Congress Should Act Now to Accelerate the Economic Recovery With A New “Main Street Capital Fund” to Provide Startup Entrepreneurs With Capital for New Businesses

COMMENTARY

by Ash Shrivastav and Drexel Sprecher

America is starting to shift its attention from containing the Coronavirus to recovering from the economic damage it has inflicted. While the recent aid packages for small business are a part of the picture, they will only partially restore the status quo. America needs to get ahead of the curve and take bold steps to move beyond the status quo. The best way to do that is to complement these packages with a new initiative to provide startup capital to “Main Street” entrepreneurs to enable them to quickly start new businesses and accelerate the recovery, replace lost jobs, and expand total employment.

America needs a new “Main Street Capital Fund” to provide startup entrepreneurs with capital for new small businesses to compensate for the loss of existing businesses that will not be coming back. This fund will combine the tremendous access to capital that the United States government can provide to an American sovereign wealth fund with the entrepreneurial energy of local entrepreneurs and the locally informed judgment of business and community leaders in thousands of American cities and towns.

The Political Debate Has Presented Americans With A False Choice

Regrettably, the Coronavirus crisis has amplified the polarization that has defined contemporary American politics for a generation.

Americans who lean toward the left and globalism have strongly supported strict health measures and have deemphasized the economic consequences. Americans who lean toward the right and nationalism have questioned many of the health measures and have emphasized the economic consequences.

Both sides of this debate are half right and half wrong.

A long term strategy needs to balance health and economic factors. More importantly, it needs to be designed to reduce the tradeoffs between health and economic impacts.

Necessarily, the short term priority had to be to slow or contain the virus. Health issues have been front and center since the Coronavirus threat was recognized, and economic issues have had to take a back seat.

Nevertheless, in any system that emphasizes one factor for a long time, another factor will emerge and become more important. That is happening with the economy.

The leading edge of the effort needs to shift toward economic damage control and economic renewal and revitalization, while we continue to address the health issues.

Small Businesses Are the Foundation of Our Economy

Discussion of the American economy tends to focus on the largest companies and the stock market.

This is only natural. For example, nationally known retail businesses are on the brink of collapse, and the nationally known brands they sell could soon follow.

This is sensational news.

Unfortunately, it focuses on vivid symptoms and misses underlying causes.

Small businesses represent approximately half of the American economy. Small businesses also employ approximately half of the Americans who have jobs.

That alone should make them a core component of our economic recovery plan.

In addition, many small businesses grow into medium size businesses, some grow into large businesses, and a very few grow into very large national businesses.

Every nationally known business is the long term result of a small business someone started in the past.

Small Businesses Have Been Hurt the Most by the Crisis

The scope of the economic devastation is only starting to become clear.

Many businesses that are viable in normal times are the first to falter in a crisis that brings the economy to a standstill. Major retail chains are failing rapidly. Some will have to resort to bankruptcy. Some will not survive. Major consumer brands that depend on retail outlets will suffer from a domino effect. Some of them will not survive. Many medium to large businesses with multiple locations are likely to close up shop in small towns.

While this drama is unfolding, small businesses are hurting even more.

Small businesses are fragile.

They do not have the capital reserves that large businesses have, and they certainly do not have the access to credit, nor to investment capital.

Many operate month to month, and some operate week to week.

Many have already run out of money, and most are worried they will soon run out of money.

Small Businesses Have Benefitted the Least from the Remedies

None of this is the fault of these small businesses. To the owners, this is an almost pure example of failure due to factors beyond their control.

Accordingly, a minimal policy objective would be to create the conditions for shuttered small businesses to return to normal operations.

Unfortunately, not only are small businesses the most harmed by the shutdown, they are also those that have least benefited from the Paycheck Protection Program.

The first stage of the Paycheck Protection Program did not get very much money to small businesses. The Small Business Administration (SBA) did not seem able to administer the program. Most small

businesses encountered insurmountable obstacles and delays when applying. Then the money ran out. Banks stopped accepting applications.

Credible sources suggest that less than two percent of the $2 trillion went to small businesses.

Shockingly, a lot of the money went to large companies that did not need it.

Unfortunately, for many small businesses, the program was their last and best chance to survive.

More has now been done, and still more is likely to be done.

