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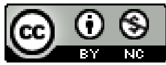

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Role of Institutions in Startup Financing: An Institutional Theory Approach

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Abstract

It has been established by many researchers that entrepreneurs do not create opportunities in isolation; rather, every activity related to the entrepreneurial process is affected by an interconnected network of economic and cultural forces. Hence, the entrepreneurial activity of reaching out to potential sources of external financing is also affected by an interconnected network of various forces. These forces include different actors such as the entrepreneurs, investors as well as the institutions. To understand this interconnected network of forces affecting the startup financing, it is critical to understand this phenomenon from the viewpoint of people who experience it first-hand i.e. entrepreneurs/founders of startups. Hence, this study utilized the institutional theory's framework to understand different forces/actors/institutions in startup's surroundings that affect the process of startup financing. A total of 20 semi structured in-depth interviews were conducted from startup founders in Peshawar region, which were analysed using a series of steps suggested by Creswell (2009) and Miles and Huberman (1994). In accordance with the institutional theory presented by Scott (2014), all the institutional forces identified by startups' founders were categorized into three categories i.e. institutional forces, normative forces, and cultural-cognitive forces. All the institutions under these three categories either create opportunities or challenges for the startups in accessing the external sources of financing. The startups can utilize this research to understand the kind of institutions operating in their surroundings and their potential effect on the financing process to avoid any obstacles or inconveniences while seeking external financing.

Keywords Startup Financing, Institutional Forces, Entrepreneurs, Network

Introduction

Until the 20th century, entrepreneurship was considered in the context of activities of an entrepreneur as an individual, who had the ability to notice and take advantage of opportunities for exclusive benefit. Hence, his activities were not linked to socio-economic development (Skala, Skala & Barlow 2019). However, entrepreneurial activities do not take place in isolation i.e., entrepreneurs do not identify or create opportunities without the support of an interconnected network of economic and cultural forces (Greve & Salaff, 2003). The creation of a business requires additional factors such as a multi-layered interconnected network of individuals and organizations (Jack & Anderson, 2002), which is a part of an entrepreneurial ecosystem to promote entrepreneurship at the regional level (Autio, Kenney, Mustar, Siegel & Wright, 2014). Hence, it can be contended that the entrepreneurial activities are embedded within entrepreneurial ecosystems and entrepreneurs need the support of an interconnected network of economic and cultural forces to create or identify opportunities (Greve & Salaff, 2003). Therefore, 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/opportunities encountered by entrepreneurs during that process are affected by an interconnected network of various forces embedded within an entrepreneurial ecosystem in which the startups operate. Hence, it is important to understand how these actors/institutions create challenges/opportunities for startup financing because unless the dynamics of these institutions are

explored, startups will not be able to make progress in accessing external sources of financing successfully.

Research Question

What is the role of institutional forces in creating opportunities or challenges for startups in accessing external financing?

Literature Review

According to Tolbert, Davis and Sine (2011, p.1340), *"Although the intersection of entrepreneurship research and institutional theory has been neglected in the past, there is some evidence that the number of researchers addressing this intersection is growing—but we believe it remains rich with opportunities for further scholarship that can enhance our understanding of entrepreneurial phenomena and contribute to the intellectual tradition of institutional theory".* Hence, recently, institutional theory has become increasingly popular as many researchers are using it as a lens to study different areas of research including entrepreneurship (Bamfo, 2013). It provides a perspective to determine the effect of social and cultural context on entrepreneurship, which is important because the final decision to start a business depends upon this context (Audretsch et al. 2002).

Before discussing the constituents of institutional theory, it is important to understand the definition of an institution and the difference between organizations and institutions. At its heart, institutional theory seeks to explain "the elaboration of rules and requirements to which organizations must conform if they are to receive support and legitimacy" (Scott & Meyer, 1983, p. 140). Thus, institutions define the rules of the game while organizations are the actors, who play in accordance with the defined rules (DiMaggio & Powell, 1991). According to Scott (2014, p.56), *"Institutions comprise regulative, normative, and cultural-cognitive elements that, together with associated* activities *and resources, provide stability and meaning to social life".* These regulative, normative, and cultural-cognitive elements have been identified by many social theorists as the essential elements of institutions.

