Thin markets, the finance gap and regional economic decline: Financing innovative firms in peripheral regions

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Abstract
External finance is an important factor in innovation. Yet a number of studies have suggested that innovative small and medium sized enterprises may actually find it harder to obtain finance than other firms. This is particularly problematic in peripheral regions without a critical mass of innovative firms, where there may be ‘thin-markets’ for specialised finance. This may lead to self-reinforcing problems in firm financing, as investors lack the incentives to search or evaluate opportunities in these areas and firms are less likely to seek it. This paper considers geographical variations in the demand and supply of finance for innovative firms in the UK. It uses a detailed cross-sectional survey on the finances of over 50,000 UK Small and Medium Sized Enterprises for 2011 - 2013. It investigates both the extent and type of finance for innovative firms in less developed regions, whether funders accept their applications and whether acceptance rates reflect objective criteria, such as credit scores, or simply geography. It also considers how these results differ by type of finance sought and whether the problems apply to start-ups or established firms.

Keywords: Finance; Innovation; Peripheral Regions; SMEs

JEL: M13; 031; R30; D22
1. Introduction

Finance is seen as an important input into the innovation process. Schumpeter highlighted the importance of external finance for innovative firms who require investment to create and commercialise new products and services (Schumpeter 1959). Innovative firms are particularly likely to seek growth finance, rather than working capital (Lee & Cowling, 2014). Because of the importance of innovation for economic growth, ensuring innovative firms have the external finance they need is an important objective of government policy.

Yet a number of studies have suggested that it may be harder for innovative firms to access finance than other firms (Freel, 2007; Lee & Cowling, 2014; Mazzucato, 2013; Mina, Lahr, & Hughes, 2013). This structural problem in the financial system may be the result of several factors. One is that there may be information asymmetries between the firm and provider. Alternatively, innovative business models may be complex and market-specific and require specialist (and so expensive) valuation. Erratic returns may discourage some providers from financing innovative companies (Coad & Rao 2008). And the social benefits of new innovations may exceed the benefits which accrue to the particular firm. So while innovative firms are economically important, there are concerns that they may find it harder to obtain the finance they need to grow.

These problems may be exacerbated in certain regional economies. Economic geographers have long highlighted the tendency of innovative firms to cluster in relatively dynamic regions (Storper, 2013). Similarly, the availability of finance for innovative firms may be spatially bounded (Alessandrini, Presbitero, & Zazzaro, 2009; Mason & Harrison, 2002; Özyildirim & Önder, 2008). While some bank finance is allocated by algorithm and unlikely to vary spatially, some forms of specialist finance may rely on relationships between financier and entrepreneur with regular contact between the two (Martin, et al. 2005; Martin, Sunley, & Turner, 2002; Mason & Harrison, 2003). This may mean geographical proximity is important in some lending decisions: the stereotypical Silicon Valley Venture Capitalist is said to follow a ‘one-hour-rule’ where they are unwilling to invest in a firm more than an hour’s drive away (Griffith, Yam, & Subramaniam, 2007). Innovative firms in peripheral regions may be more reliant on bank finance if more specialised forms of finance are hard to obtain.

In peripheral regions these problems – that innovative firms are important, yet require specialised finance which may be geographically limited – may exacerbate each other. First, there will be a demand side problem with fewer innovative firms in peripheral regions and fewer firms seeking finance. Second, there may be supply-side issues if providers of finance are not seeking to make investments in peripheral regions. These two effects may be linked, creating a ‘thin-market’ with too few specialist firms and specialist financiers to allow the
successful matching of innovative firm to provider of finance (Nightingale et al., 2009). In this case, finance may not simply reflect regional disparities – it may play a significant role in exacerbating them. This is particularly problematic in the case of innovative firms which are particularly important to regional growth, yet are exactly the sort of firm most likely to need specialist financing.

This paper investigates financing for innovative small and medium sized enterprise (SMEs) in peripheral regions of the UK. It uses the SME Finance Monitor (SMEFM), a large survey of Small and Medium Sized Enterprises (SME) in the UK and a series of regression models controlling for selection effects. It addresses the following research questions:

1. Are there differences in the demand for finance between non-peripheral and peripheral regions in the UK?
2. Are there differences in the supply of finance, measured through (i) acceptance rates and (ii) costs of financing, between non-peripheral and peripheral regions?
3. How do the results of (1) and (2) vary according to whether firms are innovative or not?

