FUNDING FOR START-UPS OWN CAPITAL & BANK FINANCING

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ABSTRACT

The funding of a start-up is crucial for its success, and there are various ways in which it can be achieved. One common way is through a combination of the start-up's own capital and bank financing.

Using their own capital, start-ups can invest their own money into the business, whether it be through personal savings, investments, or borrowing from friends and family. This provides the start-up with a degree of autonomy and control over their funding, as they do not have to rely solely on external sources.

Bank financing is another [1]option for start-ups, where they can obtain loans or lines of credit from banks or financial institutions. These loans can be used to fund various aspects of the business, such as purchasing inventory, equipment, or hiring employees. However, bank financing often comes with stringent requirements and may require collateral, making it a more challenging option for some start-ups.

[2]Combining both approaches can provide a balanced funding strategy for start-ups, allowing them to leverage their own capital while still benefiting from the additional resources provided by bank financing. This can help the start-up to build credibility and establish a strong financial foundation, which can ultimately lead to further growth and success. It's important for start-ups to carefully consider their funding options and to seek professional advice when necessary to ensure they make the best decisions for their business.

[1]"The Lean Startup" by Eric Ries
[2]Angel: How to Invest in Technology Startups - Timeless Advice from an Angel Investor Who Turned $100,000 into $100,000,000" by Jason Calacanis

INTRODUCTION

Access to finance for startup firms has always been an issue of debate within the circle of Economists and Researchers. [3]Issues related to the capital structure decision have attracted lot of attention, because of the reason that these issues are primarily dominant in small size and young firms. This paper will therefore address the financing options that are available to these startup firms along with their pattern and duration of availability. Furthermore with the emphasis over possible alternatives the startup firms can adopt in order to make sure the smooth availability of finance in crucial times. The main small size of firms that are addressed in this paper refer to "Start-ups" and not the ones that are already operating. Since the financial options and preferences differ for both of them. During the period of the startup firms applying for finance, many constraints are encountered as well. These constraints will be addressed along with the relevant options. The main concern for these startup firms is not only limited up to the fact that how these sources of finance are successfully acquired but also how these sources are effectively implemented once they are made available, since the startup firms lack both the experience and expertise in dealing with the core business operations.

[4]Starting a new business is an exciting venture, but it often requires significant investment and funding to get off the ground. One of the most critical aspects of starting a successful business is securing adequate funding. While there are various ways to fund a start-up, using a combination of own capital and bank financing is a common approach.

Using own capital, such as personal savings or investments, can provide start-ups with a degree of control and autonomy over their funding. However, for many start-ups, this may not be enough to meet all of their financial needs. This is where bank financing can come in handy, providing additional funds that can be used for various aspects of the business.

[5]While bank financing can be a valuable resource, it's essential for start-ups to carefully consider the terms and requirements of any loans or lines of credit they are considering. Some loans may require collateral or have strict repayment terms that could be challenging for a new business to meet. However, by carefully considering their funding options and

[3]The Lean Startup" by Eric Ries

[4]"Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist" by Brad Feld and Jason Mendelson

[5]"Startup Funding Explained: Everything You Need to Know About Raising Capital for Your Startup" by John Mullins

developing a balanced approach, start-ups can establish a strong financial foundation that can help them grow and thrive In this context, this topic will explore the benefits and challenges of using own capital and bank financing, and how start-ups can combine these approaches to secure the funding they need to succeed.

FIRM LIFE CYCLE

Just like the products, firms also follow the same life cycle. The firm life cycle is divided into four different stages. Each stage has its own prescribed characteristics. [6]The different stages of the firm lifecycle are Birth or Startup stage, Growth stage, Maturity Stage and finally the Decline or Revival stage.

The firm lifecycle refers to the stages that a business goes through from its inception to its eventual closure or transformation. While there are different models of the firm lifecycle, the most widely recognized one includes four stages: introduction, growth, maturity, and decline.

Introduction Stage: This is the initial phase of the firm's lifecycle where the company is formed and launched. The introduction stage is characterized by high uncertainty and risk as the business tries to establish a foothold in the market. During this stage, the company typically invests heavily in research and development, marketing, and building its infrastructure. The primary goal is to establish a customer base and create brand recognition.

Growth Stage: During this stage, the firm has successfully established itself in the market, and its revenues and profits are increasing. The company focuses on expanding its market share, increasing production capacity, and developing new products or services. At this stage, the business may also consider entering new markets or acquiring other companies to increase its reach.

