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SECTION 2
CORPORATE
GOVERNANCE OF
FAMILY FIRMS



WHAT ROLE DO FINANCIAL INSTITUTIONS PLAY IN THE GROWTH
OF FAMILY FIRMS? A PUZZLE FROM THE ITALIAN MARKET

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Abstract

Through an analysis of 54 family firms, all displaying excellent growth over a 5-year period, two hypotheses have been examined concerning the role that financial institutions play in the development of this type of enterprise. The first addresses the existence of different paths for financial growth; the second centers on the presence of numerous models for relationships with financial institutions. Empirical evidence proves that family firms follow paths for financial growth and use models for their relationships with financial institutions that differ in structural terms. From these results, indications can be formulated regarding the expected effects on financial institutions and family firms. Moreover, new research streams clearly emerge which lay the groundwork for further study.

Keywords: growth, financial institutions, finance, family firms.

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Introduction

The study of methods for growth in firms seeks to discover the reasons for certain growth paths. Over the years, empirical research has shown that the internal features of firms as well as the personal traits of the entrepreneur carry significant weight. These factors are very influential, and often even decisive in business development. However, external aspects must not be neglected, such as relationships between firms and financial institutions, and the relationship the industrial world is able to create within the financial system as a whole.

Within this context, the purpose of this paper is to examine the role played by financial institutions in the growth paths of family firms, by investigating

relationships that are established between financial institutions and firms. Specifically, the objective is to test two hypotheses: the first concerns the existence of different paths of financial growth among family firms; the second explores the existence of different models for relationships between financial institutions and firms. Based on the results of this study, an assessment can be made as to whether financial institutions can be considered suppliers of tools and products, within the framework of a guided process which can be associated with a single firm, or whether the link between financial institutions and businesses may be fruit of a more complex mechanism, which is capable of integrating the characteristics of operators in the financial world with the process of growth and development within firms.

The theoretical framework

As regards the roles of financial institutions and the financial system within the context of the growth process of firms, the literature offers two proven, consolidated propositions. At the same time past studies feed into a “heretical” attitude and an underlying doubt, originating from analyses of empirical testing that do not confirm the principles of main explanatory theories. The proven, consolidated propositions refer to:

- the stream of evolutionary models
- the stream of discontinuity models

Evolutionary models endorse the idea that the true development path of the firm and its financial development path are symmetrical, and that the two are linked to the life cycle of the firm (Scott and Bruce, 1987; Jovanovic and McDonald, 1994). This interpretative framework, with particular reference to financing issues, comes to the fore the role of financial players and sources of financing, specifying that as a firm progresses toward maturity, the more extensive its group of financial institutions will be, and the more diversified its system of financing sources (Berger and Udell, 1998; Rajan and Zingales, 1998). In fact, in some hypotheses which develop these propositions, the theory is that if the firm is not able to branch out in its relationships with financial institutions, at the same time it can not diversify sources of financing; this will jeopardize its growth path and chances for development (Cabral and Mata, 2003).

Discontinuity models delve further into the evolutionist issue, proposing the theory of “normal times” and “discontinuous times” (Trento and Giacomelli 2004). The empirical study in question focuses on the coherence and effectiveness of the financial structure of firms, as well as the relationship between banks and firms, in terms of circumstances of economic stability (i.e. normal times) and periods of environmental or strategic turbulence (phases of discontinuity), resulting from the implementation of growth policies rather than internationalization.

In light of this reasoning, in times of economic stability even an unbalanced financial structure can prove effective in the development of a firm. This is due to the characteristics of indebtedness and the number of available financiers, which provide the firm with “patient” capital. These funds, though in the form of credit, have the same features as equity capital. On the other hand, during times of discontinuity, the firm’s financial structure must find stability by increasing equity capital, creating a system of relationships with a number of financial institutions, and diversifying sources of financing.

Taken together, both streams view the finance function as a key aspect of dimensional and organizational development for a firm, linking finance-related decisions with other corporate issues such as business strategy, production and commercial policies, responsibilities of specific business units,

company organization charts. Both models are also relevant to understanding the financial behavior of institutions, because each phase in a firm’s life cycle is associated with different approaches to handling relationships with the business world. Relationship banking (Bhattacharya and Thakor, 1993; Thakor, 2000; Berger and Udell, 2002) is rooted in this interpretative framework, because its objective is to become progressively integrated into the financial function of the firm, thus contributing to its development.

In empirical studies and in the real world, often experiences and behaviors come to light that can not be associated with or interpreted by traditional theoretical models. The ever increasing number of such cases has cast doubt upon the certainty of the role of finance within a firm, and its presumed ability to sustain overall development. This conclusion is not an abstract one. Rather, it is based on an evaluation of the profile of firms that reveals a clear inconsistency between the prescriptive content of financial activity and what actually happens in firms, or rather, with what takes place between firms and the world of financial institutions.

Doubts arise as to the interpretative capability of traditional models from an investigation of certain corporate situations in which a “poor” financial function is associated with “evolved” conditions in a firm.

- Excellent firms do exist that do not utilize financial institutions, or only do so in a very marginal way, particularly in terms of critical choices effecting the life of a firm (Caselli, 2001; Cole and Wolken 1995).
- Many excellent firms, or those with accelerated growth paths, show little satisfaction with financial institutions or the financial system in general (Coleman and Carsky, 1999).
- Often, along with dissatisfaction with the financial system’s offerings, there is a preference for a system of professionals and corporate “counselors” who take over the financial institution’s role of advisor (Storey, 1994; Gallo and Villaseca, 1996).
- It is not common in Italy for medium sized firms in a phase of rapid growth to opt for listing on the stock exchange, and even less so in France and Germany (Morck, Stangeland, Yeung, 2000; Sraer and Thesmar, 2004)
- On the Italian, French and German markets, several firms have grown to impressive sizes without utilizing external sources of financing, but by simply leveraging internal resources (Urban, 2003; Caselli, Di Giuli and Gatti, 2005).

The impact of these findings is felt in two ways. The first, entirely internal to the organization, involves the role of the finance department in the management and organization of the firm. The second, which has mainly external effects, casts doubt upon the model of the relationship between financial institutions and the business world. For the purposes of this paper, the second consideration warrants more

thorough investigation, since it proves to be especially worrying for financial institutions who, contrary to evolutionist assumptions, do not necessarily find a natural niche or actual market space in the complexity of corporate paths. Put another way, the relationship banking model implemented up to this point by financial institutions as a basis for contact and development strategies in relationships with firms (especially excellent firms and/or those with particularly solid growth) could be invalidated by the behaviors of entrepreneurs who do not actually follow the evolutionary path predicted by traditional models.

