Keeping Up with the Gazelles, Part 3: Financing the Herd

Of all the many types of hurdles founders of small companies encounter, financing is a common denominator. *Economy Matters* talked to some gazelle founders about how they financed their endeavors and how it shaped their approach to business.

December 23, 2015

Editor's note:This article is the third in a series of articles that explores the findings of the Atlanta Fed's Gazelle Project.

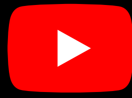
About the Gazelle Project

The Gazelle Project collected qualitative data in a series of face-to-face interviews with southeastern entrepreneurs who started their businesses within the past 13 years. The project was spearheaded by the Atlanta Fed's John Robertson and Ellyn Terry. This series of articles will summarize the results of the project. Articles will examine a decline in business formations to set the context; firm founders' motivations and experience; the role of social capital, including social and professional relationships, in building gazelles; and the financing of gazelles.

The Atlanta Fed's Regional Economic Information Network (REIN) staff interviewed dozens of entrepreneurs across the Southeast to gather information about three broad areas:

- **Human capital:** The skills, knowledge, and experience of the individuals involved in launching and building the businesses.
- **Social capital:** The network of social and professional relationships that the founders use to identify and access resources.
- **Financial capital:** The financing the founders used to begin operations and to fund growth.

The Atlanta Fed's interest in small business focuses on three related issues: the role of small business in job creation; the role of small business in local economic development, and the role of the banking system in small business financing.



Splashy venture capital investments make business headlines for good reason: they're rare. Even among high-growth firms, fewer than 10 percent receive institutional venture capital, according to research by groups including the Ewing Marion Kauffman Foundation.

Far more numerous are the young firms funded through less glamorous methods such as personal savings and credit cards, according to the Atlanta Fed's Gazelle Project and other small business surveys.

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In an Atlanta Fed study of four dozen founders of high-growth companies–gazelles–in the Southeast, 75 percent reported using personal savings to start their company. Roughly a third of the gazelles the Atlanta Fed studied took equity financing, selling a stake in their enterprises. Among those who took equity financing, venture capital investment was rare. Most equity injections came from informal investors, including "golf course" financing and "angels." Some gazelle founders relied heavily on their families. (However, one founder described the downside of family funding when he said it makes a family gathering feel "like a board meeting.")

Those findings from the Gazelle Project are roughly in line with broader studies. For example, in the Kauffman Firm Survey, 63 percent of owners invested their own funds in the business during the first year of operation, while only 4 percent used equity financing from outside investors (see table 1). Although rare, external equity capital was critical for the firms that did use it. Firms receiving outside equity secured an average of $153,608 in the first year of operation, compared to an average owner investment of $36,367.

Table 1
Sources of Small Business Financing

	Percent of businesses using	Mean amount used
Owner equity	63	$36,000
Insider equity	4	$36,000
Outsider equity	4	$154,000
Owner debt	24	$11,000
Insider debt	11	$52,000
Outsider debt	29	$86,000

Note: "Insider equity" includes family members. "Owner debt" was mainly personal credit cards. "Insider debt" includes loans from family members, employees, and owners, "Outsider debt" includes bank loans, business credit cards lines, and other credit lines.

Source: Kauffman 2010 Firm Survey, "An Overview of the Kauffman Firm Survey"

After several years of operations, many gazelles obtained business loans and lines of credit. But most of those founders said they used that capital only for expansion and repaid the loans quickly. The idea that bank credit is more common for expansion than startup is also apparent in the U.S. Census Bureau's 2007 Survey of Business Owners (SBO). According to that survey, firms were twice as likely to use a business loan from a financial institution when they needed expansion capital as when starting up.

A heavy reliance on personal financing sources is a recurring theme in most small business financing surveys. But where the owners obtain the funds is less clear. The Gazelle Project found that most firm founders tapped 401(k) accounts for seed and early-stage funding. Fewer than a third of the entrepreneurs in the survey used home equity lines of credit. The amount needed for startup varies widely by the type of business. Roughly 30 percent of firms in the SBO needed less than $5,000 to start, while 1.5 percent needed $1 million or more. In their firms' formative stages, founders in the Gazelle Project marshaled amounts that ranged from $100, which one spent on online advertisements, to six figures.

A broader look at small-business financing

In addition to the Gazelle Project, the Atlanta Fed conducts a regular survey of small businesses that routinely includes questions about financing. The most recent Small Business Credit Survey (SBCS) was conducted jointly with the New York, Cleveland, and Philadelphia Federal Reserve Banks during the fall of 2014, and asked about firms' credit experiences during the first half of the year (see table 2).

