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FINANCE AND SMALL MANUFACTURING FIRMS: DO MARKET LISTING AND SIZE ENTAIL BEHAVIOURAL DIFFERENCES?

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Abstract

It is possible to study companies according to their methods of gaining access to finance, and in particular the stock market. Two approaches are possible. The first looks at the organisation of such access through the relationships built up by the company with suppliers of capital, enabling the financial territory of the company to be defined. The second approach, which does not exclude the first, is to compare companies according the degree to which they enjoy access to financial markets, which can be defined in terms of whether a company is listed on the stock market or not. Both approaches have been tested using data for recent years. The purpose of this paper is to examine firstly the differences in access to financial markets between large and small companies, and secondly the effects and constraints generated by the fact of being listed (comparison of listed and unlisted companies).

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Comparison of small and large firms highlights a difference in their behaviour according to size. Small manufacturing companies accumulate at a higher rate and evidence greater economic profitability that their larger counterparts, along with a higher level of debt (see Paranque, 1994; Paranque, 1995; Jullien, Paranque 1995; Cieply, Paranque, 1996; Paranque, 1997).

Given this, the central issue is how the requirements of a company's business are funded. From this point of view companies can be contrasted according to the ways in which they gain access to sources of finance, and in particular the stock market. Two approaches can be considered here. The first analyses the **organisation** of such access through the relationships built up by the company with suppliers of capital, which enables its financial territory to be defined (Belletante, 1991). The second, which does not exclude the first, compares firms according to the **degree** of access they enjoy to financial markets, which can be defined by whether the company is listed or not. Both approaches have been tested using data for recent years. The work of OFEM [*Observatoire Financier des Entreprises Moyennes* - Observatory for Small Company Finance] (Belletante *et al.*, 1994, 1995, 1996) has highlighted the relationships and financial policies of 104 companies typified by small or medium levels of market capitalisation (under USD350,000). In addition, analysis of the effects of market listing has been made possible by the availability of information on "listed - unlisted" statuses and on the existence of financial links in September 1996 for manufacturing firms registered with the Balance Sheet Centre of the Banque de France.[1] The sample examined in 1996 contained 12,044 companies whose 12-month financial years fell within the period July 1, 1995 to June 30, 1997.

The purpose of this paper is to examine, firstly, differences in access to financial markets between large and small companies, and secondly, to define the consequences and constraints entailed by market listing (comparison between listed and unlisted firms).

1 CORPORATE SIZE AND ACCESS TO FINANCIAL MARKETS

A test of independence applied to corporate size (companies with less than 500 employees / companies with more than 500 employees) and listing on the stock market leads to the rejection of the hypothesis that these are independent. The percentage of small manufacturing firms listed is 1%, compared with 12% of large companies, the percentage being 1.5% for the entire sample. If we look only at the listed companies included in the OFEM study (Belletante *et al*., 1994, 1995, 1996) we find the same phenomenon. For the 0.4% of the companies studied simultaneously by B. Belletante, the percentage is 0.3% for small manufacturing firms, against 3.4% for large companies.[2]

The existence of financial links is visible for 68.7% of the companies in the sample. Companies whose capital is held only by private individuals other than those acting for the company on the stock market and which can be described by the label "general public" have been excluded. Capital structure can be examined for 85.6% of the companies (58.8% of all the companies in the sample). Seven categories of shareholder were identified: companies, banks, holding companies, the State, the general public (stock market), employees and private individuals. In each case the category was deemed to apply only when the holding reaches a minimum threshold set at 10%.

Such links are more frequent in the case of the large companies (99.3% compared with 68.7% of the sample as a whole), whereas in small manufacturing firms occurrence is lower (67.1%), but not negligible. The main differences are to be found in the structure of their capital. If 10% is adopted as the significant level for equity interests, banks are less frequent shareholders in large companies (9% compared with 11.4% of all companies for which this information is available), whose securities are more frequently held by holding companies (50.3%, compared with 38.7%) or the general public (2.4%, compared with 0.8%). Holdings higher than 10% in small manufacturing firms are usually in the hands of private individuals

[1] Using the Banque de France's *Observatoire des entreprise* database, built up by E. Kremp.