The sample and its use

In order to study the financial development path and relationship models of family firms with financial institutions, an ad hoc sample was compiled cross referencing aggregated data from the Banca d'Italia and AIdAF (the Italian Association of Family Firms). Within the time horizon limited to the period from 1999 to 2004, Italy counted 4257 family firms with at least 50 employees according to the data bases of the abovementioned organizations. Of these firms, 1241 showed growth in turnover exceeding 30%. Nonetheless, for the purposes of the present study, the field of investigation had to be further circumscribed so as to exclude small firms or those emerging from the start-up phase, as well as companies in which family control could be considered a debatable variable.

In terms of size, two factors were taken concurrently: the growth rate in turnover and the number of employees. Specifically, the sample used for this study included only organizations that counted more than 250 employees in 2004, and that saw an upsurge in turnover of more than 50% from 1999-2004. In applying these conditions, the number of firms in the group dropped from 1241 to 168. [footnote: This sample was utilized to conduct a broader study led by Guido Corbetta and promoted directly by AIdAF and Unicredit Banca d'Impresa S.p.A., with the aim of pinpointing dynamics of growth in family-run businesses. Research centered on governance models, activation of growth processes, profitability of initiatives, degree of internationalization, and managerial structures.] As regards the definition of family control, the study includes only firms controlled by one or more owners related to each other, in which ownership and/or management is actually held and allocated also (or only) to family members at least of the second generation. This limitation further reduced the number of family firms; in fact the group of 168 was brought down to 54, which make up the sample used in the present study.

On one hand, these criteria significantly limited the number of firms which could have been part of the study but, on the other hand, they guaranteed that two indispensable objectives were achieved in verifying the conclusions of the financial theory:

- to construct an appropriate sample for testing the validity of the evolutionary model
- to construct a sample of economic interest to financial institutions

There is both a negative and positive side to the final size of the sample. The negative aspect is that a sample so small does not ascertain whether the resources provided by institutions actually suffice in guiding family firms along their growth paths. Consequently, conclusions can not be drawn on the strategies implemented by the former or the latter. The positive aspect is that the small number of cases makes a level of analysis possible which results in a clearer focus on operative processes that may facilitate or hinder growth, with regard to the relationship between firms and financial institutions. Moreover, in light of the process applied to come up with the final 54 firms, this sample can be said to encompass excellent firms that have embarked on a solid growth path. Therefore, this group can be used as a benchmark for recognizing areas of weaknesses and/or errors committed by all the other firms that are not members of this set.

To enhance the internal consistency of the sample (i.e. its adaptability for empirical research) a series of in-depth investigations were carried out in addition to the usual quantitative analysis (based, for example, on studying balance sheets, identifying financial positions, and defining models of corporate governance). In fact, an ad hoc questionnaire was compiled to determine the mission and the role of the family in the management of the firm. Individual interviews were also conducted with owners and management in order to discover whether the decision-making process is actually shared, in other words, if there is an autonomous development model for the financial variable which the firm and its key business units had chosen and followed. [footnote: The proposed article is the outcome of developments in the study mentioned above that was coordinated by Guido Corbetta. Two main conclusions were drawn from that research: a) family firms do not necessarily need to grow in order to survive, even though increasing in size is decidedly advantageous; b) such firms can set out on lucrative growth paths and support growth processes when certain "initial conditions" are present. Based on these ideas, this article focuses on paths for financial growth followed by these family firms, and the relationships that the entrepreneurial world can establish with financial institutions. In this sense, therefore, focus on growth and evolution of the tools that are implemented might no longer represent the competitive model that characterizes the banking world.]

The empirical results and the testable hypothesis

The cases in this study show that among excellent family firms there are examples which can clearly be

associated with evolutionary logic, alongside others which display a “poor” financial function.

In the first case, distinctive features which signal the presence of evolutionary logic in the financial behavior of the 54 firms in question can be found in the following:

- 21 firms with financial structures that are highly diversified in terms of sources of financing, some of which do not come from the original family unit of the owners
- 24 firms where the finance department is totally independent of the owners and other business units and has an influential voice in corporate decisions
- 21 firms where the relationship with banks and the financial system is a professional one, in which the firm identifies operators that can come up with the most suitable technical solutions to satisfy specific corporate needs
- at least 27 firms which implement financial tools which serve to develop a growth path or manage structural discontinuity

Vice versa, factors that may indicate a poor financial function, even among excellent family firms, can be found in the following:

- 48 firms where the structure of financing sources mainly revolves around short term credit, internal financing, and equity collected from members of the owner family
- 30 firms where the finance department’s setup and positioning within the corporate organizational structure seem marginal, and serve as support for management
- 33 firms where the relationship with banks providing financial backing appears to be a traditional one, where there is a group of important, stable operators, along with a set of readily substituted operators with marginal quotas
- 24 firms where the relationship with the financial system is founded on an implicit pact of stability and non-interference between the firm and the banks, with financing oriented toward bank loans.

Due to the concurrent presence of a large number of factors, a dual interpretation of the financial behavior of firms is possible. For this reason, research was taken one step further to offer a more effective explanatory framework than the current theoretical positions on the contribution of financial institutions and the financial system to the development of firms. Specifically, two hypotheses can be put forth which are the subject of the investigations presented in this article.

Hypothesis 1. Family firms grow along two different financial paths: one based on the use of external financial sources and the support of financial institutions, and the other based on the use of internal financial sources and limited involvement of financial institutions.

Hypothesis 2. There is no single model of the relationship between firms and financial institutions that guarantees growth; instead, several options are available. A firm that grows is one that is able to

choose the option which is most suited to its particular characteristics.

Discussion of Hypothesis 1

According to this first hypothesis, there are two structurally different growth paths for firms which imply different underlying attitudes in terms of financial behavior. Specifically, one may find:

- a “finance based” growth path
- a “firm based” growth path

A distinction between the two can be drawn on the basis of two parameters: the amount of resources provided by financial institutions, and their degree of involvement in the financial function of the organization. The finance based path, therefore, would typically involve financial institutions contributing significant resources and participating actively in the finance function. With the firm based path, on the other hand, one would find limited resources and little involvement from financial institutions.

