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SMEs' Alternative Financing: The Case of Latvia

R. Rupeika-Apoga[1] S. Saksonova[2]

Abstract:

This article analyses the ways how companies operating in EU countries attract alternative financial resources. The importance of non-traditional, alternative/innovative financing is gaining recognition in both developed and emerging economies throughout the world.

SMEs' financing in Europe remains primarily bank based, in spite of many policies proposed to develop alternative financing instruments (e.g., adopting directives on venture capital, improving the transparency and visibility of SMEs on capital markets, etc.).

The research is therefore to expose recent trends in alternative financing in EU, significantly enhancing the evidence base on this key source of entrepreneurial finance. As a source of 'smart money', supporting new and early stage businesses, alternative providers are widely accepted as being a critical part of the competitiveness enhancement.

Generally accepted qualitative and quantitative methods of economic research were applied in this paper, including in-depth face-to-face interviews with the board members of the nine banks of Latvia, operating in the other Baltic and Nordic countries as well as 1200 companies' owners or top managers.

Main findings show that alternative financial service providers are competing and often outcompeting the traditional ones at high speed. Conducted empirical analysis shows the most available financing sources except banking products are Friends and Family (FF) and different state (including EU grants) support programmes, Venture Capital (VC) and Business Angels (BA).

Keywords: *Alternative financing, business angels, crowdfunding, SMEs.*

JEL Classification: *G28, G32.*

[1]*University of Latvia, Latvia, email: rr@lu.lv*
[2]*University of Latvia, Latvia, email: svetlana.saksonova@lu.lv*

1. Introduction

Availability of funding has been a pressing obstacle for SMEs' entrepreneurs, banks and academics since 2009. In many countries, small and medium firms are dominating, for instance, in Latvia about 95% of all companies are small and medium, providing market with the majority of jobs. The shape of financial market is changing, partly because of the 2008-2009 crisis, and partly due to other world processes that have been developing alongside it. Starting from the second decade of 21st century business models of banks are challenged by non-traditional financial service providers almost in all areas, including the core banking functions as loans and deposits. Companies' financing mechanism is changing, reshaping the traditional bank activities and promoting alternative financing provider activities.

Non-traditional financing for companies is an alternative solution how to get the necessary funding, when traditional financing resources, as credit lines, loans, overdrafts and credit cards, are not available. Alternative financing is a new field, with a gap in the theoretical and empirical aspect. It is not clear how to manage these resources effectively both from the authorities and the entrepreneurs point of view.

Freshly-established firms face many challenges to get funding, and they have increased since 2008. Consequences of the last financial crisis, geopolitical situation and economic uncertainty are effecting bank risk tolerance towards new firms crediting. To get a loan from a commercial bank a company needs stable financial indicators and credit history that is not common practise for freshly-established firms. These processes effect small companies harder than the large ones, thus, they have to pay higher risk premium, can get loans for shorter maturities and also need bigger collateral.

Availability of capital markets by issuing equities and bonds for SMEs is also problematic. Only companies with good financial statements and positive credit history, with good reputation and well-known in general, can attract money directly through the capital markets. Small amount of listed companies and small capitalisation in Europe confirm the difficulties of raising funds through capital markets, for instance, in 2015 the market capitalization of listed domestic companies (% of GDP) in the US was 139,0 % comparing with 65,3% in the Euro area (World Bank, 2017).

Meanwhile venture capital firms have become more risk adverse due to pressures in the industry and have focused on later stage investments. Angel investors have become more visible and active through groups, syndicates and networks, but they 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.

Although the amount of publications and research papers on the topic of raising alternative, informal or non-traditional financing has increased since 2008, the availability of this financing has not been sufficiently researched yet. Mainly the researchers are specializing in one kind of alternative resources instead of focusing on the whole market (Kuzmina and Kublina, 2014; Prohorovs and Fainglozs, 2014; Venckuviene and Snieska, 2014). Additionally, there is lack of statistics (Prohorovs and Fainglozs, 2014) in this field making the research even harder. The research question in this study is how well known are alternative financing resources for the small and medium companies in Europe.

2. Literature Review

Statistic reports of ECB, European Commission, national countries economic reports indicate that SMEs are mostly using the formal bank credits (ECB, 2014; EM, 2014; European Commission, 2015; Japparova and Rupeika-Apoga, 2017; Karlan and Morduch, 2010; Havlicek *et al.*, 2013). During 2015-2016 EU28 SMEs most often reported using short term bank finance (credit line/bank or overdraft/ credit card), followed by long-term bank loans, leasing or hire-purchase, trade credit. Latvian SMEs reported bank loans (50%), equity investment (25%) and loan from other sources as the main types of external financing for future development projects (Kwaak and Zeijden, 2016).

