKING** is an example of a small business that was able to successfully leverage EB-5 funds. The company's goal is to first grow a transportation hub in Indianapolis of up to 300-500 trucks, then expand into other markets to ultimately build a national transportation network. E3 Cargo Trucking did not use a regional center. It is structured as a partnership between E3 Investment Group, LLC, and each EB-5 investor as an independent limited partner in the trucking company. Branded as the Scalable-Direct™ business model, each limited partner investor's capital is a direct $500,000 EB-5 investment, which will fund its own separate and distinct entity, co-managed and run by E3 Investment Group and its affiliated entities.

Since historically the profit margins of trucking companies are fairly low, private equity is not typically interested in the trucking industry. EB-5 capital was chosen due to its low cost compared to the traditional private equity market. The developers believe their model will attract EB-5 investors because they are expected to receive their $500,000 investment capital after four years, plus a return on their investment of approximately three percent. Because E3 Cargo Trucking is using the direct investment model, rather than the regional center approach, they believe their EB-5 applications are being approved fairly quickly, within 12 months.

E3 Cargo Trucking was officially launched in January 2015 and has attracted several investors to date, from India, China, Vietnam and Japan.[101] They have secured their operational funding, are in the process of hiring their first employees and deploying the capital of one investor, and plan to have their first trucks on the road within the year.[102]

**Size of Market:** Although revenue-based financing has been used to fund established companies since the turn of the twentieth century,[103] an exhaustive search did not surface any reliable estimates of the total amount being invested using revenue-based capital. Experts differ in their opinions on whether this type of financing is increasing or decreasing.

**Best Fit:** Revenue-based capital has been used for more than a century in the U.S. in the oil and gas, movie, music, publishing, and pharmaceutical industries and, as such, early and expansion stage companies in these industries are especially attractive targets for this type of capital.[104] While mostly used for companies looking for early stage financing,[105] new online entrants focused on the seed stage (like Fledge profiled below) are innovating beyond revenue-based financing's traditional uses. This type of capital tends to work better for high-margin businesses that can retain profitability while paying a percentage of monthly sales.[106]

**Advantages:**

+ A significant advantage of revenue-based capital when it is structured as debt is that it allows entrepreneurs to retain full ownership over their company.
+ It can be used to fund growth projects, which are often considered too risky for traditional bank lenders and too small for most equity investors.
+ Since investors receive returns based on growth, and not on buyouts or IPOs, they have the incentive to support additional business growth and not seek exit events.
+ When it is structured as debt, there are no complex negotiations over valuation as with venture capital.[107]
+ Compared to traditional debt financing, revenue-based financing typically does not require personal guarantees, restrictive covenants, or collateral.[108] Firms with seasonal revenue models may prefer revenue-based capital to loans that must be repaid regardless of actual cash flows.

**Disadvantages:**

– Perhaps the biggest disadvantage of revenue-based capital is that it is a relatively small market that is currently captured by businesses within a few industries.

– In addition, since this is an unique source of capital, there is often a learning curve associated with closing deals, potentially making them more time consuming.

– When it is structured as equity, companies dilute their ownership and control.

– If it is structured as debt, it could prevent a business from obtaining follow-on equity because debt is paid out first in the event of bankruptcy.

– Depending on the terms of the contract, entrepreneurs may have to pay investors before cash flow is realized and may have to pay off the principal even if the business is struggling.

– Revenue-based financing typically ranges from $50,000 to $800,000, although providers can syndicate to higher totals.[109] For large second and third rounds of funding in capital-intensive industries, this may not be sufficient.

– This type of capital typically does not include the same level of management and advisory services for entrepreneurs as traditional private equity or venture capital, nor does it offer the same level of connections to potential new customers, suppliers, and providers of services.

