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Venture Capital and Private Equity investing in Western Balkan region

Rezime: Fondovi pribvatnog kapitala i Fondovi zajedničkog ulaganja su institucionalni investitori koji su spremni da ulože sredstva u kompanije koje nemaju dugu istoriju poslovanja. Njihov cilj jeste da prepoznaju kompaniju sa potensijalom rasta, ulože novac u nju i finansijki, marketinški i tehnološki pomognu njenom razvoju. Kako je ova vrsta investitora uključena u svakodnevne aktivnsoti kompanije, prisutna je pretopstavka stabilnog ekonomskog i institucionalnog okruženja. Kada se odluče za investiranje u zemlje u razvoju, koriste različite modele za procenu stabilnosti okruženja.

Ključne reči: Fondovi zajedničkog ulaganja, Ekonomski razvoj, Region Zapadnog Balkana, analitički model

Summary: Private equity and Venture capital funds are institutional investors willing to take high risk by investing in companies with no strong tracking record. Their aim is to recognize companies with potential high growth, invest money in it and help company with financial, marketing and technological experience and contacts. Because they are intensively involved in day to day business operation of company, they assume stability of economic and institutional sourandings. When they are making decision to invest in developing countries, different models for enviromental stability analysis are used.

Key words: Venture capital, Economic development, Western Balkan region,analitic model

1. INTRODUCTION

The main aim of this paper is to analyze attractiveness of Western Balkan region for Venture Capital and Private Equity investors using indexes developed in theory and information from leading financial institutions, such as World Bank, EBRD, IFM, IFC, Transparency international, etc. Index used in survey is developed by Alexander Peter Groh and Heinrich von Liechtenstein in their paper [see 18] where they gather information about economic activity, capital market, investor protection and corporative governance, taxes, human environment and entrepreneurial opportunities. Using the results from Groch and Liechtenstein research, respecting the importance of

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different factors on PE/VC investment decision, the analysis of Western Balkan region will be conducted.

The Western Balkans is the term used by the European Union for the sub-region comprising Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Serbia and Montenegro. Kosovo, under UN administration, is a province of Serbia. With the exception of Albania, the countries of the Western Balkans were formerly constituent republics of the old Federal Republic of Yugoslavia. The Western Balkan region is composed of relatively small size economies. While the largest country in terms of population is Serbia with 7,2 million people, Croatia is the largest in economic terms, with a GDP of more than € 45 billion. The population of the whole region is almost 25 million people, equivalent to 6.5% of the EU or one third of the ten acceding countries' population. The GDP of the whole region reaches €113 billion, equivalent to approximately 0.09% of the EU's GDP [see 28]. The GDP per capita at current nominal exchange rates in the region is equal to around € 4,393, with a great difference between the GDP per capita in Croatia [around € 10,678] and that in the other Western Balkan countries, which is below € 5,000[see 28].

Finding are showing that at this point of time, VC/PE industry can not recognize West Balkan as a place for intensive investment activity, but their presence can be more case to case strategy. VC/PE funds willing to take more risk, and invest in the region can obtain profit rates above industry average because of lack of competition in the field economic activity financing sources. Because of that they can negotiate conditions more profitable than in the countries with PE/VC industry presence.

2. METHODOLOGY

In this paper methodology used comes form Groch and von Liechenstein research during 2007 where they gave answer on how VC/PE investors make decisions about new, emerging markets. During the research authors, analyzed literature related to investment decision process and due to it created index which reflected research results. In their research, VC/PE investors were questioned, giving them opportunity to select the most important factor determine decision for making investment. As a result, they have weighted factors determine decision. Justification for including selected indicators in research and index creation, Groch and von Liechenstein found in literature.

First, in wide literature dealing with VC/PE industry economic growth is seen as an important precondition for development of VC/PE industry. The reason is found in research verifying assumption about connection between growing economies and possibility to find within fast growing sectors to invest. Further research on subject verified significant correlation between GDP growth and VC/PE industry activities [see 29]. Second, IPO process is seen as main driver of VC/PE activity because it is main exit strategy trough which VC/PE funds can

