



*Trento SME Policy Seminar,  
12-15 October 2009*

# Financing innovative SMEs and start-ups

**Jonathan Potter**

**OECD Centre for Entrepreneurship,  
SMEs and Local Development**

# Presentation structure

- The financing issue
- SME finance sources
- Policy recommendations
- Learning models
- Conclusions

# SME financing issue

- Surveys regularly show that access to and cost of finance is a significant obstacle to growth
- The problem is particularly marked for innovative start-ups – no income until the product is fully developed
- Supply is often not well developed – there is too much focus on loans, and a small equity gap
- Demand is often not sophisticated – in awareness of options and capacity in presenting the investment case
- Different firms/projects are in different situations and the right type of finance should be accessed

# SME financing issue

## Some reasons for problems in SME finance markets

- Information asymmetry – investors not able to assess risks and returns
- Immaturity of the market – entrepreneurs may be reluctant to innovate in their use of finance
- Insolvency of market segments – start-ups cannot afford to pay market prices for business services
- Average investment size – fixed costs of due diligence

# SME financing issue

## *DEMAND SIDE BEHAVIOUR*

### *Pecking order theory*

- Firms use finance sources in the following order (costs of compensating for information asymmetries)
  1. Internal funds (retained earnings, equity from insiders)
  2. Long term and short term debt
  3. Outside equity

### *Life cycle model*

- Start-ups have no track record, little collateral assets, negative cash flows. Rely on savings, family, subsidies,
- Mature firms have a reputation, track record, collateral. Use loans and outside equity

