

## **Venture capital funds – alternative sources for economic development financing**

**Rezime:** Trenutna ekonomska situacija pred kreatore ekonomske politike stavlja jako ozbiljan zadatak, obezbeđivanje dodatnih izvora kapitala za finansiranje ekonomskog rasta i razvoja. Većina zemalja, naročito u jugoistočnoj Evropi, nema razvijene alternativne izvore finansiranja poput finansijskih tržišta i fondova zajedničkog ulaganja tako da bankarski sektor nije motivisan da razvija dugoročne partnerske odnose sa preduzetnicima. Fondovi zajedničkog ulaganja predstavljaju institucionalne investitore koji ulažu u poslovne poduhvate za koje procene da će im nakon aktivnog učešća doneti profit kroz različite izlazne strategije.

**Ključne reči:** ekonomski razvoj, kapital, fondovi zajedničkog ulaganja

**Abstract:** The current economic and financial crisis has put a serious task in front of the economic policy makers, especially in the countries that are relying on banking sector. This task concerns how to find enough money to support steady economic development in future. Most of these countries do not have alternative sources of capital such as capital markets or venture capital funds. In the absence of competition, banking sector is not motivated either to decrease interest rates or to become a partner through investment with entrepreneurs.

**Key words:** economic development, capital, venture capital funds

### **1. INTRODUCTION**

**T**he main problem for Serbian economy in future period will be lack of fresh capital in the form of direct investments in the economy. Serbian economy needs capital, but even more it needs technology, modern management, know-how, etc. Simply, Serbian economy needs improvements in various areas of conducting business and this emphasizes the question how to solve this problem. One of the possible solutions is to create the favorable environment to attract venture capital funds (VCFs). The aim of this paper is to point out venture capital funds as alternative capital resources and to analyze their current position in Serbian economy as well.

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## **2. THE ANALYSIS OF THE VENTURE CAPITAL BUSINESS**

New conditions for every national economy functioning during the time of crisis exert great pressure on increasing productivity and creativity. This crisis will force economies to become more aggressive while acting like a large entrepreneur: in attracting capital, improving organization, developing new technology and human resources, creating new products and so on. Having this in mind, it is clear that one of the most significant things in the next period for every economy is to attract the venture capital and private equity funds as capital resources and as a prerequisite for improving entrepreneurship.

As we can find in the literature, the private equity market can be divided into two parts (see [1], p.5):

- venture capital, which is primarily devoted to equity or equity-linked investments in young growth-oriented ventures and
- private equity, which is devoted to investments that go beyond venture capital – covering a range of other stages and established business including management buy-outs, replacement capital and turnarounds.

Venture capital can be organized by private (individual) or institutional investors.

Private investors are wealthy individuals, known as business angels (often designated as 'informal venture capital'), ready to invest their own money in different stages of business (see [3] p.7). They are often former executives investing in the known field of business, using contacts and experience in building up the business project. They try to select a non-listed company, with great growth opportunities and scarce funding sources in which they invest and later sell its share through IPO at the financial market.

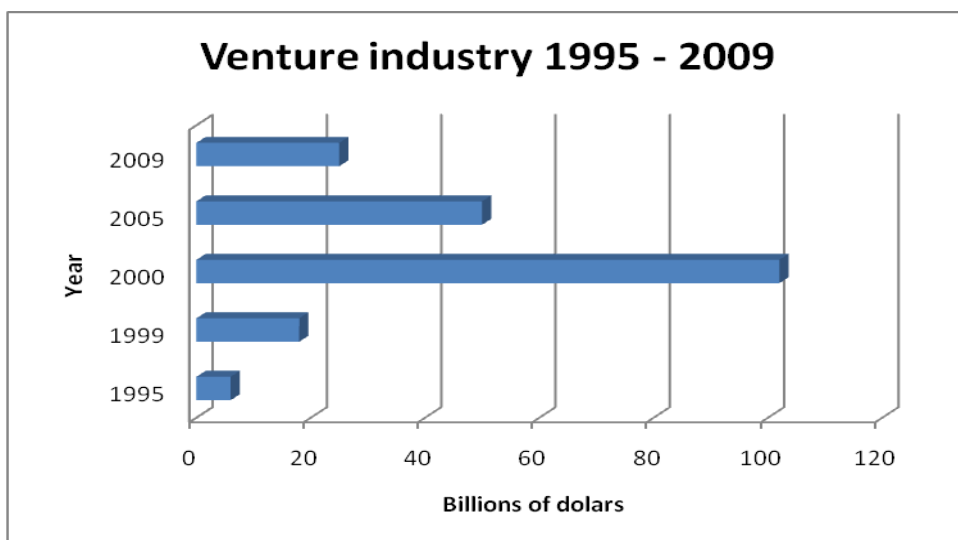
Institutional venture capital firms are intermediaries between financial institutions and unquoted companies (see[2], p.5), they are raising funds from the former to the latter. Their primary task is to find interesting business projects with growing opportunities and then to convince financial institutions to invest their money. Financial institutions are pension funds, insurance companies, wealthy families, etc. The organizational forms of the institutional venture capital can be different, depending on the ownership structure (see [3], p.6):