obtain the highest returns on investment [see 19]. As a confirmation, other researchers [see 2] showed connection between risk capital activity and deep,liqued capital markets. Country with deep and liquid market is more attractive for risk capital investment activities. Third, legal environment is quite important for countries ability to attract outside finance sources. In their paper La Porta et el.[see 21] showed that legal system strongly determine size and extent of capital markets and local firm's ability to receive outside financing. Further more, followed research activities showed that country's legal system has strong impact on faciliting VC/PE-backed exits, even more then country's stock market size [see 7]. Connected with PE/VC industry is new enterprises creation trough which is possible to asses the level of entrepreneurial activity in one country. This is an important information for VC/PE fund because of possible investment opportunities. If a country has dynamic changes in numbers of enterprises, entrepreneurial spirit is present and investment opportunity supply side give opportunity for making choices. Related with new enterprises is fairness and property rights protection, because only in a country with strong property rights protection people are willing to enchage themselves in entrepreneurship activities [see 11]. Fifth, tax policy is quite important tool in attracting VC/PE fund, because taxes are very influencing on business entry and exit [see 6]. Connected with institutional environment Lazear [see 22] and Blanchard [see 3] showed strong connection between work protection and employment, in a sense that increased work protection lead to employment reduction. Sixth, in order to find suitable activity for investing, VC/PE fund must have acknowledgment about innovation capacity in country. The innovation is closely related with entrepreneurial activities because, only entrepreneurial spirit will lead to innovation level increasing. VC/PE funds are interest in economies where companies are willing to create new solution for process related to its core business. To make possible measuring level of innovation capacity in literature various data are used, starting from R&D culture are Universities and laboratories [see 26] to level of R&D activities, number of employees in R&D, number of patents and similar [see 23].

Groch and Liechtenstein summarized all factors found in VC/PE literature and conducted research across VC/PE industry, giving funds opportunity to mark the most important factor determine their readiness to make investment in new markets. The answers received from industry are summarized in next table:

Table no.1 Weighted factors determine PE/VC investment decision

Indicator	*Mean Nomination*	*Factor Analyses*
Economic activity	*.161*	*.068*
Capital market	*.155*	*.188*
Taxation	*.151*	*.197*
Investor protection and Corporative governance	*.204*	*.158*
Human and Social Environment	*.164*	*.190*
Entrepreneurial Opportunities	*.166*	*.198*

Source: [27,30]

The data from previous table, show that with using mean nomination, Investors protection and Corporative Governance receives highest weight [0.204]. On the other hand, factor analysis changes the results, so the highest weight has Entrepreneurial Opportunities [0.198] along with Taxation [0.197]. In both cases, economic activity is not weighted significantly, leading to a conclusion it is not so important investor decision determinate.

Using the methodology developed by Groch and von Liechenstein, in this paper region of Western Balkan will be analyzed. In order to have adequate information, data from national institutions will not be used. Whole research will be based on international, recognized institutions and their data and recognized indexes.

3. DETERMINE WESTERN BALKAN REGION AS A VC/PE INVESTMENT MARKET

The issue of attractiveness of Western Balkan countries for PE/VC industry can be seen trough investment opportunities, but also trough straights and weakness of institutional framework. New conditions for every economy in the region functioning during the time of crisis exert great pressure on increasing productivity and creativity [see 30]. 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 [see 25]. 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 [see 25].

As we can find in the literature, the private equity market can be divided into two parts [see 16]:

- 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 16]. 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 27], 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 27]:

- 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 27].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. Methodology developed by Groch and von Liechenstein will be used to analyze Western Balkan region as a potential market for VC/PE industry. The analysis will cover Economic activity, Taxation, Capital markets, Investors protection and corporative governance, Human and social environment and Entrepreneurial Opportunities. In order to have proper information about mentioned factors, international organizations will be used as a sources. Also, the comparative analysis will be conducted, meaning that information regarding Western Balkan countries will be compared to EU members, Czech Republic and Hungary. These countries were at the similar development level before 15 years as Western Balkan countries.

3.1. Economic activity

Economic activity across the region will be analyzed trough GDP per capita, GDP growth, Exports as a percentage of GDP, imports as a percentage of GDP, unemployment rate and foreign direct investment. These data will show can regional economies be seen as a growing, leaving opportunity for fast growing businesses.

Looking at information about economic activities, the conclusion is that region as a whole lack behind EU because Czech and Hungary do not represent the most developed countries within EU. Beside Croatia, whole region has GDP per capita two times smaller, some countries even more: Montenegro's GDP is nine time smaller then Czech's. But, GDP growth rates across the region had smaller

decline during 2009 then Hungary and Czech Republic. Albania was a single country in region with positive growth rate [3,30%].

