SocioBrains
ISSN 2367-5721, JOURNAL HOMEPAGE: WWW.SOCIOBRAINS.COM
INTERNATIONAL SCIENTIFIC REFEREED ONLINE JOURNAL WITH IMPACT FACTOR
ISSUE 52, DECEMBER 2018

ALTERNATIVE FINANCING SOURCES SUPPORTING SMES GROWTH

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Keywords:
SMEs, financing, fintech models, innovation, economic growth

1. Introduction

SMEs are considered to be the backbone of every economy. Their crucial role in the development of an economy is evident from the size of the SME sector and the number of people employed in this sector. This importance is also recognized by the policy makers, trying to develop SMEs friendly environment for the purpose of achieving economic development and growth. Even though, the importance of SMEs for the economy is well accepted, there are numerous barriers obstructing the development and growth of small and medium enterprises. One of the most important barriers is the limited access to finance. Not being able to obtain the needed capital would mean that SME sector can’t finance their investment activities and day to day activities. Consequently, the growth of SMEs is limited.

Technological developments have opened up the opportunity for the development of new sector, financial technology sector. This sector is offering financial products and services using technological advances. New alternative financing platforms have appeared with the objective of serving the unserved sectors in the economy. SME sector is widely recognizing the benefits of the products and services offered in the alternative finance market. The fintech companies can offer cheaper loans, low cost transactions, faster application process, etc. because of the digitalization of their activities.

2. Major obstacles for SMEs growth

The importance of SMEs is widely recognized by the policy makers, and thus they aim to provide support for their development and growth. Going through some figures, nine out of ten businesses globally are represented by SMEs, while they participate with more than 60% of the employment around the globe and approximately 80% of jobs in developed world are created by SMEs (Peterhoff, et. al., 2014). Thus, it could be said that SMEs may well be considered as one of the main factors promoting economic growth and development. In addition, policy makers are also utilizing the development of SMEs sector as a mechanism to fight poverty, and elevate the living standards of the population.

Nevertheless, although the importance of SMEs is widely recognized, they still face certain barriers which are directly obstructing the SMEs growth and development levels. These obstacles can be in terms of: access to finance, tax rate, competition, electricity and political factors (Wang, 2016). Although there are numerous barriers impeding SMEs growth, limited sources or no-sources at all for raising the needed funds for growth can be considered as one of the most important barriers resulting in limited SMEs growth. Although policy makers aim is to strengthen the SMEs sector development, the problem they should primarily overcome is the access to finance for SMEs (Vasilescu, 2014; Samitowska, 2011; Tabas, et.al., 2011). This problem is additionally augmented by the banking sector, or more precisely the perception of banking sector regarding the SMEs sector. Namely, SMEs have the potential to be profitable, but because of the political stability and macroeconomic (in)stability in developing countries, along with other factors, SMEs have limited access to bank loans (Beck, et. al., 2008).

There are multiple reasons regarding the unwillingness of banks to provide loans to SMEs sector. In essence, banks have reduced the lending activities for SMEs because of the high cost, smaller loan amount, lack of information, lack of history for SMEs, low level of collateral and the need for higher reserve capital. Because of the higher riskiness level of loans provided to SMEs, banks should maintain higher level of reserve capital in accordance to the post crises banking regulation. Maintaining higher reserve capital is decreasing the credit potential of banks, which negatively impacts the profitability level. Moreover, banks have higher cost when lending to SMEs because of the smaller loan amount. Namely, there could be negligible difference in the processing time and the attention dedicated to analyzing big client and client coming from the SMEs sector. This means that bank cost to process a loan application is more or less the same for both categories of clients. The difference is in the fact that a client from SME sector will require lower amount of credit compared to the big company. Thus, the banks will earn smaller profits from a loan approved to an SME sector, while the costs will remain more or less the same as when they would lend money to a big client i.e. when they approve bigger loan. Noteworthy mentioning is that loans to SME sector could be categorized in higher risk category. Lack of information or more precisely, the problem with asymmetric information is additional limiting banks' desire to provide loans to SMEs. Namely, because of the way SMEs conduct their activities, very often banks are not able to make adequate assessment of their creditworthiness.