Table 2
Changes in Small Business Financing during Maturation

	Types of business		
Primary funding type	**Startup (%)**	**Grower (%)**	**Mature (%)**
Retained earnings	18	27	10
Personal savings	**43**	**16**	**4**
Equity investment	2	1	0
Credit cards	**17**	**17**	**3**
Loans	8	12	13
Lines of credit	**4**	**21**	**53**
Trade credit	2	1	2
Commercial mortgage	**0**	**2**	**10**

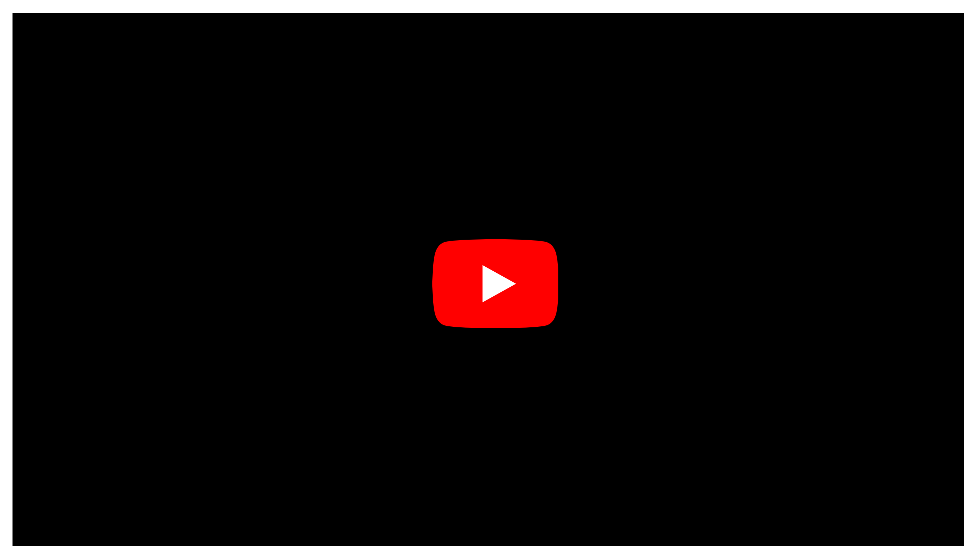
Note: "Startup" indicates a firm five years old or younger. "Grower" indicates a profitable firm with rising revenues. "Mature" indicates a firm more than five years old with 10 or more employees and that holds debt

Source: Joint Small Business Credit Survey Report, 2014; Federal Reserve Banks of Atlanta, Cleveland, New York, and Philadelphia

These surveys and other research show that, even in a strong economy, young businesses often struggle to obtain financing for two major reasons among others. First, young firms are inherently more risky than older firms. Lenders generally assess creditworthiness based on a company's credit history. By definition, young firms have little history. And lenders are cautious with young companies because half of them fail before they are five years old.

The higher risk of small business loans is reflected in the time spent searching for credit and the collateral required when they are approved. On average, firms participating in the SBCS spent 24 hours searching for credit in the first half of 2014. And smaller loans generally require more collateral, as a percentage of loan value, than do larger loans. According to a recent Federal Reserve study, commercial and industrial loans of $10,000 to $99,000 made by commercial banks in the United States required collateral equaling 90 percent of the loan value, for loans made in early February. By comparison, lenders demanded collateral of 45 percent on loans of $1 million to $9.9 million, and 23 percent on loans of $10 million or more. In the SBCS, young companies were much more likely to be discouraged even from applying, anticipating rejection or unaffordable credit terms. Twenty-two percent of firms under five years old were discouraged borrowers compared with 4 percent of "mature" firms.

Second, fledgling companies usually don't want to borrow much, and banks often don't find it profitable to expend the fixed costs of detailed credit analysis in order to make relatively small loans to opaque firms without substantial credit history.



Difficult, not impossible, for young companies to secure financing

Because of creditworthiness concerns and a tendency to seek smaller loans, among other reasons, a majority of microbusinesses with less than $1 million in annual revenue–and young firms (those five years old and younger)—were unable to secure any credit, according to the SBCS.

Yet although difficult, obtaining financing is not impossible for young companies. In the most recent survey, 38 percent of small firms under six years old were able to obtain at least some of the financing they sought. This 38 percent figure for young firms strongly contrasts with the 93 percent of “mature” small firms that found at least some credit. Mature firms are more than five years old, hold debt, and have at least 10 employees.

Though most "mature" firms reported primarily using bank credit to fund their businesses during 2013, nearly half of young firms mostly used their personal savings. Seventeen percent relied primarily on credit cards.

Some of the difficulty obtaining credit stems from the matching of borrowers to lenders. For example, for all applying firms in the SBCS, the approval rate at small regional or community banks was much higher than at large national banks. Fifty-nine percent of firms applying to a small bank received at least some credit, compared to 31 percent of firms applying to a large bank.

Yet roughly similar proportions of firms applied to each source. Online lending could alleviate some of the mismatch in borrowers to lenders, and interest appears to be growing. In the first half of 2014, 18 percent of firms sought a loan or line of credit online and 38 percent of applying firms were approved, according to the survey.

For small businesses, a lack of available credit remains a significant challenge. In the SBCS, difficulty accessing credit was listed as the number 1 business challenge for startups, the number 2 challenge by profitable firms with increasing revenues, and the

number 3 challenge among companies five years and older with 10 or more employees. (For more information and statistics about small business financing, see the Atlanta Fed's Small Business Trends web page and the Small Business Survey.)

