

Small Business Finance Roundtable

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Small Business: An Economic Overview

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Small businesses play a significant role in the Australian economy, accounting for almost half of employment in the private non-financial sector and over a third of production. This paper outlines some of the key characteristics of small businesses. Small business owners tend to set up their businesses as companies or sole proprietorships, and over recent decades, there has been a trend towards incorporation. Small businesses tend to have lower survival rates and more volatile revenues than larger firms. Consistent with this, small businesses are less likely to use debt finance, and often draw on the owners' household assets for financing. Over recent years, small businesses appear to have found economic conditions more challenging than large firms, partly reflecting differences in the industries in which they operate.

Defining Small Business

Although the concept of a 'small business' is quite intuitive, there is no consistently used definition. Common definitions categorise businesses based on: their number of employees, as used by Fair Work Australia (FWA) and in most surveys of small businesses; or annual revenue, as used by the Australian Taxation Office (ATO) (Table 1). Reflecting the available data, the RBA typically categorises loans as being 'small business' loans if the loan principal is under \$2 million, or if the borrowing business is unincorporated. Financial institutions use a wider range of criteria, including the loan size, number of employees, revenue, and balance sheet indicators.

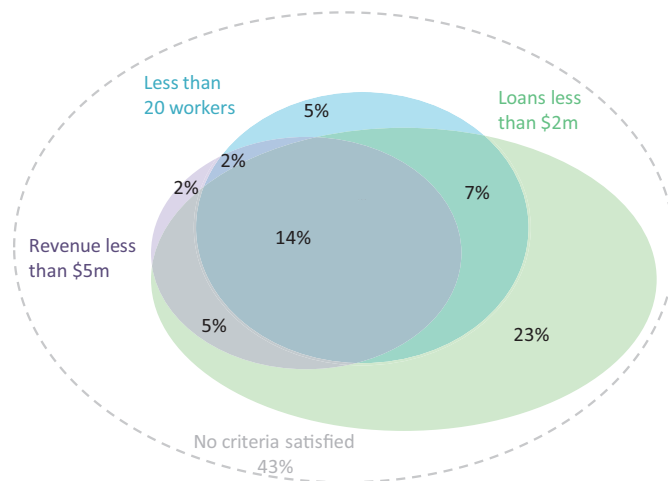
Table 1: Examples of Small Business Definitions

Metric	Threshold	Institution	Purpose
Employees	<15	FWA	Unfair dismissal laws
	<20	ABS	Business surveys
		ACCI and Sensis	Business surveys
	RBA	Business liaison	
<50 ^(a)	ASIC	Annual financial reports	
Legal structure	Unincorporated	RBA	Analysis of financing conditions
Revenue	<\$2 million	ATO	Taxation
	<\$50 million	APRA	Prudential supervision
Individual loan size	<\$1 million	APRA	Prudential supervision
	<\$2 million	RBA	Analysis of financing conditions

(a) Used in conjunction with thresholds on assets and revenues
Sources: ACCI; APRA; ASIC; ATO; FWA; RBA; Sensis

An analysis of unlisted corporations based on information on corporate borrowers from Dun & Bradstreet indicates that the various definitions can identify rather distinct groups of small businesses (Graph 1). For instance, fewer than half of the unlisted corporations with loans under \$2 million also have fewer than 20 employees. Conversely, three quarters of firms with fewer than 20 employees have loans under \$2 million. When revenue of under \$5 million is also considered, only a quarter of the businesses satisfy all three criteria. Furthermore, as highlighted by Lattimore *et al* (1998), there remains considerable diversity within small businesses identified by such criteria, potentially justifying further breakdowns into small and very small or ‘micro’ businesses.

Graph 1
Companies Satisfying Small Business Criteria*



* Unlisted companies with employees; illustration not to scale
Sources: Dun & Bradstreet; RBA

Inconsistency in the definition of small businesses is also a challenging issue when making cross-country comparisons. OECD (2012) highlights significant variation in definitions, with many statistical agencies defining small businesses as those with fewer than 50 employees. The OECD recommended that financial institutions use a definition based on firm size rather than the size of loans, so that financial data would then conform to the definitions used by statistical agencies. However, the OECD found that many financial institutions were reluctant to switch to reporting based on the number of employees unless required to do so by regulators.

Domestically, the Parliamentary Joint Committee on Corporations and Financial Services (2011) recommended that the Government assess the value of developing uniform definitions of ‘micro’, ‘small’ and ‘medium’ businesses for data collection, analysis and policy development by state and federal government agencies. The Committee was of the view that consistent definitions would assist the analysis of the health of the small business sector and promote more informed policy making.

Achieving a uniform, precise and relevant definition may help provide a clearer picture of small businesses’ contribution to various aspects of economic activity, as well as conditions and challenges faced by the sector. In relation to financing, a uniform definition could assist analysis of issues such as access to finance, interest rates faced by small business borrowers, lenders’ loan-to-valuation standards, and financial institutions’ aggregate exposure to the small business sector.

With these caveats in mind, this paper mainly uses the ABS definition of businesses employing fewer than 20 employees to outline the economic contribution of small businesses.

Economic Contribution

Small businesses play a significant role in the Australian economy, particularly in terms of their contribution to employment and production. Around 95 per cent of the 2 million actively trading businesses in Australia in 2011 were small businesses: around two thirds had no employees, a quarter had up to four employees and a tenth had between 5 and 19 employees (Table 2).¹

Table 2: Businesses in Australia, by Size

	Number of employees	Number of businesses in 2011		Employment Per cent of total ^(a)	Value added Per cent of total ^(a)
		'000	Per cent of total		
Small	0–19	2 045	96	47	35
<i>of which:</i>	0	1 306	61		
	1–4	509	24		
	5–19	231	11		
Medium	20–199	81	4	23	22
Large	200+	6	0.3	30	42
Total		2 132	100	100	100

(a) Share of private non-financial sector employees in mid 2010 and value added in 2009/10
Source: ABS

Small businesses accounted for almost half of employment in the private non-financial sector in 2009/10. Their contribution to employment is highest in agriculture, where small businesses accounted for 86 per cent of employment (Table 3). Small businesses also accounted for over half of employment in the construction and business services industries. Unsurprisingly, their contribution to employment is lowest in industries requiring substantial investment in equipment, such as manufacturing and mining. Small businesses accounted for 35 per cent of production, with their contribution across industries following a similar pattern to employment. Small businesses' lower contribution to production, relative to employment, highlights the fact that small businesses are more labour intensive than larger businesses.

Small businesses are an important source of innovation in the economy. While ABS data indicate that small businesses are less likely to engage in innovative activity than larger businesses and account for a relatively small share of research and development expenditure, almost 90 per cent of the businesses engaging in innovative activity are small businesses, reflecting that small businesses are much more numerous.² According to the OECD (2010), the contribution of small businesses to innovation is increasing as a result of new technologies, which make it easier for small businesses to overcome barriers to entry and access larger markets. Consistent with this, the ABS reports that small businesses account for around one third of research and development

1 The fact that the majority of businesses do not employ any employees reflects two factors. First, Table 5 shows that in industries such as agriculture and construction, a large share of employed people work in their own unincorporated businesses and most of these workers do not have employees. Second, the 1.3 million active non-employing businesses also include arrangements that would not generally be considered as being 'businesses' (in the sense that they do not sell goods and services to the general public). Such arrangements include residential and commercial property strata bodies and corporate and trust structures whose main purpose is legal or financial in nature.

2 The ABS Cat. No. 8166.0 reported that in 2009/10, 42 per cent of small businesses were engaging in innovative activity, compared to 62 per cent for larger businesses. The ABS Cat. No. 8104.0 reported that in 2009/10, small businesses accounted for 13 per cent of research and development spending.

Table 3: Small Businesses in Australia in 2011, by Industry

	Number of small businesses				Employment	Value Added
	No employees	Have Employees	Total		Per cent of industry ^(a)	
	'000	'000	'000	Per cent		
Agriculture	141	53	194	12	86	83
Mining	4	3	8	0.5	14	9
Manufacturing	39	41	80	5	30	19
Construction	218	127	344	22	69	56
Distribution services ^(b)	190	145	335	21	40	32
Business services ^(b)	236 ^(c)	160 ^(c)	396 ^(c)	25 ^(c)	51	44
Household services ^(b)	115	124	239	15	45	41

(a) Share of private non-financial sector employees in mid 2010 and valued added in 2009/10

(b) 'Distribution services' refers to Wholesale Trade, Retail Trade and Transport, Postal and Warehousing; 'Business services' refers to Information Media and Telecommunications, Rental, Hiring and Real Estate Services, Professional, Scientific and Technical Services and Administrative and Support Services; 'Household Services' refers to Accommodation and Food Services, Education and Training, Health Care and Social Assistance, Arts and Recreation Services and Other Services

(c) Excludes property operators (entities engaged in renting or leasing property, including strata corporations)

Source: ABS

spending in high-tech industries. However, the Department of Innovation, Industry, Science and Research (2011) highlights that small businesses face many barriers to innovation, including access to funding, and that there is potential for more firms to innovate with the removal of these barriers.

