

THE STATE OF SME's ECONOMIC AND SOCIAL RATIONALITY

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ABSTRACT. The paper analyse the economic rationality of SMEs (Small and medium size enterprises) trough some pertinent indicators that reveals the importance of SME for the employment market and for the entire economy. Despite their adaptability these entities have faced always different problems and the most noticeable has been the need of capital infusion. The paper proposes a new type of capital infusion in Romania: the private equity investment. We explore the venture investment mechanism and its implications at economic level for the SME. To identify the economic impact of venture capital, European preliminary figures provided by EVCA (European Venture Capital Association) will be analysed to determine if private equity capital represents a solution for capital infusion in SMEs.

Key words: economic rationality, social rationality, venture capital, SME;

JEL Classification: D29

1. Introduction

We are facing a financial crisis, which has extended itself at all economic levels during the last year.

The crisis took place when a loss of confidence by investors in the value of securitized mortgages in the US resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the United States Federal Reserve, Bank of England and the European Central Bank.

At the time, an indicator of perceived credit risk in the general economy, the TED spread (difference between the interest rates on interbank loans and short-term U.S. government debt) has attained around 150-200 bps. In September 2008 the crisis determined a series of stock markets crash and a considerable number of banks, mortgage lenders and insurance companies failed.

On November 3rd, 2008, the EU commission at Brussels predicted for 2009 an extremely weak growth of the BIP, by 0.1 percent, for the countries of the Euro zone and a negative number for the UK (-1.0 percent), Ireland and Spain. The

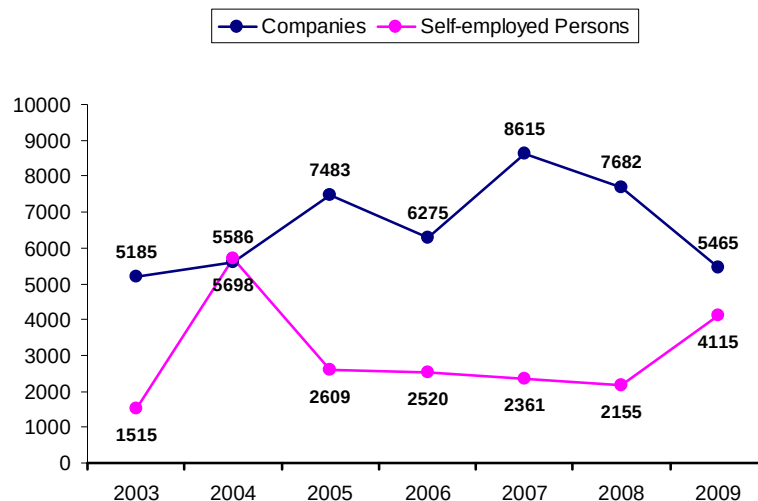
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Bank of England and the Central Bank for the Euro zone, respectively, reduced their interest rates from 4.5 percent down to 3 percent, and from 3.75 percent down to 3.25 percent. Regarding the economic situation of the production sector, all industries seem to be involved. As a consequence, starting from November 2008, several countries launched programs of rescue for their economies.

In these times the SMEs are the most affected organisations. Nevertheless in January 2009 in Romania, were being created no more then 5000 new firms which had an average asset value around 22 000 RON which classifies them like SMEs (classification based on asset level). The trend of creating new-start-ups is decreasing but if we observe also the “self-employed persons”, we can see that the total number of start-ups is the same only the organisation form have been change. [chart no. 1]

Chart 1 : The evolution of start-up in January 2003-2009
[Source of the data: Trade Register]



The phenomenon can be explained by the high level of adaptability of SMEs at the environment. To build a complete image of the Romanian SMEs Sector for a better understanding regarding its specific characteristics (like their adaptability) we will analyze the economic and social rationality of these entities and the difficulties that this sector is facing. The solution proposed by the authors to the most present difficulties encountered at SMEs level, the lack of capital, will be presented in the “Private Equity” Section of this paper. Having a complete picture of this sector trough a series of quantitative and quality indicators we will be able to suggest a pertinent solution for Romanian SMEs lack of capital.