**FLEDGE**, established in 2012, is the "conscious-company accelerator," an investment fund and business accelerator based in Seattle that uses revenue-based equity. Their mission is to "help the entrepreneurs making a true impact in the world; improving lives, the environment, health, communities, or making a more sustainable world."[110] Fledge supports entrepreneurs via an intense, 10-week program of guidance, education, and mentorship.[111] Fledge targets early stage social enterprises that address traditional social problems like homelessness and poverty, but also for-profit businesses in clean and financial technology.[112] Each accepted company receives a $20,000 initial investment in return for a percentage of future revenues capped at a finite amount.[113] Fledge has invited approximately seven companies each session (twice a year) into its accelerator since its founding for a total of 39 companies to date.[114]

Chicago-based **BOLSTR**, founded in 2012, also utilizes revenue-based capital to fund small businesses. It uses a lending model that structures monthly payments based on a percentage of revenue until the predetermined repayment amount (a multiple of the loan) is met. It targets firms in the consumer goods, retail and manufacturing industries that need capital for growth projects (e.g., expansion into a new market). Bolstr uses a marketplace lending platform (https://bolstr.com) to match investors with businesses. Similar to crowdfunding platforms (discussed in more detail below), Bolstr curates the businesses who apply to their platform based on a proprietary methodology. They have shared that they use everything from credit scores to Yelp ratings for their due diligence.[115] Even though Bolstr has only been funding projects since 2013, it already can showcase an impressive list of deals ranging from a lobster roll restaurant in Chicago that paid back its first loan of $70,000 in seven months to a San Francisco brewery that raised $150,000 in capital in 24 hours.[116] It has funded 19 businesses to date (approximately $1.1 million in total investment) and it has over 1,000 accredited investors. Loans are capped at $500,000 with an average loan of $59,000; the largest to date is $175,000.[117] Bolstr applies a rigorous credit underwriting model to each business and prices each opportunity to target a certain return for investors based on the riskiness of the investment opportunity.

## CROWDFUNDING

Crowdfunding and crowdfund investing is the most recent, innovative, and fastest-growing alternative source of capital for small businesses. According to Rogers, it "demands the attention of all entrepreneurs."[118]

### REWARDS-BASED CROWDFUNDING

**Definition:** Crowdfunding, or rewards-based crowdfunding, allows individuals and businesses to use a web-based platform to offer some type of set reward (e.g., a product or service) in exchange for a financial commitment to their project or business.[119] Notable examples include Kickstarter and Indiegogo and boutique, curated platforms such as Plum Alley. Crowdfunding is fundamentally different from financial-return crowdfunding, which is also referred to as web-based peer-to-peer (P2P) lending (e.g., Prosper and Lending Club). The latter facilitates direct financial transactions between individuals without a financial intermediary such as a bank.[120]

**Size of Market:** One reliable estimate states that in 2012, crowdfunding across all platform types represented $1.6 billion in North America.[121] An exhaustive search did not surface any reliable estimates for U.S. crowdfunding.

**Best Fit:** Projects and firms that need a one-time infusion of capital for a well-defined outcome (e.g., the development of a new product or a building). Most crowdfunding campaigns are relatively small dollar.

**Advantages:**

+ The greatest advantage of rewards-based crowdfunding is that it allows entrepreneurs to retain full ownership over their company. The financial commitments are made up front and are in exchange for a pre-determined reward.
+ It is highly flexible and low cost capital that flows to small businesses across diverse industries and regions.
+ While competitive, crowdfunding platforms have higher success rates than traditional private equity and venture capital sources.
+ It can be used to support companies who are not ready for an equity round or have been turned down by venture capital funders. It gives them an opportunity to provide proof of concept, prove they are serious, have tapped into their network and have refined their message.
+ It also allows companies to continue to gain essential management training and knowledge about product viability before diluting equity with an angel or venture capitalist.
+ It is a low-risk source of capital that typically requires less time and effort than other sources of capital.
+ Venture capital and angel investors use crowdfunding to assess demand for a company's products or services. Follow-on funding may be easier to obtain after a successful crowdfunding campaign.

