MICROFINANCE CENTRE

CASE STUDY

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SUPPORTING "GENERATION START-UP": OPPORTUNITIES FOR ROMANIAN MFIS

This case note presents our initial research findings and analysis on the start-up enterprise landscape in Europe (in particular: Romania, Hungary, and Bulgaria). This initial exploratory research was designed to identify current good practice among microfinance service providers serving start-ups; understand the future potential role of microfinance vis-a-vis start-ups; and propose concrete and practical steps to bring about more support for start-ups. This project is being implemented within the four-year Framework Partnership Agreement of MFC and the European Commission within the EaSI Programme. MFC plans to continue the research in additional countries of in Eastern and Western Europe in 2017.

THE BIG PICTURE

Until the global financial crash, Romania was considered the economic "tiger" of Europe, due to its high growth rates (over 7 per cent GDP growth in 2008, recovering to 3.5 per cent by 2015) and rapid economic development. Its transition from a state-planned economy commenced in the early nineties, whilst not always a smooth road, was aided by support from the IMF, the World Bank, EBRD and USAID – as well as high levels of foreign direct investment (totaling $72 billion per annum in 2008). Romania formally joined the EU in 2007. Today, the services sector is the largest sector of the economy, accounting for just under half of employment and just over half of GDP. Industrial production (notably cars and machine tools) accounts for a third of GDP, and the agricultural sector accounts for a third of employment.

Small and medium enterprises comprise over 99 per cent of total businesses, but contribute only 55 per cent of GDP. In terms of "red tape landscape", Romania ranked 36th (out of 190 countries) in the World Bank's Ease of Doing Business survey (down from 35th the previous year). Within the various indices, it scores well in terms of gaining access to credit and trading across borders, yet the "starting a business" index fell to 62 from 51 in the previous year.

Ease of Doing Business Survey: Indices and indicators

Starting a business – Procedures, time, cost and minimum capital to open a new business
Dealing with construction permits – Procedures, time and cost to build a warehouse
Getting electricity – procedures, time and cost required for a business to obtain a permanent electricity connection for a newly constructed warehouse
Registering property – Procedures, time and cost to register commercial real estate
Getting credit – Strength of legal rights index, depth of credit information index
Protecting investors – Indices on the extent of disclosure, extent of director liability and ease of shareholder suits
Paying taxes – Number of taxes paid, hours per year spent preparing tax returns and total tax payable as share of gross profit
Trading across borders – Number of documents, cost and time necessary to export and import
Enforcing contracts – Procedures, time and cost to enforce a debt contract
Resolving insolvency – The time, cost and recovery rate (%) under bankruptcy proceeding

THE START-UP LANDSCAPE

Decades of economic hardship during the Soviet era have given rise to a strong culture amongst Romanians of enterprise, self-sufficiency and resilience—which has spawned a growing commercial business sector and a wealth of technical skills and resources. In the nascent start-up community, a culture of innovation and incubation is emerging. High-quality universities provide a steady stream of talent and innovation. The presence of multinational companies also help certain segments of start-ups as large companies become clients of such startups. The Romanian start-up ecosystem now boasts numerous incubators, co-working spaces and dedicated events to help emerging entrepreneurs. National start-up figures are modest, but growing. However this landscape is not uniform over the country. There are barriers to business growth including a lack of start-up funding, bank lending and equity investment, as well as a relatively small domestic consumer market (source: Start-Up Manifesto). So too does a lack of complementary business skills (including marketing) limit the potential growth of start-ups; indeed government statistics point to the fact that nearly 60 per cent of microenterprises do not create employment opportunities beyond the family unit (source: Horizon 2020 report).

The stakeholders whom we interviewed in this initial research phase noted that the majority of start-ups they work with are active in the service and trade sectors (e.g., transportation, beauticians, and market traders), rather than the industrial or agricultural sector. This observation is in line with the Horizon 2020 report, which notes the concentration of small businesses in the services and trade sector. Typically too: the report also points to a failure rate of two-thirds in the first year of the typical small business—so the scope for increasing support to the start-up segment is wide indeed.

THE SURROUNDING ECOSYSTEM

Government support

In 2014, the Romanian government published its National Strategy for SMEs and Business Environment (Horizon 2020), which outlines its seven-year programme to create a favourable environment for business, private initiative and entrepreneurship, stimulating the creation and development of small and medium enterprises (SMEs) and support to increase the competitiveness of the local business environment but also the development of existing businesses and creating new jobs by the end of 2020.

