THE RELEVANCE OF PECKING ORDER THEORY TO FRIEND AND FAMILY FINANCING

Gary Hancock: The University Of Adelaide, Adelaide, Australia

Contact: Gary Hancock, The University of Adelaide, ECIC, L1 Engineering South Bldg, North Tce, 5005 Adelaide, Australia, (T) 83030125, Email: gary.hancock@adelaide.edu.au

ABSTRACT

This research investigates the relevance of Pecking Order Theory in the case where capital is sourced through investment by family and friends (F&F) in new venture start-ups. Entrepreneurs typically finance new ventures through self-financing, loans, bootstrapping, and equity investment. About US$196 billion annually is sourced from F&F investors (Bygrave, Hay, & Reynolds 2003). Firms utilize different forms of finance at different lifecycle stages. Pecking Order Theory has been used to explain how entrepreneurs choose the type and source of their finance at different stages. Contemporary research into early stage equity finance primarily used capital structure theories when examining informal business angel and formal venture capital (VC) investors. F&F finance research using Pecking Order Theory, however, is scant.
The research questions addressed in this research are: “How well does Pecking Order Theory explain F&F investment in new venture start-ups?” and “Should Pecking Order Theory be refined to better explain F&F investment?” This paper develops propositions derived from a qualitative analysis of data collected from 22 in-depth interviews with investors, entrepreneurs, advisors, and venture finance experts. This approach is appropriate because F&F investment is a new area of investigation lacking an underlying specific theory. Although F&F investment can draw upon relevant financial theories where “arm’s length” investors are involved, these are insufficient to explain the intersection of the family and/or friend relationship “dynamic” with the investment decision. As such, the purpose of this research is to build upon existing financial theory and contribute toward the development of a theory of F&F investment.

The conclusion is that F&F investment behaviour is difficult to adequately explain using existing Pecking Order Theory. A major finding is that, in Pecking Order Theory, the unit of analysis and economic assumptions are framed from the perspective of the firm; yet, F&F investment is couched in individual and social relationships. Relationship aspects need to be included in future theory development of F&F investment and this is a differentiating feature of this form of investment.

Theoretically, this paper contributes to the understanding of the limitations of existing theory and identifies the need for new theoretical development in this under-studied area of entrepreneurship. Practically, an improved understanding of F&F investment can assist strategy development for entrepreneurs, investors, and advisors. Understanding the shortcomings of existing financial theory will enable policy makers to devise and implement better policy that takes into account this very significant economic activity.

F&F investment is a significant phenomenon yet it has attracted little research to date. The need for theory development is clearly established by this paper and it identifies the value of such research to the understanding of entrepreneurship.

Introduction
This research investigates Pecking Order Theory where capital is sourced through investment by family and friends (F&F) in new venture start-ups. The research questions addressed in the research are: “How well does Pecking Order Theory explain F&F investment in new venture start-ups?” and “Should Pecking Order Theory be refined to better explain F&F investment?”

The research is couched in terms of an entrepreneurship context using a qualitative research methodology. The paper also followed a sociological paradigm in that it used a number of theoretical viewpoints rather than adopting a narrow focus price theory approach which is more common in economic discussions using a view of human behaviour governed by self interest (Eisenhardt 1989).

The paper is organized as follows. First there is a discussion of the research motivation followed by the context and scope of the research. Second, the research method employed in the empirical analysis is discussed. Third, the empirical evidence for the Pecking Order Theory is examined. Finally, the paper concludes with a discussion of the findings, conclusion, implications, and limitations of the research followed by recommendations for future research.

MOTIVATION AND IMPORTANCE OF THIS RESEARCH
Understanding new venture formation is important because it is a key component of economic growth (Kirzner 1973; OECD 2003). In particular, the process by which individuals obtain the resources to turn ideas into a business is key to the study of entrepreneurship (Shane 2003). After allocating personal capital and utilising bootstrapping techniques, the entrepreneur may look to debt, equity, or grants for continued growth of the enterprise (Hisrich, Peters & Shepherd 2008).

