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Private Equity Funds as Possible Source of Capital for SMEs in Transitional Economies – Case of Serbia[1]

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ABSTRACT – *Analyzing current problems which a lot of entrepreneurs and small and medium enterprise managers encounter in Serbia, as well as in some neighboring countries in the region of Central and South-Eastern Europe, it has become obvious that limited approach to quality long-term sources of financing is the most worrying one. As small and medium enterprises, according to many parameters, represent the most dominant sector in terms of its share in GDP, total production, employment and creation of values, in this paper we have tried to look into the role that private equity funds (PEF) may have in their financing. Analyzing alternative sources of financing SMEs on the one hand and basic principles of the function of private equity funds on the other, we have tried to identify the most important advantages and disadvantages of this source of financing in order to draw conclusion in terms of possible impact that PEF may have on the development of a certain number of SMEs.*

KEY WORDS: *small and medium enterprises (SMEs), private equity funds, venture capital, financial sources*

Introduction

In many countries in transition sector of small and medium enterprises represent, according to many parameters, the dominant sector of economy. Data that is going to be presented in this paper should be considered utterly conditionally, since it has been changing very fast as well as the very SMEs sector. However, we believe that it shows their significance. For example, if we consider a few countries from the region of Central and Eastern Europe, which are our neighbours, the following characteristics can be identified:[4]

- In Romania – number of private SMEs amount 99.7% of total SMEs, their share of economy vary from 2.8% in agriculture, 13.6% in industry up to 77.4% in the services, 56.6% of all employees working in SME sector, etc.
- In Bulgaria – SMEs represent 99.3% of all enterprises, 78.2 of total employees working in SMEs, private SMEs generate 72.7% of the total private sector turnover, etc.
- In Albania – SME sector contribution to GDP is 64%, to employment 60%, etc.

The similar situation can be found in Hungary and Croatia as well as other neighbouring countries. The importance of small and medium enterprises in Serbia has increased as well. There is an increasing number of SMEs, their share in GDP has grown (over 40%), in employment (over 55%), gross

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[4] Group of Authors (2008), *Strategies for the Development of Enterpreneurship and the SME Sector in the Black Sea Economic Cooperation Region,* Konrad Adenauer Stiftung, Ankara, pp. 38, 61, 89.

value added (over 54%), total profit (over 50%), etc. Evidently it is a very vital sector, which contributes greatly to the most important macroeconomic parameters and the total growth and development of the country.

Due to comparatively undeveloped financial systems which are mainly bank-orientated the majority of entrepreneurs and owners and managers of SMEs has a few conventional methods of crediting on their disposal. Most often these are bank loans which represent relatively unavailable and expensive source of financing. This source is relatively unavailable having in mind credit worthiness and rating of many SMEs especially in the early stages of development. On the other hand, this is a relatively expensive source of financing, especially under the conditions of the global financial crisis which has impact in many countries in transition, with the trend of increasing interest rates. For example, in Serbia, in the second part of the year 2008 interest rates for bank loans in the sector of SMEs were over 12% per annum for loans made in EUR, while for loans made in RSD the interest rate is much higher and totals over 25% per annum.

This paper consists of three major parts. Further we would point out the most important results of a small qualitative analysis based on the example of some ten companies from Serbia where we identified the urgent need for additional finances on the one hand, as well as serious interest for accepting private equity capital as a potential source of financing, on the other. After that, in Part 2 we have tried to emphasize the basic principles of functioning of venture capital firms (VCF) and private equity funds (PEF) so as to identify under which conditions and to which type of SMEs these types of institution could present important sources of financing. Finally, in a conclusion, we would analyze advantages and disadvantages of this source of financing in the sector of SMEs, expressing our opinion that VCF and PEF may present an important source of financing for some types of SMEs, in certain sectors under certain conditions. These attitudes become more important under conditions of global financial crisis that spread over the world during the course of 2007 and 2008. Finally, there is an appendix with a review of PEF which have worked in Serbia in mid-2008.

