

SMALL BUSINESS



CAPITAL BUDGETING IN THE SMALL FIRM

The allocation of capital in small firms is as important as it is in large ones. In fact, given their lack of access to the capital markets, it is often more important in the small firm, because the funds necessary to correct a mistake may not be available. Also, large firms allocate capital to numerous projects, so a mistake on one can be offset by successes with others. Small firms do not have this luxury.

In spite of the importance of capital expenditures to small business, studies of the way decisions are made generally suggest that many small firms use “back-of-the-envelope” analysis, or perhaps no analysis at all. For example, the Graham and Harvey study cited in the Chapter 10 box entitled “Techniques Firms Use to Evaluate Corporate Projects” points out that small firms are more likely to use simple rules such as payback, whereas large firms are more likely to rely on NPV and/or IRR. These findings confirm earlier results found by L. R. Runyon. Several years ago, Runyon studied 214 firms with net worths ranging from \$500,000 to \$1,000,000. He found that almost 70 percent relied upon payback or some other questionable criteria. Only 14 percent used a discounted cash flow analysis, and about 9 percent indicated that they used no formal analysis at all. Studies of larger firms, on the other hand, generally find that most analyze capital budgeting decisions using discounted cash flow techniques.

We are left with a puzzle. Capital budgeting is clearly important to small firms, yet these firms do not use the tools that have been developed to improve these decisions. Why does this situation exist? One argument is that managers of small firms are simply not well trained; they are unsophisticated. This argument suggests that the managers would use the more sophisticated techniques if they understood them better.

Another argument relates to the fact that management talent is a scarce resource in small firms. That is, even if the managers were exceptionally sophisticated, perhaps demands on them are such that they simply cannot take the time to use elaborate techniques to analyze proposed projects. In other words, small-business managers may be capable of doing careful discounted cash flow analysis, but it would be irrational for them to allocate the time required for such an analysis.

A third argument relates to the cost of analyzing capital projects. To some extent, these costs are fixed; the costs of analysis may be larger for bigger projects, but not by much. To the extent that these costs are indeed fixed, it may not be economical to incur them if the project itself is relatively small. This argument suggests that small firms with small projects may in some cases be making the sensible decision when they rely on management’s “gut feeling.”

Note also that a major part of the capital budgeting process in large firms involves lower-level analysts marshalling facts needed by higher-level decision makers. This step is less necessary in the small firm. Thus, a cursory examination of a small firm’s decision process might suggest that capital budgeting decisions are based on snap judgment, but if that judgment is exercised by someone with a total knowledge of the firm and its markets, it could represent a better decision than one based on an elaborate analysis by a lower-level employee in a large firm.

Also, as Runyon reported in his study of manufacturing firms, small firms tend to be cash oriented. They are concerned with basic survival, so they tend to look at expenditures from the standpoint of their near-term effects on cash. This cash and survival orientation leads firms to focus on a relatively short time horizon, and this, in turn, may lead to an emphasis on the payback method. The limitations of payback are well known, but in spite of those limitations, the technique is popular in small business, as it gives the firm a feel for when the cash committed to an investment will be recovered and thus available to repay loans or for new opportunities. Therefore, small firms that are cash oriented and have limited managerial resources may find the payback method appealing. It represents a compromise between the need for extensive analysis on the one hand and the high costs of analysis on the other.

Small firms also face greater uncertainty in the cash flows they might generate beyond the immediate future. Large firms such as AT&T and General Motors have “staying power”—they can make an investment and then ride out business downturns or situations of excess capacity in an industry. Such periods are called “shakeouts,” and it is the smaller firms that are generally shaken out. Therefore, most small-business managers are uncomfortable making forecasts beyond a few years. Since discounted cash flow techniques require explicit estimates of cash flows through the life of the project, small-business managers may not take seriously an analysis that hinges on “guesstimate” numbers that, if wrong, could lead to bankruptcy.

THE VALUE OF THE FIRM AND CAPITAL BUDGETING

The single most appealing argument for the use of net present value in capital budgeting is that NPV gives an explicit measure of the effect the investment will have on the firm’s value: If NPV is positive, the investment will increase the firm’s value and make its owners wealthier. In small firms, however, the stock is often not traded in public markets, so its value cannot be observed. Also, for reasons of control, many small-business owners and managers may not want to broaden ownership by going public.

It is difficult to argue for value-based techniques when the firm's value itself is unobservable. Furthermore, in a closely held firm, the objectives of the individual owner-manager may extend beyond the firm's monetary value. For example, the owner-manager may value the firm's reputation for quality and service and therefore may make an investment that would be rejected on purely economic grounds. In addition, the owner-manager may not hold a well-diversified investment portfolio but may instead have all of his or her eggs in this one basket. In that case, the manager would logically be sensitive to the firm's stand-alone risk, not just to its undiversifiable component. Thus, one project might be viewed as desirable because of its contribution to risk reduction in the firm as a whole, whereas another project with a low beta but high diversifiable risk might be unacceptable, even though in a CAPM framework it would be judged superior.

Another problem faced by a firm that is not publicly traded is that its cost of equity capital is not easily determined—the P_0 term in the cost of equity equation $\hat{k} = D_1/P_0 + g$ is not observable, nor is its beta. Since a cost of capital estimate is required to use either the NPV or the IRR method, a small firm in

an industry of small firms may simply have no basis for estimating its cost of capital.

CONCLUSIONS

Small firms make less extensive use of DCF techniques than larger firms. This may be a rational decision resulting from a conscious or subconscious conclusion that the costs of sophisticated analyses outweigh their benefits; it may reflect non-monetary goals of small businesses' owner-managers; or it may reflect difficulties in estimating the cost of capital, which is required for DCF analyses but not for payback. However, nonuse of DCF methods may also reflect a weakness in many small firms. We simply do not know. We do know that small businesses must do all they can to compete effectively with big business, and to the extent that a small business fails to use DCF methods because its manager is unsophisticated or uninformed, it may be putting itself at a serious competitive disadvantage.

SOURCE: L. R. Runyon, "Capital Expenditure Decision Making in Small Firms," *Journal of Business Research*, September 1983, 389–397. Reprinted with permission.