A key part of governmental support for start-ups comes in the form of the National Agency for SMEs and Co-operatives (DAPIMM) and its SRL-D programme. SRL-D targets those people with no previous business ownership experience. Whilst initially the programme was only available for those under the age of 35, the age restrictions have since been lifted. The programme has two key tracks:

- Launching a company with 2-4 employees (which qualifies the business for tax and social security exemptions) with a commitment that the business keeps those staff on for at least 3 years.
- Reimbursement of up to half of the approved business budget (up to €10,000) for equipment and the like – with a commitment that start-ups cannot sell those assets, or close the business, within a three-year period.

DAPIMM also has a non-financial services programme (called EMPRETEC) to promote an entrepreneurial culture and skill base among its beneficiaries. EMPRETEC is a 10-day training curriculum (designed at Harvard) and certification program. The training covers standard business topics such as: SWOT analysis, sales and marketing. A typical course costs €8,000, but when government funding can be secured, then the end-user receives the training for free.

Other support organisations

Startmeup Romania is a new not-for-profit support organisation (launched in late 2016) funded by donations from corporate CSR initiatives. It currently develops education curricula for young students, but also plans on providing business development support services in future. It also plans to engage in research-based policy work, as a way of engaging with the debate around reducing barriers for new entrants the marketplace.

Whilst most starts-ups are in the IT and tech sectors, Startmeup sees its role in supporting more service-based businesses. So too do most start-ups obtain their seed capital from either external (foreign) or private sources (family or crowd-funding). That said, Startmeup notes that Romanian law changed last year to allow tax deductions on income invested in a small business (the so-called "angel investment" law).

NEEDS OF ENTREPRENEURS

Our initial discussions with local support organisations, financial service providers, and entrepreneurs themselves revealed a range of ways in which start-ups need support. These include:

- **Access to credit:** Start-ups are variously defined as: 1) someone with a business idea but no registered company, or 2) a company aged less than 12 months (without one year of financial activity, they cannot access bank credit), or 3) a company aged less than 24 months (with one year activity financial statements they already have access to banks). They need both long-term investment and working capital – with long grace periods and tailored repayment schedules that match both the instability and projected growth of turnover/cash flow. The terms should also accommodate a break-even point that might be as far as 24 months in the future.

- **Innovative ideas:** Given the sheer number of existing SMEs, few start-ups are created with the aim of taking a truly innovative idea to marketplace. Often, start-ups are created when a person "branches out" – taking skills they learned in formal employment and opening their own business. However, franchising existing models can potentially offer a good "low risk" means for someone to start a business in a sector they're less familiar with, or when someone needs to start a business (after losing their job, for example) without a business idea of their own.
- **Business skills:** Few start-up entrepreneurs understand how to analyse their break-even point, do cash flow analysis, conduct market research or write a business plan. They also lack the critical "hustle" needed to kick-start their business in the first few months: expecting customers to come to them, rather than going out and "pounding the pavement" to increase visibility and sales.
- **Business development support:** When it comes to training services, there seems to be both a supply and demand problem. That is to say: few organisations within Romania offer these types of services; likewise, few new entrepreneurs are prepared to admit that they lack the business acumen required for success. Similarly (and perhaps this is a remnant from the Soviet era), some people (older generations in particular) are hesitant to openly discuss their business concept lest someone "steals" it.
- **Networking opportunities:** Horizontal networks between start-ups can provide a rich source of peer support and knowledge-sharing, which can complement more traditional training activities.
- **Mentoring:** Where entrepreneurs have great ideas but poor implementation skills, mentoring and coaching can help keep them motivated and help them respond effectively to the challenge of running a business

CURRENT MICROFINANCE INITIATIVES

MFC has approached microfinance organizations in Romania to ask who is working with start-up clients (defined as client who has business up to 2 years of existence). Two organizations responded and agreed to extensive onsite visits by MFC staff to discuss their experience. In addition, we held other meeting with organisations working in the start-up space, including phone call with ROMCOM.

Vitas Romania

Vitas Romania (established in 1996 as CHF Romania) provides traditional microfinance services, offering the services to "unbankable" entrepreneurs. Their market shrinks however, due to the number of banks moving downstream and undercutting their market. As part of searching for niche markets, it is planning to deliberately target the start-up market in future (a segment where banks are not active).

That said, Vitas does have significant ad-hoc experience with start-up clients within its portfolio. In the past, it has offered an interest-only credit line product with an end-of-term lump-sum repayment. The loan was disbursed in tranches, with each tranche disbursed once it confirmed that the previous one was spent according to the agreed plan. In some cases – tranches were disbursed directly to a supplier. In terms of approving new clients – as start-ups lack business and credit history, Vitas assesses the applicant's skill set and business plan. It also requires collateral (in the form of relatively liquid assets), or a guarantor, for each loan.