The second stage of the Paycheck Protection Program provides an additional $310 billion for small business. It sets aside $60 billion of this for loans to be made by community banks, credit unions, and other small lenders.

The National Federation of Independent Business recently proposed allocating $400 billion to small businesses. It strongly recommended that $200 billion of this should be allocated to businesses with fewer than 20 employees. These are the existing businesses that are suffering the most, and that most deserve assistance.

Unfortunately, many of these small businesses will not be coming back. Some of them will lose their leases. Others will lose customers who develop new shopping habits during the shutdown. Some owners will give up. Maybe half of them will come back. Maybe even 80 percent will come back.

Even then, there will be dramatic effects.

This will likely result in more "cookie cutter" national chains replacing local businesses.

It will reduce diversity.

It will make the "farm team" of small businesses that grow into large businesses smaller and weaker.

These things will not be good for employees or for consumers.

Something else is needed.

America Needs to Rapidly Accelerate Small Business Formation

Some existing "Main Street" businesses will get back on their feet as normal activity resumes in the coming months. A small percentage of the people who have what it takes to start successful new "Main Street" businesses will get started.

Sadly, this will not come close to making up for the entrepreneurs who had to shutter their businesses, sometimes losing in weeks what took years to build.

There has long been a severe shortage of capital for "Main Street" entrepreneurs.

Most "Main Street" businesses are financed by owner savings, very small amounts of capital from friends and family members or mortgage loans that come with the risk of losing a home.

Some “Main Street” entrepreneurs have been able to “bootstrap” their businesses into existence with very minimal personal resources, no access to credit, and no outside help.

Unfortunately, this is a slow process. It is certainly not the best way to maximize the strength of this foundational sector of our economy.

Notwithstanding their aggregate value to our economy and their tremendous contribution to our total employment, America has done very little to help “Main Street” entrepreneurs get started.

Even during the normal course of operations, United States does not have institutions that are able to offer support for most of the potential entrepreneurs who want to start a business, yet lack the minimal startup capital they need. These entrepreneurs often are looked down upon because they do not have friends and family who are willing or even able to provide the startup capital needed to finance the first stage of investment popularly known as the “friends and family” round.

Angel investors and venture capital firms often come to mind when startup capital is discussed. These investors provide capital for a limited number of relatively visible startup companies. Unfortunately, neither angel nor venture investors can address the need for capital for the large majority of deserving small businesses.

First, fewer than 5% of entrepreneurs receive any funding from individual “angel” investors. These angel investors are the rare investors who have the freedom to invest their own money. Since they are not investing the money of other people or institutions, they can decide to trust their experience or instincts, and make a decision without the level of vetting that typically occurs when someone is investing other people’s money.

Slightly less than 2% of entrepreneurs receive funding from venture capital firms. Sadly, with a very few exceptions, the 2% that receive venture funding are people who share similar characteristics, and those characteristics are not necessarily merit based nor accurate predictors of success. Among other things, these characteristics include family background, ethnicity, and attendance at certain educational institutions.

Second, first generation entrepreneurs whose families have little or negative net worth would almost certainly not get any funds to start their businesses. In Silicon Valley, a small number of angel investors and an even smaller number of “pre-seed” venture firms are writing first checks to firms that have not had the capital to demonstrate proof of concept or product market fit. It is nearly impossible for this small group of investors to fund more than a small percentage of qualified entrepreneurs. In addition, these investors also look for people who have the same characteristics as the 2% group.

Third, venture firms lack diversity of professionals in terms of gender and race. This tends to prevent the decision makers at these firms from sourcing and funding great entrepreneurs with diverse backgrounds. Very few venture capitalists even attempt to seek to find entrepreneurs with “other characteristics.”

Women are still nowhere near equality in venture firms. Although there has been progress over the last decade or two, women are still a small percentage of venture capitalists. According to Women in VC, almost all women venture capitalists have difficulty assembling funds with the large amounts of money that the most successful venture capital firms routinely raise. This limits the number and type of investments these firms can make.

Among other consequences, fewer women entrepreneurs get startup capital, and those that do get small amounts. Another unfortunate consequence is that startup companies are denied the benefit of the competitive advantage women have in consumer sectors where women are the primary buyers.