Research and findings

Institute of Economic Sciences expert team carried out a number of different projects for a certain number of small and medium enterprises in Serbia in the course of 2007 and the first 6 months of 2008. Projects varied by their nature, starting from market research, organizational transformations, strategic analysis and strategy formulation, restructuring, up to value assessment and due diligence. Some of these companies are quite well-known in Serbia, as well as in the region. We will mention some names: Galeb Group from the town of Šabac, Progetti from Vladimirci, Zimpa from Ub, Telefonija from Belgrade, Anavi from Belgrade, as well as several enterprises that were undergoing privatization process.[5]

The reviewed enterprises are quite homogenous by their composition. They belong to different economic branches, ranging from telecommunications, production of steel products, shoes, coffee, up to trade and services. In addition, they vary in size, from those relatively small employing only some 15 people, up to those that candidate to join a group of the big ones or even be listed in A List of the Belgrade Stock Exchange.[6] Frequent contacts with owners and managers brought us to a conclusion that doubtlessly one of the biggest and most serious issues is – a limited approach to good quality long-term sources of financial resources.

Similar situation is to be found in other countries of the CEE region. Even though some countries are now part of the European Union (EU), structure of the problem has not significantly changed.[7]

5 For more information on the listed companies see the following websites: www.galeb.com, www.eastwest.it, www.zimpa.co.yu , www.telefonija.rs and www.anavi.co.rs.

6 Such as e.g. Telefonija, stock company, Belgrade.

7 Look for more details in: Erić, D. (2006), "Access to Financing SMEs", *Erenet profile*, No. 2, Vol. 1, Budapest, http://www.erenet.org/publications/profile2.pdf

Analyzing alternative sources of financing in Serbia, as a possible solution to this topical issue referring SMEs sector, we have noticed the following sources:[8]

- Bank loans – Having completed the analysis, we have concluded that, under current circumstances, bank loans are not favourable source of financing SMEs, due to the fact that, depending on the agreement with a bank, effective interest rate is 12% on average per annum for loans granted in Euro currency, with no exchange rate risk. Interest rate for RSD currency loans, including the risk of this kind, is much higher, over 25% on average per annum.
- Securities as debt instruments – Having analyzed financing payability via corporate bonds or e.g. commercial papers in the light of current capital expenses, we have concluded that, no matter how one defines denomination (nominal value – either in RSD or in Euro), investor's required rate of return would have to be quite high, i.e. this is also an expensive source of financing for SMEs. We have learned this by studying what has been going on in the Serbian financial market, in which at this moment, and indexed in EUR, minimal required rate of return is over 6.6% (which was an average annual require rate of return for the Republic of Serbia bonds denominated in EUR currency), i.e. in RSD – 15.75% (which was NBS's reference rate in mid-2008). Every second stock would have to include danger money, which makes debt instrument issue less attractive to the issuer. Besides, costs of issuing should also be added and calculated, which makes this source even dearer.
- Issue of shares – Having examined possibility of financing by the means of issuance of shares, we have concluded that equity capital would be a very expensive source of financing for the time being. It is true that a stock company does not have to pay dividend since this is not a legal liability. Nonetheless, stockholders in this case expect stocks market price will go up, since they would be able to effect capital gain by selling stocks, as an element of their return. The problem is, however, related to expectations of potential investors, who want to see attractive required rates of return in order to invest in a stock. Issue of stocks is also connected with significantly high issuance costs, as well as with uncertain success of the issuance, due to political and economic situation in the country and ongoing worldwide financial crisis, which has also been affecting Serbia for a while now.[9]

Considering relatively limited, unavailable or expensive sources of financing, we have refocused our analysis on venture capital and private equity funds as potential sources of capital for SMEs sector.

Conceptual foundation of private equity funds

It often comes to confusion in terminology between the terms such as venture capital (VC) and private equity capital. According to certain beliefs VC has five main characteristics:[10]

- A VC is financial intermediary, meaning that it takes the investors capital and invests it directly in portfolio companies.
- A VC invests only in private companies.
- A VC takes on active role in monitoring and helping the companies in its portfolio.
- A VCs primary goal is to maximize its financial return
- A VC invests to fund the internal growth of companies.

