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SME Financing in Latvia: is there an Alternative to Banking Present?

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Abstract. Small and medium enterprises (SMEs) are the strength and core of the European economy, where the data by the European Commission (2015) indicates that 9 out of every 10 enterprises is an SME and generate 2/3 of jobs. Data by International Trade Centre and World Trade Organisation (2014) show that on the global level around 95% of all companies are SMEs, create 60-70% of private sector jobs and provide substantial input into tax payments. When challenged by the recent financial crisis, SME segment and predominantly its need for financing came into focus of the politicians and researchers. In 2015 Capital Market Union (CMU) initiative was presented by the European Commission (EC) in order to provide stable, more available and diverse financing for European SMEs. Activation of the European capital market including its corporate bond segment is one of the core areas of the existing CMU action plan.

While holding the broader CMU perspective and its capital market focus, the aim of this paper is when analysing the SME sector dynamics and development potential in Latvia, discover its financing needs and potential for alternative financing (including corporate bonds). The methods used in this paper are scientific publication analysis, statistical data analysis. The paper discovers the dependence of SME financing on the structure of the banking sector and existing regulatory environment, where access to finance is losing its importance among other concerns for SME sector. When evaluated on the EU level, Latvia outperforms other EU Member States in access to finance area with sharp decrease of rejected loans for SMEs. With its active stimulation of alternative financing to SME segment by Latvian authorities and decreasing lending dynamics the country indicates its need and readiness for CMU introduction and thus further development of alternative to banking financing.

Keywords: SME segment, financing, access to finance, corporate bond.

1. Introduction

SMEs make up to 99.8% of all EU enterprises, 57.4% of value added, and 66.8 % of the employment (European Commission, 2016). In Latvia, the increasing importance of SME segment is supported by the surge in value added by over 45% and employment by 16% by non-financial SMEs in the period of 2010-2015 with positive growth outlook. (European Commission 2017c). Besides to being in the focus and daily agenda of the European Commission the study by International Trade Centre and World Trade Organisation (2014) indicates that SMEs are widely discussed by G20 and the United Nations, where the latter is reviewing the implementation of the General Assembly Resolution A/67/202 "Entrepreneurship for Development. Moreover, European Commission (2015) stresses the need of help for SMEs.

With its heavy weight in EU economy the accessibility of financing for SME development should be available and stimulated. The investment in capital expenditure of a company provides the stimulus for the development of its scope thus stimulating the employment. While the banking sector was reluctant to provide the stable financing over the recent economic cycle, the EC initiative to create stimulus for financial markets development by the means of introducing Capital Markets Union was established by the European Commission. CMU initiative stresses the importance of SME financing and stimulates alternative financing by activating capital markets.

Both bank lending and alternative financing are available for SME to dissimilar extent in different EU countries. The variation comes from different combination of local financial market participants, capital market development stage and financial literacy by both issuers and investors. Capital markets and their corporate debt segment is one of the primary focus of CMU and a recognised means of borrowing by the European corporate. The study of Tocelovska (2017a) identifies three main areas of CMU initiative: capital markets activation for SMEs (including market harmonisation), investor base diversification and cross border investment. Latvian companies do actively utilise corporate bond segment where 94% of all Baltic corporate bond issues come from Latvia thus naming Latvian corporate debt market as the most developed in the Baltic region (Nasdaq Baltic, 2017). Latvian corporate segment displays the rapid growth and recognition of corporate bonds as the source of alternative to bank lending financing method.

The aim of this paper is while analysing the SME sector dynamics and development potential in Latvia, discover its financing needs and potential for alternative financing (including corporate bonds). There are no similar academic studies made on Latvian SME financing needs and potential for alternative financing in capital markets.

This paper contributes in two fundamental ways to the current literature on Latvian SME sector development and financing potential (including potential for alternative financing). Firstly, the author scrutinizes the existing academic research for discovering the factors affecting SME choice for financing. Secondly, the author examines SME segment in Latvia for financing needs and potential.

The structure of this paper commences with a review of EU SME sector and its structure, is followed by the review of the SME financing structure and factors affecting the choice. The author of this paper then analyses the existing studies and data on Latvian SME segment, its financing needs and challenges as discovered by the academic and political papers. Finally, the results of the analysis of Latvian SME segment and its potential for financing is made with the focus on alternative financing, the results of the analysis are presented and described as well as future areas of research are proposed.

