CONSIDERATIONS REGARDING SME's ACCESS TO FINANCE

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Accesul IMM-urilor la fondurile necesare creşterii şi dezvoltării este o problemă ce se află permanent în atenţia Comisiei Europene şi a guvernelor. Lucrarea prezintă un rezumat al principalelor dificultăţi pe care IMM-urile le întâmpină în accesul la finanţare, ciclul de finanţare, sursele generale fiecărei etape, precum şi modalităţile de îmbunătăţire a finanţării. Se fac referiri la contextul românesc comparativ cu cel european, precum şi la particularităţile accesului la finanţare al IMM-urilor inovative. Sunt prezentate sursele europene de finanţare disponibile IMM-urilor româneşti, precum şi instrumentele de inginerie financiară dezvoltate de Comiste pentru îmbunătăţirea finanţării IMM-urilor .

The SMEs access to funds needed to grow and development is an issue being into ongoing attention of European Commission and governments. The paper presents a summary of the main difficulties of SME's access to finance, their financing lifecycle and common sources of each stage, as well as the ways to improve financing. Thoughts are given to Romanian versus European context, and particular issues of financing innovative SME's. There are presented European financing sources available for Romanian SME's, as well as the financial engineering instruments developed by the Commission to improve SME's financing.

Key words: SME's, access to finance, financing lifecycle, Structural Funds, Seventh Framework Programme

1.Introduction

The Lisbon and Gothenburg strategies aim to:
- ✓ promote productivity, innovation, and competitiveness;
- ✓ make Europe by 2010 "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and grater social cohesion"; and
- ✓ "decouple environmental degradation and resource consumption from economic and social development".

Due to the fact that SME sector is the backbone of the economy, the EU has integrated the "think small first" principle into all policy-making and tried to ensure a SME's friendly environment. 99% of all EU businesses are SMEs and

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91% of these are micro-enterprises [1]. Therefore, support for small business is absolutely key for Europe.

However, when it comes to SME access to finance there are still more to be done. Finance is important to make sure economic growth, and many small firms consider access to finance to be one of the greatest barrier. The majority of European SMEs still depends on banks and most of them borrow from just one bank [2]. According to Flash Eurobarometer: surveys on SME access to finance in the EU [3], less than two thirds SMEs surveyed in the New Member states (except Romania and Bulgaria) had sufficient financing for their business development, while in the EU-15 more than three quarters had enough financing for their activities. A survey carried out in Romania by CNIPMMR [4] in 2005 revealed that only 60.1% used external financing, and approximately 82.2% have indicated that the access to finance is difficult and very difficult.

SMEs may face financing difficulties due to a number of well-known reasons [1,5,6,7]:

- ✓ SMEs have usually few assets and are lowly capitalized, which means that they have a *low level of solvability*:
- ✓ The high flexibility associated with SMEs has a reverse coin: it means easy entry but also frequent exit. *The rate of mortality of SMEs is very high*, meaning more risks for the investors;
- ✓ SMEs are more exposed to market fluctuations and to a deterioration of market environment. It is therefore riskier to invest even in a good project when there is a risk of deterioration of the overall situation;
- ✓ *Information asymmetry* is much more common with SMEs. Due to lack of financial records history and usually lowly detailed business plans SMEs creditworthiness is uneasy to assess for creditors;
- ✓ SMEs are commonly in need of limited amounts of financing. It means high *administrative and transaction costs*. It is especially the case for traditional creditors such as commercial banks, which have to engage high costs to study proposals for a limited expected return;
- ✓ *Lack of information, lack of knowledge* and *skills, shortage on supply of capital to meet demand, weak institutions*; are other common reasons.

2. SMEs access to finance, sources of funding, and financing lifecycle

The term “access to finance” relates to the ability of SMEs to obtain the most appropriate source of finance applicable to their stage of development and likely future profile[1]. It is therefore directly related to the:

- ✓ provision of business and financial advice to SMEs;
- ✓ culture and attitude of business owners;
- ✓ quality of management and business planning;

- ✓ supply of equity at all stages of business development at all deal sizes as well as of a range of alternative forms of mezzanine and non-equity finance (loans, grants, etc) for all businesses across the region and within specific groups.

