BIG BIO Researchers & Publishers
International Journal of Business and Management Sciences **E ISSN**: 2708 – 4337 **P ISSN:** 2708 – 4329
Available online at http://www.ijbms.org
International Journal of Business and Management Sciences
Volume 04 (02), 2023
Received, 25 May, 2023, *Revised 19 June, 2023,*
Accepted, 21 June, 2023, *Published Online, 30, June, 2023.*

CHALLENGES FACED BY STARTUPS IN ACCESSING EXTERNAL FINANCING

[1]*Marium Saleem,* [2]*Muhammad Atiq*

Keywords:
Startups,
Challenges,
External Funds,
Entrepreneurs,
Peshawar

ABSTRACT

A startup faces many types of challenges during its life cycle. Among all those challenges, access to external financing is the most robust and consistent challenge faced by entrepreneurs. Therefore, it is necessary to understand the challenges faced by startups in accessing external financing to increase the chances of their survival and the ability to generate profits as well. Hence, this study has been conducted to understand different challenges faced by startups in accessing external financing by using case study methodology. In-depth interviews were conducted with 20 startups in Peshawar region to understand the challenges from their viewpoint. The data were analyzed using a series of steps suggested by Creswell (2009) and Miles and Huberman (1994). As a result of the study, the main challenges identified by the startups include unrealistic requirements put forward by external funds providers such as demand for collateral, equity sharing, and huge returns on investments. These requirements can easily be satisfied by established businesses. However, it becomes difficult for startups to meet such criteria, which creates challenges for them in accessing external financing. These challenges are enhanced for startups operating in Peshawar region due to its comparatively less developed infrastructure and lack of opportunities. It implies that before reaching out to any potential source of external financing, startups must do prior research to understand its evaluation criteria to save time and resources. The external fund's providers must also design a separate evaluation criterion for startups rather than treating them like any other typical business.

INTRODUCTION

Startups face different challenges during each stage of their life cycle. It has been observed that during the early stage, one of the biggest problems faced by startups is acquiring financing. Ayyagari, Demirguc-Kunt, and Maksimovic (2008) also reported that among all

[1] *PhD Scholar, Institute of Management Sciences, Peshawar, Pakistan.* marium.saleem3622@gmail.com *(Corresponding Author)*
[2] *Assistant Professor, Institute of Management Sciences, Peshawar, Pakistan.* muhammad.atiq@imsciences.edu.pk

the obstacles faced by firms, financing constraints, crime, and policy instability have the most constraining effect on firm growth. They further argued that out of the three most constraining obstacles present in a business environment, the financial constraint was found to be the most robust and consistent one “regardless of which countries and firms are included in the sample” (p.484). The dilemma is that small firms that can provide more jobs and economic growth are provided with limited access to investment capital (Cowling et al. 2010). These firms are also more likely to fail as compared to the established companies (Stemler, 2013) because an established company has resources, power, scalability and established processes needed for the success of a business, which small firms generally lack (Weiblen and Chesbrough, 2015). That is why, startups must focus their efforts on securing the needed funds during earlier stages of development because access to financial resources is critical to the success of any entrepreneurial venture (Grilli, Mrkajic & Latifi, 2018). It plays a crucial role in the entry of firms into a market, especially small firms. It also affects the post-entry growth of small firms. Hence, it is necessary to have easy access to both private credit and stock markets for both smooth entry into the market and expansion later (Aghion, Fally & Scarpetta, 2007).

Despite the crucial importance of entrepreneurship in the growth of an economy, it is the least focused area of research especially in the developing countries (Lingelbach, De La Vina & Asel, 2005). Furthermore, among all the challenges faced by startups, the most robust and consistent constraint/challenge happens to be financial constraint (Ayyagari, Demirguc-Kunt, and Maksimovic, 2008). These financial constraints have a significant effect on both the survival and profit generation of a startup during its initial years (Stucki, 2013). Therefore, it is necessary to understand the dynamics of these financial constraints to increase the chances of survival of a startup and its ability to generate profits. Hence, this research has been conducted to move the field of entrepreneurial finance forward by exploring the challenges faced by startups in accessing external financing in context of a developing country.

LITERATURE REVIEW

There are many reasons due to which startups face challenges in accessing external funds. For example, Makena, Kubaison and Njati (2014) conducted a study on the factors hindering the ability of women entrepreneurs in accessing business finance in Kenya. They identified collateral as the major factor creating challenges for women entrepreneurs in accessing financing for their ventures. Similarly, lack of a prior track record is also considered a significant reason for the inability of startups in accessing external financing (Grilli et al.,

2018). That is why, during the creation phase, it becomes difficult for startups to obtain financing from banks (Mustapha & Tlaty, 2018). The problems enhance due to the unavailability of the information as only the entrepreneurs know about the real potential of their firms and this information is not available to the financiers, which results in the unavailability of the resources and funding for the small firms (Carpentier & Suret, 2006; Coleman & Robb, 2012).

