EDITORIAL INTRODUCTION:

ENTREPRENEURIAL FINANCE IN A REGIONAL ECONOMY

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Geographical considerations generally attract little consideration in studies of entrepreneurial finance. However, financial systems are inherently spatial, characterised by complex institutional geographies that both reflect and influence their functioning (Martin, 1999). Three geographical effects can be identified.

First is the effect of space. This refers to the effects of physical distance on interaction and flows. There is a cost – both financial and time – in overcoming distance. Hence, other things being equal, the interaction between places is likely to be in inverse proportion to the distance that they are apart. In the case of finance it is argued that greater geographic distance between small business borrowers and their banks will reduce in-person visits due to the high costs of travel by bank staff, particularly time costs, thereby exacerbating information asymmetries which, in turn, increases the risk of adverse selection leading to higher default rates and loan losses. The economics literature contains support for both the relationship between loan rates and distance between firm and lender (Degryse and Ongena, 2005) and between borrower-lender distance and loan default (DeYoung et al, 2008a). The use of technology-driven credit scoring techniques to make small business loans, by reducing the need for personal interaction between lender and borrower, has been associated with an increase in longer distance lending in the USA (DeYoung et al, 2008b). However, after controlling for distance effects, banks that use credit scoring techniques experience higher default rates. This may be explained by the benefits that banks derive from a high volume credit scored and securitised lending strategy (e.g. scale economies, fee generation). But it may alternatively reflect the lower amount of information collected in credit scoring processes which, in turn, leads to more loan approval errors (DeYoung et al, 2008b). In contrast, the venture capital investment process is based on the collection and analysis of significant amounts of ‘soft’ information and so is not amenable to standardisation and automation. This is reflected in the localised nature of investing by both business angels and venture capital funds (Martin et al, 2005; Mason, 2007; Cumming and Dai, 2010). This, in turn, has significant local economic benefits. For example, Samila and Sorenson (2009) find that the local supply of venture capital has positive impacts on the number of firm starts, employment and aggregate income, implying that venture capital stimulates more than just the firms that it directly funds. Zhang (2007) notes that because of the plentiful supply of venture capital firms in Silicon Valley start-ups are able to access venture capital at a younger age, giving them first mover advantage which, in turn, has positive effects on their profitability and employment and the chance of completing an IPO. Fritsch and Schilder (2008), on the other hand, argue that the importance of spatial proximity in venture capital investing, especially in comparison with other types of financiers, is over-stated. Of course, longer distance flows of venture capital do occur, but generally this involves a process of syndication with local investors. Hence, such flows tend to gravitate to regions that already have significant sources of their own (Florida and Smith, 1991; Sorensen and Stuart, 2001). Cross-regional flows of business angel finance also flow from peripheral to economic core regions (Avdeitchikova; 2009; Harrison et al, 2010).

Second are place effects. Financial institutions have their own geographies. The key contrast is between centralised and decentralised financial systems. Historically the UK was characterised by a system of strong regional banks but as a result of a remorseless process of financial centralisation during the 20th century regional and local banks have largely disappeared and the supply of finance is now provided through the branch banking systems of a small number of mainly UK-owned national and international banks. The US, in contrast, has traditionally had a local/state system of banks, partly on account of the large distances between urban centres and also because of regulations which prohibited out-of-state banking. However, the relaxation of these restrictions since the 1970s has allowed the emergence of interstate banks. A decentralised banking system is also a feature of many European countries but here again they have been transformed into centralised systems in recent decades as a result of changes in the regulatory landscape. One example that has been well documented is Italy (Alessandrini and Zazzaro, 1999), where the decline in local banks has had particularly adverse effects for the south of the country (Alessandrini et al, 2009).

