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A new beginning for SMEs development?

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Abstract. *In the first part of our paper we emphasize the role of SMEs in achieving sustainable economical, social and environmental goals, in both emerging and developed economies. In the second part of the paper we briefly present the macroeconomic trends and business climate for SMEs during crisis and post-crisis, while further are presented the most common conventional and alternative financing solutions for SMEs. The fifth part of the paper represents an inquiry about the government authorities' role in supporting SMEs. The paper concludes with the recent changing paradigm related to SMEs financing, from a passive intervention of authorities towards a closer approach to real economy, providing the paths towards a robust and sustainable growth.*

Keywords: financial gap, business angels, mezzanine financing, credit guarantee, SMEs, financing solutions, financial crisis, government policies, structural funds.

JEL Classification: E51, G01, G21, G23, G24, G32, G38, H81, L2.

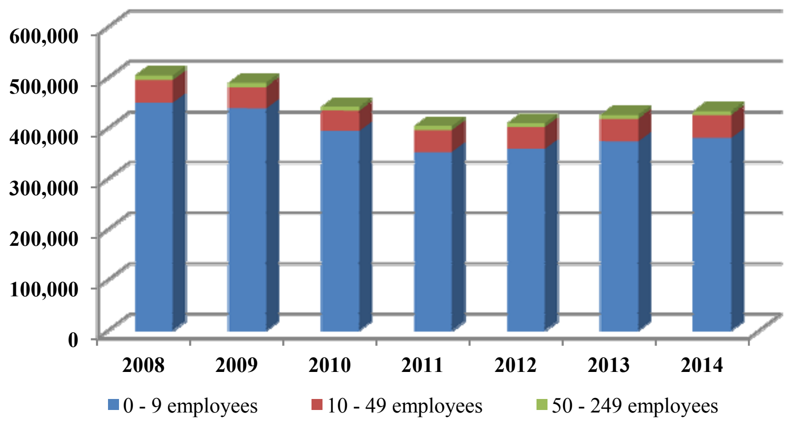
1. Introduction

Small and Medium Enterprises access to funding issue is not new, it has been a problem for long time, but it has further exacerbated nowadays, as a result of the latest financial crisis and economic downturn. It is well-known that more than 20 million European SMEs play an important role in the European economy. Besides the fact that they are major source of innovation, entrepreneurial skills and employment, SMEs provide almost 87 million jobs across the 27 member states of the European Union, representing 66.5% of all European jobs by the end of 2012 (European Commission, 2014). Micro-enterprises (almost 19 millions) have provided nearly a third of the total employment figure and generated 21% of the value added at factor costs. In Romania, more approx. 400.000 SMEs hire more than 2.5 million employees. (Figures 1-4). By the end of 2012, all EU-27 SMEs have delivered 57.6% of the gross value added generated by the private, non-financial economy in Europe. Both in emerging and developed countries, they are the most common form of business administration and lay a crucial role in the development of every national economy.

Differences among regions and countries exist, funding being not as acute in countries with solid financial systems and capital markets developed as a viable alternative. Although there is an official EU definition(1), practical definitions vary among countries and lenders, almost every bank having their own version of SMEs business segmentation according to their marketing strategies (Bădulescu, 2012: pp. 329-330).

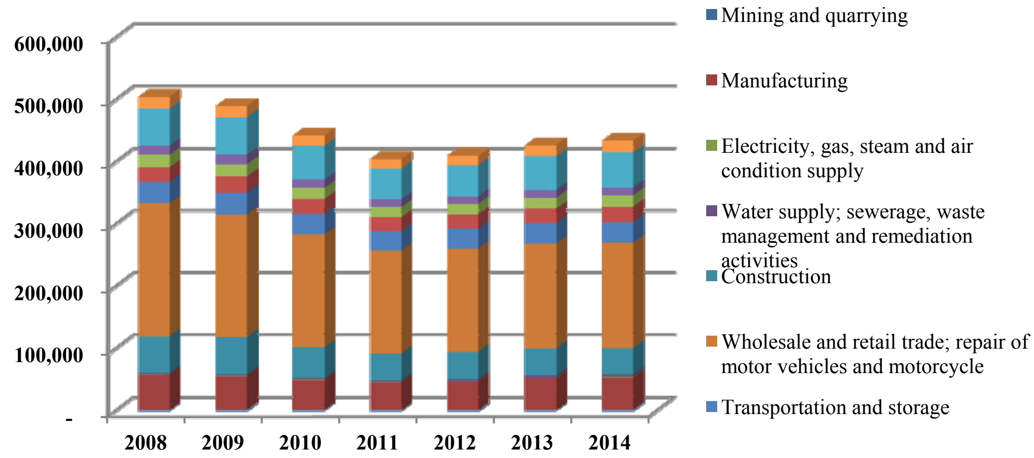
Their main competitive advantages reside in innovation, flexibility and dynamism. Although SMEs are often promoters of change, support for them is very important and when it comes to access for financing, there is still much to be done, especially for innovative SMEs. During the crisis, many SMEs have confronted severe market imperfections being forced to scale back.

