



## 09 Deals and Financing for Incubator Clients



Trainee Manual Part 2



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# Introduction to the Training Program



## INTRODUCTION TO THE TRAINING PROGRAM

This is the trainee manual for Module 9 Part 2 – out of 11 modules in total - of *infoDev*'s State-of-the-Art Business Incubation Training Program for Business Incubator Managers in Developing Countries.

*infoDev* ([www.infodev.org](http://www.infodev.org)) is a research, capacity building and advisory services program, coordinated and served by an expert Secretariat hosted by the World Bank Group. It helps developing countries and their international partners use innovation and information and communication technologies (ICT) effectively as tools for poverty reduction and sustainable social and economic development. *infoDev* is a leader in business incubation of technology-enabled enterprises. *infoDev*'s global business incubation network reaches close to 300 business incubators, more than 20,000 small and medium enterprises, and has helped create over 200,000 jobs across 87 developing countries.<sup>1</sup>

*infoDev* has found that high quality leadership is a key factor determining the probability of success for an incubator. *infoDev* therefore seeks to increase the capacity of business incubation managers – and their stakeholders – through one-on-one technical assistance, regional and topical peer-to-peer networks, the bi-annual Global Forum on Innovation and Entrepreneurship, and its web-based networking and knowledge-sharing tool [www.idisc.net](http://www.idisc.net). This training program was designed in direct response to repeated requests from *infoDev*'s technology entrepreneurship community for an in-depth business incubation training program relevant to the developing country context.

This training program is the first-of-its-kind, drawing from the lessons, models, and examples in business incubation from across Africa, East Asia and the Pacific, Europe and Central Asia, Latin America & the Caribbean, Middle East & North Africa, and South Asia. More than 30 experts contributed directly to the writing of the training modules, and the materials were tested with more than 300 professionals in developing countries all of whom provided inputs to the final design.

This training program is designed for business incubation managers and other business incubation stakeholders wishing to increase their understanding and know-how of the business incubation process. It consists of 11 training modules ranging from basic introductory topics designed for professionals new to business incubation, to specialized topics such as Technology Commercialization and Virtual Business Incubation Services.

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<sup>1</sup> Source: *infoDev* activities from 2002 to 2009 - <http://www.infodev.org/en/Article.473.html>

The modules include:

#### SUITE 1 – BUSINESS INCUBATION BASICS

##### **Module 1 – Business Incubation Definitions and Principles**

This module provides an introduction to business incubation. It introduces key definitions and presents the main principles and good practices of business incubation. It aims to equip current and future incubator managers and policy makers with the knowledge, skills and understanding of the fundamentals of business incubation in order to effectively foster and encourage businesses.

##### **Module 2 – Business Incubator Models, Including Success Factors**

This module aims to illustrate various business incubator models based on practical examples of incubators from all over the world. The ultimate goal of this module is to empower current and future incubator managers with a thorough understanding of the various business incubator models and their critical success factors as well as to help them identify the best model to adopt for their own incubator to be successful.

#### SUITE 2 – BUSINESS INCUBATOR OPERATIONS

##### **Module 3 – Planning an Incubator**

This module, which divided in two parts, covers assessing the feasibility and designing the business model for an incubator. The first part is aimed at providing a thorough understanding of developing a feasibility study. This includes the steps to undertake a pre-feasibility study, the components that it should address, as well as how to gauge the market need and decide whether an incubator is the most appropriate solution. The second part of the module focuses on business planning to establish the incubator business model.

##### **Module 4 – Marketing and Stakeholder Management**

This module is designed to support efficient and effective communication of the incubator with key customers and other stakeholders based on a good understanding of the market place. This is important since it will help the incubator to establish and increase its reputation as a sustainable organization that fulfils its mission.

The first part of the module focuses on identifying, assessing, and reaching customers/ stakeholders, as well as potential ally organizations providing business support services to enterprises; while the second part is dedicated to defining the incubator's value proposition and engaging marketing channels.

##### **Module 5 – Financing an Incubator**

The first part of this module aims to guide current and future business incubator managers through mastering the incubator's financial data (such as costs and revenues) in order to enable them to identify the financing needs of the organization as well as to explore potential sources of financing.

Building on the first part, the second part of the module is dedicated to demonstrating, to current

and future business incubator managers, how to develop a fundraising strategy and to monitor the financial performance of an incubator.

#### **Module 6 – Managing the Incubator**

This module provides current and future business incubator managers with an overview of sound management practices for a successful incubator.

The first part addresses the topics of incubator policies and governance and the second part is dedicated to operations and human resources management.

#### **Module 7 – Monitoring, Evaluation and Benchmarking**

This module aims to provide incubator managers with the required information, skills and insights to develop their own monitoring and evaluation system and to carry out benchmarking activities.

The first part of the module is dedicated to helping the incubator manager understand the added value of monitoring and evaluating the performances of his/her incubator; defining relevant and adequate performance indicators; and exploring how to monitor and evaluate, notably by studying existing tools and methodologies.

The second part focuses on empowering the business incubator manager to use the data collected through monitoring and evaluation activities to compare the business incubator's performance with those of similar organizations.

### **SUITE 3 – ADVANCED INCUBATOR MANAGEMENT**

#### **Module 8 – Implementing a Mentoring Program**

This module provides, in its first part, a conceptual framework for gaining a thorough understanding of the mentoring process and its purposes from three perspectives: that of the business incubator, the mentor, and the mentee.

The second part of the module focuses on how to implement a mentoring program.

#### **Module 9 – Deals and Financing for Incubator Clients**

This module aims to provide a thorough understanding of the alternative sources of financing for incubator clients by notably describing programs and processes that will enable the incubator manager to assist his/her clients in accessing financing.

The first part focuses on preparing incubatees to engage in the process of accessing financing while developing the capacity of the incubator to assist incubatees in accessing financing. The second part of the training module explores financing from the perspective of both the incubatees and the incubator.

#### **Module 10 – Technology Commercialization through Incubation**

This module describes technology commercialization divided in two parts. The first relating to

challenges and lessons learned associated with this process as well as how to manage expectations regarding the results of technology commercialization. This part also concerns the role of the incubator in facilitating technology commercialization in the pre-incubation phase.

The second part of this module focuses on the role of the incubator in technology commercialization in both the incubation and the growth phases.

### **Module 11 – Setting Up Virtual Services**

The first part of this module provides a conceptual framework for understanding virtual services. It is designed for current and future business incubator managers who are considering virtual incubation either as a stand-alone business model or as part of their overall incubator service portfolio to extend their current service offering.

In its second part, the module aims to guide current and future business incubator managers and help them to decide if virtual incubation is the right solution for their incubator. The module then explores the most common challenges and how to address them.

Figure 1 groups the modules by preferred level of experience and suggested module sequence.





**Figure 1 – Module Selection and Sequence**



# Acknowledgements



## ACKNOWLEDGEMENTS

The training curriculum was developed by the following consortium under the direction of *infoDev*:

**European Business & Innovation Centre Network**

- Robert Sanders, Head of International Projects
- Julia Brethenoux, Project Manager

**Babson College**

- Mark P. Rice, Frederic C. Hamilton Professor for Free Enterprise

**Sociedade Portuguesa de Inovação, S.A.**

- Augusto Medina, President
- Mark Spinoglio, Senior Consultant
- Douglas Thompson, Senior Consultant
- Nuno Gonçalves, Consultant

*infoDev* wishes to thank its innovation and entrepreneurship community, including those who provided material for and whose names appear in the case studies. In particular, *infoDev* wishes to thank the following individuals for their contributions to developing this training curriculum:

- Seth Ayers ICT – Policy Specialist, *infoDev*
- Michel Botzung – Business Edge Manager, International Finance Corporation
- Alistair Brett – Cottingham Associates LLC, Consultant Member of the Science Technology Innovation Global Expert Team, The World Bank
- Raimund Broechler – Senior Delivery Manager, Intrasoft
- Valerie D’Costa – Program Manager, *infoDev*
- Heinz Fiedler – *infoDev* Regional Facilitator for the Middle East and North Africa
- Han Fraeters – Manager, The World Bank
- Steve Giddings – *infoDev* Regional Facilitator for the Africa region
- Stephen Hampson – Managing Partner, Powerhouse-Ventures
- Jane Hill – Venture Partner, Powerhouse-Ventures

- Sheila Jagannathan – Senior Education Specialist (E-Learning), The World Bank Institute
- Natasha Kapil – Private Sector Development Specialist, The World Bank
- Anthony Lambkin – Task Manager, Low-Carbon Innovation Program, *infoDev*
- Gideon Maas – Co-Director of the Institute of Applied Entrepreneurship at Coventry University, United Kingdom
- Kiragu Maina – Senior Operations Officer, International Finance Corporation
- Siobhan McQuaid – Project Director, ABÚ International Project Management
- Mustapha Mezghani – *infoDev* Regional Facilitator for Africa
- Mark Nielsen – Senior Advisor, Business Edge Management Training, SME Management Solutions, International Finance Corporation
- Ellen Olafsen – Operations Officer, *infoDev*
- Edward Rubesch – Director, Technology Licensing Office National Science and Technology Development Agency, Thailand
- Tania Saba Mazraani – Director, Technology & Health, Berytech, Lebanon
- Jill Sawers – *infoDev* Innovation and Business Incubation Consultant
- Stefan Schandera – *infoDev* Regional Facilitator the East European and Central Asian region
- Julian Webb – *infoDev* Regional Facilitator for Asia
- Cesar Yammal – *infoDev* Regional Facilitator for Latin America and the Caribbean
- Krzysztof Zasiadly – *infoDev* Innovation and Business Incubation Consultant
- Sylvia Zulu – SME Toolkit Program Manager, International Finance Corporation

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# Module Objectives



The objectives of this module are to (1) provide a thorough understanding of the alternative sources of financing for incubator clients and (2) to describe programs and processes that will enable the incubator manager to achieve the following:

- Help incubatees develop fiscal discipline and financial management systems;
- Introduce incubatees to alternative sources of financing;
- Educate incubatees with respect to the typical terms, conditions and risks associated with the various sources of financing;
- Enhance the readiness of incubatees to engage with different sources of financing; and
- Connect sources of financing and financial expertise to the incubator.

#### TRAINEE TRAINING OBJECTIVES

Through this module, a trainee who is an incubator manager, a volunteer financial counselor (e.g. from the incubator board of advisors), a coach or a staff member within an incubator, can understand and put into practice the above objectives. By the end of this training, the trainee will understand how to:

- Engage with incubatees in developing expertise related to financial management and accessing financial resources;
- Identify and connect incubatees to potential sources of financing within the incubator's ecosystem;
- Support the development of additional sources of incubatee financing; and
- Establish processes for connecting incubatees to potential sources of financing.





# Introduction to this Module



New ventures do not typically have all the resources they need to proceed, nor are they likely to get them handed to them. That means they will need to be adept at “resource acquisition”.

For incubatees, this means accessing resources in the innovation and entrepreneurship ecosystem, typically using the incubator as an intermediary. These resources could include:

- (a) expertise - through the incubator’s know how network;
- (b) facilities for research, development, prototyping and /or production – through the incubator and its sponsors, and possibly through potential suppliers or early adopter customers;
- (c) investment – through friends and family, angel investors, venture capitalists, pre-payment for goods and services by early adopter customers and a broad range of self-supporting techniques.

Incubatees are typically in the pre-venture, start up, or survival modes of operation. For many or most client companies, cash flow is negative during the period in which the entrepreneur is trying to figure out how to create a sustainable business. They graduate when they have progressed past survival, and have achieved some degree of sustainability – either as a stable small business or as an enterprise in the initial growth phase. The major issue is that frequently, the entrepreneur does not understand the importance of exercising fiscal discipline to grow a sustainable business and only pays attention when faced with a financial crisis. Hence, when incubator clients fail to graduate from the pre-venture / start-up / survival modes to sustainability, in most cases they do not fail spectacularly. They simply run out of money due to their lack of fiscal discipline before they figure out how to succeed - and abandon their ventures.

