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Access to Finance for Latvian SMEs

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Abstract:

In this paper, we attempt to explore why banks possessing free assets and willingness to lend, on the one side, and businesses lacking money, on the other side, do not meet. We are looking for answers why all EU initiatives for more available funding for SMEs still haven't resulted positively and loan growth rate is more than modest.

The empirical part of the research is based on the quantitative and qualitative assessment of the commercial banks, SMEs of Latvia and case studies of timber industry. The result of the analyses has been discussed and recommendations have been provided for policy makers and academician, opening new areas for this timely topic research.

Keywords: *SMEs financing, access to finance*
JEL codes: *G21; L10; O12; 016*

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1. Introduction

Access to finance for SMEs during the past 3 years in general has improved, nevertheless remains wide divergences across the euro area countries. In 2016 access to finance remained the dominant concern for SMEs in Greece (31%,), while 13% of SMEs in Italy and 12% in both Ireland and the Netherlands named access to finance as the most important problem, compared with only around 6% of SMEs in both Austria and Germany and 8% in Finland (European Central Bank, 2016). In Latvia in 2016 the most important problems faced by SMEs were finding customers (20%), availability of skilled staff or experienced managers (15%), competition (13%), costs of production or labour (12%) and finally access to finance with 10% as the fifth most pressing obstacle (Kwaak and Zeijden, 2016).

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; Breckova, 2016).

At the same time, the loan portfolios of both non-financial corporations and households in Latvia had been shrinking in the period between 2008 and 2016. Even slower pace of shrinking in 2016, hasn't changed the common negative picture, the ratio of loans granted to private nonfinancial corporations and households to GDP has shrunk to 44.8%. ECB data on loans to residents of the euro area suggest that lending dynamics in Latvia lag behind lending development in the neighbouring countries (Lithuania and Estonia). The average rate of change in lending in the euro area as a whole is also slightly higher than in Latvia (Latvijas Banka, 2016). The aim of the research is to analyse the supply and demand factors that interfere with the availability of funding to SMEs and to develop recommendations for policy makers and academician, opening new areas for this timely topic research.

The following tasks are conducted:

- Based on the bank expert interviews, to carry out the qualitative analysis of the bank credit supply;
- Based on the SIBIL and LURSOFT data, to analyse the credit demand;
- Based on the timber industry's case studies, to analyse companies experience in getting loans;
- To design recommendations for policy makers and academician.

During the research the following research methods were used: the generally accepted quantitative and qualitative research methods in economics, including the comparative analysis and synthesis and graphical depiction.

2. Literature Review

In Latvia SMEs form the largest part of companies, providing the majority of jobs. Small and micro companies find it difficult to obtain commercial bank financing, especially long-term loans, for a number of reasons, including lack of collateral, difficulties in proving creditworthiness, small cash flows, inadequate credit history, high risk premiums, underdeveloped bank-borrower relationships, high transaction costs and shadow economy (Rupeika-Apoga and Danovi, 2015; Rupeika-Apoga and Solovjova, 2017; Theriou, 2015). European Commission Survey on the access to finance of enterprises (SAFE) in 2016 report the same problems: insufficient collateral or guarantee (22%) compared to EU28 (15%); interest rates or price too high (15%), too much paperwork is involved (8%) and financing not available at all (8%). Unfortunately, only 24% of companies stayed that there are no obstacles for getting financing that is twice lower than in EU28 in general (44%).

Conducted literature and surveys review shows that the access to finance is still one of the main obstacles for doing business, especially for SMEs (Dorin and Viorela, 2015; Havlíček, Thalassinos and Berezkinova, 2014; Mareš and Dlasková, 2016; Thalassinos and Liapis, 2014; Suryanto, 2016; Vovchenko *et al.*, 2017). However, the reasons why banks do not fund businesses in the situation when they dispose of large amount of free assets and lack objects of investment have not been sufficiently analysed up to now. Where is the problem, on demand or supply side?

In his research Beņkovskis indicated that misallocation of capital in Latvia became an important source of total factor productivity losses in 2013. The increased misallocation of capital can be related to tighter credit conditions of Latvia's banks and the reason that exporters of goods face higher capital costs due to restricted credit supply (Beņkovskis, 2015; Denisova *et al.,* 2017; Boldeanu and Tache, 2016).

