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Article

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Funding Continuum for Private Business Owners: Evidence from the Pepperdine Private Capital Markets Project Survey

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Abstract

The Pepperdine Private Capital Markets Project survey for business owners, administered during the spring of 2010, reveals an increasingly important role of friends and family (Friends/Family) to provide capital for privately-held businesses. Examining business owners' perceptions of their sources of capital reveals that, overall, business owners prefer Friends/Family and angel financing as well as asset-based lenders and banks (ABL/Bank). Business owners consider Friends/Family financing to be the least costly. However, business owners also believe venture capital (VC), private equity (PE), and angels provide more benefits than friends/family and ABL/Bank. This study unveils a detailed spectrum of the funding continuum for privately owned firms across different levels of firms' size, age, and information availability.

JEL Classifications: G10; G20; G24; G31

Keywords: Funding continuum, private capital markets, business owners' impressions

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I. Introduction

According to the Statistics of U.S. Businesses and Industries from the U.S. Census Bureau, more than 2 out of 3 employees in the United States are in small and medium sized private businesses. Small firms with 1 to 4 employees represent over 47% of the total number of establishments while large, publicly traded companies with more than 500 employees only represent 15% of the total. Publicly owned firms only contribute 1 out of 6 employments in the United States.¹ Therefore, there is no doubt that small and medium sized private businesses play a significant role in job creation. On September 27, 2010, President Obama signed the Small Business Jobs Act to restart the Small Business Association recovery lending program, beginning with more than 1,300 small businesses that have been waiting to get the credit they need. The Act also included new tax cuts for small businesses to provide an immediate incentive for businesses to make new investments and to expand. While the U.S. government has recently increased interest in funding for small businesses by initiating significant credit funding and incentives to support small businesses for job creation, there are limited studies that examine the perception of private business owners toward various sources of capital available to them.

Historically, banks (senior lenders) and private equity funds have been considered as the major players to provide funding for private business owners. However, the availability of credit from senior lenders and the size of private equity investments have been adversely affected by the contraction in the global capital market. In 2008, the total capital raised by private equity funds was \$459 billion. A significant drop occurred in 2009 and 2010 as the total capital raised reached only \$140 billion and \$150 billion, respectively (The City UK, 2010). According to the U.S. Financial Data from the Federal Reserve Bank of St. Louis, total commercial and industrial loans in the U.S. have fallen by approximately \$200 billion from 2009 to 2010. Therefore, private business owners are questioning whether they can rely on banks and private equity firms for their financing needs. As business owners face a challenging period obtaining funding from traditional sources of capital, funding from their friends and family have taken the lead.

Slee (2004) indicates that private firms do not solely rely on private equity firms, venture capital, and banks when seeking capital. Business owners also seek funding from asset-backed lenders, angels, and more importantly from their friends and family. All of these fund providers are classified under the heading of *private capital markets*. Berger and Udell (1998) indicate that small private business financing evolves based upon size, age, and information availability for the firm. This financing growth cycle is known as the firm funding continuum. There are limited studies that examine the existence of the firm funding continuum for small businesses. Fluck, Holtz-Eakin, and Rosen (1998) find that the proportion of funds from insiders rises during early stages of the firm's life cycle, while the proportion of financing from outsiders declines. Gregory, Rutherford, Oswald, and Gardiner (2005) empirically test the financial growth cycle and find mixed results. Bhaird (2010) and Bhaird and Lucey (2010) examine capital structures for Irish small and medium-sized firms and find that age, size, ownership structure, and provision of collateral of the firm are important determinants of the capital structure. They also find that private business owners utilize their personal assets as collateral to secure short-term financing.

We found no existing studies that examine the overall characteristics of the private capital markets, especially funding from business owners' friends and family. Most of the

¹ U.S. Census Bureau Statistics of U.S. Businesses and Industries is available at <http://www.census.gov/econ/smallbus.html>.

existing studies that examine the existence of the firm funding continuum (Berger and Udell, 1998) for small businesses find mixed results at best. Very little is known about the private business owners' perceptions regarding their various sources of capital. This study attempts to provide information about the characteristics of small privately owned businesses and the private capital markets. This study also focuses on the existence of a firm funding continuum based on business owners' perceptions of their sources of capital using recent survey results from the Pepperdine Private Capital Markets Project for business owners conducted during the spring of 2010.²

The study reveals that the majority of private business owners operate within the service industry (i.e. business, software, employment, and consulting services), followed by manufacturing, technology, and financial industries. Most firms have concentrations of annual sales between zero and \$500,000 and \$1 million to \$5 million. Their business operations have a median age classification of 5 to 10 years. Nearly half (48.9%) of the participants report having work experience of greater than 20 years and over 75% have at least ten years or more. Most owners are actively managing their own businesses. The majority of private business owners report that their source of financing comes from friends and family (Friends/Family) followed by senior lenders (Bank), angels (Angels), asset-based lenders (ABL), private equity (PE), and venture capital (VC).

In examining the business owners' perceptions of cost and benefits from a variety of funding sources, this study finds that funding from Friends/Family is considered least costly by business owners. However, business owners believe that funding from VC, PE, and Angels are most beneficial compared to Friends/Family and ABL/Bank. We believe that business owners consider these equity investors as information generators that enable business owners to secure their future funding needs.

Examining the business owners' impressions of Net Benefit (benefits minus cost), we find that business owners favor financing from Friends/Family and Angels when they have no revenue or the age of the firm is less than two years, or there is low information availability. Firms with positive annual revenues, but less than \$1 million, or an age between 2 and 5 years, prefer funding from VC and PE in addition to Angels and Friends/Family. ABL/Bank funding begins to play a significant role relative to Friends/Family funding when a firm's annual revenue is above \$1 million, a firm's age is above five years, or there is a high level of information availability indicated by having audited financial statements and having resources to grow. When a firm's annual revenue is above \$10 million or a firm's age is above twenty years, business owners prefer ABL/Bank financing over the rest of their funding choices. Overall, the impressions of Net Benefit provide empirical evidence to support the existence of the firm funding continuum for small private businesses starting from Friends/Family, ABL/Bank, Angels, PE, and VC.

