

# Challenges in Accessing Finance for Early-Stage Startups in Emerging Urban Clusters of India

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## Abstract

India's startup ecosystem has seen a significant diversification in terms of geography, with Tier-2 and Tier-3 cities (emerging urban clusters) accounting for around 45-50% of DPIIT-recognised startups. Despite this diversification of the entrepreneurial activity, early-stage ventures in these locations encounter considerable hurdles in accessing formal finance. This paper explores the structural, institutional and ecosystem-related barriers around capital availability for early-stage startups beyond the traditional hubs of Bengaluru, Mumbai and Delhi-NCR. Using secondary data from Tracxn, DPIIT and industry reports, the paper identifies key constraints around the geographic concentration of venture capital, collateral/credit requirements for bank finance, information asymmetries, local investor networks, talent, and infrastructure. Analysis shows that while seed funding has seen improvement, the capital availability for growth is far more constrained, and non-metro startups account for only a small share of total venture funding. The paper concludes with policy and practical recommendations for improving financial inclusion of startups in emerging urban clusters.

**Keywords:** *Early-stage startups, Access to finance, Emerging urban clusters, Tier-2 and Tier-3 cities, Venture capital, Startup India, Entrepreneurial finance, India.*

## 1. Introduction

India has become one of the world's largest startup ecosystems, with over 1.15-1.8 lakh DPIIT-recognised startups by 2025, and was ranked among the top four by funding in recent years. Traditionally this has been concentrated in a few metro regions - Bengaluru, Mumbai and the NCR of Delhi - which provided dense networks of investors, talent, incubators and supporting infrastructure. In recent years a shift has been observed: emerging urban clusters (often referred to as Tier-2 and Tier-3 cities) now contribute almost half of all the recognized startups.

While this diversification is positive from the perspective of inclusive growth and regional development, the ease of access to formal finance (venture capital, institutional equity, even formal debt) has remained skewed to the traditional hubs. Startups in smaller cities often rely on personal savings and informal networks, with formal equity and debt channels being challenging to access. This constraint in capital availability limits their ability to scale operations, hire specialised talent, invest in technology and compete nationally or internationally.

The situation is particularly acute at the early stage:

while some improvement has been recorded in seed-stage activity in non-metro locations, the transition to larger rounds is constrained. Growth-stage capital is scarce, and only a small share of Series B and later funding reaches startups outside the major metros. This creates a structural "funding cliff" which prevents many promising regional ventures to achieve their full potential.

This paper seeks to explore the challenges faced by early-stage startups in accessing finance in India's emerging urban clusters. It has the following objectives: (i) to map the current landscape of the startup formation and funding outside major metros using secondary data, (ii) to identify and analyse the primary barriers to formal finance - equity and debt - (iii) to discuss the implications of these barriers to founders, investors, and policymakers (iv) and recommend actionable steps for improving capital access and regional innovation ecosystems.

## 2. Literature Review

### Theoretical Foundations of Entrepreneurial Finance

Entrepreneurial finance literature has long highlighted that early-stage ventures have higher information asymmetry and uncertainty around future cash flows, and possess limited collateral

compared to established entities (Berger & Udell, 1998; Cassar, 2004). These characteristics make them less attractive to traditional lenders and increase the cost of equity capital. In emerging economies, the frictions are exacerbated by underdeveloped capital markets, weaker legal enforcement of financial contracts and thinner secondary markets for shares, and concentrated investor networks. As a result many entrepreneurs in developing countries rely disproportionately on informal sources, personal wealth and family networks in the early stages of venture development.

The pecking-order theory and life-cycle models of small-business finance suggest that firms typically move from internal funds to debt, and then to external equity as they mature, thereby reducing information asymmetries. For technology-oriented and high-growth startups, the sequence is often different - external equity (angel and VC) becomes critical earlier due to need for substantial investment before revenue generation and due to limited debt capacity. When such equity is concentrated in geography and sector, regional startups face structural disadvantage.

### **The Indian Startup Finance Context**

In the Indian context, studies have highlighted that first-time entrepreneurs often struggle with product-market fit assessment, realistic valuation expectations, estimation of addressable market size, and understanding of entry barriers (Springer Nature chapter on early-stage Indian entrepreneurs, 2020). Access to formal credit for MSMEs and startups is constrained by collateral, absence of credit history, high transaction costs for lenders, and risk-averse banking practices. Formal credit penetration of Indian MSMEs has been reported as significantly lower than in developed economies and thus many are forced to informal and costly sources of capital.

