SMEs, FDI and capital market imperfections

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ABSTRACT

This paper aims at exploring the problems experienced by SMEs in gaining access to debt and equity finance for FDI projects. We develop several hypotheses why SMEs are expected to face severe financing constraints for foreign investments and provide an empirical analysis of these issues for a sample of 33 Belgian SMEs. The market of FDI finance for SME is found to be subject to considerable capital market imperfections, which hinders small firms in their internationalization strategy and negatively affects their economic performance.

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1. Introduction

A remarkable and extremely important business phenomenon of the 20th century was the internationalization of large and small as well as established and new venture firms (Sapienza, Autio, George and Zahra, 2005). Next to the fact that young and small firms increasingly tend to internationalize, another novel element of the globalisation trend has been the impressive rise in foreign direct investment (FDI). Yet, it is widely acknowledged that small and medium-sized enterprises (SMEs), in general, are subject to substantial financing constraints.[1] In this paper, we hypothesize that SMEs that invest in foreign countries will face even more severe finance constraints. We argue that many of the financing difficulties are similar in nature as those experienced by firms that try to finance R&D projects: volatile returns, asymmetric information and a lack of collateral cause SMEs to have poor access to debt for their FDI projects. Moreover, financiers are likely to suffer from a home bias and the evaluation methods used by banks to assess these projects may present a further impediment to attracting finance. In the empirical section of this paper, we provide evidence of these hypothesized capital market imperfections for a sample of Belgian SMEs, and we examine whether they have a negative impact on these firms' growth and economic viability.

Many countries spend substantial sums of public money to moderate equity and debt gaps that are assumed to be present, particularly among small firms. A wide range of policy schemes, such as direct loans, interest subsidies and loan guarantees, have been established to alleviate finance rationing of SMEs (Cressy, 1996; European Commission, 2003a). FDI credits for SMEs are available in several countries, which suggests the existence of a severe financing gap. However, apart from anecdotal evidence, there is little empirical verification of these alleged capital market imperfections. Notwithstanding their huge relevance and economic importance, FDI financing decisions in SMEs have received comparatively little academic attention; moreover, little effort has

[1] Financing constraints are present when a firm is not able to raise a sufficient amount of finance in time at a fair price that reflects the true risk of the project/company financed.

been spent to systematically analyze the potential lack of finance for FDI as one of the impediments for SMEs' performance and growth potential. Interest in large mature multinational firms as the unit of analysis dominates the international business literature (Oviatt and McDougall, 1994; Coviello and McAuley, 1999). Most research on internationalization does not focus on FDI but on other types of international activities, like export, or focus on internationalization problems experienced by specific companies, for instance high-tech firms. Very few papers have investigated FDI by SMEs. This paper, based on hypothesis development and empirical testing with 33 Belgian SMEs, aims at exploring the problems faced by SMEs in gaining access to debt and equity finance for their FDI activities.

Due to the substantial asymmetric information problems that are often present in small firms, adverse selection and moral hazard may cause SMEs to be confronted with significant financing gaps. On top of this, small firms are more risky than large enterprises. Access to public capital markets is often not available for SMEs, and the traditional private financiers, venture capitalists and banks, are often reluctant to provide financing. These financing issues potentially hinder SMEs in exploiting their full growth potential. It could well be argued that these financing constraints for SMEs in case of FDI will be even more severe. Though FDI may offer a variety of benefits, to date, its aggregate effects on SMEs' performance are not well known (McDougall and Oviatt, 1996). Foreign investments may result in a further increase in the risk profile of an SME and additional information problems. Whether SMEs that pursue FDI activities indeed experience these hypothesized financing gaps, is an important research question, as it is widely known that financial constraints have real impact. For instance, capital market imperfections negatively affect the number of entrepreneurial initiatives (Evans and Jovanovic, 1989), drive down firm growth, economic viability and entrepreneurial survival (Bates, 1990; Holtz-Eakin, Joulfaian and Rosen, 1994b).

Small and medium-sized enterprises play a prominent role in the European economy. SMEs are as innovative as large-scale enterprises (Davis and Haltiwanger, 1992); they account for about two-thirds of employment and half of the business sector turnover (Wagenvoort, 2003). A financial environment that supports SMEs' growth is an indispensable condition for the success of small businesses. By extension, inadequate

access to external finance, both for domestic and foreign investments, improperly hampers economic growth and welfare.

The majority of SMEs in almost all industries nowadays face growing competition due to internationalization (European Commission, 2003a). Becoming multinational is often a matter of survival rather than a hunt for excess returns. Even primarily domestically oriented SMEs must operate internationally in order to guarantee their competitiveness and viability (Shapiro, 1982; Wright and Ricks, 1994; Etemad, 1999). Growth by international diversification is a vital strategic option for large firms and SMEs; during the most recent years, SMEs have taken up an increasingly active international role (Oviatt and McDougall, 1994, 1999). As the world economy is becoming gradually more integrated, with continued declines in regulatory barriers and sustained advances in technology, internationalization and FDI activities by SMEs are likely to gain further momentum (Lu and Beamish, 2001).

Combining the above elements, FDI is definitely crucial for the performance of small firms, but at the same time it involves an additional need for financing. For SMEs, attracting external financing for domestic projects already presents a challenge. We hypothesize that the extra risks that foreign projects include, together with the increase in informational problems, results in a failure of the private market to finance FDI projects for SMEs; this market failure is argued to lower economic welfare. In order to obtain insight in the issues that SMEs face in attracting FDI financing, we provide an explorative empirical study with both the demand and supply side of FDI finance. We have interviewed 33 Belgian SMEs that (consider) carry(ing) out FDI; in addition, we have interviewed 5 banks and 5 venture capitalists. Based on the interviews with the SMEs, we have composed a questionnaire that was sent to the very same SMEs that have been interviewed. This allowed us to obtain a more complete understanding of all FDI financing issues these firms are confronted with. Belgium offers an interesting setting to carry out this study as international business research has highlighted that firms from small countries have a lengthy tradition and noticeable experience in internationalization (Jones, 1996). Moreover, the financial environment in Belgium is quite typical for Continental Europe: a bank-based system, with relatively underdeveloped capital markets, and an immature venture capital industry.

We find overwhelming support for our hypotheses. Severe capital market imperfections exist in both equity and debt markets for financing SMEs' foreign projects and prevent small firms from realizing their full growth potential. Our study contributes to the literature in a number of ways. We provide insight in the financing of SMEs' FDI, we develop theoretical arguments for the financing constraints SMEs face for investing internationally and we document the existence of these alleged financing gaps. Finding empirical evidence of finance constraints is inherently difficult, and little is exactly known about their significance and effects. Our study confirms the existence of financing constraints experienced by SMEs for their foreign investments and elaborates upon the induced effects.

This paper is structured as follows. Section 2 presents a literature review on financing constraints and FDI, and develops our hypotheses. Section 3 provides a description of the methodology and sample used. The results of our research are presented in Section 4. The paper ends with a discussion of the findings and potential avenues for future research.

2. Literature review and hypothesis development

In this section, we first review the literature on financing gaps for large and small firms and on the effects of internationalization and foreign investment on firm performance. Then, we combine elements from both reviews in order to develop why we hypothesize severe financing constraints to be present for SMEs that want to carry out FDI.

2.1 Financing constraints for large and small firms

Under perfect market assumptions, firms can instantly raise sufficient funds to take advantage of valuable investment opportunities (Merton, 1987). However, markets are not perfect and many firms suffer from financing constraints. Information asymmetries between firm and financier may drive a wedge between the cost of external financing in an uninformed capital market and internally generated funds (Hubbard, 1998). Financing constraints occur for various types of firms and/or projects, for example for starting entrepreneurs (Evans and Leighton, 1989; Holtz-Eakin, Joulfaian en Rosen, 1994a) and

innovative projects like R&D (Arrow, 1962; Kamien and Schwartz, 1978; Spence, 1979; Himmelberg and Petersen, 1994; Carpenter and Petersen, 2002; Hall, 2002). Firms in developing countries typically cite credit constraints as one of their primary obstacles to investment (Harrison and McMillan, 2003). Fazzari, Hubbard and Petersen (1988) even find evidence of significant capital market imperfections for publicly traded manufacturing firms in developed markets.

An extensive literature documents the relationship between internal resources and firm investment (Meyer and Kuh, 1957; Fazarri, Hubbard and Petersen, 1988; Hubbard, 1998; Harrison and McMillan, 2003). In business surveys companies repeatedly allude to the lack of external finance as a major obstacle to their investment and innovation activities (Harhoff and Körting, 1998). These findings suggest the presence of finance rationing phenomena, which are typically considered as problems of moral hazard and adverse selection due to information asymmetry.[2] Their potential effects on the provision of outside finance have been addressed in important papers by Akerlof (1970), Rothschild and Stiglitz (1976), Leland and Pyle (1977) and Greenwald, Stiglitz and Weiss (1984). Jaffee and Russell (1976) and Stiglitz and Weiss (1981) argue that banks may ration credit rather than increase interest rates to clear the market as the latter may deter good borrowers and result in incentive problems. In equity markets, Myers and Majluf (1984) describe why firms may need to sell new stock at a discount ('lemon' premium).

