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THE ROLE OF VENTURE CAPITAL IN ECONOMIC TRANSITION IN SERBIA[1]

Uloga preduzetnog kapitala u privrednoj tranziciji Srbije

Abstract

Venture and more broadly private equity finance is in early stage development in Serbia, both in form of seed-capital financing for innovative small and medium size enterprises (SME) and private equity financing in growing companies. Banking dominates as a source of finance with significant drawbacks in terms of cost and required collateral, especially hampering potential growth of SMEs that constitute 99% of all businesses in Serbia. This article finds private equity investments made to date to have demonstrated positive results, confirming data from other, especially transition economies, presented in the introductory literature overview. In the mid-term, Serbia stands to benefit both from entrepreneurial private ventures and important regional initiatives supported by the European Union such as the Western Balkan Enterprise Development and Innovation Facility, whose innovation and expansion investment funds are expected to start operations in 2014. Serbia is also eligible for the new EU Programme for the Competitiveness of Enterprises and SMEs (COSME), which will have an equity facility, stimulating venture capital stream for SMEs. Education of local financial institutions and SMEs in Serbia about venture capital and investor readiness will be vital, facilitating the construction of project pipelines. In conjunction, the legal framework should be upgraded, both by enacting the amendments to the Law on the Export-Credit Agency (AOFI) and the Law on venture capital funds, accompanied by wider regulatory reform to improve the business climate and foster entrepreneurship.

Key words: *venture capital, private equity, Serbia, EU, Western Balkans, access to finance, SMEs*

Sažetak

Finansiranje iz izvora preduzetnog kapitala, i u širem smislu privatnih investicionih fondova, u početnoj je fazi razvoja u Srbiji, bilo da se radi o početnom finansiranju za inovativna mala i srednja preduzeća (MSP) ili za rastuća preduzeća. Banke preovlađuju kao izvor finansiranja uz probleme visoke cene i traženog kolaterala, što posebno otežava rast MSP koja predstavljaju 99% privrede u Srbiji. Ovaj članak nalazi da su dosadašnje investicije privatnih fondova imale dobre rezultate, potvrđujući podatke iz uvodnog pregleda literature. U narednom periodu Srbija će imati koristi i od privatnih preduzetnih investicija i važnih regionalnih inicijativa koje podržava Evropska unija kao što je Institucija za razvoj preduzetništva i inovacija za Zapadni Balkan (*WB EDIF*), čiji fondovi za inovacije i za rastuća preduzeća počinju sa radom 2014. godine. Srbija takođe može da učestvuje u novom programu EU za konkurentna MSP – KOZME koji predviđa i investicije za MSP. Obrazovanje domaćih finansijskih institucija i MSP o preduzetnom kapitalu i investicionoj spremnosti od suštinskog su značaja i omogućiće pripremu investicionih projekata. U sklopu sa tim, pravni okvir treba pojačati, i kroz izmene Zakona o AOFI i novi Zakon o društvima preduzetnog kapitala, uz širu regulatornu reformu sa ciljem unapređenja poslovne klime i podsticanja preduzetništva.

Ključne reči: *preduzetni kapital, investicioni fondovi, Srbija, EU, Zapadni Balkan, pristup finansiranju, MSP*

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Introduction: The role of venture capital in fostering growth

Venture and more broadly private equity finance is in early stage development in Serbia, both in the form of seed-capital financing for innovative small and medium size enterprises and private equity financing in growing companies. Banking dominates as source of finance with significant drawbacks in terms of cost and required collateral, especially hampering potential growth of small and medium size enterprises that constitute 99% of all businesses in Serbia. This article explores the potential of venture capital and private equity finance as an alternative source of financing that could facilitate economic growth.

In developed economies, high-growth potential businesses have typically relied on financing from sources other than traditional lenders such as banks during their early growth phases. Venture capitalists usually filled this gap by providing capital to early stage ventures with good growth potential [48]. The availability of such capital has helped to promote the emergence of numerous high-growth firms in the United Kingdom, United States, and several other developed economies. This has led many to conclude that venture capital (VC) is a crucial factor in fostering a region's economic growth [22].

Private equity as a financial tool can be informally and formally organized. If it is informally organized, private equity can take the form of business angels, who are wealthy individuals with corporate experience. These individuals are ready to invest their money, contacts and experience in a particular industry in order to profit from an increase in the company's value. When it is formally organized, private equity takes the form of private equity funds, a limited partnership where investors are limited partners and the fund manager serves as the general partner. Once established, a private equity fund is looking for companies with a prospective future and growth potential [40]. The Serbian Private Equity Association (SPEA) gathers private equity investors and promotes this type of investment as an alternate source of finance.

A venture capital fund is part of the private equity industry specialized in financing companies in their first phases of growth. Hence, VC funds are professional investors willing to take a risk investing in companies without a track record and companies that are not listed on stock markets. Venture capital can invest in the seed phase (research, assessment and development of initial concept, i.e. R&D phase), start-up phase (product development and marketing) and expansion phase (growth and expansion for achieving profitability) [40].Venture capital involves a five-step process; (1) obtaining funds from limited partners; (2) identifying, analyzing, and selecting appropriate entities in which to invest; (3) structuring the terms of the investment; (4) implementing the deal and monitoring the portfolio firms; and (5) achieving returns and ultimately exiting from the investment [32]. VC funds must be raised competitively, as are the funds raised for leveraged buyout (LBO) and project financing (especially in the case of R&D limited partnerships); all three situations involve investments by limited partners, which are risky, illiquid, long-term investments. LBO situations are heavily debt-financed and involve firms with large cash flows; venture capital involves firms in the early stage of their life cycle in situations where debt is not a suitable financing instrument. Unlike an R&D limited partnership, the purpose of venture capital investment is not so much to develop and patent a new technology as it is to create value and generate wealth for both the entrepreneurial team and venture capital pool investors [32].

It is a generally accepted fact that venture capitalists (VCs) play an important role in innovation and economic development [7], especially in a knowledge economy. VCs are usually perceived to be active investors [4] that are much more involved in the firms they back than ordinary shareholders [39]. This type of behaviour is to be expected, given that their own profits are conditional on the firm performance. However, empirical research has shown that their involvement varies from virtual passivity to active participation in the firm's organization [39], although the impact on added value is not always obvious. Some studies have shown that VC involvement is positively correlated to firm performance [12], [6], while others found no evidence of added value and even, in some cases, identified negative impacts for the entrepreneur, such as underpricing during initial public offerings (IPOs) [17].

