Private Businesses Predict Limited Growth for 2013

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ABSTRACT

The quarterly private capital access (PCA) index and the private capital demand (PCD) index, economic indicators published by the Pepperdine Private Capital Markets Project, predict continued low levels of both demand and access in the near future. Thus the near-term prospects for robust economic growth are restricted. The implied policy recommendation for national and local governments is to enhance loan guarantee programs for private firms with revenues of less than five million USD ($5M).

Keywords: Private Capital Markets, Debt, Equity, External Capital

Introduction

Public capital markets are decreasingly useful in explaining or predicting aggregate economic growth. In fact, the relationship between public stock returns and real economic activity has been shown to be weak, at best[i,ii]. Therefore, it is reasonable to turn to private markets for answers, since it is generally recognized that GDP growth in highly developed economies is significantly driven by the private sector and by entrepreneurial activity in particular[iii].

In 2012, the Pepperdine Private Capital Markets Project began publishing quarterly economic indicators with the intent of capturing these private-sector economic drivers in a way that can be utilized by leaders in business for planning purposes, and government for policy purposes. The first indicator is the Private Capital Demand (PCD) Index which measures private business demand for growth capital on a scale from zero to one hundred. Once a firm recognizes opportunities for growth in its business, there will soon be a corresponding demand for equity or debt financing in order to fund that growth. Thus, we should see a spike in the PCD Index before significant economic growth occurs. Subsequently, once there is a demand for growth capital, whether or not the financing actually happens is dependent upon the supply of capital. The Private Capital Access (PCA) Index measures the availability of growth capital to these companies. This is also measured on a zero to one-hundred scale. Expansion of private business is dependent upon the simultaneous increase of both capital demand and capital access.

The current levels of the PCD and PCA indices are low (well below fifty), and their trend is flat or slightly decreasing. Therefore, there appear to be significant near-term challenges to growth for private companies.

The Private Capital Demand Index and the Private Capital Access Index

The PCD and PCA indices are constructed using survey response data from more than 6000 small businesses (less than five million dollars in revenue) and middle-market businesses (between five million and one hundred million dollars in revenue) across the United States. The surveys are conducted through a partnership between Pepperdine University's Graziadio School of Business and Management and Dun & Bradstreet Credibility Corporation. The methodology for constructing the PCD Index and the PCD Index is documented in a separate paper by Everett and Paglia[iv].

The survey is conducted on a quarterly basis and the questions reveal business owners' perspectives concerning current need for external financing, success rates of raising new capital, accessibility of various forms of capital, and plans for growth. The survey responses are analyzed using an exploratory statistical approach called factor analysis, which creates a correlation matrix of all the survey response variables and then identifies potential clusters of highly correlated variables in the sample. These clusters, or factors, represent potential latent drivers in the data.

When the survey data for the first two quarters was processed using factor analysis, two clear factors emerged. One of the clusters was clearly grouped around the survey questions regarding the firms' need for outside capital. This factor was thus labeled "private capital demand." The other cluster of correlated variables was related to the questions regarding success in securing outside financing. This factor was labeled “private capital access.”

The factor analysis process also identifies the appropriate coefficients for each variable for each factor. Thus, an overall index value is calculated by taking the sample mean for each variable and multiplying it by its coefficient, summing all of these products, and then scaling the result from zero to one hundred.

Since the indices range from zero to one hundred, values greater than fifty can be generally interpreted as a good environment and values less than fifty as a challenging environment. Although not universally the case for all businesses, it has been shown in empirical studies that, in general, access to external capital is helpful to business growth[v] and that hindrances to capital access depress economic activity[vi].

Quarters when the PCD exceeds the PCA suggest a tight market for financing, where investors and lenders have the upper hand for negotiating financing terms. This results in a tight credit or equity market for private firms. On the other hand, if the PCA exceeds the PCD, it suggests that funds are available but not demanded – because firms do not see opportunities for growth.

