VENTURE CAPITAL AS A SOURCE OF FINANCE FOR ENTERPRISES

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Abstract. Among the sources of finance, private venture capital investment is an important element creating a venture capital industry in the process of its development. While examining and assessing the possibilities for attracting venture capital, the authors focused on examining the affecting factors.

The research aim was to examine the trends and problems in and opportunities for the venture capital industry in Latvia. Based on the aim, the following tasks were set: to ascertain the increase in Latvia's competiveness among the Baltic States in the context of the Global Competitiveness Index and to analyse the attraction of venture capital investments; and to analyse the factors affecting the venture capital industry based on the findings of an expert survey.

The authors of the paper examined the environment and factors influencing innovation, which can affect private venture capital investment in this segment. The following qualitative and quantitative methods of economic analysis were employed: the monographic, logical and constructive methods, the SWOT analysis, a survey of experts, analysis and synthesis.

Key words: innovation, Latvia, venture capital investments, competitiveness.

JEL code: G24, G28, G32

Introduction

Sources of finance for innovation can form several patterns, depending on the national innovation policy, its priorities, and the extent of national support. One of the sources of finance for innovation is private venture capital. The aim of the present research was to examine the trends and problems in and opportunities for the venture capital industry in Latvia. Based on the aim, the following tasks were set: to ascertain the increase in Latvia's competiveness among the Baltic States in the context of the Global Competitiveness Index and to analyse the attraction of venture capital investments as well as to analyse the factors affecting the venture capital industry based on the findings of an expert survey.

Data sources and research methods: the following qualitative and quantitative methods of economic analysis were employed: the monographic, logical and constructive methods, the SWOT analysis, a survey of experts, analysis and synthesis. The research analysed data of the Global Competitiveness Report, opinions of the members of the Latvian Association of Private Investors as well as published opinions and forecasts of several experts on venture capital investments.

Research results and discussion

Based on the Global Competitiveness Report 2013−2014, Latvia is ranked the 52nd (a rise by 12 places in two years). Latvia is still behind Estonia that holds the 32nd place and Lithuania ranking in the 48th place (a fall by 4 places in two years) (Figure 1). Switzerland (1st place), Singapore (2nd), and Finland

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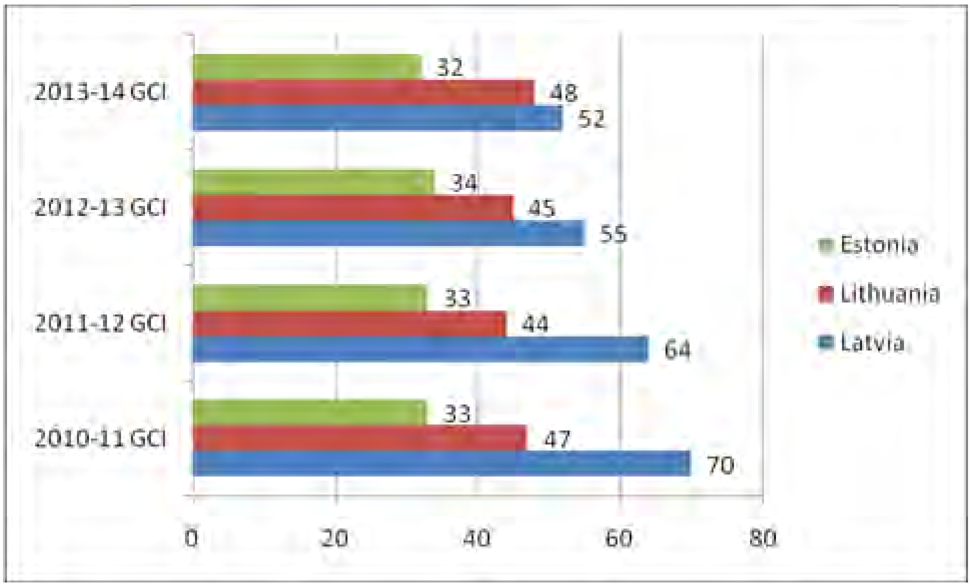
(3rd) retain their leader positions. Estonia remains the best performer within the Eastern Europe, up two places this year to the 32nd. The country has an excellent education system and highly efficient and well-developed goods and financial markets as well as a strong commitment to advancing technological readiness. In addition, Estonia's 22nd rank in macroeconomic stability reflects its relatively well managed public finances. The country's margin ahead of the rest of the region also reflects its more flexible and efficient labour markets (the 12th), which continue to be rigid in other countries throughout much of Europe as a whole (the Global Competitiveness Report 2013–2014).



Source: authors' construction based on the Global Competitiveness Report 2012–2013 and Global Competitiveness Report 2013–2014

Fig.1. **Latvia's rank in the Global Competitiveness Index among the Baltic States**

In the ranking, the place of Latvia's macroeconomic environment showed the greatest rise, climbing to the 29th place compared with the 93rd place in 2011. The efficiency of Latvia's goods market is ranked the 40th. The market size has the lowest score, ranking Latvia in the 95th place in the world.

As regards innovation capacity, Latvia is ranked the 68th, Estonia – the 35th and Lithuania – the 44th (the Global Competitiveness Report 2013–2014).

Venture capital is intended for innovative projects in industrial sectors. The key purpose of investments made by venture capital funds is to foster faster growth and development of an enterprise as well as to make profit. Therefore, enterprises with fast growth potential or projects which, if implemented, may generate considerable profit relative to the capital invested in the project are chosen as objects of venture investment (Venture Capital Funds, 2013). The involvement of a venture capital fund is especially useful in situations when: an enterprise has to be modernised or increase its output capacity; there is a new business idea and own resources are insufficient to implement this idea; a business partner is needed, which would help make a management team by attracting new customers, to tackle accounting and legal problems and to assist in acquiring the EU Structural Funds (Tamuzs, 2011).

