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EVOLUTION OF THE VENTURE CAPITAL FINANCING FOR GROWING SMALL AND MEDIUM ENTERPRISES IN CENTRAL AND EASTERN EUROPE COUNTRIES: THE CASE OF MACEDONIA

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Abstract

The objective of this paper is to examine and analyze the differences between Venture Capital development in Macedonia and several Central and Eastern Europe countries, to determine the reasons, and hence extract certain conclusions that will serve as a guideline in Macedonia's venture capital industry development.

Venture capital is an important intermediary in financial markets, providing capital to firms who otherwise have difficulties attracting financial support. Moreover, venture capital funds provide managerial expertise to the company they are investing in, and have impact on the overall economy through innovation, job creation, economic growth, increased competition and improved corporate governance.

Private equity and Venture capital funds are present for over 20 years in Central and Eastern Europe. The institutional investors evaluate the individual countries' attractiveness to identify the best investment opportunities for their asset allocation. On the basis of the performed analysis in this paper regarding the PE/VC fundraising and investment activities, conducted interviews, and Country Attractiveness Index (including the economic activities, depth of capital market, taxation, investor protection and corporate governance, human and social environment and entrepreneurial culture and opportunities), Macedonian small and medium size enterprises are obviously not on the PE/VC investors` map, according to the small amount of their investments up to now.

Keywords: financial markets, financial institutions, venture capital, small and medium enterprises, entrepreneurship
JEL classification: D53, G24, L26, N20, O16

Introduction

The entrepreneurial activity is important element of the growth in a transition economy, since the new domestic businesses are crucial for new industries development and revitalization of the stagnant once. Moreover, sales and employment grow faster in entrepreneurial ventures than in state or privatized firms. This view emerges from the observation that post-socialist economies with quite robust model of entrepreneurial development have relatively high rates of economic growth (Berkowitz & DeJong, 2004). Successful small and medium size enterprises (SMEs) are often facing with difficulties in providing financial resources from the banking institutions, mainly because of their law credit rating. The alternative way of financing appears as private equity and venture capital (PE/VC) support of the development of the SME sector, by supplying additional assets, improving its management, involving business know-how, experience and networks. Engel (2002) highlights that firms which receive venture capital achieve significantly higher growth rates owing to financial involvement and services provided by venture capitalists. Hence, policymakers in the emerging countries should focus on the creation of an adequate setting for a prospering VC/PE market to support entrepreneurial activities and growth.

The *Private Equity* market as an alternative form of providing capital to companies became an integral part of the financial market in Central and Eastern Europe (CEE) in the 1990s. According to European Private Equity and Venture Capital Association (EVCA) (CEE Statistics, 2010) this market is still developing, namely the CEE`s amount of fundraising and investing activities is only 3% of the total funds and the total amount of PE/VC investments in Europe in 2010. The CEE private equity investment market is highly concentrated in the larger countries, Poland, Czech Republic, Ukraine, Romania and Bulgaria accounted in total 94% of the total investment value in 2010, according to the EVCA statistics. The private equity market in the rest of the CEE countries, as well as in Macedonia, is understated. This completely different situation between the two groups of the CEE countries raises the question for factors that determinate the country attractiveness for international venture capitalists.

The SME sector in Macedonia is on European average, according to the European Union Enterprise and Industry Small Business Act 2009 Survey on Macedonia, it is composed by 45 thousand firms (99.8 percent of the total business units) and almost 41 thousand are micro-firms (90.6%). The SMEs contribution to the employment is in Macedonia significantly higher (71.2%) than the EU-27 average (67.4%). Following the World Bank /European Bank for Reconstruction and Development (EBRD) Business Environment and Enterprise Performance 2010 Survey, Macedonian firms consider the access to finance as the main problem in their common activities, followed by the court actions, the high tax rates and the corruption. Additionally, in Enterprise Surveys: MACEDONIA, FYR – 2009, identified problems as main obstacles by SME`s are: practical informal sector, the access to finance and licensing process as well as political instability. According to the World Bank's *2011 Doing Business* survey, the business climate in FYR Macedonia is among the best in the transition region, and the country ranks 38th out of 183 countries in terms of ease of doing business. Why then the private equity investment in Macedonian SME remains underdeveloped?

