Aalto University
School of Business

The Lack of Private Capital in the Finnish Fashion Ecosystem
A Case Study of Finnish Fashion Start-ups and Investors

Accounting

Master's thesis

Toni Tervilä

2015

Department of Accounting
Aalto University
School of Business

Aalto University
School of Business

Aalto University, P.O. BOX 11000, 00076 AALTO
www.aalto.fi

Abstract of master's thesis

Author Toni Tervilä	
Title of thesis The Lack of Private Capital in the Finnish Fashion Ecosystem – A Case Study of Finnish Fashion Start-ups and Investors	
Degree Master of Science in Economics and Business Administration	
Degree programme Master's Programme in Accounting	
Thesis advisor(s) Seppo Ikäheimo	
Year of approval 2015 **Number of pages** 83	**Language** English

Abstract

Objectives: The Finnish fashion industry has not been able to produce competitive companies with strong global sales for decades. At the same time, neighboring countries Sweden and Denmark, with similar socio economic conditions than Finland, have been able to grow their fashion industry with many young brands. Although Finnish design in general is highly praised globally, and Helsinki was recently appointed as the World Design Capital, the lack of Finnish fashion in the international market is peculiar.

A major reason for this odd situation is the lack of private money in the Finnish fashion ecosystem. The purpose of this study is to examine why the level of private investments in Finnish fashion industry is so scarce.

Methodology: I selected a qualitative case study as the research method for this study. The empirical part of the thesis examines four Finnish fashion start-ups and four investors in the fashion industry. The focus is to explore how entrepreneurs and investors see a successful fashion start-up ought to be run, and what are the factors determining success in this industry. The cases in the study were examined using effectuation theory by Saras D. Sarasvathy to compare their decision making and thinking processes. Data was collected through semi-structured interviews with the selected fashion entrepreneurs and private investors.

Results: The findings of the study indicate that Finnish fashion entrepreneurs are more prone to using effectual logic in business practices. On the other hand, private investors were identified to prefer more causal logic in solving similar business problems. Main differences between the two parties of the study were entrepreneurs' considerably lesser amount of planning and budgeting, investors' more commercial mindset in target setting, and the conflicting views on usage of trend analyses and customer feedback. These key strategic differences may explain why the fashion start-ups and investors do not seem to find mutual understanding in investment deals in Finland.

Keywords Finnish fashion, fashion ecosystem, effectuation, start-up funding

Aalto-yliopisto
Kauppakorkeakoulu

Aalto-yliopisto, PL 11000, 00076 AALTO
www.aalto.fi

Maisterintutkinnon tutkielman tiivistelmä

Tekijä Toni Tervilä

Työn nimi Yksityisen pääoman niukkuus Suomen muotiteollisuudessa – Tapaustutkimus Suomalaisista muotikasvuyrityksistä ja sijoittajista

Tutkinto Kauppatieteiden maisterin tutkinto

Koulutusohjelma Laskentatoimi

Työn ohjaaja(t) Seppo Ikäheimo

Hyväksymisvuosi 2015 **Sivumäärä** 83 **Kieli** Englanti

Tiivistelmä

Tutkimuksen tavoitteet: Suomen muotiteollisuus ei ole pystynyt tuottamaan kilpailukykyisiä kansainvälisiä yrityksiä vuosikymmeniin. Samaan aikaan, naapurimaat Ruotsi ja Tanska ovat samanlaisista olosuhteista ponnistaneet maailmalle kasvattamalla muotiteollisuuttaan useilla uusilla muotibrändeillä. Vaikka Suomalainen muotoilu on yleisesti hyvin arvostettua maailmalla, ja Helsinki on hiljattain valittu ”Maailman Design Pääkaupungiksi”, suomalaisen muodin puuttuminen kansainvälisiltä muotimarkkinoilta on merkillistä.

Yhtenä suurena tekijänä tälle oudolle tilanteelle on riskirahan puuttuminen suomalaisesta muotiekosysteemistä. Tämän tutkimuksen tavoitteena on selvittää miksi pääomasijoitusten määrä suomalaisessa muodissa on niin alhaisella tasolla.

Tutkimusmenetelmät: Valitsin tutkimukseni menetelmäksi laadullisen tapaustutkimuksen. Tutkimuksen empiirinen osuus käsittelee neljää nuorta suomalaista muotiyritystä ja neljää sijoittajaa. Keskiössä on tutkia miten yrittäjät ja sijoittajat kokevat sen, miten muotikasvuyritystä tulisi johtaa, ja mitkä tekijät määrittelevät onnistumisen muotialalla. Tutkimusaineistoa tarkasteltiin Saras D. Sarasvathyn kehittämän Tehokkaan yrittämisen teorian avulla saadaksemme selville ja pystyäksemme vertailemaan eri osapuolten päätöksentekoa ja ajatusprosesseja. Tutkimusaineisto kerättiin puolistrukturoitujen teemahaastattelujen avulla.

Tulokset: Tutkimuksen tulokset osoittavat, että suomalaiset muotiyrittäjät käyttävät enemmän tehokasta logiikkaa yritystoiminnassa. Sitävastoin, yksityisten sijoittajien huomattiin suosivan kausaalista, eli syyperäistä logiikkaa samanlaisten liiketoimintakysymysten ratkaisemisessa. Osapuolten suurimmat eroavaisuudet menestyksekkään liiketoiminnan johtamisessa olivat yrittäjien huomattavasti vähäisempi suunnitelmallisuus, sijoittajien kaupallisempi tavoitteiden asetanta ja eriävät mielipiteet trendianalyysien ja asiakaspalautteen käytössä liiketoiminnan tukena. Nämä strategiset eroavaisuudet voivat osaltaan selittää miksi muotialalla toimivat kasvuyrittäjät ja sijoittajat eivät pääse yhteisymmärrykseen pääomasijoituksista neuvotellessaan.

Avainsanat Suomalainen muoti, muotiekosysteemi, yrittäjyysteoria, kasvuyritysrahoitus

Contents

1. Introduction 1
1.1 Background 1
1.2 Recent studies and research gap 6
1.3 Theoretical framework and research questions 6
1.4 Structure of the study 8
2. Fashion as a business 9
2.1 Definition of fashion 9
2.2 Fashion as an industry 10
3. Introduction to traditional business valuation 11
3.1 Traditional business valuation 11
3.2 Strategy analysis 12
3.3 Accounting analysis 14
3.4 Financial analysis 14
3.5 Prospective analysis 16
3.6 Problems of traditional valuation methods 20
4. Introduction to early stage funding 21
4.1 Business angels 21
4.2 Venture capital 22
4.5 Literature on the success factors of an early stage company 24
5. Theoretical framework / literature review 31
5.1 Background 31
5.2 Theory 32
5.2.1 The problem 33
5.2.2 The process 33
5.2.3 The principles 38
5.2.4 The logic 40
5.3 Critique 41
6. Methodology 42
7. Empirical analysis 45
7.1 The *bird-in-hand* principle 46
7.2 The *affordable-loss* principle 52

7.3 The *crazy-quilt* principle 53
7.4 The *lemonade* principle 55
7.5 The *pilot-in-the-plane* principle 59
8. Discussion and analysis 64
8.1 Finnish fashion entrepreneurs using effectual logic 64
8.2 Private investors prefer causal logic in running a fashion start-up 68
8.3 Finnish fashion entrepreneurs and private investors think differently 71
9. Conclusions 73
9.1 Summary 73
9.2 Managerial implications 75
9.3 Suggestions for further research 75
9. References 77

LIST OF FIGURES

Figure 1 Causal process vs. Effectual process (Sarasvathy, 2001a, p. 3) 35
Figure 2 The Effectual Process (Read, S. & Sarasvathy, S. 2005) 37
Figure 3 Finnish fashion entrepreneurs' data distribution. 65
Figure 4 Finnish fashion entrepreneurs' total distribution. 65
Figure 5 Private investors' data distribution 68
Figure 6 Private investors' total distribution 69
Figure 7 Comparison between Finnish fashion entrepreneurs and private investors 71

1. Introduction

The purpose of this thesis is to investigate why there is so little private money available for Finnish early stage fashion companies, and by doing so, increase knowledge in the existent literature on the Finnish fashion entrepreneurship and the whole ecosystem surrounding it. By conducting a case study of four Finnish early stage fashion brands and four private investors this thesis aims to find out is there a fundamental difference in thinking processes between the two parties, which could potentially prevent the investments from happening and the fashion industry to grow. The study also tries to help Finnish fashion start-ups and investors to better understand each other to facilitate more cooperation between the two in the future. This introduction chapter will briefly lay out the background and motivation for the study as well as define the research problem and research questions.

1.1 Background

Finnish economy is in a serious downturn. The unemployment rate is rising up and new investments are scarce. While the nation desperately needs a boost to its economy, and everyone's attention is in the technology sector, I'm suggesting that a more traditional industry such as fashion could offer at least some relief to the economy.

To kick-start the economy we need to get work for people, and to do that, we need additional capital in the form of investments (HS, 2014). We also need more brave entrepreneurs with ambitious goals. However, small Finnish companies often do not want to, and do not know how to expand and grow internationally (Heiskanen, 2014). According to Heiskanen, lack of will and lack of know-how among entrepreneurs is slowing down the economic recovery.

Entrepreneurs' unwillingness to grow businesses is something that is harder to fix and should be taken very seriously. On the other hand, resources in terms of capital and business know-how are relatively easier to acquire. What is more, these assets often come from the same origin, investors.

New jobs, and thus more capital, are indeed needed in Finland. In addition to new investments in mature companies, the Finnish economy, and any economy for that matter, also needs new innovative companies to fuel growth. According to Bob Zider (1998), innovation can be seen as the engine of economy. What is more, he adds, innovation can be seen as the collective imagination of a nation. Finland, for the most part, has lost its imagination.

Recently, the Finnish media declared the mobile gaming companies as the savior of the nation. Undoubtedly, the recent acquisition of Supercell by a Japanese gaming giant not only made the founders of the company millionaires, but also assisted the Finnish economy with 260 million euros in taxes (Helsingin Sanomat, 2013). After Microsoft had swallowed Nokia's mobile phone business, the young entrepreneurs were seen as true heroes of the tiny Nordic country as Ilkka Paananen famously said "it's now our time to give back to the society". The founders of Supercell have also been publicly very grateful for the financial assistance they have received from the Finnish Funding Agency for Technology and Innovation (Tekes), as well as from the private investors, because without the capital, most likely none of the success would have happened.

As with the case of Supercell, behind many successful new business ventures often lies a strong cooperation between the enthusiastic entrepreneurial team and the investor with his or her know-how and capital.

> The popular press is filled with against-all-odds success stories of Silicon Valley entrepreneurs. In these sagas, the entrepreneur is the modern-day cowboy, roaming new industrial frontiers much the same way that earlier Americans explored the West. At his side stands the venture capitalist, a trail-wise sidekick ready to help the hero through all the tight spots – in exchange, of course, for a piece of action. (Bob Zider, 1998, p. 131)

Shortly after, however, the other mobile gaming superstar of Finland, Rovio Oy, reported laying off 16% of its employees (Kauppalehti, 2014). Due to this unexpected event, the eyebrows of the Finnish media were raised by the surprise as even the booming gaming industry faced difficulties. As a matter of fact, the mobile gaming industry is often described as a hit driven business with no real certainty regarding the future. Wired (2014) came to a conclusion in their report that Rovio's layoffs prove mobile gaming industry being an industry of one-hit wonders. The obvious question for Finland is where do we find the drivers for growth? How can we create new jobs? And where do we find the capital to create those new jobs?

In my opinion, there is no one industry that will save the Finnish economy alone. As oil constitutes 60% of Russia's exports with quite serious consequences as we are witnessing, the same cannot be said for Finland (MacFarquhar and Kramer, 2014). As a small country, Finland relies on exports from multiple industries. Danske Bank's economist, Juhana Brotherus, states that in order to get Finland back on track in terms of growth, exports must increase (Taloussanomat, 2014). Handelsbanken's chief economist, Tiina Helenius, agrees to Brotherus adding that the products we produce simply must be so good that there is a demand for them (Kinnunen, 2014).

As stated, I am suggesting that one of those industries with export potential could be the fashion and apparel industry. Traditionally, the Finnish garment industry has put emphasis only on the functionality and practicality of the product (Lille, 2010). The logic of functionality "as long as the rain coat keeps you dry, the customer's expectations has been fulfilled" has been clearly a wrong approach since the demand for Finnish fashion items is scarce. Garments are much more than the mere functionality of the product. In order to thrive in the immensely competitive fashion industry the companies and brands should focus on creating, selling and maintaining emotions. According to Lille, clothing company's most important asset nowadays is a strong brand and innovative business operations. Failure to realize that has plummeted the number of persons employed by the apparel industry in Finland.

Although Finnish design in general is highly praised globally, and Helsinki was recently appointed as the World Design Capital, Finland is not particularly well known for its fashion with maybe the rare exception of Marimekko (Timonen, 2012). At the same time, neighboring countries such as Sweden and Denmark are constantly growing their garment industry not only for the benefit of the shareholders of the companies, but also for the economy as a whole. Luckily, during the past ten years, young and innovative fashion companies have started to spawn also in Finland (Lille, 2010). Another encouraging signal supporting the awakening of the Finnish fashion industry is the new fashion accelerator, Telakka. The founder, Kirsimari Kärkkäinen, has brought together independent designers, fashion entrepreneurs and professionals with different backgrounds to make all the necessary business skills available for everyone (Tammilehto, 2014). The emergence of *Royal Majestics*, Finnish private equity fund investing into fashion and design, and *Feelis Helsinki Oy*, an investment and development company for prominent Finnish design companies also give hope for a better future in terms of capital and know-how.

The global apparel market alone was valued at $US 1.7 trillion in 2012 and employs approximately 75 million people (FashionUnited, 2014). According to Keller et al (2014), the size of the global fashion business is expected to generate double digit growth between now and 2020. What is more, due to new innovative digital sales channels, they estimate that online clothing retailing is growing at a rate three times that of the market overall. However, the growth potential that the fashion industry possesses isn't understood in Finland (Lille, 2010).

Undoubtedly, that is a huge industry that is highly under represented by the Finnish brands. Even though the manufacturing of clothing has largely moved to countries with lower labor costs, the value adding processes like designing, branding, marketing and distribution can be still profitably located in countries such as Finland. Examples with similar settings can be found all over Europe.

Unfortunately, according to Bhose (2014), Finnish investors do not see fashion and design industry as a lucrative business, at least not yet. That is why Finnish entrepreneurs in this field have had to bootstrap new ventures on a shoe string budget. This is a huge problem for fashion start-up companies since the industry typically requires more capital in the initial stages than for example the much praised mobile application and software industry.

Lille's (2010) study of Finnish fashion companies also made clear that the biggest hindrance for growth is the lack of funding.

In fact, in 2013, only 4% of the total business angel investments in Finland were funneled in the creative industries (FiBAN, 2014). The situation with venture capital funding is even worse (FVCA, 2014). We have to keep in mind that the *creative industries* in the investment activity reports is an umbrella category for all design - fashion representing only a small fraction of it. In other words, there is close to zero capital available for Finnish fashion entrepreneurs.

The CEO of the only Finnish private equity fund investing in Finnish fashion and design brands, Henri Kulvik, states "Investments in Finnish fashion and design should be awarded with a medal of honor. The lack of capital in Finland is a fact and one of the biggest obstacles for a young company." (Bhose, 2014).

Although *Finnvera*, the Finnish state owned financing company, and *Tekes*, the Finnish funding agency for Innovation, have provided more capital for early stage companies in fashion and design in recent years, the private capital is still scarce. According to Saarinen (2014), investments not only help to tackle the capital obstacles mentioned by Kulvik, but also offer vast networks, experience and know-how, which together are proven to help young companies grow their business.

Kulvik argues that the rather small home market has been traditionally the excuse for the commercial failure in Finnish fashion. But that's no longer a valid argument due to globalization. What is more, fashion powerhouses such as H&M and Acne Studios from Sweden, and Jack & Jones and Selected from Denmark have also had tiny home market, yet they have literally conquered the world.

Evidence makes it clear, that in order to capture a bigger piece of the global fashion market pie, more investments in the fashion companies are needed. There has to be a reason for investors' disinterest towards Finnish fashion companies. This study tries to uncover that reason.

1.2 Recent studies and research gap

Only few studies regarding Finnish fashion industry have been made. Recent study by Timonen (2012) investigated three Finnish fashion firms in terms of their product selection and marketing efforts for international markets. The study found evidence that Finnish fashion brands adapt both the product and the marketing mix according to the needs of different markets. According to her, adaptation leads to increased competitiveness, so one could argue that Finnish fashion brands excel at least in that regard. Indeed, when it comes to the actual product, Lille (2010) and Kotler & Rath (1984) argue that Finnish design is often described as interesting, distinctive and outstanding. However, Lille's report found evidence that Finnish fashion entrepreneurs would like to have more support in general business skills such as sales and marketing. The entrepreneurs in Lille's paper also identified a link between the general lack of respect toward the industry and funding. Salonoja's research (2013) shed light on the Finnish fashion ecosystem, and also pointed out that better business skills and collaboration among industry stakeholders would make them more lucrative as an investment target. She also discovered that there is a very limited understanding about the industry in general, which makes investors conservative with their investment decisions. There have not been enough efforts to examine why the investment flow is so thin in the Finnish fashion economy.

1.3 Theoretical framework and research questions

As stated, one of the biggest obstacles for growth for Finnish fashion companies is the lack of funding. For some reason, the two parties involved can't find common understanding about the industry's potential and its exploitation. The aim of this study is to dig a little deeper on why there is such a shortage in private money in the Finnish fashion industry. To be more exact, I try to look beyond very particular and pinpointed factors such as "lack of business skills", and instead try to find out whether there is a fundamental difference in the logic and problem solving behavior between entrepreneurs and investors about the process of building a successful fashion company. Fundamentally different ideas on how to run a company would naturally prevent any cooperation between the two.

