

Possibilities for the Development of Venture Capital Funds in the Republic of Serbia

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Abstract: The paper will present the basic differences between investment funds, venture capital funds and private equity. It will presents the basic determinants of the development of private and venture capital funds and discuss the current state of private and venture capital funds in the Republic of Serbia The legal regulations for the development of these funds will also be presented.

Keywords: risk capital, venture capital, investment funds

1. INTRODUCTION

Private equity starts in late 1980s by buyout fund activity. it involves investments of equity capital in private business. It does not mean that investing company is private. Many private equity companies are listed on a stock exchange, but still investing in unquoted companies.

Venture capital (VC) is long-term, hands-on equity investment in privately held, high growth-potential companies, initiated and managed by professional investors [1].

Private equity covers not only the financing required to create a business, but also includes financing in the subsequent stages of its life cycle. Venture capital is a subset of private equity and refers to the equity investments made for the launch, early development or expansion of the business. It has a particular emphasis on entrepreneurial activities rather than on mature businesses. Private equity and venture capital refer to different stages of investment [2].

in Figure 1 is presented main differences of private equity and venture capital refer to different stages of investment:

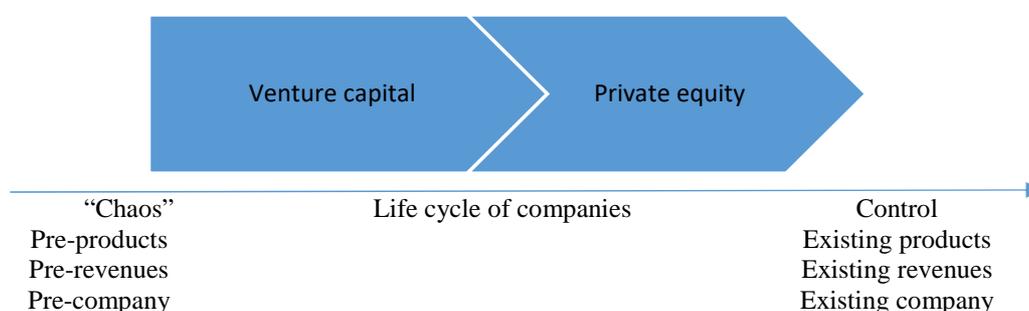


Figure 1: The concept of private equity and venture capital's role on a financial market

Source: Krzysztof Dziekoński, Sławomir Ignatiuk (2015), Venture capital and private equity investment preferences in selected countries, „e-Finanse” 2015, vol. 11 / nr 3

There are 12 main differences between PE and VC:

- Stage: Private equity firms tend to buy well-established companies, while venture capitalists usually invest in startups and companies in the early stages of growth. Typically, private equity firms will seek out companies that are already mature but on the downturn due to some inefficient management. PE firms come in so they can streamline operations with the goal of increasing revenue.
- Company Types: Private equity firms often have diverse portfolios that cover all industries, from healthcare to construction, transportation to energy. Venture capitalists usually have a narrow focus on tech companies.
- Deal size: Private equity firms possess vast wealth, even compared to the most affluent venture capitalists. Therefore, private equity acquisitions often dwarf deals done by venture capitalists.
- Percentage Acquired: A key difference between private equity and venture capital is that private equity firms usually purchase the entire company, whereas venture capitalists only get a portion.

- Risk Appetite: Venture capitalists expect that the majority of companies they back will eventually fail. However, the model works because they hedge their bets by investing small amounts in lots of companies. This strategy would never work for private equity firms. Private equity firms target mature companies, as the probability of failure is virtually zero.
- Structure: While venture capital funds are simply cold, hard cash, private equity firms fund their takeovers with a combination of cash and debt.
- Return Differences: Both private equity firms and venture capitals target about 20% internal rate of return (IRR). However, more often than not, they usually fall short. For venture capitalists, the return hinges on the success of the top companies in their portfolio. Private equity returns can come from all sorts of companies, even ones that aren't as well-known.
- Operations Involvement: Private equity firms usually strive to enhance and expand the companies they buy. This invariably makes their assets much more valuable when the right time comes to sell. On the other hand, venture capitalists are more intimately involved with companies beyond the balance sheet, especially if they have been involved since the project's early days.
- Effort: The work at private equity firms is akin to investment banking. Conversely, venture capital is a relationship-driven process.
- Pay: The median salary for both private equity and venture capital associates is about \$150K, with variable bonuses. However, overall, if you want to be sure big returns, private equity is the way to go.
- Culture: Venture capital has a more relaxed atmosphere, bringing together people from varied backgrounds, particularly tech. Compare that to the pure finance background that many people in private equity tend to have.
- Exit: In private equity, there are a few exit options: Move into hedge funds, Switch to venture capital or Join a corporate company. For venture capitalists exit options are: Initial Public Offering (IPO), Mergers & Acquisitions or Shares buyback