Fiscal discipline includes both managing cash flow and understanding when and how to acquire investment to cover negative cash flow. This module is designed to help incubator managers understand how to engage incubatees in understanding and implementing fiscal discipline, in order to reduce the rate of companies that fail to graduate. The following components in Part 1 and Part 2 will help incubator managers develop understanding and support mechanisms so that they can be effective in counseling clients and in connecting them with external resources. Module 9 is a valuable complement to Module 8 of the current training program, “Implementing a Mentoring Program”, as it addresses one of the major challenges most incubator clients must overcome.



## Component 3 (Part 2 Training):

### Financing from the Perspective of Incubatees



## COMPONENT INDEX

### **Section 3.1:** Understanding and Addressing Expectations of Sources of Financing

#### **Section 3.1.1:** Expectations from Friends and Family

#### **Section 3.1.2:** Expectations from Grant-Making Agencies (Government or Foundation)

#### **Section 3.1.3:** Expectations from Debt Investors (Lenders)

#### **Section 3.1.4:** Expectations from Equity Investors

### **Section 3.2:** Preparing to Engage with Financing Providers, Including how to Prepare an Appropriate Financial Forecast for a Potential Investor

#### **Section 3.2.1:** What to Prepare?

#### **Section 3.2.2:** How to Prepare?

## COMPONENT OBJECTIVES

Upon completion of this component, trainees should understand the motivations and expectations different financing sources across debt and equity financing, so that they will be able to sensitize and educate incubatees about this issue. Furthermore, trainees will be able to create a process for preparing incubatees to engage productively with financing sources.

## Section 3.1: Understanding and Addressing Expectations of Sources of Financing

Section 1.3 provided a list of potential sources of financing for incubatees in a mature innovation and entrepreneurship ecosystem, such as Silicon Valley. In this section we will explore four types of investors that span the spectrum of sources of financing together with the typical expectations of each class of investors.

### Section 3.1.1: Expectations from Friends and Family

Except for internal financing entirely through cash flow management and investing from one's own personal resources (self-financing), accessing financial resources from friends and family is the most common method for funding negative cash flow of an incubator firm. There may be several scenarios involving investment from friends and family that incubatees should consider. The nature of entrepreneurship being pursued by the incubatee, whether necessity or opportunity based, may be an important factor.



• **Scenario 1: Supporting financial survival of the incubatee.** If the incubatee is engaged in “necessity-based entrepreneurship”, i.e. the entrepreneur has no job prospects and insufficient resources to survive, friends and family may see investing as a way to help the incubatee overcome the lack of a job and to achieve financial independence at a minimum at the subsistence level. Assuming the investing friends and family have “excess capital”, they may be less concerned about return on investment and more focused on supporting the incubatee.

• **Scenario 2: Unrealistic expectations of return on investment.** If the entrepreneurship being practiced by the incubatee is opportunity based, friends and family may become enamored of the upside potential associated with the growth of the incubatee’s enterprise and may desire to share in the financial success. The incubator should help the incubatee recognize the personal danger inherent in this scenario. Friends and family are typically not “sophisticated investors” and hence do not have the capacity to judge the risk associated with the venture. If the incubatee’s venture fails to achieve the financial success imagined by friends and family, and hence if the investment does not provide the desired return on investment, or worse yet if the friends and family lose their investment entirely, then the incubatee may find that relationships with friends and family are irreparably damaged. Generally it may be best to avoid accepting investment from friends and family under this scenario.

• **Scenario 3: An advance on an expected inheritance.** It is possible that an incubatee may have a wealthy relative who intends to transfer that wealth to the incubatee upon his or her death – the proverbial “rich uncle” (or “rich aunt”). The wealthy relative may be willing to “advance” part of the expected inheritance to the incubatee to support the entrepreneurial vision of the incubatee – with no expectation of any kind of return on investment. The “rich aunt – or rich uncle” might have the following perspective. “My niece is going to receive my wealth as an inheritance when I pass away. If I provide part of that inheritance now, my nephew will be able to use this investment to support a potentially valuable learning experience and I will have the joy of watching her/ him pursue her/ his dream.”

### Section 3.1.2: Expectations from Grant-Making Agencies (Government or Foundation)

Government agencies or foundations may seek to advance socio-economic objectives by creating a program through which grants can be made to enterprises whose activities may lead to the accomplishment of those objectives. Typically the process of acquiring these grants is competitive and the incubatee will need to make a proposal that is more attractive than competing proposals. Grant writing in some contexts is a highly evolved capability and some organizations hire experienced and capable grant writers. Assuming an incubatee can apply for a grant, the incubator should try to engage experts in its extended network who have experience with grant proposal writing. Furthermore, if the

incubatee wins the award, the incubatee will need to effectively manage the grant in order to complete the tasks and achieve the outcomes defined in the grant agreement and will need to comply with various processes embedded in the grant agreement, for example filing periodic financial reports and other forms of performance reporting.

### Section 3.1.3: Expectations from Debt Investors (Lenders)

In the western economies, the primary objective of a lender is to fully recover the initial investment and be paid an appropriate interest rate over the life of the loan. Typically debt investors are relatively risk averse. Hence they will require full disclosure of all assets and relevant details related to the operation of the business. Additionally, they will require that the investee pledge significant business and /or personal collateral that can be liquidated if the incubatee defaults on the loan, and may also require that the incubatee personally guarantee the loan. In most cases, incubatees and their companies lack sufficient assets that will be acceptable collateral from the perspective of traditional lenders and hence incubatees often will not qualify for debt investment until they are more established – with a stronger balance sheet and predictable, positive cash flow. These expectations are common for lenders in western economies. As indicated earlier in this module, these will need to be revised to reflect variations in lender expectations in other countries, as discussed in greater detail in Component 4.

### Section 3.1.4: Expectations from Equity Investors

Typically incubatees face significant uncertainty on multiple dimensions. There are more unknowns than knowns and hence more assumptions than facts. As a result, financial projections may be mathematically correct, but they are based on so many assumptions that the potential for significant error is very high. Equity investors deal with this reality by managing risk through diversification in a portfolio of investments. Staged investing enables the entrepreneurs and investors to determine, on an ongoing basis, whether sufficient future promise has been revealed as a result of the value created through the learning process to warrant additional investment. Additionally, for the entrepreneur, establishing a portfolio of investors guards against the negative impact of losing the support of any single investor. Because investing is staged, the entrepreneur must constantly strive to create sufficient value in the eyes of investors so that the next stage of investment will be committed. In essence the entrepreneur is on a resource acquisition treadmill, requiring continual attention to manage current investors and attract future investors in order to ensure that the venture will continue to attract the resources required to fuel its growth.

Generally equity investors are buying part of a venture's equity with the expectation that the entrepreneur, using the investment wisely, will successfully build the value of the enterprise over time and that there will be an opportunity at some point in the future to exit the investment and to harvest the value that has been created. Usually the exit and the harvest occur either when the venture is acquired by another (usually larger) enterprise or when the venture goes public via an Initial Public Offering. The expected rate of return is a function of the perceived risk. For example, a typical venture capitalist might require a ten-fold return on investment over a five year period. An angel investor might be willing to accept a lower return on investment because the angel may

have a complementary non-financial motivation for investing, e.g. giving back to the community by helping nascent entrepreneurs. Likewise it's possible that an established company that is willing to make an equity investment may accept a lower return on investment because the company may seek "strategic" value, e.g. value derived from gaining access to innovative technology that will complement the financial return on investment.

As mentioned in Section 1.3, one option of equity financing to explore may be to attract long-term investment from private partners (i.e. shareholders). This type of investment is quite genuine in the sense that the emphasis is put on the long term and these investors not only provide capital, but also knowledge to the business. These investors are not expecting a short-term high return on investment such as venture capitalists do, but a rather long term involvement in the financing and management of the business. This option does not offer high growth potential to the business, but these investors have to be considered as full business partners who are expecting regular returns. In developing countries, often wealthy nationals are looking for investment opportunities and foreign businesses may seek long term business partners. These individuals may prefer to invest in existing small businesses rather than starting a new business themselves.

Incubatees need to be familiar with the expectations of potential investors. When incubatees demonstrate naiveté in this regard, they raise "red flags" that alert the investors to the fact that they are unsophisticated with respect to investor expectations and hence probably unsophisticated as well with respect to leveraging investment to create substantial value. It is important, therefore, that the incubator staff and by extension those in the incubator's extended network help incubatees acquire knowledge, skill, and sophistication with respect to the investment process.

## Section 3.2: Preparing to Engage with Providers of Financing, Including how to Prepare an Appropriate Financial Forecast for a Potential Investor

Incubatees can waste a tremendous amount of time, energy and financial resources unsuccessfully “chasing” investment if they are not well prepared for the process. In addition, the process of chasing investment can be so time consuming that the entrepreneur may not provide sufficient time to managing and developing the business. As consequence, the business may decline, lose value in the eyes of potential investors and may even fail. Under the best of circumstances, securing investment from any of the sources described above in Section 1.3, with the exception of family and friends, is likely to take six to nine months. Hence the incubatee should be prepared to move through the process as expeditiously as possible and aim for the highest probability of success by appropriate preparation. The incubator can and should help the incubatee in this preparation.

It should be kept in mind that the preparation needs a slightly different focus depending on the type of financier, i.e. the focus will be different when engaging with an equity investor from engaging with a venture capitalist.

### Section 3.2.1: What to Prepare?

Generally all potential investors will require a business plan. (In the case of a government agency, NGO or foundation, that may take the form of a proposal or project plan, in response to a request for proposal.) The process of developing a business plan will enable the incubatee to determine whether the incubatee fits the profile of a target investment for each particular class of investor. There is no point in pursuing investment from an investor who is only interested in funding companies with a profile that is significantly different from that of the incubatee. Available resources describing business plan writing are widely available and the incubator should make these available to incubatees. For example, the SME Toolkit dedicates a full section to Business Plans<sup>13</sup> which includes a diversity of helpful material. These include in particular sample business plans providing concrete examples of what a business plan may look like in different formats (e.g. word and excel) as well as a training session guiding the trainee step by step towards the definition of a business plan.

<sup>13</sup> Source: SME Toolkit.org - <http://www.smetoolkit.org/smetoolkit/en/category/922/Business-Plans>

**The Business Plan should address the following queries:**

- What is the business called?
- What is the nature of the business?
- What is the main product /service that the business offers?
- What industry is the business in?
- Who owns and who manages the business?
- What are the most attractive features of the product?
- What are the goals of the business?
- How will the business make money?

Annex 1 reproduces the outline of the Business Plan explored during the “Try It Yourself” workshop<sup>14</sup> from the SME Toolkit section on “Creating an Effective Business Plan” and which teaches trainees to create a compelling business plan through a series of exercises that will test their ability to create some of the plan’s most important elements. By participating in these exercises, the trainee will be assisted in developing their own business plan.

Two critical elements of the business plan require particular attention and will be addressed in this section: *Critical Risks, Problems and Assumptions and The Financial Plan*.

**Critical Risks, Problems and Assumptions**

Sophisticated investors expect the business plan to provide a clear description of the offering (product and/or service) and the market need being addressed, which together define the opportunity, and all the information necessary to understand how the entrepreneur will pursue the opportunity. They will also expect to learn about the management team and key advisers. The section describing the critical risks, problems and assumptions provides the entrepreneur with the opportunity to demonstrate awareness of what can go wrong and what are the most critical challenges the venture faces, as well as his /her proposals for how to diminish /counteract these risks.

<sup>14</sup> Source: SME Toolkit.org - <http://www.smetoolkit.org/smetoolkit/en/content/en/799/Try-it-Yourself>

### Risk Evaluation

Some common types of risk may include the following.

#### Market risks

- New entrants to market
- Ease of entry
- Potential threat to market share
- Slower than expected adoption

#### Staffing risks

- Availability of skilled workforce
- Union issues



Agency risk is defined as “probability of loss due to an agent’s pursuance of his or her own interests instead of those of the principal. Also called agency cost”.<sup>16</sup> In this context, there is a risk that a particular individual involved in a venture as a founder, employee, investor or adviser may have interests that are misaligned with the interests of the overall venture. For example, it is common for the stresses associated with venture difficulties and even the stresses associated with growth beyond the capacity of the venture to result in misalignment of interests among founders leading to the destruction or dissolution of the management team.

