

**THE SMALL BUSINESS EQUITY CAPITAL SITUATION:
AN ECONOMIC DEVELOPMENT PERSPECTIVE**

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ABSTRACT

Many observers perceive a gap between the need for high risk, patient equity capital and its availability to privately-held, small businesses. Owners of successful companies, consistently profitable but small and lacking glamour, often report that rapid expansion is hard to fund. The major sources of working capital for such firms are loans, and lenders are uncomfortable with rapid change. Lenders view fast growth and debt financing as incompatible. The alternative is equity funding, and equity funding seems hard to find.

The authors review the equity capital situation for small business. They weigh the relative merits of differing expert opinion, and assess the policy implications. The authors take an economic development perspective; i.e., they seek solutions that will make the economic pie bigger. They contend that the best solutions will have a balanced, twofold impact: (1) increase the availability of high risk, patient equity capital, and (2) increase the availability of high-quality equity investments in privately-held, small businesses. They argue that the best solutions will combine evolutionary changes in public policy and private action. The authors describe specifically how legislation, regulation, and financial institutions might evolve. The resulting marketplace would provide the strongest small companies with better access to the capital needed for rapid growth. They also describe specific steps that small businesses and their advisors can take to better prepare to enter equity markets.

INTRODUCTION

Many entrepreneurs and their advisors perceive an equity capital gap. The gap exists between (1) the need for high risk, patient equity capital, and (2) the capital available to privately-held, small businesses. Owners of successful companies, consistently profitable but small and lacking glamour, often report that rapid expansion is hard to fund. The major source of working capital for such firms is commercial bank loans. However, lenders are uncomfortable with rapid change. Lenders view fast growth and debt financing as

incompatible (Dennis, 2000). The alternative is equity funding, and equity funding seems hard to find.

The first section of this article reviews the equity capital situation for small business. It appears the equity capital situation has two major dimensions. First is the availability of high risk, patient equity capital. (In this context, "patient" refers to equity investors that do not require buyout in five years or less.) Second is the availability of high-quality equity opportunities for investment in privately-held, small businesses. The article reviews both dimensions, weighing the relative merits of differing expert opinion in a sophisticated U. S. financial marketplace.

Next, the article assesses the policy implications. When considering public policy, taking an economic development perspective is useful, and the authors do so. If economic development is the policy goal, what should be done about the equity capital situation for small business? Is it significant enough to warrant attention? If so, what kind of attention will it require? The article argues that the best solutions will combine evolutionary changes in public policy and private action. The article describes specifically how legislation, regulation and financial institutions might evolve. The resulting marketplace would provide the strongest small companies with better access to capital needed for rapid growth. The article also describes specific steps that small businesses and their advisors can take to better prepare to enter equity markets.

THE AVAILABILITY OF EQUITY CAPITAL FOR SMALL BUSINESS

It appears that the availability of equity capital has two major dimensions. First is the availability of high risk, patient equity capital. Second, is the availability of high-quality equity investment opportunities in privately-held, small businesses? This section reviews both dimensions. It weighs the relative merits of differing expert opinion in a sophisticated U.S. financial marketplace.

Is There A Shortage of High Risk, Patient Equity Capital?

Expert observers have differing opinions about the perceived shortage of small business equity capital. Two main schools of thought dominate concerning the perceived shortage or "equity capital gap," each with different policy implications. One school argues that an equity capital availability shortage exists in the United States (Kuratko, Lamone & Kash, 2000; Numark, 1995; Sive & Ames, 1996). They contend several factors contribute to this shortage including market inefficiencies, fraud, legislation, and regulatory practices. The other school argues that no significant equity gap exists (Dennis, 2000; Black, 1998). They contend that U.S. equity markets are efficient, and that current legislation and regulatory practices are appropriate. They offer as evidence the fact that the U. S. is the strongest equity marketplace in the world.

A recent survey report by the Global Entrepreneurship Monitor (GEM) provides useful international data. Results of the survey suggest that both schools of equity gap opinion are partially right, and partially wrong (Zacharakis, et al., 2000).

GEM research teams conducted in-depth interviews and administered questionnaires to experts in selected domains of entrepreneurship. The study notes that experts in the financial

support domain perceive that, among venture capitalists, too much money is chasing too few deals (\$80 billion in the first nine months of 2000) (Zacharakis, Bygrade & Shepard, 2000). It also estimates that 7 percent of adults in the U. S. were informal investors ("Angels"). Angels invested an average of \$3800 per year in recent years, predominately in new ventures started by family members, work colleagues, neighbors and friends. The study extrapolates its findings to the U. S. population as a whole. It estimates that angel investors contribute about \$54 billion per year in venture financing (Zacharakis, et al., 2000). A final observation from the study, relevant here, is that the "geographic disparity in entrepreneurial activity (especially high technology entrepreneurship) and infrastructure support for entrepreneurship (especially risk capital) continue to be a problem in many parts of the United States. Two-thirds of the total venture capital invested nationwide in 1999 went to five states." (Zacharakis, et al., 2000). The states were California, Massachusetts, New York, Texas, and Colorado.

