Startup-Stage Financing of Innovative Ventures: The Case of UNNADO.com

Nurhan Aydın, Prof. Dr.
Department of Business
Faculty of Economics and Administrative Sciences
Anadolu University, Eskisehir, Turkey

Abstract

Entrepreneurship has a very important role in economic development. Today we need entrepreneurs who transform information to products and services, at the same time who take risks and manage them. In order to fill this need, there should be an environment that is suitable for entrepreneurship. One of the principal components of such an environment is financing opportunities, affecting both existing and potential entrepreneurs. Without easy access to finance, business ideas can't come to live and sustain even if the idea itself is a very good one. Many studies show that many inspired enterprises end up with failure because of insufficient finance resources in their early phases.

This study explains the financing options for enterprises in their early phase of life. The financing model of "Unnado.com" is presented. "Unnado.com" was founded by Göktuğ Okan Oğuz and Haldun Uraz Boralılar, who were recognized as "Endeavor Entrepreneurs of 2012" by "Endeavor Türkiye".

Keywords: Seed Finance, Early Stage Finance, Venture Capital

1. Introduction

No matter how important the innovation or how entrepreneurial the entrepreneur, a great idea needs financing to become a reality. Innovative ventures with high growth potential have limited ways of reaching capital, particularly in their seed and early stages. Entrepreneurs who lack experience, adequate capital, or collateral are unlikely to benefit from bank resources, the traditional financing method. Many studies show that particularly in the early stages, the most frequent problem for entrepreneurs is the hurdle of financing. Many ventures with good prospects for success fail for lack of capital (Bottazzi& Da Rin , 2002; Marco Da et al, 2015). In this study we examine different venture stages and the financing sources that would most benefit ventures at each stage. Subsequently, we elaborate on the financing method of a venture selected as the most successful in Turkey, along with the financing policy of the entrepreneur.

2. Financing the Venture

A venture faces different financing alternatives at each stage of its life cycle. A financing option suitable for a certain stage may not be suitable for other stages. The financing stages of a typical venture are usually grouped as early-stage financing, growth-stage financing, and bridge financing In addition, the various phases in each stage should inform financing policies so that they are suitable to the characteristics of the venture in these phases (Kreamer & Schillo, 2011; Wilson & Silva, 2013)

2.1 Early-Stage Financing

2.1.1. Seed Stage

A venture at the idea stage is said to be at the "seed stage," when the entrepreneur solidifies the fundamental idea and vision and performs an initial analysis of the business. The seed stage is also called the "pre-commercialization" stage. At this stage the entrepreneur is testing the validity of the business idea, and has completed basic research but not yet officially established a commercial enterprise. In this stage uncertainty is high, so entrepreneurs tend to finance with their own savings, or by raising funds from family members or friends. Raising capital from venture capital firms is usually not possible this early in the process (Hofstrand, 2013).

At the end of the seed financing stage, the entrepreneur decides whether to establish an enterprise. Many ventures come to an end at this stage because the entrepreneur lacks either capital or the required motivation. (Oehler et al, 2015)

2.1.2. Pre-Market Entry Stage

When an entrepreneur succeeds in moving beyond the seed stage and decides to establish an enterprise, the venture is said to have reached the pre-market entry stage; it is in this stage that the enterprise is established. At this point the important thing is to develop a business plan that outlines in detail how the enterprise will be set up and operated. Usually the need for financing is greater at this stage than during the seed stage. At this stage, a venture will benefit from angel investors more than from venture capital firms (Kreamer & Schillo 2011).

2.1.3. Startup Stage

The startup stage, also known as the market entry stage, is when sales start and the product is served to the market. Startup-stage finance is working capital, needed from the completion of pre-startup financing until the enterprise starts operation, to cover all losses accrued during the startup stage as well as any unexpected hurdles during the startup process. Since this stage is less risky than the seed stage, both angel investors and venture capital firms begin to show interest now **(**Wilson & Silva, 2013).

2.1.4. First Stage

The first stage is also known as the rampancy stage, when production and sales ramp up. This financing is the last phase of early-stage financing. Ramping up an enterprise through increased sales is an indicator of success, because it means that the business model of the company has gained acceptance in the market and the company has moved into profitability. If the venture reaches profitability during the startup stage, or if it has sound indicators that it will reach profitability in the rampancy stage, more and more venture capitalists will be willing to finance this stage. Ventures that attain profitability move toward the growth stage, in which they finance the operation through internal resources (Metrick & Yasuda, 2011).

2.2 Growth-Stage Financing

2.2.1. Second-Stage Financing Phase

This financing follows first-stage financing. In this stage, when the company is manufacturing and marketing products, the venture is still not certain to be profitable, despite the fact that it has made progress. Changes in products or services, or additional investments, may be needed to expand the market. The role of the venture capitalist at this stage can be more strategic. In addition, a company at this stage needs managerial support. The financial and managerial support of a venture capitalist can make an important contribution to overcoming any problems.