Enterprises have been shown to require different types of finance at different stages of their lifecycle (Timmons and Spinelli 2007). Many start-up ventures find that debt or grant finance is either unavailable or not suitable. Equity finance from institutions or individuals may be sought from formal sources known as Venture Capitalists or informal sources that are referred to as Business Angels (Mason and Harrison 1995). However, many entrepreneurs turn to friends or family (Bygrave & Hay 2004).
This research does not address formal venture capital (institutional private equity finance) because this is already relatively well addressed in the literature (Gompers and Lerner 2004) or Business Angel investment because we have an increasing understanding of Business Angel behaviour (Sorheim 2005). Business Angels are private investors who provide risk capital directly to new and growing businesses in which they have had no prior connection and excludes investments in their own firms or in family businesses (Mason and Harrison 1995).

Developing an understanding of the mechanisms by which new firms are started and, in particular, financed is important because this knowledge enables entrepreneurs, their advisers, and policy makers to make better decisions. Informal finance has been identified as an important enabler in the establishment of entrepreneurial new businesses (Bygrave, Hay et al. 2003) and “informal capital markets are the leading source of external risk capital fuelling entrepreneurial start-up and small business growth” (Gaston 1989, p223). This is an important source of capital because many early stage enterprises could not survive without it (Abernethy and Heidtman 1999).

Research into the equity financing of entrepreneurial firms, however, has predominantly addressed venture capitalists and business angels (see, for example, Mason and Harrison 1997; Gompers and Lerner 2004). Yet, the largest supply of informal finance is from people who are known to the entrepreneur (Bygrave, Hay et al. 2003). The proportion of new ventures in Australia that accept finance from friends or relatives compared with other forms of equity finance is consistently above 83% (O’Connor and Hindle 2006; Hancock, Lindsay, Hindle 2007).

The impact of this behaviour is significant. The average number of people who invest globally on an informal basis is 3.4% of the adult population. This accounts for (US) $196 billion annually (Bygrave et al 2003). In Australia, 3.3% of the adult population, accounting for 1.26% of GDP, engages in informal investment behaviour with F&F (Hancock, et al. 2007). Venture capital investment, by comparison, is insignificant in terms of activity. The basis upon which entrepreneurs and informal investors make their decisions is not well understood and calls have been made to address this gap (Bygrave, et al. 2003; Maula, et al. 2005; Wong, Ho, 2006).

Capital structure theories are one means of explaining how entrepreneurs choose the type, source, and ratio of equity to debt of their capital structures (Frielinghaus, Mostert and Firer, 2005). There have been a number of studies examining the capital structures of business start-ups. Calls have been made for studies beyond the quantitative approaches that look for averages in the market to unravel the personal and motivational aspects of this behaviour (Cassar 2004). Myers(1984) identified how capital structure theories had been around for some time but that they required more development before they could explain actual behaviour. Even as late as 2001, Myers argued that there was little reason to expect that a satisfactory universal capital structure theory could emerge (Myers 2001). Lemmon (2006) also concluded that there was much work yet to be done to understand the capital structure puzzle.

This research follows a similar approach to Frielinghaus, et al. (2005). They examined the behaviour from the joint perspective of capital structure theory and life-cycle theory of the firm theory. This research also draws upon the findings of Harris and Raviv (1991) who argued that capital structure theories can be, and should be, categorised in order to present better focussed research in this area of interest. This research answers the call to use integrated theory by examining one of the capital structure theories and investigating how well it fits with early stage venture creation in the special case of F&F investment.

**CONTEXT AND SCOPE OF RESEARCH**

Entrepreneurship is a process (Timmons and Spinelli 2008), therefore, research activity in entrepreneurship should clearly identify where in the process the research activity is focused (Baron 2007). The lifecycle theory of the firm proposes that firms evolve through stages with different identifiable characteristics. There are many variations on this theme but the important aspect for this research is that there are differing characteristics and needs of the firm at different life-cycle stages (Peacock 2004). This research focuses on the early stages of the start-up of a firm. It accepts that resources provide one of the competitive foundations for sustainability and competitiveness (Barney 1991). One resource that entrepreneurs require is capital (Hancock, et al., 2007). This can be obtained from different sources and in different ways.
Essentially, capital can be sourced from internal or external funds with the external funds taking the form of debt or equity.

The scope of this research is to examine, through the lens of the Pecking Order Theory, the external capital acquisition of funds from F&F at the early stage of venture creation.