#### Financing risks

- Liabilities
- Poorly worded investor contracts at risk of litigation
- Investor pull-out
- Lack of follow-on funding to complete project

#### Managerial risks

- Poor board or investor dynamics
- Agency risk particular to the venture

#### Risk Management Plan

Detailed plans are more often found as part of internal plans. Plans written for funders may need to include a high level of description if there are significant controllable risks.<sup>15</sup>

<sup>15</sup> The summary outline of the risk analysis section of a business plan is drawn from [http://en.wikipedia.org/wiki/Content\\_of\\_a\\_business\\_plan](http://en.wikipedia.org/wiki/Content_of_a_business_plan)

<sup>16</sup> Source: <http://www.businessdictionary.com/definition/agency-risk.html>

If the entrepreneur fails to address this issue adequately, the investor will conclude that the entrepreneur is unaware, unsophisticated or in denial. By conducting a careful analysis of the business plan, assuming the critical perspective of the potential investor, the entrepreneur should be able to identify at least some of the critical risks, problems and assumptions. In addition, after advisers and experienced entrepreneurs have engaged in a “friendly review” of the draft plan, the entrepreneur can ask them to provide their insights about the venture and its potential challenges. Through an iterative process with multiple drafts of the business plan and multiple reviews, most of the critical risks, problems and assumptions can be identified. Even so, it’s highly likely that they all won’t be identified and hence the investor will be judging the capacity of the entrepreneur and the entrepreneurial team to recognize and deal with unanticipated, emergent risks and problems.

### The Financial Plan

Typically incubatees have little or no financial history and thus, the importance of the financial plan in the eyes of investors, is that it presents a model of the projected performance of the venture, reflecting the impact of the proposed investment. Sophisticated investors know that the projections are unlikely to turn out to be reality, but they want to see that the entrepreneur can tell a believable story about the future of the venture in financial terms. One venture capitalist stated: “The financial statements will not by themselves win an entrepreneur an investment, but a poorly prepared set of financial statements can lose the investment.” The assumptions underlying the financial statements are an important part of the story, and the entrepreneur’s ability to elucidate them and explain why they are reasonable is important to gaining the acceptance of the investor.

#### The Financial Plan should explore the following elements:

- **Business running costs** (e.g. rent, electricity, printing and stationery, staff costs, taxes...)
- **Start-up costs** (e.g. licenses, fees, office supplies...)
- **Personal finances** (i.e. assets and liabilities)
- **Borrowings** (start-up and running costs, how much money is needed, how much is needed to borrow, and so on)

There are many resources available to help entrepreneurs prepare The Financial Plan section of a business plan. For example, the SME Toolkit provides a variety of useful material in its section dedicated to “Accounting and Finance”. The section includes a comprehensive detailed presentation of the basic concepts driving the preparation of financial statements.<sup>17</sup> Also extremely useful is “How

<sup>17</sup> Source: SME Toolkit.org:

<http://www.smetoolkit.org/smetoolkit/en/content/en/92/Preparing-Financial-Statements-Basic-Concepts>

to fix your business”<sup>18</sup> which provides a roadmap to lead a business from trouble to success including pointers on how to identify the potential problems of a business as well as the solutions to put into place towards a healthy business.

To go in more detail, the tutorial “How to Read a Financial Report” (developed by Merrill-Lynch) can be very useful. This tutorial can be accessed at <http://www.ml.com/philanthropy/ipo/resources/pdf/howtoreadfinreport.pdf>. The document is a particularly comprehensive and easy-to-read guide for helping incubatees figure out financial statements, including identifying signs of a healthy business and signs of potential problems referring to the illustration of a fictional company. With the help of competent advisers, incubatees should be able to implement financial management that is appropriate to their stage of development.

Additionally, a presentation introducing the topic of pro-forma financial statements has been included as an Annex 3.

### Section 3.2.2: How to Prepare?

The easy answer is: “early and often.” That is, incubatees need to begin to prepare for engagement in the finance seeking process long before they need financing. First of all, it takes time to develop the minimum level of knowledge and skill to successfully compete for financing. Secondly, once the incubatee begins to engage in the process, under the best of circumstances, it is likely to take many months to complete the process.

Preparation will generally take the form of training, which can be provided by the incubator or through various sponsoring and affiliated organizations (local universities, Chamber of Commerce, NGOs), as well as interaction with others more experienced in the process (entrepreneurs, professional advisers, investors) who are willing to help incubatees practice the art and gain the skill. This topic is discussed in greater detail in Component 4 from the perspective of how the incubator can engage with the incubator know how network to help incubatees prepare for the financing process.

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<sup>18</sup> Source: SME Toolkit.org - <http://www.smetoolkit.org/smetoolkit/en/content/en/2840/How-to-Fix-Your-Business>



## COMPONENT CONCLUSIONS

Generally the individuals and entities that are potential sources of financing for incubatees are much more sophisticated and experienced with the investment process than will be the incubatees. Hence incubatee's preparation for engagement in the process is critical for increasing the odds of success. Preparation starts by understanding the expectations of the various different sources of investment. Without this understanding incubatees may be pursuing investors for whom they have no chance of meeting expectations.



## Component 4 (Part 2 Training):

### Financing from the Perspective of the Incubator



**COMPONENT INDEX**

**Section 4.1:** Engaging with, and Developing, Existing Sources of Financing for Incubatees

**Section 4.1.1:** Counseling

**Section 4.1.2:** Training

**Section 4.1.3:** Incubatee Advisory Board

**Section 4.1.4:** Networking

**Section 4.2:** Creating and Implementing Programs for Connecting Incubatees and Sources of Financing

**Section 4.3:** Catalyzing the Development of New Sources of Financing

**Section 4.3.1:** Government Participation in the Entrepreneurship Process

**Section 4.3.2:** Financial Sector Support for Entrepreneurial Activities

**Section 4.3.3:** The Challenge of Financial Capital

**COMPONENT OBJECTIVES**

**At the end of this component, trainees should be able to:**

- Understand how to develop a support system, process and infrastructure for enhancing the sophistication of incubatees with respect to acquiring financing;
- Establish one or more programs that create opportunities for incubatees to interact with others more experienced in the venture financing process (experienced entrepreneurs, professional service providers and investors);
- Assess the portfolio of sources of financing currently available to incubatees and identify gaps; and
- Play the role of catalyst and supporter, with other interested entities, in the development of individuals and organizations that can fill the gaps in the portfolio of sources of financing.

## Section 4.1: Engaging with, and Developing, Existing Sources of Financing for Incubatees

Incubatees are vulnerable to succumbing, sooner or later, to the cumulative effects of negative cash flow. As suggested earlier, most of the time incubatees do not fail spectacularly by being subject to bankruptcy laws. Instead, they quietly go out of business because they run out of cash before they figure out how to succeed. Therefore, a primary objective of the incubator should be to help incubatees develop financial literacy. For most incubatees this does not require that they become highly sophisticated with respect to financial management. However they should learn the basics of cash flow management and should be aware of the pitfalls of financial management that could get them into trouble with the legal system and with various government agencies, particularly those engaged in collection of taxes.

On the other hand, when the incubatee is ready to seek investment from sophisticated investors, then mastery of the basics of financial management will most likely not be sufficient. At that point, the company will need to be competent and professional in its financial management systems. Long before an incubatee reaches the level of maturity where it is considering seeking investment, it should have financial management competence embedded in its management team, ideally in the form of a Chief Financial Officer (CFO), in its accounting and legal professional consultants and/ or in its advisory board or board of managers. A CFO is generally a senior manager responsible for the overall financial management of a firm. Often incubatees are not big enough and complex enough to warrant hiring a CFO and hence another member of the leadership team (e.g. accountant) may take responsibility for this function and /or part of the function may be outsourced.

Both with respect to developing financial management acumen and with respect to preparing to seek outside investment, the incubator can and should play a significant role as a partner in the development of the capacity of the incubatee.

The next four sub-sections will demonstrate four ways the incubator team can engage in this development process.

### Section 4.1.1: Counseling

The incubator management team can reinforce the importance of this issue by setting performance expectations in its formal and informal counseling interactions with incubatees.

### Section 4.1.2: Training

The incubator can offer periodic training programs and strongly encourage, or require, the participation of incubatees. The incubator may choose to make participation in a “Basics of Financial Management” training program a condition for admission and continued participation in the incubator. Training may be conducted by a member of the incubator management team or incubator advisory board, assuming

someone within that group has sufficient knowledge and training capability, as well as an instructor from a local college or university or by a volunteer from the incubator's extended network, perhaps an appropriate representative of a local accounting firm or a local investment firm.

Special training programs exist for incubator staff and their incubatees. These training materials are most helpful to provide a thorough understanding and helpful practical implementation of financial management concepts. **Business Edge**<sup>19</sup> material contributes to the International Finance Corporation (IFC)/PEP-MENA's objective to stimulate private sector growth through the promotion of a unique approach to management training.<sup>20</sup> The IFC provides its Business Edge product range, which includes 36 self-study management workbooks, trainer manuals and train-the-trainer workshops in 5 different topics (i.e. marketing, human resources, production and operations, finance and accounting and productivity skills) to local training providers. These in turn use the Business Edge products as a core in designing their training programs to enable SMEs and potentially business incubators' managers and staff to improve their efficiency and profitability.

The different series of training materials provide helpful workbooks for business incubator staff wishing to acquire additional knowledge and useful tools in order to improve their financial management skills. The Finance and Accounting Workbooks include:

- Accounting for non-accountants,
- Controlling costs,
- Making a financial case, and
- Working with budgets.

Each workbook provides the trainees with the following helpful and complementary content to support them in implementing financial management activities:

- **Background information**, including details, explanations and examples of key concepts related to financial management;
- **Activities**, to help think about the concepts and topics related to financial management proactively;
- **A Self-Assessment** to check the trainee's understanding of the concepts and topics addressed;
- **A summary** to review key points;
- **A reflect section** giving an opportunity to reflect upon the learning outputs and how to apply these within the daily activities of the trainee;

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<sup>19</sup> Access to the Business edge products and training is ensured through the certified training partners in Egypt, Saudi Arabia, Yemen, Oman, Jordan, and the West Bank and Gaza. For their contact information, visit "Business Edge Partners" on Business Edge website: [http://www.businessedge-me.com/cms.php?id=about\\_be\\_contacts](http://www.businessedge-me.com/cms.php?id=about_be_contacts)

<sup>20</sup> The IFC PEP-MENA Program (Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA) is a 5-year regional technical assistance program implemented by the International Finance Corporation (IFC))

- A quick **quiz** to test the trainee's understanding of the concepts presented in the workbook;
- A **case study** to apply the trainee's knowledge and skills in the analysis of a real situation;
- A **reflect and review session** to give the trainee an opportunity to measure his/ her own achievement level upon completing the workbook; and
- An **action plan** to apply the learning outcomes at the trainee's workplace.

#### Section 4.1.3: Incubatee Advisory Board

Not only for the financial management development process, but for many other reasons, the incubator should help each incubatee develop its own advisory board or board of managers. The board should include experienced professionals with expertise in the areas requiring development, including financial management. Additionally, the incubator can engage with incubatees and their boards in appropriate oversight processes that will encourage or require the incubatees to develop financial management and other disciplines required for survival and success.

#### Section 4.1.4: Networking

It is one thing for an incubator firm to learn about and understand the principles of financial management, but it is an entirely different thing for an incubator firm to become skilled at the practice of financial management. Without feedback from external professionals, the incubatee will not have a frame of reference for judging whether the firm's practice of financial management discipline is adequate. Hence, it is useful to for the incubator to help incubatees engage with external sources of expertise who can review the incubatees financial management processes and outcomes, and provide feedback. This can be done formally, for example through a program like the Regular Rigorous Review Program described in Module 8: Annex 2, or informally, by inviting external experts into the incubator to meet with incubatees; and by encouraging incubatees to attend networking events outside the incubator in which they will have the opportunity to interact with professionals from the business services community: accountants, bankers, business lawyers, investment professionals, and so forth.



