New Approaches to SME and Entrepreneurship Financing
Broadening the Range of Instruments

Glossary of key terms

Back-end incentives

Incentives that are proportional to an investment's capital gains, including capital gains tax provisions, rollover and carry-forward of gains or losses. See also *Front-end incentives*.

Business Angel

A private investor who provides both finance and business expertise to an *investee* company in exchange for ownership equity. Business Angels typically participate at an early stage of a firm's life. Business Angels are considered to be informal investors who, unlike venture capitalists, typically do not manage the pooled money of others through a professionally-managed fund. However, angel investors are increasingly organising themselves into angel networks or angel groups to share research and pool their own investment capital.

Business Angel Network

An organisation whose aim is to facilitate the matching of entrepreneurs (looking for financing) with business angels.

Buy-and-hold investors

An investor who buys and holds assets for a long period of time, regardless of fluctuations in the market. An investor who employs a buy-and-hold strategy may actively selects assets, but once in a position, is not concerned with short-term price movements and technical indicators.

Buy-Out

A transaction in which private equity capital is used to acquire a private or public company from the current shareholders. After buyout, the purchased firm usually becomes a private company. Buyouts include a number of specific types of investments, including management buyout (MBO), management buy-in (MBI), institutional buyout (IBO) and leveraged buyout (LBO).

Buyout Fund

A Private Equity fund whose strategy is to acquire other businesses.

Deal Flow

The total number of investment opportunities available to a Venture Capital firm.

Debt Financing

Capital provided to a firm with an obligation that it be paid back. It includes a wide variety of financing such as loans from individuals, banks, or other financial institutions; selling bonds, notes or other debt instruments; and other forms of credit such as leasing or credit cards. The lender gains no equity position in the firm and the borrower's obligation is to repay the debt, usually with interest.

Development Capital

See Expansion Capital.

Due Diligence

Process of evaluation of a project by a potential investor based on material facts. For private equity professionals, due diligence can apply either narrowly to the process of verifying the data presented in a business plan/sales memorandum, or broadly to complete the investigation and analytical process that precedes a commitment to invest. The purpose is to determine the attractiveness, risks and issues regarding a transaction with a potential investee company. Due diligence should enable fund managers to realise an effective decision process and optimise the deal terms.

Early Stage

General term applied to all the firm life's stages prior to the *expansion stage*. Thus, it includes the pre-seed, seed and start-up stages of a business. While a firm may enter the expansion phase at an earlier date, the early stage is usually considered to be the first 3 to 5 years of the firm's life. Firms with a growth objective normally require financing during this stage.

Early-Stage Fund

A venture capital fund focused on investing in companies in the early part of their lives, prior to the *Expansion Stage*.

Equity

Ownership interest in a company, represented by the shares issued to investors.

Equity Financing

Financial resources that are provided to firms in return for an ownership interest. Equity investors have no guarantee that any specific amount of money will be returned. Rather, their return on investment will be determined by the success of the firm. They may sell their shares in the firm, if a market exists or they may get a share of the proceeds if the firm is sold. The large category of equity finance is sub-divided into *Public Equity* and *Private Equity*.

Equity-related debt

Convertible debt or bonds with equity warrant are a type of bond that the holder can convert into shares of the company or cash of equal value, at an agreed-upon price and up to a specified expiration date.

Exit Stage

The stage at which Venture Capital, Business Angel or other private equity investors liquidate their holdings in a *portfolio company*. Methods of exiting an investment include: trade sale, sale by public offering (including *IPO*), write-offs, sale to another equity investor or sale to a financial institution.

Expansion Capital

Financing provided for the growth and expansion of a company, which may or may not be operating profitably. The capital may be used to fund market or product development, finance increased production capacity or provide additional working capital. Also called *Development Capital*.

Expansion Stage

Stage at which the firm is producing and selling products or services, while seeking to expand output of products and/or services and to increase revenues. Usually, at this stage, operating revenues are not sufficient to fund the expansion and thus the firm seeks financing through formal and informal risk capital and/or debt. Normally a firm is in operation for 3 years before the expansion stage.

Family Office

An office that provides services to one (i.e. Single-family office) or several families (i.e. Multi-family office). Services can range from investment management and advice, accounting, tax and financial advice to educational planning or concierge services.