The sources of funding can be classified in the following categories [8]:

1. Internal: own funds, family members and friends, sale of assets, working capital and cash flow management (accounts receivables, stock, accounts payable);
2. External funding:
   - External debt financing (banks and finance companies);
   - External equity (business angels, venture capitalists, corporate investors/strategic investors);
3. Grants.

For the management of all firms knowing where they are is the first step to knowing where to go [9]. There is a financing lifecycle for SMEs and its graphic model is presented in Figure 1.

The characteristics of lifecycle's stages:

I. Seed and start-up stage characteristics:

- ✓ Initial concept of business is being formed;
- ✓ Working models of product/services being researched, planned and developed;
- ✓ Employees: founders and key personnel (engineers);
- ✓ Very High-risk, many would be companies likely to fall out;
- ✓ Funding requirements: small;
- ✓ Possible funding sources: self-finance, family and friends, grants, "Angel" investors.

II. Early stage characteristics:

- ✓ Formal operations;
- ✓ Continued product/services development;
- ✓ Employees: more professional managers;
- ✓ High-risk, but corporate structure/discipline more-or-less in place;
- ✓ Revenues start to trickle, not yet profitable;
- ✓ Funding requirements: growing, funding full-scale operations and selling products/services;
- ✓ Possible funding sources: venture capitalists, strategic investors, corporate sponsors, banks, leasing companies, financing institutions.

III. Mezzanine stage characteristics:

- ✓ Continued products/services development; next generations versions being tested by customers;
- ✓ Employees: growing skilled and specialized personnel;
- ✓ Lower-risk, corporate structure/discipline improving/evolving;

- ✓ Revenues streams showing stable growth;
- ✓ Funding requirements: growing, mostly for working capital, usually the last stage of venture capital funding before IPO;
- ✓ Possible funding sources: venture capitalists, large corporate strategic investors, bigger banks, leasing/financing companies, receivables factoring.

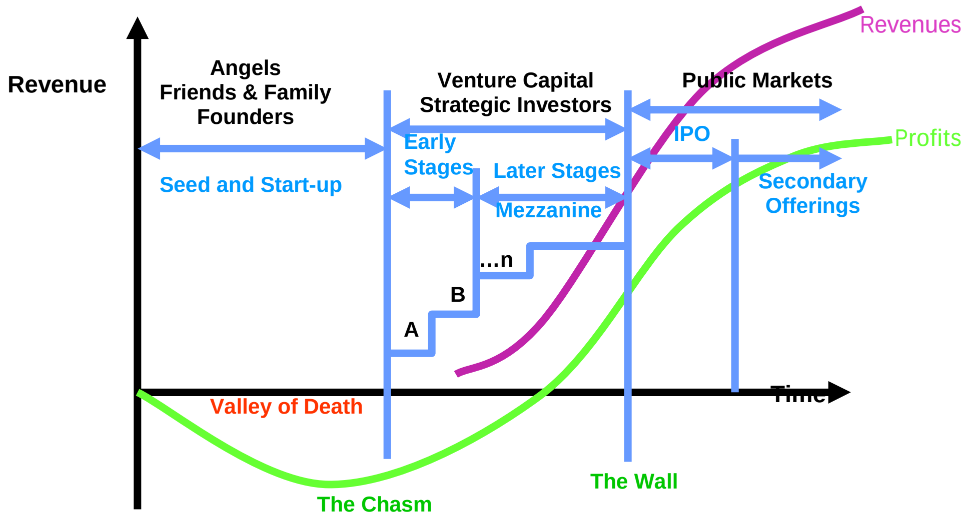

Fig. 1 – Company typical financing lifecycle
Source: Adapted from [8]

3. Particular issues in financing innovative SMEs

It can be said that there is no country without competitive enterprises, there is no competitive enterprise without competitive product or service, and there is no competitive product without innovation. Speaking globally, there are two kinds of SMEs regarding the approach to innovation and knowledge: the ones that create innovation and the ones that use it. The first category is obviously a very little minority while the second represents the overwhelming majority.