Since the two parameters are difficult to monitor in the real corporate world, alternative indicators must be used that can measure them.

Specifically, the provision of resources by financial institutions in quantitative terms is assessed by using the ratio of internal financing to fixed investments as the proxy measurement. Instead, seven qualitative proxies are used to determine the level of involvement of financial institutions in the finance function of an organization: type of activity with financial institutions, degree of international diversification in the relationship with financial institutions, the presence of a financial director in the firm, status as a listed/unlisted company, model for financial development stated and actually utilized, involvement of financial institutions in the governance of the firm, financial institutions’ useful contribution of financial competencies to the firm.

As regards the ratio of internal financing to fixed investments, the average balance sheet figure from 1999-2004 was used in order to arrive at a measure of the need for external financing, independent of specific contingent conditions (like an investment made in a particular year). Hence, a low indicator is proof of a high positive need for external financing; vice versa, a high value underscores the firm’s self-sufficiency in shouldering its investments.

The survey of the seven qualitative proxies, on the contrary, required major intervention in the form of two phases of interviews. The first involved defining the single options to link to each proxy, delineated on a scale of 1-10 (1 corresponding to a minimal degree of involvement of financial institutions). The second, more in-depth phase examined the degree of accuracy with which each response was chosen by the firm in question, to confirm the value indicated in the survey. [footnote: Qualitative data was collected by means of an ad hoc questionnaire given to all 54 firms in the sample, and

through a series of individual interviews with owners, general managers, and financial directors (if such personnel were present) in the firms. This process was feasible because of the limited number of firms, which allowed researchers to conduct an extremely in-depth study of each family firm in question.]

The options drawn up for the seven proxies refer to the following:

p1= type of activity carried out with financial institutions: from exclusively loans (1) to diversified activity based on several options for business financing (10)

p2= degree of international diversification in the relationship with financial institutions: relationships with only Italian institutions (1), diversified relationships with both Italian and foreign institutions (10)

p3= presence of a financial director in the firm: not present (1), present with considerable autonomy and decision-making input (10)

p4= presence on the financial market: the firm does not participate (1), the firm participates and is listed (10)

p5= the financial development model that is stated and actually utilized by the firm: centered on loans (1), diversified over the entire range of financing operations (10)

p6= involvement of financial institutions in firm governance: no participation (1), substantial level of participation (10)

p7= useful contribution of competencies by financial institutions: no transfer of financial competencies to the firm (1), transfer of significant competencies (10)

Successively, the accuracy of responses given on a scale of 1 to 10 was verified for each of the seven proxies by means of in-depth interviews to fully elucidate the reasons for the preferences indicated.

Data on the ratio of internal financing to investments led to a classification of the 54 firms, from the highest figure (172.72%) to the lowest (46.70%). As regards the results which emerged from the seven proxies, first an average score was calculated for each firm from the interviews. Then, the 54 firms were reclassified on a scale of 1 to 10 starting with the highest number (8.86) and running to the lowest (1.140). These scores make it possible to formulate a representation of the involvement of financial institutions in the finance function of the organizations.

FIGURE 1 ABOUT HERE

Generally speaking, the combined use of quantitative and qualitative proxies allows a clear distinction to be made between two specific groups of business organizations: 30 have a finance based profile, i.e. financial institutions are very involved and contribute major financial sources; 24 have a firm based profile, i.e. there is little involvement and very limited financial contributions from institutions.

The finance based growth process

The 30 firms with a finance based growth profile show a score of the ratio between internal financing and fixed capital from 46.70% to 145.78%, and level of involvement of financial institutions from 4.29 to 8.86.

Therefore, the foundations for the finance based growth path are: sizeable financial sources in the form of debt capital and equity capital provided by the finance system and financial institutions, and their active involvement in the firm's finance function. These firms tap into external financial sources as an essential impetus to trigger and sustain growth: the ratio of internal financing to fixed investments in the 30 finance based organizations is 82.48%, compared to an overall average of 97.25%. Though the overall results are clear, due to the variety in the range of scores found in the group of 30, two distinct sub-groups can be delineated according to type of finance based growth path: proactive or static.

With the proactive path, the use of external sources of financing is based on an explicit process centered on creating value and acquiring competencies from financial institutions. This means that financing decisions are made in consideration of the firm as a whole. Furthermore, institutions, which act as counterparts, focus on providing solutions rather than individual instruments. In fact, the average score for the degree of involvement by financial institutions is 7.64, compared to an overall average of 4.81. The proactive model characterizes 18 firms, 9 of which are listed.

TABLE 1 ABOUT HERE

The following profile can be drawn from an analysis of the data that emerges from interviews and balance sheets:

- The use of internal financing is significant but not exclusive; the ratio of internal financing to fixed investments is 73.28%.
- Relationships with financial institutions are oriented toward debt capital and equity capital (average score: 7.56).
- There is a financial director with substantial autonomy in decision making (average score: 7.61).
- Relationships are established with both Italian and foreign financial institutions indiscriminately (average score: 7.72).

In addition to these factors, findings also show that typical of proactive finance based organizations is the importance placed on the financial development model that is stated and followed (average score: 8.61). Beyond orienting decisions in financial matters, this model represents an efficient tool for channeling into the firm all knowledge which derives from the firm's relationships with the outside world. In fact, the answers given by the operators in this study were unanimous in defining the actual contribution of competencies by financial institutions as "particularly

high" (average score: 7.61). Noteworthy is the fact that these aspects are not associated with the presence of a financial director, or a reference person for finance-related decisions. This provides empirical proof that a formal finance function in the firm is not necessary in order to follow a highly effective growth and development path. When the role of financial director is present in proactive finance based organizations, the primary purpose of this position seems to be that of developing diversified activities with financial institutions, as well as establishing relationships with different kinds of operators.

The average score on the firm's presence on the financial market is very high compared to the overall average (7.56 and 4.11 respectively), but the presence and performance of listed firms also impact this figure. In actual fact, subdividing proactive finance based organizations into listed and unlisted companies, the presence on the financial market of the first group is clearly much more significant (average score: 9.22); for the second group however this factor is not considered strategic or relevant to the firm's growth to the same extent (average score: 5.89).

