

# ACCESS TO CAPITAL

HOW SMALL AND  
MID-SIZE BUSINESSES  
ARE FUNDING THEIR  
FUTURES



NATIONAL CENTER FOR  
THE MIDDLE MARKET



MILKEN INSTITUTE



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# ABOUT

## THE U.S. SMALL BUSINESS MARKET

The Small Business Administration defines small businesses as firms with fewer than 500 employees. Small businesses are the linchpin of U.S. economic growth, with more than 28 million small businesses employing 56 million Americans—nearly half of the workforce population—across the country. Small businesses represent more than 99.7 percent of all U.S. businesses—more than half of the nonfarm private GDP in the United States—and contributed two of every three jobs generated in 2014.

For the purposes of this report, a small business is defined as a company with less than \$10 million in annual revenue.

## THE U.S. MIDDLE MARKET

The U.S. middle market comprises nearly 200,000 companies that employ 44.5 million people and generate more than \$10 trillion in combined revenue annually. In addition to their geographic and industry diversity, these companies are both publicly and privately held and include family-owned businesses and sole proprietorships. While the middle market represents approximately 3 percent of all U.S. companies, it accounts for one-third of U.S. private-sector GDP and jobs. The U.S. middle market is considered by many to be the segment that drives U.S. growth and competitiveness.

For the purposes of this report, a middle-market company is defined as a firm with annual revenue between \$10 million and \$1 billion.

## HOW THE SURVEY WAS CONDUCTED

The survey was conducted among 636 owners and c-suite executives from small firms and middle market companies. The online survey was administered by RTI International from Jan. 22 through Feb. 6, 2015. The purpose of the survey was to provide a snapshot of small and middle-market firms' corporate financing structures and approaches to raising capital—in particular: how and in what ways businesses are accessing capital, what factors are considered in raising capital, whether they are comfortable with debt, and whether and how they plan to deploy new capital they raise. The survey used common English words and phrases and sought to avoid the use of jargon or technical language where possible. No terms were defined for the respondents, who were expected to use their own understanding as to the question's meaning. This report was jointly designed and prepared by the National Center for the Middle Market and the Milken Institute.

## THE NATIONAL CENTER FOR THE MIDDLE MARKET

Founded in 2011 in partnership with GE Capital and located at The Ohio State University Fisher College of Business, the National Center for the Middle Market (NCMM) is the leading source of knowledge, leadership, and innovative research on the U.S. middle-market economy. The center provides critical data, analysis, insights, and perspectives for companies, policymakers, and other key stakeholders in this sector to help accelerate growth, increase competitiveness, and create jobs. The center's website, [www.middlemarketcenter.org](http://www.middlemarketcenter.org), offers a range of tools and resources for middle-market companies.

## THE MILKEN INSTITUTE

A nonprofit, nonpartisan economic think tank, the Milken Institute works to improve lives around the world by advancing innovative economic and policy solutions that create jobs, widen access to capital, and enhance health. We produce rigorous, independent economic research—and maximize its impact by convening global leaders from the worlds of business, finance, government, and philanthropy. By fostering collaboration between the public and private sectors, we transform great ideas into action. For more information about the Milken Institute, visit [www.milkeninstitute.org](http://www.milkeninstitute.org).

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# EXECUTIVE SUMMARY

SMALL BUSINESSES AND MIDDLE-MARKET FIRMS CONTRIBUTE GREATLY TO THE ECONOMIC OUTPUT OF THE UNITED STATES. ACCESS TO CAPITAL IS THE LIFEblood OF THESE FIRMS AND OF THE OVERALL ECONOMY. HOW FIRMS ACQUIRE CAPITAL AND THE DECISION MAKING SURROUNDING THEIR CAPITAL STRUCTURE AND EXPANSION PLANS ARE IMPORTANT IN DETERMINING THE OUTLOOK FOR SMALL BUSINESSES AND MIDDLE-MARKET FIRMS. UNDERSTANDING THE MARKET IS IMPORTANT FOR COMPANIES, CAPITAL PROVIDERS, AND POLICYMAKERS, ALL OF WHOM HAVE AN INTEREST IN EFFICIENT, FAIR, AND TRANSPARENT MARKETS. BECAUSE MID-SIZE AND SMALL COMPANIES ARE THE MOST IMPORTANT CONTRIBUTORS TO ECONOMIC GROWTH AND JOB CREATION IN THE UNITED STATES, THE CAPITAL MARKETS' EFFECTIVENESS IN SERVING THEM IS OF GREAT IMPORTANCE TO THE COUNTRY.

Research conducted by the National Center for the Middle Market and the Milken Institute explores how small businesses and middle-market firms raise capital, their appetite and strategy for debt within the capital structure, the important factors driving consideration of financing, and outlook for expansion. The purpose of the research is to map the markets now and reveal opportunities for improvement in how companies use the opportunities they have, how providers of capital serve these companies, and how public policy influences the two.

This research has led to the following key findings:

- 1 Self-financing is preferred, debt is the second choice, and everything else is a distant third**  
Small and middle-market firms of all sizes prefer to fund operation and expansion via cash on hand, and aim to have little to no debt. To the extent that outside capital is necessary, the strong preference is for bank debt, followed by other private debt, with nondebt options (e.g., equity offerings) preferred by very few firms.
- 2 Many firms plan to grow, and the cost of capital isn't going to stop them (unless it does)**  
A significant number of surveyed firms, especially middle-market firms, are planning to expand their businesses in the next year. Of those firms with an expansion plan, the majority say that their plan would not change based on changes to the cost of capital. However, a sizable minority of firms say their plans are sensitive to a change in interest rates.
- 3 Size may bring sophistication**  
Middle-market firms are more likely than their smaller brethren to set targets for debt loads, prepare annual budgets, and follow formal processes for evaluating debt strategies, projects, and investments. That is, they appear to view debt more strategically.

**4 Price, access, speed, and certainty—and a positive relationship—win the outside funding race**

Firms of all sizes cite the same factors as important when deciding on what type of outside capital to pursue: cost (usually the interest rate they pay), ease of access, speed of execution, and certainty of execution. However, the importance of relationships cannot be ignored. In fact, a strong relationship was cited by the majority of firms seeking bank capital as the reason they choose to use a bank. Capital options that provide those values and enjoy positive relationships with firms attract use, while those that do not are seldom used.

**5 No outside capital option is considered superior, but banks are the predominant choice**

When asked if nonbank funding sources are “superior,” the firms surveyed are almost evenly divided between positive, negative, and neutral responses. In terms of their actual behavior, however, small and mid-size companies use bank financing by a three-to-one margin over the next most popular choice, nonbank lenders.

This report provides a look into the corporate-financing and structure decisions at small businesses and middle-market firms, what ultimately drives firms to seek capital, whether they intend to deploy said capital, and to what extent government initiatives have been beneficial to companies seeking capital. As the lifeblood of economic activity, how firms access capital and what they do with it has profound implications for the U.S. economy. It is our hope that this report both provides insight as to the current state of play and helps generate positive changes in the business and policy environment for small and middle-market firms nationwide.



# DETAILED RESEARCH FINDINGS

## THE LANDSCAPE: HOW SMALL AND MID-SIZE BUSINESSES ACCESS CAPITAL

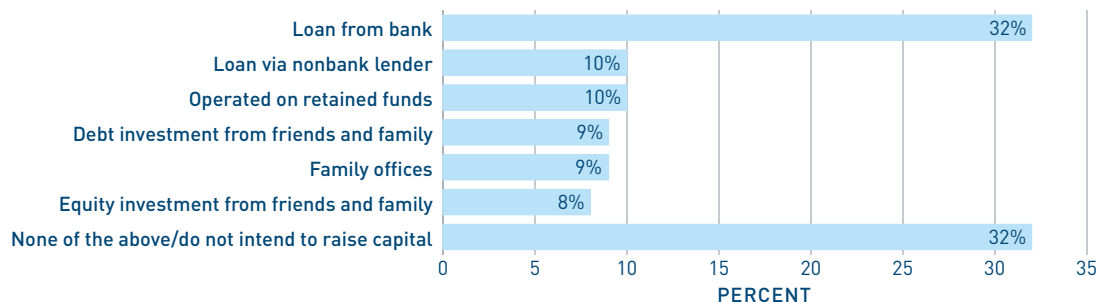
### MANY BUSINESSES SELF-FUND

Contrary to what some may believe, every business of every size may not be actively looking for opportunities to raise capital. For instance, more than 30 percent of small businesses and middle-market firms have not raised capital in the past three years, and approximately 40 percent of firms do not anticipate raising outside capital in the next three years.