According to Black VC, only 3% of venture capitalists are Blacks, with even fewer controlling the $80B+ invested annually in the US. At the partner level where most of the investment decisions are made, only 2% are Blacks. Realizing the gap, some diversity focused funds have been introduced. Unfortunately, these funds face the same obstacles as the first time "resource-deprived" entrepreneurs. These funds have a difficult time raising funds and are often so small in size that they cannot make the type of investments that venture capital firms typically make to be successful. A study conducted by Diversity VC found that most venture-backed startups are "overwhelmingly white, male, Ivy League-educated and based in Silicon Valley."

That should be especially troubling for Americans who want to see the heartland thrive.

Other troubling findings were:

1. Just one percent of venture-backed founders were black.
2. Women-funded startups received only 9 percent of investments.
3. Latino founders made up 1.8 percent of those receiving funding.

Fourth, the majority of angel investor and venture capital funded companies fail. While it is easy to say that most startups fail, looking from another lens, it could also be said that the angel investors and venture capital firms often miss to pick the best companies when they choose which companies to fund.

This raises another important question. Of the 98% who do not receive VC financing, how many potentially great companies did not receive funding, simply because they did not fit the typical characteristics that investment firms apply when making investment decisions?

Finally, the number of venture capital firms and the total dollars they control is nowhere near sufficient to fund more than a tiny fraction of the entrepreneurs who are worth funding. In addition, these investors need to be very careful with their limited capital. That means they have to very carefully vet potential entrepreneurs and business plans to ensure that select a lot of winning companies and avoid most losing companies.

The transaction costs involved in that level of vetting can easily exceed $25,000, or more, which means that it is prohibitively expensive for them to make most investments in small startup businesses.

So what do small entrepreneurs do?

Often, entrepreneurs raise a few thousand dollars from their closest family and friends and use that small sum of money to test their ideas by developing products or solutions. Then they reach out to angel investors or venture capital firms. Unfortunately, most startup entrepreneurs do not get any angel or venture capital to get started. The resulting shortage of capital eliminates many potential entrepreneurs from having a chance to achieve their dreams. Most never get an opportunity to launch their business. Many excitedly register their business and attempt to start running it. Sadly, they soon realize they will not be able to obtain financing. Most of them shut down, becoming another statistic on the list of failed companies.

That excludes a lot of talented and capable people from contributing to our economy.

Accordingly, new institutions are needed to provide crucial startup capital for emerging “Main Street” entrepreneurs, who will each employ a handful of people yet, when aggregated, will provide a solid foundation for our economy.

Most of these “Main Street” entrepreneurs are local. Most of them will not be scalable.

Their value to society is not that they might become very large nationally recognized companies that employ tens of thousands of people.

Their value is that hundreds of thousands of them can generate many jobs with reasonable salaries.

Obviously, American society needs some way other than angel investors and venture capital firms to finance the startup capital these businesses require.

Existing Government Programs to Assist Small Businesses Are Aimed at Later Stages

The United States government does provide some support to various agencies with the intent that these agencies will help small businesses launch and ultimately thrive. For example, the SBA provides funds to small business investment companies (SBICs) that make investments in small businesses.

Unfortunately, the SBICs do not meet the need for capital to be available to “Main Street” entrepreneurs who comprise the majority of startup companies. Rather, the SBICs mostly operate as growth equity or debt capital providers for businesses that are well past the seed stage. Even more unfortunately, the SBICs often look for the same elite characteristics as many prominent angel investors and most venture capital firms.

It is time for America to support its most overlooked potential entrepreneurs. These are the entrepreneurs who do not have a recognized or impressive family background, do not have a brand name, do not have personal funds or powerful connections, and do not have family and friends with first stage funds to invest.

America Needs to Support “Main Street” Entrepreneurs With A New Fund That Invests Directly In Privately Held Early Stage Businesses

When the existing types of individual angel investors and venture capital firms are unable to place bets on the ability of these promising American entrepreneurs to succeed, America should step in and help.

In order to minimize the time required to get new businesses up and running and creating new jobs, we need a combination of the aggregate amount of capital that only our government can provide with the kind of rapid and reality-based decentralized decision making that only local business and community leaders can provide. This decentralized decision making will avoid the risk of a “one size fits all” approach resulting from unnecessarily detailed government standards, will be responsive to local needs, and take advantage of local opportunities.

What is needed is a new program to fund as yet unknown American entrepreneurs through the first stage of development of their businesses. These first stage investments would be very small, with dollar amounts comparable to what angel investors and “pre-seed” venture capital firms provide, typically ranging from $25K to $250K.

