

FINANCING OF INNOVATIONS: PROBLEMS AND OPPORTUNITIES IN LATVIA

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Abstract. One of the leading contemporary strategic management thinkers professor Michael Porter identifies three stages of development of nations regarding competitiveness: factor-driven economy, investment-driven economy and innovation-driven economy. Developed countries of the world nowadays have moved to the latter model which is based on heavy attention to and investment in research and development. Current tendencies of development of countries are based not only on basic factors of production like natural resources, labor and capital but more and more on developed factors like technology, infrastructure, knowledge, access to different forms of financing. Development and competitiveness of modern economies are unthinkable without serious investment in innovations.

Currently innovative companies face financing problems. Money lenders are not ready to lend money to innovative companies at the early development stages qualifying such deals as a high risk deals. Traditional financial sources are not suitable for innovative companies as cash flow of companies in early stages is mostly negative.

There are several ways how to finance innovations. Typical types of financing innovations in Latvia are government and municipality capital, company capital, EU fund programs, capital investments, grants and guaranties as well as business angels.

This paper will analyze and explain theoretical background of innovation financing possibilities in Latvia. Author will compare traditional sources of financing innovation and will stress strengths and weaknesses of each type as well as prepare suggestions for improvement of existing situation. The aim of this paper is to determine the most convenient and appropriate ways of financing innovation in Latvia.

Keywords: Innovations, financing, competitiveness, capital.

Introduction

National economy of Latvia as a small opened economic country depends of possibility to create and accomplish competitive service and products in world market. Possibility to create new ideas and accomplish them in business is the main driving force to be a developed country. Important problem of implementing new technologies and ideas is the financing. Entrepreneurs are facing innovation financing problems thus slowing down whole development and competitiveness of the country. In theory there are two ways how to get financing – internal and external financing. This paper will compare traditional sources of financing innovations and will stress strengths and weaknesses of each type as well as give suggestions for improvement of existing situation. Paper will determine the most convenient and appropriate ways of financing innovation in Latvia. Both quantitative analyses of indicators and qualitative analysis of economic policy decisions and theoretical aspects are analyzed within this paper.

Financing need of innovations

Development is one of the most important issues in nowadays. Measured by levels of economic development, defined by Michael Porter (1990), top developed countries have chosen the innovation driven economy. There are many theoretical definitions of innovations, but in practical way innovation is new products, new processes, new ways to penetrate new markets, new supply sources or distribution methods and new industries (Schumpeter, 1983). An innovation includes many additional factors like skilled personnel, wages, organization structure, marketing and communication with government and investors. The importance of each factor depends on region where entrepreneur is operating, but of the hardest questions for all region innovative enterprises is financing. Financial needs of innovative enterprises vary according to type of production or service, development and implementation costs. For any given innovation the Entrepreneur may, but need not, be the person who furnishes the capital. (Schumpeter, 1983) Therefore entrepreneurs have to attract financing for innovations either from internal or external resources.

Table 1

Financing sources by development stages

Development stage	Financial source
Seed stage	Owner money. Grants
Start-up stage	Business angels
Early-growth	Venture capital Bank loan
Expansion	Bank Loan Stock Market

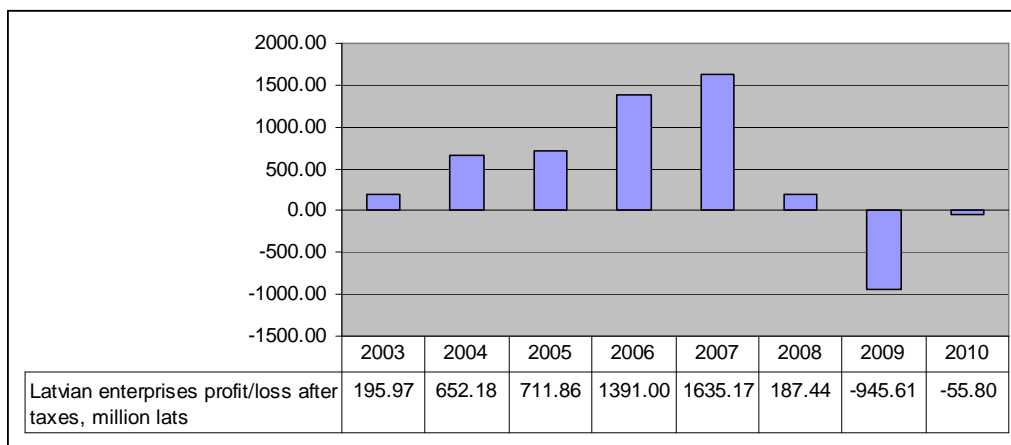
Source: Compiled by author

Each innovator meets financial fund need in different stages. Some are facing this problem in seeding stage when making research of possible business concepts and trying to understand the viability of their idea. Others need to raise funds in start up stage when innovators are registering their legal entities and making additional researches of potential market. In next stage innovative enterprises are making first business deals. In this stage first economical growth is recognized, therefore companies need rise financial funds to proceed with economical growth. In final stage companies are improving company growth where financial investments are needed to become stabile company and play key role in the market. Considering risks and amounts required each of mentioned stages has different types of financial sources (see Table 1).

