Small Business Funding in Australia

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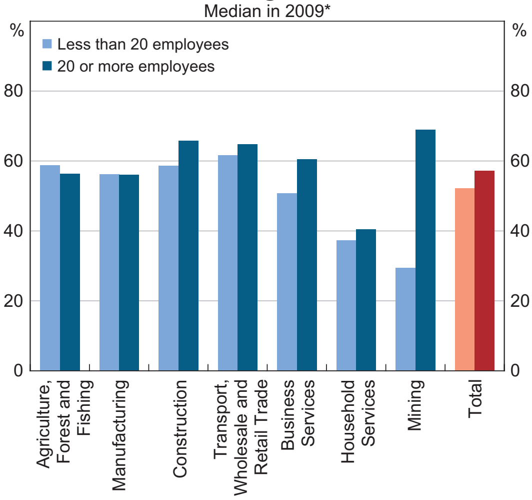
Smaller businesses typically access funding on less favourable terms than larger businesses. The reasons mostly relate to their size, in that smaller businesses' revenue streams are more volatile, increasing the riskiness of these loans to lenders. The costs associated with raising debt directly from capital markets are also relatively high for smaller businesses. Size issues are less relevant for equity funding. Equity is typically raised internally through profits from the owner, or from friends and family.

Overview of Small Business Funding

As noted in the 'Small Business: An Economic Overview' paper, unincorporated business owners are less likely to use debt and have lower gearing levels than incorporated businesses. Among unlisted incorporated entities, smaller businesses are less likely than larger businesses to have any debt and, when smaller businesses use debt, they use less debt than larger businesses, although this masks some differences at an industry level (Graph 1). Furthermore, there are sizeable differences across individual businesses, particularly between the smaller entities (Graph 2). The fact that Australian small businesses tend to use less debt than larger businesses is consistent with international studies (see, for example, De Jong, Kabir and Nguyen (2008)).

Graph 1
Gearing Ratio
Median in 2009*



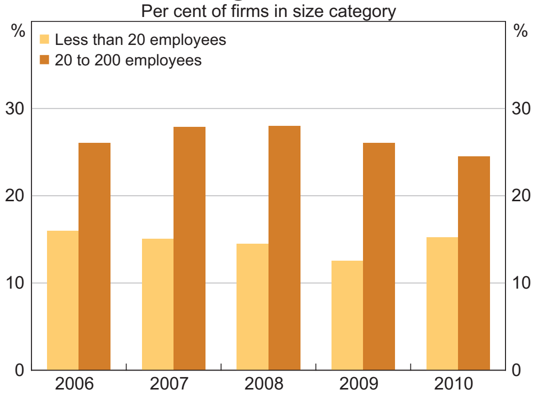
* Data are for unlisted corporations who have debt
Source: Dun & Bradstreet

Graph 2
Distribution of Gearing Ratios
Per cent of business size category in 2009*

* Data are for unlisted corporations who have debt
Source: Dun & Bradstreet

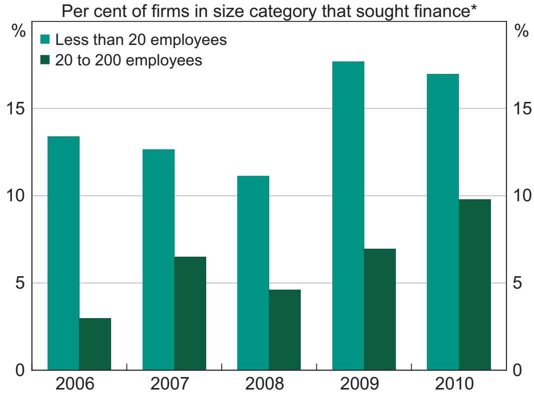
More generally, survey data covering both incorporated and unincorporated Australian businesses show that smaller businesses are less likely than larger businesses to seek 'external finance' (debt and external equity funding) (Graph 3). Of the small businesses that choose not to seek external finance, only a small proportion attributes this to an expectation that it will be difficult to obtain. This suggests that, in general, internal equity funding and existing debt facilities meet small business' needs. Nevertheless, when small businesses seek external funding they are more likely to be rejected than larger businesses (Graph 4). Liaison with banks suggest that about 80 per cent of small business loan applications are accepted, while data on venture capital funding shows that only a small fraction of businesses who seek this form of funding are successful.