Whereas another strand of the literature focuses on the non-traditional/alternative financing that can help fill the gaps between SMEs financial needs and available traditional financial resources (Casey and O'Toole, 2014; Cycle, 2013; Kuntchev, 2014; Prelipcean and Boscoianu, 2014; Rupeika-Apoga and Solovjova, 2017). A broad range of studies have highlighted governmental supporting policies for alternative financing providers (Alperovych and Hübner, 2015; Cumming and MacIntosh, 2006; Guerini and Quas, 2016). Conducted literature and surveys review shows that there are still some unanswered questions. Are alternative financing resources competing with traditional ones? Would they replace the traditional financial service providers in the next 5 or 10 years?

Therefore the main aim of this research is to analyse access to finance, including alternative finance (risk capital funds and business angels, seed funding and crowd-funding) of companies in Latvia.

3. Research Methodology

Generally accepted qualitative and quantitative methods of economic research were applied in the paper, including in-depth face-to-face interviews with the board members of the nine banks of Latvia and 1200 companies' owners or top managers. The research of Latvian financing opportunities shows that the most common forms of funding of freshly-established companies are FF (Friends and Family), commercial banks offering special programmes and state supported programmes, but with rather limited available amounts. If a company is interested in bigger amounts Venture Capital (VC) comes to overcover the needs mainly supported by EU funds, and business angels.

The following methods are applied to analyse alternative financing possibilities in Latvia:

- SIBiL (Survey of Innovative Businesses in Latvia), that follows the development of more than 1200 small and medium-sized businesses in manufacturing in the period from 2008 to 2015. The data were collected in the form of in-depth face-to-face interviews;
- In-depth face-to-face interviews with the board members of the nine banks of Latvia in 2015/2016;
- By analysing information from national "Business Angel Networks" or the "European Business Angel Network", from Venture Capital funds and grants programmes both public and private.

The main resources used by companies in Latvia can be divided into the following groups:

Traditional:

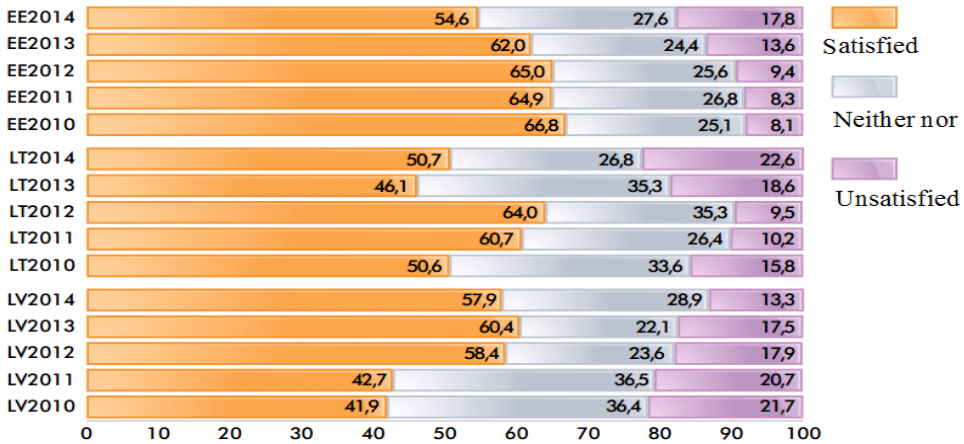
1. Banks loans;
2. Banks' special support programs;
3. FF (Friends and family);
4. Loan guarantee programmes;
5. Tenders/competitions.

Alternative:

1. Venture capital funds;
2. Business angels/informal investors;
3. Crowdfunding.

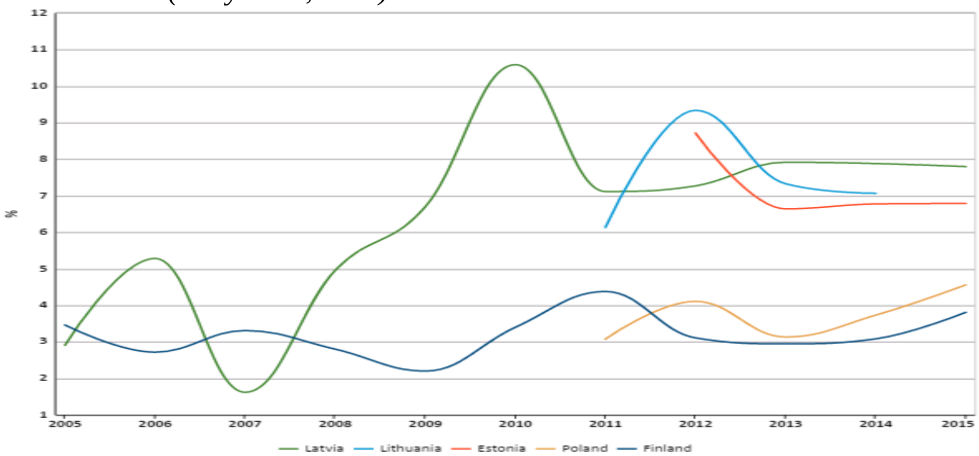
Latvia's government responded to the global financial crisis and its intervention on companies' financing have been imposed with a variety of instruments. The most popular measure was loan guarantee programmes, which expanded substantially over 2007-2011. Furthermore, new elements were added to these programmes, or new instruments were created outside of the traditional guarantee programmes. 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 Latvia consider the applying process too bureaucratic; too much work for rather small financial support. Banks' special support programs are temporal and have target-character, additionally granting small amounts; thus, this financing type is of limited availability for SMEs, especially new ones (Solovjova, 2018).

Figure 1. *Satisfaction with the state support to employees, % of GDP (SSE Riga and SEB, 2015)*



As suggested by the data from ECB and research of the Sustainable Business Centre of Riga School of Economics, business people are still relatively dissatisfied with the state support (loans to SMEs, Venture Capital and guarantees implemented from the EU funds) to businesses (42.2% in 2014) (Figure 1). There is no official statistical data about FF availability, but it is rather clear that this source comes first when new entrepreneur is looking for money. Additionally, it is also not clear how to separate FF from informal investors both from the definition concept and from the statistical point of view. Analysing the share of personally provided funds for a new business, started by someone else, in the past three years - Informal Investors Rate - Latvia's performance is better than in Nordic countries, the leader in this field is Finland. It's also better than in Poland and as well as in Lithuania and Estonia (Figure 2).

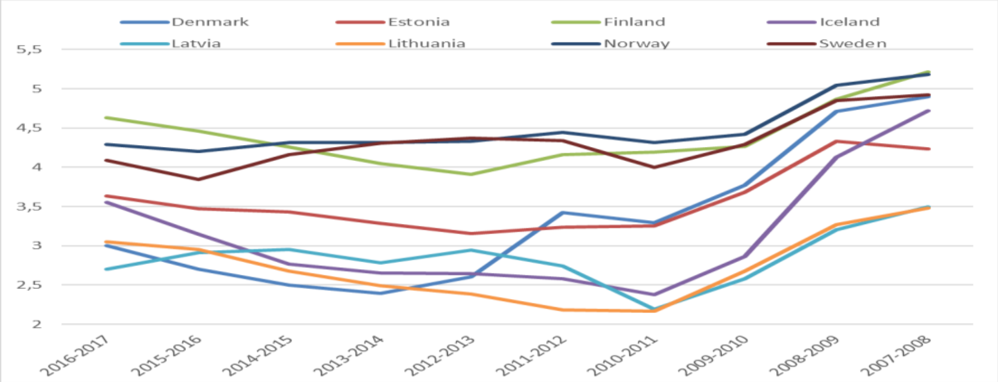
Figure 2. *Informal Investors Rate in the Baltic States and Poland with Finland from 2005 till 2015 (Kelly et al., 2015).*



Estonian Business Angel Networks states that during the first year of their activities (2013-2014) the total investment sum reached 4,6 mln. EUR (EstBAN, 2015), Latvian Business Angel Networks is not collecting these data and Lithuanian Strata (STRATA, 2015) as well is not offering such statistics.

From the analysis of access to Venture Capital in the Baltic States (Figure 3) we concluded that Estonian financial market is more innovative compared with Latvia's and Lithuania's and, what is very positive, more creative than the average EU-15 market. In some market segments the competition among venture investors is rather tight, involving five and more market players. Financing can be provided to business projects worth over 50 000 EUR and can exceed hundreds of millions.

Figure 3. *The Baltic and Nordic States World economic forum venture capital availability rating (World Economic Forum, 2017).*



It would be fair to say that Estonia is leading the Baltic group with more local VC's, angels and investments than in other Baltic countries. This can be partially explained by success of such companies as MicroTask and of course Skype. However, in the last couple of years Latvia and Lithuania have made a lot of progress to catch up and it is expected a lot of new companies will come in the future.

