ENTREPRENEURIAL FIRMS AND FINANCING CHANNELS: INTERDEPENDENCE ELEMENTS

Tudor CIUMARA, PhD *

Abstract

In this paper we propose a novel perspective regarding the interdependence of certain elements, crucial in providing financial resources to entrepreneurial firms, using a variety of different financing channels. We use a theoretical approach to define a set of layers that can be used to determine the relevance of certain financing types, for companies with certain characteristics. These layers are represented by company development stage, field of activity, size, use of financing resources, orientation for long- or short-term financing, complexity of legal and administrative procedures and refundable or non-refundable nature of the financing. We discuss the perspectives of this analysis model for future empirical analyses that may contribute to its improvement.

Keywords: funding, companies, financial resources

JEL Classification: D25; G32; L26

1. Introduction

Company finance is a topic of great interest for several reasons. Perhaps, most important of all, we can see that the financial field is generally of particular interest, being easier to perceive by a variety of interested parties. In this paper we explore a segment of company finance, represented by entrepreneurial finance, with the purpose of exploring the manner in which some important factors connect with each other in the process of obtaining financial resources for the company.

* *Senior Researcher, "Victor Slăvescu" Centre for Financial and Monetary Research, Romanian Academy, Bucharest.*

2. Literature review

The notion of entrepreneurship is elastic (Eisenmann, 2013) and, while everyone has a representation of what it means, the common understanding is rather vague. A common definition of entrepreneurial companies is that they are built on a suite of entrepreneurial processes that generate a specific dynamic. Studies such as Muzyka, De Koning and Churchill (1995) and Mason (2006) can be reviewed in this regard. An essential aspect is the fact that “the entrepreneurial firm is based on opportunities, not on resources” (Karami, 2007).

As Scherr et al. (1993) note, research in the field of corporate finance is much more abundant in terms of large firms and less common in terms of the financial structure of start-ups. Therefore, the differences between corporate finance and entrepreneurial finance must be taken into account (Vinturella and Erickson, 2004) in such an analysis.

The literature on financing entrepreneurial firms is largely focused on start-ups. In addition to the attention paid to traditional financing methods (such as banking or the capital market), in recent decades a line of research has begun to develop, dedicated to financing through alternative channels (venture capital funds, business angel investors, self-financing etc). It is noticeable that the landscape of financing offered to entrepreneurial firms is increasingly complex (Bessiere et al., 2019).

Scher et. al (1993) find that the determinants of the financial structure of small firms are the preferences regarding the risk-return ratio of the owner, the costs related to financing and the characteristics of the firm (such as the field of activity or the structure of assets). In essence, the structure of financing attracted by entrepreneurial firms results from the interaction between the preferences of entrepreneurs for certain types of financing and the willingness of financing providers to respond to these preferences (Huyghebaert, & Van de Gucht, 2007).

We may observe that many companies seem doomed to be financed mainly by loans, since they are not attractive enough to investors, because they do not have the potential to grow rapidly and substantially, either because of the characteristics of the market in which they operate or because of the characteristics of the way they are run (McNaughton and Bell, 2004). Given that lending is the main financing channel for entrepreneurial firms, it can be concluded that it

is very important for the banking system to function efficiently (Balling et al., 2009). We note the conclusion of Balling et al. (2009), according to which risk capital can be a buffer for cyclical fluctuations in the economy, helping firms to have a more robust balance sheet and better cope with economic fluctuations. We also need to consider the possibility of a substitution effect between state subsidies and venture capital financing (Pukthuanthong et al., 2007).

Simplifying the analysis, companies can be financed through three major channels: loan, activity-generated resources and sale of shares. The theory of the irrelevance of the financial structure of Modigliani and Miller (1958) is notable, but the hypotheses on which it is based complicate the translation of the conclusions to the real environment.

3. Methodology

We seek a theoretical development of financing conditions for entrepreneurial companies, to provide a model of analyzing the financing perspectives of such companies. In order to achieve this, we look at how financing options are conditioned by different relevant elements in the entrepreneurial ecosystem, and how they influence them, in turn. Subsequently, we also observe the complementarity of different sources of funding. In order to be able to rank the different options, we use a basic scale, with the following notations: 0 = Inadequate, 1 = Inadequate, 2 = Adequate, 3 = Very adequate. It should be noted that the notations from 0 to 3, awarded in the analysis, are used purely for model presentation, and may/need to be adjusted on the basis of more detailed, empirical assessments. We appreciate that in this paper it is mainly useful to introduce this perspective of analyzing the sources of financing and their relationship with the characteristics of entrepreneurial firms and not so much their precise classification, based on rigorously determined markings.

