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Investment funds and portfolio of loan guarantees as financial steps proposals to support innovative Small and Medium Enterprises

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Abstract. *In order to fully beneficiate of the results of research and development innovations, young SMEs and startups need to be supported in early development stages through direct and indirect interventions. The following proposals are based on the analysis of the financial market failures and the corresponding priorities set by the Partnership Agreement signed between Romania and the European Commission, as well as the objectives of the approved operational programs related to the financial instruments financed by the European Structural Funds and Investment.*

Keywords: SME loans guarantee, SME, business accelerators, alternative finance, research development investment.

JEL Classification: D20, D24, G11, H81, O30.

Introduction

The first loan portfolio guarantee provides a cover credit risk on a case by case basis to create a portfolio of eligible transactions for SMEs. The guarantee covers the losses incurred by the financial intermediaries for each eligible SME transaction. Losses covered by warranty are those relating to a portfolio only of new SMEs eligible transactions and must not exceed in total the ceiling agreed in the guarantee agreement. The credit risk retained by the financial intermediary should be at least 20% of the loan portfolio (based on the principle *pari passu* of risk sharing with the administrator of the Guarantee Scheme). Expected and unexpected losses will be determined by the market conditions (level of bad loans, recovery rates, etc.).

The implementation of a loan portfolio guarantees for SME investing in Research – Development – Innovation

Given market assessments of credit guarantees administrated by the National Guarantee fund for SMEs Loans and the former analyzes made by Diana Soare (2015a, 2015b), we propose a conservatively leverage of 5x time that could be achieved in Romania. Leverage is a function of the rate guarantee and rate ceiling. The budget allocation is available to cover the default cover part of their portfolios; thus, the loan portfolio created is greater than the budget allocation (in this case 5 times higher). In addition, by introducing a ceiling for payment, leverage is increased, for example, the same loan portfolio is covered by the same budget allocation. Loan guarantee for financial instruments required in today's market in Romania, where SMEs are considered risky and their collaterals lost significant value due to the crisis (especially real estate collaterals). More so, for innovative SMEs, which have predominantly intangible assets (patents, software, platforms ITC) this product is highly appropriate. The tool provides better access to finance for innovative SMEs eligible by guaranteeing up to 80% of individual loans included in a portfolio (capped under a contractual agreement). It is necessary to ensure that the full benefit of the instrument will be switched to SMEs who would therefore benefit from lower prices and improved loan collateral requirements.

This proposal for a financial instrument should be complementary to other actions; Such loans covered by the tool may be used to co-finance the eligible costs of European projects funded with ESIF grants subject to the rules of cumulation of aid.

The budget allocated for loons guarantee portfolio to credit SMEs general investments could be successfully used through allocation of budgets from the National Program for Rural Development and to the National Fund or the Regional Operational Programme for SMEs Loans Guarantee, as a result of the last results in the area (Dumitrescu et al., 2014).

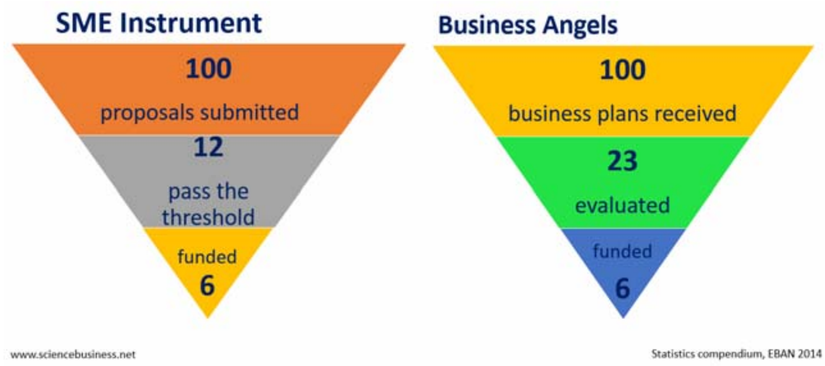
Regarding the guarantees for innovative loan portfolio, our recommendation is to opt for designating the European Investment Fund as Manager of the Fund, given the expertise that it has at European level on financing innovative SMEs. Thus, Romania may opt to transfer part of the budget from Operational Competitiveness Program to EIF for the establishment of a guarantee scheme for credit type InnovFin SME Guarantee Facility for SMEs innovative which are then allocated to Romania by Financial Intermediaries (following the example Jeremie 2007-2013). Romania also can opt for joining the SME Initiative as is the case for Spain, Malta and Bulgaria by allocating budgets from the Regional Operational Program.

