FINANCING SOURCES FOR SMALL AND MEDIUM-SIZED ENTERPRISES

CARAGANCIU Iulian¹, OLTEAN Livia²
¹Ph.D. student, ²Ph.D.student Lucian Blaga University Sibiu, Romania

Abstract: This article shapes the need of financing of SMEs, by synthesizing and explaining the available resources they can use in order to finance their activities, as well as by presenting the common issues they have to face. Specialty studies revealed the fact that SME financing sources change according to the development phase the firm is running. Therefore, during the launching period, the most commonly used source is the owners’ money, and, afterwards, the investors’ interest in the company grows proportionally to its expansion level. The article presents, besides classic financing sources, other ways, which are not so commonly met.

Key words: SME, financing, business angels, risk capital, mezzanine financing.

JEL classification: G2, G3

The biggest challenge SMEs all over the world have to face is finding and combining financing sources. The obstacles that appear when trying to get financing are due firstly to the fact that SMEs don’t develop large projects that could both attract investors and offer guarantees regarding the credit payment.

A company’s economic and financial life can’t be conceived outside the environment where it develops its activities. This environment is the place from where the company collects its resources and where it makes payments, funds restitutions etc. Under the conditions of market economy, identifying financing possibilities has a major impact on economic agents’ activities. Selecting and combining external financing means and their balance compared to internal financing is a major decision of the company’s financing policy.

After acknowledging the importance of the SMEs to the European economy, the European Commission demanded the European Central Bank to develop a series of researches in order to scale the problems faced by this type of companies. The results were published in the Flash Eurobarometer Access to Finance (No. 271). According to these, one of the most common problems of European SME managers is access to financing (European Central Bank, 2009, Gallup Organization, 2009), this problem generating over 16% of the options (second place after “finding customers”, but ahead “competition” or “finding qualified personnel” [Daniel Bădulescu- Finanțarea IMM-urilor: dimensiunile nevoii și răspunsurile diferitelor structuri de creditare].

Regarding the distribution by country, inside EU there are important differences between the northern and southern Europe.

This shows that access to financing is of extreme importance to countries such as Greece, France, Italy or Romania, but moderate for Germany or Holland and less important to Finland.
SME financing is also complicated because these enterprises often need a wide range of financial instruments, according to their development stage. Specialty literature identified various growing phases of a company, each with its own financing needs, which can be accomplished through different sources [Financing innovative SMEs in a Global Economy, Innovative SMEs, lifecycles and financing Growth, Istanbul, 3-5 June, 2004].

During the launching period, companies have problems insuring the necessary working capital, because they present a high risk to investors and creditors.

The result of this situation is that more than 75% of the new businesses are financed through the entrepreneur’s personal resources, more precise personal savings and credits. Another important role is played by family and friends, who insure a part of the money necessary to start the business. This is the “seed financing”, and, because the money comes from those close to the entrepreneur, it is often called ‘love money’. In this stage the most important part is played by the will and perseverance in searching financing sources, both personal and governmental [http://www.consultantabuzau.ro/surse-de-finantare/].

The following development phase is, probably, the most delicate, as the firm starts developing, but it still doesn’t have the power to demand a bank loan. This is the survival phase, when personal funds are over and finding a new external source is of extreme importance. In this stage, the investments are still risky, with high failure rates, needing high revenue potential rates. Generally, firms that get to this situation aren’t large enough in order to draw the attention of risk investors [Financing innovative SMEs in a Global Economy, Innovative SMEs, lifecycles and financing Growth, Istanbul, 3-5 June, 2004]. This is the moment the so-called “business angels” category emerges- people who support the business with their capital and, sometimes, professional experience, which they offer most often in exchange for key-positions in the company’s management or shares, that make them co-owners of the business.

Usually, these investors have a rich business experience and they are willing to assume the risk, because these investments represent a small share of their total investments portfolio. They are most commonly interested in obtaining profit, but, at the same time, they get informed regarding a certain type of activity. Most investors of this kind want to remain anonymous and they don’t give information regarding their investment activities. This is the reason why the real sizes of the “business angels” market are hard to estimate [Giurca Vasilescu Laura –Mezaninul financiar – alternativă pentru finanțarea firmelor ?, Revista Tribuna Economică, nr. 2/2011].

After the company overpasses this beginning stage, in order to get to the expansion phase, it needs another capital injection, necessary for growing the production and distribution facilities, as well as for research and development. However, the fact that it’s still depending on intangible assets, with unsure cash-flows, turns the firm into a not so good candidate to loans. This is the stage when venture capital is needed/offered by risk investors. When companies require venture capital to professionals, they are usually developed up to the point where a venture capital specialist can add value. He will usually supervise the management, offer expertise and financing based on setting objectives. Venture capital specialists are, usually, interested in companies that can generate a fast growth and they can, in a few years, reimburse the capital. The time frame is, usually, 3-8 years.

Venture capital funds have been developing in the USA for the past 3 decades [Ovidiu Nicolescu, Ciprian Nicolescu – Intrepreroriatul și managementul întreprinderilor mici și mijlocii, Ed. Economică,
București, 2008, pag. 187] and they mostly finance firms who promise to be extremely profitable. “A venture capital fund is made like a closed investment fund, which mobilizes financial resources from individuals and organizations and places it in businesses which, even if they have a high economic risk, have a great potential of economic performance” [Ovidiu Nicolescu, Ciprian Nicolescu – Întrepreriatul și managementul întreprinderilor mici și mijlocii, Ed. Economică, București, 2008, pag. 187].

