Analyzing the key determinants of Investment decisions while setting up an entrepreneurial business in the United Kingdom

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Abstract

Start-ups are essential in developing products in the United Kingdom's economy by stimulating modernization and robust competition (Dr. Achibane & Jamal, 2018). *Notwithstanding start-ups' vast influence on British economic development, several challenges are coercing these promising ventures. Nearly 40% of UK start-up ventures fail due to obstacles regarding raising new capital in the seed stage* (Philips, 2019).

The capability to access finance is significant for a start-up regarding starting investment for the business, increasing growth development, and smoothing day-to-day business activities related to cash (Andreas Kuckertz, et al., 2020). This study will also focus on understanding the major constraints faced by entrepreneurial ventures in the United Kingdom while accessing the capital market during the starting phase. The starting stage of a firm refers to the pre-commercialization stage when there is no product to commercialize. In this stage business idea is tested for its viability. Capital needs to channel Research and Development, conduct market research, expand the efficient team, and so on (Hisrich, 2013). *Therefore, this study aims to find out the important determinants of investment decisions during the starting stage of UK ventures.*

To conduct the research, data were collected by using primary and secondary sources. To gain primary data researcher used an online closed-ended questionnaire. The questionnaires were distributed to the innovators from the London region via emails or social media platforms. The convenience sampling technique was used to reach these 70 innovators, but 50 responses were received from those respondents.

Findings show that most of the respondents identified that the majority of the lenders asked for business plans, guarantors, and professionally audited financial reports which are not easy to generate at the start-up stage by the entrepreneurs.

Introduction

Research context

A start-up is a venture started by an entrepreneur. With a start-up, an entrepreneur wants to pursue a successful business model (Baldridge & Curry, 2022). Start-up plays a significant role in the growth of an economy (Gulati, 2019). Start-ups are not the only providers of economic opportunities, they are also creators of employment and unique products and services that are in latent demand by customers, contributors to GDP, and so on (Cohan, 2019). However, a deficiency of funding can coerce regular business activities and hinder the further development of business (Otte, 2022). There are several obstacles faced by an entrepreneur while starting a new venture; the major challenge faced by entrepreneurs is accessing funds in the early phase of their ventures. Approximately 52% of start-ups fail within three years of starting due to running out of funds in the UK (Szmigiera, 2021). Though the chance of using external funding is vital in the initial stage, more than half of the ventures cannot use traditional sources of external finance due to inadequate collateral, unsatisfactory cash flows, and colossal information irregularity with external investors (Cosh, et al., 2009).

New ventures usually receive external funding in their development stage. Ample research has been done on start-up financing in later stages, however, very few studies have been conducted on the starting stage financing of firms. The field of study on initial period ventures is somewhat abstruse, the subject is lacking in academic studies. Therefore, this study aims to find out the important determinants of investment decisions during the starting phase of UK ventures.

1. 2 Research aim, question, and objectives

The core aim of this study is to 'identify the details that create obstacles for newly created British ventures to utilize different types of finance during their starting stage'.

Several questions are vital to be responded to while pursuing this particular research. However, there is only one question this study needs to answer. This is in the following:

- What are the major constraints the start-ups face while wanting to use external capital sources during the early stage in the UK?

The answer to this question will help new firms specifically the seed stage firms by providing information regarding sources of external finance, constraints connected with retrieving external money, and some suggested preparations they can follow to raise the chances of getting external funding.

To achieve the aim of the research the study also considers some objectives. These are as follows:

1. to explain the need for external capital during the starting stage and available sources an entrepreneur can use during the initial stage in the UK.
2. to use earlier theories to relate the connection between a firm's capital structure and key obstacles they faced in the early phase while wanting to access external finance.
3. to investigate the key determinant that prevents firms from accessing finance sources during the starting phase in the UK.

Literature Review

2.1 Introduction:

This section provides a brief description regarding the uses of capital and sources of funds in the starting phase for the entrepreneurial business, some key theories to investigate how entrepreneurs face challenges during the starting of the start-ups, and research gaps are also presented. Finally, a summary will conclude this section.

2. 2 Uses of capital and sources of finance during start-up

Most entrepreneurial ventures need to raise money in the preliminary stage for three reasons (Barringer & Ireland, 2021). Firstly, cash flow issues such as training employees, establishing a brand, and so on (Tore Frimanslund, et al., 2023). Here company is generating negative cash flow which indicates it spends capital before making a profit. Negative cash flow can be justified early in a company's life but can cause serious problems later. Businesses usually fail if they spend all their capital before making a profit. As a result, inadequate financial resources are a significant cause of new business failures (BURNS, 2022).

