

## **Entrepreneurial Finance Strategies for MSME growth and performance**

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### **Abstract**

Micro, small and medium enterprises (MSMEs) play a crucial role in economic growth and job creation. However, access to finance remains one of the key challenges facing MSMEs, limiting their growth and sustainability. Entrepreneurial finance provides alternative financing options to support MSMEs. This paper reviews the concepts and evidence on entrepreneurial finance for MSMEs. It discusses the emergence of entrepreneurial finance, key financing instruments, investor motivations, and the role of entrepreneurial finance ecosystems in supporting MSME growth. The paper concludes with implications for research and practice on enhancing access to entrepreneurial finance for MSMEs.

### **Introduction**

Micro, small and medium enterprises (MSMEs) are drivers of innovation, economic growth and job creation globally (OECD, 2017). MSMEs account for over 90% of businesses and more than 50% of employment worldwide (World Bank, 2019). In emerging economies, MSMEs contribute up to 40% of GDP on average (OECD, 2017). However, access to finance remains one of the biggest constraints to MSME growth and sustainability, limiting their investments, productivity and competitiveness (Fatoki, 2014; Quartey et al., 2017).

Traditional sources of small business financing such as bank lending are often constrained after economic crises. For instance, the global financial crisis of 2008 led to a decline in bank lending, leaving an SME financing gap (Kraemer-Eis et al., 2019). Entrepreneurial finance has emerged as an alternative source of financing for MSMEs and start-ups. It encompasses diverse formal and informal financing instruments that channel funds to entrepreneurial firms (Cumming and Groh, 2018). This conceptual paper reviews key concepts, instruments, actors, and evidence on entrepreneurial finance, focusing on its role in supporting MSME growth.

Globally recognized as catalysts for innovation, economic growth, and employment, Micro, Small, and Medium Enterprises (MSMEs) constitute over 90% of businesses, generating 50-60% of jobs worldwide. In emerging economies, their contribution to GDP averages between 30-40%, fostering equitable development by promoting financial inclusion and providing livelihoods for disadvantaged groups. Despite their pivotal role, MSMEs face significant constraints due to limited access to finance, impacting productivity, competitiveness, and growth aspirations, as highlighted by Quartey et al. in 2017.

During economic crises, traditional financing channels for MSMEs, such as bank lending, often contract. The 2008 global financial crisis, for instance, triggered a credit crunch and risk aversion that reduced bank lending, resulting in a financing gap for small and medium enterprises. In response, alternative financing models collectively termed entrepreneurial finance have emerged, aiming to expand MSME access to capital through non-traditional channels like online platforms, angel investors, and venture capitalists, as detailed by Cumming and Groh in 2018.

Over the past decade, entrepreneurial finance has witnessed exponential growth globally, facilitated by widespread digital adoption. Equity crowd funding volumes surged from \$0.6 billion in 2013 to \$14 billion in 2019, and peer-to-peer (P2P) lending experienced a substantial increase from \$11 billion to \$64 billion over the same period, according to Statista and the Cambridge Centre for Alternative Finance in 2019. However, in many emerging economies like India, Malaysia, and Brazil,

bank lending continues to dominate formal MSME finance, and entrepreneurial finance serves as a nascent supplement striving to address unmet small business financing needs.

Despite the rapid evolution of the entrepreneurial finance landscape, research and evidence have lagged behind practice, as noted by Cumming and Groh in 2018. As the industry matures, there is a critical need to examine concepts, instruments, and evidence to inform policies and business models, ensuring a more substantial impact on MSMEs. This paper specifically delves into key issues within entrepreneurial finance, with a focus on MSMEs in emerging economies, aiming to bridge the gap between theory and practice for enhanced effectiveness in addressing the financial needs of small businesses.

### **The Emergence of Entrepreneurial Finance**

Over the past few decades, entrepreneurial finance has emerged as a vital alternative financing model, offering solutions to the funding challenges encountered by startups and small businesses. Various interconnected factors have fuelled the rise of entrepreneurial financing, as explored by Cumming and Groh (2018) and Kraemer-Eis et al. (2019). One significant driver has been the impact of financial crises and recessions on traditional bank lending. The 2008 global financial crisis, in particular, triggered a decline in bank lending and tightened credit standards, creating a substantial financing gap for small and medium-sized enterprises (SMEs). In response, entrepreneurial finance stepped in, playing a pivotal role in bridging this gap by providing alternative sources of capital.