However, the barrier created by information asymmetry can somewhat be counteracted by providing collateral to send a positive signal to the borrower (Binks & Ennew, 1995). However, according to Brierly (2001), technology-based firms are based on intellectual capital rather than tangible assets, which makes it difficult for investors to assess the true worth of these firms. Therefore, the lack of tangible assets, which can serve as collateral, also makes it difficult for them to access external funds (Astrebo & Simons, 2003). Even when these new technology-based firms succeed in accessing bank loans, the amount of loans is not enough to get their operations started at the desired level (Colombo & Grilli, 2007). Furthermore, the firms that are based on new technology have a higher risk of failure, which also hinders their ability to access external capital, especially from banks (Guidici & Paleari, 2000).

In addition to bank loans, entrepreneurs also rely on angel investors to access the investment they need. A business angel can be defined as a person, partnership, or corporation which provides its own funds to companies, especially early-stage companies (Hill & power, 2002). In entrepreneurial finance, angel investors come before venture capitalists and after family & friends (Mason & Harrison, 2000). They also earn more return on investment as compared to other informal investors including friends and family (Riding, 2008). However, angel investors also expect a return on their investment just like any other investor. As they take a high risk by investing in the early stages of the formation of an enterprise, therefore, they also expect a high return on their investment. However, they are different from typical investors in the sense that they not only provide money but also provide mentorship and advice to entrepreneurs. That is why, angel investors are the primary source of external financing for very young enterprises (Preston, 2007).

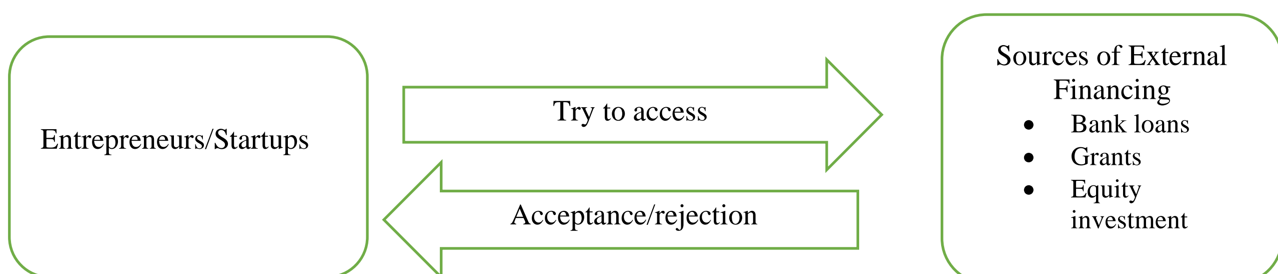
Other than bank loans and investments from angel investors, grants are also a major source of funding for startups. Grants are funds provided by the Government, charity, or trust. These are funds that are not to be paid back and entrepreneurs are not required to give up a share in equity in return for funds. Hence, these features make grants very attractive, which in turn

results in tough competition among entrepreneurs to secure the available grants (Nesta, 2019). They have a significant impact on a startup as they not only provide liquidity but also decrease opportunity costs (Butler, Galassi & Ruffo, 2016).

Theoretical underpinnings

The theoretical foundations of this research are based upon entrepreneurship ecosystem theory, which entails that entrepreneurial ecosystems are "a set of interdependent actors and factors coordinated in such a way that they enable productive entrepreneurship within a particular territory" (Stam & Spigel, 2016, p.1). The understanding of the phenomenon that entrepreneurial activities do not take place in isolation and require a well-established network of forces has shifted the attention of researchers from activities of individual entrepreneurs to the formation and sustainability of entrepreneurial ecosystems, which provides a well-connected network of social, economic, cultural, and legal forces to generate and promote entrepreneurial activities (Roundy, Brockman & Bradshaw, 2017). It has also been observed by many researchers that entrepreneurs do not identify or create opportunities without the support of an interconnected network of economic and cultural forces (Greve & Salaff, 2003). Hence, it can be safely proposed that the entrepreneurial activity of reaching out to potential sources of external financing also does not take place in isolation. Rather, the challenges encountered by entrepreneurs/startups during that process are affected by an interconnected network of various forces, embedded within an entrepreneurial ecosystem in which the startups operate. Hence, to understand the challenges faced by startups in accessing external sources of financing, it is necessary to understand it in relevance to the entrepreneurial ecosystem in which the startups operate.

