Analyses of financing needs of SMEs by size and age in Albania

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Abstract

Small and Medium Enterprises (SME) play a very important role in the economy as the biggest employer and also with a contribution of more than 50 % of the turnover and value added. Because of this they have been the subject of many studies and analysis on various aspects of their activity. The most typical approach when studding them has been their comparison by size, but the literature suggest that age can also be an influential factor on firm behavior and decisions specially when it comes to financing options and constrains. This study compares these two approaches in an attempt to find out which one is actually better in explaining firms' behavior in Albania. For this purpose we analyzed different patterns of behavior of firms of different sizes and ages on the usage of several bank services regarding their external financing options. The results suggested that size is a better explanatory on firm financing options and constrains, but age even though not being a good explanatory variable on its own it can nonetheless be a very good supporting argument when combined with size and by this can help develop a better understanding of the behavior within size groups.

Keywords: Albania, SMEs, Financing, Size, Age.

Introduction

In the early 2000s, Albania was one of the fastest-growing economies in Europe, with growth rates of 5% to 6%. But this fast economic expansion was interrupted by the global economic crisis of 2008–2010 and by the following Euro-zone crisis, in particular in neighboring Italy and Greece, and reached its lowest growth rate of 1.1% in 2013. In 2014 growth picked back up and the economy has grown with 2.6% in 2015, and is expected to be at 3.2% for 2016 (World Bank, 2016). Albania has built on a consumption-oriented economy and the growth has been driven mainly by remittances from Albanian emigrants mainly in Italy and Greece. Remittances level has been as high as 16% of GDP in the mid-2000s and this flow of income increased the purchasing power of the population. This may be the reason that the dominating economic sector in the country is trade. Although remittances now represent only 8–9% of GDP, their role is still high, and trade is generally expected to continue dominating the SME sector (EIB, 2016).

In the post crisis era Albania is facing the need of a new strategic growth model. The economy must shift from a consumption-oriented economy towards a production driven one and this shift must be done fast in order to catch up on the growth train. Falling remittances and the significant decrease in the construction sector, which used to be a big contributor in the economy in the 2000s, make this shift necessary and urgent.

The focus of this paper will be on Small and Medium Enterprises (SMEs) because like in many other countries SMEs in Albania play an important role in terms of employment, turnover, and value added. SMEs sector, in 2014, accounted for 60.3% of total employment (micro – 31.7%, small – 7.8%, medium – 20.8%), which is comparable to the 67% in EU countries. SMEs account for more than a half the total turnover and value added. In 2014, SMEs contribution to total turnover was 55.5% (micro – 13.8%, small – 11.7%, medium – 30.0%). Albanian SMEs provide about 50% of the value added, slightly below the 58% in the EU countries (EIB, 2016). Their role is even more important in this period when unemployment is high. While unemployment reached its lowest rate of 13.0% in 2008 it has increased since then. In 2015, the unemployment rate stood at 17.1%, with the lack of employment being more pronounced among youth. The youth unemployment rate has been increasing over the last decade and stood at 33.2% in 2015, up from under 20% in mid-2000s (EIB, 2016). Youth unemployment has become a top concern, given Albania's average population age of only 31. As a remedy for unemployment, entrepreneurship may be a good and efficient mean, but in Albania this is generally considered to be low. According to the EIB report (2016) the legacy of state ownership is still there making many Albanians to prefer a stable job working for somebody else rather than owning an enterprise. Even if unsuccessful with employment, starting a business is not always seen as a good opportunity due to various reasons including low self-confidence and fear of failure, which comes from a lack of entrepreneurial knowledge. Beside entrepreneurial knowledge and risk aversion another important constrain on entrepreneurship is the access to finance. This constrain is relevant not only for the start-up businesses but also for other SMEs of different size and ages. The demand for loans from SMEs in the economy is estimated at EUR 1.4 billion, which is about 14% of GDP and 34% of the total loans of the financial system (EIB, 2016). Because capital markets are not functional, the banking sector is the main channel for SME financing, accounting for more than 88% of total supply. At present there is a moderate funding gap for loans in Albania, as banks are more conservative due to high NPL levels. As lending is mostly collateral-based, the gap is higher in rural areas, with agriculture remaining largely underserved, and a rather large funding gap exists for people in the remote mountain areas.

