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Croatian SMEs: Current Stage and Prospect

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Small businesses in Croatia are recognized as a locomotive for economic restructuring and increase of rate of employment. Bank credits have become more accessible in Croatia for the SME sector following privatisation by foreign banks, which now participate with more than 90 percent in total bank assets of the country. Although foreign banks had a positive impact on the domestic banking market they tended to prefer household and large scale enterprise lending.

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Besides creating an equity gap, especially for the earlier stage non-technology based SMEs, asymmetric information leads to imperfect lending (credit rationing) even for prospective SMEs with fast revenue growth. SMEs' role in banks lending decreases with bank size: small businesses have dominant place in small banks credit portfolio (cca 50% of credits). Furthermore, small business experience obstacles in assurance of appropriate bank finance. However, there is a trend among larger banks of paying greater attention to small businesses, as well as positive development in the variety of sources used for investment finance.

1. Introduction

Small businesses are known for its vitality, flexibility, and variety but higher mortality, too. SME sector is praised because of its important contribution to economic development, job creation, reduction of regional development gaps, innovative capabilities and improvement of economic structure. Although SME sector is not homogenous, it is known for certain specificities. Specificities of the SME embrace greater growth prospects and options, higher failure rates, shorter asset maturities (Sherr & Hulburt, 2001, Diamond, 1991), orientation to less competitive and more restrictive financial markets (Berger and Udell, 1998, Viducic, 2006).

A small firm adjusts more flexibly to changes of the market, representing a fertile ground for innovation. Employees in micro and small enterprises usually exhibit more than one job; organizational structure is simpler while communication among owner/manager and employees is of higher frequency and more fundamental.

On the other side, there are certain disadvantages of small businesses encompassing scarce managers and financial resources, especially in the growth phase of enterprises. Due to higher mortality rate compared to large enterprises, small businesses may encounter a problem when trying to employ adequate capital and highly qualified experts. Small enterprises are dependent (complementary) on large enterprises which may be the source of liquidity constraints. Moreover, it happens more frequently that an entrepreneur is not able to perform managerial function in times when number of employees is growing and/or organizational structure is getting more complex.

2. Do Small Businesses Experience Disadvantages on the Financial Markets?

SMEs usually do not quote on the stock exchanges leaving the credit market as their main source of external capital. Administrative and lending procedures and overall climate may represent severe obstacles for establishment and operation of SMEs. Banks represent major sources of external finance for SMEs, even in developed market economies, including those where financial systems are oriented towards security market. Banks provide long-term loans and especially short-term loans to SMEs. However, the variety of bank funds supplied varies among countries. Furthermore, banks have been traditionally known as suppliers of both debt and equity in some countries, like Germany and Japan, while in others they have not until recently, offered equity finance.

Literature examining small businesses underlines agency costs and informational asymmetry. The reasons for SMEs' difficulties in ensuring external finance in appropriate amount and/or competitive terms, embrace issues such as higher uncertainty and imperfect information (Stiglitz, Weis, 1981; Harrison, Mason, 1991; Brigham, 1991). Asymmetric information and clash of interests between different agents involved in lending process are further aggravated by qualitative factors such as lack of credit ratings, concentration of ownership and control in entrepreneurs' hands (Fazzari et al, 1988; Riportela and Papis, 2006). Lack of credit ratings and inadequate transparency and late introduction of credit and movable property registry leads to high requirements for collateral and personal equity which SMEs usually lack (Cruickshank Report, 2000; Deakins, 1996). The characteristics of SMEs' owner-manager profile may represent further obstacles for optimal SME financing. These obstacles embrace reluctance to share control by raising external equity, reluctance to raise debt due to risk aversion, as well as fear of bureaucratic procedures and unfriendly attitude of officers/local politicians (Scherr and Hulburt, 2001, Barton and Gordon, 1987, Mugler, 2000). Furthermore, impediments to qualitative financing may stem from lack of appropriate experience and education, including financial illiteracy, and insufficient corporate finance knowledge.

