Research Paper No.18

EXECUTIVE SUMMARY
May 2014

(full paper link: http://enterpriseresearch.ac.uk/publications/erc-research-papers/)

The financing of diverse enterprises: Evidence from the SME finance monitor

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This analysis of the quarterly SME Finance Monitor examines the finance outcomes of diverse SMEs, focusing on women owned and ethnic minority owned businesses. Central to the analysis is the development of a new typology of borrowers which identifies three categories of demand: *Patent Demand*, *Partial Demand*, and *Latent Demand.* This typology enables a more granular view of the SME Finance Monitor dataset and a more detailed analysis of types of discouragement than previously presented.

Patent Demand accounts for 45% of the total sample. Of these, half are existing borrowers who have made no new application within the past twelve months, 44% are new borrowers having made a successful application within the past twelve months, and 5% were rejected applicants, either declined by the bank or who declined the bank's offer.

Partial Demand accounts for 6% of the total sample and comprises SMEs that successfully applied for bank credit, but are discouraged from applying for the desired

volume or credit facility. This category of partial demand for credit, that includes partial discouragement, potentially extends current notions of discouragement beyond those who do not apply for bank finance.

Latent Demand accounts for 49% of the total sample, and comprises SMEs that have made no application for bank credit within the past 12 months and have no existing facility. Of these, the largest proportion (71%) are *indifferent non-borrowers* who have no present need for financing. 92% of these have never applied for bank finance, while 8% are prior users of bank credit but have no present need. The *latent demand* category also includes 14% of the total sample who are *potential borrowers*. These are SMEs that have or have had financial needs in the present year but have not made a formal application due to debt-aversion.

The typology of borrowers distinguishes between SMEs that are discouraged (56% of potential borrowers) and those that are disinterested (44% of potential borrowers). In line with conventional thought, the former are SMEs that want bank credit but certain factors discourage them from making a formal application. Disinterested borrowers also require finance but do not apply because they prefer non-bank sources.

Among discouraged SMEs, relatively few (1% of total sample) are directly discouraged by banks either dissuading them against application (0.8% of total sample) or through disillusionment having been rejected by banks in the past (0.2% of total sample).

A much larger proportion is indirectly discouraged by non-bank factors (7% of the total sample), for example, media reports or hearsay (4.6% of total sample), self-diagnosed likelihood of rejection (1% of total sample), perceptions of unsuitable products, prices or procedures offered by banks (1% of total sample), or daunted by notions of what bank borrowing entails (0.4% of the total sample).

The typology of borrowers provides six distinct analytical groups: existing borrowers; new and renewed borrowers and declined borrowers (*Patent Demand*); partial borrowers (*Partial Demand*); potential borrowers and indifferent non-borrowers (*Latent Demand*).

At a bivariate level, gender exhibits a marked effect on finance outcomes. Women-led SMEs are under-represented in the successful borrower categories, i.e. existing borrowers and new/renewed borrowers, and over-represented among potential borrowers and indifferent non-borrowers. Among SMEs that apply for bank borrowing, there is an over-representation of women requesting smaller volumes of finance and under-representation of women requesting larger volumes of finance.

Gender differences are apparent in risk ratings accrued from an individual's or a business's financial track record. Women-led firms are significantly under-represented in the minimum and low risk categories, and have a higher incidence of credit anonymity. More than a tenth of women-led firms do not have an adequate track record that a financial institution can use to approximate a risk-rating for the firm, suggesting a gendered dimension in the incidence of information opacity among SMEs.

Ethnicity also exhibits a powerful influence on finance outcomes. Bivariate analysis shows substantial variations by ethnicity across successful borrower groups, i.e. existing borrowers and new/renewed borrowers. Within the potential borrower group there is a clear over-representation among Black African, Asian Pakistani, Asian Bangladeshi and Mixed White and African ethnic groups.

Ethnic differences are also apparent in risk ratings. BME enterprises are under-represented within the minimum, low, and average risk rating bands and over-represented within the above average risk rating band.

In multivariate analyses, gender effects that were notable and significant in the initial phases of analysis were largely dissipated when other factors, such as sector, firm size and firm age, were considered.

The relative risk of partial borrowing, complete debt-aversion and investment indifference over borrowing success remains higher among ethnic minority business owners compared to White British and Irish business-owners even after controlling for sector, firm size, the presence of a business plan, firm age, and legal form.

The analysis suggests that differences in finance outcomes are largely, but not entirely, a consequence of underlying structural factors that lead women-owned and black and minority ethnic businesses to present a particular set of characteristics. Coupled with the marked gender and ethnic dimension to financial track records which inform risk ratings, these structural effects influence finance outcomes for many diverse enterprises.