When studying SMEs usually we find that researchers are analyzing their characteristics, performance and behavior by comparing them by their size. Whilst these approaches are valuable, they largely ignore the issue of the sources of finance employed by a firm at various stages of its life cycle, and how the combination of financing changes and evolves across stages of development (Mac an Bhaird, 2009). Weston and Brigham (1970) in their book, outline sources of finance typically available at various growth stages of the firm, along with potential financing problems that may arise at each stage. The financial life cycle model they propose incorporates elements of trade-off, agency, and pecking order theories, and describe sources of finance typically advanced by funders at each stage of a firm's development. At the start-up phase firms have difficulty accessing external finance due to information opacity (Huyghebaert and Van de Gucht, 2007). At this stage personal savings of the firm owner, and finance from friends and family members are the most important and commonly-used sources of finance (Ullah and Taylor 2007). As successful firms survive nascent and start-up phases, and matures through growth stages, personal funding becomes relatively less important as investment finance is increasingly sourced from retained profits. Furthermore, accumulation of a trading history facilitates access to increased sources and amounts of external financing, particularly bank financing and trade credit. Over time Diamond's (1989) reputation theory suggest that internal equity becomes the most important source of financing, as firms increasingly employ retained profits. This source is augmented by short-term debt, which is employed progressively more as age profiles increase.

Myers and Majluf (1984) in their pecking order theory of financing argued that since financing comes from three sources, internal, debt and equity firms adhere to a hierarchy of priorities in using one or the other form. According to them, firms' first preference is internal financing when available, second they will choose debt financing and only as a last resort they will turn to equity. The equity financing would mean bringing external ownership into the company and that's why companies use it as a last resort financing option. Following this logic older firms having more history on performance, good reputation and credit face less adverse selection problems and thus can obtain loans and better financial terms compared to their younger counterparts and will use debt financing before equity (Bulan and Yan, 2007). New and younger firms are more prone to face severe financing constrains and this may also reduce the likelihood of starting a business as is shown by Paulson and Townsend (2004). Without access to formal financing, start-up firms might resort to informal sources and this is found to be very common for SMEs in start-up and growth phases in India (Allen, et al. 2006).

This study will look into the Albanian firms financing patterns by dividing them by age and size in an attempt to discover the relationship between firm age and the sources of external finance available. The results will be compared against those of firms divided by size in order to find if age or size is the most determinant factor when considering financing options and constrains in the case of Albanian enterprises.

Methodology

This paper methodological approach is based on a comparative analysis between SMEs of different age and size. Row data are taken from the Enterprises Survey conducted by the World Bank. This is a firm-level survey of a representative sample of an economy's private sector. The survey covers a broad range of business environment topics including access to finance, corruption, competition, infrastructure, performance measures, etc. (World Bank Enterprise Survey, 2013). The Enterprise Surveys implemented in Eastern Europe and Central Asia is jointly conducted by the World Bank and the European Bank for Reconstruction and Development (EBRD) and is also known as Business Environment and Enterprise Performance Survey (BEEPS). BEEPS is being answered by business owners and top managers which gives more accuracy to the collected data. The first grouping is done by age and it contains 7 groups corresponding to the age intervals of 1-2 years, 3-4 years, 5-6 years old, 7-8 years old, 9-10 years old, 11-12 years old, and older than 13 years.

Another grouping is done based on SMEs size using the size classification used in the survey which defines micro enterprises those with less than 5 employed persons, small ones those with more than 5 and less than 19, medium enterprises those with more than 20 and less than 99 and large enterprises those with more than 100 employees.

Data Analysis

SMEs by size and age

When grouped by age the structure of SMEs in Albania shows that the majority of the firms, around 40%, are older than 13 years old, while there is a more proportional share split between other groups. This pattern holds no mystery since in Albania was applied a shock therapy approach as a strategy for the transition from planned to market economy, and in the '90s there was not that much of other choices than to start a new business. This situation led to a boom of new enterprises most of which apparently survived until today making them the biggest group as is shown in figure 1/a. Looking again but this time on the composition of this big group of enterprises, figure 1/c, we notice that almost 80% of the enterprises are small ones, which suggests that they despite the age they never grew bigger. By the absence of big enterprises in the first age group we can conclude that the enterprises start as small or medium to further on grow. Evidence for this is the dropping share of small enterprises in the other groups down from over 90% on the first two age groups to almost 70% in the last groups. The most common jump in size is from small to medium which can be seen in the growing percentage of this group as age goes up (starting at 9% at the first age group and growing to as high as 28% on age 9-10 and settling at 19% later on). It results that the pattern of distribution of enterprises by size within age groups is no different than that of the overall pattern of the country as seen in figure 1/b.