All risk investors avoid the uncertainty and informational asymmetry associated to young companies, through intensive auditing of the firms before offering financial help, and through monitoring. Examples include offering gradual help, in time, making alliances or unions with other risk investors, becoming members to the managing board or setting up compensation schemes that include the option of becoming shareholders. Usually, risk investors gather the capital from other investors and invest it in a fund, most commonly structured as a limited partnership. Their main objective is to maximize their return rates [Financing innovative SMEs in a Global Economy, Innovative SMEs, lifecycles and financing Growth, Istanbul, 3-5 June, 2004].

Reaching the expansion and maturity phase reveals to SMEs the perspectives of negotiation and obtaining bank loans. The bank is the most commonly used financing source, even if its relations with the company are complicated and often rough.

In their effort to discover financing resources to use in the best interest of their business, entrepreneurs are open to various ways of financing their firm- short and long- term. They search and combine other sources too that might ensure the survival of the company. Some of these will be presented next.

- Mezzanine financing is a financing hybrid, between loans and shareholder’s equity, used for companies already existent. In the conditions that even profitable have limited financing options, the economic environment determines the need for such alternative forms. The advantage of such a financing can be seen from the balance sheet perspective, when the mezzanine capital “works like a connection between shareholders’ equity and loans” [Laura Gürca Vasilescu –Mezaninul financiar – alternativă pentru finanțarea firmelor, Revista Tribuna Economică, nr. 2/2011]. The costs of this type of financing consist in the fixe interest and the revenues obtained by selling shares of that company. The efficiency of mezzanine investments rise to 12-17% all along the investment, which means more the banks’ (7-8%), obtained for loans, but less that the efficiency of private funds (at least 25%) [http://www.wall-street.ro/articol/Money/34718/Finantarea-de-tip-mezanin-imprumuturi-participare-la-capitalul-social.html].

Mezzanine financing is a modern product, which will make the financial market even more sophisticated, as it has been proven that, by using mezzanine, there appear to be higher efficiencies for capital investors. Moreover, this type of financing allows making higher volume transactions and it can be used in situations where bank loans are unavailable.

- Leasing financing. Leasing is a modern financing mean which is used frequently by SMEs, due to its multiple advantages: shorter starting period compared to a bank loan, higher flexibility and fiscal advantages. To all this adds the continuously growing leasing offer. The major disadvantage of this type of financing is the contract’s total cost, which is high. Buying a piece of equipment through leasing is much more expensive than through normal conditions.

- Commercial credit. Financing through commercial credit consists in using the business partners’ resources. This is probably one of the most profitable financing possibilities, being used in the relations with suppliers and customers. Drawing financial resources from partners depends highly of the entrepreneur’s ability to negotiate contracts, but his credibility as well.

- Franchising. Financing a business by franchising is “an important indirect financing, ensuring an important share of the resources necessary to start a business. Without franchising, that value should be financed with liquidities by the entrepreneur” [Ovidiu Nicolescu, Ciprian Nicolescu – Întrepreriatul și managementul întreprinderilor mici și mijlocii, Ed. Economică, București, 2008, pag. 166]. Its biggest disadvantage is the constraints imposed to the franchisee, which will have to give up most of his business independence, receiving in exchange from the franchiser consultancy, a brand, technology etc.

- Factoring. Taking over the receivables of a small company by a financial institution is advantageous because the firm purchases liquidities in a short time, but it is also very expensive.

The EU acknowledges the importance of SMEs and works with national authorities in order to improve the SMEs’ financial environment. Through the organization of experience and common practices pools between governments, the Commission allowed many member states to bring improvements to this environment. The commission also got involved in the dialogue between bankers and SMEs, in order to identify and reduce the main issues smaller companies meet when searching for a financing means
Strategic EU documents treat SMEs as “a major sector of the EU economy” [Ovidiu Nicolescu, Ciprian Nicolescu – Întrepreroriatul şi managementul întreprinderilor mici şi mijlocii, Ed. Economică, Bucureşti, 2008, pag. 438]. We must remind here the European Charter for SMEs, adopted in 2000 at the Lisbon summit, followed in 2008 by the Small Business Act. This SME law on the level of the EU acknowledges the SME importance to the economy and gives them support and priority for financing out of EU’s funds.

On the EU level there are developed various projects and programmes designed to support SMEs according to their development stage, activity field or innovation degree.

In conclusion we can say that an SME could get financing resources from more than one source. Mainly the SMEs are seen as a sole proprietorship so they get financed by “Love Money”, and are seen as a family business.

There are also some cases where after keeping the business on float with the help of the “Love Money” for a couple of years, the “Business Angels” appear. These are known for financing businesses and then either taking a key-role in the company or by getting shares, as it was presented above. One of the well known cases of “Business Angels” intervene was the Amazon, which started as a simple family business and after receiving the appropriate resources from the “Business Angels”, the company went even better. The first owners of the company have left the board of Directors to let other people decide on the strategy of the company, and now they are getting a percentage of the revenue generated by the Amazon.com company. And this percentage is way more than they could have ever gotten if it weren’t for the financing and the experience of the “Business Angels” involved in the process.

Another way of financing the SMEs is by the EU programmes or projects. Which, if managed properly, can give the company a great increase be it in market share or revenues. To help young companies have more chances on winning these projects, the government could provide the appropriate consultancy to SMEs, thus increasing its chances to succeed in winning such a project.

As it was presented earlier on in this article SMEs play a key role in economic growth and development of countries. So as to increase this growth of the SMEs sector the government could increase the number of SMEs in the national economy, this could be achieved by either lowering the taxes for the first years of its existence, simplifying regulation terms in means of tax collecting or generating appropriate consulting for SME owners.

With these been said these measures would drastically improve the economy generating more supply and sustaining a healthy market through generation of competition.

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