**RESEARCH METHOD**

Entrepreneurship is multidimensional and complex in nature (Mitchell, Busenitz et al. 2002; Neergaard and Ulhoi 2007). New venture investment decision-making adds to this complexity because of the additional investment theories that may be relevant to augmenting entrepreneurship research. For example, a focus on economic analysis alone provides an incomplete explanation of investment behaviour (Basu and Parker 2001; Cassar 2004). There are many aspects of the investment decision that may impact on an individual’s motivation to invest in a venture. Similarly, there are many financial theories regarding financial investment (Kaplan and Stromberg 2004). This is further complicated by the introduction of the complex dynamics of F&F (Neubauer et al., 1998). Therefore, some authors predict that any attempt to explain investment behaviour through rational economic theory is doomed to failure because exchanges are made in the context of altruism, personal bonds, loyalty, spite, and duty (Estin 1995). However, that should not mean that we discard any attempt to use empirical evidence to test existing theories or develop new ones. Rather, it indicates that the methodology and epistemological approach needs to be able to encompass complexity and ambiguity in the investigation. It is therefore preferable to use research methods that enable exploration of the complexity under investigation. The purpose of this research is to develop an understanding of whether and how well existing theory can be used to explain the complex processes that underpin the behaviour of investment in new ventures from F&F.

The process of investment by F&F is embedded in a social construct. The very definition of the F&F relationship between the investor and entrepreneur means that the investment behaviour is part of a larger social environment. This research is, therefore, investigating a social rather than a natural phenomenon and, together with the exploratory nature of the complex processes, lends itself to a qualitative methodology (Neuman 2000; Paul, Whittam et al. 2007). This research is ideally placed to answer the call for a greater focus on qualitative methodologies within the entrepreneurship discipline (Hindle 2004). This is important because even though a qualitative approach has been recognised as important to the field of entrepreneurship, it is rarely used (Gartner and Birley 2002).

This research is, therefore reported from an interpretive paradigm. The goal of the research is to describe and explain the situation and to provide a deep understanding. The outcome is theory building through discovery and code analysis (Pittaway 2005).

**DATA COLLECTION**

Having established the reasons for using a qualitative methodology in this research, the semi-structured interview was chosen as the most appropriate data collection method. This was deemed appropriate because it gave respondents the opportunity to introduce insights that may otherwise have been missed by a more structured questionnaire (Neuman 2000). Insights were important because, as discussed earlier, discovery is important in this research. The interviewer used existing theory to elucidate responses from the participants, but allowed them to raise any issues that they thought appropriate to the discussion. Responses from each interview were used to influence subsequent interviews (Corbin and Strauss 2008). After completion of 22 interviews, the researcher concluded that saturation of the issues within the subject was close. This approach provided a context and framework without restricting the respondents’ abilities to provide comprehensive responses to the interviewer and allowed for concepts, themes and opinions to be introduced by the participants.

Participants were selected using a purposeful sampling strategy. They were chosen for their knowledge and expertise of F&F investment. This method was chosen because the purpose of this stage is to develop theory and identify the key dimensions that will inform later research stages (Miles and Huberman 1994). Interviews were held with people who had different perspectives of F&F investment behaviour to minimize bias from any particular perspective. Interviews were conducted with entrepreneurs, investors in start-up ventures (VCs, business angels, and friends), advisers with experience in dealing with early stage
investment, and academics identified as being experts in the field. The sample was drawn from introductions through the personal network of the researcher, introductions provided by The Venture Capital Board of South Australia, and academics identified through their research activities and publication records.

The data for this study was obtained through theoretical sampling of the transcribed interviews (Corbin and Strauss 2008; Miles and Huberman 1994). In other words, the content of the transcribed interviews were analysed with the specific purpose of looking for evidence for the concepts that were the focus of this research. In this way, the research was looking for theoretical concepts that were supported or otherwise by the data. It is important to note that this does not imply representativeness; rather, it is driven by theory.

The data was drawn from 22 interviews which were recorded and transcribed. All interviews were conducted face-to-face with the researcher and were between 60 and 90 minutes in duration. The transcribed interviews were analysed by looking for themes and comments that appeared relevant to the theory under question. The transcribed passages that were deemed relevant were checked against the original recording and notes of the interviewer to both confirm the relevance and examine the context in which the comments were made. The results provided a rich understanding within a social constructivist paradigm. The analysis was conducted using the NVivo software program (Version 8).