Several empirical studies report evidence that financing constraints have a greater impact on the investment behaviour of small firms (Hall, 1992; Berger and Udell, 1998; Harhoff and Körting, 1998; Michaelas, Chittenden and Poutziouris, 1999; Giudici and Paleari, 2000; Carpenter and Petersen, 2002) and that SMEs' growth is determined by their access to internal finance (Butters and Lintner, 1945; Spence, 1979; Moore, 1993). The financial constraints faced by SMEs present major impediments to economic growth (Chittenden, Hall and Hutchinson, 1996). The European Commission has acknowledged the financing difficulties, both for equity and debt, of smaller firms and recognizes the existence of a market failure due to information problems and transaction costs (European Commission, 2003b). As a result of the financing gaps, small firms tend to rely more on self-financing,

[2] Alternative theoretical frameworks are problems of costly state-verification (Gale and Hellwig, 1985; Mokerjee and Png, 1989) or incomplete contracting (Aghion and Bolton, 1992).

have lower liquidity and leverage, seldom issue equity, and rely more on short-term bank financing, trade credit and owner loans (Bates, 1971; Chittenden, Hall and Hutchinson, 1996). The efficient and effective provision of finance is fundamental in ensuring that SMEs can exploit their growth opportunities. A positive association between external finance and business performance has been shown to exist (Keasey and McGuiness, 1990). A number of reasons that account for the financing issues that SMEs regularly encounter is presented next.

First, SMEs are disadvantaged in a number of aspects compared to large firms. They have a smaller pool of financial and managerial resources to cope with random shocks or to survive critical periods. SMEs have a shorter expected life, may face intergenerational transfer problems and are expected to be less profitable (Pettit and Singer, 1985; Ang, 1992). Large firms usually have better-trained management, closer contracts with creditors, advantages in raising capital, more favourable tax conditions and government regulations, and can better compete for qualified labour (Brüderl and Schussler, 1990). They benefit from scale economies in debt collecting and financial monitoring (Cressy and Olofsson, 1997). Empirically, failure rates are notably higher for SMEs (Brüderl, Preisendörfer and Ziegler, 1992)

Second, agency and asymmetric information problems may be more pronounced for small firms. Agency costs can expected to be higher as a small business manager is likely to put his own and his firm's interest first. Additionally, solutions to agency problems are more costly to SMEs, thereby raising the transaction costs between small businesses and their financiers. Moreover, the fixed cost element of transactions puts small firms at a disadvantage (Coase, 1937). Monitoring SMEs is more difficult and expensive as information on them is less easily available, they have less credit history, are subject to less rigorous reporting requirements and the quality of their financial statements may vary (Pettit and Singer, 1985). Furthermore, employing bonding methods like incentive schemes may be complex for SMEs (Michaelas, Chittenden and Poutziouris, 1999). All these elements result in SMEs often facing difficulties in signalling their creditworthiness (Scholtens, 1999).

For SMEs, access to external equity has long been identified as a problem (Macmillan, 1931; Radcliffe, 1959; Bolton, 1971; Wilson, 1979). As a consequence of the persistence

of an equity gap for small businesses, the bulk relies for external funding upon bank debt (Binks and Ennew, 1996). In general, SMEs do not have access to capital markets. First, a stock market flotation is relatively more expensive to arrange for smaller issues (Lee, Lockhead, Ritter and Zhao, 1996). Second, initial public offerings of smaller firms are subject to higher underpricing (Buckland and Davis, 1990). Venture capitalists (VCs), as specialized financial intermediaries, may mitigate the substantial information problems that prevail in SMEs. However, Sahlman (1990) presents evidence that venture capital (VC) is very expensive. In addition, VCs back only a tiny fraction of all new ventures.[3] Besides, the VC market in Continental Europe is relatively underdeveloped compared to Anglosaxon countries. Moreover, due to the high fixed costs of monitoring, especially small businesses are not very attractive to VCs (Scholtens, 1999).

Furthermore, despite the scarce availability and the high cost of bank loans, it has been well established in the small business literature that SME owner-managers are reluctant to sell equity to outsiders and give up independence and control (Cooley and Edwards, 1983; Cressy and Oloffson, 1997; Jordan, Lowe and Taylor, 1998; Giudici and Paleari, 2000). This control aversion is more important for smaller firms; obviously, this demand-side financial constraint further increases financing issues for SMEs.

In addition, SMEs are more constrained in the use of control mechanisms as collateral, long-term relationship and reputation than large firms to ease information problems (Scholtens, 1999). As small firms are limited in the extent of their internal earnings and in their potential to issue equity, they depend more on bank loans. However, regarding bank loans, SMEs find themselves again in a deprived position compared to large firms as ex ante as well as ex post information asymmetries are more prominent.

For instance, collateralization may under some circumstances contribute to attenuate credit rationing problems; collateral serves as both a signalling device to overcome adverse selection and as an incentive device to overcome moral hazard (Bester, 1985). Yet, the potential to put up collateral depend on the industry and on the asset specificity of the firm. The younger and smaller a firm, the less it is able to pledge collateral. Furthermore, SMEs usually are less capital intensive than large ones. The intangibility of

[3] For instance, in 1997, a record year for US venture disbursements, 707 companies received first-round venture financing, while 885,000 businesses were started in the US (Lerner, 1999).

the assets, an important characteristic of start-up and small firms, also impedes this control mechanism (Scholtens, 1999). Pledging personal collateral in the form of a guarantee offers only a partial solution as it is limited in supply (Giudici and Paleari, 2000). Despite the fact that SMEs generally lack sufficient collateral, lending to SMEs is more often based on pledging collateral (Chittenden, Hall and Hutchinson, 1996).

2.2 Internationalization-FDI and firm performance

While exporting, as the traditional way for firms to internationalize, is still very significant, during the last decade internationalisation has become a much more differentiated activity that is critical for achieving competitiveness. 30% of European SMEs have foreign supply relationships, 18% export, 3% have collaborative relationships with foreign firms, and 3% have established foreign subsidiaries (European Commission, 2003a). Today, a majority of firms engage in inward and outward international activities (Fletcher, 2001).

Some of the principal drivers for the growing internationalization of SMEs are rooted in political, economic and technological evolutions. Numerous countries opened up their economies during the 1990s; trade and investment liberalization programs far outnumbered more restrictive measures (Van Tulder, van den Berghe and Muller, 2001). The increasing number of people with international business experience has become more internationally mobile. Furthermore, the rising homogenization of markets in distant countries has made the conduct of international business more accessible for everyone (Madsen and Servais, 1997). Spectacular increases in the speed, quality and cost efficiency of international communication and transportation have greatly reduced the transaction costs of multinational business (Porter, 1990). Consequently, exploring and exploiting international business opportunities is no longer the preserve of large corporations (Oviatt and McDougall, 1994). An ever quicker economic and technological pace urges typical SMEs to lever their competencies abroad, especially when they operate in undersized domestic markets (Etemad, 2004). Few small firms can avoid foreign competition and many of them are thus imposed to adopt an international perspective (Ohmae, 1990; Porter, 1990).

Many advantages associated with internationalization are well documented in the literature. Geographic diversification offers a range of exploration and exploitation benefits (Lu and Beamish, 2001). Internationalizing firms may realize economies of scale and scope (Caves, 1971; Hymer, 1976), reduce fluctuations in revenue by spreading investment risks over different countries (Hirsch and Lev, 1971; Hughes, Logue and Sweeney, 1975; Kim, Hwang and Burgers, 1993), reduce costs and boost revenues by increasing market power over its suppliers, distributors and customers (Kogut, 1985). They have the opportunity to exploit market imperfections in the cross-border use of firm-specific assets (Caves, 1971; Buckley and Casson, 1976). FDI can help to enhance a firm's knowledge base, capabilities and competitiveness through experiential learning. Moreover, internationalization potentially provides tax rate arbitrage, profitable innovation transfers from one location to another (Bartlett and Ghoshal, 1991), cheaper input factors and better operations from experiencing greater competition (Porter, 1990). Additionally, expanding a firm's international business activities may even be a prerequisite for survival in some markets (Ohmae, 1990).

Though exporting involves less risk in terms of capital outlay, market-based transactions may be extremely risky due to technology transfer, reputation concerns, informational asymmetries and moral hazard problems (Teece, 1977; Rugman, 1986; Horstmann and Markusen, 1996). FDI enables firms to minimize these risks through internalizing markets for proprietary asset exchange. Besides, FDI permits the leverage of various ownership and/or location-based advantages such as a competitively priced labour force, access to critical resources and development of new capabilities (Dunning, 1980; Kogut, 1985; Porter, 1990; Lu and Beamish, 2004). In summary, FDI takes place in order to exploit market imperfections, firm-specific advantages or technological superiority (Vernon, 1966; Knickerbocker, 1973), and to reduce transaction costs (Williamson, 1975). In addition, developing countries frequently provide special FDI incentives as it may for instance ease credit constraints faced by local firms (Harrison and McMillan, 2003) or bring in advanced technology (Haddad and Harrison, 1993).

Yet, internationalization may be risky. A foreign firm may face some specific disadvantages like governmentally instituted barriers to trade and an incomplete understanding of local laws, language, culture and business practices (Oviatt and

McDougall, 1994; McDougall and Oviatt, 1996). On top of increased political (Adler and Dumas, 1975; He and Ng, 1998) and exchange rate risk (Solnik, 1974), Armstrong and Riddick (1998) argue that international firms suffer from greater agency costs and information asymmetry. It is more difficult to monitor managers in international markets due to geographical constraints, cultural, language and legal differences, multi-country financial statements and multi-country auditors (Lee and Kwok, 1988; Burgman, 1996).

