

TOWARD AN UNDERSTANDING OF THE CAPITAL STRUCTURE OF FRIEND AND FAMILY FINANCING

Abstract

This research investigates capital structure theories when capital is sourced through investment by family and friends (F&F) in new venture start-ups. Entrepreneurs typically finance new ventures through self-financing, loans, bootstrapping, and equity investment. About US\$196 billion annually is sourced from F&F investors (Bygrave, Hay, & Reynolds 2003). Firms utilize different forms of finance at different lifecycle stages. Capital structure theories have been used to explain how entrepreneurs choose the type and source of their finance at the different stages. Contemporary research into early stage equity finance primarily used capital structure theories when examining informal business angel and formal venture capital (VC) investors. F&F finance research using capital structure theory, however, is scant.

The research questions addressed in this research are: “How well does capital structure theory explain F&F investment in new venture start-ups?” and “Should capital structure theory be refined to better explain F&F investment?” This paper develops propositions derived from a qualitative analysis of data collected from 22 in-depth interviews with investors, entrepreneurs, advisors, and venture finance experts. This approach is appropriate because F&F investment is a new area of investigation lacking an underlying specific theory. Although F&F investment can draw upon relevant financial theories where “arm’s length” investors are involved, these are insufficient to explain the intersection of the family and/or friend relationship “dynamic” with the investment decision. As such, the purpose of this research is to build upon existing financial theories and contribute toward the development of a theory of F&F investment.

The research examines current knowledge about F&F investment with four capital structure theories:

- Static Trade-Off Theory
- Information Asymmetry Theory
- Pecking Order Theory, and
- Agency Cost Theory.

The conclusion is that F&F investment behaviour is difficult to adequately explain using existing capital structure theories. A major finding is that, in capital structure theories, the unit of analysis and economic assumptions are framed from the perspective of the firm; yet, F&F investment is couched in individual and social relationships. Relationship aspects need to be included in future theory development of F&F investment and this is a differentiating feature of this form of investment.

Theoretically, this paper contributes to the understanding of the limitations of existing theory and identifies the need for new theoretical development in this under-studied area of entrepreneurship. Practically, an improved understanding of F&F investment can assist strategy development for entrepreneurs, investors, and advisors. Understanding the shortcomings of existing financial theories will enable policy makers to devise and implement better policy that takes into account this very significant economic activity.

F&F investment is a significant phenomenon yet it has attracted little research to date. The need for theory development is clearly established by this paper and it identifies the value of such research to the understanding of entrepreneurship.

Introduction

This research investigates capital structure theories when capital is sourced through investment by family and friends (F&F) in new venture start-ups. The research questions addressed are: “How well does capital structure theories explain F&F investment in new venture start-ups?” and “Should capital structure theory be refined to better explain F&F investment?”

The research is couched in terms of an entrepreneurship context using a grounded research methodology. The paper also followed a sociological paradigm. It used a number of theoretical viewpoints rather than adopting a price theory approach which is more common in economic discussions that use the view of human behaviour governed by self interest (Eisenhardt 1989).

The paper is organized as follows. First there is a discussion of the research motivation followed by the context and scope of the research. Second, the research method employed in the empirical analysis is discussed. Third, the empirical evidence for each of the four capital structure theories is examined. Finally, the paper concludes with a discussion of the findings, conclusion, implications, and limitations of the research followed by recommendations for future researchers.

Motivation and importance of this research

Understanding new venture formation is important because it is a key component of economic growth (Kirzner 1973; OECD 2003). In particular, the process by which individuals obtain the resources to turn ideas into a business is key to the study of entrepreneurship (Shane 2003). After allocating personal capital and utilising bootstrapping techniques, the entrepreneur may look to debt, equity, or grants for continued growth of the enterprise (Hisrich, Peters et al. 2008).

Enterprises have been shown to require different types of finance at different stages of their lifecycle (Timmons and Spinelli 2007). Many start-up ventures find that debt or grant finance is either unavailable or not suitable. Equity finance from institutions or individuals may be sought from formal sources known as Venture Capitalists or informal sources that are referred to as Business Angels (Mason and Harrison 1995). However, many entrepreneurs turn to friends or family (Bygrave & Hay 2004).

This research does not address Venture Capital – institutional private equity finance - because this is already relatively well addressed in the literature (Gompers and Lerner 2004) or Business Angel finance because we have an increasing understanding of Business Angel behaviour (Sorheim 2005). Business Angels are private investors who provide risk capital directly to new and growing businesses in which they have had no prior connection and excludes investments in their own firms or in family businesses (Mason and Harrison 1995).