Figure 1. *Romania's number of SMEs*



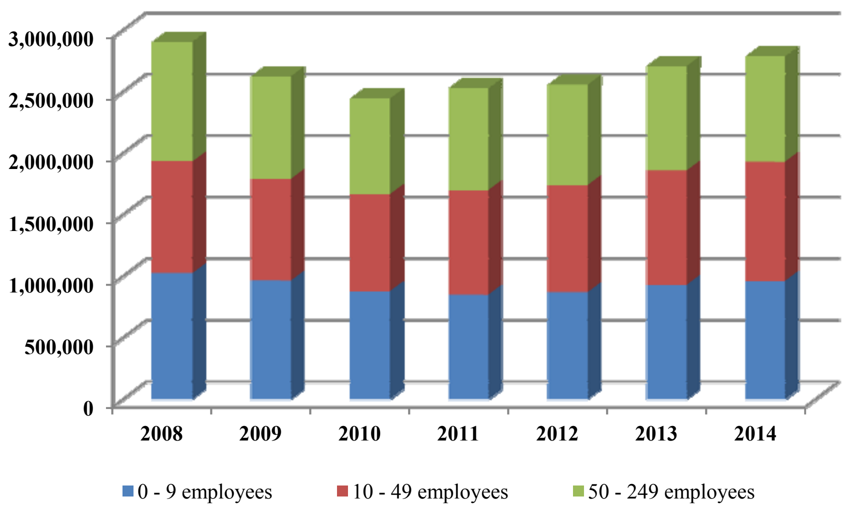
Source: European Commission, 2013-2014.

Figure 2. *Romania's number of SMEs by sectors of activity*



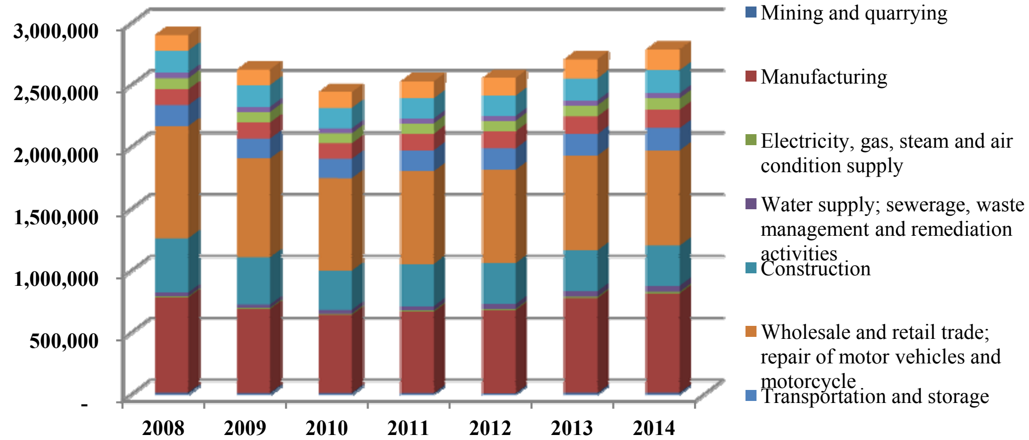
Source: European Commission, 2013-2014.

Figure 3. *Working employees within Romanian SMEs*



Source: European Commission, 2013-2014.