The theoretical framework used in this study to compare the underlying thinking processes is the effectuation theory by Saras. D Sarasvathy. By analyzing fashion entrepreneurs' and investors' problem solving behavior with the theoretical framework, I hope to shed light on the different thinking processes of entrepreneurs and private investors, and see whether they are aligned with one another or not, and whether they are aligned with the findings of Sarasvathy on successful entrepreneurship. This is conducted by semi-structured interviews with Finnish fashion entrepreneurs and private investors interested in the fashion and design industry.

Sarasvathy's theory on entrepreneurial expertise fits particularly well with fashion entrepreneurship, because modern fashion companies need to be extremely agile and dynamic – always looking for new products and new innovative processes due to the industry's cyclicality. Even though one could argue that fashion, or clothing in general, is an old industry with no room for radical innovativeness or substantially better products, the industry consists of many other functions that can and need to be improved. For example business models, distribution, marketing, fabrics and sourcing are few of the value drivers that can be the crucial competitive advantage for a young fashion company. A holistic view on a fashion start-up is much more than the sole garment.

The study is built around the following research problem:

Why Finnish start-ups in the fashion industry are lacking private capital?

In order to provide a comprehensive answer to the research problem, following research questions will be addressed:

Are Finnish entrepreneurs using effectual or causal logic in running a fashion business?

Do private investors prefer effectual or causal logic in running a fashion startup?

Is there a difference in the way of thinking between fashion entrepreneurs and private investors that might be preventing Finnish fashion industry to grow?

This thesis has both academic and managerial objectives. Firstly, the study aims to increase knowledge in the existent literature on the Finnish fashion entrepreneurship and the whole ecosystem surrounding it. Secondly, in terms on managerial implications, this study tries to help Finnish fashion start-ups and investors to understand each other better, and thus support Finnish fashion industry by increasing the amount of private capital in the Finnish fashion ecosystem.

1.4 Structure of the study

The overall structure for the rest of the study will go as follows. In the second chapter I will shortly define what fashion is, what are the type of companies this study is focusing at, and describe some special characteristics of fashion as an industry. The third chapter will introduce traditional business valuation to give a reference point to the discussion about the early stage funding on a theoretical level. The fourth chapter will support the business valuation theory by introducing the different players involved in early stage funding and the typical factors defining start-up success. The fifth chapter is a literature review on Saras D. Sarasvathy's effectuation theory and will work as the theoretical framework of this study. Then I will move on to explain the methodological choices of the study. This brings us to the empirical part of the study, where case study findings will be discussed. After that comes the discussion and analysis of the findings, and lastly the conclusions.

2. Fashion as a business

2.1 Definition of fashion

Barnard (2011) defines fashion as everything modern people wear, not just which is ‘up to the minute’. That includes all instances of what people wear, from catwalk creations, through High Street and Shopping Centre purchases, all the way to military uniforms. Fashion is a type of communication, which is strongly related to culture, because different people in different cultures communicate via wearing different clothing. Hauge (2007) state that fashion is hard to define, and that it means different things to different people. Fashion is also one of the ways in which people are constructed as members of cultural groups. Crewe (2011, p.633) point out that fashion is inevitably predicated on change and obsolescence, it’s a target that keeps moving. Jackson and Shaw (2009, cited in Timonen, 2012: p. 7) describes fashion as everything from seasonal fads to a global industry with diverse and plentiful business operations.

Fashion products are seasonal as new collections typically emerge every 6 months. Some fashion companies are introducing new products even more frequently. Unlike in many other industries, fashion companies must continuously innovate, produce and market new items. Selling what turned out to be a success in the last collection is not an option in fashion. (Burns et al., 2011).

Basically, what this means is that fashion items are something everyone needs at least on some level, and which expiration dates run out rather quickly. This ought to make the fashion industry profitable playground at least for some players.

However, the focus of this study is on start-ups described as “high-end” or “designer” brands, which do not compete on price but rather quality of products and immaterial symbolic value of the brand. Thus, when referring to fashion industry or fashion brand, the study examines in this particular part of the whole apparel industry.

2.2 Fashion as an industry

In 2013, The Finnish fashion and apparel exports were 337 million euros. At the same time fashion imports were 1.5 billion euros, making Finland a heavy net importer of fashion (Finatex, 2014). To put these numbers into perspective the fashion exports for Sweden and Denmark, with quite a similar socio economic conditions than Finland, were 1.6 billion and 3 billion respectively (WTO, 2014). From 1998 to 2008 the number of people employed in the textile and garment industry in Finland decreased from 5000 to 2500 (Lille, 2010).

There are almost 850 000 fashion companies in the EU as of 2009 accounting for 3% of the EU's GDP. The industries within the community form complex, strongly interlinked value chains, manufacturing of materials, fabrics and fashion goods, and the distribution and retail networks all the way to the final consumers. The whole industry provides employment for over 5 million people, of which 2 million are employed in fashion manufacturing alone. That is roughly 6% of all EU manufacturing jobs. The other 3 million European jobs can be found throughout the supply chain. These activities, which can be still profitable also in Finland, include design, marketing and branding, supply chain management and retail. Although the persons employed in the fashion manufacturing has declined significantly, in fashion distribution new jobs are being created every day. (European Commission, 2012).

According to Salonoja (2013), from a nation's perspective the benefits of fashion is not just the profit individual companies make. Successful fashion companies also help countries to sharpen their image around the globe like any creative or cultural product via spill-over effect. The importance of design for the national competitiveness of Finland has also been affirmed by Timonen (2012). Thus, improving the fashion ecosystem would not just brighten the conditions of apparel start-ups, but the country as a whole.

Hauge (2007) point out that fashion is seldom bought rationally, because of highly subjective and imperfect information aiding the decisions. It's very rare that fashion products are thoroughly examined and their innovation, quality and utility assessed, like you would do when buying for example a TV. This is why the added value comes from immaterial and symbolic value of the product or the company, which can be improved by innovation and entrepreneurial attitude.

Undeniably, fashion is less about the needs and more about emotional appeal. The utility value can be fulfilled with any clothing and with very little costs, but there seems to be no limit to the costs involved in fulfilling the emotional needs (Hauge, 2007). Salonoja (2013) state that brands have a fundamental role in the success of a fashion company, since consumers often base their purchasing decisions on the emotional notions associated with being part of the brand experience.

3. Introduction to traditional business valuation

This chapter firstly describes how investments are typically analyzed, reviewed and completed. Secondly, I will shed light on why these techniques do not apply in the startup context as such.

3.1 Traditional business valuation

According to the finance literature (Brealey et al. 2011), the valuation process of a firm is complex due to the varied factors that come into play.

Value is created when a company's business activities generate more income than its resources create costs. To achieve this goal, a firm develops and employs business strategies. The business activities of a company are influenced by the overall economic environment, the industry, and the chosen strategy. The business strategy of a company determines how it plans to achieve a competitive advantage and how it tries to position itself among the competitors (Palepu et al. 2007).

Palepu et al (2007) introduce a comprehensive framework how to analyze business and how to ultimately determine the valuation of an enterprise. This framework relies heavily on financial statements but includes also traditional management accounting concepts in terms of strategy considerations. Their framework presents four key steps for valuing a business: business strategy analysis, accounting analysis, financial analysis, and prospective analysis. The purpose of this chapter is to shed light on tradition business analysis process, and finally discuss the weaknesses these approaches possess when utilized with early stage companies.

According to Palepu et al. (2007 pp. 293) valuation is “a process of converting a forecast into an estimate of the value of the firm or some component of it”

3.2 Strategy analysis

Strategy analysis is a qualitative analysis which purpose is to reveal the underlying economics within and around a company. According to Palepu et al. (2007) strategy analysis helps to identify the company’s profit drivers, key threats, and the sustainability of the firm’s performance. They argue that thorough analysis of a firm’s strategic position requires examination of three perspectives: industry perspective, competitive perspective, and corporate strategy perspective. The strategy analysis is considered as a good first measure to evaluate an enterprise valuation. The following sub-chapters briefly clarify these three strategic choices.

Industry analysis

Each industry has its own distinguishing profit potential. That potential, regardless of the firm and its abilities to execute, has an impact on the valuation of the firm. A regressive industry can break even the most competent company. On the other hand, emerging industry can make even a mediocre company look impressive. For this reason, evaluation of investment has to include the industry analysis.

Palepu et al. (2007) argue that the assessment of profitability of various industries can be quite predictable due to the systematic differences among them. Porter (1980) suggests that there are five structural components which determine the profitability of an industry: 1) competition among existing firms, 2) threat of potential entrants, 3) bargaining power of buyers, 4) bargaining power of suppliers, and 5) firms producing substitute products. The full analysis of these components helps investors to realize whether the investment in a specific company is profitable or not.

Competitive strategy analysis

"Every firm competing in an industry has a competitive strategy, whether explicit or implicit. This strategy may have been developed explicitly through a planning process or it may have evolved implicitly through the activities of the various functional departments of the firm. "(Porter 1980, p. xiii)

In addition to the strategic elements of the industry, the firm's profitability is also influenced by the competitive strategy it may utilize. Porter (1985) state that there are two fundamental sources of competitive advantage a firm can possess: cost leadership and differentiation. Cost leadership enables a firm to offer the same product for less money. Differentiation strategy stands for a superior product with a higher price.

According to Palepu et al. (2007) both of these strategic options can allow a firm to create competitive advantage in the long term. However, Porter notes that 'being in the middle' is not a good strategy. It possesses no competitive advantage, since cost leaders and differentiators are eventually better positioned in any market segment. Similarly to industry analysis, careful competitive strategy analysis advises investors whether the investment in a specific company is profitable or not.

Corporate strategy analysis

Corporate strategy analysis adds to the strategy equation the possible benefits of running multiple businesses, possibly in multiple different industries at the same time. The potential benefits, such as cost reduction, may occur due to synergies across different business sectors. Palepu et al. (2007) point out that the resources that enable the exploitation of synergies must not be available for competition through markets or by other means. The value creation via well executed corporate strategy naturally increases the value of the company, and thus needs to be included in the investors' strategy analysis while evaluating the investment as a whole.

3.3 Accounting analysis

Palepu et al. (2007) state that the purpose of accounting analysis is to evaluate, if a firm's financial statements capture true and fair image regarding its actual business performance. The ownership and management of a company is usually separated, and since the owners are obviously eager to know how their investment is doing they need means to examine it. For this reason financial statements are created.

However, due to the flexibility of accounting, those statements are not always unambiguous. Accounting analysis tries to elicit the possible places of such flexibility, and by evaluating the decency of the accounting practices, investors can have better understanding of the real financial performance of the company.

Palepu et al. (2007) find six proceedings how to carry out proper accounting analysis: estimation of accounting policies, evaluation of the degree of accounting flexibility, evaluation of motivation behind accounting flexibility and its use, assessment of the quality of financial statements, identification of possible red flags in the accounting practices, and finally removal of bias and restatement of accounting numbers.

Through diligent accounting analysis, the explanatory power of financial analysis and prospective analysis can also be enhanced.

3.4 Financial analysis

The purpose on financial analysis is to evaluate whether companies are profitable and stable enough to be invested in. This process usually involves examination of financial statements such as the income statement, balance sheet, and cash flow statement. Palepu et al. (2007) argue that financial analysis usually consists of two basic tools: ratio analysis and cash flow analysis. Ratio analysis is a quantitative analysis that is calculated based on the information in the financial statements and is then compared to previous years, other companies, or the industry in general to figure company's true performance. Cash flow analysis is used to evaluate for example a company's liquidity and how the financing of its operations is managed.

Ratio analysis

According to Palepu et al. (2007) firms can gain profitability and growth by managing their operations, investments, financing strategy and dividend policies. The ratio analysis is a vehicle to assess each of these components of profitability, and ultimately give numerical values to guide investors to make better investment decisions. The typical measurements of ratio analysis are return on equity (ROE), net profit margin, current ratio, and dividend payout ratio to name a few. By calculating and comparing these metrics to the historical performance of the company, competitors or the industry, investors can make a judgment of the performance of the company.

Cash flow analysis

Cash flow analysis adds to the ratio analysis by taking the flows of cash into and out of the business into account. According to Palepu et al. (2007) this provides further insights into issues such as the company's ability to meet short-term financial obligations, the degree of investments in growth, if those investments were made with internal or external financing, or how the dividends were funded. Cash flow analysis also provides information regarding the financing policies of the company and whether these policies create unwarranted risk to the investor.

3.5 Prospective analysis

Prospective analysis pursues to determine firm's current value by forecasting future performance. According to Palepu et al. (2007) estimation of firm's value require two phases. First of all, forecasting the future, and secondly, conducting a valuation based on the forecast and different valuation techniques. Naturally, the more different valuation techniques are utilized, the more reliable the valuation becomes. Combining these two applications the investor or analyst can reach a relatively accurate valuation estimate for a company or an asset.

Forecasting

Palepu et al. (2007) state that forecasting represent the first step of prospective analysis. According to them, the forecast should not be seen as a separate procedure than the analyses covered so far in this paper, since they utilize the information obtained from the strategy analysis, accounting analysis, and the financial analysis. Future projections of a company are based on the findings of analyses conducted so far, and thus, cannot be much more explicit that the analyses underlying them. This highlights the importance of prior work.

Palepu et al. (2007) say that the best way to forecast future performance is to include not only earnings estimations, but also other items found in the financial statements. Inclusion of balance sheet and cash flow forecast mold it into a more comprehensive package, and diminishes the possibility of errors in the model. Forecasts typically involve couple of key predictions, like sales and profit margin, which drive most of the projected numbers.

Valuation

Previous chapter discussed about forecasting and now we take a closer look on the valuation theory of a business. Valuation is a process which determines the current worth of a company. The price of a venture is based on forecasts of its performance and current financial situation. There is variety of different methods to carry out valuation process, but so far none of the techniques have stood out as a superior method. It is generally accepted that utilization of several different methods leads to most accurate valuation.

Valuation is necessary when investors are evaluating an investment into an early stage company, similarly as it is to price initial public offering (IPO).

According to general finance theory (Palepu et al. 2007) shareholder's worth is simply the present value (PV) of future cash payoffs.

$$Value\ of\ an\ investment = PV\ of\ expected\ future\ cash\ flows$$

However, future payoffs need to be discounted using a discount rate to take the time value of money into account. If we denote the expected future cash flows for a given year as *CASH* and *r* as the cost of capital (discount rate), the value of an investment can be stated as follows:

$$Value\ of\ an\ investment = \frac{CASH_1}{(1+r)} + \frac{CASH_2}{(1+r)^2} + \frac{CASH_3}{(1+r)^3} + \cdots$$

This is the underlying idea of the next two widely used techniques in company valuation.

Abnormal earnings methods (Residual income method)

This approach utilizes company's book value of equity and future abnormal earnings. In this method, also known as the residual income method (RIM), abnormal earnings represent the net profit that is adjusted with a cost of capital. In other words, this method simply tries to determine the present value of future adjusted net profits plus the book value of investment.

$$Investment\ value = Book\ value\ of\ investment + PV\ of\ future\ abnormal\ earnings$$

Naturally, if the value arrived at through the abnormal earnings method is higher than the current cost of the investment, the opportunity may be a good one.

According to Palepu et al. (2007), there is vast evidence showing that abnormal earnings estimates of value outperform traditional multiples discussed in the next subchapter for predicting fluctuations of share price.

Discounted cash flow method

Maybe the most popular method of valuation is the discounted cash flow method (DCF method). Similarly to the abnormal earnings method, DCF method is derived from the general finance idea that the value of an investment is the present value of future earnings.

Discounted cash flow method involves three steps (Palepu et al. 2007). First, a forecast regarding future free cash flows to the investor is made, typically for a period of 5-10 years. Then, a forecast of free cash flows beyond the terminal year is estimated based on some simplifying assumption. Lastly, the forecasted free cash flows are discounted to investor in order to get the valuation of an investment. The following equation summarizes the DCF model:

$$Investment\ value = PV\ of\ free\ cash\ flow\ to\ investor$$

Obviously, if the valuation is higher than the current cost of investment, the opportunity most likely is profitable.

Valuation using price multiples

Valuation using price multiples is basically comparing one firm to another with a specific price multiple. Comparisons are usually made within the same industry for maximum accuracy. Price multiples can be any ratio that combine the share price of a company to a specific financial metric in order to evaluate the company's financial situation. Typical multiples include the price-to-earnings ratio, the price-to-book ratio, and the price-to-sales ratio.

According to Palepu et al. (2007) valuation using price multiples is a popular method of valuation, because unlike the two methods discussed earlier in this chapter, this method does not require a multiyear forecast of the future. They point out, however, that identification of comparable firms is challenging. Also, due to the simplicity of this method, it should not be used as the only criteria when assessing a potential investment, but preferably in combination with other measures.

Sensitivity analysis

Brealey et al. (2011) state that whenever you are confronted with a financial forecast, you should try to think what else can happen. Due to its nature, forecasts regarding the future performance of a company usually call for a sensitivity analysis. In the end, the projections solely represent an educated guess.

The purpose of a sensitivity analysis is to consider the magnitude of forecasting errors to the forecast and valuation. It determines how changes in independent variable impact the dependent variable under a given set of assumptions. In other words, sensitivity analysis is a technique to predict the consequences of an investment decision if the key assumptions turn out to be wrong. Palepu et al. (2007) point out that the number of possible scenarios is limitless.

3.6 Problems of traditional valuation methods

The traditional valuation methods rely heavily on future payoffs. However, according to Sievers et al. (2013) characteristics often found in startups such as a short history of the company, lack of analyst forecasts, negative earnings, zero revenue or lack of first customer makes forecasting these payoffs virtually impossible.