Developing an understanding of the mechanisms by which new firms are started and, in particular, financed is important because this knowledge enables entrepreneurs, their advisers, and policy makers to make better decisions. Informal finance has been identified as an important enabler in the establishment of entrepreneurial new businesses (Bygrave, Hay et al. 2003) and “informal capital markets are the leading source of external risk capital fuelling entrepreneurial start-up and small business growth” (Gaston 1989, p223). This is an important source of capital because many early stage enterprises could not survive without it (Abernethy and Heidtman 1999).

Research into the equity financing of entrepreneurial firms, however, has predominantly addressed venture capitalists and business angels (see, for example, Mason and Harrison 1997; Gompers and Lerner 2004). Yet, the largest supply of informal finance is from people who are known to the entrepreneur (Bygrave, Hay et al. 2003). The proportion of new ventures in Australia that accept finance from friends or relatives compared with other forms of equity finance is consistently above 83% (O'Connor and Hindle 2006; Hancock, Lindsay et al. 2007).

The impact of this behaviour is significant. The average number of people who invest globally on an informal basis is 3.4% of the adult population. This accounts for (US) \$196 billion annually (Bygrave et al 2003). In Australia, 3.3% of the adult population, accounting for 1.26% of GDP, engages in informal investment behaviour with friends or family (Hancock, Lindsay et al. 2007). Venture capital investment, by comparison, is insignificant in terms of activity. Yet, the basis upon which entrepreneurs and investors make these decisions is not well understood and calls have been made to address this gap (Bygrave, Hay et al. 2003; Maula, Autio et al. 2005; Wong, Ho et al. 2006).

Capital structure theories are one means of explaining how entrepreneurs choose the type, source, and ratio of equity to debt of their capital structures (Frielinghaus et al., 2005). There have been a number of studies examining the capital structures of business start-ups. Calls have been made for studies beyond the quantitative approaches that look for averages in the market to unravel the personal and motivational aspects of this behaviour (Cassar 2004). Myers (1984) identified how capital structure theories had been around for some time but that they required more development before they could explain actual behaviour. Even as late as 2001, Myers argued that there was little reason to expect that a satisfactory universal capital structure theory could emerge (Myers 2001). Lemmon (2006) also concluded that there was much work yet to be done to understand the capital structure puzzle.

This research attempts follows similar approaches to Frielinghaus, Mostert and Firer (2005). They examined the behaviour from the joint perspective of capital structure theory and life-cycle theory of the firm theory. The research also draws upon the findings of Harris and Raviv (1991) who argued that capital structure theories can be, and should be, categorised in order to present better focussed research in this area of interest. This research answers the call to use integrated theory by categorising existing capital structure theories and specifically acknowledging that the stage of the business cycle is important in both entrepreneurship and capital structure research.

Context and scope of research

This research was conducted within an entrepreneurship context acknowledging the lifecycle of the firm and different types of finance are appropriate at different lifecycle stages. This research uses the process model approach of entrepreneurship as proposed by Timmons and Spinelli (2008). This approach contends that entrepreneurship can be examined from the perspective of the resources, the opportunity, the lead entrepreneur, and the team. The research specifically addresses the resource component.

Entrepreneurship is a process, therefore, research activity in entrepreneurship should clearly identify where in the process the research activity is focused (Baron 2007). The lifecycle theory of the firm proposes that firms evolve through stages with different identifiable characteristics. The stages have been referred to as start-up, early rapid development, maturity, and decline. There are many variations on this theme but the important aspect for this research is that there are differing characteristics and needs of the firm at different life-cycle stages (Peacock 2004). This research focuses on the early stage of firm start-up. It accepts that resources provide one of the competitive foundations for sustainability and competitiveness (Barney 1991). One resource that entrepreneurs require is capital (Hancock, et al., 2007). This can be obtained from different sources and in different ways. Essentially, capital can be sourced from internal or external funds with the external funds taking the form of debt or equity.

The scope of this research is to examine the external capital acquisition of funds from friends and family at the early stage of venture creation using capital structure theories. The capital structure theories chosen for this investigation are: Static Trade-Off Theory; Information Asymmetry Theory; Pecking Order Theory; and Agency Cost Theory. These were chosen because of their existing use to explain early stage capital structure decision by firms, (Freilinghaus et al., 2005; Cassar, 2004).