Many of these difficulties may be associated with the liability of foreignness (Hymer, 1976) and newness (Stinchcombe, 1965). A new subsidiary faces similar challenges as a start-up, as it needs to build business relationships with stakeholders, establish its legitimacy and train new employees to staff new operations. Due to political, economic, legal and cultural differences, an internationalizing firm is required to adapt its resources developed in a domestic context (McDougall and Oviatt, 1996). Mistakes in various business decisions are more likely for foreign firms. Similar to product diversification, transaction costs increase with the degree of geographic diversification (Williamson, 1975). Information asymmetry, incentive and coordination problems between headquarters and foreign subsidiaries may also prevail in multinational enterprises (Denis, Denis and Yost, 2002). Having more foreign subsidiaries gives rise to a higher number of internal transactions, and governance and transactions costs may exceed any internalization benefits (Bartlett and Ghoshal, 1991; Tallman and Li, 1996; Hitt, Hoskisson and Kim, 1997). Obviously, FDI entails greater foreign resource commitment than exporting, is more difficult to reverse and less flexible in dealing with investment risks like adverse market conditions.

In international management theory it is often hypothesized that internationalization enhances firm performance, and this hypothesis is supported by early empirical research. Shapiro (1978) argues that internationalisation reduces bankruptcy risk. Higher levels of internationalization are associated with superior relative market share and ROI (McDougall and Oviatt, 1996), larger future earnings (Bloodgood, Sapienza and Almeida, 1996), improved labour productivity and sales growth (Bürgel, Fier, Licht and Murray, 2004), and enhanced sales margins (Hitt, Bierman, Uhlenbruck and Shimizu, 2005). Doukas and Travlos (1988) document positive effects of international diversification by means of acquisitions. Goerzen and Beamish (2003) find that the

relationship between economic performance and international asset dispersion is positive. Internationalization increases turnover and competitiveness. More complex forms of internationalization have a more sizeable impact on competitiveness; FDI allows SMEs to achieve more solidity and durability in all their economic activities compared to SMEs that only do export (European Commission, 2003a; Spigarelli, 2003).

Conversely, later empirical research has produced rather mixed results (for a review see Goerzen and Beamish, 2003). In fact, the most recent research seems to suggest that the relationship between internationalization and firm performance is curvilinear, resembling an inverted U-shape. While early actions to expand internationally positively influence firm performance, at some point, the increased diversity results in substantial complexity and coordination problems, and hence in lower firm performance (Hitt, Hoskisson and Kim, 1997; Lu and Beamish, 2004; Hitt, Bierman, Uhlenbruck and Shimizu, 2005).

Still other evidence supports a reverse causation between international business activity and superior firm performance due to self-selection of good firms into foreign markets (Bernard and Jensen, 1999; Fryges, 2004). What's more, the empirical findings presented above are based on samples of large multinational corporations. It has been well argued and documented that smaller businesses are not just smaller versions of large firms. By contrast, they deeply differ in ownership and resources, and in organizational structures and management systems (Lu and Beamish, 2001). All in all, the ultimate effects of internationalization and FDI on SMEs' performance and risk profile are still unclear.

2.3 SMEs, FDI and financing constraints

Although a number of papers have revealed that exporting SMEs frequently face a lack of capital to finance their exports (Bilkey and Tesar, 1977; Hook and Czinkota, 1988; Crick, 2004), there is not a single study in the literature that investigated the financing constraints SMEs experience when pursuing FDI. However, a survey by the European Commission showed that in particular SMEs that engage in outward internationalization activities may confront a shortage of capital (European Commission, 2003a).

For many firms, the scale of expansion and threats that FDI involve are significant. The monetary commitments and the accompanying risks are substantial and affect both long-

term company performance and the capital allocation among financiers (Chetty and Campbell-Hunt, 2003). FDI requires a fundamental departure from current business practices and increases the risks of failure (Miller, 1983; Sapienza, Autio and Zahra, 2005). Goerzen and Beamish (2003) found that FDI country environment diversity is negatively associated with firm performance. In conclusion, FDI exposes a firm to competition in markets that they are less familiar with than incumbents and may threaten the survival of the firm.

Prior research has documented a strong predisposition of equity investors towards geographically and culturally proximate investments (Feldstein and Horioka, 1980; Coval, 1999; Grinblatt, 2001). This home bias is claimed to be due to cognitive bias towards familiar investments (Huberman, 2001) and lower information costs (Merton, 1987). Similarly, VC firms (and banks) rather invest (lend) in geographical areas close to their home base. As geographical distance rises, reducing information asymmetries between firm and financiers becomes more challenging (Sorenson and Stuart, 2002). Moreover, VCs and banks who invest outside their home country need to invest resources in order to understand the local legal and institutional environment (Johanson and Vahlne, 1977).

We argue that many of the issues that firms face in attracting capital for FDI are equivalent to those experienced by high tech firms (or for financing an R&D project). Comparable to high tech investments, FDI is characterized by highly variable returns, asymmetric information and a lack of collateral; as a result, access to debt is likely to be poor. First, returns to FDI are volatile and skewed. As creditors do not share in the upwards states of nature, they only care about the left tail of the distribution of returns (Stiglitz, 1985). When borrower returns are decidedly uncertain, extensive use of debt may result in expected losses for lenders (Carpenter and Petersen, 2002). Second, information asymmetries between firms and potential investors are expected to be more pronounced for FDI projects. Foreign investments are hard to evaluate and insiders will likely have much better information than outsiders about the project's prospects. As a result, creditors may rationally decide to ration credit (Jaffee and Russel, 1976; Stiglitz and Weiss, 1981). Third, like R&D investments, FDI often has limited collateral value. Foreign investments repeatedly incur sunk costs with little or no salvage value at the

initial stage, such as expenses of foreign market analysis, legal consulting services, translation of documents, adapting products to host markets, travel expenses or the costs of setting up a foreign sales channel (Horst, 1972; European Commission, 2003a; Fryges, 2004). FDI frequently involves intangible assets or firm specific assets, and therefore provides little or no collateral value (Carpenter and Petersen , 2002), as there is a higher risk of losses for creditors since the assets involved cannot simply be traded on other markets (Williamson, 1975). A large body of literature demonstrates the importance of collateral for debt financing (Bester, 1985; Berger and Udell, 1990; Boot, Thakor and Udell, 1991). Empirical evidence suggests a negative relationship between a firm's intangible assets and leverage (Gompers and Lerner, 1999). For high tech SMEs, next to all long term debt is secured (Carpenter and Petersen, 2002). Thus, the rather limited collateralizability of FDI assets restrains access to debt.

SMEs face even greater challenges than their larger counterparts in obtaining financing for FDI. Small firms often have internal shortages of information, finance, management time and experience (Bell, Murray and Madden, 1991; Etemad, 1999). These limited resources result in a higher vulnerability to environmental changes and a lower capacity to absorb the hazards of exploring inherently risky and competitive international markets (Buckley, 1989; D'Aveni, 1994; Castrogiovanni, 1996; Sapienza, Autio and Zahra, 2005). These constraints inflate the liabilities of foreignness and of newness and make internationalization a challenge to SMEs (Lu and Beamish, 2001).

Furthermore, supply-side financial constraints, in particular credit rationing, for FDI are likely to be worse for small firms than for large businesses. The so-called home bias of VCs and banks is due to information costs. Given that the costs of collecting and processing information are to some extent fixed, they will tend to be more significant for SMEs. Even more importantly, the methods of evaluation used by banks to assess small business loans may give rise to financial constraints. In perfect markets all valuable projects should be funded; therefore, the income gearing approach (used for large firms) to bank lending is preferable to the traditional capital gearing (used for small firms) method since it relies on the firm's future performance rather than on the provision of collateral. However, this requires the bank to understand how the firm and its markets operate; for banks, the assessment of future cash flows of FDI projects is often unfeasible

(Binks and Ennew, 1996). Similar to high tech investments, judging the prospects of a FDI by an SME might be challenging for a bank. High tech SMEs typically complain with banks of their limited competency in correctly evaluating their business potential and about the excessive amount of warranties required; smaller firms suffer most from these problems (Giudici and Paleari, 2000). Additionally, the income gearing approach requires the firm to provide the bank with up-to-date information which has been argued to be a problem. In summary, for SMEs that apply for a loan, banks usually rely on the capital gearing method; however, in case of FDI, the required collateral is often lacking.

As an alternative to providing collateral, developing good working relationships with banks would allow SMEs to reduce information asymmetries and may induce banks to conduct relationship based rather than transaction based lending. However, SMEs often fail to achieve this. The empirical evidence suggests that SMEs are dissatisfied about the quality of service rendered by their banks and generally perceive the quality of the banking relationship as poor (Binks and Ennew, 1996). By contrast, larger firms are prone to have a more established relationship with their banks, thereby enabling banks to draw on information produced in past lending transactions (Sharpe, 1989).

Financing constraints that SMEs experience for their foreign investments may severely hurt their survival chances and growth potential. Obtaining sufficient financing serves as a buffer against unforeseen setbacks and allows SMEs to explore and exploit a broad range of challenging foreign investment activities (Westhead, Wright and Ucbasaran, 2001). SMEs that face financing constraints will rather internationalize in less capital intensive ways, and rather export than opt for FDI; hence, they will be inhibited to exploit their full growth prospects (Stopford and Wells, 1972).

Based on the discussion of theoretical arguments presented above, we formulate two hypotheses:

H1: SMEs experience financing constraints for their FDI projects.

We hypothesize that these financing constraints will be present both for equity and debt financing:

H1a: SMEs experience equity financing constraints for their FDI projects.