1

#### Methods of raising capital used in the last three years

Thirty-two percent of small and middle market firms have not raised capital in the last three years



### DOES GROWTH INFLUENCE A COMPANY'S APPROACH TO CAPITAL?

Companies that are growing or expect to grow quickly naturally have a greater appetite for capital than those that are growing more slowly or focusing on profitability. Predictably, these growth firms are more likely than stable organizations to plan on a wider range of expansion options over the next 12 months, including forays into new domestic and international markets, investing in technology and R&D, and adding new plants or facilities. Some of these growing companies—specifically those that have experienced past year revenue growth of 10% or more—are significantly more likely to take on additional debt in the coming year.

However, in many ways, growing companies have similar attitudes toward debt and borrowing practices as their peers. Most have a preference for low debt levels, and close to half currently maintain less than \$500,000 in total debt. However, companies with plans to grow larger are more likely than their counterparts to feel comfortable with moderate levels of debt.

In particular, small businesses have been less likely to seek capital than mid-size companies: while about one-third of small businesses have not raised any capital in the past three years, about one-fifth of middle-market businesses have not raised capital.

## COMPANIES PRIMARILY UTILIZE TRADITIONAL LENDERS

Small and middle-market firms that do raise capital predominantly use bank loans.

While roughly one-third of small businesses rely on bank loans, the percentages jump significantly for middle-market companies. Close to half of firms with revenue of \$10 million to \$1 billion have used a bank loan to raise capital in the past three years.

With banks dominating the financing space, it is not surprising that bank debt is the largest type of debt for both small businesses and middle-market companies.

The observed preference for traditional providers of capital makes sense for a couple of reasons. The length and breadth of relationships matter in financing decisions, and many businesses have preexisting relationships with banks. Furthermore, many small and middle-market businesses have limited knowledge of alternative sources of financing.

Additionally, most businesses feel comfortable with their borrowing rates. More than half (53 percent) of small and middle-market firms indicate that borrowing costs are around the prevailing market rate, with a further 28 percent believing that they pay less than market rate.

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## OWNERSHIP STRUCTURE IMPACTS HOW COMPANIES VIEW AND ACCESS CAPITAL

The research reveals interesting differences in how companies approach corporate funding based on who owns the company.

### FAMILY BUSINESSES

Family-owned companies are more likely than private equity firms to fund expansion with cash on hand. Over the next 12 months, most of these businesses will expand through the introduction of a new product or service or by tapping into new domestic markets, and the majority will not take on additional debt to grow.

Currently, most family businesses hold less than \$500,000 in debt, and more than a third prefer no debt at all. Businesses in this category are most likely to have a debt-to-asset ratio of 0%–10%. When family-owned companies do borrow, they typically work with traditional banks, and only a quarter of these firms view nonbank sources of funding as superior options.

### PRIVATE EQUITY COMPANIES

The research paints a different picture when focusing on private equity firms. Private equity companies are much more expansionary than other businesses, and they are more likely to invest in technology or systems, R&D, add a new plant or facility, expand internationally, or conduct an IPO in the coming year. Private equity businesses are also most likely to take on additional debt to fund expansion.

Well over half of private equity firms maintain more than \$2.5 million in debt, and close to a third hold over \$10 million in debt. The firms are most likely to have a debt-to-asset ratio of 11%–15%.

Like their peers, private equity businesses are most likely to have bank debt. However, private-debt is a close second, and these businesses are more likely than other types of firms to consider private equity, private-debt, hedge fund, and venture capital funding in the next three years. Private equity firms are also the only type of company to believe nonbank sources of financing are superior to traditional bank debt.

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## 2

**Types of debt firm currently has**

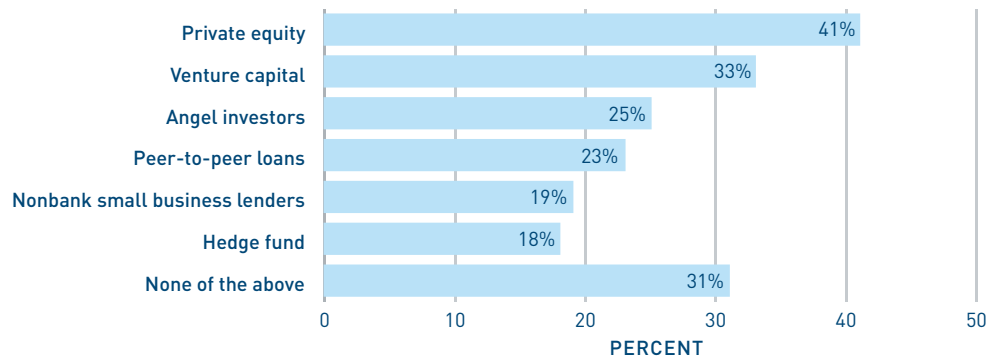
Bank debt is leading type of debt for small and middle-market companies

	<\$500K	\$500K–\$2.5M	\$2.5M–\$10M	\$10M–\$50M	\$50M–\$100M	\$100M–\$1B
<b>Bank debt</b>	41%	46%	47%	53%	53%	49%
<b>Private debt</b> (i.e., debt issued in a private offering)	22%	23%	34%	26%	40%	33%
<b>Project debt</b>	14%	14%	19%	28%	17%	24%
<b>Publicly held debt</b>	3%	3%	5%	7%	6%	18%
<b>Other types of debt</b>	1%	2%	2%	3%	4%	—
<b>None of these</b>	30%	27%	20%	14%	16%	13%

## 3

**Awareness of nontraditional sources of capital**

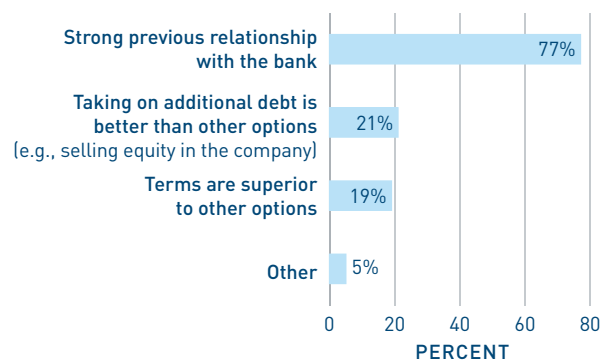
Less than one-third of all firms are aware of nontraditional sources other than PE



## 4

**Reasons would consider borrowing from a bank**

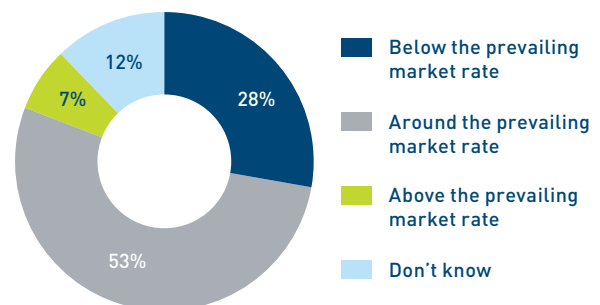
Strong relationships drive interest in bank loans



## 5

**Perception of borrowing costs**

Most businesses perceive borrowing costs to be fair



### PARTICIPATION IN GOVERNMENT PROGRAMS AND FAMILIARITY WITH RECENT CHANGES TO THE SECURITIES LAWS ARE LOW

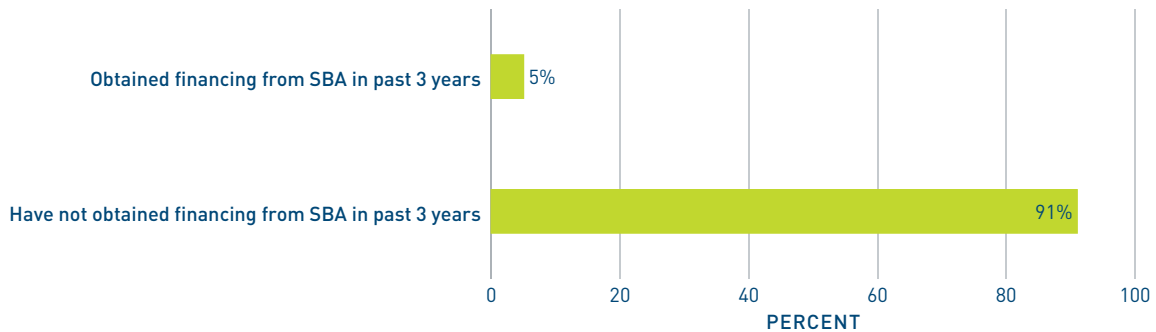
For small and mid-size businesses looking to raise capital, programs provided by the Small Business Administration (SBA) and recent changes to security laws—the Jumpstart Our Business Startups (JOBS) Act in particular—can help small businesses access capital. However, familiarity with and use of these options are low.

Only 5 percent of small and mid-size businesses surveyed have used SBA programs within the last three years. Reasons for not participating include a difficult or bureaucratic process, lack of awareness, and onerous program terms and requirements.