The institutional investors, who are providing VC, are analyzing several economies for their international asset allocation. Therefore, they evaluate the individual countries' attractiveness mainly based on the availability of adequate investment opportunities. Emerging countries with exceptional growth opportunities and the need of significant funding are in the main investors' focus. Numerous studies examine the countries investment` attractiveness according to various determinants. In this paper we will provide an overview of private equity and venture capital industry development in CEE countries. For this purpose we use several CEE countries` private equity and venture capital funds annual data ranging from 2005 to 2010 as well as the Global Venture Capital and Private Equity Country Attractiveness Index - 2011 annual to make a comparative analysis of those CEE countries and Macedonia. The venture capital industry in Macedonia is underdeveloped and it is far behind the other CEE countries, according to the private equity investments as percentage of the Gross Domestic Product (GDP). Being the less develop segment of the Macedonian financial market, there is no interest of domestic and foreign academics to consider this matter in their research. Therefore, the main contributions of this policy-oriented paper are: i) summarizing the reasons for the underdevelopment of the VC industry in Macedonia; and ii) generating conclusions and recommendations for attraction of VC investments in Macedonia.

Small and Medium Size Enterprises and the Private Equity Investment

EVCA defines *Private Equity* as the providing equity capital by investors to non-quoted companies. According to the development stage of the financed company's life cycle, EVCA distinguishes the following types of *Private Equity*, i.e. *Venture Capital*, *Growth Capital*, *Replacement Capital*, *Rescue/Turnaround Capital* and *Buyouts*. *Private Equity* is provided by either private investors (referred to as *Business Angels*) or institutional investors (*Venture Capital Funds*). Their objective is to increase in value the invested capital with acceptable amount of risk. The companies use *Private Equity* for the aim of development of new products and technologies, expansion of company activities or strengthening the capital structure. Hellmann & Puri (2000), and Kortum & Lerner (2000) show that VC/PE - backed companies are more efficient innovators, and Belke et al. (2003), and Fehn & Fuchs (2003) prove that they create more employment and growth than their peers.

The PE/VC exists almost 20 years in selected CEE countries and its significance differentiates among those countries. The main status explanation of a specific country depends of the state of its economy and its prospect for economic growth. Gompers & Lerner (1998) point out that there are more attractive opportunities for entrepreneurs if the economy is growing quickly. Romain & van Pottelsberghe de la Potterie (2004) find that VC/PE activity is cyclical and significantly related to GDP growth. Black & Gilson (1998) and Gompers & Lerner (2000) point out that risk capital flourishes in countries with deep and liquid stock markets. Black & Gilson (1998) discuss major differences between bank-centered and stock market-centered capital markets. They argue that well-developed stock markets, which allow general partners to exit via Initial Public Offerings (IPOs), are crucial for the establishment of vibrant VC/PE markets. Alongside the disadvantages of bank centered capital markets, Greene (1998) emphasizes that low availability of debt financing is an obstacle for start-ups in many countries.

Bruce (2000, 2002), and Cullen & Gordon (2002) prove that tax regimes matter for business entry and exit. Djankov *et al.* (2008) show that direct and indirect taxes affect entrepreneurial activity. Roe (2006) discusses and compares the political determinants of corporate governance legislation for the major economies and focuses on the importance of strong minority shareholder protection to develop a vibrant capital market.

Cumming *et al.* (2006) find that the quality of a country's legal system relates more closely to facilitating VC/PE. Black & Gilson (1998), Lee & Peterson (2000), and Baugh & Neupert (2003) argue that cultures shape both individual orientation and environmental conditions, which may lead to different levels of entrepreneurial activity backed exits than the size of a country's stock market. Djankov *et al.* (2002) investigate the role of several societal burdens for startups in different countries. They conclude that the highest barriers and costs are associated with corruption, crime, a larger unofficial economy and bureaucratic delay.

Especially for the early stage segment, the number of potential investments closely relates to the research output in an economy. Gompers & Lerner (1998) show that both industrial and academic research and development (R&D) expenditure significantly correlates with VC activity.

