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Availability of Alternative Financial Resources for SMEs as a Critical Part of the Entrepreneurial Eco-System: Latvia and Italy

Ramona Rupeika-Apoga\textsuperscript{a} Alessandro Danovi\textsuperscript{b,*}

\textsuperscript{a}University of Latvia, Riga, LV-1059, Latvia
\textsuperscript{b}University of Bergamo, Via Caniana, 2–2412, Bergamo, Italy

Abstract

The importance of non-traditional alternative/innovative financing is gaining recognition in both developed and emerging economies throughout the world (OECD 2012; EC 2013; ECB 2013; ECB 2014). SME financing in Europe remains primarily bank based, in spite of the many policies proposed to develop alternative financing instruments (e.g. adopting directives on venture capital, improving the transparency and visibility of SMEs on capital markets, etc.)

The paper aims at understanding the availability of alternative resources for SMEs by analyzing them rigorously, understanding the obstacles for the development of non-bank finance and developing recommendations to overcome them.

The research is therefore to expose recent trends in innovative financing in Latvia and Italy, significantly enhancing the evidence base on this key source of entrepreneurial finance. As a source of ‘smart money’, supporting new and early stage businesses, innovative providers are widely accepted as being a critical part of the entrepreneurial eco-system.

Keywords: Alternative financing; business angels; crowdfunding; SMEs

* Corresponding author. Tel.: +37129331977
E-mail address: rr@lu.lv
1. Introduction

Availability of financial resources is a key determinant for business start-up, development and growth for SMEs and they have very different needs and face different challenges with regard to financing compared to large businesses. Access to finance for companies is changing, partly as a result of the 2007-2008 crises itself, and partly due to other global trends and developments such as Juncker’s €315bn investment plan. These changes are challenging the business models of today’s banks as alternative providers emerge across almost all aspects of the ‘banking spectrum’, including the core banking functions. Companies financing mechanism is changing, reshaping the traditional bank activities with promoting innovative financing providers activities.

The importance of non-traditional innovative financing is gaining recognition in both developed and emerging economies throughout the world (EC, 2013; ECB, 2013, 2014; OECD, 2012). Alternative financial resources have significance for policy-makers seeking to support business start-up and growth as SMEs play a crucial role in countries development. Given this increasing reliance of governments on the innovative-alternative funds market as a key source of entrepreneurial finance the research concludes by considering the policy implications that arise from current alternative financing trends. European Commission together with member states and other states governments have been developing actions supporting access to finance for SMEs by focusing on non-traditional financing instruments. In accordance with Regulation (EU) No 1287/2013 the Commission shall support actions which aim to facilitate and improve access to finance for SMEs in their start-up, growth and transfer phases. Such actions shall aim to stimulate the take-up and supply of both equity and debt finance, which may include seed funding, angel funding and quasi-equity financing subject to market demand. Additionally the possibility of developing innovative financial mechanisms, such as crowdfunding, subject to market demand, should be examined.

The Baltic States governments in the National Reform Programmes have outlined plans for the country’s competitiveness strategy to achieve the objectives of Europe 2020, by highlighting the SMEs’ access to finance and facilitating adequate financing responding to the varied needs of business entities. Some of the priorities of the governments concerning SMEs’ access to finance are to provide financial support for early financing mechanisms (business angels and start-up capital).

For example, Estonian government considers Estonian SMEs limited access to venture capital and other less-traditional sources of financing as one of the main weaknesses for ensuring economic development.

The paper aims at understanding the availability of alternative resources for SMEs by analyzing them rigorously, understanding the obstacles for the development of non-bank finance and developing recommendations to overcome them.

The tasks of the paper are to determine the theoretical and practical background, current trends of alternative financing and its role in the financing of SME in Latvia and Italy. Alternative financing has significance for policy-makers seeking to support business start-up and growth as SMEs play a crucial role in countries development.

Methodology. During development of the paper the generally accepted qualitative and quantitative methods of economic research are used including comparative analysis and synthesis, graphical illustration methods, monographic method, logical and constructive method, descriptive statistics method and benchmarking study.

The study considers all stakeholders involved in SME financing (comprising the entrepreneurial eco-system): the firms themselves, banks, alternative investors, government, and other private sector parties.

Research findings indicate the difficulties in SMEs innovative financing and provide the governments and other stakeholders with a tool to understand SMEs’ financing needs that help to improve access to financing for companies.

