Contemporary Research on Organization Management and Administration
2016, 4 (2)
ISSN (online) 2335-7959

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ALTERNATIVE INVESTMENTS FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Abstract

The paper attempts to investigate possible alternative investments for small and medium-sized enterprises (SMEs) in Europe by performing the analysis of respective market opportunities. The results show that the sources of capital for SMEs are not homogenous and different financing alternatives exist. These alternative investments differ according to the number of financing instruments suggested by capital providers. The analysis is focused on motives of capital providers and SMEs for participating in alternative investments. The SME financing types can also be profiled according to their firm-, product-, industry- and country-specific characteristics.

Purpose of the scientific research is threefold: to outline the new alternative sources of capital for small and medium enterprises (SMEs), to highlight the motives that encourage both sides (investors and SMEs) to take part in alternative investment processes.

Design/methodology/approach. The starting point for our investigation is the neoclassical investment theory that focuses on optimization problem of a firm. Investment theory is used to support the decision-making process of choosing alternative investments for various purposes. The theory also assumes optimization of the behavior on behalf of the decision makers (investors).

Findings – different form of alternative investments stemmed from current shifts into financial system are highlighted; the motives for both sides (investors and SMEs) to be involved in alternative investment processes are analyzed and compared.

Research limitations/implications – since this study uses some data from private companies which deals with crowdfunding and venture capital that can't be provided by official statistics. But if more comprehensive data is available, more precise result could be obtained.

Practical implications – findings can contribute to the assessing the impact of current changes in relationship lending on SME financing policy and to designing financing alternatives tailor-made to the specific needs of SMEs.

Originality/Value – comparative analysis of different alternative investments for SMEs allows to highlight the peculiar motives of both capital provider and firms to establish relationship lending in every specific case.

Keywords: alternative investments, crowdfunding, marketplaces, start-up capital, small and medium enterprises.

Research type: case study.

JEL classification:
F36 – Financial Aspects of Economic Integration
G19 – General Financial Markets: Other
G21 – Banks, Depository Institutions, Micro Finance Institutions, Mortgages
G28 – Government Policy and Regulation
016 – Financial Markets; Saving and Capital Investment; Corporate Finance and Governance
O12 – Microeconomic Analyses of Economic Development

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Introduction

The emergence of new sources of capital is occurring against the backdrop of other trends in the global world affecting the entire alternative investment industry, which over three decades has evolved and become an integral part of the financial system. The alternative investment industry has become an influential part of the global economy and the financial system as well. It provides broadening access to finance for innovative companies, start-ups and other firms, including SMEs.

New firms account for an average of only 17% of employment, but they create 42% of new jobs (Calvino et al., 2015; European Commission, 2016). Small and medium-sized enterprises, in turn, is embedded within Schumpeterian "shaping" institutional environment in which new and re-positioning firms can grow rapidly to take advantage of emerging opportunities" (Schumpeter, 1947). Therefore, the success of such kind of firms is crucial to the future of jobs and economic growth in Europe. But business environment securing investment finance is challenging for these firms. Access to finance for young, innovative firms is a problem even in countries where access to bank finance has remained stable since the world crisis. Banks continue to provide the majority of the funding to SMEs due to their strong local networks and relationships. However, less than a half of SMEs in Europe receive access to necessary financing without any limitation through the bank lending. Furthermore, access to finance for SMEs is restricted by high information asymmetries, agency risks, and insufficient small transaction volumes. In this context financing instruments used by SMEs depends on different firm- and product-specific characteristics such as firm size, firm age, ownership structure or innovativeness of firms (Artola and Genre, 2011). It is obviously that SMEs are more likely to use alternative external financing instruments.

Deeg (2010) summarizes and evaluates changes in the financial systems of the advanced capitalist economies. While the share of financial claims held by all financial intermediaries has remained steady or increased in most cases for banks there has been a clear decline since the early 1990s in asset intermediation ratios. So investors are increasingly bypassing banks and holding assets in bonds, equities, and other alternative investments. So these resources are potential for funding the SMEs development and innovation implementation. In many countries enterprises are also borrowing less from banks. Firms become seeking the new sources of alternative finance that can also give extra opportunity to validate business idea and concept.