Figure 4. *Working employees within Romanian SMEs by sector of activity*



Source: European Commission, 2013-2014.

Although considered to be the backbone of the Romanian economy and probably the most reliable source of employment generation and economic growth, SME's had difficult struggles for filing the financing gap (Belanova, 2011: p. 326). Romania is one of the markets where banks do not have solid competitors (developed capital markets, private equity and venture capital industry). In this respect, banks prefer to lend money to government sector and larger, more predictable companies. Some other factors enhancing credit supply tightening could have been: low SME economic prospects, stagnation in interbank lending and increased funding costs. Banks have chosen to freeze lending to riskier companies, in order to preserve or strengthen capital base, triggering customer polarization.

2. Macroeconomic trends and business climate during crisis and post-crisis

The latest financial and economic crisis has hit millions of existing European SMEs from largest to smallest. Although the crisis has been felt in Romanian economy with a certain delay, the Romanian SMEs had to adapt gradually to the new circumstances by adopting austere and painful strategies, for instance: lay offing personnel and reducing wages to trim down administrative costs, production scale down due to modest demand, causing an overall below capacity resource utilization.

There are many factors to be found that have caused difficulties and even ceases among Romanian SMEs during the crisis, some of the most important factors being: tightening credit conditions (reduced credit supply, increased interest rates and harsher credit standards), depreciation of national currency, lower durable goods demand, massive public financing from private banks (Visinescu and Micuda, 2011) and fund redraws from parent companies of branches present in Romania, low rates of European funds absorption, exports decline, insufficient foreign investments in strategic sectors and industries, drastic drop in demand for goods and services due to lower real income of companies and households and nevertheless increased taxes (Negoescu and Lucacs, 2010: p. 384).

Beside the crisis context, there are many “traditional” reasons arousing difficulties for SMEs accessing funds:

- Incomplete, insufficient promoted and not tailored financial solutions for SMEs needs;
- Incomplete knowledge and promotion of alternative funding schemes: mutual funds schemes, business angels, venture capital, alternative investment markets;
- Information asymmetry and moral hazard for both lenders and entrepreneurs (Popescu, 2008: pp. 98-99): the business owners may pursue riskier strategies for higher risk adjusted returns while lenders may not consider the owner’s profitability but mostly the capability of reimbursing the loans. Informational asymmetries may trigger errors in processing credit score assessment;
- Insufficient management and technical skills, neither interest to nurture corporate governance principles;
- Greater business volatility and non-regular patterns of earnings and growth, making irrelevant business track-record and financial statement history;
- Weaker financial structure and credit rating not sufficient collateral;
- Lack of corporate governance and difficulties in dividing the business objectives from its owners;
- Difficulties in scaling back activities since they are already small and less diversified;
- High transport costs due to poor railway and highway infrastructure;
- High costs for business support services (export management, business plan elaboration, hedging currency and interest rate risks);
- Lending regulations, rigid legal and tax framework, various bureaucracy barriers affecting negatively SMEs.

SMEs impeding factors for accessing funds should not be considered in isolation but as a complexity, involving economical, financial, social and cultural aspects. The access to finance depends both on quantitative factors and qualitative, some of the qualitative factors being the quality of management/owners, business planning, culture/responsibility in developing the business, reputation of the owners and the supply of equity at all stages of business development. As well, the higher collateral is, the lower the funding costs and repayment flexibility shall be. Although the most common type of guarantee asked by banks is either mortgage or gage on financed objects, banks accept widely other types of guarantees: promissory notes, collateral deposits, pladge on shares, guarantee letters, public and private/corporate guarantees. The National Fund for Guarantees and Loans for SME’s has an important role in providing guarantees to SMEs, since the guarantees letters may cover up to 80% of the credit value, have competitive fees (as a percentage applied on the guaranteed amount) and banks prefer a mix of guarantees in order to diversify their own financial risk.

