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CORPORATE FINANCE

SME FINANCING IN ICELAND
An empirical study of capital structure and the financing environment of SME’s in Iceland.

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Abstract
The thesis analyses the capital structure decisions of Icelandic small and medium sized firms (SME’s) and how market participants perceive the Icelandic financing environment by surveying CEO’s and interviewing market participants. The research finds that capital structure decisions conform most to the financial growth cycle (FGC) and pecking order theories (POT). Firms prefer internal financing, then debt and finally equity. It is difficult to determine whether they make these choices out of preference and asymmetric information (POT) or because they have limited access to other options (FGC).

Responses reveal that less than 10% of firms have considered issuing external common equity. There are two active securities markets in Iceland, Nasdaq’s main market and First North. Although many neighbouring countries have thriving markets such as First North where SME’s are traded, only three firms are registered on Iceland’s First North. Many believe that this is a result of the financial collapse of 2008 and that the markets still have a long way to go to recover their trust and reputation in the eyes of public investors. Interviews reveal that respondents feel that access to financing is limited. More options as well as suppliers of financing are needed to enhance the SME sector, something very important for future economic growth in Iceland.

The research finds that Iceland has a very strong base environment for founding companies, but does not follow through in later stages and that firms, especially high-growth ones, have problems funding growth. Capital controls deter foreign investment and the financing environment is still damaged from a financial collapse in 2008. Most institutions and regulatory parties are crippled by strict supervision, limiting their abilities to rebuild their processes and protocols. Trust and reputation must be rebuilt in order to restore the damaged market and re-include the now very risk-averse public in investments and the financial markets.
Declaration of Research Work Integrity

This work has not previously been accepted in substance for any degree and is not being concurrently submitted in candidature of any degree. This thesis is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by giving explicit references. A bibliography is appended. By signing the present document I confirm and agree that I have read RU’s ethics code of conduct and fully understand the consequences of violating these rules in regards of my thesis.

Date and place       Kennitala       Signature
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1. Introduction

How do firms finance their operations? How should firms finance their operations? What factors influence these choices? These important questions have been among the main research priorities in finance for a long time.

The main purpose of this thesis is to shed a light on the financing environment of small and medium sized firms (SME’s) in Iceland. The research is aimed towards finding how Icelandic SMEs choose their capital structure, which factors are most important and how the Icelandic financing environment affects these decisions.

SMEs account for 99% of all non-financial businesses in Europe, 67% of total employment and generate 58% of all value added to the economy. An SME is defined as a firm that employs less than 250 employees, has a turnover of less than EUR 50 million per year or a balance sheet of less than EUR 43 million (Muller, Gagliari, Caliandro, Bohn, & Klitou, 2014). In Iceland, 99.8% of businesses are SME’s, employing 71.7% of employees and generating 70% of value added (The European Commission, 2014). SMEs are an essential and critical part of the European economy and one of the essential factors in their ability to grow is the source of finance to support their business (La Rocca, La Rocca & Cariola, 2011). In a study by Carpenter and Peterson (2002) empirical evidence showed that small firm growth is constrained by sources of financing. Cost of financing and availability presents a large hindrance to SME growth. Solid public policies and efficient financial markets are crucial to SME growth and viability, for both start-up and existing companies (Storey, 1994).

The Icelandic SME environment has developed rapidly. Following an economic collapse in 2008, many high quality and highly educated individuals found themselves without employment. Many of these individuals went on to work on their own projects, creating a wave of entrepreneurialism in Iceland. Following these events, many small to medium sized companies have emerged, calling for a more sophisticated SME financing environment. Storey (1994) found similar development in the UK, where self-employment rose with a higher rate of unemployment. Responding to these changes, more venture capital and private equity funds have emerged and regulatory changes have been announced to encourage marketplace registration and trading of SMEs and encourage private investment. The research will attempt to create a full picture of how developed the Icelandic financing environment has become in comparison to more mature SME financing markets.
Capital structure is one of the most researched and written about subjects in corporate finance. It has been covered by many of the greatest thinkers in business and economics and two main theories have emerged. The tradeoff theory is based on the assumption that firms find an optimal leverage ratio where they weigh the various costs and benefits of borrowing until the firms value is maximised (Myers, 1984). The other opposing theory is the pecking order theory. It is based on information asymmetry, postulating that the costs of financing increase with asymmetric information and that the firm will prioritise financing options, preferring internal funds to debt and debt to outside equity (Myers & Majluf, 1984). A ruling theory in SME financing is the life cycle hypothesis, which states that a firm’s funding requirements vary at different points in its life cycle. This study will use these frameworks to analyse the structure of Icelandic SMEs, compare the results to previous work, and attempt to identify if and where any funding gaps occur in the Icelandic environment.

The study is built on two methods. The first examines capital structure decisions with information gathered from a survey of Icelandic SME chief executive officers (CEO’s). The second extends the analysis by examining the views of different stakeholders on the financing environment and its development. The two methods complement each other and create a deeper understanding, as the survey shows which sources are used by SMEs while the interviews look deeper into why they choose them.

The survey is based on previous work by Hernádi and Ormos (2012) and Graham and Harvey (1999). Hernádi and Ormos researched the capital structure and the choice of financing alternatives across a broad sample of Central and Eastern European companies while Graham and Harvey surveyed American chief financial officers (CFO’s) about the cost of capital, capital budgeting and capital structure. This study combines the two, focusing on capital structure and decisions. It is notable to mention that Iceland is a small country and therefore its SME’s are relatively smaller than SME’s surveyed in the previous research. The survey was sent to over 1100 CEO’s, with a response rate of 15%.

To expand on survey responses, stakeholders from various areas of the Icelandic SME financing environment were interviewed about their opinions and experiences. They answered a standard set of questions and expanded on matters in their areas of interest or expertise. Participants included CFOs, bankers, investors, entrepreneurs and politicians.
The first part of this thesis will account for some of the existing literature and research on capital structure and other relevant topics that will be encountered in this analysis. Part two will discuss the survey and its results. The method of research will be analyzed, and the data gathering and method choice will be described. The Icelandic results will be compared to the results of similar research from Central and Eastern Europe and the US. Part three will discuss the interviews and their results. Data gathering, research methods and other factors will be described and results discussed. The fourth and last part will discuss the combined results.
2. Literature review

There is an extensive literature on capital structure theories and research and hoping to cover it all would be impossible. Therefore, some important parts have inevitably been left out. However, following is a review of some of the most notable work in the area of capital structure and SME financing. A review of the literature shows that attempts to apply traditional capital structure theory to small and medium sized firms appears to be a prominent research priority.

2.1 Modigliani and Miller

The Modigliani and Miller (1958) theorem arguably forms the basis for modern capital structure thinking and research. The basic theory, sometimes referred to as the irrelevance proposition, states that the market value of a firm is irrelevant to its capital structure. They argue that the market value of a firm is determined by its earning power and the risk of its underlying assets, independently of the way it chooses to finance its investments. They state that under certain conditions, the choice between debt and equity does not affect the value of a firm, there is no optimal capital structure nor an optimal dividend payout ratio. However, these assumptions are based on drastic simplifications, which do not accurately reflect the world that we live in, that contains information asymmetry, taxes, bankruptcy- and transaction costs and non-equivalence in borrowing access and costs (Modigliani & Miller, 1958). Given these simplifications, one might be tempted to find the theory itself irrelevant. The truth is that they teach us exactly why capital structure matters, by showing when it does not. Because Modigliani and Miller's (MM) assumptions are indeed violated in reality, we are forced to think about the assumptions needed to make the theory relevant, how those decisions affect firm value and why. In Merton Millers' own words: “Looking back now, perhaps we should have put more emphasis on the other, upbeat side of the “nothing matters” coin: showing what doesn't matter can also show, by implication, what does” (Miller, 1988, p.100).

In a way, the development of corporate finance can be described as an exploration of the consequences of relaxing the assumptions made in the irrelevance theory (Pagano, 2005).

2.2 Capital structure theories

Myers (1984) sets the tone for future capital structure research by dividing previous work into two contrasting theories, a static tradeoff framework and a pecking order framework. In the tradeoff framework, the firm sets a leverage target which it gradually moves towards, adjusting continuously. The pecking order frameworks' main implication is that there is no target ratio, instead it assumes a strict ordering of financing, where internal funds are always preferred and
equity is only issued as a last option. Myers argues that the two theories both perform as well in explaining what we already know about financing choices and presents them as broad organizing frameworks to aid in future research in the field. He then finds that if a choice was to be made, extended research of a modified pecking order theory would be the route to take (Myers, 1984). Researchers have since done much work on behalf of both frameworks and they appear to hold equal respect.

Another common view is to look at the two frameworks simply as a part of a broad spectrum of factors that determine a firm’s capital structure. The empirical literature supports a number of generalizations that appear to be robust but no model is known to incorporate them all. In fact, the standard versions of existing models contradict some of these known facts (Frank & Goyal, 2007). Therefore, it is easy to see how researchers would not want to reject either model, instead using factors from both on the quest to find a more applicable one.

2.2.1 Tradeoff Theory
The static tradeoff framework explains how firms find an optimal debt to equity ratio by a tradeoff of the costs and benefits of borrowing. The firm must take into account the various costs of borrowing and bankruptcy and balance them against benefits such as tax shields. The firm will then substitute debt for equity or vice versa until its value is maximized (Myers, 1984). However, empirical tests of the model can only be done with a static on-period model, which hinders it from containing a target adjustment as predictions about dynamics can only arise from dynamic models (Frank & Goyal, 2007). In the quest for a more dynamic model, target adjustment theory emerged, which receives much clearer empirical support than either the tradeoff framework or the pecking order theory. The target adjustment hypothesis assumes that a firm has a target leverage level that it gradually moves towards, while considering a number of aspects that were ignored in the previous model, not only the cost and benefits of debt (Frank & Goyal, 2007). The main focus of the tradeoff theory remains the same in both frameworks, there is an optimal leverage ratio and firms will minimize all deviation from the target.

2.2.2 Pecking Order Theory
Jensen and Meckling’s (1976) agency theory forms the basis for the pecking order theory. They divide equity into outside and insider equity and explain that an agent (manager) will not always act in the best interest of the principal (owner). This presents an agency cost, which is the cost that the principals incur for monitoring the agent, bonding expenditures by the agent and the residual loss that occurs because these expenditure have to be made. The value of the firm is
therefore reduced by these unavoidable agency costs. This implies that insider financing is more efficient and less expensive than outside finance. The theory also suggests that the firm is not distorted by taking on riskless debt, essentially implying a financial hierarchy or pecking order (Jensen & Meckling, 1976).

Myers (1984) is the first to use the term pecking order theory, although the theory itself had been evolving in previous work in various fields. As an example, Donaldson’s (1961, 1969) managerial studies show heavy reliance on internal finance and debt. Myers and Majluf (1984) presented their version of the Pecking Order Theory, continuing where Myers (1984) left off. The theory suggests that the costs of financing increase with asymmetric information. This creates a financial hierarchy where firms will prefer to rely on internal sources of funds, as they involve minimum informational asymmetry and therefore carry the least costs as described in the Agency Theory. Then the firm will take on low-risk debt, risky debt when the former is used up, and will only issue equity if they can not avoid it. Firms will possibly restrict dividends when investment opportunities are modest or issue stock when managements information advantage is small to try to maintain a slack, in order to be able to take on unexpected positive net present value (NPV ) investments. They might also not maximise their low-risk borrowings, in order to maintain slack. The reason is that issuing outside equity is expensive, and a firm might need to pass up a positive NPV project in the existing stockholders interest (Myers & Majluf, 1984).

The reason that firms are reluctant to issue new equity is because of adverse selection. Managers are believed to have superior information about the firm, its asset value and growth opportunities. Investors can only attempt to guess these values. Because of this information asymmetry, investors believe that the firm will prefer to issue equity when managers know the firm to be overvalued and therefore place a lower value on the issue. In the same way, a debt issue signals to investors that managers believe that company is undervalued (as they do not issue new equity) (Myers & Majluf, 1984).

Myers (1984) suggests the pecking order decision rule to be: “issue debt when investors undervalue the firm, and equity, or some other risky security, when they overvalue it.”(p.15). Obviously, if investors expected this, they would always adjust the price that they were willing to pay accordingly. Another strategy that investors would then follow, to be sure to pay only a fair price, would be to only buy equity when it is known that the firm is at its debt capacity, effectively forcing the firm into a pecking order strategy. Myers notes that this is an extreme scenario that is not descriptive of real life events, firms could never systematically take
advantage of purchasers of new equity in a rational expectations equilibrium. The examples however do show how this model of asymmetric information predicts the two factors of pecking order theory: firms prefer internal financing and firms prefer debt over equity (Myers, 1984).

Asymmetric information, the main incentive of the POT, is a direct violation of the MM theory of capital structure. The inability of investors to distinguish between firms because of a lack of information can raise the firms’ cost of funding (Gregory, Rutherford, Oswald, & Gardiner, 2005).

Pecking order theory has been found to be particularly relevant in the small business arena (Gregory, Rutherford, Oswald, & Gardiner, 2005). Holmes and Kent (1991) suggest that SMEs are characterised by two factors, they do not have access to outside equity financing and even if they did they would be reluctant to take it. They find that SME managers are often the business owners and as such are worried about ownership and control. As a result, those managers are reluctant to dilute their share in the firm and therefore prefer debt financing. Holmes and Kent (1991) claim that these results suggest that a modified POT is required to fully explain the financing needs of SMEs. The unavailability of outside equity and the owner-managers reluctance to dilute their share and control does not comply with the standard pecking order theory (Holmes & Kent, 1991).

2.2.3 The Financial Growth Cycle

Most historical research in capital structuring and finance has been focused on corporations, paying little attention to SME’s, despite the differences between the two, such as information asymmetry and access to public markets. There has been some focus on SME financing recently, however, most of the work has focused on empirical testing of the main theories of corporate finance. Not many models exist that focus on SMEs, therefore SME financing still revolves mostly around adjusting corporate finance theories to the SME environment. These empirical investigations of SME financing usually adopt the theoretical approaches that have been developed for the world of corporate finance, such as the tradeoff and pecking order models which are used to investigate the determinants of the financial resources chosen by SMEs (Bhaird, 2011).

Following a growth in smaller firms, attention has been focused on their capital structure decisions. Financing problems have been dominant in SMEs and they appear to differ from larger firms in terms of capital structure decisions Chittenden, Hall & Hutchinson (1996) find
that in an attempt to avoid higher costs of capital, smaller firms are forced to use more short-term debt, which carries lower costs but raises the firms' risk.

An SME financing theory that has gained much attention and can be considered a breakthrough in relation to the financing of SMEs, is Berger and Udell’s (1998) financial growth cycle. The theory addresses how each stage of a firm’s life cycle presents a different optimal capital structure. Instead of the corporate finance theory view of capital structure as a constant, SME financing is seen as a dynamic, ever-changing progression. A firm’s funding requirements vary significantly over the course of its life cycle, along with access to various sources of financing (Bhaird, 2011).

Berger and Udell’s work on the Financial Growth Cycle examines the economics of small business financing in private equity and debt markets. They propose that optimal capital structures vary at different points in a firm’s lifecycle, as a function of the firm’s size, age and information availability. One of the main assumptions of the model is informational opacity. When a firm is young and small, very little information on its operations is readily available. This causes limitations in the financing options available, as suppliers of financing will avoid investing in a firm that they have little information about, and the firms rely mostly on private capital markets. This leads to private capital markets characterized by complex contracts managed by specialized financial intermediaries. As the firm grows, it becomes less informationally opaque and more experienced, causing its financing options to change and expand. Older and/or larger firms therefore have access to more financing options such as public debt and equity and long term debt (Berger & Udell, 1998).

Berger and Udell (1998) therefore conceptualise a funding sequence that occurs over the firm’s life cycle, focusing on information opacity and following a financial pecking order. Smaller firms will be forced to rely on insider finance, angel investments and trade credit, and as they advance, they will gain access to external debt and equity. They do not present any age categories or stages of development, and one of the main drawbacks in comparing the financial growth cycle to other theories is the lack of retained earnings as a financing option.

In essence, the financial growth cycle model (FGC) includes factors from both the pecking order and tradeoff theories. They have an optimal capital structure, while the financing options follow the pecking order theory closely as small businesses rely heavily on the pecking order of financing (POT). As Berger and Udell (1989) describe: “(perhaps) the most important characteristic defining small business finance is information opacity.” (p.616).
There has not been much empirical testing of the financial life cycle model, however there is some notable work. La Rocca et al. (2009) believe that the controversy in empirical literature on capital structure is based on a failure to take into account the different degrees of informational opacity and consequently each firm's characteristics and need at different times in their life cycle. They investigated the effects of firm and market characteristics on the FGC and found that the state of the firm’s market is a large factor in SME financing. If financial markets are inefficient or unsophisticated, a firm’s financing options are reduced, which greatly effects its capital structure decisions. Young firms are especially vulnerable to difficulties in accessing credit, due to their opacity, while older firms can often access other types of financing or source credit from other markets. They find that young firms in less developed markets, who do not have enough internal financing to support their business, turn to debt financing before eventually rebalancing as internal capital grows. The results are in line with both the financial growth model and the POT (La Rocca, La Rocca, & Cariola, 2011).

Fluck et al. (1998) investigate the sources of financing for firms in the very early stages. Contrary to the life cycle theory they find that funds from internal sources increase in the beginning, while outside financing declines. They claim that the pattern will eventually reverse and believe the reason to be informational asymmetry. Insiders have more information in the earliest stages which makes insider finance less costly, then eventually the firm develops enough of a reputation to be able to obtain easier access to less expensive outside financing. This happens between two to nine years after the time of first sale (Fluck, Holtz-Eakin, & Rosen, 1998).

Bhaird (2011) conducted empirical research on the financial growth life cycle, gathering data by a questionnaire survey with a 42.6% response rate. His finding are consistent with both the theory of the financial growth life cycle and the pecking order theory. Bhaird’s data shows distinct differences in sources of finance over time, with external and internal sources approximately equal for the total sample. Báird finds the most used source for the youngest groups (as measured by firm age) to be personal savings of the firm founder, along with funds from friends and family. Respondents in older gaps report to rely less on those resources and more on retained earnings, which are the single most used source of financing for all firms except the ones in the youngest gap. The proportion of financing that comes from retained earnings increases for all firms less than 30 years old, peaking for 20-29 year old firms. Debt, mainly short term, is the second total most frequently used source of financing. Long term debt, business angels and venture capital are also frequent sources of financing for firms in the first
gap, while mature firms prefer short term debt (Bhaird, 2011). This matches the results of Berger and Udell (1998) and also corresponds to basic pecking order theory.

Bhaird adds a warning to his results. He notes that a growth cycle model such as the one presented by Berger and Udell suggests that a single model can be used to describe the financing of SMEs. A single model approach ignores all differences in growth rates and availability of resources (Bhaird, 2011). Others have issued the same warning, that the financing of small and medium firms can not be explained by a “one size fits all” universally applicable model (Gregory, Rutherford, Oswald & Gardiner, 2005).

Gregory et al (2005) claim that trying to predict capital structure based on SME characteristics is fruitless, as SMEs are characteristically different. Their research partially supports the Berger and Udell (1998) theory, finding that larger firms as measured by the number of full time employees, are more likely to use private equity and long term debt financing. However, they also find that younger firms are more likely to use private equity and long term debt financing than older firms (Gregory, Rutherford, Oswald & Gardiner, 2005).

Some believe that this might be explained by recent theories on the “gazelle” effect, where young growth firms are theorized to attract attractive forms of financing (Birch, Gunderson, Haggerty, & Parsons, 1999). Gregory et al (2005) comment that the growth cycle model does not provide a full connection between SME characteristics and capital structure, as their research only found firms’ size to be a significant predictor of financing decisions and finding that younger firms are securing venture capital and long term debt, which is counterintuitive to the life cycle theory. They feel that SMEs are characteristically different, their behaviours varying as much as their owner’s personalities, and therefore they can not be put in one universal box. SME financing is much less standardized than the financing of large publicly held companies (Gregory, Rutherford, Oswald, & Gardiner, 2005).

Another perspective comes from Welch’s (2002) National Buerau of Economic Research working paper: “Observed corporate capital structure is primarily driven by external stock returns, and not by managerial responses thereto (or to any other factors) “(Welch, 2002,p.28).

Welch (2002) finds that in corporations, the capital structure is merely the result of outside influences, claiming that managers fail to adjust their capital structure in response to stock returns which results in increased equity values that typically accrue over time. Therefore, a firms capital structure can be predicted by “simply” predicting their future stock return. This result is partially supported by Graham and Harvey (2001) who find that surveyed managers
are not concerned with rebalancing following changes in equity value. Welch's (2001) work is partly complemented by Graham and Harvey (2001) who find that optimal capital structure theories are not important to executives. Managers surveyed by Graham and Harvey (2001) claim to focus more on credit ratings, financial flexibility and earnings dilution. They do however, contradicting Welch (2001), issue equity when they are highly leveraged.

Welch is not the first to argue against capital structure literature. Weston (1955) argued half a century ago that the issue of capital structure was so complex that the idea of creating a single scientific explanatory theory was impossible. A wide variety of factors influence financial decisions and their importance varies from one situation to another. Some are even being very subjective to each decision makers'character. Weston argues that finding more than one feasible solution is a well known situation in business case analysis, and therefore it should be impossible to assert that one unique answer could be found to the puzzle of capital structure (Weston, 1955).

