



[VC Firms Still Expect High ROIs](#)

Video interview with Dr. John Paglia, Associate Professor of Finance, Graziadio School of Business and Management

Danielle L. Scott

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Start

Danielle L. Scott: Hello, this is Danielle L. Scott, managing editor for the GBR Blog. Today is August 4th, and we have Dr. John Paglia, associate professor of finance at the Graziadio School of Business and Management here with us today. In addition to teaching, Dr. Paglia performs business valuations for privately held companies. He has testified as an expert on valuation matters, and on July 28th, he released a national study showing that even with the recession, private capital providers still expect high returns on investments. Dr. Paglia, thank you so much for being with us here today.

John Paglia: Thank you for having me.

Danielle L. Scott: So my first question, what do we need to know about private capital markets? Why is it important?

John Paglia: Well, Danielle, over 99 percent of all businesses that exist out there are privately held. These companies contribute over half the gross domestic product in the country, and also half of all the

employment levels, yet very little is known about the private capital markets. They have no filing requirements, and as a result, we are unable to learn information about private businesses. So what we set forth was to understand in greater detail what the behavior of the private capital markets are, so that we can inform private business owners to understand what it takes to access capital, what sort of rates they may face, if in fact they're pursuing capital, and what sort of other hurdles they may have to jump in order to obtain that capital. So there's a lot of information that's not known in that area that we wanted to shed light on.

Danielle L. Scott: So besides private businesses, who else are the primary beneficiaries of the study?

John Paglia: Well, private businesses, as you point out, they're going to be a huge beneficiary, and the information that we've provided allows them to better understand what their overall cost of capital is. That is, the cost of obtaining funding from the various private capital market sources. And one of the things that we determined is that for the average lower and middle, middle market type company, with access to all the private capital market segments, that their overall cost of capital is about 15 to 18 percent. Now what that means for them is that unless they're unable to earn those rates of return, it's likely that the resources that they're using in their business operations can be put to use to other areas, where they can earn greater rates of return. So private business has now had the opportunity to determine whether or not they're creating economic value. Furthermore, for our private capital providers, it gives them the opportunity to determine what other players in their space are doing. That is, what sort of lending they're doing and what sort of investments they're making, what sort of guidelines they're using to determine whether or not they're extending those facilities, and it sheds a lot of light onto their operations. So understanding that from the private business orientation, and the capital provider orientation, and realizing that there's really a bigger purpose here, and that's to contribute to the overall growth of the economy, is really quite important. We see a lot of beneficiaries here.

Danielle L. Scott: So give us the good, the bad, the ugly. What did you find out from the survey?

John Paglia: Well, let's start with the good. The good is that private capital providers expected demand for their loans, for their investments, is expected to increase over the next 12 months. What that seems to indicate, and suggest is that private businesses are out there trying to obtain growth capital because they see opportunities to create value. On the bad side, there's a few things to note here. One item to note is that most capital providers in the private space seem to believe that restrictiveness or access to capital is going to become tighter, and that can be really challenging for the average small or midsize business that's trying to obtain capital to survive in this environment. So that's a little bit of a challenge going forward. We also see that a couple of the economic indicators forecasts are less than pleasing, at least at first glance here. And so the expectations that interest rates will increase over the next 12 months, and of course, that really doesn't bode well for the average small company relying on bank

financing to cut expenses and improve their operations. So it's going to become costlier for them to do business. And then finally, there was an estimate put forth on gross domestic product, and most of the survey participants believe that GDP in fact will decline over the next 12 months, and that the median consensus number was negative 1.5 percent. Now there's a little bit of a silver lining in this, and that is that a couple of the GDP numbers have been released since the survey had been deployed. So taking that into account, it seems to suggest we're looking at a fairly flat economic environment for the rest of the year.

Danielle L. Scott: So what is the information that lenders, private capital providers and private businesses should take away from your study? What should they pay attention to the most?

John Paglia: Well, first and foremost, our study set out to understand the cost of capital by segment, and to understand the behavior of each participant that exists. And so from a cost of capital orientation, one of the things we'd learned is that the average senior lender's expecting an all inclusive rate of about 6.5 percent in this economic environment. Asset based lenders are expecting a rate of about 11 percent on their new investments, and it increases from there. Mezzanine funds, which are hybrid between debt and equity, are expecting 18 percent, private equity, 25, and venture capital, approximately 42 percent. So it's important for them to understand what their industry is doing, what they're charging in terms of rates, and then also how they're assessing risk, because this risk-reward type profile is really in delicate balance these days.

Danielle L. Scott: So what do we need to still learn about private capital markets?

John Paglia: Well, there's plenty of things that we still need to learn about the private capital markets. We're just getting started. This was our first survey and it was the first simultaneous and comprehensive investigation of the major private capital market segments. So having gone through our first iteration, we're seeing all kinds of opportunities to add in various areas that's going to be prime benefits to the various contributors of the survey, the survey participants, and also to private businesses. So one of the things we see on the horizon is that first of all, we're planning on offering our next survey in October of this year, just a couple of months away. And in the survey, we're making revisions already to all the various segments that we already have surveyed, and we're trying to add some expert panels to each capital segment, to make sure that we're asking the questions and obtaining the answers that they really want to know. And so by working with them, we're streamlining this operation process and making for an even more sound survey, as we go forward. In addition to that, we're also planning on launching Center for Private Capital Markets, and in this, we're in the process of trying to create the fundraising efforts and to determine a more formal vehicle from which we can deploy the survey and conduct more comprehensive research reports.



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Danielle L. Scott: Dr. Paglia, thank you so much for your time with us today. Best of luck on your next project and the center.

John Paglia: Thank you. Thank you for having me. I'd like to put a call out too, to those various capital market participants who may wish to participate in the survey. You can do so by registering on the Pepperdine website at bschool.pepperdine.edu/privatecapital.

Danielle L. Scott: Thank you. This is Danielle Scott for the GBR Blog. Find us online at gbr.pepperdine.edu/blog.

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