

The Financial Characteristics of Small Businesses

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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

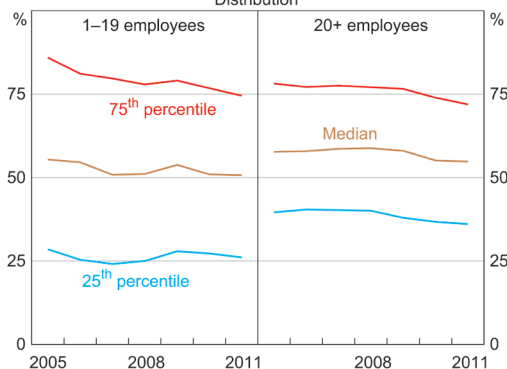
As discussed in the 'Small Business: an Economic Overview' paper, smaller firms are less likely to borrow than larger ones. When small businesses do borrow, they tend to be less leveraged than larger businesses. Median gearing – measured as liabilities (including trade credit) divided by assets – of 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.

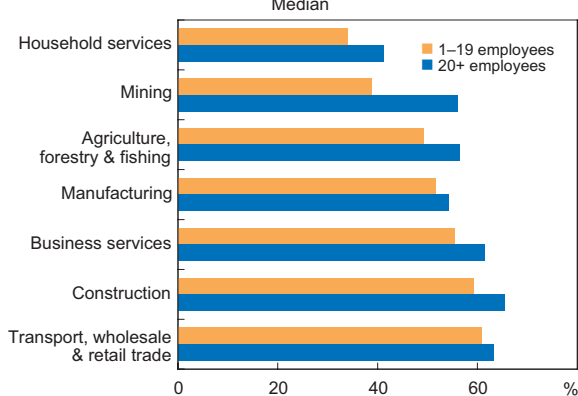
2 Listed companies have more extensive funding options than unlisted firms: they can raise equity on the ASX and access bond markets.

Graph 1
Gearing Ratio*
Distribution



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

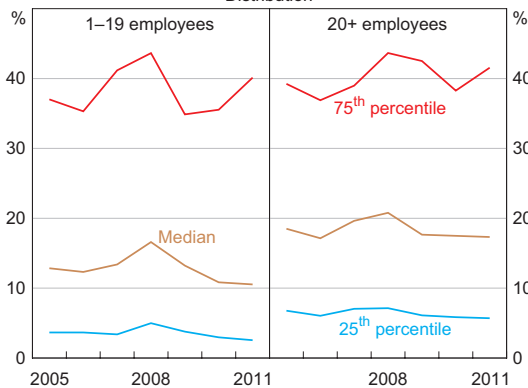
Graph 2
Gearing Ratio*
Median



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

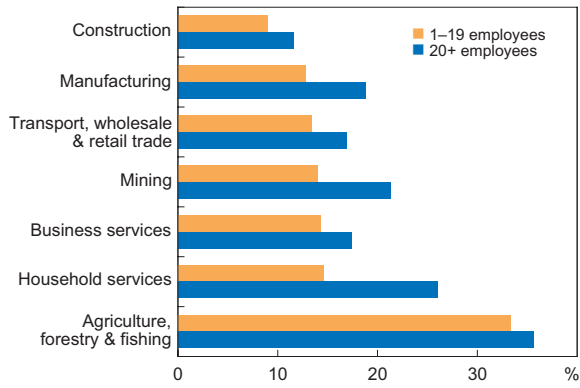
Because of small companies' lower leverage and higher profitability, discussed in the next section, their debt-servicing ratios – measured as interest payments to pre-tax earnings – also tend to be lower than for large companies (Graph 3). This is the case across industries, although the level of the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



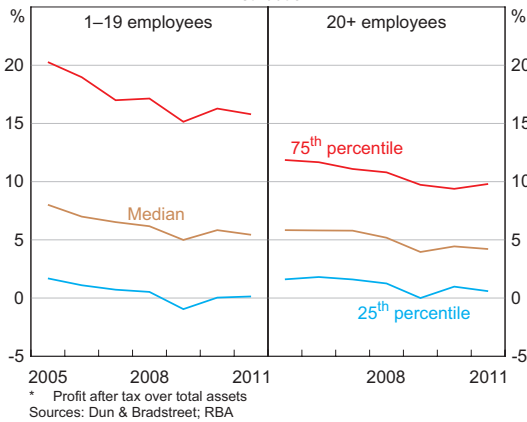
* 2003–2011; estimated interest expense over EBIT
Sources: Dun & Bradstreet; RBA