The literature review reveals that there are several theories on the optimal capital structures of SME’s, most derived from corporate finance, but no model has been found to completely explain the behaviour of SME’s. Certain factors from models such as the pecking order theory, tradeoff theory and financial growth cycle have been found to be robust and many view these models as equally accurate and use a combination of their factors on the quest for a more complete model. Others argue that finding a model applicable to all SME’s is impossible, and that there will always be more than one optimal solution as these firms are all characteristically different. This suggests that the capital structure of SME’s is not nearly as clear cut as that of corporations, and that researchers still have a long way to go before finding a true model, assuming that one does indeed exist. In the following chapter, Icelandic firms' capital structure characteristics will be matched with the main factors in these ruling theories of capital structure.
3. Survey

In order to gain understanding of how SME’s in Iceland choose their capital structures, a survey was sent to a large sample of SME CEO’s with a response rate of 15%.

3.1 Survey design

A sample of 1100 CEO’s of small and medium sized Icelandic firms (SME’s) were sent a survey, asking them to answer various questions about their capital structure decisions. The survey was sent by email and completed using the webservice Surveymonkey.com. Respondents were given 14 days to complete the survey. Using an internet service to collect replies insures complete anonymity as well as ease of access for both the participants and the researcher. As the survey was modeled after previous surveys published in English while respondents were generally Icelandic, in order to preserve clarity and avoid misunderstanding the questions were presented both in English and Icelandic. The respondent sample was obtained through Creditinfo, an Icelandic company specializing in company information, using a direct link to the Icelandic IRS database.

The survey focuses on the decisions of Icelandic SME CEO’s regarding the firm’s cost of capital and capital structure. It is built with components from two surveys, Hernádi and Ormos (2012) and Graham and Harvey (2001), from now on to be referred to as GH and HO. Both surveys were aimed to, among other, explore managers’ views on capital structure decisions. The reason for using previously tested survey questions is both one of convenience, as all biases have been minimized by previous researchers, as well as for ease of comparison.

GH built their survey to research the current practice of corporate finance in the US, and although their research surveys much larger firms, they create a good base for the research of current thinking on the subject and are well balanced with HO who researched a similar subject among SME’s in Central and Eastern Europe. The most applicable and relevant factors regarding capital structure decisions were extracted from both papers, as HO focus on the capital structure of SMEs and their choices of financing while GH bring a valuable factor to the table as they focus on analysis based on firm and CEO characteristics. That way we can examine the relation between the CEO’s responses and firm size, CEO education, age and tenure, leverage ratios, dividend policy and management ownership. The variation in executive and firm characteristics allows for a rich description of the practice of SME financing, and indicates whether these characteristics affect the decisions made and if responses are consistent with the main academic theories. Results from both GH and HO will be used to benchmark responses.
and to position Icelandic SME’s and their environment among their peers elsewhere. An important caveat before proceeding forward is that Icelandic SME’s are much smaller than SME’s in the USA, and most would be categorized as micro firms in that market. They are more similar to European SME’s, while still small.

Icelandic SME’s can be divided into two categories. On one hand there are established SME’s that are not preparing for much growth or expansion such as retailers and restaurants. They do however require financing for various parts of their steady business. On the other hand there is a large wave of young high growth companies with ambitious business plans and products. These are usually innovative companies, run by their founders, with a plan to expand vastly in a very short time. These companies have distinctly different needs and growth cycles while both have in common the need for financing.

The survey is built to uncover the motivations of managers when making capital structure decisions and whether they follow the frameworks of the pecking order theory, tradeoff theory, the financial growth cycle or a mix of factors. The survey consist of 14 questions, most with subparts, followed by eight questions designed to collect responder demographics. The total number of questions asked is 83, with most questions having a subpart asking respondents to rate several factors on a scale of not important or never (1) to very important or always (5). The survey sent to respondents can be found in appendix 2.

3.2 Delivery and response
At first, a sample of 1.000 CEOs was randomly chosen from all Icelandic firms with a balance sheet of ISK 5-500 million according to tax statements for the year 2013. This selection excludes two categories, firms with less than ISK 5 million (EUR 0,32m) and more than ISK 500m million (EUR 3.2m). The reason being that the smallest firms are mostly individual part-time businesses, and the largest group contained a significant amount of large companies that were difficult to exclude. The business environment in Iceland is relatively small compared to other economies, and it can be assumed that balance sheets are smaller in comparison as well.

The European Union defines a micro firm as a firm with less than EUR 2m balance sheet, a small firm as having less than 10m and a medium sized firm as having less than EUR 43m balance sheet (Muller, Gagliari, Caliandro, Bohn & Klitou, 2014).

130 responses were collected from the original sample. 1000 surveys were emailed to CEOs, whose email addresses had been collected by the Icelandic IRS. 99 surveys were not delivered which reduced the sample to 901. Just over 400 of the emails were opened, and 130 completed
the survey for a response rate of 14.4%. A logical reason for the low response rate is that many of the firms in the sample are very small, and might have either gone out of business or have either seasonal or very little current operations and therefore did not receive the email or see reason to participate.

After analysing the results from the first sample, it was clear that it did not completely represent SMEs as they appear in previous research. Only five companies had more than 50 employees, which does not fairly represent SMEs, which can have up to 250 employees. Therefore it was decided to expand the survey to include the highest IRS category, containing firms with > ISK 500m (EUR 3.2m) balance sheets. The issue of large firms skewing the data was considered less important than the missing medium sized firms. A survey identical to the previous one was sent to 200 CEOs of firms in the >500m category. The results merged with the previously collected responses and were not analysed separately. The researcher firmly believes that the addition of firms creates a stronger sample that is more representative of SMEs. In addition, collected data shows that only one company employs more than 249.

Out of the 200 surveys sent, 35 responses were collected for a response rate of 17.5%, or a total survey response of 15% from both samples combined. Given the length and depth of the survey, the response rate is significant. In comparison, GH surveyed 4.400 CFO’s, with a response rate of 9%. Investigation into non-response bias concludes that the sample is representative of the population.

A caveat to address before results are discussed is the fact that while a survey offers a balance between large-sample numerical analyses and smaller clinical studies, a survey generally conveys the beliefs and opinions of respondents, and does not necessarily reflect or predict actions. Survey analysis has not been widely used in global nor Icelandic corporate- or SME finance research, and therefore provides a fresh view and understanding of how firms operate.

3.3 Summary statistics and data issues
Appendix 1 presents a summary of information on the firms in the sample. 25% of the firms are in wholesale or retailing, 17% are in a specialized scientific or technical sector and 14% in construction. Others are in the financial sector, tourism and hospitality, agriculture, transportation or other. This is fairly representative for SMEs in Iceland and should provide a good balance.

Nearly 40% of the sampled firms have an average turnover of less than EUR 1.6 million (table 1A), while nearly 30% have a turnover of 1.6-6.5 million. 4% have a turnover of more than
EUR 195 million. The firms surveyed by GH were significantly larger, the most frequent average turnover being between 807 million to 4 billion euros. HO do not ask about turnover or balance sheet sizes and use firm size as measured by number of employees as a proxy for firm size. As they survey firms with 25 to 650 employees, the results from their survey should be more compatible to Icelandic results, although their sample does include larger firms. Nearly 40% of the Icelandic firms surveyed have 2-9 employees, which corresponds to the Icelandic economy, as companies of 2-9 employees are nearly 33% of all companies in Iceland. Less than 10% only have one employee, which is explained by the fact that firms with a balance sheet of less than EUR 300,000 were not included in the survey, and therefore many micro firms are excluded.

The survey reveals that 88% of respondents do not set a target leverage ratio. This is drastically different from GH’s finding, who showed a varied response with nearly 20% having no target ratio, 40% having a flexible one, 30% a somewhat tight ratio and 10% a strict one. HO report that 73% of surveyed SME’s do not have a target leverage ratio, and only 40% of those that do, have a strict one. These result indicate that capital structure decisions vary significantly between SME’s and larger firms. When asked whether firms calculate a cost of equity financing, over 80% said that they do not, while over 60% of GH’s respondents calculate the cost. Out of those who do calculate a cost of equity (table 1E), only 10% always use the capital asset pricing model (CAPM). Over 40% claim to never use the model, which also contrasts GH where over 40% of respondents always use the CAPM.

Most of the responding firms have a long-term average debt to equity ratio of 50-79% (app.1) Many have no debt, while others have a ratio well above 100%. The ratio does not deviate much from GH, the only large difference being that more of the Icelandic firms have no debt.
CEO characteristics were also examined. Over 40% of CEO’s are aged between 40 and 49. Another 40% are 50 to 59 years old. Only 7% are above the age of 60, a group which GH categorize as mature CEO’s. Results also show that CEO’s do not appear to change positions often.

Over 50% had been in their current position for over 9 years, 30% had been in the same position for 4-9 years and only 15% had been for less than 4 years, while nearly 40% of GH respondents had been in their current positions for less than 4 years. Nearly 40% of CEO’s have an undergraduate degree as their highest level of education, 15% have a non MBA masters and 13% have an MBA. Over 20% have other or less education, 18% of which have completed industrial training or hold other non-university degrees. As could intuitively be expected by a sample of large US companies, over 80% of GH’s CEO’s have either an undergraduate degree or an MBA.

80% of respondents reply that 20% or more of the firm’s shares are owned by the top three executives, indicating that a large part of Icelandic firms are owner-run. Only 13% respond that executive ownership of their firm is less than 5%. HO find that 67,8% of respondents claim that less than 5% is owned by top three officers and only 20% responding that more than 20% is owned by the top three officers. In a similar fashion, GH find over 50% of respondent firms top officers owning less than 5% and only 20% of respondents owning more than 20%.

Over 60% of respondents pay dividends, which is not unsimilar to the 40% in GH. The largest contrast and perhaps the most descriptive one for the SMEs is the fact that only 10% of respondents have seriously considered issuing common equity and/or convertible debt. In GH nearly 40% had considered common stock and 20% had seriously considered issuing convertible debt.
3.4 Survey responses

When analysing the survey responses, emphasis is put on discovering the motivations of CEO’s when making financing decisions and whether they appear to result in a static trade-off theory (STT), pecking order theory (POT), financial growth cycle (FGC) or a mixed framework. Survey responses will also be compared to results from similar surveys by HO, GH and others. The research was built to expand on these findings for the Icelandic financing environment and will be compared as opportunity arises.

Several questions with numeral subparts were asked about debt, equity, convertible debt, debt ratios and other factors of a firm’s capital structure. In order for organization and ease of understanding, responses will not be covered security by security. Instead, main findings will be grouped into sections based on the theoretical hypothesis or frameworks. The groupings are in no way mutually exclusive and are not to be considered as all encompassing, they are only meant to organize the presentation of information.

A univariate analysis of the survey responses to each question was performed, conditional on each separate firm characteristic. The full results are listed in a table in appendix 3. By dividing respondents into various subgroups based on characteristics, a pattern can possibly be seen in specific financing decisions.

At first sight, the most important factors affecting the choice of debt levels is maintaining financial slack to be able to internally finance new projects when they come along and a low score is given to the importance of the personal tax investors face and the potential costs of financial distress. This initially indicates a strong preference for the pecking order theory. 69% of respondents report retained earnings to be important or very important when financing new investments and 53% find straight debt important or very important, ahead of restructuring assets, external common equity and convertible debt (app.3.1). These figures provide strong support for the POT. GH also find strong support for POT consistent behaviour but question whether the behaviour is brought on by the information asymmetry of the POT or other factors. They also find that managers find financial flexibility very important, but believe that it is driven more by comfort than a goal of optimizing financing costs.

Firms are asked whether they have applied for a new loan or capital lease in the last three years, as a measurement of access to funding. HO state that in the past, firms in Baltic countries have had a very low leverage due to lack of access to long term financing. In their study they found that nearly 70% of respondents answered the question positively, indicating that the business
environment had changed substantially from the credit rationing in the 00’s. Responses to the survey reveal that 46% of respondents have applied for a loan or operating lease in the last three years and were always approved. 41% had not applied and 12% had applied and received mixed responses. Only 0.6% had applied and always been rejected (app.1).

5. Given an investment that could not be undertaken without modifying the actual balance sheet structure, what action would you take?

<table>
<thead>
<tr>
<th>Choice</th>
<th>% of important or very important</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>b) cut the dividend</td>
<td>69.94%</td>
<td>3.88</td>
</tr>
<tr>
<td>c) restructure assets</td>
<td>37.42%</td>
<td>2.91</td>
</tr>
<tr>
<td>d) forgo the investment opportunity</td>
<td>22.09%</td>
<td>2.45</td>
</tr>
<tr>
<td>a) deviate from the capital structure</td>
<td>20.24%</td>
<td>2.42</td>
</tr>
</tbody>
</table>

Table 4: Financing investments

A surprising result, which can be seen in table 4, is the manager’s willingness to restructure assets in order to take on a new investment. 37% of respondents rate the factor important or very important (rating 2.91). The answer suggests that executives are aware that they could free up potential internal cash reserves by targeting their pool of assets, using a sub-optimal investment option to solve their financing problems rather than issuing new debt or equity (2.42 in table 4) or forgoing the opportunity. The fact that managers view this as an equally or even more important factor than external debt or equity financing is interesting. Results show that larger firms are more willing to deviate from the capital structure (rating of 3.00 in app.3.1), which leads to the question whether larger firms have better access to affordable outside financing, while smaller firms must restructure assets to free internal financing? Large firms would first cut the dividend (3.68), then alter the capital structure (3.00), restructure their assets (2.77) and finally forgo the opportunity (2.64). Smaller firms would cut the dividend (3.95), restructure assets (37.42) and then find altering the capital structure (2.38) and forgoing the opportunity (2.33) nearly equally important. This indicates that access to financing is a larger determinant than CEO preference. There is not a large difference in CEO preferences based on their education, tenure or age. Younger CEO’s are slightly more willing to restructure, and CEO’s with a non university education are very willing (3.44). The largest obvious difference in preference is firm size.

Answers also reveal that managers with a mixed shareholder-manager function are more inclined to keep a firm’s capital structure fixed, and have a higher willingness to pass up an attractive investment opportunity if the investment can not be undertaken without changing the balance sheet structure.
3.4.1 Cost of capital

The survey included one specific question about the cost of capital and how respondents calculate it. The reasoning for including the question is to see whether Icelandic SME’s generally calculate this cost, as none are publicly traded, and to compare the results to previous research. In GH three questions are asked about cost of capital. In this research, only one of them was determined to be applicable and informative for this purpose. The question determines if and how firms calculate cost of equity. The other questions in GH inquired which risk factors firms account for when determining project valuation and how those models are used f.e. in evaluating a project in foreign markets. As Iceland has been under capital controls since 2008, foreign investment was not determined to be currently relevant to Icelandic CEO’s.

The survey revealed that only 14% of respondents calculate a cost of equity capital (app.1). The most popular methods are the CAPM, both regular and multibeta, as well as giving investors the return they require (app.3.4). Each of these factors is only rated as being used always or very often by 30% of respondents. This contrasts starkly to GH who report CAPM as the most popular choice of their respondents with 73.5% always or most often using the method. They also find that larger firms are more likely to use the CAPM than smaller firms (rating of 3.27 versus 2.49) and that smaller firms are more likely to choose the method of “what investors tell us they require“. They also find that CEO’s with MBA’s are more likely to use the single factor CAPM, the same as firms with low leverage or small management ownership and that public firms are much more likely to use the method.

The survey reveals that there is not a large difference between small and larger firms in terms of CAPM use (app.3.4). Highly levered firms are more likely to use the single factor CAPM. A particularly illuminating result is that larger firms are most likely to choose the method of “what investors tell us they require“ or a multifactor CAPM, while smaller firms are most likely to use a single factor CAPM or to follow regulatory decisions in their calculations. No respondent firms involved in manufacturing calculate a cost of equity capital. Firms with low ownership capital are very likely to use the single factor CAPM, however, only 11% of respondents where management ownership is high calculate a cost of equity, while 30% of firms with low management ownership calculate the factor (untabulated results). Another illuminating fact is that respondent CEO’s over the age of 59 do not calculate a cost of capital and CEO’s with MBA’s are most likely to use “what investors tell us they require“.
As the surveyed firms are much smaller and not publicly traded, it is logical that CAPM is not as widely used as GH found. For these firms, beta can only be calculated via analysis of comparable publicly traded firms. This also explains why only 14% of respondents calculate a cost of equity capital. There is little need for privately held companies to regularly calculate a cost of equity as it is complicated and not as accurate as for publicly traded firms.

3.4.2 Capital Structure

3.4.2.1 Trade off theory

Tradeoff theory explains how firms find an optimal debt to equity ratio by trading off the costs and benefits of debt. Firms balance costs of borrowing such as bankruptcy and transaction costs with the benefits of borrowing, such as tax shields from interest payments, and find an optimal target leverage ratio. The firm will then substitute debt for equity or vice versa moving towards the target, minimizing all deviations, until its value is maximized (Myers, 1984). Miller (1977) later added the factor of whether firms considered the personal tax of their investors, when weighing the costs and benefits of debt. The question of whether firms have target debt ratios is one of the longest standing unresolved questions in corporate and SME finance.

Survey responses show that the tax advantages of debt (app.3.8) are rated as important or very important by 22% of CEO’s, with a scale of 2.35 on a scale of 1 (not important) to 5 (very important). Younger CEO’s find them more important, while respondents with a masters degree or higher level of education find them less important. GH have a similar result in terms of scale positioning. Conversely, only 8% find the personal tax that investors face to be an important factor when deciding the appropriate amount of debt issuance, and none find it an important factor when issuing common stock (app.3.6). These results make it unlikely that firms target investors with certain tax preferences, although it can not be ruled out that investors choose to invest in firms based on payout policy.

When asked directly, firms do not find the costs of bankruptcy or financial distress to be a large factor (1.95 on a scale of 1-5) in their choice of debt levels (app.3.8) and the factor is among the lower scoring ones in the category. However, the volatility of earnings is considered important or very important to 33% of CEO’s, which is consistent to reducing debt when the probability of bankruptcy is high. Intuitively, firms with a high leverage ratio consider the costs of financial distress more important than firms with a lower ratio, as do larger firms. A factor that respondents find more important are the transaction costs and fees, scoring a 2.92 with 40% of respondents claiming it to be important or very important. The volatility of earnings is
considered important or very important to 33% of CEO’s, which is consistent to reducing debt when the probability of bankruptcy is high.

88% of firms responded that they do not have a target leverage ratio (app.1). This starkly contrasts GH, where only 19% of respondents do not have a target ratio, and corresponds to HO where nearly 80% of respondents did not have a target leverage ratio. This suggests that larger firms are more likely to set a target leverage ratio than smaller ones. The fact that the firms in this survey are not publicly traded does not seem to be important, as although around 80% of the Icelandic firms are owned by top three officers, the firms in HO (SMEs) GH (Corporations) were only manager held (>20%) in 20% of the cases, despite the variation in firm size between the surveys.

These results provide mixed support for the tradeoff theory, which is based on the fact that firms trade off the costs and benefits of debt, coming to an optimal ratio. GH give untabulated results that show a target leverage to be more important to larger firms in their sample, this however is not visible in our data. Accordingly, only 8% of managers find it important to issue common stock in order to maintain a target leverage ratio (app.3.6). More support against the existence of a target ratio found in both GH and our responses, is that firms do not appear to issue debt when the price of their stock changes (3.77% and 16.38% in GH). The result from this survey is more extreme, however, it is intuitive as not many firms actively calculate a cost of equity and none are publicly traded.

According to responses, the transaction costs and fees are among the most important factors in a firm’s debt policy. 40% of respondents claim it to be important or very important (app.3.8). Transaction costs and fees are however not considered important when delaying debt (app.3.9), rating an average of 2 (on a scale of one to five). For younger CEO’s it is especially unimportant, with a rating of 1.43. These results give a mixed answer, as transaction costs appear to be very important when considering issuing debt while not being considered important when retiring it.

3.4.2.2. Pecking Order Theory

Myers and Majluf (1984) presented the Pecking Order Theory, picking up where Myers (1984) left off. The theory suggests that the costs of financing increase with asymmetric information, creating a financial hierarchy where firms will prefer to rely on internal sources of funds such as retained earnings, then they will issue riskless debt, risky debt and finally equity only if they can not avoid it. Financial slack is also important to firms that follow the pecking order
framework and they might restrict dividends when investment is low or choose not to maximize their low-risk borrowing, to try to maintain a slack. The reason is that issuing outside equity is expensive, and a firm might need to pass up a positive NPV project in the existing stockholders interest (Myers & Majluf, 1984). The POT assumes that firms do not have a target level of leverage, and only take as much debt as they need when internal finances run out.

Financial flexibility is one of the distinguishing factors of the POT model. Respondents were asked to rate the importance of financial flexibility when choosing the appropriate amount of debt for the firm (app.3.8). 49% responded that restricting debt in order to have enough internal funds available was important or very important, giving it a rating of 3.21 on a scale of 1-5. The factor is most important to CEO's with an MBA, who rate it a 3.69. The same applies for larger firms, who give a rating of 3.45 while firms with low leverage find it less important. Opposed to findings by GH, we find that flexibility is more important for non-dividend paying firms, and least important for firms with low leverage, which corresponds to the POT. Firms with a low leverage will not need to restrict debt, as they most likely have slack already due to their low leverage. Dividend paying firms do value the factor, which suggest that this could also be driven by other factors than POT, as they would not pay dividends if they needed to borrow. When executives were asked whether the firm retained a part of its free cash flows when investment was low, 73% said they did. According to the POT, retained earnings are the cheapest source of financing. These results match those when asked which sources of long-term funding were most important for financing new investments, where 69% found retained earnings to be important or very important. This also corresponds to the high number of respondent firms that have little or no debt in their structures (app.1).

