Forum

Encouraging Business Start-ups in North Carolina

An Interview with Professor Dick Levin

Heidi Walter Powell

Dick Levin is the Phillip Hettleman Professor and former Associate Dean for Management Programs in the Graduate School of Business Administration, the University of North Carolina at Chapel Hill. He specializes in strategic planning, new ventures, and financial management in private companies. A small businessman himself, he has written several popular books on finance and management which serve as practical guides to new and small businesses.

CP: What are some of the characteristics of enterprise development in North Carolina?

LEVIN: The period is just about over for recruiting large out-of-state companies to open up in North Carolina. Though there are still announcements of openings, the big numbers are behind us, not in the future. On the other hand, small businesses create about 80 percent of new jobs. Here in North Carolina, between 1979 and 1987, 37 percent of new jobs were created by firms employing fewer than 20 people. If we want continued prosperity and growth, we need new enterprises. We are behind in encouraging the formation of new businesses—we are making a run at it to be sure, but we started late compared to other states.

CP: Since the time for recruiting large companies is almost over, has the state redirected its money and resources accordingly, or does it continue to concentrate its efforts on industrial recruitment?

LEVIN: There are a number of people in state government who do not believe that the great elephant migration is over. They are wrong. There are also a number of influential people in this state who recognize that it is over. In my judgment, the state has been too slow to react to the evidence; it is chasing the wrong prize.

CP: You indicated that the state should be encouraging new and small business start-ups. What are the barriers to developing such enterprises?

LEVIN: Creating a new small business is completely different from increasing the size of a large business or attracting one to our state. First, start-up capital (or seed money) is hard to come by. You generally beg and borrow this from friends and relatives, or mortgage everything you own. Second, there is no organized capital market for new ventures as there is for existing firms—you are not able to issue bonds to finance your idea. Third, banks lend on assets and collateral; if you are poor with a great idea, banks cannot help you much at all. That is simply not their business. Fourth, until recently in North Carolina, there has been a limited source of management assistance for starting a new business. About 80 percent of new businesses fail within five years, due to a lack of management know-how. Some changes are underway, but it will take a lot more time to provide the assistance that start-ups need. Fifth, when you start a business yourself, there is no staff to fall back on, no corporate research department to analyze markets, and no one but yourself to depend on; that is entirely different from working for a larger corporation. The venture founder has to be all things, perform all functions, deal with all of the customers, capital providers, employees, and regulatory institutions; that is difficult when you do not know much about business to begin with. And yet, in spite of this difficulty, we have thousands of eager North Carolinians who start their own business every year.

CP: Could you clarify the distinction between "new" and "small" businesses?

LEVIN: "New" to me means "start-ups." I tend to use "small business" as a term meaning an existing business. I'm not so sure that the distinction between them is clear.

CP: Could you comment on the common assertion that many small service businesses create numerous low-paying jobs while contributing little to the generation of real wealth, and that innovation—which often happens in young, growing firms—is the key to economic growth.

LEVIN: The effect of small businesses depends on the economic conditions in the particular locality. If the locality is essentially agricultural and there is exceedingly low per family income, then opening up 100 McDonald's is a grand idea because you employ 900 people who were previously unemployed, all making about $4.00 an hour. It is true that *ceteris paribus* it would be better to have higher income jobs, but putting people to work at some reasonable pay is the first objective in an area that suffers from low per family income. Wages in most of these areas do not jump from unemployment to $12.62 an hour. That is not the way it works—it is a step-up function. It is not just the wage people get, it is the profit. If the company makes a profit and stays in the county and the city, and all the purchases tend to be local or regional, you produce a multiplicative effect of jobs. I am not dismayed at creating new low-paying jobs if the precursor were no jobs. But I am unalterably opposed to averaging down the wage rate.