During the crisis, most of the Romanian banks have focused on anti-crisis measures like restructuring their existing portfolio rather than offering fresh funds to existing and new SMEs. Very few of them have tried to make available funds to new businesses, allowing the state and its institutions (state banks, guarantee funds) to make funds available for innovative and new SMEs. The reduction of credit supply addressed to SMEs has affected even more the Romanian SMEs because the state has borrowed money from private banks, leaving them with less money and willingness to finance the real economy. The downside evolution of the economy has influenced significantly the borrowing capacity and entrepreneur's confidence in business climate, leading to a decrease of credit demand as well (Silivestru Popescu, 2012: pp. 185-186).

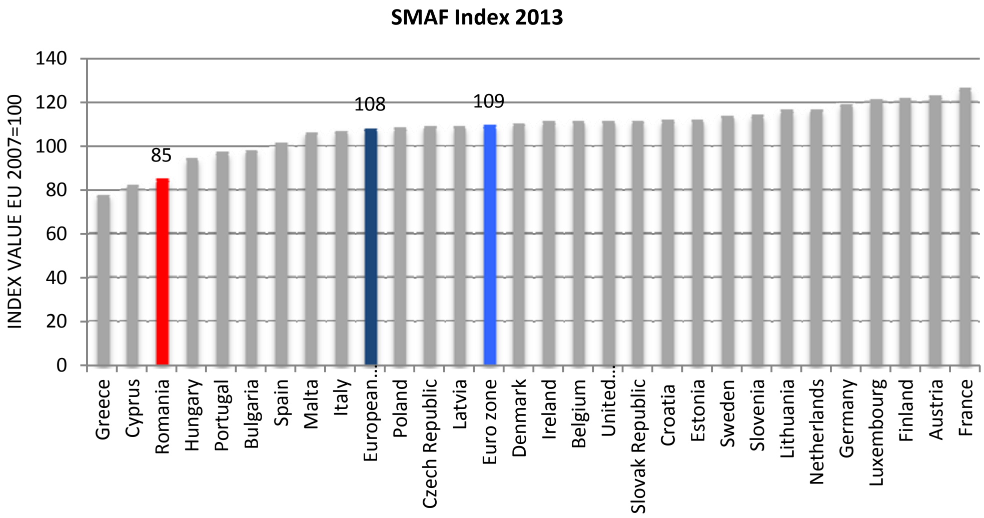
Access to financing is a key factor in the development and growth of SMEs, since affects their ability to invest in the economic re-launch after such a prolonged financial and economic crisis. Governments and central banks around the world have taken important fiscal policy and monetary loosening decisions and to prevent a dramatic fall in consumption and investment, but no particular focus with sound effects on SMEs are known. Although central banks have cut interest rates and lowered reserve ratios, in most cases the lower interbank market funding costs were not fully and automatically passed to SMEs (Gjorgieva and Jovanova, 2012). On the contrary, lenders have offered fewer loans at even higher spreads in order to consolidate their financial positions as a precaution against willful neglect and default.

So far, there has been only a slow and gradual recovery of bank lending to Romanian SMEs, depending on the expectations of the improvement in overall economy, ***SME Access to Finance Index*** confirming this point.

The European Commission developed the SME Access to Finance (SMAF) Index to monitor developments in SMEs access to financial resources and to analyze differences between EU states. The index is calculated using a baseline of 100 related to the year 2007 at the European Union level, allowing comparison between countries and across time. The base reference of 2007 deliberately provides a baseline before the onset of the financial downturn. The index comprises two main elements or sub-indices: access to debt finance (the debt finance sub-index representing 85% of the SMAF weighting) and access to equity finance.

Although the SMAF EU Index score for 2013 is 108, indicating an improvement of 8 points comparing with the score for 2007 (France, Austria and Finland being the top performers with a score over 120), Romania is among the top 3 worst performers, ahead of Greece and Cyprus. As may be seen from the Figure 5, Romania has experienced a deterioration of the access to finance index score comparing to the original situation in 2007.

Figure 5. *SMAF Index 2013*



Source: European Commission, 2013.

3. SMEs conventional financing options

SMEs have fewer financing options although they represent an important source for growth in both emerging and developed economies. Over the last decades in both business and academic media there have been many discussions about the linkage between economy growth and capital markets as an alternative way for bank lending channel. There are many studies confirming the idea that the development level of financial markets is highly correlated with the level of the country's income per capita. To what extend do SMEs use debt, equity and alternative financing, depends on many factors like entrepreneurs' culture and attitude of business, management experience, business plan and nevertheless the supply of equity at all business stages.