**PECKING ORDER THEORY**

This section examines the evidence from the interviews in relation to Pecking Order Theory. A brief description of the theory is followed by a discussion using evidence from the empirical data. A conclusion is then drawn about the research questions with concluding remarks.

There are principally three main groups of capital structure theory: Static Trade-off Theory, Agency Theory, and Pecking Order Theory (Sen and Oruc 2008). This research examines Pecking Order Theory. It proposes that there is uneven information between managers and investors. This theory provides a means of overcoming some of the limitations of the original capital structure view (Chirinko and Singha 1999). Static Trade-off Theory, first proposed by Modigliani and Miller in 1958 (Myers 1984; Harris and Raviv 1991), essentially predicts that firms moved toward a point of ideal debt to equity ratio. This ratio is independent of the market value of the firm and lifecycle stage. It is used to describe how firms utilise taxation to manipulate profitability to develop an optimum (maximum) debt level. Debt levels, however, increases the risk of bankruptcy (as the debt to equity ratio becomes unsustainable). Therefore, there is an optimal debt level where the present value (PV) for the firm using beneficial tax shields are balanced against an acceptable PV cost through the financial stress of high leverage.

Pecking Order Theory was developed to overcome weaknesses in previous capital structure theories (Frielinghaus et al 2005). It proposes that firms prefer internal funds over external funds. When internal funds are not available either through exhaustion of this resource base or not available from the start, debt is preferable to equity due to the riskiness of equity (Myers 1984). Internal funds hold no adverse selection risk. The cost is internal and completely controlled by the firm. Debt is a higher risk, there is the need to repay it, but the costs are external and therefore are considered to be moderate or incur minor adverse selection risk. Debtors are usually able to put in place instruments that reduce the risk of information asymmetry. For example, banks that lend to start-up enterprises will nearly always look for some security, often in the form of real estate. Equity comes with a higher adverse selection risk and information asymmetries between the investor and firm are significant (Cassar 2004). Therefore, the cost of such finance is much higher with the investor factoring in the higher risk thus looking for a higher return and placing even more stringent instrumental control over the entrepreneur to reduce their information asymmetry risk. Therefore, equity is only sourced after the ability to borrow funds is exhausted (Frank and Goyal 2003). Pecking Order Theory has been supported by a number of studies in various environments (Cassar 2004).

**THE EMPIRICAL EVIDENCE**

The principle of the theory states that a business will initially use its own internal finance resources (bootstrapping) before looking to debt and then equity. There was some evidence that support this concept that internal funds are first used,
“they did use a little bit of the boot strapping. The fact that they're doing some undergraduate teaching ... and resources and family and one of them basically has been supported by his wife, that’s the big difference for him.”

However, there is no evidence at all that there is a pecking order regarding debt and equity. In fact, there is some evidence that start-up entrepreneurs skip the search for debt altogether and move straight to equity finance. This could be for a number of reasons; chiefly amongst them is that there is a belief that banks simply do not lend money to start-ups. When they do, they actually lend on the basis of a steady income independent of the start-up business and adequate security in the form of collateral (invariably real estate). Because of this, any debt that an entrepreneur is able to secure is personal. This is evident in many interviews as the discussion regarding this finance is focused on the entrepreneur, rather than the firm.

This has interesting ramifications for this theory. In the case where an entrepreneur is able to secure a business loan, what appears to be occurring is that loans are provided to the entrepreneur. Then, that capital is injected into the business. Thus, it is owner's equity rather than external equity. Therefore, the concept of using internal funds then debt is not relevant in a start-up situation. Even when an entrepreneur can obtain a loan, the firm is not incurring the debt, the entrepreneur is. In some cases, the F&F source is used to bypass other forms of equity finance such as venture capital,

“I used to do angel investing... and people that came from wealthy families actually had a big advantage 'cause they had the whole extended family they could get backing for so they could avoid the angel round and even the first venture round”

There are also significant distortions in the market in which the start-up occurs. For example, taxation regimes can influence how investors behave. This was clearly illustrated by one respondent in the UK, who said,

“Now, in this country everybody does ordinary equity. That’s the only one that gets the tax relief. That’s what I was talking about distorting behaviour.”