According to Darrough and Ye (2007), most accounting-based valuation methods fail to take so called “hidden assets” into account, and often assume this non-accounting information to be zero. They argue that accounting earnings and book values do not fully capture the true potential of a firm. Especially, as the economy is becoming more knowledge based, unrecorded intangible assets become more important. Thus, these assets are consequently playing a bigger role in the valuation of early stage ventures. De Clarcq et al. (2006) argue that although enterprise valuation is theoretically determined by future earnings, these calculations are not accurate in the startup context. That is why Sarasvathy’s effectuation theory is better tool to analyze young companies with no track record.

4. Introduction to early stage funding

The previous chapter introduced the classic valuation techniques and the reasoning behind valuing an asset or a company. This chapter is an introduction to the ecosystem surrounding start-up funding.

The vast majority of startups rely initially on personal savings, family funds and bank loans (Brealey et al. 2011; De Clercq et al. 2006). The amount of capital available via these sources is usually very limited. For this reason, some of the ventures continue to grow with so called equity investment. Equity investment is additional capital pumped into the company in exchange for company shares i.e. company ownership. There are usually two types of possible sources of capital an early stage company can turn to, business angels and venture capitalists (De Clercq et al. 2006).

Investments into early stage startup companies involve extremely high risk. Brealey et al. (2011) quite optimistically estimate that for every 10 first-stage venture capital investments, only two or three survives. However, high risk is often compensated with high reward. The underlying idea behind early stage investments is that you lose your money often, but the rare occasion of success more than make up for the losses. This is why angel and venture capital money is often funneled into high-potential firms.

4.1 Business angels

Business angels (BA) are wealthy individuals typically with extensive experience in the industry they invest in. They invest their own capital and are often either entrepreneurs who have sold their companies and wish to invest their money, or retired senior executives of large companies (De Clercq et al. 2006).

De Clarcq et al. (2006) characterize BAs as being interested in the equity growth. Worthy of notice, they argue that many are also drawn by the chance to be heavily involved in an exciting venture where they have the opportunity to leverage their industry contacts and expertise to mentor the early stages of a promising young company.

Business angels usually invest in the seed stage where the funded teams are still very young with no functional product or proven business model. This stage in the life cycle of a company does not yet attract VC investors, and thus BAs and VCs rarely compete for deals. According to Clarcq et al. (2006), the angel investments typically range from $50,000 to $100,000.

On the contrary to venture capital funding, business angel financing is usually much lighter in terms of reporting requirements. Also, the relationship between the investor and the entrepreneur is much more informal than in the venture capital setting.

The main exit mechanism for BAs is a trade sale, which refers to the sale of a company (or part of it) in its early stages. This type of exit is usually unplanned, unlike the exits in the VC context.

4.2 Venture capital

What is maybe the biggest difference to business angels, venture capital firms pool funds from a variety of investors (De Clercq et al. 2006). A venture capital firm is simply a group of VCs. However, similarly to the business angels, VC firms also seek out fledgling early stage companies to invest in and then work with them to maximize its' potential (Brealey et al. 2011). Even though most VC firms are specialized in a specific industry, bigger firms may have multiple funds, each of which specialized by industry sector or stage of development.

Brealey et al. (2011) and De Clercq et al. (2006) explain that venture capital funds are organized as limited private partnerships with a fixed life. They continue that pension funds and other investors are typically the limited partners, while the management company, which is responsible for making and overseeing the investments, are the general partners. Limited partners are not directly involved in investment decisions or management of the company (De Clercq et al. 2006). The management of the venture capital fund is compensated usually with a fixed salary and a share of the profits.

Venture capital firms do not only provide capital to their portfolio companies. Entrepreneurs should be also interested in the potential non-monetary benefits, such as industry expertise, that add value to the company. This is well illustrated by John Wilson (as cited in De Clecrq et al. 2006, p. 95) who describes the early days of Microsoft:

> Money alone was certainly not what won David Marquardt (a VC at a firm called TVI) a chance to put $1 million into Microsoft Corp. . .. The company. . . was generating more cash than it could use when Marquardt heard in the Fall of 1980 that [Bill] Gates was interested in lining up his first outside investor. 'They absolutely didn't need our money, but they wanted outside counsel and I was the first venture capitalist they had talked to who understood their business.' Marquardt, who had been a computer hobbyist for years, spoke Gate's language well enough to win a place on the Microsoft board of directors.

Brealey et al. (2011) argue, that VCs are active investors, meaning that they provide ongoing advice to the firms they invest in and sometimes also play major role in recruiting the senior management team. However, VCs want to make sure the entrepreneurs stay motivated, since the VCs do not want to run the entire business (De Clercq et al. 2006). Brealey et al. (2011) propose that venture capital firms tend to specialize in high tech firms that are difficult to evaluate. Black & Gilson (1998) argue that their experience, expertise in the industry, and contacts often turn out to be valuable in terms of recruiting management and technical personnel in the early years of a startup.

In addition to capital and advice, VCs also provide so called *reputational capital*. Venture capital financing enhances the credibility of an early stage company with third parties, whose contribution will be crucial to the success of the startup. Respected and well know VCs add a credible signal to the operations of a young company, thus increasing the trust of customers as well as improve the willingness of cooperation by the suppliers. (Black & Gilson 1998; De Clercq et al. 2006).

Venture capitalists typically have two possible ways to cash in on their investment, which are preferably planned before the investment is made (De Clercq et al. 2006). Firstly, the company or part of it may be sold to another company. A recent example of this type of exit is the Finnish gaming company Supercell, which sold 51% of its equity to a Japanese gaming company for 1,1billion euros as reported by the Helsingin Sanomat (2013). The other way for venture capitalists to cash in is to go public, as we witnessed the professional networking website, LinkedIn, more than double its value in the first day of trading (CNN, 2011). Black & Gilson (1998) argue that IPOs of rapidly growing startup firms needs an active stock exchange. They conclude that for this particular reason the US has a more thriving venture capital ecosystem than for instance Japan and Germany.

According to Clercq et al. (2006), venture capital investments typically range from $2m to $10m.

4.5 Literature on the success factors of an early stage company

The problems of traditional valuation methods described in chapter three calls for supplementary approach to startup valuation.

Mainstream finance literature agrees that the valuation process of a firm is complex (Brealey et al. 2011). The sole reliance in financial considerations in the form of income statements and balance sheets leave out important qualitative measures such as industry characteristics, intensity of competition, and firm characteristics such as the quality of its management team which significantly influence firm value. To add these factors of business success into the company valuation equation, we need to look to other theories than finance for guidance. Miloud et al. (2012) propose that the entrepreneurship and strategic management literatures offer worthy alternative to examine the performance drivers and how value is created in an entrepreneurial process.

Sievers et al. (2013) compare the explanatory power of financial and nonfinancial models regarding venture capital investment. Their analysis indicates that both of the models are equally accurate when applied on their own. However, when they combined the two models, the accuracy level of the model increased significantly. This finding adds support to the importance of nonfinancial proxies when determining startup valuation.

Miloud et al. (2012) identify three different strategic perspectives which drive company performance, and thus, valuation. They divide the perspectives to industry organization economics, resource-based view and network theory. Each of these perspectives includes strategic factors that try to explain true potential of the venture.

Frenke et al. (2008, p. 459) point out that "as VCs are considered experts in identifying promising new ventures, their evaluation criteria are often interpreted as success factors for emerging firms". Thus, discovering these evaluation criteria entrepreneurs can turn their start-up companies into more attractive investment opportunities.

The following sub-chapters introduce the success factors that drive early stage startup valuation and are often used by business angels and venture capitalists in their evaluation of start-ups. These value drivers help us understand what the entrepreneurship science community considers as important, and consequently what investors are explicitly or implicitly thinking while interacting with a young company seeking for funding. These elements basically help us understand the mind of a typical investor, and thus help understand the reasoning in the empirical findings of this study.

Team composition, diversity

Roure & Keeley (1990) state that in addition to individual qualifications, diversity of founding team helps avoid errors in critical decision making. They continue that firm's performance is influenced by its composition. Just like a football team needs defenders, midfielders and strikers; a company requires competence in different fields to win the games. Franke et al. (2008) and De Clercq et al. (2006) argue that a balanced team of both technical and management skills is superior from VC's point of view to teams that have only management or technical founders. Zimmerman (2008) adds that top management team's functional heterogeneity is positively and significantly related to the value of the company.

Founding team size, more than one preferably

Miloud et al. (2012 p.157) argue that due to the ever increasing competition due to globalization and the constantly burgeoning technology, solo founders nowadays face almost impossible mountain to climb – “simply because no one can have all the necessary skills and knowledge to effectively compete”. As a matter of fact, their quantitative analysis on startup valuation finds strong support for higher valuation for entrepreneurial team rather than ‘one-man’ shop.

These findings are also consistent with Franke et al. (2008) whose study argues that having a team with different set of skills and heterogeneous experience is more likely to receive funding from VCs, and thus, is more likely to prosper.

Roure & Keeley (1990, p. 204) suggest that “it (the team) must be large enough to do its task, but not much larger”. This statement is supported by Aspelund et al. (2005) who argue that too large teams are problematic due to ‘affective conflicts’ which are associated with lower performance. They emphasize, however, that ‘competence density’ of the entrepreneurial team is more essential than the mere size of the team.

Tomas Chamorro-Premuzic (2013), Professor of Business Psychology, analyzed the team size’s impact on entrepreneurial effectiveness and innovation. His finding was that contrary to popular belief, innovators seldom are ‘independent spirits’ or ‘individualistic geniuses’, but that innovation mostly involve a group of people.

Aspelund et al. (2005) argue that larger entrepreneurial teams increase the startup’s range of resources and competencies. In addition, they continue, larger team usually leads to faster decision making processes and better ability to execute selected strategy. This, in turn, sculptures the new venture into a viable investment target.

Complete management team

Completeness of management team means that all the important roles and positions to run a successful business are filled up internally. The size of the team is not important since each venture requires different set of skills, and thus each business has its own optimal mixture of founding partners. Zider (1998) shed light on the allocation of time by venture capitalists. Turns out that VCs have much broader set of functions and tasks than just advising and nurturing their portfolio companies. This in turn means that complete teams are valued higher just because VCs do not have to participate in the running of everyday business, let alone hire additional managers to reinforce the incomplete management team. De Clercq et al. (2006, p. 101) report similarly: “entrepreneurs should also understand that most VCs do not want to tell entrepreneurs how to make day-to-day operations…”.

From a series of semi structured interviews on the decision process and criteria of venture capitalists, Hall & Hofer (1993) came to conclusion that a balanced management team is an important criterion in the evaluation of venture proposal. Similarly, in their study of predictors of success among technology based new ventures, Roure & Keeley (1990) discover a significantly positive correlation between completeness of management team and returns of investment. More recently, in their quantitative research, Miloud et al. (2012) found that entrepreneurial teams with a complete management team were valued significantly higher than teams lacking one.

CEO education/abilities

De Clercq et al. (2006) report that entrepreneur’s educational capacity, and availability of general skills do effect on VC’s valuation of a company. Franke et al. (2008) argue that academic background is essential in order to gain the interest of Venture Capitalists. However, their analysis reports that not every member of team needs to possess academic degree. They continue that the attractiveness of the startup does not considerably change whether all members or some members have a degree. Against this backdrop, CEO does not have to be necessarily university graduate to receive funding. In her study, Zimmerman (2008) found a positively significant relationship between top management team’s educational heterogeneity and company valuation. This indicates that academic background is not only important *per se*, but the degrees should be preferably from different fields of study.

De Clercq et al. (2006, p. 92) argue, that in the later stages of venture financing, the demonstrated ability of the CEO to bring venture to the market increases in importance.

Team experience in start-ups

Franke et al. (2008) report positively significant relationship between startup experience and VC funding. However, they add that not all the members of the team need to have this kind of experience. The positive relationship remains significant with teams including one member with prior startup experience. De Clercq et al. (2006) argue, that VCs typically focus on the track records of the entrepreneurial team. They point out, that a “world-class status” of the entrepreneurs is particularly important in the early stages of financing. They continue, that experience in the startup process in terms of selecting and motivating a high-quality team is a critical distinguishing factor.

Team experience in management

Zider (1998) argue that in the early stages of business development (which is characterized by high growth), identifying the company that ‘has it’ is rather difficult task since their financial performance usually looks identical. Thus, Zider continues, the essential mission for investors is not to try to identify the right company, but the right management team that can execute the business plan. Franke et al. (2008) state, that similarly to the case with CEO education, management experience is required to get in to later stages of investment evaluation by VCs. Nevertheless, not all members of the founding team are required to possess these skills. They reason that “this is rather plausible finding since not all members in a venture team can assume a leadership role”. De Clercq et al. (2006) propose that investors nowadays want to see someone with top management experience, who can take the company from early stages all the way to a successful exit. Absence of such competence might lead to a rejection of the deal, or at least to a hiring of a manager appointed by the investors.

Industry experience

Hall & Hofer (1993) argue that entrepreneur’s lack of relevant experience lead to rejection in a VC funding proposal. Evidence makes it clear that experience of similar assignments and businesses lead more frequently to successful firms. In their study, Franke et al. (2008)

point out that industry experience is the single most important characteristic determining startup valuation by VCs. They say that having no industry experience will most certainly lead to no funding. De Clercq et al. (2006) find that understanding key success factors, crucial value chain activities, and possessing reliable access to distribution channels are among the most important characteristics of team from VCs perspective.

First customer, revenue

Aspelund et al. (2005) claim that early stage startups that have experienced their first customer are more likely to survive than similar companies with no customers. Zimmerman (2008) reports positively significant relationship between prior sales and initial public offering (IPO) value. Even though this study concentrates in venture capital funding and angel investments, Zimmerman's findings on the relationship between IPO valuation and sales are applicable due to similar valuation process of IPO and VC funding.

Product differentiation

Venture Capitalists agree that industry's economic conditions should be such that a new entrant may enter the market without strong retaliation in order to make it an attractive investment opportunity (Hall & Hofer, 1993). Same study reveals the importance of 'defendable competitive position' in regards to the product, which means that VCs value higher firms which are able to differentiate their products better.

Roure & Keeley (1990) report statistically significant positive relationship between product superiority and firm value in their quantitative research of early-stage venture capital investments. Similar statistical significance is found by Aspelund et al. (2005) who report that 'technological radicalness' in regards to the product increases the probability of survival, and thus, increases the valuation of the new venture.

Porter (1980) argues that firms operating in an industry characterized by low product differentiation require more capital to compete. Heavy capital requirements might not attract investors who are already exposed to a great risk.

Growth rate of an industry

Hall & Hofer (1993) argue that the economic environment in a given industry must include the potential for long-term growth and profitability in order to attract VC funding. Absence of such condition would most likely kill the probable VC investment. Zider (1998, p. 133) claim that venture capitalists investing in good people and good ideas is merely a myth. He states: “the reality is that they invest in good industries – that is, industries that are more competitively forging than the market as a whole”. Zider also point out that Venture Capitalists usually time their investment in the middle part of the industry S-curve, where the growth is typically the fastest. According to Miloud et al. (2012) VCs give better valuation to startups from industries characterized by high growth because the high demand of the market allow even some mistakes, and hence lower the risk of the investment.

Porter (1980) argues that in the early stages of an industry the rapid growth rate usually lead to good financial performance despite the fact that competition might reduce one’s market share.

According to De Clercq et al. (2006), VCs are interested in growth, and therefore the growth potential of the venture and the capability of the management team to realize this growth are paramount to VCs. They specify that VCs are generally looking for concepts that address markets of at least a half-billion dollars in size.

5. Theoretical framework / literature review

5.1 Background

What are the characteristics, traits, habits and behaviors of the species *entrepreneur*? What makes entrepreneurs "entrepreneurial"? Is entrepreneurship learnable and teachable? What are the common elements that entrepreneurs share with each other across various industries? Is there such thing as "entrepreneurial thinking" that can be applied across space, time and technology? (Sarasvathy, 2001a)

In 1997, Saras Sarasvathy pondered these very questions. She decided to take the challenge by traveling across 17 states in the United States to meet 30 experienced and successful business founders from a variety of industries. Her meetings with these entrepreneurs were not just ordinary interviews, but she challenged each one of them with the same set of problems regarding a hypothetical building process of a new company, as if they were starting a company. She wanted to find out if the group of expert entrepreneurs shares any commonalities in the decision-making process when dealing with the same key decisions in early stages of a company.

After analyzing the decision-making processes of these expert entrepreneurs, she witnessed a clear pattern to unfold. The patterns were turned into a set domain specific heuristic principles, which according to Sarasvathy (2001a, p. 1), "rested on a coherent logic that clearly established the existence of a distinct form of reasoning and thinking that we have all long recognized intuitively as *entrepreneurial"*. What is interesting and especially beneficial for potential entrepreneurs, is that these principles can be used as testable and teachable decision-making and problem-solving techniques for start-up companies (Sarasvathy, 2008).

5.2 Theory

According to Sarasvathy (2008), entrepreneurial performance has traditionally been studied in one of two ways. Firstly, the performance of an entrepreneur has been examined as a set of personality traits that explain the success or failure of the firms he or she creates. In other words, the entrepreneur either has the right characteristics or does not. Secondly, performance has been investigated as a set of circumstances of the company and its environment which need to be identified and exploited in order to be successful.

Sarasvathy (2001) argues, that we should forget the idea that certain characteristics or personality determines the success of an entrepreneur. For example, Palich & Bagby (1995) revealed that contrary to popular belief, entrepreneurs have no greater risk propensity than non-entrepreneurs. Similarly, Gartner (1988) states, that identifying successful entrepreneurs by personality traits or characteristics has been difficult if not impossible. Thus, instead of looking at a special trait in people as a success driver, we should look for certain problem solving behavior and logic.

