SWP 62/87 FINANCING SMES - A DISCUSSION PAPER

FINANCING SMEs - A DISCUSSION PAPER

PAUL BURNS
National Westminster Bank Professor of
Small Business Development
Cranfield School of Management
Cranfield Institute of Technology
Cranfield
Bedford MK43 OAL
United Kingdom

(Tel: 0234 - 751122)

Presented at the 17th European Small Business Seminar, Genoa Italy, September 1987

School Working Paper 62/87

Copyright Burns 1987

CONTENTS

1. Introduction

2. The Funding Profile of SME's

3. The Life Cycle Dynamic and Equity Capital

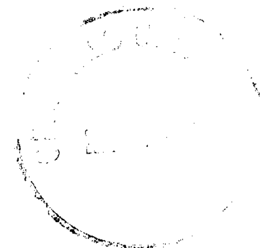
4. Institutional Sources of Equity Capital

5. Loan Finance

6. The Cost of Funds

7. Policy Issues

I should like to thank Sue Birley, Jim Dewhurst and Malcolm Harper for their helpful comments on an earlier draft. Errors and omissions are, of course, my own responsibility



1. INTRODUCTION

This paper explores the background to five major policy questions facing European Governments seeking to encourage the growth of SME's:

1. Has the balance of constraints on SME growth shifted, such that institutional sources of funds is no longer a major constraint?
2. Is there an over-emphasis upon the adequate provision of seed corn finance?
3. Will SME's ever be able to start up and grow without the provision of subsidised finance?
4. What is the role of public and private sectors in these developments?
5. Is it time to adopt a more consistent pan-European policy for SME's?

Inevitably, the answers to these questions require value judgements about the scope of Government intervention. This paper attempts simply to set out a framework for making these judgements.

2. THE FUNDING PROFILE OF SME'S

There is a dearth of reliable statistics on SME's and a notorious lack of consistency in international statistics. It is also well known that statistics on the financial data of small firms are the most fragile of all since, not only are they affected by the different accounting and tax practices followed in various countries, but they are also largely at the discretion of the proprietor of the SME. There are virtually no data bases which permit a consistent international comparison of the financial structure and funding of SME's.

One international survey covering the UK, USA, France, Japan and Israel was conducted by Tamari[1]. His data is now rather old (1964 to 1973) and, as is still the case today, the definition of SME's vary from country to country. His broad conclusions, however, have been verified by more recent research in the UK[2]. They were:

1. SME's operate with gearing ratios (debt to total funds) similar to or higher than large firms.
2. The proportion of debt represented by long term loans in SME's is significanctly lower than for large companies.
3. SME's are significantly more dependent on creditor finance than large companies.

Table 1 summarises UK research data on financial structures over the 20 year period 1962 to 1982.

Tamari's research would also seem to suggest that shareholders loans are a significant element in funding SME's, varying between 11% of total assets in the USA, 18% in France, 6% in Japan, 22% in Israel and 3% in the UK. (The Wilson Report put this figure at 11% in the UK by 1975).

This high gearing with a heavy dependence on short term funds is normally seen as inherently risky and unstable. It perhaps goes some way to explain the general lower investment by SME's in fixed tangible assets than large companies, and must mean that SME's are not as well placed

to weather economic recession. To redress this imbalance would require the input of long term equity capital.

3. THE LIFE CYCLE DYNAMIC AND EQUITY CAPITAL

The nature of long term equity capital which is appropriate and available to small businesses varies as a new venture progresses through its life cycle. Figure 1 illustrates the types of equity capital appropriate to new ventures at various stages of this life cycle. It is adapted from Vickery[4] who based the life cycle stages on work by Churchill and Lewis[5].

As can be seen, the nature and variety of equity capital is very wide. Virtually all businesses will have to rely heavily on owners' equity in the early stages of the life cycle.