Foreign direct investment in 2009 were at similar level across the region, but half smaller than in Hungary and four time smaller then in Czech Republic. This can be the most important signal regarding economic activity for VC/PE industry not or to invest in region. Small FDI can be seen as a signal that the region has a very unsecured condition for investment or there is not adequate investment opportunities. Either way, PE/VC players will skip region as a investment destination. On the other hand, VC/PE funds can see this as a opportunity, looking at the region as an unexploited for profit making activities.

Table no.2 Economic activity across region[2009]

Indicator	GDP per capita	GDP growth	Exports as % of GDP	Imports as % of GDP	Unemployment rate	Foreign direct investment as % of GDP
Serbia	5,154	-3,00%	30,70%	50,80%	18,30%	3,10%
Croatia	10,245	-5,80%	47,70%	56,30%	9,60%	3,80%
Macedonia	3,593	-0,50%	48,10%	66,80%	35%	2,90%
BiH	3,595	-3,20%	32,90%	62%	29%	6,90%
Albania	3,096	3,30%	22,80%	47,30%	13,75%	3,10%
Montenegro	2,888	-5,30%	49,40%	79,10%	N.A	3,30%
Czech Republic	17,923	-4,1%	49%	49%	7,9%	14%
Hungary	13,496	-6,7%	52%	63%	11%	7%

Source: [27,30]

3.2. Taxation

Looking at the taxes as a precondition for making VC/PC investment decision, next must be pointed out, taxes can influence VC/PE activity in process of fundraising and in process of exiting, when VC/PE obtain profit. Research in this field [see 17] showed that *''capital gains tax does not arise trough its effect on those supplying venture capital, but rather by spurring corporate employees to become entrepreneurs, leading to more demand for venture capital''*. On other side, taxation on capital gain obtained after exiting period can be motivation or demotivation for VC/PE industry. If countries are willing to attract VC/PE industry they must motivated them trough lower tax rates.

Assessing taxes across region will be done by using information from World Economic Forum, where in the *Goods Market Efficiency* pillar, 6th in a roll, the variable used as a proxy for tax rate is given full weight [see 32]. Total tax rate is a combination of profit tax [% of profits], labor tax and contribution [% of profits], and other taxes as a profit percentage [see 32]. The findings are presented in next table:

Table no.3 Total tax rates across the region

Country	Total tax rate	Country	Total tax rate
Serbia	46	Czech Republic	91
Croatia	40	Hungary	115
Macedonia	10		
BiH	23		
Albania	84		
Montenegro	26		

Source: [30]

Information from the table are very interesting, because all countries from the region have favorable tax policies comparing to Czech Republic and Hungary. Knowing that taxation is very important factor in investment decision, conclusion is that the regions very attractive for investing, if we look at tax policy. The best position according to data has Macedonia at 10th, followed by Bosnia at 23rd and Montenegro, at 26th.

3.3. Capital markets

In their paper, Black and Gilson, argued that precondition for developed VC industry is strong financial market where IPO can be organized as a the most profitable exit option for VC/PE industry. They pointed the fact that USA with its banking sector playing a limited role in the governance of large corporations, along with well developed stock market with frequent initial public offerings [IPOs]. On the opposite side, Japanese main banks and German universal banks are larger in size relative to Japanese and German firms, and play a larger role in monitoring large firms [see 2]. Looking further they argued that neither country have had an active IPO market in past.

For analysis, data from World Bank will be used, showing basic charactersditics of capital markets across the region. The analysis will cover next variables: financial market sophistication, interest rate spread and country credit rating. Financial market sophistication addresses for question how would economic subjects assess the level of sophistication of financial markets in country where they conduct business activities [see 32]. The level of sophistication is measured on a scale 1 to 7, where 1 stands for very low development level and 7 for high development. Interest rate spread shows average interest rate spread between typical lending and deposit rates [see 32]. Country credit rating is a variable showing assessment of the probability of sovereign debt default on a 0–100 [lowest probability] scale, and higher results stand for lowest probability of default.

Looking at previously mentioned factors, they will be helpful in gathering information about possible IPO exits but also some conclusions can be brought

about competitors for VC/PE industry in financial sources market. The data are summarized in next table.