Graph 3
Firms Seeking External Finance
Per cent of firms in size category



Source: ABS Business Longitudinal Database

Graph 4
Failure to Obtain External Finance
Per cent of firms in size category that sought finance*



* Data are for firms who responded in all five years
Source: ABS Business Longitudinal Database

This paper discusses the funding composition of Australian smaller businesses in greater detail, and examines recent developments. Since the onset of the financial crisis, for example, the stock of borrowing by smaller businesses, whether measured by loan size or legal status, has remained steady while the stock of borrowing by larger businesses has contracted. This is despite the borrowing cost for small businesses increasing by more than the borrowing cost for large businesses.

Debt Funding

Smaller businesses tend to raise more of their debt from financial intermediaries and use less trade credit than larger businesses. Only the largest businesses are able to access debt funding directly from capital markets, because the fixed costs of organising direct debt issues are large.

Intermediated debt

Businesses with less than 20 employees source around half of their debt from financial intermediaries, which is slightly more than for businesses with more than 20 employees (Graph 5).

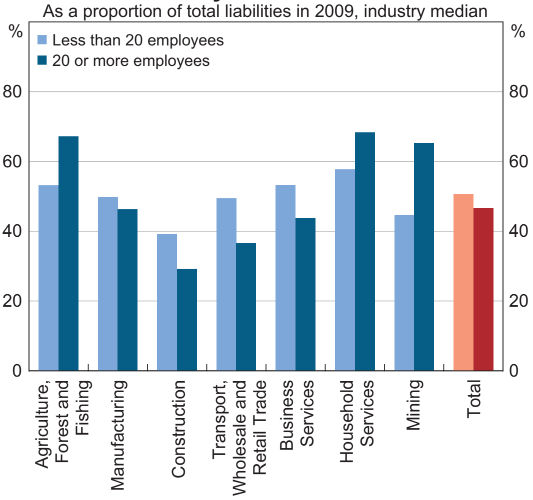
The type of financial intermediary used is similar across business sizes, with banks by far the most commonly used financial intermediary, accounting for more than three quarters of lending (Graph 6).[1] Banks are, however, less dominant in business lending than they are in household lending. This is generally attributed to the large branch structure being viewed as less of a competitive advantage in business lending than in the delivery of household lending, and the specialised nature of some of the lending. Many businesses use finance companies,

1 While these data are somewhat dated, they are consistent with slightly less detailed data from the CPA Australia Asia-Pacific Small Business Survey 2011.

Graph 5

Credit Provided by Financial Intermediaries*

As a proportion of total liabilities in 2009, industry median



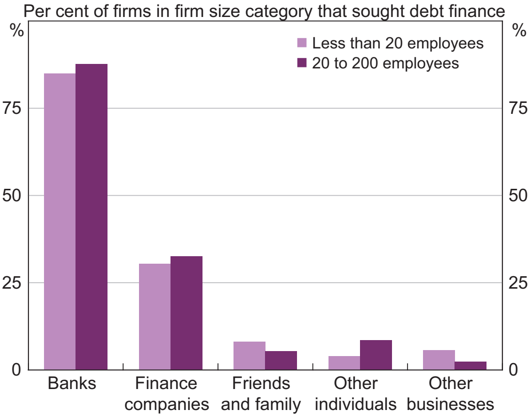
* Calculated as the difference between total liabilities and accounts payable; data are for unlisted corporations who have debt

Source: Dun & Bradstreet

Graph 6

Source of Debt Finance in 2005

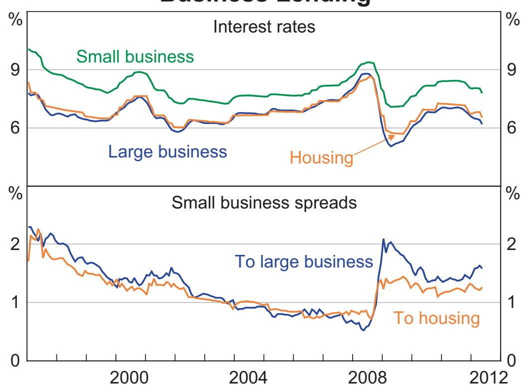
Per cent of firms in firm size category that sought debt finance



Source: ABS Business Longitudinal Database

Graph 7

Business Lending



Sources: APRA; RBA

particularly for specialised debt products such as leasing, vehicle and equipment loans, and debtor finance. Aggregate lending data suggest that since 2005, finance companies' share of business lending has fallen, while lending by banks has increased. Businesses sometimes access banks and finance companies via finance brokers. Stephen (2011) suggests that, relative to housing loans, smaller business loan products are more heterogeneous and more costly to organise, so small business lending brokers are less common than household brokers.