Through innovation and expansion, small businesses are a source of employment growth and competition. Consistent with this, the Household, Income and Labour Dynamics in Australia (HILDA) survey indicates that around one third of those who entered the workforce over the 2000s were working for small businesses at the end of the decade.³ Furthermore, Samuel (2004) highlighted the role of small businesses in boosting competition through innovation and efficiency improvements, with small businesses having the capacity to respond to changes in the competitive environment with more agility than larger, more established competitors.

Legal Structure and Location

Owners of small businesses use a range of different legal structures for their businesses. The most common type is the company structure, accounting for one third of all businesses, where the owners of the business typically have limited liability for the company's debts and obligations (Table 4). Companies are particularly prevalent in the business services and construction industries. Unincorporated business structures (sole proprietor and partnership) are also prevalent, playing the largest role in agriculture, where around 40 per cent of workers are proprietors, and in construction.

³ The HILDA Survey began in 2001 covering 7 500 Australian households, and amongst other things provides snapshots of the financial position of Australian households in 2002, 2006 and 2010, including their business assets and liabilities.

Table 4: Businesses by Type of Legal Structure^(a)

	Number of businesses in June 2011 ('000s)	Share of businesses in June 2007	Share of businesses in June 2011
Companies	702	32	33
Sole proprietors	623	31	29
Partnerships	341	19	16
Trusts	466	18	22

(a) Includes medium and large businesses, which account for 4 per cent of all businesses
Source: ABS

Over time, there has been a trend away from sole proprietorship and partnership towards companies, as owners seek the legal protection of limited liability and the lower tax rate on corporate profits relative to the marginal rate of personal income tax.⁴ The trend has been particularly prevalent for sole proprietors and partnerships with employees. According to ABS data, employment in these entities has fallen from 5 per cent of the workforce in 1986 to 2 per cent in 2011 (Table 5). In comparison, sole proprietors and partnerships with no employees have remained at around 10 per cent of the workforce. The decline in proprietors' share of employment has been particularly notable in agriculture and distribution services such as wholesale and retail trade. The trend has also coincided with a marked increase in the average age of proprietors, with the share aged over 55 years rising over the past 25 years from 17 per cent to 30 per cent.

Small businesses are slightly more prevalent in regional areas, with 35 per cent of small businesses based outside of capital cities, compared to 33 per cent for medium to large businesses. By state, small businesses are particularly prevalent in regional Queensland and Tasmania, with over half of small businesses in these states based outside of Brisbane and Hobart respectively (Graph 2). Business services is the most common industry for small businesses in capital cities, accounting for 40 per cent of small businesses; in regional Australia agriculture and business services are the most common industries, each accounting for a quarter of small businesses.

Graph 2
Small Businesses in Regional Areas*
Share of small businesses by state, 2008/09



⁴ As noted in Bishop and Cassidy (2012), since 1960 there has been a large decline in gross mixed income of unincorporated enterprises as a share of GDP, reflecting the trend to corporatisation and also the relative decline of the farm sector. In contrast, corporate gross operating surplus as a share of GDP has trended upward over recent decades in Australia. See Ellis and Smith (2007) for a discussion of rising profit shares evident in a number of countries over recent decades.

Table 5: Characteristics of Unincorporated Business Owners
Per cent

	Share of total employment by category			Share of unincorporated business owners		
	1986	2001	2011	1986	2001	2011
Total	15	13	11	100	100	100
No employees	10	10	9	67	73	78
Have employees	5	4	2	33	27	22
By industry						
Agriculture	63	49	41	25	18	11
Mining	2	3	1	0.2	0.2	0.2
Manufacturing	5	7	7	5	6	5
Construction	34	35	27	16	19	22
Distribution services	17	11	8	24	18	14
Business services	15	14	15	11	15	20
Household services	10	9	9	17	21	25
By age						
15–34	9	7	6	30	22	20
35–54	20	16	13	53	56	51
55+	27	27	20	17	22	30

Source: ABS

The Life Cycle of Businesses

The life cycle of firms is important for innovation and growth, with employment and investment moving from old and contracting firms to new and expanding firms. According to the ABS, there is significant turnover in the population of small businesses, with the rate of entry and exit steadily declining with business size. Around 300 000 new small businesses begin operations each year, representing around 15 per cent of the total number of small businesses, while a similar number cease to operate (Table 6).⁵ The rates of entry and exit are highest for businesses without employees and lowest for medium-sized businesses. These rates have been reasonably stable since 2007/08, with the rates slowing a little in 2010/11 compared to previous years.

There is also movement of businesses between the small, medium and large categories, as more successful firms expand while less successful firms contract. The small businesses most likely to expand are those with between 1 and 4 employees, while few businesses without employees evolve to take on employees. These rates of expansion and contraction appear reasonably stable over time, with similar rates in 2007/08 and 2010/11 despite different economic conditions.

⁵ Business entries and exits are based on the registration or cancellation of a business' ABN or GST role. Business exits are broader than business failures, and can include the sale or merger of a business.

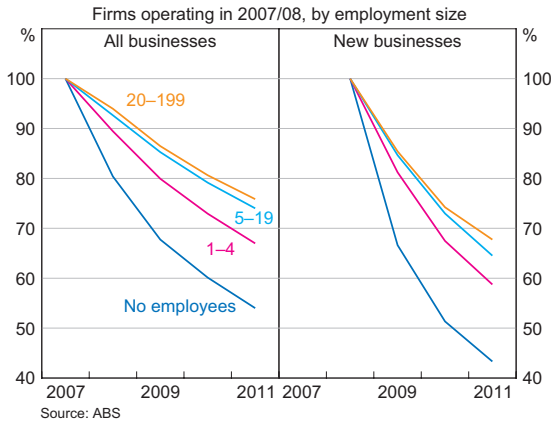
Table 6: The Life Cycle of Businesses
Per cent of businesses by number of employees at start of financial year

Number of employees	Entry rates		Exit rates		Expansion rates ^(a)		Contraction rates ^(a)	
	2007/08	2010/11	2007/08	2010/11	2007/08	2010/11	2007/08	2010/11
	0	18	15	20	17	3	3	na
1–4	15	15	11	10	8	8	10	10
5–19	7	7	7	6	6	5	16	15
20–199	4	3	6	5	1	1	16	16
200+	7	7	6	5	na	na	17	15

(a) Expansion (contraction) rates refer to the proportion of firms at the beginning of the financial year that have grown (contracted) to be in a higher (lower) employment category by the end of the financial year
Source: ABS

The likelihood that a business survives increases with the number of employees: while just over half of businesses without employees in June 2007 were still in operation by June 2011, around three quarters of medium-sized businesses were still in operation (Graph 3). Much of this is, however, likely to reflect recently established small businesses having a lower survival rate. For the businesses that started during 2007/08, only 43 per cent of businesses without employees were still operating in June 2011, rising to just under 70 per cent for medium-sized businesses. In contrast, the relationship between survival rates and firm size is weaker when the analysis is restricted to well-established businesses. For instance, the survival rates of businesses with employees that have been operating for at least five years do not noticeably increase with business size.⁶

Graph 3
Small Business Survival Rates
Firms operating in 2007/08, by employment size



6 Using the ABS Business Longitudinal Database, the survival rates by June 2010 for business that had been operating for at least 5 years in June 2006 were 67 per cent for non-emplying businesses, 75 per cent for businesses with up to 4 employees, 78 per cent for businesses with 5–19 employees and 74 per cent for businesses with 20–199 employees.

