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How Small Companies Choose Investors Instead Of Initial Public Offerings To Borrow Money: A Descriptive Study

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Abstract

This research paper shed light on how small cap companies acquire funds. It focuses on a new trend available for small companies and for private investors instead of an old option or traditional way of Initial Public Offerings (IPOs) to raise money. The study focuses on changes happening. It justifies it for different reasons like new technology, too many rules for Initial Public Offerings, uncertain stock markets, wanting more control over their business, and thinking about growing for a long time. To understand these reasons better, the research referred to information from financial reports, academic studies, and market analysis. It focuses on small companies and private investors in India. The study suggests that small companies are now looking at other trending options to acquire money, like crowdfunding platforms and Special Purpose Acquisition Companies (SPACs), instead of just doing Initial Public Offerings. These alternatives have different advantages for the small cap companies like fewer rules to follow, more control over their business, and a focus on long-term growth. The research study focused on new trends or patterns of raising funds for companies like direct listings and using SPACs instead of Initial Public Offerings In nutshell this research helps us to know how small companies are changing their way of acquiring money. It gives insights that can help entrepreneurs, investors, and financial experts make better decisions in today's complex financial world.

Keywords: Small Cap Companies, Private Investors, Initial Public Offerings, Borrowing Funds.

1. Introduction

Small companies often face a problem in taking decisions when they need money: should they go public with an Initial Public Offering (IPO) or acquire funds from private investors? This research studies why many small companies select the latter option, choosing private investors over the complexity of an Initial Public Offerings. By understanding the reasons behind this preference, we can gain understanding about the financing strategies of small businesses and the dynamics of the investment landscape. This study aims to put light on the factors influencing the decision and their implications on the small companies looking for funds.

In the past, small companies mostly raised money by becoming public through an Initial public offering. But things have changed. Now, there are more options, like getting money from venture capitalists or angel investors. This has made small companies think about the right way to get funds.
By understanding why small companies prefer private investors over an Initial Public Offering, we can learn about the financial decisions made by small cap companies. This research aims to explain why this happens and what it means for small companies trying to get money. It's important for everyone involved in business to understand these choices, from entrepreneurs to investors to people who study finance. This study wants to help small companies make smart choices about how they raise money in today's competitive world.

2. Literature Review

An Article by Christopher Hansen titled "Which companies go public via Special Purpose Acquisition Companies? The role of private equity and venture capital financing" in the year 2024, looks at two types of companies that went public in 2020 and 2021, those that merged with special-purpose acquisition companies (Special Purpose Acquisition Companies) and those that went through the traditional IPO process. It also examines how private equity and venture capital funding affected their decisions and their performance after going public. Where they find that there weren't many differences between SPAC merger and traditional IPO companies before they went public. Neither type of company had strong profitability or financial structure.

However, after going public, companies that merged with Special Purpose Acquisition Companies equally performed worse in terms of their stock returns compared to those that did traditional Initial Public Offerings. Over one year after going public, SPAC companies' stock returns were on average 45 and 25 percentage points lower than the broad market and traditional IPO companies, respectively.

Accordingly, the source of investor funding didn't affect the choice of going public method. But companies with more reputable investors and those with private equity investors tended to prefer traditional Initial Public Offerings over SPAC mergers. This article fails to show, that how private equity investors are advantageous for Small Cap Companies. It studied only two companies and the role of private investors in the year 2024

Research paper published by Aarti Sharma, Ankit Singhal and Vishwanatha Saragur Ramanna in Journal International Review of financial Analysis in Jan 2024 titled as "The effect of lead institutional investors on investment and capital structure of young firms: Evidence from Indian Initial Public Offerings. This research paper investigated the consequences of a regulation that allows Anchor Investors to participate in Initial Public Offerings. The regulation brought an increase in IPO volume. They found that more companies decided to go public because of this rule. After the rule, companies with big investors had to spend less money to go public. They also started spending more on growing their business and owing less money to others.
This change in spending and debt was especially big for companies that were growing fast and didn't have a lot of money. Those kinds of companies, with big investors, were able to get 26.4% more money from selling shares than companies that weren't struggling financially. This research paper talks about institutional investors and how these investors affect their investment decision and capital structure framing.