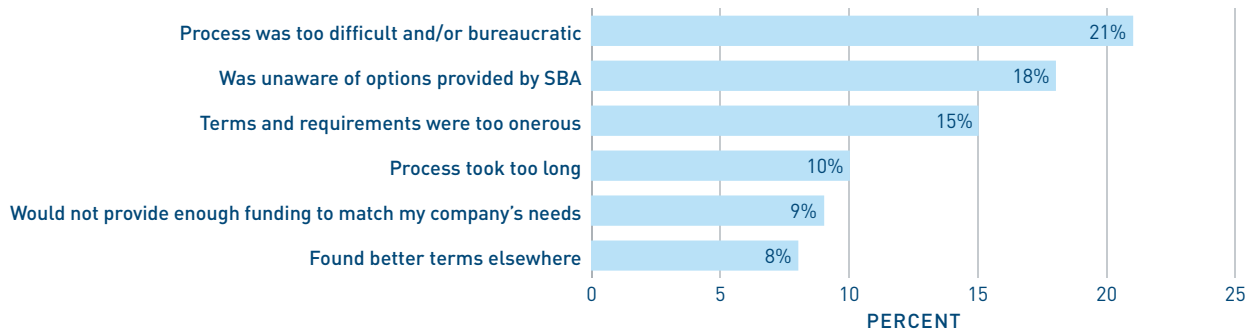
Small and mid-size businesses also lack awareness of securities law changes. Most companies (79 percent) are unfamiliar with the changes found in the JOBS Act and state crowdfunding bills. Companies with more than \$10 million in annual revenue are slightly more knowledgeable about recent revisions to the laws than smaller businesses.

Across all revenue segments, just 10 percent of companies are considering taking advantage of any of the new funding sources that have originated as a result of the changes. These companies are motivated by the potential positive public relations, or the pursuit of what may be better borrowing terms. However, many companies feel they don't know enough to be comfortable with these options. Others are concerned about legal requirements and the potential for investor fraud.

### 6 SBA program financing (past three years) Ninety-one percent of businesses have not participated in an SBA program in the past three years



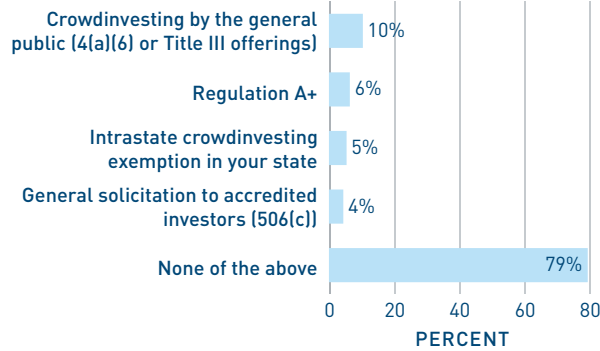
### 7 Reasons for not participating in SBA programs Difficult process and lack of awareness cited as the top reasons behind the lack of participation



8

**Familiarity with securities changes**

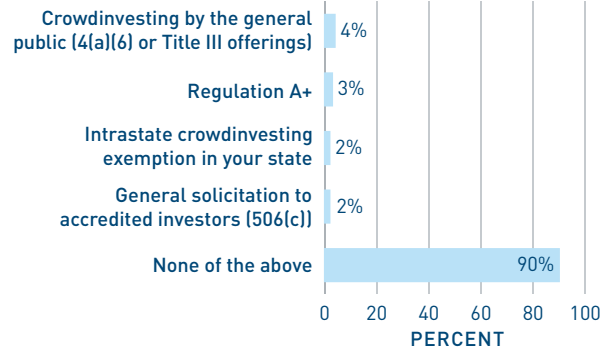
Nearly 80% of firms are unfamiliar with recent changes to securities law



9

**New methods company would consider using in the future**

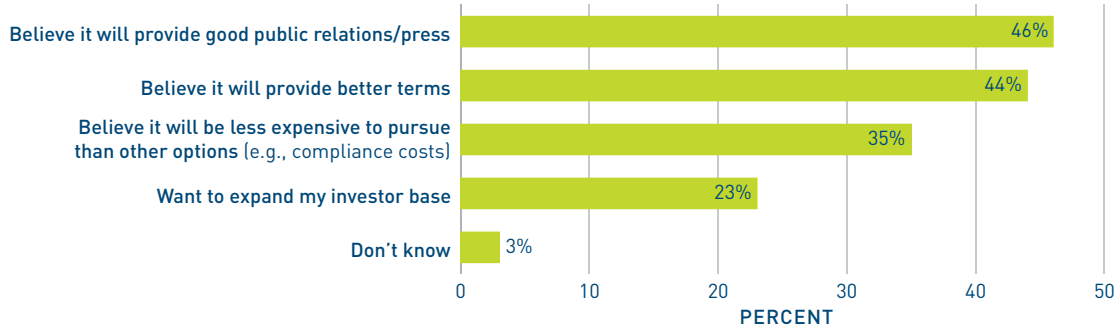
Ninety percent of businesses would not consider new funding sources from securities law changes



10

**Reasons would consider using a new funding source**

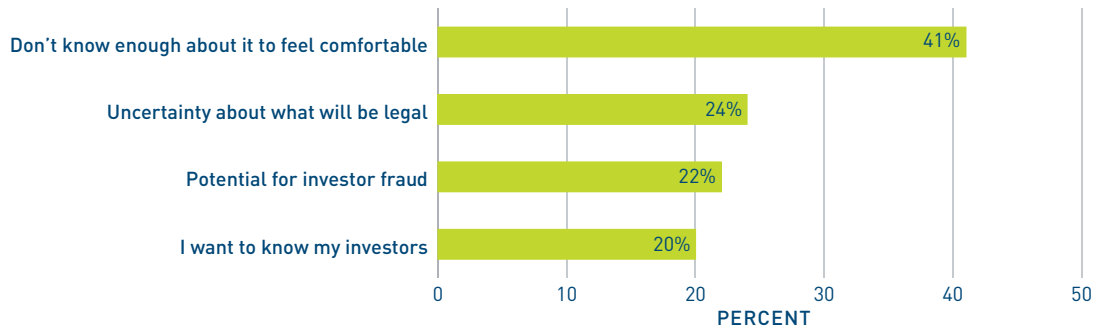
Good PR and desire for better terms cited as most common reasons for using new funding sources



11

**Reasons would be hesitant or unwilling to use new methods of financing**

Major deterrents to companies seeking to utilize JOBS Act provisions



### VERY FEW COMPANIES LIST ON A STOCK EXCHANGE

The vast majority of small and mid-size businesses—92 percent—are not listed and are not considering listing on a stock exchange. Only 3 percent of these companies are currently listed, and only an additional 3 percent have considered listing.

Companies that have considered listing but decided against it feel that their firms are too small for such financing. Many businesses also have concerns about the cost of filing and compliance and the burdens of regulation.<sup>1</sup>

### THE DRIVERS: WHAT INFLUENCES FINANCIAL DECISIONS FOR SMALL AND MID-SIZE BUSINESSES

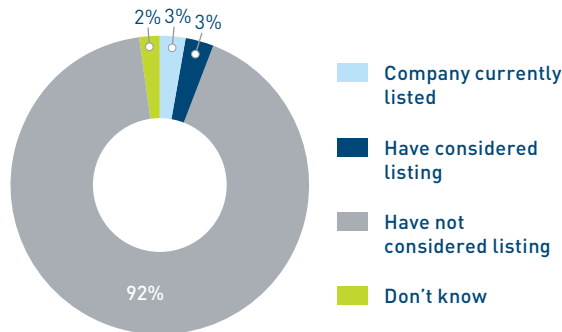
For companies that do intend to access outside capital in the next few years, a variety of factors will weigh into their choice of capital.

#### RELATIONSHIPS MATTER

When small businesses and middle-market companies consider financing, their existing relationships with banks are central to their decision making. More than three-quarters (77 percent) of small and middle-market businesses considering a bank loan cite strong previous relationships with the bank as a reason for pursuing this option. Firms not considering financing from a traditional bank are most likely not looking for financing at all.