2. Literature Review

Being frequently called the backbone of EU economy, much attention is paid to exploring and developing SME sector both on political and academic level. The focus on SME segment is globally present where one common SME definition is missing. While Forsman (2008) indicates that typical SME definition criteria includes small scale, personality and independence, the global perception of SME enterprises is based on evaluation of number of company employees, annual company turnover and amount of the assets company possess (Table 1).

While the analysis of globally accepted criteria of SME definition indicates the substantial variation (up to 6 times in the number of the employees), there is one accepted and applied SME definition in the countries of the European Union. The subsequent division between micro, small and medium-sized companies is made (Table 1). The existing difference: 25 times; within the SMEs definition of micro and medium-sized companies provides the challenge for treating so distinct companies as one group and analysing them together. Gibson and van der Vaart (2008) treat them as distinctly different, and believe they cannot be usefully discussed together. Besides to the clear and transparent definition of SME segment, European Commission provides and sound SME policy, which is mainly concentrated in five priority areas: promotion of entrepreneurship and skills; improvement of SMEs' access to markets; cutting red tape; improvement of SMEs' growth potential, and strengthening dialogue and consultation with SME stakeholders (Eurostat, 2017).

Table 1: SME Definition Criteria

Institution	Maximum # of Employees	Maximum Revenues or Turnover ($)	Maximum Assets ($)
World Bank	300	15 m	15 m
Multilateral Investment Fund- Inter-American Development Bank	100	3 m	none
African Development Bank	50	none	none
Asian Development Bank	No official definition. Uses only definitions of individual national governments		
United Nations Development Programme	200	none	none
EU: SME Medium-sized	< 250	≤ € 50 m	≤ € 43 m
EU: SME Small	< 50	≤ € 10 m	≤ € 10 m
EU: SME Micro	< 10	≤ € 2 m	≤ € 2 m

Source: Author’s constructed based on Gibson and van der Vaart (2008) and European Commission (2017a) data.

The existing academic and political papers provide deep analysis on the present and potential problems SMEs need to overcome. Forsman (2008) indicates the resource and knowledge limitations, lack of money, reliance on a small number of customers and need for multi-skilled employees. Report by International Trade Centre and World Trade Organisation (2014) specifies that size roots the challenges of the SMEs such as: access to finance, trade finance, lack of institutional support, insufficient skilled personnel, disproportionately high trade costs, lack of access to technology, unfavourable business environment. European Commission (2015) concentrates on overcoming SMEs structural problems such as a lack of management and technical skills, rigidities in labour markets and a limited knowledge of opportunities for international expansion. All of the studies indicate access to finance as the potential SME development constraint.

The main problems as defined by the SMEs are: finding customers, access to finance, availability of skilled staff or experienced managers, competition, costs of production or labour, regulation (European Commission, 2015). The importance of SME problems as identified by European Central Bank (2016) is indicating the shift from the infrastructural problems such as SME financing to more natural business-related struggle for customer and resources: finding customer and access to finance were the top concerns of SMEs in 2013, being replaced by finding customers and availability of skilled staff or experienced managers in 2015 (Figure 1). European Commission (2016a) points that in 2009 the financing problem was the second-most urgent for EU SMEs.

While decreasing in its importance on the aggregated level, access to finance remains the dominant concern for SMEs in Greece. SMEs in Italy, Ireland and the Netherlands frequently name access to finance as the most important problem (European Central Bank, 2016). Moreover, the importance of access to finance has the negative correlation with the size of the company- micro companies experience the most concern. The existing difference between the countries is present due to several reasons including the diversity of the traditions and development of financial markets i.e. the presence and effectiveness of operation of the local stock exchange, presence of bond market, presence of both reasonable issuer and investor side. Moreover, the European Commission (2016a) stresses that the substantial differences in financing conditions for SMEs between Member States continue to exist. The latter is being in focus of the Capital Markets Union (CMU) initiative introduced by the European Commission in 2015. (European Commission (2017).