Secondly, fixed investment where businesses often need early financing to fund their capital expenditures. The company's founders may be able to support the initial activities. Still, they may be required to purchase land, construct buildings, acquire machinery, or finance other assets (Janaji, et al., 2021). Finally, long product development cycles where companies in some industries need to raise money to cover the initial costs of a longer product development cycle. For example, developing an electronic game usually takes two to four years. It takes ten years to reach a patient from a laboratory in the pharmaceutical industry. This turtle-paced product development requires a significant initial investment to get the expected return (David, 2017).

According to Wilson and Silva (2014), at the different stages of the financing cycle, there are three sources of financing instruments: 1) equity sources, 2) grants, loans, and guarantees, and 3) debt sources (Karen E. Wilson & Filipe Silva, 2014).

To begin with, equity sources of finance are getting finance from bootstrapping, crowdfunding, business angels, and venture capital. Financial bootstrap is one of the funding sources for start-ups; Bhide first coined the term in 1992, where it permits the generation of a business with limited capital. Horváth (2018), Identifies bootstrap as a source where starting capital can be obtained from customers, internal business optimization, external lenders, business partners, owners, friends and families, suppliers, and employees. Crowdfunding is defined as the online collection of funds from many people. The users of this platform typically deliver trivial sums to permit the venture to be comprehended or an opening start-up to collect maiden funding (Herve & Schwienbacher, 2018). According to Block et al. (2019), business angels are people who invest capital in a completely new business with no family connection. Business angels perform four different value-added roles: premeditated role, management role, capital-gaining role, and mentoring role. Many authors agree that venture capital plays an important role in addressing the asymmetric information challenge because due conscientiousness allows them to observe and control the actions of companies (European Investment Fund, 2018).

Besides, several entrepreneurial firms are qualified for government grants in the first phase, particularly those based on cutting-edge research, including university research. Most developed states back private research and development through aid or tax breaks to confirm the optimum distribution of resources for entrepreneurs. These strategies aim to inspire investment in new business, particularly in high-capital-intensive areas such as potential new ventures (Szulczewska-Remi & Foltynowicz, 2016).

Finally, bank finance is considered the most available source of debt finance used by start-ups as external capital (Stuart Fraser, et al., 2015). There are growing academic suggestions that bank funding is an important source of financing for numerous entrepreneurial businesses. Firstly, bank loans eradicate the problem of unequal information between the lenders and the entrepreneur by transferring all investment risk to the borrower (Durkin, et al., 2013). As a result, if the innovation fails, the loan agreement requires settlement of the acquired obligations. Second, banks protect these loans with imperceptible properties such as intellectual property (IP), which can become sources of collateral and thus aid as an advantage in the procurement of finance (Mateos-Garcia, 2014).

2. 3 Key theories to investigate issues faced by innovators

Capital structure theory (Modigliani, F & Miller, M.H, 1958), pecking order theory (Myers & Majluf, 1984), and life cycle theory (Berger & Udell, 1998) accept that entrepreneurs face constraints in accessing external finance. They accept Informational asymmetries create barriers in the case of new firms to get funding like greater publicly traded companies. Small businesses naturally do not have the choice of distributing shares and bonds since the expenses are unaffordable for new businesses at the opening stage. These smaller firms are more likely to rely on other financial sources, such as personal loans, bank debt, trade credit, capital from private stakeholders, venture finance, and, in some cases, government grants. Usually, there is a "pecking order" of sources of financing designed to allow the owner of the businesses to hold as much control as possible for a longer time. These theories indicate owners of the firms desire to use personal capital first, followed by short-term loans, long-term finance, and exterior equity.

Agency theory relates to how lenders approach new ventures (Jensen & Meckling, 1976). A new venture has no defined track record, and the financier has little information on borrowers to base their financing decision. The information on borrowers that is provided to the lenders may not be trustworthy or relevant to making the financing decision (Cheng Huang, et al., 2014). This means that the financier must incur additional costs in obtaining and verifying the information required to make and then monitor their decision. Many of these expenses are fixed, regardless of the size of the transaction or the return made by the small firm. According to agency theory, a bank's natural response to these problems is to charge higher interest rates, impose conditions in the loan agreement (e.g., on the use of funds or the provision of information), and request business or personal collateral. When adequate collateral is available, the bank may believe that less information is required because the debt is more likely to be improved in the event of default. Indeed, the bank may believe that providing collateral provides the entrepreneur with a strong incentive to see the business succeed (BURNS, 2022).

Studies by Maditinos, et al. (2019) and Guenzel and Malmendier (2020) say the locus of control means people's(owner's) insight into their control over the business. In the case of startups, if the owners do not want to share the ownership or any control with other people then attaining any sources of external finance cannot be possible. Several studies by Sarasvathy (2001); McMullen & Shepherd (2006); and Garrett & Holland (2015) confirm that uncertainty is one of the most common things in an entrepreneur's character. However, external lenders, want to secure their investment, hence, want to avoid uncertainty (Nguyen, et al., 2006). Risk can be measured but uncertainty cannot be calculated to take measured steps to reduce damage. That's why they do not want to invest in the most promising businesses of entrepreneurs trying to use their savings (Beck, 2007).