The next section reviews the literature and discusses the survey methodology. It is followed by descriptive statistics of the sample and regression analysis. It concludes with a summary of the main findings, limitation of this study, and directions of our future research in the field of private capital markets.

² The Pepperdine Private Capital Markets Project report is available at <http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/reports.htm>.

II. Background

One of the main challenges for business owners to grow their businesses is their ability to raise external capital to fund their project opportunities. Jensen and Meckling (1976) indicate that when initial owners decide to sell part of the ownership in the firm, their cost of consuming non-profit maximizing activities and their benefit from maximizing market value of the firm decreases. Changes in initial owners/managers' incentives create a principal-agent problem where the initial owners/managers' objectives are no longer aligned with the external investors or shareholders. They demonstrate that higher initial owners/managers' ownership reduces the principal-agent problem. Therefore, initial owners/managers tend to retain their ownership and tend to rely on reinvestment of retained earnings to fund the growth of their firms rather than seeking external capital. Similarly, Leland and Pyle (1977) analyze the problem of business owners to raise external capital when initial owners have more information than potential external investors. This information asymmetry between informed initial investors and uninformed potential investors creates an adverse selection problem where at the equilibrium only bad firms raise external capital. They also demonstrate that higher initial owners' personal funds invested in the project are interpreted as a good signal by external investors.

Myers and Majluf (1984) present a pecking order theory of financing based on the assumptions that managers know more about revenue streams and investment opportunities than outside investors and that managers act only in the best interest of existing shareholders. Announcements of new equity issued will be perceived as a bad signal since new external investors perceive new equity issues as a signal that the equity price is currently overvalued. This information asymmetry gives rise to underinvestment since existing owners/managers are unable to raise external capital to capture growth opportunities. At the end, they suggest that underinvestment can be avoided by funding investment opportunities with internal capital from reinvestment of retained earnings. In short, the principal-agent, the asymmetric information, and the pecking order theories suggest that business owners (entrepreneurs) are facing significant challenges to raise capital externally.

Berger and Udell (1998) provide a framework of funding sequence during the firm's life cycle. Based on the information asymmetry, principal-agent, and pecking order theories, they indicate that financing sources for small businesses evolve based on their size, age, and information availability. This is known as the *financial growth cycle* or the *firm funding continuum* paradigm. They show that funding starts with owners and owners' Friends/Family, and then moves to Angels, lenders, VC, and PE, and finally concludes with public equity and commercial paper financing. Unlike large firms, small firms typically have a substantial amount of their funding provided by the entrepreneur, other members of the start-up team, family, and friends. In addition, small businesses generally receive their external funding in private equity and short-term lending markets rather than public markets.

Berger and Udell's (1998) paradigm has spawned significant interest among researchers to empirically test the existence of the firm funding continuum. Fluck, Holtz-Eakin, and Rosen (1998) empirically examine the life cycle of financing from insiders (owners) and outsiders (banks, VC, and private investors). Using the Wisconsin Entrepreneurial Climate survey, they find that the proportion of funds from insiders rises during the early stages of a firm's life cycle, while the proportion of financing from outsiders declines. However, after the first revenue realization, this pattern reverses as the firm's age increases beyond 80 to 90 months. Romano, Tanewski, and Smyrniotis (2000) investigate capital structure decisions for Australian family

businesses. They find that firm size, family control, planning, objectives, and industries correlate with financing choices. Firms with no planning tend to rely on family loans; older firms and owners who have a preference for retaining family control are less likely to use external equity financing.

Gregory, Rutherford, Oswald, and Gardiner (2005) specifically focus on empirical tests for the financial growth cycle of small and medium-sized enterprises (SMEs). Using the Survey of Small Business Finances (SBBF) from the Federal Reserve Bank, they find that larger firms with higher numbers of employees are more likely to use public equity financing or long-term debt as opposed to insider funding. However, they find that younger firms are more likely to use public equity and long-term debt than older firms. They also find that the firms' information availability does not significantly influence SMEs funding choices. They conclude that the financing growth cycle of SMEs cannot be generalized into a single firm financing spectrum as indicated by Berger and Udell (1998). Cassar (2004) investigates the determinants of capital structure and sources of financing for startup firms. He finds that larger startup firms tend to use greater proportion of debt, long-term debt, outside equity financing, and bank financing. However, firms with lower tangible assets are financed with loans from individuals. Faulkender and Petersen (2005) examine the capital structure choice of firms and find that small private firms are credit constrained. Small private firms have very little public information, and given their small size, the relative cost of collecting credit worthiness information is high.

More recent studies examine the existence of the firm funding continuum outside of the United States. Ullah and Taylor (2007) examine funding for small technology-based firms in the United Kingdom. They find that 80% of the small firms are still financially constrained even after two decades of efforts to overcome their capital needs. They also find that entrepreneurs use their own personal financing as the main source of capital. Bhaird (2010) examines Irish private firms and finds that internal equity financing is the most important source of financing as private firms increasingly rely on their retained earnings. As the firm's age increases, they are able to obtain short-term debt financing. He also finds that the youngest firms tend to use short-term and long-term debt and use their personal assets in addition to the firms' assets as collateral. Bhaird and Lucey (2010) examine determinants of capital structure for Irish SMEs. They find that firm age, size, ownership structure, and provision of collateral are important determinants of the capital structure. They also find that private business owners utilize their personal assets and external equity financing to overcome the lack of adequate tangible assets as collateral for short-term loans.

Using the Kauffman Firm Survey (KFS) data from 2004 to 2007, Robb and Robinson (2010) examine capital structure decisions from newly formed companies in the United States. They find that startup firms rely to a high degree on both business and personal bank loans relative to Friends/Family financing in their early stage of life cycle. In regions that have more credit availability, as indicated by increased supplies of home loans, startups tend to rely on larger bank debt. They also find that firms use smaller amounts of trade credit and tap them less frequently in comparison to carrying external debt. They conclude that heavy reliance on external debt underscores the importance of well-functioning credit markets to support the success of these new businesses.