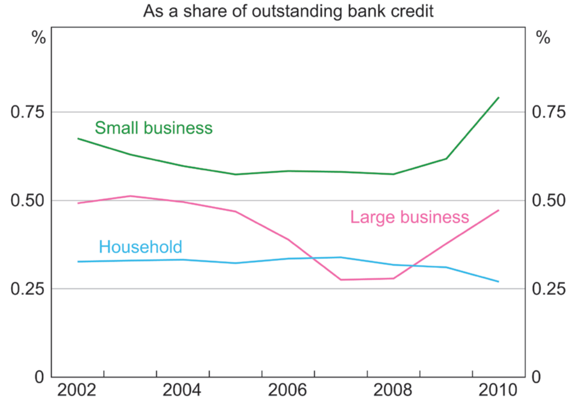
Smaller businesses pay more, on average, for debt than both households and larger businesses. This is true in terms of both interest rates and product fees (Graphs 7 and 8). Interest rates do, however, vary considerably between small businesses (Graph 9).

A key reason for the difference in borrowing costs is that smaller businesses are typically viewed as having more volatile revenue streams. In turn, this reflects their small scale, which limits the range of work that they can undertake, weakens their bargaining positions with suppliers, and generally prevents diversification in resources, products and customers. Smaller businesses make greater use of riskier forms of loan collateral, such as inventory,

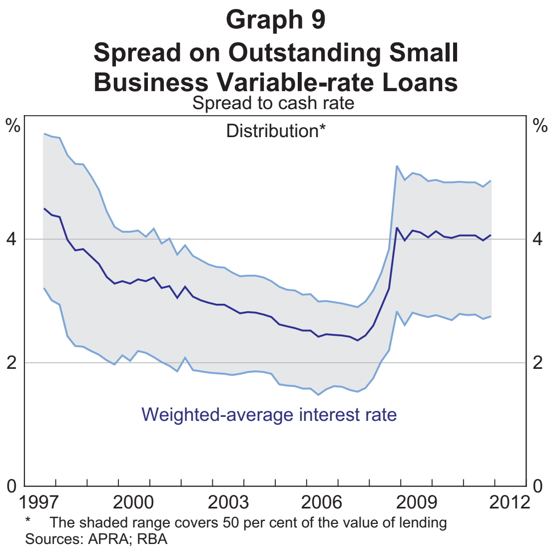
Graph 8

Bank Loan Fees

As a share of outstanding bank credit



Source: RBA



vehicles, equipment, and accounts receivable, and make more use of unsecured debt products. Indeed, these factors result in small business borrowers being more than twice as likely as standard mortgage customers to default. Once a default has occurred, the lender is likely to lose more money on a defaulted small business loan than on a housing loan even if it is secured against identical collateral. Lenders adjust for this additional risk by charging higher interest rates as well as by rejecting or modifying a greater proportion of small business credit applications.

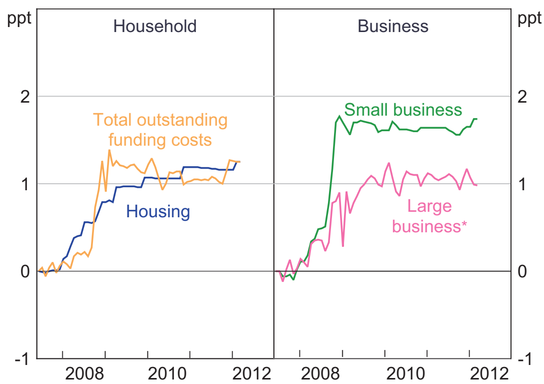
Another likely reason for the difference in costs is that the potential interest revenues from smaller business' relatively small loans do not justify the same ongoing relationship management and detailed credit risk assessments that businesses with larger loans receive. Also, because smaller businesses tend to have less detailed reporting requirements and a shorter financial history, banks have less financial information with which to make credit risk assessments, a problem that has become greater in recent years as banks' have placed more weight on quantitative risk assessment methods. As a result, lenders charge small businesses a premium for the added uncertainty of having less information upon which to base a credit assessment.

