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J. William Petty
Baylor University

William D. Bygrave
Babson College

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INTRODUCTION

There has developed within the past decade an increased interest among academicians and policy makers in the small companies and entrepreneurs of the world. Domestically, small business is viewed by the "true believers" as the engine that drives the machinery, citing innovation and job creation as two areas where the small firm has outdistanced its larger counterpart. The title of the book, *Small is Beautiful*, by E.F. Schumacher, has become ideology for many. The interest has been heightened further by the melting of the cold war and the collapse of the socialist economies of the former Soviet block, in combination with the interest of the affected countries in imitating some form of a capitalistic economy. Within the past several years, Eastern Europe has witnessed the creation of millions of new business owners, financed mostly by the savings of family and friends. Privatization of the large state-run enterprises, and converting them into many small, efficient companies run by entrepreneurs or as joint ventures with Western partners, is considered by most to be the primary hope of avoiding disaster.

The developments of the past few years will, most likely, make small business and entrepreneurship one of the key research areas for this decade, and possibly beyond. Thus, for those of us who have a combined interest in the finance discipline and small business or entrepreneurship, an opportunity to make a significant contribution may be upon us. So the question that has been with us for some time now carries with it new relevance, that being: "Does finance have anything to say to the small business owner-manager or the entrepreneur and do they in turn have anything to say to finance? Only if there is potential for a meaningful dialogue do we have any purpose in the sharing of ideas and research findings.

We begin our search for an answer, which we would not suggest is any way novel, by first thinking about what finance has to say to firms in general, without respect to size or their entrepreneurial bent. Then, we look briefly

J. William Petty • Hankamer School of Business, Baylor University, Box 98004, Waco, TX 76798-8004.
William D. Bygrave • Babson College, 239 Tomasso, Babson Park, MA 02157

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at the nature of the small and/or entrepreneurial firm in an effort to understand the "clientele" before offering any counsel. Next, recognizing the nature of the issues and phenomena to be studied, we consider the role of research in facilitating the proposed dialogue. Lastly, we search for the intersection of finance and entrepreneurship in the hopes of providing some insights into the needed content of the dialogue.

Finance: The Basic Issues

Given our objective, that of identifying the overlapping issues thought to be important both in finance and for the entrepreneur or the owner-manager of a small business, a natural departure point would be first to ask what are the issues that have been on the minds and hearts of finance academicians? For some of the issues, albeit surprisingly few, resolution has been achieved. For example, few would question the concept that the value of a project is equal to the present value of future cash inflows less the present value of its outflows. For other theories and concepts, the opportunity is still ours to develop improved thinking and/or to gather better evidence; that is, there is still a "future" for these ideas. Fortunately, for our purposes, we need only specify the issues, without having to reach definitive conclusions.

It could be said that the essence of finance, as perceived by academia, deals with the allocation of cash, risk and time among the various claimants of the firm's cash flows. Conventional wisdom suggests that the manager's role is to make these allocations in a way that creates the highest possible value for the common stockholders. However, while it is the manager who makes the allocations, it is the investors in the capital markets who assign the value. Thus, for us to know about finance requires that we understand both the nature of the firm and that of the capital markets.

Finance, as we know it today, has largely been the result of the seminal work of Modigliani and Miller [10], who argued that the value of a firm is a function of its operating cash flows, and not how these cash flows are shared by the various claimants, such as debt and equity. From that point forward, the issues being addressed in academic finance have largely focused on valuation or related matters with little regard, by the way, for firm size. Moreover, not all matters are of equal importance. Our "theory of finance," as developed over the past several decades, has said that some things are more fundamental to our beliefs. No doubt, what is deemed to be part of the "core," or at the center, depends on one's personal perceptions and experiences. However, at the risk of committing sins of omission and/or commission, we believe the important matters would certainly include the following areas:

