START-UPS in Latvia: A Pain or a Gain?

by

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Abstract

Latvia, a Baltic country, is ranked 27 in the World Bank Business Ranking (2016). If it needs to prosper, it needs to create an ecosystem to foster more citizens to start their own enterprise. The aim of the research is to analyze the importance of internal and external factors of start-up development in Latvia. The following hypothesis was tested: H(o): Internal Factors do not play a statistically significant role in the development of a start-up in Latvia. H(a): Internal and External factors do play a statistically significant role in the development of a start-up in Latvia.

Keywords: Latvia, Start-ups, Funding

Introduction

What is a start-up? Nowadays, the term start-up is understood as either a procedure before the company performs its economic activities (European Commission) or a "gazelle", which is a subset of a high-growth enterprise (OECD, 2015). Lowe and Marriott (2007) define a start-up as a synonym to new venture creation. Its strategy is focused on three dimensions –the business environment, the resources of the organization, and the values of the organization. Wickham (2006) describes a start-up as a process of moving from the conventional labor pool to the entrepreneurial pool. The reverse process is called a fall-out. According to the Ministry of Economics of the Republic of Latvia (2015), a start-up is a newly established small business. Eric Ries, the author of the book *The Lean Startup,* suggests that a start-up is an organization dedicated to creating something new under conditions of extreme uncertainty. In the literature, there is no common definition of a start-up. The authors collected different views and concluded that scalability is one major condition for success. Following the views of Kim, Gross, Demers and Bennet (2016), here is a summary of the most common factors that influence the performance of a start-up: Summary of most common factors that influence the performance of a start-up (Table 1, below).

Table 1.

INTERNAL	EXTERNAL
1) Product idea	1) Market demand for the product
2) Team management/leadership	2) Financing
3) Planning	3) Competition
4) Marketing	4) Legal and political environment
5) Customer relationship management (CRM)	5) Timing

Internal factors are categorized as factors that are controlled by the team in the business, whereas external factors are factors that influence the development of start-ups more from the external sources, such as government rules and regulations, customers, creditors/financiers.

From a leadership perspective, the authors found the work from Rodríguez-Sánchez and Perea (2015) the most compelling. They state that transformational leadership and teamwork are important factors to improve team resilience and the success of the organization. According to the authors, "the role of leadership has been emphasized in creating a culture of innovation and proactivity responsible of resilience culture in organizations. Thus, according to our behavioral approach, the leadership style closer to the idea of proactivity and innovation is transformational leadership." As mentioned before, start-ups are in their core innovative and pro-active companies, therefore these factors are having a strong correlation between the success of a start-up and team management/leadership.

Furthermore, marketing is an important tool in start-ups and in every business because it is the tool, with which the business communicates with the client. For each type of client, business, or consumer, the tools differ. Neil Patel mentions these five important marketing tools for an online start-up (Patel, 2014):

1) Superb web design – the design of the website must tell a story and it has to communicate with the client and find what he or she needs.

2) To be social everywhere – a start-up should communicate with its clientele through social networks, such as Facebook, Twitter and also through other networks, such as AngelList, Midsize-Insider, and others.

3) A large amount of content – content means that a business has passion and that it has something to say.

4) Fast response to emails and social inquiries – it plays an important role together with customer relationship management because if the business doesn't respond to the customer, it can negatively affect the brand value and reputation.

Personal branding – before start-up founders advertise their business, it should advertise its people, its team.

The final aspect is financing. Atherton (2012) analyzed 20 start-ups and found the following most common financing types: a)formal equity (venture capital investments), b)formal loans, c) informal investments (Friends, Family, Fools), d) overdraft, e) HPLF (hire, purchase, leasing, factoring), f) grants from local authorities.

To conclude this section, the authors looked at the work of Gross (2014), cofounder of PIMCO. He analyzed multiple start-ups and how much different factors such as ideas, business model, funding, and timing influenced their success. Gross concluded that timing is everything.

The start-up environment in Latvia

The authors looked at the Innovation Union Scorecard (IUS), used by the European Commission (EC) to improve the research activities in each EU Member state. The IUS distinguishes three main types of indicators-outputs, enablers, and firm activities. The Table 2 summarizes the type of indicators and their dimensions.