As stated, the effectuation theory has its grounds in Sarasvathy's studies of successful entrepreneurs in the late 90's. However, the breakthrough of the theory can be said to taken place in 2001 when her article was published in *Academy of Management Review*. The theory has been since refined and it has been cited all over the entrepreneurship research field. Her theory explains entrepreneurial success by entrepreneurial expertise which consists in tacit as well as explicit aspects of experience that are related to successful entrepreneurial ventures.

The effectuation theory by Saras D. Sarasvathy will be used as the theoretical framework in this thesis. This chapter will focus on the theory and its applications by first defining the problem the theory was developed to cure, then the process of effectual reasoning, and after that the principles of effectual theory employed in the empirical part of the study. Lastly, we shed light on the logic of the theory and examine popular critique towards the theory.

5.2.1 The problem

In MBA programs around the world students are mainly taught causal or predictive reasoning (Sarasvathy, 2001;2001a;2008). Causal thinking begins by setting a goal. Then, with given set of means, the entrepreneur or the company tries to reach the pre-determined goal as efficiently or cheaply as possible. She continues, that a make-vs-buy decision in production, choosing the target market with the highest potential return, picking a portfolio with lowest risk in finance, or even hiring the best person for the job in HR department, are all examples of problems of causal reasoning.

According to Sarasvathy (2001, p. 243), these decisions may be discussed at an entrepreneur or a company level, "…but underlying almost every one of these decisions is the assumed existence of the central artifacts and contexts of business within which the decisions take place". That is, none of the above mentioned decisions lead to new artifacts, like new ventures. She argues that MBA classrooms globally lack the analytical tools for addressing issues common in start-up environment such as:

- How do we make the pricing decision when the market for the product does not exist?
- How do we hire talented people for an organization that does not yet exist?
- How do we value companies in industries that are only beginning to emerge?

Theory of effectuation, which is fundamentally a decision-making model, is a valuable tool for answering these types of questions, and more generally, how to create a thriving firm. Sarasvathy (2001) argues that the process of causation in the business decision context in the early stages of company life cycle is often wrong approach due to abovementioned reasons. Thus, she suggests, that we should rather look at the process of effectuation as the driving logic behind those critical decisions.

5.2.2 The process

Let us define what the processes of causation and effectuation are.

Causation process takes a certain goal as given and focus on selecting between different means to achieve that particular goal. On the other hand, effectuation process takes a set of means as given and focus on selecting between different goals that are achievable with that set of means. (Sarasvathy, 2001)

The differences between the two types of thinking processes can be explained and clarified with a simple example:

> Imagine a chef assigned the task of cooking a dinner. There are two ways the task can be organized. In the first one, the host or client picks out a menu in advance. All the chef needs to do is list the ingredients needed, shop for them, and then actually cook the meal. This is a process of causation. It begins with a given menu and focuses on selecting between effective ways to prepare the meal.
>
> In the second case, the host asks the chef to look through the cupboards in the kitchen for possible ingredients and utensils and then cook a meal. Here, the chef has to imagine possible menus based on the given ingredients and utensils, select the menu, and then prepare the meal. This is a process of effectuation. It begins with given ingredients and utensils and focuses on preparing one of many possible desirable meals with them. (Sarasvathy, 2001, p. 245)

Both of these approaches share the same end goal; to cook a meal. The distinguishing characteristic between causation and effectuation is the way how to achieve it. Sarasvathy points out, that whereas causation models consists of choosing the means to achieve one goal, effectuation models involve given means to achieve multiple different goals. As Figure 1 illustrates, causal reasoning is goal oriented, and effectual reasoning means oriented.

To put the above mentioned example in a more relevant design start-up context, we could think of an imaginary company - say, creating a piece of furniture. An entrepreneur with causal problem solving process would first design the product, and then find the resources necessary to make it. On the other hand, an entrepreneur with effectual reasoning would first assess the resources he or she already has, and then make the product or products that are doable with his or her given resources.

The effectuation theory suggest, that an entrepreneur using the mindset, can actually create multiple companies even in many different industries as he or she pivots the original idea along the entrepreneurial journey. This is due to the effectuation logic, which do not set a fixed goal. As Sarasvathy (2001) puts it, the process not only enables the realization of different outcomes, but it also allows the entrepreneur to change his or her goals and even to shape and construct them over time, making use of contingencies as they arise. According to her, several successful enterprises have begun with no conscious intention to even build a business.

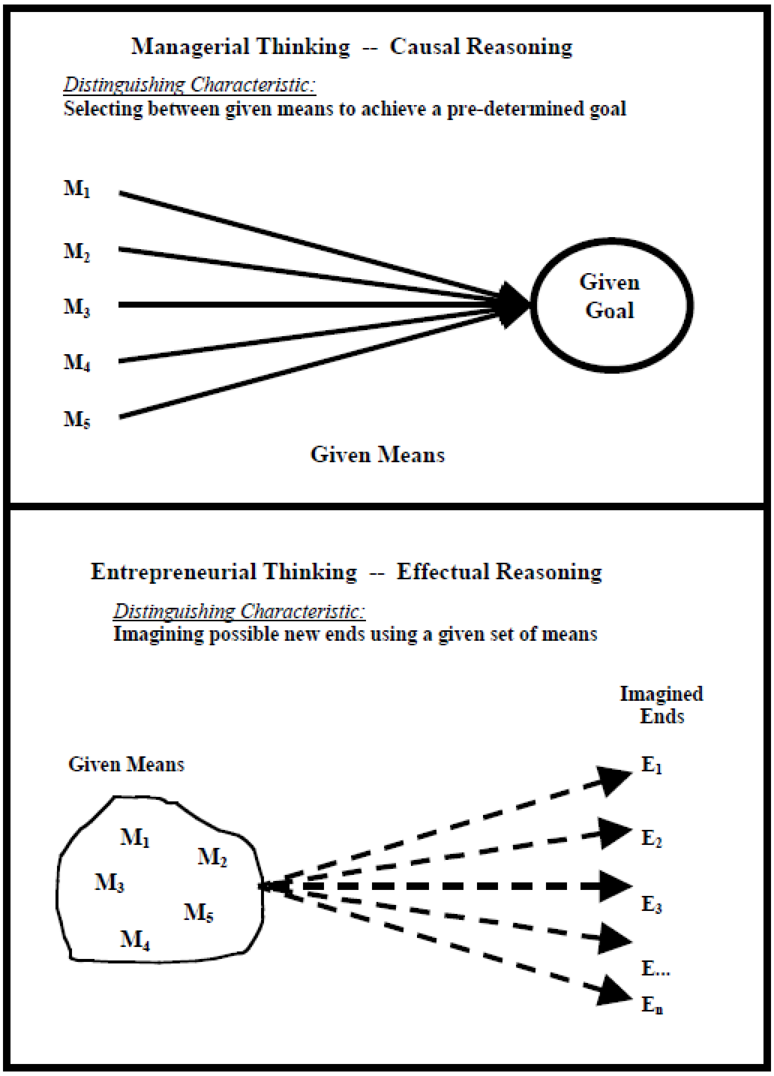

Figure 1 Causal process vs. Effectual process (Sarasvathy, 2001a, p. 3)

Effectuation theory suggests that the effectual reasoning process begins with three categories of means. Entrepreneurs firstly evaluate who they are, and what are their traits, tastes and abilities. Then they reflect what they know, by analyzing their education, training, expertise and experience. Thirdly, entrepreneurs consider who they know, and what are the professional and social networks they are a part of (Sarasvathy, 2001;2001a).

At a company level, just like at the entrepreneur level but only in larger scale, startups would analyze its physical resources, human resources and organizational resources. With these instruments, the entrepreneur or the company starts to vision different goals that are achievable and worthwhile. Typically the expert entrepreneurs begin with resources that are closest to them and are easily applicable, and move almost instantly into action without developing too thorough of a business plan. Sarasvathy (2001a) point out, that in contrast to causal reasoning that comes to life via careful planning and only then execution, effectual reasoning is all about the execution. Effectual entrepreneurs, to quote a famous sportswear brand, just do it, without worrying too much about what they ought to do. Business plans are in constant change and are affected by new information from the entrepreneurial environment. However, the big picture and the vision still remain clearly in the minds of entrepreneurs despite the turmoil in everyday proceedings. Expert entrepreneurs actively seek for partners in order to minimize risks and capital need, and to still acquire more means and new possible goals. Through their actions, and with their partners, the effectual entrepreneurs' set of means and set of possible goals change and are reorganized. Eventually, as Figure 2 illustrates the process, most desirable goals are identified and pursued as new firms.

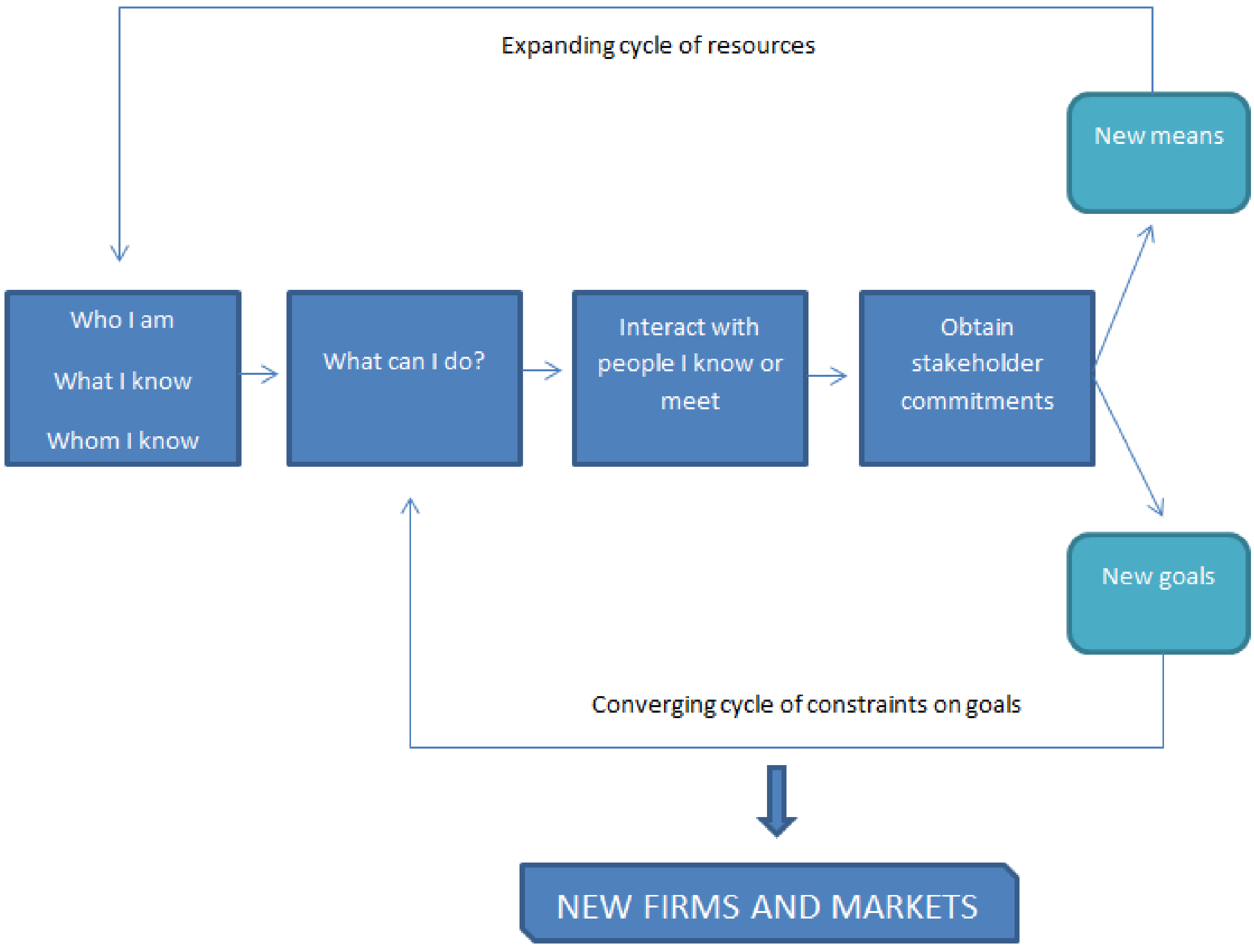

Figure 2 The Effectual Process (Read, S. & Sarasvathy, S. 2005)

Still, this type of reasoning, thinking and behavior are seldom encouraged in business schools or government run entrepreneurship programs as Sarasvathy (2001a, p. 3) laments:

> We teach potential entrepreneurs an extremely causal process – the sequential progression from idea to market research, to financial projections, to team, to business plan, to financing, to prototype, to market, to exit, with the caveat, of course, that surprises will happen along the way. Seasoned entrepreneurs, however, know that surprises are not deviations from the path. Instead they are the norm.

5.2.3 The principles

Causal problems are problems of decision; effectual problems are problems of design. Causal logics help us choose; effectual logics help us construct. Causal strategies are useful when the future is predictable, goals are clear and the environment is independent from our actions; effectual strategies are useful when the future is unpredictable, goals are unclear and the environment is driven by human action. (Sarasvathy 2008, p. 73)

Sarasvathy's study led to the formation of five key principles that demonstrate the kind of reasoning and decision-making criteria that successful entrepreneurs time and time again employ in the new business creation.

The *bird-in-hand* principle

This is a principle of means driven in contrast to goal driven action. This principle emphasizes creating something new by asking: who am I, what I know, and whom I know. The principle encourages innovation with the available means rather than discovering new ways to achieve given goals. Imagined products or markets of a company originate from the means of the venture. (Sarasvathy, 2008)

The *affordable-loss* principle

According to Sarasvathy (2008), this principle highlights that an entrepreneur should determine beforehand what he or she is willing to lose rather than trying to estimate expected returns of a certain project. By limiting risks successful entrepreneurs can choose goals where there is upside even if the downside ends up happening. She elaborates (2001) that effectual entrepreneur tries to experiment with as many strategies as possible with the given limited means. Decisions that create more options in the future are preferred over decisions that maximize returns in the present. Taking product to market quickly without spending too many resources on market research is effectual entrepreneurship.

The *crazy-quilt* principle

This is a principle which focuses is on building partnerships rather than on doing a thorough competitive analysis. Since entrepreneurs often start their businesses without assuming the existence of a predetermined market for their idea, competitive analyses do not do any good for them in the early stages of their ventures (Sarasvathy, 2001a). Strategic alliances also help to bring the idea to market at really low levels of investments due to shared interest between the parties, and also reduce uncertainty. In addition, entrepreneurs often co-create new markets and/or products with their partners since no particular market has been determined in the first place.

The *lemonade* principle

This principle emphasizes the ability of leveraging surprises rather than trying to avoid them, and to turn the unexpected into the profitable (Sarasvathy, 2008). Successful companies are often products of contingencies, as opposed to pure luck. Unforeseen events may lead to scientific breakthroughs and products if surprises are regarded more like an opportunity than a threat. Effectual entrepreneurs pursue to leverage the contingencies that come upon them and do not fall into despair in the face of unexpected events. This principle echoes the widespread saying "When life gives you lemons, make lemonade".

The *pilot-in-the-plane* principle

This principle urges relying on and working with human agency as the prime driver of opportunity rather than limiting entrepreneurial efforts to exploiting external factors such as current technological advancements or social-economic trends (Sarasvathy, 2008). By focusing on factors within their control, effectual entrepreneurs trust that their efforts will result in the desired outcomes. This principle is rooted in the belief that the future is not discovered, but rather made. This principle emphasize the entrepreneur's intelligence, intuition, vision, and pure gut feeling in decision making, because it's impossible to accurately predict the future.

These five principles reduce the need for predictive strategies to control uncertain future in entrepreneurship.

5.2.4 The logic

The logic behind effectuation theory differs profoundly from causal reasoning in terms of assumptions regarding the future. According to Sarasvathy (2001a; 2008) and Read et al. (2005), causal reasoning is based on the logic *"To the extent that we can predict the future, we can control it"*. That assumption is the main reason why modern corporations spend huge amounts of resources predicting the future. Conversely, the logic behind effectuation theory goes *"To the extent that we can control the future, we do not need to predict it"*.

While causal entrepreneurs take the future as the continuation of the past, effectual entrepreneurs act as there is no future to be "discovered", but rather that the future gets created by their actions. The logic behind effectuation theory encourages to shape the future rather than to predict it. Markets are made rather than found. In fact, Sarasvathy (2001) points out, that effectual entrepreneurs often proceed without any certainties about the existence of a market for his or her product. This type of yet-to-be-made reasoning is particularly effective in highly uncertain environments, often found in new venture creation. In these uncertain conditions, the entrepreneur's effectual logic is highly influential to the success of the firm (Andersson, 2011).

Effectual entrepreneurs do not try to avoid failure; they try to make success happen (Sarasvathy, 2008). Starting a business is like cooking without a recipe. Before finding the perfect combination of ingredients and spices many mistakes will inevitably be made. Failing is an integral part of effectual entrepreneurship. By failing often and early, and most importantly by learning from one's mistakes, effectual entrepreneurs leverage their accumulated knowledge in creating thriving businesses.

Sarasvathy (2001) argues that causation process is not wrong approach per se, but it's usually more applicable and effective in static environments where the future is more predictable. On the other hand, in a startup environment, where the future is highly unpredictable, effectuation process is typically more effective. Sarasvathy (2001a) and Andersson (2011) highlight that same person, depending on the circumstances, can and should use both processes of decision-making. In fact, the most successful entrepreneurs are capable of using both types of reasoning, but they prefer effectual over causal during the early stages of a company.