It is difficult to emphasize the importance of stated criteria, since many of them are highly inter-correlated. Some academic studies (Groh, Liechtenstein & Lieser, 2011) aggregate and provide the most important information required from institutional investors for international VC and PE allocation decisions. They create an index that addresses institutional investors' concerns and evaluates countries with respect to their criteria for international VC and PE allocations. These criteria include, in the first instance, the expected deal opportunities in a country or region from a macro perspective.

Methodology and Data

Our research is both qualitative and quantitative, where we collect and analyze data focusing on venture capital fund raising and investment activities for selected CEE Countries with special review on Macedonia. Data were processed using selected methods of descriptive statistics.

First, we will analyze the CEE Venture capital and Private equity development in the period 2005-2010, focusing on the fundraising activities and funds' sources. Next, the investment activities for same period will be analyzed, as a percentage of GDP, for measuring the development the CEE countries` PE/VC market. Secondly, the development of PE/VC industry in Macedonia will be analyzed. Afterwards the analysis will be focused on the reasons for underdevelopment of Macedonian PE/VC industry, where the fundraising and investment activities will be examined. In order to recognize these reasons, 31 interviews were planed with the key actors in PE/VC industry in Macedonia: 2 pension funds, 6 commercial banks, 4 insurance companies, 2 investment funds, Small Enterprise Assistance Funds (SEAF), EBRD, Ministry of Finance and 14 companies that have used PE/VC funds. Only 10 of them accepted the interview and they are presented in Table 1.

Table 1: Conducted interviews with key actors in PE/VC industry in Macedonia

Institutional investors and Regulators	"Venture Capitalists"	Companies
1 Pension Fund 2 Commercial Banks 1 Insurance company 1 Investment fund 1 Ministry of Finance in R.M.	2 managers in SEAF 1 manager in EBRD	2 companies that used funds from SEAF

Finally, we will compare the Macedonian attractiveness for private equity investors with other CEE countries, using the Global Venture Capital and Private Equity Attractiveness Country Index, where 6 key factors are analyzed: economic activities, depth of capital market, taxation, investor protection and corporate governance, human and social environment and entrepreneurial culture and opportunities.

To achieve the aim of this paper, several financial institutions` data will be used: European Private Equity and Venture Capital Association (EVCA) – for the fund raising and investment activities in the selected CEE Countries; Small Enterprise Assistance Funds (SEAF) – for the venture capital investment activities in Macedonia; European Bank for Reconstruction and Development (EBRD) – for the private equity investment activities in Macedonia; Macedonian Ministry of finance – for the legal data regarding the registration and operation of private equity and venture capital fund companies stated within the Law on Investment Funds, Government and Central Bank activities - regarding the issuance of treasury securities; Security and Exchange Commission – for the private investment funds general data; Agency for Supervision of Fully Funded Pension Insurance – for the pension funds investment regulation; Macedonian Stock Exchange – for the IPO's by Macedonian companies. The data for the global venture capital and private equity country attractiveness index for the selected CEE Countries in this paper are taken from the 2011 Report. The index measures the attractiveness of 80 countries for investors in venture capital and private equity limited partnerships.