How do the GEM findings compare with arguments made by those who believe an equity gap exists, and those who do not? Kuratko, et al. (2000), represents the National Consortium of Entrepreneurship Centers. The consortium believes an equity capital gap exists. In a September 2000 white paper, Kuratko, et al. (2000), observe that the lack of infrastructure support is not due to the amount of money needed, but is due to a lack of efficient means of distribution of the needed funds. In their view, the private equity marketplace extends far beyond venture capitalists. It is "the last truly disjointed 'low tech' financial marketplace in the United States," comprising "nearly \$5 trillion in assets that are not now efficiently made available for investment purposes (i.e., private equity deals)." (Kuratko, et al., 2000). Kuratko, et al., also cite data lending support to the GEM project's contention that geographic disparity exists, at least regarding venture capital investments – nearly 75 percent goes to Silicon Valley, the New England region, the Raleigh Research Triangle/Southeast region, The Midwest, The Baltimore-Washington-Richmond corridor and the N. Y. Metroplex (Kuratko, et al., 2000). Many good business plans do not get funded simply because of an unhappy accident of geography. In their view, the market for private equity is unorganized and depends mainly on personal relationships. "A ... small circle of VC firms are attempting to handle an astounding amount of business. However these firms cannot possibly handle the deluge of (New Economy) business opportunities now being developed throughout the country. The result: an inordinate number of viable business plans go unreviewed merely because there are not enough people to analyze them, or they are not able to reach anyone's radar screen" (Kuratko, et al., 2000).

William J. Dennis, Jr. presents the views of the National Federation of Independent Business (NFIB). The NFIB concludes, with some qualification, that there is not a significant equity capital gap (Dennis, 2000). According to Dennis, accessibility to "loans, investments and other infusions of capital from outside the firm... have varied substantially over the last quarter century, but more capital is available today for more small-business men and women than at any other time in memory. Yet, financing gaps remain – situations and people who for one reason or another (besides being a poor risk) cannot obtain funds to finance their small business operations. The task of policy makers is to focus resources for these gaps rather than spreading the largess across the country" (Dennis, 2000).

Dennis concludes that, "the small business finance problem, when and where it exists, consists of a series of gaps in the credit and equity markets (i.e. 1. Mid-Sized Starts, 2. Rapidly Growing Businesses, 3. Business Cycles, 4. Transitions (in the nation's financial

sector), 5. Certain Ethnic Groups (discrimination against African-Americans, and to some degree Hispanics and Asians), and 6. Troubled Businesses.) Unfortunately, it is difficult to quantify the size of the gaps or the numbers impacted, but the lack of overall concern among those directly involved suggests that they are limited – at least at this time” (Dennis, 2000). Of the six gaps that Dennis mentions, the first two relate most directly to the present discussion. Considering the results of the GEM study, the first two gaps may be more important to economic development than Dennis estimates.

1. Gap One, Mid Sized Starts, refers to the estimated 10 percent of starts that rely on private investors, not including venture capital companies, and that need between \$250,000 to \$3,000,000. The financing gap for new starts appears when the start’s planned need for capital outstrips the amount that an individual, or an individual and a partner can raise. The amount varies due both to the individual’s resources and his ability to find others willing to invest. (Assuming the owners wish to find informal investors.) According to focus group studies reported by the National Commission on Entrepreneurship and Freear, et al., (1994), the gap appears when the planned need for capital is about \$250,000 to \$3,000,000 (Building Companies, 2000; Freear, et al., 1994).
2. Gap Two, Rapidly Growing Businesses, refers to the capital needs of firms with growth rates exceeding 20% per year. As they expand, cash receipts never quite catch up with cash going out. Further, such firms often do not grow steadily so cash flow is unpredictable.

“Lending to these firms is very difficult. They customarily have relatively few assets to use as collateral. (The entrepreneur is the biggest asset.) They seem to need money all the time, but the lender can never be quite sure if a sales downturn is the prelude to another upturn or the precursor of disaster. There is a huge up-side to lending to these firms from a bank’s perspective. If successful, the business will eventually stabilize, and the bank will certainly enjoy the inside track for a profitable relationship. But there is also a huge downside. The chances of the firm going “belly-up” (are higher), and (the chances of) the bank being able to recapture resalable assets are much less, than in a slowly growing firm. Banking is not a high risk-reward business. It is a fiduciary business meaning there are strict limits on the risk it can take with high growth firms. Equity appears to hold the greatest potential for rapidly growing firms. But, matching angels and entrepreneurs is not easy. Institutional venture capital funds may be possible, but industry, geography, and the speed of the firm’s growth, investment size, etc. limit the opportunity. ” (Dennis, 2000).

In summary, a majority of researchers and practitioners agree with the qualitative assessment that the small business equity capital gap does exist. Research sponsored by the NFIB suggests that few small businesses view it as critical – perhaps less than 10 percent of new and rapidly growing firms (Dennis, 2000). However, when the need exists, deserving owners face difficulties in accessing capital because of the unorganized marketplace for private equity (Kuratko, et al., 2000; Numark, 1995; Sive & Ames, 1996). Lenders will not fill the gap (Dennis, 2000). Further, if three common conditions exist, venture capitalists will not fill the gap: (1) the equity infusion required is \$250,000 to \$3,000,000, (2) the firm is not in the right

industry, or (3) the firm is not in the right geographic area (Zacharakis, et al., 2000; Building Companies, 2000; Freear et al., 1994). The capable business owner must pursue the elusive angel investor.