Having insufficient internal funds is the factor most respondents (36%) find important or most important when deciding a debt policy (app.3.9). It does however only receive a moderate rating of 2.72. Non-dividend paying firms find this more important than dividend payers, suggesting that firms will first cut the dividend before issuing debt, which is consistent with the POT. CEO's with an MBA also find this factor more important than non-MBA CEO's. There is also modest evidence of firms issuing equity when internal funds are not enough to finance operations (app.3.6), a rating of 2.38 and even less evidence that firms issue equity because of inability to obtain financing using debt, convertibles or other sources. Both of these factors are more evident for larger firms than smaller and only firms in other business than retail, wholesale or manufacturing consider issuing equity. This contrasts the POT, but a warning should be posed that very few respondents have seriously considered issuing equity.
Another factor in the POT is that firms will not issue equity as it will be undervalued due to informational asymmetry. One of the highest rated factors in whether firms would issue convertible debt, is the factor that they believe that their stock is undervalued (app.3.5). This is most evident for highly leveraged larger firms with MBA educated CEO’s, indicating that a certain sophistication is required to find convertibles a considerable option. The amount by which the firm’s stock is undervalued is however not considered important by respondents when considering common stock issuance. This result contrasts GH where it was the most important issuance factor. Finding that firms avoid equity when they perceive it to be undervalued is generally consistent with POT, though respondents only found it important when issuing convertible debt, not equity. In Iceland’s case it can be argued that as respondents are not publicly listed nor is listing currently a very viable option, these results are likely a result of irrelevance rather than POT.

When asked which factors were important for financing long-term investment, respondents found retained earnings to be most important (3.88), then straight debt (3.21), restructuring assets (2.50) and finally external common equity (2.10). This order of importance is a strong indicator for the POT (app.3.1).

One of the most important factors when choosing debt levels is restricting debt to have enough internal funds available for new projects (3.21, app.3.8). On the contrary, the factor that most respondents list as important or very important is to limit debt so that customers/suppliers are not worried about the firm going out of business (3.26) and is more evident for firms in manufacturing or wholesale/retail. This contradicts GH who found very little support for the statement, and suggest Titman’s (1984) theory that consumers will avoid buying a product if they believe that the producer/seller might be going out of business, especially if the product is unique. The factor is more important to larger (3.55) and highly levered firms (3.53). The small size of the economy is a possible explanation for this effect, as customers will be reluctant to buy a specialized product when there are few other providers available if their business partner goes out of business. The fact that this factor is equally and higher rated than financial slack provides evidence against a pure POT. Firms also show strong support for cutting dividends first when financing is required.

To sum up, the importance of financial flexibility and security issuance decisions is mostly consistent with the POT theory of financial hierarchy. The question is whether informational asymmetry is the cause of these decisions as the POT suggests. Although the results show that firm’s value financial flexibility which is generally consistent with POT, there can be other
unrelated reasons for the importance of financial flexibilitly and it is therefore not enough to prove that the POT is the true model of capital structure.

3.4.2.3. Modified Pecking Order Theory
Holmes and Kent (1991) suggest a modified POT, taking in to account their theory that SMEs are characterised by two factors. They do not have access to outside equity financing and even if they did they would be reluctant to take it. SME managers are often the business owners, worried about ownership and control and reluctant to dilute their share in the firm, therefore preferring debt financing.

The survey shows that only 8% of respondents had seriously considered issuing common equity, and 9% had considered convertible debt (app.1). Further evidence for a modified POT can be found when respondents were asked what action they would take if an investment opportunity could not be taken without changing the balance sheet structure (app. 3.2). 70% responded that cutting the dividend would be important or very important (rating 3.88), other options being restructuring assets (2.91), forgoing the opportunity (2.45), and deviating from the capital structure (2.42). The second most important reason for forgoing the opportunity was in order to hold independence (3.65). When asked about top management's share ownership, over 80% of respondents replied that over 20% was owned by top three executives (app.1). This evidence gives substantial support to the modified POT theory, however, there is no evidence about firm access to equity financing and therefore the theory can not be proven as the true model of capital structure.

3.4.2.4. Agency theory
The financial hierarchy of the POT originates in Jensen and Meckling's (1976) agency theory. Agency theory predicts that an agent (the manager) will not always act in the best interest of the principal (owner). This creates an agency problem, which requires expenditures from both parties in order to monitor and bond the two. The residual loss that is left in the firm is an agency cost, one that would not have been incurred if the owner and manager were one and the same. This implies that insider financing is more efficient and less expensive than outside finance. The theory also suggests that the firm is not distorted by taking on riskless debt, essentially implying a financial hierarchy or pecking order (Jensen & Meckling, Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure, 1976).
Myers (1977) argues that investment decisions can be affected by what he calls an underinvestment problem, and suggests limiting total debt or using short-term debt to minimize the problem. When a firm has long-term debt in their capital structure, shareholders may “underinvest” by refusing to make low-risk investments, passing up positive NPV projects. The reason being that they perceive that the profit will be used to pay off existing bondholders (Myers, 1977).

Participants were asked if they attempted to borrow short term in order for shareholders to capture more of the profits rather than committing to pay long term profits as interest to debtholders. There is modest support for the statement, 23% find it important or very important and in total it is rated 2.26 (app.3.7). However, 37% find it important or very important to restrict borrowing in order for profits to be captured more fully by shareholders, rather than being paid out as interest (table 13). Another facet of the underinvestment problem is that as shareholders only invest in risky projects, which is contrary to the interests of bondholders. Shareholders capture all returns above those paid to bondholders and other liabilities, and have limited responsibility when returns are not enough to pay debtholders, therefore they intuitively prefer risky investments. Bondholders on the other hand are not compensated for the extra risk.

When asked whether firms used short term debt in order to reduce the chance of taking on risky projects, again a modest result of 2.2 was received. A small sign of support for the theory is that dividend paying firms show more support (2.30) for the statement than non-dividend paying firms (2.08). However, this is still weak support for the theories of using short term debt to control agency costs. These results are not solid enough to support the theory of underinvestment. GH also showed weak support for the underinvestment theory among larger firms.

It is a longstanding concern that managers of rich companies will waste some of the cash on unefficient investments and perquisite assets. A theory using of debt to control agency costs is presented by Jensen (1986). He argues that managers will take advantage of an ample free cash flow by financing low return projects that might otherwise not have been funded by the equity or bond markets. By committing to pay out the cashflows and using debt, managers should be forced to work more efficiently (Jensen, 1986). Icelandic CEO’s do not seem to be worried about this, when asked whether they used debt to ensure upper management worked efficiently, little evidence (rating of 1.47, app.3.8) was found that firms discipline their managers in this way.
3.4.2.5. Financial Growth Cycle

Berger and Udell (1998) propose that optimal capital structures vary at different points in a firm’s life cycle, as a function of the firm's size, age and information availability. The main assumption of the model is that when a firm is young and small, it is extremely informationally opaque which limits its options of outside financing. As the firm grows and more information and track records become available, more financing options become available to the firm. This asserts that a firm in its early stages can not set and maintain a target debt ratio (STT) or make a choice between financing sources based on their costs (POT), rather, it can only choose between the options available. While they do in a sense follow a pecking order framework, and responses suggest POT, the difference lies in the reason that firms make these financing choices. Is it because this is the order of availability, or the order of preference? Some responses may also suggest an STT, however the reason behind the decision, again, is crucial. According to FGC firms experience various optimal ratios along their life cycle, however the question to ask is whether they arise from choice or availability?

To test whether survey responses are consistent with the financial growth cycle, responses were categorized into size groups in order to position them in their life cycles. Berger and Udell (1998) do not present any age categories, create any certain stages of development or conduct imempirical testing in any way. Bháird (2011) uses age as a categorization while Gregory et al. (2005) use number of employees. Here both the number of employees and yearly turnover are used as a proxy for size, and it can be intuitively proposed that firms will be older as they become larger.

When asked about target leverage, untabulated results show that the use of a target leverage increases as the firm becomes larger. As only 12% of respondents have a target ratio, the results are not completely reliable. We find some evidence that the smallest firms find debt to be the most important option for financing new projects in the long run (4.50), while also finding retained earnings very important (4.25). As firms grow larger, retained earnings remain the first choice in all instances, while straight debt comes second and more importance is given to new equity.

Bháird (2011) finds that the youngest firms (as measured by firm age) are financed with personal saving and funds from friends and family. Older respondents rely less on these factors and more on retained earnings. Firms in the youngest group also use long term debt, business angels and venture capital, while mature firms prefer short term debt. Consistent with Bháird,
the survey finds that firms in the youngest group rate debt as very important, however they do not find external equity as important, which suggests little use of business angels or VC funds.

Consistent with FGC, most loan applications are denied when young firms with a low turnover are involved. Only one responding firm found their applications always denied, however 12% had mixed responses. As firms grow, the odds of not being granted a loan that was applied for are diminished. The survey also reveals that the ratio of firms who did not apply for loans in the last three years, lessens as firms grow larger when size is proxied by turnover. Similar results are shown when measured by size, while not as apparently. This suggests that according to GCT, firms do not apply for loans in the earliest stages because of informational opacity.

It is difficult to determine whether firms have not applied because of choice (POT) or unavailability (FGC). The fact that more companies in the size category 20-49 employees than in the 10-19 had not applied for a loan in the last three years, suggests that choice might be more relevant than unavailability.

Respondents are asked whether they believe common stock to be their cheapest or least risky source of financing (app.3.6). Although the factors in general only receive a rating of 2.38 and 2.17, the larger firms in the sample claim that stock is their least risky source (3.40) and also their cheapest (3.40). CEO’s with an MBA also have the same belief, finding common stock their cheapest source of funds (4.50) and the least risky (4.00). GH found similar results for firms with the characteristics of small start-up companies with growth options. This is intuitive as the larger firms in our survey are medium sized firms that could well fit as being startups, which often get better deals with equity financing as they do not have access to cheaper debt financing.

As firms grow larger in regards to increased turnover, they are less likely to retain earnings when investment is low. A similar results can be found when size is measured by number of employees, though not as clearly. Again, firms in the employee category of 20-49 give a much greater importance to retaining cash flows than the firms in the categories above and beneath them. This does correspond to the fact that a large part of these firms has not applied for loans or leases in the last three years. Intuitively, these firms might be high growth young firms, who do not have access to favorable financing and therefore rely on retaining earnings to grow.

When asked about reasons why the firms would consider issuing outside equity, firms in this category rated “providing shares to employee bonus/stock option plans” an importance of 4 on the scale of 1-5, more than any other size group. This is very consistent with a high-growth young firm, as they also believe that equity is their cheapest source of finance (rating of 3) and
“if our stock price has recently risen, the price at which we can sell is high “an importance of 3. This indicates young growing firms who perhaps are not eligible for affordable debt financing and as they grow they become more valuable, therefore able to sell each share for a higher price while attracting promising staff with bonuses/stock options. This choice of a young growth firm to finance with equity and long term debt does not rhyme with the FGC. It does, however, match Birch et al (1999) who suggest a “gazelle effect” where young growth firms attract attractive forms of public financing such as long term debt and equity. Gregory et al (2005) also find that larger firms as, measured by number of employees, are more likely to use private equity and long term debt.

Larger firms are more likely to deviate from the capital structure than restructuring assets, opposite to smaller firms. The fact that as firms grow, they will prefer to seek external financing than restructuring their balance sheet to release internal funding, suggests that they find external funding more appealing as they grow. This is consistent with results from Fluck et al. (1998) who find that funds from internal sources increase in the beginning while access to other financing is unavailable and then eventually reverses.

When asked why the firm would forgo an investment opportunity rather than changing their balance sheet, little evidence was found that smaller firms had less access to external debt or equity financing or that access changed with size or growth. This evidence suggests that firms are making a conscious choice (POT) rather than being forced because of inavailability (FGC).

La Rocca et al. (2009) claim that there are no definable stages, firms all vary in their degrees of informational opacity and characteristics and need at different times in their life cycles. They do however suggest that young firms in less developed markets will first turn to debt while they do not have enough internal financing, and then eventually rebalance.

Bhaird (2011) and Gregory et al. (2005) both warn that “one size fits all” theories can never describe or predict the financing of SME’s, as they ignore the fact that SME’s are all characteristically different in key factors such as growth rates and access to resources. This again brings us to access of financing.

3.4.2.6. Other theories
Surveyed managers do not seem affected by the leverage of other firms in their industries (app.3.8). When asked if debt levels of other firms in the industry affected their debt policy, only a rating of 1.83 was given, making it one of the lowest scoring factors. It is a little more important for firms with low management ownership (2.62). The highest rated factor (3.07)
when choosing between short- and long term debt is matching the maturity of debt with the life of the firm’s assets (app.3.8). This is a good example of how firms can use capital structure to manage their risk. This is especially important for highly levered firms (3.38). Following GH, the survey also asks whether firms issue debt when they have accumulated substantial profits (app.3.9). GH find no support for the statement, however, we find vague support (2.04), where 13% of Icelandic SMEs find the factor important or very important.

3.5 Summary
To summarize, little evidence is found in support of the trade off theory. Few firms set a target leverage ratio and firms do not rate the tax advantages of debt nor the potential costs of financial distress as highly important factors in debt decisions. Similar to HO there is some evidence of firms with a target leverage giving more importance to tradeoff aspects than POT, however, the results do not show these firms to be less concerned by POT factors.

There is substantially more support for the pecking order theory. CEO’s rated financial flexibility highly and their choices of long term financing options suggest support for the POT. However, when asked what factors they rated most important when deciding debt levels, most managers found that supplier/customers’ fears of the firm going out of business the most important. There was also substantial support for issuing debt when internal funds ran out and maintaining financial slack, giving a mixed response favoring the POT. Support is also found for a modified POT, which implies that a factor in the POT is the fact that firm’s access to outside equity financing is limited and so is their willingness to lose control of their companies. Not much support is found for the agency theory as a single true model though its factors and assumptions are valuable as a part of the POT.

The financial growth cycle find similar support as the POT, which is intuitive as the theories are not dissimilar. POT suggests that firms will always choose internal financing over debt, and debt over equity. FGC suggests that firms have limited access to financing, beginning with internal equity, then gaining access to external debt and equity as their informational opacity decreases and therefore having multiple optimal leverage ratios as they progress through their life cycle. Considerable evidence was found for the FGC. There is some evidence for firms finding equity financing more important as they grow larger and a connection is found between loan applications and firm size. As firms become larger they are more likely to issue debt or equity, although small firms also rate debt as a very important source of financing, giving a mixed result.
To sum up, Icelandic firms appear to adhere to both the POT and the FGC. The question to answer is whether the order of financing choices is out of conscious CEO choice (POT) or availability (FGC).

The survey also finds that only 14% of respondents calculate their firm’s cost of equity capital, 8% have seriously considered issuing common stock and 9% have considered convertible debt. Icelandic SME’s are more owner-managed than respondents in HO. Results show that over 80% of firms are owned > 20% by it’s top three executives. In contrast, HO found that only 28% of firms are owned > 10% by its top three executives. Owner-managers find retained earnings most important, then straight debt, restructuring, common equity and finally convertibles. Non-owner managers find retained earnings more important than owner-managers, the same is found with straight debt, equity, restructuring and finally convertibles. HO found that firms managed by insiders declare ordinary debt and retained earnings equally important while non-owner managers clearly prefer retained earnings over restructuring and straight debt.
4. The Icelandic SME financing environment

The second part of this research focuses on the Icelandic financing environment and how market participants perceive it. Several active participants from various parts of the environment were interviewed and asked to share their views and experiences in order to create a full picture of the Icelandic financing environment for SME’s.

4.1 The Icelandic Economy

Modigliani and Miller (1958) state that a firm’s capital structure is irrelevant to its market value. Under similar constraints, it could also be stated that the geographical position of a firm does not affect its market value. In reality, cost and availability of financing differs between countries and each economy faces different constraints.

Iceland is a Nordic nation of 325,000 people, a constitutional republic with its own currency, the Króna. The Króna was one of the most volatile currencies in the developed world, before capital controls were enforced in Iceland. GDP in 2013 amounted to EUR 33.98 thousand per capita, which in 2013 was the 14th highest per capita GDP globally, reclaiming its pre-crisis position (Iceland Chamber of Commerce, 2014). The standard of education is high, with ten years of compulsory education and 35% of the population completing secondary education and a university degree (The Central Bank of Iceland, 2014).

The Icelandic economy is still haunted by the financial collapse of 2008. Before 2008, Iceland had a decade of a very impressive economic record, achieving one of the highest per capita GDP growth rates in the world while maintaining low inflation and unemployment. Following the global financial crisis, the three large private banks experienced major liquidity problems consequently being taken into government administration. The collapse of the banks, paired with rapid depreciation of the Icelandic Króna, brought an unprecedented economic and financial crisis. The economy contracted by more than 10% in total, more than other European countries in the same position experienced. In contrast, Iceland’s economy has seen a more robust recovery than its neighbouring countries. This robust recovery is expected to continue and even accelerate, fueled by the export sector and a rapidly growing tourism industry (Iceland Chamber of Commerce, 2014). While the economy has recovered by most measures, capital controls still remain in place without a clear timeline for their removal.
The capital controls were introduced by the government and the IMF (the International Monetary Fund) in 2008, as a temporary measure to prevent a dramatic outflow of capital. Such an outflow could have resulted in a collapse of the Króna, which would have severely destabilised the already vulnerable economy. The capital controls limit financial outflow, while allowing inflow and all trade in goods and services. This helped stabilise the Króna, allowing the economy to recover as firms and households restructured their debt (which was largely in foreign currency or linked to inflation). However, the capital controls also have a negative impact. Pension funds have difficulty finding appropriate investment opportunities and investment is limited. This is due to both the uncertainty that the capital controls bring to the economy as well as problems attracting foreign investment and growth through mergers and acquisitions, which decreases their possibilities of Icelandic companies to become globally competitive. Due to the capital controls, foreign investors can not be sure that they could get their investments or profits back out of Iceland, which deters them from investing. Such a closed economy is also at a risk of causing over investment and price bubbles, as investors can only invest in limited domestic options, with pension funds that must invest over 120bn ISK annually (Iceland Chamber of Commerce, 2014). The main reason given for not lifting the controls is a shortage of foreign currency to restabilise the exchange rate, following the risk of capital flight, as large amounts of capital could seek a rapid exit when the controls are lifted, destabilising the exchange rate and therefore the Icelandic economy (Iceland Chamber of Commerce, 2014).

The Icelandic financial system is large compared to the size of the economy and has undergone major changes following the collapse in 2008. At the end of 2013, total banking system assets amounted to nearly twice the GDP, as opposed to ten times the GDP in 2008. The banking system consists mainly of the three large commercial banks, which are currently all in inactive ownership by either the government or estates of the “old banks“, two investment banks and seven small savings banks. The three “old“banks‘ unwinding boards are now the owners of the new banks, who took over the domestic operations of the three old banks while their foreign assets remain in the old banks. The new banks are strong, and all hold a capital adequacy ratio above regulated requirements. There was a sizeable impact when the banks reevaluated and dismissed loans following corporate restructuring. The commercial banks assets consist largely of lending, and they are funded mainly by deposits (58%). Only some 6% of deposits are foreign owned (The Central Bank of Iceland, 2014). The lack of foreign investment and foreign investment opportunities, makes pension funds the main investors in the economy. In Iceland it is mandatory to pay at least 12% of total wages and salaries to pension funds, 8% is
contributed by the employer and 4% by the employee, making the pension funds total assets at the end of 2013 amount to 149% of GDP which is significant in international comparison. Ten of the largest pension funds hold about 81% of the net assets of all pension funds in 2013. Thereof, the two largest pension funds hold 35%, which highlights the concentration in the domestic investor market (The Central Bank of Iceland, 2014).

There is one authorised stock exchange in Iceland, the Nasdaq OMX Iceland, which operates both a regulated market and the MTF (multilateral trading facility) First North. There are currently 13 firms listed on the main market and three on First North. The Icelandic bond market is ruled by government issues, as bonds issued by public entities or firms owned by them account for 83% of total issuance. Corporate bonds account for 9% of issuance, however, they also issue unregistered bonds which are not included in these numbers. The secondary market turnover is concentrated on bonds that carry a treasury guarantee (The Central Bank of Iceland, 2014).

There is widespread support for entrepreneurship in the political environment, with the government taking part in various science oriented grants, venture capital investment and support systems for entrepreneurs. A report was introduced in 2014 where the government lists its goals for 2014-2016 regarding science and technology. Among these goals are intentions to increase private investment in science, research and entrepreneurship, utilizing the tax system as well as making regulatory changes. The government also funds technology and research funds. There is a number of active private equity funds, in which pension funds are always the largest contributors along with mostly domestic private investors. Three early stage venture capital funds are currently active, with a few more in the process of closing financing, and over ten private equity funds. There are two active business accelerators, and some options for grants, although mostly for young science or technology projects.