H1b: SMEs experience debt financing constraints for their FDI projects.

Second, we hypothesize that the assumed financing constraints seriously hinder SMEs' growth:

H2: The financing constraints SMEs face for their FDI projects have a significant detrimental impact on their performance and growth.

3. Methodology and sample description

3.1 Methodology

In order to empirically study our research question, we have interviewed both the demand and supply side of SME FDI finance in Belgium (Flanders in specific): 33 SMEs[4] that are involved in FDI projects, 5 banks and 5 venture capitalists. To examine FDI finance issues, it is imperative to choose a market in which the majority of SMEs operate in multiple countries. Smaller countries with open economies but small domestic markets are more internationalized (European Commission, 2003a). Multicountry activity is widespread in small European countries, even among independent, owner-managed companies (Sapienza, De Clercq and Sandberg, 2005). Consequently, we selected Belgium as the research site.

Accordingly, our population contains all Belgian SMEs that pursue foreign direct investments. In our study, we are only interested in productive FDI; thus, for instance, opening up a foreign sales office is not included as this requires less capital and has a different risk profile than true productive foreign investments (e.g., set up a new plant). It is infeasible to find a listing of all SMEs that pursue productive FDI, so we have contacted several sources in order to compose our sample. The Belgian Corporation for International Investment[5] (BCCI), the Entrepreneurship, Governance and Strategy Competence Centre at the Vlerick Leuven Gent Management School, the Cabinet of

[4] According to EU directives, SMEs are firms that employ less than 250 people, report sales of less than 50 million euro or alternatively report an accounting asset value of less than 40 million euro. Additionally, the SMEs in our sample had to comply with an independence criterion: no more than 25% of their equity capital must be owned by one or several companies (see Giudici and Paleari, 2000).

[5] BCCI is a government-supported investment company whose main objective is to co-invest and to provide long-term co-financing of foreign investments by Belgian companies.

Economic Affairs, and sector federations like Agoria[6] and Febeltex[7] all provided us their records of companies involved in FDI. Flanders Investments & Trade (FIT), a government agency promoting sustainable international business, forwarded us a list of firms that were registered for participating in a seminar on financing and insurance of foreign investments. Also, we asked the SMEs that we interviewed, if possible, whether they knew other SMEs that were involved in foreign investments. Despite the fact that we could count on several sources of information, it turned out to be extremely hard to identify SMEs suitable for our research. First, smaller firms are notably less internationalized than their larger counterparts, and the difference is particularly manifest for more complex forms of internationalization like FDI (European Commission, 2003a). Second, a large part of FDI does not involve productive investments.

We managed to identify a group of 130 firms that were considered to be SMEs carrying out productive FDI. An email was sent to all these firms informing them about our research project. Afterwards, all firms have been contacted by phone and we checked whether they met our sample criteria. 33 SMEs met our requirements and were willing to cooperate. We have interviewed the owner/manager of each firm as they possess all relevant information about and ultimately decide on the SME's internationalization. In order to be well informed about the SME to be interviewed, financial data and other firm characteristics were looked up in advance through annual reports and the firm's website. The interviews were based on a study of the literature on the topic; however, as there is not a huge deal of information available, we have composed a questionnaire that deals with all the relevant items that came out of the interviews held. This questionnaire was sent to the very same SMEs that have been interviewed and was addressed to each firm's owner/manager. We have pretested our questionnaire with academics experienced in entrepreneurship and internationalization research, and with one SME that carries out FDI; based on their comments, minor revisions were made to the formulation of a couple of potentially confusing items. Next to providing some general information about the SME and its foreign projects, owner-managers were asked to report how they finance

[6] Agoria is Belgium's largest employers' organisation and trade association; it represents companies active in the technology industry.

[7] Febeltex is Belgium's employers' organization of industrial textile manufacturing companies.

FDI and to score a broad range of statements or items on a 5 point Likert scale (with 1, totally disagree, and 5, totally agree). 16 questionnaires have been filled out and returned to us.

In addition to examining the demand side of FDI finance for SMEs, we also investigated the topic from the perspective of the supply side, as a check on the validity of the results obtained with SMEs. SMEs might have several reasons to complain about access to finance and exacerbate the extent of financing constraints they face, for instance to induce the government to provide cheap FDI finance. Five banks and five venture capitalists have been interviewed; we spoke to both large and smaller banks, to banks with a general focus and with a specific focus on small and medium sized businesses. Similarly, we have interviewed large and small VCs with varying investment profiles.

3.2 Description of the sample

Our sample is active in a very wide range of industries. Table 1 provides an overview according to the Nace Bel industry classification scheme. Several firms operate in more than one industry.

Table 1: Industry classification of the sample

Nace Bel Industry Code	*Nace Bel Industry Description*	*Number of firms in interviewed sample*	*Number of firms in surveyed sample*
01	Agriculture, hunting and related service activities	2	
15	Manufacture of food products and beverages	5	
18	Manufacture of wearing apparel/ dressing and dyeing of fur	1	
22	Publishing, printing and reproduction of recorded media	1	
25	Manufacture of rubber and plastic products	1	
28	Manufacture of fabricated metal products, except machinery and equipment	7	
29	Manufacture of machinery and equipment	4	
31	Manufacture of electrical machinery and apparatus	1	
32	Manufacture of radio, television and communication equipment and	2	

	apparatus		
33	Manufacture of medical, precision and optical instruments, watches and clocks	1	
34	Manufacture of motor vehicles, trailers and semi-trailers	2	
35	Manufacture of other transport equipment	1	
36	Manufacture of furniture.	2	
45	Construction	2	
51	Wholesale trade and commission trade, except of motor vehicles and motorcycles	6	
60	Land transport/ transport via pipelines	1	
72	Computer and related activities	1	

Some important characteristics of the firms that returned the questionnaire are reported in Table 2. The average number of employees at the end of 2005 was 141. Average sales totaled 22.4 million euro, while the mean balance sheet total amounted to 13.9 million euro. The characteristics of the firms interviewed are qualitatively similar. By the end of 2005, two firms in our sample have become quite large and do not meet the SME criteria any longer. However, we have explicitly asked these firms to talk about their FDI finance issues during the time they were small or medium sized. Moreover, when they carried out their most recent international investment, they still met all SME criteria.

Table 2: Sample firm characteristics (at end of year 2005)

	Mean	***Standard deviation***	***Minimum***	***Median***	***Maximum***
Number of employees					
- *interview sample*	96.0	137.0	0	41	700
- *questionnaire sample*	140.8	181,4	0	74	700
Total sales (in euro)					
- *interview sample*	13,881,359.2	13,588,263.5	100,000	8,480,000	48,458,232.0
- *questionnaire sample*	22,241,735.7	25,196,058.5	185,000	10,900,000	84,000,000
Total assets (in euro)					
- *interview sample*	9,062,852.8	9,415,279.5	12,500	4,959,500.0	32,300,000
- *questionnaire sample*	13,957,275.8	11,636,099.5	378,468	13,650,000	37,000,000

100% of the firms surveyed export. On average, 53% of their sales are generated in other countries. 94% of the SMEs have foreign suppliers; 41% of their purchases are made abroad. We asked the SMEs about their most recent foreign direct investment. Table 3

gives an overview of the country of investment. Continental and Eastern Europe are very popular regions of investment. 56% of the sample already had experience with FDI.

Table 3: Country of FDI

Country of investment	*Number of firms in interviewed sample*	*Number of firms in surveyed sample*
Egypt	1	
Dominican Republic	1	
Romania	4	4
Ukraine	2	
Bulgaria		
Guinea	1	
Poland	1	
Slovakia	3	1
Philippines	1	
Italy	1	
China	4	4
USA	1	
Hungary	2	1
Norway	1	1
Iran	1	
Russia	1	
Brasil	2	1
Algeria	1	1
Ghana	1	1
Sri Lanka	1	1
Missing	2	

The average foreign investment equals 923,461 euro, and is mainly needed for land, buildings, machinery and equipment.

4. RESULTS

This section reports results and analyses drawn from the surveys filled out, together with additional valuable information provided during the interviews. We start by providing a summary of the results of our sample's financing constraints. Then, we briefly discuss motives and risks of FDI. Subsequently, we elaborate upon the financing sources for FDI and any financing constraints perceived. Afterwards, we go into detail about the impact of foreign investment on SMEs' performance. Finally, we present our findings obtained from interviewing the supply side of FDI finance.

4.1 Summary of the results

Clearly, as shown in Table 4, the SMEs in our sample report facing considerable financing constraints for FDI projects (mean score: 3.75), which negatively impacts their growth potential (3.62). They claim that the problems experienced are much more severe than for attracting finance for domestic projects (3.80), and than for large firms (4.07). Hence, they observe a failure in the private market to finance SMEs' FDI projects (3.85).