- independent limited partnerships, in which the venture capital firm serves as the general partner, raising capital from limited partners such as institutional investors ( pension funds, insurance companies and banks)
- captive venture capital firms which are mainly funded by the internal resources of a parent organization – a bank or an insurance company, or by non-financial institutions
- government venture capital organizations, which are financed and controlled by government institutions.

As the third group within the venture capital industry, the corporate venture capital is mentioned. It is defined as 'equity or equity-linked investments in young privately held companies, where the investor is a financial intermediary of a non-financial corporation' (see [1], p.7). The corporate venture capital is organized by a large corporation in order to develop a specific product or technology that can be related to the current business or it can be totally new, providing new sources for profit.

The native land of the whole venture capital sector in modern time is the USA, where the first forms of the venture capital business might be seen during the development of a few industries such as railroads, steel, petroleum and glass. One such venture investment was the creation of the IBM as a result of several mergers and investment made by the wealth individuals. But, there are some economists saying that the first venture capital project was the Columbus' journey to the west. This was a project completely financed by a wealth individual, the Spanish queen, and it was highly profitable.

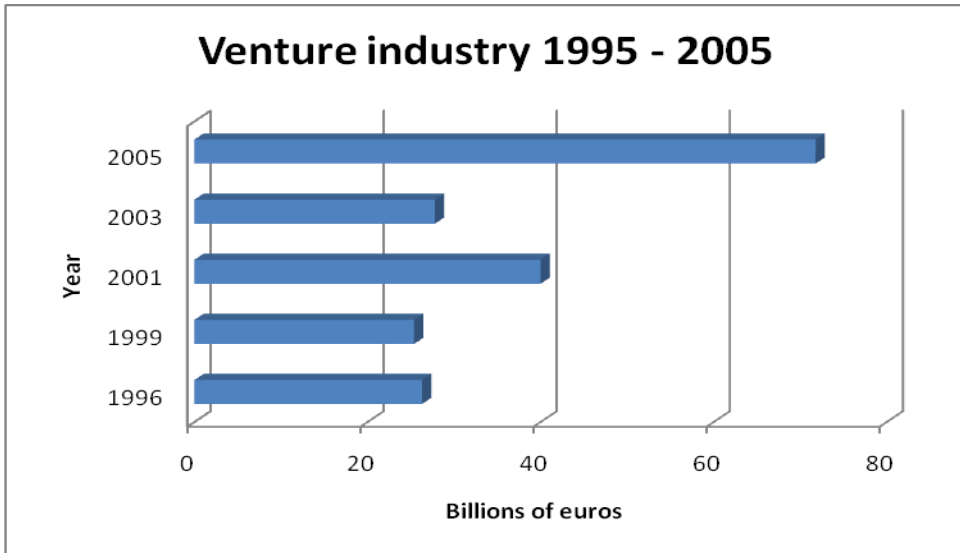
Today, Venture capital industry is becoming more recognizable as a very important source of economic development, especially in field of financing highly innovative and risky investments. Data shown in graphic number 1 are presenting capital under venture capital funds in USA economy in last fourteen years. We can see very modest committed capital during 90-ties, and a peak in 2000 when we had more then 100 billions under the management. After 2000, the venture capital market declined until 2006., but financial crisis at the end of 2007 and at the begging of 2008 (see [3], p.13) caused retrieving capital from venture capital industry.



