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JOSEFIN REGIONAL MARKET STUDIES

SUMMARY

Access to finance for innovative SMEs in the Baltic Sea Region

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1 Introduction

The JOSEFIN (Joint SME Finance for Innovation) project aims at promoting improved SME finance for innovation throughout the Baltic Sea Region (BSR).

The Baltic Sea Region is one of the most prosperous and innovative regions in Europe. Small and medium-sized enterprises (SMEs) are drivers of the innovation process and an important engine for growth and prosperity in this region.

SME's growth is often hampered by local focus and regional markets, thereby often failing to gain advantage from their full business potential. In order to boost competitiveness of Europe, international business activities of SMEs need support, especially by the stimulation of direct transnational cooperation of SMEs and the provision of improved access to finance for innovation projects and to exploit and to commercialise the project's results.

The JOSEFIN partnership works on improving this situation. It encompasses 23 institutions from 7 countries in the Baltic Sea Region (BSR) that co-operate to develop and implement an integrated support package for the internationalisation of SMEs linking information, contacts, coaching and finance.

The partner institutions include:

- European Enterprise Network (EEN) institutions, Incubators, Technology Transfer Centres or similar
- State-owned Structural Development Banks, Funds Entities or similar
- Regional authorities

As an important step in the work of the project regional market studies were conducted in 11 JOSEFIN regions: Berlin (GER), Brandenburg (GER), West-pomerania (PL), Greater Poland (PL), Lower Silesia (PL), Lubiskie (PL), Lithuania, Latvia, Estonia, Darlarna (SE) and the Oslo Region (NO). The results are summarized in this report.

The aim of the studies was to

1) Gathering general information on the economic context for SMEs in the JOSEFIN regions.
2) Analyzing the potential demand for JOSEFIN solutions, both financial and non-financial by:
    - Identifying the main non-financial drivers and obstacles for SME Internationalisation in the JOSEFIN regions.

- Identifying the financial needs of innovative SMEs in the JOSEFIN regions.

3) Analyzing the supply of financial and non-financial schemes for innovative SMEs in the regions in regard of market gaps

The results of the individual regional market studies were synthesized into a summary report to evaluate, if the proposed JOSEFIN Service Model is suited to meet the demand structure of innovative SMEs and to fit into existing market gaps in the surveyed regions.

The individual studies brought forth the finding that the regional frameworks for SME finance are quite heterogeneous. Therefore it was agreed, that the individual regional market studies should also be used to identify the main challenges for the regional implementations of the JOSEFIN Service Model.

2 Methodology

The methodology for the regional market studies on demand and supply of finance for innovation and internationalisation of SMEs was devised to comprise both a quantitative and a qualitative analysis.

The main research questions were:

- What are the patterns of internationalisation among SMEs in the region?
- Which motives have SMEs to internationalise or not?
- How are SMEs managing internationalisation, including an analysis of the internal and external problems they face during the internationalisation process?
- What are the patterns of the demand and supply of finance for innovation and internationalisation?
- What are the barriers/challenges and needs for financing innovation and internationalisation of SMEs?

Due to budget and time constraints, two alternative methodologies were proposed, a basic and an extended methodology approach (see annex for a detailed description of both approaches).

The **basic version** included a review of existing literature of the demand and supply of finance for innovation and internationalisation of SMEs in general and from a regional perspective, qualitative measures for the demand analysis for SMEs, such as case studies of internationalised SMEs, and supply analysis of finance for innovation/internationalisation, such as in-depth assessment of best practice examples and interviews with financial intermediaries and experts on financing for innovation/internationalised of SMEs. The basic methodology was applied in Berlin/Brandenburg (GER), Lower Silesia (PL), Greater Poland (PL), Lubuskie (PL), Lithuania, Latvia and Estonia.

The **extended version** of methodology was based on all elements of the basic version. Further, a quantitative survey amongst entrepreneurs and managers within SMEs in the region was added with the minimum number of 250 participating SMEs. The extended methodology was applied in Darlarna (SE), Oslo Region (NO) and Westpomerania (PL).

3 Regional Economic Profile

3.1 Macroeconomic Indicators

The time period between 2005 and 2007 was marked by considerable economic growth in all partner countries. Since then, the countries have suffered from economic recession induced by the financial crisis, so the GDP growth rates in 2009 show that all JOSEFIN partner countries have been affected conidERably by the global economic downturn. Simultaneously, due to the economic crisis, the inflation rate increased in some partner countries, for instance Lithuania, Estonia, Latvia and Norway, in 2008.

In 2009, the Estonian GDP decreased by 13.7% over the year as a result of the weak domestic and foreign demand.

Table 1: Macroeconomic Indicators for Partner Countries[1]

Macroeconomic Indicators	PL	SE	DE	EE	LT	LV	NO
Population, total million (2008)	38.12	9.22	82.14	1.34	3.36	2.27	4.77
Inflation (annual %, 2008)	3	3	2	8	10	15	9
GDP growth (annual %, 2009)	1.2	-4.5	-5.0	-13.7	-15.0	-18.0	-0.3
Exports (% of GDP, 2007)	41	52	47	74	54	42	46
High Technology exports (% of manufactured exports, 2007)	4	16	14	12	11	7	18
Import (% of GDP, 2007)	43	45	40	85	68	61	30

All JOSEFIN partner countries are characterized by a high share of exports of goods and services of its countries GDP. In general, the EU and the Baltic Sea Region (BSR) countries are the largest trade partners when it comes to export, whereas Germany is a dominant export and import market for each of the partner countries.

Germany accounts for more than 10% of all Swedish and 70% of all Lubuskien exports.

High technology exports, defined here as manufactured exports, represent 10 to 40% of all exports in the countries, so that most of the export and import

[1] Cf. www.worldbank.org.

activities are dominated by larger enterprises from traditional industries, such as traditional services, trade and production.

Regarding the general grade of innovation in the SME population, the reports indicated that a high share of the enterprises in the surveyed regions is spending at least some part of its budget on innovation activities, like R&D.

3.2 Regional Context for SMEs

The economies in the JOSEFIN regions are mainly based on micro, small and medium size enterprises (MSMEs[2]), whereas the micro enterprises account for more than 90% and MSMEs for more than 99% of all enterprises in the regions.

Table 2: Number of Enterprise Entities in the Regions according SME EU Definition

Region	Micro	Small	Medium	Large	Total
LV[3]	110,683	12,346	2,486	393	125,905
LT[4]	63,192	16,068	4,761	553	84,574
EE[5]	69,234	7,137	1,376	201	77,984
Darlana (SE)[6]	6,980	1650	269	35	8,934
Berlin[7] (DE)	138,940	8,126	1,762	419	149,247
Brandenburg (DE)	88,418	6,643	1,361	208	96,630
Oslo Region (NO)[8]	148,895	14,135	2,668	301	165,999
Lubuskie[9] (PL)	96,668	4,281	798	114	101,861
Lower Silesia (PL)	303,665	10,564	2,109	382	316,720
Westpomerania (PL)	205,065	6,561	1,331	167	213,124
Greater Poland (PL)	340,881	16,601	3,108	456	361,046

[2] In the study, we use the definition of MSMEs adopted by the European Commission in 2003. An enterprise is classified as medium-sized if it has less than 250 employees and its turnover does not exceed 50 million EUR and/or its balance sheet total is less than 43 million EUR; as small if it has less than 50 employees and turnover and/or balance sheet total of less than 10 million EUR; as micro if it has less than 10 employees and turnover and/or balance sheet total of less than 2 million EUR.

