Chapter Two:

What are the Benefits of Investment?

As all business owners know, a business needs to balance the money coming in with the money going out while seeking opportunities to make the business grow and increase in future income. Typically, business growth depends on further spending. However, many starting businesses find it difficult to get the money they need. This is where investment comes in. Investment can help businesses grow by providing more money and resources to generate income. Below we go into a little more detail to illustrate exactly how obtaining investment can increase your income.

Cash flow vs Profit

This can be a difficult concept to understand, but it is helps explain how investment can help a business grow.

Profit

A business' profit is the revenue (or sales) minus the expenses. Seems fairly simple right? Where it gets more complicated is when we factor in items, such as large equipment, buildings or, other assets. This is because assets do not affect profit immediately even though they do affect cash flow.

Cash flow

Cash flow is the flow of cash in and out of the business. Very simply, it is all the cash that comes into the business, minus all the cash that goes out of the business. Cash flow and profit are related but not the same. The distinction between cash flow and profit is very important to understand when considering investment. The purpose of an investment is to help a business have adequate cashflow to grow.
Let's have a look at a simple example.

Sophea's Coffee Shop

Sophea's business starts the month with $3000 in cash. She sells $1000 of coffee that month and spends $700 on expenses such as coffee, rent, and salaries. However, she also buys a new coffee machine for $2000.

To calculate Sophea's profit, we would subtract her expenses from her revenue: her revenue is $1000, and her expenses are $700. This yields a profit of $300. To calculate Sophea's cash flow, we would take her $3000 starting cash, add $1000 of cash in sales, subtract $300 for expenses, and subtract $2000 for the new coffee machine. This leaves her with $1,700 in cash at the end of the month. Even though Sophea made a profit of $300, she has less cash at the end of the month than she started with.

If Sophea did not have $3000 at the start of the month, she would need to find an investment of $3000 so she could buy her new coffee machine, this is how investment can help a business grow.
Note that this is highly a simplified example. It does not cover all the details of accrual and cash- based accounting or of profit vs cash flow.

It is common to need money to help your business grow.

Growth of your business might include getting more customers, developing new products, or improving the management,[2] and this often calls for the acquisition of new assets. Assets are anything that a business hopes to benefit from having, whether over a short or long period.[3] Assets can be tangible, such as machinery or property, or intangible, such as the number of users on an app, technical knowledge, or a skill. Assets cost money, and it can take time for a business to be able to generate the income needed to cover the expenses of growth. Many businesses don't generate a profit until they have reached a certain stage of maturity,[1] and even if they do, it may not be enough. This is where understanding cash flow and profit is important.

Early-stage businesses in Cambodia often struggle to access bank-based financing.

Entrepreneurs can struggle to access the money they need to grow their businesses. More than a third of business owners in Cambodia have to use their own savings, and close to half rely on money from friends and family.[3] This can be a great place to get started, but when it's time for growth, there are new

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[2] Metrick, A. and Yasuda, A. (2011), Venture Capital and Other Private Equity: A Survey. European Financial Management, 17: 619-654. doi:10.1111/j.1468-036X.2011.00606.x

[3] Ma'aji, M. Sok, P., and Long, C., (2020), Working Capital Financing Preference Among Small Businesses in Cambodia. Journal of Economics and Sustainability. 2(1): 48-61.

[1] National Venture Capital Association, n.d, What is Venture Capital, viewed 01/11/2020, < https://nvca.org/about-us/what-is-vc/>

[4] Ehst, Michael; Sak, Sambath; Sanchez Martin, Miguel Eduardo; Van Nguyen, Lan, 2018. Entrepreneurial Cambodia. Cambodia policy note. Washington, D.C.: World Bank Group.

challenges. For example, banks commonly require a high level of collateral and/or a registered business, which can be a barrier for some entrepreneurs.[4] See Chapter 3 for more information on choosing the right type of investment.

If you can't access bank-based money, you can still benefit from other forms of investment.