More and more entrepreneurs have started to rely on IT technology to find directly financial resources from the public platforms ("crowd") instead of approaching financial investors such as business angels, banks or venture capital funds (Lambert & Schwienbacher, 2010). This technique is called "crowdfunding". Investigation into crowdfunding shows that investment decisions can be influenced by different factors that are crucial and have to be explored (Bretschneider, Knaub, & Wieck, 2014). Other entrepreneurs may seek to share risk with less risk-averse investors such as business angels and venture capitalists, appreciating the non-monetary values that such investors give. Venture capitalists may engage in a number of value-adding activities, including monitoring, support and control. Those activities are largely noncontractible, but may have real consequences for the way of doing business and making the profit. However even among firms with high-growth potential venture capital is far from widespread as well as business angels. Less than 20% of firms presented on the list Inc. 5000 of the fastest-growing private companies in the US are financed by venture capital (Inc. 5000, 2016).

The **purpose** of the scientific research is threefold: to outline the new alternative sources of capital for small and medium-sized enterprises (SMEs), to investigate the shifts into the alternatives, and to highlight the motives that encourage both sides (investors and SMEs) to take part in alternative investment processes.

The paper explores the state of alternative sources for investment: start-up capital, crowdfunding (marketplaces) as well as private debt. The relevant factors fostering the participation of both capital providers and SMEs in investment processes have been identified. Basic research into the alternative investment industry combined with analysis of applied research into the region's innovative-driven enterprises allows to develop the insight into the current lending opportunities for SMEs.

Theoretical background

The theoretical background of the given research is based on meta-analysis and on the works of relevant scientists that conduct some research into the essence and variations in the patterns of available types of funding. In particular, Swedroe and Kizer (2008) as well as Debski (2006) define alternative investments as a kind of investment that are not included in the traditional forms of the financial market such as stocks, bonds and other debt instruments with high investment risk assessment. However, there is other opinion on this definition. For instance, Dorsey (2008) encompasses hedge funds, private equity, currencies, real estate, commodities and even raw materials. But definition seems to be controversial due to the fact that goods, currencies and commodities could be classified as traditional investments. As a result, due to the high diversity and customized features of some alternative investments, it looks more logical to define alternative investments regarding their investment strategies (Chorafas, 2003).

Moritz and Block made a literature review and outlined the scientific perspectives on this issue (2016). Belleflamme, Lambert and Schwienbacher investigated the peculiarities of crowdfunding in Europe (2013). Torre, Pería and Schmukler studied banks involvement with SMEs and their lending relationships (2010). The previous findings of the applied research of innovative-driven enterprises in Sweden have discovered sources of capital for innovative startup firms available in Sweden (Söderblom & Samuelsson, 2014).

In general, the majority of the studies revealed the theory and practice of alternative investments and the motives that encourage different investors (from "crowd" to institutional investors) and entrepreneurs to take part in alternative investment processes (Shane 2012; Ahlers et al. 2015; Ordanini, 2011; Schwienbacher 2010, Bretschneider, 2014).

In our investigation we explore if broadening range of SMEs has instant access to these analyzed alternative resources. Because this part of business environment is crucial for further development of economy. But traditional bank poses big challenges to SMEs, in particular to newer, innovative and fast growing firms with a higher risk-return profile.

Research methodology

The study uses the data assembled and disseminated by the statistical office European Comission, Hedge Fund Research, World Economic Forum, Kauffman Foundation, Center for Venture Research, Deloitte Touche Tohmatsu. The venture capital data also come from Thomson Financial Securities Data. It covers the statistics of European countries.

Also some data have been acquired from scientific works. We have analysed the data on the number of investors per different project, the amount of capital raised, and the speed of capital-raising in an effort to understand the value of the different signals of potential project quality. ASSOB platform is the source of the sample (Ahlers et al. 2015). Other research takes up on a deeper understanding of the crowd's motivation for investing in start-ups and contributes to the understanding of motivations in crowdsourcing (Belleflamme, 2013). The source of this research is the equity-based crowdfunding platform Innovestment. Innovestment is a crowdfunding platform based in Germany that funded 25 start-ups so far with more than 2 Mio € in total.