[3] Cf. Data for 2008, Central Statistical Bureau of Latvia.

[4] Cf. Data for 2009, Statistics Lithuania.

[5] Cf. Data for 2008, Statistics Estonia.

[6] Cf. Data for 2008, Statistics Sweden.

[7] Cf. Data for 2006, State Statistical Institute Berlin-Brandenburg.

[8] Cf. Data for 2008, Statistics Norway.

[9] Cf. Data for 2008, National Statistics Office Poland.

Typically, SMEs operate in their local or regional market and are much more evenly distributed across the regions than the large enterprises. In the surveyed JOSEFIN regions the SME sector is growing and getting more and more diversified. Also, the regional economic structure is very diversified, but still dominated by traditional sectors, e.g. energy, production, trade, etc.

In Sweden, small businesses accounted only for 10.8 percent of all Swedish exports.

However, the importance of international activities is growing in the regions under examination, not only for larger industrial firms, which are still responsible for the main share of export and import volumes in the partner regions, but as well for the SME sector.

In recent years, there is a clear trend of increasing Internationalisation among SMEs. Not only in the form of an increase in foreign trade, but as well a rising importance of foreign capital among the SME sector, evident in the JOSEFIN partner regions.

In Westpomerania (PL), 1.5% of the registered companies, especially medium-sized, in the region are entities with a major share of foreign capital.

Although the markets of JOSEFIN partner regions show a high overall integration already, Internationalisation activity is still dominated by larger enterprises. Therefore, the development of innovation capacities of SMEs is seen as an important task by public authorities and policy makers in all surveyed JOSEFIN regions. Significant investments need to be made in skill development, means for a better capitalizing on existing innovations (e.g. the commercialization of new products) and increasing international ties. Overall, the entrepreneurial environment needs to be developed and in this regard. The safeguarding of well-functioning capital markets for SMEs and new companies are seen as a critical factor in this task (see 4.2.).

4 Demand Analysis on Financial an Non-Ninancial Needs of SMEs

Internationalisation of SMEs has no longer a focus on exporting activities, but has become a much more differentiated business activity encompassing trade, cross-border clustering, cross-border collaborations, alliances or subsidiaries, branches or joint ventures abroad. Therefore, the regional studies and surveys describe at first the degree and patterns of internationalisation and innovation to provide a complete picture of the SME landscape in the Baltic Sea Region.

Further, several motives and drivers of internationalisation of SMEs can be identified, which support a diversified approach to internationalisation. In addition, SMEs that go or are planning to go international are facing different obstacles and barriers, which will be differentiate in the following into internal and external aspects. Finally, the report aims to identify and analyse in particular the financial demand of these SMEs, focusing on their needs of the SMEs and the barriers they are facing.

4.1 Degree and Forms of Internationalisation and Innovation in the Regions

Throughout the whole EU, 63% of SMEs have not yet gone international[10]. Those non-internationalised SMEs can be divided in two groups[11]. First, there are those, who find internal or external barriers too high, for instance, due to lack of managerial capabilities and contacts. The second group are those who have, so far, not even considered going international due to their lack of awareness of the business opportunities abroad. In their opinion internationalisation is irrelevant for their business. This group encompasses 60% of the non-internationalised SMEs in the EU. If internationalisation takes place, it mainly consists of import and export activities, only about 6% of all SMEs in the EU are yet involved in some kind of more sophisticated internationalisation strategy like foreign subsidiaries, setting up branches abroad or the establishment of collaborative partnerships with foreign SMEs[12].

About three out of 10 SMEs in the EU indicated that they are involved in innovative activities[13]. Further, about every tenth Euro spent by SMEs in the EU is spent on a new or significantly improved product or service[14]. At the same time,

[10] The degree of Internationalisation of a company can be measured using the following values: the number of foreign markets on which the company operates, the turnover on the foreign markets, the share of the turnover on the foreign markets in the overall turnover volume, the profit generated on the foreign markets, the number of employees abroad, the value of investments and assets abroad.

[11] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

[12] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

[13] Cf. Flash EB No. 196 – Enterprise Observatory Survey (2007).

[14] Cf. Flash EB No. 196 – Enterprise Observatory Survey (2007).

almost four in 10 SMEs report that they are not involved in any innovative activity. The larger an enterprise, the more likely it is to capitalize on innovation. 37% of SMEs in general and respectively 38% of micro enterprises do not report any turnover from improved products or services, while the proportion of the larger enterprises in the SME sector is with 24% considerably lower[15]. The share of SMEs which reported innovations was higher in the old EU Member States than in the new Member States. Four constituting, and equally important barriers to innovation were stated: problems in access to finance, scarcity of skilled labour, a lack of market demand and the high cost of human resources.

The results from the regional surveys[16] mainly support the trends that can be gathered from the general EU data. For the SMEs' from the surveyed regions, the most easily accessible form of Internationalisation is still conducting purchases and sales abroad, i.e. to import and export goods and services. In addition to trading, the forms of Internationalisation occurring in the JOSEFIN partner regions are cooperative links in the supply of semi-finished products, in finished product sales, in technology support related to the above-mentioned links, contacts in the technology transfer, machinery and equipment purchases, participation in international fairs, economic missions, creating companies with foreign capital, creating businesses, agencies and distribution structures abroad, contacts aimed at obtaining or exchanging information on trade, law, etc. The survey results make clear, that there is a higher share of both exporters and importers among medium sized than small businesses. There is no clear focus of industries active in international business. The decision for foreign trade activities depends rather more on the specific company profile and the interests and contacts of the owner/manager than on the sector in which they are doing business.

In Darlana (SE), 20% of the entrepreneurs surveyed have business activities abroad and 49% have some foreign business contacts. 44% of the entities surveyed already started going international.

In general, the share of non-internationalised SMEs in the surveyed regions is slightly lower than the EU average of 63%. Within the group of non-internationalised SMEs the surveys report a share of around 40% that want to internationalise. Consequently, there is still a high amount of non-internationalised SMEs that have not even considered going international because they think it is irrelevant for their business.

In Lithuania, the share of innovative enterprises in the SME sector is 18.4% and in the Oslo Region (NO) the share is about 20%.

However, the link between internationalisation and innovation has to be highlighted, as both increasingly become interlinked aspects of companies' strategies for growth. The share of SMEs with a deeper involvement in innovation activities like R&D and innovative product development is lower than 20% in most of the surveyed JOSEFIN regions. Compared with other countries, it appears that SMEs in the JOSEFIN partner regions are less innovative both in

[15] Cf. Flash EB No. 196 – Enterprise Observatory Survey (2007).