The aspects that we analyze in this framework are the following:

a) Company development stage;
b) Company field of activity;
c) Financing use;
d) Company size;
e) Orientation of the use of long- or short-term financing;

f) Complexity of legal and administrative procedures necessary to obtain and manage the financing;
g) Refundable or non-refundable nature of the financing.

These aspects are critical in the process of determining the financial requirements of an entrepreneurial companies and the proper management of such financial resources.

4. Discussion

The development stage of the company is a very important aspect, given the fact that at different stages of the company's life the optimal sources of financing may be different. We need to look at the decisions and the possibilities of financing the activity and development of the entrepreneurial companies through the prism of their positioning within the life cycle. Life-cycle based company financing options are being examined by many researchers, including La Rocca et al (2011) and Leach and Melicher (2012). While the former argue that as firms mature, they balance their financial solutions by reducing indebtedness and increasing capital-based financing, the other authors take a more general approach, noting that “each stage in the life cycle requires a specific understanding of the financial management tools and techniques, potential investors and their mindset, and the financial institutions supporting that venture stage”. The issue of options for financial structure based on life cycle positioning is also addressed by Fluck (2000) who investigates whether a firm's subsequent financing decisions are affected by the results of previous decisions. Related to this aspect, we can also analyze the age of the business - newly established companies, without a history, find it more difficult to access bank financing, for example. When it comes to financing entrepreneurial companies, the focus is largely on newly established companies or even those still in the concept stage.

The structure we propose in Table 1 indicates that certain types of financing are better suited for certain company life stages. We could hardly imagine crowdfunding as a relevant financing source for a mature company or sale of equity for a business in the concept stage. Some sources of financing, such as grants. are more adaptable and relevant for most stages in the company life-cycle. While the value of this perspective is not obvious from just this element, it becomes more powerful when we introduce additional dimensions in the analysis.

The field of activity in which the companies operate or intend to operate is another crucial element. Companies in different sectors have different business models that also involve a different set of elements in the process of financial decision. Financiers may also have preferences in this regard or may even specialize in certain areas of activity. It is certain, and clearly highlighted both in the literature and in empirical analysis, the preference for funding businesses that can be defined as innovative and scalable. For this reason, we have introduced in Table 2 a column that defines, perhaps somehow improperly, a field of activity named *Innovative*, although in this category one can find companies from the entire spectrum of fields of activity. We may determine that most types of financing are equally well adjusted for all or most fields of activity, and we made consequent notation in the table. However, certain types of financing – public grants, for example – may be more sensitive to this element.

The use of financing is another relevant element. It should be taken into account the preference of most financiers for the existence of guarantee for the funds made available to the company, or for the existence of significant growth prospects. Therefore, in Table 3 we provide a set of assumptions regarding the relationship between certain sources of financing and the use of funds. While bank loans can be used to finance a large spectrum of needs, leasing (any many other types of financing) is not relevant for paying off outstanding financial obligations.

The size of the financed company is also particularly relevant, both regarding the amount of funding required and also the possibilities the financier has to control the results. A more detailed analysis of these issues was recently conducted by Masiak et al. (2018), highlighting the greater preference of micro-enterprises for internal financing and shorter-term financing. What we note in Table 4 is that a very small company, for example, can benefit little from equity sale, for obvious reasons, this may be a very relevant source of financing for a larger company. In a reverse perspective, microfinancing may be very relevant for a small company and irrelevant for a larger one.

Short, medium or long-term guidance on the use of funding is another factor that filters out possible funding channels that can be used. From this point of view, the basic elements of the need for financing of the companies, as well as the preferences, characteristics or specialization of the financing channels are also relevant. Therefore, we propose in Table 5 that sale of equity is not a relevant source of

financing short term needs, while microfinancing is not relevant for longer term needs.

Another important aspect concerns the administrative procedures for obtaining financial resources from different sources. Regarding the complexity of legal and administrative procedures, presented in Table 6, we preferred not to use the scoring system from 0 to 3 but to mark the degree of complexity associated with each type of financing, simply marking the most likely level of complexity for each type of financing. One possibility to refine this element of analysis would be to track the costs associated with financing. These costs can be both financial and interpreted in the resource consumption note (mainly time). These elements of the analysis compound nicely with perspectives of other elements, such as the time horizon, since more complex procedures most often require more time, making the corresponding financing types less relevant for needs with shorter time horizon.

An essential issue associated with the financing of companies is whether or not the money raised should be returned to the financier. Hence the reimbursable versus non-reimbursable nature of the financing, highlighted in Table 7.