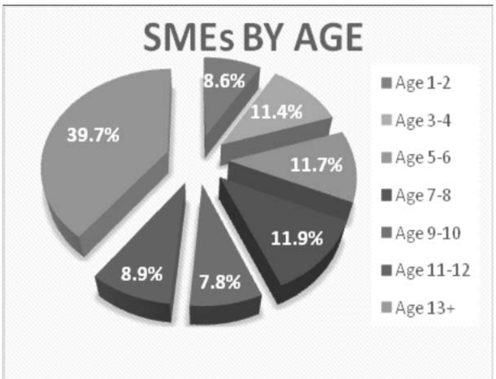


Figure 1/a. Distribution of total firms by age

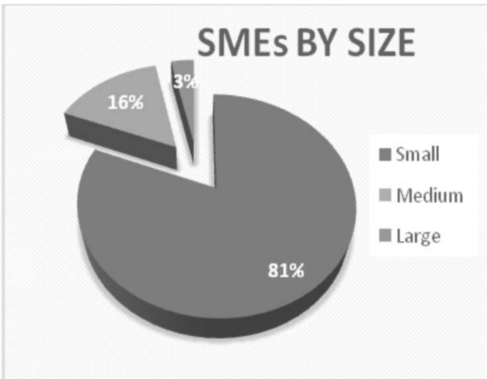


Figure 1/b. Distribution of total firms by size

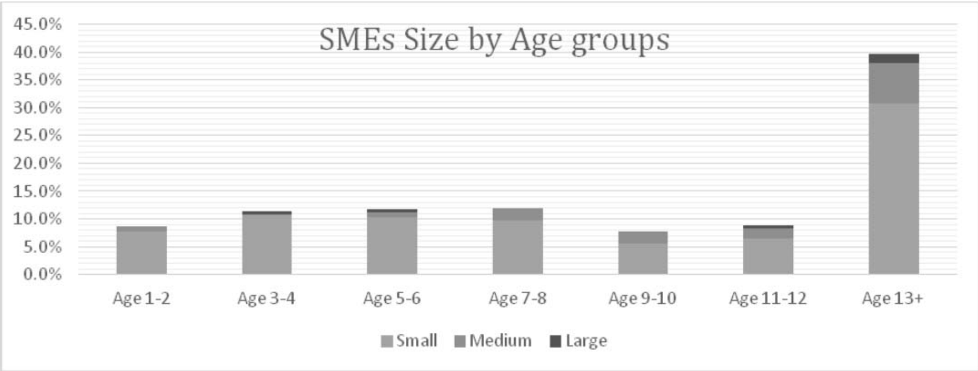


Figure 1/c. Distribution of total firms by age & size

Usage of banking services by age and size

In Figure 2/a, and Figure 2/b we examine the usage of various banking services by SMEs age and size. In total 71% of all enterprises have a bank account which is below the European & Central Asia mean of 89% (BEEPS, 2013), 56% of them have overdraft and only 21% have a line of credit. Having a bank account or overdraft seems to not be influenced by age. The same cannot be said about having a line of credit for which even though the pattern is not very consistent for all age groups, it suggests that older firms are more prone to have one (28% of them has one) compared to younger ones (14% for the 3-4 years old group). In comparison when we analyze the usage of the same bank services by SMEs grouped by size we notice that the patterns are more consistent and that in this case size does have an influence. Bigger enterprises have greater usage of banking services than smaller ones. The difference is bigger on the use of bank line of credit. Here a big enterprise is twice more likely to have a line of credit than a smaller one.