The definition of innovative SME can be: “SME that is related to a process connecting knowledge and technology with the exploitation of market opportunities for new or improved products, services and business processes compared to those already available on the common market, and encompassing a certain degree of risk” [10].

From the innovation point of view, Romania’s performance compared with other EU states is very poor (Figure 2), although with a fast growing rate.

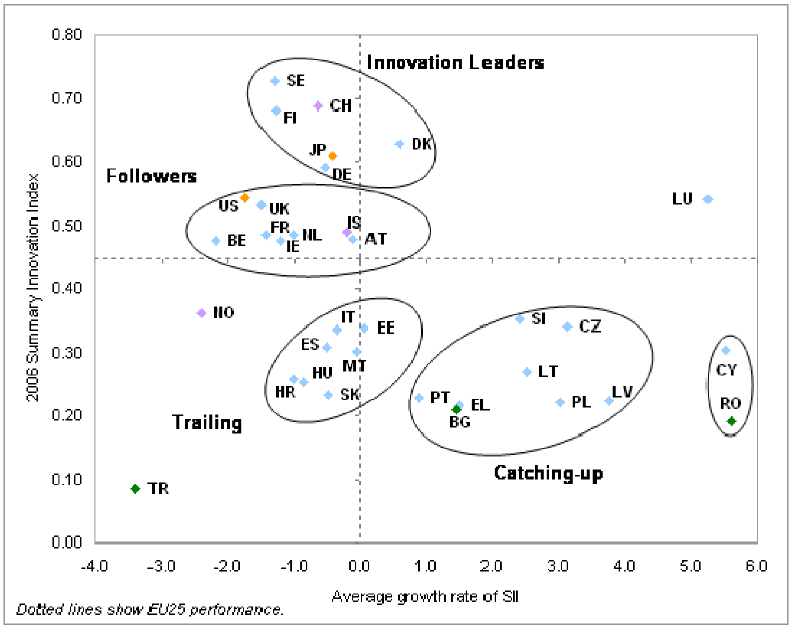

Fig.2- Summary of Innovation Index in EU states
Source: European Innovation Scoreboard (EIS) Report 2006

Besides other reasons, in our opinion this situation is due to the followings:

- ✓ Low levels of public and private R&D expenditures (0.17% of GDP, and 0.21% respectively; source EIS 2006). The recent studies came to the conclusion that the countries with the highest R&D expenditures are the most innovative ones, this being also true at the branch level [5];
- ✓ Low level of population with tertiary education, only 11.1% per 100 population aged 25-64;
- ✓ Constant down trend in the number of science and engineering graduates coupled with their low level of accumulated knowledge;
- ✓ Lack of proper entrepreneurship culture;
- ✓ Most entrepreneurs business philosophy is for short-run profits than for long-run sustainable growth;
- ✓ Brains' emigration;
- ✓ Inefficient government policy;
- ✓ Low access to finance.

Speaking about low access to finance, besides traditional reasons for difficulties, innovative SMEs may face a number of additional problems:

- ✓ The success of innovative SMEs is linked to *non tangible factors* like scientific knowledge, intellectual property, and economic application of

innovative ideas. They are almost impossible to value properly and makes it even more difficult to assess the quality of project;
- ✓ Relying mainly on human skills factor, innovative SMEs do not have tangible valuable assets to offer as *collateral* to creditors;
- ✓ Innovation means new, untested products, with a *high percentage of failures.*

4. Ways to improve SMEs access to finance

Improving the access to finance of SMEs in general and innovative SMEs in particular addresses three main areas [5]:

1. Improve commercial bank lending;
2. Develop venture financing;
3. Use of complements to finance;
4. Support of the State.