Simply, venture capital firms (VCF) and private equity funds (PEF) provide private equity capital by private investors (or the venture capitalists) to the SMEs, especially in early stages of development (seed phase). It is very important to emphasize that they do not invest their own capital, but rather

[8] Look for more details, e.g.: Institute of Economic Sciences (2008), *Company "Progetti" - Vladimirci Financial and Operating Improvement Strategy*, Belgrade; Institute of Economic Sciences (2007), *Proposal for New Organization of "Telefonija" Business System & Strategy Adjustment to New Business Environment*, Belgrade; Institute of Economic Sciences (2007), *Development Strategy of Enterprise "ZIMPA" Ub within "Galeb Group"*, Belgrade.

[9] This viewpoint has been grounded on fluctuation of prices data at the Belgrade Stock Exchange. See: www.belex.co.rs

[10] Metrick, A. (2007), *Venture Capital and Finance of Innovation*, John Wiley & Sons, New York, pp. 3.

raise bulk of funds from other institutions and individuals. As for the difference, there is another type of organization which also provides funding for SMEs in their early stages of development, known as business angel, or simply angel investor. These are not intermediary organizations such as VCF or PEF, but companies which invest their own money as angels.

When financing through VC or PEF is concerned, it is a method of financing which is not based on credit sources, i.e. there is no debtor-creditor relation between the investor and the company that is being invested into. That is a proprietary relation, i.e. equity financing which has its implications on the character of general and financial management of companies.[11] It is believed that, apart from the role of investing, VC and PEF have two additional roles of monitoring and exiting[12].

Most often private equity investors remain minority owners. The company may stay as a limited liability company or joint stock company. It does not go public. It s shares are not publicly traded on an organized market but it is possible to make necessary preparations for going public later. Thus, however, some authors think that private equity markets have helped reinvent the market for corporate control, particularly in the US.[13]

Private equity investor does not have to be involved in everyday operations management of the company which has been invested into. It is a passive type of investor. However, it is more often that a private equity investor actively participates not only in strategic but in operations management as well in order to help business performances and gain the most important mutually defined targets in terms of return rates that have been defined in advance. Regardless of their involvement in management, VC or PEF have monitoring function which is first of all directed towards control of realization of financial performances of the target.

Peculiarity of PEF businesses lies in their required rates of return, which are said to be considerably high. In many cases in developed courtiers they vary from over 20 per cent and more of internal rate of return (IRR). In less developed countries and countries in transition they are even higher and vary from 30-35% IRR. One of the reasons for so high internal rates of return is a high level of risk that VCF and PEF encounter in conditions of relatively non-developed economic, and particularly, financial systems of these countries.

Within financial analysis, and particularly during the process of due diligence VCF and PEF identify as targets those companies which operate in dynamic economic areas with increasing demand and high potential for internal growth. This reduces possibilities for investing in many SMEs. Since investing through VC and PEF is very complex, the issue of valuation is crucial for the whole process of investment decision making. Apart from the analysis of the return rates, the important issues are connected with the analysis of value drivers, among which the question of the cost of capitals is the most sensitive one. Unfortunately, the scope of this paper does not allow us to go deeply into many aspects of financial analysis.

It is very important to point out that PEFs deal almost exclusively with sophisticated, 'professional' investors. These investors are able to understand and accept the risks and returns of investing in the asset class. According to the European Private Equity and Venture Capital Association (EVCA) that fact is largely reflected in the type and level of regulation across Europe. In addition, although there is no harmonized framework for private equity at the European Union level, a number of EU legislative measures in place indirectly affect the industry, such as MiFID, UCITS, the Pension Funds Directive, and the Capital Requirements Directive.