SMEs' credit demand is negatively affected by external uncertainty and the associated caution to make new investment and by delay in absorption of EU funds since the beginning of the new programming period of EU funding. The available resources provided by EU funding support lending, in particular when investment by SMEs themselves is insufficient (Thalassinos *et al.*, 2014; 2015). Within the framework of the European Fund for Strategic Investments programmes Latvian SMEs, more than has previously been the case, will be able to get support for guarantees from JSC *Attīstības finanšu institūcija Altum* as well as directly from the European Investment Bank. The programmes could improve access to financing by SMEs with no credit history and in need of the first loan (Latvijas Banka, 2016).
This paper adds to the literature by highlighting the contradiction or even the paradox of the banks possessing free assets and willingness to lend, on the one side, and businesses lacking money, on the other side, do not meet.

3. Reseaarch Methodology

In the research three instruments are used to establish what is going on in the area of SMEs financing:

- In-depth face-to-face interviews with the board members of the eight banks of Latvia in 2015 and 2016.
- A unique set of data designed by Vjačeslavs Dombrovskis and his colleagues at TeliaSonera Institute of Riga School of Economics: SIBiL, Survey of Innovative Businesses in Latvia where they follow the development of more than 1200 small and medium-sized businesses (SMEs) in the area of manufacturing in the period from 2008 to 2015.
- In-depth case studies analysis, including in-depth face-to-face interviews with the board members, of the 4 Latvian export oriented companies in the timber industry's.

Data

The sample of SIBiL is drawn from the database of Lursoft, the largest database in Latvia that fully mirrors the Business Registry. It is a universe of all registered businesses in Latvia. The database includes a wealth of information on the owners of all registered business, as well as balance sheets, income statements going back to 1996. Lursoft database was used to obtain information on the location of the firm, as well as its registered phone number, information on the chairman of the board and the largest owner – i.e. name.

Target population for the survey is composed of small economically active firms in certain market activities (by NACE classification) in Latvia. Small (or micro) firms are defined as those that employ less than 10 employees, for the exception of certain high-tech and knowledge-intensive industries. Active firms are defined as those that have filed financial reports in 2005 with non-zero assets and turnover. New firms that must file reports to the enterprise register and which were established in 2006 are also considered to be part of the target population. Only firms in the following industrial sectors were included in the target population of the survey:

- mining and quarrying (NACE 10-14)
- manufacturing (NACE 15-37)
- electricity, gas and water supply (NACE 40-41)
- wholesale trade (NACE 51)
- transport, storage and communication (NACE 60-64)
- financial intermediation (NACE 65-67)
- computer and related activities (NACE 72)

The firms which are not included are those that were either not active in 2006 (i.e. had zero sales), or which did not have valid industry classification, or had no data about the number of employees. This means that stratification could not be done.

Surveys

SIBil data are based on two waves surveys made in 2008 (wave1) and in 2010 (wave 2). SIBiL core questionnaire is the one used in CIS4 innovation survey. In wave 2, a large section is devoted to access to financing, adopting the US Federal Reserve's

Survey of Small Business Financing questionnaire (Survey of Small Business Finances,2003). The interviews were conducted by Latvijas Fakti, a premier survey firm in Latvia. The invitation letters were sent, signed by the principal investigator, to each firm asking to participate in the project. Then, the interviewers contacted the firms by phone and agreed on time of the interview. The interviewers were only allowed to interview with specific people who were owners-managers of the firm. The interviews are face-to-face, that helps conduct longer interviews and thus, use longer questionnaires. On average, interview lasts about 40 minutes.

Case Studies

In order to analyse the availability of funding from the demand side, in-depth analysis of 4 companies working in the Latvian timber industry sector, one of the most competitive export sectors, has been conducted. The choice of companies was based on their size (turnover) and credit history, including one of the strongest and biggest Latvian company (Latvijas Finieris) and three middle and small companies with different credit histories.

