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Original scientific paper

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**FORMAL VERSUS INFORMAL SOURCES OF SME FINANCING  
– THE CASE OF THE REPUBLIC OF MACEDONIA**

**Abstract**

SMEs play crucial role in the economy through promoting competition, technology transfer and regional trade. Their major advantages imposed by innovations, filling the unemployment gap and flexibility have been promoted through many practical examples in various economies. Yet, making decision regarding the input of formal and informal sources of financing SME operation has been a crucial topic for many researchers. The proper and adequate input of SME finance design the future operation, costs, development, ownership and other major questions in SME. The paper addresses the comparative analysis between various formal and informal sources of financing. Furthermore the empirical analysis of the explored SMEs in the Republic of Macedonia identify the current situation of employing formal versus informal sources of SME's financing, deriving obstacles for wider use of formal sources of financing, which can be aligned to the traditional approach in SME's financing in RM with the dominant role of informal financing sources.

**Key words:** formal sources of financing, informal sources of financing, SME's financing

**JEL classification:** G21, G23

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## **Introduction**

One of the key element in SME operation is financing and the type of resources obtained by the SME. It has extraordinary importance in the phase of establishment and development, and adequately as important in the higher stages of a company's lifespan. Financing is a challenge that entrepreneurs are facing on a daily basis and finding the best additional sources is their main focus. Without proper financing, the development of enterprises could be in danger. Hence, the ability of the entrepreneurs to receive the proper source of additional finance has great importance. In order to make the right decision, entrepreneurs should be aware of the existence of more than one source of additional financing (Brus R. Baringer, R.Djuan Ajrenlend, 2012:315).

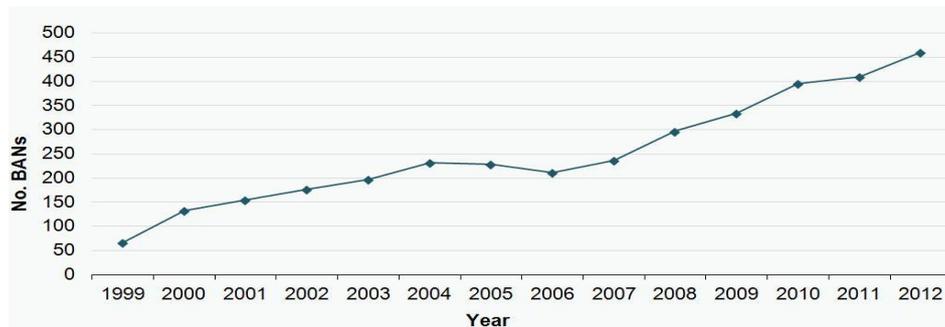
Formal sources of financing are focused on formal financial institutions such as banks, formal venture capital, and stock exchange. Those institutions have great importance because they are public and well-known so the entrepreneurs as well. Fundraising, on the other hand could be very challenging and must meet a series of conditions. Venture capital (VC) in the Republic of Macedonia is far from developed. The first formal VC company was founded in 2013 and is still not fully functional.

Unlike formal sources of financing, the informal sources of financing are composed of 3F money and business angels. 3F money refers to founder, family and friends (Colin M Mason, 2005:5) and it is the starting point for all newly established enterprises. Nearly 90% of all new enterprises are founded only with 3F money.<sup>3</sup> Investing the entrepreneur's own money has a great importance for the entrepreneur. It will be a sign for other investors that the founder truly believes in the success of the company. This will encourage other individuals, such as family and friends, to invest or borrow money. The pace of development of Business Angels Network in Europe in the period 1999-2012 indicates steady upward trend (Figure 1).

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<sup>3</sup> <http://www.kauffman.org/what-we-do/research/kauffman-firm-survey-series>. Accessed 15.08.2014.

**Figure 1: Registered Business Angels Network in Europe in the period 1999-2012**



Source: EBAN European Angel Investment Overview, 2012

Business angels in the Republic of Macedonia are almost gone, at least when it comes to those who professionally perform this activity. The first network of business angels was formed in May 2011 by the USAID. This network represents the first formal network of angel investors willing to invest their own funds, knowledge, skills and social capital in new and innovative business ideas with the potential for future and greater growth. However, this business angel network is still under development and is not yet fully functional.

