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Small Business Research Summary

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Friends or Foes: The Spatial Dynamic between Established Firms and Entrants

An Office of Advocacy Working Paper
By Lawrence Plummer, University of Colorado, [35] pages. Under contract SBAHQ-06-Q-0015

Purpose

State and municipal economic development agencies are increasingly designing policies to nurture and support home-grown businesses to achieve their growth objectives.

This research explores the impact on established firms of new local entrants. It evaluates the competing views that new firms increase competition and thus hurt existing firms and, on the other hand, that new entrants provide positive spillover effects that benefit everyone, including existing firms.

Overall Findings

In the first year of a new firm's existence, before the entrant has time to contribute to positive local effects, its entry is more likely to hurt the financial performance of existing firms. By the third year after entry, however, the effect on the financial performance of existing firms is positive. In the short term, entrants are foes and in the long term, entrants are friends.

Highlights

- The average return on assets for the sampled 377 focal firms was negative during the 1990 to 2004 period. This is consistent with the belief that newly public firms often take a few years to show a positive financial return.
- In the year of local business entry, the effect on existing firms' financial performance (return on assets) was negative. One and two years following entry, the impact subsided (was not statistically significant).
- The three-year lag effect of entrants on existing firms was positive (and statistically significant). This is consistent with the belief that in the first two years or so of a firm, they produce limited positive spillover effects as they are struggling for survival, but eventually positive spillover effects occur.
- Technology-oriented existing firms are less affected by entry than are nontechnology-oriented existing firms.
- Smaller first-year local entrants cause less damage to existing firms. Existing firms' financial performance in the entrant's first year decreased as the average size of the entrant increased.
- The research points out that existing firms may want to conduct activities that nurture new entrants to improve their own future financial performance. Results suggest they would do well to befriend other firms in the immediate area.
- The control variables showed little statistical significance throughout the econometric models (this was understandable because the lag of the independent variable was used as a dependent variable to ward off spurious results).

Scope and Methodology

The research uses 377 firms that filed initial public offerings from 1990 to 1993 as the basis for existing firms and follows their financial performance from 1990 to 2004. Employer establishments entering a 75-mile radius of the 377 existing firms were considered entrants.

Econometric models were used to test the impact of various lag intervals of entrants on the return of assets for 377 firms. Control variables included a technology component (R&D expenditure), firm advertising expenditures, and the area's business environment (business size and density).

This report was developed under a contract with the Small Business Administration, Office of Advocacy, and contains information and analysis that was reviewed and edited by officials of the Office of Advocacy. However, the final conclusions of the report do not necessarily reflect the views of the Office of Advocacy.

Two side projects were also evaluated The technology component was tested to see if the technology intensity of the existing firm had an effect on its financial performance impact from entrants, and the impact of the average entrant's size on existing firms was studied.

The researcher procured special tabulations from the U.S. Census Bureau on establishment births and utilized Compustat data for financial information as the basis for data in the models.

This report was peer-reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting the Director of Economic Research via email at **advocacy@sba.gov** or (202) 205-6533.

Ordering Information

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration's Office of Advocacy are available on the Internet at **www.sba.gov/advo/research.** Copies are available for purchase from:

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