Is There a Shortage of High-Quality Equity Investment Opportunities?

The second dimension of the equity capital situation for small business is the availability of high-quality equity opportunities for investment in privately-held, small businesses. Jill E. Fisch summarizes the views of many. "The inability of small businesses to find adequate capital may not indicate a market failure. The high failure rate of small business demonstrates the risky nature of small business investment; small businesses may not generate sufficient returns to compensate investors for assuming this risk. The inability of businesses to obtain funding does not demonstrate the existence of underfinanced [investment opportunities] with positive net present value[s]." (Fisch, 1998). Observers subscribing to this viewpoint argue that the problems lie with the companies seeking funding and with their advisors and underwriters. They argue that adequate equity funds are available for companies with savvy, honest management, a good track record, and knowledgeable advisors. In their view, equity scarcity reflects shortcomings in the investment offered and in the way the company offers it. Equity capital is available for good investments.

For example, the GEM study reports that, in 2000, experts in the financial support domain perceived that, "among venture capitalists there is too much money chasing too few good deals." (Zacharakis, et al., 2000). While Kuratko, et al. (2000), and Dennis have differing views concerning the capital-availability dimension, they have similar views concerning the quality dimension. Kuratko, et al. (2000), observe that, "VC funds often turn away interested investors, with money in hand, because they cannot find enough qualified deal flow." (Kuratko, et al., 2000). Why can't they find qualified deal flow? Dennis perhaps provides some answers. He observes that financing is not the most difficult problem faced by people who started new firms in the late 1990s. Other issues, such as poor marketing, stall the move from business planning to accomplishment. In other words, many new ventures suffer from novice errors easily spotted by sophisticated investors. Dennis also notes that many established owners do not fit the qualified-deal mold. (They will)... "skip an offer because they have to surrender too much control. The purpose of business ownership in the first place may have been to escape curbs imposed from the outside. Therefore, the owner may (choose to accept)... slow growth to retain full ownership." (Dennis, 2000). In short, the small business owner doesn't know how to play the external equity game and, once he learns, may not choose to play. Perhaps equity markets will have to evolve that are more "owner friendly" in order to attract qualified deals.

Experts in securities markets and securities law have given much thought to the evolution of equity markets. Specifically, they explore future ways to match equity capital with qualified deals in public and quasi-public offerings. They discuss topics such as use of the Internet, direct public offerings, and how to maintain honest markets. Their work is rich in intelligent commentary on investment quality applicable to the present discussion (Black, 1998; Choi, 1998; Cielusniak, 1998; Coffee, 1997; Hass, 1998; Hernandez, 1993; Langevoort, 1997 and 1998; Mason, 1998; McGlosson, 1997; Mondschein, 1999; Niesar & Niebauer, 1992; Thompson, 1999).

A prime example is Bernard S. Black's discussion of information asymmetry (Black, 1998). Black's views reflect the thinking of many concerning investment quality. He expresses doubt about whether the Internet will significantly reduce the cost of obtaining capital through a public or quasi-public offering. Also, he does not believe the Internet will increase the availability of high-quality equity investments.

Black observes that the issuer making a direct public offering via the Internet knows the quality of the securities offered. However, the investor does not and cannot easily find out. The issuer has information; the investor needs information.

"The issuer has an incentive to puff or lie and the investor can not directly verify the quality of the information that the issuer provides. This problem is especially serious to small issuers. The smaller the issuer, the less the investor can rely on the issuer's prior reputation as a signal of the quality of the information that it provides securities markets are an example of a market for lemons. Investors don't know which issuers are truthful and which aren't so they discount the prices they will offer for all securities. That makes honest issuers less interested in offering securities, but doesn't discourage the dishonest ones. This problem of 'adverse selection' by issuers, in which high-quality issuers leave the market because they cannot obtain a fair price for their shares, while low quality issuers remain, makes the lemon problem faced by investors still more severe." (Black, 1998).

Black goes on to argue that successful securities markets develop institutions and "reputational intermediaries" (who lend their reputations of offerings by their clients' companies) to counter adverse selection, including:

- Securities laws that require extensive disclosure.
- Sanctions for misleading disclosure, including liability of reputational intermediaries who lend their reputations to offerings without performing due diligence.
- Well funded regulatory agencies.
- Accounting rules that limit fudging of financial results.
- A skilled accounting profession that can detect fraud.
- Investment bankers who will investigate the issuers of securities that they underwrite. (They perform due diligence because their firm's reputation depends on not selling fraudulent, or over priced, securities to investors.)
- Securities lawyers that perform due diligence, ensure offering documents comply with disclosure requirements, and counsel against excessive puffing that might lead to legal liability.
- For smaller firms, venture capitalists who also conduct due diligence of issuers, and then lend their reputation to an offering.