**Disadvantages:**

- The funding amounts are typically small, which may not be sufficient for many small businesses.
- Individual investors do not have access to a larger fund of capital and may not have the resources available for multiple rounds of funding.
- Typically, crowdfunding platforms do not provide technical advisory services, nor offer the same level of management and advisory services provided by private equity and venture capital funds.
- Likewise, they do not offer firms the same level of access to new customers, suppliers or specialized services as private equity or venture capital firms.
- Entrepreneurs still need to be able to define a clear value proposition for their business and leverage their network. It should not be viewed as an alternative for entrepreneurs unwilling to ask for funding from their network.

**PEBBLE TECHNOLOGY CORPORATION**, headquartered in Palo Alto, California, was founded in 2012 to develop and manufacture smartwatches.[122] The company first attempted to raise equity from traditional venture capitalists in 2011. When that failed, they started a crowdfunding campaign on Kickstarter in 2012 to support the development of the Pebble Smartwatch. Pebble's initial goal was to raise $100,000 in approximately one month. Within the first two hours of the campaign, Pebble Technology met its initial goal and 28 hours after the launch, Pebble had exceeded $1 million. By the end of the funding period, Pebble had raised over $10.2 million from nearly 70,000 people and had become the highest funded project on Kickstarter to date.[123] In part because of this success, Pebble was able to secure an additional $15 million from venture capitalists.[124]

**PLUM ALLEY**, founded in 2012, is a web-based platform that increases the economic strength of companies founded by women and provides them with greater access to capital.[125] Originally founded as an e-marketplace for female entrepreneurs, the company has since evolved into an innovative crowdfunding platform specifically for women-owned businesses and female entrepreneurs.[126] They focus on companies positioned for growth, representing all industries, that need seed and early stage funding, but Plum Alley is also used by established companies to test market demand for new products. Plum Alley's model is unique in that it blends crowdfunding with some of the best features of accelerators. Plum Alley provides value added services to its portfolio of companies through coaching, mentoring, and seminars developed specifically to troubleshoot problems faced by women entrepreneurs.[127] Entrepreneurs have access to a paid group of experts to help then navigate everything from fundraising to industry-specific business problems.[128]

To date, Plum Alley typically has in the pipeline between 75-100 companies at any one time, with an average campaign ranging between $20,000-$30,000.[129] While Indiegogo and Kickstarter have a high volume of campaigns on their sites at any point in time, Plum Alley prides itself on being a high-touch platform, delivering exceptional client service to its campaigns. Campaigns posted on Plum Alley have a 70-80 percent success rate. Women have long been underserved by American capital markets, so the company's tailored support for women entrepreneurs to help them overcome traditional barriers may be especially beneficial to women-owned small businesses.[130]

## CROWDFUND INVESTING

**Definition:** Crowdfund investing, or equity-based crowdfunding, allows businesses to use a web-based platform to raise equity in exchange for an ownership share in their business.[131] Angel List and Fundable are two well-known platforms.

**Size of Market:** This type of crowdfunding with unaccredited investors is not yet available in the U.S., although there are hundreds of startup companies leveraging accredited investors that are poised to expand. Interest in this new source of capital has been growing since the Jumpstart Our Business Startups (JOBS) Act was passed in 2012. Title III of the JOBS Act allows the general public (i.e., unaccredited investors) to purchase equity in small businesses, but the Securities and Exchange Commission (SEC) rules governing how this happens have not yet been finalized.[132] Allowing unaccredited investors would significantly increase the pool of potential equity investors for small businesses.[133]

**Recent Updates:** On March 25, 2015, the SEC approved new rules that will allow startups and established companies to raise money from accredited and, for the first time, unaccredited investors online through what is formally a Regulation A Tier II offering but is colloquially being called a Regulation A+ offering.[134] Essentially a mini-IPO without the requirement to list on a formal exchange like Nasdaq or restrictions on marketing to the public, this new upgrade to Title IV of the JOBS Act will allow businesses to raise up to $50 million by advertising directly to the public through online channels. The old Tier I Regulation A offering was rarely used primarily because of Blue Sky Laws, which are onerous requirements that companies officially register in every state in which they plan to sell equity.[135] As a result, from 2009-2012, only $73 million was raised from 19 qualified Regulation A offerings.[136] However, the new Regulation A+ is exempted from Blue Sky Laws and allows unaccredited investors to invest up to 10% of their net worth or income in offering SMEs.[137]