These questions have significant implications for government policy. Past efforts to increase the supply of specialised finance in peripheral regions have had, at best, a mixed record of success (Martin et al., 2005; Mason & Harrison, 2003; Mason & Pierrakis, 2013; Nightingale et al., 2009). More recent proposals to address perceived regional problems of access to finance have included a network of regional banks (Miliband 2013). Yet the evidence base for such interventions is currently weak.

The paper is structured as follows. Section two reviews the literature on finance for small firms in peripheral regions and develops a set of hypotheses to test. Section three describes the dataset and presents an empirical model to test the hypotheses. Section four considers demand for finance, the likelihood of firms in peripheral regions applying and the types of finance they seek. Section five considers the success of applications and whether applications are more successful now than before the crisis. Section six concludes with a discussion of the implications of the results for theory and policy.
2. Literature review

Financing small firms

Since Schumpeter highlighted the role of finance in helping firms create new products (Schumpeter 1959), researchers have considered the importance of the supply and demand of finance in enabling innovative firms (Freel, 2007; Hutton & Lee, 2012; Mazzucato, 2013; Mina et al., 2013). Research suggests three main reasons why innovative firms may find it harder to access finance than other firms (Lee & Cowling, 2014). The first is the risky nature of innovations. While some firms achieve a significant benefit from innovation, others fail to benefit to the same extent (Coad & Rao, 2008). Some financiers may be reluctant to invest in this context. Second, there may be information asymmetries between provider of finance and the firm (Mina et al. 2013). In particular, the true value of an innovative new product may not be obvious to the provider and investments may suffer from poor quality as a result or, at least, require specialist valuation. Third, innovations may be context specific and so hard to use as collateral on a loan. The result may be a “finance gap” which makes it harder for innovative small firms to access the finance they need. Yet the counter-argument is that innovative firms will be worth investing in as they will be growth oriented and may achieve rapid growth in future. If this is the case, financiers may prefer to invest in these firms.

The evidence on access to finance for innovative firms is quite mixed. Freel (2007) finds small innovative firms who apply for finance are less likely to receive it than others. Lee et al. (2014) similarly finds that innovative small and medium sized enterprises in the UK are more likely to be turned down for finance in the recession than other firms but, while this worsened in the recession, the situation improved relative to other firms. In contrast, in a comparative study of larger firms Mina et al. (2013) find innovative firms find it no harder to access finance in the UK, but actually easier in the US. Their results differ according to the measure of innovation used.

Geographical variations in the demand and supply of finance

Despite a vast literature on access to finance, it has traditionally ignored by regional economists who assumed no friction of distance between places and so no spatial variation in access to finance (Dow & Rodríguez-Fuentes, 1997). Yet, as Colin Mason argues, while geography has not been seen as particularly important for research on finance: “financial systems are inherently spatial” (Mason, 2010: 167). A number of commentators have suggested that firms outside London and the South East of England may find it harder to obtain finance and that this problem, in turn, exacerbates regional disparities (Cox and Schmueker 2013).
There are essentially two positions on the existence of regional finance gaps. The first is the view that location will not matter. In this view, technology will have rendered location unemployment. Computerised credit scoring and other automated systems may make face-to-face contact a less significant part of the financing decision. Banks see geography as less important than other characteristics such as the firm balance sheet. ‘Mundane’ finance which comes from banks is, by this view, unlikely to vary spatially. In some studies of SME finance variables for geography are also included whether in the form of geographical variables such as the number of bank branches (e.g. Alessandrini et al. 2009) or simple regional dummies (e.g. Armstrong et al. 2013). Yet these studies do not tend to show a consistent picture of geographical variation in either the demand or supply of finance.

The second position is that geography will matter for the supply of finance. Economic geographers have highlighted the potential problem of the UK’s highly spatially concentrated markets for small firm equity, and suggested that this may lead to a problem for firms seeking external finance (Klagge and Martin 2005). Some authors highlight the importance of the ‘pecking-order’ theory of finance (Klagge and Martin 2005; Mina et al. 2013). Firms will choose first to use internal finance, then debt finance and will only reluctantly use equity finance. However, innovative firms may prefer equity to debt at early stages in their development (Klagge and Martin 2005). They may thus be pushed towards bank finance even if other forms of finance are more suitable.