Research Method

Entrepreneurship is multidimensional and complex in nature (Mitchell, Busenitz et al. 2002; Neergaard and Ulhoi 2007). New venture investment decision-making adds to the complexity because of the additional investment theories that may be relevant to augmenting entrepreneurship research. For example, a focus on economic analysis alone provides an incomplete explanation of investment behaviour (Basu and Parker 2001; Cassar 2004). There are many aspects of the investment decision that may impact on an individual's motivation to invest in a venture. Similarly, entrepreneurs may prefer various forms of finance. There are many financial theories regarding financial investment (Kaplan and Stromberg 2004) and this is further complicated by the introduction of the complex dynamics of family and friends (Neubauer *et al.*, 1998). Therefore, some authors predict that any attempt to explain investment behaviour through rational economic theory is doomed to failure because exchanges are made in the context of altruism, personal bonds, loyalty, spite, and duty (Estin 1995). However, that should not mean that we discard any attempt to use empirical evidence to test existing theories or develop new ones. Rather, it indicates that the methodology and epistemological approach needs to be able to encompass complexity and ambiguity in the investigation. It is therefore preferable to use research methods that enable exploration of the complexity under investigation. The purpose of this research is to develop an understanding

of whether and how well the various capital structure theories can be used to explain the complex processes that underpin the behaviour of investment in new ventures from friends and family.

The process of investment by F&F is embedded in a social construct. The very definition of the (family or friend) relationship between the investor and entrepreneur means that the investment behaviour is part of a larger social environment. This research is, therefore, investigating a social rather than a natural phenomenon and, together with the exploratory nature of the complex processes, lends itself to a qualitative methodology (Neuman 2000; Paul, Whittam et al. 2007). This research is ideally placed to answer the call for a greater focus on qualitative methodologies within the entrepreneurship discipline (Hindle 2004). This is important because even though a qualitative approach has been recognised as important to the field of entrepreneurship, it is rarely used (Gartner and Birley 2002).

The research follows the approach of Corbin and Strauss (2008). The main departure in this research from the original Glaser and Strauss (1967) grounded approach is that the research is informed by current theory in order to avoid a “data overload” (Miles and Huberman 1994). Existing theoretical bases provide a framework that is used to inform the data analysis (Miles and Huberman 1994).

Data Collection

Having established the reasons for using a qualitative methodology in this research, the semi-structured interview was chosen as the most appropriate data collection method. This was deemed appropriate because it gave respondents the opportunity to introduce insights that may otherwise have been missed by a more structured questionnaire (Neuman 2000). The interviews were guided by existing theories that informed the research design. This approach provided a context and framework without restricting the respondents’ abilities to provide comprehensive responses to the interviewer.

Participants were selected using a purposeful sampling strategy. They were chosen for their knowledge and expertise of F&F investment. This method was chosen because the purpose of this stage is to develop theory and identify the key dimensions that will inform later research (Miles and Huberman 1994). Interviews were held with people who had different perspectives of F&F investment behaviour to minimize bias from any particular perspective. Interviews were conducted with entrepreneurs, investors in start-up ventures (VCs, business angels, and friends), advisers with experience in dealing with early stage investment, and academics identified as being experts in the field. The sample was drawn from introductions through the personal network of the researcher, introductions provided by The Venture Capital Board of South Australia, and academics identified through their research activities and publication records.

The interviews covered a wide range of topics regarding the subject. The data that was drawn for this study was obtained through theoretical sampling of the transcribed interviews (Corbin and Strauss 2008; Miles and Huberman 1994). In other words, the content of the transcribed interviews were analysed with the specific purpose of looking for evidence to fit into the concepts that were the focus of this research. In this way, the research was looking for

theoretical concepts that were supported or otherwise by the data. It is important to note that this does not imply representativeness; rather, it is driven by theory.

The data was drawn from 22 interviews which were recorded, transcribed, and analysed using content analysis. The analysis was conducted using the NVivo software program (Version 8). All interviews were conducted face-to-face with the researcher and were between 60 and 90 minutes in duration.

Capital Structure Theories: The empirical investigation

This section examines the evidence from the interviews in relation to each of the four capital structure theories. A brief description of each theory is followed by discussion using evidence from the empirical data collected. A conclusion is then drawn about the relevance of each theory with concluding remarks about the use of capital structure theory.

Four capital structure theories examined in this research are:

- Static Trade-Off Theory
- Information Asymmetry Theory
- Pecking Order Theory, and
- Agency Cost Theory.

Static Trade-Off Theory, Information Asymmetry Theory, and Agency Cost Theory are closely related in that the latter two are derived from shortcomings of the Static Trade-Off Theory. Some authors place all three theories under the same category (Cassar 1994). The Pecking Order Theory, however, uses information asymmetry and agency costs to argue for a different approach. For the purposes of this research, all four are discussed as separate approaches because we are looking for a deep understanding of F&F investment behavior and, of interest, are variations rather than similarities.