## Section 4.2: Creating and Implementing Programs for Connecting Incubatees and Sources of Financing

There are two purposes for connecting incubatees with sources of financing. First, long before an incubatee is ready to formally engage with the investment community in order to seek investment capital, engaging with investment professionals informally creates two potentially valuable results. The incubatee can develop an understanding of the expectations of sophisticated investors, and the interaction may begin a relationship that could at some later date turn into a formal engagement and due diligence process. At this future date, the incubatee will presumably be ready to seek investment capital and may need investment to support operations at the current level or to support growth.

In either case, it is important to prepare both the incubatee and the investment professional to engage with appropriate expectations.

With respect to the incubatee, this means helping them to be aware of how they will appear to the professional investor at their current state of maturity and helping them prepare to have a constructive engagement – both with respect to what they present to the investment professional and the questions they should ask.

With respect to the investment professional, business incubators have the potential to offer a great added value to financiers. The first advantage for a financier to partner with an incubator is the facilitated access to a steady pool of potential financing clients. When looking for businesses to invest in, financiers must carry out due diligence and handholding tasks which, in the case of investing in incubatees, are implemented by the business incubator whose manager can appraise the individual about the current maturity of the firm, the potential of the firm, and the current needs of the firm – either for guidance in the development process, or the readiness to seek investment. This means for the financier, reduced costs but also reduced risks.

A most helpful and pedagogical presentation has been included as Annex 4 entitled “The Story and the Plan: or how to explain your business to your grandmother and raise money”. Bela Musits, Managing Director of High Peaks Venture Partners, developed this most comprehensive presentation which provides pointers on how to develop a pitch to a financier by positioning the entrepreneur within the mind of a financier. Thus for each element to be addressed when pitching for investment (e.g. the product, the market...) the presentation details what the entrepreneur might consider as relevant, but is not expected by the financier to highlight what the financier is really looking for.

Another pedagogical support material is the video “Hearing about a Venture Capitalist’s expectations to invest in a company” from the “New Dawn Café” DVD that was produced in the framework of the project ACHIEVE<sup>21</sup> funded by the European Commission. During the interview, Martin R, a venture capitalist based in Cambridge (UK) explains what are the key elements he watches out for when looking for investing in a company, i.e. what does he view as positive signs? What are the things that make the “red warning flag” go up? What makes him feel more comfortable with the potential risks?<sup>22</sup>

**Incubators around the world have developed a variety of programmatic approaches for connecting incubatees and sources of financing. Some of these include:**

- An incubator sponsored training program for incubatees featuring a panel of investment professionals who make short presentations and engage in Q&A with the incubatees.
- Incubator tours in which visits with incubatees are arranged for investment professionals. These can involve multiple or single incubatees, and multiple of single investment professionals.
- Networking meetings, with an investment professional as the keynote speaker.
- “Rocket pitch” sessions where incubatees make a pitch for funding to a panel of investors, and the investors critique their presentations. (See annex 3)
- Business plan competitions or showcases, in which investment professionals serve on a panel of reviewers or judges.
- Project courses, co-sponsored by a local university and the incubator, in which teams of students collaborate with incubatees in the development of a business plan, or market research project, or financing plan. In some cases the student teams are given advisers, who are generally sophisticated investors. In other cases, the final project reports are presented at the end of the course to a panel of outside experts – which may include sophisticated investors and experienced entrepreneurs.
- Alumni events at a local university. Often alumni are most interested in engaging with current students or recent alumni. The incubator may be able to sponsor an incubatee that was co-founded by a current student or recent alumni.
- Chamber of Commerce or other local meeting of business leaders. Often the sponsoring organization is willing to invite incubatees to attend as guests of the organization.

<sup>21</sup> Source: <http://archive.europe-innova.eu/index.jsp?type=page&lg=en&classificationId=5180&classificationName=ACHIEVE&cId=5118>

<sup>22</sup> The video is available at: <http://www.euconnect-video.co.uk/new-dawn-cafe/video-vault-1.htm>

## Section 4.3: Catalyzing the Development of New Sources of Financing

As indicated in Section 1.3., which reviewed alternative sources of incubatee financing, the sources of financing and the conditions under which debt or equity financing might be made available to entrepreneurs vary by country, by region and by culture. For example, the banking system in one country may vary from another. Governments may participate in the financial support of economic development and entrepreneurship through different programs and processes. The laws governing default in financial agreements vary. The availability of equity investment through venture capital firms or professional investors varies widely across regions of the world.

A common banking practice in western countries is issuance of debt, secured by collateral, which is repaid over a period of time with interest. By comparison for instance, Islamic banking<sup>23</sup> refers to a system of banking or banking activity that is consistent with the principles of Islamic law (*Sharia*) and its practical application through the development of Islamic economics. Sharia prohibits the payment of fees for the renting of money (Riba, usury) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haraam, forbidden). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba (*usury*).

### Section 4.3.1: Government Intervention in the Entrepreneurship Process

With respect to government intervention in the entrepreneurship process, laws governing default on financial contracts may be more or less forgiving with respect to the penalties paid by the individual or organization that defaults, and hence less favorable toward the investor or vice versa. Government policy and investment can drive the development of new industries. For example the oil crisis of 1973 resulted in gasoline shortages and increased recognition of the dangers of oil dependence in Brazil. In response to this crisis, the Brazilian government began promoting bio-ethanol as a fuel. Today Brazil is the world's second largest producer of ethanol fuel and the world's largest exporter.<sup>24</sup>

Government policy can be deployed for both economic development and to promote social policy. In the last 20 years, the Malaysian economy has been transformed from a protected low income supplier of raw materials to a middle income emerging multi-sector market economy driven by manufactured exports, particularly electronics and semiconductors, which constitute about 90% of exports. Since 1970, and the institution of the New Economic Policy following deadly riots in 1969 against economically dominant ethnic Chinese, the government's commitment to the free market has been hedged by its bumiputurna (literally, "sons of the soil") policies aimed at providing "constructive protection" for Islamic Malays against economic competition from other ethnic groups and foreign investors, particularly in the domestic market.<sup>25</sup>

<sup>23</sup> Source: Drawn from [http://en.wikipedia.org/wiki/Islamic\\_banking](http://en.wikipedia.org/wiki/Islamic_banking)

<sup>24</sup> See [http://en.wikipedia.org/wiki/Ethanol\\_fuel\\_in\\_Brazil](http://en.wikipedia.org/wiki/Ethanol_fuel_in_Brazil)

<sup>25</sup> See <http://www.nationsencyclopedia.com/Asia-and-Oceania/Malaysia-ECONOMIC-DEVELOPMENT.html>

Government support can also be the catalyst for industry-specific incubators. For example, in April 2009 the Ministry of Trade and Industry in South Africa launched the Mthatha Furniture Incubation Centre. The incubation centre is intended to kick-start the re-development and growth of the furniture and wood industries in the region and the province. The project is envisaged to further diversify and expand the value chain of the forestry sector in the region. Incubators and their incubatees need to be aware of opportunities to leverage resources dedicated by local, regional and national government agencies to support development of the entrepreneurial sector. Another example is the ‘Technopreneur Promotion Programme’ (TePP) Tiruchiarappalli Regional Engineering College – Science & Technology Entrepreneurs Park (TREC-STEP)<sup>26</sup> in India has been managing since 2008 in collaboration with the Department of Scientific and Industrial Research. The program aims to support innovators to become technology based entrepreneurs, i.e. so called “technopreneurs” by providing a comprehensive financial support for the realization of new product/ process ideas into actual prototypes and process models that can be potentially commercialized. More details are given in the case study dedicated to TePP as part of Module 10 of the current training program, “Technology Commercialization through Incubation”.

#### Section 4.3.2: The Financial Sector Support Towards Entrepreneurial Activities

The extent of development of the financial sector that supports entrepreneurial activity varies across the world. In many part of the world, there are few if any well-established venture capital firms and often no angel investors or angel investor networks. Incubators, working with other organizations striving to develop and support the local, regional or national innovation and entrepreneurship ecosystem, can catalyze and support a process through which the missing elements of a comprehensive financial resources system can be developed.

In some regions, government agencies (national, state or regional) may provide funding for and establish organizations that can pilot the concept of the venture capital firm, which may later on be adopted by individuals and organizations in the private sector. Large established businesses may opt to establish internal venture capital firms that support innovation and organic growth, as well as new ventures emerging from university laboratory research.

In other regions, it will be important to develop a set of skillful angel investors who can serve as the catalysts for the development of a risk capital industry. Incubators, in collaboration with universities that have deep expertise in entrepreneurship and venture capital, can sponsor training programs for potential angel investors. Often the candidates for such a training program are wealthy business people serving on the boards of managers of universities, NGOs and other not-for-profit organizations. As part of the training program, the sponsoring organization(s) can help organize individual angel investors into angel networks – which can reinforce the learning process for all members and spread risk through syndicates of angel investments. As angel networks mature and demonstrate success, they can be the catalyst for the development of professional venture capital firms.

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<sup>26</sup> Source: <http://www.trecstep.com>

### Section 4.3.3: The Challenge of Financial Capital

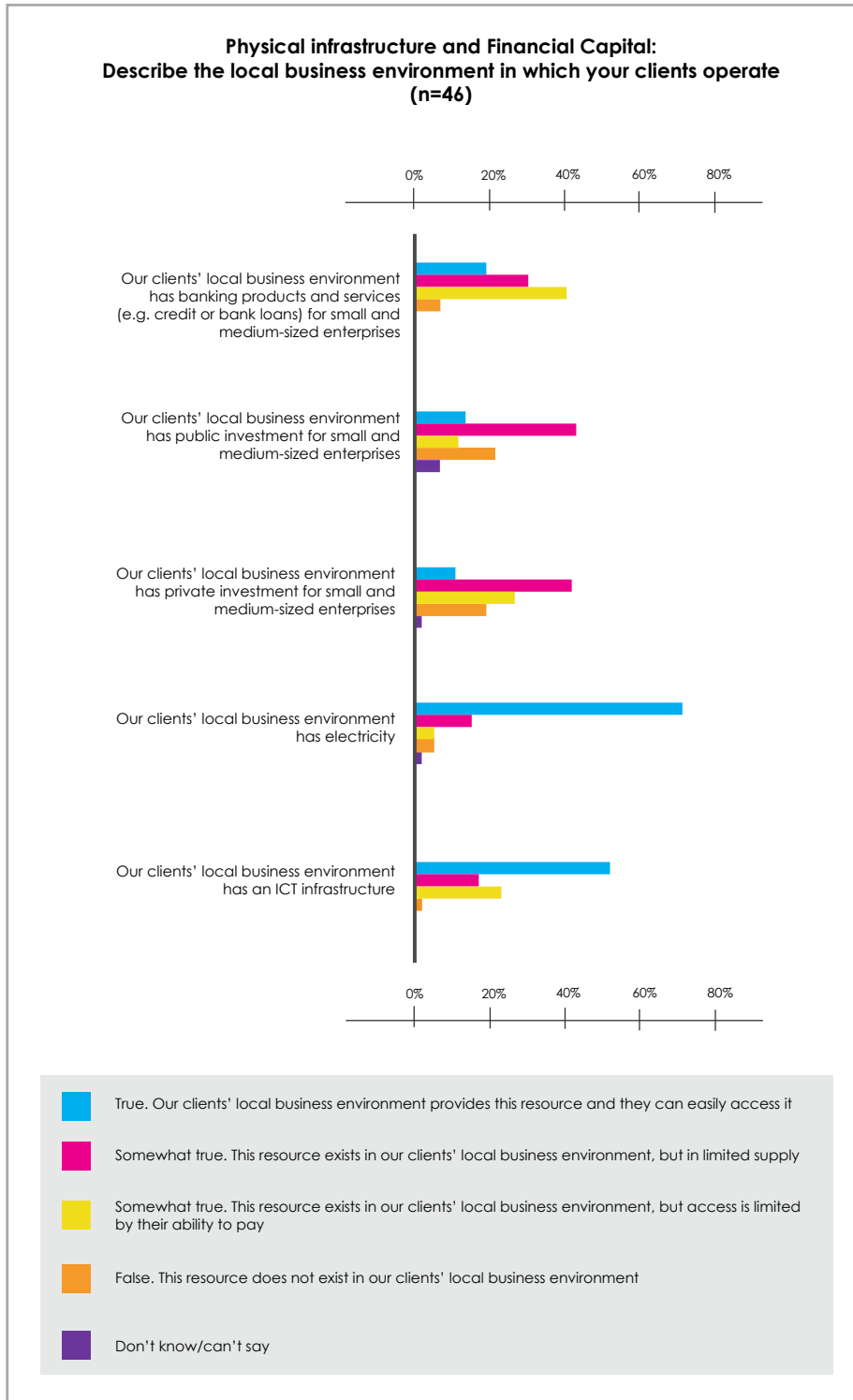
*infoDev* carried out a study that “chronicles the outcomes, impacts and lessons learned from *infoDev*’s Incubator Initiative and the work of its business incubation grantees more generally. The assessment team was asked to determine the broad relevance, effectiveness, efficiency and sustainability of *infoDev*’s support for business incubators, as well as the performance lessons that can be learned about how business incubation fosters entrepreneurship and innovation”.<sup>27</sup>

