# ENTREPRENEURIAL ECOSYSTEM AND ENTREPRENEURIAL FINANCE: A STUDY OF FINANCING AND FUNDING OF EARLY STAGE VENTURES

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## ABSTRACT

*Early stage ventures need funds to build and develop products; acquire early customers; build initial teams and mobilize resources. Most of the new ventures need financing or funding due to the cash flow woes; need for the capital and the investments; long product design and development cycles; and lengthy sales processes and long payment cycle. Entrepreneurs take unusual path while building the businesses and deploy entrepreneurial methods of financing and funding the new ventures. This paper explores various sources of financing and funding early stage ventures; key elements of entrepreneurial finance and the role of entrepreneurial ecosystem in financing and funding of the early stage ventures.*

**Keywords: Entrepreneurial Finance, Entrepreneurial Ecosystem, Financing of New Ventures, Funding New Ventures**

## INTRODUCTION

New ventures are fundamentally different from the established ones. The entrepreneurs are also characteristically different from the business managers operating the corporations. Decisions about making financial decision for new ventures and startups are very different. Though, 'Finding Money' or 'Raising Funds' is the core of the entrepreneurial finance; it also involves application of the fundamental financial principles and theories of finance. In practice, entrepreneurial finance is all about the adaption of the principles of corporate finance and theories for the new venture. The nature, needs, and dynamics of financing and funding of a new venture leads to area of entrepreneurial finance.

Over the years, few facts have been established for the financing of new ventures. The new ventures find it difficult to get the outside money. Majority of the new ventures are both boot-strapped and funded by the personal savings of the entrepreneurs. Financial realities faced by the entrepreneurs are very unique to each business idea; and each entrepreneur has different risk taking abilities, network, resource mobilization capability and understanding of how money works.

Entrepreneurial ventures are the central part of the growing economies and an important element for the economic development and generation of new employment. The new ventures ventures lead to the creation and development new markets, emergence of the new technologies, new products and creation of altogether new industries and finally creation of new jobs. (Megginson 2004)

These new ventures and early stage companies require considerable amounts of funds for their sustenance and growth. In general, the past research studies on entrepreneurial finance have largely focused on the venture capitalists and the angel investors. However, there are many new and innovative sources of financing and funding which have emerged. (Bruton et al. 2015)

Especially, new business ventures operating in the science and technology field may identify various sources of financing and funding. In fact, one of the interesting conclusion from the research show that that new ventures depend upon some of the traditional sources of funds like debt financing including bank financing. The capital structure decisions of the entrepreneurial ventures have been an area of research. (Robb and Robinson 2014) New ventures have also raised funds and achieved growth without raising the external financing; sometimes considered

as essential by some other firms. Such ventures have avoided external financing and funding by way of bootstrapping. (Baker and Nelson 2005 and Winborg and Landström 2001) Furthermore, global financial markets have made it possible for the new ventures to approach and get funds from angel investors and venture capitalists from the different parts of the world. (Devigne et al. 2013, Mäkelä and Maula 2005)

## FINANCING AND FUNDING OF EARLY STAGE VENTURES

Based on the evidences of the importance of new ventures in the economic development and role played by new ventures in the new employment opportunities generation, few researchers addressed the need to identify the different sources of financing and funding's relationship with the growth of the ventures. (Fraser, Bhaumik, and Wright 2015). Past research studies focused on the distinctiveness of the entrepreneurial ventures and context to analyze mainstream theories of finance. (Burchardt et al., 2016, Sapienza and Gupta 1994; Wright, Pruthi, and Lockett 2005) emergence of the new financing models like crowdfunding and other sources of creative funding provide interesting possibilities to study and test existing theoretical foundations. This may lead to challenging the conventional wisdom and create new frameworks of entrepreneurial finance. Overall, the research work done till now has focused on the peripheral areas of the new and innovative sources of entrepreneurial finance. A lot is required to be done in the areas of entrepreneurial finance and sources of financing for the new ventures.