[16] There are no survey data results from the regions Lower Silesia, Latvia, Norway and Estonia, which includes only qualitative methods in their studies due to the proposed basic version of the methodology.

terms of R&D activities and launching new products/services. International comparisons of entrepreneurship environments like GEM[17] indicate a general lack of innovativeness in start-ups and existing enterprises according to various criteria, i.e. the elaboration and implementation of new products and services, the elaboration of innovations and the general development of enterprises (growth of turnover/ profit/ number of employees). Further, the results of the regional market studies indicate a low awareness level among SMEs regarding the resources and strategies needed to implement innovative solutions.

40% of the innovative enterprises in the Oslo Region (NO) are cooperating with international partners.

[17] Global Entrepreneurship Monitor

4.2 Drivers, Obstacles and Barriers for Internationalisation

4.2.1 Internal and external drivers

The regional markets identified both external and internal drivers of SMEs to develop internationalisation projects. This summary starts with the results on **internal drivers**.

Theoretically, there are two main set of internal drivers centred on the ambition to improve competitiveness of the company from a value chain perspective[18], i. e. maximising returns and minimising costs in purchasing, production and sales:

- **Markets** – market diversification/growth and launching new products
- **Sub-suppliers** – driven by rationalisation of the production.

From a company's perspective, there exists a second set of major drivers for internationalisation, which are linked to a more strategic development of the enterprise and improvement of their innovative capabilities[19]. The SMEs may fulfil their international ambitions by using:

- **International competences and resources** (technology, know-how, etc.),
- **International business relationships** which also include a learning element in terms of common R&D/innovation activities and by sharing knowledge,
- **Finance/capital** from foreign markets.

The survey results confirm the notion that these are the two main sets of internal drivers for innovative SME in the JOSEFIN regions to go international. The results further indicate that the most important incentives for entrepreneurs to enter international markets are an expected rise in sales and the opportunity to attract new business partners for sub-contracting and knowledge-sharing.

In all regions, an important motivation of SMEs for internationalisation is to enter new markets for strategies of market diversification, market growth and the launch of new products. The enlargement of the EU increased the awareness among the SMEs that the **search for new markets abroad** and especially a more internationalised business strategy can be important for the growth of the enterprise. Further, enterprises are looking for possibilities of growth by increasing the opportunities for selling products, gaining technology and cooperative links. The access to a larger market plays a key role for JO-

The main factors for internationalisation in Lubuskie (PL) are the willingness to increase the sales market, gaining sources of raw materials and semi-finished products, and searching for solid cooperative ties.

83% of surveyed SMEs in Darlana (SE) are interested to access new and larger markets.

[18] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

[19] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

SEFIN regions in smaller countries, such as Lithuania, Sweden, Norway or Latvia. The lacking market size at home forces SMEs to look for suppliers, partners and customers abroad for sustainable business strategies. Innovative SMEs that are specialising in certain niche markets are especially in need of sizeable markets in order to take profit of the often costly investments into its innovation processes. For those SMEs, the EU accession of their countries removed a lot of internationalisation transaction costs (like permits, tariffs, etc) and therefore opened the way for doing business throughout the whole of EU. Nevertheless, the other side of the coin of the unified European market is an increase of the competition in maximising returns and minimising costs in purchasing, production and sales. Despite this development and the fact, that the Baltic Sea Region is geographically an easily accessible market for the companies, the market is hardly developed by the regional SMEs in the partner countries.

In Estonia, many SMEs offer subcontracting to large companies abroad.

In the Oslo Region (NO), 15% of the participating SMEs desire support measures to identify new market opportunities abroad.

Another strong driver for SMEs to go international is the search for sub-suppliers driven by **rationalisation of the production** and other strategies that aim at a respective cost reduction for the SME. The most common SME strategies in this regard that were identified by the surveys were the search for sources of raw materials and semi-finished products and for longer lasting international co-operations in terms of production and services. Further, there are regions among the JOSEFIN partners, e.g. Lithuania, which have still a competitive advantage in relative low labour costs while offering low transaction costs due to its geographical location. These regions are especially attractive for SMEs in other regions, which search for rationalisation opportunities regarding their production chains.

In Greater Poland (PL), the third most important reason for going international is increasing competitiveness by lowering the operating costs, mentioned by 51.7% of the responding SMEs.

The search for and availability of **competences and resources** (i.e. technology, know-how, etc.) are important drivers for SMEs to go international and to develop innovative products and processes. The Baltic Sea Region and in particular the new member states of the EU are very attractive markets for high tech products and services like renewable energy technologies, etc. Therefore, a big opportunity for knowledge transfer can be recognized in these regions, as the legal systems and the cultural backgrounds are comparable to other countries of the Baltic Sea Region. The surveys results show that the competences and experience of the SMEs' personnel are a crucial factor of success in entering international knowledge transfer projects, as foreign partners tend to work only with competitive, experienced and competent specialists.

6% of the SMEs in the Oslo Region (NO) claimed that the most important area of improvement was better knowledge of international markets.

Another driver for Internationalisation and innovation is the search for close **international business relationships**. They allow to explore new business opportunities and to establish joint ventures with SMEs from partner regions. The surveys showed that for developing an international partnership it is impor-

In Greater Poland (PL), the access to foreign know-how and technologies is the second most important motive mentioned by 54.2% of the respondents.

tant to communicate continuously with potential partners, providing up-to-date information on cooperation opportunities and relevant competences.

External drivers which stimulate enterprises in the process of Internationalisation are mainly assistance programs offered by the EU, local government, financial institutions and other business organizations. But also the availability of funds for financing internationalisation projects (e.g. to support the search for business partners or to secure exchange rates), promotional activities organized by chambers/guilds, the harmonization of laws and regulation among EU and new EU member states, and the future access to the euro zone are external drivers that influence significantly the SMEs decision for Internationalisation and as well the Internationalisation process. Influencing factors

Figure 1: Overview of important Internal and External Drivers for Internationalisation[20]

Internal Drivers	External Drivers
• Market diversification, growth and launching new products	• Availability of the funds
• Rationalisation of the production (Sub-suppliers)	• Assistance programs by the EU, local government, financial institution, etc.
• International Competences and resources	• Promotion actions by chambers/guilds
• International business relationship	• Future access to the euro zone

4.2.2 Obstacles and Barriers for Internationalisation and Innovation

From a theoretical perspective the following obstacles and barriers for SMEs' internationalisation can be derived:

- **Limited awareness**: Concentration on local/regional markets, no awareness about the business opportunities in other countries,
- **Lack of know-how** regarding international issues/managers lack international experience,
- Difficulties in finding **suitable and reliable foreign partners**,

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[20] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

- **Lack of explicit strategy** in the initial phase and **lack of ability to implement strategies** (insufficient planning or skills),
- **High cost** of the Internationalisation process (as internal barrier) or **lack of capital or finance** (as external barrier).