2.2.2. Third-Stage or Intermediate Financing Phase

In this phase the enterprise, continuously increasing sales volume and profitability, realizes dramatic growth. Funds at this stage go toward capacity expansion in factories, market research, working capital, or developing a more advanced product.

2.3 Bridge Financing

When the enterprise is ready to undertake an initial public offering (IPO), the financing that carries the company through the IPO is called bridge financing. Bridge financing is made available to enterprises that will go for a public offering within six months to a year. At this stage, enterprises take the form of more stable companies.

3. Advantages and Disadvantages of Financing Sources Used to Fund Early-Stage Ventures

3.1 Debt Finance

Although debt finance is the option that small and medium-sized enterprises generally use, it is not a good resource for early-stage financing. Early-stage ventures tend not to benefit from debt finance due to the information asymmetry between lending individuals or institutions and the ventures, or high transaction costs. Credit institutions are not as knowledgeable as entrepreneurs about venture success. Therefore, either the finance requirement of the venture cannot be met or very little of it can be met, and what is possible can be prohibitively expensive. On the other hand, undertaking such an obligation is not considered appropriate for a venture in the start-up stage – particularly if it is an innovative and tech-oriented one – because it would jump the already high risk to even higher levels. Many studies reveal that often successful projects eventually fail because of difficulties in repaying loans.

3.2. Equity Financing

3.2.1. Personal Savings and Resources Obtained From Family Members

Frequently, entrepreneurs start off with informal financing from their own savings, family members, or friends. Studies show that 95% of early-stage firms raise capital from these three basic sources (http://www.smallbusiness.co.uk)

Most of the time an entrepreneur's own savings or funds from friends or relatives are not adequate. Particularly when financing innovative ventures with high growth potential, the financing need is high and new financing sources are needed.

Since a venture capital sector that supports innovative business ideas from conception and plays an important role in converting innovations into entrepreneurship has not yet developed in developing countries, many business ideas there cannot find an opportunity to survive.

3.2.2. Venture Capital

Equity or equity-like investments in ventures that produce new technologies and that have high development potential are called *venture capital,* and people and institutions that provide venture capital are called *venture capitalists.* This model essentially is based on partnership. On the one side of the partnership are entrepreneurs and on the other side are the venture capitalists who finance the entrepreneurs. It is also argued that venture capital is not only critical in helping firms overcome credit constraints, but it also helps firms to be born in the first place (Bottazzi and Da Rin, 2002)

Venture capitalists are exposed to the risk of getting high returns when the venture becomes successful and of losing the capital they invested when it fails (Mollica &Zingales, 2008). Venture capitalists can finance ventures directly or indirectly. Investors who make direct investments in ventures are called *business angels* or *angel investors*. In indirect transfers, the funds are collected in venture capital firms (such as venture capital investment trusts and funds) and transferred to ventures by these companies. In such cases venture capital investments become more professional and institutionalized.

Angel Investors

The term *angel investor* has various definitions. In general, investors who fund ventures which they have no family or friendship connection are called angel investors. Studies report that angel investors finance approximately 90% of seed and early-stage ventures, while venture capital firms finance only 2% (OECD, 2011 http://europa.eu/).

The Internet has made lower level investments much easier, opening up investment opportunities for angel investors, who usually assume a role in early-stage financing. In addition to increased opportunities, with the possibility of exiting from the investment in a shorter time, it is now possible to invest in a large number of entrepreneurs. Especially in recent years, efforts have intensified to form and popularize *angel networks* to facilitate meetings between angel investors and potential entrepreneurs. These networks do not make direct investments or investment decisions. However, they allow entrepreneurs seeking angel investors to meet with potential investors and hence contribute to the development of this sector(Metrick & Yasuda, 2011).

Venture Capital Firms

While venture capitalists can fund ventures directly they can also work through venture capital firms. Essentially venture capital firms' investments are equity investments. However, they can also be in the form of long-term debt or debt convertible to equity. Venture capital firms usually do not finance early stages of ventures but do provide capital in later stages. The partnership share ratio that the venture capital firm will get is determined through negotiations and bargaining between the entrepreneur and the firm. As the project's risk increases, the share rate of the VC firm will also increase. When the partnership is established, the VC firm shares the entrepreneur's profit or loss.

4. The Case of Unnado.com

Unnado.com is one of Turkey's biggest online shopping ventures, selling special branded products for moms, babies, and children. Having worked at Microsoft, Sony, and Yellow Pages as a high-level manager, entrepreneur Goktug Okan Oguz established Unnado.com together with Haldun Uraz Boralilar in 2010. The venture started in a 6 square-meter room and is now operating in a 2,000 square-meter facility with more than 500,000 members.

