

FINANCING OPTIONS AND ALTERNATIVE FINANCIAL SOURCES FOR MACEDONIAN SMES

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Abstract

Small and medium enterprises are the core of each economy. Therefore, it is not unusual to connect SME growth to economic growth in a system. However, it is difficult to state whether Macedonia provides sufficient and adequate SME financing options. The paper will focus mostly on financing options available to SMEs, but will also cover other options that are not widely used by SMEs as well as the reasons for their usage omission. Further, the paper will explore "alternative" financing options, which have currently appeared as financing solutions, or propositions for financing solutions for Macedonian SMEs. Given that this is a rather vaguely explored field of interest, data for conducting a research are few, which may be a limitation to the conclusion. But in order to Researches on this subject matter may lead to further education of the business environment on the subject of SME financing, leading to a strive for improvement of financing conditions of SMEs in the region.

Keywords: SMEs, financing options, debt, equity, venture capital, mezzanine financing

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1. INTRODUCTION

Small and medium-sized enterprises (SMEs) have always been considered as the backbone of any economy. They are considered as the pillars of economies, in the sense of providing employment, leading to market development and inducing economic growth. And as such, their existence is essential to economic growth. Therefore it is not surprising that most developed economies are comprised of SMEs, in over 90% of their composition.

One of the main issues regarding the creation, development and success of SMEs worldwide is the financing of SME operations. Obtaining finance for SMEs has always been a managerial challenge, especially when it comes to financial sources for micro and small companies. Despite the essential role SMEs play in economies worldwide, obtaining funds and financing SMEs has never been an easy task. However, throughout their growth and development, many countries have tackled this issue by providing more financing sources and increasing the governmental support for SMEs.

Macedonia is still a rather small and developing country. The private sector is rapidly developing, but many issues of economic growth have not yet been dealt with. SMEs in Macedonia represent the largest portion of the Macedonian market composition. However, operations and financing of SMEs are yet difficult processes and many SMEs liquidate their businesses because of the harsh operating environment. Financing options are limited for SMEs, although in the Macedonian economic environment, this is the case for large companies as well. Additionally, compared to neighboring countries, Macedonian SMEs have a very limited spectrum of financing options. Standard financing solutions that are commonly used are own sources or bank loans. The choices have extended throughout recent years, but still mainly focus on pure debt or pure equity financing options. Very recently, introduction to "alternative" finance attempts have been made, although it is yet too soon to discuss the success of this type of finance. "Alternative" financing sources include mezzanine financing, venture capital and business angels. Although in theory there is favorable ground for the development of these financing options, it is yet to be seen whether there will be practical implications of the same.

The significance of financing SMEs is great. SMEs are the backbone of the Macedonian economy, and as such, their number and their effective operation must increase in order to achieve economic growth. The liberation of the financing market and

the increase in financing options available for SMEs in Macedonia will indirectly be a factor to lead to economic growth.

2. SIGNIFICANCE OF FINANCING SMALL AND MEDIUM ENTERPRISES

The development of the Macedonian market is intrinsically connected to the growth and development of its largest segments. A recent study shows that the most significant portion of the total business units in Macedonia are SMEs² - more than 95% of the total number of business units. In 2009, the employment in Macedonia has mostly been based on SMEs employees. In 2012, this number has risen significantly, with over 80% of the private companies job posts offered by Macedonian SMEs³. The market of small and medium sized enterprises has employed over 60% of the employed workforce in Macedonia⁴. An important note is the fact that most of the growth, as well as employment of workforce occurs in micro and small enterprises, well above the average of the European Union. These facts lead to the conclusion that perhaps the essence of growth lies in the development of Macedonian SMEs, with an accent on small and micro firms. Economic growth thus, can be related to growth of MSMEs as well. And a significant issue of growth is that it needs to be financed. Therefore, the adequate financing solutions for SMEs can eventually lead to market growth.

However, the lack of proper financing can have the adverse effect on companies, with a negative impact on the economy as a whole. Recent studies show that in the period between 2004 and 2007, when the number of SMEs operating in EU has actually grown, the number of SMEs in Macedonia gradually diminished, by a rate of 2% over the period⁵. Lack of financing options has led to the liquidation of a portion of Macedonian SMEs in the period. In the very same period, employment by SMEs has decreased by 5% percent in Macedonia, which can be compared to the 7% increase of employment by EU SMEs. Once again, such decrease in employment can be well caused by the lack of financing options for Macedonian SMEs, especially in comparison to the same period in the EU, when financing options such as venture capital and private equity flourished, leading the

² Informest Main International financial facilities available for SMEs. Project Recipient country survey: Macedonia, 2011.

