The View from Wall Street

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In reviewing the topic of financing for rural America, the first question I asked myself is why we are having the conference and why at this time. The simple answer is that rural America has historically lacked sufficient access to nonbank capital. Although statistical evidence is limited, a number of researchers have concluded that there is a relative lack of equity capital in rural America. This view is supported both with anecdotal evidence and by a review of equity deals. Geographic barriers have played a role in this situation, but I believe the lack of access is also the unintended consequence of long-standing regulations and policies favoring bank and debt financing.

Although a lack of access to the capital markets is a consideration, I think it is only part of the answer to the question of why we are having this conference now. I believe the conditions for accessing capital throughout the United States are improving dramatically. As a result, we can now see the increasing and exciting potential for Wall Street financing to improve business conditions and spur growth.

AN IMPROVING LANDSCAPE

Three fundamental trends are changing the financial services industry and increasing access to the capital markets. These trends will have especially profound implications for smaller companies located outside of traditional financial centers. Since large, well-established companies have been able to access the capital markets regardless of location for many years, they will not be affected as much by these changes and are not the focus of this paper.

Telecommunications and technology

First, improvements in telecommunications and technology are rapidly removing geographic and other barriers to relationships and to the spread of information. Information can be sent anywhere in the world in nanoseconds at virtually no incremental cost. Because financial services and capital markets are heavily based on information, these changes have profound implications for our industry. At Merrill Lynch, telecommunications and technology increasingly allow us to provide superior service and quality information to clients without regard to geography. We also see our clients using new technologies to achieve greater geographic freedom in their business and personal lives.

Real world examples and statistics show how technology is changing the way businesses operate and obtain information on raising capital. For example, the Small Business Administration has developed the Internet forum ACE-Net to facilitate small companies seeking equity capital investments. A host of private Internet-based companies have also sprung up to help small businesses raise capital. The growing number of small businesses going on-line also demonstrates the importance of the Internet. According to a survey by Cyber Dialogue, 37 percent of non-home small businesses with fewer than 100
employees are now on-line. At the current pace of adoption, half could be online by the end of 1998.

**Investing culture**

Second, an investing culture has swept across the United States. Despite inevitable cyclical fluctuations, the evidence of this trend is overwhelming. Financial instruments have replaced the home as the largest store of wealth for the average American. Similarly, the United States now has more assets in mutual funds than deposits in its banking system. It is estimated that 130 million Americans hold stocks on the NYSE indirectly through mutual funds and that 60 million hold these stocks directly. We have shifted from a country that stores its wealth in homes and banks while depending on fixed pensions, to a nation that invests in the market. This change in investment behavior means more money is available for capital markets financing. Moreover, the availability of money to fund businesses should continue to grow as the United States generates greater wealth and baby boomers save for retirement.

**Financial services restructuring**

Third, and perhaps most important and controversial, the restructuring of the financial services industry is increasing companies’ access to a broader range of capital sources. Given the liberalization under way and anticipated, financial firms are now expanding their geographic reach and scope of products. As a firm with a long-term commitment to rural America, Merrill Lynch sees growing competition from large, diversified firms with considerable resources. These new entrants are positioned to offer not only an array of financing options but also links to the capital markets. Of course, local banks should continue to play an important role in rural America, but they urgently need regulatory reform to compete effectively. I will return to this issue later.

**GROWING IMPORTANCE OF SMALL BUSINESSES**

The combined forces of telecommunications and technology, increasing investing by the public, and financial services restructuring should expand the opportunities for rural businesses in the capital markets. At the same time, the growth of small businesses itself is getting more and more attention from Wall Street. Small businesses, which we roughly define as privately owned enterprises with less than $100 million in annual revenues, represent 40 percent of the U.S. Gross Domestic Product and 50 percent of the U.S. work force. This segment is vital to Merrill Lynch because over a quarter of our private-client households own a business. The increasing number of successful small businesses is also generating tremendous demand for financial advice, products, and other services. We project that $10 trillion in small business assets will be transferred through sales, generational transfers, or public offerings from current owners over the next ten years.