Nevertheless, there continue to be significant national and sub-national differences in the composition of the financial sector, with implications for the supply of finance. Specifically, it is argued that local and regional banking systems will be more supportive of local economies because of their lower information asymmetries and as local institutions they have a vested interest in the well-being of the local/regional economy. Under centralised branch banking systems regions and localities might vary in terms of the depth of supply (number of competitors), discretion of local branches to make their own lending decisions, and experience and turnover of staff. Studies which have used measures of ‘functional’ or ‘organisational’ distance (i.e. the distance between the borrower and the bank head office) in order to compare local with non-local banks identify effects on both interest rates (Casolaro and Mistrulli 2008) and use of collateral (Jiménez et al 2009) which points to the informational advantages that local banks derive from their ability to establish close relationships with borrowers on account of their physical proximity. In the case of venture capital, its concentration in particular regions means that the business community (firms and intermediaries) in such regions will have a much greater knowledge of the role of venture capital and ways to access it, thus stimulating demand, whereas in regions with few venture capital firms knowledge is weak and incomplete, reducing demand and the prospects of success for those firms that do seek venture capital (Martin et al, 2005).

Third are flows of capital. The functioning of financial institutions involves the collecting, receiving or earning of money from all the localities and regions of a country and from other nations which is then recycled through various circuits of capital (lending, investing, trading, speculation) in different regional and international geographies. In other words, the savings of a local or regional population many be reinvested in other geographies rather than being recycled locally and for the benefit of the local economy. The pension fund industry in particular is associated with creating uneven financial geographies (Clark, 2000). In the UK the contributors to occupational pension schemes are distributed across all regions. However, the vast majority of these pension fund flows are managed and controlled from London and South East England and mostly invested in the shares of companies based in, or headquartered, in the South East, with little of the money trickling down to other regions in the form of capital investment or business expansion (Martin and Minns, 1995). Another example of this process is the UK’s Business Expansion Scheme (BES) – the predecessor of the current Enterprise Investment Scheme – which provided tax incentives to private individuals to invest in certain types of unquoted companies. This also has contrasting geographies of investors and investments, with a net inflow of investment into the South East and net outflows from every other region, reflecting the dominance of BES Fund Managers in London. Interestingly, BES Funds that were based in regional financial centres typically had mainly local investors and predominantly invested in local businesses (Mason and Harrison, 1989).

This provides the context for this special issue that comprises papers based on the financing of SMEs in Scotland. The papers are revised and reworked versions of presentations to a seminar on Scottish SMEs’ Access to Finance that was organised by the University of the West of Scotland’s Enterprise Research Centre in January 2009.

As a context for the first and second papers which focus on access to bank finance it is important to note that Scotland’s banking structure is rather different to that of the rest of the UK and as a result the supply of SME finance is distinctive (Scottish Parliament, 2010). The Royal Bank of Scotland (RBS) and Bank of Scotland (now HBOS following its merger with Halifax) which, prior to the financial crisis of 2007, were two of the largest banks in the UK (RBS was the 5th largest bank in the world), are the dominant providers of finance to SMEs in Scotland, with a combined market share of 68% (Federation of Small Business, 2009). Indeed, the overall level of market concentration in the SME finance market is even greater in Scotland than elsewhere in the UK with the top four providers of SME finance accounting for 87% of the market (Federation of Small Business, 2009). The mix of banks which serve the Scottish market is different to other parts of the UK, with some (e.g. Clydesdale Bank – owned by the National Bank of Australia) more prominent in Scotland while others (notably Lloyds-TSB and Barclays) are much less significant.

These two papers are from the same research project and complement one another. The paper by David North, Robert Baldock and Ignatius Ekanem (2010) investigates whether there is evidence of market failure in the provision of bank finance to Scottish SMEs. The paper is based on a study that was commissioned by the Scottish Government because of its concern that a significant minority of SMEs had reported problems in accessing finance in the 2005 UK-wide Annual Small Business (ASB) Survey. The North et al paper looks at the demand side, and is based on an examination of Scottish firms reporting problems in accessing finance in either the 2005 or 2006 ASB survey and supplemented by interviews with a sample of these firms in 2007. A slightly higher proportion of Scottish firms trying to access finance reported problems, compared with the UK as a whole. Nevertheless, the proportion of Scottish firms experiencing problems in accessing debt finance from banks was very small. However, interviews highlighted certain types of SMEs that had particular difficulties in accessing bank finance. These included manufacturing firms seeking funding for new product and market development or to upgrade plant and machinery (and hence seeking larger amounts of finance) and new and recent start-ups which suffered from their lack of trading record and insufficient collateral.