Profitability

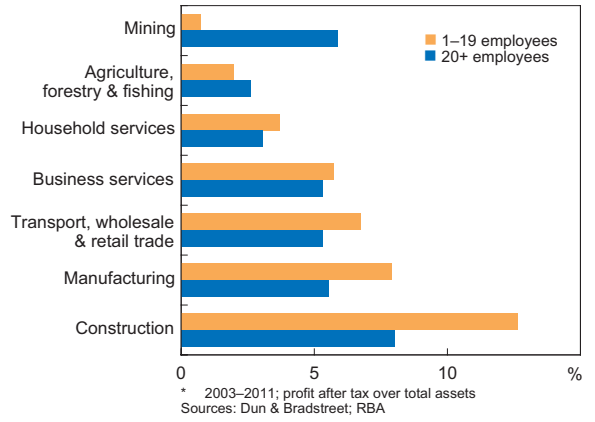
In broad terms, small (indebted) companies appear to be more profitable – measured here as having a higher return on assets – than large companies (Graph 5).³ Profitability also varies across industry (Graph 6); for example, construction companies have tended to have a higher return on assets over the 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



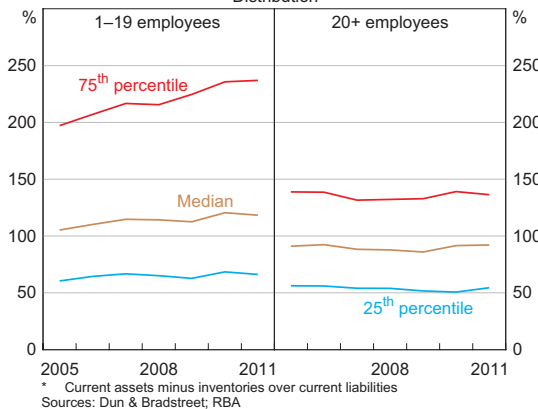
companies; investors require higher expected returns on riskier investments. The greater dispersion of return on assets among small firms compared to large firms supports this. Furthermore, the average variability in a firm's profits over time is about twice as high for small firms compared to larger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

Liquidity

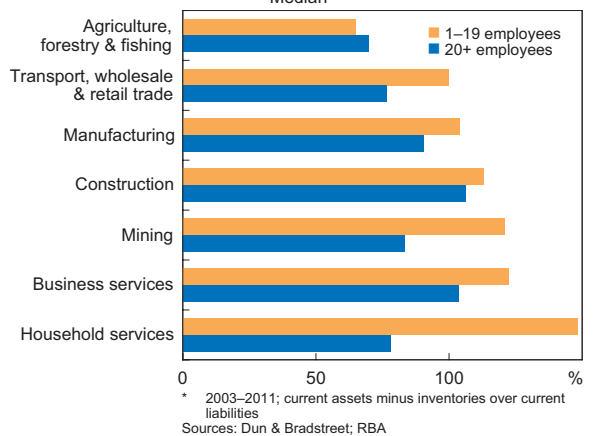
Liquidity refers to a company's ability to pay its short-term debts, bills and other obligations from cash or from assets that can be turned into cash very quickly. One measure of this is the "quick ratio": the ratio of a company's current assets (excluding inventories) to its current liabilities. Smaller 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

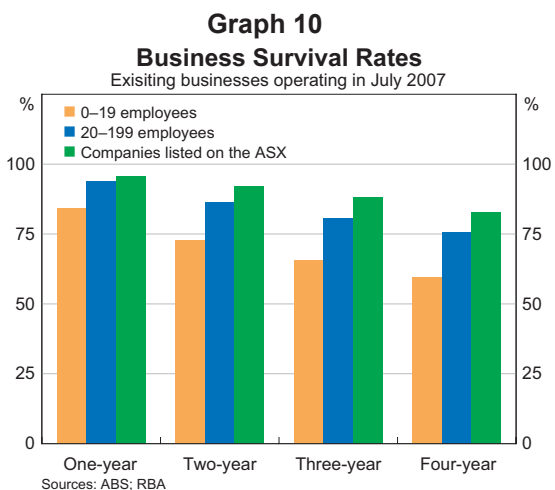
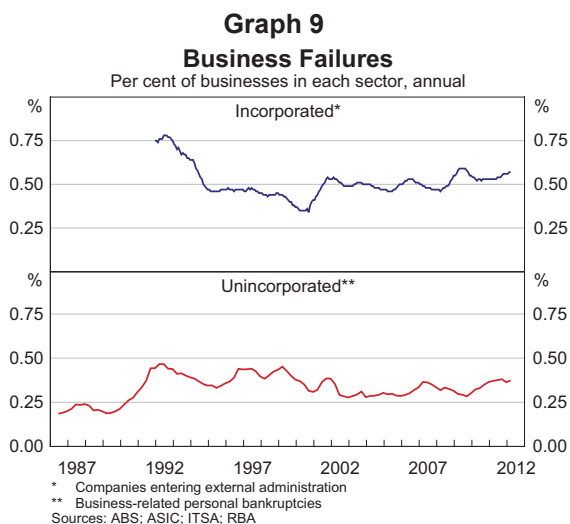


Factors that Influence Success

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.