Time horizon for investment can be different. These are usually mid-term investors. In some, very exceptional cases, time horizon may vary from a couple of months (rarely, only in case of very specu-

[11] Willis, J. R. and D. A. Clark (2005), "An Introduction to Mezzanine Finance and Private Equity", *Journal of Applied Corporate Finance*, Vol. 2, Issue 2, pp. 77.

[12] Metrick, A. (2007), pp. 9

[13] Wruck, K. H. (2008), "Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control", *Journal of Applied Corporate Finance*, Vol. 20, Issue 3, pp. 9

lative investors or major changes on the market) to 2-3 years. However, it more often happens that they stay within a company for 3 or even up to 10 years. Most often they stay 3-5 years.

Exit strategies can be very different. They involve several alternatives:

1. Selling back holdings to original owner or company founders – which are a rare case and are not simple at all, as they usually, have not enough means. It has to be taken into consideration that during the years the company value increases greatly.
2. Selling to some of the strategic investors – who have strategic interest in company's business.
3. Selling to some of the financial investors – who estimate that a company may grow more and that it is possible to make preparations for initial public offer (IPO) and going public.
4. Selling through IPO – at the stock exchange, to a great number of individual investors.

Although they first appeared in the US after the World War II (the first formal PEF was established in 1946. – American Research and Development – ARD)[14] VC and PEF have spread through out the world soon. The number of investors, as well as the number of funds, has grown year in year out. Particularly dynamic growth was in the late 70s and early 80s as well as during the year 2000. In 2000 there was the record growth of PE investments in the US of about 120 billion USD. During the following years that growth has somewhat decreased, but it still remained considerably high varying from 40 to 50 billion dollars per year.

In Europe, investments by European PEF and VCF amounted to € 73.8 bn in 2007, and approximately 5,200 European companies received private equity investments. About 85% of these companies have fewer than 500 employees. Studies show that between 2000 and 2004 European private equity and venture capital financed companies created 1 million new jobs, which translates to a compound annual growth rate of 5.4% per year (eight times the EU 25 total employment rate of 0.7%). Between 1997 and 2004, the average employment growth in buyout-financed companies was 2.4%, compared to 30.5% for venture-backed companies.[15] Using the same sources of information - EVCA we can find additional facts: "Between 2000 and 2004, European private equity and venture capital-financed companies created over 1 million new jobs. About 630,000 jobs originated from venture investments, whereas buyouts gave rise to 420,000 jobs. The employment grew by an average rate of 5.4% annually over this same period, compared to a 0.7% growth rate of the total employment in the EU25".[16]

For example, only in the second quarter of 2008 from the total of 17,6 billion euros new European investment, VC makes 5,6 billion which represents growth of 2,4 billion euros if compared to the first quarter of 2008 or even 2,9 bn in comparison to the fourth quarter of the year 2008.[17]

The most important feature of VCF and PEF business is that they can be found in countries in transition. In the appendix to this paper we present a review of some private equity funds that are active on the Serbian market.

Conclusions

Studying the nature of PEF's business as an alternative source of financing available to SMEs sector in countries in transition, we would try to draw appropriate conclusions. We may divide all findings into two large groups – advantages and disadvantages.

Advantages are the following:

- Relatively simple and available source of capital, without any limitations
- There is no fear of bankruptcy

[14] Lerner, J., F. Hardymon and A. Leamon, (2005), *Venture Capital and Private Equity – A Casebook,* 3rd edition, John Wiley & Sons, New York, pp. 2

[15] www.evca.eu/publicandregulatoryaffairs/default.aspx?id=86

[16] www.evca.eu/knowledgecenter/default.aspx?id=618

[17] www.evca.eu/knowledgecenter/latestdata.aspx?id=500

- Improvement of solvency and financial parameters, bringing about more efficient usage of loan-related sources
- Continuity in business, no inevitable loss of control as with a classic equity financing
- Focus of management on business activities, growth and development, and not on resolving the issue of ”how to reach capital”
- Possible expert assistance and consulting by the private equity investor
- Acceptance of innovations, entrepreneur way of thinking and new organizational culture
- Raising level of responsibly for business performances.

