Financing SMEs in EU and in Hungary, with special attention on venture capital

Balázs KOVÁCS

PhD-student, sajto@rfh-rt.hu

Summary

The financing of the SMEs is always a hard thing in the European countries. Especially is it a fateful question for a country that is so much dependent on SMEs like Hungary. Since Hungary is on the way of reorganization, every government take it a priority to facilitate the SMEs to reach capital, reach new markets, and Hungary tried hard to simplify the administrative burdens of small and medium sized enterprises. The accession to the European Union indicated new factors on this project, and since 2004, Hungary is based on EU regulation. This accession provided us new perspectives and new goals on globalized market, and force us to become more and more competitive not only with other EU countries, but with the whole world market.

This short study is based upon the Hungarian government's conception of development of SME's, publicated in February of 2007, extended with the surveys and studies presented from the professionals of the subject.

1. Small and Medium Sized Enterprises on focus

1.1. SMEs in Europe

Companies classified as small and medium sized enterprises (SMEs) are defined officially by the EU as those with fewer than 250 employees and which are independent from larger companies. Furthermore, their annual turnover may not exceed 50 million Euros, or their annual balance sheet total exceed 43 million Euros. This definition is critical in establishing which companies may benefit from EU programmes aimed at SMEs, and from certain policies such as SME-specific competition rules.

SMEs account for a large proportion of Europe's economic and professional activity. In practice, 99% of businesses in the European Union are SMEs, and they procide two-thirds of all private sector jobs. So small firms ara, in fact, the real giants of the European community. Micro-businesses (those fewer than 10 employees) dominate employment in counties such as Italy and Poland.

Type of enterprise	Micro (1-9 employees)	Small (10-19)	Medium size (50-249)	Large (250+)
% in the private sector	29,8%	20,8%	16,5%	32,9%

Table 1.

Source: Eurostat – SBS data 2003

Despite its huge importance for the European economy, entrepreneurship is not a preferred career option for most Europeans. As many as 60% of EU citizens say that setting up their own business has never even occurred to them. It is a challenge for policy-makers both at the European and at the national level to reverse this trend.

SMEs comprise all types of firms ranging from one-person businesses to co-operatives. Whilst some SMEs offer very traditional services or craft products, many others are fast-growing high-tech companies. Despite their differences, though, Europe's SMEs share many challenges.

1.2. SMEs in Hungary

Enterprises in 2005	Micro	Small	Medium	Large	Together
Number	**662 771**	**27 627**	**5068**	**934**	**696 400**
%	**95,17%**	**3,96%**	**0,73%**	**0,14%**	**100**

Table 2.

Source: Hungarian Central Statistics Office, 2006

The competitiveness of the Hungarian SMEs is basically dependent on how fast and how dynamically can they react on the challenges set by the large companies. On this question the Hungarian economy created various types of co-operations between the small companies. The most important are:

1.2.1. Diversification of work

The SMEs cannot work out economically those management functions, which are essential to competitiveness. The accounting, marketing, legal and IT services are more often "borrowed" from external companies. More than two third of the Hungarian SMEs is buying some kind of strategic service, more than 75%

“employs” outsider accountant. Furthermore, these service providers themselves are small and medium sized as well!

1.2.2. Networking

One of the most effective instruments to moderate the handicap of size is to be organized into a network. There are several examples to verify that these self-organized, formal or informal networks can cope with big companies.

1.2.4 Financing

In the last 4-5 years, the opportunities for reaching financial support increased remarkably. In this process the commercial banks played the greatest role. Between 1999-2005 from 460 milliard HUF the credit staff of SMEs grow to 2 800 milliard HUF, which means the sum has grow six times more. At the end of year 2005 the SMEs credit staff reached the half of the hole company-staff. The state guaranteed credits played important role in this as well, although their share from the whole credit staff stayed under 10%.