The second paper, by David Deakins, Geoff Whittam and Janet Wyper (2010) takes a supply side approach, looking in detail at rejected loan applications. Using verbal protocol analysis this study sought to validate a sample of loan rejection decisions. Six business proposals from Scottish firms that had been rejected by a bank were considered by an independent group of bank managers who were unaware of the original decision on the application. This revealed that lending decisions are made on the basis of financial models but with latitude for loan officers to use their discretion. Bankers would, as far as their discretion allowed, support existing businesses with which they had an existing personal relationship. However, those businesses and business owners who significantly deviated from bank norms found it much harder to get funded. Specifically, the study identified situations in which the sector (manufacturing), location (rural area) and age of the entrepreneur (young) would affect the ability of firms to raise finance.

The third paper, by Richard Harrison, Gavin Don, Keith Glancey Johnstone and Malcolm Greig (2010) switches the focus from SME loan finance to the early stage risk capital market. It is recognised that access to early stage risk capital is a key enabler and driver of business development and is of particular significance in Scotland on account of its smaller pool of growth-oriented businesses and the limited success of its indigenous technology sector. Given the challenges in obtaining comprehensive data on early stage risk capital investments, particularly by business angels, one of the key contributions of the paper is its use of a novel data source (form 88(2) from Companies House) to provide a unique insight into the composition of this market in a regional context in the period 2000-2007. The paper highlights the dichotomous nature of early stage investments and the critical importance of the business angel market. First are a very small number of venture capital-led mega deals (over £10m), mainly involving international investors. This part of the market is significant in terms of amounts invested but small in terms of investment numbers and is episodic. Second, are large numbers of smaller investments by institutions and business angels and supported in more than half of these deals by public sector co-investment funds. This segment of the market – which accounts for more than twice the amount invested by the institutional venture capital community – is growing. Moreover, these two markets are increasingly segmented, with angels, alongside co-investment funds, accounting for virtually all new investing whereas the larger venture capital funds are mainly making follow-on investments.

One of the distinctive features of the Scottish early stage risk capital market is that angels have been much more willing than in most other parts of the UK and elsewhere in Europe to invest together in organised groups rather than as solo investors or in small ad hoc groups. Angel groups (or syndicates) therefore account for a significantly higher proportion of angel investing in Scotland than elsewhere. The final paper, by Stuart Paul and Geoff Whittam (2010), is the first to explore the role of angel group ‘gatekeepers’ who manage the day-to-day operations of these organisations. In this exploratory paper based around in-depth interviews with gatekeepers the authors identify the background experience and skill sets of such individuals and scope-out their multi-faceted roles in the investment process as first point of contact for entrepreneurs seeking finance and their intermediaries, their internal role involving working with members of the group, and their deal facilitation role which involves them in all aspects of the investment process. The availability of people who are able to perform the gatekeeper function is an unrecognised barrier to increasing the supply of angel finance to meet the increased demand that has been fuelled by the withdrawal of venture capital funds from early stage investing, and reductions in bank lending.

It is not a flat world, distance is not dead, geography is not history. Location and place are not losing their relevance. Indeed, there is strong evidence to suggest that the world is likely to become more ‘spikey’ in the future. At both the global scale and within individual countries the geographical allocation of economic activity is likely to become more uneven and more differentiated (Christopherson et al, 2008). Consequently, as these papers illustrate, well-constructed local and regional studies continue to have an important place in scholarly research on entrepreneurial finance.

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