

**GETTING THEIR SHARE? SMALL BUSINESS FINANCE IN NEW ZEALAND:  
FINDINGS FROM THE 2004 BUSINESS FINANCE SURVEY**

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**ABSTRACT**

*Difficulties in accessing finance are often cited as a barrier to SME growth in New Zealand. However, there has been little empirical evidence to test this assumption. In 2004, the Ministry of Economic Development oversaw a Business Finance Survey to collect data on the demand for finance by New Zealand firms. The survey was the first of its kind in New Zealand and targeted small businesses – over 90 percent of the 4,775 respondents had 20 or fewer employees.*

*The paper covers the following areas. First, it presents the issue of a financing “gap” and provides background information on why New Zealand undertook the survey. Secondly, it presents results on the recent financing experiences of firms, including the key sources and types of finance requested and received by SMEs, success rates, and the amount of debt and equity finance requested over a twelve month period. It also explains the capital structure of SMEs, including sources of current outstanding debt and paid in capital. The paper also presents the characteristics of individuals responsible for raising finance. Finally, the benefits and implications of the survey results for policy development are discussed.*

## **INTRODUCTION**

Efficient and transparent financial markets are widely recognised as a vital element of a country's economic development. Research emphasises that expert financial intermediaries and well-functioning markets ameliorate information asymmetries and transaction costs and thereby foster efficient resource allocation and long-run economic growth. Governments have a key role in establishing the framework in which financial markets operate largely through enforcing a sound legal environment. However, Governments are also interested in addressing market imperfections in the demand and supply of finance to businesses.

Similar to most OECD countries, the New Zealand economy has proportionally large numbers of SMEs. As at February 2005, 96% of enterprises in New Zealand had less than 20 employees. Difficulties in accessing finance are often cited as a common barrier to SME growth in New Zealand. However, until recently, there has been little empirical evidence to test this assumption. In 2004, the government undertook quantitative research to better understand the demand for business finance and to test the extent of the 'finance gap'. This paper presents the results of the New Zealand Business Finance Survey, 2004<sup>1</sup>.

## **MARKET GAPS**

Many of the public policy issues related to the financing of SMEs revolve around the concept of "gaps" in financial markets. There are, however, several ways of interpreting finance gaps. Traditional assumptions on SME financing in New Zealand revolves around the idea of a shortage: a sense that the supply of the commodity in demand is insufficient and that the demand cannot be satisfied. Research also puts emphasis on information asymmetries as a key determinant of SME financing problems (Berger & Udell, 1998). The higher risk generated

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<sup>1</sup> Full report and tables available at <http://www.stats.govt.nz/analytical-reports/business-finance-2004.htm>

by a lack of information can force lenders and investors to demand a higher return to protect their investment, which can raise the cost of capital to small firms, potentially to an unviable level. This creates an incentive for small firms to rely heavily on internal sources of finance<sup>2</sup>.

Work conducted on behalf of the Business Development Bank of Canada (Angus Reid Group, 2000) suggested four perceived gaps that relate to the debt markets in which SMEs participate. According to the report, Canadian SMEs face four types of financing gaps:

1. A **size** gap such that business owners who seek small loans perceive that their borrowing needs are too small to be of interest to institutional lenders.
2. A **risk** gap whereby lenders do not price loans to reflect risk (rather, they reject loan applications if risk exceeds a particular threshold or if insufficient collateral is available).
3. A **flexibility** gap such that financial institutions do not provide flexible terms and conditions on their loans.
4. A **knowledge** gap based on the belief that “financial institutions do not understand knowledge-based businesses.”

Another way to analyse finance gaps is to identify groups of firms with lower than average financing success rates. However, the simple observations that firms that have lower-than-average success rates is not evidence of a ‘gap’ in the marketplace. Some firms may, on average, be smaller or younger or riskier, rendering them lower success rates. The real issue is whether these firms are consistently less successful and achieve less favourable financing terms after controlling for other relevant factors such as size, age of business and sector. Nonetheless, there is widespread belief in many countries that financial market gaps exist,

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<sup>2</sup> Refer to Figure 2 for sources of current paid in capital.

which places policy makers under pressure to intervene with remedial measures.