4.2 Financing options currently available in Iceland
Table 5 lists the currently available financing options for SME’s in Iceland along with requirements and average rates. The information is a consensus reached between multiple experienced parties that were separately asked to fill in the table to the best of their knowledge and experience. A comparable table for firms with access to international financing can be found in appendix 5. The information was provided by a large Icelandic firm that received the information from a foreign consultancy firm when sourcing financing. The information was then confirmed by the consensus. REIBOR is the Reykjavik Interbank Offered Rate, similar to
how most countries use the LIBOR (London Interbank Offered Rate). Interest rates in Krónur are usually quoted in REIBOR or the prime rate, plus a premium which is quoted in BP (basis points) the same as premiums on LIBOR. Icelandic loans also come either indexed (inflation linked) or non-indexed. Nearly all real estate or other long term loans in Iceland are indexed or hybrids of indexed loans. As non-indexed loans are more common for firms, non-indexed rates are quoted.
Financing options available to SME's in Iceland

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Senior Bank Debt (Asset-based)</th>
<th>Senior Bank Debt (Cash Flow)</th>
<th>Senior Bank Debt (Asset-based)</th>
<th>Senior Bank Debt (Cash Flow)</th>
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<tr>
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<td>None</td>
<td>None</td>
<td>None</td>
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<td>Asset Value Approach**</td>
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<td>1-3 years</td>
<td>4-7 years</td>
<td>1-3 years</td>
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<td>Covenant flexibility</td>
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<td>Semi strict</td>
<td>Semi strict</td>
<td>Semi strict</td>
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<td>Interest rate risk *</td>
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<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Collateral</td>
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<td>Yes***</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Prepayment Penalty</td>
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<td>Minimal</td>
<td>No</td>
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</tr>
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<td>Timing</td>
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<td>6-12 weeks</td>
<td>6-12 weeks</td>
<td>6-12 weeks</td>
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<tr>
<td>Investors</td>
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<td>Banks***</td>
<td>Banks***</td>
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<tr>
<td></td>
<td>Funds****</td>
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<td>Funds****</td>
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<table>
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<tr>
<th>Senor Notes</th>
<th>Subordinated Secured Loan</th>
<th>Subordinated Notes</th>
<th>Mezzanine</th>
<th>Private Equity</th>
<th>Public Grants</th>
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<tbody>
<tr>
<td>Non-indexed: REIBOR + 175-250</td>
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<td>Limited</td>
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<td>N/A</td>
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<tr>
<td>Non-indexed: REIBOR + 275-325</td>
<td>Asset Value Approach**</td>
<td>Asset Value Approach**</td>
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<td>N.M.</td>
<td>N.M.</td>
</tr>
<tr>
<td>Non-indexed: REIBOR + 150-225</td>
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<tr>
<td>Non-indexed: REIBOR + 250-300</td>
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<td>Semi strict</td>
<td>Minimal</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

* Various hedging options are available

**Liquidation value as basis, however, cash flows are important measure as they indicate ability to service debt

****Not available at the moment, however several credit funds are being raised

Table 5: Financing options available
The first thing to notice in table 5 is that both senior and subordinated notes are currently non-existent in Iceland. Larger firms that have access to financing abroad have access to these instruments, while Icelandic lenders do not offer them. Covenant flexibility is semi-strict in Iceland and collateral is important, while covenants abroad are not as strict. Premiums over REIBOR are considerably higher for bonds secured with cash flows, though the range is smaller than for asset secured debt (which can range in quality). The rates quoted in app.5 are for larger firms (those that have access to these markets) and are therefore not completely comparable. Icelandic banks are found to be willing to lend up to 4.0x EBITDA, however that depends on each firm and can be in the range of 1.0x to 4.0x. The time it takes to process a loan application can range from 6 to 12 weeks. Simple applications can be quickly processed, while more complicated matters take longer time. Six weeks is very efficient in foreign comparison.

Debt is currently only issued by banks in Iceland, although this may change soon as some credit funds are in the process of closing funding. When and if credit funds become available, they are expected to offer both typical bonds as well as some forms of mezzanine, which is currently mostly unavailable. The table in app.5 shows that several more providers of debt exist in foreign markets and that mezzanine structures are more common. Private equity financing is available in Iceland, though less so than debt financing. There are currently three active venture capital funds (Frumtak, Eyrir, Sprotar and NSA) and several private equity funds. The funds range from ISK 3-8 billion, excluding one fund that which raised ISK 54 billion and focuses on investments in large Icelandic companies. Many of these funds focus on larger companies which can be listed on the main market in the near future, while some focus on travel industry companies or other developed SME’s. Grants are also available for new firms/projects, the largest provider is government run Rannís, whose largest fund focuses on science and technology research, while other specialized foundations provide smaller grants to specific projects. Grants are usually assigned once every year and Rannís requires firms to co-invest an amount equal to their grant. Grants are not a part of the table in app.5, as that table is focused on larger firms. Although the comparable table was created for a large Icelandic firm, the firm is only medium sized in international comparison and its lending options abroad should therefore reflect the options that SME’s would have in the smaller economy of Iceland.
4.3 Views on the environment
In order to give depth to survey results, interviews were conducted, establishing a consensus on how participants perceive the Icelandic financing environment. Participants are all active and experienced members of the financing market, representing various parts of the environment.

4.4 Research design and response
The second part of the research was carried out by interviewing a sample of eight individuals. The sample was a judgement one (Marshall, 1996), where individuals were chosen based on previous experience and fields of expertise. Sampling techniques used in quantitative research are rarely appropriate for qualitative research, as qualitative research usually requires a more flexible design and is often developed further as the study progresses. No certain sample size is traditional for qualitative studies and sample sizes usually vary, although usually small, the main rule being that the sample size should be the one that adequately answers the research question. The generalizability of quantitative research is sacrificed in order to obtain specialized knowledge more able to answer the research question (Marshall, 1996).

Interviewees were selected based on their field of expertise. They represent various facets of the financing environment: banking, government, company founders, SME CFO’s, financial advisors, fund managers and more. Although chosen to represent their experiences in a certain field, as Iceland is a small country, many have had previous experience in other parts of the environment which only adds to their contribution. Although eight individuals were formally interviewed, many more gave their opinions on various subjects during unstructured casual conversations, and some of these views will also be expressed. The eight individuals were all asked the same nine questions during a semi-structured interview. As their expertise varies, some had extensive knowledge and input on one subject and less on another. For this reason, interviewees were encouraged to expand further on their areas of interest and conversation often flowed to their various areas of expertise. Participants were also encouraged to give both their personal and professional opinions and to share their experiences. For this reason the interviews are kept anonymous. Participants were contacted either by phone or email and asked to participate and a time was chosen to conduct the interview. The researcher then visited each interviewee in his/her workplace and the interview was recorded and later transcribed. The interviews were conducted in Icelandic and the eight respondents are believed to represent a diverse cut of the environment. The topic of SME financing holds much interest in Iceland and participants had a strong opinion on most subjects, same as others that were less formally interviewed.
As previously stated Icelandic SME’s can, and should, be divided into two categories. On one hand there are established SME’s that are not preparing for much growth or expansion, and on the other hand there is a large wave of young high growth companies with ambitious business plans and products. The financing of the latter is a much more popular subject in the Icelandic community than the previous, but attention was paid to gaining insight into views on the financing of both.

4.5 Interview results

The interview results are grouped by questions and/or themes of discussion. The list of questions that participants were asked can be found in appendix 4. For ease of analysis and presentation, when themes of previously asked questions emerged in later conversation, those views were added to the appropriate part of the analysis although the comment was not a direct reply to the question.

4.5.1 How developed is the environment

The first question that respondents were asked was whether they find the Icelandic SME financing environment to be developed or underdeveloped. Most agreed that the market is rather underdeveloped. One preferred to refer to it as damaged, and another feels that there is definitely room for improvement. Another interviewee says that the market is not underdeveloped, but not very developed either, and that it has vastly improved in recent years.

Participants offer various reasons for their views. One feels that there is little to no financing available, and those that do get financing are being sold too cheap, as they have no other options available. He also mentions that capital controls are a large factor in forcing companies abroad, weakening the Icelandic environment. Another participant has the same view, and notes that the capital controls must be removed so that companies can source financing abroad without taking their company out of the country. The participant finds this important, as most firms are forced to look abroad for growth financing, which he believes is not widely available in Iceland. He feels that SME’s mainly have access to bank debt financing and that other options are not highly available. The participants also add that the investor environment is not very developed in the case of SME’s, and that they have very little access to the main Icelandic investors: pension funds. Others mention a positive development from the government. Government funding of grant programs such as Rannís is increasing and an ambitious action plan for 2014-2016 was recently introduced by the Science and Technology Policy Council. The action plan is comprised of 21 actions that provide a key to strengthening research and science in Iceland.
It is the first of its kind, with fixed time limits, cost analysis and specified responsible parties as each action is made the responsibility of either a ministry or a public institution (Science and Technology Policy Council, 2104).

Most also agree that Iceland has a very strong foundation for new and young companies and does well in supporting them when they are taking their first steps. There is a vast support environment, innovation houses and centers are highly developed and available, grants are visible, business accelerators and mentors are available and the support for starting a firm is all in all available and of high quality. However, some feel that the financing market is too small and that expertise in high-growth financing is lacking within the Icelandic banks. Non-growth companies get decent service in the banking sector, but the rates are too high and companies must either produce collateral or take on the debt personally.

Many are optimistic that new VC funds will be closed in 2015, some of them seed funds, and have hopes that this will make more financing available to SME’s. Respondents also claim that there are around 20-30 currently active business angels in Iceland. These individuals all have different backgrounds and specialties, but most have one thing in common: they value their privacy highly and do not flaunt their investor status. Interviewees claim that some keep in contact and discuss deals, although not in any sophisticated way as can be seen abroad, where individuals often title themselves as professional angel investors. One participant believes that this is a matter of maturity, it will still be a few years before individuals will be proud to call themselves investors or angel investors, while other agree but believe it to be a matter of reputation. The finance market’s reputation is still very damaged in the Icelandic community and many respondents believe that there is still a little stigma to associating with investments. Another hopes that this will soon change and notes that it lies in the nature of the entrepreneurship community that it is a cycle. As more innovators sell their firms, more angel investors will emerge, as these innovators have the experience, knowledge and funds neccessary to make other ventures successful. Participants all agree that the knowledge, experience and support from angel investors and/or funds is just as important to them as the funding received. A participant with experience of working with these Icelandic VC’s agrees that the work has been successful and a good experience.
One participant notes that being an investor and being an angel investor are not to be confused. Angel investors are individuals who accompany their investments with an active role in the firms. They share their knowledge, networks and provide guidance to the firms. Being an angel investor can be complicated and is not a heavily recognised practise in Iceland, the companies are different from the usual steady cash flow firms. It is also not a role meant for all investors. Another feels that the banks have created a difficult business environment for SME's by taking different stances on debt writeoffs following the financial collapse in 2008. Some banks created healthy customers by cancelling an amount of their debt, while others keep their customers highly leveraged, creating a market where companies are not equal and some are not capable of professionally managing their finances. Another notes that there are also differences in laws and regulations, restricting the Icelandic financial market in comparison to other economies.

4.5.2 Strengths and Weaknesses

When asked about the environment's main strengths, many again mentioned the good support systems for young companies and startups. Iceland is a small country and so are its banks and other institutions. Naturally the lines of communication are short and decisions can therefore be made quickly for customers, such as loan extensions and other straightforward decisions. A respondent claims that reaching your bank to enquire about anything is easy and access is good. The foundations are small and therefore can make quick decisions with a certain autonomy so things can move quickly. A participant noted that the size of the economy also makes it very easy to reach someone to ask for an advice or information, it is simple to look up a phone number or email address and nearly anyone can be reached. He also feels that Icelanders are usually very willing to assist and share their experiences, the same as another participant notes. Another opinion expressed is that those that do have access to financing have access to much more financing than in other countries. One participant’s experience is that Icelandic banks appear to accept higher leverage ratios than other economies, though he finds counting that as a strength to be arguable, although this eases access to financing for firms. The participant also notes that access to those that have financing can be easy due to the small market and short lines of communication, but the downside is that those that have the funding are not many.

The interview also asked participants what they perceive to be the main weaknesses of the Icelandic financing environment. Many participants feel that finding the money to fund growth is difficult. One notes that initial startup funding is not as difficult, there are various grants, business accelerators, friends and family and others who can fund and support the first stages of the firm, supporting it in creating a prototype and finding users/buyers. However, once the
firm wants to grow, the part of going from 5 to 25 employees, there they run into trouble finding funding. Another interviewee adds that there are not enough funds and other investment vehicles bringing funding to the market which is a statement echoed by most participants. A company founder agrees, adding that there are only one or two if any equity funds available that could suit his business at each time. He feels that specialization in high-growth firms and their financing needs is lacking in Iceland except for a few venture capital funds, which are his preferred financing option as they are the only specialized parties. Financing options are limited and the level of flexibility is low. Another respondent feels that there is not enough business experience in the banking system. They have well educated bankers and financiers, but believes that they lack people who have experience in running a smaller business that know what issues they deal with on a day to day basis and what kind of services would suit them best. He adds that there are no banks or advisories that focus on SME’s and specialize in servicing them and another notes in the same way that the banks in general are very similar and little specialization is happening in the environment as a whole. The capital controls are also mentioned by many to be a large weakness and that a way must be found for firms to finance themselves without leaving Iceland. Another interviewee feels that the Icelandic consulting environment is very corporate-centered. In countries with a more developed SME financing market, there are many advisors who specialize in SME’s and are experts in their registration and general financing. In Iceland, advisories mostly focus on larger firms, lacking the specialization required to service smaller firms. A participant also mentions Icelandic investment culture as a weakness. In countries such as Sweden, the general public is an active investor and includes it as a part of their retirement savings, while the Icelandic public is very little involved in the Icelandic markets. Participants also find that tax incentives to bring the public into the markets are a viable option that has proven itself before. Many believe that accomplished Icelandic firms such as Marel and Óssur received much of their growth funding 15 years ago due to tax incentives.

An SME CFO notices stricter lending terms in the banks following the 2008 collapse. He feels that borrowing is difficult and that banks are reluctant to lend to companies with low equity ratios. The banks have money to lend but have strict rules and, perhaps due to recently being burned, are reluctant to lend money that they are not 100% certain to reclaim. The respondent adds that his experience is that banks are reluctant to lend to averagely levered companies. He also feels that they attempt to avoid all changes in large loan agreements after they have been made, in order to avoid going before their board of directors for approval. He notes that some banks will make an effort to convince companies to keep inefficient terms to avoid going before
their board. He feels that everything that requires long term commitment, which is riskier, is difficult to obtain. Another interviewee agrees and mentions that alot of trust was lost in the protocols and processes of financial institutions in the collapse of 2008 and that they have been forced to re-invent many of them. The new procedures slow everything down, and appear very bureaucratic at times. Large companies are suddenly running into hurdles with issues that used to be unproblematic, that now have to go before risk control boards and everything that falls outside the norm appears to be very difficult to provide. He feels that institutions such as the FME (The Financial Supervisory Authority) have grown in scope and that some believe a lot of effort is being spent on unimportant issues. He adds that these are ghosts of the financial collapse, the rules are stricter now and the market is more careful. Finally, a few respondents mention that overseas connections are missing from the financing community. Not many have the knowledge or connections to assist firms in finding and negotiating foreign capital.

4.5.3 Government support of growth firms
As many respondents mention, the government has shown much support for young growth firms and a strong support environment is readily available. This might partly be traceable to a report issued by McKinsey & Company in 2012. In the report, McKinsey and co. (2012) claim that in order to eliminate Iceland’s vicious cycle of a current account imbalance and slow economic growth, new sources of exports are needed. The report assumes a balanced long-term real economic growth target of 4% and in order to fill the expected gap, Iceland needs new exports of ISK 1 trillion by 2030 – roughly doubling the level of current exports. The report suggests a growth agenda focused on productivity improvements across the economy, growing internationally oriented sectors to create a long-term economic balance. McKinsey and co. (2012) highlight, among other, Iceland’s international sector. Facilitating rejuvenation and building a strong entrepreneurial environment will ensure the long-term sustainability of the sector. They also highlight increased efficiency in the domestic service sector, where increased competition is considered the driving force of increased productivity, and specifically mention that Iceland’s high corporate debt levels and lack of private ownership can distort competition (McKinsey & Company Scandinavia, 2012). Here the previous division of SME’s into high-growth firms (internationally oriented) and established SME’s (domestic service firms) and their very different needs are apparent.
McKinsey and co. (2012) find the investment rate in Iceland to be low, and that it has not recovered as could be expected. Iceland is currently not a hospitable country for foreign direct investment (investment was mainly fueled by foreign capital in previous years), delay in company restructuring has dragged down investment rates (27% of the companies that ended in bankruptcy in 2008 were still directly owned by Icelandic banks at the start of 2012) and finally the investment climate is expensive and ambiguous, causing investors to pass up promising opportunities. “Rather than allocating capital to productive but relatively illiquid investments, capital is sitting idle as deposits in banks or is invested in more liquid real estate“ (p.22) With the current investment rate, Iceland is only able to support a 1% annual long term growth in real GDP per capita (McKinsey & Company Scandinavia, 2012).

A former mentioned report issued by the Science and Technology Policy Council of Iceland puts forward an action plan for 2014-2016 to strengthen research and technology in Iceland. The report lists 21 actions, which have all been cost analysed, given a specific timeframe and allocated to a specified responsible party. The government has agreed to provide funding for the plan, subject to the parliamentary approval. Among the actions listed are increasing science and innovation funding to reach 3% of GDP by 2016, using the tax system strategically to encourage private investment in scientific research and innovation by using tax incentives and deductions and creating an environment for active trading of shares in innovative companies (Science and Technology Policy Council, 2014).

As some respondents mentioned, the action plan is very ambitious, and many have high hopes that some of the actions will be successful in strengthening the financing environment of SME’s. The McKinsey report received much interest, and has been widely discussed in the Icelandic community. The government appears to be putting emphasis on strengthening the international environment, while a question remains about the aforementioned increase in competition in domestic service markets. As one respondent mentioned, a perceived weakness in the Icelandic financing market is the uneven competition that banks have created by enforcing different policies in debt writeoffs for SME’s after the 2008 collapse.

McKinsey and co. and Icelandic competition authorities pointed out various potential conflicts that arise with the high leverage and bank ownership of Icelandic firms. Some of the highlights include bank discrimination in funding, bank access to confidential information about competitors (as 27% of SME’s are still bank owned) and the debt overhang. The debt overhang of Icelandic firms can lead to inefficient investment strategy, insufficient investment, resources
spent on un-operational resources such as lawyers and accountants and companies being kept alive when they are overleveraged due to inefficiencies instead of external events. McKinsey and co. advise that more resources and capabilities should be given to competition authorities to enforce guidelines on sales time constraints and acceptable market behaviour and to act firmly and quickly when they are broken. Pressure should be put on the banks to move ownership to long-term owners. To facilitate this however, a favorable environment must exist for divesting/listing positions (McKinsey & Company Scandinavia, 2012).

4.5.4 Financing and access
When interviewees were asked how they would advise an SME to obtain financing, most agreed that there is no one correct answer. SME’s and their needs are diverse and as well as the optimal structure for each project. A general agreement was that most mature and/or well developed firms and projects have good access to debt financing from banks. Some felt that smaller firms and firms looking for equity financing might be better off with a financial advisory firm that could help in finding and negotiating with private investors. One respondent feels that the financing system has a solution for most situations where the risk is moderate and well defined. However banks do require collateral for most financing, which creates a problem for those that can not provide it, which are then dependent on equity, which can be harder to obtain.

Another participant notes that smaller firms are often in a very specialized business, and it is important to map out the sector and attempt to find investors or lenders that know and understand the firm’s business, as it can often serve as a speedbump when the investors do not understand the business or environment that the firm operates in. The participants believe that the willingness to learn about the business sector might be more visible with banks than private investors (non-angel investors), that the banks have a more service oriented view while investors only see it as an investment. Therefore it is clearly important for businesses to know how to approach their banks and have a good connection. An interviewee stresses that it is also vital to keep the search for financing organized and professional, whether the firm is looking for debt or equity financing. In his experience, many have failed by inquiring too many parties in a disorganised manner that can easily be perceived as desperate. Organization and professionalism is critical to success, whether firms decide to hire advisors or not.

An experienced banker not formally interviewed also commented that having a good knowledge of your firm’s finances and needs and being able to communicate them to your bank was very valuable. If a customer appears to have good knowledge and understanding of the
financing he is asking for, the bank is more likely to give it. He believes that more firms are becoming aware of their finances, not just signing the yearly report from their accountant anymore but reading it, understanding, and having an opinion on how they would like their financing to be. If a customer knows his business, his finances and what he needs and how, he is more likely to obtain it than those who do not.

One participant suggests business accelerators such as Startup Reykjavík and Seed Forum, where startups can obtain funding and guidance and are then connected to private investors. He also believes that some banks assist firms in obtaining funding from the banks’ other clients. One respondent believes that the only sensible way to obtain financing is to go abroad. Firms that plan to grow quickly will eventually have to go overseas for later stage financing, and therefore they should focus on finding a country where they would be happy to place their headquarters. He hopes that this will change if and when the capital controls are removed, but until then the best thing for firms is to look for foreign capital financing.

When the conversations turn to access to financing, one interviewee felt that either firms had access to a lot of financing or none. He feels that firms that cannot gain access to pension fund funding (including pension fund funded VC’s) will have problems finding other options. The money is not equally divided in the markets, 3000 billion lies with pension funds that are legally limited in their investment choices and the money only finds its way into certain investments. Another respondent feels that if firms can produce collateral, they get good service in the banks. Equity financing is much harder to obtain, especially for firms that are looking for their first ISK million, or looking to grow and take the jump from 5-25 employees. Many participants mention this growth funding gap. These firms are too small to have access to pension fund money and the respondent feels that leaves very few options in an environment where venture capital is still relatively weak. Another notes that the access to financing is controlled by the fact that there are only three banks and very few VC funds, which limits opportunities and access. Another respondent stresses that the environment can change quickly and that it is important to read the market and try to obtain financing when opportunities arise.