If banks and other typical early-stage finance options are difficult to access, equity financing can help fill the gap. As a reminder, equity financing is where a business is given some cash in return for a share of ownership. We call this share of ownership equity. Someone with equity in a business is entitled to a share of future profits. Equity investment can be particularly useful for young businesses without a well-established cash flow or a lot of collateral, as it is based more on future potential than on past or current performance.1 Later, we will describe some of the more complex aspects of equity financing.

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[5] Naqi, S,A. Hettihewa, S., (2007), Venture capital or private equity? The Asian experience. Business Horizons, 50(4): 335-344,https://doi.org/10.1016/j.bushor.2007.03.001.

[6] Scheela, W., Isidro, E., Jittrapanun, T. et al., (2015), Formal and informal venture capital investing in emerging economies in Southeast Asia. Asia Pac J Manag 32: 597–617 (2015). doi: https://doi.org/10.1007/s10490-015-9420-5

[7] Metrick, A., Yasuda, A., (2011), Venture Capital and Other Private Equity: A Survey. European Financial Management, 17: 619-654. doi:10.1111/j.1468-036X.2011.00606.x

Businesses with hands-on investors also gain from the investors' experience and knowledge.

One of the key aspects of equity investing is that investors typically bring much more than money to a business. There are multiple types of investors who might get involved with a young business, including angel investors, venture capitalists, and potentially even larger investors. Different types of investors offer or expect varied levels of engagement with the business beyond its finances.[2] However, all types of investors tend to be highly experienced business-people and may have industry knowledge that makes them most suitable for a particular business sector. An investors' expertise can help you gain knowledge about business strategy and operations, improve your business management team[2], or help to expand your network of customers and investors.[5] This advice, expertise, and new contacts can drive the business to be better in addition to adding cash to a business.

Why would someone invest in me?

Investors only choose to invest their money and experience in businesses they think are likely to make a good return or, for some, to make an impact. Investors have limited resources, both in terms of money and how many businesses they can be involved with at any one time. They have to work out which businesses they think are going to do the best with their help.

Finance-first investors, or investors whose primary goal is financial return, have a number of tools they use to work out how much a business or idea is worth, what the risks of investing are, and how much future return justifies that level of risk. Impact investors, those whose primary concern is impact, consider a wider range of factors, including how much non-financial change a business might make, such as to the environment or socially. Investors then agree on a contract with business owners, which normally minimizes the risk for the investor and aims to help the business grow.

What do finance-first investors gain from investing in me?

Finance-first investors typically invest for a share of future income. They are primarily motivated to invest in companies with the potential to return more money than they invest for the least amount of risk.[6] They might invest in businesses at varied stages of development, but those who invest in micro-, small, or medium companies tend to look at future earning potential rather than current profitability.[7] Such investors want to help your business grow and achieve the believed potential, with the hope that this will increase their return. This is in principle reason why most financial-first investors invest in businesses: to benefit from the future profits made by the business.

How do investors get a share of my future profits?

There are a number of ways your investors can benefit from your growing business, but they typically ask for some ownership of the business. This sharing of ownership, or equity, may entitle them to a number of ways of earning money from their investment. For example, early-stage investors might sell their equity to other investors when the company has grown in value.[7] Another example is the payment of dividends, which are shares of the profit paid to investors once the business has reached a certain size.[8] Other mechanisms for return exist and depend on factors such as the performance of the business, how much equity the investor holds, and how long they are willing to wait before getting their money back.[7]

How do investors decide how much they want to invest?

There are different methods of working out how large an investment to make to yield the desired profit without taking on too much risk, but, in general,

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[8] Easterbrook, F., (1984), Two Agency-Cost Explanations of Dividends. The American Economic Review, 74(4): 650-659. doi http://www.jstor.org/stable/1805130

[9] SHRIEVES, R.E., WACHOWICZ, JR, J., (2001), FREE CASH FLOW (FCF), ECONOMIC VALUE ADDED (EVA™), AND NET PRESENT VALUE (NPV):. A RECONCILIATION OF VARIATIONS OF DISCOUNTED-CASH-FLOW (DCF) VALUATION, The Engineering Economist, 46(1): 33-52, doi 10.1080/00137910108967561