Entrepreneurial ventures are considered to be of crucial importance for economic growth and development worldwide [31]. However, especially in Europe, they often lack sufficient availability of and access to funding sources to set up, maintain, develop and grow their businesses [26]. This problem is extremely acute when banks are reluctant to lend money to these companies and/or the formal VC market is not highly developed. Unlike other types of finance providers, the contribution made by venture capitalists (VCs) to the small and medium-sized enterprises (SMEs) they fund is not strictly financial in nature. Because they have a stake in the firms' profits and losses, they often play an active role as investors, for example by helping to introduce business processes and practices conducive to long-term development and performance [42]. In recent years, researchers have identified four types of strategic capabilities over which VCs have an influence. They are: (1) product innovation and development; (2) market and customer development; (3) networking; and (4) strategic human resource management, which helps ensure that other capabilities can be deployed adequately within the firm by obtaining the appropriate personnel and conditions [20]. These capabilities are primarily concerned with assessing the internal and external environment, and the VCs' experience and knowledge can be extremely useful in this respect [4].

More recently, venture capital has started to reach into emerging economies, encouraging the establishment of local venture capital industries [8]. This has proved to be a challenge as many emerging economies are undergoing significant economic transition and offer little protection for either investors or private property [37]. Such an ambiguous business environment adds to the already difficult task faced by venture capitalists in the selection of firms to fund and monitoring those investments effectively [38]. Venture capitalists count on a stable institutional regime with a predictable rule of law and enforcement regime to facilitate and safeguard their investments [11]. In addition to legal stability, venture capitalists seek environments with efficient markets for corporate control and capital, which readily allow exit from ventures as well as systems with minimal corruption [48]. This institutional stability and predictability reduces uncertainty and risk, and enhances the likelihood of success in new ventures.

Small and medium size enterprises access to finance problems in transition economies and the European Union

One of the issues facing countries in the transformation from centrally planned into market economies is the need to develop small and medium sized enterprises (SMEs). At the firm level, transformation involves a shift from public to private sector ownership, which can occur either through the direct privatisation of former state owned enterprises or through the creation of completely new businesses. As a consequence, the pace of new venture creation, combined with their qualitative characteristics and the type of barriers they experience, may be seen as a barometer indicating how quickly the process of market reform is occurring. A second element in the process of transformation is the liberalisation of markets, where central administration of prices is replaced by market mechanisms, involving an increase in market opportunities for entrepreneurs, as well as in the level of competition. A third element in the process of economic transformation involves the creation of market institutions, such as banks and other financial intermediaries, and business and training services. Whilst this may create opportunities for entrepreneurs in some cases (such as training providers), the absence or slow rate of establishment of the basic market institutions can be a major constraint on the extent to which the small business sector is able to develop [41].

Studies referring to emerging economies in great part relate to Latin American and Asian countries [49], [30], [46], with relatively few studies investigating early internationalization of SMEs from Central and Eastern European (CEE) countries. Research suggests that entrepreneurship development findings from more advanced economies may not be applicable in the context of emerging markets [8], [50]. Two key explanations for this could be institutional differences and resource constraints, resulting partly from different institutional settings and histories. Recent surveys of entrepreneurship behaviour [14] indicate that the index of entrepreneurial climate is on average lower in CEE transition economies, than in Western Europe. The same research indicates that entrepreneurs in CEE can rely less frequently on entrepreneurial family traditions and are on average younger, and therefore also less experienced than SME founders in Western European countries. Such differences could be ascribed to the fact that only since the 1990s has entrepreneurship been officially recognized and encouraged in these post-communist economies, after a long pause during Communist rule that allowed very limited entrepreneurial ventures.

For most of the 19th and 20th centuries, large corporations were considered the primary and driving force of economic and technological progress. Large corporations dominated research and development (R&D) and the introduction of innovations, and experienced major improvements in production efficiency. The exploitation of economies of scale and scope were considered to be the driving force of economic development. Beginning in the 1970s, however, large manufacturing firms in key industries began to lose competitiveness and a number of important empirical studies began to document the critical role of SMEs. For example, *Acs* [1] argued that newer and smaller firms entered sectors as "agents of change". Studies using direct measures of innovative activity – such as measures of new products and processes – replaced older measures (such as R&D) and showed that small firms and not the larger incumbents introduced innovative activity [2]. SMEs also began to play an important role as efficient providers of intermediate goods and services to large firms. Many papers showed that developed countries that encouraged entrepreneurship and SMEs had higher economic growth [23].

Unlike the United States, which experienced a natural birth of new, small firms, the SME sector in Eastern European countries emerged as a result of the privatisation and breakup of large state-owned enterprises, as well as through a large number of new, generally very small firms that came as a consequence of the market liberalisation process. The restructuring and downsizing of large firms, the privatisation of public utilities and other large companies, the outsourcing of many support services, and the vertical fragmentation of production are all forces that promoted the creation and expansion of SMEs [23].

Both in the developing and developed world small firms have been found to have less access to external finance and to be more constrained in their operation and growth [5]. Small firms do not only report facing higher growth obstacles, but these higher obstacles are also more constraining for their operation and growth than in the case of medium-size and large firms [5]. *Berger* and *Udell* [6] found that small and young firms – with generally shorter banking relationships – pay higher interest rates and are more likely to be required to pledge collateral. *Peel* and *Wilson* [36] showed that in SMEs have higher costs and reduced access to financing because of the information asymmetries associated with newer, smaller firms.

Statistics show that the size of the SME sector as measured by the percentage of total employment in Eastern European countries is smaller than in most developed economies. Although we find in almost every country a large number of SMEs as a percentage of total firms, the SMEs in Eastern Europe are generally small and hire few employees. However, SMEs seem to constitute the most dynamic sector of the Eastern European economies, relative to large firms. In general, the SME sector comprises relatively younger, more highly leveraged, and more profitable and faster growing firms. At the same time, these firms appear to have financial constraints that impede their access to long-term financing and ability to grow. They tend to borrow short-term debt, which appears to be the prevalent, often only type of financing that these firms can access [5]. The Serbian market fully reflects the observations made for Eastern Europe.