## **SURVEY BACKGROUND**

The New Zealand Government's economic development strategy, the Growth and Innovation Framework (GIF), recognises efficient financial markets as an important factor in the Government's goal of creating a more innovative and globally-connected New Zealand economy. In particular, the GIF highlights the significant role of the venture capital market in financing the commercialisation of innovation. Difficulty accessing finance is a commonly held perception of the SME market in New Zealand despite the fact that SME surveys consistently rate access to finance well below other barriers to business growth<sup>3</sup>. However, the government decided to carry out research on the financial markets to test whether in fact SMEs and firms in general, experience problems accessing finance and whether this is a constraint on economic growth. The research was also intended to ascertain how New Zealand's financial markets operate in comparison with other economies.

Conventional thinking on finance issues persuaded policy makers to first research the supply-side of business finance, including the financial system and its constituent parts (PWC, 2003; Infometrics 2004; LECG 2005). The research highlighted a number of small business issues such as the use of residential housing by the major banks to secure small business loans (PWC, 2003). However, the research uncovered no major inefficiencies in the markets. While understanding supply-side issues is critical, it cannot provide a complete picture of the state of firm financing. That is because these studies do not highlight the relative importance of non-intermediated or "private" capital flows, which are an important source for all but the largest of firms. As such, the government became increasingly aware of the need to address the

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<sup>3</sup> See for example the quarterly National Bank Small Business Monitor Report. [www.nbnz.co.nz](http://www.nbnz.co.nz)

demand-side knowledge gap on New Zealand's financial system. A business survey was identified as the most efficient way to collect this information.

The 2004 Business Finance Survey was the response to the groundswell of interest in empirical evidence on the demand for business finance and, in particular, the financing experiences of small businesses. The survey was developed jointly by the Ministry of Economic Development and Statistics New Zealand, the national statistics agency. A major driving force behind the Business Finance Survey was to help stakeholders (both public and private) to better comprehend the challenges and opportunities surrounding the provision of capital to New Zealand firms. The objectives of the survey were to:

- Improve understanding of business financing needs and, therefore, form the basis for better informed public debate;
- Give financing providers a more comprehensive understanding of their clientele, thus better enabling them to design products and services that meet market needs; and
- Facilitate the assessment of whether firms' financing needs are being addressed by the market, and help with gauging the effectiveness of government policies and programmes.

Learning from other jurisdictions also encouraged New Zealand to undertake a demand-side survey. For example, New Zealand observed that SME finance data collected by U.K, Canadian and U.S agencies generated a significant amount of further research and led to refinements in policy. The international data appear also to stimulate debate in both the public and private sectors on wider finance issues.

## **SURVEY RESULTS**

The Business Finance Survey was a postal survey, sent out in late August 2004. A sample of businesses with between 1 and 500 employees in a wide selection of industries were surveyed.

The survey form was directed to the 'Managing Director'. The target population for the survey was live enterprise units on Statistics New Zealand's Business Frame at the population selection date which:

- were economically significant enterprises (those with an annual Goods & Services Tax turnover figure of greater than NZ\$30,000)
- had between 1 and 500 employees inclusive
- had been operating for six months or more
- were not subsidiaries, more than 50 percent owned by another business
- were classified to Australian and New Zealand Standard Industrial Classification.

Businesses with no employees were not surveyed in order to limit respondent load for small businesses. However, this creates limits in terms of drawing economy-wide conclusions as New Zealand has a proportionally large number of self-employed enterprises. In 2003, 43 percent of all businesses were working proprietor-only enterprises (MED, 2005). The employment criterion was also deliberately used to exclude the largest firms in the economy. This is because policy makers were interested in intermediary-based rather than market-based financing. Large firms are more likely to use market-based mechanisms, such as the New Zealand stock exchange, for financing and would have contributed disproportionately to the aggregate statistics. This highlights the survey's focus on small business financing and financial intermediaries, which play a more important role in small open economies in

reducing information asymmetries. This is because these economies, such as New Zealand's, have a large number of small firms which are more likely to be affected by information imbalances (Claus et al 2004).

The target overall response rate from the survey was 80 percent for questionnaires returned. The survey achieved this overall rate of return, which represented 4,775 businesses. Because of the large number of businesses surveyed it is possible to assume that the sample is fully representative of New Zealand firms (within the given employee threshold). The initial high-level results of the survey were released by Statistics New Zealand on 2 May 2005 and the full report in August 2005.

For the purposes of the survey report, SMEs are defined as firms with 1-20 employees. This accounts for over 90 percent of respondents.

