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## **ACCESS TO FINANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES IN SLOVAKIA**

***Abstract:** Small and medium-sized enterprises (SMEs) are the backbone of all economies, as well as a key source of economic growth, dynamism and flexibility. Small businesses are particularly important for bringing innovative products or techniques to the market. Despite these facts, they are commonly constrained by finance. How to solve their financial constraint is a worldwide problem. In Slovakia, SMEs are also suffering from financial gap and due to the fact that their financing relies mainly on bank sources (as detailed below), this paper focuses on the issues about SMEs' borrowing ability from the bank. The paper reveals the results of the survey aimed at the SME finance in Slovakia. We present factors affecting SMEs' ability to borrow from the bank in Slovakia, stating that the fact whether SMEs can provide a collateral or guarantee is a decisive factor; factors such as a firm size, amount of information requested by banks, administrative burden, and long loan granted procedures play an important role.*

***Keywords:** small and medium-sized enterprises, financial gap, bank loan, information asymmetry.*

**JEL:** G 21, G 30

### **Introduction**

Small and medium sized enterprises<sup>1</sup> create an inseparable part of each developed market economy due to their vital role in job creation, contribution to the elasticity of the market mechanism and competitive environment potential. Creation of an appropriate business environment is an important factor in the small and medium business sector development.

It presupposes, among other things, especially improving of the access to capital. As various empirical studies show (for example [1]), concerning the financing, SMEs use predominantly bank sources.

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<sup>1</sup> The categorisation of enterprises used in Slovakia, as well as in other EU Member States, is according to the Recommendation of the European Commission No. 2003/361/EC valid from 1 January 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.

There is much literature dealing with financing of SMEs at home and abroad. But many of them including recent entrepreneurial finance conference papers<sup>2</sup> mainly focused on the source of capital, capital structure and similar topics, and only few of them investigate SMEs' ability to borrow from the bank (for example [2] [3] etc.).

In contrast to them, this paper contributes to entrepreneurial finance literature in a way of exploring the parameters that affect SMEs' ability to acquire a bank loan in Slovakia. The remainder of this paper is organized as follows. Section 1 presents the quantitative characteristics of the SME sector in 2012 in the context of its development over the past few years and comparison of the available data on the business sector in Slovakia and the EU. Section 2 deals with the SME finance in Slovakia generally. Section 3 introduces data source and methodology; Section 4 presents analysis; Section 5 draws a conclusion of an empirical study carried out in 2011.

## **1 The Position of SMEs in the Economy of the Slovak Republic**

In Slovakia, likewise as in other developed economies, SMEs are recognised and qualified as a basis of the economy. In order to improve the business environment for their development, it is necessary to assess their position and monitor their development. A deeper analysis of the SME sector in the context of time allows identifying existing trends, expecting future developments and preparing measures to ensure the optimal development.

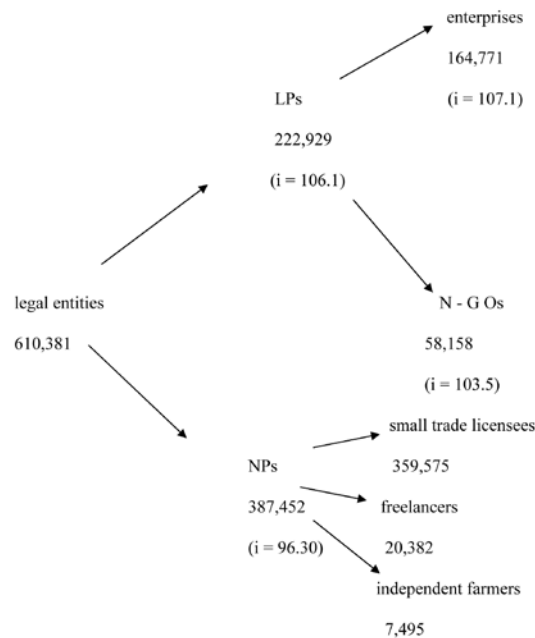
As for their development, the different tendency of particular legal forms of SMEs continued in 2012. For the fourth consecutive year the category of natural persons – entrepreneurs recorded a fall – their numbers declined by 3.70% year on year. The number of legal persons – enterprises generally continued to increase, with a year on year increase of 7.08% (Figure 1).