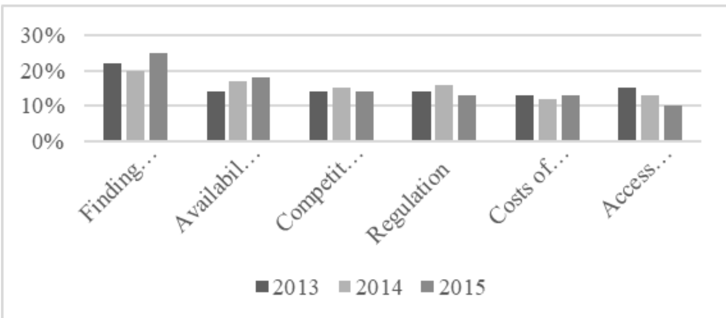

Figure 1. The most important problems faced by euro area SMEs

Source: Author’s constructed based on European Central Bank (2016) data.

The fragility of the bank-based financing dominating in the European Union was tested and underlined by the financial crisis of 2008. CMU initiative of the European Commission is bringing into light the need and development of the alternative financing for SME segment. The study of Tocelovska (2017) indicates the evident skewness of the research concentration on supporting the bank-based view on the European economy, where the minor shift towards more market-based view is stimulated by the consequences of the financial crisis of 2008. The focus of the EC towards CMU is accelerating the process.

While Moritz et al. (2016) underlies the lack of homogeneous financing structure of SMEs in Europe, the vast majority of academic research present in the area of SME financing concentrates on exploring the link between banking sector and SME financing. Behr et al. (2015) points that SMEs are credit-constrained and bank dependent, which is challenged by high information asymmetries, agency risks, insufficient collateral and small transaction volumes, which found to limit SMEs' access to finance by Moritz et al. (2016). Harel and Kaufmann (2016) describe the common obstacles in access to finance for SMEs as: asymmetry of information and lack of data; a fear of moral hazard on the part of lenders; adverse selection; and lack of experience and sophistication on the part of small businesses in dealing with financial institutions. The study names asymmetry of information, lack of data, moral hazard and adverse selection as the main obstacles of traditional industries to access finance.

Correlation between SME financing and the structure of the banking sector is found by Hasan et al. (2014). Where the increasing number of foreign banks in a country stimulate the vulnerability of the SME segment. The relation between the ownership of the banks, scale of banks and their lending practices to SMEs is found: local cooperative banks lend more than large domestic banks and foreign-owned banks. Moreover, it is found that SMEs perform better in counties with a majority of cooperative banks than in counties dominated by foreign owned banks or large domestic banks. Popov and Udell (2012) find that foreign bank presence in a country is associated with higher access to loans, higher firm-level sales, and lower loan rates and higher firm leverage, as well as their tendency to finance only larger, established, and more profitable firms. Hakenes et al. (2014) verifies the direct positive link between presence of small regional bank and the development of the local economy and its growth with the effect being stronger in less developed regions, while stressing their role in many European countries. The study of Hasan et al. (2014) proves the negative effect on profitability, leverage, and investment of SME firms of the presence of a larger number of foreign-owned banks in a country. Popov and Udell (2012) stress the heave foreign ownership in eastern European banking whereby 2008 foreign banks controlled around 4/5 of the assets of the banking segment. Behr et al. (2015) stresses the role of the government involvement in the lending process via banks with government ownership and their lending patterns relevant to the respective economic cycle phase. Those banks would approve relatively more SME loan applications in recessions, while being less generous in booms thus controlling the cyclicality of the banking system in a country. The stimulation of economic growth via stimulating SME lending is emphasised by Behr et al. (2015). The study suggests the increased role of local savings banks, government-sponsored or guaranteed lending.

Academic studies find the influence on the SME financing pattern and existing regulatory environment. Mc Namara et al. (2017) proves that countries' lending infrastructure influence SMEs capital structure. The maturity structure of the corporate debt is found to be influenced by the bankruptcy, information, legal and regulatory environments. The long-term debt is found to be dependent on efficient bankruptcy environment, and short-term debt on the information and legal environments. Both long-term and short-term debt are found to be dependent on the regulatory environment is important for. While there is a considerable focus on bank financing for SMEs as studied by the academics, Harel and Kaufmann (2016) stress that 50 percent of SMEs in traditional sectors have no assets to provide as collaterals, where Mc Namara et al. (2017) accents that most of the research in the area focuses on publicly listed firms with much less known about SMEs. Moreover, the importance of diversifying traditional bank-based financing is stressed by the academic research. Mc Namara et al. (2017) suggests encouraging SMEs to consider alternative financing on the policy level where Popov and Udell (2012) strass that SMEs may be particularly sensitive to changes in the supply of credit.