[7]**Maturity Stage**: In this stage, the firm has reached a stable position in the market, and its growth rate starts to slow down. The focus is on maintaining profitability, reducing costs, and improving efficiency. The company may also consider diversifying its product or service offerings to maintain its market

[6]Scaling Up: How a Few Companies Make It...and Why the Rest Don't" by Verne Harnish
[7]The Startup Owner's Manual: The Step-by-Step Guide for Building a Great Company" by Steve Blank and Bob Dorf

position. Decline Stage: Eventually, every firm experiences a decline in its performance due to various reasons, such as increased competition, changes in consumer preferences, or technological advancements. During this stage, the company may reduce its operations, sell off assets, or merge with another company. If the firm fails to take corrective measures, it may eventually lead to its closure.It's important to note that while the firm lifecycle model provides a general framework, not all businesses follow the same path, and some may skip or repeat stages. Successful companies are those that are adaptable and able to pivot and evolve as needed to stay relevant in their industry.

START UPS

Although there are no clear definitions to define startups, however various criteria's like number of employees, annual sale, or net profit are some of the dimensions that could help differentiate between the definition for large and small startup firms. There are mostly two types of startup firms. The first type of startup is explained in the scenario of "Entrepreneur", "Where an individual who thinks, reasons and acts to convert the ideas into commercial opportunities and to create value" (Leach &Melicher, 2012). [8]This phenomenon refers to the stage even before the Birth or startup stage of the firm lifecycle. Describing it in a nutshell, this type is just before setting the foundations of the firm, where the owner (Entrepreneur) plans to convert an idea into a profitable opportunity, by planning to start a firm. On the other side, the second type explains the startup firms which are already carrying their operations and are in their working phase; however they are yet to achieve the status of a small developed and operating firm. These startups are usually in the Birth or startup stage of the firm life cycle. (Aurelian, 2008) defines the first type of [9]startups as firms where the initial business concept is formed. With the initial products and services that are to be offered are observed.A startup is a newly established company or business venture that aims to develop a scalable business model around a product or service. Startups are typically characterized by their innovative and disruptive ideas, a high level of uncertainty and risk, and a focus on growth and scalability.

- Here are some key features of startups:

[8]"The Art of Startup Fundraising" by Alejandro Cremades
[9]Zero to One: Notes on Startups, or How to Build the Future" by Peter Thiel and Blake Masters

Innovative and Disruptive Ideas: Startups often offer new and innovative products or services that challenge traditional business models or disrupt existing industries.

High Level of Uncertainty and Risk: Startups operate in an environment of high uncertainty and risk. They often have limited resources and face fierce competition from established players in the market.

Focus on Growth and Scalability: Startups typically have a goal of rapid growth and scalability, often in the form of attracting investors or going public. The focus is on achieving high levels of revenue growth and market penetration.Lean and Agile: Startups typically operate with a lean and agile approach, with a focus on speed and flexibility. They often iterate quickly based on feedback from customers and stakeholders.

Technology-driven: Many startups are technology-driven, leveraging advances in computing, artificial intelligence, and other emerging technologies to develop innovative products and services.

Entrepreneurial Culture: Startups are often characterized by an entrepreneurial culture that values risk-acing, innovation, and collaboration.Overall, startups play a vital role in driving innovation and growth in the economy. However, they also face significant challenges, such as funding, scaling, and managing risk, that require careful planning and execution to overcome.

BRILLOPEDIA

TYPES OF FINANCING

There are different types of financing options that are available for the startups during the different stages of the firm life cycle. The financing types are based upon the level of growth of the startups from the first stage of the firm life cycle to the final stages along with their growth and production scale. Since the type of finance vary across different stage of the firm life cycle. These types are classified as followings (Leach &Melicher, 2012) Seed financing, Startup financing, First round financing, Second round and Mezzanine finance. The importance of the types of financing can be explained by the findings that about 23.7% of startup[10] firms disappear within the first 2 years and further 52.7% are vanished in a time span of 4 years and the major reasons behind their failure are the bankruptcy, owner's health,