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<sup>2</sup> See entrepreneurial finance conference papers on website <http://www.aofef.org>

Figure 1

Statistics of Legal Entities in Slovakia according to the Legal Forms



**Source:** Own elaboration from the Statistical Office of the Slovak Republic (SO SR), data valid to the end of December 2012

Note: LPs – legal persons, NPs – natural persons, N – GOs – non-governmental organisations

If we take into account only enterprises, SMEs create approximately 85% of this category. The development of the SMEs – legal entities according to the number of employees is shown in the following table (Table 1).

SMEs – Legal Entities

Table 1

Enterprises Whole economy (number of employees)	2009M12	2010M12	2011M11	2012M12
0 - 9	91,201	113,886	117,338	125,782
10 - 19	17,292	6159	9445	7563
20 - 49	3607	3390	4425	3588
50 - 249	2925	2724	2762	2573

**Source:** Own elaboration from SO SR data.

Regarding the branch of the business, SMEs – legal entities were active mainly in business, business services, industry and construction in the period observed.

As we can see in Table 2, size structure of the business sector in Slovakia is largely similar to the size structure of enterprises of the other EU Member States. It is necessary to mention, that the data presented show some methodological differences to be taken into account in mutual comparison.<sup>3</sup>

The statistics show that of the total number of almost 21 million businesses in the non-financial business economy in the EU countries, SMEs account for 99.8% (with a strong representation of micro-enterprises – 92%) and contribute to jobs by 66.7%.

According to the data, SMEs in the Slovak Republic represent (including natural persons – entrepreneurs) 99.9% of the total number of businesses (micro enterprises account for 96.1%) and participate in jobs in the business economy by 72.2%.

Based on the data presented in Table 2, it can be concluded that in the Slovak business sector the micro-enterprises represent a more significant proportion than in other EU countries. In Slovakia, micro-enterprises reach 96.1% of the total number of businesses, which is by 3.9 p.p. more than in the EU countries and contribute to jobs in the business economy by 39.6%, which is by 10.6 p.p. more than in the EU countries.

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<sup>3</sup> Data for the EU-27 are compiled by Eurostat methodology for *Structural Business Statistics* and cover the sectors of the non-financial business economy. The data for the EU-27 in the case of Slovakia, in contrast to the other countries, have included data only for legal entities – enterprises. The number of businesses in Slovakia (enterprises – legal entities and natural persons – entrepreneurs) in Table 2 represents the whole economy of the Slovak Republic and the data source is the Register of Organisations of SO SR. In the case of the employment rate, data presented represent the average number of persons employed in the corporate profit-oriented economy according to the results of the quarterly corporate reporting of the SO SR.

Table 2

## The Size Structure of the Business Sector in the Slovak Republic and EU

		Size of the company					
		micro	small	medium	large	SMEs	Total
		0-9	10-49	50-249	250+		
EU-27 (2009/2008)	Number of businesses in non-financial business economy, 2009 (in thousands)	19,169	1,351	229	42	20,750	20,791
	Share in the number of businesses	92.2	6.5	1.1	0.2	99.8	100.0
	Number of persons employed in non-financial business economy, 2008 (in thousands)	39,325	27,856	23,410	45,185	90,591	135,776
	Share in the employment rate	29.0	20.5	17.2	33.3	66.7	100.0
SR (2011)	Number of businesses	534,766	17,968	2,874	598	555,608	556,206
	Share in the number of businesses	96.1	3.2	0.5	0.1	99.9	100.0
	Number of persons employed in the business economy	716,172	309,111	281,475	502,325	1,306,758	1,809,083
	Share in the employment rate	39.6	17.1	15.6	27.8	72.2	100.0