**Geographical variations in the supply of finance for different firm types**

However, even if widespread geographical disparities do not exist, certain types of firms may still face significant problems in accessing finance (North et al. 2013). There is a wider body of research on geographies of access to finance, but this has tended to focus on specialised forms of finance such as venture capital (Klagge and Martin 2005). In the context of technological change which makes it easier for banks to gain information on potential partners from a distance, some authors have suggested that spatial disparities may be reducing in importance. US research does find that firms further from banking provision find it harder to access finance, but that the importance of geography is reducing (Petersen and Rajan 2002). For example, start-up firms may find it hard to access finance, as might new technology-based companies or those run by disadvantaged groups. The problems faced by these specific groups may interact with geographical issues, such as lack of access to specialised finance for technology-based firms outside of London and the South East.

Moreover, the decentralising force of technological change, which will reduce geographical disparities in access to finance, needs to be balanced against the agglomeration of banking provision in particular cities or regions, which may increase disparities. Evidence for Italy
suggests that firms which are geographically further from banking provision may face greater financing constraints (Alessandrini et al. 2009). Because of this, technological change may actually increase the importance of geography for firms seeking external finance.
3. Data and methodology

Data

To investigate geographical variations in financing patterns for innovative firms I use the UK Small and Medium Sized Enterprise Finance monitor survey (UKSMEF). This is a cross sectional survey which gives comprehensive information on firms, their balance sheets and financial history, applications for finance, and the success of these applications and costs of financing. The survey had a quota for size, sector and region. Enterprises needed to have a turnover of less than £25 million, be a for-profit enterprise and not be more than 50% owned by another country. Weights are used to make the results representative of the business stock.

Defining Peripheral Regions

The UK SME Finance Monitor data includes the postcode in which the firm is located. Peripheral regions are then defined according to the regions which are subject to European regional policy. These are defined according to NUTS regions, however, and these do not perfectly overlap with postcode areas. All postcode areas which overlap with the relevant NUTS areas are used. Firms are aggregated into two groups to match EU regional policy:

1. Less developed regions – these are regions with less than 75% of the EU average GDP. The regions are Cornwall and the Isles of Scilly (postcode areas: TR, PL), West Wales and the Valleys (LL, SY, SA, LD) (note we exclude Cardiff and Newport from this definition)

2. Transition regions – these are those with GDP between 75 and 90 percent of the EU average GDP. The UK regions in this category are; Cumbria (CA, LA), Devon (EX, TQ, TA), East Yorkshire and North Lincolnshire (YO, HU), Highlands and Islands (KW, IV, PH, PA, ZE), Lancashire (LA, PR, BB, BD, FY – note exclude Manchester, Oldham, Wigan and Blackburn), Lincolnshire (LN, DN), Merseyside (L, CH, WA), Northern Ireland (BT), Shropshire and Staffordshire (ST, TR), South Yorkshire (YO, S), Tees Valley and Durham (DH, TS, DL).

For clarity of interpretation and to avoid small sample sizes both sets of regions are included in a single variable.

Defining innovative firms

Studies suggest that the success of firms in accessing finance depends on the type of innovation (Hain & Christensen, 2013). Two definitions of innovation are used here. The first
is the purest: (1) Innovation - whether they have introduced a new product or process in the past 3 years. This is similar to the measure used by Lee et al (2014) in their study of access to finance in the recession and one incorporated in the study of Mina et al. (2013). Lee et al. (2014) find evidence that innovative UK SMEs find it harder to access finance than others; Mina et al. (2013) find innovative firms no more or less able to access finance.

In addition to this basic measure of innovation, a second indicator is used in tests to capture business model or process innovations. This is whether the “Business has significantly improved an aspect of the business the past 3 years”. For brevity this variable is termed Business model innovation.