Whereas, in a different (US) tax regime, another respondent said when discussing the implications of debt and equity structure,

“Well clearly, if I'm an entrepreneur, or if I'm a local lawyer, or accountant who’s helping someone in the formation stage, you know, they can just learn one sentence, like, ‘convertible loan’, you know, ‘convertible’”.

These comments reflect a common theme that was evident with investors. A feeling of frustration was communicated regarding the lack of “sophistication” among entrepreneurs and their F&F backers. This appeared to be due to evidence that suggested that a number of respondents reported a lack of understanding by entrepreneurs and their financiers over whether the finance is debt or equity. The parties often do not establish whether it is a loan with (or without) interest repayment, or equity with expectations of a dividend, or even a grant with no expectation of any return.

One of the major assumptions in the Pecking Order Theory is that firms operate in an economic system that allocates resources in order to reach economic equilibrium. There are market assumptions that there are plenty of sources of finance (supply is not constrained), and many firms needing finance (demand is plentiful). This may hold in the general finance market, but in the case of F&F financing, different forces appear to be at play. There is very little evidence in this study that supports the free market assumptions. When F&F are investors other mechanisms are apparent. One example shows how, within a trusted network, the supply and demand of finance is not an open market,

“if they don’t know you, they won't do business with you and they won't give you money ... you won't even be invited to a party, they don’t know you and they don't know you well...there's close circuits like that and business at a certain level is about family connections”
Another assumption of capital structure theories is that there is a clearly identified cost of finance. The following statement was made in the context of “cost”, but it was clearly a reference to personal and emotional issues,

“when you're taking mum and dad’s money, you know, what are they expecting, what do they really expect in return, what is your obligation to them, and what do you expect from that?”

The mechanisms that are available to formal investors to reduce costs associated with agency costs, cost of finance, opportunity cost and the like, are simply not used within F&F. The use of contractual arrangements, guarantees, or other such instruments appears to be absent. Rather, the arrangements are made in the context of obligation and trust.

Many interviewees reported that the entrepreneur often had no other option than to look for external capital from F&F. Therefore, on a number of fronts, the Pecking Order Theory simply does not hold. Under this theory, equity is the finance of last resort; however, the evidence suggests that equity can be, and often is, finance of first choice.

DISCUSSION
The following discussion addresses the main findings that analysis of the interviews revealed.

1. Unit of analysis
The Pecking Order Theory uses the firm as the unit of analysis. However, when we examine the workings of the investment in a start-up enterprise, the unit of analysis is the individual entrepreneur and his/her relationship with the investor. F&F investment behaviour may be seen as an extension of the relationship rather than an economically driven and rational financial deal. This means that the unit of analysis is at the individual level between the two parties involving their relationship or contract. Greater complexity arises because the deal can also impact on the relationship. An example was expressed by a respondent, who had consulted to families in this situation,

“Does it affect relationships where friends and family put up money? It certainly can do ... You have to advise the friends and the family exactly what the risks are and it's quite difficult to be that ruthless when you're trying to raise money [from family] ... it is quite easy for these people to feel that they’ve been abused”

There is also a significant issue in the understanding of what occurs from an accounting perspective. A number of respondents questioned whether the business actually was the recipient of the finance, no matter whether it was a loan or equity,

“If however the money goes into the business and not into the bloke’s pocket then that’s a separate issue.”

The general feeling from respondents was that money is provided to the entrepreneur in the majority of cases. The entrepreneur then uses the capital in the business for the business. This creates an interesting accounting dilemma because the capital, in many instances, is irrelevant as to whether it is debt or equity since the intention is that it is always the entrepreneur’s, and thus it is really owner’s equity. The arguments put forward by the Pecking Order Theory become irrelevant in such instances even though the affairs of the business may be structured to make use of taxation laws, debt to equity ratio, risk, and so forth.