Another obstacle leading toward the limited access to bank credits for SMEs is the traditional client assessing methods. Namely, traditional methods used by the bank to assess the creditworthiness of a client could be considered as obsolete, especially, when assessing SMEs. The criteria employed by the present evaluation methods can lead toward categorization of SMEs application as risky. The reason is that the current evaluation is based on financial reports, past performance of enterprises, qualification and experience of business owners, level of collateral, etc. While these criteria may be adequate for well established businesses, they are excluding the SMEs as reliable client for banks. Accordingly, the traditional assessment methods are preferring companies which have been operating for couple of years or even decades.

The aforementioned obstacles are some of the common obstacles limiting the growth and development of SME sector. Maybe one of the most important obstacles hindering SMEs growth is the limited access to finance, especially in developing countries. This problem is additionally augmented by the banking sector, which is reluctant to provide loans to small and medium enterprises. Maybe this limited access to finance could be sometimes justified by the characteristics of SMEs. Justified or not, policy makers should find a solution to eliminate this barrier, since SME sector has major impact on economic development and improvement of living standards.

3. Alternative financing models supporting SMEs growth

The last decade, or the post crisis period, is marked with increased number of innovations in the sphere of financial products and services. The technological advances created the opportunity for development of vast number of alternative financing models. Moreover, limited access to credit for certain categories of borrowers have spur the growth of the new, fintech, lenders. These categories have been commonly underserved by the traditional financing models, or have been faced with high cost for borrowed funds. Thus, the alternative financing models have become attractive substitute for entities looking for funds to finance investment activities and day to day operations. This is especially true for SMEs who have been unable to obtain the necessary funding from banks and financial markets. For instance, the obstacles for obtaining the needed capital faced by SMEs in developing countries has resulted in the creation of credit gap in the amount of $2.3 trillion (Hieminga, et. Al.,2016). Stated differently, there are approximately 180 to 220 million, out of 400 million, SMEs in developing markets who are faced with lack of adequate level of financial resources (Owens and Wilhelm, 2017).

This credit gap along with the need of SMEs for financial products and services has been identified and exploited by new, technologically advance, companies offering financial products and services. Development of these innovative financial technological companies created new opportunities for SMEs' by increasing their access to capital needed to augment their growth. These new opportunities come in the form of different fintech business models (Ventura et al, 2015). Consequently, the new financial alternatives have attracted many SMEs and start-ups to use the new fintech products and services. Most common business models utilized by the SME are presented in table 1.

Table 1: Alternative finance model for SME

Alternative finance models	Definitions
Marketplace/P2P Business Lending	Individuals or institutional funders provide a loan to a business borrower.
Balance Sheet Business Lending	The platform entity provides a loan directly to business borrower.
Marketplace/P2P Real Estate Lending	Individuals or institutional funders provide a loan secured against a property to a consumer or business borrower.
Invoice Trading	Individuals or institutional funders purchase invoices or receivables notes from a business (at a discount)
Equity-based Crowdfunding	Individuals or institutional funders purchase equity issued by a company
Reward-based Crowdfunding	Backers provide finance to individuals, projects or companies in exchange for non-monetary reward or products.
Donation-based Crowdfunding	Donors provide funding to individuals, projects or companies based on philanthropic or civic motivations with no expectation of monetary or material return.

Source: Robert Wardrop et a.. (2016) "Breaking New Grounds – The Americas alternative finance benchmark report", Cambridge Centre for Alternative Financing April and Polsky Center for Entrepreneurship and Innovation, pp. 30.

The concept behind peer-to-peer (P2P) model is to bring together potential borrowers with potential investors, willing to lend their funds and receive interest (Fenwick et. al., 2017). The P2P platform earnings come as a percentage of the interest paid by the borrowers to the investors. The role of the platform is to collect, evaluate and disseminate information about borrowers' creditworthiness to potential investors. Investors then decide on the type of investment they are willing to make. Another possible alternative for SMEs financing is the profit sharing alternative. With this alternative source businesses are able to sell securities to investors, and share the profits and royalties of the business in return (Ziegler et. al., 2017).