In order to increase commercial bank lending to SMEs the following measures can be undertaken:

- ✓ *Reducing information asymmetry and improving risk management*. Even in highly developed countries with stable financial markets and largely disseminated use of transparent and comparable financial statements, SMEs do not reach a significant threshold in assets to produce standardized accounts. It would therefore be useful to define a set of rules (standardized formats and adherence to generally accepted practice) according to which SMEs could offer better financial information to banks. Other ways of reducing information problems may include: the creation of credit scoring systems; the sharing of risks with third parties, e.g. loan and mutual guarantee schemes; the introduction of methods based on evaluating the price of lending according to the level of risk; the dissemination of information to entrepreneurs about the risks that banks assumes when they grant them credits;
- ✓ *Develop products better adapted to SMEs needs*: participating to the provision of seed capital to start-ups (includes instruments such as equity, subordinated loans, and soft loans); training of bank staff specialized in clientele of SMEs.

Venture capital has become a key instrument for financing high-technology firms in developed countries. But in order to be successful and effective a number of factors must be combined:

- ✓ *Strong individual entrepreneurial spirit*;
- ✓ *Readiness on the side of individual entrepreneurs to open their capital*, i.e. to sell significant equity to outsiders;
- ✓ *Flexibility and availability of well-trained specialists in the labor market*;

- ✓ *Strong analyst skills on the side of venture capital specialists*, in order not only to better monitor the risks, but to assist and advise growing firms as well.

Options available as complements to finance are:

- ✓ *Leasing* schemes which do neither require a collateral, nor a third-party source of finance as the customer is able to finance 100% of its acquisition;
- ✓ *Factoring*; A type of account receivable financing in which the factor assumes the risk of collection, bad debt, and errors in pricing, etc., but usually at a cost higher than borrowing from a bank;
- ✓ *Insurance*: mutual guarantee agreements; credit insurance (or export credit insurance) which cover the risk for a firm of not being paid after having delivered its good to a client;
- ✓ *Business angels*; Start-ups and high-tech SMEs are usually in need of certain amount of seed capital to begin their activity. In order to fill this gap, apart from the own resources, the entrepreneurs may use business angels; angels are accredit investors who [11]:
    - ▪ expect a financial return;
    - ▪ believe in giving back to their communities;
    - ▪ invest locally and regionally;
    - ▪ participate in the investment process;
    - ▪ show interest in personal relationships with companies and employees;
    - ▪ offer wisdom and guidance to entrepreneurs.

How the Government can support the development of dynamic SME sector:

- ✓ *Providing the right macroeconomic and legal environment*;
- ✓ *Offering financial and fiscal incentives*;
- ✓ *Institution-building*.

5. European funds and financial engineering instruments

For the period 2007-2013, the Cohesion Policy of the European Union was reformed in order to better respond to the objectives set at Lisbon and Gothenburg. As a consequence, the cohesion policy will have three instruments: *European Regional Development Fund* (ERDF), *Cohesion Fund* (CF), and *European Social Fund* (ESF).

The three instruments will be used to reduce the economic development disparities between different regions of the European Union, with a stress on knowledge and innovation, on creating new and better jobs, on cooperation between regions and on transforming the regions in attractive places for investing and working.

The Structural and Cohesion Funds for Romania amount to 19.668 billion Euros, out of which 12.661 billion Euro will be canalized through the Structural Funds under the Convergence Objective, 6.552 billion Euro for the Cohesion Fund, and 0.445 billion Euro will be allocated for the European Territorial Cooperation.

There would always be a limit to the amount of funding available, and as a consequence a substantially part of SMEs will be left out, on one hand. On the other hand, a series of studies on grants schemes demonstrated that the majority of interventions were short term in their nature, and had limited sustainable impact on the local economy. Additionally, the evaluation of past Structural Funds programmes built up the informal evidence that too great an availability of grants had lead to an anti-entrepreneurial culture, with firms becoming entirely dependent on grants and not seeking to improve their sustainability by non subsidized activity.