Generally, the obstacles and barriers for SMEs to go international can be divided from the companies' perspective into **internal and external barriers**[21]. **Internal** factors can be influenced by the enterprise or respectively the management, such as **high cost of internationalisation process**, **price of own products and services**, **insufficient skills** or **competence of staff**, **quality and/or specifications of own products and services**. In contrast, **external** barriers depend on external factors, which cannot be influenced explicitly by the company, for instance **existing laws and regulation**, **lack of capital or finance**, **lack of support and/or advice**, **cultural and language differences** and **lack of available information**.

Figure 2: Overview of important Internal and External Drivers for Internationalisation[22]

Internal Barriers	External Barriers
• High costs of the internationalisation process	• Existing laws and regulations
• Price of our products and services	• Lack of capital and finance
• Insufficient skills or competences of staff	• Lack of support and/or advice
• Quality and/or specifications of our products and services	• Cultural and language differences
	• Lack of information

Both types of barriers have an important meaning for SMEs' decision for international and innovative projects.

The JOSEFIN regional market studies and their respective survey results confirmed these theoretically assumed obstacles and barriers for SME internation-

[21] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

[22] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

alisation[23] and innovation. Moreover, the survey results indicate that the most important barriers for the SMEs in the JOSEFIN region are **financial obstacles**, such as problems in acquiring external finance to substitute lacking equity. These are followed by **lacking human resources**, **language problems**, **cultural differences, not enough market experiences abroad, problems to find the right partner for co-operation** and generally **lacking strategies to go abroad**. Other external barriers which are identified in the surveys are **too much competition in the target markets, lack of new technologies, exchange rate risks, legal restrictions and outdated infrastructure in the target country/region.**

The most important barriers in Berlin/Brandenburg (GER) are financial obstacles and missing human resources, followed by language problems, not enough experiences abroad and a missing strategy to go abroad.

The survey results indicate that ex post, SMEs often assess the importance of these barriers differently, once they have successfully realised internationalisation.

20% of the responding SMEs in Westpomerania (PL) mentioned lack of funds as the most important barrier before, but only 2% after internationalisation.

It is nevertheless important to consider that even only the perception of barriers and obstacles can hinder SMEs in entering internationalisation and innovation projects and thus, they may remain focused on their regional markets. The market studies argue that the most prominent of these obstacles need to be tackled to allow SMEs to internationalise and innovate.

The high cost of the internationalisation process (as internal barrier) and the corresponding **lack of capital or finance** (as external barrier)[24] is seen as the most important obstacles by the non-internationalised SMEs surveyed in the JOSEFIN partner regions. Internationalisation projects are often accompanied by high costs, which in turn reduce the international competitiveness of the enterprise. Commercial banks on the other hand are in most cases not interested in financing specific projects of local SMEs in foreign markets which includes innovative projects. The surveys in the JOSEFIN regions showed that some SMEs engage in international collaboration projects to attract external financing that would not be accessible for them if they would internationalise on their own. Subsequently the limited availability of external financing is an explicit determinant of internationalisation for many SMEs in the JOSEFIN regions.

Some Latvian enterprises had to cancel their international projects due to problems with the availability of financial resources, especially external funding.

One of the most important internal barrier voiced by the SMEs surveyed in the regional market studies is the **lack of know how or competences** regarding international issues (esp. law and regulation issues) and the lack of SME managers' international experience. Especially in the SME sector, the enterprises have staffing problems, i.e. a shortage of people with appropriate qualifications and skills. It is worth mentioning that these skills must involve all the aspects of

62% of participating SMEs reported that improved market knowledge would be the most important challenge the coming year in the Oslo region (NO).

[23] Cf. Observatory of European SMEs (2003): Internationalisation of SMEs.

[24] Availability of external funding among Latvian entrepreneurs is identified as one of key challenges for business development – 49% of Latvian entrepreneurs directly claim availability of financial resources as a significant business obstacle. Data source: „Administrative Procedures and Business Environment in Latvia 2001-2009." Cf. The Laboratory of Analytical and Strategic Studies, Ltd., Riga, 2009.

the internationalization process, such as managing a business in different regulatory environments, dealing with bureaucracy, understanding complex trade regulations, risk management, the ability to overcome language barriers and the search for needed capital for further growth. The self-perception of lacking competences or skills required for the process of internationalization is a main reason for the observable habit of SMEs in the regions to develop skill improvement policies first before engaging in internationalization and innovation processes. As a result these activities are markedly slowed down or postponed.

In Lubuskie (PL), external barriers come down to language barriers, lack of awareness of legal differences and cultural differences.

The surveys also indicate that **difficulties in finding suitable and reliable foreign partners** are one of the more important external barriers of SMEs for going international. This includes the difficulties arising in communication with foreign partners due to language barriers and cultural differences, which is indicated by the majority of the SMEs in the partner regions as a barrier in internationalisation efforts. Survey results, for instance from Lithuania and Latvia, point out that just like the state and municipal representatives also the entrepreneurs themselves have poor foreign language skills, which is a significant obstacle for development of international collaboration. Cultural differences that include different mentalities, ways of thinking, working habits, and management styles are also viewed as a problem.

The regional market studies indicate that SMEs in the surveyed regions are generally characterized by **a lack of explicit strategy** in the initial phase of internationalisation and innovation projects and a **lack of ability to implement strategies** (insufficient planning or skills) for innovative and respectively international activities. For most SMEs, the development of new products, services or processes require the adoption and integration of technology or knowledge from outside, a task in which a lot of SMEs in the surveyed regions do not perform well. The company needs to have additional knowledge, skills and competences on how to design, implement and manage innovative projects and adopt the technology or knowledge from outside their firm in order to strengthen the competitiveness of the company.

Finally, the **limited awareness of internationalisation and innovation opportunities** is another important internal barrier for internationalization in the surveyed regions, as the SMEs are still mainly focused on local and regional markets. Higher levels of awareness can more often be found in medium enterprises, actively operating on foreign markets and using knowledge and technologies from there. Quite opposite is the attitude of relatively small firms which do not see any advantages in the process of internationalization, and have therefore only low incentives to start operations on foreign markets. There is a generic need for coaching and rising awareness of SMEs to engage in international and/or innovative projects, so that SMEs become aware of their need for additional skills, competences and knowledge for going international.

In Westpomerania (PL), only a few SMEs are aware of the availability of grants supporting the process of internationalisation.

4.3 Demand Analysis on Financial Needs of SMEs

As shown by the regional studies the access to finance is already a crucial success factor for internationalisation and innovation of SMEs in the JOSEFIN regions. For the future, it can be expected that it will become even more important for the SME sector in the Baltic Sea Region, as the unified European market makes internationalisation a more accessible strategy for SMEs in this part of the EU. The possibility of raising external capital for development at transparent and fair conditions will be one of the most important pre-conditions for SMEs to realise expansion strategies to foreign markets. In addition, the development of financing structures that have a transnational focus and are available in different European countries and regions will further encourage innovative companies to expand their business activities, as those companies tend to look for transnational as potential sources to fund their activities.

