The Financing Choices of Young Firms

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Myths from the Classroom

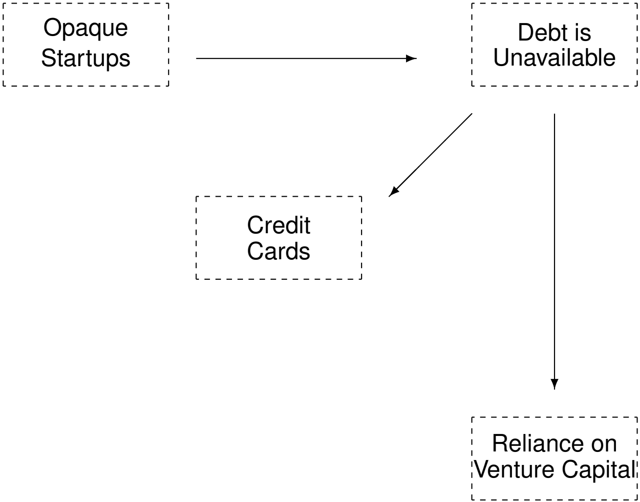
Opaque
Startups

Myths from the Classroom

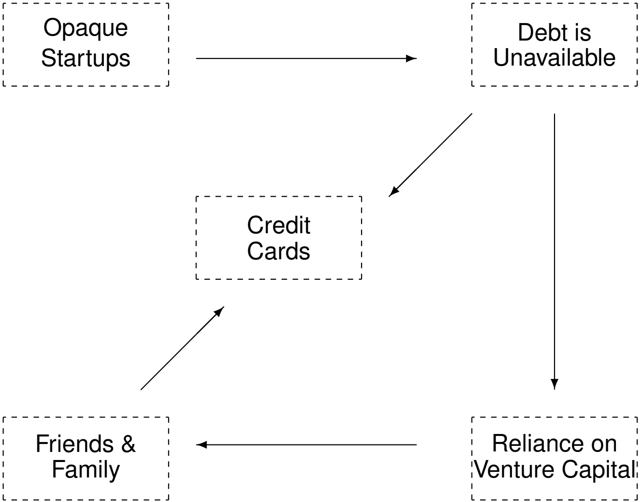
Opaque Startups

Debt is Unavailable

Myths from the Classroom



Myths from the Classroom



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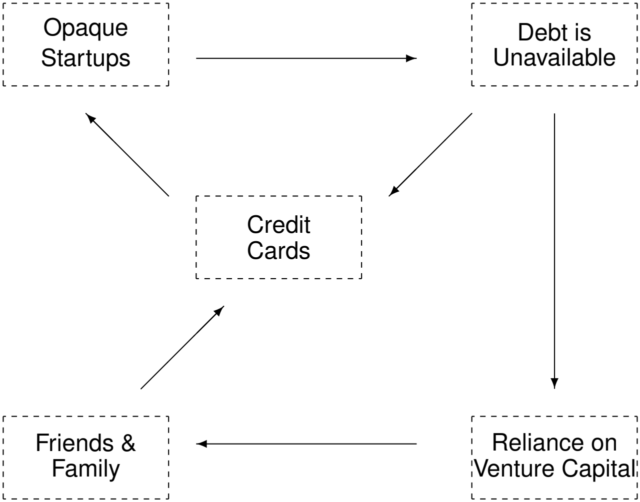
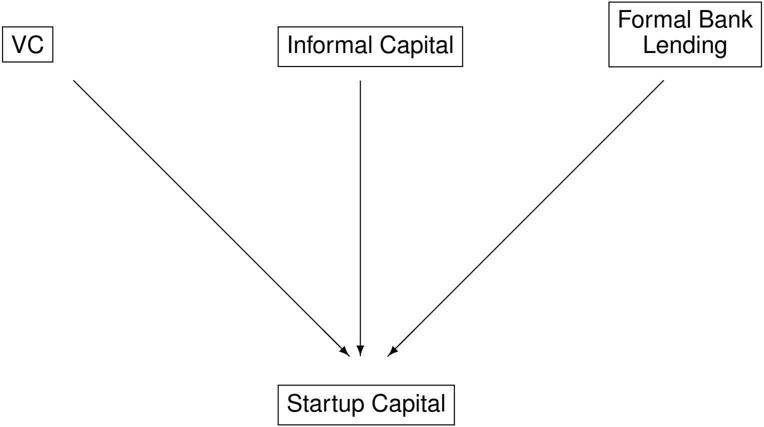


A more accurate picture?