The most common source of funding for European SMEs represents loans obtained from commercial banks. Over the last decade, most of the banks have designed dedicated financing solutions for SMEs, covering financing needs for day to day business activities (working capital, payments of supplies and wages), funding acquisitions (real estate/ production halls, machines and equipment) and other more sophisticated funding solutions.

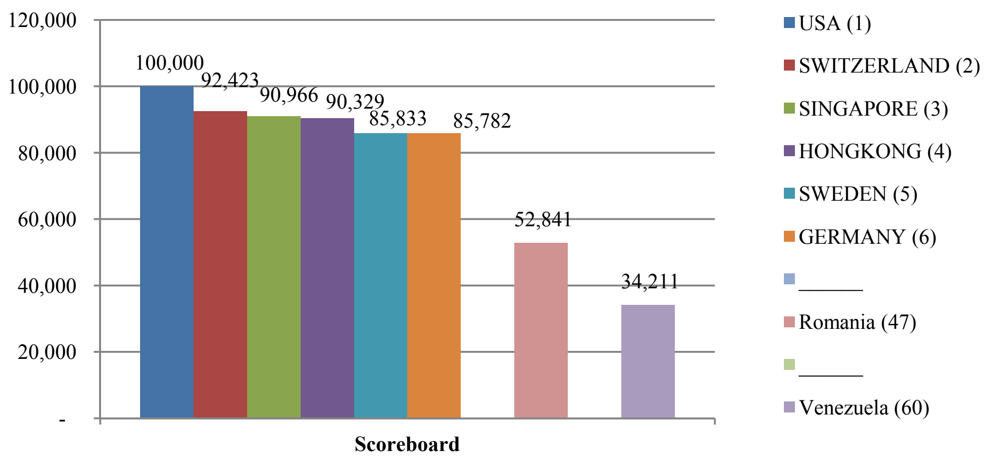
Facing with tightening credit conditions during the crisis, SME's had to explore alternative funding sources such as their own assimilated funds mobilization (owner funds, family and friends, sale of assets) and external sources, consisting of commercial paper financing (factoring, discounting, forfaiting), leasing, and raising equity, accessing grants and other risk capital sources (Daskalakis et al. 2013: pp. 97-98). Risk capital sources cover informal investments realized by business angels, venture capital and stock markets through dedicated platforms to SMEs and high growth companies (Klonowski, 2012: pp. 336).

When choosing criteria for financing, SMEs have to consider many aspects: the appropriate funding solution, the amount needed vs. fund availability, utility for accessing the money, business environment and contractual terms. They have to make their own assessment about the business opportunity and capacity for accessing and repaying the funds (eligibility conditions) and collateral needed, besides the lender's analysis.

The access to one or other funding solutions is closely related to the development stage of the enterprise. If in the pre-seed phase entrepreneurs need small amounts that may be covered from their own funds, on the early stage (start-up phase) they may need alternative funding solutions. Start-up phase is critical because it is the moment where there is most lack of funds, no bank or business angel would want to invest. Only in the first stage of development entrepreneurs may catch the attention of business angels and banks (Man and Macris, 2013: pp.312). Innovative SMEs may have even more problems. Most probably they may have negative cash-flows, new business models promoted and high initial investments needs in unconventional technologies. As business evolves, entrepreneurs gain access to tailored bank loans and alternative funds (venture capital, private equity funds private placements, mergers and listed securities).

Capital markets, venture capital and business angels are essential as an alternative way of funding to bank lending channel since banks either do not finance incipient businesses or ask for higher risk premiums, reducing business opportunities (Stancu et al., 2010, pp. 105-106). There is a considerable need for another type of relationship, personal, distinctive and genuine relationships between SMEs and banks, especially with the SMEs from areas of activity that are not the most attractive and innovative SMEs. Innovative SMEs are the ones bringing new products and services to the market, playing a crucial role in raising the region productivity and competitiveness. As may be seen from the chart no. 6, Romania ranks as the 47th most competitive economy in the world (IMD, 2014)

Figure 6. *The Word Competitiveness Scoreboard*



Source: IMD, 2014.