Factors that interferes growing			Ranks			Importance indicator 2005[1]
	0	1	2	3	4	
High taxes and administrative pays	**14,1**	**3,6**	**12,3**	**20,2**	**49,8**	**72**
Strong competition	20,2	5,6	17,4	22,9	33,9	61
Unpredictable economic laws	**24,4**	**7,1**	**19,3**	**20,3**	**28,7**	**55**
Unfair race	33,0	8,3	16,8	17,4	24,5	48
Not enough orders	31,5	6,4	22,2	17,3	22,6	48
Late of partner’s payment	46,5	12,0	14,8	11,3	15,4	34
Lack of capital	49,2	9,4	16,7	11,7	13,0	32
Difficulties of supply	70,2	9,8	10,8	5,3	3,9	16
Lack of bank loans	75,7	5,6	6,8	5,0	6,9	15
Anachronism of present	73,9	9,0	11,8	3,0	2,3	13

1 Calculation of factors: the answears are transformated to a 5 degree ranking. The values are multiplied with the number of answear-givings, and portioned with the possible maximum value of the factor. This way the we got a percentage, which is 100 if everybody put the greatest importance on the factor, and 0 if everybody put the smallest importance on the factor.

capacity						
Other interfering factors	77,6	4,5	8,8	3,4	5,7	13
Lack of labour force	85,8	4,7	5,6	1,9	1,9	8

Table 3. Representative survey of the Ministry of Economics and Transport, Nov. 2005

Despite of the last 15 years fast growing, the Hungarian SMEs performance indicators failed the average of the EU-15. The size of the Hungarian SMEs is too small, in the EU-15 only in Greece and Italy are smaller enterprises, than those here, and the same size has Portugal. The share of the large companies of the employment is about one third, which share is rather a specific of the developed countries. The reason in Hungary is the great share of foreign capital and their role in keeping the manpower.

The biggest difference is in productivity. The Hungarian SMEs are producing nominally tenth of the EU-15 average.

As a result, let us see, what the EU plans to do with tax procedures, which seem to be the most important factor for SMEs.

1.3 EU and simplified tax

As mentioned before, small and medium-sized enterprises constitute the backbone of the European economy: There are approximately **23 million SMEs** in the European Union, which account for 99% of all enterprises and provide around 75 million jobs. It has been recognised that an SME-friendly business environment, both at Community level and in the Member States, is crucial for growth and jobs in Europe. One of the most common complaints by business and their organisations is the amount and complexity of the various regulatory and administrative obligations that have to be observed by enterprises. SMEs suffer disproportionately from the regulatory burden compared to larger companies, since the smaller enterprises often do not have sufficient financial and human resources to manage their obligations in the most efficient way.

Tax obligations (which comprise not only the actual payment of taxes, but also activities such as registration, documentation, reporting and recording) constitute some of the most important obligations enterprises have to comply with. For the various tax compliance procedures, enterprises require either internal resources and/or need to call in external resources, e.g. tax consultants and accountants. Thus, tax compliance represents an important cost factor that must not be underestimated. The regulatory and

administrative burden in general and tax compliance in particular represent a significant cost element in relation to the turnover of enterprises and also the taxes they pay, especially for SMEs. It is recognized that entrepreneurship is a major driver of innovation, competitiveness and growth. Europe needs a more entrepreneurial climate. The conclusions of the Lisbon Council in 2000 emphasized the

dependence of business competitiveness and dynamism on the regulatory environment.

With the European Charter for Small Enterprises[2], the participating countries have committed themselves to better legislation and regulation and to simplifying national and EU rules wherever possible. Recognizing the need for dynamic change in Europe to promote entrepreneurship, the Commission launched a wide debate on entrepreneurship with its Green Paper on Entrepreneurship in Europe[3]. The responses received after the publication of the Green Paper clearly highlighted the need for effective reduction and simplification of the administrative and regulatory burden, especially in the tax area. As a follow-up to the Green Paper and on the basis of a wide public consultation, an Entrepreneurship Action Plan was adopted by the Commission in February 2004. The Action Plan suggested horizontal measures for the Commission and the Member States to create a supportive framework for entrepreneurship policy, and focuses on five strategic policy areas, one being the "creation of a more SME-friendly regulatory and administrative framework".