Some disadvantages may refer to the following:

- High required rate of return – may discourage SMEs’ management
- Harder to find good quality investment opportunities – a high IRR causes a high discount rate used with capital budgeting method, which narrows number of acceptable investment projects
- Fear from control-loss and conflicts among founders (former owners) and managers or new owners, which my result in an agency issue.

This short analysis explains that private equity funds in countries in transition may bring more good than bad things. Majority of surveyed managers from Serbian enterprises has a very positive opinion about them as potential investors. However, one needs to be cautious. This primarily refers to exaggerated expectations of the SMEs themselves. Financial analysis process and the overall due diligence is often time-consuming, selection of potential candidates in PEF by investment analysts requires application of rigorous criteria, as well as signing a deal, which implies a great number of administrative and legal issues. All the abovementioned notes may have an impact on objective obstacles to conclusion of agreement.

PEF’s role in financing SMEs has to bee reviewed in the light of their interests in maximal values. Consequently, not all SMEs hold the same position, which is directly caused by economic area they deal with, as well as by the demand and the market circumstances. This form of financing may be quire favourable for areas with significant internal growth potential, as well as a serious risk for using others, let’s call them classic financing models.

In the countries in transition, including Serbia as well, VCF and PEF may be interested in the SMEs which favourably unite at least three groups of factors, such as:

- Economic – big potential market, big opportunities for the increase of sale and profit, high rates of investors returns, developed financial system and financial markets, developed infrastructure, primary as well as in the sector of services. Availability of the factors of input of the appropriate quality, stable economy with stable monetary system and tax incentives, quality management teams, hidden internal sources of growth, etc.
- Social – quality and well-trained human resources, stable political situation with democratic political system, attractive climate for research, interesting research results and scientific discoveries, intensive cooperation between universities and economy, social acceptance of failures, etc. This group can also include developed entrepreneurial spirit which greatly depends on the consciousness of people, their creativity, initiative and mindedness.
- Legal – corporate and tax laws that encourage entrepreneurial activities, simple procedures for opening business, easy access to stock exchanges, liberalized investment guidelines for institutional investors, etc.

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www.evca.eu

www.belex.co.rs

Appendix - Private equity funds operating in Serbia – mid of 2008.

In the mid 2008 the following private equity funds were active in the Republic of Serbia:

Name	Characteristics and investments in Serbia
SEAF South Balkan Fund B.V.	Basic principles: Minority stakes, range of investment - €0.3-2 million per investment, targets industries in food, media, services, IT, Internet technology sectors, etc. Investments in Serbia: IT distribution, Supermarket chains
Copernicus Adriatic	Basic principles: Minority stakes, range - €1-3 million per investment, currently fundraising for a new fund, targets industries in food, media, services, IT, Internet technology sectors. Investments in Serbia: parcel delivery firm (start-up) and private security services company (already exited)
Poteza Adriatic Fund	€66.5m AUM (Assets Under Management), covers South-Eastern Europe (SEE) region, majority or sign. minority stakes, industries: agriculture, construction, consumer (retail), financial services, manufacturing, other services. Investment in Serbia: cattle food producer (May 2005) In August 2007, Poteza Group has founded mutual investment fund "Fokus Premium" that invests in the shares listed on the regional stock markets, with the primary focus on Serbia
Salford	Mainly privatization-oriented. Acquired several state-owned dairy firms and three food companies through privatization; currently in the process of consolidation; probable exit in the next two years
Midland	Mainly privatization-oriented. Acquired major state-owned meat producer in 2003 and sold it to Ashmore Investment fund in November 2006; holds stakes in a restaurant chain and in port of city of Pančevo
KD Group	Private equity fund, established recently, €31m AUM, made no investments so far, targets € 3-5 million deals, covers SEE region

The others – with not clear strategy and short-term horizon - MidEuropa Partners, FPP Balkan Limited, Finartis Private Equity, etc.