Questioning entrepreneurs of the SME sector about the kind of support they expect for innovation and internationalisation, mostly pointed at the need of enhancing the access to financial resources. The survey results indicate that despite the large existing demand for external financing of innovative processes and internationalization of business, entrepreneurs do not know how to obtain these funds.

4.3.1 Financing Investments

The forms of external finance that are already in use by SMEs in the surveyed regions to finance investments are loans, leasing and state support programmes. Financing through venture capital or capital markets is not widespread yet. The three most common purposes for which SMEs, for instance in Lithuania, apply for external funding are investments into equipment and machinery, into other tangible assets and finally into working capital. Investments in innovation (R&D and product development) and human resources are very rare mentioned as reason for applying for external finance (both in the past and planned in the future).

Taking into account the percentage of applications made by SMEs and rejected by banks, and the estimated value of loans granted to SMEs in Lower Silesia (PL), the unrealised demand for loans is around EUR 200 million.

Loans from commercial banks are generally the most important source for financing general investments, but access is tightening in all surveyed regions. An increase in access to loans would have high impact on continued growth of SMEs and an extension of the access of companies with risky projects to loans would have a positive effect on the companies' growth potential.

Leasing is the second most important instrument used. Apart from the obvious barriers that prevent the financing of some types of SME's investments by leasing (not all forms of investment projects can be subject to leasing), financing through leasing might turn out to be the most commonly used finance instrument for SMEs.

State support programs are as well an important financing instrument for the SMEs in the regions, focused mainly on the support of business start-ups and self-employment. The existence, design and importance of such schemes differ highly among the partner regions. Loans from these schemes may have lower access barriers than loans from the commercial banking sector, but this is often undermined by high application requirements and/or procedures.

4.3.2 Financing Investments in Innovation and Internationalisation

It is not common for SMEs from the surveyed regions to finance investments for internationalisation externally. Therefore, most of SMEs concerned with internationalisation plan to use **own funds/ equity**. The main additional source of funding for innovation or Internationalisation are commercial banks and their various types of loans. According to the companies' experience credits of suppliers, public support or leasing are rather minor sources in this regard. In this context, representatives of financial institutions have reported that most entrepreneurs have limited information about other ways of attracting external finance than loans (e.g. risk capital, business angels, business incubators etc.). The surveys showed that entrepreneurs in the SME sector have in general only limited knowledge about external forms of financing Internationalisation and innovation. Supportive and knowledge building activities would be necessary to change that situation. On the other hand there is the need to raise the awareness level of SMEs regarding the existing possibilities to finance their international and innovative projects.

In the Oslo Region, the main source of funding for an entity going international is its own contribution, i.e. equity.

Rejection rates of applications from SMEs to finance investments in innovation are very high in the JOSEFIN partner region[25]. Therefore, in most regions loans are not seen as the most likely instrument for financing innovation and internationalisation projects. Most of the rejections of loan applications are connected to **inadequate and excessive collateral requirements** that cannot be met by SMEs, e.g. due to insufficient amounts of collateral, guarantees and/or own equity. SMEs also report a lack of trust from commercial banks in the companies' business ideas and the companies' financial statements.

In Poland, there exist high collateral requirements both in the commercial banking sector (up to 250% of the loan amount) and for the regional loan funds (up to 100%).

The biggest obstacle for financing is the collateral requirements for the SMEs in Berlin/Brandenburg (GER).

Another often mentioned obstacle for access finance from a SME point of view is the usage of **complicated application procedures** for soft loans and state support programs. This connects to the finding that time efficiency is an important issue for SMEs in the process of requiring external finance for innovation and/or internationalisation projects. The SMEs would prefer simple and easily processed application and high standardised approval procedures. The survey results also indicate that SMEs in the JOSEFIN regions have made the experience that available public financing is not only complicated to access but also

[25] Cf. EU Commission Staff Working Document (2009): Financing Innovation and SMEs, http://ec.europa.eu/enterprise/policies/innovation/files/swd_financing_innovation.pdf.

not provided in sufficient amounts for the development and realisation of international innovative projects, often due to lacking co-financing by the enterprises.

5 Supply Analysis for Financial and Non-Financial Schemes

5.1 Analysis of Financial Schemes

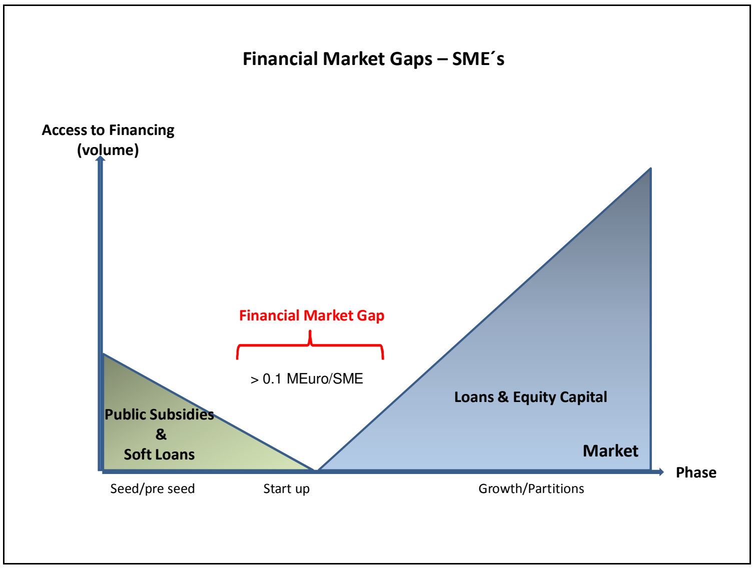
The surveys on the drivers and obstacles of internationalisation in the JOSEFIN partner regions showed, that the general level of internationalisation and innovation of SMEs is still low in the Baltic Sea Region. As has been shown above, the most important barrier for going international is in all regions the lack of suitable external financing options. However, the studies demonstrated that financial frameworks and structures in the regions are very differently developed and organized, and differ widely regarding dominant actors, available products and outreach. The following summary of the results from the regional supply side analyses consequently focuses on the individual regional market gaps regarding the financial supply by commercial banks, venture capital/investors and public sector funding[26].

In the **Scandinavian countries** represented in the market studies (Norway and Sweden) a common characteristic is the lack of widely used public support schemes for SMEs (both public loans and guarantees). This situation is connected to limited availability of EU structural funds in these countries.