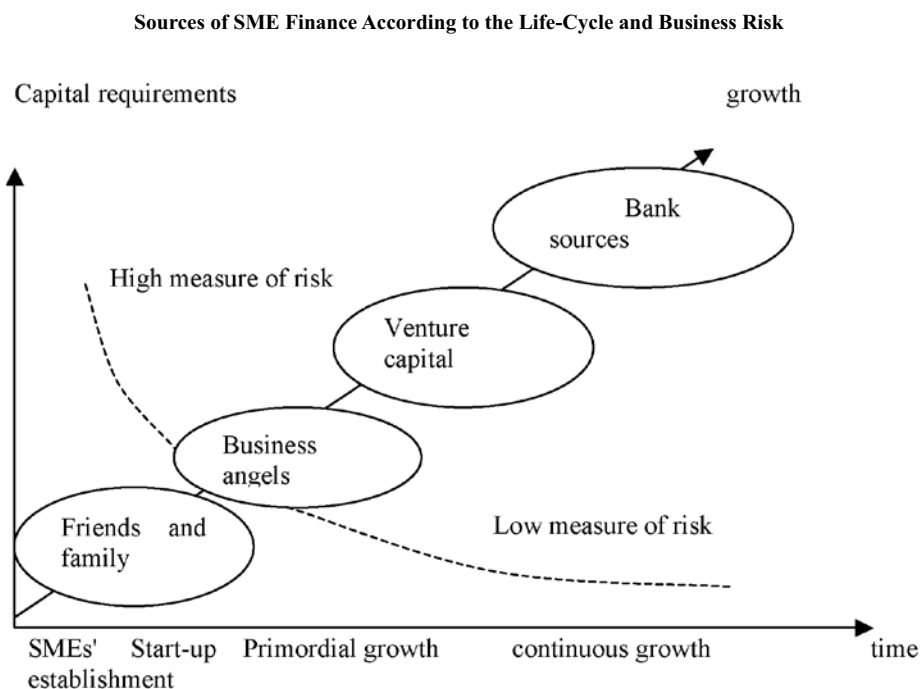
Source: [4]

## 2 SME Finance in Slovakia

Despite the documented importance of SMEs for the economy of our country, the share of SMEs that experience problems with access to finance in Slovakia is above the EU average, 27 % versus 21 % [5].

SME finance is more complicated due to the fact, that they require different spectrum of financial tools in various stages of life-cycle (Figure 2).

Figure 2



Source: [6]

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 significantly influence the development trajectory. Internal sources consist of the businessman's own savings, retained earnings, depreciation or sources acquired by the sale of the assets. External sources can be generally divided into own and foreign, foreign to classical and alternative ones. The classical external sources include bank loans, factoring/forfeiting, leasing, trade credit, and bonds, stable and unstable liabilities. The alternative external sources include private equity investments, venture capital, and financial help of the EU through the structural and communitaire funds, help from other states of the EU, state help. [7]

SMEs depend critically on external sources of finance, especially bank products, as confirmed by the latest Survey on the access to finance of SMEs [1].

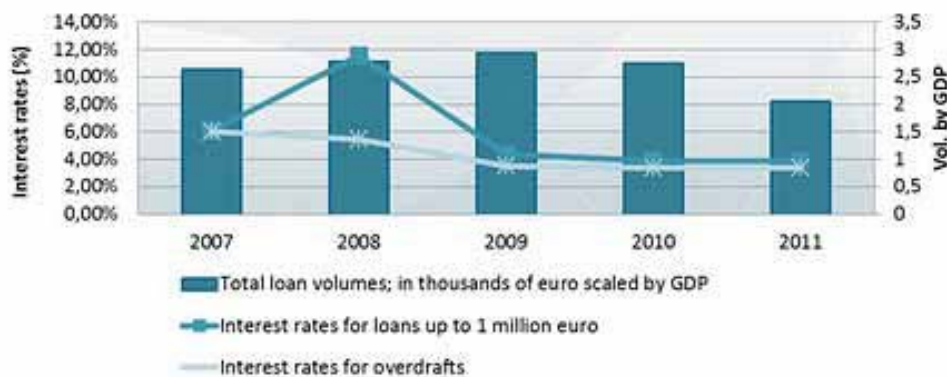
Financial, as well as debt crisis in the Euro area naturally influenced acquiring of the loans. Before them the bank loans had been as a source of financing quite common and accessible even in Slovakia, also for the risky segment of SMEs (depending on the core and genesis of their business). Thanks to high levels of their deposits commercial banks 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. According to a survey of the National Bank of Slovakia (NBS) the first recorded decline in corporate lending was in the first half of 2009. It was due to the mentioned tightening of the conditions. Risks associated with required guarantees had the highest impact on the tightening of the standards, which were tightened especially for the category of SMEs.

