Capital structure and competitive intensity: Considerations for Start-Up Firms

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Abstract

This short perspective article discusses the effect of a start-up firm's capital structure on the nature and degree of competition in the marketplace. Specifically, the article argues that the nature of financing availed by the start-up firms expose them to the risk of predatory price-based competition from a well-capitalized competitor. The staged model of capital infusion works best when tangible progress can be demonstrated at every new round of financing. Indian start-up firms need to acknowledge this fact, pursue innovations that complement the local realities and develop a distinct local model that justifies the need for additional capital.

There exist various definitions for a start-up firm with limited convergence. Some definitions are based on metrics of age, growth, revenue and profitability while others prefer to use metrics of novelty and scalability. The department of industrial policy and promotion defines start-up as company "working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property" that is less than five years old and has a revenue of less than Rupees 25 Crores in a year (Ministry of Commerce and Industry, 2016). The start-up firms, new entities with novel business models, in India witnessed a record capital investment in the year 2015 at USD 8.2 billion and a start-up was funded at every 10 hours on an average considering 890 deals consummated during the year (KPMG, 2016). But the willingness to invest in Indian start-ups has decreased significantly since then and the total investment in the year 2016 at USD 3.3 billion was lower by 60 percent. A number of promising start-ups of 2015 shuttered while others retrenched employees (Ayyar, 2016). Investors in many of these firms are urging management teams to contain costs and concentrate on profitability metrics instead of driving customer acquisition volume to gain scale. The focus is back on the resilience of the business models and the sky-high valuations used for the recent round of financings are marked down by investors (Sen, 2017). Concerns are being raised that many business models are unsustainable without raising additional funds from investors and a mark-down of prior investments makes additional fund raising a challenging task. It is in this context that certain start-up firms have requested a government intervention to prevent 'capital dumping' by certain foreign firms (Chanchani, 2016). These demands that were initially raised the promoters of the start-up firms have also received recent support from Indian investors in these firms (Peermohamed, 2017; Davda,2016).

Paradoxically enough, the companies that are looking for government intervention today were accused in the past by the unorganised players for causing an appreciable adverse effect on competition by creating product specific monopoly leading to manipulation of price, control of production and supply (Mohit Manglani versus Flipkart and others, 2014). The proponents of government intervention claim that a significant capital infusion by established global firms constitute a market manipulation and distort 'level playing field'[i] doctrine. They further argue that the employment benefits from the growth of global players do not accrue proportionately to local labour markets when compared with the benefits from the growth of local players. The opponents to such demand argue that the local firms rallying for protection from foreign capital inflow are themselves funded by the foreign capital. Therefore, a sudden change in stance for these companies is anomalous, to say the least. The opponents also argue that inferior service offering is the primary reason for the loss in the market share of local players and the call for protectionism is a convoluted effort to restrict the competitors gain in market share. Amidst this cacophony of arguments and rhetoric from both sides, we risk the ability to parse through the real issue – effect of a firm's capital structure[ii] and predatory pricing[iii] on the nature and degree of competition in the market-place.

