FUNDING WINTER – EFFECT ON INDIAN STARTUPS

CA. Venkatesh Bhat

Even a casual reader of finance publications would have noticed the dominance of discouraging news about startups in 2022. A few themes kept appearing in headlines last year - employee layoffs, investors delaying capital infusion decisions, lower spends by startups in marketing, some startups getting valued lower than their previous funding rounds, etc. All these events of different startups and on different dates have one common underlying reason - drying up of capital flows or " Funding Winter".

What is Funding Winter?

Funding winter means an extended period of reduced capital inflows to startups. This has been a global phenomenon throughout 2022 and expected to have an extended run in 2023 as well. Prior to funding winter, globally many startups were able to raise funds at increasingly higher valuations with relative ease. India being the third largest startup ecosystem in the world, these trends are reflected in the capital flows to India startups as well. A recent PwC report mentions a drop of 33% funding of Indian startups during 2022 in comparison to 2021.

The effect of funding winter has been more pronounced on late stage funding; early stage funding and relatively new sectors continued to attract capital flows in 2022.

What caused Funding Winter?

Investment cycles are a recurring economic phenomenon of the global economy. Businesses faced inflationary pressure for the last few quarters with soaring food, energy and commodity costs. Geopolitical factors such as Russia's war on Ukraine have created instability and uncertainty that are impacting large parts of the world. These prevailing macroeconomic and geopolitical conditions have caused a market slowdown and economic volatility. Recessionary trends have been forecast for 2023 which would impact the growth rates of businesses across multiple sectors. Cost of capital has been rising taking into account the various risk factors, leading to funding slowdown.

Venture Capitalists and PE Investors are not rushing into new deals; many prefer to invest in their existing portfolio where the business has progressed as per projected milestones. Most investors look for a clear path to profitability while investing.

According to data compiled by private market intelligence platform Tracxn Technologies, the number of unicorns in India nearly halved from 44 in 2021 to 23 in 2022; globally there is a 55% drop in the number of startups attaining valuation of One Billion dollars or more.

Why is there a dependence on global capital?

Common sources of funding for the startups can be from the own savings of the founders, Angel Investors, Venture Capitalists, Private Equity Funds, Strategic Investors, Debt funds from Banks and other financial institutions. The source depends on the size and the stage at which the startups are operating.

The Government of India launched the Startup India programme in 2016; January 16 is celebrated as national startup day. This initiative focuses on meeting multiple requirements of early startups, one of them being funding. Seed funding and Fund of Funds programmes support eligible startups mostly at an early stage. This initiative is apart from funding programmes of Indian financial institutions, many of whom have focused schemes for startups. In order to attract foreign capital, the Government of India has also relaxed FDI norms across sectors.

Despite the growth of an enabling Indian ecosystem for startups, a large part of the funding of Indian startups comes from global VC/ PE funding since this is the capital focusing on early and mid-stage growth and is unsecured in nature. Indian risk capital as well as institutional funding are not significant enough to insulate the startup system from global investing trends.

What are the negative consequences of the funding winter on start ups?

Many startups have laid off employees and are refocusing on core businesses. There have been cuts of marketing spends between 30% to 60% in 2022 impacting pace of user acquisition. Those startups that necessarily require continuous capital injection to build businesses are most impacted. Strategic sale of part of business, and in some cases, distress sale is the only viable option for some startups to survive. Funding winter has also constrained the start-ups from pivoting into other business models when one business model has not earned the desired fruits.

Are there positive implications of funding winter on start ups?

Funding winter has given opportunity to the smaller startups to grow their business and market reach tremendously. Smaller startups are seeing growth in their businesses as the larger startups which were spending large amounts on marketing aspects are currently constrained by the funding winter. Early stage investing is relatively less impacted especially for those startups with deep technology.

On the other hand, funding winter is also helping the larger startups to re-organise themselves and relook at their business models. Marketing spends are becoming smarter and personalised; there is renewed focus on cost of acquisition (CAC) of customers . Large teams are being reviewed frequently for more efficiency and efficacy. This is helping start-ups to strive for the execution stage from the idea stage.

History is replete with examples of business operations that run efficiently when faced with resource limitations. These businesses discover their path to the virtuous cycle of profitability -improving operational efficiencies & reducing cost of acquiring and retaining customers lead to increasing profit pool. Most of the companies that survived the major recessionary events (the great depression of 1930, DotCom burst of 2000, subprime crisis of 2009, COVID pandemic of 2019) performed well once they survived the difficult phase.

Question is, how should startups navigate these turbulent times of uncertainty and fund crunch?

Strategies to cope with funding constrained environment

Experts suggest a few tried and tested strategies for startups to survive the funding winter.

Firstly, investors will seek the startups that are able to demonstrate Balanced focus on growth and profitability. Startups need to demonstrate profitability in mature parts of business and take a calibrated approach to growth investment.

Secondly, market fitness of the product becomes more relevant than being an early player in a sector. Businesses need to listen to customers continuously and adapt to changing market conditions.

Thirdly, startups would target cash optimisation in business processes. Strategies will include efficient working capital management, sticking to tried and tested marketing strategies & shorter experimentation periods for new ideas.

Startups that managed to raise money in the previous twelve months will adopt strategies that extend cash runway - postponing decisions that require large capital commitments and even renegotiating debt repayment commitments.

What would be the implications for CAs who advise startups?

In summary, funding winter will continue till global factors contributing to enhanced risk perception remain dominant. In the meantime, startups need to devise coping mechanisms to survive and exploit the market conditions. Startup founders need assistance in building and executing right strategies for acquiring capital which is appropriate to their stage of business and immediate priorities. This need can be effectively fulfilled by Finance Managers and advisors; they also need to assist startups in executing these strategies effectively. Finance managers and advisors should also advise the startups on the optimization of the spends, managing cash flows efficiently and increasing the runway.