2. Literature Review And Hypotheses

Although the number of publications and research papers on the topic of non-traditional capital investments has increased over the last years, alternative financing (business angels, venture capital and crowdfunding) in entrepreneurial eco-system has never been defined and has not (yet) developed into a scientific field by itself, with systematic research and rigorous theoretical frameworks. Given the universal importance of SMEs, it is vital to understand the real situation that SMEs are facing when trying to access financing within entrepreneurial eco-system.
During the recent turbulent crisis years, the supply of bank funding to European economies has been very significantly reduced exposing gaps in the way Europe finances economic activity. These issues have limited and even threatened to prevent Europe’s ability to generate economic growth and to reduce the unacceptably high levels of unemployment, which prevail in most countries. Additionally, although support to access to finance for SMEs is being a priority for the EU, there is no research program/project allowing coordinated regional and national experiences on innovative financing, which can establish a common European perspective based on real-world studies.

Access to finance in 2013 was the second most pressing problem mentioned by 15% of EU SME managers, only finding customers was a greater problem. Access to finance was mentioned as the most pressing problem by 40% of SMEs in Cyprus, 32% in Greece, 23% in Spain and Croatia, 22% in Slovenia, and 20% each in Italy, Ireland and the Netherlands. It was least likely to be mentioned in Germany (8%), Austria (7%) and Luxembourg (6%).(EC, 2013)

Among those SMEs expecting to grow in the next few years bank loans were clearly the most preferred source (among 67%) of external financing. The second most popular option (but preferred by just 12%) were loans from other sources such as trade credit, related companies, shareholders or public sources. Only 6% preferred equity investment.

Beck & Demirguc-Kunt concluded that access to finance is an important growth constraint for SMEs, that financial and legal institutions play an important role in relaxing this constraint, and that innovative financing instruments can help facilitate SMEs’ access to finance even in the absence of well-developed institutions.(Beck & Demirguc-Kunt 2006)

Ayyagari, M., Demirgüç-Kunt, A., & Maksimovic, V. in their research “Formal versus informal finance: Evidence from China” contradicted the belief that nonstandard financing mechanisms provide effective substitutes to formal financing channels in promoting growth. They suggested that the role of informal relationship based financing and governance mechanisms in supporting the growth of private sector firms is likely to be overestimated.(Ayyagari, Demirgüç-Kunt, & Maksimovic, 2010 a)

Firms that use bank finance to finance their new investments and working capital are more likely to pay bribes and not evade taxes, whereas firms that use informal financing and financing from family and friends and other sources are more likely to evade taxes and not have to pay bribes. (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2010b)

The dominant view is that informal financial institutions play a complementary role to the formal financial system by servicing the lower end of the market - informal financing typically consists of small, unsecured, short term loans restricted to rural areas, agricultural contracts, households, individuals or small entrepreneurial ventures. (Ayyagari, Demirguc-Kunt, & Maksimovic, 2010a).

One strand of the literature on SMEs finance indicates that SMEs are mostly using the formal bank credits (Karlan & Morduch 2010; EC 2013; EM 2014; ECB 2013; OECD 2012; European Commission 2014; ECB 2012; Rupeika-Apoga 2014b; Saksonova 2014)

Another strand of the literature focuses on the informal/alternative financing that can help to fill the gaps between SMEs financial needs and available traditional financial resources.(Casey & O’Toole 2014; Oncioiu 2012; Karlan & Morduch 2010; Beck & Demirgüç-Kunt 2008; Angela 2011; Prelupean & Boscoianu 2014; Beck & Demirguc-Kunt 2006; Cycle 2013; Innovation n.d.; Kuntchev 2014; Role & Angel n.d.; Rupeika-Apoga 2014a).

Conducted literature and surveys review shows that the access to finance is still one of the main obstacles for doing business and that gaps can be filled by other/alternative resources.

The authors of the paper put forward two hypotheses:

**H1:** Access to finance for SMEs is still pressing problem in Latvia and Italy.

**H2:** The importance of alternative financing is growing, but is not considered by SMEs as the essential source of external financing.
3. Methodology

3.1. Research Goal

In this study the authors aim at understanding the availability of alternative resources for SMEs by analyzing them rigorously, understanding the obstacles for the development of non-bank finance and developing recommendations to overcome them. The tasks of the paper are to determine the theoretical and practical background, current trends of alternative financing and its role in the financing of SME in Latvia and Italy. Alternative financing has significance for policy-makers seeking to support business start-up and growth as SMEs play a crucial role in countries development.

During development of the paper the generally accepted qualitative and quantitative methods of economic research are used including comparative analysis and synthesis, graphical illustration methods, monographic method, logical and constructive method, descriptive statistics method and benchmarking study.