#### ***Financing Conditions for SMEs in 2004***

Statistics New Zealand figures show growth in the New Zealand economy over the 2003/2004 financial year period covered by the survey, with GDP growth and annual growth in the number of full time equivalent employees (FTEs) of over 3 percent. This may have some bearing on a business's growth expectations and desire for expansion and also the willingness of finance providers to supply finance.

#### ***Requests for Debt Finance***

Thirty-three percent of SMEs sought additional debt financing in the 12 months prior to August 2004. The vast majority of debt finance requests made resulted in finance being obtained. Overall, 90 percent of debt finance requests resulted in either some or the entire amount sought being received. Of those SMEs that did not request additional debt finance, 85

percent responded that it was not required, followed by 24 percent who wished to avoid getting into debt. The survey found the main reasons for rejection were insufficient income or cashflow (31 percent) and insufficient collateral or security (31 percent). Just 2 percent of respondents said their request was declined because they had no business plan.

The most popular type of debt requested was bank overdrafts, which were requested by 36 percent of SMEs. Other common types of debt were long-term loans, leasing or hire purchase agreements and increased credit facilities or limits. Banks were the most common source of SME debt financing requests. Banks accounted for 79 percent of SME debt financing requests. Finance companies (including hire purchase or lending companies) were the next most common source. In the twelve months to August 2004, SMEs requested a total of NZ\$3,820 million worth of debt finance and received a total of NZ\$3,634 million.

Most debt finance requests were for working capital purposes, accounting for 47 percent of respondents. The next most common intended uses of requested debt finance was the purchase of machinery and equipment (23 percent) and purchase of vehicles (20 percent).

### ***Requests for Equity Finance***

Five percent of SMEs sought additional equity financing in the twelve months prior to August 2004. Overall, 83 percent of equity finance requests made by businesses resulted in either some or the entire amount sought being received. Of the SMEs that did not request additional equity finance, 93 percent said that it was not needed. Just 6 percent of SMEs did not request equity to avoid diluting the owner's control of the business. This result was interesting as equity aversion or an unwillingness to take on additional shareholders, is often perceived as a reason why New Zealand SMEs prefer debt over equity (Coopers & Lybrand, 1993).

Forty-five percent of SMEs did not specify why their requests were unsuccessful. However, 27 percent said insufficient income or cashflow was the main reason for their rejection. The most common source of equity requested was from individuals in control of the business. They were a source of 83 percent of SME requests. Friends or family were the next most common single source (15 percent). Just 5 percent of SMEs requested equity from venture capital or private equity funds. In the twelve months to August 2004, SMEs requested a total of NZ\$623 million worth of equity finance and received a total of NZ\$426 million.

Sixty percent of equity finance requests were for working capital purposes. The next most common intended uses of requested equity finance was the purchase of machinery and equipment (25 percent) and debt consolidation (15 percent).

### ***Financial Structure of New Zealand SMEs***

The Business Finance Survey collected information on the current financial position of businesses. At the time of the survey, SMEs held NZ\$22,154 million worth of outstanding debt. The most common type of SME debt was trade creditors or suppliers followed by shareholders current account (24 and 22 percent respectively). Figure 1 shows banks and business owners were the dominant sources of outstanding debt.

Total SME equity stood at NZ\$16,204 million as at August 2004. Paid in capital accounted for 60 percent of total equity, with accumulated retained earnings and other sources making up the remaining 40 percent. Overall, the survey found larger businesses have a proportionally higher amount of accumulated retained earnings than smaller businesses. A

breakdown of the sources of paid in capital for SMEs in Figure 2 demonstrates the key role of business owners as suppliers of equity finance.

While the survey indicates venture capital forms a relatively small source of current paid in capital for SMEs, activity in the venture capital and private equity markets has steadily increased in recent years. In 2004, the amount invested in all private equity was \$158 million. The total number of deals undertaken was 59, up from 39 and 51 in 2002 and 2003 respectively. Investment in early stage capital has averaged \$13.4 million over the last 3 years. However, there has been a strong increase in expansion stage capital, increasing from \$14 million in 2002, to \$44 million in 2003 and \$96 million in 2004 (Ernst & Young, 2004).

### ***Expansion and Projected Turnover Growth***

Twenty one percent of SMEs invested in expansion during their last financial year representing a total of NZ\$2,483 million. Overall the survey found larger businesses were more likely to invest in expansion than smaller businesses and the manufacturing industry invested more than other industries. The survey also found the majority of SMEs (76 percent) expected positive turnover growth, including 18 percent that anticipate growth in turnover of 11 percent or higher in the next three years. The survey data also examined the extent to which the demand for finance relates to SME investment in expansion and growth projections. The results showed a positive association. SMEs that requested finance were more likely to invest in expansion and expect positive turnover growth.