Vitas Romania's credit line product

Having access to the right amount of capital at the right time for the right amount of time (and not paying interest on credit until it's being used for productive purposes) was crucial for start-ups managing small and unstable cash-flows. For this reason, Vitas' credit line product was an ideal fit. However, from an investor's point of view, it's a highly risky product; because it is classified as a restructured loan, it is counted as "portfolio at risk" and weakens an MFI's financial position. For this reason, MFIs need investors to provide patient capital that looks at risk in the long-term, rather than the short-term—and defines "success" using different metrics along the way (such as growth in turnover, job creation, etc).

On a small scale, Vitas also offers free business training services (the training curriculum development was underwritten by a donor) in the areas of financial analysis, strategic planning and business assessment (from the perspective of a lender or investor). In 2015, it also launched a "best start-up business plan" competition for new entrepreneurs, offering a €5,000 grant to the winner. The competition includes a workshop for applicants, training them to create a business model canvas (including financial projections). Vitas has spending relatively little effort on promotion, and despite receiving only a modest number of applications in the first year, the second year has seen a marked increase in interest from the general public (the importance of building the trust of the public that this is a reliable initiative is not to be underestimated).

Considering their experience with start-up clients to date, they note the following lessons and challenges:

- Start-ups most often fail due to some combination of the following factors: an inability to keep expenses under control, and an inability to break even (because of poor planning, high competition, and the need to break even in the short-term rather than the medium term).

- The cost of microfinance investment funds is coming down, but not enough to close the gap with what clients can get from banks after their first year of operation.

- The traditional MFI approach of graduating businesses from micro to small business (through loans that aid business expansion) isn't appropriate for start-ups. Start-ups are more volatile, more uncertain and slower to grow and become sustainable–thus the role of the MFI is to provide the right amount of funding and flexibility until start-ups achieve a measure of financial stability (not limited to a year's worth of statements).

- Non-financial services are expensive, unless you create standardised digital services (although in Vitas' view, tailored support is better than a generic package). Because of this, MFIs offering non-financial support requires a shift from a "profitability" to a "sustainability" mindset.

- MFI staff need to be highly skilled to deliver business development services effectively.

good.bee Credit

good.bee Credit was launched in 2008 and is active in microfinance and small enterprise finance. It has 20 branches across every county. Ninety per cent of its portfolio is in small-scale commercial agriculture. It typically reaches "unbankable" clients, and aims to "graduate" them to traditional banks in future. Many of their clients are so-called "unbankable" because their level of income is too low—others because some or all of their income is earned in the informal sector (which isn't taken into consideration by banks).

As its targeting is based on economic sector, good.bee Credit's experience to date with start-ups is modest (and incidental). It doesn't serve the youngest start-ups in the marketplace—focusing instead on individuals with 2-3 years of trading experience that convert into companies in order to expand (and are thus technically "start-ups"). Nominally it offers loans to firms with as little as three months' experience – but this threshold will soon increase to 12 months. Particularly in the agricultural sector, this 12-month threshold is important for assessing the potential viability of the business (whereas with trading/services companies, the future trajectory is easier to see after 4-6 months). Where clients approach good.bee Credit with a new idea (rather than an established self-employment concept), good.bee Credit mitigates its risk by assessing the clients' level of business experience, business plan, investment by the client and collateral structure.

In future, good.bee Credit plans to diversify its portfolio towards a more urban market, which could potentially include start-ups as well. To do so, it would need to mitigate its own risk levels–potentially by offering coaching/training services. This would be delivered by a specialist partner organisation, rather than directly—because they see it as a conflict of interest to fund and advise the business concurrently. It would also be important to work out what sort of collateral arrangements were most effective – even symbolic or "psychological" collateral (e.g. small amount of money put into business by client, entitlement to equipment bought using loan capital, and friends who guarantee the loan). That being the case, good.bee Credit (a beneficiary of the EaSI guarantee facility) would be in a position to disburse relatively unsecured loans to start-ups.

ROMCOM

IFN ROMCOM SA is a small size non-bank financial institution incorporated in 2006 as a microcredit provider, headquartered in Oradea (northwest Romania) and active mainly in northwest and western regions. It provides long and short-term loans for investment and working capital to start-ups and the SME sector, as well as non-financial services (in the form of training). Its aim is to support economic growth, and as part of this nearly a quarter of its portfolio is invested in start-ups.