CP: What effect, if any, has the Community Reinvestment Act had on small and new business start-ups? (The CRA requires that a certain percent of a bank's investments must be made locally, *ed.*)

LEVIN: Though it is bound to have helped, I do not know if you can measure it. The bank still is not going to invest in a low-tech business that has no collateral. It will make home loans, but it is not going to put up money for a new business. I think they can meet CRA requirements by making secured loans. What we need for low-tech is hardly secured loans; we need risky low-tech venture capital loans, which bankers are not used to making. A banker is dismayed at the thought that maybe two-thirds or more of what she lends will not be repaid. Most banks write off less than one percent of loans; some banks are down under half a percent. Compare that to new start-ups and low-tech businesses—more than three-quarters of them are going to fail.

CP: What existing state programs assist new and small business people?

LEVIN: Chambers of Commerce around the state sponsor small business and new business programs. The Small Business and Technology Development Center devotes its energy to helping new businesses in seven locations across

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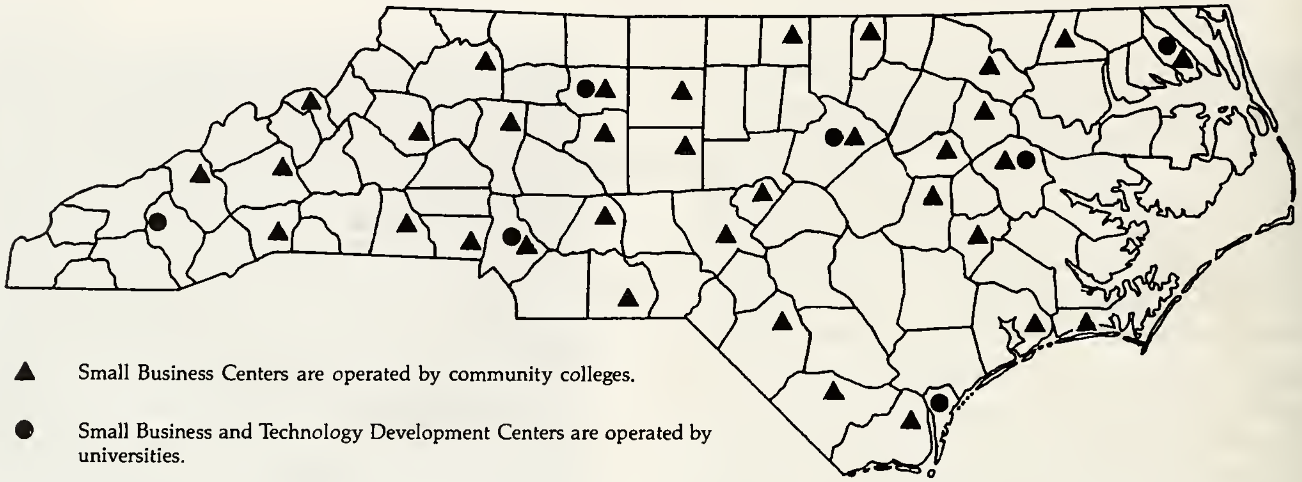
the state. It provides research, management and technical assistance to entrepreneurs and businesspeople and it conducts research and assists in the delivery of a specialized training program. The community college system has small business centers operating in most of its locations. The North Carolina Department of Commerce works at helping folks who want to travel this route, with some special attention to minority small businesses. The Small Business Administration offices in North Carolina work hard to help those who want to start a business, too; the Institute for Private Enterprise in Chapel Hill also focuses on new businesses; and at least seven of our universities offer some kind of course in new venture development. Yet, with all of this talent, activity, effort and money, two facts still nag us: the rate of new business creation in North Carolina is far too low, and the rate of failure of those new businesses that do get started in North Carolina is too high. Those are value judgements that I have made after looking at the situation for a long time. The failure rate among low-tech businesses is certainly too high.

CP: Why is the start-up rate low and the failure rate high for new businesses?

LEVIN: The start-up rate is too low because of insuffícent attention to and support of start-ups as a state strategy. There is a lack of seed-financing (capital available), an absence of a supportive infrastructure, a lack of encour-



Small Business Centers and Small Business and Technology Development Centers provide research, management, training and technical assistance to entrepreneurs in locations throughout North Carolina.

agement of willing entrepreneurs by the community, and a lack of identification and nurturing of entrepreneurs at a sufficiently early age. It is difficult in Conetoe to get someone to help you write a business plan. It is even more difficult in Enfield to meet a venture capitalist, or learn what seed capital providers look for in a new venture idea.