Revenue and Profitability

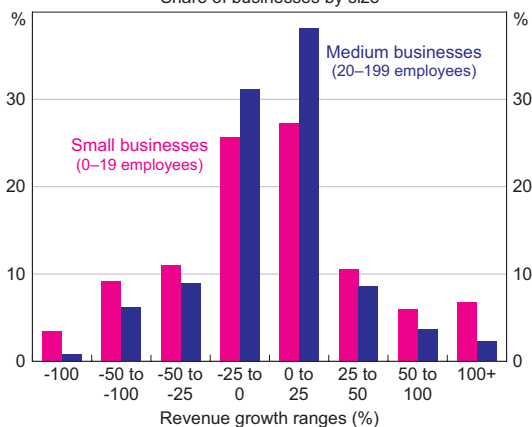
Small businesses tend to have a higher risk-return profile than larger businesses, reflected in a wide variation in revenue and profitability. According to the ABS Business Longitudinal Database, for example, median revenue varies by both business size and legal structure, with companies earning higher revenue than sole proprietors with similar numbers of employees (Table 7). The volatility of business revenue is significantly higher for small businesses than larger businesses. For instance, over the years between 2005 and 2010 annual revenue changed by at least 25 per cent for almost half of small businesses each year, while in comparison, the share was only 30 per cent for medium-sized business (Graph 4). One explanation for the higher degree of volatility in the revenues of small businesses is their greater reliance on a small number of customers, with the addition or loss of a customer having a much larger effect on revenues than for businesses with more diversified customer bases.⁷

Table 7: Median Business Revenue by Number of Employees^(a)
\$'000, 2005/06

	No employees	Under 5	5–19	20–199
Companies	100	263	1 373	4 785
Sole Proprietors	74	164	302	330
Partnerships	95	263	449	465
Trusts	158	286	1 090	4 276
Total	78	245	1 198	4 033

(a) Businesses that reported positive total sales in their business activity statements
Source: ABS

Graph 4
Annual Revenue Growth*
Share of businesses by size



* Sample of businesses reporting revenue in consecutive years between 2005 and 2010, where each business per year represents an observation
Sources: ABS; RBA

⁷ According to the ABS Business Longitudinal Database, a little over 50 per cent of small businesses are reliant on a small number of customers, compared to a little over 40 per cent of medium-sized businesses.

Given the wide dispersion in revenue growth for small businesses, it is unsurprising that only around 60 per cent of small companies (using the ATO definition of revenue under \$2 million) and three quarters of unincorporated business were profitable in 2009/10. The likelihood of a business being profitable increases with size, with 85 per cent of the largest companies (earning over \$10 million in revenue) making profits in 2009/10. There is some variation in profitability by industry, with small mining companies (that tend to be involved in exploration) least likely to be profitable, while companies providing business services were most likely to have made profits.

Focusing on the profitable firms, the average earnings before interest and tax was around \$79 000 for companies, above the average earnings of unincorporated businesses of \$47 000 (Table 8). This is consistent with the divergence in revenues between companies and sole proprietors highlighted in Table 7. For the 40 per cent of small companies that were unprofitable in 2009/10, their average loss was \$43 000. Aside from loss-making mining and utilities companies, the largest average losses were for companies involved in agriculture and manufacturing and financial and insurance services.

Table 8: Small Business Profitability in 2009/10^(a)

	Profitable small businesses		Profitable small businesses	
	Share of small businesses by industry		Average earnings before interest and tax (\$'000)	
	Incorporated ^(b)	Unincorporated ^(c)	Incorporated	Unincorporated
Agriculture	54	48	91	46
Mining	42	68	122	na
Manufacturing	56	76	71	33
Construction	57	89	64	47
Distribution services	55	78	56	43
Business services	64	80	83	61
Household services	58	79	60	35
Total^(d)	61	75	79	47

(a) Profits do not include wage income earned by business owners

(b) Using ATO small business definition of companies with revenue under \$2 million

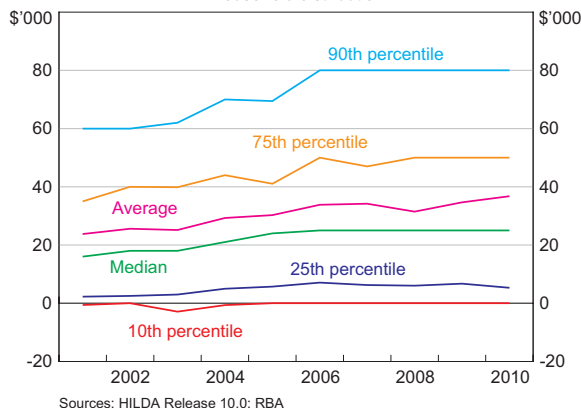
(c) Individuals with business income including distributions from partnerships and some types of trusts

(d) Additionally 'Total' includes utilities, financial and insurance services and companies without a specified main industry

Sources: ATO; HILDA Release 10.0; RBA

Data from the HILDA survey illustrate the wide distribution in profits for unincorporated businesses, with the bottom 10 per cent of unincorporated businesses receiving negative or zero profits over the decade, while the top 10 per cent of unincorporated businesses earned profits at least three times the profit of the median business (Graph 5). While small business income grew solidly from 2001 through to the mid 2000s, since then, business profits have been broadly flat across the distribution.

Graph 5
Unincorporated Business Profits
Household distribution



Balance Sheets

In general, small businesses are less likely to have debt than large businesses. According to ATO data, under 40 per cent of small companies (with before-tax profits of under \$100 000) had debt in 2009/10, while around 60 per cent of larger companies (with profits of over \$5 million) had debt financing. Similarly, according to the HILDA survey, the proportion of unincorporated businesses with debt increases with the size of the business; around a quarter of businesses without employees had debt, compared to a third for those with 5–19 employees. Businesses in capital-intensive industries such as agriculture and manufacturing were more likely to have debt than less capital-intensive industries such as business services, although firms in these industries also tended to have relatively high net assets (Table 9).

Table 9: Small Business Balance Sheets in 2009/10

	Businesses with debt		Average net assets	
	Share of businesses by industry		\$'000	
	Incorporated businesses ^(a)	Unincorporated businesses	Incorporated businesses	Unincorporated businesses
Agriculture	49	44	385	1 079
Mining	39	na	3 533	na
Manufacturing	55	38	169	200
Construction	54	26	121	49
Distribution services	52	39	93	85
Business services	31	21	196	144
Household services	46	19	81	86
Total	38^(b)	28	169^(c)	238

(a) Proportion of firms with debt calculated based on firms incurring interest expenses within Australia

(b) Additionally, 'Total' includes electricity gas, water and waste services, financial and insurance services and unspecified types of businesses

(c) Excludes electricity gas, water and waste services, financial and insurance services and unspecified types of businesses. If these industries with higher average net assets are included, total average net assets rises to \$272 000

Sources: ATO; HILDA Release 10.0; RBA

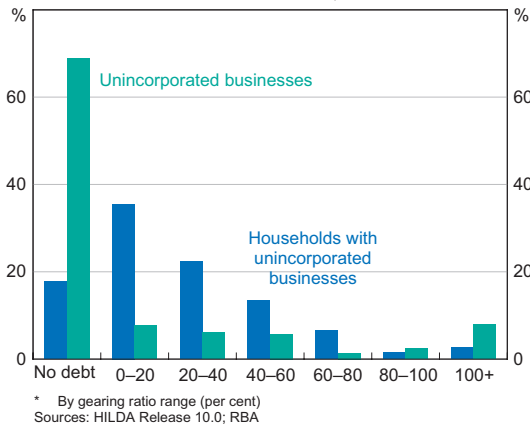
For unincorporated businesses in particular, it is also important to examine the entrepreneur’s overall financial position since the balance sheet of the business and the entrepreneur are not legally separated. Households owning businesses are more likely to have debt (including their business debt) than other households, with around 80 per cent of business-owning households having debt in 2010, compared to 66 per cent of other households, and they tend to have higher household debt relative to income (Table 10). However, this is balanced by the higher asset levels of business-owning households, with the median gearing ratio (debt as a ratio to assets) around 25 per cent for all households regardless of business ownership. Within business-owning households, owners of incorporated businesses are slightly more likely to have debt than owners of unincorporated businesses, and the debt-to-income ratio for such households is significantly higher, again reflecting their greater assets. When the balance sheets of unincorporated small businesses are compared with those of the households that own those businesses, the households are much more likely to have debt than the businesses (Graph 6). This suggests that many small businesses may be financed indirectly by household borrowing rather than through explicit business borrowing.

