



Hard Facts on Capital Sourcing for Small Companies

Where do small businesses get their capital? Not from the sources you think.

Small businesses are more sensitive to the contraction of bank lending than previously thought, and the conventional wisdom about how small businesses finance themselves may be hogwash, according to a new working paper from the National Bureau of Economic Research. The paper, "The Capital Structure Decisions of New Firms," found that newly created firms rely heavily on "outside" debt financing, such as owner-backed loans, business bank loans, and business credit lines. The average amount of bank financing is seven times greater than the average amount of "insider"-financed debt — money from family members and personal networks of the owner. Those groups were previously thought to be the primary providers of fuel for start-ups.

What's more, equity is used only one-fifth as often as debt. Even then, however, in only about 5% of cases does the owner take equity investments from a spouse or other family member. In the study, equity from external sources — including venture-capital firms — was used by 205 companies out of nearly 4,000, with the average amount being \$355,000. Still, on average that group had 25% of its capital structure in the form of bank debt.

The study, by Alicia Robb of the University of California at Santa Cruz and David Robinson of Duke's Fuqua School of Business, used a subset of 3,972 small businesses tracked by the Kauffman Firm Survey, a longitudinal study of small businesses launched in 2004. The businesses in the study have been continually surveyed.

The Robb-Robinson sample businesses run on the small side, but even those in the earliest stages of founding, including pre-revenue firms, got twice as much of their capital from bank loans than from more-informal channels. About 36% of the firms in the sample are sole proprietorships, and 28% are structured as S or C corporations. A large majority (86%) market a service, and nearly 60% have no employees other than the founder. Half operate out of the owner's home or garage, and about 20% had more than \$100,000 in revenue in their first year. The average bank debt taken on by these firms in 2004 was \$48,000, with the top source being a business bank loan, followed by a personal bank loan. Government loans proved a stingy source of funds: the average amount was only \$1,330 out of total financial capital raised of \$109,000.

The study also throws cold water on the popular image of the small-business owner who piles on credit-card debt to fund his or her start-up. Only 25% of entrepreneurs in the survey used their personal credit cards to finance their start-ups, and the average amount was \$15,700. That personal credit-card debt was just one-third the amount of owner's equity, and only about 5% of the average firm's total capitalization. Trade credit proved to be a more important capital source, with \$21,800 used on average.

Moreover, the prevalence of outside debt continues as firms grow, according to Robb and Robinson. The portion of new capital that comes into a company through outside debt financing rises as the average firm matures, while owner equity declines. The study also looked at the impact of these capital-structure decisions on firm survival, employment growth, and profitability growth. Firms that had a capital structure largely built through formal credit channels had a greater likelihood of success.

The authors admit that the surprising degree to which start-ups relied on bank debt in 2004 was partly a function of the availability of such credit, but add that "the notion that start-ups commonly rely on the beneficence of a loose coalition of family and friends seems misleading given our findings." Perhaps more important, the study suggests that liquid credit markets are critical — more so than previously believed — for the formation and success of young companies.

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