Table 4: Financing constraints faced by SMEs pursuing FDI: general overview
To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- there is a clear failure in the private market to finance SMEs' FDI projects	3.85	0.020	0.0	38.5
- my SME faces financing difficulties and constraints for its FDI projects	3.75	0.018	6.3	25.0
- financing problems for FDI hinder my SME's growth	3.62	0.055	6.3	31.3
- the FDI financing constraints of my SME are more severe than for				
* my SME's domestic projects	3.80	0.009	0.0	26.7
* large firms	4.07	0.000	0.0	28.6

This table provides a general overview of the financing constraints faced by SMEs that carry out foreign direct investments, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.2 Motives for FDI and risk

The SMEs in our sample indicated that they pursued FDI projects in order to reduce transportation costs and/or import/export taxes, and/or benefit from incentives offered by the host country, favourable tax conditions, enhanced payment processing and sales potential, and to create a better access to neighbouring countries. FDI also enables easier adaptation to local cultural, political and economic conditions, and permits to avoid the home country's regulatory/administrative burden and high costs of infrastructure or labour. Our respondents indicated a mean risk score of their latest FDI project (compared

to a similar project in Belgium) of 3.14, which suggests that the foreign investment is not particularly risky. Moreover, as the SMEs acknowledge the potential risks of FDI they try to control them by a profound analysis of the foreign project. Though modern communication tools like internet and webcams allow better monitoring of the foreign investment, SMEs prefer to invest in geographically proximate countries. Several firms noted that in the current economic environment a 'do nothing strategy' is risky as well.

4.3 Financing of the FDI project

We have analyzed how SMEs finance their foreign investments; we discuss impediments to the use of local/domestic bank finance, and to raising internal/external equity. In the end, we present our findings on the use of government grants and partnerships.

4.3.1. Internal financing

35.7% of the respondents indicate that their most recent FDI project was entirely funded by internal cash flows. Furthermore, 62.5% mainly finance their latest foreign investment with internal funds. Thus, generating sufficient internal funds is critical in financing FDI. These results suggest the presence of financing constraints: the relationship between internal cash generation and investment activity is a common measure of financing gaps in the literature (e.g., Hall, 2002).

Simply focusing on the mean score reported by our respondents might be misleading and may hide the fact that FDI financing issues are not homogenous for all SMEs. A score of around 3 may be the result of averaging out scores of 1 (no issue at all for some firms) and scores of 5 (a severe issue for other firms). Thus, we also examine the percentage of sampled SMEs that report fully agreeing with a statement.

Table 5 indicates that our respondents would have trouble financing the FDI project in case of insufficient internal finance (mean score: 3.75; %score 5: 43.8%), and that they more strongly depend on internal financing for foreign than for domestic projects (3.81; 37.5%). A larger wedge between the cost of external and internal financing for FDI is

also reported (3.71; 28.6%). Finally, 31.3% totally agree that raising equity from new stockholders is the last financing option they would consider.

Table 5: Internal financing of FDI projects

To what extent do you agree with the following statements?

(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- if my SME would generate insufficient internal funds, it would be very hard to finance the FDI project	3.75	0.029	0.0	43.8
- for financing FDI, my SME is more dependent on internal funds than for domestic projects (with comparable risk)	3.81	0.018	0.0	37.5
- for domestic projects, the cost of external financing is markedly higher than internal financing	3.54	0.089	0.0	15.4
- there is a larger wedge between the cost of external and internal financing for my SME's FDI projects	3.71	0.055	7.1	28.6
- raise equity with new shareholders is the final financing option that my SME would look for	3.06	0.884	12.5	31.3

This table provides an overview of statements relating to internal financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.3.2. External financing

81.3% of the SMEs uses external financing for its FDI projects. Bank financing is the most popular source of funds: 43.8% obtain local bank finance in the foreign country, while 68.8% attract domestic bank finance.

4.3.2.1. Local bank finance

Many SMEs consider local bank financing but state that interest charges (4.00; 40.0%) and collateral requirements (4.15; 46.2%) are elevated (see Table 6). Sometimes, local banks refuse to accept domestic guarantees (2.67; 25.0%). Moreover, in some countries

bank regulation is quite restrictive (3.21; 21.4%), or the bank sector is not well enough developed (3.00; 28.6%). For instance, only short or medium term loans are offered, even for the acquisition of long lived assets like buildings. Leasing does not exist in some foreign countries. China for example is reported to have a very restrictive banking system, in which a substantial equity commitment is required for the bank to consider granting a loan. Furthermore, several firms report that obtaining local bank financing is a time consuming process (3.38; 23.1%). In the interviews, some SMEs stated that they are hindered by a lack of reputation and contacts in the local bank market, or that they were faced with corruption. A number of SMEs claimed that local bank financing is more accessible for large firms.

Table 6: Impediments to attracting local bank financing for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- local banks have high collateral requirements	4.15	0.003	7.7	46.2
- local banks charge high interests	4.00	0.003	0.0	40.0
- the amount of the loan is too small	2.27	0.044	33.3	6.7
- my SME has a lack of reputation and contacts in the local bank market	2.53	0.150	20.0	6.7
- local banks refuse to accept domestic guarantees	2.67	0.489	33.3	25.0
- local bank regulation is too restrictive	3.21	0.583	14.3	21.4
- the local bank sector is not well enough developed (e.g. long term loans and leasing are not offered)	3.00	1.00	28.6	28.6
- my SME is not familiar with local bank regulation	2.67	0.29	20.0	6.7
- obtaining local bank financing is too time consuming	3.38	0.316	7.7	23.1
- there is corruption at local banks	2.23	0.065	46.2	7.7

This table provides an overview of statements relating to local bank financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.3.2.2. Domestic bank finance

A major impediment to attracting domestic bank finance for FDI is that the underlying assets cannot serve as collateral for domestic banks (4.29; 50.0%, see Table 7). This is partly due to their specificity and the resulting low collateral value (3.67; 33.3%). Domestic banks often require (further) personal collateral, which of course is limited by nature or may already be exhausted (3.54; 53.8%). The domestic bank refuses to lend to the foreign subsidiary for the FDI project and lends to the parent firm, thereby shifting the credit risk to the parent (3.53; 20.0%). The limited equity position of the firms is another important obstacle for obtaining FDI bank finance (3.20; 33.3%); however, raising equity with existing shareholders for a typical family-owned private SME is not always feasible, while attracting external equity is often undesirable. Next, domestic banks are not really interested in FDI and have a specific domestic focus (3.29 ; 21.4%), are reluctant towards foreign projects because of monitoring issues (3.73; 40.0%) and are not capable of accurately assessing the risks of FDI (3.43; 28.6%). Furthermore, domestic banks only consider lending for acquiring fixed assets, and not for any required start up costs, market studies, document translation, product adaptation, consulting services or business trips (3.57; 35.7%). For many SMEs, these high costs of internationalization present a serious barrier to foreign investments (European Commission, 2003a). During the interviews, not only the refusal of the FDI loan request was mentioned by some SMEs to be problematic, but also the long search for financing and the long period of time before a loan request is approved. While searching for funds, SMEs cannot completely focus on the core business activities and the optimal timing and implementation of FDI may be jeopardized.

Table 7: Impediments to attracting domestic bank financing for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- the domestic bank refuses to lend to the foreign subsidiary, always lends to domestic parent firm	3.53	0.120	6.7	20.0
- FDI assets cannot serve as collateral	4.29	0.000	0.0	50.0
- FDI assets are very specific and therefore have low collateral value	3.67	0.055	6.7	33.3

- the domestic bank requires domestic assets as collateral, but these have already been collateralized	2.38	0.104	30.8	0.0
- the domestic bank requires (further) personal collateral for the FDI project	3.54	0.279	15.4	53.8
- the limited equity of my SME hinders obtaining FDI bank financing	3.20	0.638	20.0	33.3
- domestic banks are hardly interested in FDI, they have a purely domestic focus	3.29	0.391	0.0	21.4
- domestic banks are reluctant towards FDI due to monitoring issues	3.73	0.036	0.0	40.0
- domestic banks are not equipped to accurately assess the risks of FDI	3.43	0.189	0.0	28.6
- domestic banks only consider lending for acquiring fixed assets, and not for start up costs, market studies, consulting services and business trips required	3.57	0.135	7.1	35.7
- the long lasting search for FDI financing is an obstacle to my SME	3.00	1.000	6.3	18.8
- the long period of time required before a loan request gets approval presents an obstacle to my SME	3.00	1.000	12.5	12.5

This table provides an overview of impediments relating to domestic bank financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The impediments were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

Our respondents claim to be very dependent on banks for financing both domestic and foreign investments (3.63; 18.8%) and that banks, on top of interest fees, charge other (fixed) costs that are more important for SMEs (3.83; 41.7%, see Table 8). The firms state that their bank also takes into account the banking relationship for assessing FDI loans (3.71; 35.7%). Banks base their credit decision for foreign projects to a higher degree on collateral, and not on the projects' profitability and cash flows, than for domestic projects (3.87; 40.0% vs. 3.31; 12.5%). For small SMEs, banks require more collateral (4.60; 66.7%). If banks judge that the FDI's risk is excessive, they will rather ration credit than raise interest rates (4.40; 53.3%). This is in line with credit rationing theories: the risk profile of foreign projects does not lead to higher interest rates due to the perverse effects this would bring along, but rather to higher collateral requirements and credit rationing. In contrast to small firms, banks do not question large firms'

repayment potential (3.67; 25.0%) and base their credit decision for large firms on the FDI's profitability (3.70; 30.0%). Moreover, for larger firms there are some possibilities to collateralize the FDI assets (3.57; 28.6%).

While obtaining domestic bank finance for exporting does not seem to be an issue (2.69; 7.7%), it is impossible to attract bank finance for FDI projects in some specific countries (3.82; 36.4%). As could well be expected, banks are more willing to provide funds for FDI projects in geographically proximate countries. For banks, there does not seem to be a preference for East Europe over Asia (3.20; 10.0%). However, attracting finance for Africa-based projects is next to impossible (4.71; 71.4%), while this is rather straightforward for US projects (2.25; 0.0%).

