CROWDFUNDING: AN INNOVATIVE FINANCIAL SOURCE OF SMALL AND MEDIUM SIZED ENTERPRISES

Lect. Katarína Belanová Ph. D
University of Economics
Faculty of National Economy
Bratislava, Slovakia

Abstract: Although small and medium sized enterprises have many possibilities how to finance their needs, their access to sources of finance is difficult. This situation is even more pronounced after the financial crisis from 2009. One of the possibilities how to secure sources of seed capital, respectively capital to fund various innovative projects, is crowdfunding, which is considered to be an alternative to traditional venture capital investment. The aim of the paper is to introduce this innovative funding mechanism for small and medium – sized enterprises, as well as to point out its specifics and benefits.

JEL classification: G01, G24

Key words: SMEs, crowdfunding, loans, financial sources

1. INTRODUCTION

It is generally acknowledged, that small and medium – sized enterprises (SMEs) represent the core of all economies, as well as a main source of economic growth, dynamism and flexibility. Their importance lies especially in bringing innovations or new techniques to the market.

Regarding Slovakia, SMEs (including the LPs – small trade licensees) represent 99.9 % of the total number of businesses. Moreover, the achieved share of SMEs in employment in the business economy of Slovakia was 71.8 %, that is 4.3 p.p. higher than in the countries of the EU – 27 in 2012 (SBA, 2012).

Despite their significance, they usually suffer from financing difficulties. Solution of their financial constraint is a problem that is spread all around the world.

As shown in the paper, SME financing relies mainly on bank sources and they have a great disadvantage when they want to obtain them comparing to large companies.

It is especially according to the fact, that their growth and earnings models are

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1 The categorization of enterprises used in Slovakia, as well as in the other EU Member States, is according to the Recommendation of the European Commission no. 2003/361/EC valid from 1.1. 2005. Enterprises qualify as SMEs if they fulfil the criteria laid down in the Recommendation. In addition to the staff headcount ceiling, an enterprise qualifies as a SME if it meets either the turnover ceiling or the balance sheet ceiling, but not necessarily both.
volatiler when we compare them with larger companies. We can add also their low survival rate.

Thus, banks and other traditional sources of credit may decide that SMEs represent a greater risk than larger companies, and respond by charging higher interest rates. This makes it more difficult for SMEs to borrow than for bigger companies, and may make it effectively impossible for many SMEs to borrow money at all because the price of credit is too high.

Moreover, financial, as well as debt crisis in the Euro area naturally influenced obtaining loans. Bank loans had been quite common and accessible source of financing even in Slovakia before 2009, which is true also for the risky segment of SMEs (depending on the core and genesis of their business). Commercial banks thanks to high levels of their deposits had started to create more flexible and affordable credit schemes.

The supply side replied to the financial crisis almost immediately, especially by the tightening of the bank lending conditions. The lending was almost completely frozen at the time of the deepest crisis (NBS, 2009). Risks associated with required guarantees had the highest impact on tightening of the standards, which were tightened especially for the category of SMEs.

Under these circumstances, the importance of alternative sources of finance is increasing.

The aim of this paper is to introduce crowdfunding as an innovative funding mechanism for small and medium sized - enterprises, as well as to point out its specifics and benefits.

2. LITERATURE REVIEW

Corporate access to finance has been the subject of interest among professional circles and corporate sector itself for a long time. There are many literature sources dealing with the issue of corporate finance, resp. in the strict definition with SME finance (e.g. Fetisovova, 2012; Majkova, 2008; Neupauerova and Valek, 2010; Belanova, 2010 etc.). However, most of them just characterize the different possibilities for obtaining financial sources, and they do not analyze their development nor specific barriers encountered by Slovak SMEs in this process (actually, there have been some trials also in the SR, e.g. Belanova, 2013 etc.) and they do not formulate specific proposals for the support of obtaining external financial sources.

SME finance is based on the same principles and it works with the similar procedures as the corporate finance generally. SMEs, however, have more specifics, which are reflected in their financial management processes.