According to the data released by the European Central Bank (ECB) loan volumes remained relatively constant over the period 2007 – 2011 (Chart 1). In 2010, the total volume of loans reached only 2.7 % of the country's GDP, compared to 5.65 % EU average. The loans in 2010 were granted with an average interest rate of 3.89 %, being lower than 5.05 % EU average. The percentage of successful loan applications by SMEs decreased from 89.3 % of all loan applications in 2007 to 76.1 % in 2010.

Chart 1

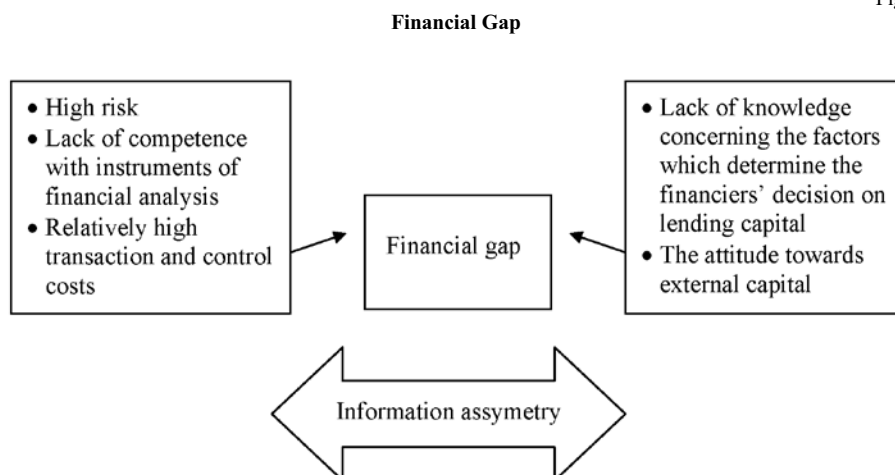
Loans as a % of GDP in Slovakia



Source: [8]

For the improvement of acquiring bank loans by SMEs theoretical papers offer a solution: decrease of information asymmetry. The core of the matter is that the most important obstacle to get bank loan financing is information asymmetry between borrower and lender, e.g., the borrower has private information about the firm that the lender does not have. For SMEs, because of their small size, short history, obscure accounting, etc., the extent of information asymmetry becomes more serious (Figure 3).

Figure 3



Source: [9]

Concerning the means to mitigate this problem, the key measure – on the standpoint of borrower – is to reduce degree of information asymmetry, specifically, conveying the intrinsic soundness of his project and distinguishing the borrower from a riskier borrower.

Those elements signalling SMEs' quality and alleviating informational problem undoubtedly become important factors affecting the borrower's ability to borrow from bank.

Then what are the factors? And what is the empirical evidence? Next sections are intended to answer these questions.

### 3 Data and Methodology

#### Data Source

In the year 2011, we carried out a survey in 62 manufacturing firms in Slovakia. The firms in our sample were small- and medium-sized. In the survey we asked a number of questions regarding bank loan borrowing and its determinants. The questions were put to the financial managers or to the owners to ensure that the answers we obtained were coming from those who actually dealt with bank loans. Next to these issues, the survey also contained questions about individual firm characteristics. The questions in our survey allowed us to investigate the factors that affect SMEs' ability to borrow from bank.

#### Methodology

We employed the method of qualitative analysis. In qualitative analysis, we will describe SMEs' characteristics of business and analyze how factors such as collateral, firm size, and relationship affect SMEs' ability to borrow from the bank.



## 4 Statistical Results and Analysis

### Descriptive Statistics

*Industry distribution.* Table 3 shows that the selected SMEs in Slovakia cover a wide range of manufacturing section and that the other manufacturing division dominates in other divisions.