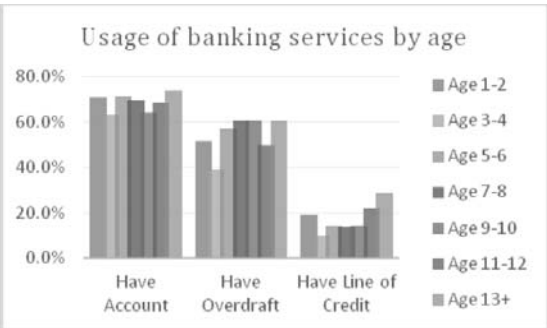


Figure 2/a. Usage of banking services by firms age

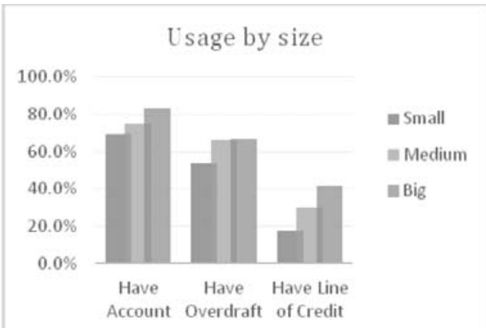


Figure 2/b. Usage of banking services by firms size

Financing new investments

Firms may need external financing for two reasons: for investing and for working capital. So we first looked for firms who invested during the last fiscal year and analyzed them by size and age. As shown in Figure 3/a the percentage of firms that did invest during the last year is almost equal through all groups with a variance of 7 from the mean 21%. The pattern doesn't support any influence of age on the level of investment a firm does, even though the mean of the first three groups is slightly higher than that of the remaining four groups, respectively 24.4% to 20.3%. On contrary when looking at the pattern of investment done by firms when we group them by size we notice a positive correlation of size on investment when bigger firms invested twice as much as the small ones.

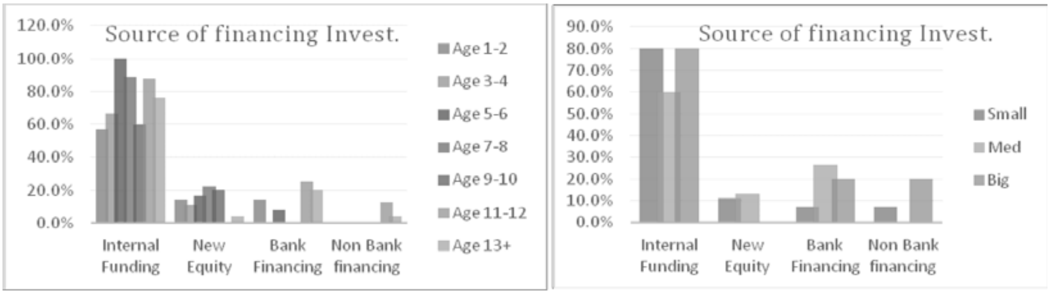


Figure 3/a. Sources of financing of investments used by SMEs of different size and age

Further on we analyzed the sources of financing used to finance these investments. For the purpose we focused on four categories: Internal financing, mainly composed of retained profits, results to be used by 76% of all enterprises; New equity, this option is used by 11% of all enterprises; Bank financing, in this category are included different bank services like loans, leasing, etc. and it's been used by 12% of them; the last category we analyzed is called Non-bank financing and it includes financing from non-banking institutions, trade credit and also financing from family and friends.

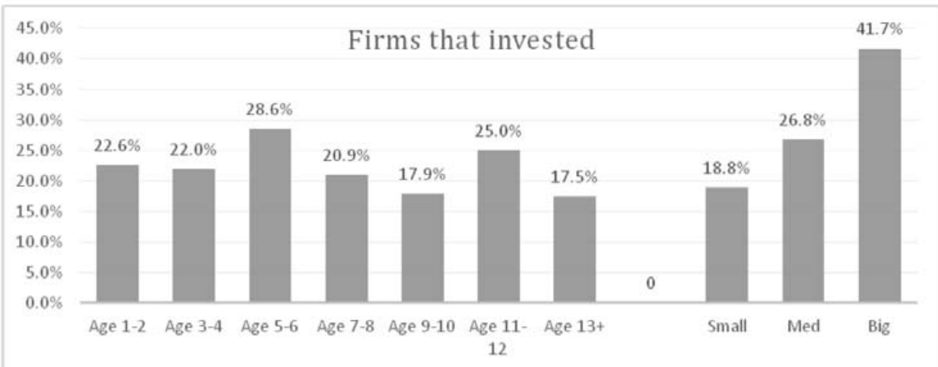
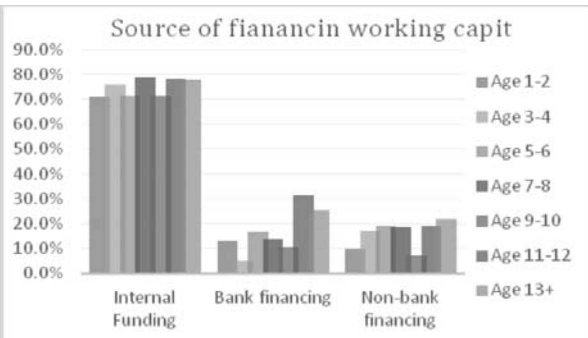


Figure 3/b. Percentage of enterprises that have invested during the last year by size and age