The Monitoring, Evaluation & Impact Assessment Study (MEIA), from which the following developments are directly extracted, explores the financial capital issue and establishes that “financial capital emerged as the primary physical capital challenge for entrepreneurs worldwide. For the most part, grantees did not stress their clients’ lack of preparation for outside financing as central to the problem. Many did, however, reveal this challenge by including the preparation of grantees to work with banks, investors and other outside financing mechanisms as part of their service offerings. Managers for the CDIMM Foundation in Romania were among the few grantees to speak directly about this issue. As they explained, “today, money is available, but it lacks talented and professional people with good ideas to make use of this money. Our role is to change the mentality.” Most grantees, however, stressed the supply side challenges of appropriate financing mechanisms for SMEs in developing economies.

More than 80% of grantees indicate that their clients are limited either because they cannot afford banking products or services or because SME-appropriate offerings do not exist in their local business environment. This gap exists in all regions.

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<sup>27</sup> Source: *infoDev*’s Monitoring, Evaluation & Impact Assessment Study - <http://www.idisc.net/en/Page.MEIA.Study.Overview.html>



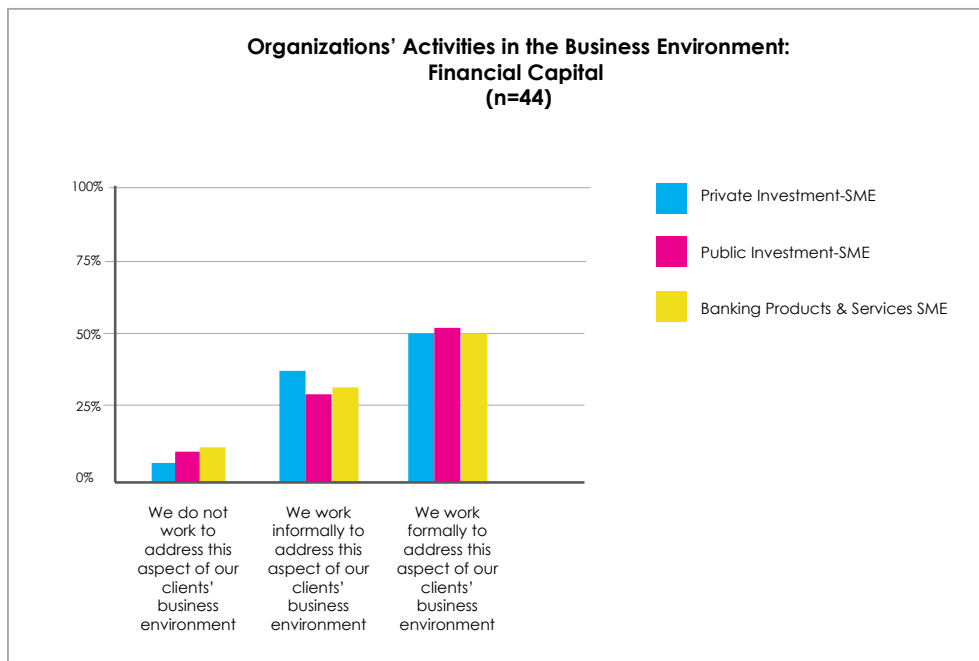
**Figure 2 – Physical Infrastructure and Financial Capital: Describe the local business environment in which your clients operate**

In China, for example, grantees describe state banks' perception of SME loans as "small, expensive to administer and high risk" and stress the need for new tools for assessing creditworthiness. To compensate for this perception of risk, annual interest rates can be as high as 25% in countries such as Uganda. This challenge is often compounded by collateral requirements that are too high for many knowledge-based companies, particularly in the services and ICT sector. In Mauritius, for example, an innovative range of mechanisms exists to fund SMEs in the ICT sector, but clients of the National Computer Board ICT Incubator Center report that the collateral requirements make these funds difficult to access.

In most cases this financing gap is not being filled by public and private mechanisms. Despite the promise of angel investors and venture capital (VC) in many developing economies, for example, their impact on entrepreneurs in *infoDev's* network has been minimal. Grantees indicate that risk capital is very difficult for their clients to secure, and that the vast majority end up self-supporting their start-up costs, with help from friends and family. Even in more developed economies such as Romania where investors have demonstrated greater comfort, CDIMM managers described the VC community as "only ready to invest if the ROI is higher than 30%," a threshold that few of their clients could meet. They described client enterprises as "too young and too difficult to scale" to be an attractive VC investment, and yet too big for microfinance institutions.

The feeling that entrepreneurs are 'stuck in the middle' between the types of small enterprises that microfinance institutions serve and the deals that banks and private investors find attractive was cited by many grantees. In most cases, governments are not correcting this market failure. Although some public mechanisms exist to address this need, in cases such as Peru, supply is limited or bureaucracy is significant. In Turkey, for example, the process to access innovative publicly-funded instruments for ICT start-ups is considered "long and burdensome." Chile has responded to this challenge by making seed capital very accessible for young entrepreneurs through CORFO, the government's industrial support agency. Funding for the next stage of development, however, the critical SME jump from small to medium, is in short supply.

In contrast with infrastructure challenges, however, grantees are not systematically addressing the gaps in SME financing. Despite the high demand for support and the centrality of the challenge for many entrepreneurs, only 50% of grantees formally work to increase their grantees' access to capital from either the public or private sectors.



**Figure 3 – Organizations' Activities in the Business Environment: Financial Capital**

Client interviews revealed frustration with the absence of financial support, and the recognition that most incubation organizations are not designed to serve this need. Those that do offer a range of products and services, from seed funding and credit guarantees to direct equity investments, such as the AI Akhawayn University Incubator in Morocco. Others actively fundraise on behalf of their clients for public support, particularly to facilitate technology transfer activities as is the case for some grantees in ECA. In other cases the support is aimed at facilitating access. Many grantees such as the ARC in Bulgaria work to facilitate a dialogue with investors and banks, brokering introductions, or coaching clients on pitching investors.

Many grantees are also expanding their realm of influence beyond their clients to include the larger environment for SME financing. CIE-TEC in Costa Rica is collaborating with a local bank to establish a financing fund for SMEs, and AccessNova in Chile responded to the gap in middle-stage financing for Chilean entrepreneurs by creating the country's first network of angel investors. The National Council of Negro Women (NCNW) in Senegal is another example of broader influence on the local business environment. The NCNW is now investigating the provision of finance facilities with the central government and the establishment of a guarantee fund using the incubation process as security. The TIC Incubator in Bolivia is also working to influence the broader environment for entrepreneurs, as an advisor to USAID in its launch of a SME financing program".<sup>28</sup>

<sup>28</sup> Source: *infoDev's Monitoring, Evaluation & Impact Assessment Study*:

<http://www.idisc.net/en/Page.MEIA.Study.Observations.html>



## COMPONENT CONCLUSIONS

Throughout the global business incubation industry, the lack of risk capital is cited as one of the most difficult barriers to success that incubatees must overcome. Without investment capital, high potential firms are unable to support growth and the incubator is left with a collection of small businesses that, even if they are viable, will have minimal impact on job creation and economic development in the region. Hence, enhancing the processes through which existing sources of capital, no matter how limited, and incubatees interact, and helping them achieve a measure of success is an important first step. In addition, catalyzing and supporting the development of a substantial regional portfolio of vibrant and varied sources of venture financing is an important role for an incubator to undertake.



# Case Studies



## Financial Management Training for Incubatees

**Incubator Name:** RPI Incubator

**Sector:** University-Based Technology Business Incubator

**This Case Study Examines:** Implementation of a pilot project testing the use of financial management systems as the basis for a formal mentoring program.

**Date:** December 2009

### PART I

#### SUMMARY

##### **Problem**

For many or most client companies, cash flow is negative during the period in which the entrepreneur is trying to figure out how to create a sustainable business. Frequently, the entrepreneur does not understand the importance of exercising fiscal discipline and only pays attention when faced with a financial crisis. When incubator clients fail to graduate from the pre-venture /start-up /survival modes to sustainability, in most cases they do not fail spectacularly. They simply run out of money before they figure out how to succeed - and abandon their ventures and return to a job or to education. (Excerpt from the Introduction to this module)

##### **Solution**

Establish a monthly review program engaging a team of professional advisers that require the incubatee to submit standard financial statements prior to the review. Gain the commitment of the incubatee to the process by negotiating transfer of a small equity position to the incubator and payment of a nominal monthly fee.

### PART II

#### BACKGROUND

See Annex 2 for a comprehensive report on the pilot project.

#### TIMELINE OF EVENTS

This approach to dealing with the ongoing challenge of getting incubatees to exercise financial discipline was pilot tested in 1991-1992 in the RPI Incubator Program with significant initial success.

## OUTCOME AND CONCLUSIONS

Though the program exceeded expectations of most of the participants (incubator manager, mentors and incubatees), during the transition from the incubator manager who launched the program and his successor, the program was suspended and never restarted. To be successful over the long term, it would require the ongoing sponsoring and championing of the incubator manager and a flow of companies through the program. Based on the experience in the pilot program, six to twelve months in the program should be a sufficient commitment from incubatees, who thereafter should be transitioned to their own board of managers or advisers.

## PART III

### LINKS

N/A

### REFERENCES

This material for this case study was contributed by the manager of the case study incubator. His report of the program, presented at the 1992 International Conference on Business Incubation, is included in Annex 2.

## Investment Readiness of SMEs in South-East Europe

**Incubator Name:** Southeast European Network of Start-Up Centers and Incubators (SENSI)

**Sector:** Youth focused business incubator

**This Case Study Examines:** Start-up's investment related needs in the Former Yugoslav Republic of FYROM, Serbia, Montenegro, Bosnia, Kosovo, Romania, Armenia and Bulgaria.

**Date:** May 2009

### PART I

#### SUMMARY

##### Problem

The availability of risk capital finance for early-stage businesses is in general very limited, especially in regions such as the South-East of Europe.

##### Solution

YES Foundation Skopje carried out a project called 'Investment readiness of the MSME sector in South-East Europe' in cooperation with the Dutch Foundation SPARK and with the support of the SENSI and ECabit networks in order to support the creation of a regional Business Angel Network. As a result of the project, the report BRIDGING THE GAP - Access to Risk Finance for Early-Stage SMEs in Southeast Europe discusses the current situation with risk capital in the region, tries to identify the major reasons for such situation, and attempts to offer recommendations for promoting access to risk finance for SMEs in the region. In doing so, frequent references and comparisons are made to the situation in the European Union as a desired final destination of all the countries in the SEE region.