However not all new businesses will have access to the other forms of venture capital listed. Most new businesses grow only in the first few years after start up and then reach some equilibrium level at which the owner-manager is provided with an adequate, independent life style. The company can stay at this stage indefinitely provided environmental change does not destroy its market niche or ineffective management reduce its competative advantage. Equilibrium businesses of this sort are unlikely to seek additional equity once equilibrium is reached. It is simply not needed. In addition equity involvement at earlier stages will be less attractive to outside backers, even if the owner-manager were to seek it. Also, owner-managers have been traditionally reluctant to relinquish ownership of their company by bringing in other shareholders.

It is therefore new ventures with growth potential that are most likely to seek, and indeed need additional equity capital.

3. INSTITUTIONAL SOURCES OF EQUITY CAPITAL

In a survey of European small business, Burns and Dewhurst[6] concluded:

> 'The UK seems to lead the other (European) countries in the number of institutional sources of equity for unquoted companies. Institutional providers of venture capital are only just emerging in many of the countries surveyed'.

In the UK, Investors in Industry (3I) dominates the institutional providers and is probably the largest institution in the world of its kind. As of March 1986, it held long term investments in some 4800 unquoted companies. Average investment is some £200 million annually in new loans and equity.

One aspect in the encouragement of non participant individuals to invest in SME is taxation. Here again the same survey concluded that:

> 'Britain stands out with its bold and generous Business Expansion Scheme (BES)'

Introduced in 1981, the scheme allows the deduction of up £40,000 in any one year from an individual's tax liability for investment in unquoted trading (and some other) companies incorporated and resident in the UK. Investors can also claim relief by investing in an approved investment fund. About £240 million was raised from private investors in two years from 1983 - 85 for investment in over 1400 companies, about half of the investments are of amounts less than £50,000. A survey by Peat Marwick[7] in 1986 concluded:

Without BES:

1. 94% of finance invested by individuals would not have gone to particular companies.
2. 93% would not have been invested in UK unquoted companies.
3. 73% would not have been invested in equities in general.

None of the countries in the survey had any scheme approaching the generosity of the UK scheme. Although Denmark had no special incentives for investment by non-participants, it did have a scheme whereby wage-earners under 40 could make deductible deposits of up to 20% of their income in an 'establishment account' and use it for setting up their own business. In France, private individuals could invest up to FF.7000 a year in quoted or unquoted companies and claim a 25% tax credit West Germany, the Republic of Ireland, Italy and Switzerland had no specific tax incentives for non participants.

In the UK, the existence of the 3rd Market, and the Unlisted Securities Market (USM) as well as the share repurchase provisions of the 1981 Companies Act has enhanced the marketability of

investment in unquoted companies and provided valuable 'take-off' stage financing for growth businesses.

Since its creation in November 1980, the USM has seen spectacular growth. It has created over 650 millionaires. Statistics recently produced by accountants Touche Ross chart the spectacular growth in terms of funds raised.

£'million	New Issue	Raised by existing Shareholders	Total raised inc. rights issues
First 17 months	**49.7**	**36.3**	**130**
Calender 1984	**NA**	**86.6**	**NA**
Calender 1985	**NA**	**90.3**	**NA**
Calender 1986	**152.2**	**140.6**	**436.8**

The USM now lists about 500 companies with a capitalisation approaching £5 billion.

There is some evidence in the UK that the availability of equity funds now exceeds the business opportunities to invest in. Many new issues on the USM are greatly oversubscribed. The launch of the Sock Shop in May was 53 times oversubscribed. A number of BES investment funds are not invested. In the eighties there was an explosion of venture capital funds. There is now an established group of Venture Capital managers whose very business existence depends upon them finding a stream of suitable investments, and frequently comment on the difficulty of doing so. In the UK even 'seed' and 'start up' equity is becoming more easily available. There are a number of local schemes to 'marry' investors with business needing finance, the best known being run by the London Enterprise Agency and currently being extended outside London. Also The Venture Capital Report, which has been published now for eight years, has raised some £20 million mainly for seed corn investments. The monthly publication carries at least ten investment opportunities each month giving details of the business, the entrepreneur, the finance sought and whether an active or passive partner is appropriate.

