A Financing Game Plan for Scaling an eCommerce Businesses

By Steven Weigler, Esq.
EmergeCounsel

https://www.linkedin.com/pulse/financing-ecommerce-company-growth-steven-weigler-s2z6c/?trackingId=G3Mnn3n8TuO%2BRLyqS4A1Iw%3D%3D

I love eCommerce because the barriers to entry are relatively low, and the opportunity to be successful is relatively high compared to almost every industry I can think of.

I. Ecommerce Low Cost of Entry Doesn't Equal Low Cost of Growth

As my hair began thinning, I became fixated with a sunscreen for balding guys eCommerce idea I had. Quite simply, there just isn't sunscreen marketed towards balding guys. I still have no idea if the Coppertone I use is ok for my scalp, will sweat off, is the right strength, interacts negatively with shampoo etc.

I contacted a formula manufacturer and cosmetic marketer and, with about a $10,000 investment, was ready to go to market on Amazon and on my own Shopify site. I built my own financial model where I figured out that with a $20,000 investment in initial inventory, logo design brand clearance, etc., and I tossed another $10,000 in programmers and operating capital, I was going to be in business with about a $50,000 investment. At the time, a series of medical articles was published linking sunscreen to cancer – so there went that.

While $50,000 is a significant investment, it's crucial to understand that if a product like the bald sunscreen had taken off, I would have needed even more funds, potentially a substantial amount, to scale the company and achieve the necessary economies of scale for revenue growth.

and achieve the necessary economies of scale for revenue growth. This includes managing inventory, storing it, and protecting the brand from new competitors. It's clear that adequate funding is a key factor in obtaining market share.

II. Scale is the Name of the Game in eCommerce

Operating Margins are a key metric in measuring the economic efficiency of a business. In eCommerce, as companies grow, they improve their operating margins. For instance, the cost of shipping, product unit cost, and warehousing cost all decrease per unit as your company buys/stores in larger volumes, leading to increased profitability.

They are calculated as: Revenue-Cost of Good Sold-Expenses=EBITDA. EBITA/Revenue=Operating Margins.

However, Operating Margins don't generally change significantly. Take my bald sunscreen company. If each of my unit manufacturing and shipping costs went down 25% because I was buying/shipping so much, that would increase my Operating

Margin, which would be great. But I may need ten more employees and a bigger inventory to make that happen. I certainly will need a bigger marketing strategy, including omnichannel platforms, keyword analysis, etc.

Still, in eCommerce, there is generally nothing more productive for the bottom line than selling more items. Looking at the same Operating Margins:

- $10,000 Revenue - $9000
- Expenses=$1000
- Gross Profit. $10,000,000
- Revenue-$9,000,000
- Expenses = $1,000,000 Revenue.
- Same gross margins, about a $999,0000 difference in profit.

III. Greater Sales=Higher Capital Needs=Finance

With those basic economic assumptions, the biggest challenge that most eCommerce businesses encounter in growth is where to get the money to grow. While scraping up $9000 to run a company seems doable for most growing businesses, scraping together, e.g., $5,000,000, doesn't. Of course, if you, e.g., have a trust fund, you could just throw your money in as needed and avoid these difficult questions. For the rest of us:

A) Bootstrap-Minimal Finance or Self Fund

Because securing capital is not easy, entrepreneurs sometimes bootstrap their businesses, paying for the growth through cash flow, out of choice or necessity. For example, my bald sunscreen product made $1,000 in gross revenue. After taxes, I would take that $750 and buy inventory to grow the company. I may find net/30 loans from the manufacturer or take out a credit card. Over time, the $750 could grow to $75,000,000. It is just a longer/slower (sometimes a much slower process).

What entrepreneurs risk in this strategy is that the market could pass them up as they are struggling with capital to grow (which happens all the time). From a psychological perspective, it also is frustrating for many entrepreneurs not to be able to grow.

What entrepreneurs like in this strategy is that they control the business. There are no investors/board or financers controlling their business. They are generally free to run the business however they see fit. If they want to take a draw, they can. If they want to take a vacation, they can. If they want to dream up a new/better product they also can. If they want to close the shop, they usually can do that also. Finally, if they want to sell the company, the decision is all up to them.

B) Finance/Debt

There are many types of loans that eCommerce growth companies utilize to finance their businesses. Money loaned sits on the company balance sheet as a liability. The lender may also make the business owners sign a personal guarantee, which means that it may also hamper other finance options, both personal and business-related.

Here are the highlights of a few common sources of eCommerce financing: ***Revenue based/share funding:***

- Business pays back based on proportion of revenue.
- Example: Company borrows $100,000 and uses to build marketing platform. Month 1: $100,000 of revenue. Lender takes e.g. 10% ($10,000). Interest accrues at 12% until principal plus interest is paid.
- Advantages: Allows Company to spend much needed cash on building the business as opposed to bootstrapping/ using revenue.
- Disadvantages: Interest rates often higher than traditional loan. Company's revenue is always going to be impacted until loan is paid off.
- Companies that Specialize: www.stenn.com; wayflier.com

Traditional Loan

- Business pays back on fixed amortization schedule.
- Example: Company borrows $100,000 and uses for operating capital.

Amoritized over 5 years at 10% interest rate. Business Keeps cash in the bank and uses when needed

- Advantages: Many more lenders creating lower interest rates and greater ability for loan acceptance.
- Disadvantages: Company really needs to know how much money it needs as a traditional loan does not take into consideration cash flow needs.
- Banks that specialize: Chase, TIAA, Bank of America, Capital One and Wells Fargo all have specific expertise in eCommerce.