ROMCOM doesn't set a lower threshold in terms of business age; it works with start-ups with less than 6 months of activity, or even with entrepreneurs that haven't formally registered their business yet (although loans are only disbursed to registered businesses). Loans are available for long-term investment (provided that the business can prove it has working capital), or short-term working capital (with a 12-month maturity). All loan applications include a thorough cash flow analysis, whether the applicant has their own capital to invest (as opposed to other borrowed sources of capital) and a collateral guarantee (in the form of land, property, or equipment). It also considers the skills and experience of the client regarding the implementation of the new business, and interrogates the business model carefully (revenue streams, income projections and product offering) to ensure that it is realistic. It has no credit scoring model as such, but the assessment process is quite thorough. At this point, it is unable to offer unsecured loans to start-ups.

ROMCOM's non-financial services include business development, business management/administration, time management, strategic planning and implementation of EU and governmental grant funds.

The organisation's general reflection regarding the start-up scene in Romania is that access to markets and clients is a challenge for start-ups. However, there are certain incentives for young entrepreneurs, offered by government (as described earlier). In terms of the businesses themselves, a culture of innovation seems lacking, as does a broader ecosystem of support organisations.

NEXT STEPS

Our general reflection in each country we visited was that MFIs act as quite an effective filtering mechanism to identify those start-ups that show promise from the outset. The importance of this is underlined by the fact that failure rates in the early stages are quite high, leading to a high destruction rate of those jobs they initially created. Inasmuch as MFIs tend to work with the newest of the start-ups, then weak performers would be culled before they failed. In theory— if the start-up market had a smaller number of higher-quality businesses, then competition for market share would be less intense for everyone in those fragile first few years of existence.

Setting the groundwork: Defining terms and attitudes

In our interviews, it became clear that there is little consensus on what precisely is considered a start-up enterprise in Romania (that being a firm with anywhere between zero and three years of experience). A clear definition is needed–not just to provide a sense of coherence, but also to frame regulations and financial products targeting this sector.

It's also important to recognise that not all start-ups are the same, and should not be treated as such in terms of funding and support. Consider for example the differences in *why* people launch start-ups, and how that impacts upon their likely growth trajectory. You might expect to see more entrepreneurial zeal (and therefore greater growth potential) from someone who launched a start-up to bring a new idea to market, and less in a start-up launched by a retiree wanting to turn a hobby into a small income stream. Some start-ups exist with the sole aim of providing an immediate income to someone who has recently been laid off by a formal employer. MFIs currently parse different start-ups not just by age but by level of experience, which helps in terms of segmentation and product tailoring.

So too do all actors in the start-up ecosystem need to support a culture of risk-taking, and of "fail fast, fail forward" learning. The current mentality around failure is a barrier to innovation, iteration and peer learning. It also prevents would-be entrepreneurs from leaving the security of formal employment to realise their dream of starting a business.

Potential support from MFIs

Based on the experiences and insights we heard in our field visits, we've outlined a number of potential solutions that MFIs might consider in future, including:

- **Offering bundled services:** (grant plus mentoring plus loan). Under current regulations, MFIs are limited to lending only. MFIs could advocate for a change in this respect, in order to play a larger role in the early stages of a start-up (even potentially engaging in equity investing, rather than relying on grants and loans.).
- **Guarantee fund:** The current EaSI guarantee scheme should be adapted not only to be available by a larger number of smaller MFIs, but also it should be adapted to the needs of start-ups (in particular the acceptable risk levels associated with this specific segment).
- **MFI-NGO partnerships:** to deliver business development services(by NGO) and investment (by the MFI)
- **Advocacy with MIVs:** In order to offer affordable financing to high-risk niche groups such as start-ups, and close the cost gap with traditional banks, MFIs need more competitive funding rates from their own investors. Also, the acceptable standards of portfolio performance should differ in the case of an MFI serving start-ups. One potential way to approach this would be for actors in the Romanian microfinance sector to compile basic data about the number of start-ups financed, and the number of jobs created and sustained as a result.
- **Subsidies for MFI clients to use non-financial services:** In early 2017, the EC will launch a co-financing program offering of non-financial services to clients, likely for those MFIs financing migrants (the funding conditions are not yet clear). MFIs receiving EaSI guarantees and providing non-financial services will receive a set subsidy per client served, under condition the client recruits from the certain target group. A similar program could be offered for start-up clients.
- **Public resource centre** (e.g. a website) listing tools, trainings, resources, etc designed to support start-ups. The EU could potentially sponsor a mapping exercise for this activity, offer an incentive to organisations to share their best practice tools publicly, and potentially have a budget to translate the best free international resources available.

Funding

The landscape of funding isn't ideal for start-ups in Romania: banks have access to much cheaper funding than MFIs, but they do not provide financial support to start-ups. Some MFIs offer financial services to start-ups but at a higher cost, which often prices start-up clients out of the market. One potential solution for this is to create a dedicated financial instrument for MFIs (especially smaller ones) specifically to on-lend to start-ups.