In a transition context, SME financing is of special importance, as small firms play an important role in the restructuring process by absorbing employees that lose their jobs in privatised, restructured, or bankrupt state-owned enterprises [24]. *Calvo* and *Corricelli* [10] and *Pawlowska* and *Mullineux* [35] show that the sharp decline in bank credit to Polish SMEs at the beginning of the transition process has significantly contributed to the strong output decline in this country. At the same time, *Carlin* and *Richthofen* [12] find that the rapid growth of the SME sector, and the availability of sufficient external funding for these firms, has contributed to the integration of Eastern and Western Germany [19]. Although the emergence of the SME sector in CEE has contributed positively to the transition process, it is a sector that remains underdeveloped. One reason put forward for the SME sector being smaller in CEE is that firms have access to expensive finance while those that are unable to raise external finance are forced to rely solely on internal finance, which is constraining their growth [18]. The EBRD Transition Report for 1998 has recommended that not only must access to finance for SMEs be improved, but there must also be greater diversification in the range of financial products available to SMEs [13]. A similar observation has been made in all subsequent EBRD Transition Reports.

Availability of venture capital and stock market financing which is related to the level of financial market development, is lower as a rule in transition economies than mature markets and constitute a restraint for new ventures in these markets [9]. In fact, according to Eurostat (2009) [15] data, early stage venture capital investments in transition economies have been much lower than average among the "old" 15 European Union countries. Research indicates that the availability of start-up venture capital in countries such as Poland, Hungary or Czech Republic is very low [33].

Equity financing was severely affected by the financial crisis. A sharp decline in venture capital and growth capital occurred between 2008 and 2009. In 2010, equity funding had not recovered to its 2007 level, despite an overall positive economic trend (OECD, 2012a). Countries with high growth rates for venture capital in 2011 include Denmark (+80%), Hungary (+62%), the Netherlands (+56%) and Canada (+30%). On the other hand, a strong decrease was observed in Portugal (-80%), New Zealand (-62%), Switzerland (-42%), Sweden (-25%) and Ireland (-11%). For half of the countries in the OECD Scoreboard, the level of equity investments in 2011 was still well below the pre-crisis period (2007), averaging about 5% of total financing. This suggests that the uncertain economic climate continued to act as a drag on equity investment. It should be noted, however, that trends in venture capital investment are difficult to analyse because of the extreme volatility in the data. In particular, just one large deal can cause volatility in countries where the market is not very developed. Furthermore, for most countries, the data are available for venture and growth capital invested in *all enterprises*, irrespective of the size class. Interestingly, in 2011 a significant growth in volumes was recorded for some countries that collect data specifically on SMEs, such as Italy (+ 65%) and Russia (+20%) [34].

The completion of a successful venture capital deal in a transition economy must confront two major problems. The first concerns the deal's progression through different stages of the venture capital process. The second problem relates to corporate governance. The most common concern for venture capitalists is an entrepreneur's use of company assets (especially financial resources) for personal purposes as well as financial reporting and accountability and regulatory compliance [24]. As in developed market economies, venture capitalists may not be appropriate for all types of enterprises, but they may have a particular role to play in supporting those enterprises with significant growth prospects. Although classically associated with new and/or small firms, venture capitalists have increasingly come to play a major role in the financing and monitoring of established firms such as management buy-outs and turn-around cases. In principle, venture capital firms may thus have a role to play in financing and monitoring enterprises which have been privatised as independent entities and which may need further development capital or aid in restructuring, as well as a more conventional role in supporting new firms [47].

According to the "Access to Finance" survey released by the European Commission and European Central Bank in November 2013, access to finance is still among the top concerns of the EU's small and medium sized enterprises and younger and smaller firms are the most badly affected. About one third of the SMEs surveyed did not manage to get the full financing they had planned for during 2013 and 15% of survey respondents saw access to finance as a significant problem for their companies. Companies believed that bank financing conditions worsened during 2013, with respect to interest rates, collateral and required guarantees. Reports of loan denials underline the generally negative perception by SMEs of bank lending possibilities. In total about one third of the SMEs surveyed did not manage to obtain the full bank loan financing they had planned for during 2013. A total of 13% of their loan applications were rejected, while 16% of companies received less than requested. In addition, 2% of enterprises declined a loan offer from the bank because they found the conditions unacceptable. Finally, 7% of SMEs were too discouraged to ask for a loan, because of anticipated rejection. This was particularly the case for young companies: 11% of those who have been in business between 2 and 5 years did not apply for a loan expecting a rejection. Indeed, younger and smaller firms were more likely to obtain only part of the finance they request, or to be rejected outright. The highest rejection rate was among micro companies employing fewer than 10 people (18%) and among SMEs active for less than 2 years (28%). In comparison, only 3% of loan applications from large enterprises (those with 250 or more employees) were rejected. Insufficient collateral or other bank requirements such as guarantees is most often reported obstacle that companies face when seeking bank financing, followed by interest rates being too high. Alternative, equity financing, was used by only 5% of SMEs in the survey period. In general, SMEs feel less confident to talk about finance with equity investors or venture capital than they do with banks. The main challenge concerning this source of financing is its lack of availability or prices being too high [16].

Access to finance was mentioned as the most pressing problem by 40% of SMEs in Cyprus, 32% in Greece, 23% in Spain and Croatia, 22% in Slovenia, 20% in Ireland, Italy and the Netherlands, compared to 7% in Austria, 8% in Germany or 9% in Poland. Rejection rates for loan applications were also highest in Greece and the Netherlands (31%), followed by Lithuania (24%). Ireland (16%), Greece and Cyprus (15%) also accounted for the highest share of companies who were so discouraged that they did not even apply for a bank loan. About 85% of all loans are still derived from banks. Half of the loans obtained in the last two years were for less than €100,000. While bank financing has decreased overall, the survey confirmed that SMEs are still strongly dependent on bank financing since banks provided 85% of loans in the past two years. More than half of surveyed EU SMEs had recently used one or more bank products: 32% of companies used bank loans and 39% used bank credit line or overdraft facilities. Bank loans are also the preferred option for 67% of firms looking for an external financing solution to facilitate growth [16].

Table 1 illustrates overall decline of bank financing for SMEs in developed countries.