In addition, there is considerable interest in start-up firms. These are likely to face particular difficulties in the financing of their innovations. In the context that firms may be unsustainable because of a lack of access to finance, investigating the context for start-ups is the closest we can come to proxying for nascent entrepreneurship. Because of this, an additional variable is the interaction between start-ups and innovation.

Methodology

Demand for finance

I follow Mina et al. (2013) in investigating both the demand and supply of finance for innovative firms using a probit model with Heckman correction for selection effects. Our approach begins with an investigation into the demand for finance (for similar applications see Fraser 2009; Lee & Drever 2014). The basic model here is one where FIN is a measure of whether a firm applies for finance in a given period.

\[
\text{DFIN}_i = \alpha + \beta_1 \text{FIRM}_i + \beta_2 \text{FINANCE}_i + \beta_3 \text{GEOGRAPHY}_i + \beta_4 \text{WAVE}_i + \varphi + \varepsilon \quad (1)
\]

Where FIRM is a set of variables for the characteristics of the firm, such as size, sector and age. FINANCE controls for the credit score and balance sheet of the firms and whether they have had issues paying previous debt. GEOGRAPHY is one of a number of variables for the location of the firm. WAVE is a control for the survey wave in which the firm was sampled. “\( \varphi \)” is a sectoral dummy variable. The constant is “\( \alpha \)” and “\( \varepsilon \)” is the error term.

The UKSMEF has data on two sources of finance: loans and overdraft. It also gives information on discouragement, and whether firms do not apply as they believe applications will not be successful (Han, Fraser, & Storey, 2009; Kon & Storey, 2003). These three variables – applications for loans, overdrafts and discouragement – are the key measures of demand for finance.
Supply of finance

While equation 1 gives an indicator of the demand for finance, the second question is the extent to which the supply of finance differs across geographical locations. This is given as equation 2.

\[ SFIN_i = \alpha + \beta_1 \text{FIRM}_i + \beta_2 \text{FINANCE}_i + \beta_3 \text{GEOGRAPHY}_i + \beta_4 \text{WAVE}_i + \phi + \varepsilon \] 

(2)

Controls are as before. The basic indicator of supply of finance is whether firms are successful in the applications for either bank loans or overdrafts. However, the likelihood of a firm being rejected for finance is conditional on their probability of applying for it. Because of this, we estimate this model using the common Heckman selection approach (for applications see [Fraser, 2009; Lee & Drever, 2014; Mina et al., 2013]).

Control variables

A series of controls are used to account for other factors which may influence both demand and success of finance. First I consider firm size and age. Size can be measured in a number of ways, but in an effort to avoid endogeneity with loan size I use total employment. This is given in six categories: 0 employees; 1 - 9; 10-49, 50 – 99, 100 – 199 employees and 200 – 249 employees. Age is also considered. An unweighted 10 percent of the sample are ‘start-ups’ defined here as being two years old or younger. The other categories are 2 – 5 years old, 6 – 9 years, 10 – 15 years with the largest category being older than 15 years. Categories are used for two reasons: to identify potential non-linearities and to avoid collinearity with other variables.

Legal structure may determine the extent to which banks are willing to lend. I control for four types of structure: sole proprietorship, partnership, limited liability partnership and limited liability company. Note that not for profits are not included in the survey.

Finally, I include a variable for the growth ambition of the firm. Firms which aim to grow will be more likely to be applying for finance for growth, rather than working capital. They may also be more likely to be innovative.

Four variables are included for the finance of the firm. The first two are dummy variables for whether the firm has made a profit or a loss in their most recent trading period (the reference category is whether firms have broken even). A control is also used for past financial problem. This takes the value 1 if a firm has missed a loan repayment, an unauthorised overdraft, bounced cheques or used the government’s Time to Pay Scheme which is for insolvent firms.
In addition, I include a variable for the risk rating of the firm. One problem is that credit score is likely to be endogenous with the decision to apply for finance. As is now standard in the literature using these surveys, I follow authors such as Han et al. (2009) in using an instrumented credit score to address this problem. The credit score of each firm is predicted using an ordinal logit model and the base characteristics of the firm.

Two additional variables control for the firms activities. The first of these is whether a firm exports. The second is whether a firm has a business plan. Firms with business plans will be more able to access finance as this can be a requirement of some financiers. It will also signal a better-managed firm. Sector will also be important and seven dummy variables are used to control for this.

