COMPARING INITIAL FINANCING FORMS TO DETERMINE THE EFFECTS ON NEW VENTURE PERFORMANCE (SUMMARY)

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Financial capital is one of the fundamental resources needed to start and operate a firm (Cooper, Gimeno-Gasco, Woo, 1994), and is a main factor in the performance of new firms (e.g. Cressy, 2006; Parker & Van Praag, 2006). Many founders have to look externally for financial capital as they are personally constrained financially when trying to start and operate their firms due to a lack of personal wealth (e.g. Evans & Jovanovic, 1989). Debt and equity are two of the main forms of external financing that founders consider using to finance the new firm's operations. These two forms of financing are readily used by a number of firms as they grow and mature (Berger and Udell, 1998). These financing options offer different benefits to new firms that could affect their performance, with prior studies finding that the amount of equity and the amount of debt used by the firm positively affects new firm performance (e.g. Astebro & Bernhardt, 2003; Cooper et al, 1994; Vanacker & Manigart, 2006).

Past research suggests obtaining any type of financing, as long as it is enough to fund the business, is the best way to improve new firm performance. However, some entrepreneurs prefer debt (e.g. De Meza and Southe, 1996; Hackbarth, 2004; Landier & Thesmar, 2009), while other entrepreneurs either desire to obtain equity financing to improve cash flow during the early years or have to obtain equity financing due to market constraints (e.g. Stiglitz & Weiss, 1981; Vanacker & Manigart, 2006; Parker, 2009). Thus, this study addresses the research question: Does the form of financing (debt or equity) used in the first year affect later performance of the firm?

Method

Using the Kauffman Firm Survey, a 6-year longitudinal study is performed to test the hypotheses and to answer the research question. Survival and growth curve analyses are performed on the data set. The dependent variables in the analyses are firm growth (revenue, number of employees) and survival over a 6-year period, with the independent variables based upon if a firm used equity first, used debt first, or used both during the first year. A robust set of control variables is used in the analyses, including variables related to the founding team, the business idea quality, type of business (product/service), and technology level. Additional analyses are performed to test the robustness of the results, including financing options used in the second and third year of a firm’s existence.

Results and Implications

Results indicate using one financing form before another during the first year does not affect the growth of the firm, as there is no statistical difference between the financing form and new firm growth in the general sample of firms. However, when only high-growth firms are examined, using external equity only in the first year of operations leads to a higher level of external funding in later years, and ultimately higher growth of the firm. This supports prior studies that only examined high-growth firms (e.g. Baeyens & Manigart, 2006; Vanacker & Manigart, 2006). In addition, robustness checks indicate the use of a combination of debt and equity in years two and three lead to a larger amount of external funding and higher growth, indirectly supporting the financial growth cycle theory (Berger & Udell, 1998). And, since new firms are able to complete the development of their products in years two or three, these firms have the ability to find a market that will buy their product. This supports the notion that a firm should find product-market fit before scaling (Zott and Amit, 2008).

The preliminary results also show the use of debt during the first year is associated with a firm closing quicker (firm failure). This suggests that having to pay creditors on a regular interval during the early years of a firm hinders the cash flow of the firm, and leads to firm closure (e.g. Cressy, 2006).

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