Research Paper by Dr.A.Fazlunnisa in EPRA International Journal of Research and Development titles as "A Study on sources of finance available for Entrepreneurs. This research paper shows how entrepreneurs can get money to start their businesses. It covers different ways entrepreneurs can get funds, like using their own savings, borrowing money through credit cards or loans, or getting money from investors. The study aims to understand where entrepreneurs get their money from and what factors influence their choices. This research paper suggest that entrepreneurs can explore different funding opportunities like business angels, venture capital, bank loans, buyouts, and financial bootstrapping. Business angels invest their money in new and innovative companies to help them grow quickly. Venture capital involves investors giving money to fast-growing companies with the hope of making a profit later on. Bank loans are funds provided by banks based on a person's or business's credit. Financial bootstrapping is when a founder uses their own money to fund their business and uses different methods to keep costs low and the business moving forward. This paper suggests why entrepreneurs should prefer private investors or other relevant sources of private equity investment. It hasn't suggested any source for small cap companies

3. Objectives of the Study

1. To study the factors influencing small companies to opt for investors over Initial Public Offerings (Initial Public Offerings) as a means of borrowing funds.
2. To identify the key motivations behind the decision-making process of small companies when selecting investors as a financing option instead of going after an Initial Public Offering.
3. To analysis and figure out the advantages and disadvantages associated with choosing investors over Initial Public Offerings for small companies seeking capital.
4. To examine the role of investor characteristics, such as risk tolerance, time horizon, and structuring strategy as per the decision-making process of small companies.
5. To identify any up-and-coming trends or patterns in the choice between investor financing and Initial Public Offerings among small companies and suggestion for broader financial standing.

4. Methodology

A. Area of Study: The study limited to small cap companies' preference for borrowing funds through private investors over Initial Public Offerings with due considerations of key factors influencing decision making for selecting appropriate source among two preferences.

Geographic Scope: This study is restricted to the small cap companies and private investors in India.

B. Research Design: This research paper uses secondary sources of data to collect and present the relevant information. This study uses a descriptive research design to provide an overview of how small companies make decisions to choose investors over Initial Public Offerings (Initial Public Offerings) for borrowing money. The descriptive approach is used to focus on documenting and analyzing the factors influencing these decisions without manipulating variables.

Secondary Data: Referred relevant documents such as financial reports, prospectuses, SEBI regulations, and market reports to assess compliance.
Research Study is done based on document analysis from financial reports, Academic Reports, Market data and Market trends reports.

5. Data Analysis and Interpretation

Factors influencing small companies to opt for investors over Initial Public Offerings (Initial Public Offerings) to borrow funds.
The study shows that these factors vary between the current scenario and the past scenario.

Current Scenario:
i) Access to Alternative Funding Sources: In the current scenario, there is an awareness about different funding sources such as venture capital, private equity, and angel investors. Small companies find these sources more approachable and strongly match their need of acquiring funds compared to the past, reducing the need to pursue Initial Public Offerings for capital.

ii) Technological Advancements: Technological improvements have changed how small companies get funds for their business. Now, they have other options beside Initial Public Offerings such as crowdfunding websites or platforms and online investment networks, which provide funds directly from individual investors without the need for an IPO to small cap companies. Through Crowd funding websites or platform small cap companies can have crowd funding campaign, here they showcase and talk about their product, idea or services offered by them and to present that what makes them special, and why they are better than others. Through this campaign lots of people become part of this and provide money in return of rewards or part of the company. A crowdfunding website is like a big online store where people can find, learn about, and help support cool projects. Through this campaign they also make friends with the people who gave them money. These friends give valuable advice, share ideas, and help small cap companies meet new people who can help them. This recent technology helps them to find diverse ways to grow their company. This technological advancement has made it easier for small companies to get money easily and grow, even without following the traditional Initial Public Offerings way.

iii) Regulatory Burden: The regulatory burden associated with conducting an IPO has increased in recent years. Small companies, especially those with limited resources, find it hard to deal with the extra rules and requirements when they want to go public through an Initial Public Offering (IPO). Companies must spend more time and money to follow rules and regulations. They must give detailed financial reports, follow rules about sharing information, and meet deadlines set by regulators. This can be burdensome for small cap companies. This takes their focus and resources way and may impact their performance at what they are best. Because of this small cap companies prefer to get money from investors, instead of going through the burdensome and tedious process of an Initial Public Offerings. Acquiring money from investors has fewer rules and paperwork compared to an Initial Public Offerings. It encourages them to raise money without dealing with the complex and time-consuming process of going public. This way, they can focus on making their business grow.