³ European Commission Progress Report - Macedonia, 2012.

⁴ Ibid, pp.23.

⁵ European Commission, SBA Fact sheet: Former Yugoslav Republic of Macedonia, 2009.

growth of EU SMEs as well. Setting comparison aside, still the 2004-2007 trend of SME financing is a negative one. The number of Macedonian SMEs diminishes in this period, showing a negative rate, and a trend to liquidate more small (especially micro) companies, than to open new businesses. The lack of proper financing has appeared to create not only stagnation of SMEs, but even deteriorating of SME operations. From this notion, it can be observed how the availability of financing options for SMEs has its own economic significance. In reference and consent to a 2007 statement in a Macedonian economic magazine: "...the failure of the Macedonian financial system to respond to the demand for finance by the local private sector appears to be a significant problem for economic growth"⁶, it can be agreed that in five years, the financial situation for SMEs has not changed at all. This statement reflects on the exact current situation the entire private sector has been in, and it has had its toll on Macedonian SMEs.

At first glance, in the past two the situation is improving, as it appears that small but significant changes are made in the legislation and government support. Additionally, various sources state that the situation is improving since 2007, in terms of the positive changes made in the SME operational environment. Administrative barriers have been minimized, business operating costs have decreased⁷. These are the information placed publicly. However, the reality is that the development of the (M)SME sector has been rather slow, and with minuscule improvements. Several more favourable financing options have appeared on the Macedonian market, leading to once again, a slow pace of development of Macedonian SMEs. Commercial bank loans have begun offering loans strictly targeted for SMEs, for one. However, according to the report of the European Commission of 2010: "There are a number of strategies and annual programmes for supporting enterprises and the SME sector which need streamlining and proper public funding. Measures addressing traditional sectors received inadequate budgets"⁸. Since then, not much has changed on this subject. In the European Commission progress report of 2012⁹, a continuous problem is outlined in the limit of access to financial sources for SMEs, which in turns is considered the major impediment to SME growth in Macedonia. As it can be seen, the adequate financing measures, vehicles, or perhaps options, have not yet been put into practice.

⁶ Karovska, K., Capital Market Analysis. Skopje, Macedonia: Centre for Economic analysis, pp.11, 2007.

⁷ European Commission Progress Report - Macedonia, 2010.

⁸ Ibid, pp.54-55

⁹ European Commission Progress Report – Macedonia, 2012.

3. BREAKDOWN OF FINANCING SOURCES AVAILABLE FOR MACEDONIAN (M)SMES

The following section will discuss the current financing options in Macedonia. Briefly going over them, it can be seen that both equity and debt financing is very limited for SMEs. It is both difficult to obtain, and limiting in future operations of the recipient of financing. Therefore, the possibility of introducing new financing options should be examined, as a basis for SME market development, leading to potential economic growth.

The financial market in Macedonia altogether is still in the infant stage. Problems in financing operations are faced even by large companies. Therefore, it is understandable that for SMEs this is more than an overly problematic area. The main options for financing any company are solely based on either equity or debt based financing solutions. Crossovers between the two theoretical fundamental financing sources are rare to non-existent on the Macedonian market, although combined equity/debt financing solutions are not unknown worldwide, especially in the form of mezzanine or hybrid financing. Whereas mezzanine or hybrid financing is vaguely and only officially present on the market, most financing solutions are defined as pure debt or pure equity financing. Even in this traditional classification of financing solutions, Macedonian financing market lags behind the world in terms of new and innovative means of financing SMEs. Business angels and venture capital investors, for example, are rarely seen to invest in Macedonian SMEs. Therefore, the key question that is imposed is – **what are the financing solutions available to Macedonian SMEs?**

3.1 Equity financing

In terms of equity financing, there are two typical, traditional sources, which are more frequently used by Macedonian companies, other than the aforementioned business angels and venture capital investors. These readily available funding sources are limited to merely internal equity financing (**own resources/capital**) or financing through the **Macedonian stock exchange**.

Regarding **internal financing**, both reinvestments of net income and owners' capital injections are considered as financing sources. These two variations of the owner's financing option are currently the most widely used equity forms of financing for Macedonian SMEs. For SMEs, reinvestment or owners' financing is the most common

source of financing, on the equity side. As it will further be discussed, most SME managers are partial or complete owners of the businesses. Therefore, the idea of sharing ownership, especially publicly, is not widely accepted by them. This is one of the main reasons, aside of readily available financing, which makes reinvestment/own financing appealing and exploited by Macedonian SMEs. Moreover, it is also one of the greatest reasons of lack of interest of equity investors in Macedonian SMEs.