There is no standardised approach to SME financing since the number of instruments available as SME financing tools ranges from own financing to bank, capital markets and state financing. Moritz et al. (2016) distinguishes six SME financing types: mixed-financed SMEs, state-subsidised SMEs, debt-financed SMEs, flexible-debt-financed SMEs, trade-financed SMEs and internally financed SMEs. Where the choice of the relevant instrument is based on the combination of various micro factors such as firm scope, age and ownership, as well as the macro factors like macroeconomic and legal environments, the innovativeness of the industry. Even though SME financing is dependent on the needs of the company and instrument choice as made by the management, the existing financial sector development and established infrastructure could influence SME choice of financing mix.

On the EU level both academic and politic papers (except of country level reports) seldom define Latvia as a separate country for analysis. The topic of SME segment is reasonably analysed by Latvian researchers with little emphasis of SME financing.

While Kotowska and Martyniuk (2016) point that reasonable criteria for SME classification for micro, small and medium size are included in the Accounting Acts for Latvia, the study of Sceulovs and Gaile-Sarkane (2012) challenges SME definition and suggest its revision for small economies like in Latvia and other Baltic States, where dominating number of companies according to their size are small and micro. The need for measuring Latvian SME performance is in focus of several researchers: Kotane and Kuzmina-Merlino (2017) and Kotane (2016) point that there is no united set of indicators measuring the performance of the SMEs', Kotane (2016) names the 1) return on sales (ROS), 2) return on equity (ROE), and 3) gross profitability as three highest ranking indicators, where Kotane and Kuzmina-Merlino (2017) name 1) gross profitability, 2) accounts receivable turnover and 3) gross profitability three highest ranking indicators. The existing problems of Latvian SME segment is found to be lack of resources (Kotane and Kuzmina-Merlino, 2017) and lack of consequent taxation changes for the micro tax payers in Latvia, which can be acquired and actively used by the SMEs (Sneidere and Bumane, 2016). The latter stresses that 60,7% of all new SMEs apply for micro tax payer status.

3. Research Results

According to European Commission (2017b) data the number of SMEs in 2015 in Latvia reached 99,81% being the same level as EU average: 99,81%. The number of employees working in Latvian SMEs reached 78,96 % or 12% above EU average. The dynamics of the SME segment both on the number of the companies and number of people employed indicates the relatively increasing weight of micro type of SMEs companies (Table 2). The dynamics of companies registered in Latvia indicate the positive dynamics in both total number of the companies registered and SME sector, where the number of large companies stays stable and new companies are generated by the SME segment (Table 2).

Table 2. Enterprises in Latvia

Number of SMEs (% of total number of enterprises									
Type of SME	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Medium	2,4	1,8	1,6	1,69	1,5	1,5	1,4	1,3	1,4
Small	13,3	9,7	9	9,3	8,1	7,9	7,2	7,1	6,9
Micro	84,3	88,5	89,4	89	90,4	90,6	91,4	91,6	91,7
Number of people employed (% of total number in enterprises)									
Type of SME	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Medium	33,6	30,8	29,5	31,3	30,2	30,5	29,6	29,6	29,4
Small	37,2	34	33,3	34,5	31,9	32,8	30,8	30,5	30,2
Micro	29,2	35,2	37,2	34,2	37,9	36,7	39,6	39,9	40,4

Enterprises in Latvia (number)										
Size class	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Medium	1826	1409	1327	1366	1424	1454	1410	1419	1436	1459
Small	10099	7506	7223	7255	7361	7567	7266	7276	7307	7348
Micro	63898	68517	71906	69803	82251	86829	92200	94147	96976	100204
Total	76043	77617	80632	78608	91221	96046	101080	103042	105920	109210
All SMEs	75823	77432	80456	78424	91036	95850	100876	102842	105719	109011

Source: Author's construction based on European Commission (2017b) and European Commission (2017d) data.

In order to compare Latvian SME sector dynamics to other of EU countries, the sample as selected by the study of EY and CityUK (2015) is made. The paper compares Latvia along with Germany, France, Italy and Poland to make a representative picture of the EU economy. While the economies of different scope are selected, relative indicators: SME employees as the percentage of the total population and number of employees per SME, indicate the relatively high development of Latvian SME segment.