4.5.5 Exiting

The concept of exiting often came up in conversation and respondents agreed that exiting possibilities are very limited in Iceland. Some even go as far as to say that it is nonexistent, except maybe for very small firms. One participant adds that the First North market could create some possibilities for SME’s if a proposed law amendment goes through congress. Another
notes that he believes that trade sales will be the main exit strategy in the near future and that firms with scalable business models and a product that receives global traction will be in the best seats.

The market is clearly still haunted by the events in 2008, and all respondents bring up some consequences that the environment is still dealing with, such as the capital controls, lack of investment, lack of trust and reputational damage. One respondent believes that the trust and reputational effects are slowly fading. He feels that an increase in education about markets and financing, both to firms and to the general public, is needed. Another respondent feels that maybe not enough time has passed yet. Many lost their savings in the crash and that rebuilding trust is an uphill battle that will take time. Although many believe that now is the time to create incentives such as tax deductions to increase private investment, the respondent believes that not enough time has passed and trust has not been rebuilt to the point that it would be sensible to launch a “everyone should go out and invest!” campaign. One of the main markets where private investment is lacking is the First North MTF. In other Nordic countries, SME’s are successfully traded on MTF’s such as the First North, and in some countries the general public is the main customer. SME’s can register to create liquidity in their shares as well as to raise funds. In an attempt to create liquidity in the Icelandic First North, which currently holds only three companies, a pension fund law amendment has been submitted to congress, in which the pension funds are given better access to MTF’s.

4.5.6 First North
The Nasdaq Nordic First North market has been a topic of discussion for a while in the Icelandic SME community. In Iceland the only active stock exchange is the Nasdaq, which operates a main market and an MTF (Multilateral Trading Facility) called First North. An MTF, according to the European Union MiFID directive, is a:

\[
\text{A multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract} \quad (\text{European Parliament, Council of the European Union, 2004}).
\]

Companies on First North and other MTF’s are subject to the rules of the MTF and not the legal requirements for admission to trading on a regulated market (Act 110/2007 on Stock Exchanges). MTF’s are governed by chapter IV on Multilateral Trading Facilities in Act 108/2007 on Securities Transactions. Issues on the FN are exempt from chapters IX of the
aforementioned act on disclosure of changes in major shareholders, chapters VII-VIII on informational requirements and chapters X-XI on takeover bids. They are however subject to article 117 on market abuse and chapter XIII on the treatment of insider information and insider trading, meaning among other that issuers must give the FME a list of primary and temporary insiders (which must without delay notify the MTF when they trade their own shares) and that insider information must be disclosed immediately and made public (with exemptions).

A financial undertaking or stock exchange that wishes to operate an MTF is given considerable autonomy to determine the MTF’s rules. Only basic regulation on market abuse and insiders are required by law, and as chapter IV of act 108/2007 on Securities Transactions lists, operators are required to:

*Establish transparent and non-discretionary rules ensuring fair and orderly trading on the MTF, including objective criteria for the execution of orders ... establish rules regarding the criteria that financial instruments must meet to be traded on the MTF ... ensure that the MTF members have access to sufficient publicly available information to make investment decisions ... Establish rules on access to the market, which shall satisfy the criteria laid down in Article 34 ... Inform its users of their respective responsibilities for the settlement of the transactions executed on the MTF, and put in place the necessary arrangements to ensure the efficient settlement of transactions* (Act No. 110/2007 on Stock Exchanges).
In table 6, a comparison of the main rules of Nasdaq’s First North and main market is listed.

<table>
<thead>
<tr>
<th>Requirements for admission to trading</th>
<th>Main Market</th>
<th>First North</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities are traded without restrictions</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Market value requirement</td>
<td>EUR 1m minimum</td>
<td>No</td>
</tr>
<tr>
<td>Operating history requirement</td>
<td>3 fiscal years, if applicable</td>
<td>2 fiscal years, if applicable</td>
</tr>
<tr>
<td>Ownership/voting rights distribution requirement</td>
<td>25% ownership by general investors, with exceptions</td>
<td>10% ownership by general investors, with exceptions</td>
</tr>
<tr>
<td>Documentation</td>
<td>Prospectus, according to Act on Securities</td>
<td>Company description (prospectus if new issue)</td>
</tr>
<tr>
<td>Supervision of admission to trading</td>
<td>FME regulated financial services firm</td>
<td>Certified Adviser</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Disclosure requirements</th>
<th>Main Market</th>
<th>First North</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insider/price-sensitive information</td>
<td>Yes, immediately</td>
<td>Yes, immediately</td>
</tr>
<tr>
<td>Financial reporting standards</td>
<td>IFRS</td>
<td>IFRS not required</td>
</tr>
<tr>
<td>Financial reporting</td>
<td>Quarterly</td>
<td>Annually and semi-annually</td>
</tr>
<tr>
<td>Language</td>
<td>Icelandic or English</td>
<td>Icelandic or English</td>
</tr>
<tr>
<td>Insider trading</td>
<td>According to Act on Securities</td>
<td>According to Act on Securities</td>
</tr>
<tr>
<td>Disclosure of changes in major shareholders</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Executive remuneration disclosure</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

<table>
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<tr>
<th>Other</th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Corporate governance disclosure</td>
<td>&quot;comply or explain&quot;</td>
<td>No</td>
</tr>
<tr>
<td>Bid requirement (takeover rules)</td>
<td>Yes</td>
<td>No</td>
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<tr>
<th>Cost of equity registration</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Fixed price for market registraton</td>
<td>ISK 3.000.000</td>
<td>ISK 650.000</td>
</tr>
<tr>
<td>Yearly Fee</td>
<td>ISK 1.200.000</td>
<td>ISK 490.000</td>
</tr>
<tr>
<td>Yearly market size related fee</td>
<td>0.0035%</td>
<td>None</td>
</tr>
</tbody>
</table>

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<tr>
<th>Cost of debt registration</th>
<th></th>
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<tbody>
<tr>
<td>Fixed price for market registraton</td>
<td>ISK 680.000</td>
<td>ISK 490.000</td>
</tr>
<tr>
<td>Quarterly fee</td>
<td>ISK 62.500</td>
<td>None</td>
</tr>
<tr>
<td>Yearly market size related fee</td>
<td>0.00175%</td>
<td>None</td>
</tr>
</tbody>
</table>

Nasdaq has its own First North Rulebook, in which it lists all requirements of firms registered on the MTF. The main differences lie in the requirements of informational disclosure. The Nasdaq are a little more lenient towards FN firms than main market ones, though not as lenient as Icelandic law allows. FN firms are required by law to notify of price all sensitive information (which could include major changes in shareholders), are not required to give notice when a large portion of shares changes hands or if changes in the articles of association are made, and are not required to make a takeover bid when their shares exceed a certain amount. Firms do not have to disclose executive remuneration (deferred payments or fringe benefits of senior
management) or any deviations from their guidelines on corporate governance. They do have to disclose information about board members, top executives and certified advisors. Firms are not required to use IFRS in their financial reporting, and are only obligated to issue financial statements annually and semi-annually. While these requirements are less strict than those on the main market, they are much more than the minimum required by Icelandic law. Intuitively, firms on the FN are smaller, younger and riskier. Some interviewees expressed concern over how similar FN requirement are to the main market, and wondered whether they reflected an SME’s need to minimize costs and time spent on market disclosures. Investors on FN should be aware of the higher risk of the investment and therefore expect lower requirements than for main market firms.

Table 6 shows that cost of issuing equity on FN is less than on the main market, and so is the yearly fee. Firms are not required to have a minimum market value to register, and only two previous annual reports are required. Most respondents agree that the reason firms are reluctant to register on FN is due both to the lack of financing in the FN market, as well as the costs and informational disclosures that accompany being registered. As the table above lists, the cost of registering equity on FN is a registration fee of ISK 650,000 and then a yearly fee of ISK 490,000, besides the costs of preparing a prospectus and roadshowing the offering. A certified advisor is also required by the Nasdaq, who has an active role in advising on the registration and must then be kept on hand while the firm remains on FN. Therefore there are annual costs in having the certified FN advisor, as well as maintaining investor relations and preparing the information that must be disclosed. In total, the upfront costs for an SME registering and issuing new equity on FN Iceland is roughly ISK 15-30m or more, and then ISK 1-3m each year after. Debt issues on FN are cheaper, but not much cheaper than issuing on the main market. According to a specialist interviewed, the main cost of issuing is the preparation of a prospectus, which is complicated and time consuming and therefore very expensive.

In Iceland, a firm can issue new shares on an MTF without preparing a prospectus, as long as the issue is less than EUR 100,000 (roughly ISK 15m). Instead a registration document is prepared. According to an employee of the Nasdaq in Iceland, securities can be issued without a prospectus for up to EUR 2.5 million in Sweden, and as a result, average offerings on the First North are just under EUR 2.5m (Nasdaq Iceland, 2014). European regulations allow new share offerings on MTF’s of up to EUR 5m without a prospectus. The costs of registering and being registered on the FN make an issue of EUR 100,000 impossible, and assuming registration costs
of ISK 15-30m, costs would be higher than the issue itself while an issue of EUR 2.5m could be a game changer for many companies, with costs averaging 5% of the issue upfront.

In other Nordic countries, SME’s are successfully traded on MTF’s such as the First North, and in some countries the general public is the main customer. SME’s register on MTF’s for various reasons such as to create liquidity in their shares, establishing credibility by adhering to market requirement and to raise funds. The First North market in Sweden is exceptional, registering the 44th company of 2014 on their list on December 11th 2014 (Nasdaq Nordic, 2014). In an attempt to create liquidity in the Icelandic First North, which currently holds only three companies, a pension fund law amendment is in the works which gives pension funds better access to MTF’s. Icelandic law sets several restrictions on pension fund investment policy, among them the rule that pension funds are allowed to invest up to 20% of their net assets in securities not registered on a regulated market (Act on Mandatory Insurance of Pension Rights and on Activities of Pension Funds, No. 129/1997).

The amendment considers securities traded on an MTF equal to securities traded on a regulated market and allows pension funds equal investment allowances (Bill of Legislation on Mandatory Insurance of Pension Rights and Activities of pension funds). This means that pension funds can invest in securities on MTF’s in the same way that they can invest in securities listed on the main market. Reactions to the bill are mixed. In reviews submitted to the Economic Affairs and Trade Committee by various parties some discuss worries over considering an MTF equal to a main market, as less requirements exist on MTF’s. Others welcome the addition and stress that pension fund investment policy should reflect the main investment opportunity at each point in time, especially in an environment of capital controls where investment options are limited. Some worry that the bill focuses too much on the rules of the Nasdaq First North when any investment firm or market operator can operate an MTF and could do so with less requirements than the Nasdaq. Most feel that the First North requirements are currently similar to main market requirements, though noting that Nasdaq and others could later change their requirements to only the minimum required by law, as operators are granted rich autonomy in forming their own rules (Reviews on the Bill of Legislation on Mandatory insurance of Pension Funds and Activities of Pension Funds). The FME (Financial Supervisory Authority) notes that the law only allows pension funds to trade on MTF’s licenced by the FME, while EES rules are in place to ensure fair trade on all EES MTF’s. Many express beliefs that the amendment will create a stronger and more liquid First North market, where VC funds and other will have a better opportunity to trade their positions in SME’s. With a liquid
FN, Venture capital funds will be able to operate more efficiently and raise more funds, supporting the Icelandic entrepreneurial environment as well as job creation and diversity. The changes should empower the financing market and increase supply of new domestic investment opportunities for investors, as well as easing access of growth financing for firms (Reviews on the Bill of Legislation on Mandatory insurance of Pension Funds and Activities of Pension Funds).

4.5.7 Views on the First North

When asked about their opinions on the First North MTF, all respondents agreed that it was a positive addition to the market, although only time will tell whether it will be successful. A respondent notes that no Icelandic firm has issued new public equity in the last ten years (except for a very small issue when Icelandair went public in 2010) although some have issued new equity privately. He feels that the success of the FN market could depend on something as equally simple and complicated as the right company issuing at the right time. Another feels that giving the pension funds better access to those firms that would be applicable to a market such as the FN could be a game changer in many ways. Another participant notes that whether FN financing is realistic depends on the characteristics of each firm. He feels that firms must have a somewhat predictable cash flow and a steady business before considering FN, which high-growth firms often do not have when they need funding to grow and therefore prefer specialized venture financing. Another disagrees and feels that the advisory environment is simply not developed enough. In countries where MTF’s are very successful, several advisories focus solely on SME’s and their financing and MTF registration and have the expertise to list much smaller and less developed firms than would be considered possible in Iceland. However, both agree that for a firm that finds FN suitable to its needs, it is a great market and addition to the environment.

Some participants see Sweden as a role model, where there are multiple successful MTF’s, FN being just one of many, and the general public is an active participant. In Sweden there is a longstanding tradition for securities trading, and most people know how to invest and invest a part of their pension and/or savings themselves. As one interviewee described “on a typical coffee break in Sweden, Sven will sit down, have some coffee and snus, and then he will look through the papers to see how his investments are doing today“. He also stressed that in order for the public to participate in markets such as the FN, people have to be educated on the risks and benefits. Investing in a FN firm is not the same as investing in a main market corporation. Some believe that even though firms would like to finance themselves abroad, being registered
on a domestic market establishes certain credibility. However, there are both costs and benefits to registering on a market such as an MTF. One interviewee said that although he supports the First North market and feels that it would make it easier to fund growth and other projects as well as for founders to sell a part of their shares, the fact that anyone could buy shares in his company worries him. When shares are sold on a publicly traded market, anyone could gain a large position in his company, and he would have no choice in the matter. His company means a lot to him (sometimes half-jokingly referred to as “his child”) and he feels a great responsibility towards his employees and customers. Others see the FN as a way to reclaim public interest in the securities markets, which was largely lost in the collapse of 2008. One participant stresses that public participation in the financial markets is important, and is a large part of many foreign economies. Another mentions that he hopes that the law amendment will create liquidity in the FN market, and then tax incentives might help in bringing the public back into the market. A SME CFO feels that going through an intermediary such as an MTF would be unnecessary for firms of a certain size. He would prefer to go directly to the pension funds or through VCs funded by them, saving himself the trouble and costs of registration.

A question that often came up in a conversation is why would a firm register on the main market, if FN registration requires less information disclosure and costs less? One felt that it was an executive’s job to protect shareholder interest and that he should therefore choose the cheaper and less restricting option, while another believed that this was a matter of signaling, that once a firm is of a certain size, the market will expect it to register on the main market and will see it as a red flag if the firm chooses an MTF. Choosing the correct market to register can therefore affect firm value, and seen that way, a manager would be doing his duty towards his shareholders by choosing the main market over the MTF. In Sweden however, it is common for firms to transfer their shares between markets, listing first on an MTF and then moving on to larger MTF’s or the main market as the firms grow.

Besides Nasdaq’s pricing, First North’s main challenges appear to be the exclusion of pension funds from the market due to trading being categorised as unregistered, regulations that require a prospectus when equity issues exceed EUR 100.000 and the lack of private investment. One interviewee is optimistic that if the amendment goes through, regulations are changed (the government has shown willingness to clear the path for a more liquid marketplace) and tax incentives are introduced (as introduced in the Science and Technology Policy Action Plan), all the boxes should be checked for an MTF to be successful. Again the difference between those that start a business with the intent to run it themselves in the long-term (those who see their
business as “their child”), and those that start a business around an idea or product that they are passionate about creating (but might not have any intentions on running a business around in the long term) is clear. This is the difference between the established SME’s that are not preparing for much growth or expansion and the high growth companies with ambitious business plans and products. Products like the First North market are more focused on the latter group, the firms requiring growth funding, and investors hoping to liquify some of their commitments in order to invest in new ones. However, it might also be beneficial for the market to focus on established and mature SME’s, whose owners might benefit from the asset liquidity.

4.5.8 Knowledge

Participants were asked how much knowledge they felt that managers of SME’s had about the financial environment and the tools and options available, as well as how educated and aware they believed those managers to be about strategic financial management and subjects such as capital structure.

A respondent suggests that managers can be divided into two groups, depending on whether they control a growth firm or an established one. The managers of startups and high growth firms usually start out as “visionaries” with very little knowledge of finance and then encounter a very steep learning curve. Once these growth firms become larger, the managers have learned by doing, grown into their roles, and have become very aware of their environment. In the later stages of growth they might attract more finance centered employees which often brings the financial side to a much higher level. The knowledge of more complicated financing products such as convertible bonds or mezzanines is normally nonexistent with those that do not come from the financial sector. This view is supported by other participants. The managers of established and steady firms with most of their business domestically do not require as much knowledge of finances. Their structure is usually simple and they do not require very complicated financing. These managers often do not have a very deep knowledge of finance or the options available. However in firms where operations are not only domestic or where the structure is more complicated, the respondent believes that the knowledge and experience of CFO’s is very good. He feels that these firms have gained much by the crash of 2008, where many experienced employees lost their jobs and took their talent into other fields and often into these companies.
Similarly, a popular view is that there are two types of CFO’s. Some firms have very strategic CFO’s that are well aware of the strategic implications of the various types of financing. Others have a CFO that is very accounting centered and completely on top of everything accounting related, but has little opinion on capital structure, working capital and generally how financing affects the value of the firm. One respondent mentioned that this environment still has a long way to go in terms of maturity. Another feels that no matter how the CFO is oriented, a financially healthy firm should have both, choosing a strategic CEO if their CFO is accounting oriented. He notes that a small firm is unlikely to have an employee that focuses purely on finances, but a balance between strategic management and good accounting should still exist there in some form. One respondent feels that firms do not employ enough strategy in their financials and notes that the reason is simply that financing is a scarcity in Iceland. It is hard to gain access to financing and when firms do, many will take any financing that they can get, irrelevant of the form or terms. As a result of this scarcity many firms have a good relationship with their bank and see no reason to look elsewhere, they just call their account manager, solve their needs with him and pay according to the bank’s price list. No negotiations. The larger firms however have more experienced employees and perhaps more power to negotiate. Others feel that not all firms should focus on strategic financial control. Some firms, especially those that are still experiencing high growth, should be focusing their attention elsewhere, at least until they reach a more steady state. Some feel that managers do not have enough knowledge of their environment and options and managers have especially little knowledge about public markets.

Guðmundsdóttir (2013) surveyed Iceland’s 300 largest firms in 2013 and found that 72% of respondents had not heard of the First North Iceland market, 15% would consider issuing public debt or equity, while 54% would turn to their bank and 31% would issue privately. A view expressed in many interviews and conversations is that firms avoid issuing publicly, partially due to lack of knowledge of the markets. One respondent notes that in his experience firms automatically turn to their banks, without exploring other options in depth. He believes that there is a wide range of knowledge with managers of SME’s, but a knowledge of the markets and how to operate there is missing, though believes that is would be quickly regained once a few firms have gone through the process. Another participant notes that even though managers do not have a high level of knowledge on some subjects, due to the size of the country and market, it is easy to gain access to someone who can educate and assist.
Another respondent feels that most managers are decently aware of their environment while the banks and other financers are not completely clear or honest about what they have to offer. He notes that when he has decided to act on opportunities that have been discussed, they are not currently available or very difficult to achieve and dependent on permission from the Central Bank of Iceland or other parties. Therefore, it is not necessarily true that managers are not well aware of their options, but that their options are actually very unclear. He also feels that many companies, as well as the banks, are still burned by the crash and proceed only with high caution. Some managers might even prefer a high equity ratio or to keep large amounts of money as bank deposits, even though they know it to be inefficient and unsophisticated.

A topic that came up in conversation is whether firms should be specialists in funding at all. The respondent believes that basic knowledge of financial structure and methods should always exist in a firm, but wonders whether they should be specialists themselves or simply hire advisors to do the task? He notes that the average SME is not arranging for financing everyday, and is perhaps better off in a good relationship with its bank and advisors who themselves are funding specialists, and let them take care of all structuring and financing?

4.5.9 The IPO Task Force Report

In 2014 the Nasdaq published a report called the IPO Task Force Report that proposes measures for improving the climate for IPO’s in Iceland. Similar reports have been issued by the Nasdaq in Denmark, Finland and Sweden. The Icelandic report discusses the First North markets in the other Nordic countries, where small and medium sized firms (one fifth of them with a market cap of < EUR 5m) are successfully traded on the MTF. The report then lists ten factors that the authors believe would enhance the Icelandic IPO market, the actions that Nasdaq Iceland will take to realise them and the timeframe in which they will complete them. They also list actions necessary from the government, and note how the Nasdaq will encourage those actions. The report is divided into two chapters, the first discusses methods to make it easier for firms to register and be registered on the stock exchange and the second discusses methods for increasing investor’s interest in the securities markets. Among the former are plans to: extend exemptions for issuing prospectuses on FN, extending authorization to supervise admission to trade (making more parties applicable to be certified advisors), shortening the process of admission to trade, creating standardized bond terms, increasing education to market participants and clarifying Nasdaq’s interpretation of their rules. In the latter, plans to increase pension fund access to lend securities and to ease pension fund access to MTF’s (the law amendment before congress), are noted, as well as more active market makers on bond markets.
and tax incentives for private investors. These goals are positive and realistic, although many rely on government action. Easing the process of admission to trade and raising the maximum for securities issues that do not require a prospectus would be beneficial for SME’s, as well as increased education. Extending authorisation to supervise admission to trade to more parties could also decrease registration costs and encourage advisors to specialize in SME advisory and registration. Some factors are already in motion, such as pension fund access to MTF’s and tax incentives.

