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Alternative financing of SMEs in the Baltic States: myth or reality?

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Abstract

Alternative financing for small business can help companies whose owners can't get traditional financing resources as small business loans, overdrafts and personal credit cards. New companies typically seek alternative financing when their companies have not been in business long enough to establish credit profiles with financial institutions. Access to alternative financing together with traditional financial resources represents one of the most significant challenges for new SMEs not only in the Baltic States but all over the world. Ensurance of new SMEs creation, existence and growth asks understanding of SMEs' financing needs and alternative funding is one of them. Alternative financing for the Baltic States is rather new area as a result there is luck of theoretical and empirical researches in this field. During development of the paper the generally accepted qualitative and quantitative methods of economic research were used including comparative analysis and synthesis, graphical illustration methods. The study results highlight the importance of alternative resources as external financing for small developing countries as the Baltic ones. Conducted empirical analysis confirms that SMEs' access to alternative financing in the Baltic States is improving and hopefully this market segment will be the way for the Baltic States to become innovative driven economies. ©

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Keywords: SMEs financing; access to finance; alternative finance recourses; the Baltic States.

1. Introduction

New SMEs face many difficulties accessing alternative funding and these have increased over the past five years. Banks have been less willing than normal to provide loans to new companies as a result of the financial crisis. Recent financial crises has effected availability of external financing for SMEs more dramatically than large enterprises, in the form of higher interest rates, shortened maturities and increased request for collateral. As a result

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nowadays access to finance represents one of the most significant challenges for SMEs' entrepreneurs and academics as well. In the Baltic States SMEs form the largest part of companies (about 95% of all companies), providing the majority of jobs. Nevertheless, SMEs commonly follow "niche strategies," using high product quality, flexibility, and responsiveness to customer needs as a means of competing with large-scale mass producers (see, for example, Hallberg, 2000 and Snodgrass, 1996), many researchers have highlighted the shortage of financial resources and access to finance as one of the main barriers to SMEs innovation capacity. Baltic companies find difficult to obtain commercial bank financing, especially long-term loans, for a number of reasons, including lack of collateral, difficulties in proving creditworthiness, small cash flows, inadequate credit history, high risk premiums, underdeveloped bank-borrower relationships and high transaction costs.

Over the past two decades, the Baltic exchanges have strived to address their clients' needs by employing the latest developments and innovations, and in taking the lead in reforming the securities market. This process has been accelerated by integrating with one of the world's largest exchange operator and technology supplier across six continents, NASDAQ OMX Group. Altogether, above eighty companies are listed on two Baltic equities lists, which had a market cap of around EUR 5.8 billion in July 2013. The biggest equity market is in Lithuania, then in Estonia and the smallest in Latvia. For SMEs the equity market is more available than the bond market. Unfortunately, the choice of making company shares available for public purchase is in most cases only possible for already well known and with good reputation as well with high growth potential ones. Only in such cases companies can attract investors and to raise public interest. There are strict entry requirements imposed on companies wishing to go ahead with this process. Nevertheless such small listed company quantity and market cap shows that capital market availability is even more problematic than banking loans.

The aim of the research is to analyse availability of alternative financing resources (business angels, venture capital funds, different government support programs seed funding and crow-finding) in the Baltic States and the reality of our companies' participation in this fast growing market segment.

Meanwhile venture capital firms have become more risk adverse due to pressures on the industry and have focused on later stage investments. Angel investors have become more visible and active through groups, syndicates and networks but also face difficulties. As a result, governments in many advanced economies have sought to address the financing gap and perceived market failures by supporting the seed and early stage market.

2. Method

The study starts with a literature review in order to highlight the importance of alternative financing resources for SMEs, then will go on to development of hypothesis. The author states the hypothesis that alternative financing: business angels, venture capital funds, different government support programs and seed funding, should become the solution for funding attraction, especially for new SMEs as in the Baltic States as over the world.

The analysis conducted in this paper is based on data and statistics provided mainly by the Baltic States Central banks, Venture Capital funds and grants programmes, by certain empirical studies and by the World economic forum data base.

Researcher uses two approaches of data collection; the first approach involves a face to face interview with SMEs owners and managers. The second approach, involves gathering information from national "Business Angel Networks" or the "European Business Angel Network", from Venture Capital funds and grants programmes as state as private, from European Investment Fund (EIF).