This paper is structured in the following manner. In part two we make several comparisons between various formal and informal sources of financing. Furthermore in part three we generate the empirical research for SME financing in RM linking to the results, whereas in part four we make final conclusions and further recommendations.

## **1. Comparison between formal and informal sources of financing**

In order to understand the basic differences between selected formal and informal sources of financing, in the following part of the paper the comparisons between them are brought to light. Such processes will force the entrepreneurs to make better choices when obtaining additional sources of financing for supporting growth and development of their enterprises.

### **1.1. Comparison between 3F money and other sources of financing**

When comparing 3F money and the other sources of external financing, there are a few things that entrepreneurs should bear in mind. Starting with the fact that the founders money are already secured, we will put our focus only on family members and close friends. Many of those people would like to support and help the entrepreneur in his/her efforts to start a new company, so with access to this kind of money, it would be a lot easier. It is very important to understand that money could be provided in three forms, such as a loans, investments or even in the form of a gifts (Stjuard Rod, Saras Sarasvati, Nik Dju, Robert Viltbanka, 2012:105).

When a loan is provided, it may or may not include interest. It is highly advised that this form of financing be supported with official agreement, which must be signed by both parties. This will prevent any disagreement between the parties that could happen in the future. It is highly possible that the lenders consider themselves co-owners of the company they had supported in growing into success even if the money where given in the form of a loan or a present. This is a very inadequate situation and could destroy interpersonal relations. However, the advantage is that the family members and close friends will be more tolerant considering the period for which the money needs to be paid back (Dzerom Kac, Richard Grin, 2012:491). The entrepreneurs must be very cautious because if their enterprise does not succeed, they may not only loose the money invested in their company, but also, and sometimes more important, their friends and family.

### **1.2. Comparison between bank loans and venture capital**

Bringing decision for using additional sources of financing in the form of bank loans or venture capital investments depends on varying circumstances. Before one searches for a loan or an investment, they should have on mind few things that distinguish these two sources of financing.

The short comparison between the bank loan and venture capital is presented in the Table 1.

**Table 1: Bank loan vs. Venture Capital**

	<b>Bank loan</b>	<b>VC</b>
Form of financing	Loan	Investment
Reduction of the influence of the owner	No	Yes
Risk aversion	+	-
Demanded interest	Around 10%	More than 40%
Finance decisions based on	Guaranty for returning the loan	Opportunity for extra profit
Directly involved in the company's activities	No	Yes
Guaranty for returning the money	Yes	No
Direct interest for the company to be more successful	No	Yes

*Source: Authors' own preview*

Table 1 clearly indicates the major differences between the above mentioned sources of financing. First, we should mention that money received from venture capital is an investment, not a loan. That means that when venture capital enters in a company it automatically reduces the influence of the initial owner, because in a return for the money VC gains equity of the company. Because venture capital does not have any guaranty for returning the invested money, the only thing they could do in order to secure their investment is to get involved in the company management. Therefore, the venture capitalist will have direct interest for the company to be as successful as possible, so that they will make everything they could in order to support growth and development. Venture capital is likely to invest a larger amount of money so that they will also expect bigger returns. For example, the banks will not ask for more than 10% interest, but the venture capital will expect to receive more than 40% of the invested money. In the process of making a decision about financing, a venture capitalist will base it on the opportunity to make a profit. On the other hand, banks will make decisions based on the collateral guaranty that the company could offer.

### 1.3. Comparison between formal and informal venture capital

Even if they look similar, there are a few differences that entrepreneurs should know about formal and informal venture capital (Table 2).

**Table 2: Informal VC vs. Formal VC**

	<b>Informal VC</b>	<b>Formal VC</b>
They are investing	Own money	Other people's money
Lifespan stages in which they invest	Lower	Higher
Risk they are ready to accept	Higher	Lower
Amount of each investment	10,000-500,000 EUR	Over 1,000,000 EUR
No. of investments	Higher	Lower
Level of professionalism	Mainly unprofessional	Professional organizations
Investment motive	Financial gain but also personal satisfaction	Financial gain
Visibility of the investment	Latent	Visible

Source: Authors' own preview based on [http://www.eban.org/the-7-things-that-you-should-know-about-business-angels/#.U2eLj\\_mSzyF](http://www.eban.org/the-7-things-that-you-should-know-about-business-angels/#.U2eLj_mSzyF). accessed 15.07.2014.