2. The market assumption
The Pecking Order Theory has been developed in the context of a large market place and the basic assumptions that were used by Modigliani and Miller have not been challenged even though many other of their assumptions have (Frielinghaus et al. 2005). This point was made by one respondent on this matter and this is important when we consider economic theories within the context of this research,

“I make the point that you can’t really talk about the [friends’ and family’s] money as being a market ... because if [the market] is not related, then your family money is inaccessible to it”
In addition, the Pecking Order Theory was developed and tested in a market context of many suppliers (capital available to invest) and many customers (firms that are looking for capital). F&F financing is not relying on market forces. F&F are not usually searching the open market for investment opportunities. The transaction occurs outside of the economic framework of supply and demand. Because of this point alone, there is doubt on the usefulness of the Pecking Order Theory within the F&F investment context.

3. Rational approach
The repayment of the money provided by F&F may be a loan or a share of the wealth of the business. In many cases, this creates considerable friction because the parties may have very different expectations on the outcome. Even when equity is clear, there is some confusion over what it actually means for the investor in particular,

“That seems to me part of the strangeness of what I call a private company and it's in a way what investors and family and friends do they get three shares for their $5,000 (or whatever it happens to be) but they can't do anything with it in a private company so what is their motivation?”

Even when the deal is structured with some sophistication, such as using convertible notes, the fact that the business is at the start-up stage makes the equity position particularly difficult to agree on,

“Take a convertible preference position. … You can’t really work out the value of the company at that stage”

Most deals, however, never reach this level of sophistication, but when advisers try to untangle the deals some time later, there are many interpretations on what the deal was. In many cases, the capital is actually never expected to be paid back, as one family investor admitted,

“Q: did you expect to get that money back at all?
A: I didn’t, no.”

When advisers try to establish what the deal actually is, they are often confronted with attitudes that are exemplified by the following comment,

“And they’re quite happy to [consider that the capital] is almost like a gift, but you ask them if it’s a gift, and they say no. But it’s really a gift.”

There are difficulties in applying Pecking Order Theory because some of its underlying assumptions do not hold when investigating F&F investment. The distinction between debt and equity is rarely clear. Many of the respondents in this research raised this as a serious issue. In many cases, the capital is provided with no real contractual understanding at all. The theories rely on clear cut definitions of what is equity and debt finance; however, the participants are unable (or unwilling) to decide. When attempting to ascertain what actually occurred from an accounting point of view, there is often too much ambiguity to be certain.

4. Motivation – sociological and humanistic behaviour
The underlying assumption with Pecking Order Theory is that the firm is valued accurately by the market, either through the market having full knowledge or the firm being able to indicate to the market via its behaviour. This valuation then leads to appropriate allocation of capital with an appropriate structure. The motivation of the market is to maximise economic returns. However, notwithstanding the problem of the market as discussed above, the motivation of investment also departs from our rational economic model. Respondents clearly identified that the prime motivation for most F&F was not maximising return on investment. One experienced investor said,

“How, with my family, I will invest because I want to help them, even if I might feel that they are not going to make me any money.”

This essentially renders the Pecking Order Theory irrelevant. Even when capital is provided, the ability for the “market” to have knowledge of the capital structure is often masked. In this context, we are examining private companies that do not have to divulge their finances publicly and, even if they do, capital structures may still be hidden, as the following comment illustrates,
“I have a friend that sold a house and gave it to his kids to invest in a company for them to build their company and he wasn’t even on the share register”

The problem for the Pecking Order Theory is that people do not behave as rational economic actors in this context. The assumptions upon which the theory is built do not hold.

5. Ontology

This research aimed to explore and understand the issues at hand. It was based on the acceptance that the world is a complex place and that the interactions among people are rarely straight forward. The Pecking Order Theory is based on a more functionalist view expecting regularities that can be used to predict firm behaviour. They are from the paradigm that firms can be viewed as a bundle of contracts and these can be measured by ascertaining their value as if they were an asset for sale in a market. Such investigations lead to theories that aim at understanding behaviour from a macro perspective, such as looking for the average on a regression line (Corbin and Strauss 2008). Entrepreneurs look to operate outside of the average, obtain resources without having to own them, and look for opportunities that the markets have failed to recognise (Shane 2003). As a consequence, the examination of the complex F&F investment phenomenon under investigation is unlikely to provide any real insights by utilising theories that are developed from a functionalist, causal analysis.

CONCLUSION

In conclusion, the Pecking Order Theory failed to provide a sound basis for understanding the issues surrounding F&F financing of start-up ventures. As a means to ascertain exactly why this is so, in addition to the discussions presented so far, the following opinions of the interviewees are presented.