# SME financing issue

## *SUPPLY SIDE BEHAVIOUR*

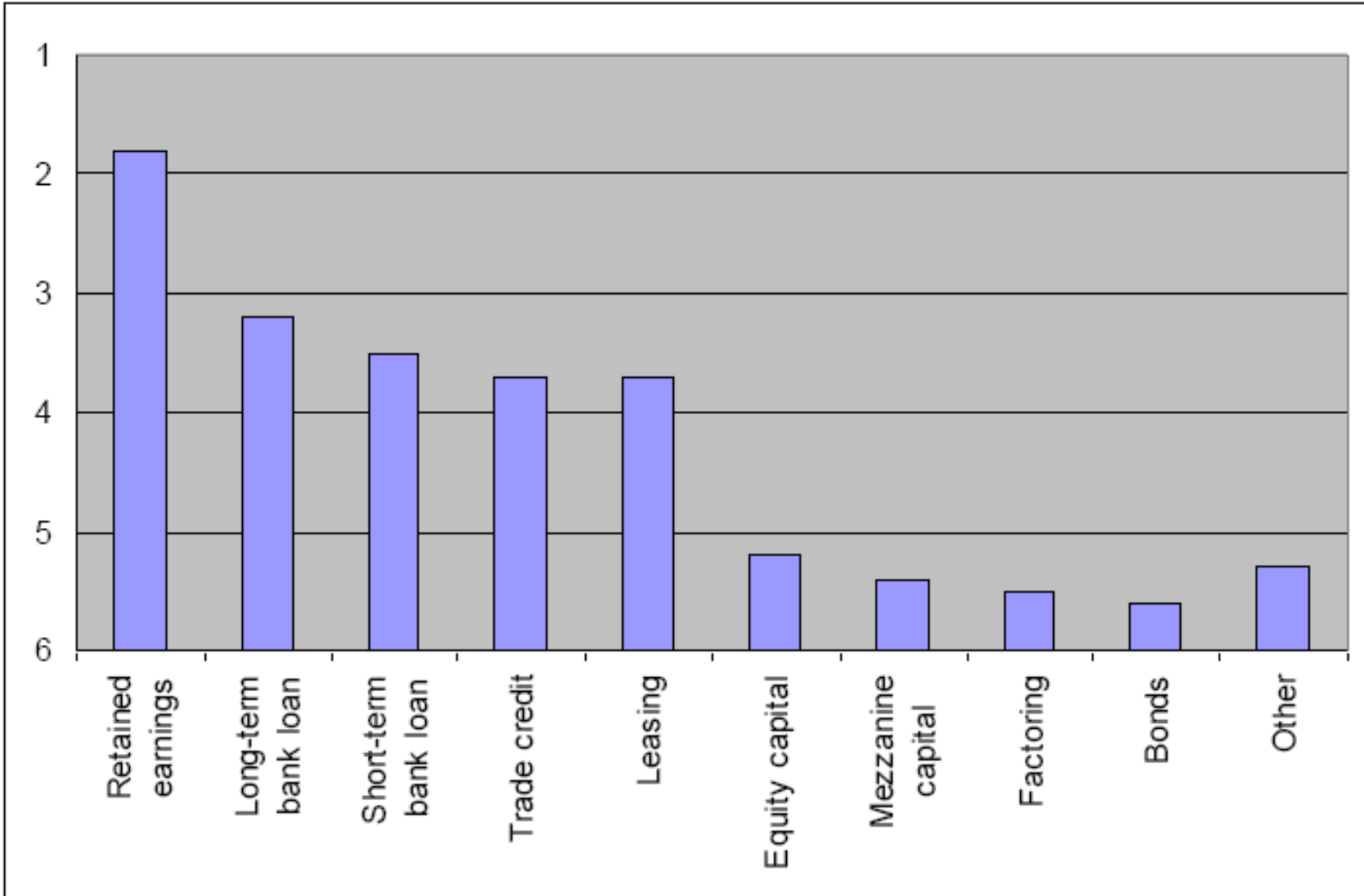
### *Credit rationing model*

- Rationing of credit rather than demanding higher interest or collateral (moral hazard, adverse selection)