Front-end incentives

Incentives that are proportional to the amount invested, including capital gains tax provisions, rollover and carry-forward of gains or losses. See also *Back-end incentives*.

General Partner

A partner in a private equity management company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.

Grace Period

The period in a term loan when no principal repayments are made. Thus, in a 5 year term loan with 2 years grace, principal repayments begin in the third year.

High Growth Enterprise

All enterprises with average annualised growth in employees greater than 20% per annum over a three year period and with 10 or more employees in the beginning of the observation period.

Initial public Offering (IPO)

The sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one the ways in which a private equity fund can exit from an investment.

IPO candidate

A company that is suitable for an IPO.

Innovative firm

A firm that has introduced a product, process, marketing or organizational innovation, according to definitions of the *Oslo Manual*.

Investee Company

The company or entity into which an equity investment is made, whether from a Venture Capital fund, a Business Angel or other informal capital. Also known as *Portfolio Company*.

Junior debt

A class of debt that, in the event of liquidation, is subordinate to another class of debt issued by the same debtor, but ranks ahead of equity investors Junior debt is more risky for an investor to own, but it pays a higher rate of interest than debt with greater security. See also *Senior debt*.

Late Stage

Late or Later Stage is a term used loosely by different organisations to refer to various types of investing in mature firms including spin-outs of operating divisions, expansion, turnaround, replacement capital and buyout.

Leverage

The amount of debt used by a firm to finance its assets. A firm with significantly more debt than equity is considered to be highly leveraged. Also, the use of various financial instruments or borrowed capital to increase the potential return of an investment.

Leveraged Buy-Out (LBO)

An acquisition of a company (or single assets like a real estate), where the purchase is financed through a combination of equity and debt and in which the cash flows or assets of the target are used to secure and repay the debt. A significant share of the equity of the company is replaced by debt, which usually has a lower cost of capital than the equity. The Principal vehicle for LBOs is the LBO association, which is organised as a private investment partnership. The general partners organise the buyout and also monitor management. The limited partners, typically institutional investors (insurance companies, pension funds and money management funds), provide most of the equity capital. The limited partners along with banks provide most of the debt financing, which typically constitutes 80-90% of the deal.

Limited Partner

An investor in a limited partnership (i.e. mezzanine, venture or private equity fund).

Limited Partnership

The legal structure used by most venture and private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). The general partner receives a management fee and a percentage of the profits. The limited partners receive income, capital gains, and tax benefits. The general partner (management firm) manages the partnership using policy laid down in a Partnership Agreement. The agreement also covers, terms, fees, structures and other items agreed between the limited partners and the general partner.

Market capitalization

A company's outstanding shares multiplied by its share price.

Mezzanine finance

A combination of debt and equity financing. The investor in a mezzanine facility accepts more risk than a provider of a senior loan and normally receives a higher return. Common forms of mezzanine finance include subordinated loans, participating loans, and equity-related mezzanine instruments such as convertible bonds and bonds with warrants. A mezzanine facility usually contains more than one of these instruments. Mezzanine finance is often used as expansion capital.

Participating loan

A special form of loan, by which the investor receives a payment linked to the profits or turnover of the company in which the investment is made. Fixed interest payments can be also included in the contract.

Payment in Kind (PIK)

A feature of a security permitting the issuer to pay dividends or interest in the form of additional securities of the same class, i.e. a financial instrument that pays interest or dividends to investors of bonds, notes or preferred stock with additional debt or equity instead of cash.

Portfolio Company

See Investee Company.

Preferred shares/stock

Shares which have preference over ordinary shares, including priority in receipt of dividends and upon liquidation. In some cases these shares also have redemption rights, preferential voting rights, and rights of conversion into ordinary shares. Venture capitalists generally make investments in the form of convertible preference shares.

Pre-Seed Stage

The earliest stage in the development of a business idea. At this stage, an idea is born and a business plan may be in development but no concrete steps have been taken to set up a business. The term pre-seed is often associated with efforts to commercialise research.

Private Equity

Capital provided to private companies, whose shares are not freely tradable in any public stock market, in return for ownership equity. The term applies to provision of equity capital across the entire cycle from seed financing to buyouts. Thus, Private Equity is used both for early and expansion stage financing of young, developing firms and for *Buyout* of mature firms.

