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## **How does the current economic crisis affect venture initial capital structure?**

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### **Abstract**

When there is an economic shock, market failure or credit crunch, smaller and riskier ventures will have more difficulties in obtaining sufficient funds.

Our preliminary results show that the current financial crisis did not change the ratio between internal and external capital. However, new ventures tend to privilege suppliers credits and leasing against the traditional bank loans.

The belief that a lack of financial capital limits the entrance, performance, and survival of start-ups is not new, and has grown during the recent economic crisis.

In normal economic conditions, access to finance is perceived as one major obstacle to entrepreneurial activity. Every firm needs money to operate their business. Without adequate funding, firms cannot pursue optimal investment and growth opportunities. Nevertheless, financial capital is even more crucial for new ventures as they struggle to survive with very low or no income or revenue in the first years. Start-ups also lack a track record, have few tangible assets that can be used as collateral and consequently, suffer from more severe asymmetric information problems (Fluck et al., 1998; Michaelas, Chittenden and Poutziouris, 1999; Huyghebaert and Van de Gucht, 2007; Korosteleva and Mickiewicz, 2011; Nofsinger and Wang, 2011) affecting their funding. Start-ups are usually small, not quoted, family-owned and do not disclose accounting and financial information. On the other hand, ventures with a larger pool of financial resources can invest more in innovation and marketing, recruit individuals with higher quality and have a higher flexibility to overcome potential threats or managerial mistakes.

When there is an economic shock, market failure or credit crunch, smaller and riskier ventures will have more difficulties in obtaining sufficient funds (N Berger and F Udell, 1998), which may lead to a decrease in performance, investment, employment, growth and even failure (Gries and Naude, 2011). Recent studies strongly demonstrate this point. Entrepreneurial activity has declined sharply with the recent financial crisis as entrepreneurs faced more difficulties in starting their business in mid-2009 (Bosma and Levie, 2010; Lerner, 2010; Shane, 2011). These difficulties are likely to extend to funding decisions.

While there has been some research on understanding the determinants of firms' initial capital structure and on understanding the impact of macroeconomic conditions on firm creation, the effect of the current financial crisis on ventures' initial capital structure decisions and sources of finance

remain partially unexplored and therefore it will be the focus of this study. Our paper contributes to the discussion by evaluating the impact of the current financial crisis on ventures initial capital structure by answering the following research questions: 1) What effect did the financial crisis have on venturesâ initial capital structure?; 2) How did new ventures cope with difficulties in raising money?; and, 3) Can we conclude that there is a shortage of credit, particularly for new ventures?. To provide answers to our key questions, we use data from Portugal. We will combine firm-level financial data with a matched employer-employee database. Our data provides detailed information on the new firms established in each municipality between 2000 and 2009. For each firm, we gather information on size, founder characteristics, and year-end data on financial, internal and external capital. The fact that the financial crisis might affect differently each municipality and vary across time is useful for our identification strategy. Portugal provides an excellent context in which to evaluate the impact of the current financial crisis. During the last two decades, government over-expenditure resulted in high levels of public deficit and public debt. With the collapse of Ireland, and then Greece, fears spread among investors that Portugal could be next in line to bankrupt. With increased pressure from bond traders, speculators and ratings agencies, interest rates on sovereign debt increased dramatically, to the point of unsustainability, forcing the Portuguese government to request a bailout package from the International Monetary Fund/European Union. All this situation, ended spreading to the private sector.

Our preliminary results show that the ratio between internal and external capital maintains de same before and after the crisis. However, new ventures tend to privilege suppliers credits and leasing against the traditional bank loans.

For policy makers and practitioners, this study is likely to have clear implications. A more thorough understanding of the implications of the financial crisis on various types of financial sources can help policy makers to better craft funding support and line of credits for start-ups. On the other

hand, initial capital structure have been shown to have important implications for firm success and/or failure (Chandler and Hanks, 1998; Cassar, 2004; Robb and Robinson, 2010; Gartner, Frid and Alexander, 2010).

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