These existing studies have empirically examined the existence of a firm's growth life cycle or funding continuum. However, we find that the empirical results are still mixed. Most studies find that firms utilize significantly higher levels of external debt financing relative to equity financing from Friends/Family in the early stages of the firm's life cycle, which is

inconsistent with the firm funding continuum hypothesis. Additionally, there is no study that examines the characteristics and investment decisions for the entire private capital market participants, especially from individual investors such as Friends/Family. The Pepperdine Capital Markets study reveals the role of Friends/Family in providing capital for private business owners. Specifically, the study focuses on the business owners' perception of their funding sources. It utilizes unique survey data that was collected directly from business owners during the spring of 2010.

The Pepperdine Private Capital Markets Project launched a web-based Qualtrics[®] survey directed to private capital market participants such as banks, ABLs, PE, VC, Angels, and Friends/Family of business owners in the spring of 2010. There were nine separate surveys that were administered during the spring of 2010: angels, venture capital, private equity, mezzanine, bank (senior lenders), asset-backed lenders, factors, appraisers, and business owners. The goal of the Pepperdine Private Capital Markets Project is to reveal characteristics of this market and to construct the private capital market line identifying cost of capital for privately owned firms that is comparable to the security market line for public firms.

Among these nine surveys, the most comprehensive survey is the business owners survey. The surveys contain questions regarding the owners' business profile, credit box (characteristics that must be displayed to qualify for financing), historical returns, expected returns, cost of capital analysis, and most importantly the business owners' impressions of their funding sources.³ The surveys were distributed via two phases of emails to 20,000 private business owners based on email lists from business associations during the spring of 2010. Based on 489 responses from the business owners survey, there are approximately 339 usable responses that are analyzed in this study.⁴ Our first goal is to provide a description and characteristics of private business owners and their financial decision making based on the data from the survey. Second, we provide empirical evidence of funding preferences for small private businesses based on their size (annual revenue), age (years of operation), and information availability. And third, we empirically test the existence of the funding continuum hypothesis (Berger and Udell, 1998) based on business owners' perceptions of their funding sources.

III. Sample and Analysis

Figure I provides characteristics of the survey participants based on the industry classification under which their businesses operate. Software, employment service, business to business service, consulting services (Service) represents 22.6% of the participants followed by Manufacturing (15.1%), Technology (13.2%), and Finance (12%).

[Insert Figure I here]

Based on regions, most participants are located in the Western region (40%), followed by Southwest (13.3%), Midwest (13.3%), Southeast (11.6%), and Northeast (8.9%) with the remaining located in multiple regions and international locations.⁵ C-Corp, S-Corp, and General Partnerships are the most common legal forms of participants' business organizations. Over 53%

³ Appendix A provides a sample of survey questions that are most relevant to this study.

⁴ The number of sample observations varies depending on variables that are used in each analysis.

⁵ We recognize that the highest concentration of our survey participants are from the western region. Therefore, we urge the readers to interpret our results with caution.

of the participants are active business owners with controlling interests in their organizations. Approximately 13% are managers of their organizations and less than 5% are passive owners.⁶

We examine the performance in terms of annual net sales and earnings before interest, taxes and depreciation and amortization (EBITDA); capital needs; and sources of capital for these survey participants. Based on Table I, we find that annual net sales and EBITDA for survey participants is bimodal. They are either small firms with net sales and EBITDA less than \$500,000 or medium sized firms with net sales between \$1 million to \$5 million and EBITDA between \$500,000 and \$3 million. Very small percentages of participants belong to large firms with annual revenues above \$25 million. Over 25% of these firms seek capital funding between \$100,000 and \$500,000. Almost 93% of the firms indicate their capital needs are below \$25 million. This indicates that most privately-held companies are small firms. When we examine the length of business operation and work experience of survey participants (Table II), we find that most businesses are evenly distributed from one year up to 30 years of operations. Their business operations have a median age classification of 5 to 10 years. Nearly half (48.9%) of the participants report having work experience of greater than twenty years and over 75% have at least ten years.

[Insert Table I here]

Looking at their sources of capital presented in Figure II, this study finds that 37% of business owners claim they receive funding from Friends/Family, followed by 23.6% from senior lenders (banks), 10% from Angels, and 6.8% from asset-based lenders. The private equity groups (PE), venture capitalists (VC), and hedge funds only represent 5.2%, 2.4%, and 2.4%, respectively. This finding provides supporting evidence that small firms typically have a substantial amount of their funding provided by the entrepreneur, other members of the start-up team, and more importantly from Friends/Family. This also implies that existing studies that focus only on banks, VC, and PE firms have missed the importance of Friends/Family as the leading provider of external capital for private business owners.

[Insert Figure II here]

IV. Business Owners Impressions for Funding Sources

The Pepperdine Private Capital Markets Project survey for business owners also asked the business owners for their impressions of funding sources based on their impressions for cost of capital (Cost) and impression of benefits (Benefits) from a variety of fund providers (Friends/Family, Angels, VC, mezzanine, PE, factoring, ABL, and senior lenders or banks). This study focuses on the business owners' impressions for cost of capital and benefits from each class of funding source. We categorize these capital sources into five distinct classes: (1) Friends/Family; (2) Angels; (3) VC; (4) PE; (5) asset-based ABL/Bank.⁷ We exclude mezzanine, hedge fund, and factoring from our analysis since 93.7% of business owners did not currently receive funding from these capital providers at the time of the survey (see Figure II).

⁶ Unreported data on geographic locations, legal forms of businesses, and controlling interests are available upon request.

⁷ We combine ABL and Bank since both are considered as lenders. We calculate the average of scores for each class of capital providers by taking average scores for ABL and Bank to arrive at the score for ABL/Bank. See Appendix A for a sample of survey questionnaires.

Business owners' impressions of cost are categorized into seven values: (1) very inexpensive, (2) inexpensive, (3) slightly inexpensive, (4) neutral, (5) slightly expensive, (6) expensive, and (7) very expensive. Business owners' impressions of benefits are originally classified into 5 values: (1) no benefit, (2) slightly beneficial, (3) moderately beneficial, (4) very beneficial, and (5) extremely beneficial. In order to compare the benefits with the cost and to calculate the benefits minus cost (Net Benefit), we rescale the business owners' impressions of benefits into a 1 to 7 scale.