Development of different fintech models have increased the base of investors willing to lend their money to the business sector. Thus, SMEs no longer depend on bank loans or traditional financial markets to obtain capital. The number of investors is additionally amplified by the different methods for investing, and earning profit, while maintaining the acceptable risk level of the investors. From the above table it can be noticed that investors lending their funds through fintech platforms can make profits in the form of interest rate paid by the borrower, capital gain though equity investment, non-monetary reward or no reward or return.

It is obvious that nowadays SMEs have wide variety of alternative financing sources. Depending on SMEs' need and future plans they could chose adequate financing option. SMEs owners can choose among alternatives such as: borrowing funds, selling equity, or seeking a donation. Some of these financing possibilities have been non-existing or very expensive in the past because of SMEs' nature. This is especially true for equity funding.

Consequently, the fintech financing models and the expansion of investors base, should contribute toward the decrease in the finance gap for SMEs. Namely, these new financing alternatives are gradually eliminating, or at least, reducing the negative impact arising from the barriers faced by SMEs. Stated differently, the alternative financing models have the potential to solve the problems of asymmetric information and lack of collateral faced by SMEs (OECD, 2017). The aforementioned issues are commonly identified as one of the main reasons for SMEs' limited access to bank loans. The attractiveness of the alternative finance market is evident from the volume of this market. Meaning that the volume of funds flowing into the market for alternative financial products and services is noted by constant growth in the last couple of years. Table 2 is presenting the volumes of online alternative finance market for different regions.

Table 2: Regional Online Alternative Finance Market Volumes 2013-2015 (€ EUR)

Region	2013	2014	2015	2016
Europe	1.13 bn	2.83 bn	5.43 bn	7.67 bn
Americas	3.24 bn	9.65 bn	29.98 bn	31.81 bn
Asia-Pacific (incl. China)	4.13 bn	20.29 bn	94.61 bn	221.66 bn

Source: Tania Ziegler et. al. (2017) Expanding Horizons: The 3rd European Alternative Finance Industry Benchmarking Report, Cambridge Centre for Alternative Finance, pp. 22.

It is evident that the online alternative finance market is marked with constant growth in the last couple of years across different regions, Europe, Americas and Asia – Pacific. Noteworthy mentioning is that the growth of the volume for alternative finance is rather significant for the period considered and could not be neglected. This growth of the volume of alternative finance confirms that there is interest for these products and services not only by the investors who are willing to invest their funds, but also by the business sector. Furthermore, table 3 is providing overview of the volume for different models of alternative finance.

Table 3: Alternative Finance Volume by Model in Europe 2013-2016 (€ EUR)

Financing model	2013	2014	2015	2016
P2P Business Lending	40 m	93 m	212 m	350 m
Invoice Trading	1 m	7 m	81 m	252 m
Equity-based Crowdfunding	48 m	83 m	159 m	219 m
Reward-based Crowdfunding	63 M	120 m	139 m	191 m
Balance Sheet Business Lending	/	/	2 m	59 m
Donation-based Crowdfunding	11 m	16 m	22 m	32 m
Profit Sharing	/	/	1 m	8 m

Source: Tania Ziegler et. al. (2017) Expanding Horizons: The 3rd European Alternative Finance Industry Benchmarking Report, Cambridge Centre for Alternative Finance, pp. 30.

As it was the case with the changes in the volume level in different regions, the same movement is identified in the alternative finance volume for different models in Europe. Namely, all alternative financing models are marked with increase in their volume for the period under consideration. The biggest increase can be seen in invoice trading as one of the alternative finance models. Noteworthy mentioning is that the increase rate in other financing models is rather high as well, and is also an indicator of the increase popularity of these models among the SMEs sector participants.