Overview

- Evidence on the role of debt in funding startups
  - Distinct from the role of banks in small business activity
- The importance of housing as a source of collateral
- Policy conclusions

The Kauffman Firm Survey

Overview

- Multi-year panel on roughly 5,000 firms that were formed in 2004. ‘Formation’ means that for the first time in 2004, they:
    - Paid state unemployment taxes, or FICA tax;
    - Established a legal status for the business or used a tax id number;
    - Used a Schedule C on a personal tax return.
- This generates a heterogeneous panel in terms of owner and business characteristics at founding
- Highly detailed data on business relationships, financial structure, founder background information.

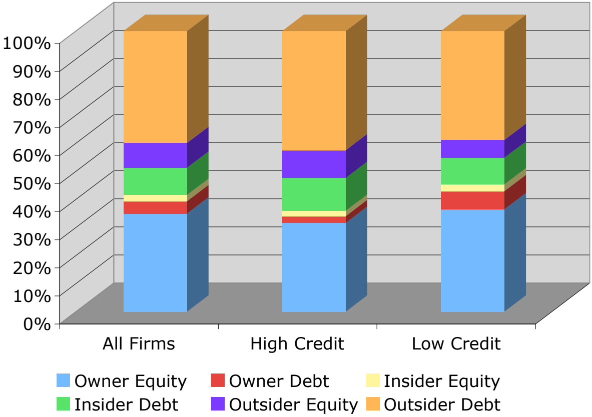
Kauffman Firm Survey

Key Survey Statistics

- Founder Demographics
  - Overwhelmingly white, non-hispanic, males
  - Median age is 35-44; over $\frac{1}{3}$ are over 45
  - The median respondent has $>$ 10 yrs. industry experience
  - More than 40% of respondents have had at least one prior startup
  - About $\frac{1}{2}$ have at least a Bachelor's degree
- Operating Statistics
  - About $\frac{1}{3}$ are pre-revenue; but around $\frac{1}{6}$ have revenues that exceed $100K