Static Trade-Off Theory

This theory, first proposed by Modigliani and Miller in 1958 (Myers 1984; Harris and Raviv 1991) essentially predicts that firms moved toward a point of ideal debt to equity ratio. This ratio is independent of the market value of the firm and lifecycle stage. The concept is the starting point for many other theories regarding how firms arrive at their capital structure. The major variation that is evident when accounting for the assumptions underpinning Modigliani and Miller's original theory is that of taxation regulations. Modigliani and Miller's (1958) theory can be used to describe how firms utilise taxation to manipulate profitability to develop an optimum (maximum) debt level. Debt levels, however, increases the risk of bankruptcy (as the debt to equity ratio becomes unsustainable). Therefore, there is an optimal debt level where the present value (PV) for the firm using beneficial tax shields are balanced against an acceptable PV cost through the financial stress of high leverage.

This theory has been both criticised and supported (Frielinghaus et al. 2005). Criticisms have predominately been from the perspective that the theory is based on assumed perfect knowledge in a perfect market (Myers 1984). Further, in many cases, firm behaviour tends not to follow the predictions of the theory. The theory predicts that highly profitable firms will have higher debt levels in order to maximise taxation benefits and increase the availability of capital. However, many observations of firm behaviour show highly profitable firms with

comparatively low debt levels (Myers 2001). Contrasting these findings, Warner (1977) indicated that bankruptcy costs were much lower than taxation advantages, thereby implying that debt levels should be even higher than the theory had predicted. Both Myers (2001) and Warner (1977) indicate that the theory has significant shortcomings.

However, there has been some recent support for the theory. Titman and Tysplakov (2007) established that firms do indeed attempt to establish an ideal debt to equity ratio and then move toward achieving that goal. Importantly however, they established that firms change these goals as they develop implicitly accepting the lifecycle theory of the firm. Their findings are based on the proposition that entrepreneurs will commence their businesses with debt to equity ratios that maximise debt such that it is acceptable to both equity and debt instrument holders. After this initial stage, the ideal ratio may change and the firm will slowly move toward the ideal.

Other studies have shown that firms in their early stages of development will aim for low debt levels (Warner 1977; Opler and Titman 1994). Freilinghaus (2005) also concludes that the Static Trade-Off Theory predicts that entrepreneurs who commence start-ups are likely to aim specifically for low debt to equity ratios because the costs for bankruptcy are high compared with any value for taxation benefits.

The empirical evidence from this research shows that there is attention paid to taxation regimes for investment in start-up enterprises. This is particularly evident when comparisons are made between interviewees from different taxation and regulatory environments. For example, there are significant taxation benefits in the UK for investment in start-ups whereas, in Australia, there are little. The trade-off for UK investors provides an incentive for equity financing whereas, in Australia, the taxation benefits of debt could be argued to be more beneficial for investors and entrepreneurs. Such differences provide some support that the Static Trade-Off Theory is important. This was clearly illustrated by one respondent in the UK, who said,

“Now, in this country everybody does ordinary equity. That’s the only one that gets the tax relief. That’s what I was talking about distorting behaviour.”

Whereas, in a different (US) tax regime, another respondent said when discussing the implications of debt and equity structure,

“Well clearly, if I’m an entrepreneur, or if I’m a local lawyer, or accountant who’s helping someone in the formation stage, you know, they can just learn one sentence, like, ‘convertible loan’, you know, ‘convertible’”

This comment was made in order to emphasise that a loan is the preferable instrument and that the loan could be converted at a later stage to equity only if the deal is attractive enough to do so. In this way, the debt to equity ratio is high at the start of the enterprise but is reduced markedly once the enterprise looks like it will be successful. This is in stark contrast to the conclusions reached by Frielinghaus (2005) who concluded that the Static Trade-Off Theory predicts that, in the early stages, a firm would have low levels of debt to equity. In a different tax regime, however, the opposite may hold.

Therefore, we can conclude that Static Trade-Off Theory does not hold for different tax regimes. There is little value in applying this theory in an F&F investment decision environment other than to acknowledge that government policy through the taxation regulations can have a significant impact on how both investors and entrepreneurs will consider structuring the finance deal. There was no evidence at all that entrepreneurs aim to achieve the optimum debt to equity ratio either at start-up or later. In fact, there seemed to be an acceptance by entrepreneurs that they took what was available.

