CASE STUDY

February 2017

SUPPORTING "GENERATION START-UP": OPPORTUNITIES FOR BULGARIA

This case note presents our research findings and analysis on the start-up enterprise landscape in 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

Bulgaria is an upper-middle-country that is a non-Eurozone member of the EU. Since transition, it has achieved solid growth, marked by periods of crisis (for example when its gas supplies were shut down during the Russia-Ukraine gas dispute) and policy incoherence (for example with contradictory tax and spend mandates, and onerous red tape for foreign investors). Its recovery since the 2009 global financial meltdown has been slow (at times stagnant), and has not yet reached pre-crisis GDP growth rates. A third of employment is taken up by the industrial sector, however this is marked by low productivity and competitiveness on the European and global markets, owing to low levels of innovation and research funding. Two-thirds of jobs are in the service sector. Unemployment, having hit double digits as recently as 2003, reached a nadir in 2008, and after a spike between 2012-15, has since fallen to 8 per cent. Bulgaria's flat 10 per cent income tax, designed to stimulate GDP growth, is the lowest in the EU.

In terms of "red tape landscape", in 2016 Bulgaria ranked 37th (out of 190 countries) in the World Bank's Ease of Doing Business survey. Within the various indices, its scores have improved in terms of paying taxes and getting electricity (historically its weakest areas), yet it still only ranks 78th in terms of the ease of starting a business. In line with EU measures, Bulgaria ranks 24th (of EU nations) in terms of entrepreneurship.

BOX 1: 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

Start-ups in Bulgaria are typically defined as a newly registered business with less than 6 months of activity. Typically, a start-up is the natural extension of formal employment – whereby an entrepreneur continues a similar activity under his/her own new brand, or runs a start-up in parallel with an unrelated line of work (as a side line, with the family involved in day-to-day management).

As with elsewhere, tech firms are the most common types of start-ups, although due to their high capital requirements and risk profile these are generally not served by MFIs. So too are these firms based in the capital, Sofia, and around Plovdiv, a key software and manufacturing hub in the south. Sofia's recent transformation into one of the leading Eastern-European start-up hubs is based on the success of a small number of these tech firms, which have won international awards for their work. MFIs, on the other hand, will tend to focus on agricultural (farming or livestock) or service-sector start-ups (shops, trade), providing both investment and working capital loans.

In terms of investment in the sector, the 2014 European Accelerator Report ranks Bulgaria 4th (although it ranks lower in terms of number of start-ups accelerated). In 2012, the European Investment Fund (EIF) allocated €21m to two venture capital funds – Launchub and Eleven (one of the top 10 European investing accelerators and venture funds) through the JEREMIE program. JEREMIE is co-financed by the Bulgarian government, and has helped to nurture the tech start-up sector in the country. According to those we interviewed, the view is that Bulgaria boasted the most effective use of JEREMIE funds. Since that time, private funding has started to emerge, but some would argue that it is not keeping pace with demand. Additionally, the shift in government focus towards financial instruments has effectively cut MFIs out of the loop, since only commercial banks are eligible.

THE SURROUNDING ECOSYSTEM

The view of those we interviewed was that the start-up ecosystem is fairly well-developed for the tech sector, and weaker for other sectors.

Financial landscape

The Bulgarian business landscape is divided into formal and informal businesses. Those in the formal sector are increasingly served by commercial banks and credit card companies. The informal (shadow) economy is still thriving (particularly given the level of red tape involved in starting a business), but implies a higher level of risk because its activities are "off book", and loan leak to consumption purposes is quite likely.

In order to access credit from a commercial bank, a business needs at least 12 months of documented operations. For this reason, MFI funding is critical to start-ups in the early stages.

Furthermore, "quick loan" companies (which, although registered as non-banking financial institutions along the MFIs, are generally predatory in nature) are starting to advertise "microloans", and so the line between micro and consumer credit is becoming blurred. A recent sharp rise in consumer loans has led the government to introduce APR transparency guidelines, however without requiring companies to include fees and commission charges, the regulation has not had the desired effect. Instead, companies can claim transparency without the bother of actually having to be transparent.

Government support

On paper, Bulgaria boasts a coherent national strategy called the Small Business Act (which runs until 2020). The SBA is designed to encourage entrepreneurship (through education and cutting red tape), promote innovation and risk-taking (through reforming bankruptcy laws), to create a positive enabling environment (by reducing the regulatory burden on small business) and encouraging access to finance, among others. However, none of the organizations that we interviewed we aware of the strategy, or any current activities associated with it. It would seem, from the brief cross-section we considered, that the government has a lot of work to do in terms of "joining up the dots" between different key players in the start-up landscape.