[2] OFEM is a set of studies of the financial behaviour of medium-sized firms listed on the stock market and has been developed by the Lyon School of Management (EM Lyon). Reference is made to the OFEM sample in this paper.

(29.7% compared with 27.6%), which may reflect the direct holding of equity by the owners (the managers) of the company.

EQUITY INTERESTS GREATER THAN 10%: BREAKDOWN BY TYPE OF SHAREHOLDER

(%)

(1)	Whole sample	Small Manufacturing Firms (<500 employees)	Large Companies (>500 employees)
Private individuals	27.6 (158.321)*	29.6 (8.9781)	4.7 (105.63)
Companies	55.3 (4.847)	55.6 (0.1698)	50.8 (1.9982)
State	0.1 (70.654)	0 -	1.1 (65,065)
Banks	11.4 (3.311)**	11.6 (0.2299)	9.0 2.7045)
Holding Companies	38.7 (34.235)	37.7 (1.645)	50.3 (19.355)
General public	0.8 (53.235)	0.6 (4.1375)	3.4 48.68)
Employees	0.3 (not significant)	0.3 -	0 -
Source and table:	Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58		Last update 11/97

(1) Interpretation: of those companies with financial links and for which the shareholding structure is known (respectively 68.7% and 58.8% of the complete sample), 27.6% have private individuals as shareholders holding at least 10% of their equity. This percentage is 29.6% for small manufacturing firms alone, compared with 4.7% of large companies.
In brackets: chi-squared and contribution to each sub-population.
* = 5% threshold
* = 10% threshold

Where listed companies are concerned, analysis of equity interests of more than 10% demonstrate the importance of holding companies (53.7% compared with 38.7%), the general public (27.2%, but only 0.8% of the whole), and finally banks (20.4% compared with 11.4%). These characteristics are more marked in the case of OEFM companies with middling market capitalisation, the ranking being, in order of size, 61.7% of securities held by holding companies, 46.8% by the public (private investors) and 25.5% by banks.

These results confirm those of the study of the behaviour of small to medium enterprises with access to the stock market (Belletante, Desroches, 1993). Firstly, market listing leads to the putting in place of structures of holding type as vehicles for the equity interests of those running the company and their families (92% of the holding companies in the OFEM sample); the direct holding of securities are the exception here and is in fact statistically insignificant. Secondly, past experience of small French companies listed on the market clearly demonstrates that their managers are not unwilling to issue stock to the general public at high levels of volume, and that they do not limit such issues to the minimum for obtaining listed status (10% on the French secondary market for example). This reflects a wish on the part of the senior management of small to medium enterprises to create a wide shareholding base.

EQUITY HOLDINGS OF OVER 10% BY SHAREHOLDER CATEGORY
FOR LISTED COMPANIES AND COMPANIES IN THE OEFM SAMPLE *

(%)

	Listed	OFEM
Private individuals	20.4 (3.893/2.7599)	NS
Companies	37.4 (19.362/8.4804)	29.8 (12.43/5.5226)
State	1.4 (28.879/28.256)	0
Banks	20.4 (12.198/10.587)	25.5 (9.433/8.3057)
Holding Companies	53.7 (14.4/8.6498)	61.7 (10.594/6.4554)
General public	27.2 (1336.3/1248.2)	46.8 (1277.745/1259.2)
Employees	0	0
Source and table:	Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97	

In brackets: chi-squared and contribution to the sub-population.

What then are the economic and financial features which firms with access to the financial markets possess, and which other companies do not? In other words, what constraints are likely to be entailed for small to medium manufacturing firms by the need to comply with the expectations of the stock market?

2. GROWTH, FUNDING REQUIREMENTS AND PERFORMANCE

In 1996, companies did not create more jobs if they were listed or unlisted — employment grew by approximately 1.8% in both categories [3]. This lack of difference is also to be seen in the rate of growth in corporate turnover (up 1.8%) and value-added (up 2.4%). This characteristic holds constantly true for all companies, whether listed or unlisted, where these are present over the entire period 1989 to 1996 (4,618 companies in each year), a fact which makes it possible to bring out clearly that the flotation of a company on the French stock market is neither beneficial nor detrimental to employment, thus militating against the idea that listed companies decide more often than others in favour of "capital" and against "labour". On the other hand, it also invalidates the argument that the strengthening of shareholders' equity by market valuation has a positive impact on jobs.