## NEW SOURCES OF FINANCING AND FUNDING

In general, till now the financing cycle for the new ventures began with the typical three "Fs" signifying friends, family, and fools. The second stage of the financing cycle involved business angels, venture capitalists and the capital markets. New and early stage ventures raised seed finance to develop the prototype and approach first few customers generally turned to their close ties. And based on the achievement of the initial milestones, these ventures expanded their circle of financiers and explored other sources of finance usually the angel investors. The wealthy and well-connected rich individuals offered capital to the early stage ventures to build and expand the business. New and early stage ventures were required to grow extensively to become attractive to the formal ventures capital (VC) funds. In some ways, gaining the VC funding was considered as an important milestone achieved. Funds received from the ventures capitalists were thought to be

a milestone and a sign of acceptability of the new ventures (Stuart, Hoang, and Hybels 1999) as well as vcrucial for network and mentorship. (Bellavitis, Filatotchev, and Kamuriwo 2014; Cumming, Fleming, and Suchard 2005; Sapienza, Manigart, and Vermeir 1996) Funds from the venture capital firms and access to their network further fuel the growth both in the domestic as well as international market. In this cycle of financing, the next stage usually involved either finally making the company public or selling the new venture to a large company. This cycle of financing and funding was a common pattern in the entrepreneurial finance field. Many popular and successful companies followed this pattern of funding cycle (Berger and Udell 1998) William Ker and Ramana Nanda prepared a framework (Figure 1) of the entrepreneurial finance based on two important parameters.

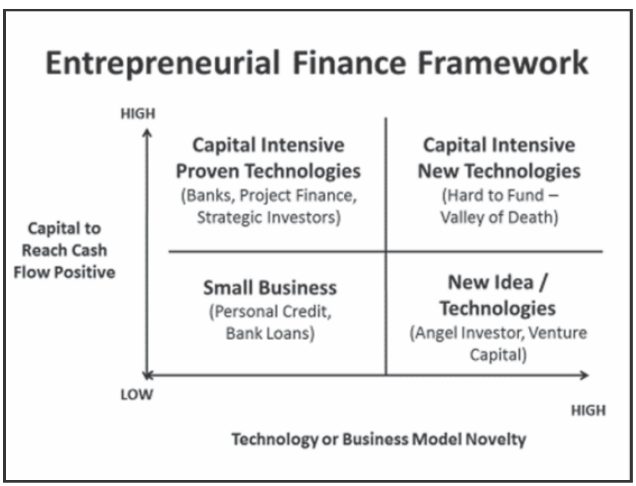


**Figure 1**

Source: William Ker and Ramana Nanda, 'Financing New Ventures' HBSP Background note 811093

However, in the present times, this funding cycle and the overall entrepreneurial finance needs a different framework. Specifically, the new ventures in the field of science and technology have access to new sources that are different than the earlier ones. Some of the new sources of financing and funding include: government grants, educational institute based seed funds, resource support from accelerators, funding and resources support from incubators, proof-of-concept centers, and crowdfunding platforms. This new sources can be accessed based on the funding cycle, nature of the business and cash flow challenges of the business. Each source provide certain advantages and disadvantages. From the research perspective, the new dynamics of financing and funding create new business challenges for the new ventures and also create new opportunities to create a unique capital structure.

It is to be noted that in the past majority of the entrepreneurs followed the traditional and conventional funding cycle discussed earlier. However, today's early stage ventures can look beyond this to raise the funds. They have the choice to customize their sources of funds and strategically time the fund raising while accessing diverse sources of finance at different stages in the life cycle of the venture.

To understand this from the practice perspective, some ventures may opt for incubator at the early stage to get access of network; whereas some other ventures may opt for raising funds through crowdsourcing campaign on Kickstarter to get access of the consumers directly. Each choice exercised by the ventures offers them a unique set of benefits and costs. For example, the founders of the AirBnB chose incubator program at Y Combinator which created a very different trajectory for the venture. On the other hand, Pebble Watch was incubated at Y Combinator and also raised initial funds from investors but later on approached the crowdfunding website Kickstarter to raise further funds required at other stages.

Over the years, the overall resource requirement to start and grow business has reduced. Specifically, the cost of logistics, set up cost, communication and the overall cost of doing business has decreased which has impacted the capital structure as well as the sources of financing and funding for the entrepreneurs. However, cost of acquiring the customers has increased over the years. In such scenario, the fundamentals of the value of the business and the valuation of the business has undergone a lot of change.