### PART II

#### BACKGROUND

The non-profit Youth Entrepreneurial Service (YES) incubator in Skopje (FYROM) was founded in 2007. It targets the youth population and works primarily in the ICT sector. It has a number of goals, including creating jobs, raising the awareness of potential entrepreneurs, decreasing the brain drain, and developing the ICT industry. Its 600m<sup>2</sup> space includes 21 offices, meeting rooms, a kitchen, and parking. At the end of 2009, the incubator had 16 clients, employing 44 individuals.

YES incubator offers free consulting services and assistance to potential incubatees as well as seed capital, trade facilitation, financial management training, business information.

### **The Problem – Finding Financing for Incubatees**

Incubatees at YES incubator are not in an ideal position to attract investment from external sources. They lack the experience and know-how needed to lure investors. YES incubator's constant search for donors and capital to sustain its own operations puts strains on the time it can provide its incubatees. Additionally, YES incubator's own inexperience in this field and the poor economic realities of FYROM place incubatees at a disadvantage when attempting to attract investors.

In confronting this problem, YES incubator with the SENSI and ECAbit networks saw that there was a vacuum in FYROM regarding investment-readiness research. Most articles simply pointed to the lack of capital and angel investors, but there was no research regarding strategies employed or best practices in the area.

To rectify the lack of information and investors in the area, YES - in cooperation with the Dutch Foundation SPARK and with the support of the SENSI and ECAbit networks - launched an investment-readiness project with the aim to increase the capabilities of incubator managers and clients in the field of investment and financing innovative SMEs as well as effective application of ICT in this area. The project kicked off in October 2008. Since then, the project has been surveying incubators around the region.

The data collected, from which the bulk of the project's findings are derived, comes from around 70 interviews. The project published its results in January 2010.

### **Conclusions**

Signs point to the need to establish a regional system aimed at attracting investments, Venture Capital funds, and angel investors. Currently the lack of a developed network and personal expertise in attracting funds has hampered success. The small size and population of FYROM limits the total financial pool from which to draw potential investors. A regional approach gives all incubators in the area and their incubatees a larger pool to potentially attract funding from, as well as a larger financial network made up of many incubators from which to fund training programs, bring in experts, and provide for other solutions.

### **TIMELINE OF EVENTS**

- YES was founded in 2007.
- The investment readiness project began in October 2008 and has been studying the problem of insufficient resources and experience regarding incubatee financing.
- The report summarizing the project's findings and recommendations was published in January 2010.



## OUTCOME AND CONCLUSIONS

This case study illustrates how an incubator found that a problem it was experiencing, sourcing financing for its incubatees, could be used as an opportunity from which to launch an extensive survey of the difficulties the incubator and its stakeholders were facing. The results gathered in a final report provide guidance about next steps which should hopefully result in concrete action items and a critical path aimed at resolving the difficulties YES incubatees face when attempting to solicit financing from investors.

## PART III

### LINKS

Yes incubator website: <http://www.yesincubator.org.mk/EN/index.php>

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ECAbit network website: <http://www.ecabit.org/>

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The material for this case study was gathered from a phone conversation with Mr Ljupco Despotovski, incubator manager of YES Incubator, on October 11th, 2009.

## The importance of financial support for early stage ventures

**Incubator Name:** Technological Incubator Program

**Sector:** Technology based incubators

**This Case Study Examines:** Technological Incubator Program in Israel

**Date:** December 2009

### PART I

#### SUMMARY

##### Problem

A market may be full of very skilled people with brilliant business ideas, but most of these cannot be implemented if nobody invests in these very early stage ventures.

##### Solution

In Israel, the government set up the “Technological Incubator Program” to develop innovative technological ideas into start-ups and lead them towards their first round of private investment.

### PART II

#### BACKGROUND

In the early 1990's, Israel faced a massive immigration wave of people from the former USSR countries. The population of Israel increased by 10% in 5 years. A large part of the immigrant population was academically skilled people with thorough technological knowledge and products ideas that could potentially be marketable.

At that time, the Israeli government already supported Research and Development activities in established companies but NOT in the preliminary phase of venture development. Hence, the government took the initiative to set up a program, the “Technological Incubators Program” based on the business incubation model and aiming to develop innovative technological ideas generated from the people living in Israel into start-ups in order to lead them towards their first round of private investment. Originally, this program was initiated to respond to the needs of the immigrant population (70% of the supported projects' initiators were immigrants). However, the program has always been a general one so that it could carry out several missions:

- To enable new immigrants to develop their commercial product and establish a startup;
- To increase the development of peripheral regions;

- To strengthen minorities;
- To support specific technological areas; and
- To enhance the entrepreneurial culture within the population, especially young people.

The main target of the program has always been and is still the following: to create an instrument that will support the very early stage innovative technological ideas so that they become ready for private investment and do not disappear, but instead become established companies.

24 Business Incubators operate under this program. They are spread over the whole country. The incubators involved have been selected to take part in the program because they meet the following criteria:

- They are all independent legal entities;
- The general manager is a skilled and experienced person;
- The Board of managers is composed by experienced people coming from the industry and academia;
- They are sector focused and linked to research institutes;
- They are equipped with suitable facilities for R&D activity, some of them are sector focused and most of them collaborate with research institutes; and
- They provide technological, financial, administrative and logistical support to projects.

The incubators involved in the program carry out 3 kinds of activities.

#### **1. Screening to choose ideas**

The incubators are in charge of evaluating the technological ideas presented to them to identify the projects with potential and hence which projects to support through the program. The projects should respond to the following criteria – they should be:

- Product oriented;
- Rooted in research & development;
- Innovative and unique;
- At early stage; very high risk level;
- Representing a significant potential market;
- Feasible with available resources; and
- An individual initiative.

## 2. Support to initiators

The incubators assist the promising projects' initiators in building teams to further develop their innovative technologies and be selected to take part in the program. The incubators offer the following services to the entrepreneurs:

- Appropriate facilities for R&D;
- Financing;
- Central administrative services (secretarial, accounting, legal, acquisition);
- Management assistance;
- Professional guidance;
- Business direction;
- Assistance in commercialization;
- Inter-tenant synergism; and/or
- Sharing existing infra-structure.

## 3. Government Assistance

Once the project is accepted in the program, the business incubator applies to the government office in charge of the program to get the project supported. (85% of the projects presented by the business incubators are accepted by the government office).

The support from the government consists of providing the company with a zero risk grant or a loan of 85% of the funds required to develop the project, that is to say on average \$0.5 million (for biotech projects, \$0.75 million). These funds aim to support the incubator for 2 to 3 years within the incubator. The remaining 15% of funds required to develop the project have to come from private sources. In the last 8 years, these 15% are coming from the incubator which takes an equity share of generally 50%. Each incubator supports an average of 10 projects.

The first investment from the government is of crucial importance for the company to become attractive to private investors. Indeed, at a very early stage of development, the ventures are not ready yet for private investment and hence, no other sources of funding are available for these early stage companies. As a consequence, there has been a constant battle to secure the government's financial support for innovative technological projects within its budget. In the last 10 years, the total contribution from the government has been stabilized to \$35 million per year to support innovative companies through this program.

Building on the strength of the program, the business incubators assist the projects they support in getting private stakeholders to invest in the businesses.

## TIMELINE OF EVENTS

**1991:** Establishment of the Technological Incubators program in Israel.

**2008:** The founder and CEO of the program, Mrs Rina Pridor, retires.

## OUTCOME AND CONCLUSIONS

By creating a general instrument implemented by business incubators all over the country, the Israeli government developed a program that suits all parts of its population. If the instrument was first thought to support immigrant entrepreneurs, it has now proved to be a scalable model meeting the whole population's needs and expectations.

Also, the success of the program is easily monitored by measuring the quantity and size of private investment allocated to innovative projects. It is worth mentioning that over the last 6 years; more than 60% of the projects supported by the program received private investment at the end of their 2-3 years of incubation and have become sustainable businesses. They usually graduate within a 5 year period of incubation and once they have graduated, they manage to raise private investment corresponding to five times the government loan.

## PART III

### LINKS

<http://www.pridor.com>

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The material for this case study was contributed by the founder and former General Manager, Mrs Rina Pridor. The information above is extracted from firsthand experience and personal involvement in the development of above tools.

**Contact details:**

rina@pridor.com



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# Annex 1: Business Plan Outline

**From Try It Yourself to Creating an Effective Business Plan section:**

<http://www.smetoolkit.org/smetoolkit/en/content/en/799/Try-it-Yourself>

- Introductory Elements
- Business Description
- The Market
- Development & Production
- Sales & Marketing
- Management
- Financials

# Annex 2: The Regular Rigorous Review Program

*(Presented by Mark P. Rice at the 1992 National Business Incubation Association Annual Conference Austin, Texas)*

### **Introduction: Anchoring Review to Financial Performance**

Without anchoring review to the concrete reality represented by financial performance, it is very difficult to determine if the problems identified by the entrepreneur are the real problems of the company, or the most important ones. Most entrepreneurs operate independently of the financial dynamics of their businesses, until and unless they are forced to do otherwise. In most cases, they view financial statements as a necessary evil and only as a basis for tax reporting. Seldom do they use financial statements as the basis for managing their businesses.

### **What's the Right Software Package?**

The right software package is the one the entrepreneur is willing to use. Given the importance of peer networking, it also makes sense to encourage the use of a common package so that the entrepreneurs can help each other.

Although long term it is not anticipated that the use of a common software package by all incubatees will be required, Quicken was specified for use by the participating companies during the trial phase of this program for several reasons. Quicken is inexpensive, relatively easy to use and is fast becoming ubiquitous. Intuit, the maker of Quicken and a sponsor of the 1992 NBIA Conference, has recently come out with a package designed specifically for small businesses entitled QuickBooks.

### **How to Get the Entrepreneur to Produce the Required Financial Reports**

The financial reporting capacity of each of the companies was addressed through three mechanisms:

#### **1. Relationship with Coopers & Lybrand**

A relationship with the national and local offices of Coopers & Lybrand through their Emerging Business Services Division was established. C&L has provided the assistance of a junior accountant under the direction of a managing accountant to assist the companies with financial reporting.

#### **2. Connection to Rensselaer's School of Management**

During the Spring '92 semester, student teams in the capstone accounting course in our School of Management adopted companies and worked with them on their financial record-keeping systems and on their facility with Quicken.

#### **3. Participation of an Incubator Company (Kent Consulting)**

One of the incubatees, Kent Consulting, is attempting to develop a user interface to make it easier for entrepreneurs to get started on Quicken. As part of the development effort for this product, Peter Kent provided training and assistance to the participating entrepreneurs to help them up their learning curves.



Even with all these intervention mechanisms aimed at helping companies implement a financial reporting system, results so far have been mixed. Only one of the eight companies has progressed to the point of being able to produce all six suggested financial statements. Some of the participants still have not even been able to consistently produce a P&L and a balance sheet.

### **The Costs and Benefits of Implementing the 3R Program**

The costs are rather obvious. Implementing the program requires a significant amount of staff time, not so much for the review sessions, but rather for the coordination and management of the process. In particular the entrepreneurs need to be stimulated to do their part and the participants in the review panel need to be coordinated.

On the positive side, in spite of marginal achievement of the overall program goals so far, each of the participating companies has received some significant benefit from the process and has recognized that benefit. To some extent, the incubator staff has gained greater facility with managing the process and has discovered ways to enhance the benefits of the program.

### **The Review Panel(s)**

In general review meetings have been held with companies monthly during the initial three to four months, and thereafter a quarterly review schedule is adopted. The core group of reviewers has included the Incubator Director, Mike Signor (a manager from C&L), and Bill St. John, the School of Management professor in charge of the capstone accounting course. In addition a local investment banker and several other members of the Rensselaer staff and faculty have participated on occasion. So far the review meetings have gone very well, in spite of the difficulties in achieving consistent financial reporting.

After the experimental phase is completed (probably within the next six months), multiple review boards will be formed. Initially it was anticipated that most or all incubatees would eventually be included in the program. (That concept is being reconsidered given the variable responsiveness of the entrepreneurs.) If multiple review boards are created, each panel would only be expected to be responsible for one periodic half day meeting with one cohort of three to four companies.