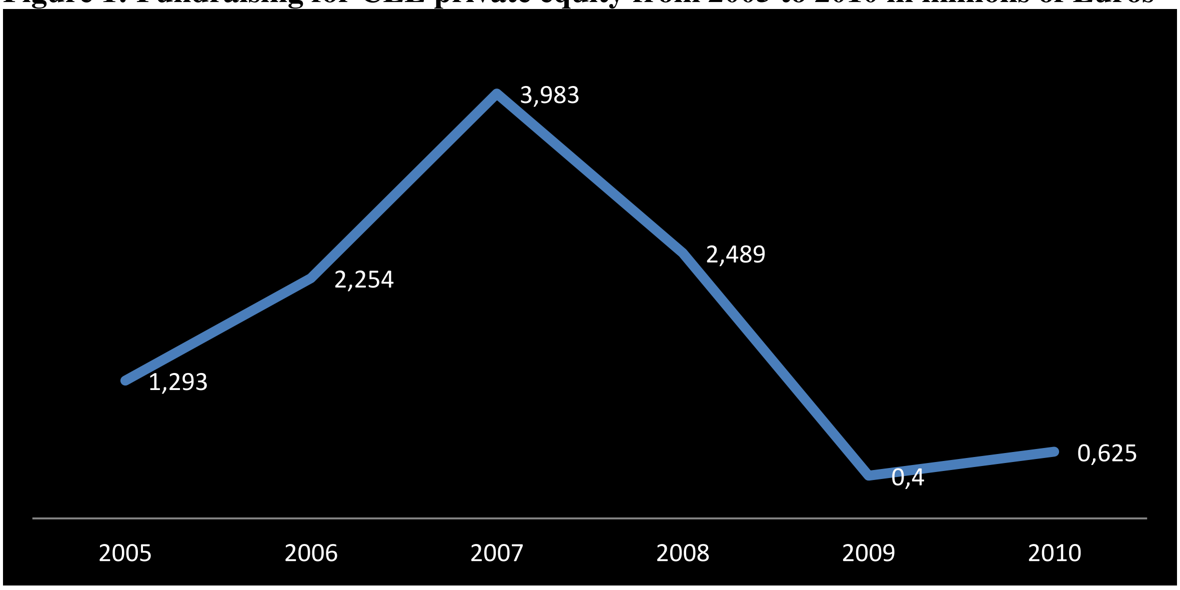
For the purpose of this paper the selected CEE Countries are: Romania, Hungary, Bulgaria, Poland, Czech Republic, Lithuania, Latvia, Estonia, Slovakia, Slovenia, Croatia and Macedonia.

Discussion and analysis of main findings

Fundraising activity

Fundraising process represents commitments to venture capital from several investors. New commitments to private equity and venture capital increased from 1,293 billion in 2005 reaching its peak of 3,983 billion in 2007 (EVCA, 2010). The growth of the market is mostly seen as a result of EU accession of some of the analyzed countries, where many changes occurred concerning the judiciary system and overall business environment that gave a boost to the fundraising and investment activity. However, there has been a significant decline in the next 3 years from 3.983 billion in 2007 to only 0.645 billion in 2010 (see Figure 1) as a result of the global financial crisis.

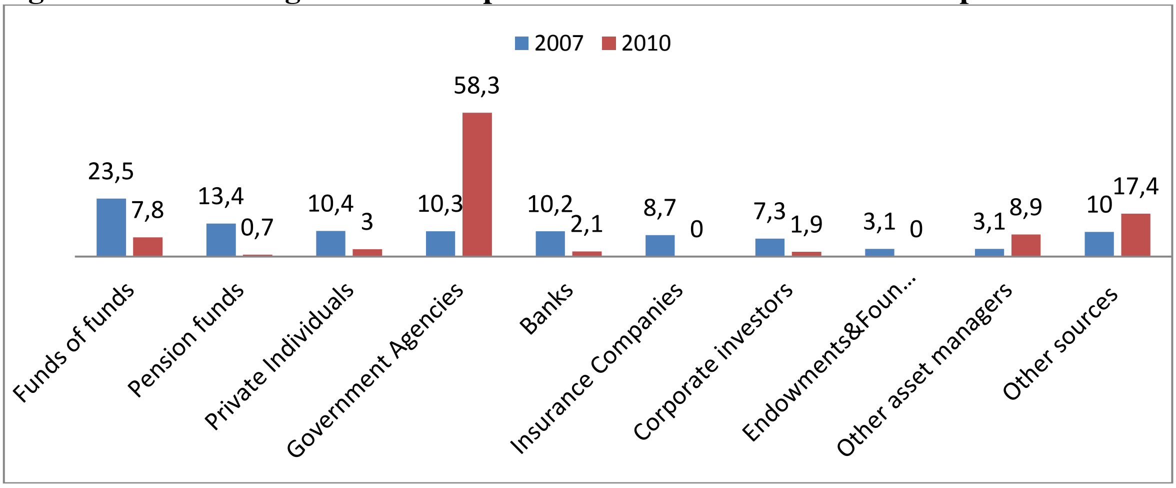
Figure 1: Fundraising for CEE private equity from 2005 to 2010 in millions of Euros



Source: Authors' own calculation on the basis of the data collected from EVCA

In Figure 2, it can be noticed that historically the biggest investors in PE/VC industry, pension funds in 2007 were overhauled by funds of funds, while still hold the high second position. However, today Government agencies are by far the most dominant investors, followed by other sources of finance and funds of funds.