Table no.4 Capital market development across region

Indicator	Financial Market Sophistication	Interest rate spread	Country credit rating
Serbia	2,98	8,7%	42,3
Croatia	4,13	8,4%	55,8
Macedonia	3,59	3,0%	42,7
BiH	2,60	4,3%	31,4
Albania	2,83	5,9%	38,2
Montenegro	4,45	5,6%	40,8
Czech Republic	4,80	4,7%	75,5
Hungary	4,34	2,9%	57,6

Source: [30]

Data from table show financial markets across region lagging behind financial markets in Hungary and Czech Republic. Single financial market close to Czech and Hungary, by development level, is Croatian. This can represent bad signal for VC/PE industry because they see financial markets as the most profitable exit route. But, on the other hand, during 2009 in Europe 17,1% of exit routes were conducted trough trade sale and only 5,6% trough IPO according to EVCA research [see 12].

Looking at the data concerning interest rate spread, Serbia and Croatia are above the average for the region with 8,7% and 8,4% respectively, and it can be justified by low credit rating but also with lack of competition among financial resources. Across the region banking sector is dominated source for financing economic activity, leaving space for obtaining extra profit rates. Smaller interest rate spread in Montenegro and BiH are results of fix exchange rates in BiH and usage of EUR as a currency in Montenegro.

3.4. Investors protection and corporative governance

Evidence provided in research by Cumming et al.[see 8] showed: ‘*’that cross-country differences in legality, including legal origin and accounting standards, have a significant impact on the governance structure of investments in the VC industry: better laws facilitate faster deal screening and deal origination, a higher probability of syndication and a lower probability of potentially harmful co-investment, and facilitate investor board representation of the investor and the use of securities that do not require periodic cash flows prior to exit*’’.

Further research by Cumming focused on Dutch PE industry reveal institutional investors regulatory harmonization has increased Dutch institutional investor allocations to domestic and international private equity funds [see 7]. If there is

transparency present about history, investment strategy and previous results, institutional investors will increase their amount to PE. Other wise, the amount allocated to PE will decrease significantly. The results of research across 49 countries [see 21] showed that countries with strong investor protection have more developed sources for financing economic activities. In these countries, investors are willing to pass their capital to entrepreneur because they feel that they are protected by law. This can be used in explaining VC/PE – company relationship. If VC/PE find that in the region investor protection is at high level, it will feel free to make investment to entrepreneurial activity or established companies with growing potential.

Next table use indexes developed by World Bank Institute, World Bank Resource Institute and World Justice Project, helping us to get clear picture about the level of investor protection across Western Balkan region. *The Regulatory Quality Index* measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. It is computed from survey data from multiple sources. The index values range from -2.5 [very poor performance] to +2.5 [excellent performance]. *The Government Effectiveness Index*, based on 17 component sources, measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The index values range from -2.5 [very poor performance] to +2.5 [excellent performance]. *The Index of Economic Freedom* measures ten components of economic freedom, assigning a grade in each using a scale from 0 to 100, where 100 represents the maximum freedom. The ten component scores are then averaged to give an overall economic freedom score for each country. The ten components of economic freedom are: Business Freedom, Trade Freedom, Fiscal Freedom, Government Spending, Monetary Freedom, Investment Freedom, Financial Freedom, Property Rights, Freedom from Corruption and Labor Freedom.

Table no. 5 The protection and corporative governance across region

Indicator	The Regulatory Quality Index	The Government Efficiency Index	The Index of Economic Freedom
Serbia	-0,21	-0,28	58,0
Croatia	0,5	0,52	61,1
Macedonia	0,21	-0,14	66,0
BiH	-0,19	-0,55	57,5
Albania	0,16	-0,34	64,0
Montenegro	-0,05	0,01	62,5
Czech Republic	1,09	1,07	70,4
Hungary	1,26	0,66	66,6

Source: [33]

Data concerning investor protection and corporative governance are pointing out serious lagging behind by countries across the regions compared to Czech Republic and Hungary. Results coming from these indexes are showing region as very unsecured looking at government possibility to enforce laws. Because PE/VC industry is very sensitive on law enformencent and investment protection this can be pointed as a main weakness for attracting PE/VC players in region. On other hand all these countries are still in some phase of transition process, and all of them are seeing EU as a final destination of transition. So, they are pressured in creating institutional framework compatible with EU. Hence, it is not strange to expect that indexes will move forward on scale, as EU become more close.

3.5. Human and Social environment

Literature connected with Social environment pointed out that highly rigid labor market policies negatively affect VC/PE development [see 22]. Also, Djankov et al. concluded in their research that increasing barriers and costs have a strong correlation with corruption, unofficial economy and bureaucratic delay [see 10]. If in a country, higher amount of time and money is required for meeting administrative burdens, this country is not suitable for new venture creation [see 23]. In order to assess Western Balkan countries in a light of their human and social environment, information from World Economic Forum will be used. Information about time required to start business, rigidity of employment index and global competitiveness index will give answer what kind of environment VC/PE could find across the region.