Industry Distribution of the SMEs' Representatives according to Nace Rev. 2

Table 3

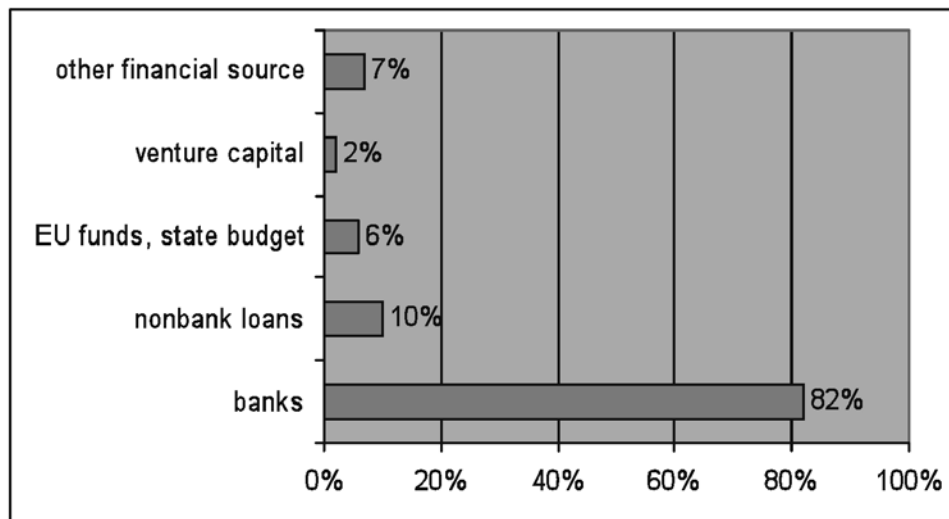
Section C - Manufacturing	observation	percentage (%)
Manufacture of food products	10	16.3
Manufacture of beverages	3	4.8
Manufacture of tobacco products	1	1.6
Manufacture of textiles	9	14.5
Manufacture of wearing apparel	5	8.1
Manufacture of leather and related products	1	1.6
Manufacture of rubber	2	3.2
Manufacture of other non-metallic mineral products	2	3.2
Manufacture of basic metals	1	1.6
Manufacture of computers, electronic and optical products	5	8.1
Other manufacturing	23	37.1

Source: Own survey (2011)

*The use of financial instruments.* Banks are the financial institution by far the most frequently used when SMEs need financing (Chart 2).

Institutions Used by SMEs to Obtain Financing

Chart 2



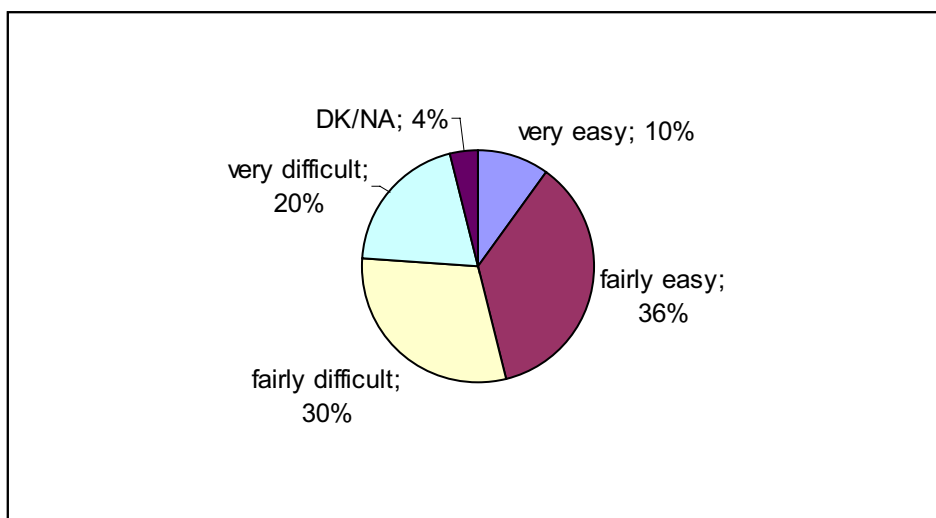
Source: Own survey (2011)

However, views about the ease of access to loans granted by banks are mixed. 50 % of the managers surveyed feel that access to loans granted by banks is difficult, while 46 % feel that it is easy.

The question in the survey was the following one: “Would you say that today, access to loans granted by banks is...”.

Chart 3

## Access to Finance from Banks



Source: Own survey (2011)

Note: DK/NA: Do not know/Not answered

It should be noted that respondents were most likely to opt for the “fairly easy”, response category (36 %), followed by the “fairly difficult” response category (30 %). Those who feel that access to loans is very difficult (20 %) outnumber managers who feel it is very easy (10 %).