2. 4 Research Gap

This study identified several research gaps in this literature review, which should be highlighted here. Firstly, there is a large amount of research conducted regarding financial constraints faced by start-up entrepreneurs, or SMEs in the capital market, but there is relatively little research done on addressing financial constraints faced by start-ups during the early stage of their financial life cycle. Additionally, uncertainty is one of the most pronounced words related to entrepreneurial attributes and works; however, there has hardly been any research conducted on addressing future uncertainty related to start-ups and its owners faced major barriers to accessing finance in the capital market during the starting stage because financial organizations or investors are unable to measure uncertainty. Moreover, the study is conducted on UK ventures; nevertheless, no survey data has been found that can estimate how many new firms face this financial constraint because there is no record related to addressing this particular issue. Finally, it has been discovered that measuring the performance of start-ups in the initial stage is difficult.

2.5 Summary

The current study seeks to identify the most important firm-specific factors influencing start-up financing in the initial stage. The study's goal is to determine the significance of firm-specific factors and how these factors influence firms' financing decisions. Information asymmetry, low collateral quality, opposing personality traits of the entrepreneur, uncertainty related to entrepreneur and start-up attributes, and high cost of capital were studied as variables affecting firm control. The analysis investigates the significant firm-specific factors that influence a firm's financing decisions in the starting stage.

Research Methodology

3.1 Introduction:

This section will explore the brief information concerning the process of conveying research philosophy and research approach. The research design methods that is data collection, and analysis strategy are discussed here.

3.2 Research Philosophy and Research Approach

The research onion invented by Saunders (2019), will be followed for the different steps of the study because the research title considers the constraints of UK ventures to access capital markets in the early stage.

To conduct the study the suitable researcher philosophy is positivism since research is objective. The study considers the specific situation that the key determinants that prevent access to external funding for the start-ups of the UK during the seed stage. Besides, the researcher used the research hypothesis to conduct the study and used an Internet questionnaire to collect primary data where the respondents selected suitable answers that were predetermined by the researcher. In this way, the researcher ensures that she/he does not stimulate the reactions given by the respondents.

A deductive research approach will be used for the study. The research used research hypotheses to get the most appropriate reasons that are accountable for funding limitations to the innovators at the starting period in the United Kingdom. An internet questionnaire is used as a research strategy to collect data from the targeted population to test the hypothesis.

3. 3 Data Collection

To conduct the study data were collected by using primary and secondary sources. To gain primary data researcher used an online closed-ended questionnaire. The questionnaires were distributed to the innovators via emails or social media platforms so that data were collected directly from the innovators and analyzed to answer the research questions. There are two sections in the questionnaire. The first part contains general information about the innovators and their start-ups such as the names of the respondents and their businesses, the age of the business, the nature and types of business, and so on. The second part covers questions regarding the funding problems that are handled by entrepreneurs during the starting period of their businesses such as whether they applied for loans from any banks or non-bank-financial organizations or not, if the respondents were rejected for any loans, why they were rejected by the lenders, and so on. To conduct the study the targeted population was 70. To reach this target population investigator used an online closed-ended questionnaire. The convenience sampling technique was used to reach these 70 innovators. Questionnaires were distributed through emails and social media platforms and 50 responses were received from the respondents.

To conduct the study secondary data were collected from some institutional publications, different literature reviews, academic journal articles, and so on. Several books and Internet sources like Google Scholar, Emerald, and EBSCO were used to gather some academic knowledge regarding start-ups, entrepreneurial finance, influential factors that prevent access to capital for new start-ups, and so on.

3. 4 Data Analysis

After collecting data, the next step was to analyze the data, which indicates that collected data are carefully posted in words (Sekaran & Bougie, 2020). To analyze the data a quantitative descriptive data analysis method is used to identify the main barriers to access finance for the start-up in starting their business in the UK. The researcher used a closed-ended questionnaire to collect data from the innovators. The researcher used a Google form to build the questionnaire which has two sections. All the responses that are submitted using Google Forms are analyzed through MS Excel, which is transformed through graphs and charts, to produce the final result.

Presentation, Analysis, and Discussion of Data:

4.1 Introduction

To conduct the study the primary data is collected by using a questionnaire. The target population was 70 entrepreneurs and questionnaires were distributed via email and social media platforms. We get responses from 50 respondents. The presentation analysis and key discussion of the responses regarding financing obstacles in the preliminary phase of entrepreneurial businesses are presented here.

