Testimony Before U.S. House Committee on Small Business

By **Ross Baird**

Testimony of Ross Baird
President, Village Capital
Innovator-in-Residence, Ewing Marion Kauffman Foundation

Before the
U.S. House Committee on Small Business

Bridging the Gap: How Capital Markets can Work for the Other 81%
July 24, 2018

Chairman Brat, Chairman Blum, Ranking Member Evans, Ranking Member Schneider, and members of the Committee, thank you for the invitation to testify at this hearing.

I'm pleased to share some insights and recommendations both from my experience as an entrepreneur, co-founding a group called Village Capital that has been one of the most active investors in new businesses in America, as well as in my role as an Innovator in Residence with the Ewing Marion Kauffman Foundation, which works together with communities in education and entrepreneurship to find uncommon solutions that empower people to shape their futures and be successful.

America's economic dynamism is in retreat: the entrepreneurship deficit

While the stock prices of big companies often dominate our views of how the economy is doing, it is small businesses, new businesses, and entrepreneurs that create economic dynamism in America.[1] New and young businesses create nearly all of the net new jobs in the country.[2]

From Silicon Valley to Shark Tank, the media narrative would suggest the United States is in a golden age of entrepreneurship. Unfortunately, that's not the case.

Entrepreneurial activity is nearing a forty-year low.[3] Over the past several decades, American economic dynamism—as measured by the ratio of new businesses starting to businesses closing—has been in steady decline.[4]

The causes of the decline in entrepreneurship are felt particularly hard in rural America. 33% fewer entrepreneurs are operating businesses in 2018 than were in 1988.[5] While

[1] "Dynamism in Retreat." Economic Innovation Group. eig.org/dynamism
[2] Haltiwanger, John, Ron Jarmin, and Javier Miranda. "Who Creates Jobs? Small vs. Large vs Young." NBER Working Paper, August 2011.
[3] Dynamism in Retreat.
[4] Ibid.
[5] Wilmoth, Daniel. "The Retreat of the Rural Entrepreneur." US Small Business Administration, 29 September 2017.

the causes of this decline are complex, today I'd like to talk about how access to capital plays an important role.

How entrepreneurs finance new businesses

Kauffman Foundation research estimates it costs $30,000 to start a business[6]. And entrepreneurs who have access to more than $100,000 in capital are 23% less likely to fail than entrepreneurs who have access to less than $5,000 in capital.

Some entrepreneurs are able to self-finance. The majority of entrepreneurs—sixty-seven per cent[7]—begin their businesses with personal or family wealth. These sources of capital include individual savings, second mortgages on homes, and contributions from friends and family.

Yet over the last 40 years, and increasingly since the Great Recession, we have seen the household wealth reserves of the majority of Americans decline. Between 2007 and 2011, 25 percent of American families lost at least 75 percent of their wealth.[8] In addition, entrepreneurs have historically used a second mortgage on a home as a source of seed financing, but the U.S. homeownership rate in 2016 was at its lowest since 1967.[9] Furthermore, student debt has grown more than 100 percent in the last 20 years, and would-be entrepreneurs with student debt obligations are less likely to pursue startups[10].

The wealth gap is particularly wide for certain populations: women, African-Americans, Latinos, and rural entrepreneurs all have lower personal wealth than average..[11][12]

This decline in personal wealth has stunted America's entrepreneurial economy: while prior recessions saw a rebound in entrepreneurial activity, on the whole, we have continued to see a decline in entrepreneurship since the Great Recession of 2008.[13]

So the first barrier preventing the success would-be entrepreneurs do not personally have the financial resources they need to get their idea off the ground.

Entrepreneurs, especially those who do not have personal wealth, turn to a second method: raising capital from external sources.

The banking industry has historically been an important source of capital for entrepreneurs in America's history, but we have seen two major changes in recent years that contribute to a lack of access to capital.