Figure 2: Fundraising sources of capital in CEE countries in 2007 compared to 2010



Source: Authors' own calculation on the basis of the data collected from EVCA

Investment activity

Private equity investment activity increased dramatically in the period before the global financial crisis in 2007 and dropped even more severely during the crisis period in most of the observed CEE countries. The peak was reached in 2007 and then almost all countries faced with a significant decline apart from Bulgaria, Slovenia and Czech R. which has felt the decline later in 2010 as it can be seen from Table 2 (EVCA, 2010). Poland, Bulgaria and Estonia had the highest investments in 2010, measured as a % of GDP. However, the industry trend is fragmented from country to country. Likely reasons for this change is that year to year variations are usually affected by limited number of very large transactions and by the level of development and integration of financial markets of each country into the world economy.

Table 2: Total investments of private equity funds in CEE countries as % of GDP, 2005-2010

Country	2005	2006	2007	2008	2009	2010
Romania	0,088%	0,115%	0,392%	0,198%	0,187%	0,101%
Hungary	0,167%	0,883%	0,487%	0,423%	0,223%	0,068%
Bulgaria	/	0,143%	1,923%	0,265%	0,530%	0,228%
Poland	0,045%	0,118%	0,222%	0,165%	0,089%	0,192%
Czech R.	0,112%	0,315%	0,133%	0,297%	1,010%	0,133%
Latvia	0,068%	/	0,793%	0,274%	0,005%	0,029%
Lithuania	0,070%	0,076%	0,567%	/	0,004%	0,006%
Estonia	0,120%	0,031%	0,332%	0,088%	0,033%	0,176%
Slovakia	0,052%	0,045%	0,043%	0,046%	0,003%	0,022%
Slovenia	0,007%	0,130%	0,139%	0,010%	0,224%	0,019%
Croatia	0,002%	0,035%	0,046%	0,213%	0,061%	0,027%
Macedonia	/	/	0,177%	/	0,217%	0,000%
Average	**0,073%**	**0,189%**	**0,438%**	**0,198**	**0,216%**	**0.083%**

Source: Milovanovic el al. Venture Capital in CEE Countries and Croatia and authors' own calculation on the basis of the data collected from EVCA

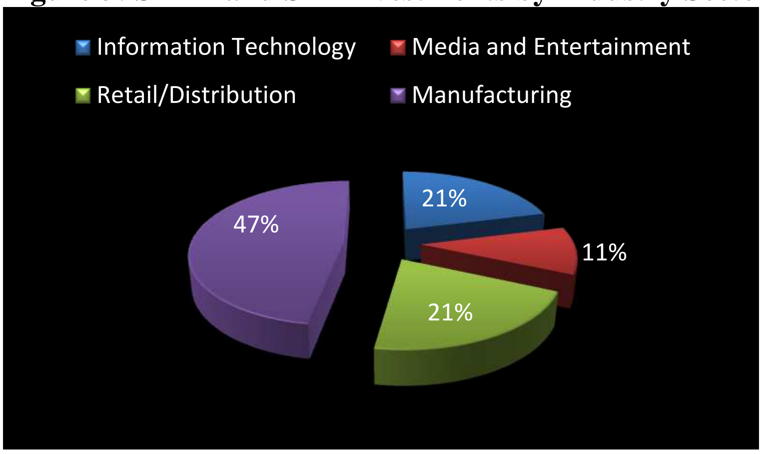
Development of venture capital and private equity in Macedonia

The legal framework for development of private equity and venture capital was established in Macedonia for the first time in 2007, by the amendment of the Law on Investment funds. Furthermore, the Macedonian government in late 2011 amended the Law for pension funds allowing them to invest part of their assets in PE/VC funds. The Macedonian private pension funds with their long term investment assets are the most evident potential institutional investor in PE/VC industry in Macedonia.