While the crowdfunding industry awaits additional SEC rules, some companies are successfully combining crowdfunding with traditional venture capital raises. Some U.S. companies are also taking advantage of U.K. crowdfunding, which already allows unaccredited investors. Crowdcube, which is Europe's largest network of angel investors, is also an equity crowdfunding platform that allows members of the British public to buy equity stakes in businesses registered in the U.K. alongside accredited investors.[138] Venovate is a crowdfunding platform that facilitates investment by accredited U.S. based investors and alternative equity issuers in a curated set of companies.[139] **BITRESERVE**, a virtual currency (cloud money) service and platform based in Charleston, South Carolina with offices in London, Braga, Shanghai, and San Francisco,[140] raised nearly eight percent of a $10 million Series B investment round ($760,000) from 130 investors using CrowdCube and Venovate during 2014-2015.[141] Given CrowdCube's focus on the U.K., Bitreserve cited this transaction as the first transatlantic raise of its kind.[142] The presence of large institutional investors investing through the platform even led some investors on the CrowdCube website to question Bitreserve's need to raise funding in this manner. Tim Parsa, Bitreserve's President of Global Strategy and Markets, responded that although the Bitreserve team "doesn't need the crowd to raise money," they did it primarily to "respect small investors."[143] This case study serves as proof of concept that the nascent equity crowdfunding industry can be scaled past Series A investments. The Bank of England's Executive Director for Financial Stability, noted financial expert Andy Haldane, said about CrowdCube and other similar firms, "At present, these companies are tiny. But so, a decade and a half ago, was Google."[144]

## Successful Models for Incubator and Accelerator Funds

Most incubators and accelerators help their tenants, primarily early stage companies, access capital as part of their overall suite of resources and services. This type of support typically includes helping businesses identify funders, making the connections, and making sure entrepreneurs are prepared with the right pitch and documentation. Although comprehensive data is not available, some incubators and accelerators manage their own capital funds. According to a survey by the National Business Incubation Association (NBIA), 83 percent of incubators provide formal or informal access to seed capital.[145] Of the 15 top-ranked accelerators, according to the latest Techcrunch U.S. Accelerator Ranking (March 2015), 13 operate a capital fund.[146] For incubators and accelerators considering establishing their own fund, this section highlights a few successful models and includes insights into the capital sources of the fund.

### FUNDING COMPETITIONS

Funding competitions that provide small businesses with cash awards (issued as convertible debt) seem to be one popular model for incubators and accelerators. These are typically focused on seed funding for early stage companies. For example, the Clean Energy Trust accelerator in Chicago has operated an annual competition, the Clean Energy Challenge, to fund early stage clean energy companies in the Midwest since 2010. The Challenge was backed by a mix of public and private funds, including federal and state government funds and corporate and individual donors. For the 2015 Challenge, Clean Energy Trust will award $1 million of total funding in early stage capital to the winning companies from a pool of 14 finalists.[147] The number of winners has ranged from three to six over the past five years. Their awards to individual companies range from $50,000 to $500,000, issued as convertible debt.[148] Once funded, Clean Energy Trust manages their investment in the winners through a seat on the board. From 2010-2014, startups participating in the Clean Energy Challenge have received a combined $2.2 million in funding from Clean Energy Trust, raised $50 million in funding from other sources and created over 300 jobs.[149] These competitions allow incubators and accelerators to invest early in promising companies.

### VENTURE CAPITAL FUNDS

Venture capital funds that focus on early stage funding may be the most common type of capital offered by incubators and accelerators. These funds fill a gap in the financing market: early stage companies that need relatively small first rounds of equity investments to bridge the gap between government funding (e.g., SBIR funds) and larger first equity drives. Small businesses need sufficient capital to continue to develop their product and get traction. The incubators and accelerators also often provide capacity building or technical assistance to their businesses to increase their chances of obtaining the equity they need. Some also provide loans to help entrepreneurs bridge the gap and continue to pay the bills.