Ownership of small businesses goes from one individual/family to wide ownership. However, in majority of SMEs major shareholders are the managers, leading to a disadvantageous position of minority shareholders. Due to high monitoring costs and informational asymmetries, besides having a limited access to credit market, small businesses face obstacles in raising outside equity (Meyers, 2000; Bathala and Bowling, 2004), too. Internally generated funds as well as loans and equity from the main shareholders are the primary sources of capital. External funds are dominantly provided by a subject having informational/ monitoring advantage namely in form of credit extended by banks, suppliers as well as family and friends (Bathala and Bowling, 2004). Research undertaken for the U.S. SMEs confirms this approach. Bank credit and owners equity were determined as the main source of capital for the SMEs regardless of the form of ownership. However, for the family – owned and closely owned firms trade credits and loans from shareholders/managers were third and fourth important sources. In the case of public firms, the third most important source was equity provided by outside investors (Bathala and Bowling, 2004).

Recent studies of profitability and riskiness of small business lenders in the banking industry raises hopes for both large banks and small businesses. Empirical results of U.S. banking industry lending performance indicate that small business lending has either neutral or positive ROA profit effects. Furthermore, portfolio analysis evidences that small business lenders tend to have higher ROE profits per unit risk due to higher specialization which lowers banks failure risk (Kolari et al, 2006). Worth noting is the possible impact of Basel II accord. Namely, banks have the opportunity to establish individual approaches toward borrowers. Improved screening procedure may increase importance of character of SMEs as opposed to exclusively financial strength based on financial statements.

3. Small Businesses in Croatia: Economic Relevance and Access to Finance

Small businesses in Croatia are recognized as a locomotive for economic restructuring and unemployment reduction. Importance of small businesses may be revealed through its participation in total number of businesses, number of employees, total revenues as well as net income. Small and medium sized enterprises' share in the total number of businesses for the year 2006 is 99.4%. In the total number of employees they participate with 64.6%, while out of total revenue they have realised 52.8% (Graph 1.). In the year 2006 Croatian business sector has achieved highest net income since 2001 when it was operating in red. Small businesses have achieved 54.0% of net income and they achieved the highest return on equity, too.

European Commission has evaluated high rating the Croatian performance in the field of cheaper and faster establishment of enterprises, legislative and regulation (regulatory guillotine), on line accesses to government services (e-cadastre, e-taxes, e-land register).

Furthermore, there is an advantage noticed in the model of electronic operation, strengthening of technological capabilities, as well as professional skills and education.

While there are valuable improvements in the field of government services and administrative burden, as well as in the field of business infrastructure, the task of enabling small businesses to get appropriate access to establishment and growth finance is still a challenging one. Banks represent major sources of external finance for SMEs, even in developed market economies. Croatian banking market is dominated by large banks and banking groups, which resembles experience of other countries in transition. Recent development confirms increased competition and lower interest rates, although due to increased efficiency banking profits are not decreasing. Bank credits have become more accessible for the SME sector following privatisation by foreign banks, which now participate with more than 90 percent in total bank assets of the country. Although foreign banks had a positive impact on the domestic banking market in terms of lower interest rates, increased reputation, and bank product innovations, they tended to prefer household lending (Graph 2). At the end of September 2007 household lending accounted for 49.3 % while business sector lending accounted for 37.9 % (HNB, 2007).

However, entrepreneurs in Croatia use unconditioned credits for investment; furthermore, they use credit cards for business purposes (bank drafts, revolving credits), so business sector finance is presented more favourably.

When business lending is considered, banks prefer lending to LSEs over SMEs. Primarily, since default risk is higher for SMEs than the larger firms, banks require higher equity capital as a precondition for lending to the SMEs. As a consequence, entrepreneurs may find high interest rates and bank charges as an important barrier for entry and expansion (Viducic, 2006). Market prejudice is responsible for excluding SMEs that do not meet collateral requirements from the commercial bank lending. Also, commercial banks seem to use a pseudo monopoly situation in the financial sector. As a consequence, banks skim deals from the market that have appropriate collateral, excluding SMEs that do not have it, which is, unfortunately, sound business and more profitable to the bank.

