

The financing options for the Romanian SMEs in the current economic condition

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Abstract: The financing decisions, together with the investment decisions, are probably the most important financial decisions that any entrepreneur or small and medium enterprise has to adopt from the very beginning of their activity. Therefore, particular attention should be paid to different factors that are influencing the financing decision such as costs, duration, flexibility, the risk involved, control, timing and so on. In this paper, we intend to analyze the way the Romanian SMEs are financing their activities in the current economic conditions, what are their options and preferences. We also intend to make a comparative analysis of the patterns of financing of SMEs in the EU with the Romanian SMEs to observe what the similarities and discrepancies are.

Keywords: Financing, Entrepreneurship, SME

1 Introduction

In 1990 Romania started the transition process to a market economy having virtually no private companies because during the almost fifty years of communism regime any form of private initiative in business was forbidden. Therefore, the transition process was long and difficult, with many ups and downs, including painful reforms that were, sometimes, stopped and then re-initiated. Despite the lack of entrepreneurial culture and the difficult business environment, the number of small and medium enterprises (SMEs) started to grow quite consistently from the end of the last decade of the twentieth century, at a pace of 7% per year (approximately 20.000 to 30.000 units each year) until 2008 when, because of the financial crisis, this positive trend was stopped temporarily (Duma, 2012).

Following the 2008-2009 financial crisis, in order to rebalance the economy, painful fiscal adjustments were implemented in Romania in 2010, among them: cutting the salaries in the public system by 25%, freezing the pensions, increasing the VAT from 19% to 24% and so on. As a result of the financial crisis, many

Romanian SMEs went bankrupt or suspended their activities and the five survival rate dropped dramatically. For example, as we can see in the chart below (Chart no.1), if we take just the case of the very small enterprises with 1 to 4 employees, the survival rate dropped from 57.6% in 2009 to only 36.2% in 2013. Also, the number of persons employed decreased from 100% in 2008 to approximately 85% in 2010. But, even more dramatic was the drop in value added by the SMEs, from 100% in 2008 to almost 70% in 2010 and the recovery only started in 2013, as we can see from the tables below (Chart no.2).

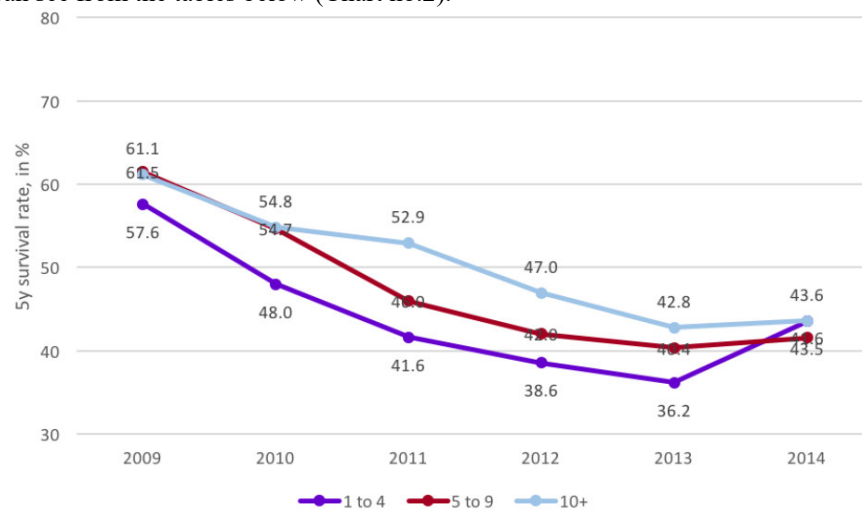


Chart 1. Romanian SMEs survival rate after the 2008-2009 financial crisis
Source: EC, 2018 - SBA