Developing an investment fund for innovative SMEs in Romania

To calculate the financing deficit for private equity and venture capital in Romania we've calculated the difference between supply and demand, based on investment benchmark as a percentage of GDP compared to other countries of Central and Eastern Europe (Hungary, Poland Bulgaria and the Czech Republic). We also used a second calculation model that evaluates six major factors of attractiveness for the analyzed Investment Funds: economic activity, the depth of the capital market, taxation, investor protection and corporate governance, human environment and social and entrepreneurial culture and business opportunities.

Qualitative analysis of market risk funding from Romania presents a set of constraints that must be known to have a complete picture on the theme. Thus, as from the evaluation of entrepreneurship culture, the local culture does not encourage serial entrepreneurs. Most people who start a business do not take into account its subsequent sale. Moreover, young people with higher education tend to prefer positions in multinational corporations, which are perceived as safer. The reluctance of these potential entrepreneurs is a weakness for the Romanian entrepreneurial culture. There is also a lack of information on risk financing options that limit SMEs in terms of development through funding. It requires raising awareness among entrepreneurs on these financial instruments in order to overcome the limited knowledge on the subject.

In Romania there are not enough private investors as business angels who can provide mentoring and support to entrepreneurs in order to reach the level where they can become interesting for private investors or investment funds. Often, entrepreneurs are not aware of the potential added value of such investors and tend to overestimate the value of their business (Maxwell, Jeffrey and Levesque 2011). It is therefore necessary to support the education of entrepreneurs in the financial realm and on the rigors of business and investment. Following there is an analysis made at European level that revels the lack of financial education is one of the main factors influencing the small rate approval for financing proposals for two of the newest types of finance: Grants through Horizon 2020 SME Instrument and Private Investments through Business Angels Networks.



Source: http://www.ecsif.eu/events

From the above we can understand that there is a lack of awareness about the steps that a company must meet as soon as it becomes part of a portfolio of an investment fund. Currently there is no legal and tax structure flexibly adjusted to protect investors in the companies under early stage. Difficulties related to the protection of property rights and the implementation of corporate governance principles are the basic factors that increase the risk faced by private investors and investment funds. Romania has a low level of research – development and innovation directly related to venture capital investments, which require the creation of specific infrastructure research – development and innovation funded with public money. As for the labor market, it is too rigid, not enhancing entrepreneurship, making it harder for companies to fire employees. Market Development IPO (Initial Public Offering) is necessary because it is one of the most attractive exit routes for private investors or investment funds.

In terms of share of total capital investment in total GDP, only Bulgaria is surpassed by Romania the last being situated at half the average of the five analyzed countries. The situation is even worse when comparing investment risk because Romania shows the lowest percentage of GDP for the countries of Central and Eastern Europe. To “catch” the analyzed countries, Romania should aim to achieve at least a share of the average risk capital investments in the countries analyzed and the best way to do this is by following the example of the leader in the region, Poland, which has a capital investment of about 1 billion euros. Considering GDP in 2013 as 143 billion Euros, the average and maximum capital investment in the analyzed countries in the region, and then deducting the efficiency of investment in year by 70 million euro, the result is that the financing gap in the Private Equity and Venture capital type in Romania in 2013 was between 20 and 70 million euros. Assuming an average GDP growth of 2.5% in the coming years, the cumulative deficit financing of this type in Romania for the period of the European Multiannual Financial Framework 2014-2020 can be estimated between 150 and 500 million euros.

Compared to the above conclusions, we propose the creation of a Venture Capital Fund for innovative SMEs. The solution will be a typical structure of private capital in the form of a venture fund established through partnerships and managed by a fund manager selected and backed by a strong team of advisors (such as RDI experts for an innovation oriented fund). The fund will invest in local SMEs at an early stage or growth primarily through equity and quasi-equity.

To ensure the diversity of the portfolio, the maximum size of investment will be up to 15% of the total size of the budget for the fund. According to the rules applicable to state aid (GBER – General Block Exemption Regulation) private capital will be at least 40% contribution to a fund for SMEs. Private investors will benefit from additional revenue. Leverage (Santagada, 2012) will be achieved directly through private participation. Given the few venture capital funds in the market, the fund is expected to catalyze additional investments in the SME segment, but a solution needed to attract private capital market consists in providing incentives to private investors through a *non pari passu* treatment with regard to income distribution.

The proposed investment strategy should set a target for the final beneficiaries, leaving room for changes (e.g. classified as innovative industry sectors that can develop over time) and be sufficiently prudent when selecting financial product. Indeed, during the implementation phase, a reasonable level of flexibility can be beneficial for the actual payment of funds.