2. DETERMINANTES OF VENTURE CAPITAL

The development of risk capital funds is affected by determinants which can be divided into macro and institutional.

S. Bonini and S. Alkan (2006), based on annual data from 16 countries between 1995 and 2000, discover that the most important macro determine of VC investment intensity is total value of stock traded. Also, GDP growth, corporate income tax rate, total entrepreneurial activity, inflation, labor market rigidities, and some of political risk variables – investment profile, socioeconomic conditions and corruption are other important determinants of VC investments in all stages. IPO (initial public offering) is significant only for early stage VC investments [3].

Elisabete Gomes Santana Félix et al. (2013) divided the determinants in three groups: macroeconomic variables, entrepreneurial environment variables and technological opportunities variables based on data from 23 countries VC capital for the period from 1992 to 2003. They examine GDP, GDP growth rate, Level of interest rate and Private Pension Funds as macroeconomic variables; capital Gains Tax Rate, Labor Market Rigidities, IPO, SMC growth rate, Capital markets returns, level of Entrepreneurship, VC investment/GDP, VC divestment/GDP, IPO divestment/GDP, WR divestment/GDP and Fundraising trends as entrepreneurial Variables and Number of Triadic patents, Business R&D growth, Stock of Knowledge and ERISA'S prudent man rule as Technological Opportunities. The results show that GDP growth rate, Market capitalization, Long term interest rate has strong positive impact while the unemployment rate has strong negative impact of the VC investments. In the case of high-tech investments the most important determinants are: the economic growth, the level of the long term interest rates, the level of unemployment rates and the market capitalizations growth [4].

Similar determinants examine van Pottelsberghe de la Potterie, Bruno; Romain, Astrid (2004). They identify and evaluate the main determinants of VC based on a panel dataset of 16 OECD countries from 1990 to 2000. they divided determinants also in three groups: macroeconomic conditions, technological opportunity and the entrepreneurial environment affect the demand and supply of VC. Interest rates and CDP growth rate have a significant impact on VC intensity. indicators of technological opportunity, such as growth rate of R&D investment, the available stock of knowledge and the number of high value patents have also significant influence to a country's investment in VC [5].

Abouzar Najmi (2019) investigates the main determinants of venture capital funding across G7 countries over 2007-2017. They presents determinants in four categories: macroeconomic condition (interest rate, unemployment rate), financial market factors (market capital, market capital return), entrepreneurship environment (ease of starting a business index) and technological opportunities (patent application, R&D expenditure). Interest rate, unemployment rate, market capital, market capital return and ease to starts a business shows positive strong impact on the venture capital. R&D and the government subsidiary are not significant [6].

Mondher Cherif (2011) examine the determinants of venture capital investments across 21 European countries over 1997-2006. According the results GDP growth, market capitalization, R&D expenditures and unemployment rate are the most significant macroeconomic determinants. Among the institutional dimensions, property rights freedom, financial freedom and trade freedom play a major role in VC [7].

Grilli et al. (2018) investigates institutional determinants of VC by systematic literature review. The analysis of this literature has revealed that the most frequently investigated institutional dimensions are regulatory policies, indicators of government quality, financial markets and other contextual determinants [8].

3. VENTURE CAPITAL IN REPUBLIC OF SERBIA

According to Milenkovic N. the main potential sectors for VC investments in Serbia are: Electricity, gas, steam and air conditioning supply, Information and communication, Wholesale and trade on retail, repair of motor vehicles and motorcycles, Manufacturing industry and Real estate activities [9]

The basic precondition for the development of venture capital funds in the Republic of Serbia is the Law on Alternative Investment Funds. The law was passed in 2019, entered into force in April 2020, and the part of the provisions that applies to small investors in early 2021.