According to Black, these institutions and reputational intermediaries reduce both the likelihood of fraud and extreme puffing and the extent of adverse selection. The work of these entities attracts honest issuers to the market and attracts investors willing to pay more for securities. However, he notes, regulatory compliance and the participation of reputational intermediaries are costly. Audits and due diligence investigations are expensive, and more expensive per dollar of assets for small companies than for large ones. Yet, he finds it hard to imagine a large market for public or quasi-public offerings of unaudited companies. (Black, 1998).

As noted above, many other experts agree with Black's observations. For example, Kevin Mason notes that "two of the thorniest problems in Internet marketing and distribution of securities are fraud and the general lack of confidence in on-line investing" (Mason, 1998). He lists many ways the dishonest can use the Internet to manipulate markets (Mason, 1998). John C. Coffee, Jr. provides a similar list of ways to defraud (Coffee, 1997). Stephen J. Choi argues that private sources of investor protection, including third party certifiers of information, will evolve to increase confidence (Choi, 1998). Donald C. Langevoort notes that "... attention ... has been paid to the function that financial intermediaries play in signaling and bonding the informational credibility of issuer disclosure. By definition direct marketing (DPOs) foregoes this type of bonding, and it is far from clear that many start-up ventures can afford to do without it." (Langevoort, 1998).

According to the SCOR Report, a newsletter that tracks DPOs less than forty percent of DPOs have been able to raise any money (Sjostrom, 2001).

In summary, the capable small business owner who pursues elusive outside equity capital must address costly quality issues. In many regards, addressing quality issues internally can improve the company. Observers, who contend that a significant equity capital gap does not exist, have a point. Some small companies have novice management teams who puff aggressively, and have no track record. Equity scarcity for these companies properly reflects shortcomings in the investment offered and in the way promoters offer it. However, right now, for the best small companies, quality assurance to attract outside investors is costly and, hence, it is only done to attract large amounts of equity. For example, the costs for a small IPO of five to eight million dollars will be about 20 percent of the gross proceeds (\$1.6 million!) (Gallagher & Hansen, 1999). Are there ways to make raising capital less costly, and to expand the pool of qualified deals, without eroding investor confidence?

POLICY IMPLICATIONS

When considering public policy, taking an economic development perspective is useful. If economic development is the policy goal, what should be done about the equity capital gap for small business? Is it significant enough to warrant attention? If so, what kind of attention will it require?

The equity capital gap appears significant. The number of new and rapid growing firms affected by the equity capital gap is small. However, the numbers have a significant multiplier through job creation and greater economic viability throughout the country. Given a sound business plan and proven track record, a projected "mid-sized" need for outside equity of \$250,000 to \$3,000,000 suggests that the firm seeking funding has large revenue and job creation potential. The risks of investment are high. However, if the marketplace can match a capable owner with high risk-reward investors, success is probable. One success can make a big difference to a small community or depressed area.

Given a significant equity capital gap, what kind of attention will it require? It appears that the best solutions must have a balanced impact on the two dimensions of the equity capital situation. The best solutions will both: (1) increase the availability of high risk, patient equity capital, and (2) increase available, high-quality equity investment opportunities in privately-held, small businesses. Devoting resources to one impact dimension, while neglecting the other, will not lead efficiently and effectively to economic development.

Presently, public and private resources, devoted to the small business equity situation, have been focused on the first dimension: increasing the availability of high-risk, patient equity capital. For example, use of the Internet is a hot topic in the securities law community. As a communications medium, the Internet can help increase the availability of equity capital. The Internet promises to reduce the cost of information transmittal from issuer to investor. It will give needed national exposure to offerings by firms in industries or geographic locations unpopular to venture capitalists and underwriters. SBA's Office of Advocacy launched the Angel Capital Electronic network (ACENet) in 1997 to match potential investors with potential entrepreneurs through use of the Internet (<http://www.sba.gov/ADVO/acenet.html>). ACENet network operators in several states act as neutral third parties to broker the deals. Waivers of "consumer protection" rules from state securities commissioners ease the flow of capital across state borders. A handful of similar Internet matching services have formed in the private sector for angels e.g., Garage Technology Ventures (www.garage.com), Offroad Capital Markets, L. L. C. (www.offroadcapital.com), Olima Co. Ltd. (www.partnerseek.com), Virtual Capital Group.com, Inc. (www.virtualcapitalgroup.com). The company associated with the National Consortium of Entrepreneurship Centers, Beacon Venture Capital.com Inc. (www.BeaconVentureCapital.com) provides matching services oriented toward financial professionals.

However, studies previously cited in this article suggest that use of tools like the Internet will not, by itself, dramatically increase "deal flow." The Internet can support private placements via angel/small business networks, quasi-public offerings, public offerings, and direct public offerings. However, unless one addresses the other dimension of the equity capital situation, quality investments, Internet matching services will not live up to expectations.

How does one increase the availability of high-quality equity investment opportunities in privately-held, small businesses? To do so, participants must take steps to transform more mid-sized starts and rapidly growing small businesses into high-quality equity investments. High-quality equity investments will be more attractive to high risk/high reward investors. Also, participants must take steps to develop quality certification methods for small offerings. Use of such methods will at least assure investors of an honest offering, and perhaps rate the company's prospects, or even provide some form of guarantee. Further,

- business owners must not perceive the cure as worse than the disease;
- the steps must enhance, not disrupt, business operations;
- the steps must be affordable; and
- the steps must not wrest ownership control away from the entrepreneur.

