Bootstrap Finance: The art of start ups

By Amar Bhide, Harvard Business Review, November-December, 1992

A lot of the focus in the case of start-ups has been on raising money. The author points out that the "big money" model, i.e. well-funded start-ups does not represent reality. Raising large amounts of money requires careful market research, well thought out business plans, top notch founding teams, sagacious boards, etc. This is not the world of the entrepreneur. The odds against raising big money are indeed daunting.

A more practical approach is bootstrapping or launching ventures with minimum capital, in many cases, personal funds. For most entrepreneurs, the biggest challenge is not raising money but being able to manage without it.

Entrepreneurs should not think that their business is doomed if a VC rejects their business plan. They should understand that the criteria used by VCs to identify big winners are difficult for most start-ups to satisfy. VCs look for scale, proprietary advantages, well-defined plans and well-regarded founders. In contrast, few entrepreneurs have a truly original plan or a proprietary technology or a brand name. Most start-ups typically pursue small niche markets. And while entrepreneurs may be energetic and enthusiastic, they are unlikely to have the necessary credentials.

For a start-up, winning over investors too early can compromise their discipline. Bootstrapping is like zero inventory in a just in time system. It reveals hidden problems and forces the company to solve them. Too much money can lead to wasteful spending.

Premature funding can also lead to diminished flexibility. Start-ups entering new industries, rarely get it right the first time. Unanticipated setbacks, detours and change in strategy are the norm. But outside investors may not tolerate and may indeed become cynical if about turns in strategy are made. Entrepreneurs who are unsure of the market or who do not have the experience to deal with investor pressures are better off without other people's capital even if they can somehow persuade the VC to agree to some funding.

Bootstrappers need a different mindset and approach. Principles and practices imported from the corporate world will not serve them well.

Get operational quickly. Often that means going ahead with copycat ideas targeted at a niche market. This way, market research costs can be avoided and competition from larger players avoided.

Look for quick break even, cash generating projects. Start-ups must be opportunistic and look for ways to make money quickly. A business that is making money builds credibility with suppliers, customers and employees and boosts the self-confidence of the entrepreneur.

Offer high value products or services that can sustain direct personal selling. Large marketing campaigns can be quite expensive. Successful entrepreneurs pick up value added products and services often with tangible advantages over substitutes. Their personal involvement, salesmanship and willingness to go the extra mile can make up for the lack of a big marketing budget.

Forget about the crack team. Start-ups have to attract "rough diamonds" giving them opportunities to upgrade their skills, rather than huge compensation packages.

Keep growth in check. This is not only a financially prudent approach but it also helps the entrepreneur to develop management skills and sort out problems without facing much pressure. This also gives a new entrepreneur the time to learn the nuts and bolts of running a business.

Focus on cash, not on profits, market share or anything else. The bootstrapper must focus on cash generation. Getting good payment terms from suppliers and timely payments from customers are critical in managing cash. Start-ups should also be good at cutting unnecessary expenses.

Cultivate banks before the business becomes creditworthy. Bank finance is a much cheaper alternative to equity. Bank finance can be crucial for financing working capital. But banks are reluctant to do business with start-ups. So, keeping the books of accounts in order and proactively developing a relationship with a local banker can be of great help.

Abandoning the rules

Once the start-up has found its feet, the focus shifts to building a durable business. This involves a painful transition for both the company and the entrepreneur. A start-up will have to emerge from its niche and start competing with larger players. Products may have to become more standardized. The focus may need to shift from cash flows to strategic goals. New talent may have to be attracted, by paying higher compensation. Early employees may have to be encouraged to leave and professionals brought in their place.