Informal venture investors invest their own money in lower lifespan stages. Except for financial gain, many of them are driven by the satisfaction of helping younger entrepreneurs and involving in new businesses. However, those investors do not expose themselves in the public, so they are hard to find and negotiate with.

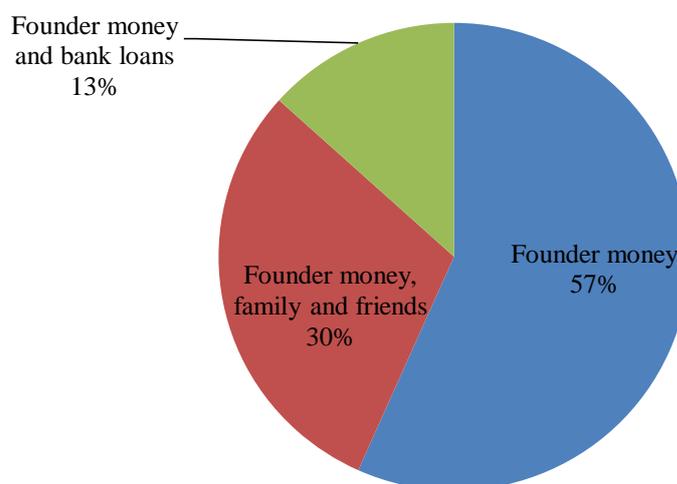
## 2. Empirical research – Case of the Republic of Macedonia

SMEs in the Republic of Macedonia represent the major vehicle for economic growth. Having in mind the importance of financing and its input in the company's strategy and costs, we aim to observe the formal

and informal sources of financing the SMEs in the Republic of Macedonia via research of 30 SMEs through a questionnaire. The structure of researched SMEs corresponds with the real economic situation in the country regarding employees, core business and city of origin. The collected data enabled us to make a solid base for particular statements and directions that are common for the entrepreneurs in the country.

Analysis of the initial financing during the startup phase of the SMEs has been presented in the Figure 2.

**Figure 2: Sources of financing used in the startup phase**

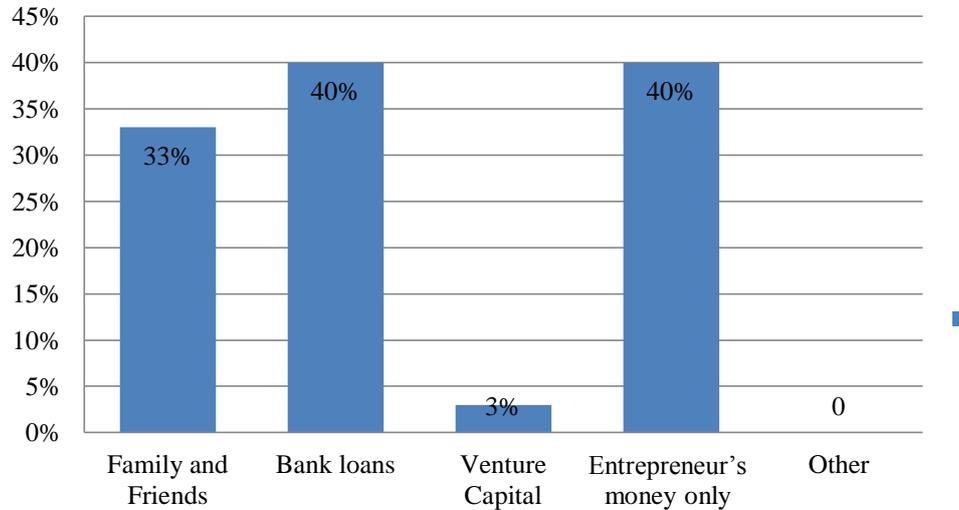


*Source: Based on the empirical research*

Figure 2 clearly indicates that almost 90% of all new companies have started working only with 3F money. Nearly 60% of the entrepreneurs have relied only on their own money. Such results demonstrate that the banks are not so interested in supporting and working with startup SMEs. Hence, a new company can rely mostly on informal sources of financing, more specifically on 3F money.

Analysis of the various sources utilized by SMEs is represented in the Figure 3.