Those we talked to were, however, aware of past government support for start-ups. For example, in years past, the government had a grant/training scheme to new entrepreneurs, managed by the labor office. The scheme, now closed, was well-intended, but arguably the grants were too large for new companies to manage, and its "classroom learning" approach didn't provide inexperienced entrepreneurs with the real-life experience they needed to make their business a success. However, this program is no longer running.

So too did there used to be a Ministry of Labor focused on job creation; once a business could prove it has created jobs (and maintained them for a certain period of time) then up to half of your loan would be forgiven. It was seen as an effective program, not least because it encouraged informal businesses to formally register.

Until 2010, the National Business Development Network (NBDN) united 34 business centers and incubators across Bulgaria as part of a UNDP program. The largest of these was in Nova Zagora, which served 10 start-ups with office space, equipment, training and mentoring. However, the business centers were located in municipal buildings, and when the UNDP funding came to a close they were evicted from their premises. A few remain in operation offering English and accounting courses, but further support (or even attention) from the government is not forthcoming.

Maritza Cooperative

Maritza Invest is a cooperative with 753 members and 5 staff. It was launched in 1996 thanks to a small EU grant, and has continued thanks to its commercial investors (Oikocredit and COOPEST). Of its total membership, 460 have active loans, and 3-4 per cent of these are start-ups. Their member start-ups are by and large from the agricultural sector (a risky investment, for which reason loan sizes are carefully managed). They offer unsecured loans but generally ask for salaried family members to act as guarantors. They also only offer loans to farmers that have been officially approved by the EU Young Farmer's Program. Maritza is financially unable to offer training to its clients, although it clearly recognizes the need for this.

NEEDS OF ENTREPRENEURS

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

- Supply vs demand for credit: Interestingly, those we interviewed did not identify funding as a "crunch point" in the lifecycle of start-ups. Rather, they pointed to a lack of suitable business ideas to fund. Specifically, with decreasing unemployment rates, new applications from start-ups have been decreasing as well. One way of tempting entrepreneurial individuals out of formal employment might be to provide them with start-up grants, rather than loans. This, however, would need government financing to achieve.

- Bureaucracy: The biggest hurdle to today's start-ups is the sheer number of bureaucrats standing in their way, and whether they are feeling supportive on any given day. Local health inspectors, local tax collectors, local safety inspectors, the labor authority – these all have a say in whether a business can operate, and their decisions can seem arbitrary at best. Corruption and nepotism in the bureaucracy is also rife, such that an entrepreneur's personal connections matter more than his/her business acumen. This corruption also works to dampen the free market in smaller towns — so that often even the best ideas cannot be brought to market.

- Seed and pre-seed grants: Grants would be an effective means of getting businesses onto the "start-up ladder". MFIs are less keen on grant-making, as they believe it sends mixed signals to their credit clients. However, these grants are best administrated by the EU, rather than the national government (insofar as corruption and mis-handling is concerned). One suggestion would be for grants equaling one year of per capita GDP (currently around €7K) to be available to anyone wanting to start a business. Even if only 20 per cent of businesses reached maturity, the potential employment effects and resulting contributions to the public purse could offset likely losses.

- Business management skills: New entrepreneurs typically lack the skills needed to successfully manage a business on a day-to-day basis (such as market analysis, marketing, financial management, accounting, etc.). Training courses are helpful to lay the foundation, but on-going mentoring within a real business setting can often be more effective. Free or low-cost training options are limited for those people that want to develop their skills.

- Financial literacy: many start-ups rely on consumer credit for seed and pre-seed funding, but given the rise in predatory lending (and cross borrowing) in Bulgaria, it's important for clients to understand the terms and conditions of the financial products they use, and to know their rights and responsibilities.

CURRENT MICROFINANCE INITIATIVES

Mikrofond

Mikrofond JSCo is a joint stock company operating across Bulgaria via a network of more than 10 branches. The microfinance institution (MFI) mainly disburses loans to micro and small entrepreneurs in urban and rural areas. Mikrofond JSCo offers a broad product range including start-up loans, agricultural loans, microloans, student loans and energy efficiency loans. The MFI has a special focus on groups with particularly limited access to financial services, such as female entrepreneurs, young entrepreneurs, entrepreneurs from minority groups or with disabilities. In 2010, Mikrofond obtained PROGRESS funds of €3m to support its lending activities. Other institutional investors include EIF (€2 million), Oikocredit (€.8m), responsAbility (€1m) and Coopest (€300K).