2. Economic and social rationality of SMEs in Romania: general considerations

The SMEs problematic has to be realised in relation with their appearance in Romania at the beginning of 90's, in a specific context of economic transition to a capital market. In all CEE (Central and Eastern Europe) countries this entities have been developed a series of specific characteristics [Nicolescu, 2001, p.127]. Because the economy has faced a complex situation determined by privatisation, reorganisation and the development of SME sector, the genesis of these companies had two origins: privatisation of Stat companies and the foundation of new ones. The first option was believed to be more efficient but in time the new formed companies have been proved a better efficiency because were based on true entrepreneurs and intrinsic private property [During, 1998]. The specific conditions of emergent economies and the speed and amplitude of SMEs creation correlated with the speed and amplitude of privatisation and reorganisation, define a very important characteristic of SMEs: the absorption of manpower available. This characteristic of manpower absorption it's still manifest itself [Table 1] which can be a very important factor in crisis time.

Table 1: Weight of staff in SMEs in total staff by activity of national economy at level of CANE Section [Source: Romanian Statistical Yearbook 2008]

	<i>percentage</i>					
<i>Activity (CANE Rev. 1 sections)</i>	2002	2003	2004	2005	2006	2007
<i>Weight of staff in active small and medium enterprises - total</i>	50.7	54.4	58.2	60.7	63.2	64.9
<i>Mining and quarrying</i>	4.8	5.7	6.5	7.2	10.1	13.6
<i>Manufacturing</i>	41.0	43.9	47.8	49.7	52.3	53.8
<i>Electric and thermal energy, gas and water</i>	10.8	11.9	12.0	12.7	14.6	16.1
<i>Construction</i>	63.2	66.6	68.8	71.5	74.2	75.7
<i>Wholesale and retail, repair and maintenance of motor-vehicles and motorcycles and of individual and household appliances</i>	91.7	91.0	90.3	89.5	87.7	86.3
<i>Hotels and restaurants</i>	84.2	86.0	85.1	85.6	86.2	87.2
<i>Transport, storage and communications</i>	28.7	32.2	38.7	42.5	44.7	46.8
<i>Real estate transactions, rentings and service activities mainly rendered to enterprises</i>	68.5	73.3	74.9	75.4	74.0	74.0
<i>Education</i>	100.0	100.0	100.0	100.0	100.0	96.8
<i>Health and social assistance</i>	97.6	97.9	96.8	95.4	95.2	94.2
<i>Other activities of collective, social and personal services</i>	59.3	61.5	66.5	64.9	64.6	61.9

We can observe from table 1 that in five years the SMEs had a very important proportion in education sector (100% for the time period in question) and wholesale and retail sector (almost 90% for the time period in question). The amplitude of SMEs sector can be appreciated also by the weight of turnover achieved by SMEs in total enterprises by activity sector at economic national level [Table 2].

Tabel 2: Weight of turnover achieved by SMEs by activity of national economy
[Source: Romanian Statistical Yearbook 2008]

percentage

Activity (CANE Rev. 1 sections)	2002	2003	2004	2005	2006	2007
Weight of turnover achieved by active small and medium enterprises - total	55.9	57.4	57.5	57.6	58.7	60.8
<i>Mining and quarrying</i>	3.8	4.1	5.4	5.1	5.6	8.7
<i>Manufacturing</i>	38.5	40.1	39.5	39.0	39.9	40.4
<i>Electric and thermal energy, gas and water</i>	1.7	2.4	3.4	7.7	15.4	25.0
<i>Construction</i>	66.0	69.0	70.2	71.3	73.7	72.0
<i>Wholesale and retail, repair and maintenance of motor-vehicles and motorcycles and of individual and household appliances</i>	86.6	84.5	82.3	79.6	77.4	76.5
<i>Hotels and restaurants</i>	76.1	79.1	77.8	78.8	81.1	81.6
<i>Transport, storage and communications</i>	37.2	40.1	41.9	43.8	46.9	49.3
<i>Real estate transactions, rentings and service activities mainly rendered to enterprises</i>	87.5	89.5	88.8	89.5	88.8	88.2
<i>Education</i>	100.0	100.0	100.0	100.0	100.0	97.1
<i>Health and social assistance</i>	93.2	93.8	92.6	92.1	92.6	90.3
<i>Other activities of collective, social and personal services</i>	54.8	44.9	52.1	53.3	49.8	51.8