Table 10: Household Balance Sheets of Small Business Owners in 2010

	Per cent		
	Share with Debt	Median Debt-to-Income Ratio (Households with Debt)	Median Gearing Ratio \$'000 (Households with Debt)
Incorporated	85	324	25
Unincorporated	79	180	24
Non-business owners	66	98	28

Sources: ATO; HILDA Release 10.0; RBA

Graph 6
Distribution of Gearing Ratios
Per cent of households, 2010*

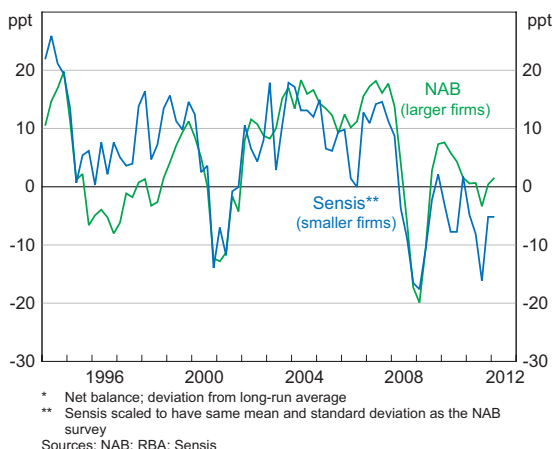


Recent Economic Conditions

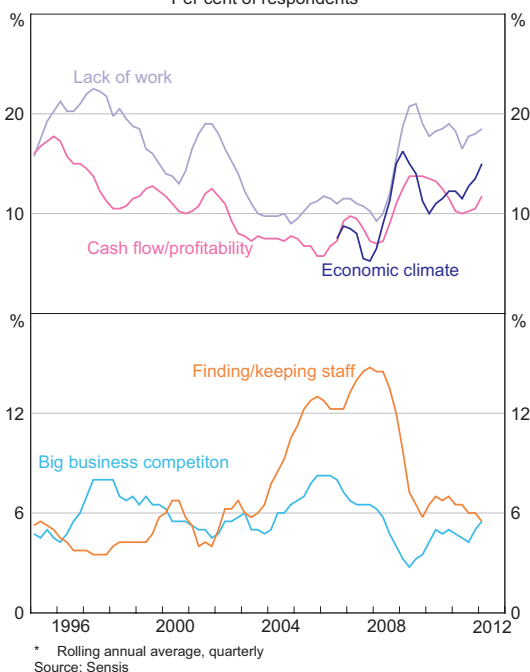
According to business surveys and the Bank’s liaison program, conditions have been weaker for small businesses than their larger counterparts over the past two years. Following the 2008 downturn, there was a less durable recovery for small businesses than for large businesses; small business conditions only briefly returned to average levels in early 2010 before being below average for most of the following two years (Graph 7).

The weak conditions are apparent in small businesses’ main concerns. In the mid 2000s, these entities were becoming increasingly concerned about attracting and retaining quality staff. Following the 2008 downturn, however, this was replaced by concerns about demand for their business’ goods and services, their cash flow/profitability and broader concerns about the economic climate (Graph 8).

Graph 7
Business Conditions*



Graph 8
Prime Concerns of SMEs
Per cent of respondents*



Part of the weakness reflects differences in the industries in which small and large businesses operate. For example many small businesses are in the construction industry, where softness in demand for new residential and commercial buildings has seen conditions deteriorate over the past two years. According to Sensis, small businesses in the construction sector have been most likely to report a lack of work as their main problem. However, there still appear to be differences within industries. For example, according to Bank liaison, small construction firms have historically been competitive against large firms for small projects due to their lower overheads, but have recently faced increasing competition from larger firms over such projects. Many larger firms are reported to not be including a costing for overheads in their bids, so as to generate work for underutilised staff. Concurrently, the average size of construction projects has increased somewhat, favouring larger firms with existing capabilities in place.

Another important issue is whether the flow-on effects from the mining boom are mainly benefiting larger businesses (e.g. large professional services firms). Mining-related projects often demand greater scale than small businesses can easily provide, and require considerable up-front expenditure to bid as a result of the significant cost of complying with miners' accreditation and workplace health & safety requirements.

It is unclear whether the lack of growth in business credit over recent years has been driven by demand or supply factors. Liaison contacts report that small businesses' greater reliance on intermediated debt means that tighter lending standards have a greater impact on small businesses and the reassessment of risk more generally by banks has also disproportionately affected small companies. Small businesses are also less able to withstand the cash flow impact from a reported lengthening of payment terms by many larger companies over recent years. This would have the potential to hamper smaller firms' investment, bids for tenders and cash-flow management. ✖

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Small Business Funding in Australia

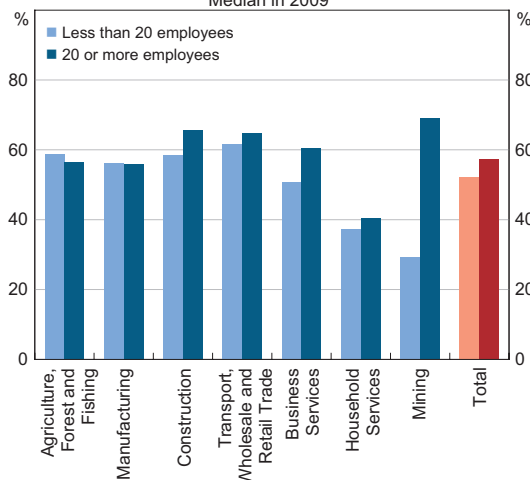
Mihovil Matić, Adam Gorajek and Chris Stewart

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

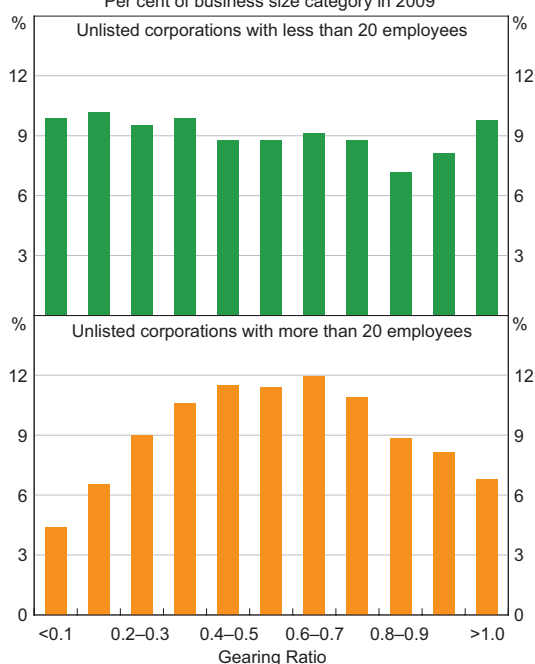
As noted in the 'Small Business: An Economic Overview' paper, unincorporated business owners are less likely to use debt and have lower gearing levels than incorporated businesses. Among unlisted incorporated entities, smaller businesses are less likely than larger businesses to have any debt and, when 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*



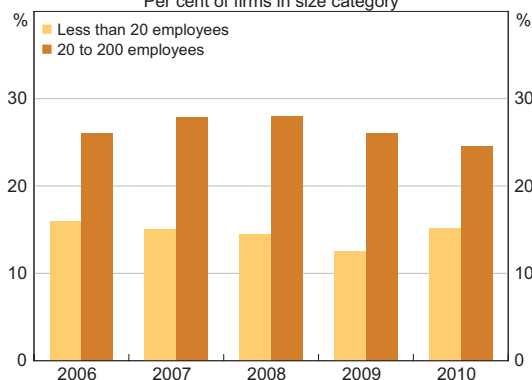
* Data are for unlisted corporations who have debt
Source: Dun & Bradstreet

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

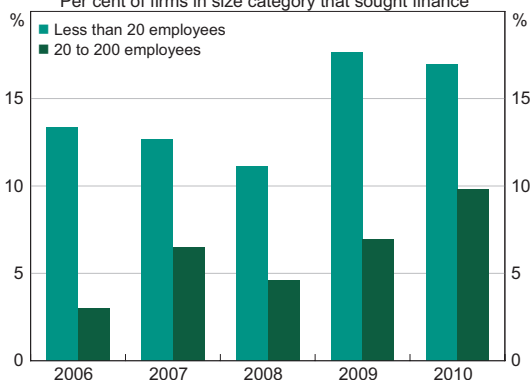


Source: ABS Business Longitudinal Database

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).

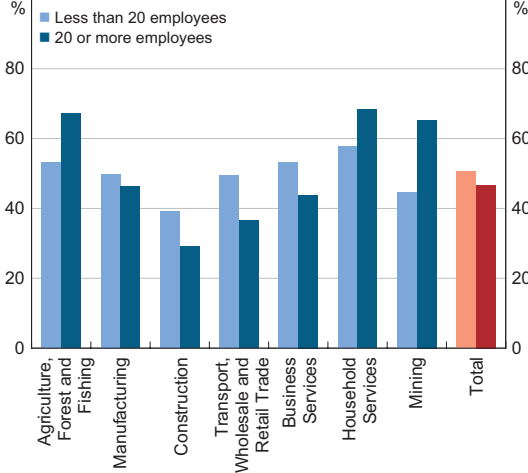
The type of financial intermediary used is similar across business sizes, with banks by far the most commonly used financial intermediary, accounting for more than three quarters of lending (Graph 6).¹ Banks are, however, less dominant in business lending than they are in household lending. This is generally 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

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.