Information Asymmetry Theory

A different approach to the Modigliani & Miller (1958) proposition was highlighted by Ross (1977). He argues that the capital structure adopted by a firm's management sends a signal to the market that influences the valuation of the firm. This is specifically due to discarding the important assumption underlying Modigliani and Miller's (1958) irrelevancy theory that the market possesses full information about the activities of the firm. The basic proposition is that if management increases debt levels, the market would assume that the managers knew more about the firm's ability to make future repayments than the market. Thus, higher debt indicates higher future returns. This position was disputed by Fama and French (1988) who found that firms with lower debt were more profitable. There is little evidence, however, that this theory has been applied to start-up firms.

Traditionally, firms attempt to reduce information asymmetries by providing track records, (of the business and its entrepreneurs) producing business plans, and involving financiers in strategic decision making processes. Financiers, on the other hand, use observation and monitoring techniques to satisfy themselves they have accurate and reliable information. They may also insist on collateral and covenants to secure their investments beyond what they can reasonably acquire as information. Start-up enterprises are able to provide little, if any, of these artefacts to alleviate the problem. The signal sent to the market is probably irrelevant in the start-up stage. The value, hence the investment, will be a mutual agreement between the entrepreneur and their investor.

It is easy to assume that because investment behaviour is between people who are known to each other that the information asymmetry issue would be minimal. In many cases, it appears that this is so; however, there is evidence from this research to suggest that this is still a significant issue. Illustrating this point is the following quote from an advisor who had a number of dealings involving F&F investment,

“[the investment] ...can quite often break friendships as well, you see, so it's very, I keep telling people you know, it's dangerous and dangerous to do that because you're a high risk, of not losing money, ... but friendships and families break-up”

This was supported by another investor who became involved with a family that had become embroiled in a dispute over an investment,

“They had become rich and they actually were acting in a very, very bad manner towards the father. They'd sold the family home to get them going and none of their promises [were fulfilled]”

The risk of information asymmetry is, therefore, very real. There is an added dimension when family and friends are concerned. That is, there is more at stake than the market valuation of the firm which is what the theory specifically addresses. The market, in terms of future investors, finds that the legacy issues that the family and friend investors leave behind can be significant and intractable. As one investor said, when discussing a deal that he made in a business that had started with family investment,

“Well, we spent about four or five years trying to untangle it”

In conclusion, when information is not well understood by all parties, the future valuation of the business can certainly be adversely effected. An interesting aspect was raised by one of the respondents in this matter in that they reported that if a business starts up by accessing family or friends’ finance, the signal to the market, rightly or wrongly, is that the business has no potential,

“There’s going to be built in bias that these businesses are going to fail and is that the case?”

This may now be a long way from the original theory that we commenced with, but it certainly starts to indicate that the source of finance (not necessarily whether it is debt or equity) can send a strong signal to the market. Therefore, Information Asymmetry Theory as proposed needs considerable extension before it can be satisfactorily used to explain the investment behaviour of friends and family.

Agency Cost Theory

Agency cost occurs when one entity engages another (principal and agent) to act for them in some manner (Jensen 1986) and costs are incurred to reduce the information asymmetry. In the case of a start-up enterprise, the entrepreneur and investor are reliant on each other, but predominantly the investor carries the financial risk. The investor will put in place costly monitoring and contractual control mechanisms to reduce their risk (Cassar 2004). Investors will attempt to reduce the extent to which the entrepreneur holds information that is not accessible to the investor. This can be done in various ways. They may provide finance that is purely debt and thus repayable in full (plus interest). They may wish to provide equity, thus maximising their return on investment beyond a loan contract, but use such instruments such as convertible bonds (Sorheim 2005). Thus, if the outcome of an equity investment looks less than attractive, the instrument may be converted to a loan that the entrepreneur is bound to repay. Investors will resort to such instruments to reduce the agency cost because the fundamental concept in this theory is that of self interest (Eisenhardt 1989).

There is very little evidence in this study that supports the use of such instruments. When friends and family are investors there are other mechanisms that appear to reduce such risks. One example shows how, within a close community, agency costs are reduced by only dealing within a trusted network,

“if they don’t know you, they won’t do business with you and they won’t give you money ... you won’t even be invited to a party, they don’t know you and they don’t

know you well...there's close circuits like that and business at a certain level is about family connections”

The issue of factoring in costs due to the agency problem is evident only to the extent of personal obligation. The theory is specifically modelled on a financial basis which simply appears to be absent in these cases. For example, the following statement was made in the context of “cost”, but it was clearly a reference to personal and emotional issues,

“when you're taking mum and dad’s money, you know, what are they expecting, what do they really expect in return, what is your obligation to them, and what do you expect from that?”