Aversion to equity financing widespread

An aversion to equity financing was common among entrepreneurs in the Gazelle Project. Numerous gazelle founders were hesitant to surrender shares in their companies for fear of ceding influence to outside investors. After all, many entrepreneurs start companies because they want to captain their own ship, and taking on outside investors can mean sharing the helm.

Mark Molinari, founder of 4th Source, a technology services firm, is representative of this mindset. He said he relishes the freedom to "do the right things at the right time for the right reasons for the business."

Mark Molinari, founder of 4th Source (photo by Kendrick Disch)

"I would highly recommend that people not [sell shares] if they can avoid it," Molinari said. If a firm founder takes on outside investors, Molinari declared, “Congratulations, you've got a new boss."

David Miller of Brightway Insurance feels similarly. Miller and his brother launched their firm in 2003 with about $200,000 in cash savings, and borrowed "a few hundred thousand" dollars in the company's early years. Brightway has grown from one insurance office to about $400 million in 2014 revenue, Miller said. He advises borrowing–even at high interest rates—rather than surrendering equity.

To be sure, debt can also be burdensome. Take Scott Green, founder of Creative Concepts Inc., a wholesale candy company in the Birmingham area. When he and his wife, Kathy, started their company in 1997, they piled up $35,000 in credit card debt, along with tens of thousands more in loans. It took years to repair their personal credit ratings, Green said.

David Miller, founder of Brightway Insurance (photo courtesy of Brightway Insurance)

Nearly 20 years on, the firm is largely debt-free, as Green prefers. He maintains trusted banking relationships, which include a line of credit that he tries to use sparingly. Creative Concepts' financing needs have changed over the years. These days, Green plows profits into designing and securing patents for sophisticated powdered-candy dispensers.

Capital needs vary among different types of gazelles. In digital advertising, for instance, people are the main cost. So Hannah Paramore, president and founder of 13-year-old Paramore/the digital agency in Nashville, took on neither debt nor equity in her firm’s early years. She had low real estate costs: Paramore worked out of her home for the first two years, and then housed the company in its original, modest office for nine years.

Not only did the firm have little need for capital but, like most founders, Paramore also prizes autonomy. "If I want to do something, I don't have to ask partners," she said.

Freedom (from financial backers) isn't free

Avoiding external investors has its upside. Yet the freedom many founders cherish cuts two ways. Paramore, for one, finds it lonely atop her gazelle at times when she would welcome reassurance and a little guidance. After she's shelled out for year-end staff bonuses and the annual holiday party, everybody is happy except her as she ponders the financial uncertainty of a long year to come, she said.

Scott Green, founder of Creative Concepts Inc. (photo by Hal Yeager)

"Come January 2, I want all that money back," Paramore said with a laugh.

And she'd welcome advice in other difficult times, such as when a client considers bolting. That situation can be a conundrum because the right short-term move-usually trying to keep the client—is not always best for the long term.

"Those are the times that I wish there was somebody else to come along and tell you it's going to be all right and help you figure it out," Paramore said.

Besides gaining the benefit of investors' counsel, founders have other reasons for seeking outside capital. Foremost, financing a firm internally is not always feasible. Many high-growth companies require considerable capital to reach levels of cash flow necessary to fund their own growth.

Hannah Paramore, founder of Paramore/the digital agency (photo courtesy of Paramore/the digital agency)

Take the case of Alex Hernandez. Months after Hurricane Katrina devastated New Orleans, Hernandez moved to the Crescent City from New York to start a construction services firm. He nurtured Hernandez Consulting through its first 18 months with savings he accumulated during three years working at Citigroup.

Eventually, however, the fledgling firm required additional capital to grow. In particular, Hernandez needed funds to secure bonding to qualify for federal contracts and subcontracts that were the company's lifeblood amid post-Katrina rebuilding.

Bonding essentially functions as insurance in case a contractor fails to perform a job or pay subcontractors. Thus, contractors are required to be bonded to win or in many cases even bid on federal construction contracts. Firms like Hernandez's pay a bonding company for this insurance policy.

Alex Hernandex, founder of Hernandez Consulting (photo courtesy of Hernandez Consulting)

Hernandez raised $700,000 in angel financing, mainly to finance bonding guarantees. That effort was aided, he said, by a Louisiana tax credit that automatically returned 40 percent of investors’ money over five years. With a nine-year record of profitability and the Louisiana state tax incentive as a backstop, Hernandez Consulting's external shareholders are pleased and not particularly intrusive in the firm’s operations, Hernandez said.

No single method of funding works for all high-growth firms. Funding solutions vary by industry, founders' objectives, and other characteristics.

Next in this series: Gazelle founders benefited from the insights of others who had already experienced the challenges of establishing a business. The fourth installment in the Gazelle Project series will explore the various ways that mentors benefited founders of new firms.

Charles Davidson
Staff writer for *Economy Matters*

Ellyn Terry
Economic policy analysis specialist in the Atlanta Fed's research department