**Figure 3: Sources of financing used by SMEs**

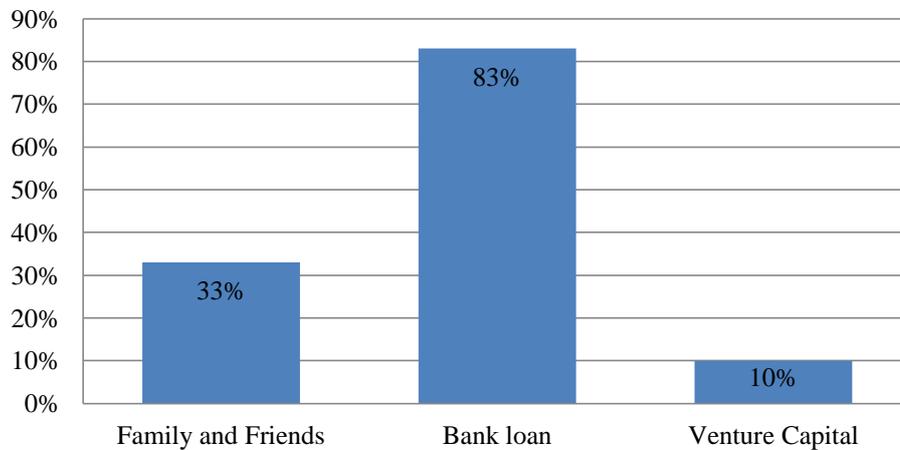


*Source: Based on the empirical research*

The results indicate that 40% of all SMEs in RM were using only their own money. This gives us a clear base that many entrepreneurs are strictly traditional, but at the same time their companies do not have potential for the above average growth. Nevertheless many of those entrepreneurs did not apply for bank loan not because they did not need it, but because of the high interest rates. We have also come to the conclusion that 40% of the SMEs have taken bank loans at least one time in their lifespan. This can be also defining as a relatively low participation of all the formal sources of financing. Venture Capital almost does not exist. From the data we can conclude that SMEs in the Republic of Macedonia in the upper stages of the development only rely on 3F money and bank loans.

In order to understand how entrepreneurs look at different sources of financing, we asked what they will rather do if they needed additional financing in the future (Figure 4).

**Figure 4: Sources of SMEs' financing that are likely to be used in the future**



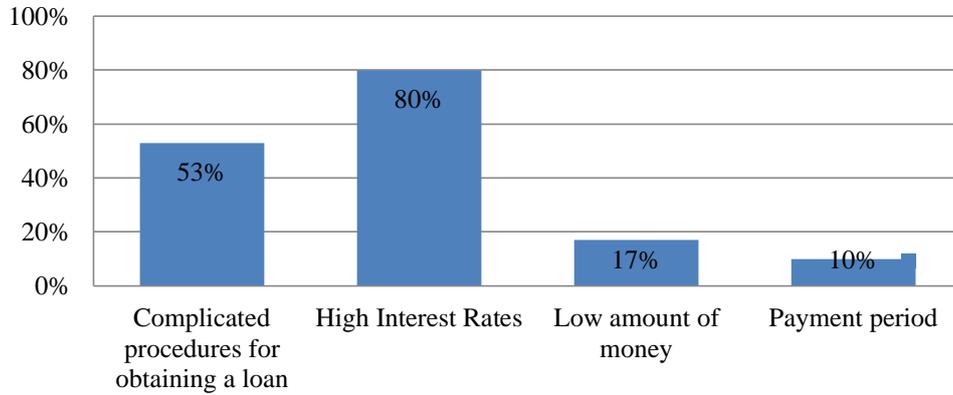
*Source: Based on the empirical research*

The results in Figure 4 indicate that 83% of SMEs would rather use bank loans in the future and one-third will ask for help from their family or friends. It is highly important to emphasize that only 10% of them will search for venture investors.

In order to determine the financial gap that occurs in funding the companies, entrepreneurs were asked whether their company is currently experiencing the need for additional external financial capital. Sixty percent of them responded affirmatively. Many of them are unable to obtain loans from the banks, while the rest have not applied due to the high interest rates. Regarding the question whether they believe that small and medium sized enterprises in the country have easy access to bank loans, the opinions of entrepreneurs are literally divided. Half of them stand on the claim that access to bank loans is quite simple, while the other half does not agree with this opinion.