The best solutions to either dimension of the equity capital situation, equity capital availability or quality investments, will combine evolutionary changes in public policy with private action. First, consider the dimension of equity capital availability to small business. Existing U. S. equity markets for larger offerings are efficient. Current legislation and regulatory practices help make the U. S. the strongest equity marketplace in the world. The task is not to throw out the established. The task is to "scale down" elements of a system that works to make a place for efficient and effective small business offerings. Table 1 provides examples of recent developments and possible future policy directions regarding the equity availability dimension.

TABLE 1: MAKING A PLACE FOR SMALL BUSINESS OFFERINGS**Recent Developments:**

1. **The SEC, has taken no action concerning matching services like ACENet and it is considering the implications of electronic medium.** It is balancing the need for equity with the need for honest markets (Use of Electronic Media, 2001; Abelson, 1995; Allebach, 1999; Arms & McGuire, 1996; Cella & Stark, 1997; Cielusniak, 1998; Coffee, 1997; Green & Sperber, 1993; Lane, Weirick & McPhee, 2000; Mahoney, 1997; Mondschein, 1999; Quinn, & Jarmel, 2000; Thompson, 1999).
2. **Current actions by the SEC and states are moving gradually toward articulation of State and Federal regulations to simplify national offerings of small offerings.** The trend reflects a long history of legislative, regulatory, and securities industry concern (National Market System, 1980; Report of the Task Force, 1997; Coulson, 1998; Easterbrook & Fischel, 1984; Galbraith, 1988; Hernandez, 1993; Makens, Barnes, & Harris, 1999 and 2000; Niesar, & Niebauer, 1992; Olson, et al., 2000; Pettilon, 1995; Raghaven, Lohse, & Anderson, 1995; Sargentich, 1984; Thomas, 1967; Train, 1981; Walton & Hogan, 2000; Sjostrom, 2001). Still, some would argue that the establishment remains too protective of retail investors. There remains less enthusiasm for encouraging the retail investor to invest in promising small companies than for encouraging state lotteries. (1995 National Gaming Survey, 1995; KPMG Peat Marwick LLP, 1994; Devine, 2001; Sive & Ames, 1996).
3. **NASDAQ, as one supporter of the National consortium for Entrepreneurship Centers, is seeking ways to address the small business equity capital gap.** Their search is not a new initiative, it has been going on for some time. Also, the NASD (OTC Bulletin Board) and the National Quotation Bureau (Pink Sheets) are seeking ways to better serve issuers and investors in small-cap equities. Issuers who do not wish to list on an exchange or with NASDAQ (Coulson, 1998; Niesar & Niebauer, 1992; Sive & Ames, 1996).
4. **The best Internet matching services are now building clientele well within regulatory guidelines** (Report on the Task Force on the Future of Shared State and Federal Securities Regulation, 1997; Fisch, 1998; Kuratko, et al., 2000; Meer & Nadler, 1998; Moriarty, 2000; Myers, 2001; Romano, 2001). However, one must view current efforts as experimental. Some, like the American Stock Exchange's Emerging Company Marketplace and the Pacific Stock Exchange's SCOR marketplace (both now defunct), will not survive. (Pacific Exchange Likely to Drop SCOR Marketplace, 1998; Coulson, 1998; Hernandez, 1993; Langevoort, 1998).
5. **Direct public offerings on the Internet, which one must also view as experimental, have experienced some success within regulatory guidelines.** Their presence will likely be a catalyst for regulatory refinement, affordable certification services, and secondary market alternatives (Choi, 1998; Fisch, 1998; Gallagher & Hansen, 1999; Giddings, 1998; Greeff, Leon-Prado, Mannix, & Ruh, 1998; Gruner, 1996; Hersch, 1998; Hulme, 1998; Mamis, 1996; McGlosson, 1997; Pounds, 2001; Rice, 2001; Romano, 2001).

Possible Future Policy Directions

1. Policy makers may refocus their attention away from dictating who will have an opportunity to invest in the small business equity market, and towards the creation of an honest, automated small business equity marketplace. One that offers retail investors, not just accredited investors, the opportunity to make informed, high risk investments.

Present policy solutions to the problems of the marketplace emphasize two approaches: (1) telling the investor that the marketplace is not a good place to invest (high risk), or (2) requiring that investors meet minimum net worth requirements. The studies surveyed in this article suggest that the intent behind legislation and regulation needs to be refocused towards how to maintain the integrity of the market and investors' confidence, with less emphasis on deciding who the market participants are. Perhaps in the near future, policy makers should allow the low to middle income investor the same opportunity as the wealthy individual to participate in the small business equity market. They are making advances in this direction. However, public policy, regulators, and the securities industry may adopt a broader, economic development view of small business offerings. For example, while regulators profess worry about retail investors, policy makers in many states have legalized gaming. Lottery states have solved regulatory issues and automated the gaming process. They spend millions to establish legitimacy in the public mind and build public confidence. Admittedly, lotteries create immediate cash flow for governments. Small business equity markets do not. However, sound, long-term reasons exist for policy makers to also overcome obstacles to efficient small business equity markets. Perhaps in the future, policy makers will promote small business equity markets extensively, as they promote state lotteries. Legalized gaming does nothing to guarantee this country's technological competitiveness on a global level. Small business equity markets can contribute significantly.