Table 1: Growth of SME Business Loans, 2007-2011, year-on-year growth rate, as a percentage

Country	2008	2009	2010	2011
Outstanding SME business loans (stocks)				
Canada	-0.1	3.7	-0.9	5.0
Chile	11.3	6.9	8.8.	13.1
France	4.8	0.3	5.4	5.4
Hungary	10.3	-7.6	-11.1	0.3
Ireland	n.a.	n.a.	n.a.	0.9
Italy	2.1	1.2	6.6	-1.9
Korea	14.4	5.0	-0.5	3.2
Norway	25.7	-7.7	4.2	n.a.
Portugal	9.2	0.9	-1.6	-4.0
Russia	n.a.	3.7	21.9	19.1
Serbia	47.0	2.3	7.1	5.5
Slovak Republic	32.4	-0.5	0.1	n.a.
Slovenia	16.6	-2.9	15.4	1.3
Sweden	7.2	20.4	-21.4	n.a.
Switzerland	5.9	5.3	1.3	3.2
Thailand	9.5	7.4	7.2	3.0
Turkey	10.6	-1.6	50.7	29.3
United Kingdom	7.9	3.0	-7.4	-7.4
United States	3.6	-2.3	-6.2	-6.8
New SME business loans (flows)				
Czech Republic	-14.3	-15.0	-14.8	3.6
Denmark	-13.7	-19.2	22.9	-2.4
Finland	2.6	-16.3	-16.5	-4.8
The Netherlands	-5.0	-24.2	5.1	17.6
Spain	-9.5	-26.3	-20.0	-17.2

Source: OECD, compiled from National Scoreboards [34]

The European Commission combats problems with access to finance using specifically targeted programmes, with increasing focus on SME access to finance. In the previous European Union financial framework (2007-2013), the Entrepreneurship and Innovation Programme (EIP), one of the three specific programmes of the Competitiveness and Innovation framework programme (CIP), with a budget of €1.1 billion for financial instruments, has helped to mobilise over €14 billion of loans and €2.3 billion of venture capital for SMEs across Europe. Serbia had access to this programme but used it to a limited extent. The new Multi-annual financial framework for the period 2014-2020 proposes an increased amount of funding for SMEs. For the first time ever, the Commission has proposed a dedicated financing programme for SMEs: COSME – EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises. COSME will have a budget of EUR 2.3 billion (at current prices) over the next seven years. Moreover, the new research and innovation programme, Horizon 2020, will significantly expand the budget for SME innovation activities (from less than €7 billion for the period 2006-2013, to almost €9 billion for the period 2014-2020) and support ambitious SME innovation projects that are driven by market insight and business potential. In addition, a significant part of the Structural Funds will be destined for SMEs and Innovation linked to the SBA. A joint financing instrument with the participation of the EIB Group will also be dedicated to SMEs [14].

COSME will facilitate and improve access to finance for SMEs through two different financial instruments, available from 2014:

(1) The Loan Guarantee Facility will fund guarantees and counter-guarantees for financial intermediaries (e.g. guarantee organisations, banks, leasing companies) to help them provide more loan and lease finance to SMEs. This facility will also include securitisation of SME debt finance portfolios. By sharing the risk, the COSME guarantees will allow the financial intermediaries to expand the range of SMEs they can finance. This will facilitate access to debt finance for many SMEs who might otherwise not be able to raise the funding they need. From 2007 to date, more than 240,000 SMEs have already benefited from a guaranteed loan or lease thanks to the CIP, the current programme supporting business competitiveness.

(2) The Equity Facility for Growth will invest in funds that provide venture capital and mezzanine finance to expansion and growth-stage SMEs in particular those operating across borders. The fund managers will operate on a commercial basis, to ensure that investments are focused on SMEs with the greatest growth potential.

Small and medium size enterprises development in Serbia and potential impact of venture capital

Micro, small, medium enterprises and entrepreneurs (SMEs and entrepreneurship) in the Republic of Serbia are a very important segment of business, due to the flexibility of the organisational forms and their efficient adaptation to frequent changes in the business environment, enabling the creation of a large number of jobs. This is confirmed by data for the year 2012, with a total number of enterprises in the Republic of Serbia amounting to 83,631, of which micro enterprises accounted for 86.2%, with 10.7% small businesses, 2.5% medium-size and 0.6% large companies. An impressive 99% of all companies belong to the segment of small and medium-sized enterprises, providing 67% of the jobs [34].

From the standpoint of the company, financial planning involves many important decisions and dilemmas, such as the decision on whether to finance business from own or borrowed resources, or how much capital should be obtained from bank loans in order to establish an optimal capital structure, etc. Micro, small, medium enterprises and entrepreneurs can obtain funding from various sources such as loans from commercial banks and companies legally authorized to offer short-term and long-term loans, to finance working capital, fixed assets, exports, current liquidity, refinance obligations and loans to other banks, overdrafts or investment loans. There are leasing companies that provide financial leasing services, as well as factoring companies, that are quite important for small and medium sized enterprises since they offer a way of overcoming the problems of current illiquidity and provide fast and secure payment of claims. SMEs are relatively informed about these, more traditional, ways of financing. However, newer forms of financing for SMEs, such as business angels, private equity or venture capital are still largely unexplored, with a low level of awareness and knowledge about these alternate forms of finance.

Many studies show that companies in Serbia are not sufficiently informed about the available funding opportunities and different forms of financing. For instance, research conducted by USAID in 2011 [44] shows that 70% of all SMEs in Serbia are financed from their own sources and that 80% of the surveyed enterprises did not plan to take a loan in 2012 (see Table 2). This indicates that SMEs find loans to be very expensive, and the procedure required to get a loan lengthy and complicated. These companies frequently lack knowledge in finance; they are focused on their primary business (usually trade or production)

Table 2: Financing SMEs and entrepreneurs: Scoreboard for Serbia

Indicators	Units	2007	2008	2009	2010	2011
Debt						
Business loans, SMEs	EUR million	2 861	4 205	4 300	4 603	4 857
Business loans, total	EUR million	13 422	17 986	18 155	18 436	18 619
Business loans, SMEs	% of total business loans	21.3	23.4	23.7	25	26.1
Short-term loans, SMEs	EUR million	1 035	1 403	1 516	1 569	1 405
Long-term loans, SMEs	EUR million	1 826	2 801	2 784	3 034	3 452
Short-term loans, SMEs	% of total SME loans	36.2	33.4	35.2	34.1	28.9
Government loan guarantees SMEs	EUR million	10.6	9.5	2.6	1.7	
Government guaranteed loans, SMEs	EUR million		10.5	2.6	2.2	
Direct government loans, SMEs	EUR million	21	40.3	370.4	530.8	400.6
Loans requested, SMEs	EUR million	3 163	5 132	4 998	6 454	5 245
Loans authorised, SMEs	EUR million	2 663	3 948	3 641	4 877	4 058
Loans authorised to requested, SMEs	%	84.2	76.9	72.8	75.6	77.4
Non-performing loans, SMEs	EUR million	236	457	810	1 010	1 204
Interest rate, SMEs	%	14.56	15.76	16.18	14.99	16.31
Interest rate, large firms	%	10.97	12.69	12.93	11.79	12.33
Interest rate spread	%	3.58	3.07	3.24	3.19	3.98
Collateral, SMEs	% of SMEs required to provide collateral on last loan	75.8	80.4	79	79.4	79.4
Equity						
Venture and growth capital	EUR million	0.1	1.3		13.2	
Other						
Payment delays	% of SMEs waiting more than 60 days for payment			34	31	31
Bankruptcies, total		1 792	1 884	2 173	2 483	2 763
Bankruptcies, total	Year-on-year growth rate, %		5.1	15.3	14.3	11.3
Bankruptcies, total	per 1 000 firms	18.3	17.8	19.4	22.3	25.9

Source: OECD Scoreboard 2007-2011

and they consider completing forms and collecting data required by the banks to be a challenging task.