4.5.10 Future ambitions

Finally, interviewees were asked what their dreams for the future would be, what they would change if they could and what they hoped to see in the near future. Respondents all agree that they would like to see more sources of funding. More VC funds and other methods such as crowdfunding and angel lists. Angel lists are common in the USA and in other mature entrepreneurial environments, where organised networks of business angels exist and an angel with a good reputation often leads a group of investors which can be a combination of funds an/or other angels who are “following” him. A liquid First North market such as the one in Sweden is desirable, where companies could issue new equity to grow and investors could trade their shares to diversify their portfolios, exit their investments and enter into new ones. As soon as investors can exit or sell some of their positions, more money becomes available to finance new projects. A market with maybe 15-20 companies in a few years, which could proceed to the main market as they grew. Another respondent hopes that the financial collapse of 2008 will be reconciled. Competition will be amended by adjusting leverage ratios for the firms that received less writedowns than their competitors and everyone can compete in a fair market where they can finance themselves in a professional and sophisticated manner.

Another feels that the governance over financial markets must also be adjusted. Monitoring and regulations in the financial markets are too burdening and have gone too far in the “safe” direction. As soon as that happens, he believes that financial institutions can safely amend their procedures and protocols, as well as using the space that creates to increase their service level. He believes that the demands for collateral will decrease and his only worry is that this development will be extremely slow. Another hopes that managers of firms that have successfully gone abroad and sold their companies will come back and share their knowledge and connections to assist others, as well as financing new projects and creating a stronger entrepreneurial ecosystem. He would like to see banks offering more professional and diverse
debt financing options, and/or to provide access to specialized financing institutions such as the Silicon Valley Bank, which would likely only be possible once capital controls are removed.

4.6 Summary
The thread running through all interviews is that investment in the Icelandic economy is very limited. Funding is difficult to obtain and more sources are needed, as well as expertise in the needs of smaller firms and high-growth firms. Participants find growth funding, taking a firm from 5 to 25 employees, to be especially difficult to obtain while startup funding is more available and support for young firms is exemplary. One of the causes of low investment is the capital controls and the uncertainty that they bring to the economy. Foreign capital is difficult to attract and investors are reluctant to make decisions in an ambitious environment. Financial institutions and supervisory authorities are still dealing with ghosts from the financial collapse of 2008 and respondents feel that there is too much caution in the system. This makes financing difficult to obtain, while financial institutions are burdened with excessive surveillance, restricting their capabilities to rebuild their processes and protocols. Firms are also very risk averse, with many respondents perceiving that firms prefer to keep high equity ratios and money in bank deposits, knowing that it is inefficient but still choosing to do so. Many capital owners also prefer to hold their money in real estate, low risk securities or deposits, preferring the safety over the higher return of other asset groups. It it apparent through the interviews that most respondents are aware of the problems, while praising the strengths, and that many are willing and actively working to clear paths for Icelandic firms.

Many that were interviewed expressed that they would like to see a stronger connection to foreign capital markets. That more support is needed to firms that choose to finance themselves abroad, and that connections and knowledge in that sectors are largely missing from the Icelandic financing environment. One expressed his belief that maybe firms should not finance themselves in Iceland beyond a certain point. If a firm was growing quickly and its main market was overseas, perhaps it would be most efficient for the firm to finance itself in that market. The theory of matching debt to cashflows was used as an example. Firms can only grow to a certain size if their only market is Iceland. Once they expand their markets and they become mainly foreign, using the approach of matching, it would be most efficient to finance in the same markets (and currency). This would not necessarily mean that firms would have to relocate their headquarters from Iceland nor that the Icelandic financing market is not capable of large investments. The respondent feels that Iceland could successfully specialize in creating
SME’s and supporting entrepreneurs in taking their first steps and then assist them in taking their companies abroad once they outgrow the environment.

It is clear from these results that the Icelandic financing environment faces various obstacles. It also possesses many strengths and perhaps its greatest strength is the evident interest and willingness of all those concerned to improve the environment. As mentioned in the beginning of the chapter, the geographical position of a firm does affect its value, as various different constraints affect each economy. A firm operated under financing constraints and capital controls is bound to be of less value than a comparable firm in a more welcoming environment. There are however multiple opportunities for improvement and a willingness to do so.
5. Discussion and conclusion

A review of literature sets forth three dominant capital structure theories for SME’s. Two of them originate in the world of corporate finance, the tradeoff and pecking order theories, while the financial growth cycle theory developed from research of SME finance. In the tradeoff theory, firms will weigh the costs and benefits of debt to come to an optimal capital structure that maximizes the value of the firm (Myers, 1984). Pecking order theory states that the costs of financing increase with asymmetric information, creating a hierarchy where a firm will first use up internal financing before turning to debt and finally equity. The reluctance to choose equity over debt stems from adverse selection, as managers are believed to have superior information, causing investors to believe that managers will issue new equity when they know that the firm is overvalued, therefore undervaluing the stock (Myers & Majluf, 1984). The financial growth cycle suggests that as firms grow they will gain access to more sources of financing and that their funding needs, and therefore optimal structures, will change continuously over the lifetime of the firm (Berger & Udell, 1998).

5.1 Tradeoff theory

A survey of 1,100 Icelandic SME CEO’s with a response rate of 15% showed limited support for the tradeoff theory and substantially more support for POT and the financial growth cycle. 80% of responding CEO’s were aged between 40 and 59 and over 50% had been in their current position for over 9 years. 40% of CEO’s have an undergraduate degree as their highest level of education, 13% have an MBA and 15% have a non-MBA masters degree or more.

These education levels are lower than those witnessed in Graham and Harvey (2001) who surveyed larger firms in the US. Interview results show that respondents find that in larger steady-growth firms, most feel that managers have a good knowledge of the financing environment and strategic financial structures, either from the CEO or CFO. In smaller steady-growth firms most feel that the level of knowledge is lower, noting that these businesses are usually uncomplicated so a wide knowledge of financing and financial structures is not as important as elsewhere. Respondents note that finance providers could do better in introducing their products and what is available to these firms. Participants mostly agree that managers of high-growth firms start off as visionaries that have little knowledge of the financial environment, who then learn by doing and grow into their roles. Later in the process these firms also often bring in others who are more financially savvy, which matures the finances of the firm and its structure. Usually, managers of young high-growth firms are not very knowledgeable about the financing environment and its tools, but learn quickly.
5.1.1 Equity Issuance

Descriptive of the availability of financing is the fact that 80% of respondents do not calculate the cost of equity. 10% have seriously considered issuing common equity and a similar number has considered convertible debt. As table 5 shows, mezzanine’s such as convertible debt are not available in Iceland and therefore are not often seriously considered. The table also shows that loan covenants are strict and that unsecured loans are not available. The fact that only 10% have seriously considered issuing equity is worrying for the Icelandic First North market. There has been much discussion about creating a strong First North market for SME’s in Iceland. A law amendment is before congress, where pension funds are to be given more access to investment on MTF’s such as the First North by legally classifying MTF investments to be on the same level as investments on the main market. Many respondents hope that this will encourage more firms to register and that pension funds will invest there and others will follow, creating a liquid market for SME securities similar to those in other Nordic countries. All respondents agree that an active First North would be an excellent and needed addition to the financing environment, although research shows that registration can be expensive. If a firm issues new securities on the FN for more than EUR 100,000, a prospectus must be written. The prospectus is a comprehensive and expensive document to create and can cost a firm up to ISK 15-30 million. The Nasdaq also requires extensive informational disclosure while the firm is registered and a certified advisor. However Nasdaq Iceland recently released a report called the IPO task force report, where among other they plan to raise the amount that can be issued without a prospectus and make certified consultancy (and new issue supervision) available to more parties. If these changes and the law amendment go through, some respondents believe that the First North market might become valuable to the environment, especially if tax incentives are introduced.

The government is very supportive of enhancing SME financing, which likely stems from a report issued by McKinsey and co. in 2012. In the report, McKinsey and co. note that current exports can not sustain more than 1% real economic growth and that new exports are needed. The report highlights a supportive entrepreneurial environment and healthier competition in domestic service.

In an action plan introduced by the Science and Technology Policy Council, the government run council among other plans to research ways to introduce tax incentives to encourage private investment. According to interviews, private investment is a scarcity in Iceland, with most investment coming from pension funds and large private investors. Business angels and other private investors are rare and many believe that the reason that many capital owners choose not
to invest is for reputational reasons. The community is still fighting ghosts from the financial
collapse of 2008 and the securities markets still have an uphill battle to fight. Not everyone
agrees that the time is right for tax incentives. While this tool has helped Icelandic firms in the
past, some believe that the community is still healing and that it would be irresponsible to
introduce tax incentives in the current environment. In contrast, the McKinsey and co. (2012)
report stresses that creating a healthy and active environment for banks to divest their assets is
a vital part of creating a healthy competitive environment in domestic service. As the banks in
2012 still directly owned 27% of the companies that ended in bankruptcy in 2008, creating an
unhealthy environment and a danger of conflicts. In order to make this happen, a market like
the First North where SME shares can be traded in an organised and efficient manner is
necessary, where both pension fund and private investment is needed for an active market.

The survey revealed that 88% of respondents do not set a target leverage ratio. This completely
contradicts studies on large firms such as Graham and Harvey (2001) conducted, who find that
20% of their respondents do not have a target ratio. This strongly indicates that the corporate
finance theory of tradeoff does not apply to Icelandic SME’s. Another factor that reduces
support for the use of tradeoff theory is that a significant portion of surveyed firms have no debt
in their structures. Interviews indicate that firms prefer to have high equity ratios in order to
“play it safe” as well as many not having access to debt financing due to lack of collateral. The
fact that firms can not access debt in order to weigh its costs and benefits to find an optimal
ratio is more evidence that the tradeoff theory is not applicable to smaller firms. Another reason
that interview respondents gave for choosing not to take on debt was that the banks have little
specialization in the needs of high-growth firms, and they therefore prefer equities. This
indicates that the costs and benefits of the debt itself are not weighed by these parties, but the
costs and benefits of the provider and therefore is neither evidence for nor against tradeoff
theory. The survey also finds that low importance is given to the personal tax that investors will
face and potential costs of financial distress, when considering appropriate amounts of debt.
The only factor observered to support tradeoff theory is the importance given to transaction
costs and fees. Interview results however suggest that most parties find bank financing to be
expensive, something that affects firms and deters them from borrowing although they do not
consider this in the terms of an optimal ratio. Some firms that have a target ratio give more
importance to tradeoff factor than POT, however they do not appear to be less concerned about
POT factors.
5.2 Pecking Order Theory

In support of the Pecking Order Theory, survey results show that one of the main factors in choosing an appropriate amount of debt is restricting debt to maintain financial slack to be able to internally finance new projects when they come along. When asked what sources of long term funds would be most important for financing new investments, 69% find retained earnings important or very important, 52% give the same importance to straight debt, 25% would restructure assets, 20% find common equity important and finally 12% feel that convertible bonds would be important. This is a significant support for the POT’s financial hierarchy. Contradicting POT, the factor highest rated by firms when asked about deciding debt levels is customer/supplier’s fears of the firm going out of business, with 52% finding it important or very important, ahead of maintaining financial slack. Titman (1984) suggests that customers will be reluctant to buy products (especially unique ones) if they believe the firm might be going out of business. As interviews show a clear effect of post-collapse risk-aversion and carefulness in the environment, it can be assumed that this effect is a ghost of 2008. Having insufficient internal funds is the factor most survey respondents find important or very important when deciding a debt policy. Non dividend firms find this more important than dividend paying firms, suggesting that firms will first cut dividends before borrowing, consistent with POT.

Modified POT implies the factor that a firm’s access to external financing is limited and so is their willingness to lose control of their companies. This theory is highly supported by the interviews conducted, where many respondents expressed similar views. Survey results show that only 8% of respondents have seriously considered issuing common equity and 9% had considered convertible debt. They also show that when firms choose to forgo an investment opportunity, the second most important factor was to hold independence.

Icelandic SME’s are mostly owner-managed. Over 80% of respondents claim that 20% or more of the firm’s shares are owned by the top three executives. In a study on Central European SME’s, 20% of firms are owned by top executives (Hernádi & Ormos, 2012) and in a study of large US companies 20% also claim that 20% or more is owned by top three executives (Graham & Harvey, 2001). In an interview with an owner/manager of an Icelandic steady-growth firm, the respondent often half-jokingly described his company as his child. He described how he felt great responsibility towards his employees and customers and how he supported efforts such as the First North marketplace, but that he would feel uncomfortable with the thought that anyone could buy a stake in his firm. This contrasts a conversation with the founder of a high-growth firm. Although he also cared about his employees and customers,
he accepted the fact that in order to grow his company the way he wanted, he would have to give up a stake in his firm to others. This evidence also highlights the difference between steady growth and high growth firms and their very different financing needs.

5.3 Financial Growth Cycle

The research also finds evidence for the financial growth cycle theory, which is not unsimilar to the modified POT as it assumes a financial hierarchy due restricted access to finance because of informational opacity. While FGC financing choices follow the same order as POT firms, the difference lies in the motive. FGC firms make their financing choices based on what is available to them at each stage in their life cycle, while POT firms choose based on the lowest cost. To determine whether firms follow a POT or an FGC, it must be determined whether their choice in financing is based on order of availability or order of preference.

To test for FGC, survey respondents were divided into size groups (by number of employees) to proxy for the lifestages of a firm. Bháird (2011) found that the youngest firms are most often financed with personal savings and borrowings from friends and family as well as some long term debt and equity from business angels and VC’s. As they grow older they rely more in internal funds and short term debt. This is mostly consistent with the Icelandic survey results as small firms rate debt as very important, while new equity is rated low and internal funds are always the most important. Also consistent with FGC is the finding that most loan applications are denied for young firms with a low turnover. As firms grow, the likelihood being granted a loan increase. The survey also reveals that firms are more likely to apply for loans as they grow larger. This indicates a limited access to debt financing that lessens as firms grow, consistent with FGC. As the smaller firms do not apply for loans, it is difficult to determine whether they are not applying as a choice (POT) or because they know it will not be available (FGC).

As firms grow, they are less likely to retain earnings when investment is low and firms of 20-49 employees give much greater importance to retaining earnings than other size groups. They are also the most obvious group that has not applied for loans or capital leases in the last three years. Combined with the fact that the same group has considered issuing common stock for the main reasons that it is their cheapest source of funds and to provide shares to employee bonus or stock option plans implies that the size group mostly holds high-growth firms. These firms often do not have access to debt financing as they can not produce collateral, and therefore are mostly dependent on equity financing. Interviews also suggest that they prefer equity financing, as VC’s and private investors are more specialized in the needs of high-growth firms,
a specialization that is not found within the banking sector. A high-growth firms CEO also mentions the benefits of gaining from the experience and connections that these investors often bring the firms. Graham and Harvey (2001) found similar results for firms that they consider to have the characteristics of small start-up companies with growth options. These characteristics match the “gazelle effect” described by Birch et.al (1999).

When asked why the firm would forgo an investment opportunity rather than changing its balance sheet, little evidence was found that smaller firms had less access to external financing or that access increased with firm growth. This result objects both the modified POT as well as the FGC.

5.3.1 The financing environment

Interview results describe an environment that is lacking investment. When asked if they believed that the financing environment was developed or underdeveloped, most participants find it to be closer to underdeveloped. They feel that investment is difficult to obtain. Mature steady-growth firms are more likely to get good service in the banks, while firms that can not provide collateral must depend on venture capital and private equity funds as well as private investors, which most respondents agree are rare. Respondents note that most firms are forced to go abroad to find growth financing. Iceland provides a good foundation of support and financing for young firms, where access to assistance and grants is exemplary. When firms need their first ISK 1 million, wanting to grow from 5 to 25 employees, they have difficulties with financing. They feel that more VC funds are needed in the environment and many hope that more business angels will appear when the ghosts of the financial collapse and the reputational effects of being “an investor” fade. Participants also mention short channels as one of Iceland’s main benefits. Decisions can often be made quickly and getting into contact with nearly anyone is not difficult.

Firms are often divided into groups of steady-growth firms and high-growth firms. Respondents feel that steady growth firms that can provide collateral will often find good service in banks and some can go to private equity funds to fund projects or growth. Bank financing is expensive, covenants are rather strict, and banks are reluctant to lend to highly leveraged firms. High-growth firms mostly choose to take on equity financing from venture capital funds or private investors. Many feel that banks do not possess enough expertise on the financing needs of high-growth firms and many can not produce collateral or cash flows to guarantee their loans. These firms also benefit from the guidance and contacts that equity investors often bring with them.
Some respondents feel that a connection with investors overseas is lacking in the financing environment and that not many can assist Icelandic firms in securing and negotiating financing abroad.

Many note that the financing environment is still damaged from the financial collapse of 2008. A respondent notes that trust in many processes and protocols was damaged and feels that monitoring by the FME has become burdening to financial institutions, making it hard for them to safely rebuild their processes. Other mentions that they experience a lot of risk-aversion, both in themselves and their environment. These results indicate that firms and managers are not behaving efficiently and that the decisions made are not necessarily what they believe to be most professional or profitable.

One respondent wonders whether it would not be smart for Iceland to focus on building a strong foundation for young firms, then assisting them in sourcing growth funding in their main markets. If a firm’s main product market is abroad, firms might be better off matching their financing with their main market. A firm can only grow so big if Iceland is its main market, the same should perhaps apply to financing.

The results are similar to La Rocca et.al (2009) who find that if financial markets are inefficient or unsophisticated a firm’s financing options are reduced, greatly impacting its capital structure decisions. Young firms are especially vulnerable to access to loans, as larger firms can often access loans in other markets. They find that young firms in less developed markets that lack internal financing will turn to debt financing before later rebalancing as internal capital grows, in line with both the POT and financial growth cycle.

Results also support findings by Gregory et.al. (2005) that younger firms (as measured by number of employees) are more likely to use private equity and long term debt than older firms, often explained as the “gazelle effect” (Birch et.al.1999). This is intuitively explained by the fact that SME’s can and should be divided into two groups, high-growth firms and steady growth firms. Interview responses confirm that equity financing in the form of venture capital funds is preferred by managers of young and high-growth firms as they are specialized in high-risk financing. These firms usually do not have positive earnings for the first few years so they are forced to finance externally, with most choosing venture capital or private equity financing when possible. Interviews also indicate that debt financing would not be available to these firms through the banks, as the banks do not have the expertise nor can these firms produce collateral.

Table 5 shows that debt financing is nearly unavailable without producing collateral or
guaranteed cash flows. Gregory et.al. (2005) also find these firms to use long term debt. Table 7 in appendix 3 shows that most firms find matching the maturity of debt with the life of their assets the most important factors affecting the choice between short- and long term debt. Table 8 in app.3 shows that projected cash flow from the asset to be financed are one of the main factors that affect the choice of appropriate debt. These results hint that matching debt is very important to firms. The only way to match debt to the cashflows of a high-growth firm is to finance them with some type of mezzanine instrument such as one with PIK interest, where the interest takes the form of additional securities rather than cash or with a bullet bond that does not require extensive collateral. Comparison of table 5 on page 42 and table 1 in appendix 5 shows that neither of these options are available in Iceland though several parties offer them abroad.

Graham and Harvey (2001) similarly found POT consistent results, but question whether the importance of financial flexibility is brought on by informational asymmetry, or a managers need for the comfort that financial slack brings. The same question is raised here. In interviews, many expressed a view that managers are risk averse following the collapse of 2008 where many companies went into bankruptcy due to foreign denominated or indexed loans. One manager expresses that he prefers to hold money in a deposit account, knowing that it is inefficient, but choosing it due to risk aversion. Other respondents agree that firms are burnt after 2008 and that they value slack highly and even prefer to keep high equity ratios that they are well aware of being inefficient. This is a clear indication of another factor than the POT causing the financial hierarchy. Survey results also show that dividend paying firms value the financial slack factor, indicating that manager comfort or other factors are present. The fact that 41% of respondents had not applied for a loan or capital lease in the last three years highlights this risk aversion, as well as the fact that often came up in interviews, that many firms know that they are not eligible for loans as they can not produce enough collateral and therefore do not apply.
5.4 Results

Results provide evidence for both the POT and FCG. The only question is whether firms choose to finance themselves this way due to choosing the least expensive option (POT), or whether they are making them because their access to financing is restricted and they are forced to choose between few available options at each point in time (FGC, modified POT).

The POT is used in Icelandic financing structure, in the way that there is a financial hierarchy that is based on choosing the least expensive financing option. However, the option chosen is often the least expensive because it is the only one available. Most firms will choose to have slack and finance themselves with retained earnings, because they are risk averse and financing is often difficult to obtain. Firms that can not finance themselves entirely with internal funds will turn to debt financing, due to the fact that this is most often the only option available to them, as Icelandic equity markets such as the First North are not liquid and private equity placement is difficult and expensive. The firms that can not provide collateral and are therefore not eligible for a bank loan will either restructure their assets (steady growth firms) or issue equity with PE or VC funds (high-growth firms). This is also consistent with the financial growth cycle. The reason that firms choose the financing that they do is that they have restricted access to financing which evolves over time.