1. How the capital markets price assets (pricing theory).
2. The opportunity, or lack thereof, for investors to earn superior returns in the product markets and/or the capital markets (market efficiency theory).
3. Defining and measuring the riskiness of an asset, either for investors holding well-diversified portfolios and for those who do not (portfolio theory).
4. Making the "best" investment decisions (net-present-value rule).
5. The possible conflicts of interest among the firm's stakeholders, such as management, creditors, and stockholders, as to what is the right thing to do (agency theory).
6. The effect of asymmetric information on firm value and in structuring financing instruments (theories of information asymmetry).
7. The use of signaling by management to convey information to the market (signaling theory).
8. Evaluating long-term financial strategies that are not well suited for the net present value model (option theory).
9. The relationship between sustainable competitive advantages and earning positive net present values (corporate strategy).
10. The principal of value additivity and its implications for firm diversification (corporate governance and restructuring).
11. The benefits and costs related to debt and equity financing (capital structure theory).
12. Understanding how managers make dividend decisions (dividend theory).
13. The mix of a firm's assets and its debt maturity structure (theory of liquidity).
14. The reaction of the capital markets to new securities and new markets (pricing theory again).

While not all inclusive, and mostly random in its order, the foregoing list certainly represents some of the most consuming issues that finance academicians have tried to resolve, with varying degrees of success to date. Before trying, however, to relate these issues to the small firm and/or the entrepreneur, we should first try to gain some perspective as to the nature of the small firm and the entrepreneur. Without such an understanding, we are not in any position to carry on a meaningful dialogue. We would be like unto a physician who prescribes without first diagnosing, which is clearly intolerable in medicine, but not exactly admirable in academia either.

With Whom Shall We Speak and Who Will Listen?

It behooves us to think for a moment with whom we the academicians are wanting to communicate. We have several options as to how we might think about the issue. One approach could involve segmenting the "listeners" into four quadrants, according to public or private markets and relative to growth and nongrowth companies, as done in Exhibit 1.

Perspective One:

In the 1990 *State of Small Business,* the Small Business Administration estimates there to be approximately 4.27 million corporations in the United States. We might surmise that only one percent of these companies' stocks, at most, are traded publicly, with 99 percent being privately held. Moreover, if we define a "growth" firm as one requiring and choosing external equity to finance at least some of its growth needs, we would not expect the number to exceed five percent in any given year. Thus, we can quickly visualize from Exhibit I what we already know intuitively: In terms of the population, the preponderance of firms fit into Quadrant I, which some call "life-style" firms. Herein lies the greatest number of prospective listeners. Secondly, we have the private companies that experience significant, if not quantum, growth opportunities (Quadrant III), which represent the high-potential firms, i.e., the "entrepreneurial companies." Bygrave [2] refers to the lifestyle firms as "micro-ventures," comprising those businesses that will remain small. Mega-ventures, on the other hand, are started with the intent of becoming large, possibly creating an entire new industry, as did Fred Smith in the founding of Federal Express.

The remaining two quadrants, II and IV, in Exhibit I comprise the public companies, with whom the academic finance discipline has long had a love affair, despite the occasional "lovers' quarrels." For our purposes, these latter two quadrants lie outside our field of interest.

While our classification scheme could be called into question on several matters, such as the failure to distinguish between firms that are "lifestylers" by choice versus constraint, the scheme is, at least in spirit, a reasonable "map of the territory." If we are to be effective messengers, we must seek first to understand and only then to be understood. If our paradigms of the world in the two quadrants of interest to us are not accurate; if we do not understand the jugular issues for these firms; if we do not know what are the important questions, then we cannot and will not contribute understanding to any meaningful extent.

	Private	Public	Total
Non-growth	I Life-style companies 94.05%	II Public non-growth 0.95%	95%
Growth	III Entrepre-nuerial firms 4.95%	IV Public growth companies 0.05%	5%
Total	99%	1%	100%

Exhibit 1. The Population

Perspective Two:

A second means of surveying the territory is to view the small firm and the entrepreneur as part of a process, and not so much a state of being as we did in Exhibit I. The traditional view of this process has the firm passing through various stages of growth. For example, Churchill and Lewis [4] identify five stages of growth: existence, survival, success, take-off, and resource maturity. We learn from Churchill and Lewis what to expect in terms of such things as managerial delegation and the need for cash as we pass through each stage. Walker [12] modifies these stages to relate to the firm's possible objectives and the different sources of financing available at each stage. For Walker, the firm travels through four stages, these being new, developing, established, and maturity. By our coming to understand the processes suggested by these writers, we hopefully gain a more complete understanding of the nature or essence of the small or entrepreneurial firm.