Source:[7]

**Graphic no.1 Size of US venture capital industry, in billions of US dollars**

The situation in Europe when it comes to venture industry is quite modest comparing with data from US (see [4], p.6-13). Next graphic is showing venture capital under the management for period from 1996 to 2005.



Source: [6]

**Graphic no.2 Size of Venture capital industry in Europe, in billions of euros**

The graphic number 2 shows that European venture industry has a continuous growth with peak reached in 2005, with more than 70 billions of Euros under the management of venture funds. This is far from a US average, but this is significant step in venture capital industry development in Europe.

The situation in Asia is quite different because of the institutional framework which, along with regulatory, legal and venture capital culture, has not been established. However, as can be found in the specialized venture surveys (see [6] and [7] ), there is a great interest in this part of the world because it can be seen as a source of capital and as a very profitable place to invest. China, India, Russia and Singapore can present great source of venture capital because of their sovereign funds established by the state and financed mainly by selling natural resources. These sovereign funds are sources of great amount of money waiting for profitable projects all around the world. China Investment Corp. (CIC) with total assets of \$200 billion , Government of Singapore Investment Corp. (GSI) with total assets of \$100 billion or Russian oil proceeds fund of \$157 billion – thanks to crude oil price rise – are all good examples to be mentioned(see [1], p. 33).

The term 'sovereign' comes from the fact that these are government-owned funds and some estimation says that sovereign funds now have \$2.5 trillion to

\$3 trillion in assets and at the same time forecast goes to the amount of \$17.5 trillion in the next ten years.

It is quite clear that in the next years the great emphasis must be on sovereign funds and efforts to attract them to national economy. Bearing in mind that every economy needs capital, future economic development can rely to some extent on sovereign funds.

### **3. CURRENT POSITION OF THE VENTURE CAPITAL INDUSTRY IN SERBIA**

The analysis of the venture capital market in Serbia provided very disappointing information knowing that single venture capital firm is conducting its business in Serbia. This suggest conclusion of the undeveloped venture capital industry, low level of entrepreneurship, lack of good investment opportunities and reduced exit chances for venture capitalists.

In this moment, the only representative of VCFs industry in Serbia is Private Equity Fund called SEAF South Balkan fund as a part of the bigger SEAF as global VCF.

The Small Enterprise Assistance Funds (SEAF) is a global investment firm focused on providing capital and operational support to businesses in emerging markets and those underserved by traditional sources of capital. The SEAF selectively makes structured debt and equity investments in locally owned enterprises with high growth potential. Based in Washington D.C., the SEAF invests in more than 20 countries around the world through an international network of 15 [offices](#) in [Central and Eastern Europe](#), [Latin America](#), and [Asia](#). [Investors](#) include a cross section of public and private institutions, including several of the international finance institutions, local pension funds, insurance companies, banks and family offices (see [5]).

In Serbia the SEAF South Balkan Fund (in further text: SEAF) is conducting the business as a foreign company's office and it is not registered as a private equity or venture capital investment fund. According to the available information, there are several procedural problems to be solved for the registration of VCFs.

Firstly, private equity and venture capital investment funds are not recognized by the investment funds law. Secondly, during the investment process it is hard to explain to the authorities the role of a venture or private equity investment fund as a new partner in the company, its rights and obligations. These are some of the reasons causing the low level of attractiveness to venture capital investment funds.

Furthermore, there are some other problems that are not the result of the legal procedure but the result of the internal SEAF research:

- very low level of business know-how among the entrepreneurs, such as basic knowledge about finance, market, marketing and company development strategy,
- very low level of transparency concerning financial results reporting,
- misunderstanding the role of private equity or venture capital investment fund in company development,
- misunderstanding company market value; several investment deals were cancelled because of the non-realistic company value assessment made by its owners; the wishes are one thing but the reality is something completely different.

