Nikola Stefanovic[1]
Lidija Barjaktarovic

FINANCING SMALL AND MEDIUM-SIZED ENTERPRISES AND ENHANCING QUALITY: PRIVATE EQUITY INSIGHTS

Abstract: *Small and medium-sized enterprises (SMEs) play a crucial role in economic growth, innovation, and development of countries. Private equity is an important, but often overlooked, alternative source for financing SMEs, particularly in emerging markets. Private equity funds aim to increase the value of their investees through internal processes and procedures. The essential element of this value creation work is the enhancement of quality. The scope of the study is to present private equity operational value creation activities and processes that lead to the enhancement of quality in SMEs. The study is based on the data from SEAF Serbia Impact Fund, a private equity fund, which, during the 2014 to 2018 period, analyzed 571 companies in Serbia. The results imply that private equity funds play an important role in financing SMEs, enhancing quality, and improving company performance.*

Keywords: *Private Equity, SMEs, Quality, Emerging Markets*

1. Introduction

Small and medium-sized enterprises (SMEs) are considered a backbone of economy and play a key role in growth and development of countries. Moreover, SMEs appear to be a fundamental part of the economy, and, in some countries, such as Serbia, they support the implementation of structural reforms (Krstic et al., 2012). Sustaining SMEs is of particular importance in developing regions, as SMEs are expected to facilitate the creation of new working places, foster economy, and increase national economic growth. Financing sources represent the most important prerogative for SMEs' development and business performance, and their availability and type fluctuates in different stages of business development. Thus, financing sources for SMEs are highly variable and cover wide range of methods, including internal and external sources (Abdulsaleh and Worthington, 2013).

Private equity (PE) is an important, but often overlooked, source for financing SMEs, particularly in emerging markets. Private equity funds are financial intermediaries, which raise money from investors and organizations and place it into other, often early stage or high-risk companies. Further down the process, they aim to increase the value of their investees through internal processes and procedures. The enhancement of quality is a consequence of the process, but also a prerequisite for the business growth and development, high company performance, and investment turnover. Although SMEs are a backbone of the Serbian economy and despite the importance of private equity funding in financing SMEs, the impact of private equity investing in SMEs on quality has not been previously

[1] Corresponding author: Nikola Stefanovic
Email: nstefanovic@singidunum.ac.rs

explored in the country.

The aim of the paper is to provide the insight into importance of SMEs, methods of funding SMEs, and the strengths and challenges of private equity funding as one of the most important source of financing in emerging markets. In addition, the paper also aims to present the reletionship between private equity funding and enhancement of quality and performance in SMEs in Serbia.

2. SME financing methods

SMEs are a more significant and more common source of employment compared to big companies, particularly in emerging markets. They also present an important base for supply and development of big companies and, in some countries, they are a partner for strategic reforms (Rijkers et al., 2014; Aga et al., 2015). The data indicate that around 99% of companies in Serbia are SMEs, however, only half of them contribute to employment and create value (Krstic et al., 2012). Further development and growth of SMEs and improvement of employment depend on various factors. One of the key factors is appropriate, made to measure, additional financing (Abbasi et al., 2017).

Financing sources for SMEs are extremely variable. They include a wide range of internal and external financing options, which also diverge in the level of their formality (Abdulsaleh and Worthington, 2013). The two most important sources of financing are debt and equity (Longenecker et al., 1994). The sources may include financing obtained through personal sources of employees or their friends or family. They may also include more formal external sources, such as angel investors, trade credit, factoring, leasing, loans, crowdfunding, venture capital, or other financial intermediaries (Abdulsaleh and Worthington, 2013).