Continuing this theme of process, Stevenson and Sahlman [11] define entrepreneurship as beginning with the identification of an opportunity and ending with the "harvesting" of the firm. As part of this process, entrepreneurship in an economic context is a behavioral phenomenon, consisting of a range of behaviors, and not a single point. It is a state of becoming, as opposed to a state of being. Moreover, Bygrave [3], while agreeing that we are wanting to understand a process, contends that it is not "smooth, continuous, [or] ordinary." Instead, the starting of a new business, Bygrave contends, is a "disjointed, discontinuous, unique event, no matter whether it is a mega- or a micro- venture." However, the size of the discontinuity would vary, depending on whether the company is a micro- or a mega-venture. Bygrave continues, "A mega-entrepreneurial startup is a quantum jump, whereas a microentrepreneurial startup is an infinitesimal step... More often than not, a new venture is triggered by relatively small changes in the variables for the entrepreneurial process," which in turn can result in large changes. Thus, our study of the entrepreneurial process should recognize the likelihood that we cannot think in terms of linear and continuous relationships if we are to explain the "world of the entrepreneurial firm" with any degree of accuracy. Also, owing to the large number of variables that come to play, including psychological, sociological, and economic influences, our task is in no way an easy one.

We will now turn our attention to the nature of the micro-and mega-ventures, respectively, which will serve as the foundation for any thoughts on what finance has to do with the small firm and the entrepreneur.

The Nature of Quadrant I Firms: The Micro-Ventures

The Quadrant I firm, or the micro-venture, of Exhibit I is almost completely defined by its owner. The company in this case is purely an extension of the owner's life style. For the most part, the owner cannot or does not separate his or her personal life from that of the firm's. They are one and the same. Therefore, the need to create value and autonomy outside the firm may be as important in making an investment decision as the investment's internal rate of return. The concept of wealth maximization has reduced meaning, since there are so many exogenous considerations influencing the decisions, besides that of economics. Utility maximization becomes the rule, rather than the conventional wisdom of wealth maximization. The objective is not so much to create value, but to provide a "preferred" life style within the community. Even for the "successful" lifestyle firms, there is little in the way of value created beyond providing a living for the owner and his or her family.

In addition to the unique nature of the firm-owner relationship for the lifestyle firm, there are some other environmental influences that come to play. Some of these are thought to include:

1. A small firm is thought to be a more risky investment than the larger firm (Fazzari, Hubbard, and Petersen [6]).
2. There is thought to be significant difficulty for the small firm to find external equity financing (Fazzari, Hubbard, and Petersen [6]). However, for many of these firms, there is a preference not to seek external financing, so that no threat exists in losing control of the business.
3. The small firm has fewer options for acquiring long term credit. To illustrate, long-term bank financing under the SBA administration loan program amounts only to a meager $16 million for all small firms, much of which is available only for disaster relief (Walker [12]).
4. Financing for the lifestyle firm comes predominantly from personal resources, including friends and relatives, short-term debt, and retained earnings. (Evans and Jovanovic [5] found that founders of new companies invest about 1.5 times their personal net worth.)
5. The ability to accumulate retained earnings is critical just for survival (Walker [12]).
6. The firm's financial objective and the alternative sources of financing available are largely dependent on the stage of development of the small business (Churchill and Lewis [4], and Walker [12]).
7. Given the interconnectedness of the owner and the firm, traditional definitions of debt and equity may not apply.
8. The owner's personal preference for financial risk, as opposed to minimizing the firm's cost of capital, determines the level of debt.
9. Personal life styles realized through the company may distort the economic content of the financial statements.
10. Bankers of small firms invariably rely on the owner's personal guarantees in conjunction with the firm's financial position.

The above descriptions of the micro-venture is based in part on conventional wisdom and in part on available empirical research. The implications of these characteristics ought to have something to say to us when we seek to bring finance and entrepreneurship together. Let's look now at the "entrepreneurial firm" or the mega-venture.

Characteristics of the Quadrant III Firm: the Mega-Venture

We may further divide the entrepreneurial firms, or "mega-ventures," into three additional categories according to their financing sources. Within this grouping, we have (1) firms financed in part by formal venture capital, (2) companies financed partly by informal venture capital, and (3) the "bootstrappers." The first group entails those ventures that need significant equity capital, amounting to at least $1 million. The formal venture capitalists, for the most part, simply cannot afford to perform the necessary analysis on capital requests for much less than the $1 million minimum. Thus, most ventures are excluded from the formal venture capital markets purely based on size; they lack the critical mass needed to justify approaching the venture capitalists.