In 2005 the Partnership for Growth and Jobs[4] reaffirmed the objective of making Europe a more attractive place to invest and work by improving European and national regulation. Better regulation will help to create more conducive conditions for economic growth, comprising measures such as simplification, well shaped legislation and efforts to reduce administrative costs. This is crucial especially for SMEs, which are disproportionately affected by regulatory and administrative obligations.

2. The current ways of financing SMEs in EU

Before we go on to the ways that can ease the life of an SME, we should know certain kind of facts on the life of a company.

---

[2] The European Charter for Small Enterprises, Santa Maria da Feira, 19-20 June 2000. Available
online at: http://ec.europa.eu/enterprise/enterprise_policy/charter/docs/charter_en.pdf.

[3] Available at: http://ec.europa.eu/enterprise/entrepreneurship/green_paper/index.htm.

[4] Communication to the Spring Council, Working together for growth and jobs, A new start for the
Lisbon Strategy, COM(2005) 24 final.

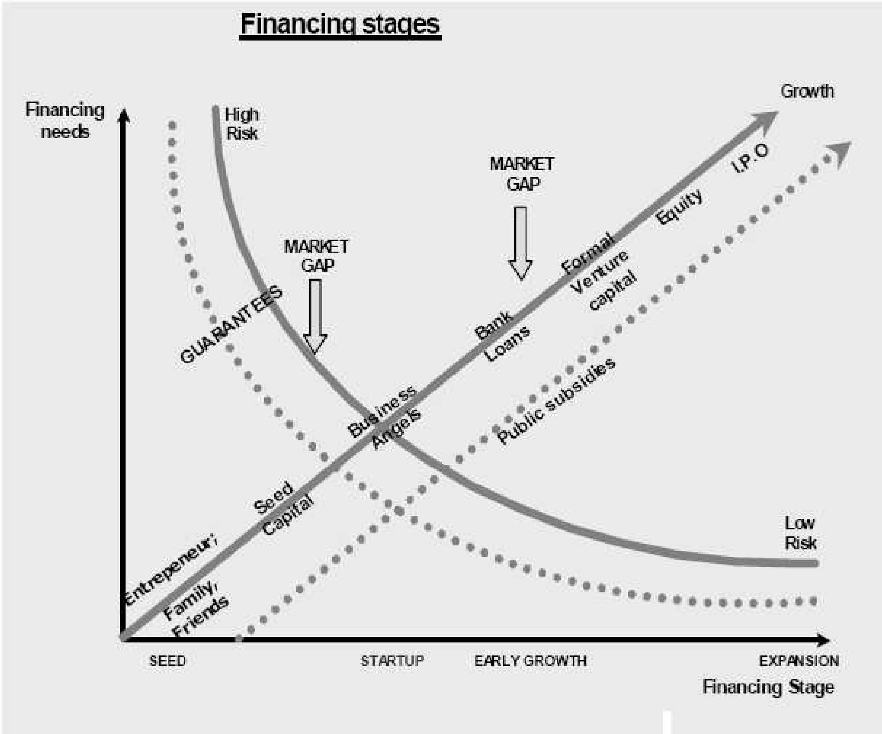

Figure 1.

Financing stages of enterprises. Source: Eurada Guidebook, August 2004.

In comparison, let's have a look at a Hungarian Ministry of Economics and Transport survey from 2005, which shows the trust index of companies by different kind of investors.

	Company without employee	Micro sized e.	Small e.	Medium sized e.	**Together**[5]
Family and friends	52	51	38	20	**49**
Business partners	36	43	51	44	**41**
Banks	16	25	43	44	**24**
Professionals association	19	25	31	42	**24**

[5] Evaluation on a scale of 1-100.

Entrepreneurs association	20	24	30	38	**23**
Consulting groups	14	21	29	44	**20**
Economical chambers	13	20	29	34	**19**
Local government	11	16	24	19	**15**
Local center of entrepreneurs	10	13	21	16	**13**

Table 4: Trust Index of investors

As a result we can face the fact, that an SME is forced to find help in it's own circles. But what happens, if somebody has got a good idea, but is lack of rich friends? At an early stage of the enterprise, comes the risk capital and the support of the state. With this recognition have we arrived to the main points of these study.