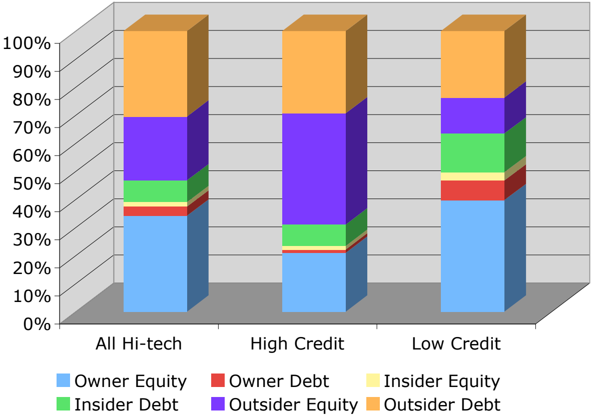
Kauffman Firm Survey 2004

All Firms

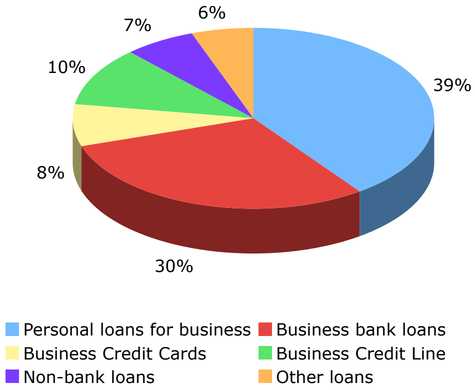


Kauffman Firm Survey 2004

High Tech Firms

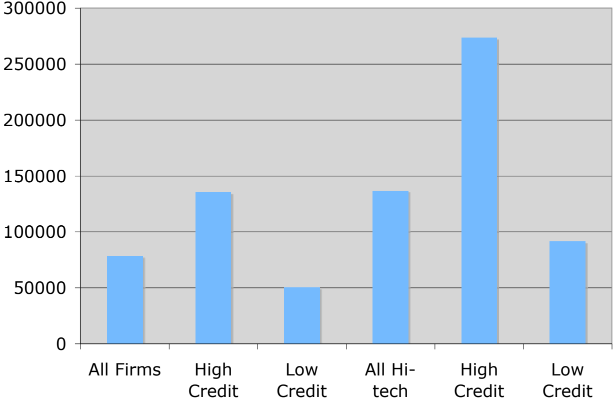


A Closer Look at Debt

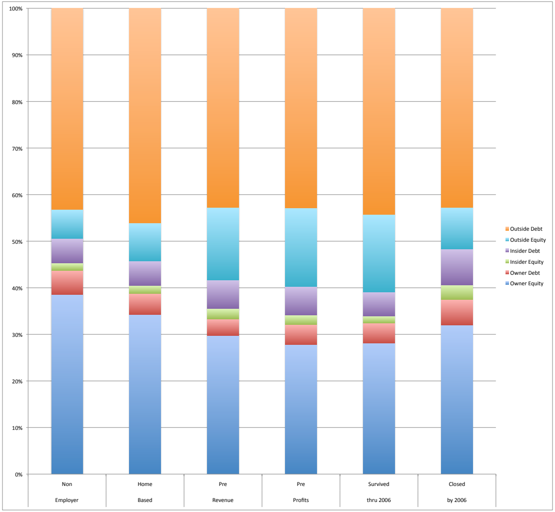


Kauffman Firm Survey 2004

The Difference: Total Capital

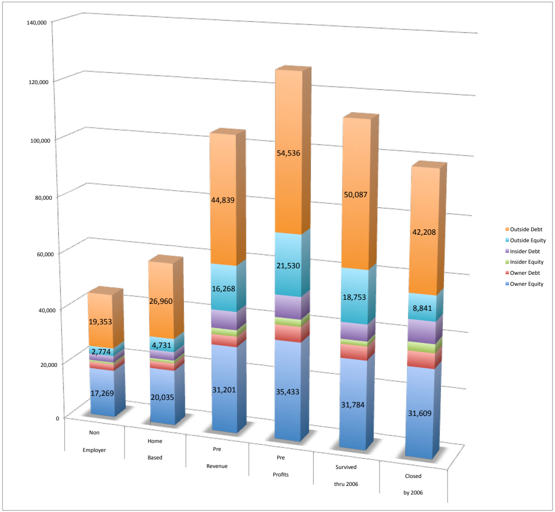


What about Garage businesses?

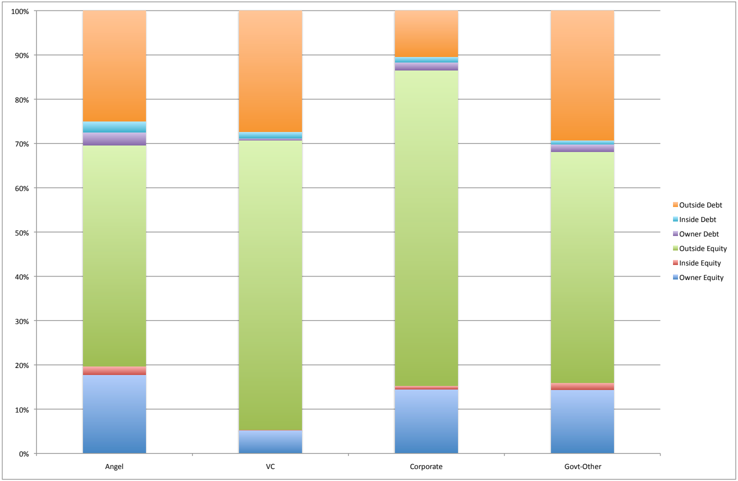


What about Garage businesses?