These are connected with their smaller size, lower degree of diversification, more limited market and higher riskiness. The specific features of SMEs include also their benefits, esp. their flexibility. SMEs have closer contact with customers and so they can adapt to their new needs faster.

They have different structure of assets compared to large companies – share of their fixed assets to total assets is significantly lower. On the other hand, the share of current liabilities to assets is higher, which indicates their higher financial vulnerability (Cressy and Olofsson, 1997).

SME finance is more complicated due to the fact, that they require different
spectrum of financial tools in various stages of life – cycle (figure no. 1).

These companies often depend on the informal sources of finance at the initial stages of their life. External sources are getting to be important with the beginning of the expansion stage and access to them can influence the development trajectory significantly.

SMEs tend to have less financial strength, do not have sufficient collateral, which is usually the main reason why banks refuse to provide credit to them and why such businesses obtain it so hard. Smaller businesses and enterprises with a shorter history have only short-term contacts with the banks and therefore pay higher interest rates and the banks require higher guarantees from them (Berger and Udell, 1995).

The situation when the SMEs have insufficient access to the sources of finance through financial markets is defined as the "financing gap" (figure no. 2). Its reasons are stated for example in (OECD, 2006).

The fact that financiers have difficulties with the assessment of the situation in financing of the company and its owners, less intensive relationship between SMEs and financial markets (SMEs often get the financial sources from informal sources) and
asymmetric information are those reasons. The information asymmetry is higher in SMEs which reduces their chances of getting financial sources compared to larger companies. Another factor influencing the intensity and character of the gap is the country where the SMEs operate. Financing gap is more evident in the so – called emerging markets than in OECD countries, though they point to the existence of partial financing gaps.

\[ \text{Financial gap} \]

\[ \text{Information asymmetry} \]

\[ \text{Source: Landström (2003)} \]

3. EMPIRICAL SURVEYS

There were many surveys realized regarding the SMEs’ access to finance. Yet, their conclusions are not always equal.

Despite the importance of SMEs for the economy of our country, reality in SME finance in Slovakia is according to their managers, resp. owners, significantly worse compared to the state in other European countries.

It is presented for example in the survey realized by the EC in cooperation with the ECB (2013)2. Managers of the SMEs included in a survey evaluated a list of eight possible problems. 15 % of them marked as a problem “access to finance“. Due to this we take it as the second most pressing problem right after finding customers (22%). It is clear that insufficient access to finance of SMEs will become the most serious problem when domestic demand for goods and services will grow again.

\[ \text{Source: Landström (2003)} \]

Figure no. 2 Financing gap

2 Survey „SMEs’ Access to Finance Survey 2013“, evaluates SMEs’ Access to Finance and it is built on the previous surveys from 2011 and 2009. It was realized among 14,900 SMEs and it included 37 countries. The collection of the data was realized from 28.8 till 14.10.2013. For the full version see: http://ec.europa.eu/enterprise/policies/finance/files/2013-safe-analytical-report_en.pdf
Regarding the evaluation of access to finance of SMEs it was quite changeable according to the country (40% of SMEs in Cyprus, 32% in Greece, 23% in Spain and Croatia, 22% in Slovenia, 20% in Ireland, Italy and the Netherlands, compared with just 7% in Austria or 8% in Germany and 9% in Poland). In case of Slovakia the value was 18% (higher than in 2011, resp. 2009).

Because 42% of the managers from Slovakia graded it by 10 points from 10, we can conclude that access to finance is extremely pressing in Slovakia.

On the other hand, it was seen as not so important in Estonia (only 3%), or Finland and the Czech Republic (both 5%).

However, every coin has two sides. That is why we have to present both sides. There is feeling of lack of funding sources for SMEs by their owners or managers on the one hand. On the other hand, we will present assessment and comparison of countries through the SME Access to Finance Index (SMAF Index) developed by the EC. It monitors Small and Medium-sized Enterprises’ (SMEs’) access to financial resources, its development in time and analyzes differences between Member States.