The evaluation of the elements presented so far, and how they impact each other, outlines a number of interesting features regarding the context in which the financing of entrepreneurial firms is carried out. Another aspect that deserves to be noted refers to the way in which the different financing channels are complementary with each other. In Table 8 we propose a perspective on this aspect. We find again that some types of financing are very malleable, complementing harmoniously most other types of financing, while others tend to be less predisposed to complementarity.

We view these elements as layers of a more complete analysis of the relationship between entrepreneurial firms' financial needs and the available types of financial sources. Adding layer upon layer of interdependent elements may significantly improve the understanding of this area.

A number of other factors may be relevant to expand the perspective presented in this paper. Such factors may influence, to a greater or lesser extent, both the companies' choices for the different financing channels and the evaluation of the financiers regarding the opportunity to grant the requested financial resources. Among these

elements we can think of the orientation towards import and/or export activities of the companies, their location (here both urban versus rural and regional differences can be discussed). Also, the innovative character of the company's activity is a strong influencing factor of the financial structure. These are elements that could be used to further refine the proposed perspective on entrepreneurial companies financing.

References

1. Balling, M., Bernet, B., and Gnan, E. (2009). Financing SMEs in Europe – some stylized facts, in Baling, M., Bernet, B., Gnan (eds.), *Finanacing SMEs in Europe,* SUERF – The European Money and Finance Forum.
2. Bessiere, V., Stephany, E. and Wirtz, P. (2019). Crowdfunding, business angels, and venture capital: an exploratory study of the concept of the funding trajectory, *Venture Capital*, vol. 22, pp. 1-26.
3. Eisenmann, T. (2013). Entrepreneurship: A Working Definition, *Harvard Business Review*, January.
4. Fluck, Z. (2000). Capital Structure Decisions in Small and Large Firms: A Life-cycle Theory of Financing, *NYU Working Paper* No. FIN-00-028.
5. Huyghebaert, N., Van de Gucht, L. (2007). The determinants of financial structure: new insights from business start-ups, *Research report 0203*, Katholieke Universiteit Leuven.
6. Karami, A. (2007). Strategy Formulation in Entrepreneurial Firms, Ashgate Publishing Company.
7. La Rocca, M., La Rocca, T. Cariola, A. (2011). Capital Structure Decisions During a Firm’s Life Cycle, *Small Business Economics*, vol. 37, pp. 107-130.
8. Leach, J.C. and Melicher, R.W. (2012). Entrepreneurial Finance, 4th edition, South-Westerrn, Cengage Learning.
9. Masiak, C., Block, J.H., Moritz, A., Lang, F. and Kraemer-Eis, H. (2018). How do micro-firms differ in their financing patterns from larger SMEs?, *Venture Capital*, vol. 21, no. 4, pp. 301-325.
10. Mason, R. (2006). Coping with complexity and turbulence – an entrepeneurial solution, *Journal of Enterprising Culture*, vol. 14, no. 4, pp. 241-266.
11. McNaughton, R., Bell, J. (200). Capital structure and the pace of SME internationalization, in Etemad, H. (ed.), *International Entrepreneurship in Small and Medium Size Enterprises*, The McGill International Enterpreneurship Series.

12. Modigliani, F., Miller, M. (1958). The cost of capital, corporation finance and theory of investment, *American Economic Review*, vol. 48, pp. 261-297.
13. Muzyka, D., De Koning, A., and Churchill, N. (1995). On transformation and adaptation: building the entrepreneurial corporation, *European Management Journal*, vol. 13, no. 4, pp. 346-362.
14. Pukthuanthong, K., Thiengtham, D. and Walker, T. (2007). Why venture capital markets are well developed in some countries but comparatively small in others: Evidence from Europe, in Gregoriou, G.N., Koolo, M., Kraeussl, (eds.), *Venture Capital in Europe*, Elsevier Inc.
15. Scherr, F., Sugrue, T. and Ward, J. (1993). Financing the Small Firm Start-Up: Determinants of Debt Use, *The Journal of Entrepreneurial Finance*, vol. 3, no. 1, pp. 17-36.
16. Vinturella, J.B., Erickson, S.M. (2004). Raising Entrepreneurial Capital, Elsevier Butterworth Heinemann.