Table III presents the means of business owners' impressions of cost, benefits, and univariate analysis to test the difference between benefits and cost (Net Benefit). The first column of Table III indicates that business owners believe that funding from Friends/Family carries the least cost but it also provides the least benefits. In contrast, VC has the highest cost, but it also provides the most benefits. The univariate t-test of the Net Benefit for Friends/Family relative to the other fund providers (Angels, PE, VC, and ABL/Bank) show that the difference in Net Benefit of Angels financing is closer to Friends/Family, followed by ABL/Bank, PE, and VC. This implies the spectrum of funding continuum for the full sample starts from Friends/Family, Angels, ABL/Bank, PE, and VC.

[Insert the first part of Table III here]

The next six columns of Table III show the breakdown of business owners' impressions of cost, benefits, and Net Benefit based on annual revenue of the firms across four classes of capital providers. When we rank the magnitude of the Net Benefit of each capital provider relative to Friends/Family, we find that the spectrum of funding for firms with no (zero) revenue starts from Friends/Family, Angels, VC, ABL/Bank, and then PE. For firms with positive annual revenue below \$1 million, the spectrum starts from Friends/Family, Angels, PE, VC, and then ABL/Bank. When annual revenue is between \$1 million to \$5 million, the spectrum of funding continuum starts from Friends/Family, Angels, ABL/Bank, PE, and VC. When revenue is above \$5 million, the spectrum starts from Friends/Family, ABL/Bank, Angels, PE, and then VC. Overall, we find that the funding continuum vary across different ranges of annual revenue. Angels are more likely to provide funding for firms with zero annual revenue up to \$5 million. VCs and PEs are more likely to provide funding for firms with positive annual revenue up to \$5 million. ABL/Bank plays more significant role in the funding continuum for firms with annual revenue above \$1 million. However, Friends/Family significantly provides the highest Net Benefit relative to other classes of fund providers across all firm sizes.

[Insert the second part of Table III here]

We also examine the business owners' impressions of cost and benefits based on the firms' years of operations (age) and level of information availability across four classes of capital providers in Table III. Based on the magnitudes of Net Benefit from each capital provider relative to Friends/Family funding, firms with less than two years of operations tend to rely on Friends/Family, Angels, PE, VC, and then ABL/Bank. Firms with 2 to 5 years of operations rely on Friends/Family, followed by Angels, VC, PE, and then ABL/Bank. For firms with 5 to 20 years of operations, they tend to rely on Angels, ABL/Bank, PE, and VC besides their Friends/Family. Firms with above twenty years of operation rely on ABL/Bank, followed by Angels, PE, and VC besides Friends/Family funding. Overall, Friends/Family and Angels are

more likely to provide funding for firms with less than 1 year up to 10 years of operations. VCs and PEs are more likely to enter the continuum when the firm's age is between 2 to 5 years. ABL/Bank plays more significant role in the funding continuum for firms with age above five years.

In examining the impact of information availability on business owners' perceptions of their funding sources, we rely on the survey questionnaires about whether business owners prepare annual financial statements audited by a certified public accountant (CPA) and whether they claim that they have necessary resources to grow. We classify the sample into two classes: (1) firms that do not have financial statements audited by a CPA and/or firms that do not have necessary resources to grow are considered as firms with low information availability, and (2) firms that prepare annual financial statements audited by a CPA and have necessary resources to grow are considered as firms with high information availability.

The last two columns of Table III displays cost, benefits and Net Benefit analysis across five different classes of capital providers across two levels of firm information availability: low information availability and high information availability. We find that firms with low level of information tend to rely on Friends/Family, Angels, ABL/Bank, PE, and then VC. ABL/Bank funding plays its significant role for firms with high information availability measured by having annual financial statements audited by a CPA and having necessary resources to grow. Overall, we find evidence of the funding continuum starting from Friends/Family, followed by ABL/Bank, Angels, PE, and VC.

[Insert Table IV here]

This study investigates the existence of a firm funding continuum for small private businesses by examining the impact of size, age, and information availability on business owners' impressions of cost, benefits, and Net Benefit in three separate multivariate regression analyses. The dependent variables are business owners' impressions of benefits (Benefits), cost (Cost), and benefits minus cost (Net Benefit). Since the dependent variables are in discrete (integer) ordered values between 1 and 7, we utilize the ordered logit regression analysis. The independent variables are firm annual revenue (SIZE), firm age (AGE), and whether firms have annual financial statements that are audited by a CPA and have necessary resources to grow or not (INFORMATION). Firm annual revenue is classified into twelve discrete values from 1 to 12 to represent zero revenue, less than \$100,000, \$100,000 to \$500,000, \$500,000 to \$1 million, \$1 million to \$3 million, \$3 million to \$5 million, \$5 million to \$10 million, \$10 million to \$25 million, \$25 million to \$50 million, \$50 million to \$100 million, \$100 million to \$500 million, and greater than \$500,000. Age is classified into eight discrete values from 1 to 8 to represent less than 12 months, 1-2 years, 2-5 years, 5-10 years, 10-20 years, 20-30 years, 30-50 years, and more than 50 years. Four industry dummy variables that represent four major industries: service, manufacturing, finance, and technology are included in each regression. Since revenue, age, and information availability are highly correlated, we run the regression for size, age, and information availability separately. Table IV presents the results of three separate ordered logit regressions based on size, age, and information availability for business owners' impressions of Benefits (Panel A), Cost (Panel B), and Net Benefit (Panel C).

Panel A of Table IV indicates that business owners' impressions of benefits from Angels and VC are most adversely affected as the firm's annual revenue, age, and information availability increase. Friends/Family and PE are less adversely affected by an increase in annual

revenue, age, and information availability. And ABL/Bank funding becomes more beneficial as the annual revenue, age, and information availability increase. Panel B of Table IV indicates that the business owners' impressions of cost mostly are unaffected by annual revenue, age, and information availability except that funding from Friends/Family is considered more costly as the size, age, and information availability increase.

