The Changing Startup Financing Landscape: Impact to Entrepreneurial Ecosystems

By: Melody Chang, Yale University

Executive Summary

- From accelerators and angel investors to crowdfunding, the profile of startups and early-stage capital has changed dramatically over the past 15 years.
- Evidence suggests that these emerging sources of capital provide a meaningful role in the growth of early-stage ventures and enrich local entrepreneurial ecosystems.
- Angel investing and crowdfunding communities provide opportunities to a more diverse set of entrepreneurs and are more geographically dispersed than traditional investors such as venture capital.
- Given more options for financing sources, entrepreneurs should strategically choose the capital providers that will be best for their ventures.

The Rising Prominence of Accelerators

Accelerators, entrepreneurial programs offering education and mentorship for seed-stage startup founders, have become a prominent institutional form in the entrepreneurial landscape over the past decade. Recent studies highlight how these accelerator programs can aid early-stage venture development, as well as bring positive spillover effects to the regional economy. Hallen, Cohen, and Bingham demonstrate the efficacy of accelerator programs. Based on the sample of four accelerator cohorts and three distinct accelerators, they find that ventures accepted and in enrolled accelerator programs experience better performance compared to those with similar quality that are "almost accepted"; the former receive 47-171 percent more funding and have a 21-35 percent greater likelihood of surviving or being acquired in the subsequent two to three years.[1]

> **"Accelerators do indeed work, and some are better at accelerating than others. Learning is the key mechanism."**
> **-- Ben Hallen, *University of Washington Foster School of Business***

"The acceleration effect is not universal and some accelerators are better than the others," says Ben Hallen, Longbrake Endowed Professor in Innovation and associate professor of strategy and entrepreneurship at the University of Washington Foster School of Business. Accelerators with more entrepreneurial and industry experience can provide a better learning opportunity for their portfolio ventures by complementing founder pre-entry experience. Also, accelerator designs can serve an important role. The key design choices — concentrated consultation (over spaced-out mentorship), fostering transparency (over privacy among cohort members), standardization of activities (over tailoring the program for each venture) — mitigate the bounded rationality of founders and provide the most learning.[2]

The introduction of an accelerator can also boost local entrepreneurial activity. The arrival is associated with a significant increase in the number and volume of venture capital (VC) deals in the region, driven by the latent regional interest in entrepreneurial activity.[3] Thus, accelerators can create a positive feedback loop in the local entrepreneurial ecosystem, supporting peer effects, providing role models for entrepreneurs in the region, and catalyzing the emergence of local VC firms and investment activities.

The Geographic Diversity and Globalization of Angel Investments

> **"Entrepreneur angels want to actively engage with their portfolio. Angels play both sides balancing psychological support and financial support for their companies."**
> **-- Pat Gouhin, *Angel Capital Association***

"While VCs are more and more focusing on later-stage deals, angel investors, along with accelerators, are filling the vacuum in early-stage capital," notes Peter Cornelius, managing director of AlpInvest. Angel groups and individuals have been playing a growing role in funding early-stage startups in the United States and worldwide over the past decade. Because angels invest their own money, they are less prone to agency problems, often documented for VC funds.[4] Many of them are former entrepreneurs and thus provide a more active role in operations, tending to maintain closer ties with founders of their portfolio companies.

Angel Investments by Region
Data source: 2019 Angel Funders Report, Angel Capital Association

An emerging trend in the angel investment space is the growing geographic diversity in which angel groups invest. While VC investments in California and the New England region represent more than 60% of the total investment amount in the United States and Canada,[5] angel investments there are more spread out across regions. According to Patrick Gouhin, CEO of the Angel Capital Association, many angel investors are successful former entrepreneurs who give back to their local community and actively engage with their portfolio companies.