**CONTINUED CHALLENGES**

Although these fundamental trends will bring greater opportunities to rural America, challenges remain. The current rush to merge and consolidate in the financial services industry may leave areas of the economy underserved. As decisions become more “globally” centralized and removed from rural areas, services may no longer be tailored to the unique needs of rural businesses. Also, services may be inadequate as financial services vendors struggle both to cover expansive territories and develop expertise in the capital markets sector. Some of these issues can be addressed through policy changes. But, before looking at recommendations, I would like to briefly review the current landscape of equity financing.
TYPES OF WALL STREET FINANCING

The initial public offering

The initial public offering (IPO) is the most visible form of Wall Street financing. It is often viewed as a sign of corporate success. In 1997, $43 billion was raised via IPOs in the United States. This year, through September 25, $25 billion has been raised. As a representative of the nation’s leading underwriter, I do not dispute the unique value of going public. An IPO not only provides a powerful equity cushion but also allows firms to gain access to new financing options and new groups of investors. In addition, it provides liquidity to owners without giving up complete ownership or management of the firm. Publicly traded stock also serves as a tool for attracting and retaining employees. The overwhelming share of large corporations in the United States that are publicly held demonstrates the advantages of publicly traded stock.

The standards set by the market for an IPO are high. The two main hurdles any company, whether rural or urban, must meet are size and return. Major investment banks typically look for IPOs of $50 million or more. The average size underwritten by Merrill Lynch so far this year has been somewhat higher at $81 million. If, let’s say, an IPO represents one-third of a firm’s value, Wall Street is focusing on firms with minimum values of $150 million. In addition to size requirements, IPO investors typically require minimum annual returns of 10 percent to 15 percent and hope for much higher numbers. The most common way for IPO companies to achieve these returns is through above-average growth.

The success of an IPO is also determined by market conditions. The IPO market is highly cyclical, and a deal that would be successful at one time might not get done at another. Widely fluctuating market cycles can be detrimental to businesses and investors. In a frothy market, for example, IPOs may be issued that are not in the long-term interests of businesses or investors. The reverse may be true in a down market.

The requirements for a successful IPO come from the interplay of size, return, growth prospects, and many qualitative factors. Investment banks, for example, are often eager to underwrite smaller deals when a company’s growth prospects are exceptionally strong. And, as we have seen with recent technology IPOs, investors are willing to pay high premiums for companies that have never generated positive earnings if growth prospects are strong enough. In contrast, a slower growth company will generally need to be larger and already have a well-established record of earnings. It is important to educate rural business owners better on the interplay of these factors and when it makes sense to complete an IPO. The conference is an excellent platform for this mission.

Venture capital and private equity

Venture capital and private equity placements are important alternative sources of capital. For the first half of 1998, venture capital investment reached $6.8 billion. Over the same time period, the market for primary and secondary equity private placements was significantly larger at $52 billion. Venture capital investors typically look for earlier stage companies and take a more active management role. In contrast, private equity investors often seek more mature companies and have less involvement in managing the firm.

Company size requirements and costs are typically lower for venture capital and private equity placements than for IPOs. The work of investment bankers is simplified by reduced due diligence standards and the common practice of undertaking deals on a best effort basis.
Some of these benefits, however, may be offset by other complicating factors. In terms of deal size, the PricewaterhouseCoopers Money Tree Survey reported that the average funding per company through venture capital in the second quarter of 1998 was $4.9 million. At Merrill Lynch, we primarily deal with institutional and investment funds seeking to invest considerably larger sums. We are, however, increasingly working to better serve lower levels of financing needs by placing equity with smaller institutions and wealthy individuals.

What firms gain in reduced size requirements and less public disclosure, however, must be compensated with higher returns. Investors in venture capital or private equity seek returns of 20 percent or more for established companies. If the company is new, they are looking for returns north of 40 percent. The lower liquidity and business risks in this market necessitate these higher returns. Investors often expect to realize high returns via an exit strategy three to four years down the road. The two common exit strategies are an IPO or an outright sale of the business.

Other opportunities

IPOs and these private markets can provide companies with a fairly broad base of outside investors. Nevertheless, issuers should consider the advantages and disadvantages of all other available options. One frequently used alternative method is getting either one wealthy individual or a group of wealthy individuals, so-called angels, to invest. Annual investment by angels is estimated to be between $10 billion and $20 billion. Although angels are an important source of equity financing, success is sporadic and often depends on having the right relationships. This venue by its nature lacks specific standards.