iv) Market Volatility: The stock market is never stable it goes up and down. This happens when the economy is not doing well or when there is a big problem globally. For small cap companies this uncertainty can make it tough to have an Initial Public Offerings. If the stock market is volatile because of economic problems or big world issues, people will not pay for their shares and will not get the required money for the business. So, instead of getting funds through an Initial Public Offerings they may prefer getting money from private investors. This guides them to feel more stable and secure, and will have more control over their finances, even when things are unpredictable in the stock market.

v) Preference for Control: Small cap company management teams prefer to have control and ownership of their business rest in their hands, which can be done through investor financing instead of an Initial Public Offerings.

vi) Focus on Long-Term Growth: Small cap companies may concentrate on long-term growth and sustainability over short-term gains related to going public. When a company gets money from investors, they always act as a patient investor. As they are willing to wait for the company to grow before expecting to make a profit. Private investors often form partnerships with them. This partnership can help them in the form of getting advice from the investors, introducing them to new contacts or to help out in developing new product or service

Past Scenario:

i) Limited Funding Options: In the past, small cap companies had a smaller number of alternatives as funding options, making an Initial Public Offerings more attractive and useful option for raising required capital to have growth and expansion of their business

ii) Perception of Prestige: Going publicly through an Initial Public Offerings seen as a big achievement for small cap companies. Conducting an Initial Public Offerings was often considered as a prestigious milestone for small companies, as it shows that they are growing up, doing well and can sell their shares to the public. The status associated with being a publicly traded company may have motivated small companies to pursue Initial Public Offerings.

iii) Easier Access to Public Markets: In the past, it was easier for small cap companies to issue shares publicly through an Initial Public Offerings. As the rules they had to follow, and the costs of acquiring funds might not have been as strict or as high as they are now.

iv) Investor Demand: Those were the days when more investors were having interest in buying shares from companies going public. This allowed small companies to have an Initial Public Offerings, because they could take advantage and sell their shares easily. When a company went public, investors were interested in buying its shares because they were new and exciting. This made small companies raise money by selling their shares to the public.

v) Market Dynamics: In the past, companies liked to do an Initial Public Offerings, because of the working of the market and the way investors felt might have made it better for companies to do Initial Public Offerings. This means that in the past, when companies went public, their shares were worth more, and investors felt surer about buying them. This made it easier for small companies to get money from the public by selling their shares on the stock market.

vi) Exit Strategy for Investors: Initial Public Offerings were an option for early investors and venture capitalists to sell their shares and make money out of their investments in small companies. When small companies go public, these investors sell their shares to the public and get their money back with some profit. This chance to make a lot of money from an Initial Public Offerings must have made small companies do an Initial Public Offerings.

Key Motivation factors for choosing investors over doing an Initial Public Offering (IPO) to raise money for small cap companies:

1. **Flexibility and Control**: In an Initial Public Offerings, where the small cap companies must follow strict rules and regulations set by the stock market, getting money from investors allows Companies to negotiate the investment terms directly as per their wish. They can choose investors who understand their business and share their vision for the future.
2. **Speed:** The speed at which they acquire funds acts as a key motivation factor for the small cap companies to think of private instead of an Initial Public Offerings. Initial Public Offerings is a very time-consuming process which take a long time, involving lots of paperwork and waiting for approval from regulators. By choosing investors, they can raise money within the required time and speed, and this also allows them to move forward with their plans to improve their performance, product or service and reach more customers sooner.
3. **Long term Support and Expertise:** Small Cap companies value the long-term support and expert advice that investors provide. Investors offer advice, connections, and resources that help the company grow and succeed in the long run.

Preferences and strategies of investors affect small companies' decisions:

Small cap companies' decision making depends upon the plans of investors in terms of like how much risk they're comfortable with, how long they plan to invest for, and how they structure their investments.