The mechanisms that are available to formal investors to reduce agency cost are simply unavailable at the start-up stage and probably would not be utilised in any case. The use of contractual arrangements, guarantees, or other such instruments appear to be absent in these cases. Agency Cost Theory is therefore unable to explain F&F investment behaviour using the evidence as presented in this research.

Pecking Order Theory

The Pecking Order Theory proposes that there is uneven information between managers and investors. This provides another means of overcoming one of the limitations of the original Modigliani and Miller (1958) capital structure view (Chirinko and Singha 1999). This asymmetry leads to firms preferring internal funds over external funds; however, when internal funds are no longer available, debt is preferable to equity due to the riskiness of equity (Myers 1984). Internal funds hold no adverse selection risk. The cost is internal and completely controlled by the entrepreneur. Debt is a higher risk, there is the need to repay it, but the costs are external and therefore are considered to be moderate, or incur minor adverse selection risk. Equity comes with a higher adverse selection risk and information asymmetries between the investor and firm are significant (Cassar 2004). Therefore, the cost of such finance is much higher with the investor factoring in the higher risk thus looking for a higher return. Therefore, equity is only sourced after the ability to borrow funds is exhausted (Frank and Goyal 2003). Pecking Order Theory has been supported by a number of studies in various environments (Cassar 2004).

The principle of the theory states that a business will initially use its own internal finance resources (often referred to as bootstrapping) before looking to debt and then equity. There was some evidence that internal funds are indeed used,

“they did use a little bit of the boot strapping. The fact that they're doing some undergraduate teaching ... and resources and family and one of them basically has been supported by his wife, that’s the big difference for him.”

However, there is no evidence at all that there is a pecking order regarding debt and equity. In fact, there is some evidence that start-up entrepreneurs skip the search for debt altogether and move straight to equity finance. This could be for a number of reasons; chiefly amongst them is that there is a belief that banks simply do not lend money to start-ups. When they do, they actually lend on the basis of a steady income independently of the start-up business and

adequate security in the form of collateral (invariably real estate). Because of this, any debt that an entrepreneur is able to secure is personal. This has interesting ramifications for this theory. In the case where an entrepreneur is able to secure a business loan, what appears to be occurring is that loans are provided to the entrepreneur. Then, that capital is injected into the business. Thus, it is owner's equity rather than external equity. Therefore, the concept of using internal funds then debt is not relevant in a start-up situation. Even when an entrepreneur can obtain a loan, the firm does not incur the debt, the entrepreneur does. In some cases, the family and friends source is used to bypass even other forms of equity finance such as venture capital,

“I used to do angel investing... and people that came from wealthy families actually had a big advantage 'cause they had the whole extended family they could get backing for so they could avoid the angel round and even the first venture round”

A number of respondents reported that an agreement as to whether the finance is debt or equity is rare. The parties do not establish whether it is a loan with (or without) interest repayment, or a dividend, or repurchasing equity.

Many reported that the entrepreneur often had no other option than to look for external capital from friends and family. Therefore, on a number of fronts, the Pecking Order Theory does not hold. Under this theory, equity is the finance of last resort; however, the evidence suggests that equity can be, and often is, finance of first choice.

Review of the Capital Structure theories as they relate to start-up & F&F finance

Application of capital structure theories to the investment behaviour of friends and family has raised a number of issues that require discussion before the answers to the research questions can be addressed. The following discussion addresses the main findings that analysis of the interviews revealed.

1. Unit of analysis

One of the outcomes that this research identified was that all capital structure theories use the firm as the unit of analysis. However, when we examine the workings of the investment in a start-up enterprise, the unit of analysis is the individual entrepreneur and his/her relationship with the investor. F&F investment behaviour may be seen as an extension of the relationship rather than an economically driven and rational financial deal. This means that the unit of analysis is at the individual level between the two parties involving their relationship or contract. Greater complexity arises because the deal can also impact on the relationship. An example was expressed by a respondent, who had consulted to families in this situation,

“Does it affect relationships where friends and family put up money? It certainly can do ... You have to advise the friends and the family exactly what the risks are and it's quite difficult to be that ruthless when you're trying to raise money [from family] ... it is quite easy for these people to feel that they've been abused”

There is also a significant issue in the understanding of what occurs from an accounting perspective. A number of respondents questioned whether the business actually was the recipient of the finance, no matter whether it was a loan or equity,

“if however the money goes into the business and not into the bloke’s pocket then that’s a separate issue.”