### 12 Whether company is listed on a stock exchange

Majority of firms surveyed have not considered listing

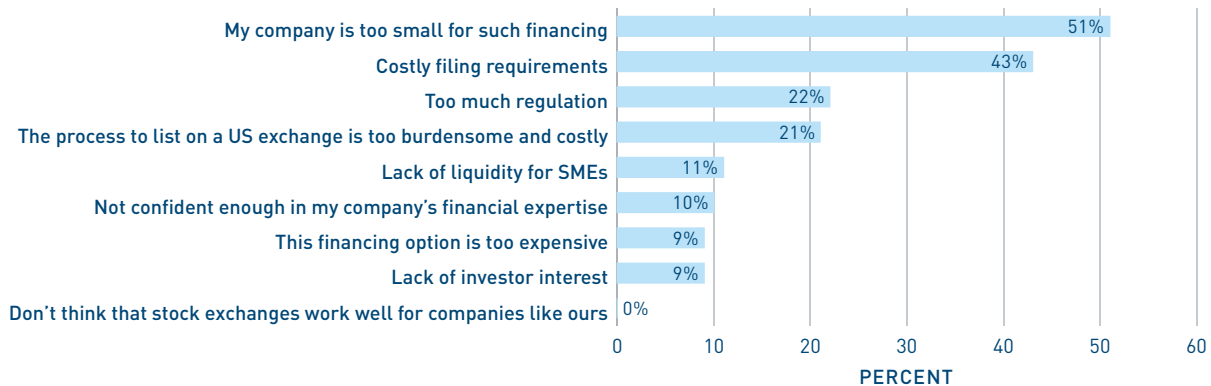


#### OBTAINING THE BEST POSSIBLE INTEREST RATE IS CRITICAL—BUT MONEY ISN'T EVERYTHING

Interest rate is the primary concern for small and mid-size firms considering financing, regardless of revenue segment, ownership structure, industry category, or growth plans. But cost isn't everything. The majority of all small and mid-size businesses are also likely to consider ease of access to funding, speed of execution, and certainty of execution when assessing their financing options.

### 13 Biggest barrier that would prevent listing

Small size and cost of filing are concerns for firms who considered listing



<sup>1</sup> It should be noted that only 25 firms had considered but ultimately declined to list on a stock exchange, so results are drawn from a small sample size and should be viewed with caution.

Of the factors listed, certainty of execution is especially important for the middle market. The majority of middle-market companies also look for industry knowledge and expertise in their lenders, seek out tax advantages, and value credit-line preservation from their bank or debt market more than smaller companies do.

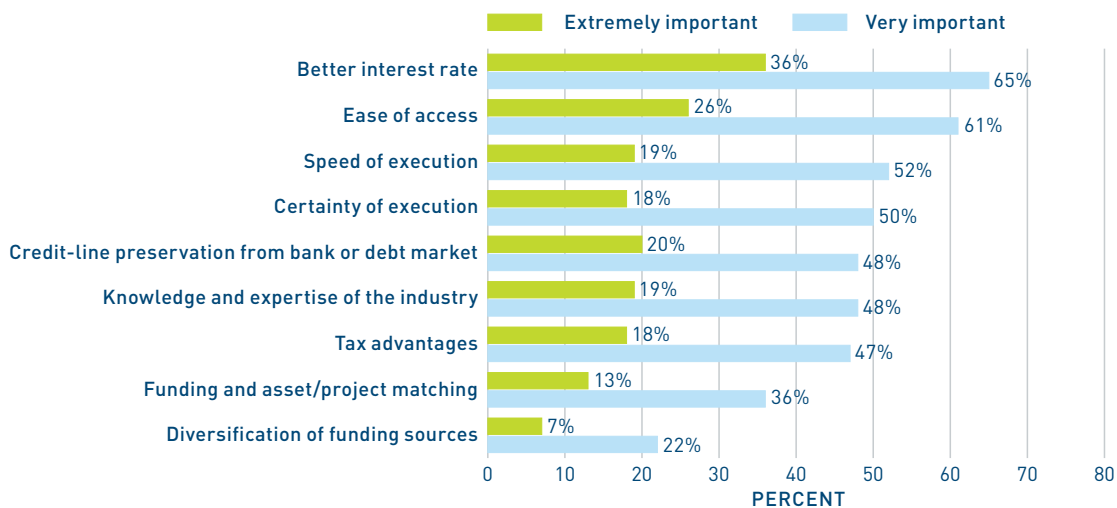
While companies place considerable importance on finding the best price for funding, their sensitivity is not great. A majority (54 percent) of small and mid-size firms say they would not change expansion plans based on

increases in the cost of capital. This is because many companies are more likely to use internal cash to fund expansion. Others see expansion as necessary regardless of the cost of capital, and they feel they can refinance at a later time if necessary.

However, more than a quarter of businesses (28 percent), would cancel, slow, or reduce their investments due to a significant interest-rate swing, which most firms define as a 1 to 2 percentage point change. For 18 percent of firms, plans are highly dependent on the cost of capital.

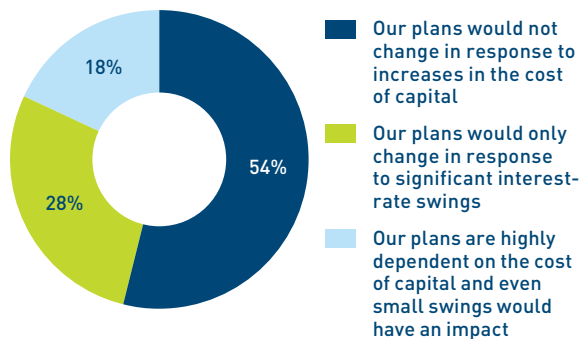
## 14 Importance of factors when considering financing

Cost, ease of access, speed, and certainty of execution top factors for financing



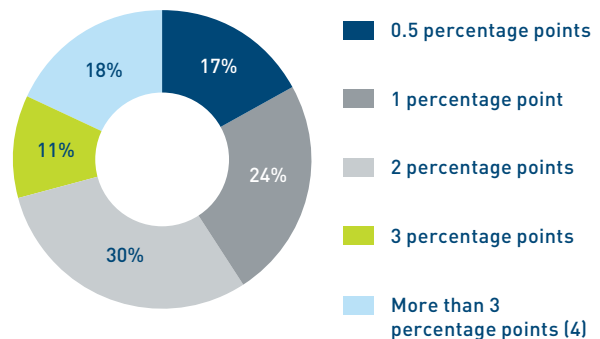
## 15 Extent to which expansion plans are subject to the cost of capital

Fifty-four percent of firms would not change expansion plans based on the cost of capital



## 16 Degree to which an increase in borrowing costs would cause firm to adjust investments in 2016

A 1%–2% interest-rate increase would cause firms to cancel/reduce investments



17

**Extent to which expansion plans are subject to cost of capital**

Most small businesses are immune to the cost of capital, with exception of a few firms who are sensitive to modest changes

	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Our plans would not change in response to increases in the cost of capital</b>	54%	58%	45%	41%	37%	46%
<b>Our plans would only change in response to significant interest rate swings</b>	27%	25%	44%	48%	61%	43%
<b>Our plans are highly dependent on the cost of capital and even small swings would have an impact</b>	19%	17%	11%	11%	1%	11%

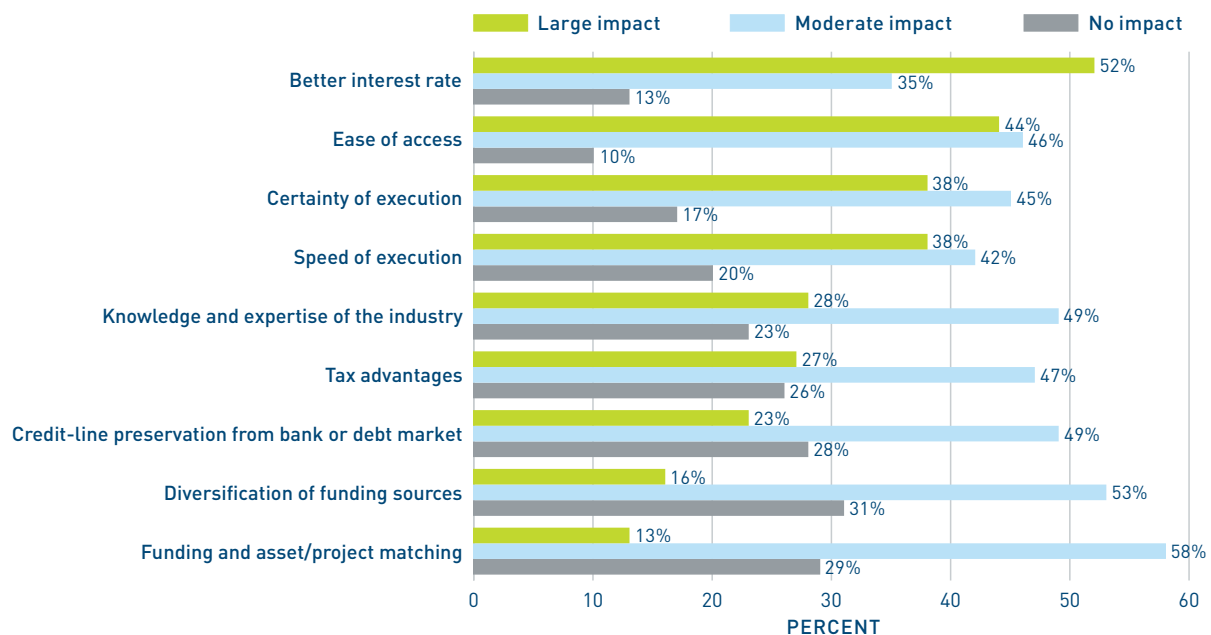
**Increase would cause firms to cancel/slow/reduce investments in the next year**

<b>0.5 percentage points</b>	20%	17%	11%	4%	7%	4%
<b>1 percentage point</b>	26%	24%	15%	21%	9%	6%
<b>2 percentage points</b>	26%	31%	45%	35%	43%	50%
<b>3 percentage points</b>	9%	12%	16%	21%	20%	26%
<b>More than 3 percentage points</b>	20%	17%	13%	18%	20%	14%

18

**Impact of factors on decision to use nonbanks for financing**

Ninety percent of firms say ease of access impacts decision on whether to use nonbanks





Smaller firms (those with revenue under \$2.5 million) are the least sensitive to cost of capital, while larger firms are more likely to allow interest-rate swings to impact their plans. However, smaller firms that are affected by cost are highly sensitive to even minor changes in interest rates, such as a 0.5 to 1 percentage point swing. It would require a larger change—2 to 3 percentage points—to alter the plans of most middle-market firms.