During the recent financial crisis, average lending rates and product fees for smaller business increased by more than those for larger businesses and households (Graph 10 and RBA 2011). Deans and Stewart (2012) show that as the financial crisis unfolded, the higher cost of deposits and long-term wholesale funding resulted in banks' funding costs increasing by more than the cash rate. In addition, there has been an increase in the assessed riskiness of small business loans. This is consistent with the increase in non-performing small business loans over this period, which have risen to be around 2¾ per cent of banks' total small business loan portfolios as of December 2011 (by way of comparison, non-performing housing loans comprised around 0.7 per cent of banks' housing loans). Overseas studies, such as OECD (2012), have found that, following the onset of the financial crisis, smaller businesses in many developed countries experienced greater increases in interest rates, greater cuts to loan maturities and greater increases in collateral requirements than larger businesses. Despite this, lending to small business has not fallen as sharply as that to large business (Graph 11).

The higher cost of small business debt facilities leads many smaller business owners to use household debt products to fund their business. For example, the RFi Intelligence (2011) survey of businesses with revenue of less than $10 million reported that around 30 per cent of respondents used a personal credit card to manage their business' cash flow. Schwartz, Hampton, Lewis and Norman (2006) also reported that around 5 per cent of housing loan equity withdrawals in 2004 were used to fund businesses, most of which are likely to be small, or commercial property purchases.

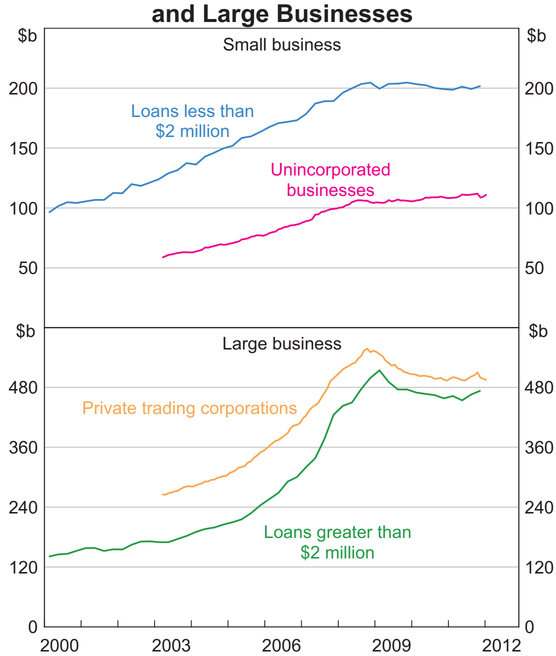
Beyond using debt products designed for households, and using residential property as loan collateral, smaller businesses also make use of alternative sources of debt (Table 1). One example is equipment and vehicle leasing. Leases differ from other forms of lending in that the lender receives legal ownership of the collateral asset. A lender may be able to provide a borrower with relatively cheap funding through a lease if the lender

Graph 10
Variable Lending Rates
Cumulative change in spreads to the cash rate since June 2007



* Loans greater than $2 million; includes bill lending
Sources: ABS; APRA; Perpetual; RBA

Graph 11
Bank Lending to Small and Large Businesses



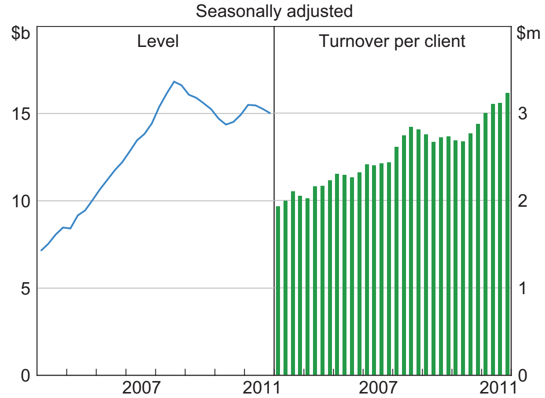
Sources: ABS; APRA; Austraclear; RBA

Table 1: Forms of Financial Intermediary Debt Used by Small Business

Finance product	Proportion of respondents
Credit card	66
Secured bank loan	41
Overdraft	34
Lease	28
Hire purchases	19
Unsecured bank loan	17
Chattel mortgage	12
Debtor finance	7
Vendor finance	6
Inventory finance	6
Other	7
None	18

Source: CPA Australia Asia-Pacific Small Business Survey 2011

Graph 12
Debtor Finance Turnover
Seasonally adjusted



Sources: Institute for Factors and Discounters; RBA is better able to use the tax deductions allowed for depreciation of the collateral asset, and if bankruptcy costs are high. The ABS Business Longitudinal Database shows that larger businesses tend to make more use of leases than smaller businesses.