2. **Policy makers may choose to encourage the creation of automated quotation media** (Section 17B(b) of The Penny Stock Reform Act). Automation would bring greater liquidity to the small business equity market and permit monitoring by private sector analysts and regulatory authorities. Trades in a strong small business equity market would be recorded real time, and would be subject to public scrutiny and regulatory surveillance.
3. **Policy makers may support of legislation that encourages reputable broker-dealers to sponsor issues in small business equity markets.** In the interest of regional economic development, government officials may provide equity guarantees for new equity offerings, putting a floor on investor risk and promoting secondary markets. Blanket guarantees would be unwise, especially without sound disclosure rules and certification of best practices. However, providing incentives to reputable broker-dealers in special situations would help provide liquidity for investors and adequate financial information to assess the investment as well. The incentives would encourage broker-dealers to sponsor and follow small issues. Currently such incentives are weak. Right now, negotiated commission rates have largely eliminated the small broker. The large firms, because of high overheads and supervision costs, are not interested in small issues. As a result, most firms will neglect any small business equity market in the brokerage industry. Without dealer support, a small business equity market has little chance to attain liquidity.

As noted above, the best solutions to either of the two dimensions of the equity capital situation will combine evolutionary changes in public policy with private action. The second dimension is availability of high-quality equity investment opportunities in privately-held, small businesses. As with the dimension of equity capital availability, existing institutions offer means to effectively deal with the two main components of the investment opportunity dimension: transformation and certification. ("Transformation" refers to services that help transform small businesses into high-quality investment opportunities, and "certification" refers to methods that assure investors concerning the honesty of an offering, the company's

prospects, or even provide some form of guarantee.). The task is not to throw out the old, the task is to realign or "scale down" service offerings. Table 2 provides examples of recent developments and recommends future policy directions regarding investment opportunity availability and its two main components: transformation and certification.

TABLE 2: INCREASING HIGH-QUALITY INVESTMENT OPPORTUNITIES

Transformation – Do Service Providers Need to Get More Involved?

Many entities claim to be in the business of transforming their clients' businesses into high-quality firms. The list includes economic development entities, adjunct programs at educational institutions, university entrepreneurship centers, Small Business Institutes, and management consulting firms. They have much to offer for prices ranging from free to exorbitant. However,

- few offer a longitudinal approach for small businesses that advise the owner and key managers for extended periods,
- few assess and certify transformations in the capability of their clients in any meaningful way, and
- few are willing to accept a pricing structure that matches the task. They prefer tuition, seminar fees, and hourly rates to annual retainers, pay for performance, or stock options. (Andrews & Welbourne, 2000; Bankman, 1994).

Entities claiming to be in the business of encouraging transformation might consider how some effective angels' approach their investments. Angels provide more than equity to the entrepreneur. Since they have been business owners themselves,

- they bring critical management skills and experience to the new firm,
- they also provide monitoring services besides operating funds,
- they expose the entrepreneur, who may have little managerial expertise, to outsiders with business experience who guide progress,
- they exercise substantial control over subsequent operations if the entrepreneur doesn't pay attention, develop capability, and get results (Cyr, Johnson & Welbourne, 2000; Dennis, 2000; Fisch, 1998; Freear, et al., 1994; Lipper III, 1998 and 1996; Silver, 1985; Van Osnabrugge & Robinson, 2000).

A Possible Future Policy Direction Concerning Transformation

- **In the future, policy makers may encourage services providers to address transformation issues more as Angels, and less as trainers.** For example, policy makers may support development of longitudinal, private-sector programs that can assess and certify their small business clients. New longitudinal programs may need seed money and initial promotional support, but effective programs may not need long term subsidies. They may be able to support themselves with annual retainer fees, pay for performance, or stock options. University entrepreneurship centers and Small Business Institutes might be logical nexus for such transformation networks, or industry-based angel networks might choose to compete.

Certification – Will The Cure Be Worse Than The Disease?

A balance must be achieved between two key certification issues to increase availability of high-quality equity investment opportunities:

- Honesty – how will new methods avoid giving false legitimacy and respectability to the securities of fraudulent issuers?
- Burden – how will new methods perform necessary audits and due diligence without being too burdensome for legitimate, small companies? (Easterbrook & Fischel, 1984; Freear, et al., 1996; Fletcher III & Edward, 1989; Friedman, 1970; Hass, 1998; Langevoort, 1997; Mason, 1998).