The Figure 1 (data acquired from the World Bank website) indicates how high interest rates in Serbia compare to those in the Netherlands [43].

According to the Report on small and medium-sized enterprises and entrepreneurship 2011 [29], there are several reasons hampering SMEs' access to adequate financing:

- SMEs have difficulty posting collateral that is acceptable to lenders. Many SMEs don't think strategically about how to manage and maintain their assets for borrowing needs.
- A variety of psychological and knowledge-related factors affect borrowing behaviour. Risk aversion is made worse by loan conditions that require personal guarantees and extensive over-collateralization.
- SMEs often lack the capacity to present their business to lenders. The challenges are compounded if they have limited or no formal credit history, are weak in financial reporting and business planning, or cannot unwind business finances from their household finances.

The confluence of these constraints has led to a large, and possibly widening, financing gap for SMEs that has created a serious economic problem. While virtually every country in the European Union and many others around the world have acknowledged the vital role SMEs in driving economic recovery, Serbian SMEs are increasingly dependent on economic recovery to survive. Without better access to finance, SMEs cannot spread risks that undermine macroeconomic stability. At a minimum, without better access to finance, SMEs cannot absorb public sector job losses or generate revenues that could soften the impact of fiscal reforms. Since access to bank loans is obviously limited (for a number of factors) it is necessary to develop alternative sources of financing and venture capital is definitely an ideal tool for many of the

SMEs that need long-term financial stability and substitute for expensive, short-term loans.

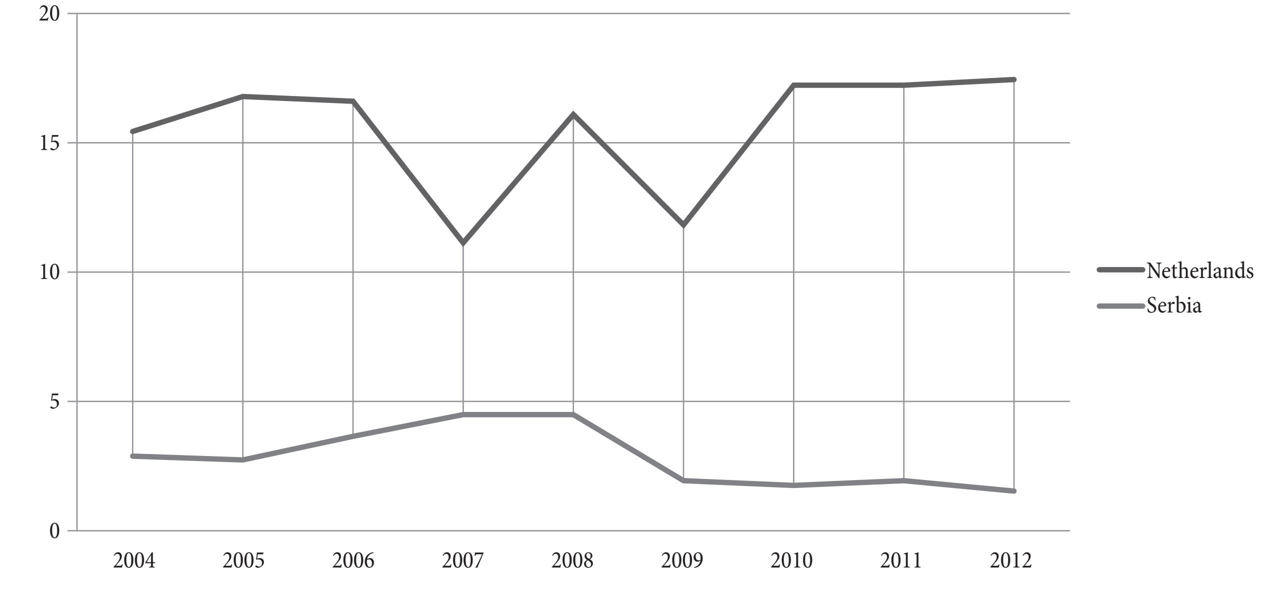
There is a wide consensus in both the Serbian Government and international financial institutions that SMEs should drive Serbian growth in the years to come and that lending to this segment should be rendered cheaper and simpler. Since the onset of economic transition in Serbia in 2001, several funding programmes targeting micro, small and medium enterprises and entrepreneurs have been developed through national support programmes and international funding programmes to enable easier access to financing for SMEs.

The government has established a range of support programmes to help overcome the financing gap, but the effectiveness of these programmes for SMEs is not clear. As evident in the overview that follows, there should be further analysis, leading to a revised approach in structuring and delivering public support to SMEs. Many SMEs are either not aware of all the available programmes, or have had poor experience in dealing with state funds. The following are the most important national institutions that support financing and advisory services for micro, small and medium sized enterprises:

The Development Fund of the Republic of Serbia was established by the Law on the Development Fund of the Republic of Serbia in 2009 (amended in 2010 and 2012), in accordance to which it carries out activities of granting loans, guarantees, purchase of securities, acquisition of legal-based equity, including the conversion of receivables and other activities on behalf of the Republic of Serbia, or on its own behalf and on behalf of the Republic of Serbia. Development Funding intended to grant priority finance to programmes whose implementation results in job creation, export promotion, and a faster return on investment. The range of services offered by the Development Fund includes loans to companies, among which are short-term loans for temporary working capital in order to boost competitiveness and liquidity of the domestic economy, investment loans and loans for working capital, promotion of balanced regional development (which is done through the Government Programme for the encouragement and development of businesses in underdeveloped municipalities and government programmes to invest in labour-intensive sectors of manufacturing industry in underdeveloped municipalities), long-term loans to entrepreneurs, long-term loans for beginners as well as start-up loans for businesses and sole proprietors, long-term loans for women entrepreneurship, etc. In September 2013, the portfolio of the Development Fund of the Republic of Serbia was made public on the website of the Ministry of Economy in line

Figure 1: Comparison of lending interest rates in Serbia and the Netherlands

Lending interest rate %									
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Netherlands	2.80	2.80	3.50	4.60	4.60	2.00	1.80	2.00	1.60
Serbia	15.50	16.80	16.60	11.10	16.10	11.80	17.30	17.20	17.40



with the transparency of public funding envisaged by the Law on the budgetary system [27]. A high-level analysis of the portfolio would indicate that many investments were made in loss-making state enterprises and to refinance troublesome large private enterprises, leading to a conclusion that the selection criteria and risk management should be strengthened for this institution to reach the intended goal of supporting economic development.