Figure no. 3 shows the SMAF Index scores for Slovakia, EU and Euro area.

![SMAF Index scores for Slovakia, EU and Euro area](image)

Source: EC (2013)

**Figure no. 3 SMAF Index scores for Slovakia, EU and Euro area**

The results of the SMAF Index are in accordance with the results of next survey (KPMG, 2014). 81% of the family businesses in Slovakia does not consider the access to finance as a problem.

According to the cited survey realized by the EC in cooperation with the ECB (2013), regarding sources of financing, we mean external and internal ones.

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4 Internal financing was defined in the survey as ‘Retained earnings or sales of assets’. External financing included “various sources of financing, including grants/subsidised bank loans, bank...
most frequent for EU managers of SMEs to use mostly external financial sources. Exact numbers say that more than half (54%) used only external financing, and it is a little less than in 2011 (56%). Next 22% of SMEs used the combination of internal and external sources of funding, and the rest (4%) used only internal sources. 20% used no source of financing, which is the same as in 2011. Regarding Slovakia, 8% of SMEs surveyed used only internal funds, 51% used only external financing, 15% used both internal funds and external financing. Countries such as Austria, Hungary and Slovakia rely on internal sources the most (more than 8%, i.e. twice the EU average).

Bank loans (excluding bank overdrafts and credit cards) as a source of external financing were used by 27% of Slovak SMEs. It is lower than in 2011 by 0.7 p.p., resp. lower than in the EU – 28 (32%, increase by 1.2 p.p).” 5 Slovak SMEs reach the lowest degree of the complete successfulness when asking for the bank loan among the V4 countries.

Bank loans also remain the most preferable source of external financing for the future. This is true for the Slovak SMEs (74%) and also for the SMEs in EU – 28 (67%).

The survey also indicates that using loans was not so spread among the smallest SMEs, among the SMEs with low turnover or among the ones with only one owner. 6

Nevertheless, there are also other sources for financing, which are not so widely used and that is why they are called alternative sources of finance (Belanová, 2010). We will present crowdfunding as an alternative financial source for SMEs in the next part of the paper.

4. CROWDFUNDING

Crowdfunding is a form of common financing. It is an alternative source of financing. It is a new form, which has appeared only in past few years. It consists in obtaining smaller funds from a large group of people (i.e. crowd). Instead of usual providers of financial sources (banks or venture capital investors or business angels) the project, or the company itself is financed by the group of individuals. The collection of funds is realised by the use of internet. It used to be a help for financing a singular projects. Nowadays even a normal man can be an investor and get money in this way. It is popular esp. in the areas such as technology and marketing, media including film, music and video games. It connects two aims: source of getting money and promotion of the project before it is launched.

Figure 4 presents development of the crowdfunding market globally and shows how crowdfunding's popularity has increased over the years. Regarding the last year, the most active crowdfunding element was social causes (30%). Nearly 17 percent of crowdfunding money received startups (next 28% to other, 12% films and performing arts, 8% music and recording arts, 6% energy and environment) (Statista, 2014).

overdrafts, bank loans, trade credits, leasing/hire purchasing/factoring, debt securities, subordinated loans and equity”.


Crowdfunding has slowly but surely come also to Slovakia. There have been two successful start – up projects: project Culcharge (smallest USB charge and data cable for iPhone and Android) and Košice`s start – up Goldee (light controller).

There are 4 types of crowdfunding (Kupferberg, 2012):

- **Donation based**: donor of the financial sources does not get any reward for the provided funds.
- **Reward based**: contributor gets a reward by a change for the financial sources. It is usually a product that the company wants to bring to the market by the help of the financial sources received thanks to a crowdfunding campaign. It is a possibility for obtaining required capital in a form of pre – sales still in prototype phase. Examples of reward based sites include Kickstarter and Indiegogo.
- **Lending based**: applicant receives a loan from a number of small creditors. He repays the principal as well as the interest.
- **Equity based**: contributor (actually investor in this case), increases equity of the company and gets a share in its ownership.