The general feeling from respondents was that money is provided to the entrepreneur in the majority of cases. The entrepreneur then injects the capital in to the business. This creates an interesting accounting dilemma because the capital, in many instances, is irrelevant as to whether it is debt or equity since the intention is that it is always the entrepreneur’s, and thus it is owner’s equity. The arguments put forward by the various capital structure theories become irrelevant in such instances notwithstanding the affairs of the business may be structured to make use of taxation laws.

2. The market assumption

All capital structure theories have been developed in the context of a large market place and the basic assumptions that were used by Modigliani and Miller (1958) have not been challenged even though many other of their assumptions have (Frielinghaus et al. 2005). This point was made by one respondent on this matter and this is important when we consider economic theories within the context of this research,

“I make the point that you can’t really talk about the [friends’ and family’s] money as being a market ... because if [the market] is not related, then your family money is inaccessible to it”

In addition, capital structure theories were developed and tested in a market context of many suppliers (capital available to invest) and many customers (firms that are looking for capital). F&F financing is not relying on market forces. F&F are not usually searching the open market for investment opportunities. The transaction occurs outside of the economic framework of supply and demand. Because of this point alone, there is doubt on the usefulness of capital structure theories in the F&F investment context.

3. Rational approach

The repayment of the money provided by F&F may be a loan or a share of the wealth of the business. In many cases, this creates considerable friction because the parties may have very different expectations on the outcome. Even when equity is clear, there is some confusion over what it actually means for the investor,

“That seems to me part of the strangeness of what I call a private company and it's in a way what investors and family and friends do they get three shares for their \$5,000 (or whatever it happens to be) but they can't do anything with it in a private company so what is their motivation?”

Even when the deal is structured with some sophistication, such as using convertible notes, the fact that the business is at the start-up stage makes the equity position particularly difficult to agree on,

“Take a convertible preference position. ... You can’t really work out the value of the company at that stage”

Most deals, however, never reach this level of complexity, but when financial advisors try to untangle the deals some time later, there may be different interpretations on what the deal was. In many cases, the capital is actually never expected to be paid back, as one family investor admitted,

“Q: did you expect to get that money back at all?
A: I didn’t, no.”

When advisors try to establish what the deal actually is, they are often confronted with attitudes that are exemplified by the following comment,

“And they’re quite happy to [consider that the capital] is almost like a gift, but you ask them if it’s a gift, and they say no. But it’s really a gift.”

There are difficulties in assessing capital structure theories because some of their underlying assumptions do not hold when investigating Friends and Family investment. The distinction between debt and equity is rarely clear. Many of the respondents in this research raised this as a serious issue. In many cases, the capital is provided with no real contractual understanding at all. The theories rely on clear cut definitions of what is equity and debt finance; however, the participants are often unable (or unwilling) to decide. When attempting to ascertain what actually occurred from an accounting point of view, there is often too much ambiguity to be certain. Under such circumstances, capital structure theories are not particularly useful.

4. Motivation – sociological and humanistic behaviour

The underlying assumption with capital structure theories is that the firm is valued accurately by the market, either through the market having full knowledge or the firm being able to indicate to the market via its behaviour. This valuation then leads to appropriate allocation of capital with an appropriate structure. The motivation of the market is to maximise economic returns. However, notwithstanding the problem of the market as discussed above, the motivation of investment also departs from our rational economic model. Respondents clearly identified that the prime motivation for most family and friends was not maximising return on investment. One experienced investor said,

“Now, with my family, I will invest because I want to help them, even if I might feel that they are not going to make me any money.”

This essentially renders irrelevant any of the capital structure theories. Even when capital is provided, the ability for the “market” to have knowledge of the capital structure is often masked. In this context, we are examining private companies that do not have to divulge their finances publicly and, even if they do, capital structures may still be hidden, as the following comment illustrates,

“I have a friend that sold a house and gave it to his kids to invest in a company for them to build their company and he wasn’t even on the share register”

The problem for the capital structure theories are that people do not behave as rational economic actors in this context. The assumptions upon which the theories are built do not hold.

5. Epistemology

This research aimed to explore and understand the issues at hand. It used an epistemology based on the acceptance that the world is a complex place and that the interactions among people are rarely straight forward. The capital structure theories that have been examined, however, are based on a different view. They are from the paradigm that firms can be viewed as a bundle of contracts and these can be measured by ascertaining their value as if they were an asset for sale in a market. Such investigations lead to theories that aim at understanding behaviour from a macro perspective, such as looking for the average on a regression line (Corbin and Strauss 2008). What are often ignored are the outliers, the firms that do not sit on the average. Entrepreneurs look to operate outside of the average, obtain resources without having to own them, and look for opportunities that the markets have failed to recognise (Shane 2003). As a consequence, the examination of the complex F&F investment phenomenon under investigation here will be unlikely to provide any real insights by establishing a regression line of behaviour. We need different theories to explain the behaviour of entrepreneurs and their affiliated investors.