Recent industry analyses by Tracxn and other platforms document progress and persistence of gaps. Between 2016 and 2025, startups outside key hubs have seen around 2200 funding rounds, and have raised about \$3.2 billion in cumulative investment. Seed-stage funding in these regions expanded notably—from roughly \$27 million in 2016 to \$167 million in 2025. This shows growing recognition of regional deal flow. Early-stage funding has seen moderation after peaks, and late-stage capital remains episodic and highly concentrated. Non-metro startups have received only a small percentage of total growth-stage funding

(around 5-6% in recent periods examined). Only a handful of startups headquartered outside major hubs have achieved unicorn status, indicating difficulty of scaling beyond early validation.

Literature also highlights complementary non-financial constraints that interact with capital access: limited availability of specialised technical and managerial talent in smaller cities, variable infrastructure (connectivity, power reliability, logistics), lower density of high-quality incubators and accelerators, and thinner local angel networks. These factors shape supply of and perceived risk of investing in regional startups.

### **Research Gap**

While reports on the rise of Tier-2 and Tier-3 startups are increasingly available, systematic exploration of the finance-access challenges faced by early-stage ventures in these locations remain relatively limited. Much of the existing literature focuses on the overall Indian startup ecosystem (metro-dominated) or MSME credit constraints without distinguishing high-growth startups. This paper contributes by synthesising recent secondary evidence around finance barriers and implications for multiple stakeholders.

### **3. Research Methodology**

This study adopts a qualitative, descriptive, and analytical research design based primarily on secondary data. It is appropriate for an exploratory examination of a multi-dimensional policy and ecosystem issue where comprehensive primary data collection across multiple cities would take large resources beyond the scope of a single MBA research paper.

#### **a. Data Sources and Analytical Approach**

Data and insights were drawn from multiple complementary sources: (a) official statistics and reports published by DPIIT and Startup India; (b) industry databases and reports from Tracxn and similar platforms on funding volumes, deal counts, stage-wise distribution, and geographics patterns; (c) peer-reviewed literature on entrepreneurial finance in emerging markets and specifically on Indian startups; (d) industry analyses, magazine features, and media reports on Tier-2/Tier-3 startup ecosystems from reputed sources, (e) policy documents related to central and state government schemes supporting startups. The analysis is thematic and synthesising rather than econometric. Key patterns around formation rates, funding

distribution by stage and geographics and reported barriers were extracted and organised in to coherent challenge categories.

## **b. Scope and Limitations**

The paper focuses on early-stage (pre-seed, seed, and early Series A) startups located in emerging urban clusters of India. It does not attempt a rigorous quantitative modelling of funding determinants or a comprehensive primary survey. Limitations include reliance on secondary sources (which may lag or apply slightly different geographics definitions), possible under-reporting of informal financing, and no direct founder and investor interview data. These are acknowledged, and the paper is positioned as a secondary research synthesis which can usefully guide future primary research.

## **4. Findings and Discussion**

### **a. The Expanding Landscape of Emerging Urban Clusters**

The Expanding Landscape of Emerging Urban Clusters

DPIIT data and industry reports consistently show that 45-50% (in some recent estimates over 50%) of acknowledged startups now originate from Tier-2 and Tier-3 cities. Cities such as Jaipur, Surat, Indore, Coimbatore, Kochi, Lucknow, Bhubaneswar, and others have emerged as notable contributors to both startup formation and early-stage deal activity. This has been aided by several enabling factors: progressive state startup policies and incubation infrastructure, lower operating costs relative to metros, improved digital connectivity and payment systems, and local and regional demand for solutions in education technology, agri-tech, regional commerce, logistics, healthcare delivery, and other sectors aligned to local economic strengths.

Despite the encouraging rise in formation rates and some improvement in seed-stage funding, the volume and quality of risk capital available to these ventures are lagging. Non-metro startups have accounted for a meaningful share of early deals but only a small fraction of total capital deployed over multi-year horizons (approx 2.1% of capital in one long-horizon analysis from 2016-2025, with growth-stage shares in mid-single digits). Median cheque sizes have risen in some periods but remain skewed. This mismatch between formation and capital allocation forms the backdrop for the challenges discussed below.

## **b. Key Challenges in Accessing Finance**

### **i. Geographic Concentration of Venture Capital and Investor Networks**

The majority of active venture capital funds, large angel networks and institutional investors remain based in or focused on Bengaluru, Mumbai and Delhi-NCR. Founders in smaller cities experience higher search costs, fewer opportunities for informal interactions, and practical necessity to travel to metros for pitch events, demo days, and meetings. While digital platforms and remote diligence have reduced some friction, relationship-driven early-stage investing continues to prefer proximity. Local angel networks, family offices, and returning entrepreneurs are expanding in several cities and often provide valuable first cheques, but typical ticket sizes are modest and follow-on capacity is limited compared with metro-based institutional funds. The result is that many regional startups either remain under-capitalised or must invest time and resources simply to gain visibility with capital providers.