3.2. Sample and Data Collection

The analysis conducted in this paper is based on data and statistics provided mainly by European Central Bank and European Commission, OECD, World Bank, Latvia’s and Italy’s Economics ministries, by certain empirical studies and by the World economic forum data base.

3.3. Analyses and results

Small and medium-sized enterprises are known as the driving force of the European economy, contributing to job creation and economic growth. In 2013, more than 21m of SMEs in the European Union made for 99.8% of all non-financial enterprises, employed 88.8m people (66.8% of the total employment), and generated 57.9% of total added value (European Commission 2014).

| Table 1. EU Definition of SMEs (European Consil 2013) |
|----|----|----|----|
| Enterprise category | Employees | Turnover | Balance sheet total |
| Micro | <10 | ≤ 2mln.EUR | ≤ 2mln.EUR |
| Small | <50 | ≤ 10 mln. EUR | ≤ 10 mln. EUR |
| Medium-sized | <250 | ≤ 50 mln. EUR | ≤ 43 mln. EUR |

The main obstacles influencing the performance of SMEs are decreased demand for the goods and services, the difficulties in accessing to finance, finding customers, doing business, high costs of production and labour as well as the lack of skilled staff.

The authors of the paper relied on “The Global Competitiveness Report” of the World Economic Forum, by assessing the most problematic factors for doing business in Latvia and Italy in 2014-2015.

| Table 2. The most problematic factors for doing business in Latvia and Italy in 2014-2015, % (Brende 2014) |
|----------------|-------|-------|
| Problems for doing business | Latvia | Italy |
| Inefficient government bureaucracy | 17.8 | 19.9 |
| Taxes regulations | 11.9 | 8.6 |
| Access to financing | 11.0 | 16.1 |
| Tax rates | 4.1 | 18.7 |
| Restrictive labor regulations | 2.6 | 11.1 |

As can be seen from table 2, the access to finance is the third most pressing problem for companies in both countries, 11% in Latvia and 16.1% in Italy.
In accordance with the European Commission Analytical Report 2013, companies’ most pressing problem – access to finance was 15% in Latvia and 20% in Italy (EC 2013).

In table 3 the authors have summarised interviews results of business owners and top managers from 336 firms in Latvia.

| Subgroup Level | Small (5-19) | Medium (20-99) | Large (100+) | All Countries/Average |
|----------------|-------------|---------------|--------------|-----------------------|
| Percent of firms with a bank loan/line of credit | 16,0 | 27,6 | 54,2 | 35,3 |
| Proportion of loans requiring collateral (%) | 61,0 | 48,1 | 95,1 | 77,4 |
| Value of collateral needed for a loan (% of the loan amount) | 230,8 | 248,0 | n.a. | 193,9 |
| Percent of firms not needing a loan | 80,0 | 76,2 | 61,1 | 44,3 |
| Percent of firms whose recent loan application was rejected | 52,5 | 20,4 | 36,3 | 11,6 |
| Percent of firms using banks to finance investments | 8,1 | 6,4 | 13,2 | 25,4 |
| Proportion of investments financed internally (%) | 79,3 | 73,8 | 84,3 | 71,7 |
| Proportion of investments financed by banks (%) | 7,1 | 3,6 | 6,8 | 14,9 |
| Proportion of investments financed by supplier credit (%) | 3,0 | 13,4 | 8,1 | 4,5 |
| Proportion of investments financed by equity or stock sales (%) | 6,8 | 7,0 | 0,8 | 4,5 |
| Percent of firms using banks to finance working capital | 10,5 | 8,8 | 41,4 | 30,9 |
| Proportion of working capital financed by banks (%) | 4,7 | 5,0 | 16,5 | 12,3 |
| Proportion of working capital financed by supplier credit (%) | 9,4 | 21,1 | 17,6 | 10,4 |
| Percent of firms identifying access to finance as a major constraint | 14,1 | 9,0 | 27,8 | 28,6 |

Enterprise Surveys data classifies the different sources of external finance for purchase of fixed assets into four categories: equity finance, and three options for debt finance: formal debt finance, including bank and non-banking financial institutions, trade finance, which includes credit from suppliers and/or customers, and the other category, which includes informal sources of credit such as money lenders, friends and relatives. The main conclusion is that nevertheless SME’s use of formal debt is relatively smaller than for large firms and SME’s consistently tend to rely more on trade credit and other external sources (informal) than large firms, the use of formal debt is relatively high.