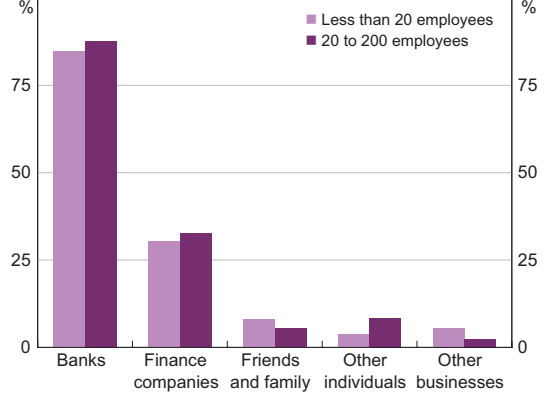
Smaller businesses pay more, on average, for debt than both households and larger businesses. This is true in terms of both interest rates and product fees (Graphs 7 and 8). Interest rates do, however, vary considerably between small businesses (Graph 9).

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 6

Source of Debt Finance in 2005

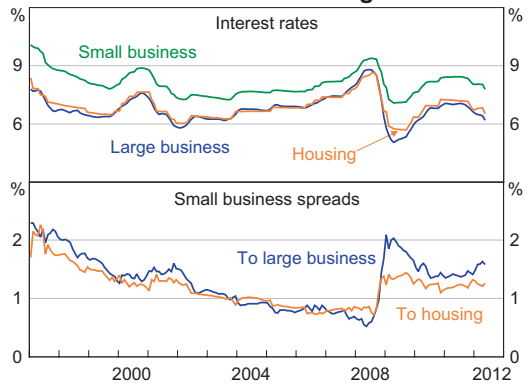
Per cent of firms in firm size category that sought debt finance



Source: ABS Business Longitudinal Database

Graph 7

Business Lending

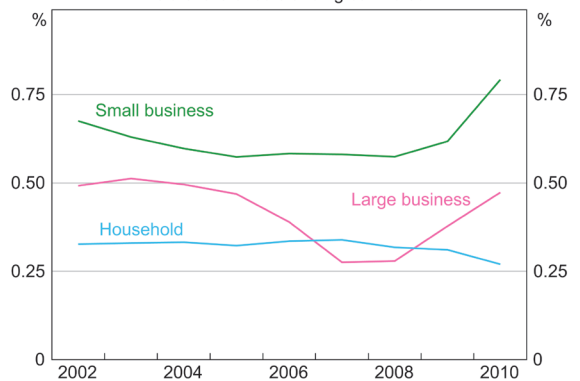


Sources: APRA; RBA

Graph 8

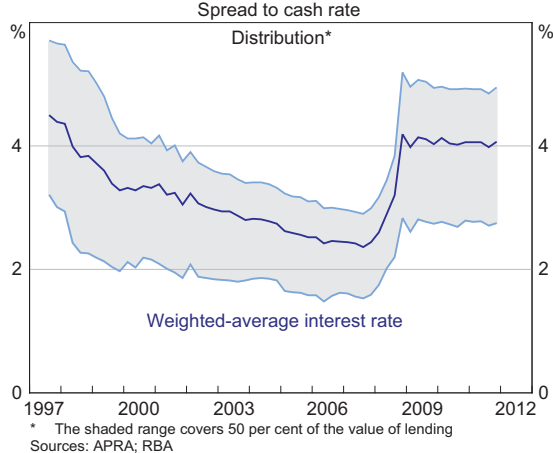
Bank Loan Fees

As a share of outstanding bank credit



Source: RBA

Graph 9
Spread on Outstanding Small Business Variable-rate Loans
 Spread to cash rate



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

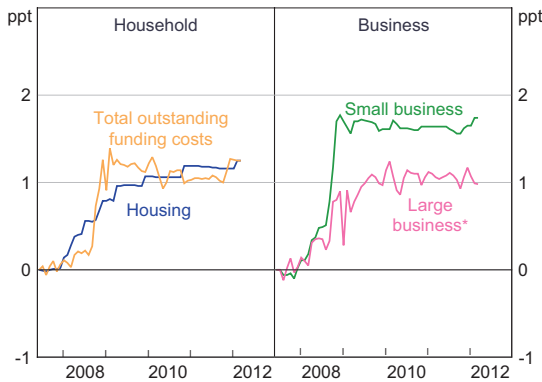
their business' cash flow. Schwartz, Hampton, Lewis and Norman (2006) also reported that around 5 per cent of housing loan equity withdrawals in 2004 were used to fund businesses, most of which are likely to be small, or commercial property purchases.

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

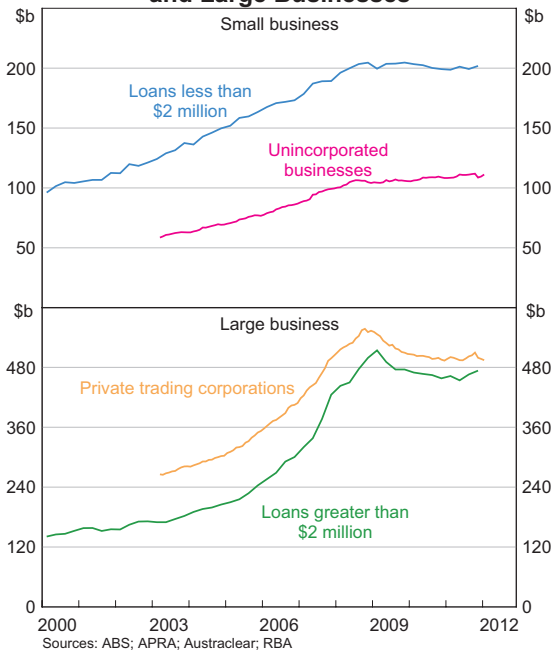
Cumulative change in spreads to the cash rate since June 2007



* 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

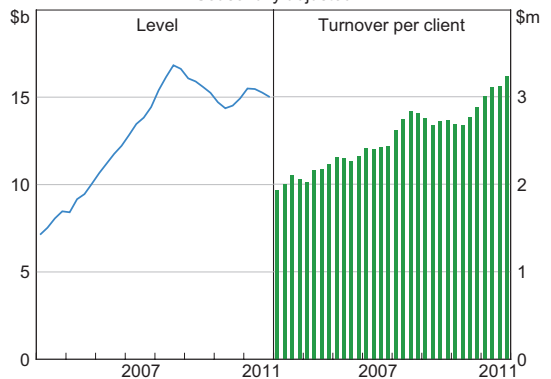
Finance product	Proportion of respondents
Credit card	66
Secured bank loan	41
Overdraft	34
Lease	28
Hire purchases	19
Unsecured bank loan	17
Chattel mortgage	12
Debtor finance	7
Vendor finance	6
Inventory finance	6
Other	7
None	18

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.

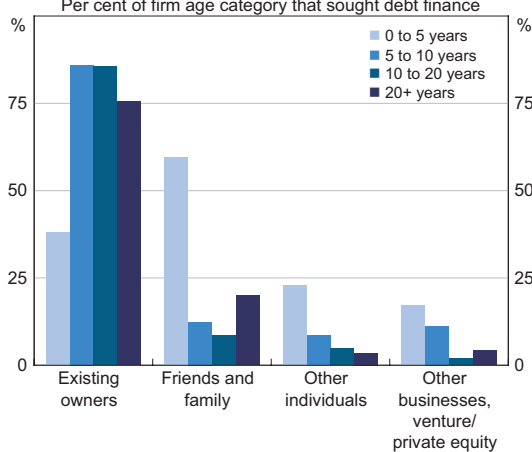
Equity Funding

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

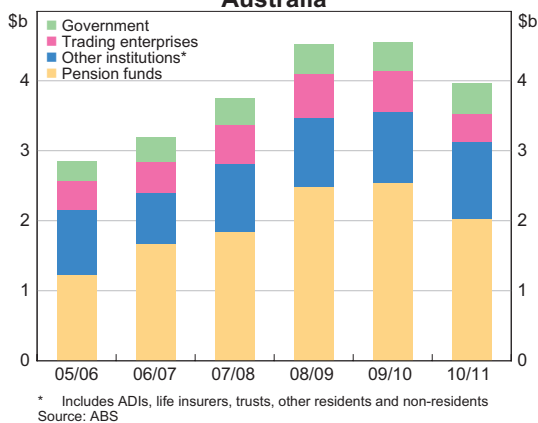


Source: ABS Business Longitudinal Database

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



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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The Financial Characteristics of Small Businesses

Susan Black, Amy Fitzpatrick, Rochelle Guttman and Samuel Nicholls

This paper covers a number of topics related to the financial characteristics of small businesses. It examines whether small businesses are more aligned with larger businesses in the same industry or with other small businesses in any industry. It appears that both industry and size are important determinants of financial characteristics. Factors influencing the survival of individual firms are also analysed. Indicators of stress such as high leverage, significant debt-servicing burdens, low profitability and limited liquidity suggest that a business may be vulnerable to failure. Finally, the economic and financial environment for small businesses is reviewed.