4. Analysis and Results

4.1 Qualitative analysis of the loan supply: interviews with bank experts

The goal of the interviews with bank experts was to get acquainted with the crediting strategy of banks as well as the vision regarding future development perspectives. The total Latvian market share in crediting of the banks examined by us was 80% at the end of the third quarter of 2016.

The persons interviewed belonged to the management of SEB bank, Swedbank, Citadele bank, Nordea Bank AB Latvia branch, ABLV bank, Bank M2MEurope, Rietumu bank, Rigensis bank. In the discussions a range of problems were outlined faced by banks and business people.

- Overall. The bank representatives stated that over recent five years no significant changes had taken place in the lending strategies of the banks, however, all surveyed persons mentioned the willingness to increase the lending volume.
- The decisions on corporate loans are highly centralized and the assessment is provided based on the submitted financial data and business history. At least regarding SMEs the company is seldom assessed locally, this particularly concerns the regions outside Riga. If the actual situation of the business differs from the one in the official reports, e.g., the business evades taxes, this aspect isn’t taken into account.
- The surveyed bank representatives consider that the role of banks in lending to start-ups 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 their significance.

- A more significant problem is the shadow economy that decreases the legal cash flow of businesses that serves as a basis for adopting the decision on granting the loans.
- The situation is also influenced by the problems related to the insolvency processes of the businesses as well as the slow and complicated examination of cases in courts that raises the actual price of credit resources for the business people.

We have summarized the information about the experience of banks regarding specific situations in the area of lending and tried to identify specific concrete groups of businesses for which it is either relatively easier or more complicated to get a bank loan. Table 1 shows the bank experts' answers to the questions above.

Table 1. *Experts' Assessment of Business Loan Applications*

Businesses for which it is the easiest to receive loans	**Main reasons for refusing a loan to businesses**	**Businesses not even attempting to apply for a loan**
Big, financially stable businesses	The business is active in shadow economy	Family businesses
Municipal enterprises	Restaurants	Businesses that are active in shadow economy.
Exporters	Big debts	Estate managers
Businesses that have survived the crises without big losses.	No experience in the industry	
Businesses with the co-operation history with the bank	Insufficient cash flow	
Businesses with a predictable cash flow	Insufficient equity	
Transparent businesses	The project is too innovative	

From Table 1 it can be seen, that banks are open for the co-operation with individual groups of businesses, like the big enterprises and export-oriented businesses. The experts also pointed out the advantages of general character, for example, the transparency and predictability of the business.

4.2 Qualitative and quantitative loan demand analysis: SIBIL and LURSOFT data

In order to understand the trends observed in Latvia since 2008, we studied enterprises grouped according to the size and source of financing. The enterprises were divided into two categories according to the number of employees and into three categories according to their loan application/receipt status. The business profile is created based on the result of the surveys made in 2008 and 2010 and

LURSOFT data that contain the data on the performance of businesses until year 2014 (inclusive).

Based on the survey results and established criteria the businesses were divided in the 6 groups:

- *Microenterprises (Micro1) / Small and Medium-Sized Enterprises (SME 1)* which received the loan, 98 and 106 companies respectively;
- *Microenterprises (Micro2) / Small and Medium-sized enterprises (SMEs2)* which applied for a loan, but did not receive it, 38 and 46 companies respectively;
- *Microenterprises (Micro3) / Small and Medium-Sized Enterprises (SMEs 3)* which have not asked for a loan, 440 and 193 companies respectively.

Analysing main financial indicators as turnover, assets, profit, expenditure structure, financial leverage, own capital, loans amounts, debt ratio, we concluded:

- Most micro-enterprises (63%) and SMEs (49%) do not apply for loans and are not interested in receiving bank loans. The majority of enterprises (65% of micro-enterprises and 70% of SMEs) that applied for loans, did so successfully;
- Enterprises that had available credit rapidly increased their own capital;
- In the examined period the cost optimization was observed in the enterprises, which partly indicates at the insufficiency of resources. P/L analysis indicates that the enterprises of group 1 and 3 worked with a profit, however, those of group 2 had losses which tended to decrease. In the microenterprises which used loans the long-term liabilities dominated, which were used for funding fixed assets, but in the SMEs with a loan the short-term liabilities (up to 1 year) prevailed and were used for funding current assets. In group 2 the indebtness structure significantly differed from group 1 where both in the Microenterprises and SMEs mostly short-term loans were used. In group 3 the proportion of commitments in the liabilities accounted for 50% (Micro) and 60% (SMEs), which is significantly less than in group 1 enterprises. In group 3 Microenterprises short-term liabilities prevailed, however the long-term and short-term liabilities of SMEs were approximately equal.
- The third group of enterprises, which have not asked for a loan, showed rather good financial results, proving the idea, that this group has high potential to get loans in case of applying for them.
- The enterprises surveys results showed, that the main reasons for not asking a loan are: insufficient collateral, high industry risks, insufficient turnover, high level of leverage, the company's business-like reputation.