Another path we see some entrepreneurs follow is a targeted business sale. This often involves an incubator strategy in which an entrepreneur develops an early-stage technology or product with the goal of selling it to a larger company.

In addition to these options, businesses should consider the appropriateness of quasi-equity funding such as convertible debt or junk bonds. While this type of financing necessitates initial seed equity, convertible debt and junk bonds have the advantage of debt-like components while potentially attracting investors who seek higher risks with above average returns.

KEYS TO SUCCESS IN RAISING EQUITY FINANCING

Catching the imaginations of investors

To successfully raise equity financing, a company must catch the imaginations of Wall Street advisors and, ultimately, of investors. Although investment banks play a vital role in marketing and supporting an issue, investors determine the success of an offering. Investors in equity placements seek the upside, hoping for dramatic returns. Therefore, they seek companies with high growth potential. With limited upside, investors prefer the debt of a company to its equity. Debt holders typically receive regular payments, hold a senior position relative to equity owners, and have less of a burden monitoring companies.

Although the features sought by equity investors can be found in almost any industry, the growth engine for the U.S. economy has been knowledge-based industries such as communications and technology. Therefore, companies in these industries dominate the equity raising process. In the second quarter of 1998, for example, 55 percent of venture capital investments went to either the software/information
or communications industries. The Silicon Valley received 33 percent of venture capital.\(^1\) While preferences and opportunities will fluctuate, I believe there is an ongoing fundamental long-term shift in the U.S. economy to these knowledge-based industries.

**Costs and economies of scale**

From the perspective of investment banks and investors, a key requirement for success is achieving economies of scale. The costs of placing and monitoring equity investments are fairly fixed and generally well above those of debt investments. Due diligence and legal obligations are considerable in equity placements irrespective of company size. In fact, it is not unusual for costs to be higher for smaller companies because financial systems and record-keeping are less organized. Although the overall expenses and obligations are lower in private placements, the same economies of scale apply.

The cost structure associated with equity investments does not end with the initial purchase. Because investors share in the full upside and downside of a company, equity investments are carefully monitored given the uncertainty of cash flows. At Merrill Lynch, a well-compensated analyst follows every company we publicly underwrite. For private placements, the investors must shoulder the expense of monitoring and perhaps managing the investment whether it is $5 million or $50 million.

**IS RURAL AMERICA UNIQUE?**

What is unique, if anything, in the ability of rural America to raise capital? In many ways, particularly with the trends highlighted earlier, not much is different. Location may play a role in developing contacts and relationships, but investors do not treat location within the United States as a distinct factor. Once an opportunity for a deal is presented to an investment banker, a rural location simply means taking a smaller plane or an extra day to travel to the company. Evidence of the declining importance of geography can be seen in the willingness of investment bankers to travel almost anywhere in the world for the right opportunity.

The more important issue is whether rural America is creating the types of companies well-suited to equity financing. We emphatically believe there are significant business opportunities here worthy of equity investors. Rural businesses ranging from hog farms to software developers have had great success on Wall Street. Rural America’s competitive advantages include lower costs, natural resources, quality of life, and diversification. We can all think of non-urban hubs, such as those in Utah, Texas, or Washington, that have successfully transformed themselves into rural commercial centers.

These hubs of activity, however, also highlight a key challenge. Namely, knowledge-based industries rely on critical mass. An irony of new technologies is that, while it has given us freedom from geographic barriers, the industry itself thrives where there are pools of talent and a favorable infrastructure. The challenge for states and rural communities is to create an environment that cultivates these clusters. Experience suggests that these groupings will not be evenly distributed or uniformly successful and at certain stages may require incentives set forth by local and state public officials.

**POLICY RECOMMENDATIONS**

**Regulation**

From a national perspective, we consider reforming the financial markets through passing the Financial Services Act of 1998 (H.R. 10) to be the single most important step for improving
rural America’s financial well-being. As highlighted earlier, banks and other financial intermediaries are quickly responding to the removal of barriers to interstate banking by expanding their geographic reach. The landscape for providing capital financing is changing rapidly, and we believe for the better. However, without more liberal regulations, banks and other competing financial institutions will not be able to provide rural areas with full and efficient access to the capital markets and to innovative financial services.