The Regional Market Study from **Darlana (Sweden)** concludes that the supply of capital to innovative SMEs is lacking, whereas the commercial market is the primary provider of both loans and equity to newly formed and existing SMEs. Therefore, there is a need for financing solutions that complement the existing system and that are also based on commercial assessments. The graph below demonstrates that the area with the biggest need for additional financing is in the pre-seed/seed stage and in the stage between seed and growth. At these stages risks are too high, so that commercial capital is seldom available. The analysis focused on regional competitiveness and growth has identified a financing gap and a need for additional financing. Borrowing by SMEs has become much more difficult and expensive in recent years, especially due to increasing loan collateral requirements. To sum up, there are currently no opportunities for SMEs to obtain government guarantees on either loans or equity, and therefore, there is a very distinct market gap, which needs to be filled.

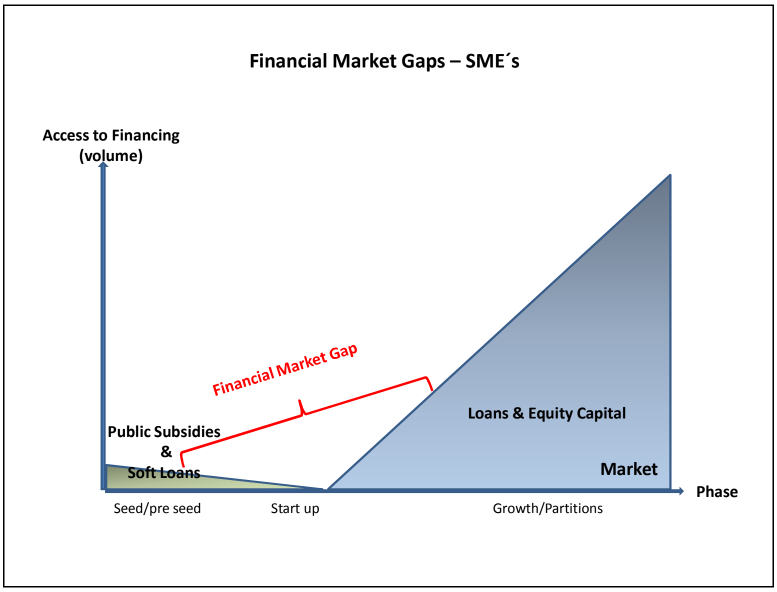
[26] Leasing companies are not included here, since in the regional market studies leasing was not seen as a suited instrument for financing internationalisation projects.

Figure 3: Financial Market Gap for SMEs in Dalarna (SE)



The SME sector in the **Oslo Region** (Norway), especially entrepreneurs/start-up companies, suffers from lack of accessible financing for innovative and international activities mainly due to **general unwillingness to take risks** in both the commercial bank market and the venture capital market (current situation). The ability to take up debts (attract financing) increases with the age of the SME. The figure below show and exemplifies the financial market gap how it is perceived in the Oslo Region. The initial phase, seed / pre seed, is not discussed in any detail, simply because public funding to this phase is virtually non-existent. In that sense, the gap may be wider.

Figure 4: Financial Market for SMEs in the Oslo Region (NO)



In the surveyed **Polish regions** SME financing for innovation and internationalisation is mainly available through public or semi-public loan funds (with the exception of Lubiskie). But those funds do not offer loans big enough to finance innovation or internationalisation projects. Loans from the commercial bank sector are tied to nadequate and excessive collateral requirements (up to 250% of the loan size) and are therefore not accessible for very small or young enterprises.

In **Westpomerania**, there are many diversified forms of financing innovation and the Internationalisation of the business activity of the SME sector. However, the barriers are complex application procedures, the ineffectiveness of information and publicity measures on existing sources of funding for these projects and the inadequacy of the available to the needed amounts for projects.

Despite the undoubtedly positive direction of the development of the loan funds in **Greater Poland**, there are still barriers in financing business activity due to the low capital endowment of the funds, which makes it impossible to finance the usually costly innovative projects. Moreover, existing loan funds are characterized by a highly asymmetric growth structure. An increase in loan numbers is mainly seen in national or over-regional funds (e.g. the Sub-regional Credit Fund "Wielkopolska Północ" and the Mikro Fund), but not in the locally operating funds. In conclusion, the access to loan funds in Greater Poland is very limited on the local and regional level, as apart from the two mentioned funds, all other funds play only a marginal role in the development of the SME sector in Greater Poland.

In **Lubuskie**, there are so far no available resources to finance investments at the regional level. Allocations of resources paying for investments are running out. Existing nationwide programmes still have some funds available, but SMEs, especially micro enterprises, do not have access to them. Similarly to banks and loan funds, the existing Guarantee Fund does not have a separate offer for innovative SMEs intending to develop internationalization. Consequently, guarantees and counter-guarantees which may be used to secure financing investment projects for internationalization are missing.

In **Lower Silesia**, external financing is realized by SMEs mainly through loans, micro-loans and guarantees. Other forms of external finance, as risk capital, leasing or factoring are still on early stage of development. There are already regional schemes in place to improve the access of SMEs to external finance. Most of these schemes are developed within the framework of the JEREMIE Initiative, that will transfer PLN 400 million (excluding management costs) into the region. The preparation report for JEREMIE identified in 2008 only limited activeness of the existing funds for microloans and guarantees. For 130,000 SMEs in Lower Silesia, only 260 guarantee agreements were executed per year. Commercial banks in Lower Silesia were also reported to be hesitant in providing loans to SMEs. The unrealised demand of regional SMEs for loans was reckoned at EUR 200 million. Besides JEREMIE schemes, other EU funds will also appear on the market in the nearer future, e.g. those supplied under Operational and Framework Programmes.

In **Germany** loans are still the most widely used instrument for financing SMEs. Venture capital and other alternative forms of equity are not yet widespread. Public loans with low collateral requirements exist at national and regional level. But due to the German "Hausbankprinzip" those products are only accessible through the commercial banks, of which most have reduced their activities in supporting high risk projects through own or public funds markedly in the recent years.

The financial landscape in **Berlin/Brandenburg** is highly developed and diversified. However, SMEs and especially micro enterprises have only limited access to financing, especially loans, for innovative and international activities. These entities must be able to address the collateral and co-financing requirements to attract financing for going international. For the promotion of the SME sector, it would be necessary to have a financing instrument with an equal risk sharing component for the financial framework in Berlin/Brandenburg.

In the **Baltic States** the market studies identified existing market gaps for accessible equity products to support innovative start ups in the first years and for internationalisation strategies. Access to loans for SMEs tightened markedly in these countries during the last two years due to the high exposure of their commercial banking sectors to the financial crisis.

The existing start-up and micro-financing schemes in **Lithuania** do not cover the demand of potential and existing SMEs and especially micro enterprises due to insufficient levels of risk capital investments, especially for the early stages (pre- seed, seed, start-up and early stage) and partly due to the absence of local players. First-time entrepreneurs have access to a number of programmes offering small grants, but largely lack equity products which offer adequate financing to support them through the critical first years of existence. Capital for further expansion investment (e.g. capital to increase production capacity, working capital and capital for the further development of the product or market) is still scarce and hard to access for existing SMEs.