Panel C of Table IV shows the impact of the size, age, and information availability on business owners' Net Benefit. We find that business owners' impressions of Net Benefit for VC funding are most adversely affected by an increase in size, age, and information availability. Angels and Friends/Family funding are also adversely affected by an increase in size, age, and information availability. Again, we find that ABL/Bank funding becomes more beneficial as the annual revenue, age, and information availability increase. Overall, our multivariate ordered logit regression results show evidence for the existence for firm funding continuum for small private businesses based on business owners' impressions of cost and benefits from a variety of fund providers.

V. Conclusions

During the recent financial crisis, private business owners have questioned their ability to rely on venture capital, private equity, and banks for their funding needs. The existing literature, which focuses on the role of venture capitalists, private equity funds, and banks is deficient as it does not address the broader participant base of the private capital markets such as funding from Friends/Family and Angels. The Pepperdine Private Capital Markets Project attempts to capture a more complete picture of the private capital market participants such as asset-based lenders and banks (ABL/Bank), private equity (PE), venture capital firms (VC), Angels, and Friends/Family.

Using the Pepperdine Private Capital Markets survey results from business owners during the spring of 2010, this study provides a description and characteristics of private businesses, performance, sources of capital, and perceptions of private business owners over a variety of funding sources. The majority of survey participants represent four important industries: service, manufacturing, finance, and technology. The size of their businesses is between small and medium size with the majority of funding coming from business owners' Friends/Family, ABL/Bank, Angels, VC, and PE rather than mezzanine or hedge funds.

This study focuses on the business owners' perceptions from five classes of funding sources: Friends/Family, Angels, VC, PE, and ABL/Bank. We find evidence that business owners' overall impressions of Friends/Family, Angels, ABL/Bank as capital providers are more positive than VC and PE due to their life cycle of funding needs. However, financing from VC, PE, and Angels provide higher benefits to business owners than Friends/Family and ABL/Bank financing. This is consistent with previous findings that VC, PE, and Angels provide monitoring and generate information that enables business owners to secure their future funding needs (Gompers and Lerner, 1999; Berger and Udell, 1998).

We find that business owners favor funding from their Friends/Family and Angels when they have no revenue or the firm's age is less than two years or there is low information availability measured by no audited financial statement and/or no resources to grow. Business owners start to consider funding from VC and PE in addition to Angels and Friend/Family funding in firms with positive annual revenue less than \$5 million or the firm's age is from 2 to 5 years. ABL/Bank funding starts to play significant roles when the firm's annual revenue is above \$1 million, the firm's age is above five years, or there is a high level of information

availability indicated by having audited financial statements and having sufficient resources to grow. When a firm's annual revenue is above \$10 million or its age above twenty years, business owners prefer ABL/Bank financing over the rest of their funding choices. Overall, we find supporting empirical evidence of firm funding continuum starting from Friends/Family toward ABL/Bank, Angels, PE, and finally toward VC based on the firm's size, age, and information availability.

Our findings reveal that small business owners rely on funding from their Friends/Family in the early stage of life cycle. We find that ABL/Bank play significant roles only when these private firms are relatively older (above five years), have annual revenue above \$1 million, and have higher information availability. Government policies to restart the Small Business Association (SBA) lending program disproportionately help those firms in their later stage. In contrast, tax cuts for small businesses and policies that address increased access to capital will provide an immediate incentive for private businesses to grow in their early stage of life cycle. More importantly, policymakers should take into account the role of informal funding from Friends/Family who helps small business owners/entrepreneurs to start their businesses.

While this study provides new venues for characteristics of the private capital market, the roles of financing from Friends/Family, and business owners' perspective over their funding sources, it is subject to weaknesses of standard survey studies. Graham and Harvey (2001) point out that survey studies suffer from two most obvious weaknesses: (1) a survey study measures survey participants' beliefs that do not necessarily reflect their actions and (2) a survey study may suffer from a sample selection bias where respondents who filled out the survey may not represent the whole population. Comparing our results with Robb and Robinson (2010), we recognize that survey results vary across different time periods. Additionally, since not all participants completed all the questions on our survey questionnaires, this study is limited by availability of data points.

As the Pepperdine Private Capital Markets Project surveys continue to evolve in future years, we continue to provide more robust time varying insights on what influences business owners' impressions of their funding, the firms' capital structure, and cost of capital for small privately owned firms. As Myers and Majluf (1984) indicated in their seminal work, information asymmetries between initial owners and external investors creates underinvestment since existing owners/managers are unable to raise external capital to capture growth opportunities. We propose to examine how funding sources influence business owners' abilities to capitalize their firms' growth opportunities in our future study.

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Table I Performance and Capital Needs

	Annual Revenues	Annual EBITDA	Capital Needs
Negative	-	15.9%	-
Zero	6.9%	4.9%	-
Up to \$100K	13.6%	22.9%	-
\$100K to \$500K	16.3%	20.4%	25.5%
\$500K to \$1M	7.6%	9.6%	17.6%
\$1M to \$3M	15.0%	11.0%	13.2%
\$3M to \$5M	10.0%	4.9%	18.1%
\$5M to \$10M	9.2%	2.0%	11.0%
\$10M to \$25M	8.9%	1.4%	7.5%
\$25M to \$50M	4.7%	0.7%	2.2%
\$50M to \$100M	2.5%	0.5%	1.8%
\$100M to \$500M	3.1%	1.1%	2.2%
Above \$500M	2.2%	4.7%	0.9%

Table II Business Operation and Work Experience

Years	Business Operation	Working Experience
Less than 1	8.5%	1.1%
1 to 2	12.2%	3.3%
2 to 5	14.3%	8.7%
5 to 10	17.4%	11.9%
10 to 20	18.0%	26.2%
20 to 30	12.8%	48.9%
30 to 50	7.4%	-
More than 50	9.5%	-