5.3 Critique

Effectuation theory and effectual logic suggest that partnerships and strategic alliances can help finding new means and resources, which help the entrepreneur to bring the idea to market at a considerably lower level of costs. Co-creation of new products and new markets are indeed a compelling proposition that might blind the entrepreneur in all its benefits. However, the logic has been also criticized for being overly optimistic, even naive, and exposing entrepreneurs to greater risk than needed.

Bachmann (2001) notes that trust has been recognized as a very important mechanism in business relationship. According to Goel and Karri (2006), entrepreneurs need to trust others in order to form and grow their networks. They state, however, that when entrepreneurs serve as trustors or trustees, they get also exposed to risks. Effectual start-ups might trust more than the situation merits in their ventures. Trusting your business partners can be seen as a beneficial maneuver, but too much of it is not.

Goal and Karri (2006) argue that effectual entrepreneurs are more susceptible to over-trust. Their study finds that entrepreneurs use certain selection criteria that typically stem from the affordable loss principle, and not necessarily evaluate the trustworthiness of their relationships that is more distinctive in the causal approach. Thus, start-ups breathing the effectual logic may expose themselves to risks that may be hidden and subconsciously assumed or actively ignored (Goel & Karri 2006).

Bachmann (2001) points out that the potential as well as the risks of trust in business context is not particularly well understood. Trust is always a risky engagement. Bachmann warns that an effectual entrepreneur may be betrayed if overly romantic assumptions take the center stage in decision making. Entrepreneurs may view trusting someone as an integral part of entrepreneurship, and thus a constraint. As a result, they may not devote any cognitive capacity of trying to reduce it. (Goel & Karri, 2006, p. 484)

Goal and Karri (2006) conclude that although effectual entrepreneurs are more likely to have a larger number of over-trust relationships than causal entrepreneurs, they do not fail more often because of the criteria affordable loss. When over-trust relationship causes failure, the losses are likely to be small and thus worth the risk taking.

Sarasvathy and Dew (2008) emphasize that effectual logic is non-predictive, and that effectual entrepreneurs do not "place bets", but only invest what he or she can afford to lose. In their article, Sarasvathy and Dew also point out that effectual entrepreneurs view intelligent altruism as a rational strategy and leverage the fact that adopting this behavior potentially cues in intelligent altruism in others. Complex entrepreneurial opportunities depend on intelligently altruistic behavior by stakeholders who are collectively aware that they depend on each other not to collapse an opportunity in the making. (Sarasvathy and Dew, 2008, p. 735).

6. Methodology

This chapter describes and justifies the methodology and the more specific methods utilized in this study. Methodology refers to a more universal approach to studying research topics, whereas method refers to a particular research technique (Ahrens & Chapman, 2006).

This thesis can be characterized as a qualitative case study. The choice had both methodological and pragmatic reasons. A case study is a great tool to research different parties in a single event or in more complex social situations. During the last decades, case studies have become a popular tool in the management accounting research (Scapens 1990; Keating 1995; Lukka & Kasanen 1995; Ahrens & Dent 1998). As a fashion start-up founder, I have got to know different players in the fashion ecosystem, and thus communication with investors and brands in this field is frequent and natural in my professional life.

Qualitative research typically refers to a case research, where large amount of data is collected from a small set of target organizations (Vaivio, 2008). The empirical part of the study focuses on four Finnish fashion start-up companies and four investors operating in the field of fashion. Emphasis is on the thinking processes, best practices, and opinions how to run a fashion company successfully to create value. The young fashion brands in the study are all employing 5 or less people, with a maximum of 270,000 EUR turnover. All the companies have been in business 6 years or less. The investor side is represented by two business angels and two venture capitalists.

The four companies represent the Finnish fashion start-up scene very well, as they are all heavily designer driven which is typical in Finnish fashion. What I mean by that is that the key decision maker in the company is also the designer of the brand and often with a school of arts background. On the other hand, the four investors weren’t solely interested in the fashion industry, but were among the few investors who saw potential in the field, and who were actively screening companies from this industry. As said before, there is not whole lot of funding taking place in the Finnish fashion scene at the moment, so these four investors represents in my opinion quite accurately the current opinions of the investors.

As stated, the empirical basis of this study is a qualitative research method. Contrary to quantitative research method in which statistical analysis accounts for results, qualitative research methods intend to describe a particular event, understand a specific activity, or to provide a theoretically meaningful interpretation about a phenomenon (Eskola & Suoranta, 1998). The goal of this study is to examine the different opinions, approaches and attitudes towards running a fashion company; hence the qualitative research method fits that purpose well.

It’s important to choose the most feasible type of interview for the research problem (Eskola & Suoranta, 1998). I chose semi-structured interviews for my thesis as the research method. According to Koskinen et al. (2005, p. 105) semi-structured interviews are the most utilized qualitative research methods in social science and business research. Vaivio (2008) also supports the idea that extensive interviews are an effective tool to research questions in the social science and business field.

The interviews of four fashion start-ups and four investors were conducted in the fall of 2014. All the semi-structured interviews were done separately to ensure the authenticity and originality of the answers. I did not want respondents' answers to have an impact on others. The objective of every interview was to shed light on the interviewee's thoughts on running a successful fashion business, and see if the thoughts differ from start-up founders to investors. According to Koskinen et al. (2005), interview is often the only available method to find out how people really see certain matters. The main purpose of an interview is to dig deep into interviewee's mind (Eskola & Suoranta, 1998). If you want an opinion on a certain matter, the best way to do that is often just to ask.

I wanted to create a relaxed atmosphere in the interviews for as open conversation as possible. According to Hirsijärvi & Hurme (1995) semi-structured interviews address predetermined themes and the conversation flows around those subjects. The interviews I conducted followed that path, but were quite interactive and conversational. Semi-structured interview is a great method for exploring less known situations and sub-conscious positions (Saaranen-Kauppinen & Puusniekka, 2006). In my interviews I noticed that this method really activated the interviewees to think thoroughly every aspects of the conversation, so the methodological choice turned out to be useful. My goal during the interviews was to be as neutral as possible, and not to guide the discussions into any predetermined conclusions. According to Vaivio (2008), this is often a risk as the interviewer might try to steer the empirical evidence into the predetermined theoretical framework.

I initially set out to interview 10 people, five entrepreneurs and five investors. However, two of the requests didn't work out as the interviewees were eventually unavailable. All interviewees were promised full anonymity to encourage open and unbiased discussion. A semi-structured interview road map was used as a base to guide the interviews in right directions. The interviews lasted approximately 50 minutes each and all but one were recorded. One respondent, who didn't want the interview to be recorded, was asked to pause once in a while so I could take accurate notes about the discussion. All the interviews were later transcribed to written form for data analysis purposes. Coding of the data was done according to Sarasvathy's (2008) principles of effectual entrepreneurship. It should be noted that this coding and is highly subjective as it is based on the author's interpretation on what each interviewee meant with each comment. What is more, although the eight interviewees represent in my opinion quite well the current situation in the Finnish fashion ecosystem, the results of the study cannot be used to make generalizations with 100% certainty

7. Empirical analysis

This chapter goes through the semi-structured interviews in order to find out whether there are differences between the entrepreneurs and the investors in terms of thinking, problem solving, and decision making. This is conducted by classifying and categorizing each interviewee's thoughts on what's important in running a young venture in the fashion industry. The entrepreneurs' point of view is naturally a bit different than investors'. Start-up founders are analyzing how they run a company, whereas the more experienced investors are defining how growth companies in the fashion business ought to be run. Radical differences between the two would intrinsically complicate funding as the investments typically require common ground and mutual understanding in terms of strategy, assets, and vision.

The opinions are categorized by the five principles of effectuation theory. Each opinion that agrees with Sarasvathy's theory on effectual entrepreneurship is labeled as "Effectual", whereas opinions disagreeing with the theory, thus supporting causal entrepreneurship, are labeled as "Causal". Each comment is also tagged to indicate whose opinion is it.

It should be noted that this coding and categorization of opinions is highly subjective as it is based on the author's interpretation on what each interviewee meant with each comment. I did not want to shorten the given opinions and comments too much in order to give the reader possibility to make his or her own interpretations and conclusions for a deeper understanding of Finnish fashion ecosystem. Thus, some broad opinions seem to fit in more than one principle category of the theoretical framework. Nevertheless, separating effectual and causal evidence from each other proved to be more accurately executable task, which in the end is more crucial to the results of the study.

We start with the *bird-in-hand* principle, and then examine the empirical evidence in the following order: the *affordable-loss* principle, the *crazy-quilt* principle, the *lemonade* principle, and finally the *pilot-in-the-plane* principle.

7.1 The *bird-in-hand* principle

The bird-in-hand principle is all about means driven in contrast to goal driven action. The principle emphasizes creating something new by asking: who I am, what I know, and whom, I know. The founding team of a start-up and their skills are essentially related to Sarasvathy's first principle. Also empirical evidence supports the idea that team is one of the most important factors when determining whether the company will succeed or fail:

> "The founders of the start-up play a big role." (Entrepreneur 3 / Effectual)

> "You definitely need a charming team that has skills and most of all has ambition. If you have a famous person as the face of the brand, the chances are you gain momentum faster." (Investor 4 / Effectual)

Industry experience in particular was seen critical among the interviewees:

> "The founders are the most important assets in a startup. People either make or break the company. When thinking about investing in a company, I mostly try to get to know the people behind it. Experience from the industry is critical to the success of a startup. Someone has to have experience in the business." (Investor 1 / Effectual)

> "An experienced designer knows what sells and what does not. You must also know the production process well in order to know what's possible and what's not. Scaling the business isn't as easy as you would think in this industry" (Investor 3 / Effectual)

"A fashion start-up needs a strong team, with lots of expertise. Straight out of school no designer could even possibly know how the whole manufacturing of a collection goes. If you have never actually gone to a fabric fair, and placed a real order you can't know the whole process." (Entrepreneur 2 / Effectual)

"Experience is particularly important in the fashion industry. When you are running a fashion start-up with a small team, experience from the field will help you see the big picture. It will also reduce risks as you probably won't make mistakes with orders, which could potentially break the whole company. However, you face new challenges every day, so you still have to be able to learn new things even though you had worked in the industry before." (Entrepreneur 4 / Effectual)

Diversity of teams was also seen valuable from both sides of the table:

"I would say that a good team is the cornerstone of a successful fashion start-up. Ideally the members of the team should have complementary skills. The team should really be world class in the core business (design), but they have to also understand the numbers, sales and finance." (Investor 3 / Effectual)

"The success of a young fashion startup really comes down to the people in the company. The more diverse team, the better. Definitely the team should consist of more than just designers. As a designer, I would ideally have a business guy with me, or a marketing superstar." (Entrepreneur 1 / Effectual)

"You should ideally have a team with multiple players. We are just the two of us and we got hands full of work. We have been trying to find the right people to complete our team but it's not easy. We did the SWOT analysis and we sure know our weaknesses. Launching a fashion company requires that all the different aspects of running a business is taken care of. Design is only a small fraction of the puzzle. Pretty often people think that design is all there

> is, but running an apparel company requires so much more." (Entrepreneur 4 / Effectual)

> "In my opinion, in many cases the designers start company with other designers, without any competence from other areas of doing business. Sometimes I see a team consisting of a designer and a sales person, but rarely so. If you have a company with many people from different backgrounds, then it gets much more interesting. And that's the problem with Finland compared to Sweden and Denmark – they got really diverse fashion startups there. You can't find a fashion startup from Sweden or Denmark without at least a sales and marketing person in addition to the designer." (Investor 2 / Effectual)

> "Only the production planning alone requires so much attention and effort that it's really hard to stay on schedule. If I only could afford hiring a salesperson I would do it immediately. Selling is so repulsive for me, as it is for most designers. Every designer hates it. I would like to be able to concentrate on the creative stuff." (Entrepreneur 2 / Effectual)

Team's skills and capability to execute were also mentioned:

> "Technical knowledge of fabrics and production is also really important as it is so important for the business. And without this knowledge the risks of making errors in production increase tremendously." (Investor 4 / Effectual)

One investor suggested that having previously founded a company will definitely be a beneficial asset for the start-up:

> "It's good to have experience from the large corporations, but experience from the start-ups gives you a good idea of the harsh reality a young entrepreneur often faces. Usually, the rule of thumb is that if you can endure the first 12 months without losing you mind and money, you might have a chance." (Investor 3 / Effectual)

Entrepreneur's or founding team's ability to pivot was seen important:

> "You also need to be fast. Things move in such pace, that if you are striving for perfection, you will be late. It's totally pointless to roll out your summer collection when the season is over." (Entrepreneur 1 / Effectual)

> "You have to be able to react fast, be flexible, be adaptable, and be humble. Things will not go as planned and you just have to push through the hard times. I would never invest in people with big ego, you have to be humble." (Investor 1 / Effectual)

According to Sarasvathy (2008) the performance of an entrepreneur has been traditionally examined as a set of personality traits that explain the success or failure of the firms he or she creates. These characteristics do not account for entrepreneurial expertise according to the effectuation theory. However, perseverance, resilience, and passion were seen crucial to the success of the company by two entrepreneurs:

> "You have to be willing to work a lot. And do everything that is required. You have to be there where the action takes place, and you have to sell. It's your responsibility to sell; no-one else does it for you. The first couple of years, you don't even notice the amount of work and the exhaustion. But after three years you just can't continue like that anymore. Then you have to start to delegate tasks to other people, only to realize that you cannot afford to hire a pair of hands because it's so expensive. Then you realize you still have to do everything by yourself." (Entrepreneur 1 / Causal)

> "The most important factor determining start-up success is the passion of the founders. Without the passion we wouldn't be doing this. You have to be a little crazy to even be doing this. The truth is that there's going to be lots of problems and those are much easier to solve if you do this from the bottom of your heart and you believe in your idea. (Entrepreneur 3 / Causal)

Effectual entrepreneur is means driven, as opposed to goal driven. They tend do what they do best and this was supported by the evidence:

> "We chose market in which we have the most potential to do something great." (Entrepreneur 3 / Effectual)

> “What led us to choose this business was our core competence. This is what we do best. We also believe that the market has potential.” (Entrepreneur 4 / Effectual)

Capital, or the lack of it, is part of the start-ups available means. According to the effectuation theory, effectual entrepreneur should create a brand or a collection with the available means and innovate new goals if current financial situation will not allow original targets. Still, capital was seen by many as an important part of building a successful fashion company, especially by the entrepreneurs:

> “Money is one of the most important factors in this industry determining success. It’s just really hard to create something cool without money.” (Entrepreneur 1 / Causal)

> “Funding is vital for young fashion start-ups since retailers typically get interested about you not until the third collection. First two collections have to be funded by yourself and cash flows out from doors and windows. Buyers do not want to buy from start-ups since there’s no guarantee for future collections.” (Entrepreneur 2 / Causal)

> ”Without money you can’t do anything in this industry.” (Entrepreneur 4 / Causal)

> “Fashion also requires loads of capital, and the other Nordic countries outpace us in this regard by quite wide margin.” (Investor 2 / Causal)

As stated, the *bird-in-hand* principle suggests that the effectual entrepreneurs are means driven as opposed to goal driven. Nevertheless, investors not so surprisingly appreciate commercial goals and maximization of wealth:

> “The Swedish fashion companies are clearly commercial in their nature, something that Finnish companies are not. For example the success of Hennes & Mauritz is based on brutal maximization of profit while still being trendy and cool. You got to have a sense of smell for money. The designers

> are not thought to think in business terms. That's why the Aalto University was founded so that the designers could learn also business. It doesn't help much to be a great designer if you don't understand anything about the numbers and sales. In the end we evaluate the commercial viability of the business. You can have all the best designers in the world, but if it's not interesting business wise I'm not going to invest in it." (Investor 3 / Causal)

> "What's fundamentally wrong in the Finnish fashion startups is that commercial strategy is frown upon and everyone is jealous. It's socially acceptable to be artistic, not to make money. And everyone in the fashion community wants to belong to the same ideology. If someone makes a decision for business reasons he or she will be lynched." (Investor 2 / Causal)

> "The biggest hindrance among the Finnish fashion startups is the lack of commercial mindset. There are too many companies run solely by the designers. As far as I know, designer might get kicked out of the designer community should he or she run the label as a for profit business. I appreciate companies that are founded by people from different backgrounds since then the commercial mindset is typically in place from the get-go." (Investor 1 / Causal)

These comments regarding the lack of commercial goals of designers, however, are from the past according to one fashion start-up founder as he states

> "The saying that Finnish designers are too artistic and can't think commercially is an old song that should be forgotten by now." (Entrepreneur 4 / Causal)

Still, Finnish start-up entrepreneurs in the fashion industry often have other than commercial goals which often conflict with the priorities of the investors:

> "It's quite hard to talk with investors. They want to see totally different things than what you would actually like to do. If you raise 100k, they want that you turn it into 500k. So from that point forward you job is to make them that money. That's the number one thing in their mind. But we are not doing

> this to maximize profit. Our priority is to change how people buy fashion and that they would use their money more ethically. We sure have other goals than money as well. As a matter of fact, my secret first priority is to secure the living of the team and myself, and after that employ other people. And only then I want to make millions for the investors. But these kinds of secret goals you couldn't say to an investor, could you? Never." (Entrepreneur 3 / Effectual)

Overall, both the entrepreneurs and investors seem to think that the founding team needs to be strong in order to succeed in the fashion industry. Evidence makes it clear that experience from the fashion business and diverse team with complementing skills are crucial building blocks for a fashion start-up. These team characteristics were also identified by the literature review on the success factors of early stage companies. Evidence suggests, however, that entrepreneurs emphasize money as being one of the most important factors determining success, whereas investors agree that strict commercial goals is an early indicator of success.