Numerous factors have limited the supply of financial resources for the SMEs sector. These factors have created a breading ground for the development of new financing models. Alternative financing models have emerged from the technological innovations and the need for financial resources. Because of the limited access to finances, SMEs were unable to obtain adequate level of funds to finance their growth and development. This created a credit gap on global level, especially in the development economies. Recognizing the importance of SMEs, policy makers are making effort to reduce the barriers obstructing the growth of this sector.

Such a defined environment with high demand and support from the policy makers, resulted in the creation of fintech companies. Changes in the volume of the alternative financing market across regions and across different models is showing wide acceptance for these products and services among the business community. More precisely, the utilization of alternative financing sources by SMEs sector is noted with constant increase in the last couple of years i.e. the post crisis period.

4. What is alternative finance bringing to the table?

Industry for financial products and services has been subject to substantial changes as a result of the digital revolution. New digital technologies have major impact on the way financial products and services are offered. This impact is significant in the industry for financing small and medium enterprises which have been underbanked or had limited or no access to financial resources required for their growth. The digitalization of financial products and services has enabled SMEs to gain access to financial products at lower transaction costs, shorter processing period and higher level of customized financial products.

Because of the utilization of digital technology, fintech companies have the opportunity to modify the financial services and products offered by the traditional financial companies. Some of the changes in the products and services for SME in terms of their need for financial resources are:

- Faster loan approval process;
- Smaller loan amounts are acceptable;
- Lower transactional costs;
- Lower cost of funds;
- Alternative credit scoring model.

Because of the improved efficiency in the decision-making process, fintech platforms are able to make the financing decision (approved or rejected) much faster compared with the traditional banks. While traditional banks are avoiding applications for smaller loan amounts because of highs costs and lower profits, alternative finance platforms are welcoming different sizes of loan applications. Thus, SMEs can apply for a loan regarding of the loan size. Since fintech platforms are utilizing the technology in their advantage, they also enjoy lower operational costs. Consequently, SMEs have the opportunity to use financial products and services and lower cost compared to the cost they have when using traditional banking products.

Maybe one of the most important aspects of alternative finance market responsible for increased access to finance for SME sector are the methods for assessment of creditworthiness. Fintech companies are excluding or are combining the traditional credit scoring methods with alternative credit scoring mechanisms. These alternative methods for assessment of the SMEs' creditworthiness are considering sources of information which are excluded from the traditional assessment methods (OECD, 2018). The scoring methods of fintech lenders could consider information for alternative sources i.e. information about sales level from Amazon, shipping history for postal services, activity on checking accounts and payment processors (Jagtiani and Lemieux, 2017). It should be noted that these alternative credit scoring methods have been criticized by the proponents of traditional scoring mechanisms. They have been criticized in terms of their ability to adequately evaluate SMEs' that could default on their loan. Although, the ability to evaluate clients has been discussed, the success rate of alternative methods for assessment of creditworthiness may not be much different compared to success rate of traditional methods.

It could be said that the alternative financing models have made significant positive impact on the SME sector development. The new financing alternative enables SMEs to gain access to funds and financing their development and growth. Specifically, increased access to finance has resulted in positive impact on SMEs activities and development. For instance, three-quarters of entities obtaining finance through fintech sources have released a new product or service, 70% of SMEs borrowing from P2P platforms have enjoyed increase in turnover and profit accordingly (Baeck, et. al., 2014).

5. Conclusion

Primary goal of every economy is to achieve economic growth and development. For this reason, policy makers are looking to eliminate all barriers which could impede economic growth. One area of focus for policy makers is the SMEs sector. SMEs have major effect on economic development through its numerous activities. Hence, any barrier hindering growth and development of SME sector will negatively affect economic growth. Even though, SME have crucial role in economic development, they face numerous challenges and obstacles in their operations.

One such obstacle is the limited access to finance. Inability to access adequate level of capital could adversely affect SMEs future plans for expansion. Thus, policy makers should direct their efforts to support companies which are offering financial products and services to the underserved sectors in the economy such as the SMEs sector. In the last couple of years, alternative finance market is gaining increased popularity among these underserved sectors in the economy. Eliminating the access to finance barrier for SMEs could result in decrease in credit gap and increase in investment activities of small and medium enterprises.

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