4.3 Case Studies of Timber Industry

Company "Latvijas Finieris"

Latvijas Finieris is a leading Latvian wood processing group, whose main specialty is plywood. The Group has 2,4 thousand employees, or about 8% of the employed in the timber industry. Company consolidated turnover in 2014 amounted 194 mln.

euro. Since 2005, the turnover of company has increased by 40% yearly that proves that the Latvijas Finieris is a growing company and there has been a steady growth in the long term. Between 2010 and 2014, the company's commercial profitability has not been lower than 6%. Also, the total liquidity is sufficient and since 2005 has not fallen below 1.4 times. Such figures make Latvijas Finieris an attractive client for banks. In recent years, the company mainly uses their own financial resources to finance fixed assets. By contrast, from 2006 to 2008, the Group had sharply increased the book value of the fixed assets, which was financed by bank loans.

The main long-term investment is financed by DNB Bank, but certain loans had been received from Swedbank and SEB bank. Since 2009, the maximum loan amount of credit each year has fallen by an average of 14%, the company has rapidly erased the debt. In 2014 the company announced plans to invest 280 mln. euro in development till 2020, what means, that additionally to reinvested profit it needs a loan. However, in an interview with the company's management was stated, that even in Latvijas Finieris case, banks are reticent to grant loans with fixed terms with maturity of more than 3 years. Therefore, public support is necessary to improve the long-term availability for loans to Latvijas Finieris and other timber industry companies whose long-term performance indicates a low credit risk.

Company "Vudlande"

Vudlande is a medium-sized pre-treatment company - produces battens, timber, containers and garden design elements, in 2014 employed 75 people. Production volume is growing, the company is working with profit that reduces dependence on borrowed funds and ensures a high level of liquidity. Vudlande financial performance meets the requirements of banks, which ensure the access to financial resources. The company uses a bank credit line of 1 mln. euro and reimburses the credit, which was used for long-term investment. To extend the company development it needs additional external resources, that banks are willing to give, but companies' management isn't ready to ask due to the company's foreign owner's conservative investment policy.

Company "Piebalgas"

Piebalgas also is a medium-sized pre-treatment company, producing construction lumber, pallet, fence posts, as well as profiled, planed lumber. The company is located in rural areas and employs 79 people. Financial indicators are relatively good, the turnover and profitability are increasing, but the company's commercial profitability ranges between 0.8-1.3% only, comparing with 2.5 to 8.1% in Vudlande. There are some problems with liquidity and only 27% of revenues come from foreign markets comparing with 77% in Vudlande. At the end of 2014 the company had loans from Swedbank, including long-term 85 thousand euro and short-term 502 thousand euro. Piebalgas from lending and economic point of view is a perspective company, but financial resources for its development are not sufficiently available (Swedbank did not agree to grant a loan) and would need public support resources.

Pallant

Pallant, employs on average 100 people in rural areas, specializing in the production of glued wooden beams for windows and doors, produced termobrusas, but from the production residues produces briquettes. The company has a relatively stable foreign market and turnover is growing, but profitability is negative, liquidity is low and it uses mainly debt capital, repayable principal exceeds EUR 1 million. With the current weak financial performance and without a clear perspective of business model development it is unlikely to attract additional financial resources for development – it is recommended to revise company's operational model to attract external resources.