Another important form of alternative debt finance for smaller business is debtor finance, which is short-term funding that a business obtains in exchange for selling its accounts receivables (Graph 12). It can be done by 'discounting', whereby the business maintains responsibility for collecting receivables, or through 'factoring', whereby the business passes on responsibility for collecting the accounts receivables, but may or may not assume the risk of bad debts. In Australia, discounting accounted for over 90 per cent of total debtor financing in 2011.

The debtor finance market has grown significantly over the past decade. Industry liaison suggests that it is particularly attractive for small businesses that have a large proportion of their accounts receivable outstanding to reputable companies; there it can free up large quantities of funding, typically within 48 hours, because the lender can easily assess the quality of the accounts that are collateralising the loan.

Trade credit

The average small business obtains the other half of its debt funding from its trade suppliers, when it obtains inventory, equipment and services without immediate payment. Smaller businesses make slightly less use of trade credit than larger businesses, a result which is consistent with studies of US businesses by Petersen and Rajan (1997) and Italian businesses by Marotta (2005). The difference is most likely to be caused by smaller business's poorer bargaining position with suppliers. Smaller businesses are also perceived to be more risky than larger businesses. An overseas study by Carbó-Valverde, Rodríguez-Fernández and Udell (2012) and Australian research by Dun & Bradstreet (2011) suggest that trade credit became a particularly important source of funding for smaller businesses when access to credit through financial intermediaries was restricted during the recent financial crisis.

Relative to debt sourced from financial intermediaries, trade credit is cheap if the small business is able to repay its debt before an agreed repayment date, otherwise it can be considerably more expensive than bank credit. Payment terms for trade credit agreements vary significantly between businesses, and are typically determined by the relative bargaining position of businesses and the perceived credit worthiness of the borrower. Payment terms for trade credit agreements will specify a payment date, which is typically 30 days in Australia, as well as a late payment penalty and often an early payment discount. The late payment penalty and early payment discount determine the cost of a trade credit agreement. For example, suppose a trade credit agreement had a repayment term of 30 days, a 2 per cent per month late payment penalty and a 1 per cent early payment discount if the trade credit is repaid within 10 days. A business that receives these payment terms will pay nothing for the trade credit if it pays within 10 days, will pay 1 per cent in opportunity cost between 10 and 30 days, and will pay an annualised rate of 25 per cent interest if it misses the 30 day repayment date. Dun & Bradstreet (2012) show that the average time it takes both small and large businesses to repay trade credit is well over 30 days, which suggests that many businesses are borrowing from other businesses at significant cost. Liaison suggests that smaller business creditors often have their payment terms unilaterally extended by larger businesses. In this case, smaller businesses are effectively providing funding to larger businesses.

Equity Funding

While it can be difficult to measure, the higher volatility of smaller businesses revenue streams makes equity, like debt, more costly for smaller businesses. Small business equity investors (including the owners) require a higher average return on equity to compensate for the higher uncertainty of the return. While small businesses make greater use of debt than equity, they use slightly more equity than larger businesses, which suggests that debt is relatively expensive for smaller businesses.

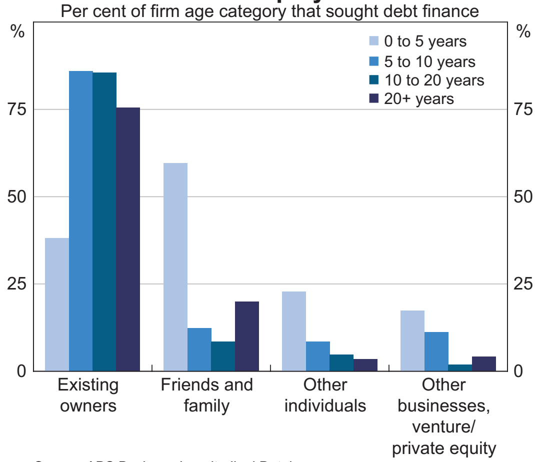
Smaller businesses are likely to use more equity than larger businesses for a number of reasons. First, small businesses use less leverage to compensate for the higher volatility of their cash flows (discussed above), and higher bankruptcy 'wind up' costs. That is, the costs of debt and equity are equated at a lower level of gearing.