Technological advances have also played a crucial role in shaping the landscape of entrepreneurial finance. The advent of the internet, digital platforms, widespread mobile penetration, big data, and artificial intelligence has significantly reduced transaction costs. This reduction has been instrumental in facilitating the identification of investors and borrowers, risk assessment, and the completion of financial transactions. The accessibility and efficiency brought about by these technological advancements have paved the way for new financing models, making entrepreneurial finance a feasible and attractive option for both investors and entrepreneurs.

The rapid growth of the digital economy further underscores the importance of entrepreneurial finance. As business models, products, and services undergo digital transformations, new entrepreneurial opportunities emerge. However, traditional investors may exhibit scepticism toward funding innovative digital ventures with intangible assets. In such cases, entrepreneurial finance becomes a crucial source of risk capital, fostering the development of groundbreaking ideas and technological advancements that might otherwise struggle to secure traditional funding.

Regulatory changes have also played a pivotal role in the evolution of entrepreneurial finance. Supportive regulations for crowd funding, peer-to-peer (P2P) lending, equity financing, and other alternative instruments have permitted new approaches to capital raising and have expanded the pool of potential investors. Despite the positive impact of these regulatory changes, finding the right balance between encouraging innovation and ensuring adequate oversight remains an ongoing challenge for policymakers and industry stakeholders.

The surge in start-up activity and the increasing appetite among investors for innovative ventures have further fuelled the growth of entrepreneurial finance. The availability of entrepreneurial talent, coupled with rising disposable incomes, has created a fertile ground for start-ups. Entrepreneurial finance leverages this growing interest from investors, utilizing technology to scale operations and connect promising ventures with the necessary capital to fuel their growth.

A compelling illustration of the rapid growth of entrepreneurial finance can be found in global crowd funding volumes. Peer-to-peer business lending, for instance, witnessed remarkable growth, increasing from \$11 billion in 2013 to \$64 billion in 2017. Equity crowd funding similarly experienced a surge, soaring from \$0.6 billion to \$6.5 billion during the same period, as reported by the Cambridge Centre for Alternative Finance in 2019. Notably, in developing regions such as Africa, entrepreneurial finance is playing a crucial role in expanding financial inclusion, providing

opportunities for individuals and businesses that may have been overlooked by traditional financial institutions.

Despite the successes, recent challenges have emerged in the entrepreneurial finance landscape. The post-financial crisis recovery in bank lending and a slowdown in economic expansion have contributed to a deceleration in the growth of entrepreneurial financing. The Covid-19 pandemic further impacted market volumes, although digital adaptation and resilience within the entrepreneurial finance ecosystem facilitated a relatively swift recovery. As the industry continues to evolve, achieving mainstream scale while ensuring sustainability remains a dynamic challenge, necessitating ongoing adaptation and collaboration among stakeholders in the entrepreneurial finance ecosystem.

### **Key Entrepreneurial Financing Instruments**

Four pivotal instruments within the realm of entrepreneurial finance are currently proving particularly pertinent for Micro, Small, and Medium Enterprises (MSMEs). Among these, Peer-to-Peer (P2P) Lending stands out as a transformative mechanism facilitating direct lending between individuals through online platforms, often leveraging big data analytics. This avenue serves as a viable alternative to conventional bank lending, allowing investors to directly support MSMEs that traditional banks may perceive as too risky. P2P lending extends financial support for critical needs such as working capital, equipment acquisition, and inventory management, thereby broadening the scope of debt financing for nascent and small ventures. As of 2017, global P2P business lending reached an impressive \$64 billion, with China leading at \$59.3 billion, followed by the Americas at \$3.2 billion and Europe at \$3.1 billion. Notably, the default rates for P2P business loans average between 4-6%, surpassing those of traditional banks, prompting ongoing regulatory evolution to enhance investor protection and risk disclosure as the P2P lending landscape matures.