We can observe an ascendant trend for the weight of turnover achieved by SMEs in the total turnover made by Romanian companies, from 55.9% in 2002 to over 60% in 2007. Given the figures observed in Table 1 and Table 2, the increasing in importance of SMEs role is highlighted thought manpower absorption and the weight of turnover at all activity sector level.

Taking into account the density of SMEs (number of entities per 1000 residents) and the average size of the firms (resources and reserves per firm), we can appreciate the importance of this sector [Gavrila, 2008]. An essential influence factor is the economic development level of the country of the region in question [Papillon, 2003]. We analyzed some selective data [Gavrila, 2008], which are given in the diagrams 1 and 2. These representations give us tow trends regarding the SME sector: a positive correlation between the level of economic development (GBP per capita) and the average size of SME and a negative correlation with the level of development and the density of SMEs.

Regarding the situation of Romanian SMEs correlation with the economic level of development and the density of this type of firms, we have a reverse situation that doesn't mach the density trend that we have in diagram 1. So in Romania a region with a high level of development is correlated with a higher density of SMEs. [Tabel 3]

This correlation can be used for the implementation of regional development policy.

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Diagram 1: The correlation between the SME density and the economic level of development

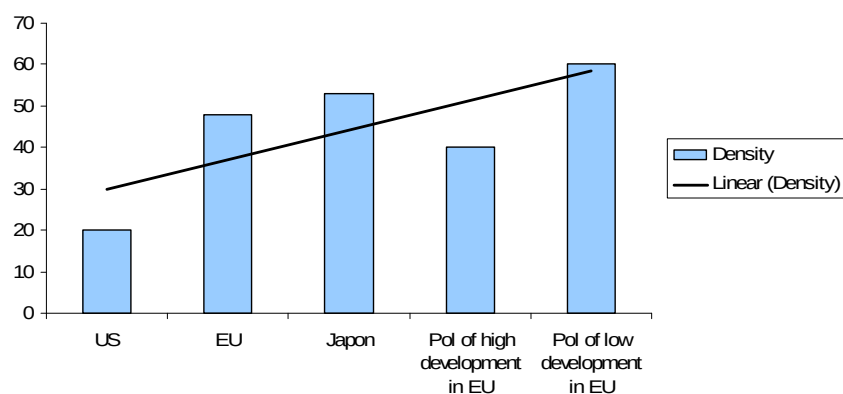


Diagram 2: The correlation between the SME average size and the economic level of development

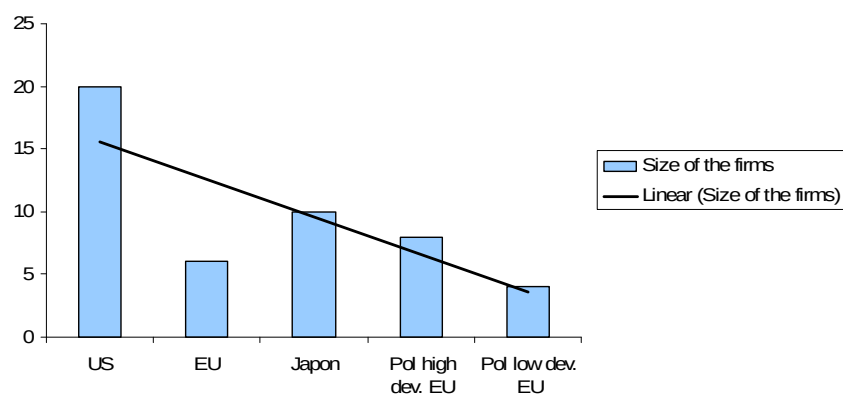


Table 3: The correlation between the regional development and SMEs
[Source: Statistic Yearbook of Romania 2008, p.84, p.512]