As a major shortage of bank loans, entrepreneurs specifically indicated the high interest rates. Even 80% of respondents agree that the interest rates demanded by banks are too high so many of the companies are giving up their previous intention to use credits, while to the other companies loans are a large burden. The second biggest drawback is complicated procedures that banks imposed as a condition for raising the loan. For most small businesses this is a great obstacle that comes in the way of the intention to run up a credit debt (Figure 5).

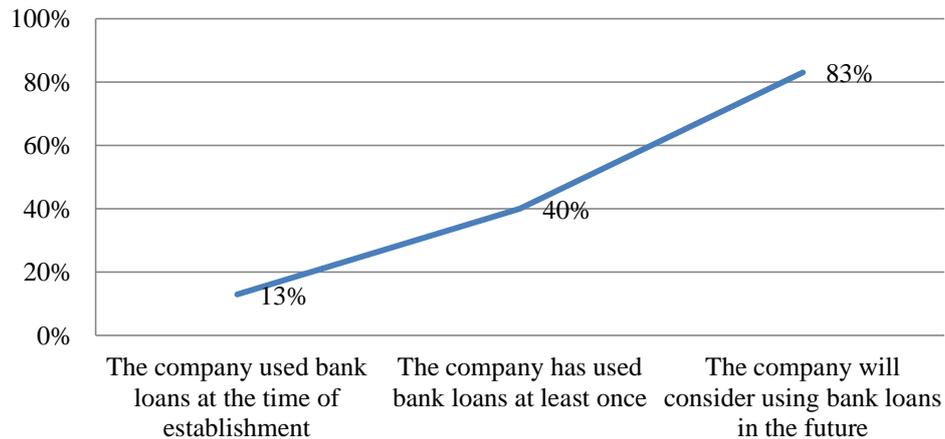
**Figure 5: Major bank's shortcomings pointed out by SMEs**



Source: Based on the empirical research

Although as much as 60% of enterprises need additional financial capital, loans are used only by 40%. We can conclude that there is not a small number of SMEs that are unable to fulfill the conditions imposed by banks for a loan.

**Figure 6: Tendency of cooperation with banks**

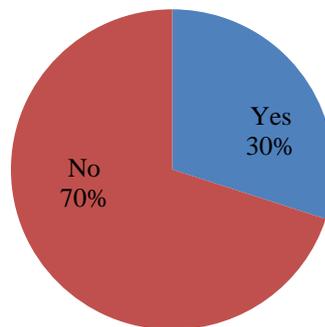


Source: Based on the empirical research

Realizing that only a fraction of entrepreneurs declare positively in relation to risk capital, investors give us the right to think that most of the SMEs are not even informed on their existence and activity. More than half of the respondents in the survey did not know about venture capital investors or business angels.

After we had explained the term “venture capital”, the percentage of the entrepreneurs who would eventually accept it in the future raised from 10 to 30%. However we can freely say that when it comes to sharing ownership, entrepreneurs in the Republic of Macedonia are pretty traditional.

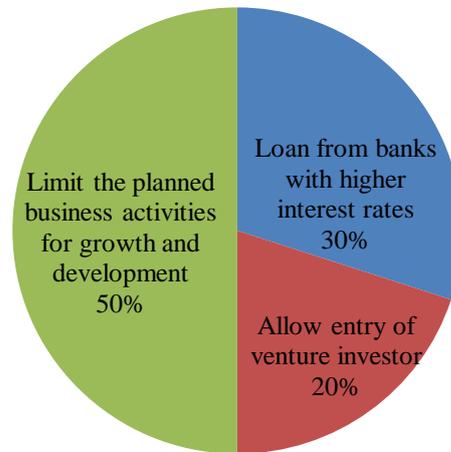
**Figure 7: Would you allow entrance of VC in your company**



*Source: Based on the empirical research*

It is very important to note the fact that 50% of entrepreneurs would rather limit the planned business activities for growth and development of their company than for the same purpose to take the necessary loan from banks with higher interest rates or allow entry of venture investors. These figures are a proof that entrepreneurs in the Republic of Macedonia have a greater aversion to risk, and that 80% of them would not share the ownership at any cost. This situation is particularly devastating for the overall Macedonian economy where instead of stimulating growth and development, the main priority is to stay on a sole ownership company, even if it meant limiting business activities, and thus limiting the prospects for further growth of the company.