Business Accelerator support for European and global development of innovative SMEs with high growth potential

From our point of view, Business Accelerators should be seen as an ongoing combination of two modules: accelerating entrepreneurship and early stage business financing.

Acceleration phase: initial funding up to a predetermined amount selected by the financial intermediaries to support entrepreneurs (eligible SMEs) to research, assess and develop an initial concept. The first phase of the acceleration program should include trainings in financial education, entrepreneurship, marketing, innovation (Lesakova, 2013) and commercialisation and mentoring sessions with proven experienced mentors. In order to attract a critical mass of applications eligible for the funding acceleration phase, the financial intermediary should consider more competitive sessions of applications. At the closure of such procedures, the awarded

SMEs (subject to eligibility and quality assessment criteria pre-defined by the financial intermediary) could receive the initial funding.

The business financing early stage: In this stage, the financial intermediaries (i) provide further funding up to a maximum eligible cap for each SME that successfully completed the acceleration phase; and (ii) finance the eligible SMEs who didn't participated in the acceleration phase, as long as the initial concept is developed (provided that financing SMEs that only have a business plan at this stage is not permitted). Most equity at this stage should be invested in graduates of the acceleration phase. The form of support at this phase could include more in depth consultancy in access to finance, sales channels, etc.

One of the defining characteristics of Romanian market is the lack of any investment funds operating in the initial stages of a businesses. This puts Romania in direct contrast to most EU countries, and jeopardize the future development of businesses with growth potential in Romania. More, the country lags behind others in terms of RDI activities.

The Instrument provides an integrated approach to supporting start-ups and innovative SMEs through key elements to start a successful business: pre-seed financing, funding follow-on and additional business experience transmitted through trainings and mentors, bringing together competencies, internationalization, expertise and funding. Thus, deficiencies traditionally related to venture capital investment in undeveloped markets such as lack of private investors and insufficient monitoring capacity, are addressed.

The recipients of this form of support will be innovative SMEs with high growth potential. Regarding the acquired company's shares, it could be in the form of a minority stakes that can be purchased from the founders. The maximum size of investments (Soare et al., 2015) to ensure diversification of the fund should be considered (up to 15% of the size of the total budget allocated to the Fund). At least 10% should be private contribution to acceleration and pre-seed financing. The leverage will be achieved through private participation. Given that there is no such instruments in Romania is expected that the fund to provide incentives for private investors that would offset the risk of investing in such a new instrument on the Romanian market with a catalyst effect on the community of local entrepreneurs. In such a case, private investors may have priority over public investors in terms of return of invested capital and/or have a clear advantage over any other investor audience.

The Business Accelerator is a tool that can benefit most of additionality due to the fact that the local venture capital market for early stages of business development is very weak.

Because ESIF new rules envisage a combination of financial instruments and additional financial support in the form of grants, technical assistance facility could be linked to financial instruments. Because of the emphasis on the pre-seed and challenges arising from different levels of development of the entrepreneurial environment in the EU countries, technical assistance could be established for the following areas:

- Financial support for marketing activities to promote the tool for potential applicants and to create general awareness among entrepreneurs (e.g., organizing and participating in events and start-up conferences, workshops, seminars, etc.);
- Financial support for the fund manager for applicants with projects in niche segments or that presents a complex nature (e.g., medical technology and biotechnology, clean technology, engineering, IP evaluation, etc.);
- Financial support for the fund manager to coordinate the provision of additional support services (management, legal and accounting services, mentoring sessions with experts in various fields, organizing investors days, etc.);
- Financial support for risk management and compliance monitoring necessary for the implementation of the instrument;
- Support in the form of training and mentoring for entrepreneurs in finance, technology, management, marketing etc.

Private Accelerators in Romania have been already successfully undergone by several companies such as Gems Foundry and the newly launched European Accelerator programme in collaboration with European Center for Services Investments and Financing that will focus on Fintech, SmartCity and Social Innovative Businesses. The programme will have a new business model that will support innovative SMEs to access European Grants for innovation such as Horizon 2020 SME Instrument or grants from Competitiveness Operational Programme. www.ecsif.eu/events.

Conclusions

In a more global and digitalysed world economy, the innovative startups and SMEs from Romania needs and coherent strategy (Ionescu and Plesanu, 2010) to support their efforts in research development and innovation. The above measures are just a part of a package of direct and indirect actions that can be implemented in a sustainable way and that can get use of the European Structural and Investment Funds allocated for Romania for the Multiannual Financial Framework 2014-2020.

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