However, in a recent survey of venture capital users[8], two out of three respondents still rated lack of both personal and external finance as a serious or moderate problem when establishing their new business and 41% saw availability of capital as a major obstacle to further growth.

5. LOAN FINANCE

There are no published figures on the proportion of commercial bank lending to SME's, and consequently it is impossible to evaluate the provision from one country to another. However, there are two areas of provision that relate specifically to small firms; credit guarantees that enable small firms to obtain bank loans that they would not otherwise obtain because of lack of collateral and subsidised loan capital for SME's.

The UK has its own Small Firm Loan Guarantee Scheme which guarantees 70 per cent of medium term loans now at a premium of 2½ per cent above commercial interest rates. Launched in 1981, the original scheme, which ran until 1984, helped 14,000 businesses with £450 million. However, bad debt claims exceeded income by £37 million. Britain's only national 'subsidised' loan scheme is provided by the European Investment Bank and administered by Investors in Industry. There is a plethora of local and regional schemes directed towards encouraging investment in specific locations rather than in SME's in particular, although there is some evidence that SME's do not make as much use of these schemes as is often supposed.

France has an extensive network of professional guarantee associations. There are well over 50 'Societes de Caution Mutuelle' which provide these loan guarantees. They are self funding and charge a small premium for their guarantee. The government only recently entered the field through its 'prets participatifs' (participating loans) which are unsecured, long-term loans with variable interest rates linked to borrowers' performance. These are intended to provide a semi-equity form of funding. A number of banks also provide subsidised loans to SME's as well as to geographical regions and specific trades.

West Germany has a government-backed credit guarantee scheme administered through private credit guarantee associations. These private associations have funds supplemented by loans and grants from the Lander and Federal Government, and normally focus on specific sectors. West Germany also has subsidised loans (often linked to loan guarantees) available through the commercial banking system. These are paid for by the European Recovery Programme.
In the Republic of Ireland the Enterprise Development Programme provides both loan guarantees and loan subsidies. In Italy, although there is a state loan guarantee scheme, there seems little uptake. Even subsidised loans, although available, seem to be little used. Whilst Switzerland has a loan guarantee scheme, it does not have any form of loan subsidy for SME's, although there is a plethora of local cantonal schemes. Denmark stands out as having very little by way of financing provision specifically for SME's although it would seem true that most businesses in Denmark really are 'small'.
Again, in the UK, there is evidence that, despite cries to the contrary, there is adequate provision of loan finance for SME's. Don Clarke, Finance Director for 3I recently wrote[9]:

> 'Dealing first with long-term debt, I have seen no signs of shortage. Had there been one, we at 3I would have had problems raising money ourselves; and what we did raise would have had to be rationed. But, at no time during my 18 years funding 3I has this happened.

In passing he points out that much of this has come from overseas sources with 3I issuing over £1000 million of debt to foreign investors since 1977. He comments that, given the bouyancy of the european market, they could have issued more 'had there been the opportunity to invest it'.

6. THE COST OF FUNDS

Even if one accepts that there are 'adequate' institutional sources of debt and equity in Europe today, there is always the question of cost. The late seventies saw high rates of inflation in most European countries which in turn generated high interest rates.

In the UK, since 1972 when 3I raised a 25 year loan stock at $8^7/_8$%, it has only once been able to raise money below 10% until a $9^3/_8$% issue in April this year. The rates of interest on a 20 year debenture over the period 1970-86 are shown in Table 2. They show the steep rise during the late seventies but they also show how, as inflation came down in the eighties, interest rates did not follow.