Interestingly, 40% of the SMEs admit that they sometimes do not even apply for bank credit for a valuable though complex FDI project as they are convinced it will not be granted; this means that the financing constraints reported by our SMEs might be an underestimation as credit requests for more complicated or hard-to-explain foreign projects may never have been submitted.

Table 8: Attracting domestic bank financing for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- my SME is very dependent on banks for financing domestic and foreign investments	3.63	0.036	6.3	18.8
- if banks judge that the project's risk is too high, they will rather ration credit than raise interest rates	4.40	0.000	0.0	53.3
- on top of interest fees, banks charge other (fixed) costs that are more important for small than for large firms	3.83	0.034	0.0	41.7
- obtaining bank financing for export activities is not a problem at all	2.69	0.392	23.1	7.7
- by raising the SME's equity, FDI bank financing would be facilitated	3.73	0.036	0.0	40.0
- banks have more substantial collateral requirement for small SMEs	4.60	0.000	0.0	66.7
- the stronger my SME's growth, the higher the financing constraints experienced with banks	3.75	0.006	0.0	18.8
- my bank takes into account my SME's banking relationship for	3.71	0.055	7.1	35.7

assessing the FDI loan				
- my bank's credit decision for *domestic* projects is based on collateral, and not on the projects' profitability and cash flows	3.31	0.264	6.3	12.5
- my bank's credit decision for *foreign* projects is based on collateral, and not on the projects' profitability and cash flows	3.87	0.010	0.0	40.0
- banks do not question large firms' repayment potential	3.67	0.136	0.0	25.0
- for large firms, banks base their credit decision on the profitability and cash flows of their FDI projects	3.70	0.111	10.0	30.0
- large firms can use FDI assets as collateral for the loan	3.57	0.231	0.0	28.6
- for FDI projects in some specific countries, it is impossible to attract bank financing	3.82	0.068	9.1	36.4
- banks would rather grant a loan for a FDI project				
* in a neighbouring country than in another West-European country	3.85	0.035	7.7	38.5
* in West Europe than in East Europe	4.08	0.003	0.0	38.5
* in East Europe than in Asia	3.20	0.555	0.0	10.0
- obtaining bank financing for FDI				
* in the US is problematic	2.25	0.391	50.0	0.0
* in Africa is problematic	4.71	0.000	0.0	71.4
- my SME sometimes does not ask for bank credit for a valuable though complex FDI project as we know it will not be granted	3.40	0.479	20.0	40.0

This table provides an overview of statements relating to domestic bank financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

According to the SMEs surveyed, the key factor driving the bank's credit decision is the firm's ability to pledge collateral (4.67; 66.7%, see Table 9). Raising new equity is also helpful in attracting FDI bank financing (4.20; 40.0%) as it facilitates respecting credit limits and minimal solvency level (4.00; 30.8%). Having a good and trustworthy relationship with the SME is critical as well (4.07; 53.3%). Other (expected) relevant factors are the country of investment (4.33; 40.0%), the presence of a strong currency (3.87; 20.0%), the realism and feasibility of the FDI's business plan (3.93; 35.7%), the risks of the FDI project (3.93; 46.7%), the SME's management team (3.73; 33.3%) and

financial performance (4.13; 33.3%). An SME experienced with FDI will probably have better access to FDI bank finance (3.53; 26.7%), and obtaining bank finance is easier when the domestic bank has a physical presence in the local country (3.85; 23.1%).

Table 9: Factors domestic banks consider in evaluating loan requests for FDI projects, according to SMEs

To what extent do you agree that domestic banks consider the following factors in evaluating loan requests for FDI projects?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- country of investment, economic and political stability	4.33	0.000	0.0	40.0
- presence of strong currency in local country	3.87	0.003	0.0	20.0
- type of assets to be financed	3.40	0.164	0.0	13.3
- sector of investment	3.60	0.033	0.0	13.3
- realism and feasibility of the FDI's business plan	3.93	0.013	7.1	35.7
- trust and relationship between SME and bank	4.07	0.003	0.0	53.3
- respecting credit limits and minimal solvency level	4.00	0.006	7.7	30.8
- strength of the underlying product	3.00	1.000	20.0	6.7
- sales potential on local market	2.93	0.849	20.0	6.7
- the SME's financial performance	4.13	0.000	0.0	33.3
- management team of the SME	3.73	0.052	13.3	33.3
- presence of the domestic bank in the local country	3.85	0.002	0.0	23.1
- motives behind FDI project	3.36	0.292	14.3	14.3
- risks of the FDI project	3.93	0.010	6.7	46.7
- the SME's ability to pledge collateral	4.67	0.000	0.0	66.7
- raise equity next to debt for the FDI project	4.20	0.000	0.0	40.0
- the SME's experience with FDI	3.53	0.178	6.7	26.7

This table provides an overview of the factors that domestic banks consider in evaluating loan requests for FDI projects, according to SMEs that carry out foreign direct investments, as reported in 16 questionnaires we received. The factors were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.3.2.3. Equity finance

37.5% of the respondents make use of new equity raised with existing shareholders. Existing shareholders are claimed to be capable and willing to provide new equity financing; however, though the scores reported are not particularly high, raising equity with external shareholders seems to be more difficult (3.07; 20.0% vs. 2.60; 6.7%) and the respondents may in some cases be reluctant to do this (3.43; 28.6%, see Table 10).

Table 10: External financing of FDI projects

To what extent do you agree with the following statements?

(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- raising my SME's equity is hard	3.19	0.485	6.3	6.3
- our current shareholders *cannot* buy new shares	2.60	0.271	26.7	6.7
- our current shareholders *do not want* to buy new shares	2.67	0.265	13.3	6.7
- my SME *cannot* raise equity with new external shareholders	3.07	0.843	6.7	20.0
- my SME *does not want* to raise equity with new external shareholders	3.43	0.272	14.3	28.6

This table provides an overview of statements relating to external financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

As raising new equity with current shareholders may not be an option, SMEs might try to attract business angel or venture capital finance. Not a single respondent makes use of business angel funds, and just one has ever applied for this source of finance. Major obstacles to business angel finance are SMEs' lack of knowledge about this source of finance (3.79; 35.7%), the high levels of control and monitoring required (3.80; 20.0%), the cost of business angel finance (3.56; 22.2%) and the fact that the requested amounts of finance are too large for business angels (3.11; 33.3%, see Table 11).

Table 11: Impediments to business angel financing of FDI projects

To what extent do you agree with the following statements?

(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*

- my SME *cannot* raise equity with business angels	2.50	0.430	37.5	25.0
- my SME *does not want* to raise equity with business angels	3.09	0.839	18.2	18.2
- my SME is unfamiliar with business angel financing	3.79	0.035	7.1	35.7
- the amount to be financed is too *small* for business angel financing	2.44	0.179	22.2	0.0
- the amount to be financed is too *large* for business angel financing	3.11	0.842	22.2	33.3
- business angel financing is too expensive	3.56	0.139	0.0	22.2
- business angels require too much control and monitoring	3.80	0.022	0.0	20.0

This table provides an overview of impediments relating to business angel financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

Just one SME in our sample has attracted venture capital in order to finance its FDI projects; however, about half of our sample has ever applied for VC finance.

Rather than not being capable of raising venture capital for their FDI projects (2.09; 9.1%), our respondents show some unwillingness to attract VC (2.92; 25.0%, see Table 12 and Table 13). There is a substantial preference for financing by an industrial partner over VC financing (4.33; 40.0%), and VC is to some extent considered as a last resort (3.15; 23.1%). SMEs do not feel that VCs are not open to investing in their firm or its FDI projects. By contrast, a VC is more interested in SMEs with foreign investments as this may boost returns and enhance exit opportunities (4.00; 40.0%). Contrary to banks, firms do not think that VCs lack the skills to accurately assess their domestic and foreign investment projects. The major obstacles reported by our sample to avoid VC finance is that VC is too expensive (3.73; 36.4%), especially given the low risk they are seeking (3.64; 36.4%), the VC's option to sell off its stake in case of bad results (3.50; 41.7%), and the SME's fear of not being able to buy back the VC's shares if needed (4.00; 38.5%). Moreover, VCs are reported to require too much control and monitoring (3.62; 15.4%), to employ very aggressive investment contracts (3.73; 27.3%), and to desire a too quick exit (3.92; 30.8%). Finally, some firms are not very well informed about VC financing (2.92; 16.7%).