External equity financing is currently represented solely by the Macedonian stock exchange, in its most basic shape – stocks. Trading in financial derivatives is not yet available. The Macedonian Stock Exchange (MSE) has been established in 1995, and it is the first, and currently only exchange for long term securities in Macedonia. Currently, it is one of the best known equity financing sources of large companies and corporations in Macedonia¹⁰. The primary stock market is in fact the basis for equity funding of companies' operations. Additionally to public stock offerings, the MSE also provides private stock offerings, for companies not publicly traded. Although the number of publicly traded companies increases each year, privately traded companies are many as well. However, according to the April 2012 report from MSE¹¹, less than 100 companies have regular cash collection via the stock exchange. Companies with stock issuance over 20.000 Euro are under direct regulation of the Macedonian Commission for Securities Exchange (MCSE), although even smaller IPOs can be made, without the MCSE regulated auditing. Such IPOs can be made at the most twice in one year.

Regarding financing for SMEs, the stock exchange is still rather unavailable. Although the formal requirements for entering the MSE as a method for funding are less stringent, and the exchange itself is better regulated nowadays, the informal requirements that stem from a potential IPO are rather unattainable for SMEs. The entire organization of an initial public offering, as well as the costs that go hand in hand with it (such as transaction costs, auditing), are some of the factors that avert Macedonian SMEs from using this funding vehicle for their operations. Currently, Macedonian SMEs still regard the stock exchange as an unfavourable and unrealizable funding option. Another reason this option seems to be closed to SMEs is the lack of knowledge of stock exchange operations for Macedonian managers. This factor is especially seen in Macedonian SMEs' managers, who see the MSE as an ineffective and risky tool for collecting cash. Therefore, they avoid

¹⁰Macedonian Stock Exchange, MSE Report April 2012, 2012.

¹¹Macedonian Stock Exchange, MSE Report April 2012, 2012.

the MSE as a funding option, regarding it as unsafe method of financing. Moreover, as it has been previously mentioned, many managers are owners as well. Although the manager-agent relation has been regarded as an undisclosed problem in modern management, for Macedonian managers-owners, the lack of separation is in fact a large portion of the problem. The loss of company ownership is regarded as loss of company control, which is not in line with managers' preferences.

3.2 Debt financing

Debt financing offers a broader palette of financing options. Aside from commercial bank loans, there are sources such as inter-company financing, varied forms of leasing for capital financing activities, as well as government financing.

The most widely used debt form of financing in Macedonia is **commercial bank loan financing**. In fact, commercial bank loans are the preferred form of financing for both SMEs and large corporations¹². However, the reality of the financing situation is not bright in this field as well. The general offer on commercial bank loans does not vary significantly from one bank to the other. Until recently, only one of the banking institutions offered a specialized loan programme an SME-financing focused programme, the Macedonian bank for development promotion. Funds available from the European Investment Bank have been offered as commercial bank loans, partially for financing Macedonian SMEs as well. International aid agencies and bodies have argued that the lack of information and mistrust in the system has lead to stringent conditions and strict screening process regarding commercial bank loans for SMEs. Although theoretically bank loans have been available to SMEs, the pre-assessment and post-reception requirements have been too difficult to take on for many SMEs. The over-collateralization of loans has been the greatest drawback for SMEs. . Commercial banks usually ask for a larger worth of asset collateral, which small and medium sized companies seldom have. Large companies can meet obstacles for financing which are not easy to overcome for SMEs. Therefore, many SMEs disregard this option at the very beginning of the decision making process. Recently, various SME-funding EU programmes have become available in the form of commercial bank loans via more Macedonian commercial banks. EU financing is used to boost SME growth, which is evidenced to lead to economic growth in some

¹² Nikolov, M., Garvanlieva, V & Andonov V., Debt vs. Equity financing in Macedonia, Centre for Economic Analysis, 2007.