### *Market power view*

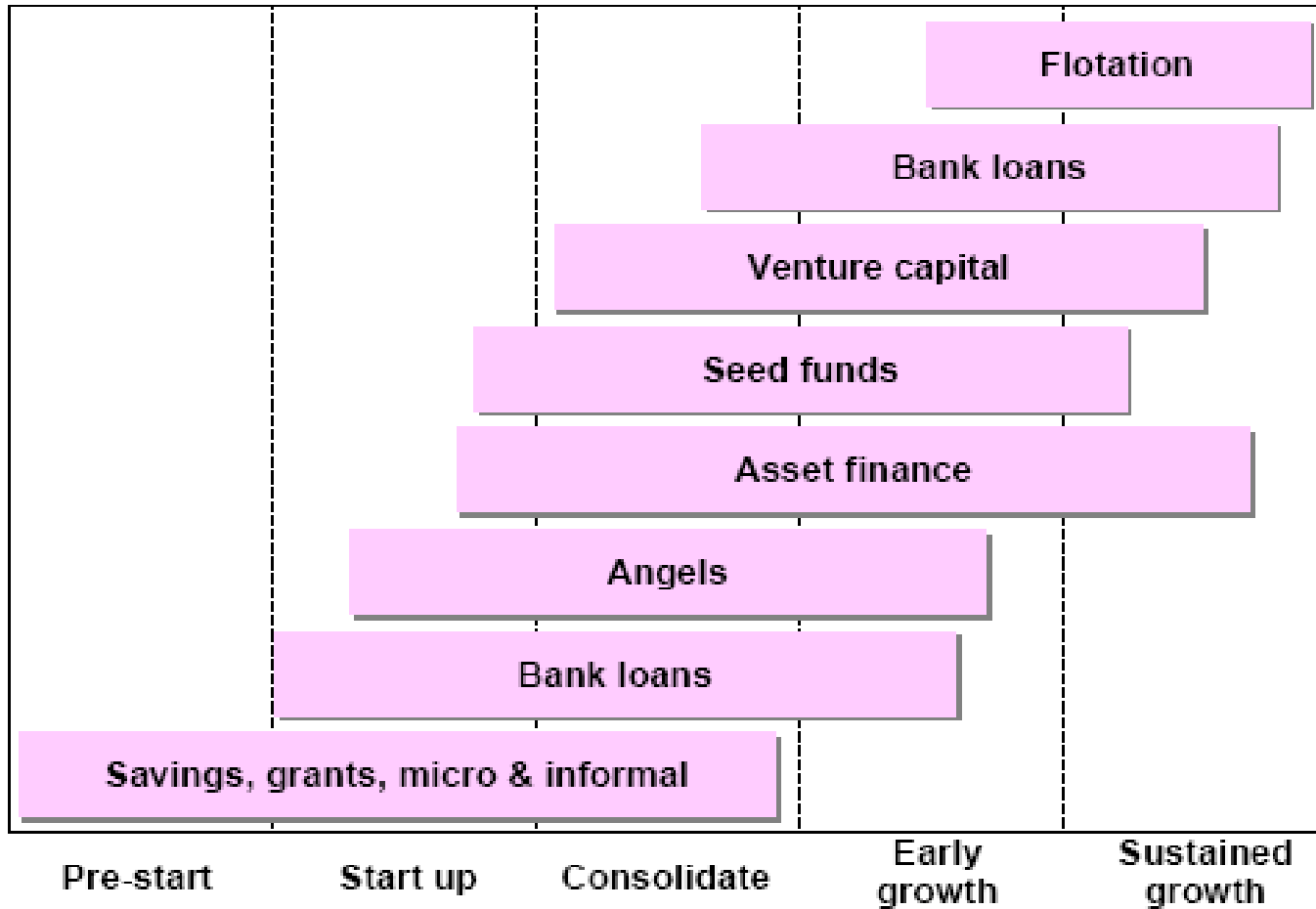
- Competitiveness in the banking market likely to be positively correlated with credit availability
- High competitiveness associated with more relationship lending, e.g. German hausbanks