### **ii. Barriers to Formal Debt Finance**

Banks and many non-banking financial companies (NBFCs) remain cautious about lending to early-stage startups. The absence of tangible collateral (especially for service and software businesses), short or non-existent credit histories, irregular or pre-revenue cash flows, and limited audited financial track records raise perceived risk. Application processes can be complex and time-consuming. Interest rates on available products, where they exist, are often high. Consequently, a large proportion of early-stage founders continue to rely on personal savings, friends and family, and informal lenders (sources either limited in scale or with high effective costs). Government schemes, credit guarantee mechanisms, seed funds exist and have expanded but founders often report awareness gaps, procedural complexity, matching-fund requirements, delayed disbursements, and documentation burdens that reduce effective utilisation particularly among first-time entrepreneurs in smaller cities.

### **iii. Information Asymmetry and Awareness Gaps**

Founders operating outside dense metro ecosystems often have lower exposure to prevailing investor expectations around traction metrics, unit economics, governance standards, valuation practices, and term-sheet structure. Familiarity with alternative instruments like convertible notes, SAFE-like instruments, or venture debt is uneven. Awareness of the full range of central and state

government schemes is also incomplete. This information asymmetry reduces effective demand for formal capital even though supply channels theoretically exist, or prolongs bootstrapping under capital constraints, or leads to suboptimal financing choices that later constrain growth. Mentorship density and peer learning opportunities are typically thinner than in major hubs, slowing the accumulation of fundraising capability.

#### iv. Talent, Infrastructure, and Perceived Scalability Risks

Limited local availability of specialised technical, product, domain, and managerial talent forces many founders into extended "chief everything officer" roles and raises investor concerns about the team's ability to scale. Infrastructure gaps (variable internet quality and latency, greater distance from major data centres, occasional power reliability issues, logistics constraints for physical goods, fewer high-quality co-working incubation spaces) affect operational efficiency and investor perceptions of execution risk. Growth-stage investors, in particular, may apply a

discount to regional startups relative to metro peers even when local traction and unit economics appear strong, due to higher perceived path to national or international scale.

#### 5. The Early-to-Growth Stage Funding Cliff

Data consistently show that seed and early-stage activity in non-metro locations has seen improvement over the last decade. However, the transition to meaningful growth capital is difficult. Late-stage funding outside major hubs is volatile and episodic, often driven by a few large deals rather than a broad flow of capital. This creates a "funding cliff": startups that successfully validate product-market fit and regional traction often struggle to raise the larger rounds required for national expansion, professionalisation of the management team, technology investments, and geographic expansion. The scarcity of growth capital limits the conversion of early entrepreneurial energy to scaled, employment-generating, potentially competitive businesses.

**Table 1: Summary of Key Challenges and Implications**

| Challenge                            | Primary Manifestation                                                        | Implication for Startups                                            |
|--------------------------------------|------------------------------------------------------------------------------|---------------------------------------------------------------------|
| Geographic concentration of VC       | Investor networks clustered in metros; limited local institutional capital   | Higher search & relationship costs; constrained follow-on capacity  |
| Collateral & credit-history barriers | Banks and many NBFCs risk-averse toward early-stage, asset-light firms       | Heavy reliance on informal or personal finance; limited scale       |
| Information asymmetry                | Uneven awareness of schemes, instruments, and investor expectations          | Suboptimal financing choices; delayed or inefficient fundraising    |
| Talent & infrastructure gaps         | Specialised skills scarce; connectivity, logistics, and facility constraints | Higher perceived execution risk; lower investor confidence in scale |
| Growth-stage capital scarcity        | Seed improves but Series B/C and later funding remains metro-heavy           | Difficulty scaling beyond regional markets; funding cliff           |

#### a. Role of Government Schemes and Support Mechanisms

The Government of India and several state governments have introduced multiple schemes to improve access to finance and support startups, including Startup India Seed Fund Scheme, credit guarantee mechanisms, incubation support, and state-specific seed and grant programs. These have expanded the formal support architecture available to founders outside metros. However, secondary evidence and practitioner accounts indicate that utilisation is uneven. Common issues include limited awareness among first-time founders in smaller cities, complex application and documentation requirements, delays in fund disbursement, matching-contribution obligations that pre-revenue

startups find difficult to meet, and limited hand-holding capacity at local incubation centres. The existence of schemes does not automatically translate into effective access for the average early-stage founder in an emerging urban cluster. Strengthening last-mile delivery, simplifying processes and improving communication and mentorship around these schemes remain important priorities.