Banks tend to be slow in loan decision making and too conservative in assessing risk ruling out higher risk and a medium rate of return on investments. Fierce competition, undertaken acquisitions and modern risk management practice leaves floor for improved SMEs lending practice. SMEs' role in banks lending decreases with bank size: small businesses have dominant place in small banks credit portfolio (cca 50% of credits), followed by medium sized banks (cca 45%), while large banks have slightly less than 40% of their credit portfolio in small business loans (HNB - annual banks report 2006). However, there is a trend among larger banks of paying greater attention to small businesses which is revealed in organization of special SMEs' sectors and marketing campaigns undertaken by larger banks. Hopefully, this will be accompanied by higher proportion of credits allocated to small businesses.

Providing finance is a heavy burden to small businesses especially in start-up phase. They are vulnerable and lacking both collateral and reputation. Due to a fragile position the main source of capital in the early phase is owner's equity. When start up finance is considered in Croatia it follows that almost 40% of finance is provided by the owners (Graph 3). However, proportion of short- term finance is high (54%) which rise concerns about future liquidity.

Access to appropriate finance with adequate terms in Croatia resembles circumstances in other transition economies. Small businesses access to capital is further aggravated due to uncompleted financial institutional structure-absence of (well funded) equity investors, a shallow and illiquid securities market. Besides creating an equity gap, especially for the earlier stage non-technology based SMEs, asymmetric information leads to imperfect lending (credit rationing) even for prospective SMEs with fast revenue growth. I

Recent analysis, undertaken by the authors, shed light on bank lending practices and financing pattern of small businesses. Graph 4 shows a range of importance of different characteristics of credit financing for small businesses. It can be seen that the largest number of survey participants have chosen the categories of complicated accessibility of long-term bank credits, numerous documentation, high interest rates according to the potential opportunity yield and especially high collateral requirement are too important for credit financing of SMEs in Croatia.

Dominance of internal sources in investment finance is confirmed by the research undertaken (Table 1). Internal sources have participated with 46.25 percent while bank credits, as a second most important source, have accounted for 26.0 percent of investment finance.

Evidence confirms aggravated approach to long term bank credits, as stated by the owners/managers. Leasing has become more important source, as well as short - term sources (short term bank credits and commercial credits). Beginning in 2001 leasing is evidencing dynamic growth representing major alternative to banks credit. Leasing share was 11.2 percent which reflects a growing leasing industry. More intensive reliance on leasing may be explained with advisory benefits and constraints in the availability of long –term credits. Recent global development in finance industry as well as US recession founder worries about both cost and availability of bank credits in the future. However, tight monetary policy, recently introduced credit and movable property registry, increased awareness of small business relevance and Basel II accord shed light on small business finance.

4. Concluding Remarks

Small businesses in Croatia are recognized as a locomotive for economic restructuring and unemployment reduction. European Commission has evaluated high rating the Croatian performance in the field of cheaper and faster establishment of enterprises, legislative and regulation, strengthening of technological capabilities, as well as professional skills and education.

While there are valuable improvements in the field of government services and administrative burden, as well as in the field of business infrastructure, the task of enabling small businesses to get appropriate access to establishment and growth finance is still a challenging one.

Research evidence confirms that there is still room for improvement of the small businesses finance. Bank credits still represent the main outside source of capital for small businesses, although banks prefer household lending, especially large ones. However, larger banks have undertaken organisational changes in order to pay greater attentions to this business segment. Along with Basel II opportunity for banks to recognize character of small businesses as opposed to financial strength based on financial statements, these changes raise hopes of a brighter prospect for small businesses on the Croatian bank credits market.