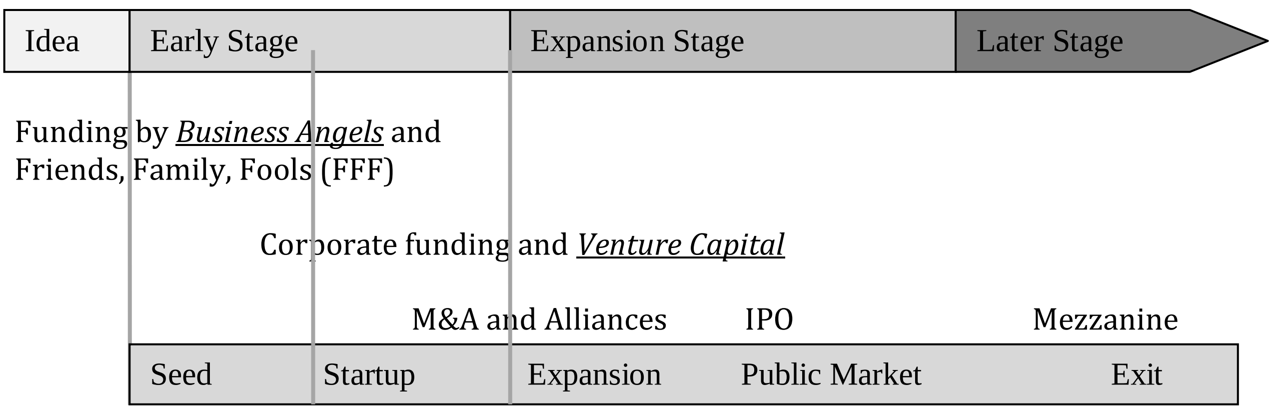
Sources of capital for innovative startup firms are also considered from the perspective of demand (Soderblom & Samuelsson, 2014). In particular, the eight cases were identified from applications to the VINN NU program at VINNOVA (the Swedish Governmental Agency for Innovation Systems). We've been provided by an accurate understanding of the role of angel investing in the entrepreneurial finance system from datasets like Entrepreneurship in the United States Assessment, Angel Capital Association, Global Entrepreneurship Monitor, Business Information Tracking Series, Survey of Business Owners and others employed in scientific research (Shane, 2012).

The methods performed in this research are literature review that allows to identify the different form of alternative investments. Qualitative and analyses are employed to reveal and describe the main reasons for using or not the alternative sources of capital as well as investigate the motives of investors to take part in these processes.

Research results and findings

There are number of potential financing sources available for small and medium-sized enterprises, including commercial banks, venture capitalists, business angels, and government agencies, private individuals, leasing or factoring companies, customers, and suppliers, amongst others. We are going to focus on merits and opportunities for SMEs stemmed from alternative investments that fulfil their needs. The review of data and relevant literature based upon deep research into the use of different investment sources by SMEs points to the following ones.

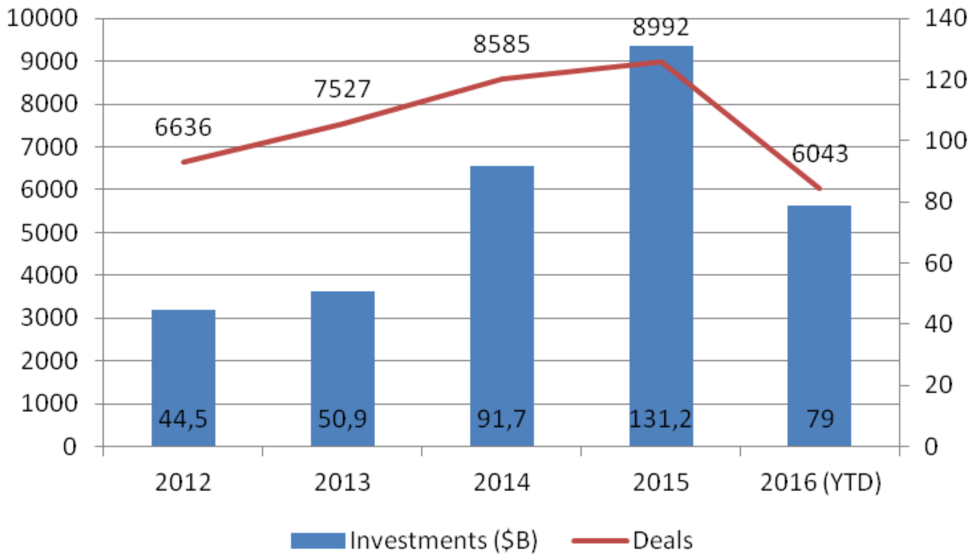
Venture capital (VC) for startups is a type of financial investment targeting privately owned companies with large growth potential in their seed, startup or expansion phases (fig. 1). Venture capital is evolving from an industry dominated by the US, and the Silicon Valley area in particular, to one with multiple hubs spread across the globe. China and India have recently become the new hubs for global venture capital. Together they attract more investment than even Europe. This is both due to saturation of the asset class in developed markets and significant growth in emerging markets. With regards to developed markets the key suppliers of venture capital and supporters of early stage companies are still institutional investors such as pension funds, endowments, and foundations (WEF, 2016).