This observation has already been made in 1995 for SMEs listed in France (Belletante *et al.*, 1996). Based on the concept of corporate responsibility, measuring changes in size of the workforce managed by given companies, it was noted that 64% of all listed SMEs increased their corporate responsibility between 1990 and 1994, with companies in the OFEM panel increasing the number of employees by a median of 50 (the mean being 98). It is therefore a significant reflection on market behaviour that listing has not harmed jobs and that the increase in the managed workforce has led to no deterioration in economic or stock market performance.

[3] A test for unequal means was verified by a non-parametric median test at a threshold of 5%.

EMPLOYMENT AND ACCUMULATION % 1996

Companies	Unlisted	Listed	All
Variation in size of workforce	1.6	1.1	1.5
Variation in corporate turnover	1.8	2.7	1.8
Variation in value-added	2.4	1.1	2.4
Accumulation rate	**11.9**	**9.0**	11.9
Displacement rate	4.1	4.2	4.1
Period covered by working capital requirements	**69.2 days**	**92.2 days**	69.5 days
Source and table: Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97			

Bold figures indicate statistically significant values.

The accumulation rate[4], expressing the effort made to strengthen productive potential, is higher in unlisted (11.9%) than in listed companies (9%) despite the fact that the displacement rate[5] is similar, underscoring the existence of a policy of investment in equipment replacement and/or productivity rather than in increased production capacity. Overall, funding requirements seem to be different, especially given that the period covered by working capital requirements is longer for listed firms (92.2 days) than for the others (69.2 days). It should be noted that this period increases in SMEs following market flotation (Belletante, Desroches, 1993). This a direct consequence of market listing. Firstly, customers have the advantage of better information on the listed firms supplying them (due to public disclosure requirements), and secondly, the management of listed SMEs observe that their customers exert more pressure on them after market flotation. This increase in the period covered by working capital requirements has frequently been mentioned as one of the disadvantages of gaining access to financial markets in the case of SMEs.

	Small Manufacturing Firms		Large Companies	
	Unlisted	Listed	Unlisted	Listed
Variation in size of workforce	1.6	2.1	- 0.1	- 0.6
Variation in corporate turnover	1.8	3.1	1.2	2.0
Accumulation rate	**12.0**	**9.2**	9.5	8.6
Displacement rate	4.1	4.6	3.7	3.6
Period covered by working capital requirements	**69.4**	**98.9**	**64.0**	**81.4**
Source and table: Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97				

While the listed small to medium manufacturing firms certainly appear to be growth-oriented compared to large firms, their accumulation pattern is nevertheless closer to that of large firms than it is to the other companies with less than 500 employees.

The OFEM studies of listed SMEs (Belletante *et al.*, 1994, 1995, 1996) show very clearly that companies which have opted for listing on the stock market do not invest at the level of unlisted SMEs. They prefer productivity to expansion of productive potential and in that respect their behaviour is not dissimilar to that of large companies. Interviews with the managers of listed SMEs highlight two main causes of this potential braking effect on investment. The first is the existence of a desire to reduce debt levels (very much a trend in all listed French SMEs), this being seen as necessary by managers since it is expected by the stock market. The second relates to the prudential behaviour of managers: they are not certain of the real level of profitability of their supplementary investment plans, either for reasons intrinsic to the projects concerned, or because of uncertainty as to future developments in the general

4 Accumulation rate = productive investment / tangible fixed assets, including assets acquired under leasing arrangements.

5 Displacement rate = accumulation rate – rate of growth in tangible fixed assets.

economic context. These two explanations illustrate clearly the impact of market flotation on SME managers as they begin to assimilate the logic of seeking the best valuation of shareholders' equity.