Furthermore, according to Dobler (2011, p.4), *"Institutions are rules that regulate human interactions. These rules can be informal and solely exist in human minds, for example certain codes of behavior. However, the rules can also be formally written down, for example laws and regulations. In any case, they regulate social interaction. This is possible since institutions allow the individual to establish expectations regarding other individuals' behaviors".* Hence, institutions not only provide the moral code of conduct acceptable in a society, but they also provide the rules and regulations to conduct certain activities within a system. These codes of conduct/rules regulate human interactions along with their expectations of each other. Hence, the external funds providers form expectations about the startups in which they want to invest i.e., if the startups/entrepreneurs will possess the characteristics expected by the funds providers then it will increase their chances of securing the external investment successfully and vice versa. These interactions also shape the perceptions of entrepreneurs about the external funds' providers; hence, they try to access only those sources which they perceive to be feasible for them.

Furthermore, Scott (2014) contended that there are three pillars that make/support institutions. These three pillars and their relevance with the current study are discussed below.

a. Regulative Pillar

The regulative pillar encompasses rules, regulations, laws, and government policies that promote some behaviors and restrict others (Hinnings & Tolbert, 2008). The institutions under the regulative pillar consist of legal and government institutions, which regulate the industry (Scott, 1995). These rules and regulations originate from governmental bodies and industry standards and involve guidelines for organizations and individuals to comply with (North, 1991). In the context of the current study, the regulative pillar encompasses rules and regulations of the institutions involved in the process of startup financing such as government, financial institutions, and international organizations. Hence, entrepreneurs must comply with the rules and regulations of these organizations to access external financing successfully (Bruton, Ahlstrom & Li, 2010).

b. Normative Pillar

The normative pillar encompasses norms and values within a society or industry that people are expected to conform to (Scott, 2014). The normative systems guide behaviors by defining what is expected or acceptable in different social and professional situations (Burton, Ahlstrom & Li, 2010). They also define goals/objectives, and acceptable ways to pursue them (Scott, 2014). In reference to

entrepreneurship, some societies have norms that encourage and facilitate entrepreneurship while some societies do not (Baumol, Litan & Schramm, 2011). This pillar is relevant to the current study by taking into consideration the norms, cultural values, and overall attitude of people towards entrepreneurship in Peshawar along with the presence of organizations supporting startup financing in direct or indirect capacity. It also entails that the goals of entrepreneurs must be in accordance with the cultural and societal expectations because only then the attitude of society will be more supportive of startups in general (Baumol et al. 2011).

c. The Cultural-cognitive Pillar

It is different from the normative pillar of institutions as the former encompasses the collective behavior of society while the cultural-cognitive dimension focuses more on the individual level i.e., the culture, language, and other taken-for-granted behaviors about which people rarely think (DiMaggio and Powell, 1991). It also encompasses the role of the entrepreneur's skills and knowledge base in creating opportunities for entrepreneurship development (Tolbert, David & Sine, 2011). This institutional pillar is relevant to the current study in terms of the role of entrepreneurs' characteristics such as skills and experience in creating opportunities for the startups in accessing external financing successfully. It also encompasses the role of institutions that could play their part effectively in creating awareness about entrepreneurship in people and providing relevant education and training.

Keeping the above-mentioned pillars of institutional theory and their relevance with the current study in mind, it can be proposed that the importance of institutional forces in creating opportunities/challenges for startups in accessing potential sources of financing cannot be ignored. Hence, to access the needed financing successfully, startups/entrepreneurs must understand the relevant institutions in their surroundings.

Methodology

Research Design

By applying Stake's (1998) classification, a collective case study design was chosen for this study because the phenomenon under investigation i.e., startup financing could only be better understood by incorporating the experiences of multiple startups.

Sampling

The sampling strategy adopted for this study was purposive sampling. Only those startups were selected for this research that had already launched their products in the market and had gone through the process of accessing different sources of external financing. Hence, a total of 20 startups from Peshawar region were selected for this study.

Data Collection

The qualitative data collection method chosen for this study was semi-structured interviews. All the interviews were tape-recorded taking explicit permission from the interviewees. The duration of the interviews varied from 30 to 50 minutes depending upon how communicative the interviewees were. Other than collecting primary data, secondary data was also collected through startups' websites, their Facebook/Instagram pages, and by reviewing news articles about the startups chosen for the study.

Data Analysis

The data collected via semi-structured interviews was first transcribed in MS Word and then organized to begin the process of analysis. The data analysis comprised a series of steps suggested by Creswell (2009) and Wolcott (1994).