Mikrofond has worked with start-ups since 1999, when it was a foundation. At the outset, it rarely rejected an application from a start-up, which resulted in a high (90%) failure rate. Since then, it has learned to be more critical about assessing the business concept, business plan and the entrepreneur's general creditworthiness. This acts to reduce risk both for the organisation and the client, especially in the case where Mikrofond's view is that the business plans needs to be scaled back until the concept can be proven. Unsalaried individuals (i.e. unemployed people) applying for start-up loans are required to provide a salaried guarantor. Given the high historical levels of unemployment, Mikrofond notes that start-ups are seen as a job security solution (and can potentially be a successful one of the quality of the business idea is high enough). Today, less than 15 per cent of its portfolio is invested in start-ups.

Microfond also reflects that the market is evolving rapidly in Bulgaria, and it can be difficult for small businesses to stay tuned into, and ahead of, these changes. For example, in times past, small shops were a low-risk start-up venture, whereas when larger box stores emerged, small shops had to "go niche" or close their doors. In terms of which applications to approve, Mikrofond relies heavily on skilled loan officer assessment. It doesn't just come down to the numbers in the business plan — the idea needs to have potential within the local market. Over the years, loan officers develop a good sense of what works, and what doesn't — what stumbling blocks arose with similar businesses in the past, and how those can be avoided. In fact, Microfond has built up a "business failure database" from the experience of disbursing €1m over 1,000 loans, half of which failed. Storing and managing this knowledge is vital to understanding the potential of future start-ups.

Mikrofond takes a number of steps to manage the risk of its start-up loans. First, it prefers to provide investment loans (e.g equipment and other assets) and rely on the entrepreneur to provide the working capital. It also requires proof of investment (such as receipts) to ensure that the loans are being used correctly. Secondly, each application depends on a successful credit bureau check, as outstanding consumer loans signals a lack of repayment capacity (especially in Bulgaria, where cross-borrowing is on the rise). Mikrofond has a client-friendly repayment policy for its start-up clients: flexibility is offered

It does not have a dedicated start-up product, offering its standard 36-month secured loan of up to €10K. Credit is available more cheaply through JOBS programs, as well as through commercial banks (for those with enough experience). One of these, Unicredit Bank provides unsecured loans and credit cards to clients with no credit history, although this is limited to Rasgrad and surrounds. Also – the willingness of commercial banks to fund start-ups often depends on the willingness of the branch manager to assume risk, rather than an institution-wide policy. Why would clients choose Microfond? Well, Microfond finds that its clients are not as price sensitive as it would have expected; rather they come for the quick turn-around time. For example, a good client can obtain a next-day secured loan of up to €10K.

USTOI

USTOI is a non-bank financial institution that emerged from a Catholic Relief Services microfinance program of the same name since 1998. Its aim is provide access to financial services to micro entrepreneurs or representatives of different ethnicities with limited or no access to financial resources.

USTOI defines start-ups as businesses that have not yet reached break-even, regardless of how long this takes (in some cases up to three years). It will work with any business that can prove it has at least 4 months of activity, and provides a loan product especially for start-ups. Typically, the critical window for start-up failure across the EU (according to some studies) lasts until the 24-month mark. By and large, failure is due to a lack of business skills (especially among first-time entrepreneurs) and an inability to adapt the business idea to a changing environment (e.g. starting cheese production when the price of milk bottoms out).

USTOI screens its applications carefully in terms of cash flow analysis and current liabilities. Some start-ups use "quick loans" (predatory online credit providers) to finance the seed stage, and refinance with USTOI once they break even to reduce their repayments and get a lower interest rate. USTOI provides secured loans up to 65 000 BGN (approx. 33 000 EUR) for a period of up to 10 years at competitive interest rates (compared to similar bank products). Interest rates vary depending on the loan size, the proposed collateral and the lack or presence of credit history with USTOI.

Like Mikrofond, USTOI finds that its clients are rarely price-sensitive — preferring disbursement speed and ease of access instead. USTOI only competes on price when it comes to more mature businesses (where commercial banks can offer more affordable credit). USTOI's sees its collateral requirements as a necessary evil: it protects the institution from risk, but decreases its potential outreach. Were an EU guarantee mechanism to be created, then it could potentially lower its securitization thresholds.