Table 4. Early stage and expansion capital in Italy 2006-2012, EUR thousands (OECD 2014)
In order to promote SME access to alternative sources of finance, in 2012 specific tax incentives were introduced for seed and early stage investments in innovative start-ups. Provisions introduced by the government included the establishment of a private equity fund with an endowment of EUR 1.2 billion to boost capitalisation and consolidation among firms with a turnover of between EUR 10 million and EUR 250 million. Promoted by the Italian Ministry of Finance in cooperation with the main financial and industrial institutions, the fund became operational at the end of 2010. Through April 2013, it had approved direct investments for the acquisition of minority stakes – amounting to EUR 310 million and indirect investments in third party managed funds totalling EUR 350 million (OECD 2014) (see tab.4).

The European Commission SMAF index provides an indication of the changing conditions of SMEs’ access to finance over time for the EU and its Member States. The index is calculated using a baseline of EU 2007=100, and so allows comparison between countries and across time.

![Fig. 1. EC SMAF index in 2013 (European Commission 2015)](image)

According to the fig.1 Italy’s and Latvia’s performance against the access to finance responds to the EU zone average level, but still has to develop to achieve the leaders as France, Austria and Finland.

![Fig. 2. EC Sub-index on access to debt finance (European Commission 2015)](image)
The sub-index on access to debt finance is comprised of indicators based on the take-up of different sources of debt finance, SME perceptions of loan finance and actual data on interest rates. As can be seen from figure the availability of debt finance in Latvia has improved significantly during the last 7 years, whereas in Italy it fluctuated around 105 and still is far from the strongest performing countries such as Luxembourg, France and Austria.

Fig. 3. EC Sub-index on access to equity finance (European Commission 2015)

The equity finance sub-index is calculated with data from the European Venture Capital Association and the European Business Angel Network reflecting investment volumes and numbers of deals/beneficiaries. Ireland, Estonia, Denmark, Netherlands and Finland are the strongest performing countries, whereas Luxembourg, Greece and Spain have the least favourable equity finance environments. Index dynamics in Italy indicates a significant improvement since 2007, whereas in Latvia there is negative tendency for last years.

Analysing European Commission SMEs’ Access to Finance survey (EC 2013), Survey on the Access To Finance of Small and Medium-Sized Enterprises in the Euro Area (ECB, 2014), The Ministry of Economics of the Republic of Latvia “ACCESS TO FINANCE ex ante assessment Latvia” (MEoL, 2014), SMEs Scoreboard (OECD 2014) and other surveys and reports the authors concluded:

- **Fund attraction:**
  In 2013 66% of SMEs in Latvia and 91% in Italy attracted funds through banks loans. As a result Latvian companies attracted also significant part of other sources: private individual: family or friend – 13% (in Italy – 2%) and other sources (e.g. microfinance institutions, government-related sources) - 19% (in Italy-7%).

- **Alternative credit instruments:**
  In Italy, in the last 18 months mini-bonds have reached 100 emissions amounting to €4.8 billion of which 81 below 50 million for a total of €774 million; 6 emissions between €50 and 150 million for a total of €615 million, and 13 emissions between €150 and 500 million amounting to €3.4 billion. Main sectors of recourse have been energy and utility (37%), manufacturing (10.4%) and financial services (9.7%). Factoring has increased in 2014 to €178 billion (2.8% raise compared to 2013), of which 66.4% with recourse and 33.6% without recourse. Recourse to private equity funds has remained stable in 2014 amounting to €3.52 billion, registering an increase in foreign investments (€1.9 billion) especially in the high-tech sector, non-financial services, manufacturing, energy and utilities, and industry. Finally, IPO have increased in 2014 to 28 (20 in 2013), of which 22 in AIM Italia, sector explicitly dedicated to SMEs, and 6 in MTA (Aifi 2015; Borsa Italiana 2015; ExtramotPro 2015; Assifact 2015). In order to support SMEs access to finance, the Italian Stock Exchange has developed a specific project called “Elite”.(ELITE 2015)

- **Most important limiting factor to get a loan in 2013:**
  - Latvian managers (35%) were the most optimistic by foreseeing no obstacles to get the loan whereas in Italy only 17% was optimistic.
  - The largest proportion of managers in EU who said that insufficient collateral was an issue was to be found in Italy, where insufficient collateral was cited by three out of ten (30%). Despite a lower percentage in Latvia (23%), research done by Ministry of Economics in Latvia rank this obstacle as the first most pressing problem for SMEs (more than 20%) in addition to lack of own capital (18%), loan history (12%), and interest rates being too high (12%).
Generally, SME managers in EU were most likely to see interest rates being too high as the major obstacle to obtain financing. This is true also for Italy where 33% of managers named this obstacle as the most problematic, whereas in Latvia only 21% did.