As the period in question is one in which lending to small firms fluctuated significantly, dummy variables are also included for the quarter of the survey in which the firm was sampled (e.g. Q1 2013; Q2 2014 etc). These dummy variables will account for aggregate changes in the supply of finance.

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1 Note that the first two waves (Q1 2011 and Q2 2011) are amalgamated in the data file. This small issue is unlikely to significantly affect the results.
4. Demand for finance

The first research question is whether innovative firms in peripheral regions have a lower demand for finance than firms elsewhere. Table 1 gives simple cross tabulations related to the financing variables according to whether firms are product innovators, business model innovators or start-ups. Significance tests are given in parentheses (to accommodate weights, these are the result of a probit regression with column 4 as the reference category).

*Insert table 1 around here*

Relative to normal firms (non-innovative firms in the periphery), innovative firms are more likely to apply for finance. The difference is relatively small, but statistically significant and it applies for both loans and overdrafts. “Normal” firms in peripheral regions are also particularly likely to apply for both loans and overdrafts as are innovative firms outside of peripheral regions.

The second panel gives information using a second measure of innovation: business model innovation. The results differ slightly, with business model innovators more likely to apply for both forms of external finance than other firms, but particularly so if located in peripheral regions. However, by this measure non-innovative firms in peripheral regions are not more likely to apply for loans and are only slightly more likely to apply for overdrafts (albeit significant at the 10.2 percent confidence level).

*Insert table 2 around here*

The basic regression results for these three measure of demand for finance - loan applications, overdraft applications and discouraged borrowers - are given in table 2. Models are estimated at probit regressions with weights. For each of the three dependent variables, models are first given with simple variables for peripheral firms and innovators but no controls, then with interactions between the periphery / innovation variables but no controls, and then for both basic variables and interactions but with full controls.

Considering first loan applications (columns 1 – 4), peripheral firms show a higher demand for applications of this sort. The coefficient is not large, but it is statistically significant, albeit only at the 10 percent level without controls. While in the base regressions without controls, innovative firms are more likely to apply for loans, this is largely explained by their other characteristics and when controls are included the coefficient, while positive, is not statistically significant.
Yet when interactions are included the picture is slightly different. Innovative firms outside of peripheral regions are more likely to apply for loans regardless of whether controls are used. Similarly, ‘normal’ firms in peripheral regions have higher loan application rates. But peripheral innovators are, once controlling for their other characteristics, no more or less likely to apply for loans than other firms.

Considering overdraft applications (columns 5 – 8) provides more nuance to this story. As with loans, firms in the periphery and innovative firms are more likely to apply for overdrafts than other firms – but in this case, this is regardless whether controls are used. Similarly, when considering interactions all three categories of firms, innovators in or outside of peripheral regions or firms in peripheral regions themselves, are more likely to apply for overdrafts than ‘normal’ firms. When controls are used, the size of the coefficient is for non-peripheral innovators (although the difference in magnitude is small with peripheral innovators).

The next question is the extent to which these firms are discouraged from borrowing. There is no evidence that peripherally matters here (although the size on the coefficient is large, the standard error is also high). But innovators are certainly more likely to be discouraged than other firms.

When considering interaction effects (columns 10 and 12), the results suggest peripheral innovators are more likely to be discouraged from borrowing than firms elsewhere, even when controlling for other characteristics such as their balance sheet. The same is true for innovative firms outside of peripheral areas but not firms simply in the periphery.

In short, the results show higher demand for external finance for both innovative and peripheral firms – and innovative firms in the periphery are more likely to apply for overdrafts than normal firms, although not loans once their other characteristics are considered. But innovative firms in peripheral regions are far more likely to be discouraged than other firms.
5. Rejection rates

Next I consider the extent to which firms who apply for loans or overdrafts are able to successfully obtain it. In this case, following the literature in this area rejection is defined as either firms who did not obtain a loan or those who applied but had issues in getting it (Armstrong, Davis, Liadze, & Rienzo, 2013; Fraser, 2009). The basic model is that of equation 2, estimated using a standard Heckman regression model which controls for the selection effect that certain firms are more likely to apply for finance than others. The exclusion criteria are both exporting and legal status. For each regression, the first column gives the final results the second gives the first stage selection equation.