Lacking finance for innovative SMEs could deprive the entire economy of innovative ideas. This kind of businesses are rarely conventionally financed because they need quite big initial investments and usually have negative cash flows and new business models, representing higher risk for conventional lenders. Innovative SMEs cannot be analyzed using the same conditions applied in conventional SME funding. Moreover many banks may set certain lending ceiling depending on industry/sector depending on their global marketing strategy. Large banks focus mainly on conventional data (financial information, scorings, national databases and risk assessments provided by external credit rating agencies) and collateral rather than personal and business relationships with the SMEs owners. They cherish transactional banking rather relationship banking.

4. SMEs alternative financing options

Funding facilities are essential to expand their operations, bring new solutions and create more jobs. Although they contribute significantly to growth, they often find funding much difficult and more costly than larger enterprises. Entrepreneurs shall take account of many criteria for accepting financial help other than simple cost. They need partners having strong reputation, offering support in designing business plans on one hand and on the other hand advice, training, business connections, knowhow and knowledge transfer and microeconomic assistance to access external markets.

A new trend in funding SMEs has been patterned since more and more SMEs that are not eligible candidates to access bank loans, rely on non-traditional investors (venture capital business angels, crowd funding and alternative capital market platforms) that provide capital in return for a share in the company. Alternative finance differs at different stages of business development. The owners initially seek seed finance from family and friends, business angels and venture capitalists, latter accessing specific structural and/or government funds to finish their research and development studies.

The role of business angels is very important at the early and middle stage of small business development. Business angels are persons or groups having as usual business the activity of investing capital risk in emergent and unlisted companies. They provide financing to the initial study and concept of the business. They generally invest money based on ideas and experiences the entrepreneurs have. Although the businesses they invest are very risky, most of them may never confirm expectations, few of them that survive provide incomparable higher profits.

As business grows and reach a solid business track record, business networks, initial down payment and collateral, they may seek finance from venture capitalist and private equity funds. Venture capital is essential for the development of innovative SMEs in the face of rapid growth or expansion. Both venture capital and business angels invest for a significant return at the exit. The exit represents the point where their investment is sold via capital markets, strategic investors or private equity funds. Unfortunately during the crisis, business angels were pretty reticent as well in investing in start-ups, preferring to continue and consolidate the existing projects. Also the „usual” route preferred by the venture capital investors was difficult to be accessed without a liquid and functional capital market.

An alternative to the previous mentioned funding “sponsors” is represented by mezzanine finance - a mixture or a hybrid form of funding, between loans and owners’ equity. Mezzanine finance takes form of any subordinated debt, convertible, redeemable and preferred equity. Some companies prefer mezzanine financing, at least from the balance sheet perspective, the cost of this type of funding being lower than raising additional capital from existing investors or borrowing money from banks when loans are unavailable (Carangiu and Oltean, 2011: p. 123).

Private equity and venture capital markets have slowed down during the global economic downturn, putting pressure on prices (exit opportunities reduced) and fundraising, being specially the case of innovative SMEs and new projects investments.

5. Ways to improve SMEs access to finance

Governments worldwide play an important role in supporting innovating SMEs, particularly where conventional lenders fail to provide suitable funding support for SMEs according to their stage of development. The aim should be to ensure the efficiency of the markets (Belanova, 2011: p. 331) and to develop support schemes for private banks to assume an active role in preventing SMEs’ depletion of working capital and helping them maintain investment level towards the revival of the economy.

Government authorities, NGOs and universities should promote financial literacy among entrepreneurs and improve awareness of the many funding possibilities SMEs may have access to. It is important to be revisited as well the regulatory framework (especially for SMEs’ insolvency and reorganization) and tax systems in order to ensure a competitive, friendly and stable business environment with a low degree of bureaucracy and tax structures based more on incentives rather than obstacles.