Results & Discussion

During the data analysis, primary themes were identified both from the literature and the collected data. All the themes were categorized under three pillars of institutional theory i.e. regulatory, normative, and cultural-cognitive pillar which play a significant role in startup financing.

Theme 1: Regulatory Pillar

Literal Analysis

The institutions under regulative pillar consist of legal and government institutions, which regulate industry (Scott, 1995). It also encompasses rules, regulations and policies which promote some behaviors and restrict others (Hinnings & Tolbert, 2008). For example, whenever a business applies for a loan, it must fulfil certain conditions such as pledging collateral with the designated bank (Gangata & Matavire, 2013). This condition is not easy to be fulfilled by many startups as in most cases they do not have any collateral to be pledged. In addition to collateral, banks also require a steady revenue stream from businesses if they want to secure business loans successfully. Again, this

requirement cannot be fulfilled by many startups because most of them either do not have any revenue during initial stages or even if they do, it is not steady enough to satisfy the conditions of a business loan. Therefore, they are unable to secure bank loans to finance their ventures. Furthermore, many grants providing institutions require the companies to be registered for at least three years prior to applying for the funds. Again, this requirement cannot be fulfilled by newly registered startups. Such rules and regulations only create challenges for the startups, which result in their ineligibility to even apply for the needed funds.

Respondent Analysis

Whenever entrepreneurs try to access any form of external financing, they must satisfy several requirements/rules put forward by external funds providers. For some startups, it is easier to fulfil those requirements while for others it is much difficult. For example, one of the entrepreneurs mentioned that,

> *"Despite running our business bank account for a few years, we were unable to secure a loan from the bank due to disagreement on the interest rate as it was not suitable for a newly established business".*

Another respondent shared that,

> *"The eligibility criteria set up by grants or investment funds is not always practical, which makes it difficult for startups to have access to funds. For example, in Karandaaz, they require businesses who are working in the industry for at least three years. As we do not fulfill their criteria so we could not even apply for it".*

Theme 2: Normative Pillar

Literal Analysis

The normative pillar of institutional theory encompasses norms and values within a society or industry that people are expected to conform to (Scott, 2014). It also embodies the attitude of a society towards certain behaviors, which results in either encouraging or discouraging those behaviors. For example, the people in Peshawar are risk averse and they avoid pursuing any venture that offers the risk of failure. This behavior is reflected in the decision making of funds providers as they prefer to provide capital to startups with traditional/tried-and-tested ideas or to the businesses that are already profitable. It also hampers the ability of entrepreneurs to seek financing as people hesitate to lend/invest money for a risky cause. As a result, most entrepreneurs must rely upon self-financing (Gartner et al., 2012), which is not feasible for everyone.

In addition to funds providers, the key role played by intermediary institutions such as incubation centers and higher education institutions is also of utmost importance. The trainings provided by incubation centers not only improve entrepreneurs' skills, but they also prepare them for investor pitch (Ester, 2017). It is then up to the startups whether they successfully secure external funding or not. In addition to incubation centers, higher education institutions also play an important role in providing relevant education and skills to students, which can be helpful later in their entrepreneurial ventures. These institutions also arrange events such as seminars, trainings, and conferences, which not only provide exposure to potential entrepreneurs but also enhance their skills set. Hence, they not only help to alleviate the skills set necessary in attracting external financing, but they also bridge the gap between entrepreneurs and external funds providers by connecting them via different avenues (Ester, 2017).

Respondent Analysis

It has been discussed above that the society in general is risk averse. This behavior is also reflected in the financing decisions taken by funds providers because they influence and are also influenced by the norms, perceptions, and behaviors prevalent in the society. Many entrepreneurs under this study have also shared their personal experiences that investors always choose the startups that have a steady stream of income or are already in the revenue generating phase. The reason is that they want to be certain that they will receive return on their investment. This kind of attitude not only discourages startups that need seed financing, but it also discourages entrepreneurs from seeking innovation because they know that innovative business ideas do not attract investors easily. One of the respondents contented that,

> *"An investor in most of the cases has an interest in the balance sheets and accounts of a start-up. They observe the amount you are spending, and the revenue being*

generated against it. No matter how the business is or significance of its idea for the founder, it must be profitable to attract investors".