PROFITABILITY (%)

Companies	Unlisted	Listed	All
Gross economic profitability	**12.4**	**9.5**	12.4
Overall balance	**4.6**	**- 1.2**	4.5
Gross financial profitability before dividends	**11.6**	**8.3**	11.5
Gross financial profitability after dividends	**8.6**	**6.0**	8.6
Net financial profitability before dividends	- 3.3	2.9	- 3.2
Dividends to shareholders' equity	4.6 **(49.7)**	4.2 **(67.3)**	4.6
Dividends to self-financing capacity	**25.2**	**37.2**	25.4
Self-financing capacity to invested capital	**6.5**	**4.9**	6.6
Source and table: Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97			

(*) Significant at a threshold of 10% and, in brackets, significant frequency at a threshold of 5% (percentage of companies for which the ratio is above the sample median)

Bold figures indicate statistically observable differences.

The economic profitability[6] of listed firms is lower, as is also their overall balance (i.e. the difference between economic profitability and extended accumulation rate). This handicap is also reflected in gross financial profitability, whether one looks at this before or after dividend distribution. Conversely, the difference vanishes when net figures are considered.

The difference in economic and financial profiles according the size of the firm and whether it has access to financial markets could confirm the existence of a behavioural discontinuity related to the methods of financing available. Given this, which is most similar to a listed small manufacturing firm, another small manufacturing firm or a large company?

	Small manufacturing firms		Large companies	
	Unlisted	Listed	Unlisted	Listed
Value added to invested capital	**66.5**	**40.5**	**48.0**	**34.1**
Overall cash flow to value added	21.9	21.4	**23.5**	**32.0**
Gross economic profitability	**12.5**	**9.1**	10.3	11.2
Gross financial profitability	**11.7**	**7.6**	9.7	9.5
Total debt to invested capital	**22.6**	**18.4**	12.6	14.1
Source and table: Banque de France *Observatoire des Entreprises* - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97				

Bold figures indicate statistically observable differences at a threshold of 5%.

The contrast is sharp between small manufacturing firms that are unlisted and the other companies which are listed, whether or not they are bigger or smaller. Notably, a small manufacturing firm, especially if it is listed, creates more wealth per unit of invested capital than large or listed companies. Where the other indicators of profitability and yield on shareholders' equity are concerned, the differences are not significant.

The OFEM studies (1993 to 1996) reveal the remarkable capacity for adaptation to recession demonstrated by three-quarters of the listed SMEs. The years 1992-1993 were difficult (turnover

6 Economic profitability: overall cash flow + extraordinary income/expense / capital employed.
Financial profitability = self-financing capacity / internal financing.
Overall balance = Economic profitability - extended accumulation rate (total investment + variation of working capital requirements / invested capital).

shrank by a median value of – 1.7% and investment fell by 18%). This took company managers by surprise, and low growth combined with shrinking margins were the result. However, by 1994 they had already got a grip on the situation. From 1994 on, one can observe growth in turnover (median rate 5.9%), and investment (median rate + 7,1%) directed largely at productivity. This is reflected in an improvement in manufacturing profitability of 16.6% (median). However, financial profitability does not keep pace with this: its median increase in the OFEM sample is 10.1%. This phenomenon has occurred in the context of financial structures with less debt and a different accumulation strategy. It is thus apparent than even if their market valuation is strong, SMEs do not invariably seek to enhance the yield on shareholders' equity, as the large listed companies seem to do. The explanation for this may be that the shares are still held, directly or indirectly, by a group of people largely limited to the owners of the company, who are less interested in short-term increases in value. The ratio of distributed earnings to self-financing capacity is higher in the case of listed companies than in that of the others, and the same is true of yield on equity, which is more frequently at a high level. This is even more true of large listed companies than for small. In the case of the latter, there is no dividend policy as such — dividends are determined largely by their nominal level the year before. The managers of listed SMEs prefer to build up reserves rather than conduct a policy of proactive distribution of earnings, although they do all admit the necessity of paying dividends when the company is listed (Belletante, 1995 ; Belletante *et al.*, 1994 to 1996).