Table 12: Impediments to venture capital financing of FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- venture capitalists (VCs)				
* are not open to investing in my SME	2.62	0.337	15.4	15.4
* are not open to my SME's FDI projects	2.69	0.472	23.1	15.4
* do not have the skills to accurately assess our *domestic* investment projects	2.62	0.420	23.1	15.4
* do not have the skills to accurately assess our *foreign* investment projects	2.71	0.470	21.4	14.3
* require too much control and monitoring	3.62	0.071	7.7	15.4
* refuse to take minority stakes	2.27	0.054	18.2	9.1
* employ too aggressive investment contracts	3.73	0.087	9.1	27.3
* desire a too quick exit	3.92	0.004	0.0	30.8
* want to pursue a too risky expansion of my SME	3.00	1.000	10.0	20.0
* take too little risk compared to the return they seek	3.64	0.152	9.1	36.4
* may abandon or sell off their stake in case of low performance	3.50	0.236	0.0	41.7
- my SME does not want to be reporting to the VC all the time	3.29	0.453	14.3	21.4
- my SME *cannot* raise equity with a VC	2.09	0.053	45.5	9.1
- my SME *does not want* to raise equity with a VC	2.92	0.862	25.0	25.0
- my SME is unfamiliar with VC financing	2.92	0.851	25.0	16.7
- the amount to be financed is too *small* for VC financing	2.60	0.309	20.0	0.0
- the amount to be financed is too *large* for VC financing	1.70	0.001	50.0	0.0
- VC is too expensive	3.73	0.054	0.0	36.4
- my SME fears to have trouble later buying out the VC	4.00	0.004	0.0	38.5

This table provides an overview of impediments relating to venture capital financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

Table 13: Venture capital financing of FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- my SME prefers financing by an industrial partner over VC financing	4.33	0.000	0.0	40.0
- I only consider attracting VC financing when all other financing sources have been exhausted and if it is the only alternative left to finance the FDI project	3.15	0.687	7.7	23.1
- a VC is more interested in an SME that does FDI projects as this boosts potential returns and improves exit opportunities	4.00	0.015	0.0	40.0

This table provides an overview of statements relating to venture capital financing of FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.3.2.4. Government grants

31.3% take up some government subsidies in the host country, while all firms in our sample make use of government grants in the domestic country. The most popular general types of subsidies in Belgium are IWT(Institute for the Promotion of Innovation by Science and Technology in Flanders)-grants, used by 56.3% of our sample, and interest subsidies, used by 37.5% of our sample. Regarding internationalization, 37.5% of the sample makes use of export subsidies, 50% of FIT(Flanders Investment & Trade)-support and 25% of BCCI(Belgian Corporation for International Investment)-support. BCCI usually provides subordinated loans and acts as a co-investor to provide long-term co-financing of foreign investments. 12.5% of our sample has received a grant from the Fund Flanders-Asia, a Flemish fund that provides support for firms investing in Asia.

Financial government support for SME FDI projects is definitely most welcome (4.19; 62.5%, see Table 14). Several firms report that, without government support, it is very doubtful that some of their FDI projects could have been executed (2.67; 20.0%). Our respondents argue that it is the government's duty to help resolve the private market's failure to finance SMEs' FDI projects (3.47; 26.7%). Critical in government support is

that no collateral or guarantees are required (4.36; 57.1%). Another way the government can help SMEs is by guaranteeing their FDI loans (3.94; 31.3%). An important indirect effect of SMEs obtaining government grants for FDI projects it that it facilitates access to private financing, due to an improved solvency position (3.71; 35.7%), but even more significantly due to the positive signal provided, e.g., to banks (4.00; 50.0%). During the interviews, one SME explicitly mentioned that it was next to impossible to obtain bank credit, but that attracting BCCI-support enabled this.[8] Similarly, some other SMEs stated that obtaining interest subsidies and/or government guarantees were requested by banks in order to grant loans.

Given the extent and alleged importance of government support, it is not a surprise that most SMEs are well informed about the different types of FDI support. Some SMEs mention that the people working at these government institutions provide added value to their international plans (3.27; 26.7%). In order to be effective, it is key that the government responds quickly to requests for FDI support (4.27; 53.3%). Obtaining FDI government grants/support is harder for small SMEs (4.36; 42.9%), limited amounts required (4.00; 50.0%) and for certain industries, like services (4.00; 37.5%).

Next to providing financial support, the government must create an environment that facilitates and stimulates international trade, e.g., through the provision of information and the promotion of domestic firms in foreign countries (4.00; 46.7%).

Table 14: Government grants for FDI financing

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- financial government support for my SME's FDI projects is most welcome	4.19	0.002	6.3	62.5
- my SME is well informed about the different types of government support for FDI projects	3.44	0.150	6.3	18.8
- the people working at government institutions that provide FDI support are an added value to my international	3.27	0.499	20.0	26.7

[8] Granting government subsidies or guarantees may send a positive signal to private financiers as knowledgeable government officials certify the recipient, thereby mitigating information problems that otherwise would have precluded attracting finance (Lerner, 1999).

plans				
- it's the government's duty to help resolve the private market's failure to finance SMEs' FDI projects	3.47	0.220	13.3	26.7
- the government should bear part of the SME's FDI project risk	3.31	0.352	12.5	18.8
- the government should guarantee the SME's loan for the FDI project	3.94	0.004	6.3	31.3
- the government needs to respond quickly to requests for FDI support	4.27	0.001	6.7	53.3
- the government must create an environment that facilitates and stimulates international trade (e.g., information provision, promote domestic firms in foreign countries,..	4.00	0.008	6.7	46.7
- sufficient government support (e.g., at BMI) can only be found for large projects and amounts	3.50	0.204	12.5	37.5
- the interest that the BCCI asks for its subordinated debt is too high	4.08	0.002	0.0	33.3
- it is important that the BCCI does not ask for collateral or guarantees	4.36	0.000	0.0	57.1
- obtaining government grants for FDI projects eases access to private financing since				
* it improves my solvency position	3.71	0.065	7.1	35.7
* it provides a good signal (e.g., to banks)	4.00	0.013	7.1	50.0
- obtaining government grants and support for FDI projects is harder for				
* small SMEs	4.36	0.000	0.0	42.9
* limited amounts required	4.00	0.015	0.0	50.0
* certain industries (e.g., services)	4.00	0.018	0.0	37.5
- the administrative burden and the efforts required for seeking for government support do not compensate for the benefits obtained	2.86	0.699	21.4	7.1
- without government support, it is very doubtful that some of my FDI projects could be carried forward	2.67	0.417	26.7	20.0

This table provides an overview of statements relating to government grants for FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to “I totally disagree with the statement”, and a score of 5 indicating “I totally agree with the statement”. Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.3.2.5. Partnerships

In addition to providing additional resources and expertise, a domestic partner may support FDI projects financially. 18.8% has partnered up with a domestic firm for (some of) its foreign projects. Having a domestic partner eases access to domestic financing (3.55; 9.1%, see Table 15).

Table 15: Domestic partners for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- a domestic partner facilitates obtaining				
* domestic financing	3.55	0.052	0.0	9.1
* local financing in the FDI country	2.80	0.642	20.0	10.0
* domestic government support/grants	2.56	0.169	11.1	0.0
* local government support/grants	2.60	0.223	10.0	0.0

This table provides an overview of statements relating to domestic partners for FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

For FDI projects, partnering up with a host country firm is quite common (43.8%), as this allows benefiting from the local partner's legal, cultural and administrative knowledge. Additionally, it facilitates access to local finance (3.54; 15.4%) and local government support (3.85; 7.7%, see Table 16).

Table 16: Local partners for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- a local partner facilitates obtaining				
* domestic financing	1.91	0.010	45.5	0.0
* local financing in the FDI country	3.54	0.068	0.0	15.4
* domestic government support/grants	1.90	0.001	30.0	0.0
* local government support/grants	3.85	0.001	0.0	7.7

This table provides an overview of statements relating to local partners for FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). %

score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.4. Financing gaps

The SMEs in our sample report limited financing constraints for their domestic projects (2.19; 0.0%, see Table 17). To some degree, their FDI projects make attracting sufficient and reasonably priced finance more difficult (2.94; 12.5%). For foreign projects, SMEs make use of suboptimal and expensive sources of finance to a much higher extent than for domestic projects since they cannot attract standard types of financing (2.88; 12.5% versus 1.75; 0.0%). Though attracting financing for FDI projects in the past has not been an insurmountable obstacle for many SMEs (2.64; 21.4%), at present it is felt to be more of an issue (3.07; 26.7%), and most SME indicate that this may be an impediment in the future (3.69; 38.5%).

Table 17: Financing gaps for FDI projects

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- my SME faces financing constraints for its *domestic* projects	2.19	0.007	31.3	0.0
- my SME sometimes makes use of suboptimal and expensive sources of finance since it cannot attract standard types of financing for its *domestic* projects	1.75	0.000	50.0	0.0
- on top of any financing issues your SME might face, its FDI projects further impede finding sufficient and adequate financing	2.94	0.860	18.8	12.5
- my SME sometimes makes use of suboptimal and expensive sources of finance since it cannot attract standard types of financing for its *foreign* projects	2.88	0.743	31.3	12.5
- attracting financing for my SME's FDI projects is				
* at present an obstacle	3.07	0.865	13.3	26.7
* has been an obstacle in the past	2.64	0.404	28.6	21.4
* potentially an obstacle in the future	3.69	0.095	7.7	38.5

This table provides an overview of statements relating to financing gaps for FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert

scale, with a score of 1 being equal to “I totally disagree with the statement”, and a score of 5 indicating “I totally agree with the statement”. Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.5. Impact of FDI on firm performance

SMEs unmistakably claim that the ability to pursue their foreign investments is critical for their market share (4.44; 62.5%), sales growth (4.44; 56.3%), profitability (4.62; 62.5%), value creation (4.63; 68.8%), productivity (4.25; 50.0%), and competitiveness and sustainability (4.81; 87.5%, see Table 18). As demonstrated above, they do experience financial constraints for their FDI projects, which thus have a severe negative impact on their operational and financial performance. Part of our respondents acknowledge opting for a step-by-step slow but sure international growth strategy due to financing constraints (3.44; 31.3%). Obviously, this strategy implies a more limited growth, but reduces the project's capital need and riskiness. From the interviews, it became clear that many SMEs feel comfortable with this gradual approach and that they use the cash flows from the initial phases to finance subsequent international operations. An additional motive for the incremental international growth strategy are the SMEs' limited managerial and human resources. In conclusion, with additional financial resources, SMEs feel that they could more fully realize their growth potential, both in the home country and abroad.