Equity Crowd funding emerges as another instrumental facet, offering MSMEs a means to secure external equity by selling shares to angel investors and the public through online platforms. Particularly suited for early-stage ventures not yet prepared for formal public listings or venture capital engagements, equity crowd funding opens avenues for investors to acquire equity in start-ups with perceived growth potential and return prospects. In 2019, global equity crowd funding soared to \$14 billion, with the Americas accounting for \$5.6 billion and Europe for \$4.9 billion. Key sectors benefiting from this model include technology, green energy, healthcare, and community projects. However, the regulatory landscape remains diverse, with some countries such as India and Malaysia still prohibiting equity crowd funding, while others, including the US, UK, and New Zealand, have embraced it under specific regulations.

Angel Investing, where affluent individuals invest personal capital into start-ups, has proven to be a vital component of entrepreneurial finance. Angel investors, often part of organized networks, contribute not only funds, typically ranging from \$25,000 to \$100,000 on average but also valuable expertise to guide the growth of MSMEs. In the US, the largest organized angel market, \$23 billion was invested across 64,380 ventures in 2016. Angel investors play a critical role in bridging the gap between early seed rounds (under \$500,000) and more formal venture capital injections (exceeding \$2 million), demonstrating a penchant for supporting technology, healthcare, and business products/services start-ups with discernible growth potential.

Venture Capital represents a more institutionally managed form of entrepreneurial finance, involving capital sourced from institutional investors and affluent individuals. This capital is strategically invested in innovative early-stage firms exhibiting exceptional growth prospects. While venture capital offers substantial funding, averaging between \$2 million and \$10 million, it goes beyond mere financial backing. Venture capitalists provide strategic guidance, operational support, mentorship, and access to extensive networks for MSMEs. This year, global venture capital funds invested a staggering \$274 billion, with the Americas receiving 61% of these funds. Despite this, the distribution of venture capital remains skewed toward later expansion stages, highlighting the distinction between venture capital and entrepreneurial finance, which is more attuned to catering to the crucial early seed funding needs of emerging enterprises. As the landscape of entrepreneurial finance continues to

evolve, these instruments play a vital role in addressing the unique challenges and opportunities facing MSMEs, providing diverse and dynamic avenues for financial support and growth.

### **Investor Motivations and Behaviour**

Comprehending the perspectives and behaviours of investors holds the key to unlocking valuable insights for entrepreneurial Micro, Small, and Medium Enterprises (MSMEs) seeking capital and devising engagement strategies. A critical determinant of funding decisions lies in investor risk perceptions and due diligence, particularly as ventures characterized by high uncertainty undergo heightened scrutiny. Unravelling the multi-faceted motivations that drive investors is imperative, with financial returns typically taking centre stage. However, it is crucial to recognize that non-financial motives also wield significant influence, the degree of which varies based on the chosen investment instrument. Notably, equity investors harbour higher return expectations compared to their counterparts in the lending sphere.

The drivers behind investment decisions exhibit a nuanced landscape, further differentiated by the investor class. Lenders, for instance, prioritize thorough risk assessment as a primary criterion, while equity investors consider a broader spectrum, including projected returns, growth potential, and the extent of their influence, encompassing elements such as voting rights. Notably, investor preferences diverge based on their level of experience in the realm of entrepreneurial finance. Novice investors, for instance, tend to prioritize tangible cash returns, while their more seasoned counterparts place a premium on voting rights, particularly evident in equity crowd funding scenarios as articulated by Cumming et al. in 2020.

Investor engagement, a crucial facet of the funding landscape, manifests divergently across different investor categories. Angel investors and Venture Capitalists (VCs) are known for their hands-on approach, providing extensive support beyond mere financial backing. Conversely, crowd funders tend to exhibit more limited involvement in the ventures they support. Moreover, geographic proximity emerges as an additional factor shaping the extent of investor engagement, underlining the importance of understanding regional dynamics in fostering effective partnerships.

Recognizing and aligning with investor considerations becomes instrumental in structuring compelling entrepreneurial funding campaigns. Investor education emerges as a pivotal element in this process, acting as a safeguard against potential risks stemming from information gaps or cognitive biases, as emphasized by the Organization for Economic Cooperation and Development (OECD) in 2015. Striking a delicate balance between the creation of financial value and social value for investors remains an ongoing challenge in the dynamic landscape of entrepreneurial finance. Navigating this delicate equilibrium involves not only understanding investor motivations but also tailoring strategies that resonate with the diverse preferences and priorities of the investor community.