### EASE OF ACCESS EDGES INTEREST RATE WHEN CONSIDERING NONBANK FINANCING

Small and middle-market businesses consider the same factors whether they are looking at bank financing or nontraditional sources of capital—interest rate, ease of access, certainty of execution, and speed of execution all weigh into the decision. As with banks, cost is king—52 percent of firms cite a better interest

rate as having a large impact on the decision to look beyond a bank.

Ease of access has a greater impact on more companies than interest rate when considering nonbank financing alternatives. Just 10 percent of companies say ease of access has no impact on their decision, while 13 percent of firms say interest rate isn't a factor.

### THE OUTLOOK: HOW SMALL BUSINESSES AND MIDDLE-MARKET COMPANIES VIEW DEBT

#### COMPANIES PREFER LOW DEBT—BUT DEBT APPETITE INCREASES WITH FIRM SIZE

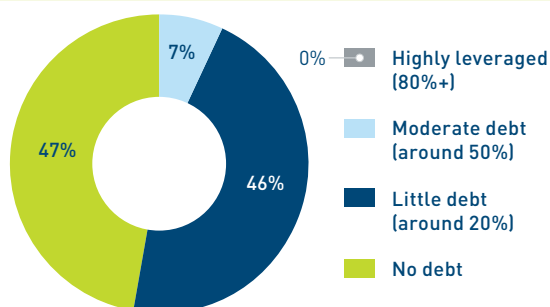
The research reveals that the majority of small businesses and middle-market firms have conservative attitudes toward debt. Nearly all (93 percent) of these companies say no debt or low debt is right for their businesses.

As expected, smaller firms are more likely than their mid-market counterparts to target and maintain lower debt-to-asset ratios. Roughly one-third of small businesses hold a debt-to-asset ratio between 0 and 5 percent. Conversely, most middle-market companies are likely to hold a debt-to-asset ratio of 6 to 15 percent, and upper middle-market firms, with revenue of \$100 million to \$1 billion, are most likely to maintain debt-to-asset ratios of 16 percent or more.

19

#### Right amount of debt for company

Ninety-three percent of firms believe little to no debt right for business



20

#### Debt-to-asset ratio

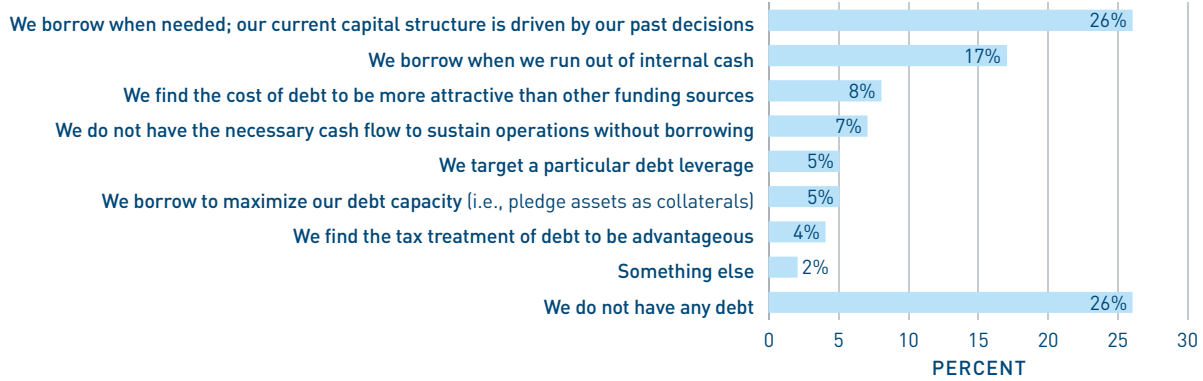
Roughly one-third of small businesses maintain ratio of 0%–5%, with most middle-market firms maintaining a ratio of 6%+

	TOTAL	<\$500K	\$500K–\$2.5M	\$2.5M–\$10M	\$10M–\$50M	\$50M–\$100M	\$100M–\$1B
0% to 5%	35%	39%	30%	31%	18%	20%	22%
6% to 15%	26%	24%	32%	25%	30%	35%	29%
16%+	21%	17%	21%	26%	27%	24%	32%
Don't know	19%	20%	17%	18%	26%	20%	16%

21

**Most important driver of current debt levels**

Borrowing is driven by previous decisions or out of necessity when internal cash runs dry



22

**Total debt of firm regardless of source**

Eighty-seven percent of small businesses have less than \$500K in debt; the majority of middle-market firms have more than \$500K in debt

	TOTAL	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Less than \$500K</b>	78%	87%	73%	45%	31%	19%	23%
<b>\$500K +</b>	16%	7%	25%	45%	59%	71%	65%
<b>Don't know</b>	5%	6%	2%	10%	10%	10%	12%

**MOST BORROWING IS DRIVEN BY NECESSITY RATHER THAN OPPORTUNITY**

The most common reasons cited by companies as driving their current levels of debt are that they borrow when needed as a result of past decisions and that they borrow when they run out of internal cash. Strategic borrowing, such as borrowing driven by a preference for debt over other sources of funding or as an effort to target a particular debt level or maximize leverage, is rarely the most important motivator for a company seeking debt.

**TOTAL DEBT RISES WITH REVENUE**

While more than three-quarters (78 percent) of all small and mid-size businesses hold less than \$500,000 in total debt, 87 percent of the smallest businesses fall into this category.

On the other end of the spectrum, approximately 20 percent of firms with annual revenue between \$50 million and

\$1 billion have such low levels of debt. The majority of middle-market firms have total debt in excess of \$500,000.

**LARGER FIRMS ARE MORE LIKELY TO HAVE A SOPHISTICATED DEBT STRATEGY**

More than half of all small and mid-size businesses have a strategy when it comes to debt. However, those that do have a strategy are split—some strategically plan their borrowing needs while others borrow on a project basis.

In general, the larger the firm, the more likely it is to take a top-down or strategic approach to borrowing. For firms that have debt, the need to borrow when cash is not available is the key driver of current debt levels.

Just as larger firms are more strategic in their approach to borrowing, they are also more likely to have a formal process for evaluating projects and investments. While just

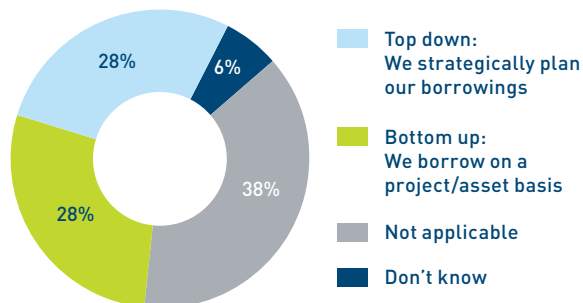
41 percent of the smallest businesses (with less than \$500,000 in annual revenue) have a formal process for evaluation, 84 percent of companies with revenue between \$50 million and \$1 billion use a formal method. For these firms, the payback method, internal rate of return, and net present value are the most commonly used tools for evaluating projects and investments.

The majority of all small and mid-size companies set annual budgets for new projects; however, firms with at least \$2.5 million in revenue are significantly more likely to do this than the smallest companies. Nearly all companies (more than 85 percent) with revenue of \$50 million to \$1 billion set annual project budgets.