The second group of entrepreneurial firms seek financing from the informal venture capitals, comprising the private investors, or the "angels," as Freear and Wetzel [8] and others have lovingly come to call them. The "typical" angel-backed venture appears to raise about $250,000 from three or more private investors. The "angels" are high net-worth individuals with extensive business and financial experience. Most of these investors are willing to take significant financial risks to earn substantial returns, and they are willing to commit funds for extended periods.

The third group of entrepreneurial firms are those who cannot or choose not to use the formal or informal venture capitalists—the "bootstrappers." The entrepreneurs here are thought to search for smaller amounts of equity capital, or more likely whatever source of capital they can acquire, to finance the company's growth. Bhide [1] found that of the Inc. 500, the fastest growing private firms in the United States, almost all were "bootstrappers." Even for these firms, where the annual growth rates for the previous five years averaged some 1400 percent, they chose to finance in ways where they did not lose control of the company. Thus, even among the entrepreneurial or high-potential companies, few use outside equity as a means of financing their growth.

As with the micro-venture, the nature of the mega-venture is affected significantly by the nature of the entrepreneur. While we need not be consumed with the psychological makeup of the entrepreneur, we need to have some understanding of his or her personal influence on the financial aspects of the firm. In this regard, we see a person who typically is focused on opportunities and not so much constraints. While they indeed seek to shift some of the risk to others, they are not reluctant to take risks. For the most part, they do not feel constrained by our financial theories, e.g., they would question market efficiency, doubting that product markets are perfectly competitive or that capital markets are uniformly efficient. They are not so much concerned about owning assets, but more about controlling them for the purpose of taking advantage of a perceived opportunity.

It can truly be said that the entrepreneurial firm is the classic case of agency problems and asymmetric information. We have no better place to develop our understanding in these issues. Owing to the need for external financing, combined with the lack of much in the way of public information about the firm, the various stakeholders are in constant search for information that gives credibility to what management proclaims. Also, there is a real need for incentives within the firm to encourage the management to act in the best interest of the investors and to deliver on their promises. For this reason, at least in part, investors in entrepreneurial firms usually perceive their role as being more than merely providing money; they frequently seek the opportunity to provide an active role in the management of the small firm. Gaston and Bell (1988), for example, found that 88 percent of the informal investors they sampled expected more involvement than merely receiving periodic statements and reports.

In terms of financing the venture, "bootstrap financing" appears to be the primary source of most high-growth entrepreneurial companies. Informal investors, i.e., the "angels," represent the second largest source of external financing for entrepreneurial firms (Freear and Wetzel [8]). A distant third is the formal venture capitalists. Also, the primary interest of the formal and informal sources of capital continues to be in technology-intensive companies where large potential returns are possible in a relatively short period of time (Florida and Kenney [7]). However, whatever the source of capital, growth is vital if the entrepreneurial firm is to have access to sources of financing (Kirchhoff and Phillips [10]). Finally, owing to the cost of initial public offerings, especially the significant underpricing of the shares at the offering date, and to the riskiness of these offerings, few entrepreneurial firms choose to use the public markets for common and preferred stock (Tinic [13]). Many others would never qualify for an initial public offering.

Without a doubt, more could be said about the nature of the small and/or entrepreneurial firms, but even with this beginning effort to provide a profile of these enterprises, we can make some initial observations about the dialogue between finance and the small owner-manager and/or the entrepreneur. However, a brief comment about the basis of the dialogue is in order.

Research: The Foundation for Effective Communication

While academic research is perceived by the business community as mostly esoteric and of no real importance in making managerial decisions, practitional should not reach the conclusion that research is merely a game played by the academician. There can be little doubt that some research has little to say to the community at large, especially with any compelling immediacy. However, the search for understanding either comes from effective inquiry or by relying on personal experiences and anecdotes. The latter option is marked with incompleteness, and typically deals only with the "how" and not the "why," which is by far the more important question. Before any transfer of knowledge may occur, the available research must first be placed on the table as the basis for any true dialogue. Admittedly, the presentation of the research may come wrapped in obfuscation; however, that is not to imply there is no merit in the content. It only says that an effective presentation has not been made to a given audience, or that it is not intended for a particular audience. Even so, given the alternatives, research represents the best available means to develop our understanding of the important issues.