QB3, a nonprofit commercialization institute founded in 2000 by the University of California system to support the growth of bioscience businesses, provides a successful example of an intermediary that raised a fund solely from private investors. It operates four incubators in the San Francisco Bay Area.[150] In 2009, QB3 raised its first for-profit $11.3 million venture fund (Mission Bay Capital), with 10-11 other limited partners, to not only support the businesses in its incubators, but also others in the sector.[151] The fund has invested in 21 companies to date, providing $500,000 to $2 million in capital.[152] There have been three exit events thus far. Almost half of the companies in the fund's portfolio have been incubated through QB3.[153] The informal connection to QB3 incubator companies allows Mission Bay Capital to gain a deep knowledge of the startups, which helps with their funding decisions.

JumpStart, which supports innovative, early stage companies in Northeast Ohio, established four different funds using a mix of public and private funds. Established in 2003, JumpStart is a leading partner in an interconnected network of initiatives in Northeast Ohio that includes incubators and accelerators, investors, research foundations and education programs.[154] JumpStart manages four different funds to serve small businesses throughout their lifecycle: the nonprofit Evergreen Fund ($29 million); Growth Opportunity Partners loan products ($10 million); the for-profit Emerging Market Fund ($1.5 million); and the for-profit Next Fund ($20 million).

The Evergreen Fund provides $250,000-$500,000 of early stage capital in the form of convertible debt to innovative small businesses across four sectors—biotech & healthcare; IT, electronics, sensors & controls; advanced materials & alternative energy; and consumer & business services. This fund has invested in 78 small businesses to date. Growth Opportunity Partners is a JumpStart company that has an independent board of directors and JumpStart is the sole member of the corporation. Growth Opportunity Partners has a mission to provide loans and advisory services to growing companies with revenues of $500,000 to $25 million that are primarily located in underserved, low to moderate income communities. This is a new enterprise with the goal of making at least $10 million in loans over three years (they are funding their first small business in April 2015). They expect the average loan will be $250,000. The Emerging Market Fund is a traditional venture capital fund that targets seed stage companies owned by minorities, women and inner city entrepreneurs. This fund has invested in three companies thus far and the average initial investment is $250,000 with the option to invest up to $500,000. The new Next Fund provides early stage investment ($1.2-$1.4 million on average) to startup companies with the potential to generate significant financial returns (2.5 times the investment). This fund has invested in two companies to date and targets software, communications and networking, hardware (IT), healthcare IT, and medical devices and diagnostics.[155]

### ANGEL INVESTOR NETWORKS

Many incubator programs take an alternative approach and want to provide capital to their tenants but do not want an ownership share in their companies. According to the 2012 NBIA survey, 82 percent of incubators do not take equity shares.[156] The NJIT Enterprise Development Center (EDC), a technology and life sciences incubator established in 1988, is one such example. In 2013, the incubator helped start the NJIT Highlanders Angel Group, which is comprised of accredited investors who are NJIT alumni, NJIT faculty and staff, private investors, others in the New Jersey area interested in investing in incubator firms, and companies that have a connection to NJIT and firms in the broader community.[157] In addition to the Highlanders Angel Network, the EDC operates a small revolving loan fund that was funded by a donation from the Prudential Foundation. Prominent firms that grew out of the EDC include LiveLook, a visual collaboration technology firm acquired by Oracle, and Edge Therapeutics, a biotechnology pioneer working to treat neurological conditions.[158]

### CROWDFUNDING PLATFORMS

LACI, a cleantech business incubator in Los Angeles, provides an example of the type of effective support that these organizations can offer to small businesses seeking capital as well as how crowdfunding can be used instead of raising a new fund.[159] Since its inception in 2011, LACI has supported roughly 30 cleantech firms, with over $50 million under investment. In recognition of the barriers small businesses face obtaining venture capital, LACI developed an investment bootcamp, "Investment Intensive," that teaches its portfolio companies and incubator members how to effectively raise venture capital. The comprehensive program includes business planning (including pitch preparation), pre-audit readiness, investor identification, access to industry databases, comps analysis, investment structuring, data room access and formatting, deal docs templates, preferred partner rates for legal review, and investor relationship management. They do not charge any fees for participation, but require warrants between two percent and five percent depending on the level of assistance required.[160]