Table 2 also gives 'real' interest rates; the difference between the 20 year debenture stock and the inflation rate. The inevitable conclusion is that real interest rates have never been higher. The rate of interest at any time is the result of supply, demand and some government intervention. The prime causes of interest rate levels and fluctuations are often disputed, however, Governments' own borrowing requirements certainly play an important part. In the UK the late seventies saw an increase in Government borrowing requirements which probably not only forced up interest rates but also inflation rates. At the same time many companies were very unwilling borrowers as they had to borrow to fill the cash flow gap caused by inflation. The crisis of 1980/81 caused many UK companies to grasp the unattractive nettle of reducing costs by reducing capacity and improving efficiency rather than accepting the palliative of filling cash flow gaps with borrowed money. Since then gearing levels for UK companies of all sizes have drifted down and at the same time profitability has improved[2]. Returned earnings and borrowings in the eighties have increasingly been used to finance growth opportunities.

Since SME's generally have high gearing ratios than large firms they are particularly hard hit by these high interest rates and any conclusions about improvements in sources of funds over the period must be tempered by the high cost of those funds in the eighties.

7. POLICY ISSUES

This brief review of SME financing and the provision of equity and loan funds in Europe, leads directly to a number of interesting issues:

1. **Has the balance of constraints on SME growth shifted, such that institutional provision of funds is no longer the major constraint?**

   There is some tentative evidence in the UK, where the institutional sources of bank and equity finance are now very good, that the problem has become one of finding sufficiently profitable investment opportunities, not the funds to invest in them. This does beg the question of 'sufficiently profitable' (i.e. sufficient, at least to meet the financing cost), however, should subsidy be given to less profitable ventures? Would state resources be better directed towards improving the volume of profitable investment opportunities? If so, how?

2. **Is there an over-emphasis on the adequate provision of seed corn finance?**

   Most SME's will either go out of business early in their life or reach some equilibrium in their development that they will not go beyond. It is unlikely that owner managers in these equilibrium firms will want to share ownership. It is equally unlikely that investment in them will be attractive to institutions. It is also clear that the administrative cost of such equity is very high relative to the investment making it of questionable benefit to anything other than those SME's with growth potential Is the tremendous growth of credit guarantees and subsidised loan capital throughout Europe is now starting to meet the start-up capital needs of these SME's?

3. **Will SME's ever be able to start up and grow without the use of subsidised finance?**

   SME's have higher gearing ratios than larger companies and often face higher interest charges. However there are certain fixed costs associated with the provision of capital (e.g. legal and monitoring costs) which make the provision of small amounts of capital expensive. Can and should there be a policy of reducing subsidies over a period such that SME's have to face the true economic cost of funding?

4. **What is the role of public and private sectors in these developments?**

   The UK has built upon the private sector institutional framework by providing guarantees and incentives (e.g. BES). Is this the way forward, rather than setting up new governmental bodies?

5. **Is it time to adopt a more consistent pan-European policy for SME's?**

   National policies vary greatly. Some countires rely upon Government intervention, others rely upon the free market. SME's get very different treatment in different countries and, unlike their larger counterparts, find it difficult to look to the international market place for help. Is this fair?

Over the last twenty years European governments have focussed increasingly on SME's and developed policies to encurage their formation and growth. Over that period the provision of institutional capital for SME's has improved vastly. In that any form of subsidy to any sector needs to be reviewed periodically, subsidies towards capital provision for SME's also need to be reviewed. In particular, given the objective of encouraging the formation and growth of SME's, are there other ways in which this 'subsidy' can be more effectively used to help the SME sector?