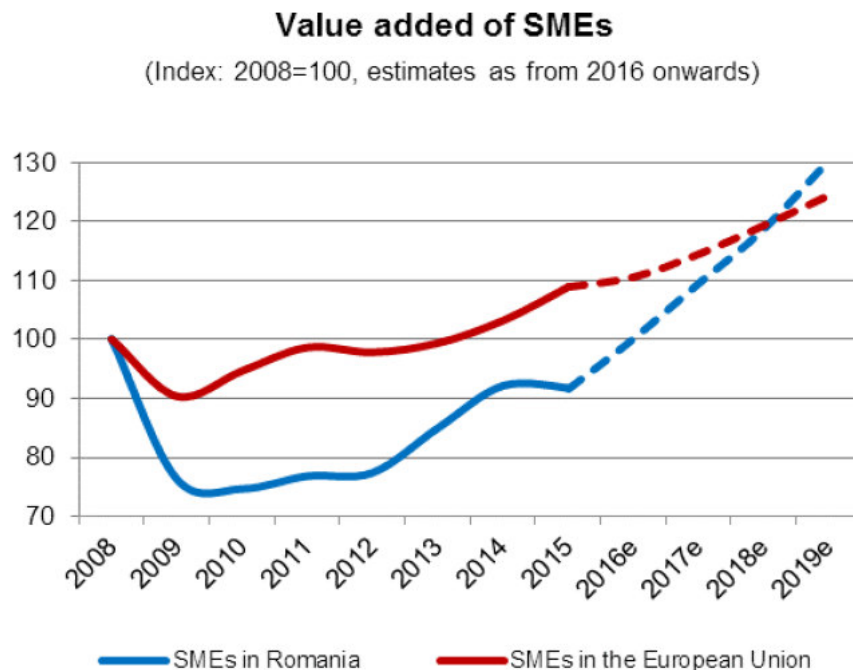


Chart no.2 Value-added of the Romanian SMEs vs SMEs in the EU
Source: (EC, 2018 - SBA)

Eventually, the positive trend started prior to 2008 was resumed some years later and while the number of persons employed in SMEs started to recover slowly, the growth of value added by SMEs was much stronger. This was possible due to the improvement in the general macroeconomic environment, but also due to specific initiatives promoted by national authorities to improve SMEs' access to finance, complemented by other tools addressing the needs of SMEs, such as loans, European Fund for Strategic Investments (EFSI) financing, guarantee funds, tax incentives, tax reductions, legislative measures, crowdfunding, business angels² and so on (Pop, 2018). Regarding the value added, the SMEs surpassed the 2008 level by the year 2016 and the projection for 2019 is to surpass even the EU average (see Chart no.2). This positive trend concerning the value added generated by the SMEs is partially due to the information technology and communication sector that has performed exceptionally well in the past five years, generating growth of 41.9% in value added and 22.3% in employment (EC, 2018). Today we are counting 480.791 active SMEs in Romania (EC,2018), meaning approximately 23 SME per 1.000 inhabitants, still far from the average in the European Union.

² A specific law regarding the stimulation of the individual investors - business angels with fiscal incentives, was promoted in Romania in 2015, Law no.120/2015

2 Financing options available for the small and medium-sized enterprises

The financing decision is a very challenging task for any company, but especially for the small and medium-sized enterprises because they encounter more restrictions and obstacles than the large companies. Basically, a small and medium enterprise can finance its activity in four major ways:

1. Self-financing.
2. With equity by “selling rights”;
3. With debt by “buying obligations”;
4. Different grants and financing support schemes.

The decision to choose one of these financing ways or a combination of them depends on several factors such as availability, cost, duration, flexibility, risk, control and so on.

Self-financing generally means using the entrepreneur’s own capital and resources to finance the company. Another way of self-financing is using family or friends’ money or resources. We think that it is not recommendable for new entrepreneurs to get capital from the so-called “3 F” (family, friends and other fools), because they will invest money mostly because they like them, not because they analyzed the business plan (if there is one) and whether or not it is realistic. However, if the entrepreneur will eventually lose their money, very probably their relationship will also deteriorate. Self-financing might look like a simple solution but it doesn’t mean that there are no costs involved, as many entrepreneurs think. Milton Friedman said once that “there is not such a thing as free lunch”, they have to consider at least the opportunity cost of the capital.

On the other hand, self-financing can come in the form of using financial resources generated by its own activity. This financing option will come in the form of plowing back and reinvesting the profit, using resources generated by the operational activity, using different reserves or other sources like cash flow allocated to depreciation. Focusing on availability, this form of self-financing is not truly an option for many SMEs, especially for the start-ups and the very young enterprises, simply because they don’t yet have a profit to plow-back or to make reserves. This financing option will come for these companies at a later stage, hopefully. Therefore, the real choice for these companies has to be made between equity, debt and financial grants, if available, or a combination of them.

Generally speaking, equity means “selling” rights in somebody’s enterprise in exchange for capital. More precisely, the investor will get a percent of the shares with all the rights deriving from it: voting rights, dividends, decision rights etc.