Therefore, the development of sustainable solutions such as financial engineering instruments, which would become self financing was essential, in order to continue the support to vital services which could not be addressed by the market.

The financial engineering is the design, development and implementation of innovative financial instruments for local regeneration.

In the context of the European Structural Funds, it describes the use of funds for the development of any forms of financial support other than grants i.e. credit-based products, guarantee funds, equity-based products.

In order to encourage financial engineering measures, the general regulations governing Structural Funds 1260/1999 Article 29 offered a 10% higher intervention rate from Structural Funds for assistance in the form of financial instrument interventions. The interpretation of this regulation was revised further in 2003 when DG Regio confirmed that where the assistance was provided to a financial engineering vehicle such as a venture capital fund, the maximum Structural Funds for that region, allowing a greater intervention rate still.

The current implementing regulations of the Structural Funds programme 438/2004 define how financial instruments can be developed in venture capital and loan funds or guarantee funds. There are no budgetary headlines for Financial Engineering within the EU Structural Funds. However, they are encouraged where ever possible and relevant. Member states can decide how much of their Structural Funds they wish to use for supporting SMEs and social enterprises, and how much is in the form of Financial Engineering.

The Commission has developed new instruments to assist Member States and regions to improve the quality of projects while, at the same time, making Community financial resources work harder by increasing the leverage effect of cohesion policy. Accordingly, for the new programmes, three new instruments have been developed to promote financial engineering for start-ups and micro-enterprises, combining technical assistance and grants, with non-grant instruments such as loans, equity, venture capital or guarantees. These three new instruments are:

1. JASPERS, "Joint Assistance in Supporting Projects in European Regions" is a new technical assistance partnership with EIB and EBRD for large projects, notably in the transport and environmental sectors, supported by the CF and the ERDF.
2. JEREMIE, Joint European Resources for Micro to Medium Enterprises", a partnership with the European Investment Fund (EIF) to improve access to finance for business development.
3. JESSICA, " Joint European Support for Sustainable Investment in City Areas", a cooperation with EIB, CEB (Council of Europe Development Bank) and other IFIs (International Financial Institutions), having as objectives to provide the authorities with a ready-made solution to the complex task of financing projects for urban renewal and development through the use of revolving funds.

The JASPERS and JEREMIE instruments will be also available for Romania, starting 2007, through the Memorandum concluded between the Ministry of Finance and EIF and the opening of the EIB's office in Bucharest.

The European Union's main instrument for funding research and development is the Framework Programme (FP). In order to improve SMEs participation to European R&D programs and to enhance dissemination and market exploitation of the results, the Seventh Framework Programme (FP7), which is proposed to run for seven years between 2007 and 2013, is organized in four programmes corresponding to the four basic components of European research [12]:

1. *Cooperation*: Support will be given to the whole range of research activities carried out in trans-national cooperation, from collaborative projects and networks to the coordination of national research programs. International cooperation between the EU and third countries is an integral part of this action. This action is industry-driven and organized in four sub-programs:
   - Collaborative research will constitute the bulk and the core of EU research funding;
   - Joint Technology Initiatives will mainly be created on the basis of the work undertaken by the European Technology Platforms;
   - Coordination of non-Community research programs;
   - International Cooperation;
2. *Ideas*: This program will enhance the dynamism, creativity and excellence of European research at the frontier of knowledge in all scientific and technological fields, including engineering, socio-

economic sciences and the humanities. This action will be overseen by a European Research Council;

3. *People*: Quantitative and qualitative strengthening of human resources in research and technology in Europe by putting into place a coherent set of Marie Curie actions;
4. *Capacities*: The objective of this action is to support research infrastructures, research for the benefit of SMEs and the research potential of European regions (Regions of Knowledge) as well as to stimulate the realization of the full research potential (Convergence Regions) of the enlarged Union and build an effective and democratic European Knowledge society.

6. Conclusion

SME's access to finance still remains an issue in Romania. However, the new financial engineering instrument JEREMIE, promises to be of real help in facilitating the access to finance.

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