2. 1. State aid for financing SMEs

2.1.1. Connection between state aid and risk capital

Risk capital relates to the equity financing of companies with perceived high-growth potential during their early growth stages. The demand for risk capital comes from companies with growth potential that do not have sufficient access to capital markets, while the offer of risk capital comes from investors ready to take high risk in exchange of potentially above-average returns from the equity invested. The Communication on State aid and risk capital (hereinafter: SARC) was adopted in 2001 to set out the conditions for granting State aid in the form of risk capital.

In its communication on the re-launched Lisbon strategy, the Commission has recognized the insufficient level of risk capital available for start-up, innovative young businesses. The Commission has also stressed the importance to reduce and redirect State aids to address market failures to increase economic efficiency as well as to stimulate innovation. In this context, the Commission has committed to reforming the State aid rules *inter alia* with the aim to facilitate access to finance and risk capital.

In fulfilment of its commitment, the Commission has published the State Aid Action Plan (SAAP) on less and better targeted State aid in June 20053. The SAAP has highlighted the importance to improve the business climate and facilitate the rapid start-up of new enterprises. In this context, the SAAP has announced the review of the SARC to tackle the market failures affecting the provision of risk capital to start-ups and young, innovative SMEs, in particular by increasing the flexibility of the rules contained in the SARC.

2.1.2. Presence of state aid at three levels

Risk capital measures often involve complex constructions devised to promote risk capital because the public authorities create incentives for one set of economic operators (investors) in order to provide finance to another set (target SMEs). Depending on the design of the measure, and even if the intention of the public authorities may be only to provide benefits to the latter group, enterprises at either or both levels may be beneficiaries of State aid. Moreover, in most cases the measure provides for the creation of a fund or other investment vehicle which has an existence separate from that of the investors and the enterprises invested in. In such cases it is also necessary to consider whether the fund or vehicle can be considered to be an enterprise benefiting from State aid. The Commission of the EU, this is responsible for the necesserity of the state aids, is taking into account the following specific factors in determining whether State aid is present at each of the different levels.

Aid to investors. Where a measure allows investors to effect equity or quasi-equity investments into a company or set of companies on terms more favourable than public investors, or than if they had undertaken such investments in the absence of the measure, then those investors receive an advantage. Such advantage may take different forms.. This remains the case even if the investor is persuaded by the measure to confer an advantage on the company or companies concerned. In contrast, the Commission will consider the investment to be effected *pari passu* between public and private investors, and thus not to constitute state aid, where its terms would be acceptable to a normal economic operator in a market economy in the absence of any public intervention. This is assumed to be the case only if public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and where at least 50 percent of the funding of the measure is provided by independent private investors.

Aid to an investment fund and/or its manager. In general, the Commission considers that an investment fund is an intermediary vehicle for the transfer of aid to investors and/or enterprises invested in, rather than being an aid beneficiary itself. However, for instance fiscal measures or other measures involving direct transfers in favour of existing funds with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the beneficiary. Likewise, aid to the fund's managers or management company will be present if their remuneration does not fully reflect the current market remuneration in comparable situations. This will be particularly the case where the managers or management company are not chosen through an open and transparent public tender procedure or if they receive any other advantages granted by the State.

Aid to the enterprises invested in. Where aid is present at the level of the investors or of the investment fund, the Commission will consider that it is at least partly passed on to the target enterprises and thus that it is present also at their level. This is the case even where investment decisions are being taken by the managers of the fund with a purely commercial logic. In all other cases, the enterprises invested in will not be considered as aid recipients if the investment is effected on terms which would be acceptable to a private investor in a market economy in the absence of any State intervention. For this purpose, the Commission will consider whether such investment decisions are exclusively driven by profit-maximization, linked to a reasonable business plan and projections as well as to a clear and realistic exit strategy. Also important will be the choice and investment mandate of the fund's managers or management company as well as the percentage and degree of involvement of private investors.

