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Demand for debt and equity before and after the financial crisis

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ABSTRACT

Supply and demand responses to financial crises result in fluctuations in credit flow to the private sector. Policy makers concerned with the sustainability and growth of viable firms should disaggregate these responses. Utilising firm level data, this study investigates characteristics of firms applying for external finance before and after the financial crisis, along with characteristics of successful applicants. Notwithstanding changes in credit conditions, salient features of external financing demand endure across the period, including ownership, asset structure, age and size. Failure to secure debt in an earlier period does not deter firm owners from applying for loans in a subsequent period. Evidence suggests that the most financially distressed firms are suffering the greatest consequences of the credit crunch.

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1. Introduction

Adequate resourcing of small and medium sized enterprises (SMEs) is of paramount importance because of their contribution to gross value added (GVA) and employment (Ayyagari et al., 2007). Provision of resources to small firms is a function of the willingness of funders to lend, combined with demand for investment finance. The preferred primary source of finance for small firms is internal equity, as they typically adhere to the pecking order theory (Mateev et al., 2013). If this source is inadequate for investment needs, firms seek finance externally, of which the most important source is bank debt (Beck et al., 2008). Reliance on bank finance causes SMEs to be particularly vulnerable if there is an abrupt and extensive disruption to the world financial system resulting in a credit crunch (Udell, 2009). Exposure to adverse effects of a credit crunch is intensified as small firms generally do

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not have diversified sources of external funding (Vos et al., 2007). It is further increased if a credit crunch is preceded by a period of expanded credit, during which firms may become reliant on debt finance (Hughes, 1997), and consequently accumulate large debt to assets ratios. The impact of tightened credit conditions may have a greater impact on firms in a poor liquidity position facing into the credit crunch (Mach and Wolken, 2012). This liquidity position is exacerbated if the credit crunch coincides with an economic recession, which can have a detrimental effect on activity in the real economy.

Economic recession also results in a reduction in demand for finance from firms as they reappraise and delay investment decisions. Furthermore, firms contribute to the contraction in private credit flow by deleveraging (ECB, 2012). Thus, it is unclear to what extent the reduction in private sector credit is a result of supply or demand side responses to financial and economic shocks. Nonetheless, governments worldwide promote supply side measures to increase the flow of credit to businesses. Whether such intervention is justified or necessary, governments persist with programmes such as the Merlin agreement in the UK (HCBIS committee, 2011), and the Small Jobs Act 2010 in the US.

Successive reports by central banks worldwide (e.g. CBoI, 2010, 2011; ECB, 2012) suggest that total lending to SMEs in the period following the financial crisis declined significantly as the economic recession persisted. This reduction in credit may have been the result of prudent lending, as lenders decline loans to firms that represent a poor credit risk, the number of which typically increase during recession. Additionally, the large decline in lending to sectors that experienced a severe adverse shock may also be justified due to significant overcapacity. Having incurred significant losses, and facing greater capital reserve requirements and a need to shrink their balance sheets, the primary issue for banking institutions was to retain capital and bolster capital adequacy ratios (Honohan, 2009).

The recent financial crisis provides a valuable opportunity to assess the borrowing behaviour of firms in a period of expanding credit followed by a period of restricted lending. It also provides an opportunity to examine differences in the lending behaviour of financial institutions in a period of credit expansion, followed by credit contraction. Whilst a number of studies and reports provide valuable information about the financing environment for SMEs in the aftermath of the financial crisis (e.g. OECD, 2009), a greater understanding of microeconomic issues can be gained by examining characteristics of firms seeking debt and equity finance, and identifying characteristics of successful applicants. This is important in order to examine if a particular type of firm reduces demand as the economy enters recession, or experiences a financing gap as credit conditions tighten. This information is valuable for policy makers attempting to mitigate the adverse effects of reduction in the supply of finance, along with reduced investment from the private sector.

This study aims to address these contemporary issues and add to the literature by investigating firm owners' applications for debt and equity before and after the financial crisis. Analysing firm level data collected from a representative sample of Irish SMEs, the study poses the following research questions: (a) are the profiles of firms seeking debt and equity finance significantly different after the financial crisis? (b) does denial of credit in a preceding period result in discouragement to apply for loans in following period? and (c) are the profiles of firms receiving debt finance different after the financial crisis?

This paper proceeds as follows: in the following section, the literature relating to demand and supply of finance for SMEs is briefly reviewed, and hypotheses are formulated. Description of data, variables employed, regression models and method of analysis are described in Sections 3 and 4. This is followed by presentation and discussion of results. Conclusions are then elaborated, followed by suggestions for firm owners and policy implications.

2. Theoretical review and formulation of hypotheses

The ability of SMEs to access finance is a recurrent subject in the literature, and the recent proliferation of studies on the issue is motivated by the effect of the financial crisis on small firms (e.g. Cosh et al., 2009; Fraser, 2009; Dennis, 2010). Although credit flow to the private sector is a function of demand and supply, these issues have traditionally been addressed separately in the literature. Demand-side studies typically examine personal and firm characteristics in seeking to provide

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