There are many examples which indicate that the venture funding cycle does not follow the same pattern and is not as simple and uncomplicated as it used to be. Entrepreneurs have various alternative modes to raise funds. This has opened up a possibility to study and research entrepreneurial finance from a very different perspective. Research scholars may find many research questions and opportunity to contribute to entrepreneurial finance area by studying the new sources of financing and usually ignored traditional sources of financing, its interaction and also the impact on the life of the venture.

## ENTREPRENEURIAL ECOSYSTEM AND ENTREPRENEURIAL FINANCE

Before we talk about the entrepreneurial ecosystem, it would be better to understand the biological ecosystem. The New Oxford English Dictionary defines a biological ecosystem as "a system of organisms occupying a habitat, together with those aspects of the physical environment with which they interact". Extending this to the entrepreneurial ventures, entrepreneurial ecosystem is the system of all the actors, institutions, government and overall business environment which affect the growth of the new ventures. New ventures germinate and grow in a better entrepreneurial ecosystem. There are various components of the entrepreneurial ecosystem. Out of the various elements of the entrepreneurial ecosystem, two elements are very relevant for the purpose of this paper; the first one financing and funding, the second one presence of incubators and accelerators as support systems.

The presence of the established venture capital industry, angel investors, private equity industry, access to debt in various forms, soft loans from the government and development agencies are the elements of the financing and funding. University based entrepreneurial ecosystem (U-BEE) or the entrepreneurial ecosystem at the educational institutes are also part of the entrepreneurship ecosystem. Table 1 presents various sources of the finance and funding including some of the innovative and new sources. Some of them are exclusively available in special entrepreneurial ecosystem. Entrepreneurs turn to relevant sources based on the ecosystem they are in or change their location to get access to the ecosystem.

**Table 1: Sources of Resources and Funds**

| Equity | Debt | Barter (exchange) | Others |
|---|---|---|---|
| Venture Funds | Credit Cards | | |
| Partner at VC's, Corporate Heads | Personal Loans | | |
| Angel Funds & Networks | SME Loans by NBFC's | | Saas instead of Product |
| Angel Syndicate Platforms | Factoring | | Get Senior people to work |
| Media Barters | Leasing | | Customer Advances |
| HNI's | Loan against Collaterals | | License your products in other mkt |
| Incubator/Accelerator | CGTMSE | Barter-Consignment Biz | Government Grants & Incentives |
| Crowd Funding | | Back office support | Managing with own revenues |
| Friends & Family | | Office Space vs product/equity | Moonlighting on job |
| Bootstrapping | | Exchange resources | Get Free resources |

Source: Compiled by the authors from the interactions with angel investors and venture capitalists

Many higher education institutes have started 'Start-up or Venture Grant' scheme to foster entrepreneurship. Such grants have served as the alternative source of funds to meet need of the initial funds. In many cases, the ventures have reduced the need for 'money' by getting access of various resources of the incubators and accelerators facilities.

Accessible markets (as one of the important component of entrepreneurial ecosystem) and customers who are ready to try new solutions have given birth to the 'Customer Funded' business model. This has changed the financing decisions and overall business decisions of the new ventures.

Many technology startups are funded by the advance taken from the customers. In many cases, the development of the prototype is funded by the customers. In practice, the entrepreneurs weigh their options and avoid external funds by making the best use of the low cost or no cost funds and resources available in the entrepreneurial ecosystem.

## CONCLUSION

The paper presented sources of entrepreneurial finance; emergence of new and innovative modes of financing and funding; some of the key issues and challenges associated with the entrepreneurs and finally the interaction of entrepreneurial ecosystem with the entrepreneurial finance. The literature in the entrepreneurial finance has undergone lot of change over the years. Further research and study may provide understanding and insights on how entrepreneurial ecosystem affects the entrepreneurial finance.

At the same time, the research may offer insights on how new and alternative modes of financing and funding would affect the entrepreneurial ecosystem. There are many research questions that emerges from the interaction of entrepreneurial ecosystem, entrepreneurial finance and the sources of financing and funding of the early stage ventures.

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