These small checks would help a lot of entrepreneurs get started quickly, and help each of them employ a few people right away. In light of the many small businesses that are shuttering at a tragic rate, this program could be titled the "Main Street Capital Fund."

The Main Street Capital Fund should ultimately be organized as an independent program.

More immediately, an interim program could be launched simply by allocating a very modest percentage of the second stage of the Paycheck Protection Program budget to them.

A major difference between the Fund and a private venture capital fund would be the expected return. While a venture capital firm typically seeks over a 1,000 percent return, the Main Street Capital Fund could seek a more reasonable and consistently achievable return. In order to do this, the Fund would adopt certain investment criteria that differ from the criteria used by most angel and venture capital investors.

First, the Fund would be nondiscriminatory in choosing the entrepreneur characteristics, and could aggressively endeavor to replace the family background and educational characteristics generally favored by most current investors with characteristics that are merit based and more likely to correlate with small business success.

Second, the Fund would invest in a much higher percentage of companies than the venture capital industry standard of 2%.

Third, to avoid deterring entrepreneurs who are reluctant to take on debt in a time of great uncertainty, these investments should be structured as equity rather than debt or convertible debt. In addition, to avoid deterring entrepreneurs who would be reluctant to give up control of their businesses and to avoid the risk of government getting involved in the management of a large number of private businesses, these investments should be structured as nonvoting stock, or stock with voting rights limited to exceptional decisions, such as adding private investors or selling the business.

Finally, while the Fund would have professional investment managers like a typical private investment management business, it would also have something that private investment firm do not.

The investments that America needs now need to be made quickly and with a less cumbersome process than the process angel investors and professional venture capital firms have to use when considering an investment.

To minimize the delays inherent in large government agencies attempting to review hundreds of thousands of applications, the applications would be reviewed by investment committees in every state, major cities, and small cities and towns, based on the number of applicants.

The investment committees would be comprised of a unique mix of professional investment managers and citizens. The professionals could include angel investors and venture capitalists, who would not see this as a conflict of interest, because they are not able to invest in these early stage businesses anyway. Most would be happy to see capital going to deserving entrepreneurs that they are unable to fund.

The government could invite successful local entrepreneurs and representative citizens from diverse background to serve on the committees.

The Program Could Leverage A Very Small Percentage of the Funds Already Allocated for Small Business

Just 2 percent of the first stimulus package reached small businesses.

If just 2 per cent of the $320 billion provided for small business loans in the new package were allocated to the Fund, that would make more than $6 billion available for investment in new “Main Street” businesses. The Fund would be able to provide early financing of $25,000 to approximately 250,000 new companies.

That is a lot of companies.

And a lot of jobs.

The gains from investment could be redeployed in subsequent Funds to finance hundreds of thousands of new entrepreneurs.

If the United States government is willing to take equity stakes in airlines to help the airline industry, the government can certainly take equity stakes in seed stage startups as well. By providing the first round of financing to “Main Street” entrepreneurs, America can help these entrepreneurs create new businesses and employ people. The economic gain from starting a seed funding program will be exponentially higher than the cost of starting or managing the program.

Conclusion

In sum, while the government may not be able to create entrepreneurs, it can create the conditions for potential entrepreneurs to have a chance to get started and thrive.

If it really wants to.

Now is the right time. With all the businesses shuttered and employees laid off due to the “Corona crisis” America has never had so great a need to stimulate exponential growth in the number of startup companies and the number of people they can employ.

Every day of delay will deepen the recession and make the renewal and revitalization of our economy more difficult.

Congress should come together on this. Representatives on the left should realize that the people who will be helped by these startup investments are those who have never had the benefit of family money and powerful connections and have therefore been excluded from economic opportunities. Representatives on the right should accept that government funding of these investments will help to correct for the longstanding market failure to provide capital for worthy small enterprises and prevent an unprecedented unemployment situation that will eventually lead to expansion of other benefits.

Citizens should come together, write and call their representatives and senators, and demand this.

In the meantime, the President and Executive Branch agencies should take a close look at the details of the Paycheck Protection Program, identify whatever discretion they have with the funds in the second stage budget, and allocate as much as possible to start the program.

Even $1 billion will start to make a difference.

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