### ***Business Characteristics***

New Zealand SMEs appear to have long-term relationships with their main bank or financial institutions. Seventy percent of SMEs had a relationship of 4 or more years; 36 percent for more than 10 years. The survey found just 7 percent of SMEs were involved in franchising.

Similarly, factoring, or the sale of accounts receivable, is an uncommon business practice amongst New Zealand SMEs. Less than 1 percent of SMEs used factoring as a form of finance.

### ***Gender and Ethnicity***

A particularly useful feature of these surveys is the ability to analyse the financing experiences of particular categories of firms and compare these results with other economies. For example, policy makers in New Zealand and internationally are interested in gender and ethnicity in relation to business performance. Governments often intervene in the market to enhance the position of women and ethnic minorities. For example in New Zealand, Te Puni Kōkiri (Ministry of Māori Development) oversees the Māori Business Facilitation Service designed to enhance growth of Māori-owned businesses. The survey results can be disaggregated to determine whether individual characteristics of business owners have any statistical relevance to their financing experiences or financial structures of their businesses. Table 1 presents a comparison of some New Zealand Business Finance Survey and 2004 UK Survey of SME Finances results by gender and ethnicity.

## **PROMOTING EVIDENCE-BASED POLICY ON ACCESS TO FINANCE**

Demand-side information facilitates more effective public policy by fostering the development of a widely accepted and empirically supported policy framework around the notion of capital market imperfections. The risk of not having this information is that anecdotally based perceptions of specific types of market “gaps” may inappropriately drive public policy. Without comprehensive information on firm financing, it is very difficult for policy makers to assess the need for, and likely impact of, existing and potential government initiatives. Public sector initiatives to promote access to finance are best justified if market

imperfections exist and result in the private sector not providing capital to firms on competitive terms. In the absence of market failure, government intervention may cause distortions – non-viable firms being subsidised at public expense. Thus, this kind of research can help policy makers determine the appropriate role, if any, for governments in addressing market imperfections.

Demand-side surveys are particularly useful in identifying patterns in SME finance, such as the dominant sources and types of financial instruments preferred and currently in use by SMEs. The surveys can also uncover what SMEs do with their finance, why SMEs *do not* request finance and the reasons why finance requests are declined. The latter point is critical in helping define market gaps by identifying the specific categories of firms (or individuals) with lower success rates than other firms and the expressed reasons for that lower success. For example, evidence from Canada suggests start-up and ‘collateral-poor’ SMEs have greater difficulties accessing finance than other firms (Industry Canada, 2003).

Since the survey results were only published in October 2005, work is still underway in analysing the information to consider its implications for policy development. However, the results tend to confirm the prevailing notion that firm financing issues are largely demand driven and that firms with sound investment opportunities usually find finance. Importantly, the high SME request and success rate in sourcing debt from banks suggests the banking system is providing adequate and acceptable services to small business. Research on bank lending practices also supports this claim (PWC 2003).

The results demonstrate the very limited role of externally sourced equity finance, certainly at the aggregate level. Supply-side research shows small businesses appear to have less knowledge of equity, including a basic understanding of venture capital. New Zealand studies

have found that many small business owners do not understand external equity finance, confuse it with debt and have a negative perception of their ability to attract external investment (Coopers & Lybrand, 1993). Anecdotal evidence sourced from the administration of the Business Finance Survey found also that many SMEs have a poor understanding of equity. The minor role of informal equity finance uncovered by the survey is useful from a policy perspective because risk capital is considered essential to the success of some high growth firms and plays a key role in the commercialisation of innovation. A strong and vibrant venture capital market is important in developing New Zealand into a knowledge-based economy. Recent research suggests venture capital markets take a long time to mature and are very sensitive to government intervention (LECG, 2005). Thus, similar to results in Canada, the survey results indicate the need for policy makers to better understand the role of business angels and venture capitalists as part of the government's ongoing economic development agenda (Industry Canada, 2003).