The Agency for Foreign Investments and Export Promotion (SIEPA) was established based on a Law on Foreign Trade, in order to facilitate export of Serbian companies and to promote investment opportunities by assisting foreign investors to start a business in Serbia. The range of services that SIEPA provides to its clients (with particular emphasis on supporting small and medium-sized enterprises) involves providing information on foreign markets, connecting Serbian companies with potential partners abroad, organising participation in trade fairs abroad, organising business meetings between local and foreign companies, organising individual visits to local companies by foreign buyers, study visits abroad and visits to trade fairs, seminars and training for local companies, and sector analysis. Until December 2013, SIEPA also administered financial incentives for investors but the decree providing the legal basis for such incentives then expired and no new subsidies to investors have been envisaged in the adopted 2014 budget of the Government of Serbia. As is the case with the Development Fund, further analysis is required to assess the cost and benefits of investor subsidies, as a basis for a more effective policy in the future to support growth.

The Agency for Export Credit and Insurance of the Republic of Serbia (AOFI) is the official export credit agency founded by law in 2005. The main activities of AOFI are insurance of short-term receivables and export financing for Serbian export-oriented enterprises. Advantages of AOFI are favourable interest rates and simple procedures for exporters' working capital financing, efficient domestic and international factoring services which allow exporters to overcome current liquidity problems, export credit insurance against commercial risks to foreign debtors for goods delivered or services rendered, as well as the issuance of guarantees (for participation in tender, refund of advance payments, performance bonds, maintenance during the warranty period). AOFI's mission is to increase the exports of Serbian enterprises through financing and insurance of export projects, which should result in increased competitiveness of the domestic economy and penetration of new markets. AOFI pursues a strategy to improve the conditions of the exporting economy and to ameliorate the export structure of the Republic of Serbia. Amendments to the Law on AOFI were approved by the Government of Serbia in December 2013 but are still awaiting adoption by the National Assembly. The amendments, when adopted, would enable AOFI to act as fund of funds for venture capital funds, and to support them financially, with 20-40% stake in their overall financing. The Government of Serbia budget for 2014 envisages cca 35 million euros for this purpose. A working group for the Law on Venture Capital is also drafting this complementary legislation to regulate venture capital operations in Serbia. These legislative changes are required to attract higher level of venture capital to Serbia.

The Republic of Serbia Innovation Fund was established by Innovation Law in 2006 to encourage and manage financing for innovation in Serbia. Innovation Fund has a mandate to co-finance innovation through cooperation with international financial institutions, organizations, donors and the private sector. The international independent Investment Committee comprising international industry experts from areas of early stage technology development, finance and venture capital, entrepreneurship, business development and applied science makes the financing decisions. Initial administrative and funding capacity was built with aid of Innovation Serbia Project, financed by the European Union Instrument for Pre-Accession Assistance (IPA) funds for Serbia and administered by the World Bank. The project includes implementation of financial instruments stimulating R&D in commercial enterprises by the Innovation Fund through Mini Grants Program, supporting early stage, private, micro and small enterprises that have technological innovation, potential for creation of new intellectual property, and meet a clear market need, as well as Matching Grants Program, designed to assist existing micro and small companies to develop their research and development activities, establish collaborations with strategic private sector partners, attract investors and bring their innovation to the market, with the goal to increase private sector investment in the technology development and commercialization resulting in new or improved products and services. Funding is provided in conjunction with company trainings in intellectual property rights protection and management, business development and fundraising.

Additional support to SMEs, either financial and/or advisory, is provided by the National Agency for Regional Development of the Republic of Serbia and its network of regional agencies, as well as by the National Employment Service, Vojvodina Investment Promotion Agency and Vojvodina regional funds [For more, see 29].

Donor-funded credit lines have been a more effective form of assistance provided to the Serbian business sector. Nonetheless, as with government funding, many SMEs are not fully aware of these programmes and face challenges in accessing support. Many market participants believe that access to credit programmes is practically limited to larger companies that already have an existing banking relationship [29]. The following are the most significant international support programmes for financing SME segment: World Bank (WB) programmes are a very important source of financial assistance to developing countries around the world, created to reduce poverty and encourage development and growth. According to the World Bank data from the 2012, WB financed 39 projects in Serbia in the period 2001-2011 in the amount of nearly $2 billion. It is important to point out that the micro-credits are granted up to the amount of €10,000, while the maximum loan amount for small, medium enterprises and start-up projects amounts to €50,000.

European Bank for Reconstruction and Development (EBRD) has been operating in Serbia since 2001, and in the period until the 2011, it has invested over $3 billion in Serbia, of which the largest percentage was directed to local infrastructure and transport (35%), followed by financial institutions (27 %), manufacturing, trade and agribusiness (23%), and finally energy (15%). There were 176 approved projects. EBRD Local Enterprise Facility (LEF) is a delegated facility for equity, quasi-equity investments and tailor-made debt financing established jointly by the EBRD and the Italian Government in 2006 and targeting Western Balkans, Turkey, Bulgaria and Romania. Developed to support financing needs of dynamic local enterprises, LEF has provided €400 million of capital provided jointly by the EBRD (€380 million) and the Italian government (€20 million), with total cumulative commitment of €298.5 million and a total of 114 projects implemented by late 2013. Key objectives are as follows: (1) Enhancing competitiveness and product quality by strengthening market competitiveness and improving the quality of goods and services provided; (2) Restructuring by introducing new, replicable products and technologies to achieve better use of labour, higher productivity and efficiency improvements; and (3) Setting standards for corporate governance by encouraging investee companies to apply higher standards of corporate governance and business conduct. The latter is particularly valuable for the market development in the Western Balkans.