This operation can be done at the very beginning or later on through a capital increase.

For the SMEs, the most common ways of financing with equity increase are: business angels, crowdfunding, venture capital, direct internet public offers etc. Family or friends can be considered equity if they get a part of the shares, but we prefer to include them in the self-financing if they only invest for personal and not for business reasons. From this point of view, business angels are a much better idea, not only because they can provide the entrepreneur with the necessary capital, but also they will give valuable feedback regarding the business. Business angels are current or former (serial) entrepreneurs or wealthy people with a lot of experience, which meets certain standards for accredited investors established by the financial supervisory authority, who can help and protect your enterprise like an “angel”.

Crowdfunding is another financing tool for entrepreneurs that use small capital contributions from a large number of individuals usually through dedicated web platforms like, for example, kickstarter.com. Another form of financing with equity is the Direct Public Offer (DPO) when the enterprise sells its shares directly to investors, usually online. The Direct Public Offers are more appropriate for SMEs than the Initial Public Offers (IPO) because they eliminate the financial intermediaries (investment banks, dealers, underwriters, etc.) and for this reason are much cheaper, lowering the cost of the capital substantially.

Venture capital is a financing option that usually comes from different types of investment funds and provides a large amount of money, but also expertise or management for the enterprise.

If equity financing is not available or enough, the other financing option is to borrow money. The debt can come in the form of bank loans, bonds or leasing.

Concerning the bank loans, the problem for the SMEs in accessing them is related to the collateral guarantees they have to provide, yet this shortcoming can be solved by leasing, either operational or financial. It might be more expensive than a bank loan and limited to just some categories of assets but is more easily available because doesn't require additional guarantees, other than the asset itself. The bonds, like the IPO, are not an option for the SMEs in Romania, first of all, because their issuance is an expensive process and, secondly, because the enterprise has to have some notoriety and good credibility.

For shorter periods of times, an entrepreneur can use some other sources of financing like payables, resources generated by the operating activity, short-term loans, overdraft loans or factoring. The advantage of these short-term financing sources is that some of them can be much cheaper and available compared to the long-term financing sources. In this category we can find, for example, the payment delay accepted by payables, customers' credit or other resources

generated by the operating activity. On the other hand, the overdraft loans or the factoring are expensive but can be very useful to cover treasury deficits.

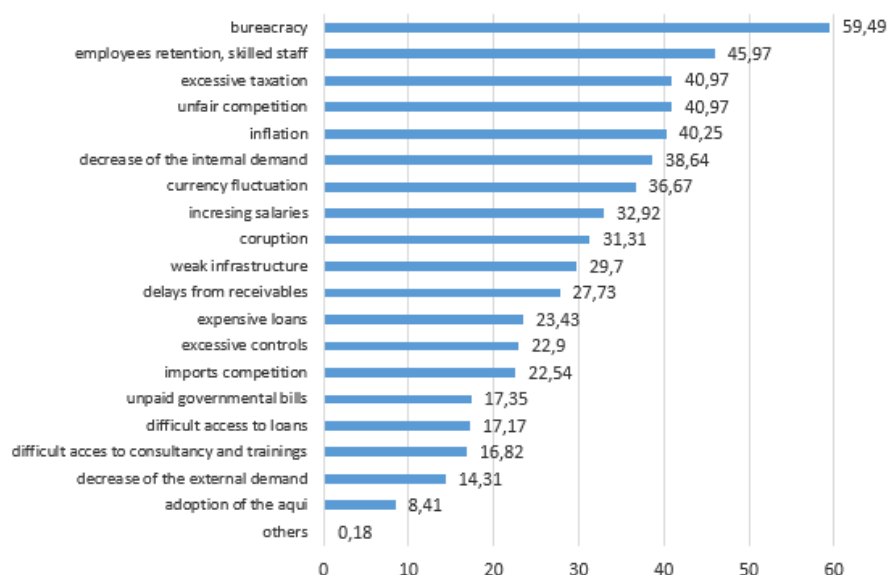
The combination of all these financing options is called capital structure policy and should have the minimization of the cost of capital as objective, as well as the maximization of the enterprise's value.