Source: Ernst & Young

Figure 1. Evolution of business plan and strategy

While 2015 was a record year both in terms of deals and dollars invested in VC-backed companies, 2016 continues to see a noticeable pullback in activity (fig. 2).



Source: Ernst & Young

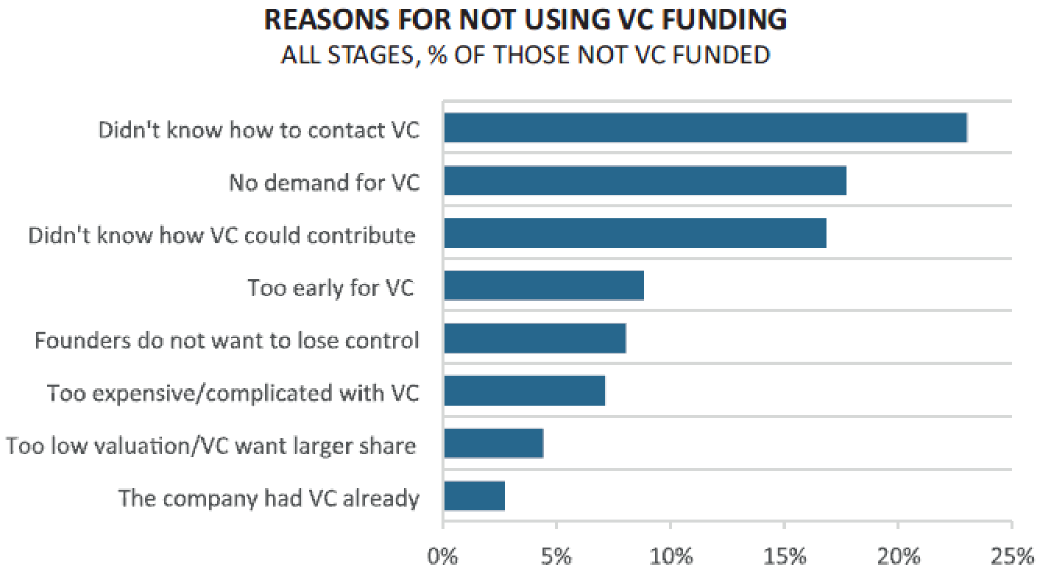
Figure 2. Annual global financing trends to VC-backed firms 2012 – 2016

At the current run-rates, both deal count and total global funding are expected to fall significantly from last year's figures. Investors make bigger bets on established businesses through later rounds. 58% of the total value was captured by later-round class. More than 45% of the total deal volume was captured by first-round class. And around 80% of the total VC deals and value were recorded by companies in the generating revenue stage (EY, 2015).

There are several types of VC firms, where most mainstream firms invest their capital through closed-end funds. Such funds are typically structured as limited partnerships in which the VC firm serves as the general partner (GP) and the investors serve as limited partners (LP). The LPs are mainly constituted of institutional investors and wealthy individuals. VC firms may also be independent, owned by its management team and investing its own capital (US-style VC investors). Another type of VC firm comprises public companies that are listed on a stock exchange. They may also be affiliates or subsidiaries of bank (bank-controlled VC), insurance company or industrial corporation (corporate VC firms), making investments on behalf of the parent firm or its clients; these are also government-funded VC firms (Soderblom & Samuelsson, 2014). They are likely to differ in the objectives they pursue, their organization, and investment capabilities.

Sectors with strong innovation dynamics in Europe include information and communications technology sector as well as areas of medical technology and biotechnology. In addition, spin-offs from higher education often generate excellent start-up ideas. Besides private VC firms, corporate VC arms, private equity firms and hedge funds in developed markets have sought to specialize by focusing on a particular set of industries (such as mobile internet, pharmaceutical, or energy) and often in a single stage of funding (early or late) (SVB, 2014).