# SME finance, East Germany

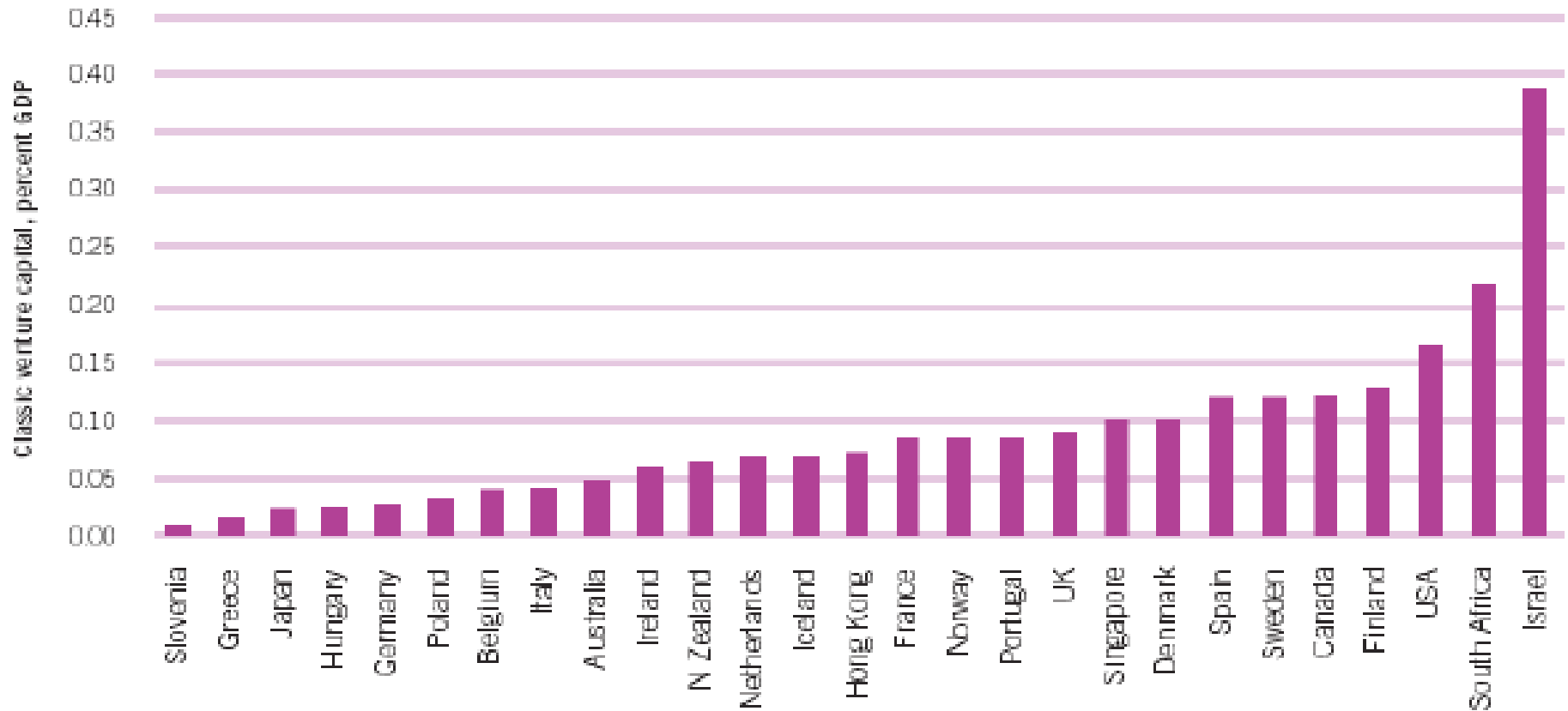


Source: KfW, 2006

# Finance escalator



# Venture capital, % GDP



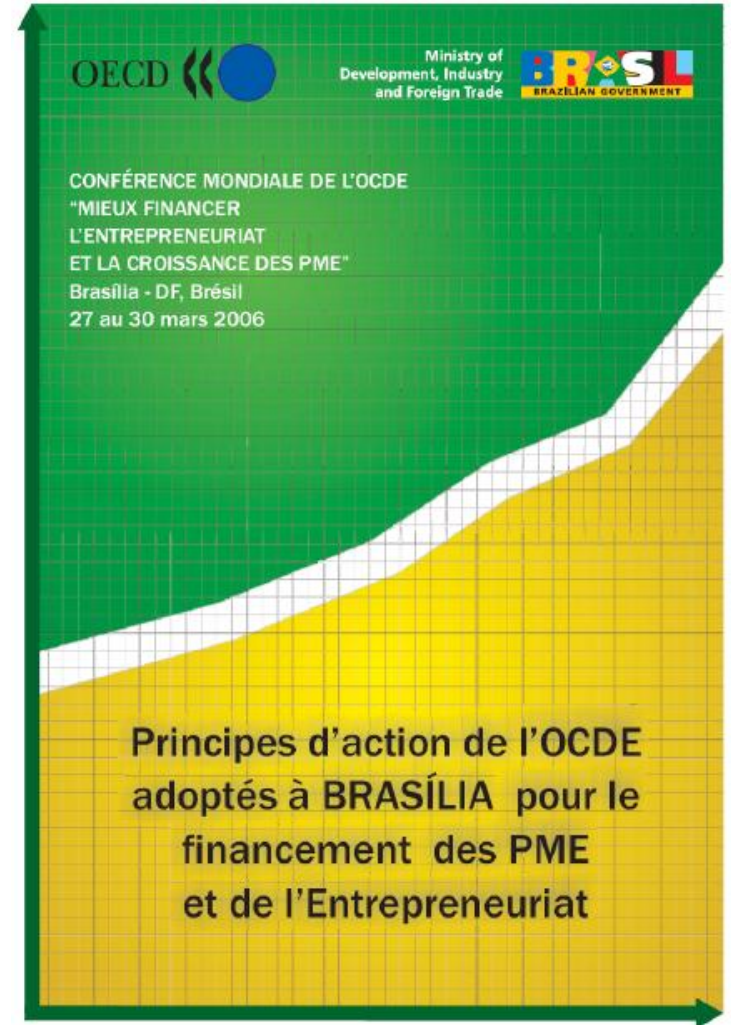
Source: Global Entrepreneurship Monitor, Financing Report

# Some policy options

- Subsidies for pre-activity
- Loan guarantees
- Mutual guarantee schemes
- Angel networks
- Strengthen venture capital
- Information supply – assistance with business plans,
- Relationship lending