In **Latvia**, the state financial support schemes are too bureaucratic and the access to financing from the banking sector is still very limited, especially for creative, innovative or international projects. Extensive loan collateral requirements prohibit access to finance for SMEs. Support (e.g. seed capital) is very limited for innovation projects that are based only on ideas without a registered enterprise. Therefore, it would be necessary to have a financing instrument with equal risk sharing between public and commercial financial institutions. Further, all existing options to attract external financing that are available in the market are focused on medium-sized and even large enterprises, which are able to provide larger amounts of collateral and to attract extra co-financing from different sources. Options for small and especially micro enterprises to receive external financing are therefore still limited.

Estonian enterprises are confronted with a limited access to the loan market, as the main source of financing is the commercial banking sector, which has recently become successively stricter in their loan activities. In addition, for innovative SMEs it is more difficult to obtain financing than for companies operating in traditional economy fields. Furthermore, the collateral requirements for the SMEs are considerably high. Financing from international sources is barely done by SMEs in Estonia.

In general, the Regional Market Studies show that for SMEs there exists a lack of access to finance innovations through loans in all JOSEFIN regions. Access is declining sharply in some of the JOSEFIN partner regions due to the financial crisis. Other financing instruments, such as venture capital or capital marke have a low market penetration in the surveyed regions mostly due to lacking supply, but also to a lack of awareness and information gaps on the side of SMEs. The commercial banking sector prefers financing medium to large companies which are able to comply with the requested, excessive collateral requirements for innovation and/or internationalization project loans. Furthermore, collateral requirements increased strongly through the crisis. Investments for innovation or internationalization by pre-, seed or start-up SMEs and especially micro enterprises are often seen as too risky by commercial banks. Existing public loan or guarantee funds are concentrating more on seed and start-up enterprises, but their application and approval procedures are too bureaucratic and time consuming in most SMEs' views.

5.2 Analysis of Non-Financial Support Schemes

The surveys on barriers and obstacles showed that SMEs in the JOSEFIN regions encounter many barriers on their way to internationalisation and innovation. Not all of them are connected to lacking access to external finance. Missing know-how, strategies and human resources, problems in finding suited co-operation partners abroad and low level of awareness of business opportunities in other countries can end internationalisation and innovation projects before external finance is even needed. Therefore the studies conducted regional supply analyses on non-financial support schemes for innovative SMEs too.

Non-financial business support programs for SMEs exist in all surveyed regions, mainly offering training and consultancy services, most of these are not specialised in internationalization. The SMEs in the regions are generally aware of their existence, but do not use them on a broad scale.

However, SMEs generally believe that such kind of non-financial support is very necessary for establishing international partnerships and to gain knowledge on their target markets abroad .For international inexperienced SMEs the risk to fail is much higher when they are on their own. With an accompanying coaching the SME is more likely to implement a long-term strategy and therefore get more favourable credit conditions. The survey results show that the availability of the coach, individual coaching for the market entrance, to find the right cooperation partners and to avoid legal and business problems is very important for the SMEs planning international and/or innovative activities. Further, coaching brings more security for the SMEs to become successful abroad and can help overcoming main obstacles for internationalization like knowledge of the market and personnel resources.

SMEs in Germany mentioned coaching as a measure to overcome main obstacles for internationalisation like knowledge of the market, personnel resources.

Increased knowledge on sales and their markets is for 70% of all SMEs in the Oslo region the most important area of improvement regarding non-financial support services.

In regions were specific innovation-support service organisations are active, the analyses showed that these organisations need to ensure the access of enterprises to the innovation support services they offer and to safeguard the quality of these services. The reports also clarify that both, sufficient human resources and their competence and proficiency are needed to deliver high quality services to SMEs in an effective way. Initiatives to increae the competence of the staff of innovation-support service organisations should be supported and the system for monitoring the competence of public innovation-support organisations must be created and implemented.

In general the Regional Market Studies point out that the coaching element in the JOSEFIN approach is crucial to assist SME’s to go abroad. Further, the SMEs assess coaching as very helpful and economically reasonable in the surveys. The results show that most support services are too general in their approach to be of help to SMEs with internationalisation plans.

The **central market gap**, which is identified by the JOSEFIN Regional Market Studies and the included surveys, is defined as **international coaching**, performed by coaches in the countries and markets that the SMEs want to establish cooperation and/or business with. There is a need in international focused coaching, e.g. support in international networking is needed or to find business partners in target markets.

6 Conclusions

The regional market studies showed that although innovation and internationalisation are a key success factor for the majority of SMEs in the JOSEFIN regions and despite the relatively high degree of integration of the markets in the Baltic Sea Region, internationalisation activity in this region is still dominated by larger enterprises and has only marginally reached down to the small and micro enterprise level. Hence, the surveyed level of internationalisation of innovative SMEs is still low in the regions. In most regions it is only slightly higher than the average EU-27 level regarding SMEs. The strong focus of regional SMEs on national and regional markets and co-operations is visible in the high amount of non-internationalised SMEs that have not even considered going international because they think it is irrelevant for their business. Support schemes for SME internationalisation have to address this issue to realize enough outreach.

The identified key drivers and obstacles for SME Internationalisation are very similar in all the surveyed regions. There is a lack of know-how and strategy regarding internationalisation and how to finance such projects/strategies externally and a lack of resources (time, finance, personnel), for searching business partners abroad on own terms. Therefore the regional market studies showed a similar demand of innovative SMEs in the surveyed regions regarding:

- Access to suitable finance (loans and equity)
- Support in building know-how and developing strategies for internationalisation
- Support in specific issues connected to internationalisation (e.g. law issues in target markets)

On the other hand the supply analyses of the financial products available to innovative SMEs delivered a very diverse picture for the surveyed regions. Specific constellation of actors and financing conditions result in very different framework conditions and market gaps.

Regional market gaps in external financing options for SME internationalisation that were identified are connected to high collateral requirements (Polish regions and Latvia), lacking public guarantee schemes (Oslo Region and Dalarna), lacking public schemes that focus on SME internationalisation (Berlin/Brandenburg) and bureaucratic hurdles (Baltic states). In addition, the macro-economic context in all surveyed regions and countries favours risk-minimizing by commercial actors involved in SME financing, mostly due to the global economic downturn in 2009.

Regarding the availability and accessibility of non-financial services (consulting, training) for innovative SMEs, the reports showed that such schemes are in place in all the surveyed regions, but are often not used on a broad scale. Most support services are too general in their approach to be able to support innovative SMEs in developing internationalisation project. There is a need in international coaching performed by coaches in the countries/markets that the SME want to establish cooperation and business with. Support in international networking is needed e.g. to find business partners in target markets

Based on the results of the regional market studies the following conclusions regarding the further work of the JOSEFIN project can be deducted.

A transnational service model for an **integrated support solution** is needed, that combines:

1) Coaching for support and risk minimizing
2) A loan guarantee/risk sharing scheme

The **JOSEFIN Loan Guarantee Model** must allow **adapted regional implementations,** due to the very diverse frameworks for financing innovative SMEs in the regions and should address the following market gaps in the JOSEFIN regions:

- A need for accessible loan products to finance internationalisation projects of smaller enterprises.
- A need for guarantee schemes to reduce collateral requirements for innovative SMEs with viable project ideas seeking external financing.