1. **Higher Risk**: If an investor is comfortable with taking big risks and waiting a long time to make money, one might be interested in investing directly. But if one prefers safer investments or wants to see results more quickly, one might prefer to go public through an Initial Public Offerings.
2. **Potential for Growth**: Private investors always look to small companies for high growth potential. They like to invest in businesses that have innovative ideas, strong leadership, and the ability to grow quickly.
3. **Strong Management Team**: Private Investors prefer companies with a strong management team. They decide to invest in such a company where founders and executives have a clear vision for the company and the expertise to execute it successfully.
4. **Market Opportunity**: Private investors evaluate the market opportunity for the company's products or services. They look for industries or sectors that are growing rapidly and where the company has a competitive advantage.
5. **Clear Business Model**: Private Investors prefer companies that have a clear and sustainable business model. As they want to understand how the company plans to make money, acquire customers, and generate profits in the long term.
6. **Risk Management:** Investors verify how risky the investment is and how the company plans to deal with those risks. They want to make sure the company knows about the challenges it might face and has a plan to handle them.

Presently, there are some emerging trends and patterns in the decisions small companies make between choosing investor financing and Initial Public Offerings (Initial Public Offerings):

1. Preferential Treatment for Direct Listings: Some small companies are opting for direct listings instead of the traditional Initial Public Offering way. Direct listing is a method by which a company go public and lists them on a stock exchange without raising additional capital through the issuance of new shares, in a direct listing, existing shares held by the company's founders, employees, and early investors are listed and made available for trading in the open market. For direct listing, the companies must engage with financial advisors, legal counsel, and regulatory experts to ensure compliance with listing requirements and market regulations. They also work closely with the stock exchange to coordinate the listing process. On the day of direst listing, the company must submit a registration statement to the Securities and Exchange Commission (SEC), giving information about its business, financials, and ownership structure. This registration statement provides the basis for investors to evaluate the company and its shares.

Once the company gets approval from the Securities and Exchange Commission, the existing shares are directly listed and begin trading on the stock exchange. There is no underwriting process or initial offering price set by investment banks, as in an Initial Public Offerings. Rather the opening price of the shares is determined by the market forces.
By opting for a direct listing, companies gain access to public capital markets and liquidity for their shares without the issue of new shares or pay underwriting fees associated with an Initial Public Offerings. The advantage of the direct listing process is that it has greater transparency and efficiency, as the company's shares are priced based on market demand rather than predetermined by investment banks.

2. Special Purpose Acquisition Companies as an Alternative to Initial Public Offerings: Special Purpose Acquisition Companies are popular as an alternative to traditional Initial Public Offerings. Special Purpose Acquisition Companies is like an empty box that goes public through an Initial Public Offerings, which means it sells shares to the public on the stock market. The investors behind the Special Purpose Acquisition Companies raise money from people, but they don't use the money right away. They put the money in a bank account and wait. Their goal is to find a private company that's doing well and buy it using the money they raised from selling shares of the SPAC.

3. Crowdfunding and Regulation A+ Offerings: Small companies are using crowdfunding platforms and Regulation A+ offerings to raise capital directly from individual investors in place of an Initial Public Offerings. This method helps companies to acquire capital from a wider pool of investors with few regulatory requirements compared to traditional Initial Public Offerings.

4. Dual-Class Share Structures: Some small companies are showing preference to dual-class share structures to maintain control over their business while accessing public markets. This structure helps founders and early investors to acquire shares with greater voting rights, which helps to have more control over corporate decisions despite diluting their economic ownership.

5. Increased Emphasis on Sustainability and Social Impact: Small companies are facing tremendous pressure from investors and consumers to give due importance to sustainability and social impact. This trend is harming their financing decisions, while some companies opt for investor financing from impact-focused funds or socially responsible investors rather than pursuing traditional Initial Public Offerings.

6. Conclusion: In this research paper, we studied how small companies decide where to get money from. In the past, preference was for going public by doing an Initial Public Offerings. But now, small companies are choosing to get money from private investors instead of following the traditional way of an Initial Public Offerings.We studied why this change is happening. Factors like new technology, too many rules for IPOs, uncertain stock markets, wish to have more control over their business, and thinking about long-term growth, all play an important role in this shift.Our aim is to understand these factors better, figure out why small companies prefer private investors, think of and talk about the good and bad sides of each option, look for different types of investors involved, and see what new trends are in this area.We did this study by focusing on small companies and private investors in India.We analysis from the study that presently small companies like other ways to get money, like crowdfunding online platforms or

Finally, our research helps us understand how small companies decide where to get money from. This helps entrepreneurs, investors, and financial experts make better decisions in today's complicated money world.

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