Initiative on
Business and
Public Policy
at BROOKINGS

EVENT SUMMARY | DECEMBER 3, 2012

Promoting Innovative Growth: Venture Capital, Growth Equity, and IPOs

Event Summary

Since the financial crisis, two critical questions have faced economists and policymakers: How do we increase business hiring and business investment? To address these questions, the Brookings Institution and the Private Capital Research Institute (PCRI) recently co-hosted a day-long discussion featuring Congressman Jim Himes (D-CT), business leaders, and academics. In his opening remarks at the conference, Martin Baily, Senior Fellow and Director of the Private Capital Project at the Brookings Institution, explained that one important factor influencing the hiring decisions of young businesses is lack of funding. Therefore, much of the discussion focused on adding clarity and depth to our understanding of why young businesses have trouble acquiring funding, the alternatives available to early-stage entrepreneurs, and the likely future funding sources for young companies.

In addition, the event examined the financing of young but already profitable firms, which have been shown to be key drivers of employment and economic growth. In particular, the conference also considered growth equity for emerging companies, the recent history and likely future of the initial public offering (IPO) market, the changing mindset of leading limited partners (LPs) in putting capital into venture capital (VC) and growth capital funds. In addition, the session looked forward, examining possible alternative sources of funding for young companies such as crowdfunding, and future areas of cooperation between government officials and academics.

The Financing Alternatives of Young Companies

Professor David Robinson of Duke University's Fuqua School of Business presented his findings on the role of debt and bank lending in the start-up market. His presentation provided evidence on the important role leverage plays in funding start-ups, discussed the importance of housing as a source of collateral, and concluded with specific policy recommendations.

Dr. Robinson began by debunking a popular myth – that start-ups are so opaque to assess that they are necessarily screened out of the formal debt market. According to Dr. Robinson, a more accurate picture is that start-ups receive capital from VCs, "informal capital" (e.g. family, friends, and personal finances), and formal bank lending. While most start-ups do not get VC funding, this source of capital is a very important source for the few that rely on them. Dr. Robinson showed evidence that 40% of the capital structure of start-ups is from outside debt (provided by banks), the next biggest source is owner equity, and then informal capital, and other sources of equity make up the rest. He finds that firm characteristics have a first order effect on size, but only a second order effect on the composition of their capital structure.

Start-ups and debt seem to mix because of the presence of assets on the part of the business owner which can be pledged as collateral. He demonstrated this relationship by looking at the financing choices of businesses that experienced less and more of a run-up in house prices (and hence owners' equity, which could be borrowed against) during the decade of the 2000s.

He left us with three policy recommendations. First, be careful to decouple policy towards start-ups from policy towards small-businesses. The reason is that small businesses do not create jobs; start-ups, which happen to be small initially, create jobs. Second, innovative growth means creating ways for start-ups to access debt. Third, the housing crisis is also an entrepreneurship crisis, such that policy to fix the housing market needs to be paired with policy to boost entrepreneurship.

Panel 1: Growth Equity and its Importance for the U.S. Economy

Professor Ronnie Chatterji of Duke's Fuqua School of Business moderated the discussion between business leaders focusing on how and why mid-size companies grow, and how policies could influence that growth. He began by defining growth capital as midsize companies seeking capital for expansion, and noted this can be a very important time in the life of an enterprise that can also create many jobs.

The panelists included Braun Jones, M&A Managing Director for Outcome Capital; Chuck Morton, Partner

at Venable; Brad Antle, CEO at Salient Federal Solutions; and Walter Florence, Managing Director of Frontenac Capital. They discussed the types of investing decisions they face, the importance of reputation and integrity and their perceptions of the recent government legislation in the JOBS Act.

Their discussion highlighted some of the unique characteristics of growth equity. A discussion with Mr. Antle and Mr. Florence revealed both sides of their investment relationship and the characteristics that defined a successful investment. Mr. Florence discussed the importance of patience and building a relationship with the firms that they have invested in.

Presentation 2: Re-energizing the IPO Market

Mirroring the private equity lifecycle, the conference turned to the process of going public, and to the important issue of returns. Professor Jay Ritter, the Cordell Professor of Finance at the University of Florida, explored why the IPO market is not where it used to be. Dr. Ritter first explored the conventional wisdom for the logic of the JOBS Act enacted in the U.S. earlier in 2012: that the IPO market is broken, largely because the Sarbanes-Oxley Act of 2002 has imposed costs on publicly traded firms, particularly on small firms. He presented data that indicates the downtrend in IPOs began in the late 1990s, well before the enactment of Sarbanes-Oxley, and that the costs imposed by recent regulations alone do not account for the decrease of IPOs for small firms.