Insert table 3 around here

Columns 1 and 2 present results for rejection for loans. They show no statistically significant relationship between loan rejection and either innovation or location in a peripheral region, even controlling for the increased likelihood of both firm types applying for finance. Note, however, that the coefficient on innovation is relatively high although so is the standard error.

In columns 4 and 5 the interaction terms are used. These again show no clear relationship between rejection and peripherality and innovation, with the exception that innovative firms in peripheral regions are more likely to be rejected for finance, even when controlling for selection and their other characteristics.

Columns 7 – 12 repeat these results for overdraft applications. In this case, innovative firms are more likely to be rejected for overdrafts even controlling for other characteristics. There is no basic relationship with peripheral firms.

When considering interactions, these results stand – firms in peripheral regions which are not innovative are no more or less likely to be rejected for overdrafts. Yet innovative firms outside of peripheral regions are more likely to find overdrafts rejected. And the coefficient on peripheral firms in innovative regions is the highest, with peripheral innovators particularly likely to be rejected for finance.

Overall, even when controlling for selection peripheral innovators are both more likely to apply for external finance and they are more likely to be rejected. Innovative firms elsewhere may also experience problems but the issues are worst for those in peripheral regions.
6. Conclusions

This paper has considered the demand and supply of finance for innovative firms and how this varies in peripheral regions versus the core. Using detailed firm-level data and econometric analysis, it has focused on the availability and supply of loans. The paper has three central findings.

First, the paper finds strong evidence of increased demand for finance for innovative firms and firms in the periphery. Both sets of firms are more likely to make applications for loans or overdrafts. Innovative firms in the periphery are particularly likely to find it difficult to apply for overdrafts, rather than loans. This may indicate a greater need for working capital rather than a greater need for productive investments. One potential explanation is that founders are less able to smooth cashflow with their own finances. Given that recent evidence suggests that the success of firms is determined in large part by the availability of personal finance to the entrepreneur (Coad, Frankish, Roberts, & Storey, 2013), this is a potentially underlooked explanation for poor regional economic performance.

Second, it finds a potential problem of discouragement amongst innovative firms in general and innovative firms in peripheral regions in particular. This discouragement is not necessarily irrational, but it does suggest the potential existence of ‘thin-markets’ where firms simply do not believe they can obtain finance and so do not seek it. The policy implications of this finding might include efforts to work with accountancy bodies to encourage entrepreneurs to seek finance even if this means helping them access sources from outside the region.

Third, it finds that innovative firms in peripheral regions are more likely to have their applications for finance rejected, even when controlling for selection effects and a wide set of firm-level variables such as credit score. This suggests that the idea that geography does not matter for firm financing is potentially mistaken. Indeed, it supports some other research in this area (Alessandrini et al., 2009; Özyildirim & Önder, 2008), but adding the nuance that it is innovative firms which are particularly effected.

Of course, there are potential methodological explanations for these results. The first is some sort of omitted variable bias and more information on balance sheets may be needed to address this problem. Alternatively, further consideration of the type of finance requested may further address this concern. The second is some sort of selection issue, with firms in peripheral areas introducing new products which are simply less commercially viable than in other areas. Regardless, it is a potentially troubling finding.
There are a number of limitations to the paper as stands. It is hard to find appropriate measures of innovation and while those used here are inclusive, they are inevitably limited and may disguise sectoral variation and hide the significance or quality of any innovation. Future work may want to address this. A second feature of the paper is that it focuses on mundane bank finance, rather than the more specialised finance such as that from venture capitalists. Other research may consider similar results with specialist financiers.
Bibliography


Tables

Table 1. Cross-tabulations: Applications by geography, firm type

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<th>% of firms:</th>
<th>Peripheral</th>
<th>Non-peripheral</th>
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<td>Innovative</td>
<td>Not innovative</td>
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<td>Applying for loans</td>
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<td>3.8</td>
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<td>Applying for overdraft</td>
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Notes: sample size 50,175. P-values in parentheses from simple probit regressions (with weights) with the reference category of column 4 – the ‘normal’ firm.
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<td>0.0754**</td>
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<td>0.155**</td>
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