**Graph 8: Additional financial capital for support SME growth**



Source: Based on the empirical research

It is known that the government can properly affect the sources of funding thereby making them somewhat more accessible to enterprises. Here we specifically refer to bank loans. Guaranteeing part of the loan, as well as offering loans with low interest rates and favorable repayment terms through cooperation with international financial institutions are just some of the activities that can positively affect the overall operation of enterprises. Evaluating the efforts of the Government in order to facilitate access to financing for SMEs, two thirds of entrepreneurs say that it is necessary in the future to pay more attention to specific issues. Greater access to loans and lower interest rates can have particularly positive impact on the overall economy of a country.

### **Conclusions and future recommendations**

Based on the empirical research conducted in this paper, we can conclude a few things when it comes to the financing of SMEs in the Republic of Macedonia. Almost 90% of all entrepreneurs start their enterprises with their own funds or through loans from family and friends (3F money). The absence of formal sources of funding is especially true in the phase of establishment of new enterprises. In subsequent phases of development, increasing the participation of formal sources of financing is quite evident, more specifically - bank loans. Forty percent of the

active SMEs had borrowed money from the banks, making this source of funding become increasingly dominant.

Venture capital in the Republic of Macedonia is almost completely absent, so this once again confirms the dominant role played by 3F money and bank loans when it comes to external sources of funding for the enterprises in the country. Analyzing the views of entrepreneurs on what funding sources would they use in the future, almost 90% of them would consider bank loans. This gives us the right to conclude that entrepreneurs in the RM are looking at the banks as the main source of external financing.

Regarding bank loans, entrepreneurs agree that high interest rates were their main drawback. Eighty percent of them agree with this conclusion. More than half of the entrepreneurs put direct attention to complicated procedures for approving loans citing in particular the barrier for smaller companies. Eradicating these two major shortages will contribute in the future to increase the participation of SMEs using bank loans, and thus to reinvigorate the economy in the country as a whole.

Trying to determine why only 10% of the entrepreneurs would accept venture capital investments in their company, we came to the conclusion that more than half of them had not even heard of the term "venture capital investors." After we explained the term, this figure tripled. However 70% of Macedonian entrepreneurs do not want to share their company with anyone, even though they would have benefit from it.

In order to determine the thinking of entrepreneurs about growth and development of the company, we came to the conclusion that half of them would rather limit the growth of the enterprise than to allow entry of VC investors or borrow money from banks with higher interest rates. This is particularly detrimental thinking, which is not aimed at the development of the overall economy in the country. "It is better to have part of the orchard than to be the absolute owner of an apple" apparently does not apply for Macedonian entrepreneurs. Most owners do not want to share ownership even if the growth and development of their company is put into question.

As we have seen earlier talking about the sources of funding that are available to small and medium enterprises in the country, they mostly come down to just two sources, 3F money and bank loans. This situation will generally remain unchanged in the near future. There are some initiatives and announcements regarding the development of formal and informal venture capital in the country, thus making it available for

certain innovative and primarily export-oriented companies. However in the short-term it will not change the picture regarding external sources of funding. Certainly these initiatives are welcomed and should be encouraged and supported as would have inspired and encouraged entrepreneurs to direct their activities towards research and development of new products and services that would have added value and would have benefit for the Macedonian economy.

Although most of the entrepreneurs indicated that the procedures for obtaining loans is quite complicated and that the interest rates required by banks are high, banks remain the dominant source of additional external financing of enterprises in the Republic of Macedonia. The expectation is that in the future banks will become more affordable for small and medium enterprises, and the newly created situation will have positive impact on the operation of enterprises while reducing their costs.

Even though entrepreneurs have some cooperation with banks regarding the use of bank loans, there are a number of things that could be improved in the future as they would be more accessible for the companies. The government should find the right way to facilitate access to bank loans to small businesses, like for e.g. investing efforts in guaranteeing loans in order to allow access to bank loans for many SMEs which have sufficient collateral to guarantee them. This will increase the number of companies that will be able to attract additional capital financially necessary for their growth and development. Moreover, in order to promote entrepreneurship and self-employment in the country, the state alone, but in cooperation with the international financial institutions, has continued to provide adequate funds offered to SMEs with low interest rates. This step is especially motivating for entrepreneurs amateurs and young people, who would have more likely to engage in entrepreneurship, and also for existing companies which would be encouraged to further grow and develop. Clearly, some of these processes occur in the present, and the expectation is that they will continue to happen in the near future with greater intensity.

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