The **JOSEFIN Coaching Model** should addresses the following market gaps identified in the surveys:

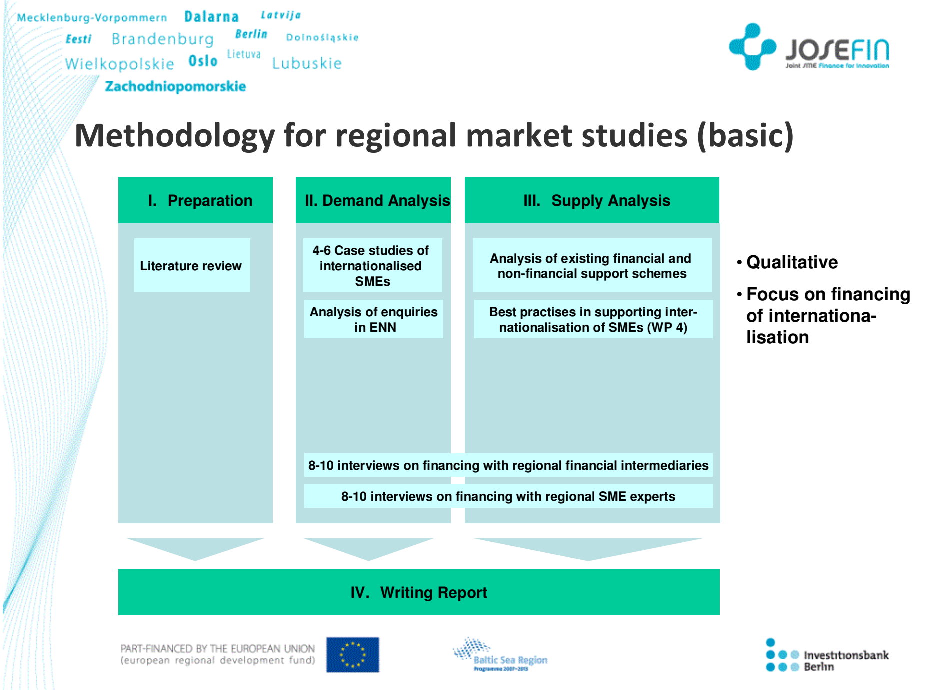
- A need in services that rise innovative SME's awareness on the opportunities of internationalisation.
- A need in international coaching performed by coaches in the countries/markets that the SME want to establish cooperation and business with.

As **main challenges to implement** an integrated JOSEFIN Service Model in the JOSEFIN regions the following issues need to be addresses by the partners:

- The main actors in SME finance are very risk-adverse at the moment.
- The target group need to be activated
- Coaching services need to be hands-on providing clearly visible added value for the SMEs
- The time efficiency of all processes is very important for the target group

Appendix: Basic and extended Methodology

Basic Methodology (mainly qualitative)



1. Preparation

- Review of existing literature of the demand and supply of finance for innovation and internationalisation of SMEs in general and from a regional perspective (will be used as background information for each of the following steps of analysis).

2. Demand analysis for SMEs (qualitative):

- 4-6 case studies of internationalised SMEs will be conducted based on in-depth telephone interviews or visits to discuss the following issues: (1) In which areas does your SME require the most support relating to finance of innovation and internationalisation?, (2) What are respective necessities of your SME? and (3) What kind of support/services can satisfy such needs?

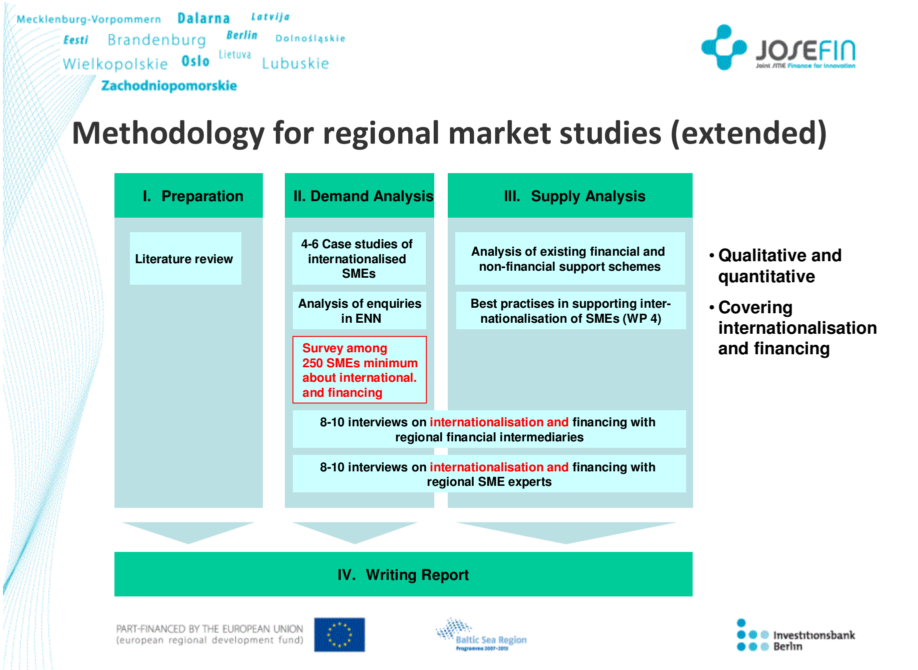
3. Supply analysis of finance for innovation/internationalisation (qualitative):

- Analysis of existing financial and non-financial support (enquiries EEN) schemes in region including in-depth assessment of best practice examples (for Work Package 4)

- 8-10 in-depth interviews (telephone) will be conducted with financial intermediaries about their financial schemes supporting finance for innovation/internationalisation
- 8-10 in-depth interviews (telephone) will be conducted with experts on financing for innovation/internationalisation of SMEs.

4. Report

Extended Methodology (quantitative and qualitative)



The extended version of methodology is based on all elements of the basic version. Further, a quantitative survey of SMEs in the region will be added with the following characteristics:

- Survey amongst entrepreneurs and managers within SMEs, all being independent private enterprises with less than 250 employees in all sectors of industry.
- The size of the sample has to be determined by considering the need to report on characteristics of SMEs with reasonable accuracy and confidence. The number of SME that participated should be 250 minimum.
- The questionnaire should be based on the questionnaire of the ENSR Enterprise Surveys used for several Observatory of European SMEs. (Observatory of European SMEs 2003, No. 4, Internationalisation of SMEs).
- The questionnaire may mainly contain questions about: (1) General characteristics of SMEs, (2) Patterns and motives of internationalisation among SMEs, (3) Internal and external problems during internationalisation process, (4) Patterns of finance for innovation and internationalisation of SMEs, (6) Internal and external problems of finance for innovation and internationalisation and (6) Self assessment of challenges and needs for finance for innovation and internationalisation.