---

[6] "Kauffman Firm Survey." Ewing Marion Kauffman Foundation. August 2009.
[7] Robb, Alicia and Morelix, Arnobio. "Startup Financing Trends by Race: How Access to Capital Impacts Profitability." *Ewing Marion Kauffman Foundation*, 2016, www.kauffman.org/what-we-do/research/2016/startup-financing-trends-by-race-how-access-to-capital-impacts-profitability.
[8] Pfeffer, Fabian T., *et al*. "Wealth Disparities Before and After the Great Recession." *The Annals of the American Academy of Political and Social Science*, vol. 650, no. 1, 25 Sept. 2013, pp. 98–123., doi:10.1177/0002716213497452.
[9] "Homeownership Rate for the United States." *FRED Economic Data*, Federal Reserve Bank of St. Louis, 30 Jan. 2018, fred.stlouisfed.org/series/RHORUSQ156N.
[10] Fry, Richard. "The Changing Profile of Student Borrowers." *Social & Demographic Trends Project*, Pew Research Center, 7 Oct. 2014, www.pewsocialtrends.org/2014/10/07/the-changing-profile-of-student-borrowers/.
[11] Fetsch, Emily. "Including people of color in the promise of entrepreneurship." Entrepreneurship Policy Digest, Ewing Marion Kauffman Foundation, 5 December 2016.
[12] Nine Charts about Wealth Inequality in America (Updated)." *Urban.org*, Urban Institute, 5 Oct. 2017, apps.urban.org/features/wealth-inequality-charts/.
[13]Economic Innovation Group.

The first trend: large banks have become larger, and small and medium-sized banks are disappearing. As one example, number of small community banks totaling under $50M in assets has declined 41 per cent since the Great Recession, either through consolidation or closing[14]. According to industry experts, loans of less than $150,000 do not meet the typical large and medium-sized bank's underwriting criteria[15], which means that the $30,000 that is the average cost to start a firm does not hit the vast majority of banks' radar.

The second is a change in the nature of new businesses. Historically, banks have lent against assets. But the majority of new businesses are services businesses, who do not have significant assets or collateral, and have cash flows that do not fit banks' traditional underwriting models. Traditional lending models no longer fit today's startups: only 18 per cent of businesses ever access a bank loan.[16]

Venture capital is another important tool to start companies. And while venture capital has been very helpful for many entrepreneurs, the industry is only focused on a very small percentage of businesses that are extremely high-growth: only .6% of businesses ever raise venture capital.[17] Furthermore, venture capital is highly concentrated: in 2016, 78 percent of venture capital went to just three states (NY, MA, and CA). Less than than one per cent of venture capital dollars go to rural areas.[18] Less than 2 percent of startup financing went to women. Only 1 percent went to African-Americans and Latinos.[19]

Because of increasing debt, rising inequality, and a decline in household wealth for the average family, the number of entrepreneurs who are in a personal position to self-finance their business is in decline. Any attempt to reverse the decline in firm creation in America must focus on expanding access to external capital to entrepreneurs.

Entrepreneur champions have focused on two ends of the spectrum—small business lending and venture capital—but 81% of new businesses do not access either source.

Gaps in capital access: the other 81%

I have a personal story about one of these 81%. I founded a firm, Village Capital, that has invested in nearly 100 businesses, and supported over 1,000 more through programs across the world. Lula Luu, who founded a business called Fin Gourmet in Paducah, Kentucky, in Representative Comer's district, in one of those entrepreneurs.

Fin Gourmet catches Asian Carp—a huge nuisance in the region—filets it, rebrands it "Kentucky Blue Snapper," and sells it to high-end restaurants in New York and San Francisco.

---

[14] Lux, Marshall, and Robert Greene. "The Current State of Banking." *The Future of Banking: In a Globalized World*, Harvard Kennedy School, 2012, pp. 1–13.

[15]Banking Strategies. "Making Small Business Loans Profitably," 7 July 2015. https://www.bai.org/banking-strategies/article-detail/making-small-business-loans-profitably

[16] Robb and Morelix.