Private Equity Fund

A vehicle for enabling pooled investment by a number of investors in equity and equity-related securities of companies. These are generally private companies whose shares are not quoted on a stock exchange. The fund can take the form of either a company or an unincorporated arrangement such as a Limited Partnership.

Prudential rules

Bank regulation intended to reduce the level of risk to which bank creditors are exposed, that is, to protect depositors and reduce systemic risk.

Public Equity

Equity investments made in companies whose shares are quoted in some form of stock exchange. Normally, public equity investors make hands-off purchases of shares in these listed companies. The investors are not involved in providing advice or otherwise assisting the owners or managers in the development of the firm.

Risk Capital

Private equity capital provided by investors to firms in pre-seed, seed, start-up and expansion stages. It includes investments from both formal (Venture Capital) and informal (Business Angels or individuals) sources, but does not include any debt finance.

Security

Enforceable claim or lien created by a security agreement, or by the operation of law, that secures the fulfilment of a pledge. A lender or obligee has a security interest in the collateral provided by a borrower or obligor to guaranty timely payment of a debt or performance of an obligation. An asset pledged to guarantee the repayment of a loan, satisfaction of an obligation, or in compliance of an agreement. Security gives a lender or obligee a legal right of access to the pledged asset and to take their possession and title in case of default for a foreclosure sale.

Seed Stage

A development phase when founders require financing to conduct research, develop products and explore market potential. This is prior to start-up and also prior to entry into entrepreneurship. The future business entity is beginning to take shape but founders have not yet established commercial operations.

Seed-stage finance

Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Senior debt

A debt that has higher priority compared to another in the event of liquidation of the debtor. That is, in the event of financial difficulties or liquidation of the borrower's assets, holders of senior debt will have a priority claim. Because senior debt has a relatively secure claim, it is less risky from the point of view of the lender and it pays a lower rate of interest compared with debt of the same issuer having a subordinate claim. See also *Straight debt* and *Junior debt*.

Short Term Debt Financing

Short Term Debt Financing applies to money needed for the day-today operations of the business, such as purchasing inventory, supplies, or paying the wages of employees. Short term financing is referred to as an operating loan or short term loan because scheduled repayment takes place in less than one year. A line of credit is an example of short term debt financing.

Sophisticated investor

An investor recognised by a third party as someone who is sufficiently knowledgeable to understand the risks involved with investing in an unquoted company. The individual has already made previous investments and has a long history of investing in a range of financial instruments.

Start-Up

Discrete event that is synonymous with the enterprise birth. This is the point at which the firm becomes an operating enterprise.

Start-up Stage

While the start-up or birth of a firm takes place at a point in time or during a limited period of time, the start-up stage is considered to cover a period in the early-stage life of a firm. During this stage, the firm has begun operations and is paying salaries but product development work may still be under way and sales and revenues may be zero. In the start-up stage, a firm often requires capital for activities such as product development and initial marketing. The start-up stage begins with the *enterprise birth* and extends through to the start of the expansion stage. As such, there is no universally-accepted period of time associated with the start-up stage.

Straight debt

Straight debt does not include any features other than payment of interest and repayment of principal, i.e. it cannot be converted into another asset, and bank claims have high priority in cases of bankruptcy. See also *Senior debt*.

Subordinated debt

Loans or bonds in which the lender agrees that senior or secured creditors will be fully paid before any interest or principal is paid.

Venture Capital

Equity capital provided through formal, organised professionally-managed funds to co-finance, with the founder or entrepreneur, an *Early Stage* or *Expansion Stage* venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. The Venture Capitalists supply not only financing but also expertise in the form of domain knowledge, business contacts and strategic advice. Venture Capital is a subset of private equity.

Venture Capital Fund

Generally a private partnerships or closely-held corporation that pools money from private and public pension funds, endowment funds, foundations, corporations and wealthy individuals, to provide equity investment for young, rapidly growing companies that have the potential to develop into significant economic contributors.

Warrants

Type of security usually issued together with a loan, a bond or preferred stock. Warrants are also known as stock-purchase warrants or subscription warrants, and allows an investor to buy ordinary shares at a pre-determined price.

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