Economic Outlook

Figure 1 shows current trends in private capital demand and access for small firms. Both demand and access have remained well below fifty for the first four quarters of the survey, indicating generally limited prospects for growth in the near future. The trend has been relatively flat for both indicators, thus no dramatic increase or decrease in economic growth is expected. A depressed PCD Index can be interpreted in one of two ways. Either the business owners do not see opportunities for growth from increased customer demand for their product or service, or they do see those opportunities, but do not feel that funding attempts will be successful so they do not plan to try. Regardless of the reasons, business growth is inhibited by lack of demand for growth capital. One notable aspect from Figure 1 is the significant drop in the PCD Index for the last quarter of 2012. Since the previous three quarters were fairly stable in demand for financing, the 2012-Q4 drop is potentially harmful to short term small business growth prospects.

A depressed PCA Index, on the other hand, reflects the perception among business owners that outside capital is simply not currently available to them at reasonable terms. Thus, even if demand for capital were healthy (which it currently is not), private business growth would still be blocked by the relative unavailability of debt or equity growth capital.

It should be noted that for small firms in the current survey, demand significantly outpaces access, which points to a very difficult financing market where small firms have less power to influence deal terms. A table containing the exact quarterly index values is included in Appendix 1.

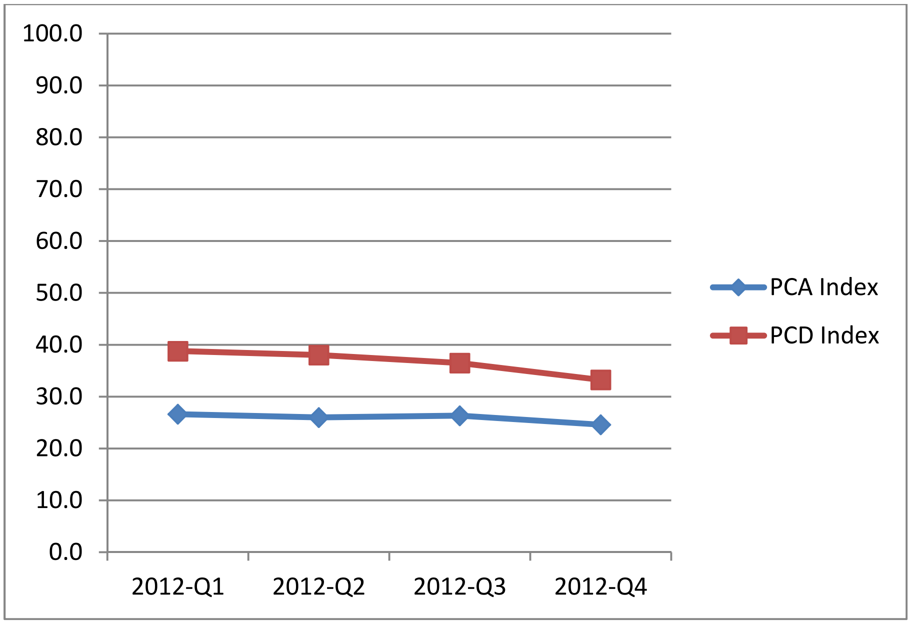

Figure 1. Private capital demand and access for firms less than $5M

Figure 2 shows current trends in private capital demand and access for middle-market firms. Similar to small firms, both demand and access are below fifty which indicates a poor capital market environment overall. Demand is lower, however, for the middle-market than for the small business market, suggesting that these larger firms see fewer growth opportunities than the small firms. Access to capital, on the other hand, is much higher for the middle-market firms than for small firms. This indicates that investors and lenders are more willing to fund the larger firms. This is consistent with previous research demonstrating higher impacts of capital restrictions on small business[vii]. Since the PCD level is lower for lower middle market companies than for small businesses and the PCA level is higher, the financing markets appear to be more supportive. The relative lack of financing frictions in this segment is likely to lead to increased growth realizations (or more successfully converted opportunities).