3. CAPITAL STRUCTURE

As is logical, the ratios of internal financing[7], as well as shareholders' equity, to invested capital[8] are higher in listed companies than for other firms (78.9% compared with 73%, and 40% compared with 31,5%), no matter what the size of the quoted company. It is therefore clear that the quotation of the company on a stock market is a factor which increases self-financing capacity, whether or not the company is a large one. Conversely, only at a level of significance of 10% does any difference become discernible for the ratio net increase in capital to invested capital, even if this is more frequently true in listed than in unlisted companies (57.7% of cases compared with 49.9%). The OFEM studies have also shown that the level of internal financing tends to increase along with the length of time that the company has been listed. This is due more to the allocation of earnings to reserves than to the use of the market to obtain capital. Indeed, the management of listed SMEs express genuine hesitation at the idea of increasing share capital, thus confirming the "pecking order" theory (Myers, 1984; Belletante *et al.*, 1994 to 1996). The studies undertaken show quite clearly that going to the market for extra share capital is the very last solution to be considered by the managers of listed SMEs (even if it is a solution they use with greater facility than the managers of unlisted SMEs), and this despite the fact that they believe it to be a less costly source than loans! This ambiguous attitude on the part of SME management can be explained as follows:

– only the cost of the operation is perceived and there is a feeling that it is technically difficult to raise capital on the market,

– dividends paid out are perceived as the only yield on equity,

– reference to remuneration offered by no-risk assets on financial markets is not considered,

– the fear of dilution of power predominates over objective reasoning.

METHODS OF FINANCING %

Companies	Unlisted	Listed	All

7 Internal finance: share capital + internal financial reserves (depreciation and provisions in accounts).
8 Invested capital = Internal finance + financial debt (including leasing agreements).

Internal financing to invested capital	**73.0**	**79.0**	73.1
Shareholders' equity to invested capital	**31.5**	**40.0**	31.6
Net increase in capital to invested capital	0.4 * **(49.9)**	0.8 **(57.7)**	0.4
Group and shareholder loans to invested capital	4.9	4.3	4.9
Bank loans to invested capital	**10.9**	**7.4**	10.9
Equity interests to invested capital	**2.4**	**15.1**	2.6
Tangible fixed assets to invested capital	**55.2**	**43.2**	55.0
Working capital requirement to invested capital	27.6	25.8	27.6
Investment securities and cash in hand to invested capital	13.9	14.6	14.0
Total debt - leasing arrangements to invested capital	**18.2**	**15.2**	18.1
Bonds and equity securities to total debt	**0.5**	**5.7**	0.5
Equity loans to total debt	**0.4**	**0.9**	0.4
Other loans to total debt	**10.9**	**17.9**	11.0
Bank loans to total debt	**52.2**	**39.3**	52.0
Short-term bank borrowing to total debt	32.9	34.1	32.9
Commercial paper to total debt	**0.1**	**0.6**	0.1
Leasing to total debt	**16.9**	**8.2**	16.8
Discounting to total debt	**13.5**	**8.5**	13.4
Debt to invested capital	**22.2**	**16.7**	22.1

Source and table: Banque de France
Observatoire des Entreprises - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97

(*) Significant at a threshold of 10% and, in brackets, significant frequency at 5% (percentage of companies for which the ratio is higher than the median for the sample as a whole).

Bold figures indicate statistically observable differences.

There are fairly distinct differences in asset structures. For example, the ratio of equity interests to invested capital is higher and the percentage share of plant and equipment is lower in listed companies. Conversely, there does not appear to be any significant difference in the ratios to invested capital of investment securities plus cash in hand or working capital requirement, which reflects constraints related more to the business than to the financial structure in the management of the operating cycle (see above).

	Small Manufacturing Firms		Large Companies	
	Unlisted	Listed	Unlisted	Listed
Internal financing to invested capital	**72.7**	**77.3**	80.4	81.6
Equity interest to invested capital	**2.1**	**10.6**	**8.5**	**22.4**
Working capital requirement to invested capital	27.8	29.3	22.7	20.3
Bank loans to invested capital	**11.2**	**8.5**	4.6	5.6
Net increase in capital to invested capital	0.35 **(50.0)**	0.14 **(53.3)**	**0.7**	**1.8**

Source and table: Banque de France
Observatoire des Entreprises - Tel.: 33+ (0)1.42.92.56.58 Last update 11/97

While market listing does not compromise jobs, it may on the other hand orient investment policy toward financial growth, and this would be even truer of big companies than small.