23

### Debt strategy

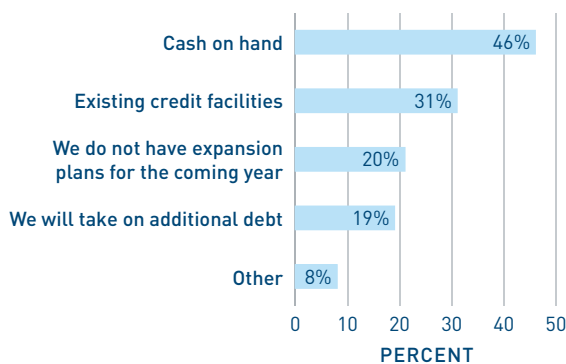
Fifty-six percent of businesses have a debt strategy (though nearly half have no strategy)



24

### Sources that will fund expansion in the coming year

Majority of businesses expect to self-fund near-term expansion plans



## THE FUTURE: HOW SMALL AND MID-SIZE BUSINESSES PLAN TO FUND NEW GROWTH

### MOST SMALL AND MID-SIZE BUSINESSES PLAN TO GROW THIS YEAR—BUT FEW INTEND TO TAKE ON ADDITIONAL DEBT

The majority of small businesses and middle-market firms do have expansion plans for the coming year, with middle-market businesses being more likely to grow than their smaller peers. Only around 20 percent of the smallest businesses do not plan on expanding, and less than 5 percent of core and upper middle-market companies (with revenue between \$100 million and \$1 billion) do not intend to expand their businesses this year.

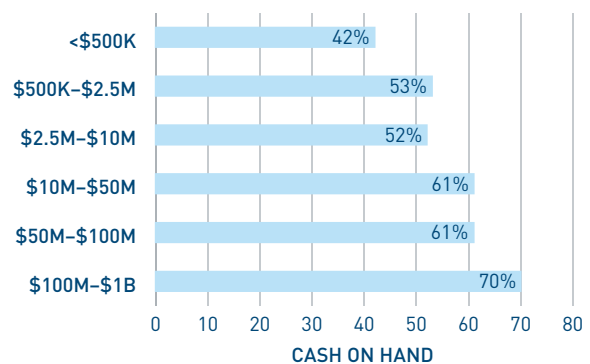
While companies will grow—primarily through innovation and forays into new domestic markets—they plan to fund expansion and new projects through cash on hand or existing credit facilities. Upper middle-market firms are the biggest proponents of paying as they go, with 70 percent planning to finance growth with cash on hand.

Just 19 percent of all small and mid-size businesses intend to take on additional debt to fund expansion in the coming year.

25

### Self-funding near-term expansion plans

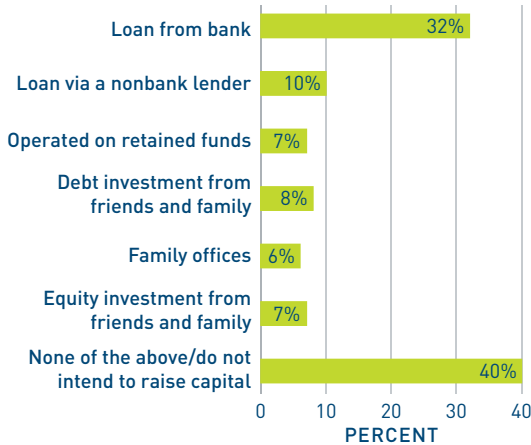
Seventy percent of upper middle-market companies plan to finance growth using cash on hand



26

**Methods of raising capital over next three years**

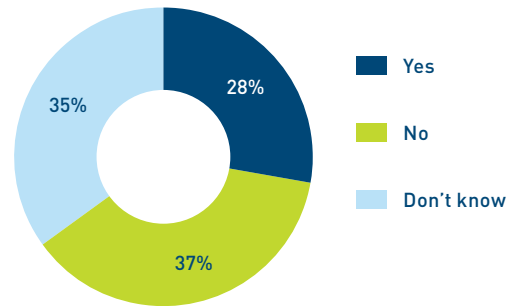
Thirty-two percent of firms plan to use a bank loan in the next three years



27

**Are nonbank sources of capital superior to traditional lenders?**

Thirty-five percent of firms do not know whether traditional lenders or nonbank sources of capital are superior



28

**Are nonbank sources of capital superior to traditional lenders?**

	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Yes</b>	30%	25%	21%	23%	26%	20%
<b>No</b>	37%	36%	42%	40%	43%	52%
<b>Don't know</b>	33%	39%	37%	37%	31%	28%

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**Considerations when borrowing from a bank**

Reasons for considering a loan from a bank in the next three years

	TOTAL	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Strong previous relationship with the bank</b>	77%	81%	70%	67%	74%	74%	76%
<b>Terms are superior to other options</b>	19%	13%	33%	14%	38%	16%	18%
<b>Taking on additional debt is better than other options (e.g., selling equity in the company)</b>	21%	19%	20%	36%	26%	35%	44%

## **BANK LOANS ARE EXPECTED TO CONTINUE TO SERVE AS THE PRIMARY MEANS OF OUTSIDE CAPITAL OVER THE NEXT THREE YEARS**

As companies look further into the future and consider their capital needs, an increasing number intend to take on some form of debt. While 40 percent of firms have no plans to raise capital over the next three years, that leaves the majority of small businesses and middle-market firms likely to access some type of business funding in the not-too-distant future. Not surprisingly, middle-market firms and firms with growth plans are more likely than smaller businesses to consider outside financing.

For all businesses, banks remain the preferred source for anticipated outside capital, with approximately a third of all companies saying they would consider pursuing a bank loan within the next three years. Bank loans are over three times more popular than the next option, loans from a nonbank lender.

## **COMPANIES ARE SPLIT OVER WHICH SOURCES OF CAPITAL ARE SUPERIOR**

Despite the tendency toward pursuing bank financing, 35 percent of small businesses and middle-market companies are unsure whether bank or nonbank sources are better. In response to a question asking if nonbank sources of funding were “superior,” 28 percent say nonbank sources are superior to traditional business banks, and 37 percent say the opposite. Among upper middle-market companies, 52 percent say banks are superior, with 28 percent unsure and 20 percent finding nonbank sources superior. Also, 37 percent of companies with under \$500,000 in annual revenue consider banks to be superior, with 30 percent finding nonbank sources to be superior and 35 percent unsure.

When asked why they consider borrowing from a bank, upper middle-market firms are the most likely to view taking on additional debt as better than other capital-raising options such as selling equity, though they also consider their relationship with the bank to be an important component. Smaller firms are less likely to view debt as a better option and are more reliant on their preexisting relationship with the bank.

# ANALYSIS

## SELF-FINANCING IS PREFERRED, DEBT IS THE SECOND CHOICE, AND EVERYTHING ELSE IS A DISTANT THIRD

Firms of all revenue sizes prefer to fund operation and expansion via cash on hand, and aim to have little to no debt. To the extent that outside capital is necessary, the strong preference is for bank debt, followed by other private debt, with nondebt options (e.g., equity offerings) preferred by very few firms.

Across the board, cash on hand is the preferred method for expansion by firms. Clear majorities of firms with annual revenue in excess of \$500,000 intend to use their own cash, with the percentage increasing as the firms' revenue increases. While the smallest firms have the fewest number of companies intending to use cash on hand (possibly because they simply do not have the cash), it remains the most popular option for those firms as well.

To the extent that outside capital is required, companies of all revenue sizes view debt, especially bank debt, as the method of choice. Bank debt is three times as popular, both as a current and expected source of outside capital, as the next closest option, a loan from a nonbank lender. Most companies also feel that they are able to borrow at or better than the market rate, which may indicate that the majority of firms believe that they are a good fit for the debt market.

While companies prefer bank debt to other options, this does not mean companies like debt. The majority of companies indicate that they both target and achieve debt-to-asset ratios of less than 15 percent, although larger businesses were more comfortable with higher limits and smaller businesses preferred lower limits. The largest drivers of firms' decisions to obtain debt were driven by necessity, not a desire to increase the company's debt load. Taken together, this indicates that the majority of firms consider debt to be a necessary evil, rather than a desirable option.

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While it is unclear why larger firms are more comfortable with higher debt loads, there are several obvious possibilities. Larger businesses are more likely to have collateral in the form of corporate assets and a preexisting track record, which can reduce the likelihood that the business owner is required to sign a personal guarantee. Large businesses are also likely to operate in a space like real estate or finance where debt is an asset rather than a liability. Finally, larger businesses may simply need more capital and are willing to accept higher debt ratios to obtain it.

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While it is clear that firms prefer debt financing to other sources of outside capital, it is unclear why. Only 21 percent of firms say that taking on additional debt would be preferable to other options like selling equity. One possibility is that many firms are not familiar with the other options available to them. "Nontraditional" (i.e., not a bank loan or public offering) methods of capital are not well understood by most companies. Ironically, middle-market firms tend to be more familiar with alternative methods than smaller firms, even though many of the alternative methods were designed to help smaller firms.

The data indicate that many firms are getting what they want in terms of access to outside capital. Either they don't want it or they can obtain it at prevailing market rates from a bank. However, given firms' preference for low debt levels, limited knowledge of alternatives to debt, and reactive rather than a proactive stance on debt, it is possible that some number of firms are seeking debt when they might also consider an alternative method of financing.