In conclusion, the intricacies of investor perspectives and behaviours are pivotal factors influencing the success of MSMEs in their pursuit of capital. As the entrepreneurial finance landscape evolves, MSMEs can leverage these insights to refine their approach, enhance engagement strategies, and navigate the delicate balance between financial and social value creation. By understanding the nuances of investor decision-making and preferences, MSMEs can forge more meaningful and mutually beneficial partnerships, fostering a robust ecosystem for entrepreneurial growth.

### **The Entrepreneurial Finance Ecosystem**

The entrepreneurial finance ecosystem is a complex network that extends beyond the primary interaction between investors and firms seeking funding. Acknowledging the breadth of this ecosystem, as highlighted by Brown et al. in 2018 and Cumming and Groh in 2018, reveals a diverse array of key players contributing to its dynamics.

Central to this ecosystem are online platforms, such as Kickstarter and AngelList, serving as crucial infrastructure facilitating connections between investors and entrepreneurs. These digital platforms play a pivotal role in showcasing ventures, facilitating transactions, and collecting valuable data. The

evolution of platform business models significantly influences the trajectory of the entire entrepreneurial finance ecosystem.

Intermediaries, acting as agents in the ecosystem, include brokerages, exchanges, advisors, and networks. They play a vital role in navigating the complexities of the entrepreneurial finance landscape, augmenting online presence through offline services, and establishing localized connections that contribute to a robust network.

Support organizations, including accelerators, incubators, innovation hubs, and research and development (R&D) institutes, provide indispensable resources to entrepreneurs. These entities offer access to mentorship, skills development, state-of-the-art facilities, and community engagement, fostering an environment conducive to the growth of entrepreneurial ventures.

Policymakers wield significant influence within the entrepreneurial finance ecosystem, shaping its growth trajectory through legislation, incentives, infrastructure development, and programs designed to promote talent development and Micro, Small, and Medium Enterprises (MSMEs).

Foundations and aid agencies contribute philanthropic capital and technical assistance to expand access to entrepreneurial finance, particularly for underserved groups such as women, rural areas, and informal sectors. This inclusive approach aims to bridge gaps and ensure a more equitable distribution of financial resources.

Professional services, provided by entities such as accountants, lawyers, appraisers, credit rating agencies, and consultants, offer ancillary support. Their services range from conducting due diligence and structuring deals to ensuring compliance and enhancing reliability within the entrepreneurial finance ecosystem.

Academia plays a crucial role in the ecosystem, with academic researchers studying its dynamics and performance. Their insights and evidence inform policies and practices, contributing to the knowledge development and sharing that underpins the ecosystem's continued evolution.

Media, both specialist publications and mainstream press, play a significant role in narrative building and disseminating information about entrepreneurial finance developments, regulations, and opportunities. Their influence extends to shaping perceptions and fostering awareness within the broader community.

The interactions within this diverse ecosystem occur through a complex web of formal and informal channels, both online and offline. The overarching goal is to enable, promote, regulate, and enhance entrepreneurial finance by mobilizing financing, skills, data, and incentives for firms with the potential for outsized impact.

Effective entrepreneurial finance ecosystems thrive on collaboration between various actors and address structural gaps for MSMEs, as highlighted by the OECD in 2019 and Brown et al. in 2018. The participation of both market players and development partners is deemed crucial for success. Supporting institutions, capacity building, open data, and inclusive policies are identified as catalysts for ecosystem growth. Building trust and transparency across stakeholders emerges as a vital factor for ensuring the sustainability of the entrepreneurial finance ecosystem.

### **Evidence on Impact of Entrepreneurial Finance on MSMEs**

Empirical evidence on the influence of entrepreneurial finance on the growth of Micro, Small, and Medium Enterprises (MSMEs) is gradually emerging, presenting a promising trajectory, as indicated by studies from the OECD in 2015 and Cumming and Groh in 2018. Peer-to-Peer (P2P) lending, for instance, has proven instrumental in expanding access to debt financing for segments often neglected by traditional banks, such as early-stage firms. This avenue not only provides these underserved entities with crucial financial support but also offers investors opportunities for portfolio

diversification. However, it comes with the challenge of higher default rates compared to traditional bank lending.