#### b. Implications for Stakeholders

For founders in emerging clusters, the implication is the need for deliberate and proactive capital strategy. Building strong local traction and unit economics that can compensate for location disadvantage, cultivating networks both locally and in metros,

documenting governance and metrics to institutional standards, and exploring a wider range of instruments (government grants and seed funds, revenue-based finance where appropriate, local angels, and selective institutional capital) become essential. Bootstrapping longer than metro peers may be necessary, but should be strategic rather than purely constrained. Founders who systematically document traction, unit economics, and governance early will improve their investability regardless of location.

For investors, there is an opportunity to capture under-served deal flow characterised by potentially more capital-efficient business models and founders solving real regional problems. Realising this opportunity requires developing capability for remote or distributed diligence, partnering with local networks and incubators, and adjusting evaluation frameworks so that location is not an automatic risk premium when fundamentals, team quality, and market opportunity are sound. Early movers who build genuine regional networks may gain proprietary deal flow advantage.

For policymakers and ecosystem builders, the challenge is to reduce structural frictions (improved credit infrastructure and alternative-data lending, simplified and better-communicated scheme access, support to professionalisation of local angel networks, continued investment in infrastructure, and mechanisms to help validated startups bridge the early-to-growth stage gap) without creating distortions that deter private capital. Measuring outcomes not only by number of recognised startups but also by the share of regional ventures that successfully raise follow-on capital would be a more meaningful indicator of ecosystem health.

## 6. Conclusion and Recommendations.

The decentralisation of startup formation across India's emerging urban clusters is a welcome development that broadens the innovation and entrepreneurial geography. But the dearth of formal equity and growth capital for such endeavours presents a worrying impediment to their success: early-stage startups in these locations grapple with network effects, institutional rigidity in debt markets, lack of information, and complementary constraints (talent, infrastructure), which altogether constrain their growth trajectories. The situation needs to change, as the promise of inclusiveness and regional balance in innovation and entrepreneurship is not being fulfilled, and regional ventures are not able to

scale to the next level.

## Recommendations

1. **Strengthen distributed investor networks.** : Encourage the building, professionalisation, and networking of local angel investor groups, regional micro-VC funds, and diaspora channels dedicated to emerging clusters, so that they can overcome geographic frictions and increase supply of early capital through remote discoverability, deal documentation standards, and co-investment with metro funds.
2. **Improve formal credit pathways for early-stage ventures:** enhanced outreach, awareness, and usability of credit guarantee schemes and seed funds, simplified documentation when possible, and cash-flow-based and alternative-data lending models better suited to asset-light, early-stage businesses.
3. **Bridge information and capability gaps:** enable informed fundraising decisions and financial literacy, through structured founder education on fundraising readiness, financial modelling, term sheets, governance, and government schemes, offered by state incubators, universities, industry associations and online, as well as mentorship links between metro-experienced entrepreneurs and operators and regional founders.
4. **Address complementary talent and infrastructure constraints:** Talent and infrastructure, through continued public and private investment in digital infrastructure, skills development, and high-quality incubation and co-working facilities, reducing non-financial frictions and lowering perceived execution risk among regional startups.
5. **Encourage mechanisms for patient growth capital:**

Blended-finance structures and public-private funds that can offer follow-on capital to validated regional startups, to enable their progression beyond the early-stage.

Future research by MBA students and academic scholars can contribute in valuable ways, by conducting primary surveys with founders across multiple Tier-2 and Tier-3 cities, structured interviews with investors active (or potentially active) in regional markets, and comparative case studies of successful scaling journeys that originated outside the major hubs. The contribution of quantitative work examining the determinants of successful fundraising by location, sector, and

founder characteristics would be equally valuable. The knowledge of the limitations and opportunities for growth of India's next wave of entrepreneurship will be enriched through such research, and the nuances of the situation and potential actions will be better understood. It can be a valuable contribution to scholarship, and an input into action by founders and investors.

In conclusion, the need to address the dearth of formal equity and growth capital for early-stage startups emerging in India's regional urban clusters is not just a matter of fairness or regional balance, it is a strategic imperative to enable a broader base of innovation, employment, and competitive enterprises across the country. With the increase in entrepreneurial activity outside the traditional hubs, and the consequent need for growth capital, there is a challenge and an opportunity for action by founders, investors, and policymakers. By overcoming the constraints to funding, the emergence of regional startups can be accelerated to a broader base of scaled, sustainable businesses.

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