Table III Business Owners Impressions of Cost and Benefits

This table presents the business owners impressions of cost and benefits of their funding sources. Business owners' impressions of cost (Cost) have discrete values between 1 and 7 and business owners' impressions of benefits (Benefits) is rescaled to a discrete value between 1 and 7 such that it is comparable to their impressions of cost. Friends/Family (F/F) represents business owners' impressions of cost and benefits from friends and family funding. Angels represents business owners' impressions of cost and benefits from angels funding. VC represents business owners' impressions of cost and benefits from VC funding. PE represents business owners' impressions of cost and benefits from PE funding. ABL/Bank represents business owners' impressions of cost and benefits from asset-based lenders and bank. The Net Benefit represents the business owners' impressions of benefits minus their impressions of cost for each class of fund provider relative to Friends/Family funding. Firm size represents firm's annual revenue. Firm age represents the number of years of operation. And information availability is determined by whether firms have their annual financial statements audited by a CPA and/or they claim that they have enough resources to grow or not. Friends/Family indicates that business owners currently receive funding from their friends and family. Angels represents current funding from angel investors. VC represents current funding from venture capital. PE represents current funding from private equity funds. ABL/Bank represents current funding from asset-based lenders and banks. ^{a, b} and ^c represent statistical significance at 1%, 5%, and 10% respectively.

Funding Sources	ALL SAMPLE		FIRM SIZE													
			Zero Revenue		Less than \$100K		\$100K - \$500K		\$500K - \$1M		\$1M - \$5M		\$5M - \$10M		Over \$10M	
			Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits
Friends/Family (F/F)	3.409	3.419	3.13	3.753	3.159	3.966	3.185	3.321	3.818	3.835	3.522	3.272	3.354	3.22	3.603	3.137
Angels	5.129	4.208	5.13	4.773	5.136	4.833	5.055	4.337	5.318	4.442	5.022	4.068	5.29	3.546	5.19	3.885
VC	6.079	4.329	6.13	4.9	6.155	4.785	6.092	4.684	6.304	4.326	5.847	4.166	6.093	3.64	6.218	4.054
PE	5.753	4.204	5.863	4	5.853	4.701	5.686	4.348	6	4.581	5.627	4.066	5.625	3.872	5.846	4.057
ABL/Bank	4.818	3.629	5.047	3.22	5.023	3.59	4.826	3.413	5.304	3.213	4.726	3.727	4.742	3.802	4.587	3.903
F/F-ABL/Bank	-1.409	-0.21	-1.917	0.533	-1.864	0.376	-1.641	-0.092	-1.486	0.622	-1.204	-0.455	-1.388	-0.582	-0.984	-0.766
Net Benefits	1.199		2.450		2.240		1.549		2.108		0.749		0.806		0.218	
T-test	7.752^a		4.293^a		5.288^a		4.492^a		4.469^a		2.569^b		3.207^a		2.818^a	
F/F-Angels	-1.72	-0.789	-2	-1.02	-1.977	-0.867	-1.87	-1.016	-1.5	-0.607	-1.5	-0.796	-1.936	-0.326	-1.587	-0.748
Net Benefits	0.931		0.98		1.11		0.854		0.893		0.704		1.61		0.839	
T-test	6.682^a		1.619		2.961^a		2.093^b		2.472^b		2.719^a		2.935^a		3.348^a	
F/F-PE	-2.344	-0.785	-2.733	-0.247	-2.694	-0.735	-2.501	-1.027	-2.182	-0.746	-2.105	-0.794	-2.271	-0.652	-2.243	-0.92
Net Benefits	1.559		2.486		1.959		1.474		1.436		1.311		1.619		1.323	
T-test	13.026^a		3.082^a		5.249^a		4.613^a		5.091^a		5.669^a		4.750^a		6.394^a	
F/F-VC	-2.67	-0.91	-3	-1.147	-2.996	-0.819	-2.907	-1.363	-2.486	-0.491	-2.325	-0.894	-2.739	-0.42	-2.615	-0.917
Net Benefits	1.76		1.853		2.177		1.544		1.995		1.431		2.319		1.698	
T-test	11.348^a		2.271^b		5.114^a		3.881^a		4.091^a		4.72^a		4.351^a		5.924^a	
Sample Size	339	339	23	23	46	46	57	57	23	23	93	93	34	34	63	63

Table III Business Owners Impressions of Cost and Benefits (Continue)

Funding Sources	FIRM AGE												INFORMATION AVAILABILITY			
	Less than 1 year		1-2 years		2-5 years		5-10 years		10-20 years		Over 20 years		Low Information		High Information	
	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits	Cost	Benefits
Friends/Family	3.148	3.629	2.809	3.43	3.537	3.539	3.363	3.349	3.578	3.233	3.611	3.434	3.382	3.485	3.515	3.154
Angels	4.851	4.822	5.357	4.27	5.37	4.437	5.218	4.089	4.947	4.173	5.022	3.938	5.135	4.318	5.106	3.777
VC	5.851	4.808	6.452	4.63	6.218	4.9	5.963	4.388	6.148	4.014	5.924	3.846	6.08	4.441	6.078	3.888
PE	5.615	4.577	5.925	4.389	5.961	4.474	5.75	4.255	5.527	4.04	5.736	3.916	5.732	4.241	5.833	4.066
ABL/Bank	4.884	3.311	4.935	3.083	4.98	3.444	4.714	3.335	4.605	3.626	4.855	4.259	4.797	3.525	4.901	4.022
F/F-ABL/Bank	-1.736	0.318	-2.126	0.347	-1.443	0.095	-1.351	0.014	-1.027	-0.393	-1.244	-0.825	-1.415	-0.04	-1.386	-0.868
Benefits-Cost T-test	2.054 3.489^a	2.473 5.955^a	1.538 4.486^b	1.365 4.628^a	0.634 1.492	0.419 1.354	1.375 7.846^a	0.518 1.807^c								
F/F-Angels	-1.703	-1.193	-2.548	-0.84	-1.833	-0.898	-1.855	-0.74	-1.369	-0.94	-1.411	-0.504	-1.753	-0.833	-1.591	-0.623
Benefits-Cost T-test	0.510 0.701	1.708 4.260^a	0.935 2.648^b	1.115 3.694^a	0.429 1.894^c	0.907 3.246^a	0.920 5.711^a	0.968 3.538^a								
F/F-PE	-2.467	-0.948	-3.116	-0.959	-2.424	-0.935	-2.387	-0.906	-1.949	-0.807	-2.125	-0.482	-2.35	-0.756	-2.318	-0.912
Benefits-Cost T-test	1.519 2.610^b	2.157 4.597^a	1.489 3.137^a	1.481 4.927^a	1.142 3.068^a	1.643 5.197^a	1.594 8.741^a	1.406 4.09^a								
F/F-VC	-2.703	-1.179	-3.643	-1.2	-2.681	-1.361	-2.6	-1.039	-2.57	-0.781	-2.313	-0.412	-2.698	-0.956	-2.563	-0.734
Benefits-Cost T-test	1.524 2.146^b	2.443 5.744^a	1.320 3.285^a	1.561 4.413^a	1.789 5.911^a	1.901 6.362^a	1.742 9.745^a	1.829 5.959^a								
Sample Size	28	28	42	42	57	57	57	57	60	60	95	95	272	272	67	67