Most innovation companies in Latvia are in first stages of development, wherewith financial pressure.

Analyses of current financing model of innovation in Latvia

The easiest way for new innovator is to use own money and invest to his business so called internal capital. Internal capital is money available for owner to invest in his business. Part of profit is the most common way for innovation financing from internal capital. Unfortunately last few year incidents in Latvian economy do not allow companies to be very profitable therefore companies in Latvia in 2009 and 2010 were working with more losses than profit therefore money for innovations has to be found in external capital sources (See figure 1).



Source: Enterprise Register of Latvia

Figure 1. Profit/loss of Latvian enterprises after taxes, years 2003-2010, million lats

In seed stage often there is not enough with own money to make researches to understand the viability of the business idea. Innovators can apply for grants in seed stage in case owner financial funds are not enough. Grants provided by government or EU is effective way of financing in seed stage. One of providers for such programs in Latvia is called ALTUM that provides grants for entrepreneurship hedging and loan repayment.

Grants often are called “free money”, but in reality it looks different. Entrepreneurs in Latvia are facing very complicated application procedure therefore lots of companies fail to receive such financing. Unfortunately in Latvia bureaucracy is at high level therefore applications for such programs are mostly done by specialists to save time and avoid waste efforts. Idea itself is very good but lack of public intelligence and lack of professionals in public sectors slows down

Research and Development (R&D) sector therefore lots of great ideas doesn't reach the start-up stage.

In start-up stage as business partners are business angels. Angels are investors that are investing not only money but also knowledge, experience and coaching. They are supporting new entrepreneurs till company is able to stand on their own feet and becomes profitable. Business angels are not well known term for Latvian entrepreneurs however this type of investment is known as private investors. Latvian entrepreneurs can use two different types of business angels – local and foreign investors. Local business angels are private businessman that have been successful and have sold their successful business receiving income that can be used for new business investment. Such success stories in Latvia are not very much as there is small amount of successful and profitable companies in Latvia. Therefore local entrepreneurs have to find business angels abroad and attract them for investment. Typical business angel investment amounts are between 25 000 EUR and 250 000 EUR.

A problem that innovators meet in Latvia is availability of such business angels. But this not only problem of innovator as Latvia is not the most attractive country where business angels are searching for partners. Business angels also are facing same problem that they can not find high quality entrepreneurs. For such reason are created business angel networks where new innovators can find wide information of each business angel knowledge, experience and financial situation.

When the company is reached economical and commercial stability it enters in early growth stage where more serious financial tools can be used. Economical strategy of venture capital investment is similar to business angels however amounts of such investments are much higher between 1 000 000 EUR and 4 000 000 EUR or more.

EU fund support programs in Latvia include support for venture capital investments. In this position efficiency is 100% as all support is used and agreement is signed with company Eiropas Investīciju Fonds that has agreements with partners AS „Swedbank”, AS „SEB banka”, SIA „BaltCap Management Latvia” and SIA „Imprimatur Capital Baltics” for capital fund establishment. Amount of signed agreement is 58 529 801,05 lats. During year 2010 in the framework of this program there is invested in 5 venture capital deals for amount of 1 440 748 lats (Ministry of Economics of Republic of Latvia, 2011, p.10). Such amounts are very small and not enough for innovators therefore entrepreneurs have to search for foreign partners

In last two years since economical crisis approached in 2008 foreign investments has dropped to minimum reaching lowest point in 2009. In 2010 foreign direct investment flow was reviving but still the amounts are much smaller than it was before crises in 2006, 2007 and 2008.

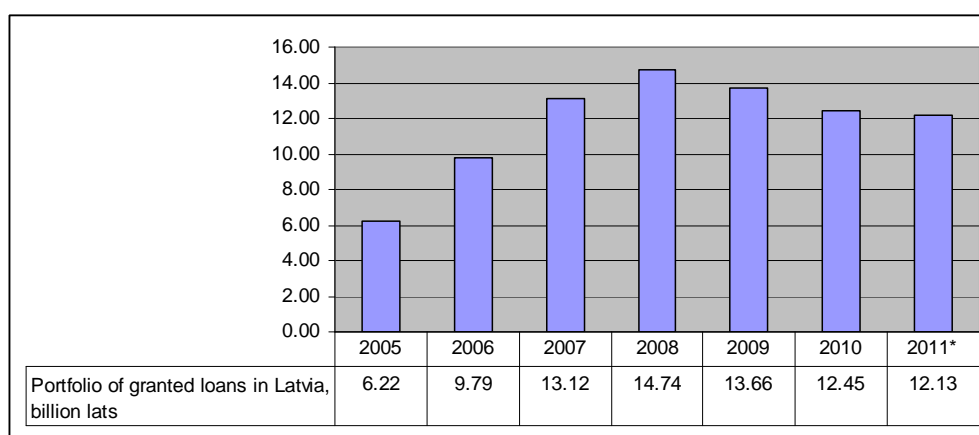
Foreign direct investment, Latvia, year 2008-2010, (mln. lats)