[10]Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist" by Brad Feld and Jason Mendelson

and access to financing options. [11](Berger &Udell, 1998). For any firm in the startup stage it is necessary to make sure the availability of finance exists in order to meet the initial needs by the entrepreneurs. In the initial stages when an entrepreneur decides to convert an idea into a business opportunity, he/she might lack financial resources to cover up the requirements. At that point, Seed financing is required in order to help the entrepreneur to develop the business concept. It is important for both types of startups. It comes under the category of the insider financing, where needs for finance are fulfilled by the startup team comprising of entrepreneur's own assets together with finance from the family, friends and colleagues. Seed financing stage investing is important for the good beginning of the startups.[12] However once the initial phase is successfully reached, Startup financing is deployed in order to meet financing needs of the entrepreneur. Like the seed financing, startup financing is also important for both types of startup. In the startup financing, funds are needed to take a startup firm from having an established business opportunity to the initial stage of production and sales. This type of financing has major sources like "Business Angels" and "Venture Capitalists" (Robb & Robinson, 2012). Another type of financing is the first round financing; which is considered important for the 2nd type of the startups in order to decide if the startup will succeed through its lifecycle. By nature first round is formal and the equity is provided externally to cover the shortfalls in the required finance for the startups to meet their expenses. Making sure the availability of first round finance, the options include commercial banks, suppliers and customer, and grants from the governments. The requirements for receiving finance from commercial banks and asking for the Trade credit represents it a formal type of financing option for the startups. [13]Formal type of financing is in the sense of collateral requirements to be fulfilled by the startups in order to access for finance. First round financing is crucial since it decides the fate and the direction of the startups. The second round financing is required when the startup firms needs to expand its core activities or operations. This type of financing is required for the second types of startups where additional finance is needed to expand firm's operational activities. There is a direct relation between the growth and purchases, since as the growth increases, earning generated are used to pay the expenses which reduces the earnings and therefore the startups have to look for the second round of finance. The sources are still the commercial banks and suppliers &

[11]"Startup Funding Explained: Everything You Need to Know About Raising Capital for Your Startup" by John Mullins
[12]"Financing the Small Business: A Complete Guide to Obtaining Bank Loans and All Other Types of Financing" by James Burkett
[13]The Art of Startup Fundraising" by Alejandro Cremades

customers based on the phenomenon of previous history and trade credit respectively (Leach &Melicher, 2012). It is considered important for the 2 nd type of the startup firms to make sure the availability of second round financing options since the demand for additional finance can occur at any stage of the firm lifecycle of the startups. Finally Mezzanine financing is another type of financing tool, where finance is needed for the marketing expenditure, expansion projects and for the improvement in products and services of the startup firm. Mezzanine finance is usually obtained through debt in the form of warrants. Warrants are the rights or options to purchase a venture's stock at a specific price within a specified time frame. The major use of mezzanine finance is for the plant expansion, marketing expenditures, product or service improvement and working capital.

- There are various types of financing options available for businesses depending on their size, stage, and specific needs. Here are some of the most common types of financing:

➢ **Debt Financing:**[14]Debt financing is a form of financing where a company borrows money from a lender or financial institution and agrees to pay it back over time, usually with interest. Examples of debt financing include bank loans, lines of credit, and credit cards.

➢ **Equity Financing**: Equity financing is a type of financing where a company sells shares of its ownership in exchange for funds. This type of financing is often used by startups or early-stage companies that are not yet profitable. Investors who provide equity financing become shareholders in the company and share in its success or failure. Examples of equity financing include angel investing, venture capital, and initial public offerings (IPOs)

➢ **Crowdfunding**: Crowdfunding is a relatively new form of financing that involves raising funds from a large number of people, typically via the internet. Crowdfunding can take many forms, including rewards-based crowdfunding, where backers receive a reward or product in exchange for their investment, or equity crowdfunding, where backers receive shares in the company in exchange for their investment.

➢ **Grants:** Grants are non-repayable funds provided by governments, non-profits, or private organizations to support specific projects or initiatives. Grants are often available for businesses in specific industries or for projects that have a social or environmental impact.

[14]"Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist" by Brad Feld and Jason Mendelson

- **Factoring**: Factoring is a form of financing where a company sells its accounts receivable to a factoring company at a discount. The factoring company then collects payment from the company's customers, often providing immediate cash flow for the company.
- **Asset-Based Financing**: Asset-based financing involves using a company's assets, such as inventory, equipment, or real estate, as collateral for a loan or line of credit. This type of financing is often used by companies that have valuable assets but limited cash flow.Overall, businesses should carefully consider their specific needs and the pros and cons of each financing option before choosing the best option for their situation.