The results are comparable with those of a survey [10] with 1,002 respondents (out of which 40% were small trade licensees, 40 % micro and 20 % small companies) realised at the beginning of the year 2013. Unfavourable situation in obtaining external funds is no obstacle for 43.1 % of respondents; only a slight obstacle for 31.7 %; serious obstacle for 17.6 % of respondents and only 7.6 % considered it to be a critical obstacle for their business. How successful the respondents were when applying for a loan in the previous 12 months is shown in Table 4:

Table 4

## Success of Respondents when Applying for a Loan (in %)

	small trade licensees	micro companies	small companies
We asked and we were successful.	71.4	60.0	68.3
We asked and were quite successful.	20.4	31.1	22.0
We asked and we were not successful.	8.2	8.9	9.8

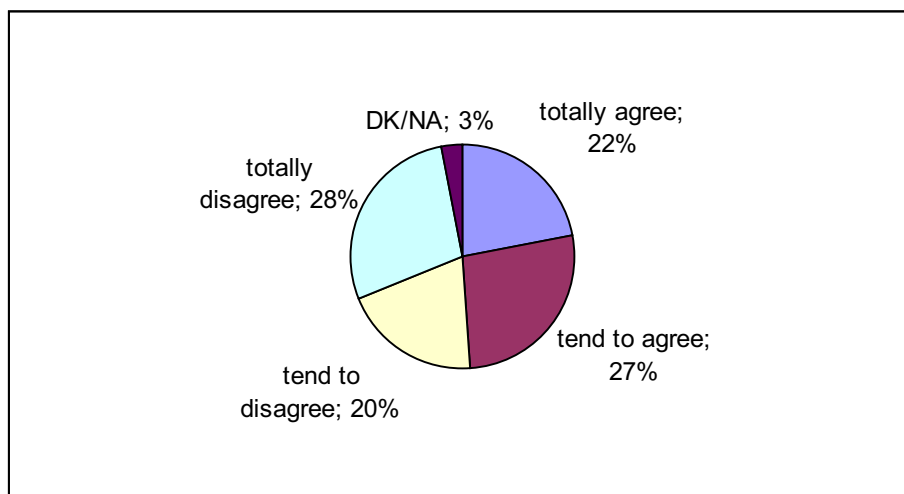
Source: [10]

Concerning the reasons of the loans' rejections, insufficient collateral of the loan was the reason for rejection in 42.3 % of fully unsatisfied applications for loans. 16.7 % of entrepreneurs had poor credit rating; the same percentage as of those who do not know the ground for refusal. Lack of business history was the reason for rejection in 11.9% of the unsatisfied applications. Lack of own resources was the reason for the rejection of the loan in 7.1 % cases and almost 5 % was the result of a lack of business potential.

Access to finance from banks is extremely pertinent to the financial well-being of SMEs. About half of the SMEs surveyed say they cannot successfully complete their projects without a loan from the bank (49 %). Chart 4 shows the results which the managers surveyed attributed to the statement "Without a loan from the bank, your projects cannot be successfully concluded".

Chart 4

## Project Completion and Bank Loan

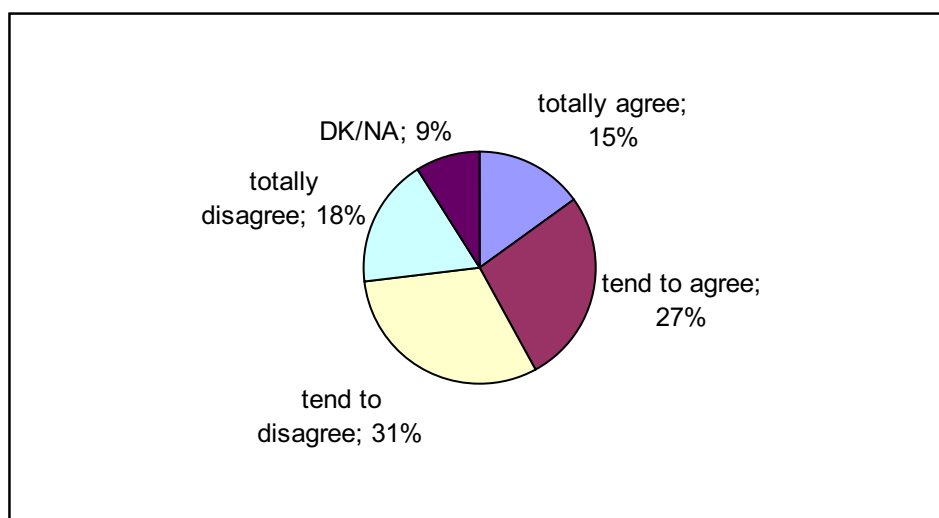


Source: Own survey (2011)