Equity crowd funding, another facet of entrepreneurial finance, emerges as a key player in providing early-stage risk capital for innovative start-ups and growing MSMEs, enabling the development and commercialization of technology, products, and business models. While the potential for positive returns exists, it often requires time for realization. Angel investing extends beyond financial backing, offering strategic value-addition for high-potential MSMEs through mentoring, skills transfer, and access to networks. Despite its potential, attracting and engaging angel investors remains a challenging aspect.

Venture capital, a more institutionally managed form of entrepreneurial finance, significantly boosts investments in productivity enhancements and business expansion for MSMEs displaying promising prospects, facilitating their scale. However, a concentration of Venture Capital (VC) in later stages persists as a characteristic challenge. Overall, entrepreneurial finance exhibits the potential to address financing gaps and constraints faced by early-stage ventures and underserved segments. The inherent balancing act between risks and returns, given the exposure to high risks, remains a critical issue. Notably, hybrid financing models, like convertible notes, are emerging, offering investors flexibility across different instruments.

Evidence suggests that entrepreneurial finance operates as a complement rather than a substitute for traditional financing channels, as highlighted by Mac an Bhaird et al. in 2019. Entrepreneurs often utilize both entrepreneurial finance and traditional bank lending for various needs and stages of their development. Establishing more synergistic linkages between these two financing realms has the potential to optimize MSME access to the necessary financial support.

Furthermore, beyond the immediate fundraising success, impact metrics such as revenue generation, employment creation, follow-on funding rates, and survival rates offer valuable insights into the overall efficacy of entrepreneurial finance, as posited by Cumming and Groh in 2018. However, obtaining a comprehensive understanding of these metrics requires longer-term studies to capture the nuanced evolution of MSMEs over time. Additionally, recognizing the heterogeneous effects of entrepreneurial finance across different regions, sectors, models, and types of firms is essential for a nuanced understanding of its impact and potential areas for improvement.

In conclusion, the emerging empirical evidence underscores the promising role of entrepreneurial finance in supporting the growth of MSMEs. While challenges persist, particularly in balancing risks and returns, the evolving landscape, including hybrid financing models and synergies with traditional channels, holds the potential to enhance the impact of entrepreneurial finance on MSMEs in diverse sectors and regions. A more comprehensive and nuanced understanding, supported by long-term studies and considerations of heterogeneity, will contribute to refining strategies and policies in this critical domain of economic development.

### **Implications and Conclusions**

The conceptual review underscores several key implications for both research and practice in the realm of entrepreneurial finance. To establish causality between various forms of entrepreneurial finance and the performance of Micro, Small, and Medium Enterprises (MSMEs), there is a call for increased engagement in field experiments and quasi-experimental studies. Leveraging natural experiments arising from policy changes offers a unique avenue to explore these dynamics. Comparative research across diverse contexts becomes imperative, aiming to pinpoint optimal instruments, business models, and combinations that align with the specific nuances of each entrepreneurial ecosystem. Effective lessons transfer requires a careful process of adaptation to ensure relevance and applicability.

Understanding investor perspectives and motivations emerges as a critical focal point for the design of impactful MSME funding campaigns, the management of investor relations, and the shaping of supporting institutions. This insight into the investor landscape holds the potential to enhance the efficacy of entrepreneurial finance initiatives. Additionally, platform innovations that incorporate skills transfer, matchmaking, and investor education are highlighted as avenues to extend the impact of entrepreneurial finance beyond mere fundraising success. The importance of global connectivity, even in the context of localized efforts, is emphasized as a vital element for amplifying impact.

Capacity building is identified as a fundamental necessity, extending to entrepreneurs, platforms, and regulators. This emphasis on both technical and soft infrastructure is deemed essential for mitigating risks and achieving sustainability within the entrepreneurial finance ecosystem. Supportive policies are highlighted as a critical enabler, with a focus on boosting entrepreneurial activity, addressing information gaps, protecting consumers, enhancing reporting standards, and facilitating responsible innovation.

In conclusion, while entrepreneurial finance holds substantial potential, it is not presented as a silver bullet solution. The provision of "smart capital," strategically targeted funding coupled with hands-on support, is positioned as a more critical factor than the mere supply of capital. While entrepreneurial finance has the capacity to address significant MSME financing gaps, its design must be adaptive and tailored to the specific context of each ecosystem to ensure a positive and sustainable impact on economic development.

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