SOURCES OF FINANCE

Owners' Capital

For the start-up firms in the initial stage, Owner's capital is seen as "Seed financing" when the options for external financing are limited. It is considered to be the primary option as a source of finance for the startups. Owner capital is a part of insider financing and is the largest sources of informal finance for the[15]startups including owner's equity, loans and credit card. Insider finance channels mostly include finance from the family members, friends and affiliates of the firm (Robb & Robinson, 2012). Insider finance comprises of funds from the startup team that consist of owner's family, friends, relatives and colleagues. With the startups insider finance is an important option since these firms have no collateral or track records. Startups have difficulty in obtaining external finance because of the vague future prospects and find difficulty in signaling their creditworthiness. However the question might arise about the amount of owner's [16]capital, this could be argued by the fact that the owner might use some of the retained earnings, as finance for their startups expedition. But in most of the cases, especially for the startups, which are relatively young and are therefore unable to harvest any profits, so they turn towards the insider finance. (Berger &Udell, 1998). Furthermore the outside sources are restricted in providing finance in the early stages of startup developments until or unless the entrepreneur successfully demonstrates the existence

[15]"Financial Accounting for Dummies" by MaireLoughran
[16]inancial Intelligence for Entrepreneurs: What You Really Need to Know About the Numbers" by Karen Berman and Joe Knight.

of a profitable opportunity to the investors (Scholtens, 1998). Once the opportunity is spotted and utilized opens the door for finance for the startups. In the United States statistical results of national survey (Berger &Udell 2002) for small business finance conducted in 1993 show that the biggest category in providing finance for the small size firms is the Principal, or in other words the Owner's capital. Results show that 31.33% of the financing patterns lead to the Owner's capital, similarly in another survey similar trend is seen by Kauffman Firm Survey (KFS) in the United States from 2004 to 2011 where a sample of 4928 firms (Small) were used. Results showed that over 75% of the firms have at least some sort of owner's capital. On contrary owner's debt in the form of[17] loans play a less significant role. According to (Berger &Udell, 1998) in the initial startup stage, the primary source of finance consists of "Startup team", beside owner, other members of this startup team includes friends, family members and colleagues. They act as a financing source in the form of interest free loans, or even donations to the startups with no formal requirements. Therefore this sort of financing is informal and insider since the there are no strict requirements for the availability of credit. The main advantage of owner's capital in terms of startup team is that family, friends and colleagues that make the availability of finance in the early stage of the financing cycle do not get involved in the financial monitoring, with or without the formal measures and ratios (Leach &Melicher, 2012). On the contrary for the startup team with no controlling over the finance provided, there might be the chance for the misuse or high risk taking by the owner. Therefore despite of all the fact, Owner's capital remains the first primary source of financing option for the startups.

Banks

As a source of finance for the startup firms, Banks are the most well know sources of finance after owner's capital. Banks are financial institutes that provided finance to all type of firms irrespective of their size. In any bank-based system, major role is played by the banks in facilitating the flow of money between various investors and organizations along with the surplus cash that require them. Countries where bank based financial system have very strong banks, with major purpose of monitoring corporations and are involved in the strategic decision making of that market. Banking finance is important for startup firms since they rarely obtain long term debt or equity, as they must rely on the bank credit as a major source

[17]The Accounting Game: Basic Accounting Fresh from the Lemonade Stand" by Darrell Mullis and Judith Orloff