The failure rate is too high because of insufficiently thought-out ideas, a lack of financing, a lack of management know-how, insufficient professional help (including accounting, legal, tax, and marketing), and the absence of any real plan on which to base action. New companies fail because the entrepreneur has enthusiasm but cannot figure a break-even point; because she works 90 hours a week but does not know how to raise money and deal with a bank; because he has a wonderful idea but cannot figure out where the market is; and because he is willing to kill himself working but cannot write or follow a good business plan.

CP: What can state government do to encourage new and small business formation and reduce the rate of failure?

LEVIN: It is possible to increase the rate of new small business formation and to reduce the failure rate in North Carolina, but not without a lot of work, some changes in attitudes, a recognition that it is these new businesses that portend our economic future, and, of course, a fair bit of money.

There are several actions that I believe we must take in North Carolina if we are truly serious about new job creation through new enterprise start-ups. We ought to start earlier. We created several generations of farmers with Future Farmers of America clubs, and 4-H clubs in school. It is time to be serious about recognizing, nurturing, supporting and finding mentors for the young men and women who have the spark to start a business but who need the encouragement and support in a formal structure. This process should start in high school and continue through the university level. We need a much more direct local community involvement in small business start-ups. This should include mentoring, capital pool information, management assistance, site selection assistance, professional help—whatever it takes. After all, it is the community that benefits from new job creation first and most directly.

We need much more attention—from state government and the General Assembly—paid to the process by which new small businesses are formed and grown. The General Assembly should look closely at eight initiatives:

1. State government encouragement of the formation of capital pools to finance new start-up ventures—without capital, nothing happens.
2. Tax incentives to make it profitable to create capital for this purpose: both seed capital for start-ups and first stage capital money to help the business once it gets going but before it qualifies for bank help.
3. Incentives for North Carolina banks to participate more in the start-up venture capital business. These can be tax incentives, loan guarantees, or interest subsidies, but without them, the banks will probably not play the role we need them to play. We do have one North Carolina bank with a venture capital operation and another starting up next month.
4. Creation of incentives for, and support of state Small Business Investment Corporations which, by mandate, must invest in start-ups only in North Carolina. There is a lot of opportunity here; we need to finance them better.
5. A much broader availability of courses, management assistance, and support for the entrepreneur at all colleges and universities in North Carolina.
6. Some tax incentives for start-up businesses to give them some relief from early cash flow problems. I was glad to see this idea endorsed by the current Commission on Jobs and Economic Growth.

7. Expansion of a more rigorous new venture creation education into the curriculum of high schools and colleges in North Carolina.
8. The provision of direct seed capital funding made available to the entrepreneur who has market-sound ideas; has received the requisite new venture management education and is certified as qualified; has comprehensive business plans for the proposed venture; has a financial feasibility analysis which suggests that the idea has a reasonable chance to work; has sufficient monitoring and infrastructure in place to help the venture succeed; and has the potential to create at least ten new jobs in three years.

In essence, these eight initiatives would say to the entrepreneur: come up with a good idea that professionals think will work; show us you have been educated in new ventures to the point that you can understand and run the business yourself; show us a sound business plan with financial forecasts; and then show us that you are going to put your heart, soul, and every last dollar you have on earth into this deal and we will come up with enough money to get you started.

CP: Could you elaborate on your proposal to use tax incentives for the formation of capital pools to finance business start-ups?

LEVIN: Venture capitalists traditionally do not look at new low-tech businesses. If we are going to foster accelerated growth in these businesses, which is essentially what areas like eastern North Carolina need, we have to do something to provide start-up money. Banks are not going to give it because they are not in the business of providing that kind of money to new businesses; they are essentially asset lenders. Venture capitalists are not going to loan them money because it is not a sexy enough venture—they are looking for a 30 percent return and paybacks within five years. I am not sure that new small low-tech businesses can provide them with that outlet, which is a real conundrum. To get lenders to loan money, we must make it less risky.