Recent evidence suggests that angel groups improve the performance and survival of startups not only in the United States, but worldwide.[6] A cross-sectional analysis of 13 angel groups in 21 countries shows that startups funded by angels have a 14-23 percent higher survival rate for the first one and a half to three years and grow their employment by 40 percent more than startups not funded by angels. Although the level of entrepreneurial activity and support of entrepreneurship differs by region, the role of angel funding is positive and consistent. Yet international angels, as opposed to U.S.-based angels, also have a strong positive impact on the follow-on financing of their portfolio startup. Thus, angels may play a more important gatekeeper or accreditation role in countries outside the United States.[7]

The Role of Crowdfunding in the Entrepreneurial Ecosystem

Crowdfunding has democratized the commercialization of innovative ideas and entrepreneurial processes for accessing capital. It has removed traditional gatekeepers to startup finance, reducing costs associated with accessing capital and exposing entrepreneurs to a broader set of investors.[8] Whereas traditional capital sources such as VCs tend to fund entrepreneurs whose demographics, educational level and professional characteristics are similar to theirs, crowdfunding has provided significant opportunities for underrepresented groups to access capital.[9]

Crowdfunding has also enabled investments in a more diverse set of geographical locations that have traditionally lacked the presence of VCs, whose investments historically have been concentrated in a small number of regions.[10] Furthermore, the rise of crowdfunding in a region attracts other forms of financing to the region. Successful crowdfunding campaigns attract VCs to innovators in regions previously unfamiliar to them.[11]

Remaining Puzzles

Recent studies on startup financing have demonstrated the efficacy of emerging forms of capital on early-stage ventures. These new sources of capital seem to complement traditional investors and enrich local entrepreneurial ecosystems. Yet we have more to learn about the consequences of the changing financing landscape. First, how can entrepreneurs choose the capital provider that is best for their ventures? It remains unclear which form of capital can provide the most learning and growth opportunities based on startup characteristics like stage, industry and founder pre-entry experience. In some cases, accessing capital from investors could bring more costs than benefits if the interests between investors and entrepreneurs are not aligned, as Bill Aulet, managing director of the Martin Trust Center and clinical professor at the Massachusetts Institute of Technology, notes: "Entrepreneurs should take caution when taking money from investors. Incentives for VC or angel mentors and nonmonetary-partaking mentors are different."

Second, it seems crucial for researchers, practitioners and policymakers to understand the potential negative consequences of the oversupply of capital in a region. For instance, the surge in nontraditional venture investors has been attributed to prolonged exit activities and overvaluation of ventures. As Cornelius notes, "Even large institutional investors are directly investing in startups. The explosion of investment activities driven by nontraditional investors has led new firms to stay private longer." Entrepreneurs not feeling the need to go public sooner or seek out strategic investors may lead to an inflated valuation of startups.[12]

Third, despite the seeming abundance of resources, there is unmet demand. While studies have documented the biases persistent in the investment decision-making process,[13] we need additional insights on the potential interventions by different institutions that could reduce bias toward minority entrepreneurs. What are the investment practices and policy interventions that can improve access to capital for a more diverse set of entrepreneurs? The panelists from the Kenan Institute Frontiers of Entrepreneurship conference call for more research on devising policy interventions that could reduce the gender, racial and income gaps in access to capital.

Policy Takeaways

- Increasing the presence of accelerators, angel groups and crowdfunding participants could enrich the entrepreneurial environment in a region.
    - It is important to understand the conditions under which each of these programs can provide the most effective learning opportunities and support system.
- These new forms of capital not only complement, but also overcome, shortcomings of traditional financing sources, such as lack of diversity and concentration of investments in selected regions.
- Despite the increasing variety and amount of growth capital, unmet demand remains, and many entrepreneurs face barriers to capital access. Policymakers should strive to provide environments in which all entrepreneurs can have equal access to capital.
- The increase of nontraditional investors and the supply of capital could lead to negative consequences, such as prolonged exit activities and overvaluation of startups.

Contributing Experts

Bill Aulet, *Managing Director*, Martin Trust Center; Clinical Professor, MIT
Peter Cornelius, *Managing Director*, AlpInvest
Patrick Gouhin, *CEO*, Angel Capital Association
Ben Hallen, *Longbrake Endowed Professor in Innovation and Associate Professor of Strategy and Entrepreneurship*, University of Washington Foster School of Business

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