The Basics of Funding

An armchair guide to the language behind the money.

BY MATT JENSEN, MBA

The February 2012 issue of *Cataract & Refractive Surgery Today* included a supplement that outlined the thoughtful views of some key experts in the ophthalmic industry regarding the state of innovation, funding, and regulation in the United States. After reading it, I had a lot of questions, and I realized there was much I did not understand about the process. What is the difference between the types of funding? Why would someone choose one source of funding for an idea versus another? How does the functionality of private equity investment work? This article aims to demystify some of the terms used to describe funding and uncover why so many, like myself, trip over the vernacular.

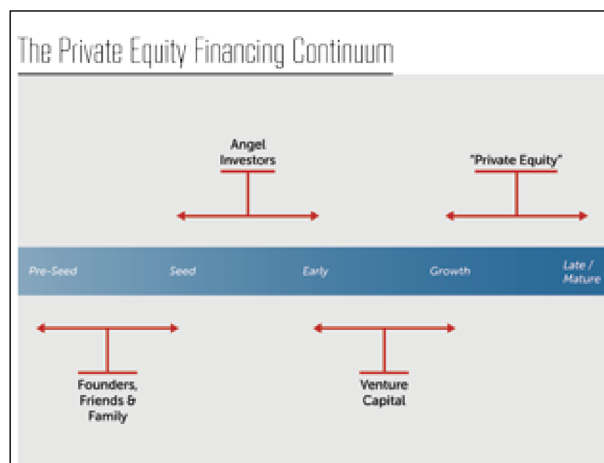


Figure. Private equity is a specific type of investment for late in a company's offering.

TYPES OF INVESTMENT

Understanding the Terms

Private equity is often thrown around as a catchall term, yet many consider it to be a more specific type of investment for late in a company's offering (Figure). "It gets confused a lot," says Michael Jerstad, president of PrairieGold Venture Partners in Sioux Falls, South Dakota. "It's analagous to someone saying they are running for Congress. What they mean is that they are running for a seat in the House of Representatives, even though 'Congress' encompasses both the House of Representatives and the Senate. Similarly, when a firm is said to have received 'private equity' funding, it typically means that it has received later-stage financing or has been bought out, even though, technically, 'private equity' refers to all nonpublic equity, including venture capital. "

Thus, when used correctly, the term *private equity* is generically used to describe all forms of nonpublic investments in equity. Although, most of the time, *private equity* refers to late-stage funding (ie, after companies begin generating measurable and predictable revenues and profits), earlier-stage private equity investment such as angel investing and venture capital can also be correctly referred to as *private equity*.

Private Equity

As noted previously, people use the term *private equity* generically to describe later-stage equity that is not public or publicly traded. This type of investment may be made to fund growth and expansion, purchase a company via a leveraged buyout, effect a follow-up strategy in a fragmented industry, or for many other reasons.

Venture Capital

In contrast, *venture capital* refers to a specific class of private equity designed to provide early funding for start-up companies. This type of investment is

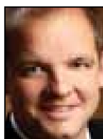
particularly popular among companies that specialize in medical devices and technological innovation that have significant intellectual property but no bankable assets or cashflow that later-stage private equity investors seek. Companies' use of venture capital can position them for rapid growth despite having a balance sheet that is light on assets. Because venture capital positions investors as stakeholders early in company's lifecycle, it is truly "risk capital," the cost of which can be very high to the entrepreneur.

Angel Investing

Even before venture capitalists determine whether an idea is worthwhile, the offering or innovation will likely require initial seed capital. *Angel investing* is a solution to this cash flow problem. Angel investors function similarly to their counterparts in venture capital. The largest differences are the amount typically invested and when the investment takes place in the offering's life cycle. Angel investing generally occurs in smaller increments. A project requiring start-up capital of $100,000 likely will not find a venture capital partner, for example, but may attract angel investors.

CONCLUSION

A clear understanding of investing terms and their functions is required for a proper discussion of financial matters. This may seem elementary, but it provides a common language. If one tells his or her partners that he or she needs $100,000 in private equity, they may not understand, as what is really required is angel money. If one tells his or her partners he or she is looking for $6 million in private equity, again, there may be confusion because venture capital may be what is needed. Once an entity has moved above that mark, other options should be considered, such as taking the new company public or seeking an acquisition by a larger industry player. ■



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