4.2 Basic Features of the Respondents:

There are two sections of the questionnaire section A contains general questions such as gender, nature and kind of businesses, and age of the businesses. The key features of the respondents are given below:

Gender

We got a total of 50 respondents, 38 (76%) male and 12 (24%) female respondents. According to the British Business Bank (2023) report, approximately 25% of entrepreneurs in the UK are female, and most of them are related to the service sector. A smaller number of Female entrepreneurs are prepared to take risks and utilize outside funding because they are more worried about uncertainty regarding start-ups in the approaching future (BVA BDRC, 2022).

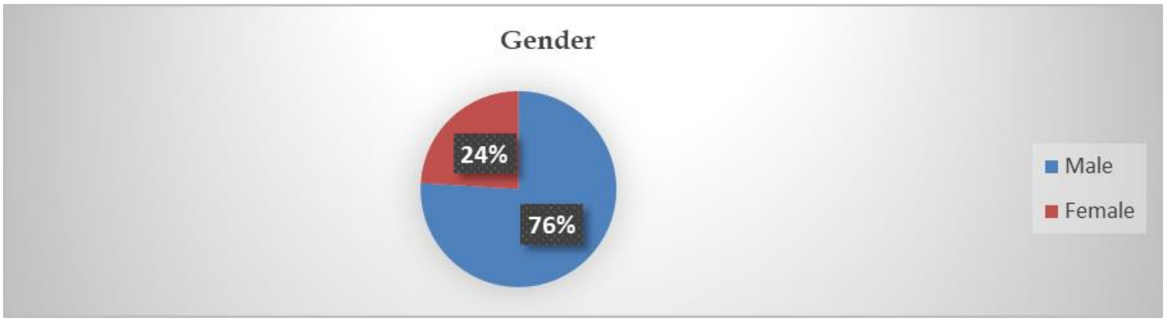

Figure 1: Forms of Respondents.

Nature of Business:

The below chart describes the respondent's nature of business where the major number of entrepreneurs are sole proprietors which is 74% of the total sample amount. 5 respondents have family-owned businesses. Partnerships, Private Limited Companies, and others have 5, 5, and 1 respondent, respectively. However, there are no respondents from Public Limited Companies.

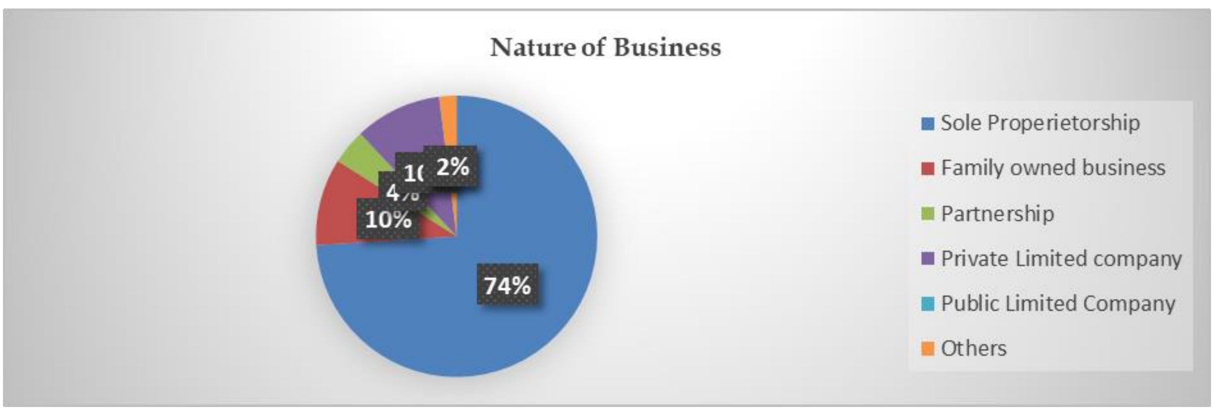

Figure 2: Nature of Business.

Types of Business:

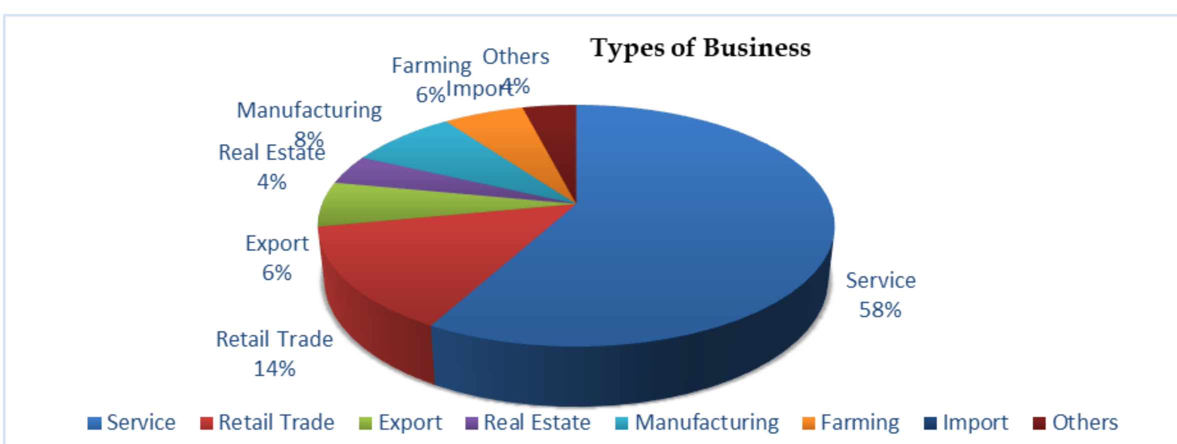

Figure 3: Types of Business.

The above figure shows the type of businesses, more respondents are from the service sector comprising almost 58% which is 29 innovators and retail trade has the second highest respondent 7 entrepreneurs which is 14%. We get 3 (6%) responses from export, 2 (4%) from real estate, 4 (8%) from manufacturing, 3 (6%) from farming, and 2 (4%) from other sectors. However, there are no samples from the import business.

Age of Business:

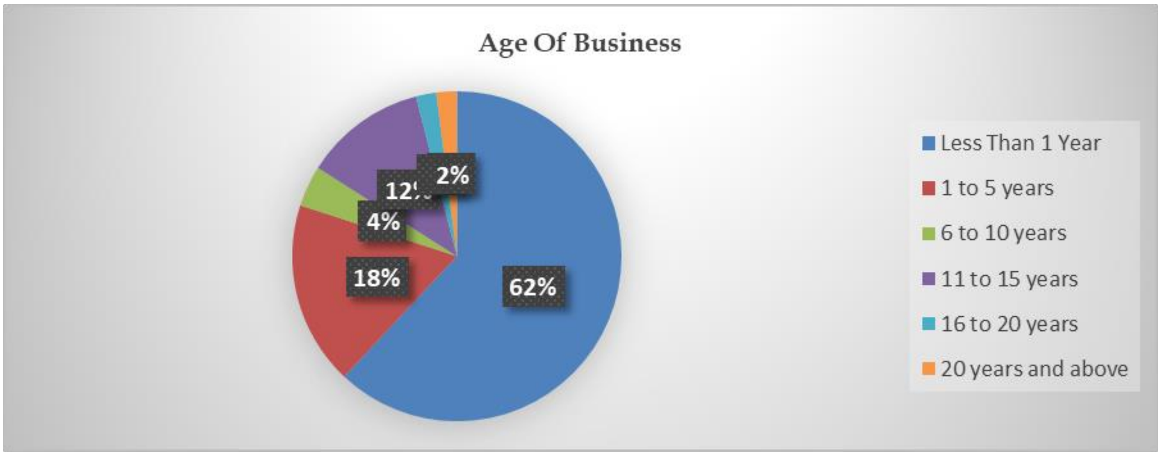

Figure 4: Age of Business.

From this pie chart, we can see that most of the respondents have newly established businesses which is approximately 62% (31). This situation indicates that in the UK entrepreneurs are encouraged to start their businesses (GEM, 2023). However, respondents from 1 to 5 years old 9 representing 18% of the total sample prove the assumption that most of the start-ups are wiped out within this time frame (Hulme & Chris, 2020). In addition, start-ups that are 6 to 15 years old account for 6 respondents. We got responses from 6 to 10 years, 16-20 years, and 20 years old and above are 2, 1, and 1 respectively.

In 2022, In the UK there were approximately 350,000 start-ups were wiped out and around 300,000 businesses started their journey. Even with government assistance to reduce COVID-19 impact, innovators experienced hardship with a higher cost of capital, inadequate funding, and a global economic crisis (GEM, 2023).

4.3 Key determinants in accessing finance for entrepreneurial businesses during the starting period:

Section B covers questions regarding the key factors that make problems for the respondents to utilize finance during the starting period of their businesses. The researcher asked the respondents if they applied for loans from any banks or non-bank-financial organizations or not, if the respondents were rejected for any loans, why they were rejected by the lenders, what are the requirements of the lenders to get loan approval, and so on. The findings from the respondents are given below:

Sources of funds:

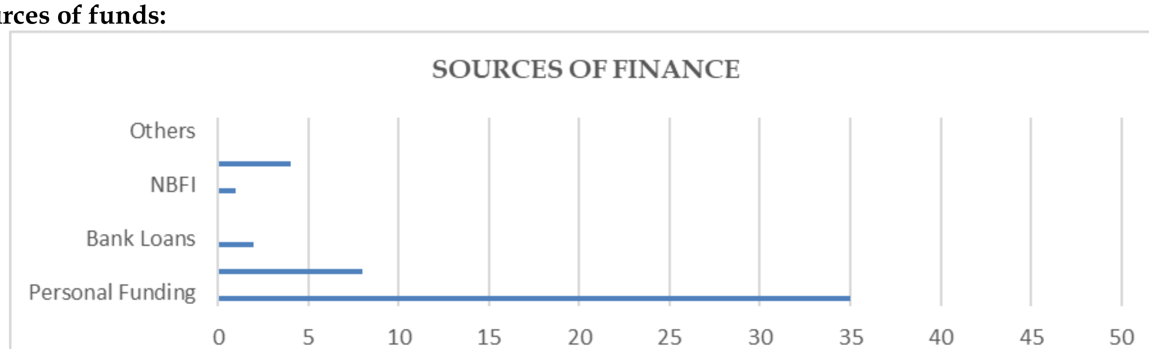

Figure 5: Sources of finance for the start-up.

The above picture shows, that more than 80% of the respondents preferred to use personal saving/ funding and finance from family and friends to start their businesses in Britain. Only 2% use Non-Bank-Financial-Institutions (NBFI) to get funding to start their businesses. 4% and 8% of innovators use bank finance and trade credit to start their businesses.

Seeking loan to finance businesses initially:

After that researcher asked the respondents are they applied for any loans to support their business finances initially. The below picture shows only 22% of respondents are seeking loans from banks and the majority of the respondents (78%) have not applied for any type of loan from any bank.

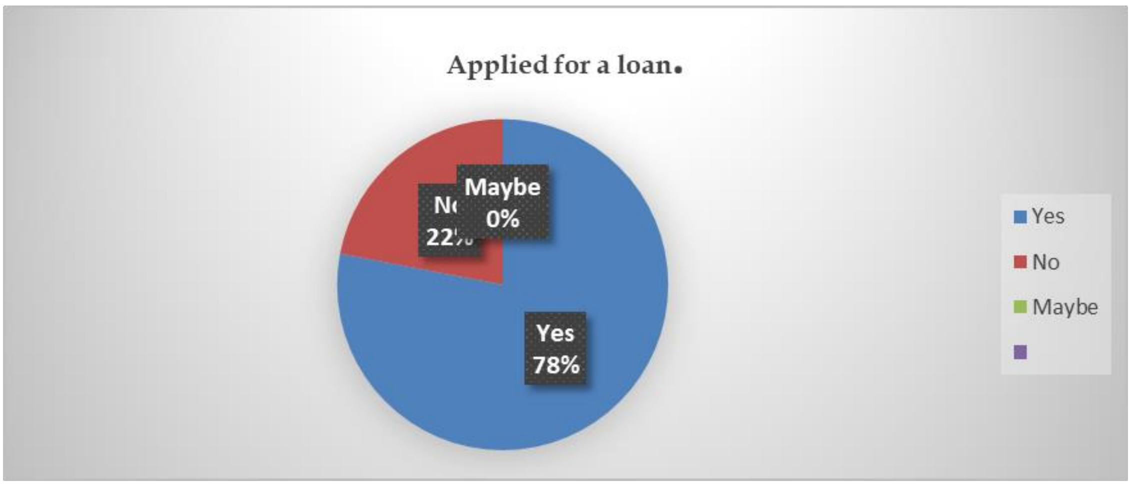

Figure 6: Applied for a loan.

Factors to not interested in any loan:

The pie chart 7 shows the prime motives of the respondents for not applying for any loans, where almost 30% of the respondents are not interested in loans and almost 40% say the high cost of capital is the most important barrier to seeking loans. Again, 26% feel because of poor collateral quality they cannot get any loan. 2% of respondents say gender discrimination and 2% say other causes will be accountable for not applying for any loans.