Garage businesses vary by size

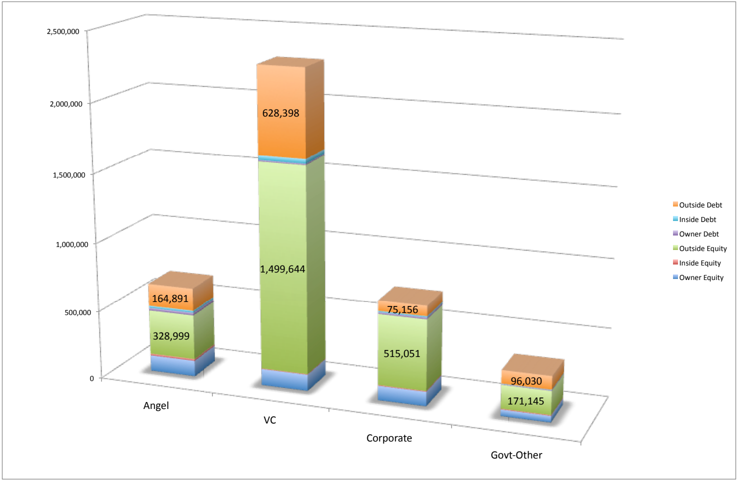


What about Equity-backed Businesses?



What about Equity-backed Businesses?

Again, Size Varies



To summarize

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- This is an extremely robust fact:
  - Robust across firm types.
  - Robust over time: debt continues to be the primary source of funding throughout the first four years of the firm's life.
  - Complementarity of debt/equity demonstrates that financing constraints are present.

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- This is an extremely robust fact:
    - Robust across firm types.
    - Robust over time: debt continues to be the primary source of funding throughout the first four years of the firm's life.
    - Complementarity of debt/equity demonstrates that financing constraints are present.
- Variation in firm characteristics has a first order effect on startup size, but only a second order effect on the mix of debt/equity.
- Evidence that the variation in supply of debt is partly responsible for findings.

Capital Structure and Housing

Access to outside debt is greater when homes are more pledgable as collateral.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Home supply elasticity	0.0163***	0.0156***	0.0153***	0.0149**		0.0150***	0.0163***
	(0.0058)	(0.0058)	(0.0059)	(0.0058)		(0.0058)	(0.0058)
State bankruptcy exemption					-1.92		-2.52*
					(1.33)		(1.48)
Industry dummies	No	Yes	No	Yes	Yes	Yes	Yes
Owner characteristics	No	No	Yes	Yes	Yes	Yes	Yes
Credit score dummies	No	No	No	No	No	Yes	Yes
Observations	2,564	2,564	2,466	2,466	3,389	2,466	2,466
R^2	0.004	0.029	0.040	0.058	0.048	0.061	0.062

The Home Equity / Entrepreneurship Channel

Adelino, Schoar and Severino, 2012

Between 2002-2007, areas with strong exogenous home price growth saw stronger employment growth

- This employment growth was strongest among the smallest firms
    - Effect for 1-4 employee firms is $\sim$ 3x that of $>$ 20-person firms
- And among firms with lower capital requirements
    - Effect for small firms: 3 times larger in low capital-intensive sectors than high intensive ones
    - There is generally no housing effect on “large" establishments in capital intensive industries

The Small Business Employment Myth

Haltiwanger, Jarmin, Miranda, 2012

- Controlling for age, there is no systematic relationship between firm size and employment
- “Small firms" are not job creators.
- Young firms are job creators.
  - They typically start small.
  - The good ones grow, the bad ones die, destroying jobs.
  - On net, creation outweighs destruction.

What Do These Facts Say About Policy?

To me, they point to three policy challenges associated with promoting entrepreneurship:

- We need to be careful to decouple policy towards business starts from policy towards small business.
- We need to embrace the fact that promoting innovative growth almost surely means rethinking the way we provide access to debt.
- We need to understand that the housing crisis is also an entrepreneurship crisis.

In Conclusion

- Most “small business employment growth" is actually “young business employment growth"
- Startups access bank debt even at their earliest stages of life.
- Variation in firm characteristics has a first order effect on startup size, but only a second order effect on the mix of debt/equity.
- Home equity is an important source of collateral for startups.
- This means that in terms of policy, we need to embrace creative solutions to debt access for small firms