### **Survey Results**

In April 1992 the participating entrepreneurs were asked to fill out a survey to provide feedback on the 3R Program. The following ratings were used to indicate the value received from the 3R Program in the areas listed in the summary table on the next page:

- 0 Some counseling or advice was offered but had little or no impact on the entrepreneur of the business.
- 1 The assistance that was provided caused the entrepreneur to think through his/her performance and the performance of the company in the areas related to the help received.

- 2 The assistance caused the entrepreneur to make changes in the way the entrepreneur or the company performs.
- 3 The changes made a significant impact on the performance of the entrepreneur or their business.

**Table A11.1: Survey Results Re. Evaluation of the 3R Program by the Entrepreneurs**

*Ratings by Company #*

ACTIVITY	#1	#2	#3	#4	#5	#6	#7
FINANCIAL MANAGEMENT	2	3	2	2	1	2	0
TAX ISSUES	2	0	1	3	0	1	0
LEGAL ISSUES	0	0	0	1	0	2	0
MARKETING SALES	2	2	0	1	1	2	1
PRODUCT DEVELOPMENT	0	3	0	0	1	1	0
PEOPLE ISSUES	1	2	0	1	1	2	0
GENERAL MANAGEMENT (STRATEGIC PLANNING)	3	3	1	2	1	2	1

#### Notes Regarding Survey Results

1. One of the first four companies in the program never made it past the first meeting. The principals in the venture split into two companies, one for R&D and the other for all other functions, and executed a licensing agreement. Therefore they did not fill out the survey, leaving the number of responses at seven.
2. Companies #1, #2 and #3 completed their sequence of monthly meetings at the end of 1991 and had their first quarterly meeting in April 1992.
3. Company #4 came into the program two months into the first sequence as a replacement for the early dropout and continued with the monthly meetings with the second cohort of four companies.
4. Companies #5, #6 and #7 started the program in January 1992. Company #7 skipped one of the monthly meetings and indicated in the survey that it was too early to rate the value of the program because of the discontinuity in its participation.

#### Conclusions Regarding Survey Results

As expected, with the exception of company #7 which has not yet implemented the financial management system, all other participants recognized an impact in the area of financial management. Most encouragingly, all seven companies cited the value of counseling regarding overall management and strategic planning for their firms. In addition, six out of the seven participants specifically acknowledged the impact in the area of sales and marketing.

In addition to the opportunity to rate specific functional areas, the survey questionnaire also asked the open-ended question: “In what ways has the 3R Program been helpful to you?” With the exception of company #7, which had not yet gotten up to speed with financial accounting, all the participants cited the importance of developing an accounting system and the capacity for financial management. In addition four of the seven companies also recognized the stimulus to focus on other management issues as well.

The survey questionnaire also asked: “In what ways has it (the 3R Program) not met your expectations with respect to being helpful to you?” Two of the three firms in the first group to enter the program cited the need for continuity after transitioning from monthly to quarterly meetings. Three firms recognized shortcomings in the original version of Quicken. (None of the firms yet has experience with QuickBooks.) Finally two of the firms indicated their desire for greater appreciation for the problems of very small businesses. Responses to the final question regarding recommendations for improvements indicated a desire for even greater intensity in terms of communication, and frequency and depth of review.

## **Recommendations and Observations**

### **1. Segmenting the Population of Incubatees**

As the pilot phase of this program winds down, one of the fundamental questions that must be answered is whether or not all incubatees should be expected to participate in the program. On the one hand this may be the best way to move all the companies up their learning curves. This program insures at least some minimal level of interaction with all participating companies. On the other hand, what happens when a company simply doesn't do its part, or doesn't show up? The initial reaction might be that the company should be booted from the program. However, many incubators can't afford to give up companies that pay their rent, given the financial pressures on their own incubator budgets.

An alternative strategy may be to limit the program to those companies that are committed to proactive participation and that are responsive. This strategy would explicitly recognize at least two other groups of companies: those that have matured beyond this program (anchor tenants) and those that haven't yet matured with respect to capacity and willingness to respond to intervention, and who therefore do not represent an adequate potential return on the investment of time by the manager. The companies in these two groups may still be good incubator tenants and may benefit from the passive interventions related to the incubator environment without taking up a significant amount of the incubator manager's time.

### **2. Building Capacity for Dealing with the Nuts and Bolts of Bookkeeping**

This is not as simple as it looks. In spite of multiple forms of assistance available to incubatees, it is difficult to get them to invest the time and dedicated intensity to make the bookkeeping process routine. This difficulty will likely be ameliorated as better packages emerge and as more incubatees get up to speed and become sources of peer counseling about bookkeeping and the software packages.

In some cases it may be better to push the company to engage a bookkeeper, where they can afford it. Then the entrepreneur will focus on using the results to consult with the members of the review panel about managing the business from a financial perspective.

### 3. Creating Multiple Advisory Panels

It seems reasonable to expect that most volunteers will not be willing or able to commit more than a half day a month to this process. Therefore recruiting enough volunteers to complement the incubator staff on the review panels becomes both a necessity and an opportunity. With respect to opportunity, if the program is well run and the entrepreneurs are responsive, then this is a very productive way to put volunteer time to good use. In most communities there will be no shortage of accountants, lawyers, bankers, consultants and successful entrepreneurs who can be recruited. The more difficult challenge is managing the logistics.

### 4. Pushing Companies to Create Their Own Advisory Boards

If the process works well, then the companies should be motivated to create their own advisory boards, or Boards of Directors, which can operate independently of the incubator. If this happens, then the logistical burden is removed from the incubator staff. Ideally, if the company is still in the incubator, the incubator manager may want to continue participating as a way of keeping current on the issues facing the company.

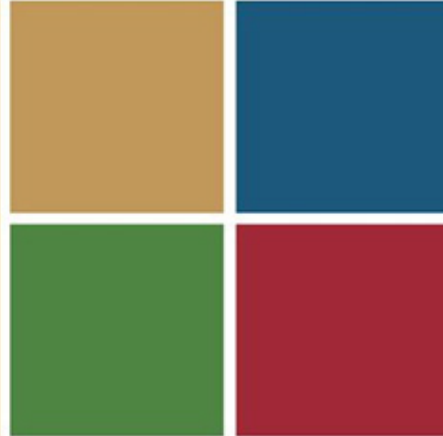
### Overall Conclusion

The 3R Program, in spite of the administrative challenges it presents, has shown significant potential as a proactive intervention mechanism. If effectively implemented, it can provide:

- A means to decrease the time dedicated to less effective forms of intervention,
- A vehicle for more effective utilization of network volunteers, and
- A more effective form of direct intervention (i.e., counseling and networking) for stimulating participating companies to improve their overall management of efforts to address their own particular critical success factors.

# Annex 3: Financial Plans for Early Stage Companies

**+** Mr. Santinelli is the founder of Dakin Management, a strategy consultancy focusing on small to medium size businesses. He was previously a partner with North Bridge Venture Partners, where he began his investing career in 1998. North Bridge is a leading seed and early stage venture capital firm headquartered in Waltham, Massachusetts. His investment interests ranged from communications, wireless, software and Internet infrastructure.



## Financial Plans for Early Stage Companies

Developed by Babson Professor Angelo Santinelli  
January 26, 2009

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### **+** Agenda

- The Background
- The Approach
- The Numbers
- The Presentation
- The Mechanics



## + The Background

- What are investors looking for?
  - Market opportunities
  - Product ideas
  - Quality management teams
  - Attractive returns on capital
- A financial plan will display this to the investors
  - Clear and concise presentation
  - Components which logically support one another
- It must convey confidence and realism
  - Pie in the sky won't sell
  - The numbers are estimates -- they will change
  - Know your details and your assumptions fully
- It must be strategically compelling and operationally achievable

3

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## + What Investors Want To Understand from Financials

- How much cash is required to get to Cash Flow Break Even?
- Cash - to - Accomplishment Ratio
  - Cash required to get to next round of funding
  - Plan for a "step up" in valuation
- Reality Check
  - Staffing plan
  - Revenue ramp
  - Comparables
- Revenue and Cost Drivers
  - Leverage in plan
  - What can go right?
  - What can go wrong?

4

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## + The Approach

- Fully detail all assumptions
  - Some factors will change, some will not. Need to adjust
  - Say your assumptions "out loud". Test them with your team
- Prepare a full set of financials (P&L, B/S, C/F)
  - Look two years forward, one year back
  - Prepare it by Month, Present it by Quarter and by Year
  - Resist making high level assumptions when building the plan
- Put together "The Book" and hand it out
  - Will give investors a degree of comfort
  - A handy reference guide for management to measure progress
  - Provides structure and discipline at operating decision points
- What you have not thought of -- will emerge. 
- What you have assumed -- will be magnified. 

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## + Bottoms Up and Tops Down

- |  |  |
|--|--|
| ■ Build revenues and costs from smallest units   | ■ Find comparables in analogous industries             |
| ■ Determine revenue drivers <ul style="list-style-type: none"> <li>■ # of customers</li> <li>■ Amount purchased</li> <li>■ Pricing</li> <li>■ Frequency</li> </ul> | ■ Run various scenarios                                |
| ■ Validate assumptions   | ■ Compare common cost percentages to industry averages |
| ■ Do same for costs  | ■ "Sniff Test"   |
| ■ Build-Up Plan  |  |

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## + The Numbers

### Income Statement

- Orders and Revenue
  - Timing of when they begin
  - Trajectory of growth ramp
- Cost of Revenues
  - Fixed costs
  - Variable costs
- Operating Expenses
  - Staffing and Payroll
  - Know your company and what you need
  - Occupancy and Fixed Costs
    - Rent, Utilities, insurance, etc
    - Compliance (tax, acctg, legal)
    - Depreciation and amortization

### Balance Sheet

- Accounts Receivable**
  - How long to collect the cash?
- Inventory**
  - How much in stock? Turnover?
- Accounts Payable**
  - What can wait, what cannot?

**CASH**

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7

## + Balance Sheet Example

	12/31/2006	3/31/2007	6/30/2007	9/30/2007	12/31/2007
<b>Assets</b>					
<b>Current Assets:</b>					
Cash & cash equivalents	\$ 11,101,167	\$ 9,208,543	\$ 6,610,608	\$ 4,923,674	\$ 4,236,005
Accounts Receivable	1,883,736	675,000	1,175,000	1,675,000	2,200,000
Inventory	185,498	109,278	167,716	239,140	239,140
Prepaid Expenses & Other assets	116,047	116,047	116,047	116,047	116,047
<b>Total Current Assets</b>	<b>13,286,448</b>	<b>10,108,868</b>	<b>8,069,370</b>	<b>6,953,861</b>	<b>6,791,192</b>
Equipment, furniture & fixtures	2,004,554	2,407,054	2,707,054	2,829,554	2,952,054
Accumulated Depreciation	(800,524)	(987,441)	(1,197,844)	(1,418,544)	(1,639,982)
Equipment, furniture & fixtures, net	1,204,030	1,419,613	1,509,210	1,411,010	1,312,072
Other Assets / Deposits	31,128	31,128	31,128	31,128	31,128
<b>Total Assets</b>	<b>\$ 14,521,606</b>	<b>\$ 11,559,609</b>	<b>\$ 9,609,708</b>	<b>\$ 8,395,999</b>	<b>\$ 8,134,392</b>
<b>Liabilities &amp; Stockholders' Equity (Deficit)</b>					
<b>Current Liabilities:</b>					
Accounts Payable	\$ 453,214	\$ 311,685	\$ 281,928	\$ 308,195	\$ 281,648
Accrued Expenses	270,006	270,006	270,006	270,006	270,006
Accrued Compensation	213,424	213,424	213,424	213,424	213,424
Deferred revenue - Service	371,235	417,537	567,509	776,452	1,076,696
Deferred revenue - Product	874,494	411,600	692,100	972,600	1,234,200
<b>Total Current Liabilities</b>	<b>2,182,373</b>	<b>1,624,252</b>	<b>2,024,968</b>	<b>2,540,677</b>	<b>3,075,974</b>
Common Stock	353	353	353	353	353
Additional Paid in Capital	52,298	52,298	52,298	52,298	52,298
Preferred Equity - Series A	6,055,838	6,055,838	6,055,838	6,055,838	6,055,838
Preferred Equity - Series B	10,099,001	10,099,001	10,099,001	10,099,001	10,099,001
Preferred Equity - Series C	14,957,205	14,957,205	14,957,205	14,957,205	14,957,205
Accumulated Deficit-prior (Retained Earnings)	(10,225,445)	(18,825,461)	(18,825,461)	(18,825,461)	(18,825,461)
Accumulated Deficit-current	(8,600,017)	(2,403,876)	(4,754,492)	(6,483,911)	(7,280,815)
<b>Total Shareholders' Equity (Deficit)</b>	<b>\$ 12,339,233</b>	<b>\$ 9,935,357</b>	<b>\$ 7,584,741</b>	<b>\$ 5,855,322</b>	<b>\$ 5,058,418</b>
<b>Total Liabilities &amp; Shareholders' Equity (Deficit)</b>	<b>\$ 14,521,606</b>	<b>\$ 11,559,609</b>	<b>\$ 9,609,708</b>	<b>\$ 8,395,999</b>	<b>\$ 8,134,392</b>