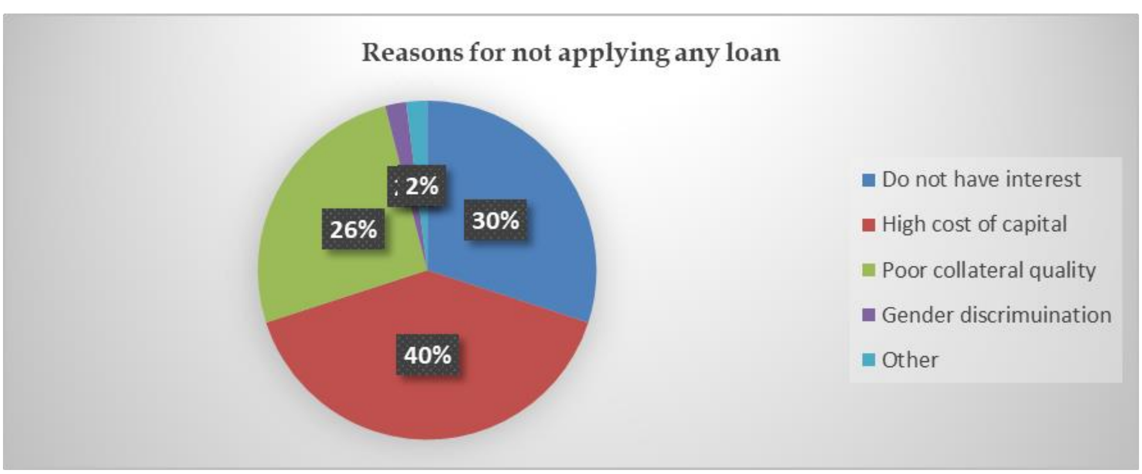

Figure 7: Reasons for not applying for any loan.

Reasons for loan denying:

Respondents are asked to identify the key causes for denying loans by different banks and non-bank financial organizations. The majority of the respondents identify too small equity (8), inadequate collateral (15), and insufficient mortgage property (14) are the three key causes for the rejection of the loans.

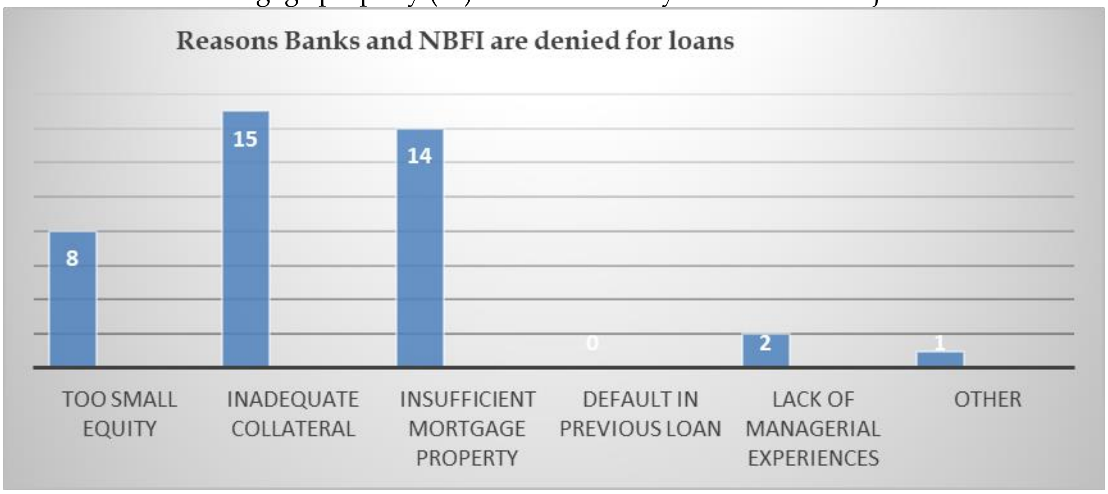

Figure 8: Reasons for banks and NBFIs denying to offer of loans.

Information or papers required for loan approval by the lenders:

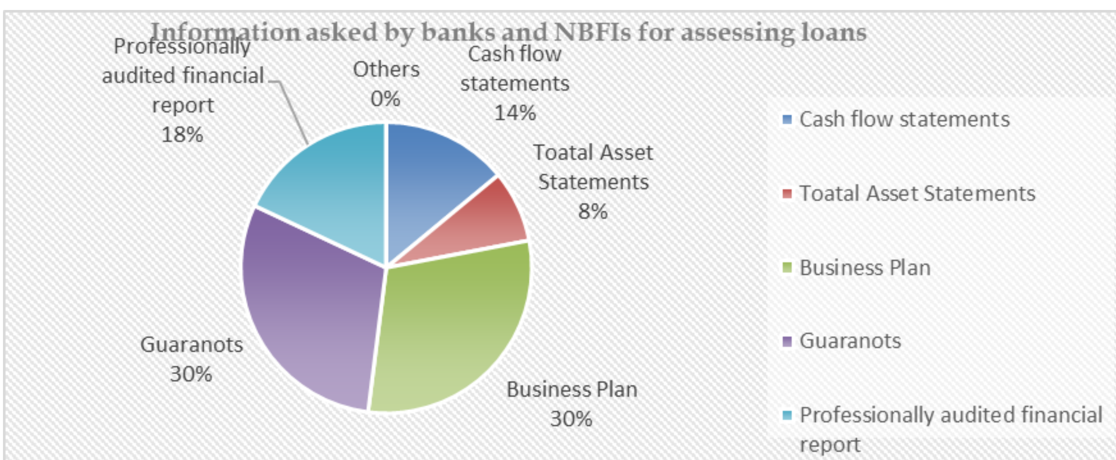

Figure 9: Information asked by banks and NBFIs for assessing loans.