Region	Density SME	2005 GBP per capita	2006 GBP per capita
TOTAL	23	13,328	15,896
Bucuresti - Ilfov	54	29,332	34,903
North - West	26	12,526	14,892
Centre	25	13,136	15,969
West	25	14,848	18,272
South - East	21	11,534	13,520
South - West Oltenia	16	10,263	12,266
South - Muntenia	16	10,906	13,109
North - East	15	9,053	10,459

2.1. The dynamic of economic rationality for SMEs

An indicator of efficiency which can highlight the economic efficiency of SMEs sector is labour productivity. We analyzed the level of productivity which have been calculated in two ways: the ratio between weight of the SME sector in the total turnover (Table 4) and the weight of staff at SMEs level and the ratio between gross value added and the weight of staff at SMEs level (Table 5). If the result is equal 1 then the productivity of SMEs is equal with the productivity of the economy. A SMEs productivity higher then the economy productivity is registered when the indicator is more the 1. This means that when the indicator is less then 1, the SMEs productivity is less then the economy productivity.

Table 4: Labour productivity in SMEs depending on turnover (The source of the data that were used for the calculation of the indicator: Statistic Yearbook of Romania 2008, p. 685)

	2006	2007
Economy	0.9317	0.7334
Industry	0.6314	0.6621
Construction	0.9945	0.9516
SALE, maintenance and repair of motor vehicles and motorcycles, Retail Trade	0.7950	0.8688
Retail Trade, repairs of personal and household articles	0.9023	0.8179
Wholesale	1.7823	1.6960
Services for population	0.9745	0.9833
Services for enterprises	0.9858	1.0669

The figures demonstrate a lower productivity in the case of SMEs then for the entire economy. Only for the wholesale the indicator shows us a higher productivity of the SMEs then the economy.

For a more constructive conclusion we calculated also the productivity indicator depending of the gross value added. (Table 5)

Table 5: Labour productivity in SMEs depending on gross added value (The source of the data that were used for the calculation of the indicator: Statistic Yearbook of Romania 2008, p. 685)

	2006	2007
Economy	0.7794	0.7914
Industry	0.5440	0.5682
Construction	1.0738	0.9814
SALE, maintenance and repair of motor vehicles and motorcycles, Retail Trade	0.8560	0.8970
Retail Trade, repairs of personal and household articles	0.9491	0.8451
Wholesale	1.8111	1.7022
Services for population	0.7194	0.6442
Services for enterprises	0.7689	0.8573

Once again the productivity of the SMEs is lower than the economy's, the exception remains the wholesale sector. Even if these enterprises create less gross added value, their profitability can be seen in earning before interest and taxes (EBIT) which represents 60% from EBIT.

We have seen many special features of the SMEs and many survival characteristics but we have to be aware that these companies encounter many difficulties regarding both the production, products and services supply.

The statistics show us that the greatest difficulty of SMEs which is the lack of capital which is very important in creating productivity.

The difficult situation on the credit market which is one of the most important sources of capital for SMEs is not very approachable in financial crisis time, so the alternative solution that this paper proposes is the private equity industry.

The industry is not very popular in Romania where these sorts of investments had been made in general only in big companies and exceptional in SMEs. The need of capital of the SMEs can encounter the private equity fund and the paper will analyze this industry and its implication at economic level [Berger, 1998]. All the consideration empirical and theoretical will be made on European data since the national activity of the industry is not notable.