2.2. The working risk capital

We often hear and read that on the one hand, investors have money but don't find enough good projects, and, on the other hand, that entrepreneurs don't find enough funding sources to finance their project (which by essence are good ones).

Who is right?

It seems that the offer of risk capital is there but that not enough equity is dedicated to seed or early stage. EVCA[6] annual reports show that in general funds leverage more financial means than they invest. In Germany, a study launched amongst 40 business angels[7] in the first quarter of 2004 showed that only one quarter of those angels had invested more than 25% of the money they intended to invest.

If the supply of capital is not considered as the main obstacle of that market, the problem may come from the quality of the demand.

The demand problem can be classified in 3 fields:

---

6 European Private Eqiuty and Venture Capital Association

7 Business angel: Younger individuals, rather than buy a business outright and run it alone, invest in someone else's good idea and work with them to develop the business. This is like a management buy-in. A younger business angel can be a succession solution. Or: Consultants who want looking for a greater reward from the results of their work, not just fees for service. Consultants then know that their advice will directly affect their own financial position. Or: Companies who have generated surplus cash through their own diligence seek to invest their systems, contacts, time and money to help another company achieve growth.

a) asymmetric information between the entrepreneurs' and investors' worlds. Entrepreneurs may confuse risk capital and credits;

b) Inefficient preparation of entrepreneurs willing to meet or meeting investors;

c) a different perception of the innovativeness of entrepreneurs project.

The implementation at regional level of specialized support services programmes should be considered as one of the solutions to be looked at in order to solve this paradox.

2.2.1. Beginnings of venture capital in EU

During the 1990s, some important changes have transformed the prospects of European entrepreneurial firms. First, the introduction of the euro, and its consequences at both product and financial market level, substantially advanced the creation of a truly European economic area. Second, there was the creation of several new equity markets targeted at innovative firms, as European stock markets have traditionally been unwelcoming of young companies without an established track record. A third major change was the dramatic increase in the supply of venture capital in most EU countries, which provided access to risk capital financing for entrepreneurial companies.

These changes have been potentially very important. Studies based on US evidence have shown that venture-backed companies are more effective in innovation and grow at a higher pace. The lack of well-established venture capital industry has therefore been identified as a major cause for the paucity of European star entrepreneurial companies. Hence one of the European Commission's goals has become the development of a European venture capital industry as a crucial step to foster entrepreneurship, competition, innovation and growth.

2.2.2. Facts on European venture capital

The Survey of European Venture Capital (hereafter: SEVeCa) is the largest academic study to date about the industry. Its goal is to provide objective data on the state of the European venture capital industry. To that end, data were collected on the activities of European venture capital firms for the period 1998-2001, including information on more than 1,300 investment companies, more than 400 venture capital partners, and more than 150 venture capital funds. The main data collection for SEVeCa consisted of a survey sent to all registered European venture capital firms. The data were augmented with publicly available sources (e.g., web pages) and numerous direct enquiries at the venture capital firms. The overall response rate (15%, which is considered quite high for this type of research) has guaranteed a dataset which is highly representative in terms of countries and typology of venture capital.

The main findings from the research project are that the European venture capital industry is much more integrated than previously believed. It also has significant links to the US, and is increasingly emulating US investment practices. However, some aspects remain distinctively European, such as the prominence of banks and corporations as investors. Bank venture capital firms have different investment styles: They tend to invest much less in early-stage deals and are less likely to frequently monitor their firms or to sit on the board of directors. That fact might be one possible explanation of the lack of evidence of a positive role of venture capital on firms' growth, when the analysis is conducted on firms listed on the Euro.NM in the same period.

It is often believed that European venture capitalists are purely local investors who do not venture beyond their country borders. The SEVeCa study disproves this belief, showing that the European venture capital market is surprisingly integrated. First, 27% of all venture firms in the sample have a secondary office in a foreign country. Second, 25% of all venture capital firms have partners that come from a foreign country. Third, 24% of investments are made in foreign companies. The fraction of deals with foreign investors is particularly high in industries such as in financial services (42%), media and entertainment (34%), and telecommunications (31%). The US is by far the most popular destination for foreign investments, accounting for almost a third of all foreign deals. There are multiple additional links between the European and US venture capital markets. For example, as many as 34% of all European venture capitalists had some work experience in the US.