On average, the sample of the countries selected employs 19% of its population by the SME segment, where Latvia indicates the highest percentage of 23% thus demonstrating the relatively high importance of SME segment for the country. Number of employees per SME of the sample is placed on 4.39 level, where Latvia employs 5.2 employees or second highest after Germany (Table 3)

Table 3. SMEs in Germany, France, Italy, Poland, Portugal, and Latvia

Country	**Population (people)**	**Number of SMEs**	**Number of SME employees**	**SME employees/ population**	**Number of employees/SME**
Germany	80 800 000	2 201 000	16 721 000	21%	7,60
France	65 900 000	2 598 000	9 587 000	15%	3,69
Italy	60 800 000	3 718 000	11 516 000	19%	3,10
Poland	38 500 000	1 475 000	5 679 000	15%	3,85
Portugal	10 400 000	775 000	2 264 000	22%	2,92
Latvia	2 000 000	88 000	458 000	23%	5,20

Source: Author's construction based on EY and CityUK (2015) data.

Latvian SME indicates the positive dynamics in its development when related to EU Member States where Latvia outperforms other EU Member State in annual Small Business Act for Europe Fact Sheet in majority of the evaluation criteria including access to finance area. The major improvement to access to finance indicator of Latvia has contributed the sharp decrease of rejected loans for SMEs. The statistical data for year 2015 indicate that almost no SMEs signalled the rejected loan application by the bank, where in 2014 around 1/3 was rejected European Commission (2017c). Despite the very high progress of Latvia in solving access to finance issue for SMEs the high speed of the situation improvement should be challenged for sustainability. Moreover, the more detailed exploration of the discouragement of 1/3 of the rejected loans application in 2014 to apply for loan once again in 2015 should be done. The results of European Commission SBA Fact Sheet (European Commission, 2017c) indicate there is no obvious need for further stimulation of access to finance area for SMEs.

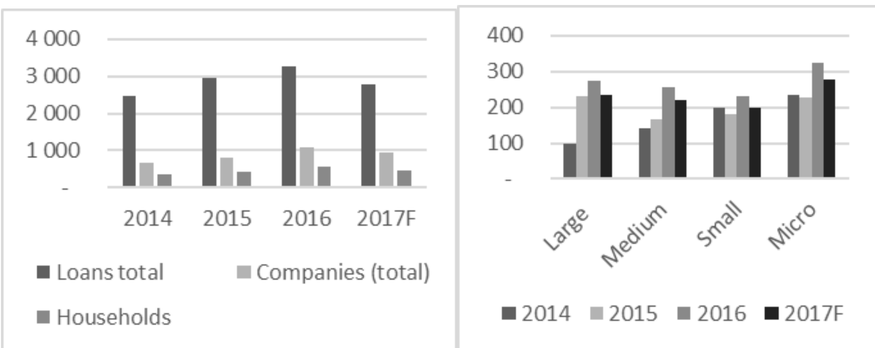

Fig.2. Newly granted loans (EUR mil)

Source: Author’s constructed based on Financial and Capital Markets Commission (2017) data.

The annual report of the European Commission (2017c) indicates the active involvement of Latvia in stimulating alternative financing to SME segment via public loan programmes, public guarantee schemes, microfinance measures, supporting venture capital, pre-seed and seed capital funds, creating a single development financial institution ‘ALTUM’ and other non-financial support including counselling, training, mentoring. The results of the initiatives introduced could be related to the drop-in loan rejected and relation analysed.

The analysis of the financing sector in Latvia with its positive loan issuance statistics (the absence of rejected loan application) contradicts the findings of Hasan et al. (2014), where the increasing number of foreign banks in a country stimulate the vulnerability of the SME segment by lending less. The share of foreign paid-up capital in Latvian banking sector is 82% in Q1 2017 with more than half of it originating from Sweden (Financial and Capital Markets Commission, 2017). The dynamics prove the previous findings of Popov and Udell (2012) about 4/5 of the assets of the eastern European banking being controlled by foreign banks.