Even if we grant research a place of honor in our mission to gain better understanding of finance and its relevance for the small or entrepreneurial firm, we must also ask: "Given the nature of the disciplines involved, what is "good" research?" Conventional wisdom teaches us that research should be theory based, where we first develop the theory, build our hypotheses from the underlying theory, which we then test empirically, i.e., deductive analysis. In an emerging, and immature discipline, where we find ourselves with small business and entrepreneurial finance, could we not also benefit from the skills of the pure empiricist? In other words, we should also value inductive logic applied to purely exploratory, empirical research; what could be called good old "enlightened speculation" (Bygrave [3]).

In short, progress will come only through more careful thinking and better empirical analysis, requiring more in-depth field studies, as opposed only to a survey on an available population. It is time to give our best thought to the area and develop a willingness to "get our hands dirty" in our empiricism. Herein lies the essence of our task.

A Potential Research Agenda: The Need for Dialogue

What finance has to say to the small or entrepreneurial firm depends much on what they want and need to hear. As we review the list of issues of interest to the financial economist set forth early in the paper, there are issues that should be viewed as being of importance to the entrepreneur, especially in understanding the whys as opposed to the hows. Without trying to address all the possible issues of commonality, let's look at several potential areas.

For the lifestyle company, our admonitions about being wealth maximizers will go largely unheeded. Also, many of our theories will offer little in the way of guidance to these firms, except possibly (hopefully) in providing the right mind set. For instance, what does signaling have to offer the owner of a micro-venture? Absolutely nothing. However, for the owner of the small firm to understand the relationship between sustainable competitive advantage and positive net present values would be fruitful. There is need for the small-firm owners to ask the "why" questions, whether or not they are accustomed to doing so. It is our role to encourage the asking of such questions. However, it is also the responsibility of the researcher to know what issues are important to the small firm and allocate time accordingly. For instance, whatever is said about the investment decision-making process must consider both company and personal wealth and recognize personal life-style preferences. Thus, we must choose from our theories those items that have some fit for the life-style owner and manager.

For the entrepreneurial firm, we have a far greater opportunity to carry on a meaningful dialogue. We simply have more to offer. The underlying characteristics of these firms relate to their need to finance high growth and manage the interests and needs of investors.

It is with the entrepreneurial or high-potential firm that valuation and the complementary issues are helpful. Hardly any issue, whether it be attracting new investors or making investment decisions, can be addressed without considering the consequence on the value of the firm. The perceived value, for example, has a direct effect on the percentage of the firm outside investors will require if they are to participate. No doubt, the complexity of the situation, which usually involves valuing a privately-held firm whose value is largely a function of growth opportunities, makes the valuation process extremely problematic. That is, the application of the theories are more difficult with an entrepreneurial firm, but not any less important. In this regard, we must also provide some encouragement for the entrepreneur to think *value,* and not *accounting profits,* in making economic decisions.

Any decision made by the entrepreneur, and for any manager for that matter, does one of three things: increases firm value, decreases firm value, or leaves firm value unchanged. The owner-manager of the privately-held firm should think about creating sustainable value, even though the stock is not traded publicly. The difficulties of many of the large public companies in the United States have come in part from their forgetting the firm's owners in their decision-making process. They could have avoided a great amount of pain by managing their firms as if they were privately owned. In like manner, it behooves the owner of the private company to manage for firm value, as if the firm was publicly traded.

Another relevant issue for both the entrepreneur and the finance academician is that of asymmetric information. The issue of financial contracting comes to play in structuring the "deal," which in turn affects the value of the venture itself. The allocation of cash and risk, the heart of financial economics, is the driving force in financial contracting. However, this process is influenced greatly by the apparent dissimilar information available to the respective contracting parties.

Concluding Remarks

We have attempted to address a single issue: Does finance have anything to say to the entrepreneur, and is there any reason why the entrepreneur should listen? Without attempting to say all the ways that finance can potentially speak to the small and/or entrepreneurial firm, we have argued the case that finance does have much to say to the entrepreneur. It is therefore our job as academicians to carry the message, and to do it effectively.

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