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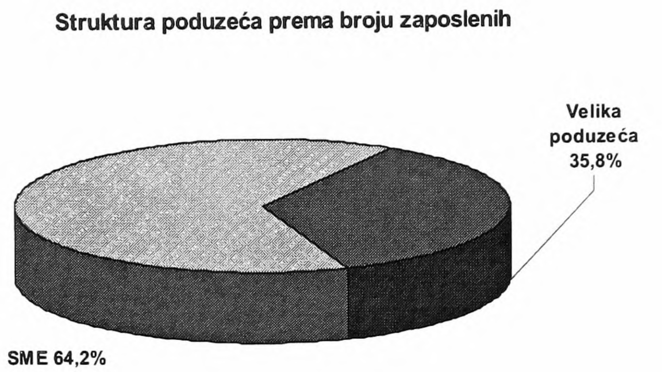
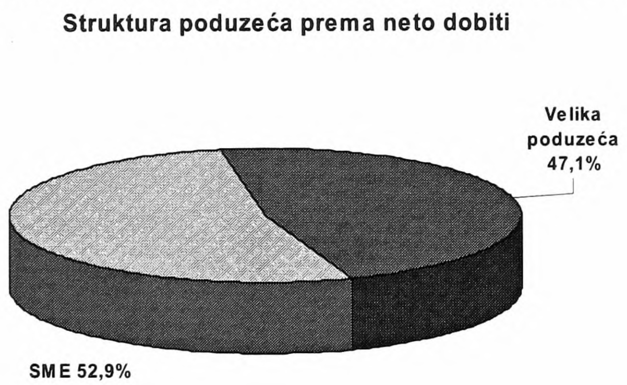
Graph 1
Importance of small businesses in Croatian economy

a) SMEs' structure compared to the total number of employees in 2007

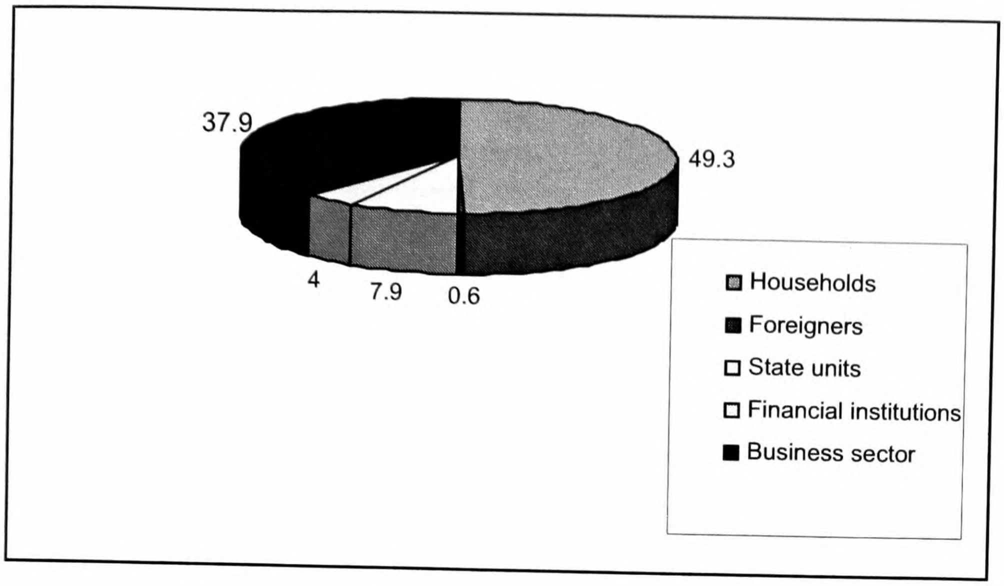


b) SMEs' structure compared to the total net income in 2007 (%)



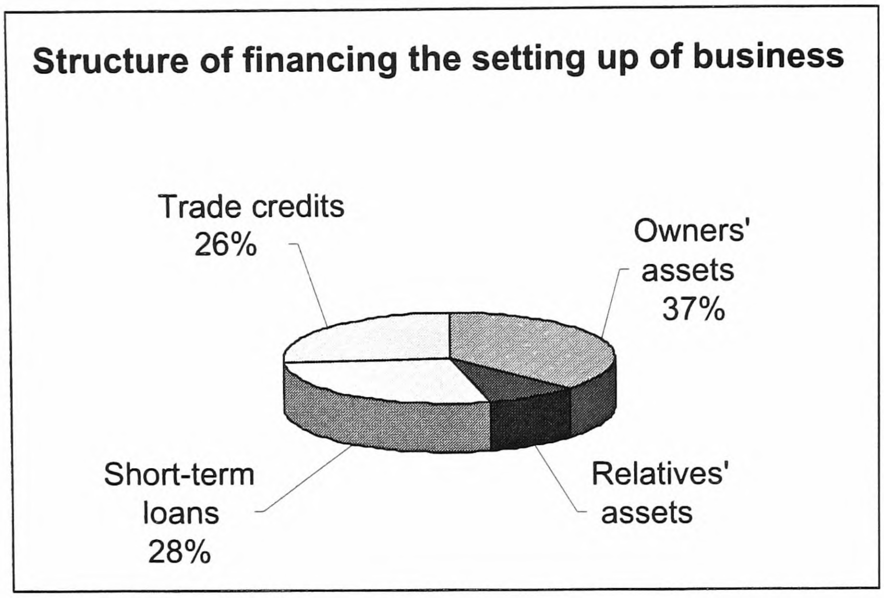
Source: FINA (2008)