In addition to investments in financial institutions, an important project aimed directly at SMEs is the Business Advisory Services Programme (BAS), aimed at providing business advice to micro, small and medium-sized enterprises to improve their business. Research conducted by the EBRD for the period 2008-2011 shows that the companies that used BAS programme increased the number of employees, revenue, productivity, provided external investment and they usually reuse consultants provided to them by BAS. In addition, financial support is also available to finance projects such as: drafting a business plan, marketing plan, website development, the development and improvement of information systems, improving financial accounting and control systems, and improving the organisational and management structure.

The European Investment Bank (EIB) is an institution that deals with the financing of projects in EU member states, the countries that are in the process of European integration, as well as partner countries. EIB support is reflected in the possibility of providing direct loans and credit lines to intermediary banks whose end-users are small, medium enterprises and local governments. These funds may be used for the purchase, rehabilitation or expansion of fixed assets, the development of the distribution network in the country and abroad, as well as for the providing permanent working capital. EIB has been providing favourable credit lines to banks in Serbia since 2001.

The Government of the Republic of Serbia received a donation in the amount of €15 million from the European Union to finance small and medium enterprises and entrepreneurs in 2001-2002. After two years, all funds were invested in firms, and the timely repayment of principal and interest has been established which enabled revolving loan fund to continue its operations. By the end of 2013, the total European Union funding allocated for the SME sector support amounted to €70.4 million (of which €50.5 million in grants for development projects and €20 million invested in credit lines for SMEs). The amount of individual loans ranges from €20,000 to €200,000 and funds are distributed through intermediary banks. Loans are granted for a maximum period of 5 years, with a grace period of up to one year. Loans can finance the purchase of equipment and machinery for the manufacturing of goods, services, construction of facilities to accommodate production capacity, with the obligation of the user to fund at least 20 % of the project with own funds. As noted above, the European Union has also developed the new Programme for the Competitiveness of Enterprises and SMEs (COSME), the first ever Commission programme that is exclusively dedicated to supporting SMEs, and in which Serbia will participate.

Bilateral programmes are also a way in which many countries can provide assistance to Serbia by supporting private sector development, which is very important from the point of view of the possibility of exchanging experience and knowledge in order to assist the segment of micro, small and medium sized enterprises. In this regard, it is interesting to note the donation of the Kingdom of Denmark through LEDIB Local Economic Development in the Balkans, which aims to support the development of the segment of micro, small and medium-sized enterprises and entrepreneurship in region of Nis (Nisavski okrug) by financing loans for investment and working capital through the intermediary bank [30]. There is also an Italian SME Credit Line that provides favourable loans and partial grants for purchase of Italian equipment [21], and a German KfW finance programme, for instance supporting investments in energy efficiency.

Venture capital development in Western Balkans and Serbia

As underscored by SPEA, venture capital and business angels are prepared to take the highest level of risk, expecting the highest level of return in comparison with other financial sources. This is a very important issue because in Serbia, according to the National Bank, 94% of total financial assets are concentrated in the banking sector. This leads to the conclusion that Serbia is characterized by the existence of a financial gap, leaving companies start up and expansion phases uncovered. The financial gap poses a serious problem for achieving dynamic economic growth because it is impossible to obtain further financial resources following the initial phases of business development [40].

The first equity finance deal came to Serbia with Overseas Private Investment Corporation investment in Serbia Broadband (SBB) in late 2000, while the first fully private equity deal was made in 2003, with the Imlek acquisition by British private equity fund Salford. Until 2013 there have been 22 deals reaching a total of €280 million. Fourteen private equity funds with 22 investments reaching €180 million in equity stakes have been identified. These funds invested an additional €100 million in technological improvements, organizational changes expanding product lines, and the development of marketing and support services. Notable private equity investments were also made in manufacturing (U.S. Darby Fund invested in copper mill Sevojno and cables manufacturer Novkabel as well as bread manufacturing Klas) information technology industry (Unicredit bank bought equity stake in Comtrade), but also in agriculture where EBRD was particularly active, buying equity in Victoria Group and Farmakom, and in a couple of state-owned banks (Komercijalna banka, Cacanska banka). There are several benefits in addition to financing, obtained by companies that got EBRD as equity partner: they improved their corporate governance, became more visible for potential strategic partners and acquired significant expertise support from EBRD. Nonetheless, in a transition economy impacted by the global financial crisis, these companies are still struggling to succeed, which also indicates that equity finance is not necessarily more successful than bank finance though it increases chances for company successful restructuring and growth. Yet, the SPEA 2012 research report concluded that equity driven companies in Serbia during the financial crisis showed performance above average [40].

During the 2009-2011 period when the Serbian economy was hit severely by the world economic and financial crisis, more then 400,000 people lost their jobs, GDP dropped and the demand for Serbian products on regionally and globally deceased. According to SPEA, during this period, according to the information available to the public, private equity backed companies have increased their total assets from €814 million in 2009 to €882 million in 2011 which is an 8.25% increase. However, if we look at the entire period, we can see a drop in total assets, and if we compare the years 2011 and 2010, it stands at 8%. An average private equity deal in Serbia includes close to €9 million for an equity stake and an additional €4.5 million invested into the company to improve performance. Looking at the sectors, most of deals were closed in food and beverage industry (9), followed by IT (6), telecommunications (2) and financial intermediary (2). If we look at the size of companies, private equity invested in eleven large, five medium and seven small sized companies. Only one company has gone bankrupt. The biggest growth increase was in the telecommunication, broadband and Internet sector. These companies have increased their assets from €202 million in 2009 to €240 million in 2011. Companies involved in food and beverages increased their total assets from €594 to €605 million. On the other hand, if we look at total equity, in the same period private equity backed companies recorded a drop in total equity in 2010 compared to 2009, and an increase in 2011 compared to 2010. During the entire period, companies have reduced total equity by 18%, falling from €315 million to €257 million in 2011. Private equity backed companies were successful if we look at net revenue obtained from goods and services sold, because during this period companies increased net revenue from €732,000 to €807,000. At the same time, companies recorded a drop in net income from €61,186 in 2009 to €32,354 in 2010, and an increase to €54,671 in 2011. In terms of employment, private equity backed companies have cut the number of employees by 4.22% in the 2009-2011 period, largely due to the staff cuts in the food and beverages industry. Employment in financial intermediaries, telecommunication, broadband and Internet companies increased by 16.94% in the same period. Information gathered from publicly available sources shows that eleven out of twenty companies had a constant increase in net income. Furthermore, six companies were experiencing net income and net loss, and two companies are having a constant increase in net loss. Along with increase in net revenues, companies increased total equity and total assets during the observed period. Speaking of employment, three out of twenty companies showed an increase while the rest were variable, increasing and decreasing [40].