Table 2. IUS dimensions

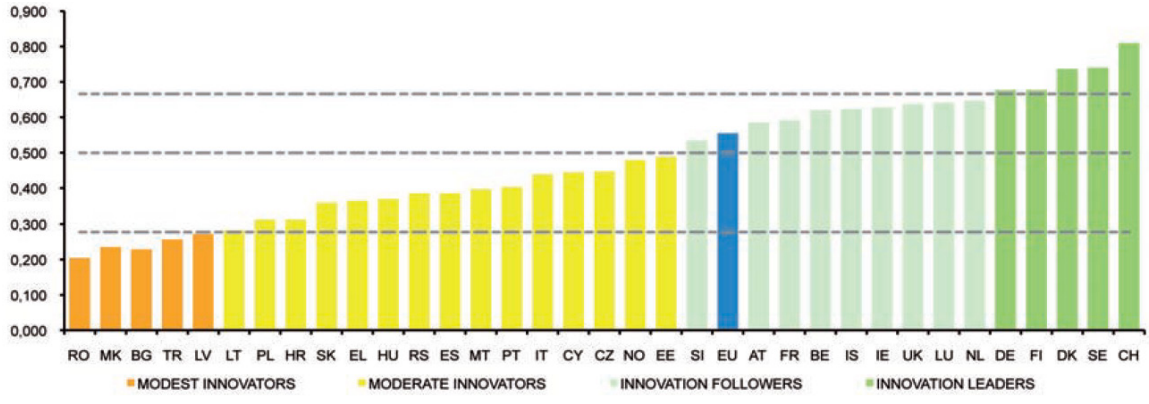
Enablers	Firm activities	Outputs
Human resources	Firm investments	Innovators
Open, excellent and attractive research systems	Linkages & entrepreneurship	Economic effects
Finance and support	Intellectual assets	

Source: Developed by the Authors based on Innovation Union Scoreboard 2015

The enablers are the main external drivers to the firm of innovation performance, such as human resources, which measures the availability of highly educated and skilled workforce, research systems, which measures the international competitiveness of the science base and finance and support, which evaluates the availability of finance from venture capital investments and governmental support in R&D expenditures. Firm activities are the efforts made by firms in innovation, such as investments in R&D and non-R&D, MSMEs that innovate in-house, a collaboration of research between the private and public sector and evaluating the different forms of intellectual property rights. Lastly, outputs evaluate how the innovation activities performed by firms affect the market.

Table 3. The graph below presents the scores for each European state in 2015

The graph indicates that the European average score is approximately 0.55 and 15% are innovation leaders; these are Switzerland, Sweden, Denmark, Finland, and Germany. Furthermore, 26% are innovation followers, 44% are moderate innovators and the remaining 15% are modest innovators, which are Romania, Macedonia, Bulgaria, Turkey, and Latvia. Although Latvia is evaluated as a modest innovator (0.27), it had one of the highest growth rates in the European Union, alongside Bulgaria and Malta, which is mostly because of a very strong increase in non-R&D innovation expenditures. Moreover, Latvia had an improvement in sales of the new-to-firm and new-to-market innovations from 2014, but there was a decline in scientific publications and R&D expenditure in the public sector. Latvia can increase its scientific specialization index (further in the text – SI) and impact on a world level by improving the knowledge base for bio-economics, biotechnology, and others.



European state innovation performance in 2015

Source: Innovation Scoreboard Report 2015

In comparison to Lithuania and Estonia, Latvia has a better SI index for biotechnology, but it has a smaller impact on the world level.

Latvia has comparatively small R&D expenditures per capita – only 81.3 Euros, whereas Lithuania and Estonia have 125.6 Euros and 217.9 Euros per capita respectively. According to the Macro Research report for 2014 performed by Swedbank Latvija, the main reason for this is that there are high innovation costs and there is high lack of funds. In order to improve the situation in Latvia, the government should increase expenditure in growth-related areas, such as education and R&D.

Latvia's biggest trading partner is the EU. On average the total amount of trade is 62% with EU countries, whereas the remaining 38% is with other world countries. In 2014 the amount of total trade was 1.1 billion Euros, whereas 74% or 780 million Euros was with EU countries. This can be partly explained due to the introduction of the euro in 2014 and therefore it was cheaper for companies to trade with other Eurozone member states. The increase was by 160 million Euros from 2013 or by 26%. The most significant increase in extra EU-28 states was in 2011 when the total trade amount increased by 200 million Euros or by 160%.

Survey Results

The authors developed a 10-question survey and sent it out to 200 start-up founders in Latvia, from February till April 2016. Key findings:

-Age: 35% of the respondents (the largest group) are in the 23-27 years age group,

-Gender: 19% female, 81% male

-Education: 20% obtained a high school diploma, 41% obtained a bachelor's degree, 25% a master's degree, 14 % other forms of education.