The complexity of the relationship is at the heart of the issue. The behaviour is not an economic one, but a social one,

“...it is about softness, it’s about friendship and experience and common values, the whole thing is worth that, it's alright to regard this as another source of money, but it isn’t”

Another respondent said,

“it's framed rarely by mind, it's framed by emotion, it's psychological for them, and they may be investing in things they wanted to do, it's part of the family, family ..., blood thicker than water.”

Although we can accept that in at least some cases, an economic underlying motivation is present, there is always an emotional element,

“you have this emotional investment as well as financial investment”

This emotional investment is extremely important and must take centre stage in the examination of this issue. It leads to a number of psychological issues that the economic theories simply fail to address. These include trust, obligation, and the development of relationships over time,

“when you have people invest in you, you have this emotional investment as well as financial investment, how those can react and how they treat it, you know, one or two or three years”

The following quote from an investor summed this issue up nicely,

“it's the ethical obligation you have, they started you, they had faith ..., they trust in you, and you should honour that in some way, some form, maybe you can't pay it back all at once, but, I think our board said, you know, be mindful of whoever got you started.”

The two research questions examined were: “How well does Pecking Order Theory explain F&F investment in new venture start-ups?” and “Should Pecking Order Theory be refined to better explain F&F investment?” This research concludes that The Pecking Order Theory, although having some interesting
perspectives that can help frame the activities, do not adequately explain F&F investment behaviour. They fail to address underlying issues of the appropriate unit of analysis, the market assumption failure, and the rational economic approach failure. In addition, there are no means to address motivations within a social context.

There is little to be gained in adjusting or building on Pecking Order Theory because it does not appear to be able to account for the complexity and multi-dimensional aspects that are needed to explain and understand F&F investment. Any theory that is developed needs to include concepts such as social norms, culture, obligation, and trust in addition to our current understanding of entrepreneurship involving new venture creation and start-up venture activity. A different epistemological basis may assist in this task. We need theory development, and in a young field of research, as F&F investment clearly is, an interpretive perspective to provide a deep understanding of the behaviour of entrepreneurs and their affiliated investors within a social context is recommended.

**RESEARCH IMPLICATIONS**

Theoretically, this paper contributes to the understanding of the limitations of existing theory and identifies the need for new theoretical development in this under-studied area of entrepreneurship. It points the way forward as to what issues should be considered with future research. F&F finance is a significant phenomenon; yet, it has attracted little research to date. The need for theory development is clearly established by the findings of this paper which identifies the value of such research to better understanding entrepreneurship and the new venture creation process.

Practically, an improved understanding of F&F investment can assist strategy development for entrepreneurs, investors, and advisors. The findings of this research may assist stakeholders to consider factors beyond those currently available.

Understanding the shortcomings of existing financial theories will enable policy makers to devise and implement better policy that takes into account this significant economic activity. If the aim of policy is to enable and support entrepreneurship, this research will enable a deeper understanding of the issues that are not addressed with current theories.

**RESEARCH LIMITATIONS**

There were a number of limitations associated with the research. The interviews analysed came from people who had experience in and had been involved with start-up enterprises and investment that included family and friends. The research is, therefore, from the perspective of observers of the F&F investment. There may be biases introduced from this perspective.

The researcher conducted all the interviews and analysed the transcripts. This introduces the potential for bias; however, the deep understanding required for such a study is believed to outweigh any negative consequences.

The interviews were conducted with respondents in Australia, UK, and USA. The research is therefore only relevant to the predominant culture of these countries. However, enough differences were identified to indicate that substantial differences may be evident in different cultures. Therefore, the findings of this research should be considered to be indicative only within these specific cultures.

This study has examined only one economic theory. It does not mean that all economic theories are not relevant to F&F investment.

**FUTURE RESEARCH**

Additional in-depth studies are recommended to further our understanding of F&F investment. Future research should examine economic theories not addressed in this research. Different cultural contexts, taxation, and policy regimes should also be examined to understand how different social influences affect F&F investment. It is clear from this research that a great deal more can be learnt and it is important given the extent of F&F investment behaviour. Policy makers, financiers, entrepreneurs, and their advisors have a responsibility to have an understanding of the F&F investment phenomenon.
REFERENCES