What's the Right Perspective – Industry or Size?

Small businesses are often grouped together for analytical purposes, yet the industry a small business operates in is also likely to play an important role in determining a firm's financial characteristics. For example, small mining companies may be more similar to other mining companies that are currently benefitting from high commodity prices, while small companies in fields related to tourism may be more aligned with other companies that are facing the challenges of the high Australian dollar.

This section examines whether industry or size is more relevant in terms of financial characteristics such as indebtedness, profitability and liquidity. A Dun & Bradstreet dataset of unlisted companies, which mostly comprises indebted companies, is used to examine the issue.¹ Small firms are also compared to indebted listed companies.² The ABS definition of small businesses, being those that employ fewer than 20 employees, is used. The analysis suggests that financial characteristics are correlated both with industry and size; within industry, size – or factors related to size – appears to be most relevant.

Gearing and debt-servicing

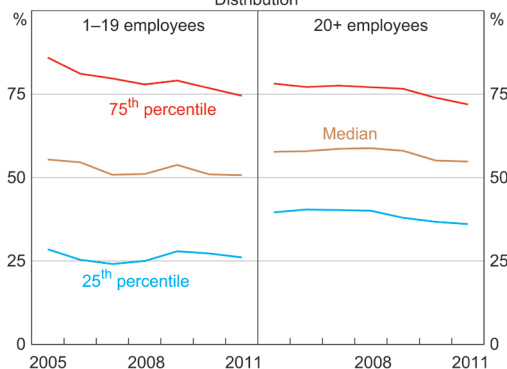
As discussed in the 'Small Business: an Economic Overview' paper, smaller firms are less likely to borrow than larger ones. When small businesses do borrow, they tend to be less leveraged than larger businesses. Median gearing – measured as liabilities (including trade credit) divided by assets – of small unlisted companies has been around 50 per cent over the past five years compared to almost 60 per cent for larger unlisted companies (Graph 1). This may reflect reduced access to finance for smaller companies, related to their more volatile revenue streams that make servicing debt more difficult. There is greater dispersion in gearing ratios among small firms relative to larger firms. The gearing of indebted ASX200 companies – typically large companies – has tended to be broadly in line with large unlisted companies' leverage, and accordingly higher than small unlisted companies' leverage.

Industry also appears to be an important driver of the overall level of gearing for a business, but within each industry, business size plays an important role (Graph 2).

1 The sample consists of between 4 000 and 8 000 businesses per year. The geographical coverage is consistent with ABS data. Note that survivorship bias and the sample being mostly indebted companies may affect the results of the analysis.

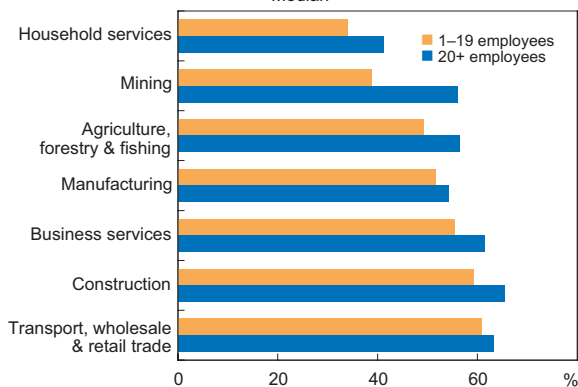
2 Listed companies have more extensive funding options than unlisted firms: they can raise equity on the ASX and access bond markets.

Graph 1
Gearing Ratio*
Distribution



* Total liabilities (including trade credit) over total assets
Sources: Dun & Bradstreet; RBA

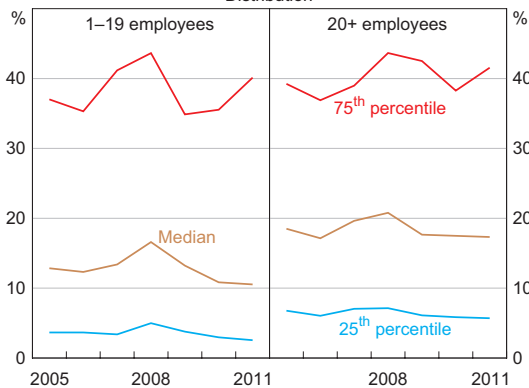
Graph 2
Gearing Ratio*
Median



* 2005–2011; total liabilities (including trade credit) over total assets
Sources: Dun & Bradstreet; RBA

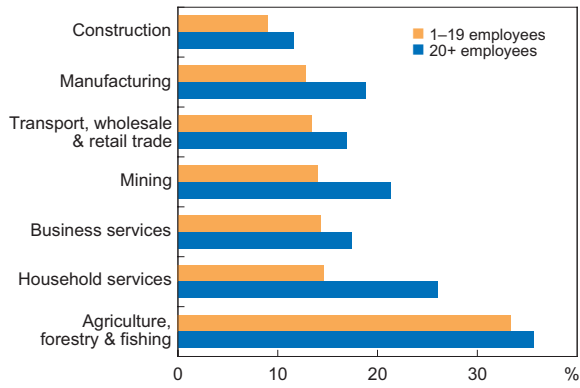
Because of small companies' lower leverage and higher profitability, discussed in the next section, their debt-servicing ratios – measured as interest payments to pre-tax earnings – also tend to be lower than for large companies (Graph 3). This is the case across industries, although the level of the debt-servicing ratio also depends on the industry itself (Graph 4).

Graph 3
Debt-servicing Ratio*
Distribution



* Estimated interest expense over EBIT
Sources: Dun & Bradstreet; RBA

Graph 4
Debt-servicing Ratio*
Median



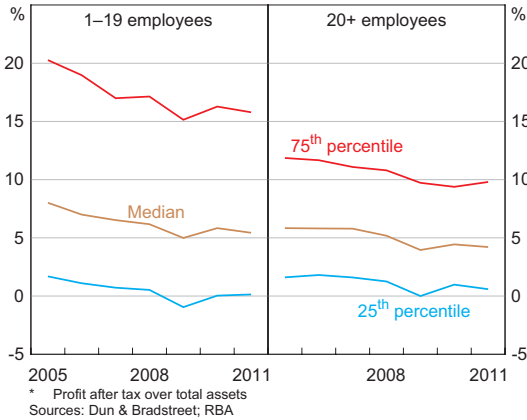
* 2003–2011; estimated interest expense over EBIT
Sources: Dun & Bradstreet; RBA

Profitability

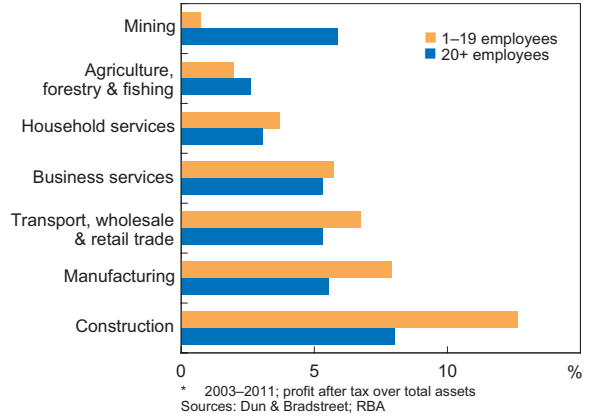
In broad terms, small (indebted) companies appear to be more profitable – measured here as having a higher return on assets – than large companies (Graph 5).³ Profitability also varies across industry (Graph 6); for example, construction companies have tended to have a higher return on assets over the most recent economic cycle (this includes the boom in construction in the early/mid 2000s and the recent period of subdued activity in that sector). However, within most industries, the median return on assets is higher for small companies. This may reflect the fact that small companies tend to be more risky, with a greater variation in returns than large

3 Small companies also have a higher return on equity (despite being less highly geared).

Graph 5
Return on Assets*
Distribution



Graph 6
Return on Assets*
Median



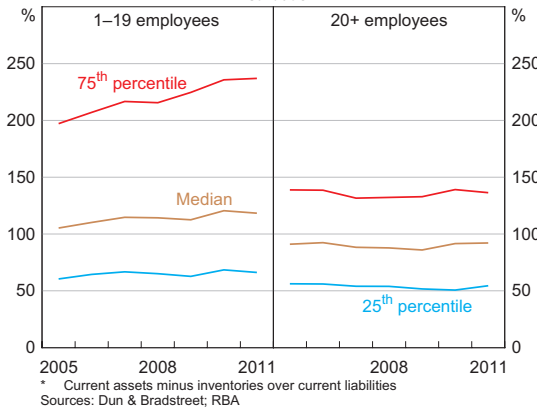
companies; investors require higher expected returns on riskier investments. The greater dispersion of return on assets among small firms compared to large firms supports this. Furthermore, the average variability in a firm's profits over time is about twice as high for small firms compared to larger ones.