Business development services (BDS) are certainly in demand, and certainly start-ups need to access free or low-cost services – but the question remains of precisely who should pay for them. At present, USTOI provides mentoring services in business planning and financial management to clients, but doesn't have the funds to subsidize full scale BDS. USTOI is in a process of developing a BDS operation as well as would be open to work alongside a specialized provider who receives grant funding for their work. In USTOI's view, much like they expect clients to put a little capital on the line in order to obtain a loan, it would be appropriate to expect clients to cover some of the costs of BDS, even if it's a symbolic contribution (such as €2).

SIS Credit and SIS Coop

SIS Credit arguably boasts the most well-developed suite of products for start-ups, including credit and non-financial services. These include:

- Start-up loan: for companies with less than 12 months of history to purchase assets and provide working capital. These secured loans range between €1,500-€7,500, and offer a 6-month grace period and a 36-month maximum maturity and no early repayment fees.

- Working capital loans: Short-term, fixed-rate unsecured €500-€2,500 loans with a maximum 24-month maturity.

- Innovation Loan: For businesses wanting to boost sales or optimize its processes through equipment upgrading. Loans range from €1,500 to €5,000 with a 36-month maximum maturity; secured through a guarantor or an asset pledge.

- Business development loan: Aimed at small and medium companies with significant operations that need fast funding to be used over a short period of time for asset acquisition or process innovation. Loans range from €1,500-€25,000 with a maximum maturity of 36 months and an optional 12-month grace period.

- Business development services (BDS) to micro businesses: Many micro and small enterprises do not have access to information about topics that are important for their business. That's why SIS Credit provides not only loans, but also BDS. This includes assistance in applying for EU grants, brokerage of all kind of insurances, tax and accounting advices, and legal advice. SIS Credit also provides free of charge consultancy to clients in the field of business planning. The practice shows that many entrepreneurs who want to start their own business are not able to elaborate their business projections and to create a business plan. This is why SIS Credit is trying to develop this area of expertise further. In addition, SIS Credit offers Bank intermediation service. SIS has intermediary contracts with most of the Bulgarian banks and supports customers to receive bank loan by consulting them with the collection of the required documents, preparation of business plan and financial projections and recommending the bank that offers the most appropriate product for their needs. There are many micro and small enterprises that SIS Credit initially finances and then helps them get a conventional funding on a subsequent stage. This service is highly appreciate by start-ups that have been funded by SIS in the early stage of development and after the second or third year of existence are supported in receiving cheaper funding for further growth.

- Special BDS services for agricultural producers- as part of its long-term strategy to enhance development of small farms, in 2014 SIS has started the project "SIS Authentic shop". The project aims to provide a full service to small agricultural producers (especially those in start-up phase) and to promote the sustainable development of agricultural sector by organizing the whole process from supporting the production through expert advises to finding market for it; Through this initiative the team of SIS would like to fight against a worrying tendency that is observed in the last years: small producers are forced to sell production at lower prices, because of lack of negotiation skills, numerous intermediaries in the selling process and low price requirements of big supermarket chains.

With these products, SIS Credit serves start-ups with a few months of experience, and equally will serve those with none. Ninety per cent of start-ups funded by SIS Credit survive for at least two years, in large part because of the careful initial selection of projects and the steady monitoring of business on place combined with expert advices during this first risky phase. The 10 per cent that fail tend to cluster in the agricultural sector. SIS Credit also serves the transport, services, and health care sectors. SIS Coop exclusively serves the farming community with funding and consultancy (and finds that serving rural areas a coop rather than a bank increases client trust among that population). While SIS Credit collects basic information about its start-ups, including number of new jobs created (at the time of application and every 6 months afterwards) — however it is currently unable to aggregate that data.

SIS acknowledges that its products are more expensive than its competitors, but is unable to provide capacity building and consulting services without passing these costs on to the client. Clients appear to be willing to pay for the service as they feel the added value of having a thought-partner is worth the price of the loan.

Microfinancing Institution JOBS (JOBS MFI)

JOBS MFI, a newly established non-bank financial institution and subsidiary of the Bulgarian Development Bank (BDB), offers microleasing and microloans to start-ups and excluded groups. Its product line includes machinery and vehicle microleasing (5 years), working capital loans (2 years), investment loans (7 years) and a 12-month credit line (renewable up to 5 times). It is also launching a new land lease product. Start-up loans are capped at €25K, whereas loans to established businesses are capped at €150K. Leasing products require a 20 per cent buy-in from clients as a security before JOBS will purchase the machine. Sources of this matched funding can be from savings, credit card debt or loans from family members.