Rather than raising their own fund, LACI launched a new funding platform in 2015 to increase the speed at which their small businesses can connect to interested investors so the CEOs can spend more time building their businesses. The platform, named the California Global Innovation Exchange (www.CAGIX.com), allows investors to easily identify, research, and invest in LACI's portfolio companies. It offers customized search tools based on sector, management team, location, and other variables. It also provides a secure data site for registered Broker-Dealer due diligence on each company. LACI developed CAGIX to solve what they believe are a number of structural issues impeding the flow of early stage capital, including risk perception, transaction costs, deal discovery, relationship building, investor identification, JOBS Act compliance and transaction closure. The platform is open to the public, but LACI also leverages their network of over 12,000 investors to join the Exchange. LACI decided to build this platform instead of raising a separate fund because of the hesitancy of institutional Limited Partners to back first time fund managers in the current market, and the high cost and time required to raise a first time fund.[161]

Launch NY, a nonprofit venture development organization established in 2012, provides another example of an intermediary using crowdfunding to source capital for small businesses. Launch NY partners with other organizations to support and invest in high-growth, high-impact companies in Upstate New York. Launch NY is headquartered at the New York State Center of Excellence in Bioinformatics and Life Sciences in Buffalo.[162] It is in the process of developing its own seed fund using crowdfunding to fill a venture capital gap in the region—97 percent of venture capital invested in New York is invested in businesses located in New York City.[163] Launch NY is currently exploring different crowdfunding portals they can use for their fund. Launch NY will provide mentoring to the entrepreneurs and help source deal flow. They will leverage crowdfunding to augment their capital raise from other public and private backers of their fund.[164]

An interesting alternative to crowdfunding are the charitable bonds being used by Allia, a nonprofit incubator and accelerator in Cambridge, England.[165] They developed a new financial product that drives community-based investing—the same objective as crowdfunding. In 2014, they launched the Retail Charity Bond on the London Stock Exchange, which is designed to provide low cost financing for social ventures and charities. The bonds provide the organizations with 5-10 year unsecured loans, gives them additional publicity and allows them to tap into a larger pool of investors.[166] It is designed to finance one organization each issue and Allia believes the market can initially handle about 10 issues per year. The product is not designed to fund smaller or risky ventures.

### FEDERAL SOURCES OF CAPITAL FOR INCUBATOR AND ACCELERATOR VENTURE FUNDS

An agency within the U.S. Department of Commerce, the U.S. Economic Development Administration (EDA) makes investments in communities to create jobs, promote American innovation, and accelerate long-term sustainable economic growth.[167] Cluster Grants for Seed Capital Funds, a new EDA program, was launched in 2014 to help improve access to seed stage capital for startups located outside of traditional venture hubs like Silicon Valley and Boston.[168] Rather than invest directly into early stage venture funds, this new grant program provides funding to facilitate the planning, formation, and launch of cluster-based seed capital funds across the country.[169]

The first round of the Cluster Grants for Seed Capital Funds program resulted in the distribution of $2 million in available capital to nine accelerators in nine different U.S. states.[170] While the maximum available grant is $250,000, the average award in 2015 was $212,987, with each grant requiring a minimum matching share of 1:1 for every federal dollar invested.[171] One illustrative example is Albany Medical College in Albany, New York, which received a 2015 grant of $124,910.[172] The medical facility, which is co-located with a newly established Biomedical Acceleration & Commercialization Center (BACC), will use the EDA grant to plan and create the investment infrastructure necessary to eventually launch a $1-$2 million bio-innovation seed fund to commercialize local innovation.[173]

The purpose of the SBA's Growth Accelerator Fund Competition is "to get an extra infusion of capital to qualified accelerators and the burgeoning ecosystem in which they play, which, in turn, provides resources to boost the startup and entrepreneurship communities around them."[174] The competition targets accelerators operating in regions that typically do not have access to significant pools of venture capital (i.e., outside of Silicon Valley) that support underserved communities, women, and manufacturing. For the purposes of the competition, the SBA defines accelerators as organizations that provide mentoring, networking, shared space, and sometimes funding to startups,[175] including accelerators, incubators, co-working startup communities, and other models.[176]