Liquidity

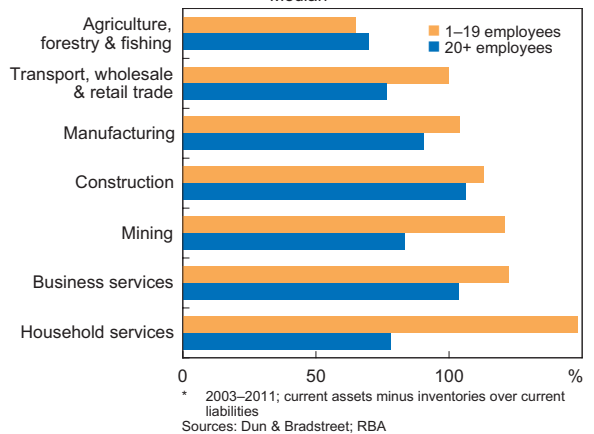
Liquidity refers to a company's ability to pay its short-term debts, bills and other obligations from cash or from assets that can be turned into cash very quickly. One measure of this is the "quick ratio": the ratio of a company's current assets (excluding inventories) to its current liabilities. Smaller businesses tend to be more liquid – have higher quick ratios – than larger businesses; some small businesses may need to maintain a cash buffer due to their more volatile cash flows (Graph 7).

Industry also appears to play a role. For example, companies in the wholesale and retail trade sector tend to be less liquid; this may be due to relatively consistent cashflows (Graph 8). Overall, small businesses tend to have higher liquidity than larger businesses across all industries except agriculture, suggesting that size – or factors related to size – is relevant in determining a business' liquidity requirements.

Graph 7
Quick Ratio*
Distribution



Graph 8
Quick Ratio*
Median

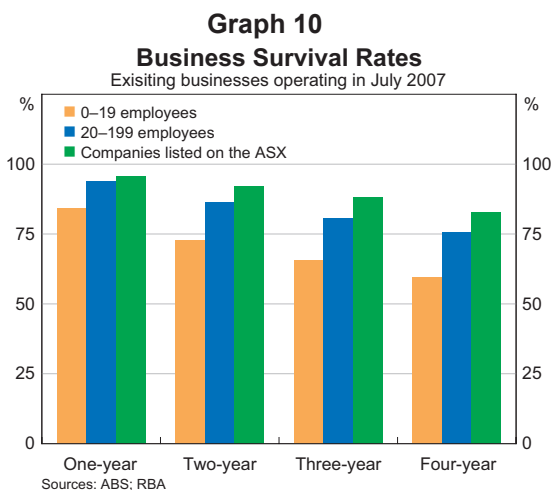
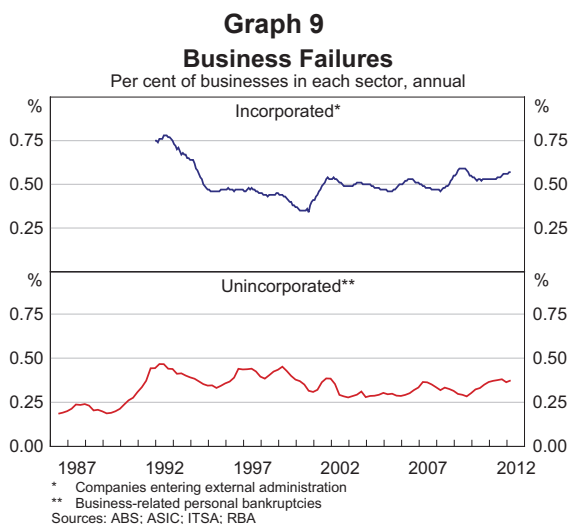


Factors that Influence Success

Success and failure rates

Overall, the majority of businesses tend to succeed, with business failure rates being relatively low. On average, 0.3 per cent of unincorporated businesses and around 0.5 per cent of incorporated businesses have failed per annum over the past decade (Graph 9). Data on business entry and exit rates collected by the ABS can be used to assess differences in survival rates for businesses of different sizes over time. In this context, a business exit does not necessarily constitute failure; an exit occurs if a business' ABN is cancelled or it has not remitted GST for five consecutive quarters. Thus, in some cases an exit may be recorded if the business is sold or taken over rather than because it has failed.

As discussed in the 'Small Business: An Economic Overview' paper, survival rates increase with business size. For small businesses (with less than 20 employees) operating in July 2007, 60 per cent were still operating at June 2011 (Graph 10). This compares with 76 per cent for medium-sized businesses (with 20 to 199 employees) and 83 per cent for listed (mostly larger) companies. In part, this reflects the fact that successful small businesses are more likely to grow and become successful large businesses, whereas unsuccessful small firms are unlikely to grow into large businesses. The greater likelihood of small businesses to not survive is consistent with historical experience of the higher tendency of small businesses to default on bank loans: the average probability of default on bank loans for small businesses at the major banks in recent years has been around 2 per cent compared to around 1 per cent for loans to larger businesses and $\frac{3}{4}$ per cent or less for residential mortgages to households.

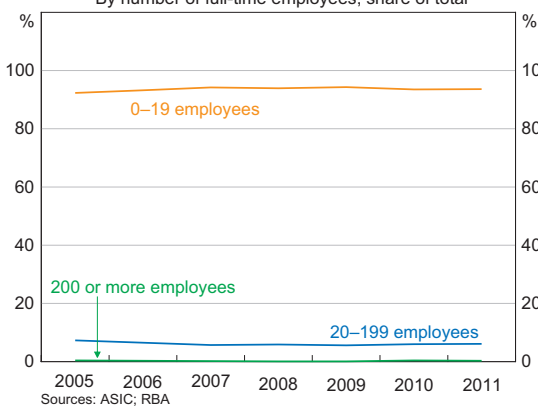


New businesses tend to have lower survival rates than existing businesses. These differences are more marked for smaller businesses; three-year survival rates for new small businesses (with less than 20 employees) are about 17 percentage points lower than the comparable rate for existing small businesses, whereas the difference is about 14 percentage points for businesses with 20 or more employees. This may reflect the tendency for small businesses' revenue to be more volatile, the higher likelihood that newer businesses will begin as a small firm, and the greater amount of business planning required to attract investors before starting a larger business. There is not much variation in survival rates across industries, although small businesses have lower survival rates in all industries.

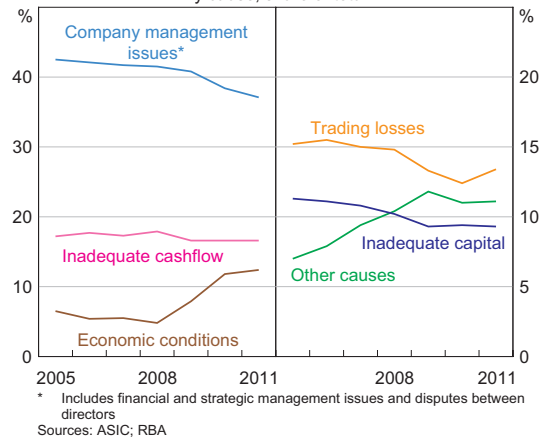
Causes of failure

Annual data on the causes of business failure for companies entering external administration are available from ASIC. These data shed light on the causes of small business failure because the vast majority of companies entering external administration are small businesses (reflecting their large share of the business population); about 90 per cent of companies entering external administration have fewer than 20 employees (Graph 11).⁴ The most common cause of failure nominated by external administrators is company management issues, especially poor strategic management and poor financial control (Graph 12). However, company management issues have become a less common cause of external administration since the downturn in 2008, while economic conditions have become more prevalent as a cause of failure although their importance is still low in absolute terms. Data from the Insolvency Trustee Service Australia indicate that economic conditions have also been cited more commonly as a cause of unincorporated business failure over this period.

Graph 11
Corporate Administrations
By number of full-time employees, share of total



Graph 12
Incorporated Business Failures
By cause, share of total



How do the characteristics of surviving businesses compare with unsuccessful business?

