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Outside Equity Capital: Before and After the Internet

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During the 1980s, the US economy began a transition from being industrial/manufacturing based to an entrepreneurial/innovation-driven economy. Currently entrepreneurial firms comprise more than 95% of all firms in the US and over 1 million new small firms are being created each year. They are generating over 85% of new jobs and are responsible for more than one-half of all innovations in the market. This impressive contribution to the US economy is not uniformly spread among the small business sector, but limited primarily to the most rapidly growing entrepreneurial firms -- often referred to as gazelles. The gazelles' appetite for resources, especially financial resources, is enormous (Timmons, 1999). Equity capital for these rapidly growing firms primarily comes from three complementary sources, directly related to the developmental stage of the firm: angel capital, venture capital, and initial public offerings (IPOs).

The major source for early-stage capital is private investors or angels (Timmons and Sapienza, 1992). These are wealthy individuals interested in the high risk and high return opportunities that new business enterprise offers. Angels invest $30-$40 billion annually in entrepreneurial companies (Sohl, 1999). These wealthy investors exist in all communities and in all cities throughout the developed nations but the best way to reach them has been through personal introduction in the economic network of a community. Advantages of this source of capital are the size and accessibility of the investment pool as well as a positive reputation many wealthy angels bring to the table. The major disadvantage is the matching of the right angel with the right firm. In some cases, investors and entrepreneurs have resorted to paying costly finders fees in an effort to link ideas and capital. Moreover, the angel investor may not have expertise in the selected firm's industry but still interfere with the management of the firm in an effort to protect their capital (Stevenson, Roberts and Grousbeck, 1989). Another potential problem arises when the original angel does not have enough money to reinvest should the need for additional capital develop.

The second source of outside equity, venture capital funds, represents wealthy investors who have pooled their resources and hired professionals to make investment and other related decisions. They consist of about 500 funds that manage $35-$45 billion and make $3-$4 billion in new investments annually (Sohl, 1999). Venture capitalists have become intensely stratified and generally specialize within industries and sectors, in the stage of the prospective company, in the type of ownership structure, or in a particular locale (Silver, 1994). They are aware of the high risk to their investment and often look for target rates of return of five times their investment in three years and ten times their investment in five years (Sohl, 1999). In addition, they require extensive research of the company and its operations, commonly referred to as due diligence, before committing funds and subject the current owners and management to intense scrutiny. Unlike angel capital, venture capitalists are often able to bring additional money to the table if needed. Major problems include the lack of understanding of the venture capital market by potential users and the matching of investors with entrepreneurs when the venture capitalists vary so dramatically in their tastes for investment and requirements for participation (Pratt, 1999).

The definitive source of equity capital, in terms of size and wealth potential for its owners, is an IPO. The firm generally contracts with an investment bank to help price the stock and distribute the shares. While the value of the firm can increase by 30% following the offering, it is a costly endeavor from finding the right investment bank to paying the bank's commission and myriad expenses (Emory, 1999). The proprietary nature of the investment banking industry may also mean that the firm is at the mercy of the bank's pricing and distribution practices. Among these practices are under-pricing, where the bank deliberately discounts the stock price from its estimated value, and spinning, where shares of hot IPOs -- those that are expected to escalate in price -- are reserved for the bank's best clients. This latter practice makes it hard for the average investor to obtain any of the shares of these better offerings. While the IPO adds tremendous value to the firm, under-pricing and spinning appear to add more cost to the offering process as a rapid increase of the stock price in the after market suggests the firm was sold for considerably less than its market value.

It is estimated that as many as 150,000 early stage, rapidly growing firms are in need of approximately $60 billion each year in risk capital. A "capital gap" currently exists in the US where less than $40 billion in early stage, risk capital is available for investment (Sohl, 1999). This capital gap acts as a constraint to innovation and to the commercialization of new technology. The existence and proliferation of Internet access may offer solutions to many of the problems of raising capital.

The major problem for angel capital, as it is for venture capital, is the matching of investor and entrepreneur. Electronic matching offers the benefit of facilitating the required networking opportunities for both angel investors and entrepreneurs. In addition, electronic markets make due diligence of investment opportunities much easier through greater access to market and financial information. Recently, web sites have been developed that attempt to assist with the matching process by acting as a clearing house and information resource for investors and business owners. One such site, ACE-Net [https://ace-net.sr.unh.edu/pub/], is a non-profit, national securities offer service that allows venture capitalists and institutional and individually accredited investors to find small, growing companies through an Internet database. ACE-Net is a fee-based listing service, but allows investors and prospective firms the opportunity to peruse possible sources and outlets for investment and capital. Investors can customize the search engine to find companies that meet their particular interest. This can be done online or by automatic E-mail notification. Special interest investors and entrepreneurs can access a national network of people with common interests. Entrepreneurs wishing to increase their firm's visibility can list on the ACE-Net Company Database. With the myriad possible specializations of angel and venture capital investors, this type of Web service adds considerable efficiency to the matching process.

In addition to sites like ACE-Net, that aggregate information and act as a clearing-house for entrepreneurs and investors, there are firm-specific sites -- another vehicle for the difficult matching process. It may be a small business seeking venture capital or an investor looking for opportunities. Advent International [http://www.adventinternational.com/], for example, is one of the world's largest private equity investment firms with $3.5 billion under management and offices and advisors in 16 countries. Their web site describes Advent's investment criteria including acceptable stages of development, uses of potential equity funding and industries where their expertise lies. Entrepreneurs can find the Advent site via one of the Internet's search engines.

Another type of web site offers links to various sources of capital. Business Nation [http://www.businessnation.com/library/finance.html], for example, offers links and a brief summary of 15 different sites, including ACE-Net. In addition to these financing links, the site includes a directory of other related government offices, individuals, libraries and databases that contain information about capital and its availability. Sites like these help to match money and ideas but also solve another of the other major problems of raising capital, the lack of information. Within easy access are hundreds of informational resources that describe the nature and hazards of nearly every type of equity financing. In addition, the vast number of possible sources allows verification and authentication of most information.

For IPOs, Investment banks such as Wit Capital and E*Offering are already posting offering prospectuses on the WEB and distributing shares via an online process. Investors, regardless of their relationship to the investment bank, need only have an account with the bank in order to purchase an allotment of shares. Eventually this online process may provide access to all IPOs for all investors. In another development, W. R. Hambrecht [http://www.wrhambrecht.com/offerings/auctions/openipo/index.html] permits investors to submit bids for the number of IPO shares they would like to buy and the offering price they would like to pay. The final offer price is set at the lowest price that clears the market. Those submitting bids below the offer price will not be allocated shares. The process, known as Open IPO, allows investors to determine the final offering price of the company's shares rather than the investment bank. While, in theory, the Open IPO should mean little if any under-pricing of the stock, the Hambrecht evidence, thus far, has not been encouraging. The $18 offer price of their third Open IPO, Andover.net, was determined by Internet auction. However, the stock opened at $47 1/2 and reached $63 3/8 by the close of the day -- a run-up of over 250%. Perhaps the ultimate step in raising public equity is the direct IPO, where the company bypasses investment banks and brokers and sells its stock directly to the investors (Liaw, 1999). Spring Street Brewery and Logo Research Systems have already successfully gone public through a direct offering.

The implications of the changes in equity financing being brought about by the Internet are dramatic. First, the matching process of investor and entrepreneur is becoming more proficient. Second, the need and cost of intermediaries, such as finders, brokers and investment banks is rapidly diminishing. Finally, with easy access to information, investors and entrepreneurs will become more knowledgeable about sources of financing and the value of businesses such that their pricing and distribution will become more efficient.

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