During development of the paper the generally accepted qualitative and quantitative methods of economic research were used including comparative analysis and synthesis, graphical illustration methods.

3. Results

Main findings:

1) From the analysis of access to venture capital in the Baltic States the author has concluded that Estonian financial market is more innovative comparing with Latvia's and Lithuania's and, what is very positive, more

creative than average EU-15 markets.

2) In some market segments the competition among venture investors is rather tight, involving five and more market players.

3) Financing can be provided to business projects worth over 50 000EUR and can succeed hundreds of millions.

4) Although the overall market in the Baltic States is small, it is also one of the reasons for growth.

5) There are a large number of grants available which are offered by governments, local bodies, sector-specific schemes or even Europewide programmes. In the Baltic markets offered grant schemes are not as broad as in other European countries, for example in UK, but this only question of time.

6) Not only government support is possible to receive, national and regional authorities offer granting schemes as well. There are a number of free and subscription websites that list available grants and help entrepreneurs to find the grant.

7) The importance of SMEs involved in innovation within the European market has been recognised and important European entities, such as the European Commission, the European Investment Bank and the European Investment Fund, have generated schemes to support innovation within SMEs.

Table 1. Access to finance for new and small/ unknown companies

Amounts (EUR)	Bank loans		FF(family and friends)	Grants	Business angels	Venture capital funds	Seed funding
	Without collateral	With collateral					
<10 000	+	+	+	+	+		+
<50 000		+		+	+	+	
<100 000					+	+	

In tab.1. the author reflected her personal knowledge of financial resources availability in the Baltic markets. The summary is general, and of course shifts in both directions are possible.

4. Discussion/Conclusions

Conducted literature and surveys review shows that importance of access to finance significantly differs on country development level, business environment and economic prospects. Across euro area countries, when asked how pressing “access to finance” is as a problem in their current situation, a very large percentage of firms in Greece (61%), Spain and Italy (both 50%) and, to a lesser extent, Portugal (40%) reported that this is a very pressing problem (scale 7-10), while the corresponding percentage in Germany and Belgium is around 30% and in Finland it drops to 24%. At the same time, 55% of firms in Finland, 45% in Belgium, and 43% in Germany and Austria considered access to finance a not pressing problem.

In accordance with SME Finance forum data Access to finance is the major problem for ¼ of all SMEs in Latvia and Lithuania and mostly companies are using loans (about 20% of all companies) or overdrafts (about 10%). Almost half of the companies have stated that they don’t need credit and companies that received loans had gotten them from private commercial banks (about 80%).

Applying for a particular grant it is important to understand, that grants are available according to certain criteria. These may be related to the industrial sector, the target group, particular development methods or processes, size of the project, etc. A lot of entrepreneurs in the Baltic States consider the applying process too bureaucratic: too much work for rather small financial support.

Availability of financial funds strongly depends on company development level, the bigger and familiar you are the broader choices you have. What is important, that for new companies alternative resources are more available than bank loans: business angels, venture capital funds, different government support programs and seed funding.

Given the increasing reliance on public sector funding in the seed and early stage market, more emphasis should be put on initiatives to attract institutional investors as well as on various equity risk-sharing arrangements between public and private investors.

The main caveats and directions for improvement for policy makers are as follows:

- business regulatory reforms including the reduction of administrative barriers and the strengthening of access to finance, as well as support for access to external markets and encouragement of greater inflows of foreign direct investment to export-oriented sectors;
- stronger supervision and regulation of financial intermediaries;
- revaluation of institutional and market infrastructure.

The Baltic States Governments responded to the global financial crisis and its effects on SME financing with a variety of instruments. The most popular measure was loan guarantee programmes, which expanded substantially over 2007-2011. Furthermore, new elements were added to these programmes, or new instruments were created outside of the traditional guarantee programmes.

Other public instruments to enhance SME finance included direct loans, micro loans, export guarantees, and support for risk capital (equity) either in the form of co-financing or tax credits for investors.

This field of alternative financing for the Baltic States is rather new, but it’s new also for other countries as a result all countries (more or less) are in the same conditions and hopefully this market segment will be the way for the Baltic states to become innovative driven economies.

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