Table no.6 Human and social environment across region

Indicator	Time required to start business	Rigidity of employment index	Global Competitiveness Index
Serbia	45	86	3,80
Croatia	75	121	4,00
Macedonia	10	33	4,00
BiH	121	82	3,70
Albania	84	9	3,90
Montenegro	45	27	4,40
Czech Republic	56	25	4,57
Hungary	6	58	4,33

Source: [30]

Concerning the information about human and social environment, the region of West Balkan is not far away from EU member states, such as Czech Republic and Hungary, looking at Global Competitiveness Index made up of over 90 variables, of which two thirds come from the Executive Opinion Survey, and one third comes from publicly available sources. They are organized into nine pillars,

with each pillar representing an area considered as an important determinant of competitiveness. The average mark for region is 3,96 which is only 0,5 less from Czech republic and 0,3 less from Hungary. We must have in mind that Hungary and Czech Republic are having ten year advantage in transition process, so once again it can be excepted that in future, GCI will mark higher values., as region become more closely to EU membership.

3.6. Entrepreneurial Opportunities

VC/PE industry can be seen as a serious element behind innovation and wealth creation, either in USA, but also in other developed and developing countries [see 17]. Decision to make investment VC/PE funds are making after serious analysis which include level of entrepreneurial activity assessment. Making direct assessment of entrepreneurial potential in a country is very difficult, so in literature we can find several suggestion how to mark entrepreneurial activity using indirect indicators. Using information about the level of R&D investment at Universities and laboratories [see 26], industrial expenditures in R&D [see 14] can be helpful in assessment process. In order to analyze entrepreneurial activity across West Balkan region, information from World Economic forum will be used. The information will present firm-level technology absorption, capacity for innovation, company spending on R&D and University-industry collaboration and they can be found in *The Global Information Technology Report* [see 32].

Table no.6 Entrepreneurial activities across the region

Indicator	Firm-level technology absorption	Capacity for innovation	Company spending on R&D	University-industry collaboration
Serbia	3,67	2,77	2,56	3,31
Croatia	4,21	3,23	3,23	3,48
Macedonia	3,66	2,75	2,55	3,32
BiH	3,53	2,33	2,41	2,33
Albania	4,31	2,34	2,27	2,20
Montenegro	4,42	2,94	3,13	3,61
Average	3,96	2,72	2,69	3,04
Czech Republic	5,42	4,20	3,18	4,37
Hungary	4,72	3,31	2,79	4,21

Source: [30]

Looking at the information concerning entrepreneurial activities across the region, conclusion is that whole region lack behind Czech republic and Hungary as EU member states. The average values in firm-level technology absorption pointing that regional firms are not difficult to engage themselves in new technology based changes in production but capacity for innovation and company spending have very small values across the region, leading to conclusion that companies are not involved in intensive self-guided efforts to

increase innovativeness level in their production processes. At the very end, collaboration between universities and industry is also at lower level than in Czech and Hungary meaning that there is no intensive technology transfer present.

4. CONCLUSION

Looking at the information gathered from international recognizable institutions, the conclusion about West Balkan region as a investment destination for PE/VC industry can not be unique. The difference comes form the fact that region can be seen at presence or in future. There is a thin line between looking region either as risky or as growth potential place. The data received during research are showing region lagging in all indexes behind Czech Republic and Hungary. Only in tax policy, region is more competitive then two mentioned countries. But, investor protection, entrepreneurial environment, social and human environment and capital markets are not attractive comparing to two EU countries. Economic activity as a indicator is also interesting because, region had lower decline in GDP movements during 2009, and one country had positive growth [Albania]. At this point of time, VC/PE industry can not recognize West Balkan as a place for increased presence, but their presence can be more case to case strategy. VC/PE funds willing for more risk taking will invest in the region and create possibility to obtain profit rates above industry average because of lack of competition in the field economic activity financing sources. Because of that they can negotiate conditions more profitable than in the countries with PE/VC industry presence. Further more, countries in West Balkan region must be seen in context of their future EU membership because this goal is pointed as a final transition step. Having this in mind, whole region will increase environment described in indicators and become more compatible with EU and PE/VC needs.

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