Continuing the division of firms into steady-growth and high-growth firms, steady-growth firms could be categorized to mostly follow a modified POT, while high-growth firms follow the financial growth cycle. However, the Icelandic environment is both damaged and underdeveloped, causing all theories that see the world in a “picture-perfect”scenario to be unapplicable. Previous warnings by Weston (1955), Bháird (2011) and Gregory et.al. (2005) that there is no “one size fits all” model that can explain how firms choose their capital structure are also very appropriate. SME’s are as different as they are many. It is clear that Iceland needs more investment, there is a lack of private investment, VC funds and liquid SME markets. Iceland is also an excellent environment to start a business, advice and education are highly available as well as grants and other support. Iceland is however not an excellent place for a high-growth firm to grow.
The financing environment and its trust and reputation is damaged and has some way to go before private investment can blossom. While tax incentives are encouraging to some, knowledge must also be built to create a strong and diverse financing environment. There has been extensive development in the start-up community which will likely continue with the creation of more VC funds, but private investment is crucial. It is also important to encourage foreign investment, as well as clearing a path for firms that wish (or have no other option) to finance themselves abroad. Burdening monitoring must be lifted to give the market a chance to reinvent their processes in order to properly serve their customers and diffuse the risk aversion that is present in institutions as well as investors.

Perhaps the small economy of Iceland is not meant to fund large international companies, rather establishing an outstanding community for starting firms and offering support in sourcing financing abroad. Maybe Iceland should not aim to do it all. A strong financing environment is necessary either way, and focus must be set on growing out of the repercussions of the 2008 financial collapse. The need for larger investments is perhaps not a need, but an opportunity for specialization in assisting firms in finding foreign investment. Unless trust is restored, private investment can not blossom, and without trust in our institutions, they can not serve their customers professionally and their customers therefore can not manage their businesses in the professional manner that they would like.

There are ample opportunities for the Icelandic financing market to become a robust environment for SME’s. The foundation is present and there are several competitive advantages at hand, such as high government support and short channels of communication. Now is the time to build upon that foundation to create a healthy and competitive space for Icelandic SME’s and investors.
Appendix 1. Respondent statistics

B. Industry

A. Turnover (€ millions)

C. Target debt ratio?

D. Long term debt ratio

E. Use CAPM?

F. Number of employees

G. Age of CEO

H. CEO Tenure
Appendix 2, Survey sent to Icelandic SME CEO’s

1. Does your firm have a target value for the leverage ratio?
   If yes,
   We usually/permanently depart from it
   We occasionally depart from it
   We strictly respect it

2. Which of the following sources of long-term funds are /would be important for financing new investments?
   On a scale of 1-4, 1 = not important, 4 = Very important.
   Retained earnings
   Restructuring assets
   Straight debt
   Convertible bond
   External common equity

3. During the last three years, did your firm apply for new loans or capital leases?
   If yes,
   Always approved
   Always denied
   Sometimes approved and sometimes denied

4. In periods when the firm's investment is low, does your firm retain a part of its free cash flows?

5. Given an investment that could not be taken without modifying the actual balance sheet structure, what action would you take?
   Á skala 1-4
   Deviate from the capital structure
   Cut the dividend
   Restructure assets
   Forgo the investment opportunity
6. If you forwent the investment opportunity, why?

Á skala 1-4

In order to hold independence
In order to keep moderate level of leverage
In order to keep the senior shareholders’ value
External equity financing is unavailable
Borrowing is impossible
Debt service is not expected to be satisfied

7. Does your firm estimate the cost of equity capital? ( ) Yes ( ) No.

8. If yes, how do you determine your firm’s cost of equity capital?

On a scale of 1-4, 1 = never, 4 = always.

a) With average historical returns on common stock
b) Using the Capital Asset Pricing Model (CAPM, the beta approach)
c) Using the CAPM but including some extra „risk factors“
d) Whatever our investors tell us they require
e) By regulatory decisions
f) Back out from discounted dividend/earnings model, e.g. Price = Div./(cost of cap.-growth)
g) Other: ____________________________________________

What factors affect your firm’s choice

9. Has your firm seriously considered issuing convertible debt? (if “no”, please go to the next question) If "yes", what factors affect your firm's decisions about issuing convertible debt?

On a scale of 0-4, 0 = not important, 4 = Very important.

a) convertibles are an inexpensive way to issue “delayed” common stock
b) our stock is currently undervalued
g) ability to “call” or force conversion of convertible debt if/when we need to
e) avoiding short-term equity dilution
h) to attract investors unsure about the riskiness of our company
c) convertibles are less expensive than straight debt
d) other firms in our industry successfully use convertibles
b) protecting bondholders against unfavorable actions by managers or stockholders
10. Has your firm seriously considered issuing common stock? (if “no”, please go to the next question) If "yes", what factors affect your firm's decisions about issuing common stock?

On a scale of 0-4, 0 = not important, 4 = Very important.

m) Earnings Per Share dilution

k) the amount by which our stock is undervalued or overvalued by the market

a) if our stock price has recently risen, the price at which we can sell is “high”

c) providing shares to employee

bonus/stock option plans

e) maintaining a target debt-to-equity ratio

j) diluting the holdings of certain shareholders

b) stock is our “least risky” source of funds

g) whether our recent profits have been sufficient to fund our activities

f) using a similar amount of equity as is used by other firms in our industry

h) issuing stock gives investors a better impression of our firm's prospects than issuing debt

l) inability to obtain funds using debt, convertibles, or other sources

d) common stock is our cheapest source of funds

i) the capital gains tax rates faced by our investors (relative to tax rates on dividends)

11. What factors affect your firm's choice between short- and long-term debt?

On a scale of 1-4, 1 = not important, 4 = Very important.

a) we issue short term when short term interest rates are low compared to long term rates

b) matching the maturity of our debt with the life of our assets

c) we issue short-term when we are waiting for long-term market interest rates to decline

d) we borrow short-term so that returns from new projects can be captured more fully by shareholders, rather than committing to pay long-term profits as interest to debtholders.

e) we expect our credit rating to improve, so we borrow short-term until it does

f) borrowing short-term reduces the chance that our firm will want to take on risky projects

12. What is your firm’s approximate long term debt/total assets ratio? _____% (e.g. 40%)
13. What factors affect how you choose the appropriate amount of debt for your firm?

*On a scale of 0-4, 0 = not important, 4 = Very important.*

- a) The tax advantage of interest deductibility
- b) The potential costs of bankruptcy, near-bankruptcy, or financial distress.
- c) The debt levels of other firms in the industry
- d) The transaction costs and fees for issuing debt
- e) The personal tax cost our investors face when they receive interest income
- f) Financial flexibility (we restrict debt so we have enough internal funds available to pursue new projects when they come along)
- g) The volatility of earnings and cash flows
- h) We limit debt so our customers/suppliers are not worried about our firm going out of business
- i) If we issue debt our competitors know that we are very unlikely to reduce our output
- j) A high debt ratio helps us bargain for concessions from our employees
- k) To ensure that upper management works hard and efficiently, we issue sufficient debt to make sure that a large portion of our cash flow is committed to interest payments
- l) We restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and do not have to be paid out as interest to debtholders
- m) Projected cash flow from the asset to be financed

14. What other factors affect your firm's debt policy?

*On a scale of 0-4, 0 = not important, 4 = Very important.*

- a) we issue debt when our recent profits (internal funds) are not sufficient to fund our activities
- b) using debt gives investors a better impression of our firm's prospects than issuing common stock
- c) we issue debt when interest rates are particularly low
- d) we use debt when our equity is undervalued by the market
- e) we delay issuing debt because of transactions costs and fees
- f) we delay retiring debt because of recapitalization costs and fees
- g) changes in the price of our common stock
- h) we issue debt when we have accumulated substantial profits

Please fill in one square from each category that best describes your company

15. Sales revenue

- <$25 million
- $25-99 million
- $100-499 million
- $500-999 million
- >$1b.
16. What is the average number of employees?
1
2-9
10-19
20-49
50-99
100-249
>249

17. CEO Education (I will add options here, as Iceland is not as MBA oriented as the USA)
< Undergrad
Undergraduate
MBA
Non-MBA masters
> Masters degree

18. Age of CEO
<40
40-49
50-59
>60

19. CEO Tenure (time in current job)
< 4 years
4-9 years
> 9 years
20. Industry
Transportation
Fishing and agriculture
Hotels and restaurants
Specialized scientific and technical operations
Finance, real estate and insurance
Manufacturing
Construction
Retail and wholesale
Other ________________

21. What percent of equity is owned by the top three officers?
<5%
5-10%
10-20%
>20%

22. Does the firm pay dividends
( ) Yes
( ) No
Appendix 3: survey results

1. Which of the following sources of long-term funds are/would be important for financing new investments?

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Management Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>a) retained earnings</td>
<td>69.32%</td>
<td>3.88</td>
<td>3.91</td>
<td>3.82</td>
<td>3.98</td>
<td>3.82</td>
</tr>
<tr>
<td>c) straight debt</td>
<td>52.76%</td>
<td>3.31</td>
<td>3.15</td>
<td>3.77</td>
<td>2.63</td>
<td>3.68</td>
</tr>
<tr>
<td>b) restructuring assets</td>
<td>24.54%</td>
<td>2.50</td>
<td>2.37</td>
<td>2.64</td>
<td>2.40</td>
<td>2.48</td>
</tr>
<tr>
<td>e) external common equity</td>
<td>20.25%</td>
<td>2.10</td>
<td>1.99</td>
<td>2.55</td>
<td>2.03</td>
<td>2.13</td>
</tr>
<tr>
<td>d) convertible bond</td>
<td>12.27%</td>
<td>1.89</td>
<td>1.86</td>
<td>1.86</td>
<td>1.70</td>
<td>1.93</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>CEO age</th>
<th>CEO tenure</th>
<th>CEO MBA</th>
<th>CEO education</th>
<th>Target debt ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>&gt;59</td>
<td>Younger</td>
<td>Long</td>
<td>Short</td>
<td>Yes</td>
</tr>
<tr>
<td>a) retained earnings</td>
<td>69.32%</td>
<td>3.88</td>
<td>4.00</td>
<td>3.89</td>
<td>3.85</td>
<td>3.94</td>
</tr>
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<td>3.31</td>
<td>2.43</td>
<td>3.34</td>
<td>3.27</td>
<td>3.29</td>
</tr>
<tr>
<td>b) restructuring assets</td>
<td>24.54%</td>
<td>2.50</td>
<td>1.71</td>
<td>2.48</td>
<td>2.38</td>
<td>2.48</td>
</tr>
<tr>
<td>e) external common equity</td>
<td>20.25%</td>
<td>2.10</td>
<td>1.29</td>
<td>2.17</td>
<td>1.91</td>
<td>2.33</td>
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<td>1.43</td>
<td>1.90</td>
<td>2.00</td>
<td>1.71</td>
</tr>
</tbody>
</table>
2. Given an investment that could not be undertaken without modifying the actual balance sheet structure, what action would you take?

<table>
<thead>
<tr>
<th>% of important or very important</th>
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<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>b) cut the dividend</td>
<td>69.94%</td>
<td>3.88</td>
<td>Small: 3.95</td>
<td>Low: 4.05</td>
<td>Yes: 4.03</td>
<td>Manuf.: 3.60</td>
</tr>
<tr>
<td>c) restructure assets</td>
<td>37.42%</td>
<td>2.91</td>
<td>Large: 3.68</td>
<td>High: 3.80</td>
<td>No: 3.68</td>
<td>Wholes.: 3.62</td>
</tr>
<tr>
<td>d) forgo the investment opportunity</td>
<td>22.09%</td>
<td>2.45</td>
<td>Low: 2.70</td>
<td>High: 2.98</td>
<td>Yes: 2.87</td>
<td>Other: 3.02</td>
</tr>
<tr>
<td>a) deviate from the capital structure</td>
<td>20.24%</td>
<td>2.42</td>
<td>High: 2.93</td>
<td>Low: 2.28</td>
<td>No: 2.80</td>
<td>Other: 2.40</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CEO age</th>
<th>CEO tenure</th>
<th>CEO MBA</th>
<th>CEO education</th>
<th>Target debt ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>very important</td>
<td>Mean</td>
<td>&gt;50</td>
<td>Younger</td>
<td>Long</td>
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<tr>
<td>b) cut the dividend</td>
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<td>2.00</td>
<td>2.55</td>
</tr>
</tbody>
</table>
3. If you forwent the investment opportunity, why?

<table>
<thead>
<tr>
<th>% of important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
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<th>Man. Ownership</th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
</tr>
<tr>
<td>b) In order to keep a moderate level of leverage</td>
<td>71.80%</td>
<td>3.81</td>
<td>3.89</td>
<td>3.44</td>
<td>3.41</td>
<td>3.92</td>
</tr>
<tr>
<td>a) In order to hold independence</td>
<td>65.34%</td>
<td>3.65</td>
<td>3.89</td>
<td>3.11</td>
<td>3.82</td>
<td>3.60</td>
</tr>
<tr>
<td>f) Debt service is not expected to be satisfied</td>
<td>41.66%</td>
<td>2.96</td>
<td>2.88</td>
<td>2.78</td>
<td>2.75</td>
<td>2.96</td>
</tr>
<tr>
<td>e) Borrowing is impossible</td>
<td>31.58%</td>
<td>2.75</td>
<td>2.78</td>
<td>2.56</td>
<td>2.88</td>
<td>2.85</td>
</tr>
<tr>
<td>c) In order to keep the senior shareholders' value</td>
<td>32.00%</td>
<td>2.64</td>
<td>2.50</td>
<td>2.22</td>
<td>2.24</td>
<td>2.64</td>
</tr>
<tr>
<td>d) External equity financing is unavailable</td>
<td>22.67%</td>
<td>2.48</td>
<td>2.50</td>
<td>2.67</td>
<td>2.59</td>
<td>2.60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
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<td></td>
<td></td>
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<td>Younger</td>
<td>Long</td>
<td>Short</td>
<td>Yes</td>
</tr>
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<td>3.90</td>
<td>3.80</td>
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<tr>
<td>a) In order to hold independence</td>
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<td>3.65</td>
<td>3.67</td>
<td>3.74</td>
<td>4.20</td>
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<td>2.41</td>
<td>2.50</td>
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<tr>
<td>d) External equity financing is unavailable</td>
<td>22.67%</td>
<td>2.48</td>
<td>1.33</td>
<td>2.72</td>
<td>2.00</td>
<td>2.96</td>
</tr>
</tbody>
</table>
4. If yes, how do you determine your firm’s cost of equity capital?

<table>
<thead>
<tr>
<th>% always or very often</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
</tr>
<tr>
<td>d) Whatever our investors tell us they require</td>
<td>31.58%</td>
<td>2.68</td>
<td>2.17</td>
<td>2.83</td>
<td>2.00</td>
<td>3.00</td>
</tr>
<tr>
<td>c) Using the CAPM but including some extra “risk factors”</td>
<td>33.34%</td>
<td>2.67</td>
<td>3.00</td>
<td>2.50</td>
<td>2.67</td>
<td>2.90</td>
</tr>
<tr>
<td>e) By regulatory decisions</td>
<td>27.78%</td>
<td>2.61</td>
<td>3.17</td>
<td>2.33</td>
<td>4.00</td>
<td>2.20</td>
</tr>
<tr>
<td>b) Using the Capital Asset Pricing model, the CAPM beta approach</td>
<td>33.33%</td>
<td>2.39</td>
<td>2.67</td>
<td>2.17</td>
<td>2.00</td>
<td>2.70</td>
</tr>
<tr>
<td>a) With average historical returns on common stock</td>
<td>10.00%</td>
<td>1.75</td>
<td>1.17</td>
<td>2.14</td>
<td>2.25</td>
<td>1.40</td>
</tr>
<tr>
<td>f) Back out from discounted dividend/earnings model, e.g. Price=Div./cost of cap.growth</td>
<td>6.25%</td>
<td>1.69</td>
<td>1.40</td>
<td>1.67</td>
<td>2.00</td>
<td>1.40</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>% always or very often</th>
<th>Mean</th>
<th>CEO age</th>
<th>CEO tenure</th>
<th>CEO MBA</th>
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<th>Target debt ratio</th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>&gt;59</td>
<td>Younger</td>
<td>Long</td>
<td>Short</td>
<td>Yes</td>
</tr>
<tr>
<td>d) Whatever our investors tell us they require</td>
<td>31.58%</td>
<td>2.68</td>
<td>2.50</td>
<td>2.50</td>
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<td>3.00</td>
<td>2.50</td>
<td>2.00</td>
</tr>
<tr>
<td>b) Using the Capital Asset Pricing model, the CAPM beta approach</td>
<td>33.33%</td>
<td>2.39</td>
<td>2.42</td>
<td>2.33</td>
<td>2.50</td>
<td>3.00</td>
</tr>
<tr>
<td>a) With average historical returns on common stock</td>
<td>10.00%</td>
<td>1.75</td>
<td>1.69</td>
<td>1.86</td>
<td>1.50</td>
<td>1.50</td>
</tr>
<tr>
<td>f) Back out from discounted dividend/earnings model, e.g. Price=Div./cost of cap.growth</td>
<td>6.25%</td>
<td>1.69</td>
<td>1.55</td>
<td>1.40</td>
<td>1.67</td>
<td>1.50</td>
</tr>
</tbody>
</table>
5. Has your firm seriously considered issuing convertible debt? If yes, what factors affect your firm’s decisions about issuing convertible debt?

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>c) convertibles are less expensive than straight debt</td>
<td>15.38%</td>
<td>2.08</td>
<td>Small</td>
<td>1.88</td>
<td>Low</td>
<td>2.40</td>
</tr>
<tr>
<td>f) our stock is currently undervalued</td>
<td>15.38%</td>
<td>2.08</td>
<td>Large</td>
<td>2.67</td>
<td>High</td>
<td>2.00</td>
</tr>
<tr>
<td>g) ability to call or force conversion of convertible debt if/when we need to</td>
<td>16.67%</td>
<td>2.08</td>
<td>Low</td>
<td>1.71</td>
<td>3.00</td>
<td>1.75</td>
</tr>
<tr>
<td>h) to attract investors unsure about the riskiness of our company</td>
<td>8.33%</td>
<td>2.08</td>
<td>High</td>
<td>1.86</td>
<td>2.67</td>
<td>2.00</td>
</tr>
<tr>
<td>a) convertibles are an inexpensive way to issue “delayed” common stock</td>
<td>14.29%</td>
<td>2.00</td>
<td>Low</td>
<td>1.50</td>
<td>3.00</td>
<td>1.80</td>
</tr>
<tr>
<td>e) avoiding short-term dilution</td>
<td>0.00%</td>
<td>1.69</td>
<td>High</td>
<td>1.50</td>
<td>2.00</td>
<td>1.80</td>
</tr>
<tr>
<td>d) other firms in our industry use convertibles</td>
<td>7.69%</td>
<td>1.69</td>
<td>Low</td>
<td>1.75</td>
<td>1.33</td>
<td>2.20</td>
</tr>
<tr>
<td>b) protecting bondholders against unfavorable actions by managers or stockholders</td>
<td>0.00%</td>
<td>1.58</td>
<td>High</td>
<td>1.29</td>
<td>2.00</td>
<td>1.50</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
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<td>f) our stock is currently undervalued</td>
<td>15.38%</td>
<td>2.08</td>
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<td>1.00</td>
<td>Yes</td>
<td>3.67</td>
</tr>
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<td>g) ability to call or force conversion of convertible debt if/when we need to</td>
<td>16.67%</td>
<td>2.08</td>
<td>Long</td>
<td>2.00</td>
<td>Yes</td>
<td>3.00</td>
</tr>
<tr>
<td>h) to attract investors unsure about the riskiness of our company</td>
<td>8.33%</td>
<td>2.08</td>
<td>Short</td>
<td>2.00</td>
<td>Yes</td>
<td>2.67</td>
</tr>
<tr>
<td>a) convertibles are an inexpensive way to issue “delayed” common stock</td>
<td>14.29%</td>
<td>2.00</td>
<td>&gt; 59</td>
<td>1.00</td>
<td>Yes</td>
<td>2.50</td>
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<td>Younger</td>
<td>1.00</td>
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<td>1.00</td>
<td>Yes</td>
<td>1.00</td>
</tr>
<tr>
<td>b) protecting bondholders against unfavorable actions by managers or stockholders</td>
<td>0.00%</td>
<td>1.58</td>
<td>Short</td>
<td>1.00</td>
<td>Yes</td>
<td>1.67</td>
</tr>
</tbody>
</table>
6. Has your firm seriously considered issuing common stock? If yes, what factors affect your firm's decision about issuing common stock?