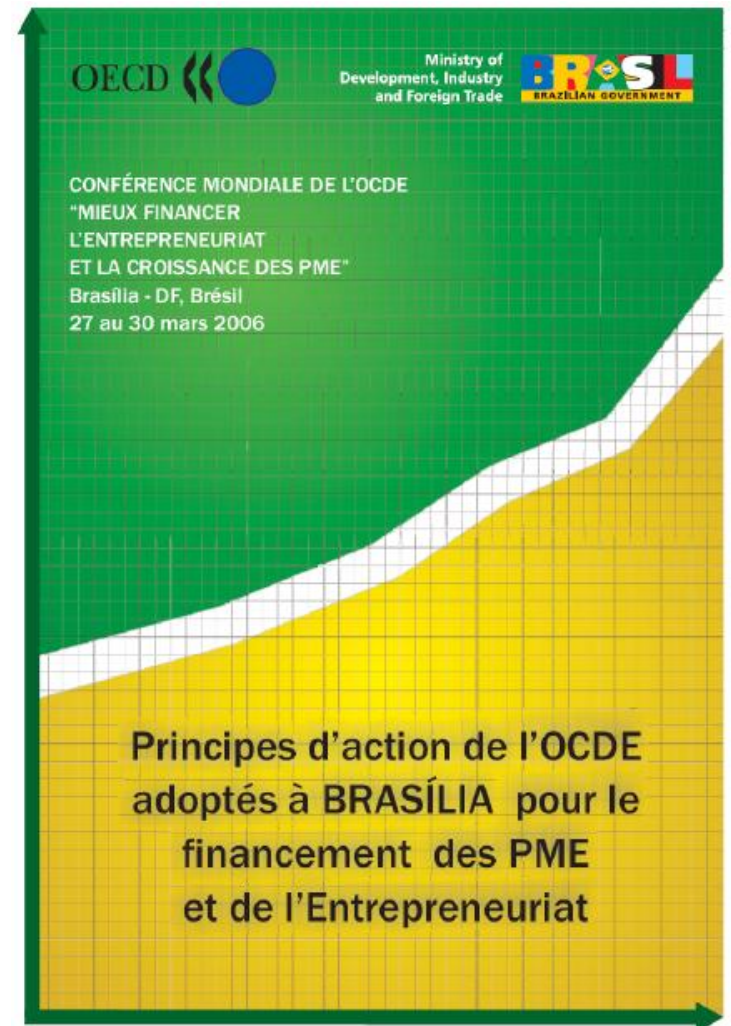
# Brasilia action statement (1/2)

- Appropriate institutional framework
- Focus on start-ups
- Stimulate early-stage finance
- Formalise SMEs
- Reduce barriers to cross-border finance
- Adopt principles of risk sharing and evaluation



# Brasilia action statement (2/2)

- Increase awareness of finance options
- Better measure & value intellectual capital
- Use social capital
- Use local development tools
- Multiply tools
- Involve SMEs in policy design



### CFECPR (Home)

- > Compendium of policy recommendations
- > Local case study areas
- > Discussion papers
- > Events
- > Strengthening Entrepreneurship and Economic Development in East Germany: Lessons from Local Approaches. Report

### CFECPR (Home)

- > Kompendium von Handlungsempfehlungen
- > Lokalstudiengebiete
- > Diskussionspapiere
- > Events
- > Stärkung von Unternehmertum und wirtschaftlicher Entwicklung in Ostdeutschland: Lernen von lokaler Praxis. Endbericht

[Home: CFECPR >](#)

## Compendium of entrepreneurship policy in East Germany

[Send](#)  [Print](#) 

The compendium is built of several themes of relevance to local entrepreneurship development in East Germany.

It brings together:

- **Recommendations** for adjustments to local entrepreneurship policies and programmes as well as implementation methods developed on the basis of six local case studies in East Germany;
- **International learning models** selected and described by OECD consultants to illustrate the recommendations given and to offer ideas and inspiration for policy innovation; and
- **Good practice in East Germany** selected and presented by the governments of East German Länder.

### Themes

- [Entrepreneurial culture and attitudes](#)
- [Entrepreneurship policy delivery](#)
- [Financing entrepreneurship](#)
- [Modernising and diversifying SMEs](#)
- [Rural entrepreneurship](#)
- [Entrepreneurship at universities](#)

### Main Partners:

- >> **Federal Ministry of Transport, Building and Urban Affairs (BMVBS)**
- >> **LEED Programme**

with the participation of 6 East German Länder (Regions): Berlin, Brandenburg, Mecklenburg-Western Pomerania, Saxony-Anhalt,

- >> **Berlin**
- >> **Brandenburg**
- >> **Mecklenburg-Western Pomerania**
- >> **Saxony-Anhalt**

Saxony and Thuringia

- >> **Saxony**
- >> **Thuringia**

# Conclusions

1. *Demand side.* Entrepreneurial education, business planning
2. *Supply side.* Guarantees, angels, venture capital, mezzanine capital
3. *Mediation.* Relationship banking
4. *Evaluate* appropriateness and impacts of different approaches in different contexts