As for crowdfunding, there are several local platforms in the Baltic States, but our entrepreneurs are quite efficient using other international platforms as Kickstarter, Indiegogo, Crowdfunder. In Estonia crowdfunding started in 2009 with a local P2P consumer lending platform called isePankur (now Bondora). The first equity based platform Fundwise.me launched in 2015. In 2017 in Estonia operate 4 local and 1 Latvian platform. In 2015, Estonia ranked second in Europe on total volume per capital. Although the Estonian market is only 1M+ people it has the potential to grow by virtual Estonians – attracted by the e-residency program that was recently launched by the Estonian government. Lithuania has the ambition to become one of the most attractive FinTech destination in Europe, in 2016 Lithuania approved a number of regulatory changes; amended KYC regulation (enables non face-to-face identification), amended consumer credit rules related to peer to peer regulation, and passed the Law on Crowdfunding. In 2017 in Lithuania are operating 5 local P2P platforms, €2,3 million has been raised on P2P consumer lending platforms in 2015. In Latvia transaction value in the "Crowdfunding" segment amounted US$ 1,8m in 2016. ("CrowdfundingHub," 2017). This fast-growing market is especially attractive to new entrepreneurs all over the world. Table 1 reflects the results of companies and commercial banks interviews on financial sources availability in Latvia.

Table 1. *Availability of traditional and alternative sources for SMEs in Latvia*

Amounts (EUR)	Bank loans		FF(family and friends)	State support programs	Business angels	Venture capital funds	Seed funding	Crowd-funding
	Without collateral	With collateral						
≥10 000	+	+++	+++	+	+		+	+
≥50 000		++	++	+	+	+	++	+
<100 000		+	+		+	++		+

Source: *Compiled by authors.*

One "+" means that resource is available, but not very popular, "++" means that resource is available and rather popular with entrepreneurs and "+++" means that resource is available and very popular with entrepreneurs. The summary is general, and of course shifts in both directions are possible.

It must be noted that to facilitate the raising of funds Nasdaq Baltic stock exchanges had created the alternative market First North Baltic, which represents a multilateral trade system (non-regulated market) with loyal regulations and lower costs also allowing for listing enterprise bonds. Further popularization of the First North Baltic market among SMEs is needed as well as simplification of the bond issue process both in terms of the costs and paperwork.
Summarising the availability of alternative financing sources in Latvia we concluded that companies mostly use short and medium loans and leasing provided by banks, or owner funding, and state support programmes as well, whereas, access to venture capital, business angels and crowdfunding is still rather limited and problematic.

4. Discussion

One of the main problems revealed in this paper is the availability of alternative financing. Mainly researchers from the Baltic States are specializing in one kind of alternative sources; venture capital in Latvia, problems of data collection, processing and use of informal venture capital, hybrid Venture Capital Funds in Lithuania etc. Non-traditional financing has experienced rapid growth during the first decade of the 21st century; institutional and private investors together with governments are interested and support the further development of alternative capital market in different regions. In the alternative financing sector, the research reveals that there is a limited access to informal investors due to lack of networks uniting informal investors, reluctance to invest due to lack of investing experience, regional incubators seldom produce start-ups attractive for alternative investors.

Building of a single social network of alternative financial service providers in regions, as the Baltic States or Nordic Baltic, or North Europe etc., would link them together, providing better availability to their services. Even though there are various information dissemination and publicity channels (as local investment agencies, development banks etc) and knowledge centres responsible for informing SMEs' about the availability of private and public financing instruments there is still lack of SME awareness about it, that should be improved.

Returning to the scope of this paper with the question *"Would alternative financing providers squeeze out the formal ones in the near future – next 5 or 10 years?"* the answer is "Yes" and "No", depending on the company type and activities area. According to statistics, the loan portfolio of the commercial bank system of Latvia steadily shrank in the period between 2008 and 2014. It, to a large extent, was due to the effect of the recession characterized by writing off the bad debts and gradual correction of the household indebtedness. Nevertheless, all interviewed banks are wishing to increase their loan portfolio in the near future. The role of banks in lending to freshly-established companies is rather small as in this stage it is virtually impossible to assess risk and possible return on the investment therefore in this segment the role of other sources of funding will retain and speed up their significance.

The current study is not free from limitations. Its current sample consists of 1200 detailed surveys of SMEs in Latvia; therefore, these findings may have limited generalizability. Future studies that replicate the current proposal, including new surveys for larger amount of companies not only in Latvia, may provide a more complete picture or add further dimensions to the current findings.

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