Appendix

Table 1

The relationship between the type of financing and the development stage of the company

	Business idea	Start-up	Growing company	Mature company (stagnation)	Declining company
Sale of equity	0	0	3	3	1
Sale of assets	0	0	2	3	3
Retained	0	3	3	3	1
Bank loans	0	1	3	3	1
Trade credit	0	3	3	3	2
Leasing	0	2	3	3	1
Microfinancing	0	1	1	1	2
Other loans	3	3	2	1	3
Grants	1	3	3	3	1
Business angels	2	3	3	1	0
Risk finance	1	3	3	0	0
Crowdfunding	3	3	0	0	0

Data source: author's analysis

Table 2

The relationship between the type of financing and the field of activity of the company

	Industry	Trade	Services	Construction	Innovative
Sale of equity	3	3	3	3	3
Sale of assets	3	2	2	3	2
Retained earnings	3	3	3	3	3
Bank loans	3	3	3	3	3
Trade credit	3	3	3	3	3
Leasing	3	3	3	3	3
Microfinancing	3	3	3	3	3
Other loans	3	3	3	3	3
Grants	3	2	2	1	3
Business angels	3	2	3	2	3
Risk finance	3	2	3	2	3
Crowdfunding	3	2	3	1	3

Data source: author's analysis

Table 3

The relationship between the type of financing and its use

	Investment	Inventory/ working capital	Hiring and training of personnel	Development/launch of new products/ services	Refinance or pay off obligations
Sale of equity	3	3	1	3	1
Sale of assets	3	3	3	3	3
Retained earnings	3	3	3	3	3
Bank loans	3	3	3	3	3
Trade credit	2	3	1	1	0
Leasing	3	0	0	0	0
Microfinancing	1	2	3	1	3
Other loans	3	3	3	3	3
Grants	3	1	2	3	0
Business angels	3	3	2	3	0
Risk finance	3	3	2	3	0
Crowdfunding	3	2	2	3	0

Data source: author's analysis

Table 4

The relationship between the type of financing and its size

	Very small company	Small company	Medium sized company	Large company	Very large company
Sale of equity	0	1	2	3	3
Sale of assets	3	3	3	3	3
Retained earnings	3	3	3	3	3
Bank loans	1	2	3	3	3
Trade credit	1	2	3	3	3
Leasing	1	3	3	3	3
Microfinancing	3	2	1	0	0
Other loans	3	3	3	3	3
Grants	3	3	2	2	2
Business angels	3	3	2	0	0
Risk finance	0	2	3	0	0
Crowdfunding	3	2	0	0	0

Data source: author's analysis

Table 5

The relationship between the type of financing and the time horizon

	Short term	Medium term	Long term
Sale of equity	0	3	2
Sale of assets	3	2	1
Retained earnings	1	3	3
Bank loans	3	3	3
Trade credit	3	2	0
Leasing	1	3	3

	Short term	Medium term	Long term
Microfinancing	3	0	0
Other loans	3	2	2
Grants	1	3	3
Business angels	2	3	2
Risk finance	1	3	2
Crowdfunding	3	2	0

Data source: author's analysis

Table 6

The relationship between the type of financing and the complexity of legal and administrative procedures

	Reduced complexity	Average complexity	High complexity
Sale of equity			X
Sale of assets	X		
Retained earnings	X		
Bank loans		X	
Trade credit	X		
Leasing		X	
Microfinancing	X		
Other loans	X		
Grants			X
Business angels		X	
Risk finance			X
Crowdfunding	X		

Data source: author's analysis

Table 7

The relationship between the type of financing and their repayable nature

	Refundable	Non-refundable
Sale of equity		X
Sale of assets		X
Retained earnings		X
Bank loans	X	
Trade credit	X	
Leasing	X	
Microfinancing	X	
Other loans	X	
Grants		X
Business angels		X
Risk finance		X
Crowdfunding		X

Data source: author's analysis

Table 8

Complementarity between different types of financing

Financing types	Sale of equity	Sale of assets	Retained earnings	Bank loan	Trade credit	Leasing	Microfinancing	Other loans	Grants	Business angels	Risk finance	Crowdfunding
Sale of equity	0	1	2	2	3	3	0	1	3	0	1	0
Sale of assets	1	3	3	2	3	3	2	3	3	1	1	1
Retained	2	3	3	3	3	3	3	3	3	3	3	1
Bank loans	2	2	3	3	3	3	2	3	3	2	2	1
Trade credit	3	3	3	3	3	3	3	3	3	3	3	3
Leasing	3	3	3	3	3	3	3	3	3	3	3	3
Microfinancing	0	2	3	2	3	3	2	3	3	3	3	3
Other loans	1	3	3	3	3	3	3	3	3	3	3	3
Grants	3	3	3	3	3	3	3	3	2	2	2	2
Business angels	0	1	3	2	3	3	3	3	2	3	3	1
Risk finance	1	1	3	2	3	3	3	3	2	3	3	1
Crowdfunding	0	1	1	1	3	3	3	3	2	1	1	1

Data source: author's analysis