-Funds: 70% used their own money to finance the start-up and 30% were willing to consider crowdfunding as a form of financing.

-Industry: 47% consider that the finance, payment, and e-commerce industry have the highest growth potential in Latvia.

Table 4 below contains parameters, which are required to perform the z-test. Z-test is "a technique used to test the hypothesis that proportions are significantly different for two independent samples or groups" (Babin & Griffin, 2013).

Table 4. Z-test parameters and testing

Sample mean	51%
Standard Deviation	3%
SE of mean	0.0045
Z-statistic	2.02
Precision	5%
Rejection z-scores	From -1.96 to 1.96
Conclusion	Reject the Null hypothesis (Ho)

Source: Developed by the Author using survey data

Based on our calculation, the null hypothesis is rejected, which means that the importance of internal factors in start-up development is not less than or equal to 50%, therefore the alternative hypothesis has been approved.

Conclusion

The study looked at the start-up environment in Latvia.

1. Reviewing the different meanings of start-up, it is clear that there are major differences between opinions of what a start-up is. One definition is that it is a phase for a company where it searches for funding, develops the business model, and prepares to enter the market, while the other states that it is a gazelle, a small high-growth young company with the potential growth of 20% per annum for five years focusing on technological products.

2. Start-ups that are considered as high-growth enterprises develop through 3 stages: the pre-startup, startup, and growth, where the main tasks during the pre-startup phase are defining the vision and mission, afterward in the startup phase develop the minimum viable product, and finding its market fit and in growth stage performs scaling.

3. Eric Ries, the author of *The Lean Startup,* has developed a method that helps build the product faster and helps start-ups improve. The method consists of three parts: generating the idea and building it faster, coding the product and measuring it through different tests, and collecting the data from the product, and learning the fields where to improve it.

4.

5. Researchers have various opinions about which type of factors influence start-up development mostly. Some researchers state that team resilience and adaptability is the secret to the success of an organization, while others state that timing in the market or planning is the most crucial factors.

6. There are different types of venture and start-up funding. Most common are business angels who provide knowledge and capital, venture capital companies who are needed for expansion into new markets, crowdfunding that is an investment from the public through the internet and founder's own funds, savings from previous ventures.

7. Latvia, according to European Commission's Innovation Union Scoreboard, was considered a modest innovator, which was one of the worst results in Europe, due to lack of attractiveness in research systems, public-private co-publications, and insignificant revenues from license and patents abroad.

8. The strengths of Latvia are relatively high non-R&D expenses in innovation, which are for investments in machinery, patents, and licenses, and the number of youth and population with secondary and tertiary education.

9. According to Innovation Union's progress report, Latvia is scientifically specialized in materials and biotechnology, while the impact on the world

level is more from health and food, agriculture & fisheries fields.

10. In comparison to EU countries, Latvia has low R&D expenditure per capita – only 81.3 Euros. The largest part of this is in the higher education sector and only 35% in the business enterprise sector.

11. Largest part of the survey sample (66%) had acquired either a bachelor's degree or a master's degree. Together with the information that 57% of the survey sample were in age from 23 to 32 years, proved that a large part of people who finish their academic studies build their own start-up or are working in one.

12. Surveyed sample evaluated that internal factors have larger importance in the development of a start-up with an average score of 4.0, whereas external factors had a score of 3.9 points. On the other hand, the demand for the product had the biggest score of 4.6 points, which is an external factor.

13. As a source of financing 70% would use their own money to finance the start-up, whereas only 35% would use crowdfunding websites. This is partly explained that more people are willing to stay independent and keep their company secret from additional competition.

14. According to specialist interviews, the largest differences between start-ups and MSMEs are that start-ups are scalable, innovative, high-growth enterprises, whereas MSMEs usually provide a product that is already in the market and does not have the potential of high growth.

15. When asked about what are the most important factors that influence start-up development, all experts mentioned that it is a set of factors and that it depends on the current goal. If it is getting funding from a business angel or a venture capital it is the team and belief in the idea, for others, it is the right timing and the geographical location.

16. The meaning of a successful start-up, for each expert was different. For some it was the exit of the start-up by selling its business to a large, international corporation, for others it was building added value and developing further with the original team, not pushing for the exit.

17. Overall, the authors conclude that internal factors are more important in start-up development than external factors, therefore proving the Alterna-

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