Interest rates are tied to the applicant's credit score, and typically range between 7-9 per cent as a fixed or floating rate (excluding fees). Credit scoring is reviewed annually based on the client's income and banking statements, and updated credit history. Any significant changes result in mid-term interest rate adjustments. Currently JOBS MFI requires 100% collateral (long term tangible assets or property) to secure their microcredit loans. Where an external guarantee can be secured, the required collateral may be less than 100%. In cases of microleasing, no additional collateral is required –the leased asset is a property of lessor and secures the financing.

JOBS currently serves 370 clients, 52 of whom are start-ups. Over 45 per cent of these are involved in international road transportation (lorries) and agriculture. Its rejection rate for new applications is around 20 per cent.

JOBS received a €6m Progress loan in 2011 (from the EIF), and as a result was obligated to report on outcomes indicators (jobs created, business turnover). However, it is currently only tracking outreach indicators (per the requirements of the BDB).

In terms of business development services: in the past as part of its work with the UNDP each client had to undergo 20 hours of training (based on an ILO training module). Now, clients are not required to partake in any training activity, but in the application process they receive full support and consultancy from JOBS MFI financial experts for business plan preparation, searching the required equipment, accountancy and other business and financing related issues.

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.

Government level

- There should be a specific definition of "start-up" at an EC level, which can frame all regulation, support and funding of start-ups (at different stages of their development).

- The EC should develop a cohesive funding program for start-ups involving both MFIs and banks at different stages. This program should have a fairly healthy appetite for risk, under the assumption that only 20 per cent of start-ups will graduate to "high performing" status. An initial government grant should be used as pre-seed and seed capital until proof of concept has been reached; then MFIs can provide start-up loans until the business is ready to graduate to a commercial bank. Two advantages present themselves with this program: 1) there's a greater likelihood that those clients graduating up to MFIs will be more credit-worthy, and 2) the government absorbs the risk of early-stage failure, rather than it turning into a black mark on the credit score of the entrepreneur (which would dampen innovation in the long-term).

- The success of any governmental grant program for start-ups is contingent on whether that program operates within the context a coherent government strategy for start-ups that includes clear goals and expected outcomes. For example, would the start-up strategy be designed to reduce unemployment, or develop the economy of depressed regions? Or would it be to promote key sectors that are typically under-funded? Would start-ups be expected (and supported) to compete in the global marketplace, or will domestic start-ups be the priority?

- The government could (in addition to making pre-seed/seed funding available to start-ups) fund MFI training programs for start-ups (on key topics such as writing a business plan and financial management).

- Create a "start-up competition" whereby MFIs nominated their "best in class" new businesses to compete for one of ten €10K prizes, to be awarded along the lines of "most jobs created" or other easy-to-verify indicators.

- Create an EU-wide universal guarantee mechanism for start-ups. Currently the EaSI program guarantee (20% of the loan value) only applies to big banks. However, big banks are more risk-averse, and so are less likely to fund start-ups in any case. Rather, they finance existing companies (which of course does trickle down into broader employment options, just not in the start-up sector). Those we interviewed proposed a 60 per cent EaSI guarantee for MFIs to expand their investment in the start-up sector. Increasing MFI outreach to start-ups would also reduce their dependence on predatory consumer loans, which would increase overall client protection and stave off an over-indebtedness crisis.

Funding

- Increase typical risk appetite with regards to MFIs funding start-ups; ring-fence start-up portfolio when looking at overall organizational non-performing loan rates.

- Give incentives to MFIs to create a “credit line” (for up to €5K) in partnership with a major credit card company. The funds could only be used to start a new business, and only those companies that survived would need to repay it (with losses covered by government funds).

- Experiment with micro-equity investment for traditional start-ups, in line with common practice for tech start-ups. The financial service provider would provide equity co-financing, and the client needs to buyout shares within a certain number of years.

Business development services

- Provide grant financing to MFIs for BDS, to be delivered by a specialist organization under supervision or in partnership with MFIs. Clients should contribute a nominal amount to access trainings. Trainings should be practical in nature and delivered by retired bankers, small business owners, etc. Banks are not well placed (or inclined) to provide this sort of support.

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