Dr. Ritter proposed an alternative hypothesis. Due to economies of scope, the percentage of small firms that are unprofitable has increased. He added that getting big fast is more important now than it was in the past. His evidence showed the percentage of unprofitable small publicly traded firms has increased.

For policy implications, Dr. Ritter offered suggestions on how to re-energize the IPO market. He believed structural changes (e.g., subsidizing analyst coverage, lowering regulatory burdens) to boost IPO activity would not be very effective in generating IPO activity. The reason, he argued, was that companies are not going public because they have less value as a small independent company than as part of a larger organization.

Dr. Ritter offered three policy recommendations. First, he proposed reducing the costs of going public by reducing investment banker fees, and the underpricing of offerings (i.e., the gap between the offering price and where it trades on the first day). Second, patent law should be changed to favor smaller and younger firms. And third, class action lawsuits should be reduced.

Panel 2: Sources of Capital Funds

Professor Josh Lerner, the Jacob H. Schiff Professor of Investment Banking at Harvard Business School and the Director of the PCRI, moderated a discussion with leading LPs, including Scott Kalb formerly of the Korea Investment Corp., Eric Doppstadt of the Ford Foundation, Pierre Lavallee of the Canadian Pension Plan Investment Board (CPPIB), and Joncarlo Mark of the Upwelling Capital Group LLC. Dr. Lerner began by focusing on how heads of endowments, pension funds and sovereign wealth funds viewed VC and growth equity.

Many of the panelists shared a skeptical sentiment towards the venture industry, which has performed poorly since the successes in the late 1990s. One reason for their skepticism was that venture is hard for a large institution to invest in due to capacity constraints. For instance, Mr. Lavallee said the CPPIB only invests in funds raising $750 million because the pension typically only invests a minimum of $150 million in a single fund to avoid issues that may emerge when a single investor has an outsized share of the fund. Dr. Lerner added that this would limit the investment universe to a handful of VC funds, and eliminate many growth equity groups. Moreover, the panelists felt that VC returns had not been good and the industry needs to prove itself.

The other major issue discussed was the alignment of incentives between LPs and GPs. There was a consensus that the state of the market plays a large role in determining the structure of the relationships between LPs and GPs and that the current market, favoring the former.

Presentation 3: Crowdfunding – The New Frontier

Ajay Agrawal, Peter Munk Professor of Entrepreneurship at the Rotman School of Management, University of Toronto, discussed his novel research on crowdfunding, as a potential source of capital for start-ups. He began with the story of Pebble, a watch that connects to a smartphone, and the challenges faced by its founder in having his backers via the Internet. He used the story to illustrate what crowdfunding was, how it works, the similarities and differences it shared with other forms of funding, and the relationship between crowdfunding and home loans.

Dr. Agrawal suggested crowdfunding provided funding that behaved fundamentally differently than other sources of capital. He examined the impact of having funding thresholds in the case of Kickstarter and Sellaband in respect to geographic distance and preexisting relationships. Based on his data, strangers seemed more willing to fund projects that are close to reaching their threshold.

One question related to the bottom line impact on innovation was whether or not crowdfunding was a realistic alternative choice for funding start-ups, especially in light of the loosening regulations in the recent JOBS Act? Dr. Agrawal responded only the future would tell, as it depends on how adventuresome crowdfunders may be as time progresses.

Keynote

Congressman Jim Himes closed the event as the keynote speaker. He shared his unique insights into the shaping of U.S. policy on entrepreneurial financing, based on his past experience at Goldman Sachs, and his experiences working on the JOBS Act in the House of Representatives. He began with an explanation of what the JOBS Act was and how it worked its way through Congress. He concluded with five recommendations:

1) Non-partisan academics need to help Congress better comprehend the complex financial world in an understandable, easily accessible way. This education should focus not just on members of Congress but their staff as well. A good place to start would be Congressional leadership who drive the agenda.

2) There needs to be analysis of the overall regulatory structure answering questions such as: Does it perform well from a public good standpoint? Who are the winners and the losers? For example, should we give tax incentives for debt?

3) It is worth considering how and if the playing field is tilted, given the natural alignment of anti-regulatory proponents and the banking lobby.

4) Financial regulation is different from other regulation in two ways. First, financial institutions are highly interconnected. Second, regulatory decisions typically do not change the balance between business and consumers, but rather between the buy side and the sell side. Thus, the impact of changes to financial regulations may not be linear, which suggests a greater level of analysis should be done on all potential regulations.

5) We need to focus on our educational system to reach the largest audience of future entrepreneurs. While regulations may have an impact on the margins, it is the improvement of the U.S. educational system that will have the largest impact on future innovation and growth. As an example, the Congressman asked why did the JOBS Act move through Congress so quickly while lawmakers did not take up reforms of No Child Left Behind?