[10] Brealey, R.A., Myers, S.C., Allen, F., (2017) Principles of Corporate Finance, McGraw-Hill Education, ISBN 978-1-259-25333-1

investors are looking to assess the potential financial return in the future and the risk of that investment.[12] Finance-first investors often estimate how much free cash they think the business will generate in the future; this is called discounted cash flow.[9,10] Once the future income potential has been estimated, they need to work out how much money they are willing to risk, as there are lots of reasons why the business may never reach its estimated potential, including aspects of the business itself or the market. Investors account for this risk and other factors, such as the fact that money invested in a business cannot be reinvested until they get any money back from their investment, by adjusting the future income estimates by a percentage decrease between now and the income of a given year. This means that any potential income in, say, ten years' time is worth less today to an investor than the same potential income in 5 years' time, assuming the same level of risk. To make up for this, investors want to know that they will make a certain minimal return. For many investors, this simple method of valuing investments is just one of the mechanisms they use to evaluate how much they think an investment is worth and how much equity they want to own.[11] More details on these calculations can be found in the Tools and Resources section of the book.

How do investors reduce the risk they are taking on?

As discussed above, investors aim to minimize the risk they take on when investing in a business. Beyond factoring risk into their valuation, they can look to protect their investments to avoid losing their money. Protecting their investments can take place at any stage of involvement, such as during the negotiation of the initial contract, when investors may set performance targets to be met before the entire investment is released to the company.[7] Other simple measures include joining up with other investors, which reduces their potential individual profit but also reduces the individual risk. Investors may introduce extra conditions to a contract that protect them, such as asking for their equity in a form that initially resembles debt, so that they can minimize the loss if things go badly.[7] Additionally, they may simply include clauses that prevent their shares from decreasing in value as the company grows and gets further funding.[13] An investor's preferred method of minimizing risk depends on a range of factors, and a business owner must also consider these aspects when seeking investment.

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[11] Lockett, A., Wright, M., Sapienza, H., Pruthi, S., (2002), Venture capital investors, valuation and information: A comparative study of the US, Hong Kong, India and Singapore, Venture Capital, 4(3): 237-252, doi: 10.1080/13691060213715

[12] Walter, J., et al. (2020). Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation, World Economic Forum

[13] Kim, J.H., Wagman, L., (2016), Early-stage entrepreneurial financing: A signaling perspective, Journal of Banking & Finance, 67: 12-22, doi: https://doi.org/10.1016/j.jbankfin.2016.03.004.

What does an impact investor gain from investing?

"Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."[14] Impact investors can range from individuals through to large international funds.[15] The wide range of impact investors means there are differences in what investors are looking for; some are focused on impact and are willing to make less money if the impact is greater, whereas others are looking for a strong financial return as well.[16] Impact investments, for the major part, are not simply charitable donations to a company, but profitable opportunities to make a difference.

How can I increase my chance of getting investment?

Those seeking investment will typically take certain steps to make themselves investment ready.

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[14] Global Impact Investing Network. What you need to know about impact investing. Viewed 30/11/2020. < https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing>

[15] Global Impact Investing Network. Who is making impact investments?. Viewed 30/11/2020. < https://thegiin.org/impact-investing/need-to-know/#who-is-making-impact-investments>

[16] Hand, D., Dithrich, H., Sunderji, S., (2020) 2020 Annual Impact Investor Survey. Global Impact Investing Network.

[17] Southiseng, N., Ty, M., Walsh, J., Anurit, P., (2008), Development of Excellent Entrepreneurs in Small and Medium Enterprises in Laos and Cambodia, GMSARN International Journal, 2: 147 – 156

Investors—focused on finance or impact—may have their own ways of screening potential investments. However, there are a number of common factors that may increase the likelihood of a company gaining investment. While many, particularly early-stage investors, may be happy to invest in an idea, they may ask for evidence of past performance or a plan for how an idea will lead to making money and impact.[7] Additionally, investors may look at the people behind an idea or company to determine whether they think they will use their investment well.[17]

The next chapter covers becoming investment ready in more detail.