To get a bank to loan money to a new business, I propose a two-pronged approach. First, rigorously screen the entrepreneur. Train her, educate her, make her pass all kinds of hurdles and requirements, and have her write a business plan. When you are satisfied that she has a reasonable probability of success, you have to find her some money. Finding the money is the difficult part. I think you have to subsidize a lender for the perceived risk. If the risk involves losing money half of the time, it makes sense that either the lender has to charge at least twice what she would normally charge, or we have to subsidize the lender, much like the Small Business Administration does. The state should say, "We'll have a fund. We know you're going to lose money x percent of the time; we'll subsidize you."

We subsidize people for growing tobacco; we subsidize people for not growing tobacco. We subsidize people for producing milk that nobody wants at a price that is too high. Why not subsidize this process? It seems to me a reasonable question. It is the notion of losing all that money that scares people. We will lose a lot of money, that is a given. The fear must be overcome in order to proceed. We have been very reluctant to get into a business in which we will lose much more than half of our money, but that is the business we have to initiate. We cannot wait until the probability of loss is very low.

There is enough money in Research Triangle for high-tech deals, but there is no money available for low-tech deals.

CP: And low-tech deals tend to be in rural areas?

LEVIN: I think that is what rural areas are about. One cannot open up a silicon chip plant in rural North Carolina. There are many opportunities for small service and product businesses that we need to pursue. The development effort needs to go forward on three or four different levels. One cannot stop trying to recruit large companies—nor should one. But the state's effort is unbalanced.

What I propose is not a give-away by state and local governments. Starting a new venture is no place for sympathy or give-aways. It is a place, however, where enlightened government bodies should back rigorously selected and trained people in a carefully analyzed risk-taking venture, aware that it can and may fail, but also knowing that this is how jobs are likely to be created in our state.

If you are lucky enough to invent the next Apple computer or a new laser device which breaks up kidney stones, venture capital folks from all over America will probably find you and beat a path to your door with money and advice. But if you live ten miles from Ahoskie or in Everetts, North Carolina, and you want to pursue a sound, low-tech idea that has the possibility of creating ten jobs in the next five years—an idea that is sensible, but not sexy—then your road is a rocky one. And that is the kind of entrepreneur we need to focus on in rural North Carolina. The venture capitalists will find the high-tech stars, but they will never find the low-tech venture in Everetts.

North Carolinians ought to look at this whole idea as an investment. Suppose in the next five years we fund 1,000 of these new low-tech ventures with $20,000 each. That is a $20,000,000 gamble. Now suppose that only one in five makes it. We can get the success ratio to one in five with heavy screening, education, and mentoring. Suppose each of the ventures that makes it creates 20 jobs in five years, that's 4,000 new jobs, and we spent $20,000,000, or only $5,000 per job created. And we have not even ciphered in the repayments of the $20,000 loan that the successful firms will make. There is no more efficient way to create jobs in North Carolina. It is possible

Incubators can serve as useful tools for small business development.

with some good planning to accomplish this goal in a short time, if we have the support we need.

CP: How would you address the problem of unbalanced growth between North Carolina's rural and urban areas, since entrepreneurs, educational institutions, venture capital, and other resources are more concentrated in urban areas?

LEVIN: I am leery of policies that restrict plant location to certain areas. Philosophically, I tend to lean more toward incentives than I do restrictions, and to solve problems involving people with incentives, which may be sufficient. It may be that there are tax incentives or direct payment incentives to new large companies that would induce them to move to rural areas. Of course, planners and developers would say that businesses locate where there is an adequately trained and motivated labor supply, which tends to be lacking in rural areas.

CP: In addition, rural areas are often unable to attract business. Don't rural entrepreneurs themselves lack access to capital, management assistance, and other resources?

LEVIN: That's why the Small Business Centers and Small Business and Technology Development Center are good ideas — they are located throughout the state. I would like to see more of these initiatives. There has been comment over the last year or so that there are too many different such operations focusing on the same problem. That does not bother me. I think that putting it all under one umbrella would create a large bureaucracy. I think the secret is not to try to regulate, control, or organize them, but to put in place largely voluntary communications mechanisms. We need aggressive people helping companies, with an awareness of what their counterparts are doing. The need is so massive that we are not going to meet it in the next five years. □

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