Table IV Ordered Logistic Regressions for Firm Continuum

The dependent variables are business owners' impressions of impressions of benefits (Benefits), cost (Cost), and impressions of the Net Benefit (Benefits minus Cost). Business owners' impression of benefits (Benefits) is rescaled to 1 to 7 such that it is comparable to their impressions of cost. All dependent variables have values between 1 and 7. The independent variables are firm annual revenue (FIRM SIZE), firm age (FIRM AGE), and whether firms have annual financial statements that are audited by a CPA and have necessary resources to grow or not (INFORMATION AVAILABILITY). Firm annual revenue is classified into twelve values from 1 to 12 to represent zero revenue, less than \$100,000, \$100,000 to \$500,000, \$500,000 to \$1 million, \$1 million to \$3 million, \$3 million to \$5 million, \$5 million to \$10 million, \$10 million to \$25 million, \$25 million to \$50 million, \$50 million to \$100 million, \$100 million to \$500 million, and greater than \$500,000. Firm age is classified into eight values from 1 to 8 to represent less than 12 months, 1-2 years, 2-5 years, 5-10 years, 10-20 years, 20-30 years, 30-50 years, and more than 50 years. Four industry dummy variables that represent four major industries: service, manufacturing, finance, and technology are included in each regression but not reported to conserve space. ^a, ^b and ^c represent statistical significance at 1%, 5%, and 10% respectively.

	Friends/Family	Angels	VC	PE	ABL/Bank
A. Benefits					
FIRM SIZE	-0.0988 (2.33) ^b	-0.1503 (3.28) ^a	-0.1268 (2.87) ^a	-0.0499 (1.16)	0.0785 (2.02) ^b
Pseudo R-square	0.0098	0.0233	0.0267	0.0133	0.0076
Sample Size	315	311	311	302	302
FIRM AGE	-0.0762 (1.17)	-0.1601 (2.76) ^a	-0.2176 (3.97) ^a	-0.1014 (1.85) ^c	0.2009 (3.91) ^a
Pseudo R-square	0.0065	0.0183	0.0333	0.0156	0.0162
Sample Size	313	309	309	300	300
INFORMATION AVAILABILITY	-0.4800 (1.64) ^c	-0.6797 (2.54) ^a	-0.5823 (2.38) ^b	-0.1362 (0.49)	0.4188 (1.68) ^c
Pseudo R-square	0.007	0.0163	0.0225	0.0126	0.007
Sample Size	316	312	312	303	303
B. Cost					
FIRM SIZE	0.0781 (2.16) ^b	0.0427 (1.09)	0.0103 (0.26)	0.0155 (0.42)	-0.0620 (1.78) ^c
Pseudo R-square	0.0055	0.0086	0.0075	0.0066	0.0074
Sample Size	329	325	326	320	319
FIRM AGE	0.1376 (2.79) ^a	-0.0359 (0.70)	-0.0876 (1.60)	-0.0461 (0.89)	-0.0102 (0.20)
Pseudo R-square	0.0078	0.0086	0.0095	0.0073	0.0047
Sample Size	328	324	325	319	318
INFORMATION AVAILABILITY	0.0797 (0.26)	0.1362 (0.49)	0.0874 (0.33)	0.1639 (0.68)	0.2544 (1.10)
Pseudo R-square	0.002	0.0081	0.0071	0.0069	0.006
Sample Size	331	327	328	322	321
C. Benefits minus Cost (Net Benefit)					
FIRM SIZE	-0.1035 (2.72) ^a	-0.1107 (2.68) ^a	-0.1111 (2.51) ^b	-0.0476 (1.27)	0.1313 (3.44) ^a
Pseudo R-square	0.0061	0.0090	0.0099	0.0045	0.0089
Sample Size	309	304	305	297	295
FIRM AGE	-0.1335 (2.33) ^b	-0.0813 (1.53)	-0.1313 (2.35) ^b	-0.0556 (1.02)	0.1835 (3.46) ^a
Pseudo R-square	0.0057	0.0089	0.0059	0.0043	0.0093
Sample Size	307	302	303	295	293
INFORMATION AVAILABILITY	-0.2669 (1.05)	-0.3780 (1.49)	-0.5115 (1.97) ^b	-0.2429 (0.89)	0.3120 (1.23)
Pseudo R-square	0.0032	0.0060	0.0080	0.0044	0.0051
Sample Size	310	305	306	298	296