3 The financing structure of the Romanian SMEs

Access to finance is not the most important issue for the SMEs in the European Union. Actually, this concern decreased from 16% in 2009 during the financial crisis to 7% in 2018. The top three most important concerns for SMEs in the EU are: availability of skilled staff or experienced managers (25%), finding customers (23%) and regulation (13%) (SAFE, 2018). According to the same survey, the access to finance is the main issue only for 7% of Romanian SMEs in 2018, in line with the EU average.

According to a survey presented in the White Charter of the Romanian SMEs (CNIPMMR, 2018), the top three most important concerns for the Romanian SMEs are: the bureaucracy, the hiring and the retention of skilled staff and excessive taxation (see the chart no.3). We can observe that only the issue related to skilled staff availability and retention is given in both the top three concerns reported by the SMEs in the EU and Romania.

Chart no.3 The main constraints for the Romanian SMEs in 2018
The main constraints for the Romanian SMEs (2018)



(source: CNIPMMR, 2018)

However, even though the access to finance is not mentioned as a major concern, neither for the Romanian SMEs, nor for the SMEs in Europe, we believe it is valuable to check what financing options they have available and if they differ significantly.

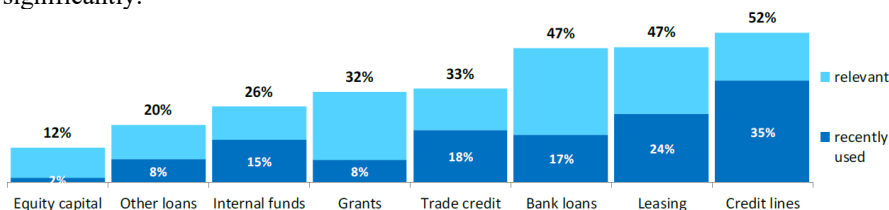


Chart no.4 The relevant sources of financing for the SMEs in the European Union
(source: SAFE, 2018)

As we can see from the chart no.4, the top three most relevant sources of financing for the SMEs in the European Union are credit lines, leasing and bank loans. We can observe that the financing with debt from a bank or from a leasing company is the relevant financing option for most of the European SMEs. Even in fourth place we still find another form of debt financing, not with a bank this time, but with payables, as well as in seventh place where other loans are indicated. Therefore, it is easy to see a very clear preference of the SMEs in the EU for debt

financing. We think this is because, on the one hand, it is more available and, on the other hand, the capital markets in the EU are not developed enough or its instruments are not suited to the needs of the SMEs. As a matter of fact, the capitalization of the stock markets from the EU is only at 75% of the GDP, while in the US it represents 136% of the GDP. But, the banking sector is more developed in Europe where the bank credit to the private sector is 104%, whereas in the US the bank credits account only for 43% of the GDP (FESE, 2014). Basically, most of the financing in the EU comes from the banks, creating so-called 'bank-centric' Europe. Only 30% of the financing comes from the stock markets in the EU compared to 70% in the US. Moreover, bank finances are four times bigger than the GDP in the EU, while in the US they amount to only 80% of the GDP (Duma, 2016). Regarding the SMEs in the EU, the percentage is even smaller, equity financing being relevant for just 12%.

Financing structure of the Romanian SMEs provides a more complicated picture, as we can see in the chart no.5 elaborated on a survey made by CNIPMMR in 2018, presented in White Charter of the Romanian SMEs.

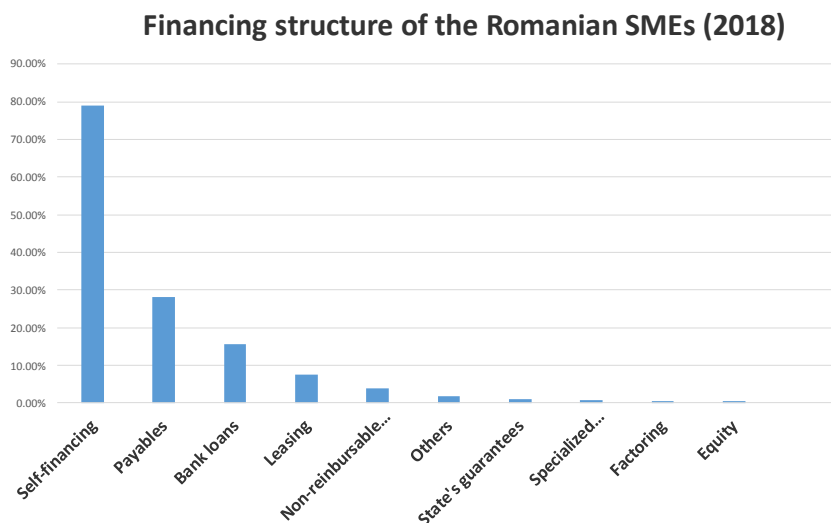


Chart no.5 Financing structure of the Romanian SMEs in 2018
(source: CNIPMMR, 2018)