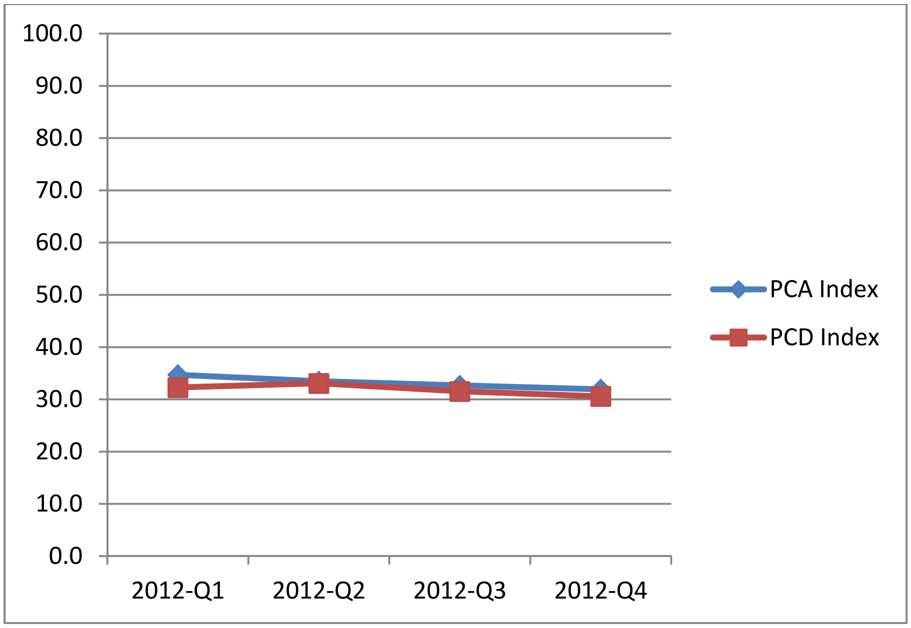

Figure 2. Private Capital Access and Demand for Firms between $5M and $100M

Conclusion

The Pepperdine Private Capital Demand Index and the Pepperdine Private Capital Access Index are currently in the low range and trending slightly downward. Demand for capital appears to be weakening even faster than access to capital among small businesses, which indicates a perception by the owners that their growth prospects are not strong right now. As leading economic indicators, changes in these indices should precede corresponding changes in overall economic growth and employment. At present, there is no indication of any near-term dramatic change in direction of the overall economy. Of course, these indicators are based on the perceptions of private business owners and cannot incorporate unexpected impacts of outside shocks (e.g. oil price shocks, European instability, congressional budget/tax or "fiscal cliff" negotiations, etc.).

There is currently a limitation to using the PCD Index and the PCA Index results to predict larger macroeconomic trends. Since there are only four quarters of survey results available to date, it is not possible to control for any potential seasonality of loan demand. But even if there are, in fact, seasonal trends, the quarterly results thus far are still relevant since a current drop in capital demand is still likely to influence small business growth in the near future, regardless of whether the drop is seasonal or not.

There are policy implications that can be derived from the PCD and PCA Index trends. Since the private capital markets for the middle-market are generally more supportive, improving capital access for these firms is likely to have less of an impact than would be the case for small businesses, where demand for capital significantly outpaces access to capital. Thus, it is reasonable to assume that improving capital access to businesses with revenues of less than $5M (through expansion of small business loan guarantee programs, for example) would result in immediate implementation of growth plans by these small businesses. Naturally, the expected result would be an increase in employment and GDP growth.

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Appendix A

Quarterly Values for Pepperdine PCD and PCA Index

	PCA Index	PCD Index
Total Market		
2012-Q1	27.8	37.0
2012-Q2	27.0	36.5
2012-Q3	27.3	35.1
2012-Q4	25.6	32.7
Less than $5M in Revenue		
2012-Q1	26.6	38.8
2012-Q2	26.0	38.0
2012-Q3	26.3	36.5
2012-Q4	24.6	33.2
Between $5M - $100M		
2012-Q1	34.7	32.3
2012-Q2	33.5	33.1
2012-Q3	32.7	31.5
2012-Q4	31.9	30.6

Appendix B – Survey Questions Used in the PCA and PCD Indices

Note: Question numbers that are missing below refer to questions in the survey that were either not deemed relevant to the PCA or PCD index construction or had too many missing values to be effectively utilized in the factor analysis.

