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POLICY BRIEFING

A Study of Finance, Growth and Productivity in Family-Owned SMEs

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Introduction / Summary

Family-owned firms (henceforth FOFs) are technically regarded as businesses governed and/or managed with the intention to shape and pursue the vision of the business held by members of the same family across generations. These firms comprise a substantial proportion of the business base in most modern-day economies and constitute the vast majority of small and medium-sized enterprises (SMEs) in such countries. Given the vast size of the cohort of FOFs, policy makers are keen to grow this part of the small business community to bolster the SME sector,

To date the volume of research on the financial affairs of these firms has been relatively modest. In the past most research has tended to treat all SMEs as a homogenous grouping despite differences in governance structure in FOFs. Owing to their central economic importance this project wishes to examine the "financial logic" characterising family firm funding and the associated growth constraints faced by FOF SMEs in the UK compared to their non-FOF counterparts.

A central concern this work sought to examine was to estimate the levels of borrower discouragement in FOFs and how these credit constraints ultimately affect their performance in terms of entrepreneurial growth outcomes. Borrower discouragement is a situation whereby a 'good' credit worthy firm with a high chance of servicing a loan chooses not to apply despite having an underlying need for external finance for fear of rejection by a lender. Despite their numerical importance research on borrower discouragement in FOFs is largely absent in the academic literature.

The main dataset underpinning this empirical analysis is the UK's single largest longitudinal survey of small firms - the Longitudinal Small Business Survey (LSBS). In terms of the project's methods, we undertake econometric analysis which employs a multi-tier empirical strategy that exploits both the broad coverage and the longitudinal features of the LSBS.

In order to augment the literature, we wish to examine the following issues using the LSBS:

- What are the financial constraints within FOFs and how does this compare to non-FOFs;
- What are the levels of borrower discouragement in FOFs compared to non-FOFs;
- What are the transitions being made by discouraged FOFs between different borrowing states;
- What are the long-term scarring effects in terms of future growth-orientation of credit rationing and borrower discouragement for FOFs;
- What effect does credit rationing and borrower discouragement have on innovation levels in FOFs;
- What are the productivity effects of credit rationing and borrower discouragement in FOF SMEs

Key Findings

Family-owned SMEs represent a dominant and influential part of the global economic landscape, significantly contributing to job creation and economic growth (Xu et al, 2020). This study has enabled us to cast new light into the complexities and specificities of finance in family-owned SMEs, particularly in relation to the nature and impact of borrower discouragement within this cohort of firms. Discouraged borrowers are a non-trivial cohort of firms and outnumber those denied credit (Han et al, 2009; Cowling et al, 2016; Brown et al, 2022).

While in recent years FOFs have been found to exhibit certain characteristics with respect to their investment and financing decisions compared to non-family firms (Jansen et al, 2023; Cordoba et al, 2024), to date scholars have yet to fully draw out how these distinctions influence and shape investment

and financing preferences of these cohort of firms. By undertaking this study, it has enabled us to make a number of novel and interesting contributions to the literature surrounding small business finance and FOFs. In doing so we are also able to draw some important policy implications which merit consideration in light of this important empirical study.

A number of key findings emerged from this novel empirical analysis of the LSBS. We examine who is affected and what happens as a consequence of this decision-making behaviour. Our findings show that FOFs have a greater propensity towards being discouraged and this applies particularly for limited liability partnerships (LLPs). It appears that discouragement in these firms may be irrational decision-making behaviour as the counterfactual approval probability of discouraged firms accessing finance is high.

FOFs do not experience any greater credit rationing than non-FOFs. In terms of the economic impact of borrower discouragement, FOFs encounter no greater discernible impact than non-FOFs. Borrower discouragement becomes a permanent *state* rather than a transitory *phase*. Despite this, surprisingly, no change in the growth ambition is detected in firms suffering from discouragement.

Key Findings at a Glance

- Finding one: Our findings show that FOFs have a greater propensity towards being discouraged than non-FOFs
- Finding two: Limited liability partnerships (LLPs) are the FOFs most predisposed towards borrower discouragement
- Finding three: The counterfactual approval probability of discouraged firms accessing finance is high
- Finding four: FOFs do not experience any greater credit rationing than non-FOFs
- Finding five: No change in the growth ambition is detected in firms suffering from discouragement.

Key Insight

Borrower discouragement in FOFs becomes a permanent *state* rather than a transitory *phase*

Conclusions and Policy Recommendations

Summary of Key Findings

Overall Conclusion

Our overarching conclusion from this study is that FOFs are more susceptible to experiencing borrower discouragement. However, this does not appear to have any discernible consequences on the firms' subsequent performance and growth-orientation.

Policy Recommendations

1. Policy Recommendation 1: The British Business Bank ought to highlight the problem of borrower discouragement both across the small business sector and the banking community.
2. Policy Recommendation 2: Another key policy recommendation is to increase financial literacy in SMEs. Financial literacy assists owners/managers to optimise the use of scarce resources by efficient and effective financial management systems. These skillsets do seem capable of being taught so policymakers should continue encouraging financial literacy training programmes for entrepreneurs, managers and founding team members because it is a critical factor in terms of managing SME organisations in difficult scenarios such as the unmet need for external finance.
3. Policy Recommendation 3: A further key policy recommendation is to increase levels of external advice in UK SMEs. Not only has work shown that increased use of external advice increases productivity levels in SMEs, it could also potentially increase their knowledge of the availability and cost of different sources of external finance.

Practical Recommendations

4. Practical Recommendation 1: Banks should be encouraged to convey to FOFs the benefits of informal contacts with loan offers to obtain information on their potential likelihood of obtaining finance in the event of a formal application
5. Practical Recommendation 2: Local bank closures may inhibit SMEs in certain spatial locations from making informal enquiries so banks should be encouraged to connect with SMEs via remote digital means or via local banking hubs in local UK post offices.

Directions for Future Research

This research raises a number of interesting research questions, which are worthy of further empirical investigation. It is well established that credit self-rationing is a complex cognitive phenomenon which is often based on crude heuristics which is largely based on the "gut feel" of the entrepreneurs and owner managers concerned (Barasal Morales, 2022). Policy makers and researchers would strongly benefit from further research which unpacks the factors shaping the cognitive mindset of entrepreneurs experiencing borrower discouragement. While self-reporting surveys are able to obtain useful information on the nature and extent of this behavioural state, more in-depth qualitative methods will probably be needed to closely probe the micro-foundations of this complex phenomenon.

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