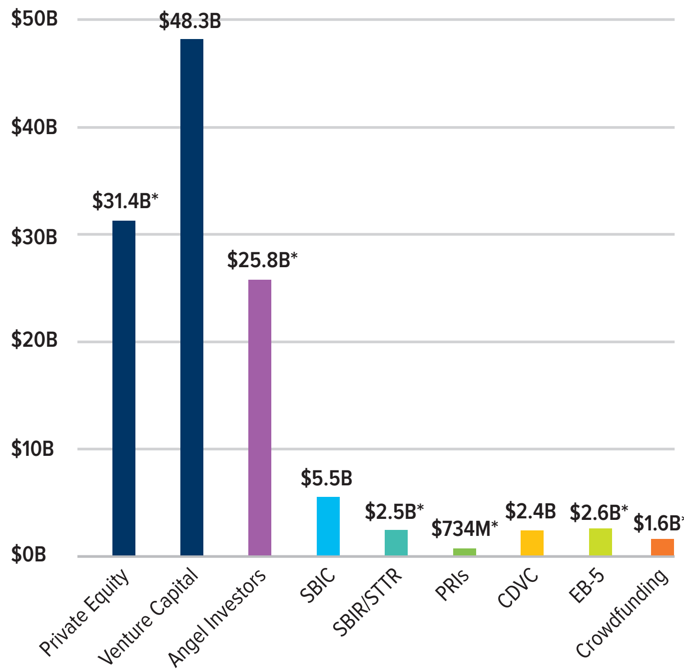
In 2014, Congress allocated $2.5 million for this initiative, which was increased to $4 million in 2015.[177] In 2014, the 50 winners each received a $50,000 cash award to support their accelerator. The winners were chosen by a committee from over 800 applications.[178] The application materials included a video, and winners were chosen based on their missions, business goals, founding team members and other core components.[179] The winners are required to submit quarterly reports for one year.[180] While the prize money does not directly flow to small businesses, it allows the accelerators to support small businesses. In 2015, 80 winners can be chosen if the prize amount stays at $50,000, and in addition to the quarterly reporting they will need to show a "concerted effort" to obtain a 4:1 match to the cash award, although the match is not a requirement.[181]

## Final Thoughts

The capital alternatives summarized in this report should offer small businesses a starting point in finding the "right" capital to support their growth. While credit is still tight, and access to capital is an important issue for small business, today's entrepreneurs have perhaps more capital options to choose from than at any other time in history, with new financial products and organizations being created each year. Admittedly, the treatment of each option in this report is relatively superficial and business owners will need to do more extensive research to find the best fit for their needs. Our hope is that our survey of the equity landscape is comprehensive and that we answered some fundamental questions that will increase the efficiency of their capital search.

We wish to thank the more than 25 experts and practitioners who shared their insights and helped shape this guide.

**Figure 4: Total U.S. Market Size by Capital Type, 2014**




**Notes:** Data was not available for Revenue-Based Capital. * = estimate. Private Equity data is from 2013. Angel Investors estimate based on Center for Venture Research (CVR) reports, 2013 & Q1Q2 2014, and 4% annual growth. SBIR/STTR data is from 2012. PRI data is from 2007. EB-5 estimate based on I-526 approvals for calendar year, assuming $500K investments. Crowdfunding estimate is from 2012, for all platform types and for North America.

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[181] Nareg Sagherian, Presidential Management Fellow, Innovation and Technology Analyst, Office of Investment and Innovation, U.S. Small Business Administration, telephone interview, March 27, 2015.

***This research was supported by JPMorgan Chase & Co. For more information about its support of small businesses, please visit www.jpmorganchase.com/SmallBusinessForward. For more information about the Initiative for a Competitive Inner City (ICIC), please visit www.icic.org.***

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