The discussion presented above can be summarized in the form of a theoretical framework as shown in Figure 1 below:



METHODOLOGY

This study is qualitative in nature and has followed an inductive approach. The data was collected from 20 case startups via purposive sampling. Only those startups were selected for

this research that had already launched their products in the market and had gone/were ready to go through the process of accessing different sources of external financing. A qualitative multiple case study design was also selected (Stake, 1998) based on the nature of research questions, which required the process of accessing external financing to be explored from the perspective of multiple startups, which also serve to be rich cases (Patton, 2002). Primary data was collected via semi-structured interviews from the founders/co-founders of the case startups. The secondary information was collected from publicly available documents and websites of the case startups. The data analysis was conducted by applying a series of steps suggested by Creswell (2009) and Miles and Huberman (1994).

RESULTS & DISCUSSION

A detailed analysis of the interviews has been carried out. First, the interviews were transcribed to make sense of the data collected. After transcription, the coding process was initiated (Miles & Huberman, 1994). The codes assigned were both pre-determined, based on the extensive review of literature, and the emerging codes that were based upon the collected data. The primary themes were identified from the literature as well as the data collected from the respondents. All of them identify the challenges faced by startups in accessing external financing. Some of these challenges are pertinent to startups in general. However, a few challenges faced by startups are due to their geographical location i.e., Peshawar.

Theme 1: *Reluctance of financiers due to information asymmetry*

Literal analysis

The owners of small businesses have more information about the potential of their business while the external finance providers do not have such information. The small business owners cannot provide detailed information of their business to financiers as they think the information might get leaked and the competitors might get a hold of the information (Winborg & Landstrom, 2001). Consequently, it becomes difficult for the financiers to evaluate the potential of the business without adequate information about it, which results in difficulty in accessing external funds. Berger & Udell (1998) also contended that the available information about startup firms is opaque, therefore, they face difficulty in obtaining intermediated external finance. This information asymmetry leads to financial constraints, which affect the entry and post-entry growth of the firms (Cabral & Mata, 2003). It has also been observed that small firms are affected more by these financial constraints as compared to large firms (Beck at. al, 2004).

Respondent analysis

The startups selected for this study have also identified information asymmetry as one of the biggest hurdles in initiating and growing their ventures. A typical investor in KPK only understands the mainstream businesses involving physical products because they are more common. However, in case of technology-based startups, the investors hesitate to invest because they do not understand their business model. As the investors are unable to comprehend the business model, they prefer to invest in a venture they understand rather than exploring an unknown domain. As one of the respondents mentioned,

"*We wanted to get financing from angel investor or venture capitalist to scale up our business, but we failed. I also had 2, 3 other ideas but they had the same problem that the investors we have here, who want to invest or do partnership with you, do not understand a technical product. I also applied for a grant for two of my ideas, but I couldn't secure it either. The reason was the same that they could not pick up the idea in terms of how much is it scalable or how much is it beneficial for the society".*

Another respondent mentioned that,

"As I said before that if fund providers cannot understand the technicality of a startup so how they will be able to analyze its potential?"

Theme 2: *Unrealistic requirements*

Literal analysis

Many researchers have contended that the mistake made by most external funds providers is that they treat startups just like any other business, which is not justified. Hence, they require the startups to fulfill the same requirements as any other established business, which results in creating challenges for startups in accessing external financing. For example, to avail a bank loan, companies are required to pledge collateral (Gangata & Matavire, 2013). This condition can easily be satisfied by established companies with enough physical assets. However, many startups especially technology-based startups fail to fulfill this requirement as they do not have any physical asset that can be pledged as collateral (Astrebo & Bendet, 2003).

Similarly, just like banks loans, private investors also have certain requirements in return for their investment. These requirements include equity sharing and huge return on investments (Balen, Tarakci & Sood, 2019). Many startups fail to satisfy both requirements because (a) the entrepreneurs do not want to share equity with the investors due to fear of losing control over their venture (Berger & Udell, 1998) and (b) they cannot promise huge return on

investment due to the inherent risky nature of startups. Hence, these requirements make it difficult for startups to find suitable investors.

Respondent analysis

It has been discussed by many case startups that the main challenge they faced in accessing external financing was due to the unrealistic requirements of finance providers, which range from pledging collateral to demanding huge returns on investment. One of the respondents contended that,

"Banks could only provide me personal loan during the initial stages, but I had to scale my startup which was not possible through personal loans. For a business loan, banks look for your revenue streams and how successful your product is while startups do not generate revenue during initial 1, 2 years. So, bank loan was not an option here".