There are certain characteristics that may make a business more vulnerable to distress, such as high leverage, significant debt-servicing burden, low profitability and limited liquidity. In this section unlisted companies whose ABNs have been deregistered or which are currently in external administration are analysed. Since many of these companies are likely to have become insolvent, this category is used as a proxy for failed companies.

Small/medium companies (with 1 to 199 employees) which later deregister or enter external administration generally tend to be slightly more highly geared in the period nearing failure than surviving businesses. Since 2005, median gearing has averaged 51 per cent for firms which became insolvent compared to 45 per cent for surviving firms. In many cases, the gearing of companies which later deregister or enter external administration increased noticeably in the one to two years prior to failure, potentially increasing their vulnerability to economic shocks and playing a role in their subsequent failure (Graph 13). Consistent with their increased gearing, their debt-servicing requirements also rose. During the financial crisis there was pressure

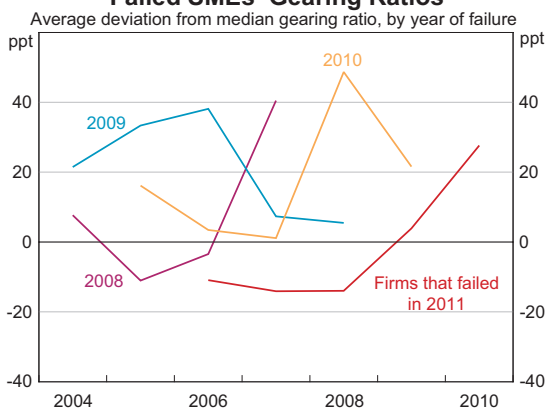
⁴ While comparative data on small companies' share of all companies are not available, various sources suggest that the share is likely to be *higher* than 90 per cent. This may reflect small companies' lower tendency to become indebted, such that small companies may be less likely to go into external administration when they fail.

on companies to reduce gearing; while the companies that became insolvent in 2009 and 2010 also reduced their gearing, they remained more highly leveraged than the surviving firms. Nonetheless, it is noteworthy that failed firms' gearing ratios were not particularly different from the median several years before they failed; only in the year or two leading up to failure did gearing pick up comparatively.

Companies that become insolvent have other signs of potential vulnerability; not surprisingly they tend to be less profitable and less liquid than surviving companies (Graph 14). As would be expected, in the lead-up to becoming insolvent, many companies experience losses. The share of loss-making companies has averaged around 40 per cent for companies that subsequently became insolvent compared to around 20 per cent for surviving companies over the past 5 years. Overall, the findings that lower leverage, higher profitability and greater liquidity are more common among small businesses that survive are consistent with the trends observed for large businesses.

Graph 13

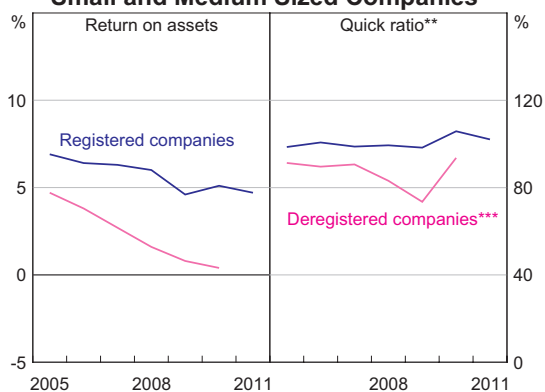
Failed SMEs' Gearing Ratios*



* Companies with 1-199 employees
Sources: Dun & Bradstreet; RBA

Graph 14

Small and Medium Sized Companies*



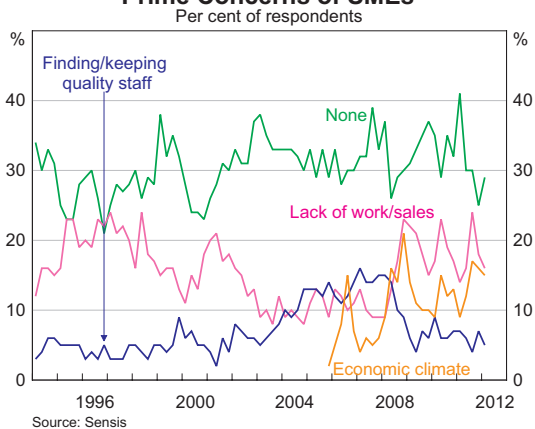
* Companies with 1-199 employees
** Current assets minus inventories over current liabilities
*** Includes companies in external administration; 2011 observations have been omitted due to small sample sizes
Sources: Dun & Bradstreet; RBA

Current Issues for Small Businesses

As discussed in the 'Small Business: An Economic Overview' paper, private sector surveys and the Bank's liaison suggest that economic conditions have been weaker for small businesses than for larger businesses over the past two years. There has been less of a pronounced recovery for small businesses than for large businesses following the 2008 downturn. Consistent with this, the economic climate and demand factors have now become more of a concern to small businesses in recent years (Graph 15). Previously, small businesses were particularly concerned about attracting and retaining quality staff whereas the economic climate and lack of work/sales have now become areas of greater concern. As such, a number of aspects related to the economic and financial environment for small businesses are discussed below.

Graph 15

Prime Concerns of SMEs



Source: Sensis

Industry composition and associated economic conditions

The difference between small and large business conditions is partly due to the different industries in which they operate, as highlighted in the 'Small Business: An Economic Overview' paper. For example, only a small share of small businesses is directly exposed to the mining industry, which is enjoying buoyant conditions, due to the scale that mining-related projects tend to require. In contrast, there is a large share of small businesses in the construction industry, which has experienced soft demand for residential and commercial construction in recent years. Moreover, there are some indications that the average size of projects has increased, which may advantage larger businesses.

Volatility in the agricultural sector particularly affects small businesses due to their significant presence in the industry. Small businesses account for the bulk of production and employment in the agricultural industry. An ongoing challenge for businesses in this industry is the volatility of farm production and prices; output growth in the farm sector is on average over eight times more volatile than non-farm output growth (RBA 2012). The large swings in farm production are often related to weather conditions. Overall the recent weather conditions have had a positive effect on farm production and current conditions in the sector. Over the past six months, much of Australia has experienced above-average rainfall. While this has resulted in flooding in some parts of eastern Australia, with associated damage to infrastructure and some crops, real farm incomes are expected to remain at a high level in 2011/12; ABARES forecasts that farm profits will be positive across all states and industries in 2011/12.

Structural adjustment in the economy is also having a varying impact by industry.⁵ The high level of the Australian dollar means businesses in certain industries, particularly those that are import-competing or non-mining exporters (such as tourism) are facing challenges. By state, corporate failures have increased in Queensland, partly reflecting the softer conditions in the tourism industry. Consistent with this, the share of business failures in the hospitality industry has increased a little recently. Nonetheless, the high exchange rate leads to lower import prices, which can help keep input costs down for businesses.

Some businesses in the retail sector are also facing weaker demand, with households being more cautious following the 2008 downturn. However, small retailers appear to be less affected than large retailers as much of the softness in retail sales has been concentrated in spending at department stores, which are large businesses. Similarly, partial data suggest that growth in household spending on services has recently been stronger than for purchases of goods; many small firms provide household services. Businesses in the retail sector are also facing increased online competition; while online purchases have increased, they remain a small share of total retail purchases. Nonetheless, these conditions provide growth opportunities for some firms, such as small online retailers.

Financial conditions

As discussed in the 'Small Business Funding in Australia' paper, small businesses typically access funding on less favourable terms than larger businesses. While this may affect their ability to pursue investment and growth opportunities to some extent, overall small businesses appear to have access to funding.

The introduction of the Basel III reforms should not materially affect access to finance for small business. Since the introduction of Basel I in 1988, banks have been required to hold more capital against loans to small- and medium-sized businesses than against residential mortgages, due to its greater riskiness. This differentiation

5 For more information on the structural adjustments taking place in the Australian economy, see Lowe (2012).

was strengthened in the Basel II package, which came into effect in Australia in 2008. While in principle this could encourage banks to concentrate their portfolios in assets attracting low risk-weights, this incentive should be offset to the extent that riskier assets offer higher returns. In that regard, SME loan rates have averaged 1.2 percentage points higher than rates on residential mortgage loans over the past year. Indeed, SME lending has remained at around 16 per cent share of credit since the introduction of Basel II. The Basel III reforms will raise the amount and quality of capital banks must hold, but this should not cause significant disruption to banks' balance sheet structures, as Australian banks already had relatively high and conservatively defined capital ratios (Byres 2011). Furthermore, the introduction of the non-risk-weighted leverage ratio as part of the Basel III package will tend to work against the potential incentive in the capital rules to concentrate portfolios in assets attracting low risk-weights. ✖

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