In this study we interviewed Endeavor Entrepreneur Goktug Okan Oguz about the financing model of Unnado.com.

Question 1: Which financing sources did you benefit from when you set up your company?

When we set up our firm, my partner and I used our own personal savings. We started with 10,000 TL equity capital. Before setting up Unnado.com, my partner and I worked at companies that paid salaries regularly so this was a new experience. Combining our savings we attempted to realize our venture with 20,000 TL equity capital. The fact that our resources were scarce has badly affected many of our attempts. But we think that starting out with our own resources gave us important elasticity in taking some risks.

Question 2: What caused you the most trouble during the establishment process of your company?

The foremost issue was the difficulty we had in finding quality personnel who were knowledgeable about e-commerce. One important reason we had this difficulty was the uncertainty about whether our venture would be a success. In addition to the problem of qualified personnel, we also had the problem of finding the financing necessary for marketing. In order to do advertisements and increase name recognition a company should have a significant marketing budget. Since our resources were limited and the venture was not profitable yet, we had to struggle with these problems during the establishment process.

Question 3: What allowed you to overcome the problems you faced in the first years of operation when you had inadequate capital?

Because our capital was limited we had to dismiss some of our attempts. However, to use our resources more efficiently and develop our existing operations we learned to keep our costs under control.

Question 4: In your first years of operation, did you use bank loans to meet your financial needs? What were the reasons if you did not use bank loans?

I can say that we did not use bank loans during the set-up period of the firm. Since we did not have adequate collateral and assets it was virtually impossible for us to get bank loans. Thinking that banks would not grant loans to a company that had not become profitable yet, we did not apply for bank loans.

Question 5: Did you raise capital from angel investors or venture capital firms?

Our firm secured financing from iLab Holding shortly after its establishment. Unnado was established in July 2010 and transferred 30% of shares to iLab after its first investment in March 2011. Unnado received a second round of investment from the same VC firm before it completed its second year, and iLab became the majority shareholder of Unnado after this investment.

Question 6: How long did the negotiation process take when you received financial support from a venture capital firm, and what kind of problems kept you most busy?

In the first round investment of iLab Holding the negotiation process took one or two months. In the second round of investment it took about eight months. In this process what kept us busy the most were issues such as what the investment ratio would be and what amount of investment we would receive.

Question 7: Why do you think the VC firm chose you?

The fact that Unnado is the leader in its field, and company management is effective, attracts the attention of venture capital firms. Also the fact that Unnado has grown very fast and has a wide customer base, and that there is significant potential in the e-commerce sector in Turkey.

Question 8: For which purposes did you use the funds from the venture capital firm?

We used the funds mostly for marketing and financing of infrastructure investments.

Question 9: What kind of support did you receive from the venture capital firm aside from financial support?

We got ideas about strategy development. However, we did not succeed in creating an environment in which we could work together.

Question 10: Does the venture capital firm impose any restrictions on your borrowing or investing?

The venture capital firm does not impose any restrictions on our borrowing or new investments. But they are not open to the idea of getting another partner.

Question 11: Is there any agreed-upon plan as to when and how the venture capital firm will leave the partnership?

We did not make a plan regarding when and how the venture capital firm will leave the partnership.

Question 12: If you happened to realize another business idea, which financing sources would you turn to?

If I were to realize another business idea, I would think about using bank loans, angel investors, and my own savings, in that order, because this would free up the way I do business and agreement terms.

Question13: If you needed to make a choice, which would you pick, the angel investor or venture capital?

I would prefer angel investors to secure financial support because the legal procedures flow much faster in securing financing support from angel investors. I also think that additional support can be secured much more easily.

When we look at the information gathered from the venture's partner we see that Unnado.com had the biggest trouble in financing during the set-up period, that it used its own resources along with capital from a venture capital firm, and that they received not only financial support but also support of other kinds from the VC firm.

5. Conclusion

Having a suitable means of reaching financial sources is one of the most fundamental factors in venture to be success. No matter how attractive the business idea is, if the entrepreneur cannot obtain adequate financing, realizing and growing the business idea will be hard. Getting bank loans during the set-up process is both difficult and inappropriate as it increases risk.

When we analyze information obtained from the entrepreneur in the case of Unnado.com we observe the following:

- The venture used the entrepreneurs' own savings in the seed and startup stages, which allowed for great flexibility
- Because the venture grew very fast and had great development potential they easily obtained capital from a venture capital firm
- They received not only financial support from the venture capital firm but also managerial support
- Since the procedural steps are few in number they prefer angel investors rather than venture capital firms

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