The risk averse behavior is not limited to the individual investors, and it can be observed in financial institutions as well. For example, one of the respondents explained that,

"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".

Hence, one of the entrepreneurs suggested that,

"First, do not bring completely new products in the market. It sounds good no doubt, but you will face problems later in getting funding and to develop it as well. So, it's better to bring innovation in a current product".

Theme 3: Cultural-cognitive Pillar

Literal Analysis

In contrast to the normative pillar of institutional theory, the cultural-cognitive dimension focuses more on the individual level i.e., the beliefs and cultural values of individuals that are reflected in the individual's or societal behaviors (Scott, 1995). It also encompasses the role of entrepreneur's skills and knowledge base in creating opportunities for entrepreneurship development (Tolbert, David & Sine, 2011).

In addition to seeking security of their investment, investors along with other external funds providers, also evaluate the founders of startups critically. This critical evaluation of entrepreneurs results in creation of opportunities or challenges for the startups. For example, external funds providers such as bank/grant managers and private investors evaluate the founder of a startup based on his/her skills, knowledge, prior experience, commitment, passion, and credit worthiness (Neergaard, 2005; Preston, 2007; Kotha & George, 2012; Robb & Robinson, 2014; Scholten et al., 2015; Frid et al., 2016). If the entrepreneur meets their pre-determined criteria, only then they extend financing to the startup in question.

Respondent Analysis

When an entrepreneur/ startup possesses, if not all, but some of the above-mentioned characteristics then it makes it easier for the startup to secure external financing in the form of grants, bank loans or private equity investment. One of the respondents reinforced this statement by explaining that,

"Even the investors do not prioritize the startup no matter how good it may be. If the founder's personality, ambition, and vision are lacking then the investors will never invest".

Another respondent reinforced this statement by sharing that,

"In my opinion it is the first impression that someone gets. Sometimes a business is led by such a founder who already has succeeded with other startups, so it gives a positive signal to the investor about making investment decision".

Conclusion

Based upon the above discussion, it can be concluded that the institutional forces that range from cultural values of individuals/society to rules and regulations implemented by competent authorities, have an important role in creating opportunities/challenges for startups in accessing external financing. For example, a startup must follow certain rules and requirements if it wants to secure a bank loan. One of the most important requirements for any bank loan is to pledge collateral. If a startup can meet this requirement, then it can secure the loan successfully and vice versa. Similarly, many grants provided by government and private institutions have certain rules and requirements that must be followed by startups to access the needed funds. If startups fail to meet those requirements, then in some cases they are ineligible to even apply for the grants. In addition to the regulatory institutions, there are some normative and cultural-cognitive institutions in an entrepreneurial ecosystem that influence the ability of a startup to access external financing successfully. For example, there are certain characteristics ranging from an entrepreneur's age, experience and communication skills to the profitability and scalability of a startup, that influence the ability of a startup in accessing the desired financing. Whenever a startup approaches any external source of financing, it is evaluated based upon a pre-determined criterion of evaluation. If the entrepreneur/startup possesses the characteristics/skills (cognitive pillar) desired by the external source of financing, then it will increase its chances in securing the funds successfully. This decision-

making ability of the external funds providers is also influenced by the norms, attitudes, and perceptions of society (normative and cognitive institutions) towards startups. If the society in general promotes risk averse behaviors, then the finance providers will also avoid investing in risky ventures and vice versa. These institutional forces are deeply embedded in the entrepreneurial ecosystem in which the startups operate and, are evident in the interactions of entrepreneurs with each other, potential sources of financing and the other actors in their surroundings. Hence, their influence on startup financing cannot be negated. Only by acknowledging these institutional forces can startups devise strategies to achieve their desired goal, which is to access external financing successfully.

Limitations and Recommendations

The current study was conducted on startups that have already launched their products in the market and have gone through the process of accessing different sources of external financing. Hence, the findings of this study may not extend to all the startups operating in Peshawar. The future researchers can extend the scope of this research by including startups in idea stage or prototype stage to explore their perspectives about the potential effect of institutional forces on startup financing. Furthermore, a comparative case study can also be conducted between startups operating in Peshawar and any other major city of Pakistan to explore the differences and how to transform those differences into opportunities for startups operating in both cities. It will not only add to the existing body of knowledge on startups, but it will also open doors for flexible policies implications according to the particular needs of the startups in question.

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