![Figure no. 4 Development of the crowdfunding market globally](http://www.crowdsourcing.org/editorial/2013cf-the-crowdfunding-industry-report/25107)

Of course, we can meet with a hybrid models in a practise. They present a combination of donation, lending and/or investment models. Recently a new form, so called innovative distribution rights models have emerged. They enable the investors to be involved in profit sharing without following a traditional investment model” (CMF, 2012).

Reward based, lending based and equity based models of crowdfunding are relevant from the perspective of corporate financial sources. Especially the use of
lending based and equity based crowdfunding is more flexible according to the situation and stage of company’s life cycle (the legislation of the country establishes the maximum amount which can be obtained in this way).

Although we can take crowdfunding as an alternative to bank loans and equity sources of financing, it has its own pros and cons. They can be summarized into the following points:

1. Access to capital – crowdfunding can provide SMEs with the capital they need to start or expand their business, esp. if they are not able to get a bank loan or attract an angel or venture capitalists. It is obvious that it is easier and faster to collect money from some individuals in a form of small contributions than from venture capital or investor, because they are required to provide higher amounts at once. This partially explains why crowdfunding usually works.

2. Awareness – thanks to word of mouth, crowdfunding helps SMEs to create brand awareness even before their businesses launch. So SMEs can make use of this marketing technique to make their mark more popular even before the product is launched to the market.

3. Feedback – if they succeed or no, SME receives feedback. Getting needed money earlier is a mark that people trust in the quality of the project. On the other hand, if it will not, it means that it needs some adjustments, otherwise it will fail.

4. Speed of response – campaigns are used to be rather short when we compare them with the getting money from venture capitalists or banks.

5. Free press coverage – these campaigns of a product or service can be so interesting that they can catch the attention of the media so potential consumers know about SME project even before it is launched.

On the contrary, SME should be aware of certain drawbacks when it wants to finance a business through crowdfunding:

1. The “All – or Nothing” model – which is used by most crowdfunding platforms. It means that if a SME is not able to raise its target amount, it will get nothing. Money will be returned back to contributors.

2. Reputation – if the campaign fails, it will be on internet, on the website visible for everybody. So they can learn about this and it is not good for the possible future activities of SMEs.

3. Pressure – because contributors want the company to launch the business on time, SME can be under a big pressure.

4. Hidden costs – it happens if SMEs use some forms of benefits for attracting investors, and they do not charge in the extra costs or when the promised rewards are higher than expected.

5. Negative impact on other financing options – crowdfunded businesses are usually indebted (debt – wise or equity – wise). It can be taken as a risk for formal venture capitalists.

6. Limitations – the total number of money a SME can get is limited and it is necessary to fulfil the legislative requirements.

7. Potential lawsuits – esp. when the business fails. There is also a risk of fraud, breach and so on.
5. CONCLUSIONS

Many small businesses consist at the beginning only of one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing. Regarding bank loans, these companies tend to have less financial strength; do not have sufficient collateral, which is usually the main reason why banks refuse to provide credit to them and why such businesses obtain it so hard. Smaller businesses and enterprises with a shorter history have only short-term contacts with the banks and therefore pay higher interest rates and the banks require higher guarantees from them.

For improvement of obtaining bank loans by SMEs theoretical papers offer a solution – decrease of information asymmetry.

Moreover, SMEs have also other possibilities of obtaining financing, namely the alternative sources. This article deals with different ways how SMEs can get money thanks to crowdfunding and the pros/cons of doing so.

As shown, crowdfunding is gaining in popularity among startup businesses and older firms willing to raise money. However, although it seems very easy to raise money in this form, actually, it is not so easy. Like any marketing or fundraising campaign, it requires a good strategy and solid execution. It is also recommended not to copy the successful campaigns, to be original.

REFERENCES

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