Financing obtained through company's employees, and their friends or family, usually represents one of the first and principal financial sources of SMEs (Abdulsaleh and Worthington, 2013; Abbasi et al., 2017). This is a very popular source in smaller businesses and in developing countries. It has more potential benefits than disadvantages. The interest rates are usually low and driven by non-financial benefits making this source particularly appropriate for startup companies and SMEs in early stage of their business cycle. The higher social intimacy loads the financial relationship and poses a potential burden. Additionally, this type of financing is usually restricted in time and amount (Abbasi et al., 2017).

Business angels are individuals with substantial financial resources that are willing to invest into companies in return for a previously agreed share in the company. They do not have any personal ties with the owners or employees but are willing to invest into different types of business. Their business decisions can be driven by financial, philanthropic, or other reasons. They usually offer smaller funding and invest into companies in the early stages of their development (Rupeika-Apoga, 2014; Abbasi et al., 2017). According to Rupeika-Apoga and Danovi (2015), companies are reluctant to use this source of funding and business angels are still trying to expand their market in Europe. One of the reasons could be the lack of information on alternative sources of funding but also the fact that business angels could request a substantial share of the company in return for the financing.

Trade credit is another type of financing of SMEs. It is a credit given with the short due date, usually a month or two. It is easy and popular way of financing of SMEs, emerging from day to day business operations. Trade credits are usually short-termed and, thus, inappropriate for companies needing additional time. They can also be an expensive source of financing as credit risk is already accounted for in the price of goods

(Abbasi et al., 2017).

Factoring is very advantageous for SMEs. This method of financing enables SMEs to have fast, easy, and flexible access to financing, to develop rapidly, improve performances and decrease financial risk placing their invoices as a collateral. Using factoring is particularly useful in financial settings affected by crisis or expensive bank credits (Vasilescu, 2010, Abbasi et al., 2017). On the other hand, this type of financing can also be expensive, time limited, and burden the business relationship.

Leasing is another method of short term financing. It is regarded among fundamental financing methods of SMEs. A company is given assets and not direct cash. The asset is given in return for payment during a fixed time frame after which the company leasing the asset can keep it. This is very effective method of financing as it improves the market strength, increases access to financing, and leaves out traditional bank credits (Abbasi et al., 2017).

Debt represents a monetary loan to be paid by the specific point of time in the future, with interest. The loan is assured by a collateral enabling the company to retain the ownership which is contrary to the equity funding (Abbasi et al., 2017). This type of financing mediated by banks and intended for SMEs is still a primary source of financing in Europe (Rupeika-Apoga and Danovi 2015).

Crowdfunding is a funding method organized by multiple individuals in the form of non-compensatory donations or in exchange for a compensation or decision opportunities. The funding providers usually engage into riskier behavior and expect a lower return on the investment. It is a contemporary, web based, method of financing tailored for young or startup companies usually dealing with new technologies and innovations. This resource is still underrepresented in Europe (Rupeika-Apoga and Danovi, 2015; Abbasi et al., 2017).

Venture capitalists are investors who tend to invest in startup companies in developing markets (Djalic et al., 2017; Rupeika-Apoga, 2014). Interestingly, apart from the majority of other financing sources, they tend to influence decision making process and business development planning. As this method of financing is related to high risk investments, it also aims to achieve high profits (Djalic et al., 2017).

Although SMEs represent an economic engine of many countries, they still encounter many challenges obtaining financing. Moreover, financial challenges emerging during the last decade have lead to additional shortage of financing sources (Ullah et al., 2018). Thus, another source of funding, not previously listed above, private equity funding, emerged as one of the most interesting, useful and easily accessible financing sources for SMEs.

3. Private equity funding and enhancing quality in SMEs

Private equity is an important, but often overlooked, source for financing SMEs, particularly in emerging markets. This type of financing is particularly adequate for companies seeking expansion, skilled leadership, and long term business support. Moreover, equity financing is tailored for high risk companies bearing a possibility for high return. The same companies often have scarce access to other sources of funding or consider debt financing costly. However, the companies may face the uncertainty in the process of equity financing as the ownership structure is changing (Abbasi et al., 2017).