Q2 Please rate your current need for new external financing (capital) for your business for each of the following categories.

	No need for financing (1)	Slight need for financing (2)	Moderate need for financing (3)	High need for financing (4)	Extremely high need for financing (5)	Not applicable (6)
Planned growth or expansion, including acquisitions (not yet realized) (1)	❍	❍	❍	❍	❍	❍
Working capital fluctuations (2)	❍	❍	❍	❍	❍	❍
Growth due to increased demand (already realized) (3)	❍	❍	❍	❍	❍	❍
Finance worsening operating conditions (4)	❍	❍	❍	❍	❍	❍
Refinance existing loans or equity (5)	❍	❍	❍	❍	❍	❍
Withdraw wealth for owners (6)	❍	❍	❍	❍	❍	❍

Q3 How would you generally characterize the current environment with regard to raising new external business financing?

	Very difficult (1)	Moderately difficult (2)	Slightly difficult (3)	Neither difficult nor easy (4)	Slightly easy (5)	Moderately easy (6)	Very easy (7)	Not applicable (8)
Equity financing (Investment) (1)	❍	❍	❍	❍	❍	❍	❍	❍
Debt financing (Loans) (2)	❍	❍	❍	❍	❍	❍	❍	❍

Q4 Is the current business financing environment restricting ______________?

	Yes (1)	No (2)	Not applicable (3)
Growth opportunities for your business? (1)	❍	❍	❍
Your ability to hire new employees? (2)	❍	❍	❍

Q6 Did your firm attempt to raise (or successfully raise) any outside business financing (loans, credit cards, trade credit, leases, grants, equity, investment capital, etc.) in the last 3 months (April 1 - June 30, 2012)?

❍ Yes (1)
❍ No (2)

Q14 Please rate your expected level of need in the next 6 months for new external financing for your business for each of the following categories.

	No need for financing (1)	Slight need for financing (2)	Moderate need for financing (3)	High need for financing (4)	Extremely high need for financing (5)	Not applicable (6)
Planned future growth or expansion, including acquisitions (planned for, but not yet realized in six months) (1)	❍	❍	❍	❍	❍	❍
Working capital fluctuations expected six months from now (2)	❍	❍	❍	❍	❍	❍
Growth due to expected increased demand (expected to be realized in six months) (3)	❍	❍	❍	❍	❍	❍
Finance expected worsening operating conditions six months from now (4)	❍	❍	❍	❍	❍	❍
Refinance existing loans or equity in six months (5)	❍	❍	❍	❍	❍	❍
Withdraw wealth for owners (6)	❍	❍	❍	❍	❍	❍

Q15 Does your business plan to raise (or attempt to raise) new external financing in the next 6 months?

❍ Yes (1)
❍ No (2)
❍ Unsure (3)

Q20 Generally, do you expect it would be easy or difficult to obtain new external financing for your business in the next 6 months?

	Very difficult (1)	Moderately difficult (2)	Slightly difficult (3)	Neither difficult nor easy (4)	Slightly easy (5)	Moderately easy (6)	Very easy (7)	Not applicable (8)
Equity financing (Investment) (1)	❍	❍	❍	❍	❍	❍	❍	❍
Debt financing (Loans) (2)	❍	❍	❍	❍	❍	❍	❍	❍

Q21 How many net new employees is your business planning to hire in the next 6 months?

❍ 0 (1)
❍ 1-2 (2)
❍ 3-5 (3)
❍ 6-10 (4)
❍ 11-15 (5)
❍ 16-20 (6)
❍ 21-30 (7)
❍ 31-40 (8)
❍ 41-50 (9)
❍ 51-75 (10)
❍ 76-100 (11)
❍ 101-200 (12)
❍ More than 200 (13)
❍ Not applicable (14)