Table 2*. Some Latvian timber companies' performance indicators, 2014. g.(Jakobsons, Schaub, Rupeika-Apoga and Solovjova, 2015)* [3]

Company name	Latvijas Finieris	Vudlande	Piebalgas	Pallant
Net sales, thousand EUR	194 136	11 691	7 372	3 873
Value of fixed assets in the balance sheet, thousand EUR	181 082	4 015	2 249	1 745
Commercial profitability, %	7.7	2.3	0.9	-2.0
Total liquidity, times	1.5	2.2	0.9	0.7
Liabilities and own capital ratio, times	1.5	1.5	2.2	7.4
Current loans	Loans from DNB, Swedbank and SEB banks.	Loan and credit line from Danske bank.	Loans and credit line from Swedbank .	Loan from Latvian Savings Bank
The opportunity to get new loans	High, but only on fixed terms up to 3 years	High, but only short-term	Limited (Swedbank refused)	Not available

In Table 2 we have summarised the main financial indicators and information about loans, as well as the opportunity to get new loans for four companies analysed in the case studies above.

[3] *Authors' calculations based on Lursoft*

5. Conclusions, Proposals and Recommendations

Based on SMEs' SIBIL and LURSOFT data:
Our surveys results highlighted that the majority of micro-enterprises (63%) and almost the half of SMEs (49%) in 2010 didn't apply for loans and were not interested in receiving bank loans, that presents significantly higher application ratio compared to the non-application ratio for SMEs in EU27 in 2010 (75%) according to European Central Bank Survey in 2010, and confirms importance of external funding for SMEs in Latvia. The majority of enterprises (65% of micro-enterprises and 70% of SMEs) that applied for loans, did so successfully, that responds to average European Central Bank data – 66% for EU27 SMEs (European Central Bank, 2011).

Our findings confirm that the enterprises with an access to loans developed faster compared to those which did not have the access. From 2009 to 2014, the turnover of micro-enterprises grew by an average of 9% annually, while the turnover of SMEs rose by an average of 5% annually. By way of comparison – enterprises, which showed no interest in bank loans, reported a much smaller increase in turnover: in the case of micro-enterprises, only 1% annually, and in the case of SMEs, 3% annually. The third group of enterprises, which have not asked for a loan, showed rather good financial results, proving the idea, that this group has high potential to get loans in case of applying for them.

Based on interviews with bank experts:
The main conclusion is that all interviewed banks are interested and planning to increase the share of issued loans in their credit portfolios. The most common reasons for refusing a loan relate to the financial indicators of the business, such as insufficient equity, big debt, fluctuations in the cash flow. This is partly connected with the shadow economy that decreases the legal cash flow of businesses that serves as a basis for adopting the decision on granting the loans. To decrease the proportion of the shadow economy, we recommend, that the policy designers pay particular attention to the problem of unreported income as well as to the construction industry. The combatting of the shadow economy must be an issue not only of the Ministry of Finance and State Revenue Service, but also other ministries and social partners should be involved in dealing with it.

Additionally, problems related to the insolvency processes of the businesses as well as the slow and complicated examination of cases in courts that raises the actual price of credit resources for the business people, affects banks decisions. The banks also view the projects in starting a business as risky (since even if the idea is innovative, the enterprise has no co-operation history with the bank).

Based on the case studies of Latvian timber industry sector:
Economically strong and prospective timber companies are able to attract external financial resources to the necessary extent; however, credit institutions refrain

allocate funds for more than 3 years with fixed lending conditions. This means, that there are limitations on the availability of financial resources for long-term investments in the timber industry. For other companies, in most cases, capital accumulation and as a result, attraction of external financial resources is restricted by the ability to sell (to a large extent - in the foreign markets) products to the extent that would be necessary to expand production. So, capital accumulation may indirectly be promoted by public support, making financial resources more available as a result ensuring better access of timber companies to the external markets and increasing competences of top-managers.

The current study is not free from limitations. First, its current sample consists of SMEs detailed surveys in 2008 and 2010; therefore, these findings may have limited generalizability. Future studies that replicate the current proposal, including new surveys for the same companies, may provide a more complete picture or add further dimensions to the current findings. Second, regarding the limited crediting when banks possess free assets and willingness to lend, due to a lack of supporting literature that directly suggests such an effect or relationship, a strong theoretical background would improve further researches significantly.

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