Quite surprisingly, we can find that almost eight out of ten SMEs in Romania are using self-financing as the main way to finance their activities. In second place, but very far behind, comes the payables which are not even a proper source of financing, in the sense that nobody is lending money, just accepting (though not always voluntary) a delay regarding payments due. Moreover, this is just for short-term and, often, only an emergency solution to cover a cash flow deficit.

Only in third and fourth place, but with a very small percentage, can we finally find some similarities with the SMEs in the EU, namely the financing with the bank loans and the leasing. There is a little similarity in the ranking (in Romania bank loans and leasing are in third and fourth place, while for the SMEs in EU are in third and second place), but not at all in percent. While for the SMEs in the EU leasing accounts for 47% of the SMEs and there is a similar percentage for the bank loans, for the Romanian SMEs the bank loans represent only 16%, and the leasing even less, just 7.5%. One reason for these low percentages is that the interest rates are much higher in Romania compared to other countries in the EU and, another reason is that the banks there are quite reluctant to credit the SMEs because of past experiences with high rates of non-performing loans. Moreover, the banks are asking for collateral guarantees that most of the Romanian SMEs cannot provide. In fact, most of the banks in Romania have an ultra-precautionary approach regarding the financing of the SMEs. Therefore, it should not come as a surprise that the level of financial intermediation in Romania is the lowest in the EU, reaching just 52.2% of the GDP, four-time less than the median in the EU where it is at 208% of the GDP (Voinea et al, 2018, p.101).

Also, despite big publicity and many talks, the non-reimbursable funds from the EU or the different grants account for only around 5% for the Romanian SMEs, while in the EU these grants are relevant to 32% of the SMEs. An explanation can be the problem in bureaucracy that was indicated as the principal constraint for the Romanian SMEs in general in 2018, but also the long duration of the whole process and the fact that the entrepreneurs and the SMEs don't know how to approach or deal with these funds.

The same discrepancy is found in equity financing, which is virtually non-existent in Romania (0.5%), while in the EU, though this percent is small compared to the US, it's still 24 times bigger than in Romania.

We can easily observe that many financing sources are very minimally represented or are missing completely from this picture of the financing structure of the Romanian SMEs, like for example: business angels, crowd-funding, grants, venture capital, IPOs, equity in general. We think this is because many entrepreneurs don't have a feasible business idea, don't know how to present it or don't know how to elaborate a proper business plan to get the appropriate financing.

Conclusions

The picture of the financing structure of the Romanian SMEs in 2018 appears strongly unbalanced, with the great majority of the SMEs having self-financing as their first option for financing. Unfortunately, very often this self-financing happens not by choice, but because of necessity, being the only available solution, this originating in 39% of the companies in Romania having negative capitals

(Voinea et al, 2018), so are rather underfinanced. If we add to this the fact that the second source of financing for the Romanian SMEs is the payables, we have a picture of companies that are financing for survival, not for organic development. Moreover, if we are looking at the most relevant sources of financing for the SMEs in the EU, we can observe that each of them account for less than 15% in the case of the Romanian SMEs.

Actually, this extremely high percentage of self-financing shows a situation of subsistence organizations (Gheorghiu & all, 2015, p.16), indicating a form of subsistence entrepreneurship in general, that doesn't have many chances of real development without enough and adequate financing.

In order to rebalance the situation and to foster the development of the SMEs, we believe that first it would be necessary to create a more favorable ecosystem for entrepreneurship in Romania and then the money will follow creative and feasible business ideas presented on logical and realistic business plans. Everything should start early with entrepreneurial education in schools at every level: primary (children can play different types of Monopoly games, for example), secondary, high schools, universities, but also outside schools with training for actual or potential entrepreneurs. The next step should be the development of a better infrastructure including business incubators, accelerators, co-working spaces, innovation labs and so on, to help the entrepreneurs and the companies at their early stage. And, of course, even after "take-off" continuing to provide support in the form of counseling, mentoring or business coaching would help these entrepreneurs and SMEs in their development.

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