- Managers confidence level in 2013:
  - Analysing the confidence of SMEs managers in talking about financing with banks the authors concluded that six out of ten managers (respectively 57% and 60%) in Latvia and Italy were confident of achieving their desired result in talking to banks, that is average confidence level comparing with most confident managers from Malta and Turkey (90% and 93% respectively) and the least confident managers of SMEs in Ireland and Spain, with over a third not confident in talking to banks about financing (37% and 36% respectively).
  - However, managers from Italy were notably less confident than those from Latvia in talking to equity investors/venture capitals firms about finance (3% and 19% respectively) and the proportion of firms who felt that this question was not applicable to their firm was significantly higher in Italy than in Latvia (83% and 59% respectively).

- Future preferences:
  - Analysing the future financing preferences amongst SMEs that expect to grow in the next two to three years, bank loans are the most preferred type of external financing: 79% in Italy and 53% in Latvia.
  - Among SMEs expecting future growth 22% in Latvia and only 9% in Italy would aim to obtain less than €25,000; only 17% in Latvia and 27% in Italy have targeted between €25,000 and €99,999; 29% in Latvia and 38% in Italy expect between €100,000 and €999,999; and 3% in Latvia and 10% in Italy are aiming for over €1 million. 30% in Latvia and only 16% in Italy did not know or could not say.

- Importance of factors in companies’ financing in the future:
  - Making existing public measures easier to obtain was considered to be especially important in Italy (an overall mean score 8,4) and not so important in Latvia (5,3).
  - Tax incentives are seen to be particularly important in Italy (8,3) and rather important in Latvia (7,7).
  - Guarantees for loans were seen as important mechanisms by managers in Italy (7,4) in contrast to Latvian managers that had low rating for the importance of this mechanism (5,2).
  - Importance of export credits or guarantees in companies’ financing in the future is significant for Italians (7,4) and has the lowest importance ratings for Latvians (5,2)

4. Conclusion

Conducted empirical analysis proves that SMEs’ access to finance in Latvia and Italy is still pressing problem to doing business in Europe, even though a great deal of policy focus has been dedicated to improving access to finance for SMEs over the last couple of years. As a result H1 (access to finance for SMEs is still pressing problem in Latvia and Italy) is fully supported.

Availability of alternative financing in Latvia and Italy is improving, but nevertheless SMEs prefer to use traditional resources. Medium size companies are mostly using debt capital (short-term credit loans, bank overdrafts and credit lines), leasing, retained earnings, government grants and different kinds of guaranties, especially export guarantees. As for small and micro enterprises the share of own capital and family and friends (so called FF) is dominating in total capital, additionally, very popular are different state support/grants programmes for start-ups.

The share of alternative resources (business angels, crowdfunding, informal investors) that were attracted or are planned to attract in the near future is considerably small, only some percent (2-5%), that supports also H2 (the importance of alternative financing is growing, but is not considered by SMEs as the essential source of external financing). In general the authors have concluded that alternative resources market is undeveloped and it is unattractive as for investors as for borrowers.

The main caveats and directions for improvement for policy makers are as follows:

- Implementation of a "Secondary Stock Exchange Market for the SMEs", for example, Italian experience with mini-bonds and Latvian experience with alternative stock exchange market (Nasdaq First North). Nasdaq First North is a multilateral trading facility (MTF), also known as an Alternative Market, operated by the different exchanges within Nasdaq. It does not have the legal status of an EU regulated market.
Companies on First North are subject to the rules of First North and not the legal requirements for listing or admission to trading on a regulated market.

✓ There is lack of legislation framework that regulates crowdfunding, business angels’ activities, as a result providing additional barriers for the development of this market. It’s necessary as soon as possible to adjust legislation framework as in national as in international levels as well.

✓ Business Angel network in Latvia is very young in comparison with Italian ones, but nevertheless the lack of united networks not only in national level, but in international or regional levels as well, hinders the alternative market development.

✓ More effective use of EU-based funding at the national level through the development of financial engineering instruments, such as:
  - microloans (partly public and private funding);
  - start-up loans (ESI and national state development funds);
  - growth loans (national and EU state support);
  - co-lending (ESI and national state development funds);
  - loan guarantees (ESI and national state development funds).

✓ Establishment of one-stop financial intermediaries in the national level, that will guide and support SMEs through the entire process of attracting finance with minimal administrative burdens.

The current study is not free from limitations. Its current sample consists of ECB, OECD, EC, World Bank and World Forum statistics of SMEs by years; therefore, these findings may have limited generalizability. Future studies that replicate the current proposal, including SMEs surveys in Latvia and Italy done by authors with specialisation on alternative financing resources, may provide a more complete picture or add further dimensions to the current findings.

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