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## + Income Statement Example

	2006		2007				
	Actual Q4#6	Actual FY#6	Plan Q1#7	Plan Q2#7	Plan Q3#7	Plan Q4#7	Plan FY#7
<b>Bookings</b>	1,533,000	3,607,605	1,200,000	2,200,000	3,200,000	4,400,000	11,000,000
<b>Revenue</b>							
Product	723,509	2,405,618	1,483,400	1,589,500	2,439,500	3,478,400	8,990,800
Maintenance	143,903	359,188	133,698	180,028	271,057	359,757	944,539
Services/Other	4,332	11,782					
<b>Total Revenue</b>	<b>870,844</b>	<b>2,776,588</b>	<b>1,617,098</b>	<b>1,769,528</b>	<b>2,710,557</b>	<b>3,838,157</b>	<b>9,935,338</b>
<b>Cost of Goods Sold</b>							
Product	87,661	313,565	179,711	218,556	335,431	478,280	1,211,979
Operations	64,038	181,169	65,516	65,808	66,010	65,916	263,249
Customer Support	54,153	117,607	110,924	151,105	152,191	160,862	575,044
Warranty/Other	16,911	26,489	3,075	7,153	10,978	15,653	36,859
<b>Total COGS</b>	<b>222,763</b>	<b>655,337</b>	<b>359,228</b>	<b>442,623</b>	<b>564,610</b>	<b>720,710</b>	<b>2,087,171</b>
<b>Gross Profit</b>	<b>648,081</b>	<b>2,121,251</b>	<b>1,257,870</b>	<b>1,326,905</b>	<b>2,145,947</b>	<b>3,117,447</b>	<b>7,848,169</b>
	74%	76%	78%	75%	79%	81%	79%
<b>Operating Expenses</b>							
Sales	961,748	2,681,451	1,181,068	1,256,787	1,344,923	1,449,556	5,234,335
Business Development			67,111	71,838	81,931	94,024	314,904
Marketing	373,773	1,227,393	371,001	280,882	371,518	278,267	1,301,667
<b>Sales &amp; Marketing Worldwide Total</b>	<b>1,335,520</b>	<b>3,908,845</b>	<b>1,619,180</b>	<b>1,611,507</b>	<b>1,798,372</b>	<b>1,821,848</b>	<b>6,850,906</b>
Engineering	1,826,907	6,665,424	1,828,630	1,839,495	1,849,939	1,865,699	7,383,764
General & Administration	140,366	688,488	213,936	226,519	227,055	229,804	894,313
<b>Total Operating Expenses</b>	<b>3,322,792</b>	<b>11,142,767</b>	<b>3,661,746</b>	<b>3,677,521</b>	<b>3,875,366</b>	<b>3,914,351</b>	<b>15,128,984</b>
<b>Profit(Loss) from operations</b>	<b>(2,679,055)</b>	<b>(9,041,516)</b>	<b>(2,403,876)</b>	<b>(2,350,616)</b>	<b>(1,729,419)</b>	<b>(796,904)</b>	<b>(7,280,815)</b>
<b>Other (Income) Expenses</b>							
Interest Income	(146,978)	(445,226)					
<b>Total Interest (Income) Expense</b>	<b>(146,978)</b>	<b>(445,226)</b>					
Other Expenses	3,270	3,726					
<b>Total Other (Income) Expenses</b>	<b>3,270</b>	<b>3,726</b>					
<b>Pretax Profit(Loss)</b>	<b>(2,535,347)</b>	<b>(8,600,017)</b>	<b>(2,403,876)</b>	<b>(2,350,616)</b>	<b>(1,729,419)</b>	<b>(796,904)</b>	<b>(7,280,815)</b>
Taxes							
<b>Net Profit(Loss)</b>	<b>(2,535,347)</b>	<b>(8,600,017)</b>	<b>(2,403,876)</b>	<b>(2,350,616)</b>	<b>(1,729,419)</b>	<b>(796,904)</b>	<b>(7,280,815)</b>

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## + Cash Flow Statement Example

	Q1 2008	Q2 2008	Q3 2008	Q4 2008	FY 2008
<b>Operating activities</b>					
Net Income/ (Loss)	(1,680)	(1,691)	(1,438)	(1,017)	(5,826)
Depreciation and Amortization	65	74	81	91	311
(Incr)/ (Decr) in accounts receivable		(325)	(94)	(360)	(780)
(Incr)/ (Decr) in inventory	(25)	(25)	(25)	(25)	(100)
(Incr)/ (Decr) in prepaid/other assets	(50)	(50)			(100)
Incr/ (Decr) in accounts payable	20	20	20	20	80
Incr/ (Decr) compensation accrual		47			47
Incr/ (Decr) expense accruals					
Incr/ (Decr) other liabilities	11	(6)	(6)	(6)	(6)
<b>Cash flow from operations</b>	<b>(1,639)</b>	<b>(1,955)</b>	<b>(1,462)</b>	<b>(1,297)</b>	<b>(6,373)</b>
<b>Investing activities</b>					
Acquisition of fixed assets	(111)	(112)	(120)	(108)	(450)
(Incr)/ (Decr) in Other LT assets					
<b>Net cash used in investing activities</b>	<b>(111)</b>	<b>(112)</b>	<b>(120)</b>	<b>(108)</b>	<b>(450)</b>
<b>Financing activities</b>					
Proceeds from issuance of stock					
<b>Net cash provided by financing activities</b>					
<b>Net increase (decrease) in cash</b>	<b>(1,770)</b>	<b>(2,067)</b>	<b>(1,582)</b>	<b>(1,405)</b>	<b>(6,823)</b>
Cash at the beginning of period	5,930	4,160	2,093	512	5,930
Cash at the end of period	4,160	2,093	512	(893)	(893)
<b>Summary Cash Burn</b>					
Cash collections			800	1,265	2,095
Cash disbursements	(1,770)	(2,067)	(2,412)	(2,620)	(8,918)
<b>Net cash burn</b>	<b>(1,770)</b>	<b>(2,067)</b>	<b>(1,582)</b>	<b>(1,405)</b>	<b>(6,823)</b>

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## + Staffing Plan Example

- **Current Headcount**
  - 34 full time employees as of December 2007
- **Executive Hires planned for 2008**
  - Vice President, Engineering – planned for Q1
  - Vice President, Sales – planned for Q2
  - Vice President, Marketing – planned for Q1
- **Hiring Growth Will be Derived From Business Needs**
  - Customer success in Q1 will dictate pace of hiring in Q2-Q4
  - Engineering current staffing sufficient to achieve 2008 product deliverables
  - Emphasis on Customer facing staff in 2008 (Sales, Marketing, Customer Service)

By Function	Actual	Q1	Q2	Q3	Q4
	Q4 2007	2008	2008	2008	2008
Manufacturing	0	0	0	0	0
Worldwide Sales	2	3	5	7	8
Worldwide Marketing	0	1	2	4	5
Worldwide Customer Support	2	3	3	4	4
Product Development	26	28	28	28	28
General and Admin	4	4	4	4	4
<b>Total Company</b>	<b>34</b>	<b>39</b>	<b>42</b>	<b>47</b>	<b>49</b>

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## + Building Models: Alternative Approaches

### Bottom Up

- Build revenues and cost from smallest units
- Determine revenue drivers
  - # of customers
  - Amount purchased
  - Pricing
  - Frequency
- Validate assumptions
- Do same for costs
- Build-Up Plan

### Top Down

- Find Comparables in analogous industries
- Run various scenarios
- Compare common cost percentages to industry averages
- "Sniff Test"

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## + Managing Cash Flow

- Cash is the lifeblood for any business
- Must efficiently and effectively control activities that make and burn cash
- Activities such as:
  - Maintain optimal levels of cash
  - Collect payments quickly
  - Disburse cash slowly
  - Hire wisely - too fast and you burn too much, too slow and you hamper development and sales
  - Raise capital at best terms possible

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## + Final Thoughts

- **Multiple Models and Scenarios are required**
  - Three versions (Aggressive, Moderate, Conservative) is good
  - Do not present all versions – but have them ready to discuss
  - Choose the most important variables and change only them
    - Too many moving parts will add confusion, not clarity
- **Be nimble**
  - Long term commitments can be very costly
  - Be prepared to make course corrections when necessary
  - Always know your options and don't be afraid to act
  - Test the effects of these changes before implementing
- **Communicate with your team**
  - Tell them what they need to know – they can help
  - Communicate facts
  - Be judicious – too much info among employees can be disruptive
- **Communicate with your Board of Directors (or Advisers)**
  - Don't expect them to make operational decisions for your company
  - Communicate facts - always

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# Annex 4: The Story & the Plan



**+** Bela Musits is Managing Director of High Peaks Ventures, and previously served as the Director of RPI's Incubator Program. Mr. Musits has founded two venture-backed companies and has held senior management and technical positions at the corporate research labs of IBM and GE. At IBM, he managed the successful spin-off of IBM technology, serving as co-founder and president of a computer-guided robotic surgery company. He raised over \$17 million in capital and positioned the company for a successful IPO in 1997.



## The Story & The Plan:

Or how to explain your business to your grandmother & raise money.



Developed by Bela Musits  
Managing Director, High Peaks Venture Partners



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## **+** The Story



-  ■ The story is what gets peoples interest.
-  ■ It is like a novel, not a documentary.



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## + Elements of The Story

### ■ The Product

- Not the technology. (An invention does not make a company)  
(Without money, there is no company)
- Not your idea.

### ■ But ....

- What are you going to put into a box at the end of the day that UPS is going to pick-up and deliver to your customer?
- What problem are you solving for your customer?
- Why is the customer going to buy it?



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## + Elements of The Story

### ■ The Market

- Not that there are 400 billion potential customers.
- Not that you have no competition.
- Not that you are the lowest selling price.

### ■ But ....

- What does your customer look like?
- Who are the first 5 people you are going to call on?
- Market dynamics
- What is the competition going to do?



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## Elements of The Story



### ■ The Team

- Not that you are smarter than everyone else.
- Not your life history.

### ■ But ....

- What is the teams relevant experience?
- Who is going to be king?
- What draft picks do you need?



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## Elements of The Story



### ■ The Financials

- Not that you are going to be a \$2 billion company in 5 years.
- Not that you have better gross margins than everyone else.
- Not that your SG&A cost are lowest in the industry.

### ■ But ....

- How fast can you really grow?
- What are your real COGS?
- Make it believable!



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## Elements of The Story



- The Financials
  - Not that you are going to be a \$2 billion company in 5 years.
  - Not that you have better gross margins than everyone else.
  - Not that your SG&A cost are lowest in the industry.
- **But ....**
  - How fast can you really grow?
  - What are your real COGS?
  - Make it believable!



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## Elements of The Story



- **Product or service** – Makes the sale
- **Market opportunity** – Closes the deal
- **Entrepreneurial team** – Defines the terms
- **Financials** – Maintain your credibility



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+ Remember



When you are raising capital, your  
company is your “product”.



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