The economic conditions at the time of the survey are another important consideration for policy makers. The twelve months leading up to August 2004 was a period of strong economic growth in New Zealand. It is assumed these conditions had a positive effect on financing request and success rates, but the extent of this is unclear as there is no other empirical data to compare with the survey. Economic conditions should also be taken into consideration when comparing data with previous domestic or with international surveys. That said, building a longitudinal element to the financing data will be important in determining whether access to finance is affected by economic cycles and to analyse changes in SME financing over time.

The New Zealand experience also demonstrates the value of undertaking the research in collaboration with national statistical agencies or their equivalents. This was important in maintaining the objectivity and integrity of the datasets as well as ensuring that the sample was sufficiently large and representative enough to draw conclusions on the economy as a whole. High quality finance data also permits countries to contrast demand-side information across different economies. This provides a useful benchmark of financing experiences and SME capital structures. International experiences demonstrate also the surveys are robust and compelling tools in which to engage the private sector. The New Zealand government intends to use the 2004 survey as a base to further engage the business community on firm financing.

In addition, evidence from the business finance survey will be used to inform policy development and evaluation of existing government financing initiatives. To date, government intervention has focussed on addressing the under-development of the venture capital market. In 2002, the government established the New Zealand Venture Investment Fund (NZVIF). The VIF Venture Capital Funds select, invest in and assist the growth of innovative young companies early in their development. NZVIF also manages the recently announced Seed Co-Investment Fund (SCIF), which is designed to stimulate development of the angel investment market<sup>4</sup>. Data from the survey will assist in the ongoing monitoring and evaluation of NZVIF as well as other finance-related government programmes such as those provided by New Zealand Trade and Enterprise and the Foundation for Research, Science and Technology.

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<sup>4</sup> For more information see [www.nzvif.com](http://www.nzvif.com)

## CONCLUSION

Results from New Zealand show that the majority of SMEs successfully access finance when required. To a certain degree, the results debunk the assumption that many SMEs struggle to raise capital and suggest the majority of profitable investment opportunities are being taken up.

The results also demonstrate that scrutiny of the ‘financing gap’ should be analysed from both a demand and a supply-side perspective. Evidence from New Zealand of high success rates suggests that the reasons why some firms struggle to raise capital may be due to factors other than supply-side inefficiencies in the financial system. Firms themselves may lack the capability to attract investment or are unable to take advantage of available finance because of their negative perception and lack of understanding of the products that are currently available. Thus, to show that a capital gap exists, we must be able to demonstrate that firms unable to obtain financing *actually merit financing*. This point was highlighted and reaffirmed by the OECD Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs, which stated that “policies should aim to ensure that markets can provide financing for credit-worthy SMEs” (OECD, 2004).

In conclusion, quantitative data from the business finance survey has sharpened the focus of the finance debate and provided empirically based direction for policy makers and the wider business community. Further data analysis broken down by industry, age and growth stage will provide yet further focus on where finance “gaps” may exist. This analysis is vital in order for New Zealand to concentrate resources in areas of its financial markets that need assistance.