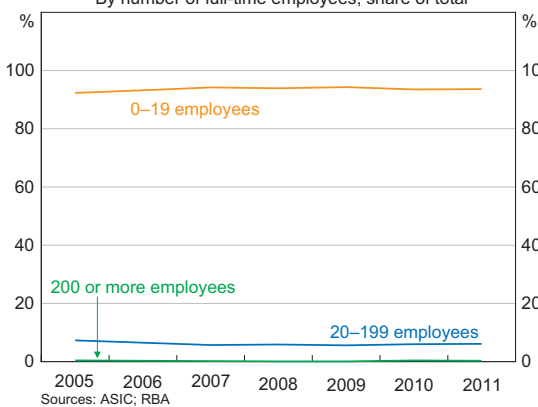


New businesses tend to have lower survival rates than existing businesses. These differences are more marked for smaller businesses; three-year survival rates for new small businesses (with less than 20 employees) are about 17 percentage points lower than the comparable rate for existing small businesses, 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.

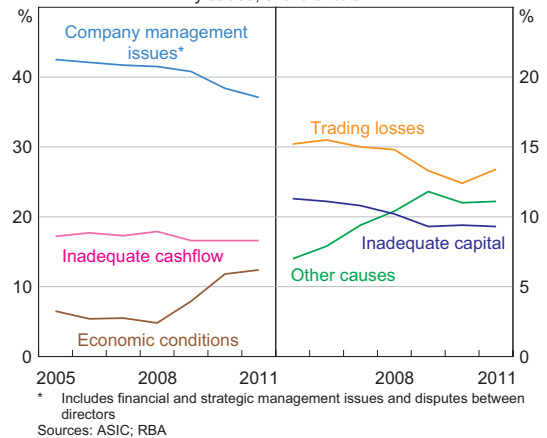
Causes of failure

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.

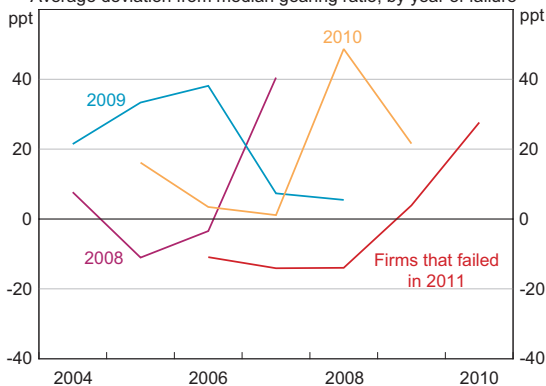
on companies to reduce gearing; while the companies that became insolvent in 2009 and 2010 also reduced their gearing, they remained more highly leveraged than the surviving firms. Nonetheless, it is noteworthy that failed firms' gearing ratios were not particularly different from the median several 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*

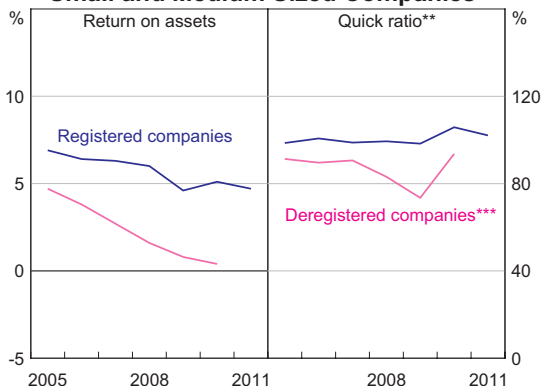
Average deviation from median gearing ratio, by year of failure



* 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

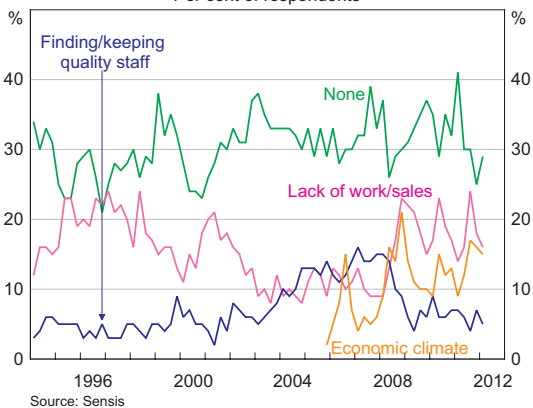
Current Issues for Small Businesses

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

Per cent of respondents



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. ✖

References

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