Currently there is several private investment funds registered in Macedonia, however most of them act as queasy hedge fund, investing only in securities. Only three private equity funds operate in Macedonia - SEAF, EBRD, and Small Investment Fund (SIF) that is the first private equity fund established in 2007 under the Macedonian Law on Investment Funds. Their investors are international organizations such as International Financial Cooperation (IFC), Deutsche Investitions - und Entwicklungsgesellschaft (DEG), United States Agency for International Development (USAID), etc.

Until today, EBRD has invested €7 million in 2 manufacturing companies in the last 2 years. SEAF and SIF have invested $10 million in 14 different companies in various industries, from media to IT, manufacturing and to retailers (see Figure 3).

Figure 3: SEAF and SIF Investments by Industry Sector in Macedonia



Source: Authors` own graph

Reasons for underdevelopment of PE/VC industry in Macedonia

We will identify the reasons for Macedonian underdeveloped PE/VC industry from the interview findings and the Country **PE/VC** Attractiveness Index

Interview findings

1. Macedonia has an underdeveloped IPO market, which is the most wanted exit rout from VC investments. Furthermore, the shallow and illiquid secondary market with a small number of quality securities limits the VC industry development as well.
2. Entering European Union (EU) and North Atlantic Treaty Organization (NATO) is important in order to create a better business climate, guaranteeing stability and providing trust among investors. Not being member of EU and NATO limits economic growth weakens political stability and increases an already high insecurity in the region. In order to accomplish this, the fight against corruption is crucial, especially towards

creating effective judicial system that provides the governing of the law that will thus comfort investors in a bad case scenario.

3. The Treasury and Central bank bills` rates are relatively high and negatively affect the supply and development of venture capital industry because higher hurdle rate contributes for higher expected rate of return which significantly limits the number of investment projects that can yield this requirement.
4. An even bigger problem exists on the demand side for VC investments. Macedonia lacks quality entrepreneurial knowledge and skills, companies are not transparent and there are not sufficient quality projects offered. The entrepreneurial education will motivate and encourage people to open new businesses and thus offer more possibilities for VC investments.

Comparative analysis of private equity and venture capital in CEE countries and Macedonia

When comparing Macedonia to the rest of the CEE countries, from Table 2 it can be seen that Macedonia is behind the CEE countries concerning private equity investments as % of GDP. However, there is very limited information for Macedonia, having data for only three years. Although, Macedonia shows better performance than most of the CEE countries (as % of GDP) in 2009 because of the EBRD`s two large investments. In 2010 the private equity investments plunged to 0%. The countries that followed an upward trend without great deviations in the examined period were only Hungary and Slovakia.

The Global Venture Capital and Private Equity Country Attractiveness Index (Groh et al., 2012) measures the attractiveness of countries for venture capital and private equity limited partnership` investors. This index focuses on six key categories, which include sub categories, for attractivness of a country for limited partners: Economic activities, Debt of the capital market, Taxation, Investors protection and Corporate Governance, Human and Social Environment and Entrepreneurial culture and deal opportunities. According to that research Macedonia is at the bottom of the countries` attractiveness (73^{th} out of 80).

Table 3: CEE Country ranking according to Global Venture Capital and Private Equity

Overall Ranking (out of 80 countries)					
Poland	36	Estonia	49	Romania	60
Czech R.	37	Bulgaria	51	Slovakia	62
Hungary	40	Croatia	52	Latvia	67
Slovenia	45	Lithuania	57	Macedonia	73

Source: Global Venture Capital and Private Equity Country Attractiveness Index 2011

We will summarize the findings according to the six key categories previously stated that determine the country attractiveness to investors:

1. **Economic activities**: Macedonia is a small economy with very high unemployment rate above 30%. Macedonian real GDP growth rate, excluding Poland is highest in the CEE region. Macedonian government' measures that have relatively successfully tackled the crisis, financial markets low integration within the international financial markets, non exposure to toxic financial instruments, financial institutions' stable and liquid positions and macro prudent measures taken by National bank of Republic of Macedonia, can be seen as the main reasons for this high GDP growth rate.