[17] Ibid.

[18] http://martinprosperity.org/media/Startup-US-2016_Venture-Capital-Goes-Urban.pdf

[19] Blanco, Octavio. "Why so Few Latino-Owned Businesses Get Venture Capital Funding." *CNNMoney*, 12 Apr. 2016, money.cnn.com/2016/04/12/smallbusiness/latino-venture-capital/index.html.

When I met Lula, she had earned hundreds of thousands of dollars in revenue and was employing a dozen people at a quality wage, in a high-unemployment part of Kentucky, but she wasn't able to access financing for her business to grow. Banks said she was too risky and early-stage for a loan, and venture capitalists said she was not "high growth enough."

With a group of partners, we made a seed investment in Fin Gourmet in an innovative, dividend-based model: we received a percentage of the company's revenue in return until we would have a predetermined return on investment. The investment helped Lula create more jobs and grow in revenue, but she still faces challenges: while a small group of us were able to develop a creative mechanism for initial financing, she has still sometimes struggled to fit the profile of formal financing mechanisms as she grows.

Lula's story is illustrative of a challenge to solve: There are tens of thousands of Lulas in America, too risky for a loan, and too "normal" for venture capital.

Ideas to increase access to capital: What Congress can do

If Congress wants to help reverse the decline in American entrepreneurship, I suggest thinking about ways to help the other 81% access capital.

First, look at ways that entrepreneurs without personal wealth can better have the financial flexibility to start a business. I've seen ideas where entrepreneurs starting a business can defer student loans for three years, or entrepreneurs who start a business in an economically distressed area, such as an Opportunity Zone, have their loans forgiven if the business is in operation for more than five years.

Second, look at ways that our capital markets infrastructure can better fit the businesses of the future. The cash-flow-based investment structure we used with Fin Gourmet in Kentucky is one type of investment structure where we are seeing both private sector and public sector innovation. Lighter Capital in Seattle has raised a $70 million fund to provide revenue-based finance to software-as-a-service companies that are growing steadily, but not a fit for venture capital. And the State of Colorado has backed an investment fund for rural entrepreneurs that primarily utilizes this revenue-based finance: its creators argue that this is perhaps a better fit than debt or equity for the majority of rural businesses.

I would also build on existing tools Congress has created. I'm encouraged by the recent bipartisan creation of the Investing in Opportunity Act, creating Opportunity Zones across the country, which can become laboratories for innovation in helping entrepreneurs like Lula access capital.

I do see a risk Opportunity Zones become a vehicle for large real estate investment, with very little capital being directed towards entrepreneurs. I'm hearing from entrepreneurs and investors possible regulatory clarity that would be helpful.

I am most frequently hearing that it is unclear at this point whether re-invested interim capital gains from entrepreneurs in opportunity zones remain eligible for the tax incentive. Should I as an investor earn a return on investment from Fin Gourmet, if I am much more likely to invest in future Fin Gourmets if the Opportunity Zone tax incentive applies to my interim gains. Regulatory clarity on this aspect could help mobilize substantial capital to entrepreneurs.

I also would encourage Congress to learn more about how other innovation in funds can be better utilized for the other 81%.

For example, the Small Business Investment Company investment fund has a $4B annual allocation, but the private sector almost never asks for the full $4B. I have heard from entrepreneurs and investors alike that the debt investment structure of the SBIC investment does not meet the needs of the majority of entrepreneurs: perhaps there is a way to use this pool of capital to spur the creation of innovative private sector vehicles. The Economic Development Authority's i6 grant has been very helpful in creating new venture capital funds, and perhaps programs such as these can also accelerate the use of more innovative private capital.

We are fortunate to be in a good economy, but according to a February survey, 55% of entrepreneurs starting a business in America think the economy is just fair or poor. If we are able to expand access to capital to any entrepreneur who faces barriers, more Americans will be able to contribute to the economic vitality of our country.