Another respondent asserted that,

"After utilizing the grant, I wanted to expand my business further, so I reached out to a couple of investors, but things did not work out because they were asking for a lot of equity in my business. The problem with our local investors is that they offer little investment in return for a large portion of equity in your business, which is not acceptable for the startups because if you give up a large portion of equity for one investor then less amount of shares will be left to offer to other investors at later stages of your startup".

Theme 3: *Geographical location*

In addition to the above challenges that are faced by startups in general, there are some other challenges faced by startups in Peshawar due to their location. For example, as explained by many case startups, grants are an important source of external financing for startups and the most common way to access grant providers is through startup competitions and seminars. However, most of these big events are arranged in other provincial capitals of Pakistan due to their more reliable law & order situation and developed infrastructure as compared to Peshawar. The founder of one of the case startups also contended that,

"The other ecosystems are better than ours because in Pakistan every new opportunity reaches Peshawar after trickling down from other markets. These opportunities will first be offered to the students of LUMS, IBA and NUST, after which if anything is left then it will be directed towards Peshawar. The important things that a start-up requires are proper guidance, working space and developers and all these things are present in descending order from markets like Karachi, Lahore, Islamabad and then Peshawar".

Another respondent explained the reasons due to which Peshawar lags behind other major cities in Pakistan in terms of conducive environment for development of startups. He explained that,

"Yes, it lags behind other bigger cities of Pakistan like Karachi and Lahore in terms of infrastructure and law & order situation".

Theme 4: ***Finding the right investor***

Some of the startups have also asserted that one of the biggest challenges faced by them is finding the right investor. For example, some of the investors they came across did not understand the nature of startups or the concept of technology/ e-commerce while others did not have the same vision for the startup as the founders/co-founders had. Hence, despite receiving the investment offers, they did not accept those offers because the investors did not have the characteristics that they were looking for. As one of the startups' co-founders contended that,

"One of the biggest challenges faced by any startup is finding the right kind of investor as every investor does not understand the nature of your startup. For example, my startup is based on R&D which requires a lot of investment to improve your product because you need to develop the prototype and then test it again and again. Our typical investor does not understand this, so it becomes difficult to convince them for an investment".

Another co-founder also shared that,

"We got 3 offers from angel investors but we declined them all because we were not comfortable with the investors. It's not only about getting an investment; the investors should also have characteristics which we are looking for. So, without finding the right investor I won't be willing to take the investment".

CONCLUSION

Startups in Peshawar face many challenges in accessing external financing due to multiple reasons, which range from unrealistic criteria of financial institutions to the inability to find the right investor. One of the main reasons for these challenges is that the financial institutions such as banks expect the startups to meet the same requirements as established businesses. For example, startups are required to pledge collateral to access bank loans, which is not feasible for every startup as most of them are technology based and have very few physical assets. The private investors also require startups to offer huge returns on investment along with equity sharing, which is not possible for every startup. Such criteria and demands demonstrate two things: (1) they have not been made by keeping startups and

their needs in mind (2) both financial institutions and private investors do not understand the basic nature of startups and their inherent uncertainties. Hence, many startups face financial exclusion due to their inability to access external financing.

These challenges are enhanced for the startups operating in Peshawar region because the entrepreneurial ecosystem of Peshawar is less developed as compared to other entrepreneurial ecosystems in Pakistan. It might be due to the geographical location of Peshawar and its comparatively unstable law and order situation. This is the reason that most of the startup competitions and seminars are arranged in other provincial capitals of Pakistan such as Lahore, Islamabad, and Karachi. These events also invite grants managers, venture capitalists and investors, and serve as an important platform to connect financiers with startups. As such events are rarely arranged in Peshawar, therefore, the startups in other provincial capitals of Pakistan get more opportunities to connect with potential sources of financing as compared to the startups in Peshawar.

Limitations and Recommendations

The scope of this study is limited to the perspectives and experiences of entrepreneurs/founders of startups about the challenges in their surroundings in accessing external financing. The perspectives of finance providers such as bank managers, grant managers, and private/angel investors have not been explored. Future researchers can explore the perspective of external finance providers to know whether their perceptions align with that of entrepreneurs and what measures can be taken to bridge the gap between their worldviews. Additionally, a comparative case study can also be conducted between a developed and developing entrepreneurial ecosystem within Pakistan to explore the differences and how those differences can be dealt with.