of finance, since they obtain much of the external capital from the entrepreneur's own funds, and informal investors like family members, friends and colleagues (Walker, 1989). The decision for startup firms to opt for banking finance depends upon different criteria's like time frame, amount of credit availability, level of interference and supervision and they vary across firms. For the startup firms it is vital to rely on the finance from the banks since the financial situation of the startup firms appear to be very opaque for the investors, therefore without the presence of a financial intermediary firm like the banks it becomes too costly for the investors to gain information in order to grant credit to the startup firms. Hence[18] bank plays an important role of classic financial intermediaries, solving the problem for the startup firms by generating the information about them, by setting terms of the loan contract to improve the incentives of the startup firms. For any startup firm, acquiring bank finance opens up many ways to gain access to finance as banks provide different types of financing options that include Credit trade, low interest loans, interest free loans, reduction transaction cost, protection against credit crunches, and credit risk insurance (Boot, 1999). Banks provide assistance in terms of renegotiating the contract whenever the startup firms are facing financial difficulty, and by diversifying the risks across many small business credits. Banks act to form long term relations with the startup firms and with the passage of time, as the working relationship matures between the two, it results in lowered interest rates and less collateral requirements in terms of further financial assistance, however the banks on the hand could impose "migration restrictions" on these startups as well in order to avoid them to opt for other sources of finance. (Meyer, 1998). Furthermore banks make sure the fluent availability of finance to the startup firms without any disruptions or discontinuities. Another advantage of using banking finance is that they demand less monitoring and the controlling rights as compared to other options for finance. They are not interested in the ownership of the firms. They mostly monitor the contract violations, worsening performances, or failing the quality of the contract that could endanger their loan (Yerramilli& Winton, 2008). However as far as the question regarding the ease of banking finance for the startup firms is concerned, (Florin, Dino, &Huvaj, 2013) hold a different point of view, according to them even after the entrepreneurs ran out of their capital in the initial stages of the startup, they still consider the option for banking finance to be still too risky for the banks to consider for providing capital or not. Even if the entrepreneur could somehow manage to obtain financial resources from the banks, the terms of providing those resources are themselves unaffordable

[18]"Bank Management and Financial Services" by Peter Rose and Sylvia Hudgins

for the startups. Furthermore banks are in a continuous need for funds, especially the liquidity funds in their course of business. Such needs might include demanding additional loans, loan commitments, and increased demands for the repayment from the startups. Failure to meet the liquidity needs have a negative impact over the banks, hence creating costs for the banks (Boot, 1999). Another issue that might come across the startup firms includes the aspect of projects with the positive future Net Present Value (NPV) to restrain from further borrowing from the banks, hence derailing the long term commitments with the banks. The worst scenario could be encountered as a result of this backing off from their commitments by the startup firms, banks that hold the information about the startups are no longer bound to keep the information secretly. Hence information can be eased which would make the condition worst.

[19]Banks are financial institutions that provide a range of financial services to individuals and businesses. Here are some of the key functions and services offered by banks:

- **Accepting Deposits:** Banks accept deposits from individuals and businesses, which can be withdrawn at any time or held for a specific period. Deposits can be in the form of savings accounts, checking accounts, or certificates of deposit.
- **Providing Loans:** Banks provide loans to individuals and businesses for a variety of purposes, including personal loans, home mortgages, and business loans. The interest rates and terms of the loans vary depending on the borrower's creditworthiness and the type of loan.
- [20]**Managing Investments:** Banks offer a range of investment products and services, including stocks, bonds, mutual funds, and retirement accounts. Banks also provide investment advice and portfolio management services to help clients achieve their financial goals.
- **Processing Payments**: Banks process payments, such as checks, wire transfers, and electronic payments, on behalf of their customers. Banks also issue credit and debit cards, which allow customers to make purchases and access cash.
- **Providing Financial Advice**: Banks offer financial planning and advice services to help customers manage their finances and achieve their financial goals. This can include advice on budgeting, saving, investing, and retirement planning.

"Bank Management and Financial Services" by Peter Rose and Sylvia Hudgins
[20]The Business of Banking: Models, Risk and Regulation" by Benton E. Gup

- **Currency Exchange**: Banks provide currency exchange services, allowing customers to buy and sell foreign currency for travel or business purposes.

CONCULSION

In [21]conclusion, start-ups have various options when it comes to funding, including own capital and bank financing. Using own capital, such as personal savings, can be a good option for founders who have a significant amount of savings or assets they can liquidate. This option allows founders to retain full control of their company and avoid taking on debt or diluting ownership. However, using own capital can also limit the amount of capital available for the business and can be risky if the business fails.

[22]Bank financing, on the other hand, can provide start-ups with access to significant amounts of capital and can be used to fund various aspects of the business, including equipment purchases, working capital, and expansion. However, bank financing also comes with interest payments and strict repayment terms, which can impact cash flow and restrict the company's ability to make other investments.

Ultimately, the choice between own capital and bank financing will depend on a variety of factors, including the start-up's financial situation, growth plans, and risk tolerance. It is important for start-ups to carefully evaluate all available options and seek advice from experienced professionals to make informed decisions about financing their business.

BRILLOPEDIA

[21]"The Lean Startup" by Eric Ries
[22]"Bank Management and Financial Services" by Peter Rose and Sylvia Hudgins