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This preference for debt is particularly pronounced in firms with over \$100 million in revenue, while under 20 percent of the smallest firms cite that as a reason. This may reflect the reality that larger companies with stable revenue streams and mature capitalization tables find debt to be easier, cheaper, and less disruptive than other options, while smaller firms are not sufficiently well positioned to obtain loans easily or have less fixity on their capitalization table.

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### **1 Many firms plan to grow, and the cost of capital isn't going to stop them (unless it does).**

A significant number of surveyed firms, especially middle-market firms, have plans to expand their business in the next year. Of those firms with an expansion plan, the majority (54 percent) say that their plan would not change based on changes to the cost of capital. However, a sizable minority of firms (46 percent) say their plans are sensitive to a change in interest rates.

As discussed previously, most firms that plan to grow plan to fund that growth with cash on hand. As such, it is unsurprising that they are not concerned with the cost of capital. However, many firms that do plan to seek outside funding also report being insensitive to the cost of capital. In these cases the primary reasons cited are the need to expand regardless of cost (a company in a “grow or die” situation) and the belief that refinancing would be an option in the future. Given today's historically low interest-rate environment, it is questionable whether a reasonably large and stable company will be able to refinance at better terms in the future. Companies that are currently smaller, have a limited track record or collateral, or have poor corporate credit but would benefit from the growth that current borrowing would enable, might be able to refinance at lower rates.

Small businesses are less likely than higher-revenue firms to say they would change their plans based on a change to cost of capital, but to the extent they are sensitive to changes they are more sensitive than larger firms. This may be because smaller firms are more likely to view growth as a matter of survival or as a way to move into another tier of company and perhaps, as discussed above, lower their borrowing cost. However, given the more limited revenue of those firms, it stands to reason that any increase to the cost of borrowing would impact them more.

### **2 Size may bring sophistication.**

Firms with larger revenue are more likely to have annual budgets and more formal processes for evaluating debt strategies, projects, and investments. This enhanced sophistication may contribute to larger targeted debt loads, as more sophisticated companies view debt more strategically than less sophisticated ones.

The sophistication of a firm, as evidenced by its use of formal planning and budgeting techniques, correlates with the firm's annual revenue. For example, while the majority of firms of all revenue sizes set annual budgets, there was a significant increase when a firm's annual revenue exceeded \$2.5 million. Likewise, the larger a firm's revenue, the more likely it was to have a formal process in place to evaluate projects and investments. Larger firms are also more likely to have a strategic plan with regard to borrowing, as opposed to borrowing on a more ad-hoc basis.

Larger-revenue firms are likely to be more complex and specialized organizations and operate in industries that require sophisticated long-term decision making. This may also explain why larger firms tend to say they feel more comfortable with and seek out relatively higher levels of debt. If firms are viewing debt as part of a long-term plan and have the cash flow and internal budgeting and monitoring processes necessary to keep control of the firm's debt load, it makes sense that they would be more comfortable with debt than those smaller firms without that ability.

### **3 Price, access, speed, and certainty—and a positive relationship—win the outside funding race.**

Firms of all sizes cite the same factors as important when deciding on what type of outside capital to pursue: cost (often in the form of the interest rate they pay), ease of access, speed of execution, and certainty

of execution. However, relationships are also important. Capital options that provide those values and enjoy positive relationships with firms attract use, while those that do not are seldom utilized.

Banks provide the most common source of outside capital for companies and appear to provide adequate price and access to keep customers satisfied. However, the terms are not what is driving the bulk of companies to utilize banks; relationships are. This indicates that banking relationships remain relatively personal but may also mean that the relationship serves as a means to address firms' concerns about access, speed, and certainty. To the extent firms have ongoing relationships with banks—and virtually all companies do for ordinary purposes such as checking and payroll—they have presumably developed an understanding and confidence about the bank's processes and reliability that extend to other services such as loans.

While cost, access, speed, and certainty remain the most important factors for nonbank lenders as well, the order of importance differs somewhat. This change is consistent with information obtained from participants in the marketplace-lending space who report customers prioritizing the ease of access to capital (as compared to a bank), over the somewhat higher interest rates. Additionally, marketplace lenders have commented that one of banks' big advantages is that they have prior and ongoing relationships with customers.

The importance of price, access, speed, and certainty is also seen in the options that companies choose not to use. The most frequently cited reasons for why a company chose not to pursue SBA funding are that the process was too bureaucratic, they are unaware of the options provided by the SBA, and the terms and requirements are too onerous. These complaints could reflect a failure by the SBA to satisfy businesses' needs for speed, access, and reasonable costs of capital, or the type of personal relationships businesses value.

Public stock exchanges were also unpopular with the businesses surveyed. Similarly, the recent changes to the securities laws were viewed as unattractive. Here again, we see that the lack of certainty, confidence in

execution (as represented by the risk of fraud), and the lack of relationship between the firm and the party providing capital render a possible investment option unattractive for the vast majority of businesses.

#### 4 No outside capital option is considered superior, but banks are the predominant choice.

When asked if they consider nonbank financing to be "superior" to bank financing, the firms are roughly divided between agreeing, disagreeing, or being unsure. However, banks were the predominant choice of firms seeking or expecting to seek outside capital, with nonbank lenders being the next most popular.

Upper middle-market firms are the most likely to consider banks to be better than other options, while the smallest firms were most likely to consider nonbank firms to be superior.

Firms between the extremes had the highest levels of uncertainty as to which type of funding was superior. The primary reason cited for companies electing to use a bank was their preexisting strong relationship with the bank. Upper middle-market companies had the most positive view of banks, while companies with under \$500,000 in annual revenue had the most positive view of nonbank lenders. While the preexisting relationship was the primary reason for small and middle-market firms of all sizes, larger firms were more likely to also consider taking on debt to be a better option than other means of raising capital. This is consistent with other data indicating that larger firms tend to view debt strategically as a tool rather than the burden smaller firms consider it.

Given the split in opinion about whether bank or nonbank options are superior, and the limited knowledge of funding alternatives by most firms surveyed, it is unclear whether firms' usage of banks is driven by rates, relationships, or inertia, and whether, as alternatives become better known in the market, firms will be more inclined to use them or will stick with their traditional relationships.



# WHAT THE FUTURE MAY HOLD

WHILE THERE IS NOTHING CERTAIN ABOUT HOW SMALL AND MID-SIZE COMPANIES WILL ACCESS CAPITAL IN THE FUTURE, THE DATA DO PROVIDE SOME GROUNDS FOR SPECULATION. ANY SPECIFIC PREDICTIONS WOULD LIKELY BE BOTH HYPOTHETICAL AND, GIVEN THE DIVERSITY OF COMPANIES AND THEIR NEEDS, INCOMPLETE. BUT SOME FUTURES SEEM MORE LIKELY THAN OTHERS AND SHOULD BE EXAMINED TO DETERMINE WHAT THEY MIGHT MEAN FOR FIRMS SEEKING CAPITAL, FINANCIAL SERVICES PROVIDERS, AND THE ECONOMY AS A WHOLE.

## HOW WILL COMPANIES ACCESS CAPITAL?

First, companies' preference for meeting their financing needs through retained earnings is unlikely to change. Small companies in particular, with smaller and often more volatile cash flow, prefer to avoid obligations like loan payments when they can. The data indicated that smaller companies are least enthusiastic about bank loans. This may reflect difficulties small businesses report having in obtaining loans from banks, in part due to the increased regulatory burden imposed on banks in the wake of the financial crisis and the resulting decreased profitability of small business loans. Conversely, banks' strong position among larger (i.e., middle-market) firms could indicate that banks are uniquely well suited to provide the scale of capital that larger firms require at an attractive price and that larger firms have less need to look for alternatives.

If nonbank sources of capital are able to develop relationships with small businesses similar to those developed by banks, or if technology changes the capital access process to be more exclusively cost driven (akin to buying a plane ticket online via a site like Kayak), thereby reducing the importance of relationships in a firm's decisions, then banks may see their pipeline of future clients constricted. Conversely, banks may continue to enjoy very real advantages. To the extent companies want to seek capital via loans, as opposed to investment, banks may be the only source of capital for loans above a certain size. For example, the bulk of small business marketplace lenders have sub-million-dollar maximums on their loans. Banks that have robust business lending programs routinely make multimillion-dollar loans. Additionally, as companies grow in size and develop a robust credit history, bank loans tend to be available at a much lower cost of capital than nonbank loans.

Nonloan sources of capital targeted at small and mid-size businesses are so far little known or understood and may not present a compelling alternative, especially given the costs and regulatory requirements of securities offerings. This is especially true for firms without a clear path to a liquidity event for their investors, which is to say most small firms.