The main aim of private equity funds is to increase the companies' value through internal processes and procedures. Once the funding is given to the company, the private equity funds tend to establish a clear, systematic and reliable operating model which suits the business strategy, respecting the company's efficiency and flexibility. The operating model aims to create additional value and enhance profit. This is done through particular steps and procedures which include: a) identifying value, b) planning for value, c) realizing value, and d) maximizing value (Kaiser and Westarp, 2019).

Identifying value or the due diligence period is the first step which a private equity fund undertakes after considering the company for investment. There are areas private equity funds particularly focus on during the due diligence period - they adopt a fully integrated due diligence model, take into account the potential risk, challenges and opportunities. The integrated due diligence ranges from gaining all relevant financial information to social or other potential important subjects that could contribute to the value creation. Taking into account the potential risks implies using highly develop, IT models of due diligence which take into account numerous factors (Kunz et al., 2018).

Planning for value is the second step of private equity investing, which takes the stage after the deal has been made (Kunz et al., 2018). It lasts usually the first 100 days after the investment and is based on identifying the value period. It implies a more in-depth analysis and sets the further course of the company development (Kaiser and Westarp, 2019).

Realizing value is the third and the longest step in private equity investing. It often called the "the holding period" as during this time the most of value is created. This is achieved through the improvements of the company's procedure, enhancement of quality, establishing structure and systems, and implementing control (Kunz et al., 2018).

During this step, total quality management (TQM) is of vital importance for the long term success of the company. It is based on enhancing competence and improving the organizational structure, while the association between different kinds of company's performances and TQM has been previously proven (Ali and Khatoon, 2016). The application of TQM, in companies invested by private equity funds, is of particular interest and importance. Thus, timely and adequate application of TQM procedures is vital in their growth and consequently profit. The application of TQM implies several steps, which range from identifying TQM as one of the priorities and developing a plan of TQM use in the company to standardization of procedures and evaluation of progress and feedback (Ali and Khatoon, 2016). More novel methods also include incorporation methods to decrease of risk and vulnerability (Arsovski et al., 2011) and the use of simulation systems in obtaining precise quality goals (Arsovski et al., 2009).

Maximizing value is the forth, final and the most important step in private equity funding. It is the time when the fund exits the company and the real value of the company is assessed (Kaiser and Westarp, 2019). The process is secured by coordinating the exit with the highest value creation and cautiously identifying the value process of the buyer (Kunz et al., 2018).

4. Private equity funding - SEAF Serbia Impact Fund

SMEs, in emerging markets, particularly face the problem of limited financing and weak institutional development when compared to larger business due to constraints in the financial systems of such countries (Beck 2007). The same was noted in SMEs working in Serbia.

The study is based on the data from SEAF Serbia Impact Fund, a private equity fund, which, during the 2014 to 2018 period, analyzed 571 companies in Serbia. The majority of the companies have previously explored other sources of financing before opting for equity funding, and the companies have been analyzed by the previously presented methods by the private equity fund. The companies receiving funding were requested to implement the quality and quality control procedures in their work. The process was monitored by the local management and private equity fund management. All companies which applied the TQM procedures had higher profits by the end of the first year following the investment.

5. Conclusion

This paper presents an empirical research on the role of private equity funding in enhancing quality in SMEs. Access to diverse financing methods in Serbia is improving, and the literature review follows our experience and shows that private equity funding is highly beneficial for company's development and increase in profit. The relationship is best explained by potential mediatory effect of quality enhancement through TQM procedures and financial analysis. Private equity funding is a fundamental part of economy's development in emerging markets and its role is best fulfilled through enhancing quality.

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Nikola Stefanovic
Singidunum University,
Belgrade,
Republic of Serbia
nstefanovic@singidunum.ac.rs

Lidija Barjaktarovic
Singidunum University,
Belgrade,
Republic of Serbia
lbarjaktarovic@singidunum.ac.rs