A unique feature of the research project is that it allows to examine the human-capital basis of the European venture capital firms.

By linking data on investment deals to the partners who are in charge, the study documents the interrelationships between human capital and investment styles. For example, the data show that partners with advanced degrees (master’s or doctoral level) are more likely to make early-stage deals and sit on the board of directors. Level of professional experience prior to entering the field is important as well. Almost all venture capitalists who sit on the board have prior experience in finance, and three out of four also have a science education.

Compared with their US colleagues, European venture capitalists have the reputation of being “hands-off ”— i.e. conservative and non-interfering. The SEVeCa data, however, point to the presence of an increasing variety of investment styles across the continent. Sixty percent of all deals are seed or early-stage investments, indicating a healthy level of risk tolerance. In terms of getting involved with their companies, 68% of venture capitalists sit on the board of directors, 69% monitor their company on a monthly or weekly basis, and 42% help to recruit key managers for their investment companies. The industry is also undergoing changes—whereas older venture capital firms tend to have more conservative investment styles, new entrants tend to be more risk-tolerant and to get more involved. The data show that new entrant firms invest more at the seed stage and that they monitor their investments more closely. Interestingly, partners in new entrant firms are no younger than those in the old guard firms (the average age of a European venture capitalist is 42 years); this suggests that they have more prior professional experience. Partners in new entrant firms are also more likely to have a business education and a master’s degree. All of these characteristics help to explain why the new entrant firms adopt investment styles that more closely resemble those of US venture capital firms.

2.2.3. Latest news on venture capital: JEREMIE

The European Commission's communication paper, "Cohesion Policy in support of growth and jobs, Community strategic guidelines 2007-2013", stresses the importance of improving access to finance for the development of SMEs. In particular, it emphasises the need to enhance support on competitive terms for start-ups and micro-enterprises, through technical assistance, grants, as well as non-grant instruments such as loans, equity, venture capital and guarantees. The report highlights the added value of undertaking these actions in cooperation with the EIB Group, namely European Investment Bank (EIB) and European Investment Fund (EIF).

Working in close collaboration, the European Commission's Directorate Regional for Regional Policy (DG REGIO) and the EIB Group launched the JEREMIE initiative in October 2005 to improve access to finance for SMEs in regional development areas, in line with the Community strategic guidelines.

JEREMIE will be complementary to other SME finance initiatives at EU level, notably the Competitiveness and Innovation Framework Programme (CIP) that EIF will operate from 2007 on behalf of the European Commission's Directorate General for Enterprise (DG ENTR). JEREMIE will offer different financial instruments from those available under CIP. JEREMIE will provide a range of instruments focused on regional level, such as investments in regional venture capital funds, technical assistance or the provision of equity to financial intermediaries and eligibility will be limited to "objective" regions.

The JEREMIE initiative foresees 3 main financial instruments:

- Advisory and technical assistance
- Equity and venture capital
- Guarantees (both for microcredit loans and SME loans)

Bibliograpy

[1.] Az Európai Unió támogatási programjai KKV-k számára, GKM, 2006. November

[2.] A Magyar Köztársaság Kormánya: A kis- és középvállalkozások fejlesztésének koncepciója. Elfogadva: 2007. február 7-én.

[3.] SME access to finance: Guidebook for public decision-makers and intermediaries, August 2004.

[4.] Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy. GlobalInsight, 2007.

[5.] Simplified Tax Compliance Procedures for SMEs – Final Report of the Expert Group, European Commission, June 2007.

[6.] European Commission's SME Portal www.ec.europa.eu/enterprise

[7.] Laura Bottazzi, Marco Da Rin, Thomas Hellmann: The Changing Face of the European Venture Capital Industry: Facts and Analysis. August 2004, Stanford University Press