Second, transactions costs also help to explain why most small businesses may prefer particular forms of external equity finance over debt and equity provided by external parties. Debt and equity finance provided by professional investors involve costly risk assessments, with associated sizable fixed costs. Most small businesses do not have a great need for capital to expand, and borrow at a scale that does not always overcome the diseconomies of these fixed costs. These small businesses instead use internal equity finance and external equity sourced from friends, family and business owners, which don't involve large transaction costs and are relatively inexpensive (Graph 13).

Graph 13

Source of External Equity Finance in 2005

Per cent of firm age category that sought debt finance

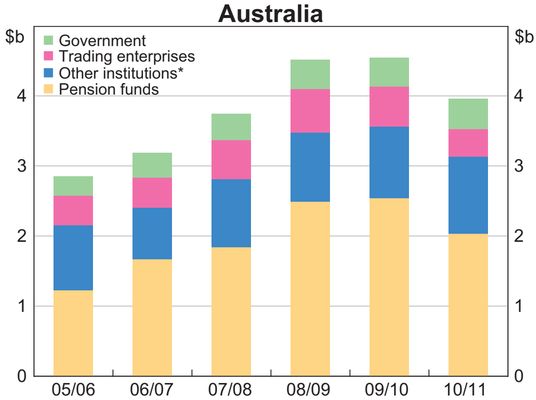


Source: ABS Business Longitudinal Database

Third, information costs help to explain why internal equity is particularly attractive for highly profitable or low-growth smaller businesses. The owner and managers of a business have more information about their company's prospects, risks and value than outside investors. The need to pay external financiers a premium for their incomplete information leads the small business owners to prefer internal equity over external finance. Highly profitable or low-growth businesses meet a relatively large amount of their financing needs with internal equity. While the 'The Financial Characteristics of Small Businesses' paper notes that small businesses are generally more profitable than large businesses, smaller businesses are likely to include a relatively large number of firms that do not intend to expand (hence they remain small businesses).

Once a small business reaches a sufficient size or its growth prospects are sufficiently strong, the importance of these factors changes and the firm is more likely to take on external equity funding. There are a number of forms of external equity funding for smaller businesses. For example, equity might be provided by 'business angels', who are individuals who invest their own money, time and expertise into promising and risky start-ups or by venture capital firms, which generally provide somewhat larger intermediated equity funding on behalf of other investors. The volume of venture capital funding has increased steadily in Australia over the past decade, with the increase sourced largely from pension funds (Graph 14).

Graph 14
Major Sources of Venture Capital in Australia



* Includes ADIs, life insurers, trusts, other residents and non-residents
Source: ABS

Government Policy and Small Business Finance

Many developed economies have policies in place that aim to increase small businesses' access to finance. Commonly used policies are limited guarantees of small loans, direct lending to smaller businesses and funding of venture capital (OECD 2012). The common thread in these government policies is that they improve access to funding for relatively risky firms that would otherwise not be able to access finance, as well as lowering the cost of funding for businesses that are already able to access external funding, with the cost of this increased financing risk largely borne by the taxpayer.

Some alternative policy responses include government-funded provision of financial advice to small businesses, such as in Denmark and New Zealand, and government provision of credit default mediation services, such as in France and New Zealand, which are intended to reduce the costs of small business loan default for banks and small business owners. The UK has recently implemented an alternative type of guarantee to the providers of bank wholesale funding, with the proviso that banks pass on their funding cost savings in full to small businesses for the money that is raised through the scheme.

Conclusion

The scale of small businesses, both directly and indirectly, makes both debt and equity financing expensive for smaller businesses relative to large businesses. These scale issues are most acute for debt financing and external equity financing sourced from professional investors. As a result, smaller businesses make relatively greater use of equity sourced from profits, friends, family and the owners. Although smaller businesses make relatively greater use of equity, debt is still the most important source of finance for smaller businesses.

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