Despite the numerous restraints SEAF concluded four investment deals in Serbia during its two-year existence using standard procedures to choose a prospective investment. As a company with American experience in the field of venture capital, they are using traditional tools in order to make a good investment project.

**Table no.1 SEAF Venture capital activity in Serbia**

No.	Company name	Industry	Amount (euro)
1.	PC Center	Software	900 000
2.	Gomex	Retail	1 400 000
3.	A2B	Logistic	625 000
4.	Logo group	System integration	1 000 000
		Total	3925000

*Source: [5]*

There are three phases in selection process. The first phase is preliminary, during which the SEAF is collecting offers for future cooperation. Hence, the SEAF have been organizing several publicly held lectures about private equity and venture capital funds, their role and aim. After that the companies were asked to fill in the form with their details: field, size, structure of capital, results and future perspective. The last phase is choosing a company to invest in. The connection with the company is not closed after the investment has been made. Furthermore, it is upgraded through the help in different fields of business – product development, organization, marketing and finance.

The situation in Serbia is clear, there is not enough capital and there are some prospective sectors where venture investors can make profit. But, the state must make several steps if it wants to attract global players in the field of the venture and private equity investment.

The first crucial steps needed are changes in the legal framework concerning investing through investment funds. The big problem for private equity and venture capital investors is that no single law recognizes them as economic units. At this moment they are registered in Serbia as offices or branches

conducting their business as intermediaries. This is a serious problem because during the investment process several laws must be met and it is quite difficult to close the deal since it must be registered with the state office and the state office does not recognize this kind of investment. This procedure is long and expensive, so in the future efforts must be made in passing the set of laws that recognize and regulate the field of private equity and venture capital investment. This should help with the registration of investment funds, with their investing process and with protection of investment projects.

The second step is concerning tax rules, because this is one of the most significant issues associated with attracting foreign investors. Investors are looking for the country where they can earn but they also pay low or no taxes. This is a field where all battles are fought in order to attract capital. Future period dedicated to capital attraction, must bring changes in tax policy. Most investment funds are interested in small and medium companies with growing opportunities and thus, they are not involved in the 'state' projects. Since investment funds are bringing money to business projects, the state must change the tax rule for them. One of the suggestions is to make a distinction between the 'green-field' investments and investing in the existing business.

Green-field projects are financed from idea to realization and they must be tax-free within a reasonable period of time (e.g. 10 years), having in mind that they are ready to support the idea and that they are ready to take the great amount of risk.

Another type of investment – investment in the existing business – should also be tax-free within a reasonable period of time, although this period should be shorter if compared with the previous one. This kind of tax rules would send the message to the investors that the state is ready to support them by taking the risk along with them. The state is taking risk by not collecting taxes immediately, hoping that the deferment will promote higher tax collection in future.

The third step should be addressed to the creation of the state investment fund as a support to the investment opportunities, but also as a partner to the venture and private equity investors.

It is not odd that states are creating so-called sovereign investments funds as a tool to invest money in profitable projects. The money from such funds often comes from energy exports (Norway, Russia, China, UAE) or as a result of the successful trading strategy (Singapore). These funds are sources of cash and states are looking for domestic or foreign projects that can bring profits in future years.

The first effort that Serbia can make is to attract such funds to invest in big infrastructural projects such as high roads, rail roads and airports. These are projects having high capital demand and no single venture or private equity investment fund is able to finance their development. Another thing Serbia can do related to the sovereign investment fund is to create its own. The question is where the money can come from. The answer is privatization process and

dissolving some of the State Agencies, Funds and other low-initiative, administrative bodies.

#### **4. CONCLUSION**

The current position of Serbian economy is characterized by the low level of capital, very old technology, lack of know-how management, but, on the other hand, Serbia is a country with a great opportunity for investing, taking into account the natural resources, qualified and rather cheap workforce and its central position in the Balkan Peninsula.

In future period, Serbia can become the leader of the region if its economic policy is defined in such a way to attract venture capital investment funds by offering profit making opportunities and adjusting the institutional framework. Serbia needs to encourage formal and informal investors by sending the clear message that it is a safe place for capital through Greenfield investment or any other form of long-term investment in the real sector of the economy.

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