Moreover, around two-fifth of the managers surveyed feel that the offers from the banks are not suited to their needs (42 %). Chart 5 shows the results which the managers surveyed attributed to the statement “The offers from the banks are not suited to your needs”.

Chart 5

Matching of the Bank Offers to Managers' Needs



Source: Own survey (2011)

Then what are the reasons that result in that SMEs cannot or cannot sufficiently be financed by the bank? What are the factors that affect SMEs' ability to borrow from bank?

### Factors that Affect SMEs' Ability to Borrow from Bank

When asked what are the reasons that lead to their difficulty in borrowing from the bank, the managers and owners of SMEs answer the question as they think right. The answers from our survey are displayed in Table 5.

Table 5

Reasons Explaining SMEs' Difficulty in Getting Bank Loan

reasons	votes	percentage (%)
Insufficient collateral or mortgage	13	21
Small firm size	12	19
Profit is not high enough	9	15
Acceptance of bank clauses	2	3
Relationship with bank	2	3
Too much information requested by banks	8	13
Administrative burden	8	13
Long loan granting procedures	7	11
other	1	2

Source: Own survey (2011)

Table 5 shows there are 9 reasons that contribute to SMEs' obstacle to borrow from the bank. Among various reasons we can see that insufficient collateral or guarantee account for 21 % of all the votes, which constitutes the most important reason; other reasons such as small firm size, low profit, bank clauses, relationship with banks, too much information requested by banks, administrative burden, long granting procedures, also lead to SMEs' difficulty in borrowing from the bank.

Table 5 indicates that owners of SMEs attribute the main reason of unavailability of a bank loan to insufficient collateral and guarantee.

Firm size. Firm size constitutes another important factor that affects SMEs' ability to get a bank loan. Table 5 shows firm size account for 19 % of the votes explaining reasons of difficulty in getting the bank loan.

Relationship with banks and acceptance of bank clauses are not so important in obtaining the bank loan (both account for 3 % of votes). The result is rather surprising considering the fact that these factors are usually mentioned in the empirical studies which deal with this issue (for example [11] [12]).

Factors such as much information requested by banks, administrative burden and long loan granted procedures are also reflected in Table 5 and are quite dominant.

The results of our representative survey are different from the results of the survey which we take as a benchmark [10]. High interest rates are the most important limiting factor according to 30.3 % of entrepreneurs. Another common reason is low willingness of banks (22.3 % of entrepreneurs).

Unsuitable general economic conditions are limiting factor according to 21.6 % of entrepreneurs. 17.8 % of entrepreneurs sees no obstacles in acquiring of the bank loan. 16.8 % of entrepreneurs think it is lack of business history, and only 12.1 % of entrepreneurs that it is an insufficient collateral. Moreover, 41.7 % of the entrepreneurs surveyed do not think the situation (concerning the possibilities to obtain the bank loans) will improve in the future.

## 5 Conclusion

There are many reasons that lead to SMEs' difficulty in borrowing from the bank. As far as SMEs in Slovakia are concerned, our empirical study finds that whether SMEs can provide a collateral or guarantee is a decisive factor; factors such as firm size, amount of information requested by banks, administrative burden, and long loan granted procedures play an important role. The result is disappointing, and it proved the existence of information problems and banks had taken a simple way to protect themselves. Most of SMEs are in the growth phase; by themselves they cannot provide sufficient and qualified collateral for a bank loan, so it is natural that many SMEs' bank applications will be refused.

If SMEs cannot find the financing they need; brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy. The other danger is that these SMEs will abandon the formal system altogether and operate in

the informal economy, sidestepping taxes and regulations, and thus not making a full contribution to economic growth and job creation.

### Literature

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