The dynamics of newly granted loans in Latvia indicates growth in the period 2014-2016, where the forecasted numbers for 2017 (based on 2017 Q1 results) indicate the expected downside of lending on all levels (Figure 2). Micro companies remain the main type of corporate borrowers, where the amounts borrowed are evenly spread between four types of the companies. With its active stimulation of alternative financing to SME segment by Latvian authorities and decreasing lending dynamics the country indicates its need and readiness for CMU introduction and thus further development of alternative to banking financing

4. Conclusions

SME segment is the backbone of EU economy, where much attention is paid to exploring and developing SME sector perception and understanding both on political and academic level. Currently there is no one globally accepted SME definition, while the evaluation criteria are: number of company employees, annual company turnover and amount of the assets company possesses. European Commission provides clear and transparent definition and policy for SME segment.

The existing academic and political papers provide deep analysis on the existing and potential problems SMEs need to overcome. All of the studies indicate access to finance as the potential SME development constraint. Among six main types of challenges faced by the SME as regularly surveyed by the European Commission, the access to finance is found to be losing its high concern. The shift from the infrastructural problems such as SME financing is taking place to more natural business-related struggle for customers and resources. While on the aggregated EU level access to finance is improving, it remains the dominant concern for SMEs in Greece, with reasonable concern in Italy, Ireland and the Netherlands. Moreover, the importance of access to finance has the negative correlation with the size of the company- micro companies experience the most concern.

The existing differences between the countries is rooted in the diversity of the traditions and development of financial markets, where the EC stresses that the important differences in financing conditions for SMEs between Member

States continue to exist. The latter is being in focus of the CMU initiative introduced by the European Commission in 2015.

This study supports the previous findings of Tocelovska (2017) indicating the evident skewness of the research concentration on studying relation to bank financing by the academics in Europe. The review of existing academic papers of SME financing highlights the dependence of SME financing and the structure of the banking sector (both local and foreign ownership and private and sovereign ownership); SME financing and the existing regulatory environment. With 50 percent of SMEs in traditional sectors lacking assets to provide as loan collateral, there is absence of homogeneous financing structure of SMEs in Europe, where six SME financing types are present: mixed-financed SMEs, state-subsidised SMEs, debt-financed SMEs, flexible-debt-financed SMEs, trade-financed SMEs and internally financed SMEs. SME choice of financing is based on the combination of factors such as firm scope, age and ownership, macroeconomic and legal environments, the innovativeness of the industry.

SME segment is reasonably analysed by Latvian researchers with little emphasis on SME financing. On the EU level academic papers seldom define Latvia as a separate country for analysis. The existing studies on Latvian SME segment propose to revise SME definition, establish SME performance measuring criteria as well as point on existing problems of consequence in taxation and lack of resources by the SMEs. Almost all Latvian companies or 99,81% are SMEs. The number shares the average EU level, while number of employees working in SMEs is exceeding EU average by 12%. The dynamics of companies registered in Latvia indicate the growth in both total number of the companies registered and SME sector, where the number of large companies stays stable while all the new companies are generated by the SME segment.

When compared to EU country sample, Latvia has comparatively higher importance of SME segment for the country, while employing 5.2 employee per SME or second highest after Germany. Latvia outperforms other EU Member State in annual Small Business Act for Europe Fact Sheet in majority of the evaluation criteria including access to finance area. The major improvement for access to finance indicator of Latvia was contributed by the sharp decrease of rejected loans for SMEs. The results of European Commission SBA Fact Sheet (European Commission, 2017c) indicate there is no obvious need for further stimulation of access to finance area for SMEs.

Latvia is actively stimulating alternative financing to SME segment via public loan programmes, public guarantee schemes, microfinance measures, supporting venture capital, pre-seed and seed capital funds, creating a single development financial institution 'ALTUM' and other non-financial support including counselling, training, mentoring. The analysis of Latvian SME financing contradicts findings of Hasan et al. (2014), where the increasing number of foreign banks in a country stimulates the vulnerability of the SME segment by lending less, while proving the Popov and Udell (2012) findings that 4/5 of the assets of the eastern European banking are controlled by foreign banks. With its active stimulation of alternative financing to SME segment by Latvian authorities and decreasing lending dynamics the country indicates its need and readiness for CMU introduction and thus further development of alternative to banking financing. Despite the very high progress of Latvia in solving access to finance issue for SMEs the high speed of the situation improvement is recommended for further analysis of its sustainability while defining the key reasons. It is recommended to further explore the potential and readiness of Latvian SME segment for alternative financing and particularly for corporate bond issues on company level.

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