	1 st quarter	2 nd quarter	3 rd quarter	4 th quarter
2008	270.3	269.9	209.7	-143.5
2009	23.5	-114.2	106.8	31.5
2010	-72.7	44.0	119.7	94.5

Source: Central Statistical Bureau

According to Latvia's balance of payments 2010, foreign direct investment inflows increased in several kinds of activity, like real estate transactions (by 164.8 million lats, primarily from Luxemburg, Finland and Sweden), manufacturing (by 49.8 million lats, mainly from Ireland, Cyprus and Denmark), and agriculture and forestry (by 21.6 million lats, in particular from Sweden, Finland and Norway) (National Bank of Latvia bank, 2010). There are recognized positive tendencies of foreign investment flow however level of this flow is very low. Foreign investors, as previously before economical crises, are investing in real estate to get quick profit therefore this not most convenient and appropriate financial tool.

The key role in innovation development in Latvia is playing commercial banks even if innovators have availability for other financial tools. Bank sector was frozen for last two years since economical crisis took effort in Latvia in 2008. Banks were working on money saving and repossessing procedures leaving financing in second plan or wasn't financing at all. Financing amounts dropped dramatically and banks had loses from terminated agreements therefore portfolio of granted loans in Latvia heavy dropped in 2009 and 2010 (see Figure 2).



Source: Financial and Capital Market

Figure 2: Portfolio of granted loans in Latvia, year 2005-2011*, billion lats

Figure 2 also shows that significant drop of portfolio is stopped in 2011 first quarter where portfolio decreased for 320 millions lats however negative tendency remains. One of the indicators that bank sector starts to recover is bank profit. Profit of banks in Latvia in first five months of 2011 is 61,7 million lats comparing to previous year first five months - 203,1 million losses. Most important for innovators is that banks has started to grant new loans by reaching 197,87 million lats in the first quarter in 2011. According to frozen bank sector and slow recovery in nowadays, financing availability is very low; therefore new innovators have to find other solutions. One of the options is EU fund support programs. The most positive aspect is that EU support programs for entrepreneurship and innovations bulks 67,48% of total EU support in 2010, therefore acquirement of EU support programs are main issue for innovators.

Government role has to be increased and governments have to become a best partner for entrepreneur. This year government has agreed to reorganization plan of one of the government owned banks to become a development bank till 2013. This plan says that Hipotēku banka will be set as 100% development bank. This is a huge step closer to development and competitiveness of enterprises and whole country despite that plan has to be approved by European commission. Functions of development bank in Latvia should be to support enterprises in seed and start-up stages. Development bank is not going to be as competitor for commercial banks in local market, even more development bank can be partner for local commercial banks by shearing risks for shared customer. Hipoteku banka has been partly acting as a development bank already for many years, therefore bank has high level professionals that are able to find the best financial tools for development entrepreneurs. Therefore establishment of development bank will solve level of education and professional's problem as one of the development bank functions is coaching and educating. Employees of public sector have to be learned how to improve the quality of government role EU support acquirement as well as innovative enterprises have to be educated about support programs. Considering that financing of new enterprises, development bank has to work closely with Guarantee Agency that is supporting high risk deals with guarantees. Development bank financing has to be most convenient way of financing innovations in Latvia only it has to be improved to higher level. Despite development bank full establishment is planed only up to 2013, Hipotēku banka is already partly acting as development bank.

Conclusions

1. Enterprises in Latvia in 2009 and 2010 were working with more losses than profit. Total loses after taxes in 2009 and 2010 are one billion lats therefore money for innovation financing has to be found in external capital sources.
2. Typical financial tools like grants, business angels and venture capitals are not presented up to level that is needed, therefore most popular ways of financing innovations in Latvia is banks and EU funds
3. In 2010 foreign direct investment flow was reviving but still the amounts are much smaller than it was before crises in 2006, 2007 and 2008. Latvian economy is not attractive for foreign investors delaying development of innovations.
4. Banks are most convenient way of financing innovator despite the fact that total portfolio of granted loans in Latvia has fallen dramatically for 2,61 billion since 2009. Banking sector shows positive tendencies of recovery - profit of banks in Latvia in first five months of 2011 is 61,7 million lats comparing to previous year first five months - 203,1 million losses.
5. EU support programs for entrepreneurship and innovations bulks 67,48% of total EU support in 2010, therefore acquirement of EU support programs are main issue for innovators.
6. This year government has agreed to reorganization plan of Hipotēku banka to become a development bank till 2013. Efficient use of developments bank and well structured functions will make development bank financing most convenient tool of financing innovations and new enterprises.

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