The broadening of VC investment is affected by the firms that create a demand for it. The number and amount raised in VC deals have steadily grown for the last years, but it is not enough popular among the capital seekers. Figure 3 provides details about responses as to why the 104 firms that have not received venture capital in the last two years, or since the time of foundation, are not funded by venture capital (Soderblom & Samuelsson, 2014). The most common reason reported by respondents for not using VC is the absence of knowledge how to contact a venture capital firm (23% of respondents). A total of 18% of the firms stated that they did not need this type of funding, 17 % reported that they did not understand how a VC could contribute to their development, while 8% have avoided venture capital because they do not want to lose control.



Source: according to Soderblom & Samuelsson, 2014

Figure 3. Use of venture capital funding

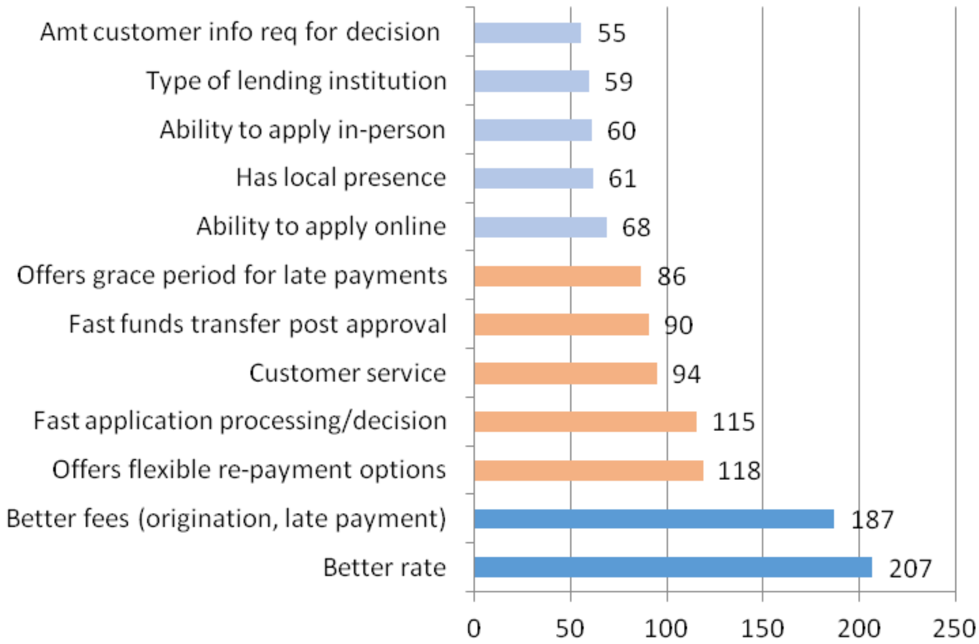
There is another form of investing like **business angels**. They invest their own funds directly into a small number of companies while taking on active roles in the businesses. Unlike venture capital firms that have fiduciary responsibility to other investors, angels tend to use various financial instruments ranging from pure debt to pure equity (Shane, 2012).

The primary motive for business angels to invest in unquoted firms is financially driven. Angels seek to exit their investments primarily through sales of shares to a third party (Riding, 2012). However, given that business angels are not forced to make an exit within a certain timeframe, as opposed to formal venture capitalists typically operating closed-end funds with limited lifespans, the investment duration is usually less critical. Business angels tend to be more willing to accept a stream of dividends from a company that has found a valuable niche, rather than constantly seeking to achieve complete exits.

Crowdfunding. Schwienbacher & Larralde (2010) define crowdfunding as "an open call, essentially through the Internet for the provision of financial resources either in form of donation or in exchange for some form of reward and /or voting rights in order to support initiatives for specific purposes". So groups of people pool money, usually (very) small individual contributions, to support a particular goal (Ahlers, 2015).

Crowdfunding platforms, known as marketplaces, bring together capital supply (investors) and demand (businesses) to interact directly with each other, rather than through traditional intermediaries, such as banks. Marketplace lending firms seek to provide competitive rates to borrowers and access to loans for those who might not be able to obtain it from traditional banks. There are obvious merits of getting a loan from alternative investors. Belleflamme et al. (2013) identify in their interviews with crowdfunding-experienced entrepreneurs three main reasons for choosing crowdfunding to finance their projects. The collection of funds was stated by all of the respondents as the main reason for using crowdfunding. Other motives mentioned were the attainment of public attention and receiving feedback for their products or services. The research made by Morgan Stanley Company (fig. 4) exhibits important attributes when choosing a lender.