countries. The European Bank for reconstruction and development (EBRD) for example, has issued a new 5 million Euro fund for bank loans specifically aimed at SMEs¹³. Another example of debt financing for SMEs have been USAID funds¹⁴, which have been channelled through commercial banks via the Small & Medium Enterprise Development Credit Authority (SME DCA). The SME DCA provides a link between SMEs and funds needed for working and/or investment capital. The programme is estimated to last seven years, ending in 2014. Until the first half of 2012, approximately 40 loans have been issued in to 35 companies in different sectors or industries. The financial injection in Macedonian SMEs is estimated to be over \$2.000.000. Currently, it is stated that this financial aid, in the form of commercial bank loans, has helped generate over 70 new jobs on the market, and increase exports for more than \$100.000. Although this may seem as a small contribution to Macedonian SMEs, it is important to note that prior to this programme, commercial bank loans have been more or less unattainable for SMEs, and mostly used by larger companies. The small input of finance via this source has had an impact on the growth and development of SMEs, which is a positive notion. However, the small scale of investment is alarming. This is not only caused by the small number of assisted companies (merely 35 SMEs nationwide), but also because of the lack of further financing development. Financial assistance such as foreign funds should not be the only applicable financing option on the market. The economic development should lead to opening of new international financing sources – often even private ones. However, until now, this has not yet occurred in Macedonia.

The main problem with commercial bank loans, regardless of the origin of funding, is the lack of non-financial support versus the surplus of bureaucratic application. Managerial or know-how assistance is not considered as a part of the “traditional” financing of SMEs. However, such support is as much worthwhile as is the financial support, especially for SMEs. Provision of a funding source that would provide a detailed guidance to how to spend received funds, is yet considered “alternative” on the Macedonian market. Moreover, commercial banks require far more evidence than a business plan to confirm efficiency of the venture that takes up a loan, and the response period is often too long. The interest rate of loans per se has never been high, but the elimination is made through the stringent screening process. One of the major drawbacks is the over-collateralization of loans, as well as the lack of unsecured loan schemes on the

¹³ Coretchi, I., EBRD's first local currency financing in FYR Macedonia, 2012.

¹⁴ USAID Macedonia, Small and medium enterprise development credit authority, 2012.

market. Unsecured debt does not really exist in Macedonian banking practice. Although legally it is possible to have junior debt in a company, there is no such source that offers it.

When debt financing is discussed, it is important to note that commercial bonds as financing form are still not available in Macedonia. Government bonds can be traded on the MSE, but commercial trading of company-issued bonds has still not been introduced to the Macedonian capital market. This is a significant drawback when exploring financing options, for any type of company. Commercial bonds worldwide have been seen as an important debt form of financing. Companies issue bonds in order to collect funds in investing periods. Additionally, commercial bonds may be regarded more positively by Macedonian SMEs, since of the appealing aspect of company control preservation. As it has been mentioned previously, one of the major drawbacks of IPOs for managers of SMEs is the possibility of change in ownership structure. Commercial bonds would be a better option in such case, since they would provide financing without the change of ownership structure. At this point, it is important to note that there is no distinct "pecking order" in terms of funding preferences in Macedonia. Because of this, debt financing, especially commercial bonds, if applicable, can be a preferable funding option.

4. „ALTERNATIVE“ FINANCING SOLUTIONS: A VIABLE OPTION?

Worldwide, different equity financing, debt financing or a combination of the both, practically dubbed hybrid or mezzanine financing, has been a hot topic when discussing SMEs or even start-up companies. Lack of conventional financing of SMEs is not an isolated problem of the Macedonian market – it has always been an issue of discussion. However, many derivative means have been implemented in developed countries to fill the financing gap between reinvested/own sources and the conventional financing sources. American and Canadian entrepreneurial companies and SMEs widely use venture capital as a financing source through early development and growth stage¹⁵, for example. Additionally, EU start-ups, micro and small companies are usually boosted through private equity investment companies, in order to achieve growth stage. **Private equity investment** companies have been the missing link between early stage/seed financing

¹⁵ Amit, R. et al., Why do venture capital firms exist? Theory and Canadian evidence., *Journal of Business Venturing*, pp.441-466, 1998.

and growth of SMEs in developed countries. The most appealing instance of these types of financing is that there is no strict regulation or form – investments are contractual, can be different for different enterprises, depending on specific requirements, can be a combination of debt and equity financing and offer managerial and know-how support in addition to financing. Such financing sources are **venture capital investments**, or even **business angel investments**. Developed markets all over the world report that these types of SME financing actually contribute towards SME progress and economic growth. But is there room for implementing these types of financial sources on the Macedonian market?