Table 18: FDI projects and SME performance

To what extent do you agree with the following statements?
(1: totally disagree; 5: totally agree)

Item	*Mean score*	*Significance*	*% score 1 (totally disagree)*	*% score 5 (totally agree)*
- pursuing FDI projects is critical for my SME's				
* market share	4.44	0.000	0.0	62.5
* sales growth	4.44	0.000	0.0	56.3
* profitability	4.62	0.000	0.0	62.5
* value creation	4.63	0.000	0.0	68.8
* productivity	4.25	0.000	0.0	50.0
* competitiveness and sustainability	4.81	0.000	0.0	87.5
- I opt for a step-by-step slow but sure international growth strategy due to	3.44	0.234	6.3	31.3

financing constraints				

This table provides an overview of statements relating to SME performance and FDI projects by the SMEs in our sample, as reported in 16 questionnaires we received. The statements were scored on a 5-point Likert scale, with a score of 1 being equal to "I totally disagree with the statement", and a score of 5 indicating "I totally agree with the statement". Mean score is the average score given by the respondents. Significance indicates whether the mean score is statistically significantly different from 3 (p-value from a one sample t-test). % score 1 (totally disagree) represents the percentage of respondents that have marked a 1 score for this statement, while % score 5 (totally agree) shows the percentage of respondents that have marked a 5 score for this statement.

4.6. Interviews with supply side

Evidently, the SME data are self-reported and unaudited. Though much secondary data used in strategic management research are self-reported, we recognize the potential for bias. Therefore, we also investigated the topic from the supply side of SME-FDI finance, as a robustness check on the results obtained with SMEs. The findings are completely in line with those gathered from the demand side.

The financiers acknowledge that financing SMEs is more risky due to their more limited and less professionalized managerial resources, their less well structured organization, their difficulties in attracting and retaining qualified personnel, and their stronger dependency on just a few projects/customers. Moreover, SMEs usually have a weaker financial structure, less equity and low transparency. Smaller firms have the highest risk profile. SMEs' FDI projects are not considered more risky by definition. Each case is analyzed separately. The following factors drive the FDI's risk profile:

- region of investment, economic and political stability, geographic proximity, presence of bank subsidiary or VC syndicate partner
- motives for FDI, realism and feasibility of business plan
- does the SME already export to this country, local sales potential, knowledge and experience of host country
- monitoring of foreign investment, presence of an expat or local partner, easy access to the FDI's financials.

According to the financiers, the key criteria for supplying finance for an SME's FDI project are the region of investment (political and economic stability), the SME management (education, experience, track record), the project's cash flow potential, the SME's solvency position and its ability to pledge collateral.

An SME is more risky than a large firm and this is inflated for foreign investments. In case of trouble, it is harder for SMEs to send a manager to the host country. Internal control mechanism and reporting tools are less sophisticated. Consequently, in order to attract FDI finance, the owner-manager and his perceived competency are crucial. For an international project, an entrepreneur requires above average management skills, knowledge of several languages and strategic vision. If the entrepreneur cannot convince the financier of its above average capabilities (even if he is very capable), obtaining FDI finance will be very hard. An essential element in the bank's evaluation is the project's business plan. However, for banks it is hard to judge the feasibility of international projects: they are not very familiar with other countries and cultures, and monitoring becomes more complex. As a result, the substantial information gap between bank and SME is often not bridged, thereby limiting the odds of attracting FDI bank finance, and inducing the need for collateral.

Due to their riskiness, SMEs are confronted with several constraints for financing their FDI projects. Banks admit that they question small firms' repayment capacity and that they ask for substantial collateral; they acknowledge providing sufficient finance to established SMEs, whereas this is less evident for young firms. Though they do support export and import activities, banks are not encouraging SMEs to carry out international investments. Domestic projects are easier to evaluate, and present fewer legal issues. An excellent business plan for the foreign project is required, and even when the loan request is positively evaluated, banks tend to provide less funds than asked for. Small businesses are charged higher interest rates for FDI projects and collateral requirements are more important. In order to reduce their risk, banks invest in the parent firm, or only invest in the foreign subsidiary when the domestic parent guarantees the loan. Banks require SMEs to have stronger equity positions than large firms; in order for the bank to grant a loan for the foreign investment, new equity may have to be raised. As mentioned before, both providing suitable collateral for an FDI project and attracting additional equity present obstacles to many SMEs.

Venture capitalists indicate that they are not very eager to invest in SMEs, as the low amount of finance looked for is insufficient to justify the substantial time and efforts a deal would require. Only in case of a very high return potential, an investment in an SME

would be considered. Furthermore, the number of VCs specialized in small businesses has decreased over the last few years. In order to compensate for their high (fixed) costs, VCs offer rather low valuations or unfavourable investment terms to SMEs, which therefore deem this source of finance to be rather unattractive. However, VCs willingly admit that firms with international projects offer a more interesting return potential and a wider range of exit options.

The financiers interviewed recognize that there is a failure in the private market for financing SMEs' FDI projects, and acknowledge a need for government intervention and support. Ideally, the government should bear part of the SMEs' risk and guarantee their loans. Alternatively, the government may provide subordinated loans to the SMEs or take equity stakes.

5. Discussion and conclusion

In line with the theoretical arguments developed, we have empirically found severe financing constraints for SMEs that seek FDI finance. SMEs are more risky than large firms and this is inflated for foreign investments. Moreover, academics are still unsure about the empirical effects of internationalization and FDI on SMEs' performance. The volatile returns, information problems and lack of collateral that often characterize FDI result in financing gaps. The home bias of financiers and the capital gearing method used by banks to evaluate SMEs' projects further reinforce financial constraints. Besides, SMEs are clearly disadvantaged compared to large firms. Our empirical findings support the theoretical hypotheses and document the negative effects of finance gaps on SMEs' performance.

When internal finance is insufficient for the FDI project, SMEs often have a hard time attracting funds. Excessive collateral requirements, high interest rates or an underdeveloped banking system may preclude local bank finance. Domestic banks are not well capable of evaluating FDI and suffer from a home bias. Furthermore, they are only willing to finance fixed assets and base credit decisions on a capital gearing approach. Typically, the FDI assets cannot serve as collateral. Attracting external equity may not be available, too expensive or require giving up control. Venture capitalists are

reported to use very aggressive investment contracts. SMEs often rely on government grants to alleviate the private market's failure to finance FDI projects. Next to a direct positive effect, government support provides a positive signal to private financiers. Partnerships, both with domestic and local firms are often utilized, and facilitate access to finance.

The capital market imperfections found suggest a further need to find ways of alleviating barriers to entry to the stock market for SMEs. The government should remove any lack of equity stemming from tax and regulatory frameworks (Wagenvoort, 2003). Furthermore, financial institutions are required to develop creative solutions to the information problems involved in SMEs' FDI projects, rather than relying on collateral. For instance, relationship-based lending may be an option. Establishing close and long-standing relationships serves to reduce information asymmetries between borrowers and lenders as it provides the bank with a clearer understanding of the business' prospects and a better picture of the owner-manager's managerial capabilities (Berger and Udell, 1995; Binks and Ennew, 1996; Boot, 2000). Government grants or other forms of support may mitigate the effects of the private market's failure; especially, the government's lack of a demand for collateral or its guaranteeing of SME commitments are crucial. Besides financial help, SMEs are convinced that the government should create a framework that facilitates internationalization.

To end this paper, we present a number of interesting avenues for future research. It would be useful to find out which variables drive the extent of the FDI constraints faced by SMEs. For instance, human capital helps firms to successfully execute their internationalization strategy (Hitt, Bierman, Uhlenbruck and Shimizu, 2005); owner education is an important determinant for banks to grant loans to SMEs (Bates, 1990). The quality of bank-firm relationships is another major determinant for banks credit decisions: SMEs with more concentrated borrowing and long-term banking relationships have better credit availability, and lower collateral requirements and interest rates (Petersen and Rajan, 1994; Berger and Udell, 1995; Harhoff and Körting, 1998). Firms in an early stage of internationalization have more difficulties in attracting finance for export activities (Bilkey and Tesar, 1977). Similarly, it could be expected that first entering an international market presents more severe financing issues. Equivalently,

substantial financing constraints are likely for SMEs expanding to dissimilar international markets due to the high costs and risks of managing locational diversity.

We have collected data about owner-managers' characteristics, like education, working experience, age, and about the SME ('s FDI), like founding date, industry, size, number of employees, region of investment and previous FDI activity. Though we have carried out some preliminary analysis, we could not detect any significant relationships between these factors and SMEs' FDI financing constraints due to our limited sample size.

Our research is subject to a number of limitations. First, the lack of public data on the key constructs required us to rely on self-reported data for many variables. We have taken various precautions to guard against any potential bias but we cannot fully eliminate the risk of biased data. Second, this study's focus on a single country, Belgium, may cast doubt on its wider applicability. Still, we see no reason why the theoretical foundations for our work should obtain more fully in Belgium than somewhere else (Sapienza, De Clercq and Sandberg, 2005). Third, our sample is composed of firms that have succeeded in carrying out their FDI plans. The true financing gaps faced by SMEs *considering* international investment might be even more substantial. Fourth, the size of the sample used in our study is limited, and for instance does not allow us to statistically examine the factors driving SMEs' financing constraints for foreign projects. On the other hand, given this paper's explorative nature and the fact that the population of SMEs involved in productive FDI is not large, our sample cannot be considered small at all. Resolving the limitations present in this study provides another fruitful area for further research.

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