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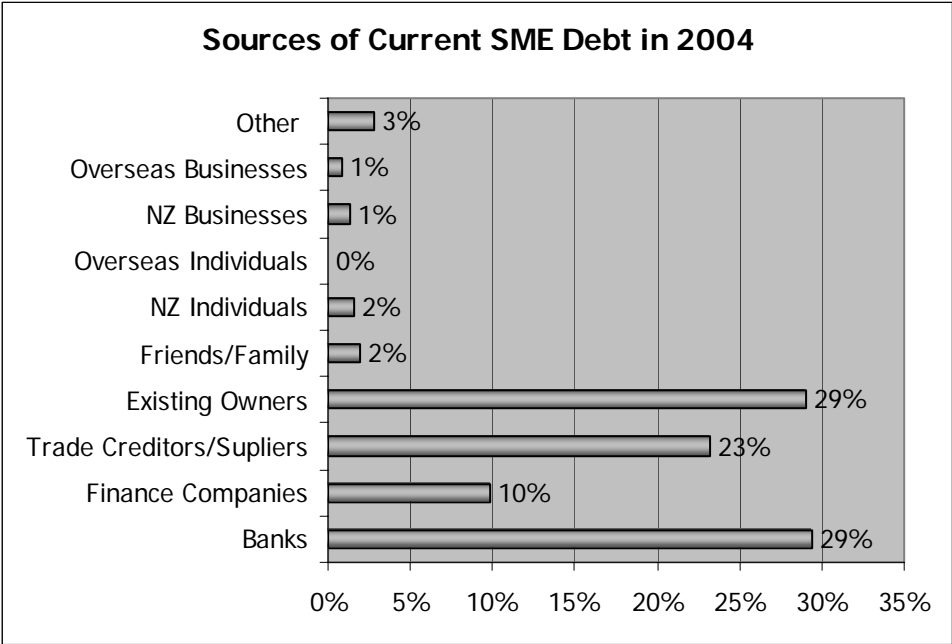
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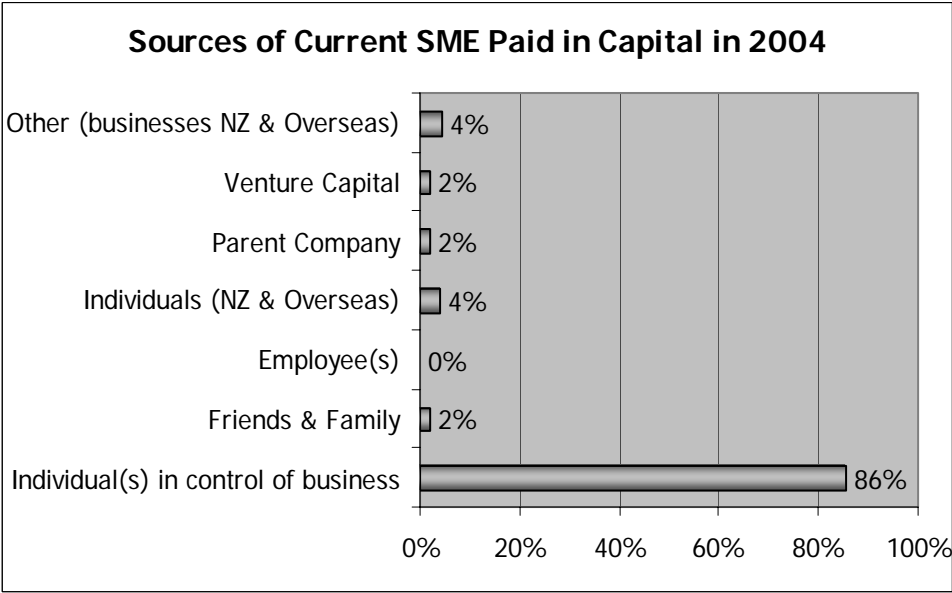
**Tables & Graphs**

**Figure 1**



Source: Business Finance Survey 2004  
 \* Figures based on proportion of dollar amounts  
 \*\* Figures relate to the last financial year for which the businesses had results available as at August 2004

**Figure 2**



Source: Business Finance Survey 2004  
 \* Figures based on proportion of dollar amounts  
 \*\* Figures relate to the last financial year for which the businesses had results available as at August 2004

**Table 1: Comparison of Recent New Zealand<sup>5</sup> and United Kingdom<sup>6</sup> Financing Experiences by Gender and Ethnicity**

	<b>New Zealand<sup>7</sup></b>	<b>United Kingdom<sup>8</sup></b>
<i>New Finance Requested</i>		
All businesses	36%	44%
Male <sup>9</sup>	35.4%	42.6%
Female	35.7%	48.2%
NZ European / White	34.3%	42.8%
Non-NZ European / Non-white	32.9%	61.2%
<i>Businesses not requesting finance as it was not needed</i>		
All businesses	81.4%	95.4%
Male	80.8%	96.8%
Female	83.6%	90.9%
NZ European / White	78.2%	95.5%
Non-NZ European / Non-white	70.1%	93.2%
<i>Businesses requesting finance that experienced outright rejection</i>		
All businesses	9.4%	11.4%
Male	9.7%	13%
Female	8.4%	7.1%
NZ European / White	10.3%	10.4%
Non-NZ European / Non-white	15.2%	23.4%

<sup>5</sup> *Business Finance Survey, 2004*. The survey covers businesses with between 1 and 500 employees.

<sup>6</sup> *2004 UK Survey of SME Finances*. The survey covers businesses with up to 250 employees.

<sup>7</sup> Figures refer to the twelve months to August 2004.

<sup>8</sup> Figures refer to the previous three years to 2004.

<sup>9</sup> New Zealand figures consider only those businesses where the owner arranged the finance. Ethnicity figures additionally only consider those businesses where the owner was answering the questionnaire as ethnicity is considered to be a self-identified characteristic. Therefore, it should be noted that the categories being calculated are below the sample design of the survey and sample errors could be significant.