From the chart we can see, the information that banks and non-bank-financial- institutions need to assess the start-up loans. Here, the majority of the respondents identified that most of the lenders asked for business plans (30%), guarantors (30%), and professionally audited financial reports (18%). However, some of the respondents identified that they need to show cash flow statements and total asset statements.

After analyzing responses from the respondents, the researcher found some aspects that create barriers for the United Kingdom's entrepreneurs to access finance in the starting phase. Firstly, The UK Entrepreneurs are in the starting phase, they do not have something in hand to commercialize and there is a lack of collateral such as poor quality of business-related papers, and goodwill in the market has not been proven yet (Sandra, et al., 2000). In most cases, innovators do not have professionally audited financial statements such as cash flow statements, profit and loss statements and so on which increases information asymmetry that makes external lenders uncomfortable regarding lending loans for the start-ups (Dr. Achibane & Jamal, 2018). Additionally, the lenders think the business is still unproven, no track record or financial statements are associated with the seed stage ventures which means the creditworthiness of the borrowers is yet to be proven which increases the chances of loan default in the future and creditors increase the cost of capital so that borrowers do not want the external loan

(Maximilian Klein, et al., 2019). Moreover, entrepreneurs who possess personality traits such as optimism and overconfidence may think that their debt guarantees will be undervalued by external lenders which results in preferring crowdsourcing, personal savings, or family and friends over external sources of finance (Susan, et al., 2023). Again, the locus of control means people's(owner's) insight into their control over the business. In the case of start-ups, if the owners do not want to share the ownership or any control with other people then attaining any sources of external finance cannot be possible. However, all entrepreneurial process is related to uncertainty whether the entrepreneur's the opportunity to search for something new character or start their business for totally unproven products or markets (Roach, et al., 2016), external lenders, want to secure their investment hence, want to avoid uncertainty (Nguyen, et al., 2006). Risk can be measured but uncertainty cannot be calculated to take measured steps to reduce damage. That's why they do not want to invest in the most promising proposal of an entrepreneur or entrepreneurs trying to use their savings (Beck, 2007).

4.4 Summary

To conclude, this section says start-ups prefer to access internal sources of capital over external sources of capital. On the other hand, institutional investors are external investors who prefer to invest mostly in risk and uncertainty-free projects that confirm the security of their investments. Information asymmetry, poor collateral, opposing personality traits of the entrepreneurs, higher cost of capital, and uncertainty are the key obstacles for the preparatory stage venture to get access to required funding in the UK.

Conclusion

The start-up is an auspicious sector for the United Kingdom regarding job creation, economic development, and so on. However, this sector is confronted with enormous problems to exist in the early stage due to inadequate capital. Sometimes most potential proposal has to be wiped out because of restrictions on attaining external finance. Several reasons are liable to make financial constraints such as initial age, small size, gender, regional disparity, low demand by the owners, and fear of rejection but, this study finds out the most suitable determinant regarding financial constraints. These are information asymmetry, poor collateral, high cost of capital, and some personal characteristics of the entrepreneurs such as locus of control and uncertainty related to the entrepreneur's character. These are the key factors for both the lenders and the creditors to initiate either not choosing external sources of capital or proposing restricted terms to create credit rationing.

5.1 Recommendation

The novice entrepreneurs that need finance must have to follow some strategy to overcome the probable barriers to attain the sources of capital. the subsequent strategies are suggested:

- New entrepreneurs must be well-informed about institutional lending. This ensures information is available for different loans and novice entrepreneurs can determine the best possible option for them. In the case of the UK, the country is occupied with a bank-based system. Consequently, the banks of the UK have to ensure a developed deal of information that makes it easy for the customer to access more information regarding the requirements of the loan, and processing time. The customer will be directly instructed potential loan will be guaranteed or not.
- Banks and owners of the start-ups should maintain a good connection that will assist in decreasing the chances of trust issues, information asymmetry, adverse selections, and moral hazard problems.
- Capital structure theories must consider the particular situations related to the macro environment of the new businesses. This will support the nascent entrepreneur in picking exact capital forecasting and institutions can be able to know which entrepreneurs have more probability of attaining a loan.
- The local representatives and lending institutions may help new entrepreneurs. They may hire some skilled specialists. The specialist can give free consultancy regarding the entrepreneur's proposals, risks, assessment of the projects, credit retrieval, and so on.

- The policymakers can ensure a guarantee for the new entrepreneurs to get the required funding if the projects look more promising or have high growth potential.

5.2 Limitation:

The study was conducted to investigate the major reasons for the financial barriers handled by innovators in the United Kingdom during the starting phase of their businesses. However, samples were not across the country but mainly focussed on London, Birmingham, Manchester, and a few other key regions used to collect a convenience sample that represents the whole population of the research. Therefore, this is a limitation of the research.

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