During the crisis, the Romanian authorities have initiated some measures to support SMEs, through the financial institutions owned by the state: CEC Bank and Eximbank, providing various sources of financing as well as guarantees and counter-guarantees for existing loans granted by other banks. Public credit guarantees are among the measures most widely used and accepted in many countries, because the levels of capital requirement for a public guaranteed credit line is low, very low or even null, depending on the extent and the characteristics of the guarantee. Via guarantee funds, schemes of guarantee offered by the state banks, the authorities aim to enhance confidence of financial lenders in supporting the development of SMEs and to take over part of the risks involved directly or indirectly by the crisis.

EU community financial assistance available to Romanian SME sector represents a great opportunity to be taken by SME sector for economic recovery and it is available mainly through some of the following instruments: the European Regional Development Fund, European Social Fund and Cohesion Fund. They represent a main priority for European Commission and are meant to reduce the economic development disparities among different regions, creating new and more productive jobs, transforming less attractive regions in places for living, working and investing. EU Funds play a crucial role especially in times of economic downturn when funding is even more difficult to access. Jeremie, Jasmine and Progress represent some of the latest measures towards promoting SMEs' access to finance. Jeremie's based financing products are expected to have lower interest rates, longer loan repayment, grace periods and potentially lower collateral requirements, supporting both investment and working capital needs as well. Jasmine is an initiative which seeks to improve access to finance for small businesses and for socially excluded people, also ethnic minorities, who want to become self-employed. Progress provides microcredit to small businesses and to people who have lost their jobs and want to start their own venture.

There are a series of important steps that entrepreneurs must realize in order to get financing. Some of the most important steps relate to realizing a technical feasibility study, assess the economic benefits and costs, rates of returns, jobs and value added and both horizontal and vertical impact assessment. In order to prevent moral hazard, most of the funds require in part own contributions from the beneficiaries. Some of the most common problems identified in accessing the EU are the following: unfair practices and potential conflict of interest in awarding contracts to preferential clientele, lack of training for both entrepreneurs and institutional staff involved in the process (Beck and Demirguc 2006), lack of transparency and administrative incapacity, high fees charged by consulting firms and scarceness of co-financing funds (Marchis, 2011: pp. 448-449).

Although the range of interventions and support SMEs access to financing is non-exhaustive, the government is keen on giving a boost to all companies through various other measures:

- Reduced social insurance contributions, tax and exemptions on reinvested profits and dividends and technical unemployment;
- Export stimulating and promoting the Romanian exporters in some of the most important capitals of the world (Grecu and Cechin, 2011: pp. 59-60);
- Simplifying administrative procedures;
- Ensuring political stability and predictability of tax policies without putting SMEs at a disadvantage;
- Developing a national training program for entrepreneurs, cultivating new mentalities among population related to entrepreneurship, nurturing long term approach and unconventional financial instruments (venture capital, business angels, capital market platforms dedicated for SMEs, crowd funding);

- Developing a specialized state bank or sovereign fund (e.g. France's Strategic Investment Fund) dedicated to sustain the Romanian SMEs inside the country and abroad.

6. Conclusions

Over the last few years, we have been the witnesses of many changing paradigms related to SMEs financing. Although in theory there are a lot of financing solutions available for SMEs, practically during the crisis most of the Romanian SMEs financed their activities based on the owner's savings and very few on new bank loans and credit facilities. Even nowadays, 6 years after the bubble burst the access of Romanian SMEs to bank loans remains problematic, although there are more tailored solutions and banks accept a broader range of guarantees. This situation is mainly because banks perceive SMEs to bear more risk than larger companies, preferring to lend their money mainly to large corporates (Paulet et al., 2014).

There is a gap between the financing offer and demand. Solutions for reducing the gap may not be found without the jointly efforts of all actors: market authorities, governments, central banks, market operators, issuers and nevertheless entrepreneurs. Some steps have already been done, but there are many steps to be done in terms of creating a robust framework for SMEs financing: banks should reassesses their credit scoring models and SMEs should enhance their efforts to reduce informational asymmetries, being more transparent about their current situation and development perspectives, while authorities shall have a closer approach to the real economy, commited to provide the path towards robust and sustainable growth.

Note

(1) *"Micro, small and medium enterprises category (SME) is formed up by enterprises that employ less than 250 persons and have a net annual turnover up to 50 million euros and /or have total assets up to 43 million euros* - definition as per Article 2 of Appendix of European Commission Recommendation no. 361/2003/CE.

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