Figure I
Sample Industry Breakdown

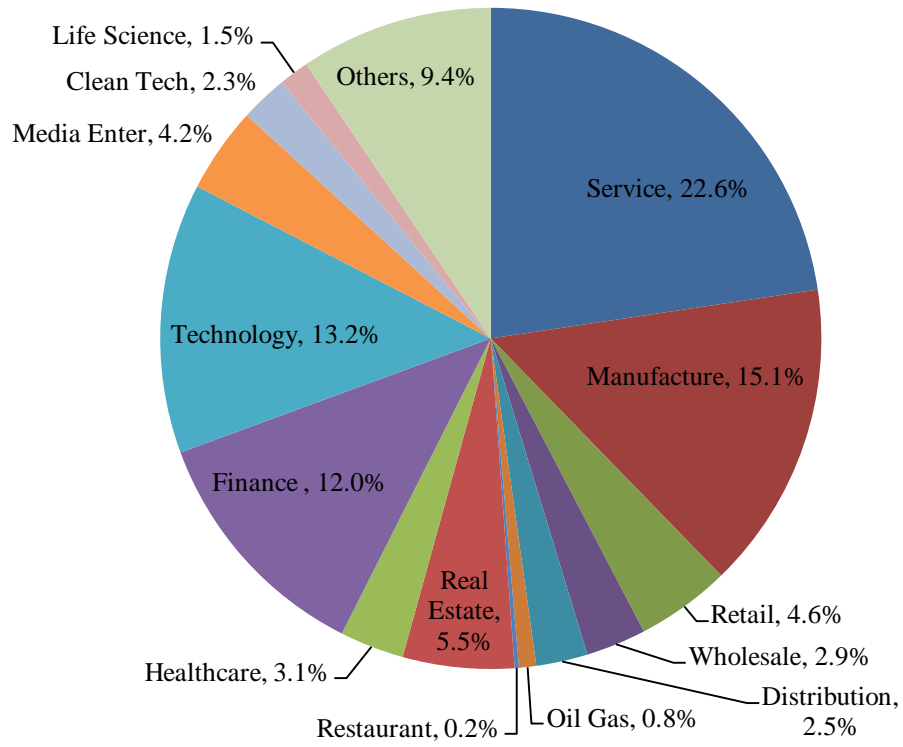
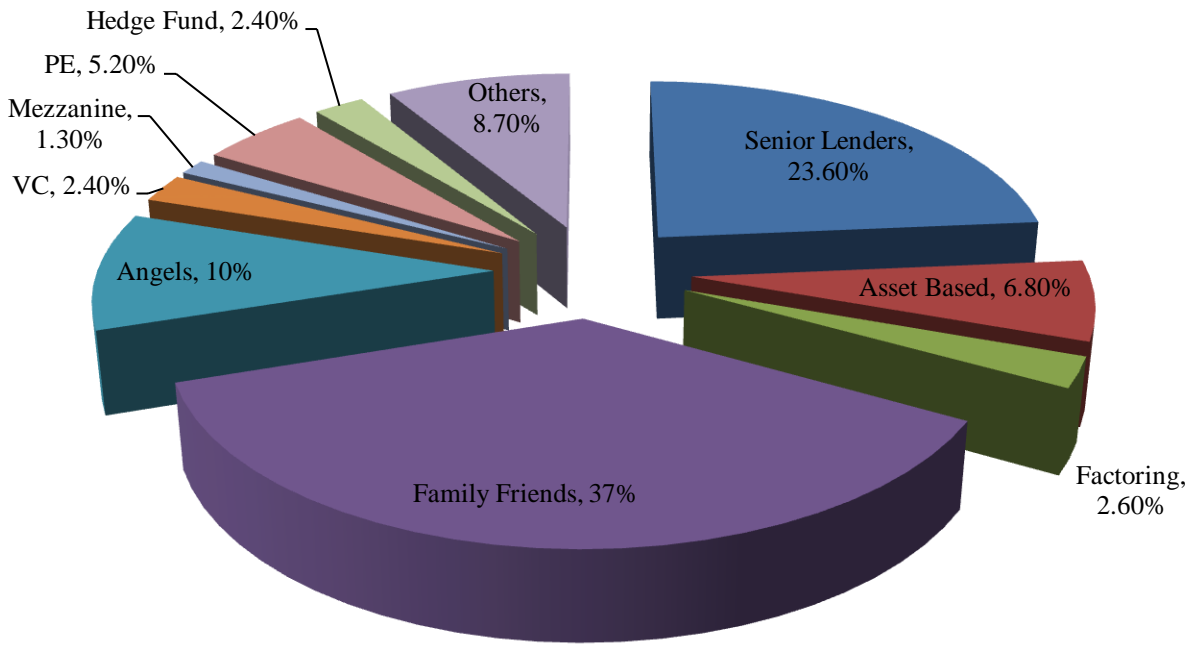


Figure II
Sources of Capital



Appendix A
Sample of Survey Forms

Is your firm currently financed by any of the following sources? (Check all that apply.)

- Friends and family
- Angel investors
- Venture Capital Fund
- Mezzanine Fund (subordinated or junior debt)
- Private Equity Fund
- Hedge Fund
- Factor
- Asset based lender
- Bank Loan
- Other

Which of the following best categorizes the size of your annual revenues (last 12 months)?

- \$0
- More than \$0 but less than or equal to \$100,000
- More than \$100,000 but less than or equal to \$500,000
- More than \$500,000 but less than or equal to \$1 million
- More than \$1 million but less than or equal to \$3 million
- More than \$3 million but less than or equal to \$5 million
- More than \$5 million but less than or equal to \$10 million
- More than \$10 million but less than or equal to \$25 million
- More than \$25 million but less than or equal to \$50 million
- More than \$50 million but less than or equal to \$100 million
- More than \$100 million but less than or equal to \$500 million
- Greater than \$500 million

How long has your business been operating?

- Less than 12 months
- 1-2 years
- 2-5 years
- 5-10 years
- 10-20 years
- 20-30 years
- 30-50 years
- More than 50 years

Appendix A (Continue)
Sample of Survey Forms

What are your impressions of the cost of the following capital sources?

	Very Inexpensive	Inexpensive	Slightly Inexpensive	Neutral	Slightly Expensive	Expensive	Very Expensive
Friends and family	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Angel investor	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Venture capital fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Mezzanine Fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Private equity fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Factor	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Asset-based lender	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Senior lender (bank)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

What are your impressions of the benefits provided by the following capital sources (in addition to providing financial capital and ignoring the cost of financing)?

	No Benefits provided	Slightly Beneficial	Moderately Beneficial	Very Beneficial	Extremely Beneficial
Friends and family	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Angel investor	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Venture capital fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Mezzanine Fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Private equity fund	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Factor	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Asset-based lender	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Senior lender (bank)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>