The static path is evident when a firm taps into external resources exclusively in the form of debt capital; financial institutions make no significant contributions in terms of competencies. Moreover, there is little diversification in the process of acquiring financial services. In this case, financial institutions simply serve as service providers; the relationship is not based on sharing common work issues or on a partnership. Of the total sample of 54 firms, 12 can be counted in this group; the objective of the firm's relationship with the financial system is to satisfy the need for external financing, and very little more. In fact, the average score on the degree of involvement by financial institutions is 5.27.

The behavior that characterizes static finance based firms is the purchase of only those financial services that prove necessary to follow the development path; experimenting and planning do not enter into financial choices. The following profile can be drawn up of static finance based firms from an analysis of the qualitative and quantitative proxies:

- Use of internal financing is more prevalent than with proactive firms; the ratio of internal financing to fixed investments is 96.28%.
- None of the firms is listed.
- Financial institutions are primarily utilized to access loans (average score: 5.83).
- There is a financial director who enjoys less autonomy than in the previous case (average score: 4.67).
- Relationships with foreign financial institutions are less common (average score: 6.67).

What emerges from an analysis of qualitative proxies is that in these firms the financial development model is less important. This fact creates noteworthy repercussions both in terms of involvement of financial institutions in corporate governance, and the capacity to exploit competencies

that can be transferred during the execution of operations. For static finance based organizations, this aspect is more pronounced than in the previous case in that the three variables are closely interrelated: in firms where there is no clear cut model for financial development, financial institutions do not contribute competencies, nor do they actively intervene in the management of entrepreneurial activity. For static finance based organizations, too, the role of financial director can be found within the organizational structure. As before (but with a markedly stronger presence) this position focuses on developing diversified activities with financial institutions as well as establishing relationships with different kinds of operators. This is completely in keeping with expectations: since the financial director enjoys less autonomy in decision making, it is entirely plausible that this position does not entail strategic facets of the function in this person's charge, but only involves more operational issues that become proportionally more important.

TABLE 2 ABOUT HERE

By analyzing the data reported in Table 2, in comprehensive terms, it is apparent that proactive organizations grow more, they are on average double in size, and they show a lower ROE than static firms. On the other hand, static organizations grow at less than half the rate; they have a higher profit margin though this is associated with much higher risk, given the leverage. Both groups distinguish themselves by the fact that they are fundamentally different from the general sample.

The firm based growth process

The 24 organizations characterized by a firm based growth path show the following: a score on the ratio of internal financing to fixed capital between 101.15% and 172.72 %; a score on the level of involvement of financial institutions of 1.14 to 3.71.

The firm based growth path is based on a preference for internal sources of financing, limited or nonuse of bank loans, and selective use of financial institutions which, in any case, have little involvement in the corporate finance function. In fact, the average score on involvement of financial institutions is 2.45. The crux of growth in a firm is represented by its ability to produce an adequate amount of resources to sustain development. Very often, single corporate resources are combined with contributions from the owner family in the dual role of financier and shareholder. In this operative context, the role of financial institutions tends to be marginal, and involves occasional solutions for specific financial problems which are addressed by defining the features of an individual instrument. An analysis of the data which emerge from interviews and balance sheets has given rise to the following profile:

- The use of internal financing is much more common than in finance based organizations; the ratio of internal financing to fixed capital is 121.87%.
- None of these firms is listed; none make use of the financial market (average score 1.83).
- Financial institutions are utilized primarily for loans (average score: 2.42).
- Often there is no financial director (average score: 2.67).
- Relationships with foreign financial institutions are rare (average score: 3.67).

In financial terms, the success of the firm based growth process is based on certain specific conditions that are clearly present in the organizations in question. First, the entrepreneur has a proven ability to prevent the risk of a gap forming over time between the ability of the owner family to find competitive management solutions, and environmental dynamics. Secondly, discontinuities that may be encountered by the firm in the growth process are effectively dealt with - always within the context of the immediate family - thanks to intervention not by financial institutions, but by entrepreneurs and “third players” near to the firm.

These typical traits can also be inferred by analyzing qualitative characteristics of organizations that follow a firm based as opposed to finance based growth path. The most noticeable differences can be seen relating to two aspects: the contribution of competencies by financial institutions, and the type of activities undertaken with these institutions. Average scores for the first range as low as 1.67 to 2.42, while for the second, both reach 6.87. These results are perfectly consistent with the features of individual growth paths taken to reach a level of excellence.

In firm based organizations, a basic relationship directly links the presence of the financial director to activities undertaken with financial institutions and the degree of diversification among various operators. Moreover, when the level of international diversification in relationships with financial institutions is high, it is likely the firm has a more solid presence on the financial market.

In addition, the financial development model adopted by these firms does not represent a significant variable (average score: 3.04). At the same time, this model does not exhibit a clear link with the performance of other qualitative variables. From a managerial standpoint, this suggests that in firm based organizations the solution to issues relating to growth do not take on a typically financial significance, as would be the case in finance based organizations.

TABLE 3 ABOUT HERE

Overall, the data collected in this study indicate that firm based organizations grow less, and are smaller than other firms in the sample in terms of assets. In addition, on average these firms have a higher ROE, but bear a far higher financial risk. Comparing data on firm based organizations with results of the analysis

on proactive finance based firms, it can be noted that the former grow at a slower rate, are smaller in size, but are marked by higher profit margins and a higher level of risk. These assessments are to be inverted in the comparison between firm based and static finance based organizations, which show the weakest profile among firms in the research sample utilized in this study.

How can we explain the underlying motivations for choosing the financial growth path?

The effects of the two paths described here can be seen not only regarding financial behavior of firms and their system of relationships with the financial environment, but also on possible behaviors of the system of financial institutions. From the viewpoint of institutions, therefore, it may prove crucial to understand the reasons underlying the choice of the finance path rather than the firm path, in order to find a more precise and effective positioning for their offerings. Research and understanding of the reasons for choosing one path or the other may prove to be difficult tasks. In fact, elements of the distant past in the life of the firm must be taken into account to answer the question why a firm chooses the path it does. For this reason such a question becomes an exercise lacking any empirical correlation or reference. The search for and understanding of the reasons for an organization’s choice of growth path were specifically addressed during the interviews with firm managers. In light of the results, certain indications may be given that can provide useful clues. Modifying the approach adopted by Gompers and Lerner (1999) to pinpoint which factors explain the variation in a firm’s need for external financial sources during various stages of its life cycle, it can be stated that definitive reasons can be traced to certain features of the firm’s context. These factors, from the standpoint of financial institutions, represent premises to analyze in order to understand the structure of the relationships with the counterpart:

- the intensity of capital in the sector of membership
- the financial culture of the founder
- the integration of the entrepreneur in the local financial community
- the nature and structure of working capital

The capital intensity in the sector, in addition to being an independent explanatory factor, can be considered one of the determinants of a firm’s external financial needs, because a portion of these funds are earmarked for fixed capital investments. In fact, several studies on venture capital (Gompers and Lerner, 1999; Gompers and Lerner, 2000; Kaplan and Stromberg 2000; Simpson 2000) emphasize the fact that the capital intensity of a sector justifies a higher demand for venture capital funds and a more solid financial structure for developing an effective fundraising process. According to this interpretation,

the presence of a highly capital intensive sector combined with a constant need for external financing can explain the reasons underlying the finance based path. Given that this need represents an explanatory factor regarding growth path of a firm, and that capital intensity can be associated with investments the firm is required to make in order to grow, it follows that in this interpretative framework, the ratio of internal financing to fixed investments can be used as a proxy for gauging capital intensity. In fact, with reference to the sectors where family firms in the study operate, the greater the intensity and the call for capital, the lower the score on the indicator.

From a sector breakdown of the firms in the sample (and compatible with the number of firms), it can be noted that the average capital intensity in sectors of membership of finance based firms is higher than in sectors in which firm based organizations operate. This lends support to the hypothesis put forth by Gompers and Lerner. In fact, the average level of capital intensity in sectors of membership of firm based organizations is 95.85%, while for finance based organizations this figure is 78.51%. Moreover, to confirm this theory, a more revealing detail can be cited, inferred from the data in Table 4: sectors in which only firm based organizations operate are characterized by a ratio of internal financing to fixed investments of 102.11%, while in sectors where only finance based organizations compete this ratio drops considerably to 60.17%. Though this datum supports even more unequivocally Gompers and Lerner's assertion, it is dependent on the makeup of the sample and for this reason not as significant as the first.

TABLE 4 ABOUT HERE

The financial culture of the founder and his or her integration in the local financial community refer to internal, qualitative factors. According to Gompers and Lerner's model, if the founder has no particular connections with the financial system, or prior experience during the start up phase with participation from external investors, or much expertise in finance, rarely will the firm in question follow a finance based path. As regards the family firms in this study, these qualitative aspects seem to have less impact than what the two authors supposed, since there is no clear cut correlation between the entrepreneur's experience or background and the financial behavior of the firm. For example, as regards proactive finance based organizations, only 6 entrepreneurs out of 18 in the study have prior experience in the finance sector, or are members of the board of directors of financial institutions, or, for that matter, have free access to bank shares. It must be remembered, however, that Gompers and Lerner's study is based on the world of venture capital and not on a group of firms reaching the maturity phase, as in the research at hand.

The nature and structure of working capital might be a final distinguishing factor between a

finance based and firm based path, in that the greater structural instability of the cycle of working capital can generate a demand for financial instruments and corporate finance to alter the imbalance of various positions that impact the firm's cash flow. In this sense, the more structural the imbalance of working capital, the more likely a finance based path will be followed. As in the previous case, this factor is not born out by the 54 firms in this study.

Discussion of Hypothesis 2

The second hypothesis of this study regards the relationship established between growing firms and financial institutions. Specifically, according to this hypothesis there is no single successful relationship model, but rather a map of possible relationship options. A successful firm is able to choose the most effective model with respect to its needs and growth path.

To understand the options for relationships with the financial system, a matrix can be defined with the following classification criteria: the type of role played by the financial intermediary, and the competitive profile of this intermediary. As regards the former, institutions can serve as *general suppliers*, *specialized suppliers*, *advisors*, or *partners*. With reference to the latter, one can find *local domestic banks*, *national domestic banks*, *specialized domestic intermediaries*, and *international financial intermediaries*. Among the 54 family firms in the sample, the options most commonly found were combinations of general supplier/domestic and national bank (36 firms) and specialized suppliers/domestic bank and international intermediary (33 firms). Instead, the consultant option was utilized in 15 cases, and partners were present in 12 firms. Local domestic banks seemed to play a marginal role only as general suppliers for Italian family firms.

TABLE 5 ABOUT HERE

The General Supplier

The offering of the general supplier revolves around credit, with no particular commitment. This bank's proposal appears vague and is readily comparable to that of any number of others from competitors, which vary in size and cover different territories. In the study, as many as 36 firms use this type of supplier, which can guarantee real benefits only if certain explicit conditions exist in the firm:

- There is a linear growth path and, at the same time, no turbulence or major environmental discontinuity.
- There is an adequate grasp of relevant financing knowledge needed in order to develop activities.
- There is no need for financial products earmarked for special purposes.

Where such conditions hold true, a general supplier (i.e. a domestic bank, either local or national) efficiently serves to provide the capital needed to sustain the growth path. In addition, the availability of a large number of financiers offers the firm a block of financial sources which is entirely adequate to satisfy the need for external financing (Pozzolo, 2004).

The Specialized Supplier

The specialized supplier can be distinguished by its ability to guarantee one or more distinctive financial services. The specific features of these services are designed to fill particular financial needs, such as supporting internationalization, providing corporate finance, securing coverage against currency risks, etc. The Italian family firms in this study very often resort to this kind of supplier; in fact 39 companies state that they turn to similar intermediaries for certain operations. The following conditions would make it advantageous for a firm to utilize a specialized supplier:

- a specific financial need which can be clearly separated from the financial dynamic of investments and sources
- the impossibility of adopting self-sufficient solutions, either due to a gap in knowledge, or the unavailability of financial sources
- the importance of the specific financial need, in terms of contribution to continuity and business development
- the value of the financial instrument from a technical/specialist standpoint for meeting the firm's needs

The most complicated step for firms is finding the most suitable specialized supplier and the most appropriate timing for utilizing this intermediary. For this reason, if the criteria for choosing this supplier are linked to financial, legal or fiscal competencies, there is no specific relationship between role and type of institution. Consequently, a specialized supplier could be a local bank, a national institution, or an international bank (Boot, Milbourn and Thakor, 1998).

The Advisor

An advisor is not a clearly defined intermediary, but rather an operator who shapes the distinct nature of his or her work according to the relationship of trust and professionalism created with the customer. Among Italian family firms, this role is not very common; in fact it is only found in 15 cases, of which 12 are finance based organizations. The following conditions would make it advantageous for a firm to utilize this kind of intermediary:

- The need for consulting on legal, fiscal, or financial matters is closely related to problems of a financial nature.
- There is a sizeable gap in firm competencies.