3. General considerations regarding private equity industry

The concept of private equity is developing over the past decade but the basic principle has remained constant: a group of investors buy out a company and sells it after its value increases [Wright, 1998]. Nevertheless the implications of the investor-portfolio company relationship became an essential element in defining the private equity concept. The investor is not a passive actor regarding the development and the evolution of his portfolio company. His involvement in the portfolio-company is very active and has extended itself at various levels inside the company: management, production, and human resources. The main purpose of the investor is to rise company value and this is a result of a very sustained effort of the investor. The potential of the portfolio-company is also playing an important role of this process, but the portfolio-company evaluation is the start element only, the reason that animates the investor to make the investment decision. The future evolution of the company depends less or more about the involvement of the investor which directly depends of the investment type. The nature of the investment type will be detailed in the section dedicated to this special topic.

3.1. Private equity investment typology and its implication at portfolio-company level

Private equity investments can be divided in two big categories venture investments and buyout investments. These two categories distinguish themselves one from another through the capital flow process and the private equity fund implication in the portfolio-company activity.

3.1.1. Venture Capital

The capital flow in a venture capital transaction is a direct infusion of capital in the company which will be used for a precise objective of the company. There are two distinguish types of venture investments that correspond to the company stage development: early stage investments and expansion investments. The early stage investments can be a seed investment or a start-up investment. The seed investment is a financing provided to research, assess and develop an initial concept before a business has reached the start-up phase. The start-up investment is a financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their product commercially. The implication of the private equity fund at this development level of the portfolio-company has a partnership nature. The portfolio-company is not owned by the private equity fund but it needs its implication and management experience. Regarding the expansion investment (later stage venture) which is a financing provided for development of a company, one may say it is a follow on of an early stage investment. The later stage capital investment may be used to: finance increased production capacity; market or product development; provide additional working capital. The private equity fund implication on this level may be less present because the portfolio-company is mature enough at this point to manage its development process. Even if we observe a certain pattern regarding the private equity implications at certain investments stage levels, there are no rules or requirements regarding these implications. Each investment has its particularities and presents new challenges for the private equity fund.

SMEs are in general the object of this kind of private equity investment.

3.1.2. Buyout Capital

A buyout is a transaction financed by a mix of debt and equity, in which a business, a business unit or a company is acquired with the help of a financial investor from the current shareholders. In this case the capital flow will be absorbed by the vendor and not the company itself. There are many types of buyout transactions: management buyout (MBO), management buyin (MBI), institutional buyout (IBO), leveraged buyout (LBO). The management buyout and the management buyin transaction are buyouts in which a management team acquires an existing product line or business from the vendor with the support of private equity investors. The differences between the two transactions reside in the fact that in the case of MBO the management team is from inside the portfolio-company. The MBI transaction is a buyout in which external managers take over the company. Financing is provided to enable a manager or group of managers from outside the target company to buy into the company with the support of private equity investors.

The IBO transaction is a buyout made by outside financial investors (for example a private equity house) with a minimum of management implication. Alternatively, the investor may install its own management.

The particularity of a LBO transaction is that the portfolio-company capital structure incorporates a particularly high level of debt, much of which is normally secured against the company's assets.

The involvement of the private equity fund in the portfolio-company which is a result of a buyout capital infusion is very important inside the company in question. This time the main shareholder is the private equity fund or the investment syndicate (the private equity firm together with other parties that join the private equity firm) which means the decisional factor depends of the investors.