Reforming the regulations that divide commercial and investment banking is critical for increasing rural America’s financial well-being. Over the years, piecemeal changes by the courts and regulators such as the Federal Reserve System have enabled the larger commercial banks to overcome many of the Glass-Steagall restrictions on their securities markets activities. However, as concluded in a recent analysis by Francis Lees and Donald Pitti, this easing of restrictions has had an unfavorable effect on the smaller, independent banks.

The Section 20 exemptions from Glass-Steagall allow banks to participate in investment banking through an affiliate so long as it accounts for no more than 25 percent of gross revenues. This exemption is of great value to larger banks but has little or no value to smaller, community banks.

Moreover, by constraining investment banks and other financial institutions, the current regulatory structure makes it more difficult and less profitable to extend services to smaller businesses. If investment banks are free to offer a full range of services, they will be more likely to increase equity raising activities in rural America. A regulatory structure that allows all institutions to offer a broader range of financial services is particularly important for businesses outside the main financial centers.

Advisory relationships

Realizing the full benefit of an improved environment for financial services, however, will not be automatic. Instead, it requires that businesses in rural areas develop long-term relationships with financial advisors. The advisory relationship is an often-overlooked factor we consider very important. Raising capital is best viewed as a long-term process, not a one-time event. A good advisor should bring deals and ideas to business owners at the appropriate times. Often, this involves understanding not only the customer’s business but also the requirements and outlook on Wall Street. To the extent firms are more removed from the activities of capital markets, developing and maintaining these relationships at an early stage are all the more important. It can be extremely damaging for a business to discover during the capital raising process that an advisor is either unreliable or lacks the ability to complete the deal.

The problem with advisory relationships is that they can be very expensive. At Merrill Lynch, we address this issue by combining the personal and business financial advisory relationship. By uniting these functions, we often achieve a scale that better justifies a close advisory relationship. Our 14,000-plus financial consultants in branch offices throughout the United States work with individuals and their businesses, and draw on the technical expertise of over 500 specialists at the appropriate time. Over the past several years, we have opened 230 special marketing offices to expand our reach. Most of these are in small towns and rural areas like Cape Girardeau, Missouri; Cedar Rapids, Iowa; Grand Forks, North Dakota; and Grand Junction, Colorado.

Taxes

The tax code plays a critical role in shaping the capital structure of American businesses
and investor patterns. Both the recent reduction in the capital gains tax and increase in the estate tax exemption to $1 million, and in some cases $1.3 million, in the year 2006 from the existing $600,000 were positive steps. Nevertheless, we believe there is much more to be done. The tax code continues to favor debt and thereby encourages excessive leveraging. More equal tax treatment of equity financing either by allowing corporations to deduct dividend payments or by further reducing the capital gains tax would stimulate small businesses to obtain additional equity capital and encourage more optimal capital structures.

In working with family-owned businesses, we regularly see the distorted incentives and damage caused by the estate tax. Raising the exemption to $1 million is certainly welcomed but does little to help the many successful family businesses that have values from $10 million to $20 million. In addition, the increase does not even keep pace with inflation since the exemption was last increased to $600,000 in 1987. The estate tax is particularly insidious because, with a top marginal rate of 60 percent, it destroys successful businesses and requires families to pay taxes on what are often illiquid assets. Owners often put most of what they own into their business, leaving little to pay inheritance taxes. Of our clients that own a business, we estimate that on average 75 percent or more of their net worth resides in their businesses.

Reforming estate taxes, therefore, would be a powerful way to support small businesses. A further reduction or ultimate repeal of the federal estate tax would benefit businesses everywhere. It would also encourage new generations to stay on location and support one of the most important forms of equity capital for small businesses, traditional owners’ equity. Individual states could also support local businesses by reducing their now disparate estate tax rates.

CONCLUSION

The outlook for accessing capital in rural America is encouraging, but we believe there is much more to be done through education and public policy. The current regulatory and tax structure continues to favor bank and debt financing and should be replaced with policies that offer balanced support of all types of financing. States and local communities need to create environments that encourage clusters of businesses and talent to develop. With such changes, rural businesses will be in a stronger position to meet the standards of equity investors. Ultimately, it is the challenge of rural entrepreneurs with the help of their financial advisors to build businesses that leverage the strengths of the rural environment and capture the imagination of investors.

ENDNOTES