By law, there are open and closed alternative investment funds (AIF). Open AIF has the form of separate assets and do not have the status of legal entities and they organize and manage by Management company of Alternative Investment Funds (AIFM). On the other hand, a closed AIF may also be in form without a legal entity and may be a legal entity established by a AIFM.

It can also be the third form - a legal entity with internal management, so it only manages its own property. The operations of these funds are regulated by the Securities Commission and the National Bank of Serbia [10].

AIFMs shall be incorporated as limited liability companies or joint-stock companies that are not a public company within the meaning of the law governing the capital market.

AIF are interesting for small and micro businesses that mainly operate in the field of information technology and do not have access to regular lending and financing due to lack of creditworthiness. Namely, their business is a project and the project cycle of IT product development lasts at least a year.

Startups, therefore, prefer financing from this type of funds because it is an investment in innovations that have a high expected profit. Biotechnology companies are usually in second place, but funds can have targeted investments, e.g. in real estate.

Currently there are no venture capital funds in Serbia. There are several regional venture capital funds that have offices in Serbia to support the capacity building of portfolio companies, although these venture capital funds are registered in countries with preferential tax status.

The venture capital fund with the highest visibility in Serbia is the Innovative Enterprise Fund (ENIF), which is currently managed by the South Central Ventures Fund. This is not a private equity fund, but a program funded by the European Union. The total fund is worth EUR 40 million to finance investments in phases from start-up to venture capital across the Western Balkans. Funding ranges from EUR 100,000 to EUR 1.5 million for investments. The amount of annual capital financing available for Serbia is EUR 2 million.

According to data of the the Securities Commission register in Serbia operate six managamnet companies of an open-ended investment fund with twenty the Undertakings for the Collective Investment in Transferable Securities – UCITS funds and with EUR 231.5 million in assets.

Foreign funds invest in Serbian companies. These funds are registered primarily in EU member states with preferential tax status. Over the past ten years, foreign investors have expanded their activities on the Serbian scene.

The following share capital funds are most prominent in Serbia:

Enterprise Enlargement Fund (ENEF) - this is an EU-funded project, sister to ENIF, and operating in the Western Balkans region. ENEF manages EUR 100 million and invests in companies that are in the expansion phase. Since its inception in 2014, the ENEF program has invested in a number of small and medium-sized enterprises in Serbia: Delmax - a company for the production and distribution of automotive parts; Gomma Line - also in the same branch of industry as Delmax, as well as BG Reklam - a company that sells materials for permanent outlets. The ENEF Fund has not announced the volume of investments in its companies.

SEAF Balkan Fund - launched in 2005, currently has an investment fund worth EUR 13 million, which is currently liquidating its portfolio and returning funds to investors. The investments of the SEAF Serbia fund amount to between EUR 300,000 and EUR 1.5 million. SEAF has invested in Adore Chocolate, Finear, Factoring A2B Express, Gomex, and others.

Blue Sea Capital - operates throughout Southeast Europe, invests in companies with potential for regional growth. The Blue Sea Fund is focused on investments in the range of EUR 5-15 million. The fund has invested in a number of private health care providers and, together with other private equity funds, has invested in the acquisition of Danube Foods Group. Serbian Private Capital Fund (SPEA) - established in 2010 with the aim of raising awareness of private capital and venture capital in Serbia. Although not active these days, their website lists 20 corporate members, such as private equity funds, law firms, consulting companies, etc.

4. CONCLUSION

Domestic companies have identified access to finance as the second most important problem they face, right behind the problem of finding customers (new markets). Venture capital funds have proven to be a good solution for financing development projects of fast-growing companies (popularly: gazelles) in countries with mature market economies.

The most important determinants of venture capital development are: GDP growth rate, market capitalization, interest rate and unemployment rate as macroeconomic determinantes and property rights freedom, financial freedom and trade freedom as institutional determinantes.

The basic precondition for the development of venture capital funds in the Republic of Serbia is the Law on Alternative Investment Funds. Currently there are no venture capital funds In Serbia, but it can be expected to be open first one.

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