Brander and Lewis (1996) initiated a strand in academic research that analyses the impact of choice of capital on the degree of competition. This body of cross-disciplinary research integrates corporate finance with strategy and market structure and establishes that financing decisions subsequently impact product market outcomes. Specifically, whether firms will accommodate to competitor's strategy without a response or will raise a counter-offence is influenced by their source of funding. The start-up firms have traditionally accessed venture capital to pursue their business objectives, both globally and in India. The lack of operating history and risk associated with an unproven business model restrict a start-up's access to traditional bank financing. Venture capitalists spend time and resources in understanding the technological developments and are better equipped to understand the underlying risk. They also provide mentoring and strategic advice to entrepreneurs in addition to capital contribution and are often instrumental in structuring exit events in the form of initial public offering, sale or a merger. A typical venture financing arrangement involves a 'staged commitment' where a capital provider's continued participation with the enterprise is contingent upon firm's future performance. The first stage of funding that start-ups avail is called seed funding or angel funding round. This round of financing enables a company to develop the product or service and define its proposed market and targeted users. A seed round helps the company in recruiting few employees and in launching an early version of the product or service. This is followed by a series 'A' funding subject to the acceptance of the product or service offering. Series 'A' funding enables firms to scale their customer base relying upon geographical diversification and enhanced product offerings. Further rounds of financing, denoted by sequential alphabetical letters, are used for growth and acquisitions. This contingent nature of commitment results in two distinct benefits for the capital provider. Firstly, it reduces the adverse selection[iv] problem (Akerlof, 1970) as a firm with a belief in its ability to meet promised staged goals is more likely to accept such financing arrangements. Secondly, it reduces agency problems[v] (Jensen and Meckling, 1976) related to misappropriation or wasteful expenditure of investor funds considering that promoters will need continued access to capital providers for ensuring the longevity of their business. The threat of termination as it relates to future capital participation serves as an effective incentive mechanism to align goals of incumbent management with capital providers. Gompers (1995) finds evidence that staging of capital infusion provides the investor with an 'option to abandon' and encourages information sharing and progress monitoring. The promoters prefer this staged financing arrangement believing that their company will be more valuable at a future date and the next round of financing will be less dilutive than the current round. But the staged nature of financing also creates an extremely valuable strategic opportunity for the competitors. Being aware of the contingent nature of funding available to the firm, the competitors will rationally engage in strategies that are likely to result in the firm not achieving its promised goals to its investors (Bolton and Scharfstein, 1990). The constraints on future funding imposed by missing targets will eventually drive the firm out of business and will increase competitor's economic profits. Shliefer and Vishny (1997) study the effects of capital constraints in reducing the financial market efficiency by imposing limits on arbitrage[vi]. Their staged model of competitive responses in the presence of capital constraints and performance-based assessment by providers of future capital makes an interesting case for comparison with start-up firms. Venture capitalists routinely review the performance of their investee companies and allocate future capital to the firms with better performance. A decline in the current period performance may incentivise the management to invest less in the business and preserve more cash to deal with the uncertainty of future funding. This cash conservation can lead to a vicious cycle where firms continuously underinvest in the product or service offering and delay the eventual outcome instead of addressing the competitive positioning.

The current competitive landscape in Indian start-up ecosystem is an instance of this multi-stage dynamics. Equipped with the knowledge that local firms need access to future funding since they are operationally unprofitable, global players are rationally attempting to increase the intensity of competition. Venture capitalists, that initially funded local players deriving comfort from their first-mover advantage, are concerned about the slow progress made in achieving operating profitability.

The past record of local players on missed revenue targets, higher than targeted cash-burn and anecdotal stories of excessive remuneration being paid to certain employees is indeed not helpful to their cause. It is naïve to expect that the government will offer protection for organised firms and their capital partners when it has not done so for the unorganised sector. The literature in competitive strategies makes a distinction between innovators and imitators. Hellman and Puri (2000) find clear evidence that innovators have a higher likelihood of receiving venture capital financing as compared to imitators. A prudent strategic response for local firms at this time will be to consider raising the bar by innovating product and service offerings and differentiating themselves from the global firms. Replicating successful business models from the developed countries and relying upon first-mover advantage and network effects[vii] to offer a competitive barrier is not an optimal strategy in this era of globalisation. This is particularly true in instances where switching costs for customers are negligible, suppliers are unconstrained to a network owing to limited network benefits and the concept of customer loyalty is utopian. A business with superior customer offering will find caterers of capital irrespective of predatory competition as the relevance of price-based competition becomes marginal in this context. The staged model of capital infusion works best when there is a new, promising chapter in the story at every round of financing that justifies need for additional capital. Indian firms need to acknowledge this fact, pursue innovations that complement the local realities and develop a distinct Indian model. Else, the cries of protectionism will continue to prevail and only change will be the name of entities demanding protection from the competition.

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Endnotes:

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[i] Level playing field refers to an economic and legal environment in which all competitors, irrespective of their size or financial strength, follow the same rules and get equal opportunity to compete. Level playing field is a concept about fairness, not that each player has an equal chance to succeed, but that they all play by the same set of rules. A metaphorical playing field is said to be level if no external interference affects the ability of the players to compete fairly.

[ii] A firm's capital structure is the composition of its liabilities. The capital structure defines how a firm finances its overall operations and growth by using different sources of funds.

[iii] Predatory pricing is the act of setting prices low in an attempt to eliminate the competition. Predatory pricing is illegal under anti-trust laws, as it makes markets more vulnerable to a monopoly.

[iv] Adverse selection describes an undesired result due to the situation where one party of a deal has more accurate and different information than the other party. The party without the information is worried about rigged trades, which occurs when the party who has all the information uses it to their advantage.

[v] A conflict arising when the agents entrusted to look after the interests of the principals use the authority or power for their own benefit instead.

[vi] Arbitrage is the process of exploiting differences in the price of an asset by simultaneously buying and selling it in different venues or forms.

[vii] A network effect (also known as a network externality) exists when a product's value to the user increases as the number of users of the product grows.