Many models exist that suggest how the certification component might evolve:

- Building on the generally accepted accounting practices (GAAP) idea, the accounting and legal professions could develop “generally accepted small business offering practices” (GASBOP). GASBOP would guide those that prepare small businesses to seek outside equity. Such standardization is possible, as evidenced by the success of ISO 9000 certification in the manufacturing realm.
- Given a more uniform nature of the equities, certified public accountants could profitably audit small firms. Also, securities attorneys could profitably perform due diligence for small firms, at lower cost.
- To further mitigate cost impacts while preserving review quality, CPAs, securities attorneys and underwriters could modify fee payment plans. For example, they could adopt a version of the approach used by corporations that offer prepaid legal plans. The approach would allow small business clients to save over time to pay for work on a future public offering. Or, they could form buying groups that help clients pool their resources so they can earn discounts on registration and disclosure expenses.
- Credit rating firms, and firms such as Moody’s, already collect financial data and assess credit worthiness. Given a uniform nature of the equities, these firms could probably devise special rating schemes. For example, they could probably rate a rapidly growing small business from an equity investment perspective. They might even devise a separate rating scheme for mid sized starts.
- Finally, in specific instances that involve a strong public interest, the government might provide equity guarantees for qualified new offerings. Guarantees of small business loans illustrate what might result from equity guarantees. Guarantees for small business loans have helped created a loan marketplace. Loan guarantees encouraged the formation of the National Association of Government-Guaranteed Lenders, Inc. (www.naggl.com). Also, they led to securitization of guaranteed small business loans. The U. S. Small Business Administration has procedures in place for qualifying “direct lenders” who directly underwrite loans with government guarantees. Similar institutions and procedures would evolve for guaranteed equities.

A Possible Future Policy Direction Concerning Certification

- **Policy makers may choose to avoid reporting exemptions in favor of certification.** They may address certification issues by demystifying and standardizing audit, due diligence, business appraisal and investment rating practices.

Small issuers generally provide negligible public information to investors regarding the financial standing of the underlying corporation. The reason is that many such issuers are not reporting companies under the Exchange Act. While regulators can “scale down” disclosure and other requirements for small businesses, allowing blanket reporting exemptions does legitimate small businesses little good. The small investor will not pay a reasonable price unless an informed trade is possible, supported by selected balance sheet and financial performance data. The SEC could make financial disclosure affordable by promoting

widespread use of the U-7 form or other standard. Also, the SEC could work to standardize and simplify periodic financial reporting by smaller companies. In this regard, the SEC could work with the legal and accounting communities. Together, they could come up with standardized, economical ways to provide the necessary information to the marketplace. Certification of quality builds investor confidence. The foundation stones of certification must be standards. The accounting and legal professions could promulgate generally accepted small business offering practices. If they do, it would be helpful if these practice guidelines went beyond full disclosure requirements, specifying practices that will prepare small businesses to seek outside equity. They, licensed third parties, or government entities, could certify compliance. Certification will help create a more uniform nature of the equities and help investors make informed decisions. For example, based on accepted practices and compliance certification, investment rating firms could rate small business offerings, even starts.

IMPLICATIONS FOR SMALL BUSINESS OWNERS AND THEIR ADVISORS

Small business owners and their advisors can act now to improve access to cash for their firms. What might work in the future at a macro, policy level can be "scaled down" to guide today's pursuit of cash. The studies reviewed for this article suggest seven important steps for improving access to cash. Table 3 presents the recommended steps. Recent articles in *Financial Executive* and the *New York Law Journal* discuss the process of raising cash and refer to many manuals, books and Web sites that can help guide small business owners and their advisors in the elusive pursuit of cash. (Littenberg, 2002; Ask an FEI Researcher..., 2001)

TABLE 3: IN PURSUIT OF ELUSIVE CASH: HOW TO IMPROVE YOUR FIRM'S ACCESS TO FUNDS

Step 1: Determine if you need equity from outside.

- Update your business plan goals, how you will achieve them, time line, revenues and costs.
- Based on your plan, prepare a rough cut cash flow projection - monthly deposits, disbursements, net cash surplus (deficit) for each month, and cumulative surplus (deficit) over time.
- Ask yourself four questions: How much money will you need and when? When will your maximum need (maximum cumulative deficit) occur? How much is your maximum needed cash? Do you already have access to sufficient cash to meet your maximum need when it occurs?
- If you have sufficient cash, you do not need outside equity capital to achieve your plans. Focus on executing your plan.
- If you do not have sufficient cash to achieve your present plan, or suspect you will need cash in the future to move to the next level, budget money to prepare for fund raising and proceed to step two.

Step 2: Build your reputation. Most angels and venture capitalists will not seriously consider unsolicited investment proposals or DPOs (Sjostrom, 2001). Unless you are referred by someone they trust, you will not get an appointment. Also, if you have a good reputation in your industry, investors will perceive less risk, and you will get a better deal. Hence, it is extremely important to build relationships with respected advisors and key industry figures who are widely known in your industry. Build your reputation by surrounding yourself with credible advisors and building business relationships with major industry representatives.