Given these issues and businesses' general preference for loans as a means of outside capital, it seems reasonable to expect that nonloans will remain a relatively small piece of the capital-access picture for most small and middle-market firms going forward.

Given these dynamics, three scenarios present themselves as possible:

### **1 Banks remain the predominant source of outside capital for businesses of all sizes:**

Whether driven by banks maintaining strong relationships, improving their provision of services to become clearly superior to competing alternatives, or just benefiting from familiarity, there is a possibility that banks will remain the

largest source of outside funding for firms into the foreseeable future.

## 2 Banks are disrupted by newer nonbank lenders and other sources of capital:

Technology and time may open doors for new and innovative alternatives, such as marketplace lenders. These alternative providers tend to focus on providing small businesses an easy application process accompanied by a quick decision, two vital considerations for firms seeking capital. While they lack the track record and relationships enjoyed by banks, that disadvantage could diminish the longer they operate, initiating a classic process of disruption in which new entrants eat into the share of larger, established players.

## 3 Banks and nonbank capital sources collaborate:

It is also possible that banks and nonbank sources will collaborate to create mutually beneficial arrangements that provide innovation to banks and scale to newcomers. This type of arrangement is already being seen with recent partnerships between marketplace lenders like Lending Club and OnDeck Capital, and banks like BBVA Compass, or bank consortiums like the BancAlliance. Such arrangements could serve to allow nonbank lenders to leverage banks' customer relationships while allowing banks to keep customers in their ecosystem throughout their lifecycles.

These possibilities should not be seen as either-or choices—the future is likely to contain elements of each as individual companies seek competitive advantage either in obtaining capital or in providing it. It seems reasonable to assume that customers will become better informed about their choices (information asymmetries have fallen in virtually every industry) and that digitization will continue to change financial services (as it has every other business). Who the “winners” will be is anyone's guess; what's most important is that the ultimate winners be the small and middle-market companies that drive America's economic growth.

Recommendations for CEOs, CFOs, and owners:

**1 Invest in relationships:** Both small and middle-market companies benefit from financial services providers that know them well, so don't be just transactional. Even if you're not in the market for capital now, maintain relationships. This may not only help you the next time you need capital but can also help you stay abreast of other services and partnerships your provider may have to offer.

**2 Your financial services capabilities need to grow with your business:** At the same time you're investing in relationships, you should recognize that the financial services provider you have now might not be able to keep up with your company's plans, which could include things like international expansion or a need for more specialized services like inventory-based financing. Keep your anticipated future needs in mind when looking for a financial services provider.

**3 Remember that financing can help build capabilities as well as growth plans:** When private equity firms purchase middle-market companies, they typically put a lot of investment into modernizing the financial and IT systems of their new acquisitions. These are financeable investments.

**4 Pay attention to how the provider industry is changing—and to special funding sources for your kind of company:** Most small and middle-market companies are unaware of government and other programs that might really help them. Also, the industry itself is changing as new forms of capital are emerging. Don't ignore these opportunities and trends. You might still want to rely on the tried and true, but you should develop a working knowledge of what is new.

Recommendations for policymakers:

- 1 Design policies and programs to fit the reality of business:** Our results show that government policies, like the recent changes to the securities laws, and government-administered programs like the SBA, are not well understood or utilized by businesses and fail to provide the competitive price, accessibility, and certainty that businesses look for when seeking capital. For these policies and programs to achieve their stated goals, policymakers should structure them to meet the needs of business, or consider enhancing and expanding collaboration with private-sector capital providers to leverage those providers' expertise and capabilities.
- 2 Expand entrepreneurial education of capital options:** Even if a source of capital is a good match for the needs of business, if businesses don't know about it they won't utilize it. Policymakers should encourage educational programs that help inform businesses, nonprofits, and government agencies of all sizes of the different capital access options, as well as their costs, benefits, and requirements. This could be a direct government effort, but it may be more effective and efficient to partner with nonprofit and business organizations focused on improving capital access.

Recommendations for capital providers:

- 1 Develop a relationship with your customers:** A positive relationship is a major driver of customers. It behooves you to get to know them and develop a positive relationship. This will not only help make the relationship "sticky" but will also help you understand the needs and trends in the market, positioning you to better adjust as the market changes.
- 2 Price, speed, certainty, and accessibility are vital:** It is no surprise that those factors are the most important to companies, so make certain you are doing your best with each one. To the extent you cannot be the best on a particular attribute, ensure that customers appreciate the importance of what you are good at.
- 3 Consider strategic partnerships:** You may not be able or willing to provide capital to all companies; however, through the use of strategic partnerships you can help keep a company within your relationship umbrella even if you aren't providing all of the necessary services.

# APPENDIX 1

WITHIN THE LAST THREE YEARS, WHICH METHODS OF RAISING CAPITAL HAS YOUR COMPANY USED?

## BANKS REMAIN PREFERRED METHOD OF FINANCING

	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Loan from bank</b>	32%	31%	33%	46%	47%	51%
<b>Loan via a nonbank lender</b>	11%	10%	7%	8%	11%	8%
<b>Operated on retained funds</b>	10%	9%	9%	16%	11%	13%
<b>Debt investment from friends and family</b>	9%	9%	14%	8%	6%	3%
<b>Family offices</b>	9%	9%	—	6%	11%	14%
<b>Equity investment from friends and family</b>	8%	10%	6%	7%	6%	9%
<b>Loan via peer-to-peer lending</b>	4%	7%	5%	6%	4%	4%
<b>Private debt offering to institutional investors</b>	2%	4%	10%	7%	3%	7%
<b>Debt investment from angel investors</b>	4%	1%	3%	3%	1%	5%
<b>Equity or convertible debt investment from angel investors</b>	2%	3%	6%	2%	1%	2%
<b>Investment from private equity firm</b>	—	6%	6%	7%	14%	8%
<b>Private equity offering to institutional investors</b>	1%	4%	3%	6%	7%	3%
<b>Equity or convertible debt investment from venture capital investors</b>	1%	3%	2%	3%	1%	3%
<b>Investment from hedge fund</b>	1%	3%	2%	5%	4%	3%
<b>Straight debt investment from venture capital investors</b>	—	1%	2%	4%	9%	4%
<b>Public offering of equity</b>	1%	1%	5%	3%	3%	10%
<b>Equity investment from a private offering to accredited investors conducted online</b>	1%	—	2%	2%	4%	3%
<b>Debt/Equity investment from a BDC</b>	—	1%	2%	3%	1%	3%
<b>Debt investment from a BDC</b>	—	—	1%	2%	—	1%
<b>Equity investment from a BDC</b>	—	1%	2%	2%	1%	2%
<b>Debt investment from a private offering to accredited investors conducted online</b>	—	2%	—	2%	3%	1%
<b>Public offering of debt</b>	—	—	4%	2%	6%	10%
<b>Other</b>	7%	3%	—	6%	4%	3%
<b>None of the above</b>	32%	33%	35%	19%	14%	21%

# APPENDIX 2

## IMPORTANCE OF FACTORS WHEN CONSIDERING FINANCING

### MIDDLE-MARKET FIRMS MORE LIKELY TO CONSIDER CERTAINTY OF EXECUTION AND INDUSTRY EXPERTISE FOR FINANCING PURPOSES

	<\$500K	\$500K-\$2.5M	\$2.5M-\$10M	\$10M-\$50M	\$50M-\$100M	\$100M-\$1B
<b>Better interest rate</b>	65%	63%	67%	72%	77%	70%
<b>Ease of access</b>	64%	54%	57%	65%	59%	58%
<b>Speed of execution</b>	55%	45%	50%	53%	53%	53%
<b>Certainty of execution</b>	50%	50%	45%	66%	63%	63%
<b>Credit-line preservation from bank or debt market</b>	49%	46%	49%	56%	54%	52%
<b>Knowledge and expertise of the industry</b>	51%	41%	47%	53%	60%	57%
<b>Tax advantages</b>	45%	50%	50%	58%	57%	51%
<b>Funding and asset/project matching</b>	38%	31%	39%	50%	44%	46%
<b>Diversification of funding sources</b>	22%	22%	24%	30%	30%	30%

# APPENDIX 3

## TOTAL DEBT FIRMS HOLD

ABOUT ONE-THIRD OF SMALL BUSINESSES MAINTAIN A DEBT-TO-ASSET RATIO OF 0%–5%. MOST MIDDLE-MARKET BUSINESSES HAVE A DEBT-TO-ASSET RATIO OF 6% OR MORE

TOTAL DEBT	<\$500K	\$500K–\$2.5M	\$2.5M–\$10M	\$10M–\$50M	\$50M–\$100M	\$100M–\$1B
Less than \$500K	87%	73%	45%	31%	19%	23%
\$500K+	7%	25%	45%	59%	71%	65%
Don't know	6%	2%	10%	10%	10%	12%





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