Line of Credit

- Same as a traditional loan but while the total cap is established at the beginning of the loan, the Company can draw on the loan (and only pay interest for that amount) when paid.
- Example: Company obtains a line of credit for $100,000. Draws on the line.
- Advantages: Only pay for the money when you need it.
- Disadvantages: The rate may be adjustable

Platform Funding:

- Although Amazon appears to be backing down from undertaking its own merchant lending, platforms including Shopify, Amazon, and Walmart do offer loans which are secured by depending on the particular loan: a) Seller inventory housed in its warehousing and b) the funds in the seller's account. The loan payments are deducted from the account. Terms vary
- Example: Shopify loans seller $50,000. Pulls monthly payments from seller's account. If seller's account is tapped, generally the loan will be called.

Regardless of what type of debt an eCommerce seller should be willing to take on depends in part on what type of collateral is required. A personal guarantee requires the borrower to pledge all personal assets (including a home, cars etc.). At the very least, most loans are "all asset" loans meaning that the lender could lose every asset on its balance sheet if the loan payments are not made (regardless of the amount due).

Relatedly, there is the issue of security priority. The lender may file what is called a UCC-1 which perfects a first priority security interest on pledged assets. So, for example, you borrow $10,000, and the lender takes out a first priority security interest on all of the company's assets and you need to borrow $50,000 more, it is going to be difficult for another bank to loan to you if that security interest stays in place.

In summary, when it comes to debt, I realize that we all generally sign on the dotted line, as most of us are not at equal bargaining position as our financier. However, there are a lot of different types of finance and it is essential to know the terms and conditions of that debt before taking it on.

C. Equity

Are you ready to take on an equity partner? Generally that means for a certain investment, you will sell a portion of your corporation or limited liability company to a generally passive shareholder.

If you ever are thinking about that proposition, I can tell you both my own and some of my client's horror stories (as well as some success stories). Here are my common questions to my eCommerce clients who are thinking of taking on an investment partner:

Are Your Goals Synergistic?
Angels and venture capital are generally looking for a larger return on investment than more traditional markets deliver. Taking on their investments can lead to entrepreneur's commitments to achieve unrealistic growth targets. In my case (I had a business before this) it led to extraordinary pressure to modify a slow but consistent growth business plan to one that had a very little chance of succeeding.

Do You Know How to Manage Investors?
Any investor wants to generally be updated and have a say in the operation of your business. While some entrepreneurs see this as natural progression, most are not used to the amount of time and effort that managing investors takes. When I took on significant VC funding, I was already working 60 hours a week and had no idea a) how to manage the investors nor b) the amount of time I would need to spend learning. Ultimately, managing "the Board" led to mutual frustration and my burnout.

Are the Terms and Investor Fair/Can You Get Along?
It is really hard to get the interest of professional investors. It is even harder to get a good deal. I have seen so many term sheets with low valuations, and unpalatable but complicated terms (like until the investors get 10x their investment, the entrepreneur gets 0). Working your butt off is just the beginning of what an investor is looking for. And while VCs are generally not bad people, their job is to care about money and less about you.

Are You Structured Appropriately?
LLCs are generally awful vehicles for investors as they don't receive the statutory rights and assurances that they would in a C-Corporation. In summary, you may need

to pay corporate tax as well as structure very intricate documents to become a C-Corporation.

Is this the Cheapest Form of Capital for You?
Generally, the answer is no. Giving up e.g. 10% of your company stock is giving up 10% of the distributions of profit. If your company grows, that is quite a lot of money. There are also compliance, legal, accountancy, and your time costs. And you will own less of the company. When I generally add this all up, the cost of private investment is astronomically higher than bootstrapping or financing growth.
There is most definitely a time and place for equity financing; whether or not it is the right step for you currently should be a very intricate/detailed analysis with both quantifiable and qualitative analysis conducted with outside guidance. Just remember, just because it may be available to you does not make it right for you.

IV. Entrepreneurism is Really Hard/Strategy Really Matters

If you want to scale in eCommerce, you are going to need funds. I love eCommerce because it provides a structure (e.g. Shopify) to succeed along with relatively low entry costs. However, there is nothing about any business that is easy. So my advice is to use those calories really carefully by strategically thinking out the best approach towards finance for your particular means.

About the Author

After years of corporate counsel experience with a Fortune 100 company, Steven Weigler built and managed a startup where he was able to create and institute a protective intellectual property strategy, commercialize the resulting products and protect the intellectual property, build and manage a sales, marketing and operations team under a “lean startup” budget, and secure both angel and A round financing, and finally negotiated an exit.

Steven’s combination of legal, entrepreneurial, governmental and corporate experience gives him a unique, focused perspective on what entrepreneurs who are starting up or emerging their businesses need but rarely have: a) someone who zealously protects their interest and b) someone who has the empathy to understand each entrepreneur’s vision and motivation as well as their business plan. Steven has a passion of e-commerce and advises many clients on all aspects of the industry.

About EmergeCounsel

EmergeCounsel strategizes with a worldwide clientele in the focus areas of protection of intellectual property and business assets for eCommerce business. Our TotalTM® provides trademark guidance, search, appeals of office actions and denials, and trademark monitoring at flat and affordable rates. In addition, EmergeCounsel has an extensive network of professionals who provide co-counsel and services for businesses of all sizes.

PO Box 13677, Denver, CO 80201
www.emergecounsel.com 1-888-Emerge0