- Consulting is required on issues which are not specific enough to justify the intervention of a specialized professional (notary public, lawyer, or accountant).

When these conditions hold true, the firm is prompted to maximize its position through the use of a financial intermediary who, along with building and supplying financial services, also has a grasp of fiscal, legal, and corporate issues as they relate to the firm. Typical examples of the role of advisor can be found particularly in the fields of corporate finance and family banking (such as setting up subsidiaries and developing corporate governance solutions). In all these contexts, the importance of advisors is not only due to the value of their products, but also the distinctive value of their intervention in relation to the entire financial system.

The partner

Partners are financial intermediaries who act as advisors in corporate financing decisions; they have a medium or long term market and contract relationship with the firm. In this sense, partners differ from specialized suppliers or advisors in terms of scope (encompassing all the financial ties between an intermediary and a firm), not because of specific knowledge or technical abilities which, in this case, are not decisive factors (Kranen, 2004; Canals, 1997). In the Italian family firms in the study, a partnership relationship is found in only 12 cases, all of which are proactive finance based organizations.

The conditions that would make this option effective in fostering growth in a firm are the following:

- the presence of an explicit project for structurally modifying the characteristics of the firm, in terms of size, market area served, or business activities
- the need for intervention on the firm's corporate governance
- the need for intervention in the relationship between the wealth of (family) owners and corporate wealth
- the need to transfer knowledge required for better corporate management

In all the circumstances cited above, opting for an intermediary other than a partner could lead to a drastic decline in the effectiveness of the firm's financial management, because no other figure can bring together specialized intervention of such a broad scope on a long term time horizon. A partnership can be built indiscriminately with a domestic or international institution; the choice depends on the range of action encompassed in the firm's strategy.

A closer look at the status of firms listed on the stock exchange

The matrix of options regarding financial institutions can be completed by adding the use of financial markets. It can be said that opting to list a firm on the

stock exchange is a viable solution only if this move can create value and support growth. In the sample of family firms in this study, the 9 listed firms give evidence of the fact that becoming a listed company is an effective development option only if certain conditions are true:

- The stock market cycle is consistent with the timing of the projects and investments of the firm.
- The firm looks to the outside for rules of governance that it is not able to produce internally.
- Listing on the stock exchange is a non-financial tool that is useful for promoting and supporting the firm's initiatives.
- The firm equates the vision of real growth with that of financial growth.
- The entrepreneur sees listing as a completely new challenge, regardless of the firm's projects.

The empirical testing conducted here confirms that becoming a listed company multiples growth and provides stability against risk (at least for entrepreneurs who have opted for this strategy). The 9 listed family firms that are part of the sample are all proactive, finance based organizations. As shown on the previous tables, they are larger in size, operate in a higher earnings bracket, and have a lower level of risk than the sample average. In addition, from the viewpoint of the qualitative proxies, listed firms typically have a stronger presence on the financial market (average score: 8.8) and a wider range of activities set up with financial institutions (average score: 7.7) compared to all other firms in the study. At the same time there is evidence of a lower provision of competencies (average score: 6.9) and less involvement in corporate governance by financial institutions (average score: 6.4).

Some critical issues for financial institutions

The different ways in which relationships with banks and financial institutions develop obliges the latter to reflect very carefully on choices to be made to enrich their contributions and to avoid investing internal resources that are not allocated for growth. One fact that clearly emerges from this study is that the system of intervention of financial institutions must be dependent on the characteristics of the growth path of the firm. Certain critical elements can be identified which may be interpreted as central issues for discussion and further managerial study. Specifically, there seem to be four aspects which financial institutions should consider if their aim is to serve family firms on a continual basis:

- the exactness of segmentation processes
- the constant search for necessary human, professional, and contractual elements in key roles
- the centrality of education processes
- the attention to and propensity for administering the financial network

Market segmentation is vital because it allows institutions to strike a balance between the

organizational structure and the characteristics of demand, as well as to create an operative link between credit policies and production and commercial decisions. For these reasons, financial institutions must avoid standard solutions which would result in a convergence of the competition on low added-value factors (De Laurentis, 2005). On the contrary, the adoption of a specific structure when dealing with one's market of reference is a potential source of competitive advantage. As an example, the decision to focus one's activities on the explicit needs of family firms can be a model for a solid market approach for a financial institution (Thakor, 2004).

The choice of market approach, taken alone, can not guarantee any competitive advantage; this is especially true in segments in which providing consulting and supplying specific services is decisive in achieving customers' goals. Logically then, the strategy of the financial intermediary must aim to find appropriate human, professional, and contractual resources for roles that shape all corporate banking activities, especially those with high value added. In addition, it is not enough for institutions to simply identify the characteristics of their customers and internal organization methods, or to create a pool of experts for single activities offered, because initial competitive advantage could dissipate quickly if it is not shored up by ongoing improvement. This observation gives rise to the third key point, i.e. the centrality of education. The cultural and professional profile of resources, in fact, is the only lever available to banks to link the variety of productive processes with the complexity of market demands (Caselli, 2005).

Lastly, the administration of the financial network constitutes the fourth criticality that affects financial institutions in the design path of corporate banking. This issue has a broader scope than the previous ones, and involves the traditional problem of the connection between the predetermined institutional model and the strategic/organizational model adopted. The presence of a financial system for family firms necessitates that new solutions be designed and administered. Such solutions should encompass methods for providing products and models for general assessment of the effects on customers, going beyond single decisions to "internalize" or "externalize" certain kinds of activities. Venture capital, for example, which represents a basic option for family firms, can clearly conflict with more banking-oriented goals. For this reason, an institution that does not question its organizational methods may find it difficult to propose. At this point, it is clear that the choice that financial institution faces does not simply entail the decision to offer one type of service as opposed to another. Instead, it encompasses the definition of an organizational framework to adopt with allows for including and excluding said services in the range of products available to a customer. In fact, to compete in the family firm segment the winning profile must

comprise an extremely extensive offering based on a policy of selective alliances and networking. Optimizing this policy means going beyond achieving the objectives relating to the single activities offered: it involves leveraging the entire value chain that links the intermediary to the firms it serves (Boot, Milbourn, and Thakor, 1998).