The behavior of capital providers is also crucial for the success of crowdfunding. The motives of capital providers for participating in crowdfunding and the factors that influence investment decisions are varied and rest on the respective crowdfunding models. But it is obvious that capital providers are not just financially motivated. They imply different motives and arrangements.



Source: according to research data of Morgan Stanley Company (2015)

Figure 4. Attributes of importance when choosing a lender (among total)

The first model is marketplace (peer to peer) when lending firms provide a platform through which non-banks can loan money to borrowers. These forms include student, commercial and real estate, payday as well as secured business loans, business leasing and factoring. The second model is equity crowdfunding that provides a new channel for entrepreneurs and SMEs to raise equity capital for their development. Particularly equity crowdfunding offers alternatives for those seeking angel or venture capital funding. A key distinction between these two models is that non-high net worth individuals are permitted to provide equity to private businesses. This triggers the growth of potential investors. However according to the Morgan Stanley Research the prevailing providers of capital are still institutional investors due to the assets under their management (Morgan Stanley, 2015). Kim and Viswanathan (2013) study crowdfunding in the mobile application market and find that early investments by experts send positive signals and increase the likelihood of subsequent financings by the crowd. The interviews with founders and employees of three crowdfunding platforms show that capital providers are interested in investing because they are innovation-oriented, prefer interacting with others, identify themselves with the company or the product, and stake on the success (Ordanini et al., 2011).

The third type of crowdfunding is a real estate crowdfunding that is kind of the equity model. It provides a new avenue for developers seeking to raise capital for their projects. Like equity crowdfunding, the growth of the segment is affected by the implementation of the JOBS Act. US President Barack Obama called crowdfunding as «game changer» and signed the JOBS Act (Jumpstart our business startups) in April 2012. The law is intended to encourage start-up companies to raise the fund up to 1 million dollars without any special package of documents and registration of shares. The main objective of the JOBS Act is to make it easier and cheaper for new and small companies to raise equity capital. As a result 56% of funds raised in 2014, were in the US. One more example is rewards-based crowdfunding that seeks to generate an investment return for investors in the form of rewards or discounts related to the products or services that are being funded by their capital. Funding for this model has also grown rapidly in recent years. In 2011 $59 million was raised this way, and $2.47 billion was raised in 2014 (WEF, 2016). The growth has been enough to attract the attention of the European Commission, which is considering applying a 23% value-added tax to all rewards received by providers of capital (Evans, 2015). Gerber et al. (2012) in interviews with capital providers reveals that the investments for financial and non-financial rewards are triggered by the intention to support the project or company. Hemer et al. (2011) further identifies the interest in using the product or service and the attainment of self-affirmation as well as fun. They want also to be active in social networks. One possible consequence of social network for capital providers is the mimicking of others' behavior ("herding") (Herzenstein, Dholakia, et al., 2011). They conclude that herding behavior is strategic and rational because it seems to reduce the default rates of loans.

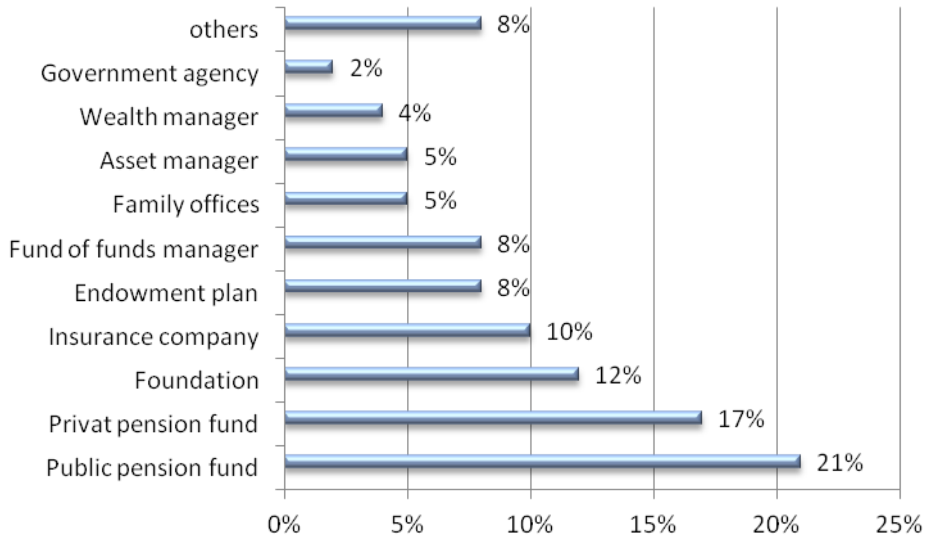
The marketplace that has to be mentioned among others is donor crowdfunding ("keep-what-you-get") that seeks to provide funding for projects on a charitable basis, with donors not expecting an investment return for their contribution. In particular, donor-based crowdfunding often focuses on entrepreneurs, social entrepreneurs and small businesses in fields that are deemed too risky for bank lending (arts, music) and too niche to attract angel or venture funding.