The reason why we grouped these sources together was because of their relatively small usage respectively 1%, 2% and 2%. Usually enterprises do not use only one type of financing but they often mix them and that's why the totals of sources used are often more than 100%. Looking at the pattern of the sources used by age groups we notice that age is still not related to the sources of finance even though we may conclude that internal founding and bank financing are used more from older firms while new equity is used more by younger firms. When analyzing financing by firm size, results are more explanatory. Big and small enterprises relay more on internal funding than medium ones. Big enterprises don't use financing with new equity. Bank financing is used more by medium size enterprises followed by big ones, while the share of small enterprises that use bank financing is relatively small. Non-bank financing is used more by big enterprises which is more under the form of trade credit, while when used by small enterprises is under the form of finance from family and friends. Medium enterprises don't report financing of this category.

Financing working capital

Another reason for which external financing may be needed is for working capital. Often firms face liquidity shortages on working capital needs and in this case external financing is needed. The typical sources of external financing used are usually short term bank credit in the form of trade credit, overdrafts, line of credit or non-bank informal financing from family or friends, in some cases even shark loans. In our analyze on the use of external financing for working capital on enterprises grouped by age and by size we find out that bank financing is used more by older firms while non-bank financing is used almost equally for all age groups except for the youngest one. Because the most representative form of non-bank financing is trade credit the relatively smaller usage of this form from the younger group can be explained by the lack of reputation and history which characterizes this group. When analyzing the source of financing used for working capital by enterprises grouped by size we see that small and medium enterprises relay more on internal funding (over 76%) while big enterprises use more bank financing (33%, compared to 17% for the small enterprises). Non-bank financing is used more from medium enterprises, and less from big ones.



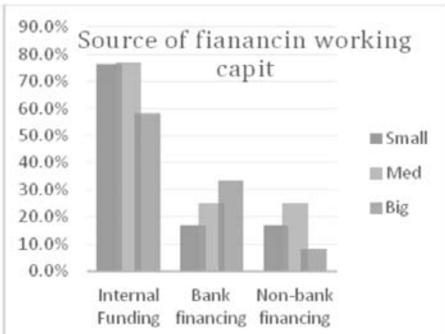


Figure 4. Sources of financing of working capital used by SMEs of different size and age

Conclusions

In the beginning of this study we assumed that age may be an important explanatory variable for the way a firm behaves when choosing what financing options to use in regard to investments and/or working capital financing needs. Based on the life cycle theory we build on a hypothesis where age is a determinant factor influencing financial decisions and options. As it turned out from our analysis age in our case is no better explanatory variable than size and usually the patterns it develops are not linear. But we conclude that even though it fails to explain financial decision on its own it can be useful as a supporting argument when explain other variables like in the case of size.

In Albania firms start as small and medium businesses with respectively 91% and 9% and in 5 years some of the medium enterprises grew big, accounting for 4.9% and some shrink to small ones. We notice that after the fifth year the medium sized group starts to grow constantly. While having a bank account and overdraft is not specifically connected to age or size, having a line of credit is more of an option for older and bigger enterprises. When it comes to investing, it results that younger and bigger enterprises tend to invest more, respectively 24 % of the younger and 40% of the bigger firms, but when it comes sources supporting these investments younger, small and medium enterprises reach to new equity more than older ones, while big enterprises don't report usage of this type of financing. When it came to bank financing as expected older medium and big enterprises are most prone to use this type of financing compared against younger and small ones which may be more credit constrained because of several terms and conditions requirements more hard to be complied by them. When looking at bank financing the same the same patterns apply for working capital financing too. Here the oldest and bigger firms have more usage of this type of financing compared to the other groups. As for non-bank financing, more widely represented by trade credit, it results a more used option from small and medium enterprises, while less used by younger ones.

The primary source of investing and working capital financing for all firm ages is retained earnings. In other words, on average, firm in all size and age buckets rely primarily on their own funds for more than half of their financing needs, which is in line with the pecking order theory of capital structure. This is also in accordance with Cani *et al.* (2000), whose interviews showed that in Albania a business is generally financed by a company's own resources. Half of the Albanian enterprises have started their business relying totally (100%) on their own capital. The other half has used debt in different percentages. But even after more than a decade later we came to the same conclusions as Bitzenis et al. (2005) who concluded that there was no change in the Albanian business mentality regarding the use of external financing. The reason behind this result is not only the skepticism of Albanian entrepreneurs to use debt as a leverage form of financing, but also the lending activity is tight, with bureaucratic procedures prolonged waiting period for the approval of applications.

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