

# Chapter 30

## Innovations and Financing of SMEs, Part I: SME Financing and Credit Rationing: The Availability of Funds

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### **ABSTRACT**

*Small and Medium-sized Enterprises (SMEs), as a major sector of the economy, have unique characteristics in terms of organisational and financial structures; reflecting the interest and strategy of the owner and financiers. With regard to the recent global financial crisis, the terminology ‘Credit Crunch’ describes a shortage in financial funds and concerns most businesses as well as financiers. On the one hand, financiers (lenders) complain about weak financial structures (especially lack of equity) and high risks investments of innovations and on the other hand SMEs (borrowers) accuse financiers for a shortage of financial funds or non-transparent and demanding credit conditions. This chapter describes various financing options and gives rationales for the credit rating process and credit conditions building the base for financing decisions. Furthermore, by discussing the topic of ‘Credit Rationing’, the authors demonstrate the impact of credit conditions on management decisions in order to justify the rationing of credits. This chapter also provides the necessary introduction and background to the understanding of the next chapter “Part II: Case Study of German SMEs in 2010”.*

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## **INTRODUCTION**

This chapter introduces definitions and financing alternatives of ‘Small and Medium-Sized Enterprise’ (SME). A comparison and validation of different SME definitions is presented to demonstrate the complex categorisation of a heterogeneous set of firms. Finance as an ‘Organisations Creative Area’ supports innovation processes by overcoming barriers that exist especially for SMEs. These barriers are not just a lack of resources (especially financial resources), but also lack of expertise in fields outside the core competencies. For instance a manufacturer may have a lack of distribution knowledge and contacts. Therefore, a non-traditional financier (e.g. Venture Capitalist) may solve some of these problems and support innovation by delivering ‘Value-Added Services’ (e.g. contacts, experience and managerial competencies). Depending on the long-run targets a firm may not need the expertise of any Private Investor and may be able to be innovative with traditional financing (e.g. Project-oriented bank loans). Therefore, choosing the right financing options, not just to optimize a firm’s financial structure, can have a synergetic effect on innovations. This chapter presents rather a theoretical background on financing SMEs, while the next chapter presents a closer focus on financing and its contribution to innovations in SMEs. In order to obtain a holistic view of what a credit crunch is and how it is caused, this chapter presents rationale of the credit market and a general description of the credit rating process. Additionally, non-traditional financing options are validated concerning the SME applicability.

## **BACKGROUND**

In Europe, the degree of bank financing is high in comparison to financing through financial markets—especially compared to the USA. In the USA, bonds take an 80% share of debt financing

and bank financing only 20%—while in Europe bank loans have an 80% share of debt financing (Schinkel, 2010). Therefore banks play a very important role in financing in Europe and it is worth it to have a closer look to the credit market and credit rationing. Due to the fact that most Small and Medium-Sized Enterprises (SMEs) are limited companies, rather than quoted companies, the access to financial markets is limited. Looking at the current financial crisis with a focus on the interplay of financiers and SMEs, companies are complaining about the so called Credit Crunch causing a shortage in funds. Financiers on the other hand complain about weak financial structures in terms of debt/equity ratios causing higher risks of losing loans. Non-traditional financing, with a potential to fill traditional financing gaps, offers especially to entrepreneurs an improved business framework; even though there are concerns about the dependence on financiers.

## **SME FINANCING AND CREDIT RATIONING**

### **A Literature Review on Small and Medium-Sized Enterprises**

Structural and economic performance characteristics of Small and Medium-Sized Enterprises (SMEs) differ not only within different nations, but also within different industries. Therefore it is important to identify differentiation criteria (quantitative and qualitative) and to contrast definition approaches; addressing the question ‘which type of firm is included in the term SME?’ Sometimes the grouping structure of cooperating enterprises makes it complicated to distinguish between legally independent entities. While some organisation’s out-sourced departments and services appear to be independent, other business units corporate to an extend that contradicts to a quantitative separated definition. Most literature about small firms was originated from America

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