7.2 The *affordable-loss* principle

The affordable-loss principle argues that taking product to market quickly with the help of the customers is part of effectual entrepreneurship. Extensive market research is seen unnecessary whereas communicating with the customers is seen effective:

> "During product development, you should always keep in mind to whom you are producing the garments. This means that you have to listen to the customers at least to some extent." (Investor 1 / Effectual)

> "If your business depends on retail I would recommend taking the retailers in the design process. You should test if you have any traction before going too far. You have to know your customer inside out, and you have to focus on selling your product to that customer segment. If you would have the fanciest product in the world, but nobody purchases it, you need to take a good look at the mirror. You just have to listen to the customer." (Investor 3 / Effectual)

> "In my opinion the most important thing is to be able to do products that people desire. Pretty generic, but that's what explains success. It's completely pointless to create something nobody uses." (Entrepreneur 3 / Effectual)

According to Sarasvathy (2008), causal models focus on maximizing returns by selecting optimal strategies whereas effectuation begins with a determination of how much one is willing to lose and leveraging limited means in creative ways to generate new goals as well as new means. Effectual founders of a start-up aren't risk lovers but they are very open to new ways of conducting business within the risk level they have chosen:

> "Life is risky. There will be larger or smaller surprises if not every day, then at least every second day. We can't change the course of the brand all of a sudden, but surely we have to respond to feedback and other signals, and react accordingly. You should trust your own thing and be patient. Rather than preparing yourself for all the risks in the world ... Everything does not go according to a plan. As a matter of fact, very little goes." (Entrepreneur 4 / Effectual)

The study found limited evidence in the *affordable-loss* category in order to make any strong generalizations. What is noteworthy is that only one entrepreneur seemed to be interested in the customer tastes in order to design the product precisely for him or her. On the other hand, two investors found it extremely important to listen to the customer when designing their collection.

7.3 The *crazy-quilt* principle

This is a principle which focuses on building partnerships rather than using resources on competitive analysis. Fashion start-ups rely heavily on networks as lots of processes need to be outsourced. Strategic alliances also help to bring the idea to market at lower levels of costs which saves precious resources for other operations. Many interviewees were aware of the importance of networks:

> “Business partners, contacts, networks and advisors are really valuable assets.” (Investor 1 / Effectual)

> “The fashion in Finland lacks professionals and contacts because the business is so small here. International partnerships are important in this business. The success of Swedish brands is based on huge networks, because you can source everything more efficiently from fabrics to software. It’s absolutely important to know big department stores and other buyers.” (Investor 2 / Effectual)

> “You have to have strong and reliable networks and partners. The factories and fabric suppliers are in the core of this business. Without good and flexible production you’re always late and everything goes down the drain.” (Entrepreneur 1 / Effectual)

> “Networks and partners are really important in this industry. The power lies in the strong network and things move forward much quicker.” (Entrepreneur 2 / Effectual)

> "Finland is very individualistic country compared to Sweden and Denmark, and that’s also a problem. We just can’t work together. We want to do everything ourselves in a highly competitive market. Many fashion start-ups in Finland are so alone with their challenges. The entrepreneurs burn out and then we ponder why the brand didn’t take off. It’s just impossible.” (Entrepreneur 4 / Effectual)

Some, however, also saw the potential in competitive analysis:

> “I think it’s really important to watch what’s going on in the industry as a whole and spy on competitors a tiny bit. Sure, if you want be a niche brand then go ahead do your own thing. But if you want to grow you have to keep an eye on the market. Watching other players on the market will give you

valuable information on pricing, marketing, and design among other things so that's really beneficial." (Investor 2 / Causal)

> "You also want and need to know your competitors. An entrepreneur should know whether the market is saturated or not. We found pretty similar companies than ours from the States, but there were no similar start-ups in Europe. That's why we figured it would be a good idea to do this right now in the European market." (Entrepreneur 3 / Causal)

> "We went to all the fairs there is and made competitor and market analysis, so we knew pretty well what's out there and what kind of garments people want to wear." (Entrepreneur 4 / Causal)

The *crazy-quilt* principle highlights the importance of networks and the evidence seems to support that. However, both entrepreneurs and investors disagree with the effectuation theory to some extent as they also see value in competitive analyses when starting up a company.

7.4 The *lemonade* principle

As stated, the effectuation theory's core logic is that *"to the extent that we can control the future, we do not need to predict it"*. The metaphor used earlier in the paper for effectual entrepreneurship went as *"running a business is like cooking without a recipe"*. The lemonade principle emphasizes the ability of leveraging surprises and leveraging contingencies, rather than execute carefully thought business plans which represent causal logic.

However, the business plans were seen very beneficial especially by the investor side:

> "The startup should have some kind of business plan, road map and key milestones, which will guide the company in the right direction. With no plan at all, I won't give my money. However, the startup environment is so

> dynamic that plans will change along the way, and it's perfectly fine." (Investor 1 / Causal)

The same investor made it also very clear that contingencies aren't something he is eager to face in a start-up context:

> "Surprises are a serious threat to a young company since startups typically don't have much cash. Any surprise brings a threat of bankruptcy with it." (Investor 1 / Causal)

Similar evidence from the importance of planning was found throughout the investor field:

> "One way to decrease risks is to plan you operations and plan them well" (Investor 4 / Causal)

> "As an investor I appreciate that the business is planned and all the possible reports are readily available and accurate. The biggest reason for lack of funding is the minimalistic planning and reporting of Finnish fashion startups. If I'm evaluating a company that cannot put together a business plan, no matter how good the idea, I'm not going to invest. The risk is too large, we simply can't. Even if the designer or the team swears that we have a great idea, we cannot see it." (Investor 2 / Causal)

> "You must have a clear and comprehensive business plan. Not for the investor, but for yourself. It helps you to see the big picture and budgets. You always have to have a plan." (Investor 3 / Causal)

The same investor also highlighted the importance of budgeting, reporting, and sense of reality:

> "It's a pity that fashion entrepreneurs rarely know how to handle money. When an investor comes along you have to be able to report your financials to him or her. You just can't spend the money as you like. It's other people's money, like I use to say. But let me tell you a cold hard fact. Every single start-up, and we don't even invest in the youngest of them, they all underestimate production schedules, financial needs, and everything critical

> in their business - always. But the sales estimates are always overestimated. Every single start-up has the *hockey stick* graph illustrating future sales. And this is not a joke, this is a fact. They come to meet us with a poker face and try to convince us that the moment we give the money the sales will soar. But then after six months when we re-evaluate the situation not one of those predictions have turned out to be correct. That's a fact." (Investor 3 / Causal)

Also the planning of each individual's tasks within the team was seen important:

> "Every member of the team should have a clear role. It's good to have constant discussion about the roles, tasks and expectations of each player so that everyone knows who is responsible for each task. Team work is more efficient when everyone knows what is expected from him or her." (Investor 1 / Causal)

The entrepreneurs didn't see planning as important, as they thought that plans are only temporary and so they should be:

> "Anything can happen. For example yesterday I had designed the whole collection and everything was ready, until I sat on a tram and got even better idea. The collection I had worked for is now forgotten. Plans change and that's how it's supposed to be. But, I don't mean that you should base all the decisions on a crazy idea. There needs to be a schedule and certain things in place all the time. I wouldn't let investors inside my head to see what's going on. If an investor does not know you thoroughly, your working habits might horrify the investor." (Entrepreneur 2 / Effectual)

> "We ended up in the market we are currently at by pure coincidence. We found a fabric from Paris that wasn't sold yet in Finland. After an encouraging feedback from the market we decided to stick with it. There was no planning what so ever." (Entrepreneur 1 / Effectual)

Some entrepreneurs went as far as stating that it's totally irrelevant to have a clear plan or roadmap for the future as so much in the fashion industry is not within their control:

> "In order for a fashion start-up to be successful they need also a healthy dose of pure luck. Luck can be the single most important factor in the success." (Entrepreneur 2 / Effectual)

> " The biggest thing determining success is luck – just joking. It [success] comes down to so many things that it's impossible to list them all. But pure luck certainly plays a role." (Entrepreneur 4 / Effectual)

One entrepreneur, however, agreed on the importance of business plans:

> "For the first time we made a five year plan. Without planning it's hard to reach goals because so many things just get undone. However, we are willing and able to make changes in those plans if needed. As a small company we can react quickly." (Entrepreneur 1 / Causal)

To sum up the evidence in the *lemonade* principle, evidence clearly shows that investors appreciate planning, budgeting and reporting. Without comprehensive business plans investors simply will not fund companies. On the other hand, entrepreneurs in the Finnish fashion industry do not put emphasis on planning that much. Evidence suggests that entrepreneurs view the business plans as temporary and sometimes even irrelevant as the future is not within their control. Thus, based on this data, Finnish fashion entrepreneurs can be described as effectual whereas investors seem to use causal logic in building a fashion brand.

7.5 The *pilot-in-the-plane* principle

Sarasvathy's theory pointed out that effectual entrepreneurs work on human agency as the prime driver of opportunity rather than limiting entrepreneurial efforts to exploiting external factors. One of these external factors is obviously existing market for the product.

However, causal logic in terms of existing market was highly valued by the investors, as all of the interviewees noted:

> "The market should exist, and the product must be good. The size of the market or the maturity of the market isn't a big thing for me because whether it's large or small, or mature or emerging, it's going to be really tough anyways. However, a good startup can be successful in both." (Investor 1 / Causal)

> "I'm not too eager to invest in totally new and radical ideas or concepts. I'd rather see some indicators and data that there is market for a product. I want to hear clear forecast that the market and the demand for the product exists. The bigger the market the better." (Investor 2 / Causal)

> "It's really important that you love what you do, but in order to be commercially successful you need a market. Use your brain and your heart when deciding which market to enter." (Investor 4 / Causal)

One investor didn't even want to meet start-ups if there's no existing demand for the product.

> "Anybody can have ideas. But it's really difficult to invest in ideas. I think that when we are talking about a new business, the entrepreneur should believe in the business so much that he or she works as an entrepreneur in its true sense. What I mean is that they should come and ask for money then, and only then, when they have a product that people actually want to buy. There needs to be a market for the product." (Investor 3 / Causal)

Entrepreneurs' take on exploiting external factors wasn't really a high priority. They often thought that a market is created rather than found as the effectuation theory suggests:

> "I didn't evaluate markets in terms of their profitability or potential, but what's interesting for me and what kind of brand I want to create. There were no market analyses what so ever. It's really difficult to stay motivated if you don't enjoy what you are doing. People often like stuff that's made with love." (Entrepreneur 2 / Effectual)

Similarly than exploiting the existing market, exploiting existing trends in the fashion business is considered as causal logic. Investors, however, seems to value start-ups which pay attention to current fashion trends:

> "I have some experience from the Nordic fashion and when it comes to the design process I've seen how they do it. For example Danish brands use a lot of trend analyses in comparison to Finnish brands which always want to draw inspiration from the Finnish nature or something along those lines. Thus, Finnish fashion is quite original, so much so that it becomes hard to sell. Danish brands can also be distinctive in terms of design as well, but the trend analysis is always the starting point. Sometimes, they just copy the analysis and make some small adjustments to make it their 'own'. But the truth of the matter is that if you want commercially successful the products must be aligned with the current trends. That's it. Finnish brands are more like niche brands – really artistic with small markets. We are afraid to use those trend analyses. We want to create 'Finnish design'." (Investor 2 / Causal)

> "You should follow the global trends. In my opinion Danish and Swedish brands are doing it right. They are extremely commercial and are copies of each other, but they get their products sold. Finnish brands want to be too original which inevitably leads to very narrow market and eventually no business. We need more commercial ambitions in Finland. We live in our own little designer bubbles and don't follow what's going on in the market." (Investor 4 / Causal)

> "In the fashion business you should pay attention to the trends and fads at least to some extent. Too weird stuff won't get sold, but only copying what others do won't develop your brand. You should be original, yet commercial." (Investor 1 / Causal)

The designer driven brands on the other hand prefer to stick to their vision and work on human agency as the prime driver of opportunity regardless of the trends:

> "We try to create timeless products so fads are not that important in decision making. Majority of the new collections are my own interpretation of what will be desirable in the future." (Entrepreneur 1 / Effectual)

> "The women's fashion market at the moment is very trend focused and fast paced. I hate that and can't relate to that at all. The clothing is made from cheap fabrics, the exact opposite I'm trying to do. If you want to maximize profits I think you have to sell your soul to the devil. But I'm not going to create something fancy just for the money. I want to design something I would wear myself." (Entrepreneur 2 / Effectual)

> "In a way you should follow the trends, and in a way you should not. But you have to have clear identity and brand, which raises questions and admiration like 'Wow, what is this?' You can't do everything, and you shouldn't." (Entrepreneur 4 / Effectual)

Measuring entrepreneurial potential by early sales is also conflicting with the effectuation theory's idea of non-predictable future. However, to investors early sales and first customers are an important indicator for success also in the long term. Entrepreneurs seem to think that early sales shouldn't be the focus when picking winners and losers, but rather the vision of the brand:

> "In my opinion there are plenty of good ideas and good people, but the critical thing is that can you commercialize it, and can you sell it. I've noticed that there are wonderful concepts coming out of Finland, but only when they get traction from the market does it become interesting for me. You have to

> be commercially-minded and you have to have salesman in the team. Often I feel like that the company has good business idea and concept, and maybe even marketing is going well, but there are no distribution channels. When I am evaluating a new fashion company, I will always look at the euros, the sales euros." (Investor 2 / Causal)

> "Sales rule. It's one of the most difficult jobs out there. You need to get your message to the customers, and we are not particularly good at that." (Investor 4 / Causal)

> "In my own experience investors require traction and sales before they are willing to proceed. After negotiations I often don't know why the funding didn't eventually happen. I think that most investors don't see or understand fashion as a business. They don't see its potential. Investors are used to a business idea including one very specific product, and then you just scale that one product. However, in fashion the products and the collections change all the time. It's much harder to sell my vision to potential investors than an actual product. In my industry the brand is the product." (Entrepreneur 1 / Effectual)

The *pilot-in-the-plane* principle urges relying on and working with human agency as the prime driver of opportunity. This principle highlights the entrepreneur's or start-up's vision and intuition in the decision making as effectual entrepreneurship:

> "As a designer I do most of the decisions by gut feeling. Analyzing is close to zero. But my intuition is quite often the correct decision! Sure, we try to pay attention to what's going on and what other designers and brands are doing, but still I must admit that gut feeling is the primary tool in decision making. A more analytical approach could be beneficial in certain aspects of running a fashion startup, I guess. Investors would probably desire more analytical approach, but I have a feeling that deep inside they also trust that the vision of the designer is the best decision making tool. That's why designers exist. Their job is to create something totally new, unexplainable – and everyone, including the investors, should trust him or her." (Entrepreneur 1 / Effectual)

> “There should be more investors that are able to evaluate the concept or the idea, and place bets on the good ones to see the revenue in the future. Investors do not understand fashion at all, so they rely solely on the sales figures when assessing a fashion start-up.” (Entrepreneur 4 / Effectual)

Some investors, nonetheless, give credit to the human agency and vision regarding decision making in the fashion business:

> “One member of the team must be the visionary, who thinks big. Really big.” (Investor 1 / Effectual)

> ”You can’t listen to customers in this business. The products are designed over a year before actually being released to market. Customers can’t possibly even know what they want to wear in the future. They live in the moment. I think fashion is a bit different industry in that sense. It really comes to the designer and his or her ability to know what people will want in the future. You have to believe in your vision.” (Investor 2 / Effectual)

Regarding strong vision, and the entrepreneur’s genuine belief in it, one investor implied that while the vision is important, the entrepreneur is the one who should believe in it the most:

> “I have one very important message to the fashion start-ups. You as an entrepreneur have to take the risk. It’s not investor’s sole responsibility to put money on the line. You have to be willing to down grade your lifestyle, and take loans to your own name. If you as an entrepreneur do not believe in your business, no-one else does.” (Investor 3 / Effectual)

Evidence in this category strongly indicates that investors prefer causal reasoning when analyzing start-up potential. They seem to think that existing market, trendy product offering and existing sales are top markers of success for the early stage companies. However, entrepreneurs seem to think as Sarasvathy’s effectual entrepreneurs as they see vision and intuition playing a big part in the success of young fashion brand.

8. Discussion and analysis

The objective of this chapter is to discuss and analyze the empirical findings of the case study by comparing them to the theoretical framework of the study.

In order to provide a comprehensive answer to the research problem, this chapter will answer to the three research questions presented in the introduction.

1. Are Finnish entrepreneurs using effectual or causal logic in running a fashion business?
2. Do private investors prefer effectual or causal logic in running a fashion startup?
3. Is there a difference in the way of thinking between fashion entrepreneurs and private investors that might be preventing Finnish fashion industry to grow?

8.1 Finnish fashion entrepreneurs using effectual logic

The purpose of the first research question was to find out whether Finnish fashion entrepreneurs are using effectual or causal logic in running a fashion business. Based on the empirical evidence of the study, the entrepreneurs are heavily leaning towards effectual rather than causal logic in running a fashion company.