3.2. Venture Capital Mechanism

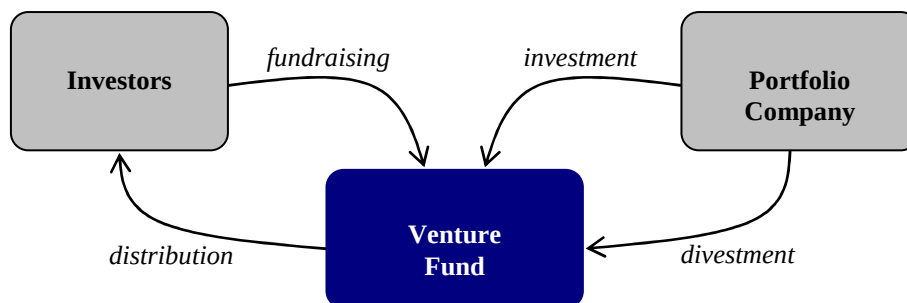
The venture capital mechanism is build by tree actors: investors, venture fund and portfolio-company [Kaplan, 2005]. The investors are entities that have liquidity which has to be placed in some profitable return activity. If they choose a venture fund, they became the investors of that fund. These investors can be: corporate investor, endowment, family office, foundation, fund of funds, other asset manager, financial institution (other than bank, endowment, family office, foundation, insurance company or pension fund), private pension fund, public pension fund, public sector.

When investors commit themselves to back a venture fund, all the funding may not be needed at once. Some is used as drawn down later. The amount that is raised is defined as amount committed or fundraising. The amount that is effectively drawn down at various timings is defined as contributed capital or capital calls. This fundraising process allows venture fund managers to do investments. The second important process of the venture mechanism is the investment which is a contribution of a venture fund dedicated to a company that will became a portfolio-company of the fund. When the portfolio-company reaches the value wanted by the private equity fund managers, the third important process of the venture capital mechanism will take place: the divestment.

The fourth process is the distribution which represents the amounts of proceeds not reinvested in the fund, which is given back to investors.

The capital flow in the venture capital mechanism is illustrated in the bellow figure:

Figure 1: The capital flow in the venture capital mechanism



3.3. Economic impact of private equity industry

The involvement of private equity capital is a long-term support, which goes to those companies, which have at all times, the potential of success and sustainability. There are in Europe, a high number of very promising European companies with great technology and enthusiastic and capable management. Private equity is there for them, to help them build businesses and grow faster than they otherwise would.

The influence of this capital infusion of the private equity fund in all activity sector has shown the need of the private equity funds now more than ever, when the liquidity represents a challenge for many companies in crisis time.

The private equity industry's contribution to employment, growth and innovation in Europe has grown. The industry's role in rejuvenating and restructuring existing companies, as well as its support in financing highpotential and often innovative enterprises [Becheikh, 2006] has become widely recognised. This has been reflected in several previous studies analysing the economic and social impact of private equity and venture capital at both European and national levels [AFIC 2004, BVCA 2004] Even if these studies are realised once at several years because of the time needed by the capital to create true sustainable value, the most recent study at European level show us the positive evolution of job creation by private equity industry.[EVCA, 2005]

Even if the industry is still young, its economic impact is notable, protecting and creating jobs, stimulating technology and being close to life sciences sector. The purpose of these funds is to guide the companies in their achievements regarding their development, growth through strategically advising.

4. Conclusions

After a complete view of the SMEs economic reality which passes through the weight of turnover achieved by SMEs by activity of national economy or the weight of staff in SMEs in total staff by activity of national economy at level of CANE Section, we have been identified the importance of SMEs and their important need of capital.

This paper has shown one of the capital resources that still are active on the investment market and its circulation doesn't have to be conditioned by the borders. This is travelling capital that will implant itself when it will find potential of development.

The private equity industry and its particular part of venture investments, represents the alternative of capital infusion, especially for SMEs that encounter difficulties regarding financing.

The industry is not very notable in Romania, like in other European countries where the venture funds have a special treatment, like in France, the country that supports the funds that made investments in innovative business and SME having also a reduce tax payment.

These actions are the result of the positive impact of portfolio-companies SMEs. This influence is more important with the density of SMEs which represents a source of innovation and job creator, an important element in economic development. Willing to construct a viable economy, Romania has to reconsider many aspects of its vision regarding many economic aspects, one of them is SMEs, which has to be seen from different angles, not only the traditional ones.

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