Graph 2
Sectoral distribution of granted gross credit



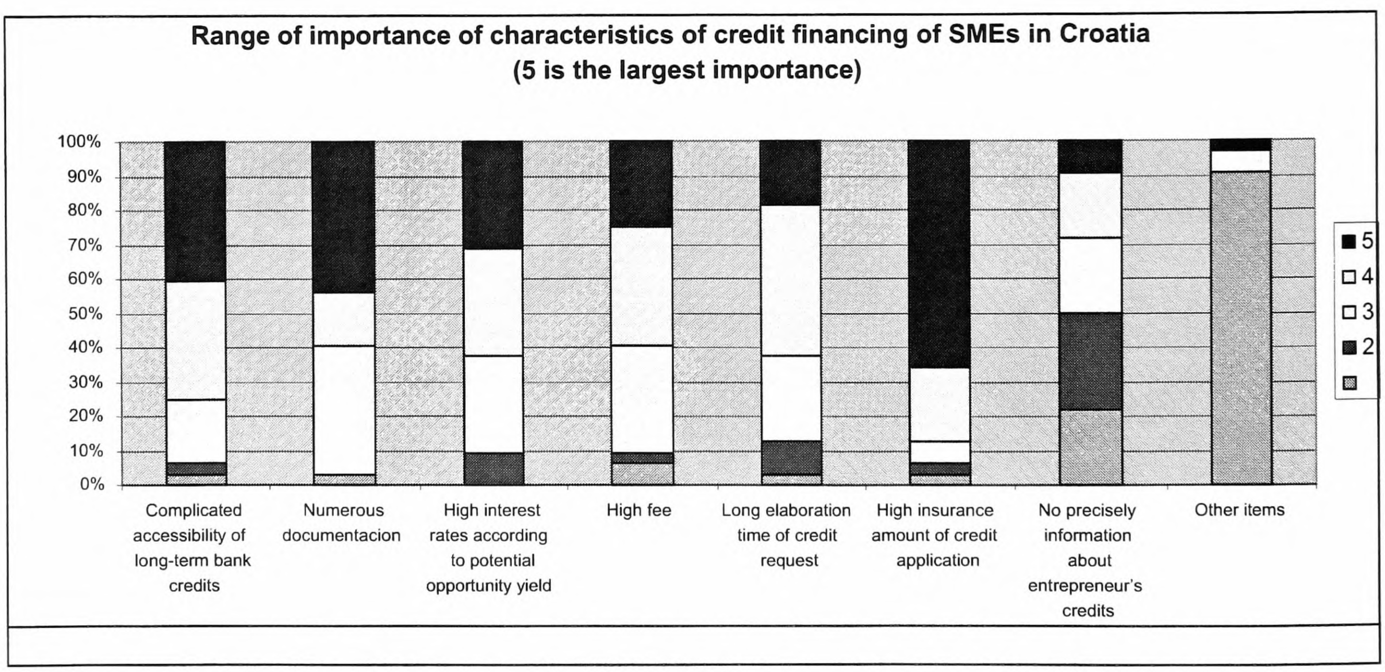
Source: HNB, 2007

Graph 3
Start-up finance in Croatia in 2007



Source: Survey research 2008

Graph 4
Characteristics of credit financing



Source: 2008 Survey analysis.

Table 1
Structure of investment finance

Investment financing sources	share (%)
amortization and holding profit	46.25
short term bank credit	20.00
long term bank credit	6.25
Leasing	11.25
subsidies sources	3.44
informal sources	3.13
commercial credit	4.06
credit cards	1.25
shares issue	0.00
Deinvestment	0.00
other items	1.25

Source: 2008 Survey analysis.