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CAPITAL STRUCTURE AND PERFORMANCE OF BUSINESS START-UPS: THE ROLE OF UNOBSERVABLE INFORMATION AND INCENTIVES (SUMMARY)

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SUMMARY

CAPITAL STRUCTURE AND PERFORMANCE OF BUSINESS START-UPS: THE ROLE OF UNOBSERVABLE INFORMATION AND INCENTIVES

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Principal Topic

Economic theory identifies two potential informational problems that affect the trade-off between inside and outside financing of business start-ups. On the one hand, firms may self select into certain capital structures based on private information about expected future performance. On the other hand, capital structure may affect the performance because of moral hazard. This paper empirically investigates these relationships by separating self-selection effect from moral hazard effect.

Method

To address the problem of potential self-selection in obtaining unbiased estimates of the effect of capital structure on performance, we specify an econometric model to jointly estimate capital structure and performance. The model is estimated using Gibbs sampling algorithm with data augmentation. We use a dataset collected by the National Federation of Independent Business Foundation. To approximate the initial capital structure we employ three broad measures of outside business financing: bank and government loans, funds supplied by individual investors, and any outside financing provided by both banks and outside investors. We use the changes in the number of employees and the survival after three years as our measures of economic performance.

Results and Implications

Several contributions emerge from our research. First, we are able to evaluate existing finance theories of capital structure and their implication for a firm's performance around the time of its creation. Second, we propose new instruments for the effect of capital structure on performance that are consistent with theories of entrepreneurship and lending. Lastly, the results we obtain in this paper suggest possible directions for future theoretical research on financing of entrepreneurial firms.

Our results indicate that the effect of leverage on the performance of business start-ups is insignificant contrary to previous findings on well-established firms. In contrast, both selection and moral hazard effects are present in the case of outside equity indicating that outside investors are able to both overcome informational opaqueness of business start-ups and provide better incentives for performance. This might explain why many new firms first acquire outside equity and later shift into debt financing.

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