This new perspective obliges institutions to completely rethink the strategies they employ in dealing with family firms, because their ability to provide corporate banking services may be called into question. In other words, these services may prove inadequate with respect to their customers expectations. To avoid being crowded out by competitors, the guidelines that these players need to follow are quite clear; they encompass the entire organizational system, as well as the following strategic priorities:

- to handle the family business area and its operators like actual business units; to begin by pinpointing distinctive features, and move on to implement evaluation models for customer satisfaction
- to make provisions for ad hoc personnel, with training and incentive plans focused on the needs of family firms
- to earmark specific investments for circumstances that do not arise in other segments in which the institution competes (for example, information systems that can handle all positions of the owner family)
- to stress the logic of the network and selective agreements to expand the offer, without negative repercussions on the economic structure of the intermediary (for example, creating partnerships with consulting firms, associated offices, etc.)

In any case, this study can not provide further information for institutions on the timing and methods for implementing new strategies. The reason for this is that the demand for corporate banking services depends on the individual family firms, so there is no way to make generalizations on this issue without running the risk of finding oneself in similar circumstances to those in which the problem arose. In other words, the results of this research can raise the alarm among financial institutions, clarifying the nature of challenges that come up in relationships with family business and offering ideas on the direction to follow in terms of new relationship strategies. Nonetheless, these same findings can not quantify the scope of innovations required or, more importantly, the exact steps to be taken in order to transition from the current situation to an optimal one.

Conclusions

Utilizing data from the Banca d'Italia and AIdAF (the Association of Italian Family Firms), a sample was compiled of 54 family firms deemed excellent in terms of growth in the years 1999 to 2004. The aim was to understand the role played by financial

institutions in the development of these enterprises. Specifically the empirical analysis centered on two hypotheses: the existence of different financial growth paths for the firms in question, and the presence of different relationship models with financial institutions. The results show that both hypotheses are valid, though they can not be generalized to the entire landscape of Italian family firms.

Regarding the first hypothesis, it was noted that both "firm based" and "finance based" organizations coexist among excellent family firms. The latter group can be further subdivided in cases where the finance function is proactive to growth, and other situations where finance takes up a static position, separate from overall development path. Firm based organizations typically grow less and have more limited funds than the sample average. Moreover, they show a higher ROE but a much greater financial risk. With respect to proactive finance based firm, again slower growth rates and smaller sizes were observed, but higher levels of profit and risk were also noted. These observations were inverted in comparing firm based and static finance based organizations. In the final analysis, in fact, the latter show the weakest overall profile in the study sample. Modifying the approach adopted by Gompers and Lerner to pinpoint which factors explain the variation in a firm's need for external financial sources during various stages of its life cycle, the following conclusions can be drawn: elements such as the constant need for major external financing as well as the capital intensity in the sector of membership can explain the choice of the financial path of family firms. Instead, neither the financial culture of the founder, the integration of the entrepreneur in the surrounding financial community, nor the nature or structure of liquid assets bears any relation to financial decisions.

As far as the second hypothesis, excellent family firms were found to segment financial institutions on the basis of relationship options most suited to internal needs, regardless of the type of organization or institutional role of these counterparts. An analysis of the 54 firms in question shows that the most common options are the following combinations: general supplier/domestic bank and national bank, and specialized supplier/ domestic bank and international institution. The options of advisor or partner were utilized in a much smaller number of cases. It was also noted that local domestic banks seem to play a marginal role and, in any case, serve only as general suppliers.

This operative context can generate repercussions which affect the organizational structure of financial institutions (Stuart and Thakor, 2004) and of firms (Filbeck and Lee, 2000). Both, in fact, may be prompted to implement innovations to bring their business models into line. The belief is that the results obtained through this study can provide a useful takeoff point for future investigations into the evolution of relationship banking. In fact, the conclusions reported here could indicate either the

need for a new relationship model between banks and family firms, or more simply call for the evolution of current models toward a specialization of roles and tools. However, in order to study the direction that the market will take, first the effects of some variables must be understood which have not been analyzed in detail here. Examples are the alignment of the interests of the firms with those of financial institutions, the impact of ultra-specific needs and other advisor positions utilized in firms (e.g. notaries, lawyers, or accountants), the level of economic convenience of operations, and disclosure requirements.

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Appendices

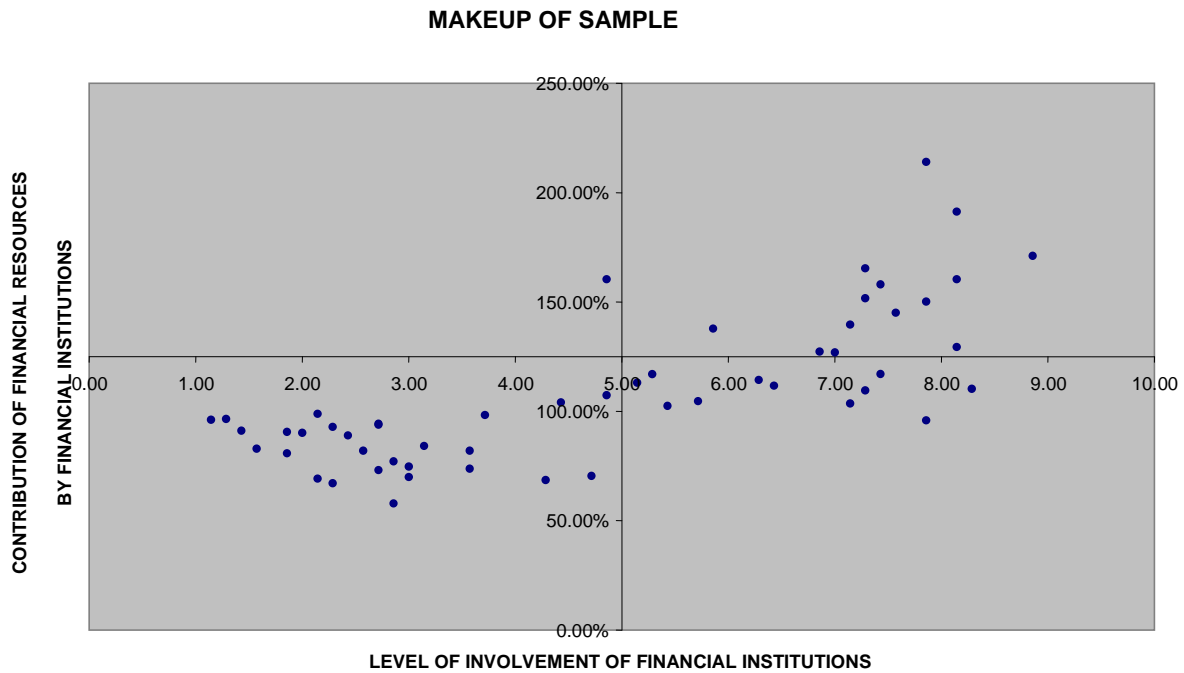


Figure 1. The profile of firms in the sample as regards size of contribution of financial sources by financial institutions and their involvement in the financial function of the firm