REFERENCES

Aghion, P., Fally, T., & Scarpetta, S. (2007). Credit constraints as a barrier to the entry and post-entry growth of firms. *Economic Policy*, *22*(52), 732-779.

Astrebo, T., & Simons, K. L. (2003). Innovation exit: why entrepreneurs pull the plug on their innovations, mimeo, Department of Management Sciences, University of Waterloo, Canada.

Ayyagari, M., Demirgüç-Kunt, A., & Maksimovic, V. (2008). How important are financing constraints? The role of finance in the business environment. *The World Bank Economic Review*, *22*(3), 483-516.

Balen, T., Tarakci, M., & Sood, A. (2019). Do disruptive visions pay off? The impact of disruptive entrepreneurial visions on venture funding. *Journal of Management Studies*, *56*(2), 303-342.

Berger, A. N., & Udell, G. F. (1998). The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle. *Journal of banking & finance*, *22*(6-8), 613-673.

Butler, I., Galassi, G., & Ruffo, H. (2016). Public funding for startups in Argentina: An impact evaluation. *Small Business Economics*, *46*(2), 295-309.

Cabral, L., & Mata, J. (2003). On the evolution of the firm size distribution: Facts and theory. *American Economic Review*, *93*(4), 1075-1090.

Carpentier, C., & Suret, J. M. (2006). Some evidence of the external financing costs of new technology-based firms in Canada. *Venture Capital, 8*(3), 227-252.

Coleman, S., & Robb, A. (2012). Capital structure theory and new technology firms: Is there a match?. *Management Research Review*, *35*(2), 106-120.

Gangata, K., & Matavire, E. H. M. (2013). Challenges facing SMEs in accessing finance from financial institutions: The case of Bulawayo, Zimbabwe. *International Journal of Applied Research and Studies*, *2*(7), 1-10.

Greve, A., & Salaff, J. W. (2003). Social networks and entrepreneurship. *Entrepreneurship Theory and Practice*, *28*(1), 1-22.

Grilli, L., Mrkajic, B., & Latifi, G. (2018). Venture capital in Europe: Social capital, formal institutions and mediation effects. *Small Business Economics, 51*(2), 393-410.

Haltiwanger, J., Jarmin, R. S., & Miranda, J. (2013). Who creates jobs? Small versus large versus young. *Review of Economics and Statistics*, *95*(2), 347-361.

Lingelbach, D. C., De La Vina, L., & Asel, P. (2005). What's distinctive about growth-oriented entrepreneurship in developing countries? *UTSA College of Business Center for Global Entrepreneurship Working Paper*, (1).

Makena, P., Kubaison, S. T., & Njati, C. I. (2014). Challenges facing women entrepreneurs in accessing business finance in Kenya: Case of Ruiru Township, Kiambu County. *Journal of Business and Management*, *16*(4), 83-91.

Miles, M. B., & Huberman, A. M. (1994). *Qualitative data analysis: An expanded sourcebook*. (2nd ed.). Thousand Oaks, CA: Sage.

Mustapha, A., & Tlaty, J. (2018). The entrepreneurial finance and the issue of funding startup companies. *European Scientific Journal*, *14*(13), 268-279.

Nesta. (2019). *Paths to Scale: Finance lessons from European entrepreneurs*. https://media.nesta.org.uk/documents/Nesta_scaling_stories_Online_v5_1.pdf

Patton, M. Q. (2002). *Qualitative research and evaluation methods*. Thousand Oaks, CA: Sage.

Roundy, P. T., Brockman, B. K., & Bradshaw, M. (2017). The resilience of entrepreneurial ecosystems. *Journal of Business Venturing Insights*, *8*, 99-104.

Stake, R., E. (1998) Case studies IN: Denzin, N. K., & Lincoln, Y. S. (2008). *Strategies of qualitative inquiry* (Vol. 2). Thousand Oaks: Sage Publications, 86- 109.

Stemler, A.R. (2013). The JOBS act and crowdfunding: harnessing the power and money of the masses. *Business Horizons*, *56* (3), pp. 271-275.

Tsai, S. D., & Lan, T. T. (2006). Development of a startup business—A complexity theory perspective. *National Sun Yat-Sen University, Kaohsiung, Taiwan*.

Weiblen, T., & Chesbrough, H. W. (2015). Engaging with startups to enhance corporate innovation. *California management review*, *57*(2), 66-90.

Winborg, J., & Landström, H. (2001). Financial bootstrapping in small businesses: Examining small business managers' resource acquisition behaviors. *Journal of Business Venturing*, *16*(3), 235-254.