There are many factors that need to be researched in order to conclude the possibility of implementing “alternative” financing methods in Macedonia. Venture capital investments are usually used to finance companies’ growth. Contracts have equity instead of assets as collateral. As it has been stated previously, asset-backed loans are usually difficult to obtain for Macedonian SMEs, merely because of the lack of sufficient collateral. Over-collateralization is one of the major issues regarding SME financing. Therefore, it can be observed that equity-backed investments will be widely preferred by Macedonian SMEs. Equity-collateralization implies that in stead of an asset received by the lender in case of default on the loan, shares of the borrower’s company are received. Therefore, most private equity investments are structured as such – if the borrower cannot repay the principle and the pre-determined rate, the lender acquires a pre-determined portion of equity in the company. There are variations in contracts, such as recipient of equity shares in case of successful investment, decisions upon interest rate or rate of return on investment and so on. However, the notion that there is no need for large asset collateral would be welcomed by SME managers.

When mentioning managers of Macedonian SMEs though, one other thing has to be taken into consideration. It has been previously mentioned throughout the paper that Macedonian company owners, especially owners of MSMEs, do not like loss of ownership control, at any cost. Most MSME managers are partially or entirely owners, as well. Therefore, it can be expected that equity-based financing may be regarded as less desirable. However, when considering two options, both with some positive and negative aspects, perhaps managers would choose venture capital investments. Having the financing option to choose would be an incentive itself.

On the other hand, investors' preferences need to be taken into consideration as well. Would venture capital investors or business angels be interested in investing in Macedonian SMEs? Private equity markets in other countries of the region have been developing rapidly. However, it appears that the development of the market for financing SMEs is closely related to the EU accession and diversion of political and economic risk. In Croatia and Bulgaria such financing options are widely accessible to SMEs. Yet, the comparison of these countries to Macedonia, in terms of political and economic stability is difficult. Macedonian environment would still be rather risky to international investing companies.

However, during a short survey of international private equity investment companies, conducted for the purpose of this paper, it has been shown that over 87% of investment providing companies, based in the EU, would be interested in providing finance to Macedonian SMEs. However, one of the major prerequisite is the preparation of a viable long term plan. Investors have reached a conclusion that more needs to be done on the field of education of managers, in order to be able to project profitable and sustainable company development through a forecasted business plan. Still, according to a 2009 study of an equity investment company, it can be expected that this problem will be tackled and overcome soon, especially with the rise in business education and the higher percentages of new-generation, young, aspiring and well-educated SME managers¹⁶.

In the end, it can be seen that new and "alternative" financing solutions can be offered to Macedonian SMEs. There is favourable ground on both sides, and there is definitely a well defined need for new financing options as well.

5. CONCLUSION

Small and medium sized companies are known to have more obstacles when looking for financing when compared to large corporations. This is especially evident on the Macedonian (M)SME market. The Macedonian business environment is a rather merciless one when it comes to financing MSMEs. Whereas traditional options are readily available, there is no essential choice between options in truth. It cannot be stated that the financing situation is grim; however, it is not the best situation for Macedonian SMEs.

¹⁶ AltAssets, Venture capital in CEE, Research by AltAssets group, 2009.

Although there is a slow growth in SME employment and profitability, it has been seen that lack of proper financing has caused stagnation and decline in growth at periods. This is a situation that needs to be avoided in the future. Additionally, the fluctuation of SME growth is a negative aspect – SME growth needs to be steady and less volatile. Good financing market can provide such growth.

The need for new options is evident, as well as their prospect place on the Macedonian financing market. Additionally, broadening the palette of financing options for SMEs will lead to creating more favourable offers from “traditional” sources. Thus, a more favourable financing environment for SMEs will lead to SME growth and development. And it has been outlined at the very beginning of the paper, as SMEs are the backbone of the economy, their growth and development will lead to economic growth, through new employment, innovative products and export increase. Therefore, creating favourable financing solutions for Macedonian SMEs needs to be a priority issue. In the end, several recommendations can be made. Firstly, financing solutions must be broadened; there is a distinct need for the opening of the Macedonian financial market. This does not necessarily need to apply only to private equity and venture capital investments; commercial bonds are another method of financing companies. Additionally, Macedonian managers/owners need to be well educated in order to be more successful. Different financing options will require broader views and understanding as well. It is important to note that this is not a real obstacle – it can be easily overcome, especially with new and young entrepreneurs. Additional to that, the process of non-formal business education is at large in Macedonia, which should lead to a more informed and prepared business environment.

In the end, there is a silver lining in the financing situation for Macedonian SMEs. However, there is still much to be done in order to achieve sustainable SME growth on the Macedonian market. And this needs to be of vital importance, as it is one of the pillars of Macedonian economic growth.

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