However, when it comes to the SME segment private equity investors are usually less interested. The reason is that investment requires about the same time and effort to produce an analysis and put the structure together, while the potential upside (due to small amount to be invested) is usually limited in absolute terms. Therefore, venture capital appears as much more appropriate mechanism to support the development of SME segment, when they need long-term financing. The key obstacle in the early stage of development of venture capital in Serbia (apart from lack of appropriate legislation and practice) is the nature of the owners of small business who find it quite difficult to surrender part of their ownership to somebody they usually do not know well, so building trust among parties is of extreme importance here.

As noted above, the Innovation Fund has been an important source of capital for innovative companies, creating an important basis for future growth, which could be aided by the venture capital fund growing out of the regional initiative supported by key European financial institutions in the framework of Western Balkan Enterprise Development and Innovation Facility (WB EDIF), comprising a set of complementary measures for improving access to finance for SMEs and assisting economic development in the Western Balkans. The programme has been launched in December 2012 in collaboration with the European

Investment Fund, the European Commission and the European Bank for Reconstruction and Development – and the Western Balkan region. The WB EDIF aims to promote the emergence and growth of innovative and high-potential companies, as well as the creation of a regional venture capital markets. The intention is that €145 million of initial capital pulled together under WB EDIF would translate into over €300 million of finance benefitting SMEs based in the Western Balkan countries.

WB EDIF, which is coordinated by the European Investment Fund (EIF), consists of four pillars:

(1) WB EDIF Guarantee Facility provides guarantees to local financial intermediaries to encourage them to build up new portfolios of SMEs loans and thereby improving access to finance. It is managed by EIF and there are negotiations under way to select the intermediary in Serbia based on an issued call for proposals.

(2) Enterprise Innovation Fund (ENIF) supports innovative SMEs in the Western Balkans in their early and expansion stage by providing equity finance through local funds management companies. Private Manager for ENIF will soon be selected and fund registered, becoming operational in 2014.

(3) Enterprise Expansion Fund (ENEF) supports the expansion of SMEs with a high-growth potential established in the Western Balkans. This fund is in the process of registration and will be managed by the EBRD, becoming operational in early 2014.

(4) Technical Assistance Facility will enable Governments of the Western Balkan countries to obtain technical assistance under WB EDIF to implement policy reforms in order to create a favourable regulatory environment to benefit innovative and high-growth SMEs in the region [45].

Conclusion: Expected venture capital developments in Serbia

Private equity investment is at an early stage of development in Serbia but demonstrating positive results, confirming data presented in the introductory literature overview based on data analysis from other, especially transition economies. Serbia stands to benefit both from entrepreneurial private ventures, as well as important regional initiatives supported by the European Union such as the Western Balkan Enterprise Development and Innovation Facility (WB EDIF), whose innovation and expansion investment funds are expected to start operations in 2014. In addition to WB EDIF, Serbian companies can benefit from the new EU Programme for the Competitiveness of Enterprises and SMEs (COSME), the first ever Commission programme that is exclusively dedicated to supporting SMEs and that will have an equity facility, which will also stimulate the supply of venture capital, with a particular focus on the expansion and growth phase of SMEs. In addition, equity financing, an especially important option for high-growth young enterprises, will be stimulated. Education of local financial institutions and SMEs in Serbia about how these programmes function and how proposals should be prepared will be a vital factor ensuring greater success of applications to advertised calls for proposals. As an important building block in this process, EU-funded Integrated Innovation Support Programme, operating between October 2011 and December 2013, delivered innovation promotion and investor-readiness trainings to 462 companies across Serbia. Such trainings should be continued, as well as business forums such as the Belgrade Venture Forum.

At the same time, a pipeline of possible investment projects should be constructed, with the active involvement of relevant business associations such as SPEA and the Government. The Best Technological Innovation Award and the Innovation Fund company beneficiaries may be a significant part of that pipeline. Improved management of business incubators across Serbia could further strengthen the potential project pipeline. In conjunction, the legal framework should be upgraded, both by enacting the amendments to the Law on AOFI and the Law on venture capital funds as discussed above, and by regulatory reform to improve the business climate. Indeed, according to a recent World Bank report, *Back to Work; Growing with Jobs in Europe and Central Asia* [3, pp. 188-190], improving the business environment could yield potentially large payoffs in private sector development, both in easing the entry of new firms and in facilitating the exit of inefficient firms. The report also confirms that access to finance is one of the strongest determinants of successful start-ups.

People who succeeded in borrowing money are 60 percent more likely to be actual entrepreneurs, while firms with access to credit to finance their investment activities also tended to grow faster.

The EU's Small Business Act (SBA), adopted in June 2008 and updated in February 2011, focuses on actions most likely to aid SMEs cope with the economic crisis. The SBA has brought SMEs into the centre of the political agenda. EU Member States have taken a significant number of policy actions in favour of SMEs (in total some 2400 measures in the past three years). Furthermore, the Entrepreneurship Action Plan, adopted in January 2013, sets a comprehensive and ambitious agenda in order to reignite the entrepreneurial spirit in Europe. It consist of three pillars, (1) the insertion of entrepreneurial education and training in all levels of the educational systems, (2) the further improvement of the business environment and (3) the promotion of entrepreneurship among specific groups, such as women, seniors, migrants, the unemployed and young people. Serbia, as an EU candidate, also strives to comply with the Small Business Act and has used this framework, as well as EU 2020 and Regional Western Balkans 2020 Strategy, to draft the new Strategy for Entrepreneurship and Competitiveness, 2014-2020, which is currently in public discussions and awaiting adoption by the Government. A crucial part of the draft strategy and accompanying action plan relates to access to finance and these regulatory measures, if successfully implemented, would be conducive to venture capital development.

As the European Commission has concluded, "To provide greater, sustained access to finance, it is necessary to reduce market barriers that prevent the flow of private capital to SMEs. Obviously, in the current economic environment, increased risk aversion and deteriorating business fundamentals negatively affect access to finance for all businesses. But only within the context of market-based solutions can enough finance be mobilized to serve the growth needs of economically productive SMEs." As a struggling transition economy, Serbia needs to focus its efforts on enhancing the business environment while educating companies – and potential entrepreneurs about entrepreneurship, innovation and the role of venture capital in facilitating growth.

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