Table 1 : Financing of SME's in the UK 1962-1982

	Various samples of small companies							Large companies	
	A	B	C	D	E	F	G	H	G
	1962-63	1964-68	1968-70	1970-71	1971-75	1975	1977-82	1962-75	1977-82
	%	%	%	%	%	%	%	%	%
Assets:									
Fixed assets	33	36	37	34	27	32	30	45	38
Current assets	67	64	63	66	73	67	70	55	62
	100	100	100	100	100	100	100	100	100
Financed by:									
Owners interests	58	59	43	53	36	45*	40**	55	47
Current liabilities	29	30	33	31	57	41	42	26	28
Bank borrowing	11	7	16	12		11	15	7	13
Long term loans	2	4	7	3	7	3	3	10	9
Minorities	0	0	1	1	0	0	-	2	3
	100	100	100	100	100	100	100	100	100

Sources: See reference 3

* includes 11% loans from directors

** excludes loans from directors

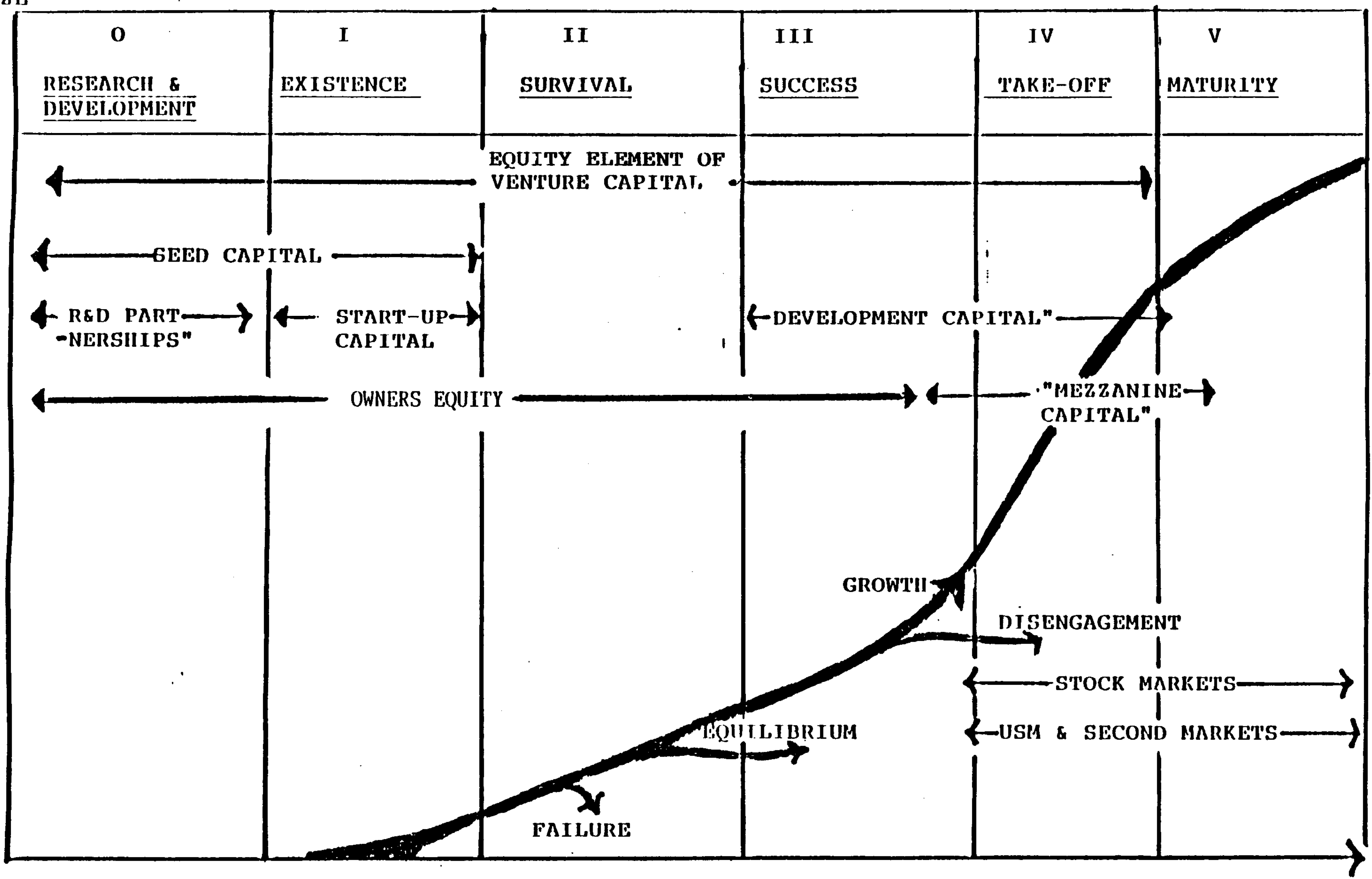
Table 2 : Interest Rates in the UK 1979 -86

