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Commentary

Economic Factors of Small Business Debt and Equity Financing

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DESCRIPTION

Economics of small business financing in private equity and debt markets. Firms are viewed through the lens of a financial growth cycle paradigm, in which different capital structures are optimal at various points along the cycle. Capital structure varies with firm size and age, as well as the sources of small business finance. The interconnectedness of small firm finance, as well as the impact of the macroeconomic environment, is discussed. The variety of research and policy issues, review, and make suggestions.

In the 1990s, the role of the entrepreneurial enterprise as a driver of economic growth received a great deal of public attention. Much of this focus stems from the belief that a thriving entrepreneurial sector is critical to innovation, particularly in the high-tech, information, and bio-technology sectors. The spectacular success stories of companies like Microsoft, Genentech, and Federal Express exemplify the notion that new venture creation is a precondition for future productivity gains. Other recent events have increased public concern and awareness about small businesses, such as the central role of entrepreneurship in the emergence of Eastern Europe, financial crises that have threatened credit availability to small businesses in Asia and elsewhere and the growing use of the entrepreneurial alternative for those displaced by corporate restructuring in the United States.

Along with the increased public interest in small business in general, policymakers, regulators and academics have become more interested in the nature and behavior of the financial markets that fund small businesses. The nature of the private equity and debt contracts associated with this financing, as well as the connections and substitutability between these alternative sources of finance, are at the heart of this issue. Aside from the micro foundations of small business finance, there is an increasing interest in the macroeconomic implications of small business finance. For example, the impact of the early 1990s "credit crunch" in the United States, as well as the effect of banking industry consolidation on the availability of credit to small businesses, has been the subject of extensive research in recent years. Similarly, the "credit channels" of monetary policy - mechanisms by which monetary policy shocks can have disproportionately large effects on small business funding - have sparked extensive analysis and debate. Other critical issues include the relationship between the IPO market and venture capital flows, as well as prudent man rules for institutional venture capital investing. The role of small firm finance in financial system architecture is only now attracting research attention.

Private markets for small business financing are particularly intriguing because they are so different from public markets for large businesses. Small businesses can access the private equity and debt markets through highly structured, complex contracts that are often extremely informationally opaque. In contrast, the public stock and bond markets fund relatively informationally transparent large businesses through contracts that are more often than not relatively generic. Financial intermediaries play an important role in the private markets as information producers who can assess the quality of small businesses and address information problems through screening, contracting and monitoring. Intermediaries screen potential customers by performing due diligence, which includes gathering information about the company, the market in which it operates, any collateral that may be pledged, and the entrepreneur or start-up team. This may entail the use of information obtained from the intermediary's existing relationships with the business, the business owner, or other involved parties. The intermediary then uses this information about the small business's initial quality to set contract terms at the time of origination.

Contract design and payoff structure are determined by the firm's and entrepreneurs financial characteristics, as well as the firm's prospects and the associated information problems. For reasons discussed further below, high risk-high growth enterprises with mostly intangible assets are more likely to obtain external equity, whereas relatively low risk-low growth firms with mostly tangible assets are more likely to obtain external debt. Finally, to prevent the firm from engaging in exploitive activities or strategies, the intermediary monitors the firm throughout the relationship to assess compliance and

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financial condition, and exerts control through such means as directly participating in managerial decision making by venture capitalists or renegotiating loan covenant waivers by commercial banks.