Other bottlenecks in the funding landscape relate to the nature of the currently offered EU funding for microfinance (EaSI guarantees): only banks and a few biggest MFIs have access to these. And it is a common knowledge MFIs are much better positioned to serve micro and start-ups, due to the nature of their relationship with their clients. Reducing barriers to funding for MFIs is important—but so too is a commitment on the part of MIVs to provide patient capital that looks at risk over the long-term rather than the short or medium term.

For the start-ups themselves, the landscape of funding opportunities is complex, opaque and daunting—to the point that often start-ups need to hire costly consultants to take them through the process. It would certainly be helpful for start-ups to have clear, free-of-charge guidance on how to apply for public funding (at a national and EU level).

Furthermore, peer-to-peer lending (angel investing) is still relatively rare in Romania, but hopefully with recent changes to the law it will flourish in future.

Government support

Encouraging cross-sector collaboration: There might be a case for different organisations taking the lead at different stages of the life-cycle of a start-up. For example, government bodies (national or EU) could offer grants (pre-seed and seed capital) and training to start-ups in the early days, with the aim of "graduating" them to MFIs for small loans for investment and working capital. After a few years, start-ups could graduate either to banks or investors, depending on their circumstances.

Reducing barriers to entry: For many start-ups, the informal economy is the specter at the feast. The red tape, *and cost,* involved in starting (and closing) a business is prohibitively complex, and therefore many people choose to stay in the shadow economy. However, for those business that are regularised, onerous and (frequently changing) regulations demand proper invoices for all transactions (with suppliers, purchasers, etc.), which precludes formal businesses from trading "on the books" with these actors. Unfortunately, this often means that start-up entrepreneurs are forced to buy and sell outside of their social networks, which can be more costly in terms of time, effort, and risk mitigation.

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Annex one: Details of Government plans to support start-ups in Romania

	Goal 1: SUPPORTING and PROMOTING ENTREPRENEURSHIP
1.	Supporting start-ups, with an emphasis on sectors with creative potential, rural start-ups
2.	Supporting the development of entrepreneurship education at all educational levels
3.	Entrepreneurial support programs (tutoring/mentoring/counselling, support, role models, etc.), including the vulnerable social groups/disadvantaged (e.g. women entrepreneurs, youth, immigrants, the unemployed, persons legally obsolete system of social protection, disabled persons, etc.)
4.	Facilitation of modern structures in support of business and improvement of existing ones (e.g. incubators/accelerators, tech centres and business hubs, industrial excellence clusters, , design centers, local production centres under the banner of "one village-one product; a city-an industry "etc.)
5.	Promote ethical behavior in business and supporting honest entrepreneurs wanting to start a business
	Objective 2: Support SME access to APPROPRIATEFINANCE
6.	Supporting creation and development of mechanisms and instruments for SME financing (including financial intermediaries and investment vehicles)
7.	Supporting the creation and development of networks of private investors
8.	Enhancing accessibility to micro-lending funds to SMES in rural areas, belonging to disadvantaged categories (women, youth, persons with disabilities, etc.)
	Objective 3: INNOVATIVE SMEs
9.	Encouraging technology transfer
10.	Development of professional and managerial education
11.	Development of business consultancy services for SMEs
12.	Development of a support system for innovation at national level
13.	To encourage technical and economic cooperation of SMEs with large businesses, especially in the field of technological and commercial innovation
14.	Supporting recovery of the competitive advantages of SMEs with potential for extensive developmentand promoting the benefits of obtaining intellectual property rights/industrial/commercial
15.	Supporting the implementation/management systems certification, as well as voluntary certification of products and/or obtaining the eco-label for products
16.	Supportconnecting SME into peer networks
	Objective 4: Access to MARKETS and the INTERNATIONALIZATION of SMEs
17.	Fostering the use of information technology in the work of SMEs
18.	Supporting the development of e-commerce and other online business models
19.	Boostthe formation and development of business networks
20.	Strengthening internal capabilities of SMEs to participate in the global market
	Objective 5: Create an SME-friendly regulatory environment
21.	Boost forms of collective bargaining power of SMEs
22.	Adapting community legislation in the field of SME and ensuring compliance with regulations
23.	Identify, reduce/simplify the tasks of administrative barriers faced by business
24.	Improving the regulatory framework for SMEs
25.	Improving the mechanism for consultation of SMEs in the process of development of new legislation
26.	Improving the quality and efficiency of public services intended for the establishment and conduct of the business