AN EDUCATIONAL POLICY BRIEF FROM THE EWING MARION KAUFFMAN FOUNDATION

ENTREPRENEURSHIP POLICY DIGEST

JUNE 2, 2015

HOW ENTREPRENEURS ACCESS CAPITAL AND GET FUNDED

Ask any entrepreneur about his or her greatest challenge, and the conversation will likely turn to capital. Finance is the lifeblood of every company, but for new firms, capital is especially critical. Realizing this, policymakers have pursued a wide variety of strategies, from government grants to investment funds to special tax breaks. Even with these measures, most firms rely on private external financing in two forms: debt and equity.

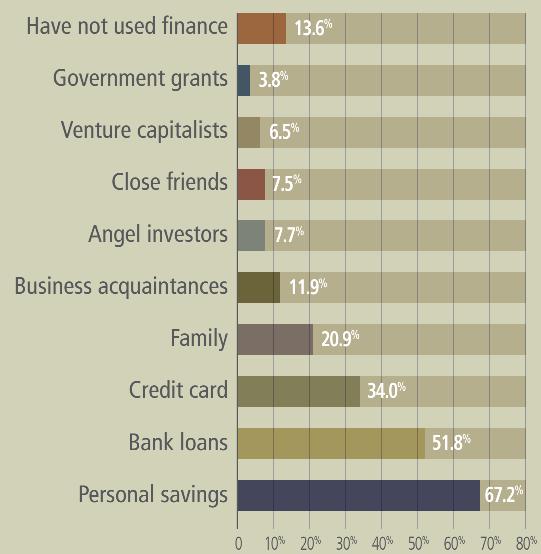
Debt dominates for the typical firm, and banks dominate among other forms of debt. Indeed, the primary source of capital for young firms is banks, eclipsing all other sources of financing. About 40 percent of the initial startup capital in a new business is debt that originates from banks[1]. Small banks, in particular, excel at lending to entrepreneurs, as they specialize in soft information that can substitute for more traditional measures of risk.

Equity is much rarer, but can be more impactful. The main sources of equity financing are angel investors and venture capitalists, which finance less than 3 percent and 1 percent of new firms, respectively. Despite their undersized presence, active investors like these can add tremendous value to companies through their expertise, networks, and guidance. As a result, recipient firms see many advantages. For example, venture-backed companies tend to professionalize earlier, have an increased likelihood of an Initial Public Offering (IPO), and have greater post-IPO survival rates.

Aside from these forms of finance, young firms are increasingly using non-traditional channels to raise capital. Crowdfunding[2], in particular, has garnered much attention, and with good reason—online loan platforms are growing at an astronomical rate, and in the first half of 2014, more than 20 percent of startups applying for loans did so through an online lender. Other sources like accelerators, government prizes, and grants round out the funding mix.

Each year, *Inc.* magazine lists the 5,000 fastest growing companies in America. In 2014, the Kauffman Foundation surveyed firms listed by *Inc.* since 1996 to learn about their sources of funding.

INC. FAST-GROWING FIRMS SOURCES OF FUNDING



WEIGHING THE PROS AND CONS OF FUNDING SOURCES

	ADVANTAGES	DISADVANTAGES
DEBT	Bank debt allows the founder to maintain full control of the business.	Bank debt is mainly about cash—it doesn't provide any of the non-financial benefits of other types of financing.
EQUITY	VC-backed companies have faster employee growth, greater sales, and faster sales growth.	Misaligned incentives can cause firms to IPO earlier than optimal, or founders to be replaced.
CROWDFUNDING	Crowdfunding can help entrepreneurs get feedback and determine the validity of their idea.	Crowdfunding may lead entrepreneurs to disclose business details or intellectual property, thereby exposing them to competitors.
GRANTS	Grants can stimulate R&D and technology commercialization that would not have happened otherwise.	Most grants are very specific. For example, more than two-thirds of SBIR-funded companies had a founder who was previously an academic.

[1] See *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* in the "For More Information" section for a discussion about home equity lines of credit.

[2] The four main types of crowdfunding are: donation-based (e.g., Kiva), reward-based (e.g., Kickstarter), debt-based (e.g., Prosper, Lending Club), and equity-based.

ENTREPRENEURIAL FINANCE AND POLICY

FEDERAL

FACILITATE INVESTMENT OPPORTUNITIES

Crowdfunding was the most highly anticipated part of the Jumpstart Our Business Startups (JOBS) Act of 2012, but the Securities and Exchange Commission (SEC) has yet to finalize the rules to govern equity crowdfunding. Nevertheless, other provisions of the law are being implemented to make more capital available to startups.

- Title II expanded the number of investors entrepreneurs could communicate with as they sought funding.
- Title IV, or Regulation A+, will allow investors to invest up to ten times as much in startups and with less onerous registration requirements.

ENSURE LARGE POOL OF QUALIFIED INVESTORS

The SEC has considered increasing the income and net worth requirements necessary to be labeled an accredited investor, which could make up to a quarter of active angel investors ineligible. These changes would shrink the pool of available investment capital and constrict entrepreneurship. They would also counteract positive developments facilitated by platforms like AngelList, which connect investors and startups.

PROVIDE CAPITAL TO HELP STARTUPS COMMERCIALIZE TECHNOLOGY

Between publicly funded basic research, and privately funded commercialization efforts, there is a financing gap referred to as the "valley of death." Programs like Small Business Innovation Research (SBIR) grants help bridge this gap, and can facilitate longer-term employment growth. One of the principal ways that SBIR does this is by acting as a signal of quality, which can attract further external financing. As a result, programs like SBIR have large net social benefits.

STATE AND LOCAL

STATE RESEARCH & DEVELOPMENT (R&D) PROGRAMS HAVE PROMISE

States have led a number of innovative efforts to improve R&D. Prime examples include the $1.6 billion Ohio Third Frontier initiative and the Michigan Life Science Corridor program. Even simpler measures, like state matching of SBIR grants, have proven to be associated with increased competitiveness in securing future funding.

RETHINK PUBLIC VENTURE FUNDS

Public venture funds, which operate like venture capital funds but with public money, have failed to promote two essential elements of successful entrepreneurship: learning and connectivity among entrepreneurs. Public venture funds can be reformed by splitting up single, large investments and instead making multiple, smaller investments. Local entrepreneurs also can be involved by helping select award winners.

PROMOTE OPEN DATA

Without high-quality, publicly available data about the financing methods of startups, researchers cannot answer questions about the types of financing entrepreneurs use and their success. Expanding access to valuable data sources will bolster knowledge about what works.

FOR MORE INFORMATION

Click on the links for access to the following resources, or contact Jason Wiens at jwiens@kauffman.org:

- Consult Kauffman's State of the Field to see what leading scholars have to say on Debt, Venture Capital, Angels, and Crowdfunding.
- Watch Kauffman Founders School videos on "The Art of Startup Finance."
- Read *Online Lending: A Boon for Young and Small Companies?*
- Read *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game*.

To sign up to receive subsequent Policy Digests, go to www.kauffman.org/policydigest.