Table 1 Data on level of involvement of financial institutions

Type of organization	p1 = activity developed with institutions	P2 = degree of international diversification in relationship with financial institutions	p3 = in-house financial director	p4 = capital on the market	p5 = financial development model stated and utilized	p6 = involvement of financial institutions in corporate governance	p7 = constructive contribution competencies by financial institutions
PROACTIVE FINANCE BASED	7.56	7.72	7.61	7.56	8.61	6.83	7.61
STATIC FINANCE BASED	5.83	6.67	4.67	3.50	5.67	4.83	5.75
TOTAL FINANCE BASED	6.87	7.30	6.43	5.93	7.43	6.03	6.87
TOTAL FIRM BASED	2.42	3.67	2.67	1.83	3.04	1.88	1.67
SAMPLE TOTAL	4.89	5.69	4.76	4.11	5.48	4.19	4.56

Table 2 Collective financial data on finance based organizations

Type of organization	Average growth rate of earnings 1999-2004	Average ROE 1999-2004	Standard deviation of ROE	Average leverage 1999-2004	Standard deviation of leverage	Average ratio internal financing to fixed investments 1999-2004	Total assets 2004 (millions of euros)
Finance based proactive	125.50%	18.71%	0.09	0.68	0.28	73.28%	549.17
Finance based static	55.57%	20.59%	0.11	1.61	0.59	96.28%	270.50
Sample Total	91.83%	19.98%	0.09	1.09	0.42	97.25%	415.94

- The average growth rate in earnings is computed based on a percentage variation of turnover reported by each firm between 1999 and 2004. The average of the results for all firms is the figure recorded in the table.

- The averages for ROE, leverage, and ratio of internal financing to fixed investments are calculated by taking single data from each year for every firm. The average of the results for the firms in question is the figure recorded in the table.

- Standard deviations for ROE and leverage are computed by utilizing the average of aggregated data from 1999, 2000, 2001, 2002, 2003, and 2004.

- Total assets are the balance sheet value of all assets net of "adjustment" funds (e.g. sinking funds, bad debt reserves, etc.). This is the figure that appears in the firm's public documentation.

Table 3 Collective financial data of firm based organizations

Type of organization	Average growth rate in earnings 1999-2004	Average ROE 1999-2004	Standard deviation of ROE	Average leverage 1999-2004	Standard deviation of leverage	Average ratio of internal financing to fixed investments 1999-2004	Total assets 2004 (millions of euros)
Firm based	84.63%	20.64%	0.08	1.15	0.43	121.87%	388.75
Sample Total	91.83%	19.98%	0.09	1.09	0.42	97.25%	415.94

LEGEND:

- The average growth rate in earnings is computed based on a percentage variation of turnover reported by each firm between 1999 and 2004. The average of the results of all firms is the figure recorded in the table.
- The averages for ROE, leverage, and ratio of internal financing to fixed investments are calculated by taking single data from each year for every firm. The average of the results of the firms in question is the figure recorded in the table.
- Standard deviations for ROE and leverage are computed by utilizing average aggregated data from 1999, 2000, 2001, 2002, 2003, and 2004.
- Total assets are the balance sheet value of all assets net of "adjustment" funds (e.g. sinking funds, bad debt reserves, etc.). This is the figure that appears in the firm's public documentation.

Table 4 Breakdown by sector of the family firms in the sample

Sector of membership according to product/service category	Average ratio of internal financing to fixed investments 1999-2004	Firm based	Finance based	Total
HA 55 – Hotels and restaurants	146.51%	1	0	1
BA 05 – Fishing, fish farming and related services	126.59%	2	1	3
DB 18 – Sewing articles of clothing	116.73%	4	2	6
AA 02 – Forestry, utilization of forest lands and related services	106.48%	1	2	3
DB 17 – Textile industry	103.25%	3	2	5
DC 19 – Leather treatment and tanning, production of travel items, bags	102.48%	1	0	1
DN 36 – Furniture production, other industries	99.79%	2	1	3
FA 45 – Construction	96.18%	1	0	1
DA 15 – Food and beverage industry	85.64%	3	6	9
IA 60 – Transportation by land	79.38%	0	1	1
DK 29 – Production of machinery and mechanical equipment, including installation and assembly	78.56%	1	1	2
DF 23 – Coke production, petroleum refineries	63.28%	2	0	2
DJ 28 – Manufacture and processing of metal products (excluding machinery and equipment)	62.15%	0	5	5
DM 34 – Production of other means of transport	58.18%	0	2	2
DG 24 – Manufacture of chemical products and synthetic and artificial fibers	56.49%	1	4	5
DH 25 – Production of rubber items or plastics	50.43%	2	3	5
Average ratio of internal financial to fixed investments 1999-2004		95.85%	78.51%	86.22%

LEGEND:

- Sector categories and the letter/number codes that identify each one are established by the Centrale dei Bilanci, a clearinghouse for balance sheets of Italian firms.
- The average ratio of internal financing to fixed investments refers to the firms that belong to the sector. These data were compiled by recalculating the results from ISTAT (the central statistics institute) and CEBI, the computerized data bank of the Centrale dei Bilanci. The data shown in the table are simply the average of single figures from 1999 to 2004

Table 5. Map of options for firms: the role of the financial system in the development of firms in the study

Type of financial institution	Types of roles chosen by firms for financial institutions			
	General supplier	Specialized supplier	Advisor	Partner
Local domestic bank	36 firms use banks which provide generic financing (12 C, 21 B, 3 A)	No specific relationship found	No specific relationship found	No specific relationship found
National domestic bank		6 A, 3 C, 6 B	9 A, 3 B	6 A
Specialized domestic intermediary		3 A, 3 C	No specific relationship found	No specific relationship found
Specialized international intermediary	No specific relationship found	6 A, 12 B	3 A	6 A

Legend: A = finance based proactive; B = firm based; C = finance based static