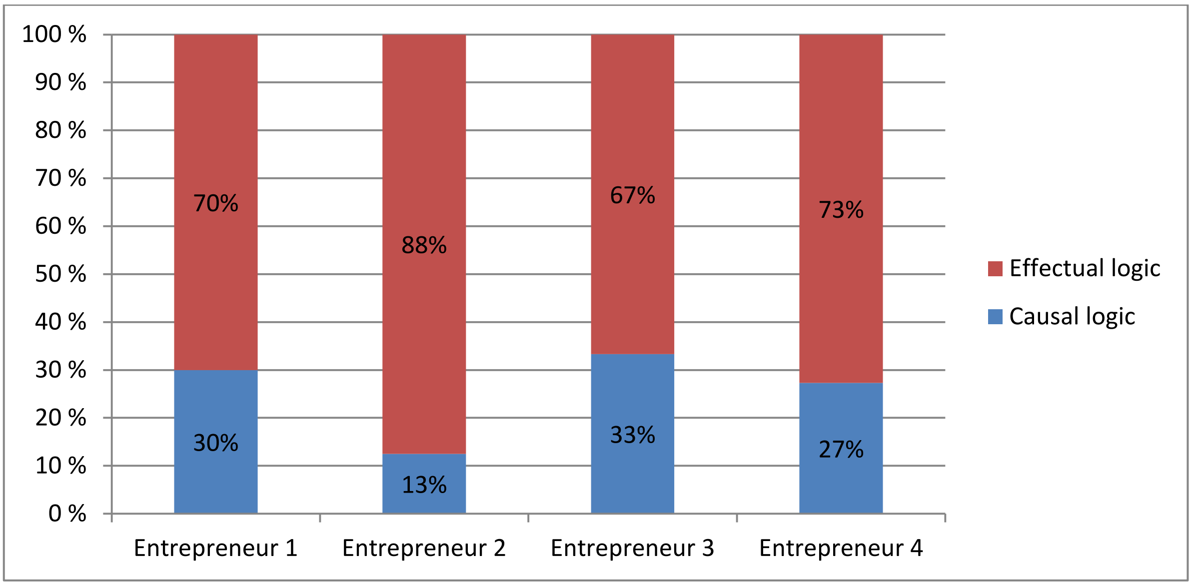

Figure 3 Finnish fashion entrepreneurs' data distribution.

All of the four entrepreneurs in the study were identified as being effectual in their reasoning. There were altogether 35 data points coded and categorized with 26 comments reflecting effectual reasoning and 9 comments representing causal logic.

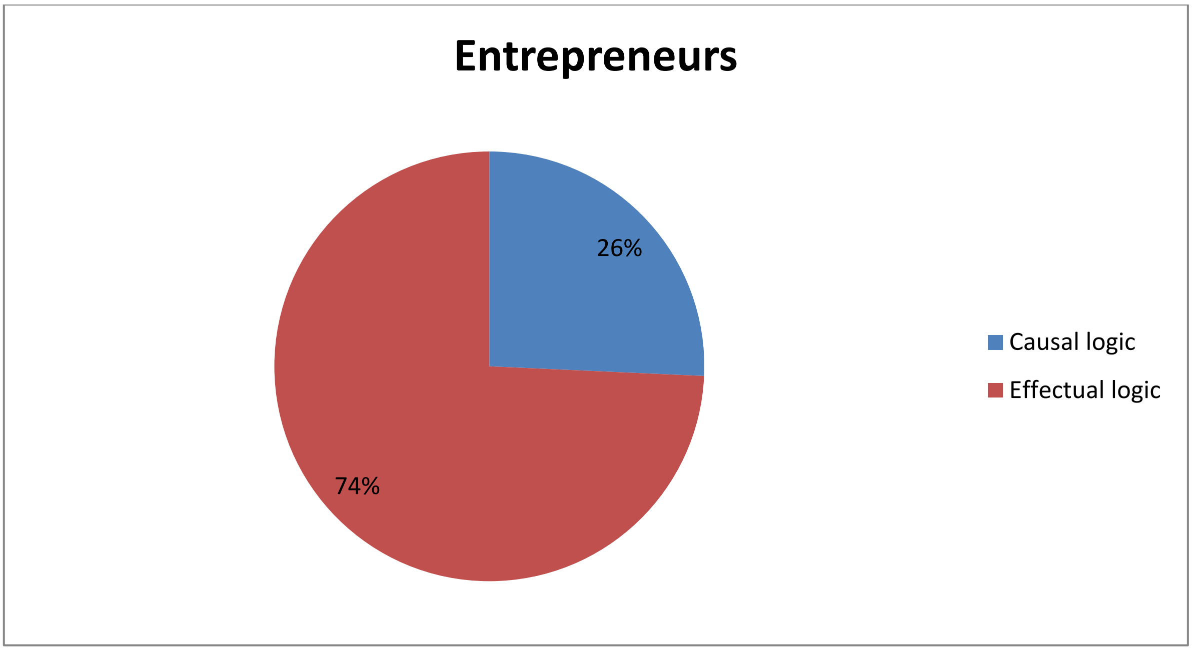

Figure 4 Finnish fashion entrepreneurs' total distribution.

Entrepreneurs in general regarded experience and diversity in founding team very important. The designing process was considered to be on good level within all the teams, but often other processes such as sales and marketing in the company were seen difficult. During the interviews many of the interviewees stated that a sales person with international contacts would be *a dream hire* for the company. The problem with fashion start-ups seemed to be the lack of money to hire a professional to take care the processes that were often overlooked.

> "A salesman with international experience would be a dream hire. Another recruitment I would happily make is an accountant or a controller, who enjoys playing with Excel and keeps the budgets in balance. We know our weaknesses, but we can't do anything about them since we have no money to hire a professional. The challenge is that there's so much to do all the time that it's hard to focus on anything." (Entrepreneur 4)

The many comments praising the importance of a great team really highlights the effectual reasoning of the entrepreneurs.

Two entrepreneurs also named personality traits such as perseverance and resilience to be vital part of fashion start-up success. This causal evidence stresses the immense amount of work fashion entrepreneurs experience in their daily lives. The same can be said, however, with other entrepreneurs in different industries.

According to the effectuation theory, effectual entrepreneur should create a brand or a collection with the available means and innovate new goals if current financial situation will not allow original targets. Still, capital was seen by many an important part of building a successful fashion company. This finding in my opinion accentuates the lack of funding in the Finnish fashion industry. Many respondents felt frustrated with the situation, and thus wanted to point out the importance of cash more than once.

> "We have all the prerequisites for a profitable fashion business in Finland. We have lots of small cool brands and plenty of knowhow in the design. What we need is a fundamental shift in the attitudes toward fashion as a business. We are forced to make things small here because of the lack of

money. It would be great if investors would fund fashion instead of mobile applications for a while.” (Entrepreneur 2)

Effectuation theory suggests that building partnerships rather than using resources on competitive analysis is a good policy. Most of the entrepreneurs thought the same way as existing networks and partners were seen very important during their young entrepreneurial journeys. However, some of them also liked the idea to observe what other brands were doing not necessarily to copy them, but to know in general what is going on in the field.

As stated, the effectuation theory’s stance on planning the future goes as *“to the extent that we can control the future, we do not need to predict it”*. The Finnish fashion entrepreneurs really seemed to follow this particular guidance of the theoretical framework. Many start-up founders did not put much effort on predicting the future, but rather trusted their ability to make the correct decision when the situation needed. Business plans were seen as temporary, which could and should be changed in a heartbeat if necessary. This kind of behavior is very characteristic among effectual entrepreneurs.

Effectuation theory suggests that effectual entrepreneurs work on human agency as the prime driver of opportunity. The empirical part of the study found evidence that Finnish fashion start-ups indeed trust their vision and intuition rather than limit entrepreneurial efforts to exploiting external factors such as socio-economic trends. Effectual entrepreneurs tend to trust the entrepreneur’s intelligence and ability to create value, so the start-ups in this study could be easily categorized as effectual in this regard.

To sum up, Finnish fashion entrepreneurs seem to use effectual logic. Emphasizing the founding team, cooperation with partners, trust in their own vision in decision making, and lack of planning all indicate that the entrepreneurs are indeed effectual.

8.2 Private investors prefer causal logic in running a fashion start-up

The purpose of the second research question was to find out whether private investors prefer effectual or causal logic in running a fashion start-up. Based on the empirical evidence of the study, the private investors can be said to prefer causal logic in running a fashion business, although the evidence is not as distinctive as with the entrepreneurs.

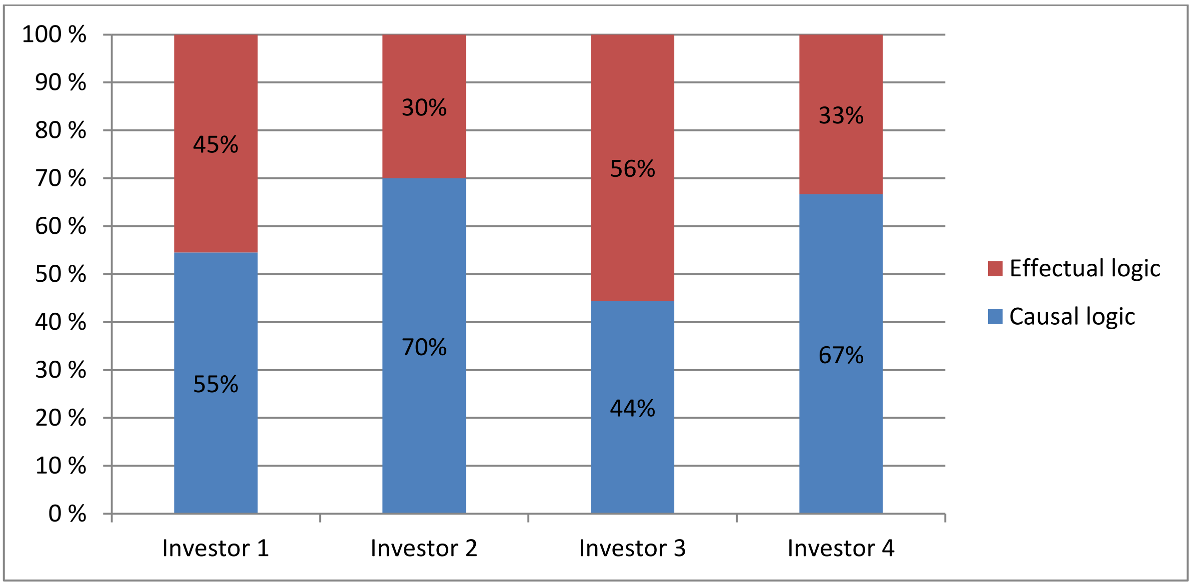

Figure 5 Private investors' data distribution

Three of the investors were identified as being causal in their reasoning, while one of them was recognized as effectual. There were altogether 36 data points coded and categorized with 21 comments reflecting causal reasoning and 15 comments representing effectual logic.

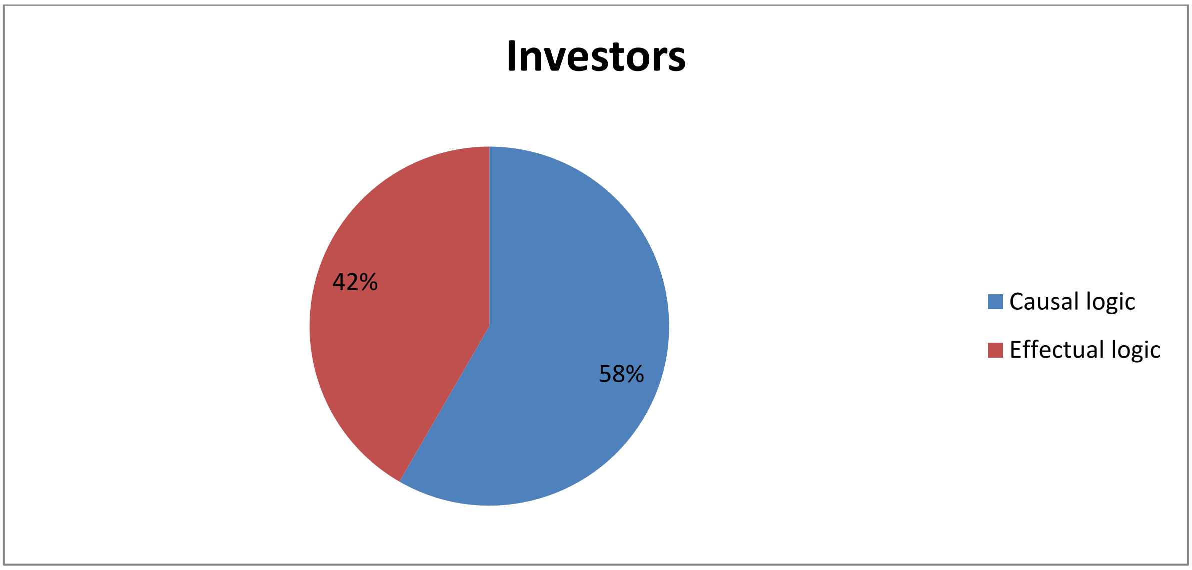

Figure 6 Private investors' total distribution

In regards to the theoretical framework, investors seemed to agree that the principle *bird-in-hand* plays a major role in determining start-up success. Experience in the industry as well as in the early stages of running a company were seen important. Also team diversity was highlighted. All of the investors have had entrepreneurial background at least to some extent, so they were quite unanimous in their comments regarding founding team's importance. Complementing skills in addition to the creative mind was seen important as the investors often bemoaned the lack of marketing and sales skills in Finnish fashion start-ups.

One important piece of causal evidence from the investor side was start-ups' commercial mindset with predefined monetary goals. Based on the empirical evidence, investors find it extremely important to have a goal driven attitude towards entrepreneurship. Basically all respondents gave the Swedish and Danish fashion companies as a prime example of how the maximization of revenue inevitably drives the young brands in the right direction.

When it comes to product design process, investors suggested that listening to customers is a clear indicator for successful companies. Knowing your customer and listening to them is part of the *affordable-loss* principle, and thus one of the examples of effectual reasoning that investors find necessary.

Similarly to entrepreneurs in this study, investors made it clear that contacts, networks, and partners are very important in the fashion industry. Nonetheless, competitive analyses and their value to the early stage company were also mentioned.

Empirical evidence made it clear, that contrary to effectuation theory's *lemonade* principle, investors did find business plans, roadmaps, and budgets essential for a fashion start-up. This was a very clear causal finding and an explicit demonstration of investors' causal reasoning. This aspect of running a business was seen particularly inadequate among the Finnish fashion start-ups, and thus one of the biggest obstacles of mutual understanding between the investors and the entrepreneurs.

Yet another significant evidence of investors' causal reasoning was the effort to exploit external factors. One of these external factors was an existing market for the product. All of the investors pointed out that there should be strong demand for the product, and that the product should be easily approachable and not too radical in terms of design.

Similarly to existing market, investors put emphasis on exploiting trends which again demonstrate investors' logic being causal. They did not find it lucrative to try to create new markets and new trends, but rather exploit the *status quo*.

Measuring entrepreneurial potential by early sales is also conflicting with the effectuation theory's idea of non-predictable future. However, to investors early sales and first customers are an important indicator for success also in the long term. Good ideas simply do not matter that much to investors. It seems that only when the ideas have been executed so well that someone has paid money for it does the proposition become interesting for the investors.

8.3 Finnish fashion entrepreneurs and private investors think differently

The empirical evidence in this study suggests that Finnish fashion entrepreneurs and private investors do think differently according to the effectuation theory. Entrepreneurs prefer to use effectual logic when running a company, whereas private investors seem to use a more causal approach in decision making.

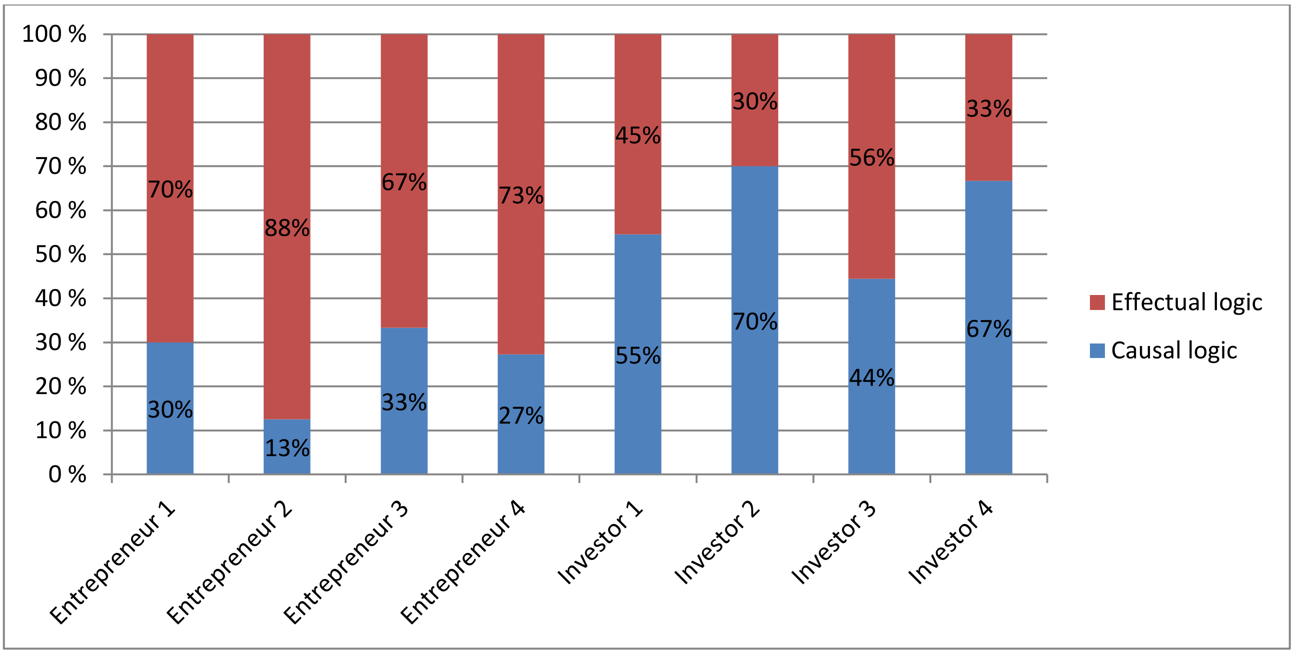

Figure 7 Comparison between Finnish fashion entrepreneurs and private investors

Noteworthy aspects explaining the differences in thinking and potentially explaining the lack of private money in the Finnish fashion ecosystem:

Finnish fashion entrepreneurs see that financial assets in terms of cash are crucial for a competitive fashion company. According to them, it’s really hard to create a cool brand in a highly competitive market without financial resources and working capital. Private investors argue that commercial mindset and financial targets are something that Finnish fashion start-ups lack, but which are extremely important qualities in an entrepreneur and a great indicator of a successful start-up.