- Get a banker on your side. Share your plan, your financial statements and your corporate and personal tax returns with your bank's loan officer. Even if you do not plan to borrow money, a reference from good loan officer who is known in your industry will help you find equity capital. Ask your loan officer for a critique and an opinion of how much cash you will really need to achieve your plan. If your bank's loan officer does not understand your business and/or cannot work through with you how to achieve your plan, seek another loan officer or lender that knows your industry. You need a lender who understands your plan, believes in your prospects, and will introduce you to potential investors.
- Get a CPA on your side. If you foresee a significant need for cash in the future, it is now time to get your financial house in order. You need advice on how to consistently make money. (Van Osnabrugge & Robinson, 2000) You need audited financial statements, budgets, and comparisons of your firm's financial performance to its industry. More than that, you need a respected CPA firm to vouch for you and to introduce you to potential investors. Share your plans. Seek a respected CPA firm that knows your industry, understands why you are special, believes you will do well, and will introduce you to potential investors.
- Get a corporate law firm on your side. Select a firm that is well known and respected in your industry. Even though you may never "go public," select an attorney within the firm who has IPO and merger/ acquisition experience, knows your industry, and believes in your prospects. Such an individual will be able to introduce you to an informal network of financial middlemen and investors.
- Get key industry people on your side - suppliers, customers, trade association executives. Actions speak louder than words. Pay promptly, deliver on your promises to customers, become an officer of your trade association and demonstrate your integrity and expertise in all your business dealings. Keep your industry network up to date concerning your plans and progress.
- Don't forget to get family and friends on your side. If they believe in your prospects and know what you need, family and friends can good sources of direct investment and even better sources of referrals. Treat them with the same respect as professionals.

Step 3: Try bootstrapping before you seek outside funds. While you build your reputation, begin building cash by committing your personal savings and credit to the business. Next, seek creative ways to acquire and use resources without raising equity from traditional sources or borrowing money from a bank. Techniques range from getting advances from customers, to establishing trade credit, to leasing equipment instead of buying. (Van Osnabrugge & Robinson, 2000; Freear, et al., 1995; Winborg & Landstrom, 1997)

Step 4: Pay attention to geography. Where are your best customers, your major suppliers, your major competitors, and major financial centers for your industry? Are you conveniently located to your potential sources of loans and equity capital? If not, consider establishing a local presence in the right areas (local mailing addresses, local telephone numbers, etc.). Are your banker, CPA and attorney conveniently located to your potential sources of equity capital? If not, consider switching to advisors who have a local presence and established network in the target area.

Step 5: Prepare for due diligence. All lenders, professional investors and many angels will attempt to verify information you provide about your company's ownership, its history, its financial performance, and its prospects. Prepare now. Obtain due diligence checklists from your banker, CPA and attorney. Collect and compile all the needed information, in accordance with instructions from your financial advisors. Back up your claims about the industry and your company's prospects with appendices containing research data and expert

opinion letters. Methodical preparation now can save you thousands of dollars in professional fees at the last minute when the right deal comes along. Also, well-organized and complete due diligence materials speak well for your professional management skills and help build your credibility with potential investors and their advisors.

Step 6: Know Your Bottom Line. What is the maximum you are willing to give to lenders or investors in return for their cash? Cash is king so those with the funds will dictate the deal structure. To best negotiate, you must know the maximum you are willing to give. Further, cash received is not the only important thing. Given the amount of cash offered, the covenants and restrictions that make up the deal structure can make the difference between a good deal and a bad one. Work with your financial advisors to define your bottom line before you contact investors. When you receive offers, go over the details of the deal structure with your legal and financial advisors. Make sure you know what you are getting into (Lipper III, 1996; Van Osnabrugge & Robinson, 2000).

Step 7: Ask for Referrals. Once you are prepared for due diligence, know your bottom line, and well before you need the cash, start shopping for cash. Approach your family, friends, financial advisors and industry network with your updated business plan. Specify the opportunity, the risks, the estimated amount and timing of your cash need, and the estimated yield to investors. Ask for referrals to investors. Treat referral sources as you would treat investors. Provide full and frank disclosure so that they can better match you with potential investors. Reveal everything up front. Do not open those who refer you to potential embarrassment by "hiding skeletons in the closet."

CONCLUSION

This article has reviewed the equity capital gap for small business. It has weighed the relative merits of differing expert opinion and assessed the policy implications as they relate to the small business equity gap. It takes an economic development perspective; i.e., it seeks solutions that will make the economic pie bigger. The best solutions will have a balanced, twofold impact: (1) increase the availability of high risk, patient equity capital, and (2) increase available, high-quality equity investment opportunities in privately-held, small businesses. The best solutions will combine evolutionary changes in public policy and private action.

Importantly, as summarized in Table 3, small business owners and their advisors can act now to improve access to equity capital for their firms. What might work in the future at a macro, policy level can be "scaled down" to guide today's pursuit of equity.

Finally, we expect financial markets for small business equities will evolve with the Internet. Stephen J. Choi, predicts that "third-party intermediaries acting as gatekeepers to certify the value of securities and information on the Internet will expand their presence....Regulators...may join in the competitive arena as potential certifiers of investment information or value." (Choi, 1998). Donald C. Langevoort notes that, "(registered) securities professionals are not used by the nonprofit matching systems.... It would not be surprising for a variety of vendors outside the securities industry to seek to enter this market." (Langevoort, 1998). Long term survival is not assured for Choi's gatekeepers, Langevoort's matching entities, or of other adaptations to existing institutions. Survival will depend on how well they work together to balance the two dimensions of the equity capital situation. The network of survivors will both increase the availability of equity capital, and increase available, high-quality equity investments.

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