Debt levels[9] are higher in unlisted than in listed companies only from 1994 onwards for companies present since 1989. In 1996, the structure of financial debt differed between the various categories of company. For example, the percentage of bonds and equity securities is higher when the company is listed (5.7% of total debt compared with 0.5%), as is that for equity loans (0.9% against 0.4%), and other loans (17.9% compared with 10.9%) while the percentage share of bank borrowing is lower (39.3% against 52.2%). In fact, use of the stock market makes it possible to reduce intermediation, although the share of short-term bank

9 Including leasing agreements.

borrowing is similar from one category to another. It should however be noted, firstly, that there is greater use of other sources of finance, such as leasing and discounting, in unlisted than in listed companies (respectively 13.5% and 16.9% of debt compared with 8.5% and 8.2%), and, secondly, group and shareholder loans are at similar levels for both listed and unlisted firms.

This difference between listed and unlisted companies is brought into sharper focus when the data are analysed by corporate size. Listed SMEs use the market very rarely to increase medium and long term debt (bond issues), and virtually never for short term debt (commercial paper). This very limited use of market funding by French listed SMEs cannot be explained solely by the tendency to reduce debt which has existed since 1992 (median debt level in 1992: 68.5%; median debt level in 1996: 49%). The other reasons relate firstly to the unsuitability of the legal and procedural parameters for the issuing of bonds by SMEs; the organisational constraints and fixed costs associated with such operations are too high for the funding requirements of firms of low to medium size and capitalisation. It is very clear according to French experience of the flotation of SMEs that the ways in which markets operate need to be adapted to the economic realities of small to medium enterprises. Secondly, the rarity of use of the market to raise capital (less than one listed SME out of every 10 in the OFEM sample) can also be explained by total ignorance of how this type of market operates on the part of the managers of listed SMEs. There is here an evident lack of expertise, and the managers concerned often criticise their bankers or stockbrokers, maintaining that while they had provided effective assistance for the initial flotation, they had left the company to its own devices afterwards (Belletante, Desroches, 1993; Belletante *et al.*, 1994 to 1996). It is apparent to us that the conclusion to be drawn from this is that if SMEs are to derive benefit from financial markets and if they are to enjoy financial structures identical to those of large listed companies, more is needed than simply to facilitate their access to the markets. Despite facilities of access, the "knowledge gap" (Tamari, 1980; Belletante, Levratto, 1996) remains. It is the task of those responsible for stock markets and the financial partners of SMEs to help the latter narrow that gap.

This difference in structure is underscored by mobilisation.

CONCLUSION

While the contrasts between companies sorted by size do not completely align with the difference between listed and unlisted companies, there are common denominators to be seen between SMEs and unlisted companies. Specifically, the accumulation rate is higher and external growth lesser, while debt levels are higher, as are economic profitability and gross financial profitability. Listed SMEs stand on the borderline between the two behavioural categories. Although they are present on the stock market, they do not make optimal use of it, due to:

– lack of knowledge of the ways in which the markets operate, and a perception that the costs and practical constraints are too burdensome,

– lack of independence between the receipt of financial resources and their employment: extra funding become available only in conjunction with investment projects,

– the lack of optimal valuation for shareholders' equity because of the absence of use of leverage effects and unimaginative dividend policy.

All the above points underscore the observation that there exists a particular logic related to corporate size and the nature of the relationship with the financial markets corresponding to specific approaches to development and, by extension, management. Access to the stock market entails changes in corporate behaviour which must harmonise with the company's strategy and its capital requirements. Contracting debt or raising capital directly on the stock market thus relate to mutually incompatible growth choices. What in fact is important is the capacity of the company, of the SME in particular, to identify the factors promoting consistency and by extension the dangers deriving from the change in the nature of the constraints to be managed.

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