Year	20 years debenture yield %	'Real' Interest %
1970 :	9.9	3.5
1971 :	9.6	0.2
1972 :	9.7	2.6
1973 :	11.4	2.3
1974 :	16.4	0.4
1975 :	16.0	-8.2
1976 :	15.2	-1.3
1977 :	13.4	-2.4
1978 :	12.8	4.5
1979 :	13.2	-0.2
1980 :	14.2	-3.8
1981 :	15.4	3.5
1982 :	14.0	5.4
1983 :	12.1	7.5
1984 :	11.8	6.8
1985 :	11.5	5.4
1986 :	10.8	7.4

* 'Real' interest is the difference between these 20 year debenture yields and the inflation rate.

FIGURE 1

FINANCING THE LIFE CYCLE OF A BUSINESS



References

1. M. Tamari, The Financial Structure of the Small Firm - An International Comparison of Corporate Accounts in the USA, France, Israel and Japan, American Journal of Small Business, Vol. IV, No.4, 1980.

2. P. Burns, Financial Characteristics of Small Companies in the UK, Working Paper, 85.8, Cranfield School of Management, 1985

3. Sources for Table 1:

   A: 1962-63: Board of Trade, Patterns of Company Finance, Economic Trends, November 1967 (348 firms with profits £4-20,000)

   B: 1964-68: Tamari, A Postal Questionnaire Survey of Small Firms : An Analysis of Financial Data, Report 16, HMSO, 1972 (Average for manufacturing firms out of 2115 firms with under 200 employees).

   C: 1968-70: R. C. Osborn, ICFC Financing Small and Medium-sized Businesses, IFC 1972 (611 firms subsequently financed by ICFC with medium and mean net assets of £50,000 and £160,000)

   D: 1970-71: S. Mason, Small Business Financing and the Capital Market, Unpublished, LBS 1975. (Most unlisted UK companies with Extel cards)

   E: 1971-75: M.E. Beesley and R.T. Hamilton, An Investigation of the Institutional Venture Capital Market in the UK, Unpublished LBS 1977. (Average of 40 technologically innovative businesses)

   F: 1975: Wilson Report, Report of the Committee to Review the Functioning of Financial Institutions, Cmnd. 7939, 1980

   G: 1977-82: P. Burns, op cit (Average for companies with capitalisation of up to £4.16 million. Data is from Business Monitor MA 13-16, HMSO, covering some 3000 companies filing accounts each year)

   H: 1962-75: E. Dimson Financing the Smaller Company, Long Range Planning; Vol.II, December, 1978

4. L. Vickery, Equity Finance in Small Firms, in P. Burns and J. Dewhurst (Eds.) 'Small Business Issues : Text and Cases, forthcoming, Macmillan

5. C. Churchill and V.L. Lewis, The Five Stages of Small Business Growth, Harvard Business Review, May-June, 1983, pp. 30-50

6. P. Burns and J. Dewhurst (Eds), Small Business in Europe, Macmillans, 1986

7. Peat Marwick, Survey of Business Expansion Scheme, Inland Revenue, 1986

8. Research study conducted by MORI, A Survey of Venture Capital Users, British Venture Capital Association, March/April 1986

9. D. Clarke, Is there a shortage of capital for British Business?, Quarterly Enterprise Digest, July 1987