2. **Depth of Capital Market**: The depth of the capital market has low ranks for all of the countries in the CEE region. The IPO as most desirable option for VC exit from one company is not feasible because of the stock exchanges illiquidity. Macedonian underdeveloped financial market is characterized by bank dominance owning 90% of the total assets in Macedonian financial sector.
3. **Taxation**: Macedonia has a 10% flat tax rate one of the lowest in Europe. Also, double taxation with most of the foreign countries is avoided. Furthermore, the tax liability is exercised after the stock is sold. However, the problem with the low taxes connected to PE/VC industry is that when tax rate are raised on wages more people are willing to become entrepreneurs. Hence, the difference between the interest income tax and corporate tax tends to be incentive for self – employment (Groh, 20). Another weakness for Macedonia is large informal economy which limits the numbers of tax receipts.
4. **Investor's protection and Corporate Governance**: The corporate governance is very high ranked for all CEE countries they are on pair with EU-15. However, Macedonia fails compared to CEE countries in security and protection of property rights and quality of legal reinforcement.
5. **Human and Social Environment**: The investments and reforms in the educational process in the past few years increased the rank of Macedonia especially comparing to other Ex-Yu countries apart from Slovenia but it is still behind the rest of the CEE countries and Western Europe. Macedonia mostly lacks entrepreneurial knowledge and skills. Additionally, Universities produce more diplomas than skills.
6. **Entrepreneurial Culture and Opportunities**: Easy to start and run a business – factor, is the higher ranked variable in the research. All other variables in this category are below the other CEE Countries. The worst figure is the low level of corporate R&D and scientific and technical journal articles.

Summarizing the findings, we make a conclusion that the very high unemployment rate, the small size of the economy and the low level of innovation with also low level of corporate and academic R&D, are Macedonian main weaknesses.

Conclusions and recommendations

Small and medium size enterprises play a crucial role in private sector development, busting innovations and accelerating the economic growth in developed and developing countries. SMEs in developing countries are particularly valuable since they develop new sectors and revitalize the stagnant ones, such as services, trade, and manufacturing. New businesses' efficiency is comparatively higher than the big companies' efficiency and therefore, they contribute more for employment rate` growth and market competition. At the beginning, they faced with lack of sources for financing their growth. Since they do not have any financial history, conventional paths such as bank loans and issuance of securities are not available opportunities. Thus, the alternative financial sources such as venture capital and private equity should fulfill this gap.

The Central Eastern European (CEE) countries are still in a transitional stage. During this transitional period they have made substantial improvements in corporate governance, enterprise restructuring, and financial sector operations**.** This region attracts the international private equity investments, although not all of them are equally attractive.

Despite the large number of Macedonian SME's (90.6% from total business units) international private equity investors still does not consider them as an attractive opportunity. Although, Macedonian micro and small-size companies define the access to finance as its main obstacle, their use of risk capital is limited. According to the Global VC/PE Country Attractiveness Index, the main reasons for the underdeveloped Macedonian Private equity/Venture Capital industry are: underdeveloped capital market, weak judicial system, poor enforcement of property rights and low entrepreneurial culture and deal opportunities.

Macedonian government need to make additional efforts towards attracting the international private equity investments. The emphasis should be placed on primary and secondary stock market development where the stock market regulators should facilitate the security issuance process, and increase the liquidity, depth and breadth of the market through attracting new companies that will list their shares and new investors that will participate in the trading activities. Judicial system efficiency and poor enforcement of property rights can be spurring through EU Directives implementation. The focus should be put as well on boosting ideas, creating entrepreneurial behaviour, improve transparency and make quality projects. Educational institutions must revise their academic programs and concentrate more on providing entrepreneurial education. Also, the government should stimulate academic and corporate R&D because the innovations are a major driving force for economic growth.

Companies' should improve employee's knowledge and skills through continuous training and seminars. Only high trained and educated employees can increase companies' productivity and profitability. Improved skills and knowledge will generate new ideas and projects, which will also attract the venture capital investments.

Finally, promotion of VC industry is needed in order to enlighten the institutional investors and companies on alternative investment opportunities, and on alternative sources of finance.

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