And the last form of crowdfunding is royalty based fund raising. The entrepreneur is able to raise capital without relinquishing an equity stake and potential control of the business, while the lender receives a stream of pre-profit income. So the letters are interested in windfall. The model is the newest of the six highlighted. And regulatory agencies such as the US Securities and Exchange Commission have not yet weighed in on how to regulate the segment. Funding level is growing with $270 million in 2014 (WEF, 2016).

Market capital. The private debt market largely consists of three forms of debt: mezzanine debt, distressed debt, and direct lending. Direct lending means that non-bank lenders provide capital to SMEs in the form of a loan rather than equity. Direct lending refers to a broad spectrum of risk profiles beyond just senior debt. Mezzanine means that private loan subordinate to a senior secured loan but senior to equity in the capital structure of a company. And distressed debt covers debt of companies with an impending or actual covenant default (ICG, 2015).

Private debt is primarily offered to small and medium sized enterprises by private debt funds, private equity managed funds, or hedge fund managed credit funds (fig. 5). Mezzanine continues to be the most utilized investment strategy among private debt managers with 37% having mezzanine as their primary strategy. 30% primarily follow a direct lending strategy, while 17% pursue distressed debt investment opportunities (WEF, 2016).

One of the motives to suggest the capital for lending is the opportunity to move from owning risk to syndicating. It can be seen clearly in the leveraged loan markets. In contrast to the minimal yields on government bonds, institutional investors often hope for returns of 8-14% from private debt funds. The higher yield is a direct result of the additional risk associated with the underlying business, since most such loans are made to businesses that were unable to obtain lower cost loans from traditional banks (Preqin, 2016).



Source: Preqin

Figure 5. Breakdown of institutional investors in private debt funds by type

One of the main and recurrent reasons for SMEs to involve a direct lending is to diversify their sources of financing and no longer depend on banks that have been volatile in their lending policies and limited to provide financing with maturity less than five years. Furthermore, capital providers create tailor-made solutions for one stop shop firms – this is the case with Tikehau (Preqin, 2016).

The European Commission's Capital Market Union (2016) initiative facilitates a wider range of alternative funding sources. There are currently 234 Europebased private debt fund managers, accounting for just over a quarter of all private debt managers globally. The UK is at the forefront, 41% of Europe's private debt fund managers. France, Germany and Switzerland are also prominent centers for private debt activity in the region.

Conclusions

Alternative investments are progressively expanding throughout Europe to become one of the mainstream options offered to SMEs to access long-term debt financing. Due to structural shifts in retrenchment strategy of the banks, alternative financing is growing at a fast pace.

The analysis shows that there is a need for alternative investment sources in this market but it takes time as the entrepreneurs gradually reach the financial investment level appropriate for their developments. We have already identified more than ten opportunities of alternative investments. The sources of capital that have been analyzed may be tailor-made and match perfectly the needs of the entrepreneurs. Because all investment alternatives considered are developing and can be adjusted by their participants. The main reason for not using the VC funding or crowdfunding is the information asymmetries between market actors. Therefore, the traditional market capital is still popular among capital seekers. But nevertheless the interest in alternative investment have been growing for the last several years that is proved by statistical data employed in the research as well as other scientific investigations. In view of the above explained motivations to take part in alternative investment processes, participants may draw on these insights to adjust and implement further features into their models in order to attract the capital or to invest it.

In the next step, we will include for our research the equity-based crowdfunding platforms to explore the significance of different factors that encourage the crowd to invest money and the SMEs to take part in alternative investment processes.

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