Investors highlight the importance of listening to customers and building the collections based on their wants and needs. However, designer driven start-ups feel that the customers do not necessarily know what they will want in a year, as the design process typically begins a year before actual product release.

When it comes to planning, private investors undoubtedly favor careful planning. Business plans and budgets must be in place not for the investor, but for the entrepreneur herself. According to investors, plans and roadmaps help the company to reach predefined goals, and thus makes the venture more lucrative investment opportunity. On the other hand, entrepreneurs figure that as the future is highly unpredictable, not much time should be put into planning. They see that a more effectual and reactive approach works better in the cyclical fashion industry because the future is not entirely within their control.

Finally, Finnish fashion entrepreneurs see that value is best created by trusting their own vision and intuition, whereas investors regard exploitation of current trends and existing market as the best practice in running a fashion start-up.

9. Conclusions

9.1 Summary

This study focused on exploring why there is so little private capital available for Finnish early stage fashion companies. The global apparel market was valued at $US 1.7 trillion in 2012, and is expected to grow in the future. For some reason this huge industry is highly under represented by Finnish fashion companies and one of the biggest hindrances of growth is the lack of funding (Lille, 2010). However, the industry in Finland has potential so fixing the funding issue might give new hope for fashion industry in Finland.

The research problem of the thesis was identified as:

Why Finnish start-ups in the fashion industry are lacking private capital?

In order to provide a comprehensive answer to the research problem the study set out to find out whether there is a fundamental difference in the logic and problem solving behavior between Finnish fashion entrepreneurs and investors about the process of building a successful fashion company. Fundamentally different ideas on how to run a company would naturally prevent any cooperation between the two parties.

To understand the differences in logic, three research questions were identified and analyzed with the effectuation theory by Saras. D Sarasvathy (2001). Next I will briefly summarize what were the main findings of the study.

Are Finnish entrepreneurs using effectual or causal logic in running a fashion business?

This study conducted interviews with four fashion entrepreneurs which were coded, categorized, and analyzed according to the theoretical framework to see how entrepreneurs are solving entrepreneurial problems. Empirical evidence revealed that Finnish fashion entrepreneurs are overwhelmingly using effectual logic in running a fashion company.

Do private investors prefer effectual or causal logic in running a fashion startup?

Similarly to the first research question, semi-structured interviews with four Finnish private investors were performed and analyzed with the same theoretical framework. The evidence suggests that private investors prefer a causal logic in running a fashion start-up.

Is there a difference in the way of thinking between fashion entrepreneurs and private investors that might be preventing Finnish fashion industry to grow?

The study discovered a difference in thinking between Finnish fashion entrepreneurs and private investors, which could potentially hinder the growth of the industry. Entrepreneurs with effectual reasoning and investors with causal reasoning had their most fundamental divergences in following aspects:

- Finnish fashion entrepreneurs see that financial assets in terms of cash are crucial for a competitive fashion company. According to them, it's really hard to create a great brand in a highly competitive market without financial resources and working capital.
- Private investors argue that commercial mindset and financial targets are something that Finnish fashion start-ups systematically lack, but which are extremely important qualities in an entrepreneur and a great indicator of a successful start-up.
- Investors highlight the importance of listening to customers and building the collections based on their wants and needs.
- Private investors undoubtedly favor careful planning. Business plans and budgets must be in place.
- Entrepreneurs figure that as the future is highly unpredictable, not much time should be put into planning. They see that a more effectual and reactive approach works better in the cyclical fashion industry because the future is not entirely within their control.
- Finnish fashion entrepreneurs see that value is best created by trusting their own vision and intuition.
- Investors regard exploitation of current trends and existing market as the best practice in running a fashion start-up.

9.2 Managerial implications

The main implication of this thesis for fashion entrepreneurs and investors is to try to see and understand each other's viewpoint in running a fashion company. Rarely one or the other is perfect in their assessment of how business decisions should be made or strategies created, so finding a common ground should be the first priority in cooperation negotiations.

Finnish fashion entrepreneurs should consider implementing a more commercial mindset, and create a strategy which enables value creation in the long term. These strategies should be planned, milestones set, and progress reported so that investors can understand the big picture and vision of the company. Fashion start-ups should also consider exploiting more existing markets and current trends in their collection development, and take feedback from the customers.

Investors in the fashion industry should notice that in the highly competitive and resource intensive industry traction usually requires somewhat large investments in collection development and marketing, which requires capital. Success stories in the neighboring countries seldom come with extremely lean business development. More emphasis should be put in the evaluation of the concept rather than early sales. Finally, as fashion is after all a creative industry, some freedom in terms of vision and intuition should be allowed.

9.3 Suggestions for further research

This study shed light on the different thinking processes of Finnish fashion entrepreneurs and private investors. As the differences in decision making and logic seem evident, more efforts to tackle this problem should be made.

Firstly, it would be interesting to run a similar study in more established fashion markets such as Sweden and Denmark to see whether the two parties are closer together in terms of logic and reasoning in business context. Secondly, a study which concentrates on improving communication between entrepreneurs and investors with somewhat different stances on strategic choices for a mutual agreement would be interesting for its managerial implications in the Finnish fashion ecosystem. Thirdly, as this study proposed some suggestions to improve the cooperation of different players in the Finnish fashion industry, a more in-depth research on these recommendations could be interesting.

9. References

Ahrens, T. & Chapman, C.S. (2006). Doing qualitative field research in management accounting: Positioning data to contribute to theory. *Accounting, Organizations and Society*, 31 (8), 819-841.

Ahrens, T. and Dent, J. (1998). Accounting and organizations: realizing the richness of field research. *Journal of Management Accounting Research, 10*, 2-39.

Andersson, S (2011) International entrepreneurship, born globals and theory of effectuation. *Journal of Small Business and Enterprise Development*, Vol. 18 No. 3, pp. 627-643

Aspelund A., Berg-Utby T., Skjevdal R. (2005) Initial resources' influence on net venture survival: a longitudinal study of new technology-based firms. *Technovation*. vol. 25:11, pp. 1337-1347.

Bachmann R. (2001) Trust, Power and Control in Trans-Organizational Relations. *Organization Studies*, vol. 22, No. 2, pp. 341-369.

Barnard, M. (2011). *Fashion Statements: On Style, Appearance, and Reality*. New York: Palgrave Macmillan, pp. 23-34.

Bhose, C. (2014) *Sattuman kauppaa*, Kauppalehti Optio, 09/2014, pp. 40-43

Black B., Gilson R. (1998) Venture capital and the structure of capital markets: banks versus stock markets. *Journal of Financial Economics*, vol. 47:3, pp. 243-277.

Burns, L.D., Mullet, K.K., and Bryant, N.O. (2011) *The Business of Fashion. Designing, manufacturing, and marketing* (4th ed.). New York: Fairchild Books.

Brealey R., Myers S., Allen F. (2011) *Principles of corporate finance*. 10th Ed. New York, NY: McGraw-Hill/Irwin

Chamorro-Premuzic T. (2013) *The Five Characteristics of Successful Innovators,* [Online] 25th October 2013, Available from: http://blogs.hbr.org/2013/10/the-five-characteristics-of-successful-innovators/ [Accessed: 1st November 2013]

CNN. (2011) *LinkedIn stock more than doubles in IPO*. [Online] 19th May 2011. Available from: http://money.cnn.com/2011/05/19/technology/linkedin_IPO/ [Accessed: 29th November 2013]

Darrough M., Ye J. (2007) Valuation of loss firms in a knowledge-based economy. *Review of Accounting Studies.* vol. 12:1, pp. 61-93.

De Clercq D., Fried V., Lehtonen O. (2006) An Entrepreneur's Guide to the Venture Capital Galaxy. *Academy of Management Perspectives.* vol. 20:3, pp.90-112.

Eskola, Jari & Suoranta, Juha (1998). *Johdatus laadulliseen tutkimukseen*. Vastapaino, Tampere

European Commission (2012) *Policy Options For The Competitiveness of The European Fashion Industries – "Where Manufacturing Meets Creativity".* Comission Staff Working Document. Brussels 5.10.2012

Fashion United (2014) *Global fashion industry statistics*, Available from: http://www.fashionunited.com/global-fashion-industry-statistics-international-apparel [Accessed: 10th October 2014]

Finatex (2014), Ulkomaankaupan tilastot, Available from: http://www.finatex.fi/toimiala/tilastot/ulkomaankauppa.html [Accessed: 9th December 2014]

Franke N., Gruber M., Harhoff D., Henkel J. (2008) Venture Capitalists' Evaluations of Start-Up Teams: Trade-Offs, Knock-Out Criteria, and the Impact of VC Experience. *Entrepreneurship: Theory & Practice.* vol. 32:3, pp. 459-483.

Finnish Business Angel Network, FiBAN (2014) *Bisnesenkeliaktiivisuus 2013* Available from: https://www.fiban.org/bisnesenkeliaktiivisuus-2013 [Accessed: 4th October 2014]

Finnish Venture Capital Association, FVCA (2014) *Pääomasijoittaminen Suomessa 2013*, Available from: http://www.fvca.fi/files/797/Pa_a_omasijoittaminen_Suomessa_13AS_fi.pdf [Accessed: 4th October 2104]

Gartner, W. (1988) “Who is an Entrepreneur?” Is the Wrong Question. *American Journal of Small Business*, vol. 12(4), pp. 11-32.

Goel S., Karri R. (2006) Entrepreneurs, Effectual Logic, and Over-Trust. *Entrepreneurship Theory and Practise,* vol. 30, No. 4, pp. 477-493.

Hall J., Hofer C. (1993) Venture Capitalists’ Decision Criteria In The New Venture Evaluation. *Journal of Business Venturing,* vol. 8:1, pp.25-42.

Hauge, A. (2007) *Dedicated Followers of Fashion: An Economic Geographic Analysis of the Swedish Fashion Industry*. Doctoral Thesis, Department of Social and Economic Geography, Uppsala University

Heiskanen, M. (2014) *Haastateltavana Jan Vapaavuori*. Talouselämä, 36/2014, pp. 12-13

Helsingin Sanomat (2013) *Supercellista 1,1 miljardin euron kaupat – puolet pelimenestyjästä myydään Japaniin*. [Online] 15th October 2013. Available from: http://www.hs.fi/talous/a1381801230914 [Accessed: 19th November 2013]

Helsingin Sanomat. (2013) *Yli 260 miljoonaa verotuloja Suomeen – ”Meidän vuoromme maksaa takaisin”*. [Online] 15th October 2013. Available from: http://www.hs.fi/talous/a1381801248681 [Accessed: 4th December 2013]

Jackson, T., Shaw, D. (2009) *Mastering fashion marketing.* Hampshire: Palgrave Macmillan.

Kauppalehti (2014) *Rovio vähentää 130 työpaikkaa Suomessa*, Available from: http://www.kauppalehti.fi/omayritys/rovio+vahentaa+130+tyopaikkaa+suomessa/201410701344 [Accessed: 10th October 2014]

Keating, P. J. (1995). A framework for classifying and evaluating the theoretical contributions of case research in management accounting. *Journal of Management Accounting Research, 7*, 66-86.

Keller, C., Magnus, K., Hedrich, S., Nava, P. & Tochtermann, T. (2014) *Succeeding in tomorrow's global fashion market.* McKinsey&Company, September 2014.

Kinnunen, T. (2014) *Ekonomistit: Suomen talous on riippuvainenviennistä*. Helsingin Sanomat. Available from: http://www.hs.fi/talous/a1402372030951 [Accessed: 12th January 2015]

Kotler P., Rath A. (1984), DESIGN: A POWERFUL BUT NEGLECTED STRATEGIC TOOL, *Journal of*
Business Strategy, Vol. 5 Iss 2 pp. 16 – 21

Koskinen, I., Alasuutari, P., Peltonen,T. (2005). *Laadulliset menetelmät kauppatieteissä*. Vastapaino, Gummerus Kirjapaino Oy, Jyväskylä, 2005.

Lille, K. (2010) *Tevallako tulevaisuuteet? Selvitys muoti- ja designalan hyödyntämättömistä voimavaroista ja potentiaalista.* Diges Ry. Available from: http://www.diges.info/pdf/Tevallako_Tulevaisuuteen.pdf

Lukka, K. and Kasanen, E. (1995). The problem of generalizability: anecdotes and evidence in accounting research. *Accounting, Auditing, and Accountability Journal, 8,* 71-90.

MacFarquhar N., Kramer A. (2014) With Russia on Brink of Recession, Putin Faces 'New Reality'. The New York Times [Online] 2nd December 2014. Available from: http://www.nytimes.com/2014/12/03/business/russia-forecasts-a-recession-in-2015-signaling-a-toll-from-sanctions-and-oil-prices.html?_r=0 [Accessed: 12th January 2015]

Miloud T.,Aspelund A. & Cabrol M. (2012) Startup valuation by venture capitalists: an empirical study. *Venture Capital: An International Journal of Entrepreneurial Finance,* vol. 14:2-3, pp. 151-174.

Palepu K., Healy P., Bernard V., Peek E. (2007) *Business analysis and valuation : IFRS edition.* London: Thomson Learning

Palich, L. & Bagby, D. (1995) Using cognitive theory to explain entrepreneurial risk-taking: challenging conventional wisdom. *Journal of Business Venturing*, vol. 10, pp. 425-438.

Porter M. (1980) *Competitive strategy: techniques for analyzing industries and competitors*. New York: Free Press

Porter M. (1985) *Competitive advantage: creating and sustaining superior performance*. London: Collier

Read, S. & Sarasvathy, S. (2005) Knowing What to Do and Doing What You Know: Effectuation as a Form of Entrepreneurial Expertise. *Journal of Private Equity*, Vol. 9, No. 1, pp. 45-62

Roure J., Keeley R. (1990) Predictors of success in new technology based ventures. *Journal of Business Venturing*, vol. 5:4, pp. 201-220.

Saaranen-Kauppinen, Anita & Puusniekka, Anna 2006. Menetelmäopetuksen tietovaranto. Yhteiskuntatieteellinen tietoarkisto.
http://www.fsd.uta.fi/julkaisut/motv_pdf/KvaliMOTV.pdf. [Referenced 5.4.2010]

Saarinen, J. (2014) *Pääomasijoittaja tuo kykyä kasvaa*. Helsingin Sanomat 2.12.2014, p. A28

Salonoja, N. (2013) *Bridging the equity and entrepreneurial gaps in the Finnish fashion industry: a comparative case study of the Swedish, Danish & Finnish fashion ecosystems*. Masters Thesis, Department of Management and International Business, Aalto School of Business.

Sarasvathy, S. (2001) Causation and effectuation: Towad a theoretical shift from economic inevitability to entrepreneurial contingency. *Academy of Management Review*, Vol. 26, No. 2, pp. 243-263.

Sarasvathy, S. (2001a) What Makes Entrepreneurs Entrepreneurial? *Harvard Business Review*, vol. 21

Sarasvathy, S. (2008) *Effectuation: Elements of Entrepreneurial Expertise*. Edward Elgar Publishing Limited

Sarasvathy S., Dew N. (2008) Effectuation and Over-Trust. *Entrepreneurship Theory and Practise*, vol. 32, No. 4, pp. 739-748.

Scapens, R. (1990) Researching management accounting practice: the role of case study methods. *British Accounting Review, 22*, 259-281

Sievers S., Mokwa C., Keienburg G. (2013) The Relevance of Financial versus Non-Financial Information for the Valuation of Venture Capital-Backed Firms. *European Accounting Review*, vol. 22:3, pp. 467-511.

Stadigh, K. (2014) *Yritysten omistajat luovat uudet työpaikat*, Available from: http://www.hs.fi/paakirjoitukset/a1412047999414 [Accessed: 10th October 2014]

Taloussanomat (2014) *Danske Bank alensi ennustettaan – Suomi kituuttaa 0,5%.* Available from: http://www.taloussanomat.fi/kansantalous/2014/12/16/danske-bank-alensi-ennustettaan-suomi-kituuttaa-05-/201417268/12 [Accessed: 12th January 2015]

Tammilehto, P. (2014) *Telakka on muodin ponnahduslauta*. Kauppalehti. Available from: http://www.kauppalehti.fi/uutiset/telakka-on-muodin-ponnahduslauta/7Xd8SKX3 [Accessed: 18th January 2015]

Timonen, E. (2012) *Adapting design to foreign markets - A case study of three Finnish fashion firms.* Masters Thesis, Department of Management and International Business, Aalto School of Business.

Vaivio, J. (2008). Qualitative management accounting research: rationale, pitfalls ad potential. *Qualitative Research in Accounting & Management*, 5 (1), 64-86.

Wired (2014) *Rovio Layoffs Prove Mobile Gaming Is an Industry of One-Hit Wonders*, Available from: http://www.wired.com/2014/10/rovio-layoffs/ [Accessed: 9th December 2014]

World Trade Organization, WTO (2014) *International Trade and Market Access Data*, Available from: www.wto.org [Accessed 9th December 2014]

Zider B. (1998) How venture capital works. *Harvard Business Review*, Nov-Dec, pp. 131-139.

Zimmerman M. (2008) The Influence of Top Management Heterogeneity on the Capital Raised through an Initial Public Offering. *Entrepreneurship: Theory & Practice.* vol. 32:3, pp. 391-414.