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>d) common stock is our cheapest source of funds</td>
<td>23.00%</td>
<td>2.38</td>
<td>1.80</td>
<td>3.40</td>
<td>2.75</td>
<td>2.50</td>
</tr>
<tr>
<td>g) whether our recent profits have been sufficient to fund our activities</td>
<td>23.08%</td>
<td>2.38</td>
<td>1.40</td>
<td>3.00</td>
<td>2.50</td>
<td>2.67</td>
</tr>
<tr>
<td>b) stock in our &quot;least risky&quot; source of funds</td>
<td>16.67%</td>
<td>2.17</td>
<td>1.40</td>
<td>3.40</td>
<td>2.50</td>
<td>2.33</td>
</tr>
<tr>
<td>l) inability to obtain funds using debt, convertibles, or other sources</td>
<td>7.69%</td>
<td>2.08</td>
<td>1.40</td>
<td>2.60</td>
<td>2.00</td>
<td>2.33</td>
</tr>
<tr>
<td>h) issuing stock gives investors a better impression of our firm's prospects than issuing debt</td>
<td>15.38%</td>
<td>2.00</td>
<td>1.40</td>
<td>2.60</td>
<td>2.50</td>
<td>1.83</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>CEO age</th>
<th>CEO tenure</th>
<th>CEO MBA</th>
<th>CEO education</th>
<th>Target debt ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) If our stock price has recently risen, the price at which we can sell is &quot;high&quot;</td>
<td>16.67%</td>
<td>2.00</td>
<td>1.80</td>
<td>2.60</td>
<td>2.75</td>
<td>1.83</td>
</tr>
<tr>
<td>c) providing shares to employee bonus/stock option plans</td>
<td>7.69%</td>
<td>1.92</td>
<td>2.00</td>
<td>2.00</td>
<td>2.75</td>
<td>1.50</td>
</tr>
<tr>
<td>e) maintaining a target debt-to-equity ratio</td>
<td>7.69%</td>
<td>1.85</td>
<td>1.40</td>
<td>1.80</td>
<td>2.00</td>
<td>1.83</td>
</tr>
<tr>
<td>j) diluting the holdings of certain shareholders</td>
<td>7.69%</td>
<td>1.85</td>
<td>1.40</td>
<td>2.40</td>
<td>2.00</td>
<td>1.83</td>
</tr>
<tr>
<td>f) using a similar amount of equity as is used by other firms in our industry</td>
<td>7.69%</td>
<td>1.69</td>
<td>1.40</td>
<td>2.00</td>
<td>2.50</td>
<td>1.17</td>
</tr>
<tr>
<td>i) the capital gains tax rates faced by our investors (relative to tax rates on dividends)</td>
<td>0.00%</td>
<td>1.62</td>
<td>1.40</td>
<td>1.80</td>
<td>2.00</td>
<td>1.33</td>
</tr>
<tr>
<td>k) the amount by which our stock is undervalued or overvalued by the market</td>
<td>0.00%</td>
<td>1.62</td>
<td>1.40</td>
<td>1.80</td>
<td>2.00</td>
<td>1.33</td>
</tr>
<tr>
<td>m) earnings per share dilution</td>
<td>0.00%</td>
<td>1.54</td>
<td>1.40</td>
<td>1.60</td>
<td>2.00</td>
<td>1.17</td>
</tr>
</tbody>
</table>

Reykjavík University 89 January 2015
7. What factors affect your firm's choice between short- and long-term debt?

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
</tr>
<tr>
<td>a) we issue short term when short term interest rates are low compared to long term rates</td>
<td>46.22%</td>
<td>3.03</td>
<td>3.05</td>
<td>2.86</td>
<td>2.55</td>
<td>3.32</td>
</tr>
<tr>
<td>b) matching the maturity of our debt with the life of our assets</td>
<td>50.00%</td>
<td>3.07</td>
<td>3.11</td>
<td>3.14</td>
<td>2.65</td>
<td>3.38</td>
</tr>
<tr>
<td>c) we issue short term when we are waiting for long-term market interest rates to decline</td>
<td>14.15%</td>
<td>2.13</td>
<td>2.06</td>
<td>2.23</td>
<td>2.05</td>
<td>2.22</td>
</tr>
<tr>
<td>d) borrow short term so that returns from new projects can be captured more fully by shareholders, rather than paying long-term profits as interest</td>
<td>22.64%</td>
<td>2.26</td>
<td>2.27</td>
<td>2.36</td>
<td>2.30</td>
<td>2.28</td>
</tr>
<tr>
<td>e) we expect our credit rating to improve, so we borrow short term until it does</td>
<td>13.20%</td>
<td>1.94</td>
<td>1.86</td>
<td>2.32</td>
<td>1.73</td>
<td>2.12</td>
</tr>
<tr>
<td>f) borrowing short term reduces the chance that our firm will want to take on risky projects</td>
<td>13.20%</td>
<td>2.20</td>
<td>2.20</td>
<td>2.27</td>
<td>2.28</td>
<td>2.17</td>
</tr>
<tr>
<td>Mean</td>
<td>50.00%</td>
<td>3.07</td>
<td>3.11</td>
<td>3.14</td>
<td>2.65</td>
<td>3.38</td>
</tr>
<tr>
<td>Small</td>
<td>3.11</td>
<td>3.14</td>
<td>2.65</td>
<td>3.38</td>
<td>2.95</td>
<td>3.38</td>
</tr>
<tr>
<td>Large</td>
<td>3.05</td>
<td>2.86</td>
<td>2.55</td>
<td>3.32</td>
<td>2.97</td>
<td>3.08</td>
</tr>
<tr>
<td>Low</td>
<td>2.06</td>
<td>2.23</td>
<td>2.05</td>
<td>2.22</td>
<td>2.19</td>
<td>1.95</td>
</tr>
<tr>
<td>High</td>
<td>2.27</td>
<td>2.36</td>
<td>2.30</td>
<td>2.28</td>
<td>2.27</td>
<td>2.33</td>
</tr>
<tr>
<td>Yes</td>
<td>1.86</td>
<td>2.32</td>
<td>1.73</td>
<td>2.12</td>
<td>1.92</td>
<td>2.03</td>
</tr>
<tr>
<td>No</td>
<td>2.43</td>
<td>3.17</td>
<td>3.11</td>
<td>3.13</td>
<td>2.92</td>
<td>3.14</td>
</tr>
<tr>
<td>Younger</td>
<td>2.71</td>
<td>3.03</td>
<td>3.00</td>
<td>3.02</td>
<td>2.92</td>
<td>3.02</td>
</tr>
<tr>
<td>Long</td>
<td>2.57</td>
<td>2.27</td>
<td>2.35</td>
<td>2.23</td>
<td>2.38</td>
<td>2.28</td>
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<tr>
<td>Short</td>
<td>2.00</td>
<td>2.23</td>
<td>2.29</td>
<td>2.13</td>
<td>2.08</td>
<td>2.23</td>
</tr>
<tr>
<td>Yes</td>
<td>1.86</td>
<td>2.11</td>
<td>2.15</td>
<td>2.04</td>
<td>1.69</td>
<td>2.16</td>
</tr>
<tr>
<td>No</td>
<td>1.71</td>
<td>1.98</td>
<td>1.91</td>
<td>2.02</td>
<td>2.08</td>
<td>1.94</td>
</tr>
<tr>
<td>Target debt ratio</td>
<td>3.10</td>
<td>2.88</td>
<td>3.01</td>
<td>3.13</td>
<td>2.24</td>
<td>2.38</td>
</tr>
</tbody>
</table>

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January 2015
8. What factors affect how you choose the appropriate amount of debt for your firm?

| % important or very important | Mean | Small | Large | Low | High | Yes | No | Manuf. | Wholes. | Other | Low | High | YES | NO | % undergrad | undergrad | masters | Yes | No | % undergrad | undergrad | masters | Yes | NO |
|------------------------------|------|-------|-------|-----|------|-----|----|-------|--------|-------|-----|------|-----|----|------------|-----------|--------|-----|----|------------|-----------|--------|-----|----|------------|-----------|--------|-----|----|
| a) we limit debt so our customers/suppliers are not worried about our firm going out of business | 52.98% | 3.26 | 3.20 | 3.53 | 2.67 | 3.53 | 3.16 | 3.45 | 3.40 | 3.50 | 2.98 | 3.46 | 3.25 | 2.90 | 3.51 | 3.16 | 3.57 | 3.03 | 3.19 | 3.28 | 2.69 | 3.56 | 3.13 | 3.63 |
| b) we restrict debt so that we have enough internal funds available to pursue new projects when they come along | 48.57% | 3.21 | 3.16 | 3.45 | 2.72 | 3.42 | 3.08 | 3.45 | 3.40 | 3.80 | 3.05 | 3.21 | 2.71 | 3.26 | 3.25 | 3.19 | 3.18 | 3.16 | 3.16 | 3.28 | 2.69 | 3.56 | 3.13 | 3.63 |
| c) we limit debt so our customers/suppliers are not worried about our firm going out of business | 39.62% | 2.92 | 2.99 | 2.68 | 2.70 | 3.03 | 2.90 | 2.95 | 2.40 | 2.50 | 3.09 | 3.00 | 2.91 | 2.71 | 2.94 | 2.84 | 3.02 | 2.85 | 2.83 | 3.03 | 2.87 | 2.88 | 2.91 | 2.94 |
| d) the transaction costs and fees for issuing debt | 35.57% | 2.85 | 2.73 | 3.18 | 2.21 | 3.18 | 2.75 | 2.95 | 3.40 | 2.62 | 2.64 | 3.08 | 2.80 | 1.57 | 2.93 | 2.76 | 2.81 | 3.08 | 2.80 | 3.27 | 2.82 | 2.91 | 2.91 | 2.91 |
| e) we restrict our borrowing so that profits from new/future projects can be captured fully by shareholders and not paid out as interest to debtholders | 37.26% | 2.82 | 2.81 | 2.90 | 2.71 | 2.83 | 3.00 | 2.56 | 2.40 | 3.04 | 2.63 | 2.65 | 2.63 | 2.50 | 2.85 | 2.83 | 2.73 | 2.84 | 3.08 | 2.70 | 2.74 | 2.95 | 2.77 | 3.31 |
| f) we restrict debt so that we have enough internal funds available to pursue new projects when they come along | 33.01% | 2.73 | 2.71 | 2.62 | 2.34 | 3.02 | 2.58 | 2.85 | 3.40 | 2.46 | 2.68 | 2.46 | 2.72 | 2.00 | 2.73 | 2.60 | 2.78 | 3.15 | 2.62 | 2.50 | 2.68 | 2.88 | 2.74 | 2.69 |
| g) the volatility of earnings and cash flows | 22.12% | 2.35 | 2.24 | 2.76 | 2.23 | 2.41 | 2.32 | 2.36 | 2.60 | 1.88 | 2.54 | 2.77 | 2.28 | 1.83 | 2.38 | 2.36 | 2.33 | 2.15 | 2.38 | 2.67 | 2.29 | 2.12 | 2.33 | 2.44 |
| h) the tax advantage of interest deductibility | 15.09% | 1.95 | 1.89 | 2.23 | 1.70 | 2.10 | 1.84 | 2.15 | 1.60 | 1.54 | 2.11 | 2.62 | 1.87 | 1.43 | 2.00 | 1.89 | 2.04 | 1.85 | 1.88 | 1.91 | 2.00 | 2.09 | 1.91 | 2.19 |
| i) if we issue debt our competitors know that we are very unlikely to reduce our output | 5.82% | 1.88 | 1.91 | 1.86 | 1.64 | 1.95 | 1.82 | 2.05 | 2.60 | 1.92 | 1.09 | 1.05 | 1.91 | 1.33 | 1.94 | 1.96 | 1.83 | 1.92 | 1.90 | 1.97 | 1.97 | 1.75 | 1.69 |
| j) the debt levels of other firms in the industry | 9.71% | 1.83 | 1.79 | 2.10 | 1.80 | 1.84 | 1.97 | 1.68 | 1.80 | 1.50 | 2.07 | 2.62 | 1.74 | 1.40 | 1.88 | 1.79 | 1.92 | 1.82 | 1.84 | 1.80 | 1.92 | 1.62 | 1.77 | 2.20 |
| k) the potential costs of bankruptcy, or financial distress | 7.62% | 1.81 | 1.80 | 1.95 | 1.83 | 1.80 | 1.86 | 1.79 | 1.60 | 1.46 | 2.00 | 1.54 | 1.88 | 1.71 | 1.84 | 1.87 | 1.78 | 1.92 | 1.82 | 1.84 | 1.86 | 1.79 | 1.82 | 1.75 |
| l) the personal tax cost our investors face when they receive interest income | 4.81% | 1.47 | 1.43 | 1.57 | 1.54 | 1.42 | 1.43 | 1.50 | 2.00 | 1.19 | 1.54 | 1.54 | 1.44 | 1.00 | 1.48 | 1.43 | 1.49 | 1.38 | 1.47 | 1.48 | 1.53 | 1.34 | 1.39 | 1.94 |
| m) to ensure upper management works hard and efficiently, we issue sufficient debt to make sure a large portion of our cash flow is committed to interest payments | 0.96% | 1.39 | 1.41 | 1.33 | 1.49 | 1.26 | 1.28 | 1.63 | 2.00 | 1.08 | 1.53 | 1.38 | 1.40 | 1.17 | 1.41 | 1.46 | 1.32 | 1.46 | 1.39 | 1.55 | 1.37 | 1.28 | 1.38 | 1.50 |
9. What other factors affect your firm’s debt policy?

<table>
<thead>
<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>Size</th>
<th>Leverage</th>
<th>Pay dividends</th>
<th>Industry</th>
<th>Man. ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Small</td>
<td>Large</td>
<td>Low</td>
<td>High</td>
<td>Yes</td>
</tr>
<tr>
<td>a) we issue debt when our recent profits (internal funds) are not sufficient to fund our activities</td>
<td>35.85%</td>
<td>2.72</td>
<td>2.68</td>
<td>2.59</td>
<td>2.43</td>
<td>2.88</td>
</tr>
<tr>
<td>e) we delay issuing debt because of transaction costs and fees</td>
<td>27.36%</td>
<td>2.45</td>
<td>2.43</td>
<td>2.50</td>
<td>2.38</td>
<td>2.43</td>
</tr>
<tr>
<td>c) we issue debt when interest rates are particularly low</td>
<td>22.64%</td>
<td>2.26</td>
<td>2.15</td>
<td>2.50</td>
<td>2.08</td>
<td>2.42</td>
</tr>
<tr>
<td>h) we issue debt when we have accumulated substantial profits</td>
<td>13.20%</td>
<td>2.04</td>
<td>2.10</td>
<td>1.91</td>
<td>1.95</td>
<td>2.13</td>
</tr>
<tr>
<td>f) we delay retiring debt because of recapitalization costs and fees</td>
<td>13.21%</td>
<td>2.00</td>
<td>1.86</td>
<td>2.45</td>
<td>1.85</td>
<td>2.03</td>
</tr>
<tr>
<td>b) using debt gives a better impression of our firm’s prospects than issuing common stock</td>
<td>6.60%</td>
<td>1.87</td>
<td>1.78</td>
<td>2.23</td>
<td>1.83</td>
<td>1.92</td>
</tr>
<tr>
<td>d) we use debt when our equity is undervalued by the market</td>
<td>4.72%</td>
<td>1.63</td>
<td>1.57</td>
<td>1.82</td>
<td>1.70</td>
<td>1.62</td>
</tr>
<tr>
<td>g) changes in the price of our common stock</td>
<td>3.77%</td>
<td>1.58</td>
<td>1.43</td>
<td>2.00</td>
<td>1.60</td>
<td>1.58</td>
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</table>

<table>
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<tr>
<th>% important or very important</th>
<th>Mean</th>
<th>CEO age</th>
<th>CEO tenure</th>
<th>CEO MBA</th>
<th>CEO education</th>
<th>Target debt ratio</th>
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<td></td>
<td>&gt;59</td>
<td>Younger</td>
<td>Long</td>
<td>Short</td>
<td>Yes</td>
</tr>
<tr>
<td>a) we issue debt when our recent profits (internal funds) are not sufficient to fund our activities</td>
<td>35.85%</td>
<td>2.72</td>
<td>2.29</td>
<td>2.69</td>
<td>2.58</td>
<td>2.75</td>
</tr>
<tr>
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<td>27.36%</td>
<td>2.45</td>
<td>2.14</td>
<td>2.47</td>
<td>2.45</td>
<td>2.44</td>
</tr>
<tr>
<td>c) we issue debt when interest rates are particularly low</td>
<td>22.64%</td>
<td>2.26</td>
<td>2.14</td>
<td>2.23</td>
<td>2.45</td>
<td>1.96</td>
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<tr>
<td>h) we issue debt when we have accumulated substantial profits</td>
<td>13.20%</td>
<td>2.04</td>
<td>1.57</td>
<td>2.09</td>
<td>2.20</td>
<td>1.90</td>
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<tr>
<td>f) we delay retiring debt because of recapitalization costs and fees</td>
<td>13.21%</td>
<td>2.00</td>
<td>1.43</td>
<td>2.03</td>
<td>2.09</td>
<td>1.88</td>
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<tr>
<td>b) using debt gives a better impression of our firm’s prospects than issuing common stock</td>
<td>6.60%</td>
<td>1.87</td>
<td>1.71</td>
<td>1.89</td>
<td>1.95</td>
<td>1.79</td>
</tr>
<tr>
<td>d) we use debt when our equity is undervalued by the market</td>
<td>4.72%</td>
<td>1.63</td>
<td>1.86</td>
<td>1.60</td>
<td>1.75</td>
<td>1.48</td>
</tr>
<tr>
<td>g) changes in the price of our common stock</td>
<td>3.77%</td>
<td>1.58</td>
<td>1.71</td>
<td>1.54</td>
<td>1.64</td>
<td>1.46</td>
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</tbody>
</table>
Appendix 4: Interview questions

Spurningalisti vegna lokarítgerðar Völu Hrannar Guðmundsdóttur í meistaranámi í fjármálum fyrirtækja

Fjármögnunarumhverfi lítilla og meðalstórra fyrirtækja á Íslandi

Hvernig þykir þér fjármögnunarumhverfi lítilla og meðalstórra fyrirtækja á Íslandi vera? Er það sterkt eða veikt? Þróað eða vanþróað?

**What is your opinion on the financial environment for SMEs in Iceland? Strong/weak, developed/underdeveloped**

Hvað telur þú vera helstu styrkleika fjármögnunarumhverfisins á Íslandi?

**What do you believe to be its greatest strengths?**

En veikleika? Hvar liggja bilin?

**What are its weaknesses? Where are the gaps?**

Hvaða leið myndir þú ráðleggja stjórnendum SME fyrirtækja að fara við öflun fjármagns?

**How would you advice SMEs to get funding?**

Telur þú það vera skynsamlegt fyrir lítil og meðalstór fyrirtæki að afla sír fjár með skráningu á hlutabréfamarkaði eins og t.d. First North?

**Do you believe that First North registration will be a good tool for SMEs to raise capital?**

Telur þú menningu hafa áhrif, að íslenskir fjárfestar séu minna til í langtíma skuldbindingar?

**Does culture play a big part in the Icelandic financing environment? Are Icelandic investors bad at being patient investors?**

Hversu mikil þekking á fjármögnunarumhverfi og tölum telur þú vera til staðar hjá stjórnendum lítilla og meðalstórra íslenskra fyrirtækja?

**How much knowledge of the financial environment do you believe to exist at the typical Icelandic SME?**

Finnst þér þeir hafa góða tilfinningu fyrir capital structure og sliku? Góða þekkingu á möguleikunum?

**Do managers have a good idea of capital structure and such theories?**

Hvað telur þú vera framtíðina? Eru einhverjar erlendar fyrirmyndir sem þú myndir vilja sjá á Íslandi?

**What is your „dream“? Is there anything happening elsewhere that you would like to see in Iceland?**
### Appendix 5: financing options of firms with access to international funding

<table>
<thead>
<tr>
<th>Considerations</th>
<th>Senior Bank Debt (Asset-based)</th>
<th>Senior Bank Debt (Cash Flow)</th>
<th>Senior Notes</th>
<th>Subordinated Secured Loan</th>
<th>Subordinated Notes</th>
<th>Mezzanine</th>
<th>Private Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost of funds</strong></td>
<td>LIBOR + 250-550bp</td>
<td>LIBOR + 125 - 300bp</td>
<td>T+ 175 - 225bp</td>
<td>10 - 12%</td>
<td>8-13%</td>
<td>11-18%</td>
<td>25-35%</td>
</tr>
<tr>
<td><strong>Dilution</strong></td>
<td>None</td>
<td>None</td>
<td>Limited</td>
<td>Limited</td>
<td>Limited</td>
<td>Limited</td>
<td>Substantial</td>
</tr>
<tr>
<td><strong>Leveragability (Multiple of EBITDA)</strong></td>
<td>Asset Value Approach**</td>
<td>Asset Value Approach**</td>
<td>Asset Value</td>
<td>Asset Value</td>
<td>Asset Value</td>
<td>Asset Value</td>
<td>Asset Value</td>
</tr>
<tr>
<td><strong>Maturity</strong></td>
<td>4-6 years</td>
<td>5-12 years</td>
<td>6-8 years</td>
<td>7-10 years</td>
<td>7-10 years</td>
<td>N.M.</td>
<td>N.M.</td>
</tr>
<tr>
<td><strong>Covenant flexibility</strong></td>
<td>Flexible</td>
<td>Flexible</td>
<td>Flexible</td>
<td>Flexible</td>
<td>Flexible</td>
<td>Minimal</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Interest rate risk</strong></td>
<td>Yes</td>
<td>No</td>
<td>Limited</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Prepayment Penalty</strong></td>
<td>Minimal</td>
<td>No</td>
<td>Make-Whole</td>
<td>Yes</td>
<td>Yes</td>
<td>Minimal</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Timing</strong></td>
<td>10-14 weeks</td>
<td>10-14 weeks</td>
<td>10-14 weeks</td>
<td>10-14 weeks</td>
<td>14-18 weeks</td>
<td>10-14 weeks</td>
<td>18-22 weeks</td>
</tr>
<tr>
<td><strong>Investors</strong></td>
<td>Banks, Commercial Finance Companies</td>
<td>Banks, Insurance Companies</td>
<td>Banks, Special Situation Funds</td>
<td>Insurance companies, Funds</td>
<td>Funds</td>
<td>Funds</td>
<td>Funds</td>
</tr>
</tbody>
</table>

* Various hedging options are available

**Liquidation value as basis, however, cash flows are important measure as they indicate ability to service debt
References


Act on Mandatory Insurance of Pension Rights and on Activities of Pension Funds No. 129/1997.