Conclusion

In conclusion, the Capital Structure Theories examined in this research have failed to provide a sound basis for understanding the issues surrounding friends and family financing of start-up ventures. As a means to ascertain exactly why this is so, in addition to the discussions presented so far, the following comments of the interviewees are presented.

The complexity of the relationship is at the heart of the issue. The behaviour is not an economic one, but a social one,

“...it is about softness, it’s about friendship and experience and common values, the whole thing is worth that, it’s alright to regard this as another source of money, but it isn’t”

Another respondent said,

“it’s framed rarely by mind, it’s framed by emotion, it’s psychological for them, and they may be investing in things they wanted to do, it’s part of the family, family ..., blood thicker than water.”

Although we can accept that in at least some cases, an economic underlying motivation is present, there is always an emotional element,

“you have this emotional investment as well as financial investment”

This emotional investment is extremely important and must take centre stage in the examination of this issue. It leads to a number of psychological issues that the economic

theories simply fail to address. These include trust, obligation, and the development of relationships over time,

“when you have people invest in you, you have this emotional investment as well as financial investment, how those can react and how they treat it, you know, one or two or three years”

The following quote from an investor summed this issue up nicely,

“it's the ethical obligation you have, they started you, they had faith ..., they trust in you, and you should honour that in some way, some form, maybe you can't pay it back all at once, but, I think our board said, you know, be mindful of whoever got you started.”

The two research questions examined were: “How well does capital structure theory explain F&F investment in new venture start-ups?” and “Should capital structure theory be refined to better explain F&F investment?” This research concludes that Capital Structure Theories, although having some interesting perspectives that can help frame the activities, do not adequately explain F&F investment behaviour. They fail to address underlying issues of the appropriate unit of analysis, the market assumption failure, and the rational economic approach failure. In addition, there are no means to address motivations within a social context.

There is little to be gained in adjusting or building on capital structure theories because they do not appear to be able to account for the complexity and multi-dimensional aspects that are needed to explain and understand F&F investment. Any theory that is developed needs to include concepts such as social norms, culture, obligation, and trust in addition to our current understanding of entrepreneurship involving new venture creation and start-up venture activity.

Research Implications

Theoretically, this paper contributes to the understanding of the limitations of existing capital structure theory and identifies the need for new theoretical development in this under-studied area of entrepreneurship. It points the way forward as to what issues should be considered with future research. F&F finance is a significant phenomenon; yet, it has attracted little research to date. The need for theory development is clearly established by the findings of this paper which identifies the value of such research to better understanding entrepreneurship and the new venture creation process.

Practically, an improved understanding of F&F investment can assist strategy development for entrepreneurs, investors, and advisors. The findings of this research may assist stakeholders to consider factors beyond those of the capital structure models currently available.

Understanding the shortcomings of existing financial theories will enable policy makers to devise and implement better policy that takes into account this significant economic activity. If the aim of policy is to enable and support entrepreneurship, this research will enable a deeper understanding of the issues that are not addressed with current capital structure theories.

Research Limitations

There were a number of limitations associated with the research. The interviews analysed came from people who had experience in and had been involved with start-up enterprises and investment that included family and friends. The research is, therefore, from the perspective of observers of the F&F investment. There may be biases introduced from this perspective.

The researcher conducted all the interviews and analysed the transcripts. This introduces the potential for bias; however, the deep understanding required for such a study is believed to outweigh any negative consequences.

The interviews were conducted with respondents in Australia, UK, and USA. The research is therefore only relevant to the predominant culture of these countries. However, enough differences were identified to indicate that substantial differences may be evident in different cultures. Therefore, the findings of this research should be considered to be indicative only within these specific cultures.

This study has examined a relatively narrow set of economic theories. It does not mean that all economic theories are not relevant to F&F investment.

Future Research

Additional in-depth studies that examine entrepreneurs and F&F investors is recommended to further our understanding of F&F investment. Future research should examine economic theories not addressed in this research. Different cultural contexts, taxation, and policy regimes should also be examined to understand how different social influences affect F&F investment. It is clear from this research that a great deal more can be learnt and it is important, given the extent of F&F investment behaviour. Policy makers, financiers, entrepreneurs, and their advisors have a responsibility to have an understanding of the F&F investment phenomenon.

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