An investor's motivations are determined by various opportunities for rewards: shares, ownership, a job position in the board etc.

Venture capital investments may be attracted at any stage of development of an enterprise. For instance, if a unique business idea is generated and sufficient financial resources are lacked to implement it, and even there is no collateral for a loan, one can attract venture capital. One can make one step further, for instance, in cases if the ratio of equity to liabilities prevents a stable enterprise from getting an additional loan, a venture capital investment might be a good solution (Da Rin M. et al., 2011).

For various enterprises, the basic principles of venture capital mainly differ in investment size, source of finance, and investor engagement in the enterprise's management. The earlier is the stage of development of an enterprise, the smaller any individual investment is required and, accordingly, the greater is engagement of the venture capital partner in the enterprise's management (Groh A. et al., 2011.).

The amount of venture capital investments, as a percentage of GDP, has continued increasing in Europe since 2009: it comprised 0.20% in 2009, 0.33% in 2010, 0.34% in 2011, while in 2012 it accounted for 0.26% of GDP (European Private Equity & Venture Capital Association, 2013:43).

The Latvian Venture Capital Association unites 28 members that may be classified as follows: investment enterprises, institutional investors, legal consultants, and financial consultants.

Presently five investment funds may be regarded as active:

- Imprimatur Capital Seed Fund (in total, EUR 3 mln); JEREMIE Programme Fund, 100% funded by the Latvian Guarantee Agency;
- Imprimatur Capital Technology Venture Fund (in total, EUR 7 mln); JEREMIE Programme Fund, 67% funded by the Latvian Guarantee Agency;
- BaltCap Latvian Venture Capital Fund (EUR 30 mln); JEREMIE Programme Fund, 67% funded by the Latvian Guarantee Agency;
- Private Capital Fund managed by BaltCap (EUR 63 mln), a fund created by BaltCap for business development and for redemption of current shareholders;
- AB.LV Private Capital Fund (EUR 15 mln), a fund created by AB.LV Bank for business development and for redemption of current shareholders;
- several funds manage investment portfolios, planning to sell the assets until 2013: Second Eco Fund, Invento, Green Light Investments.

In the period of 2002-2012, the Latvian Venture Capital Association's most active members made investments worth EUR 51 million in 30 enterprises. Of the 30 enterprises, eight were newly established enterprises, 18 attracted investments for expansion, while in four cases investments were attracted for redemption deals. In the result of investments, the turnover of the enterprises rose almost by three times from EUR 127 million to EUR 377 million. Consequently, the enterprises were able to create 1741 new jobs (an increase from 2593 to 4334) (Dreimanis D., 2012).

The authors of the paper examined the environment and factors influencing innovation, which can affect private venture capital investment in this segment.

It is important to mention the quantitative and qualitative indicators that characterise the development of private venture capital, for instance, the number of private venture capital funds, the number of PVC companies and the number of business angels which have a certain activity strategy in Latvia's market; active operation of intermediaries and support to them provided by national institutions as well as availability of information on their activity and specialisation, possibilities for implementing projects; availability of start-up managers and professionals in the field of private venture capital investments; a developed business culture and the introduction of "good practices" in entrepreneurship, which would make potential investors confident to invest in enterprises without acquiring the control package of their shares; lack of information and practice regarding the opportunities for attracting services of managers and lawyers for new growing enterprises (the services are free of charge for a certain period, yet, the enterprise's shares are granted to them), for successful structuring of projects and for attracting investors; the overall investment climate in the country, Europe and the world; openness of the economy and internationalisation of innovations, which allows attracting start-up investors from other countries; insufficient activity of the associations uniting private venture capital market participants; the small number of projects appropriate for private venture capital investments; and insufficient knowledge of professionals of new growing enterprises on the operational principles of private venture capital and the process of financing (Jakusonoka, Prohorovs, 2012).

Given the recent global financial crisis, which was very severe in Latvia, Latvia's macroeconomic situation is presently relatively stable. Its gross domestic product steadily grows, exports increase and inflation is low – which are the indicators of a healthy economy. Latvia is mentioned as a success story for overcoming a financial crisis.

On 20 May 2012, the introduction of a new national venture capital support programme – growth capital funds – was approved to continue providing the availability of venture capital for entrepreneurship start-up and development to Latvia's small and medium enterprises as well as to contribute to the competitiveness and growth of entrepreneurs. Growth capital funds allow getting venture capital in situations when the equity of the enterprise is not sufficient and the risk of the enterprise's investment is too high to get a loan from a credit institution in the necessary amount.

The development of venture capital investment legislation would be an opportunity for popularising and making "clear" the venture capital industry in Latvia. In the public arena, information about a fraudulent use of the resources intended for venture capital investments to support the enterprises being closely associated with one's own business has been regularly announced. The development of specific legislation would be able to eliminate such discussions and instances.

On 2 August 2012, the Latvian Guarantee Agency (LGA), in cooperation with the Ministry of Economics, within the national support programme, announced a tender for selecting management teams for new venture capital funds to facilitate the access of innovative micro-, small and medium enterprises to capital and to foster the emergence of new venture capital funds in Latvia. On a competitive basis, several teams were selected, which would manage the newly established venture capital funds and make investments in Latvia's enterprises.

The new funds will make investments in micro-, small and medium enterprises with high growth potential, the place of economic activity of which is Latvia. Investments of up to one million euro in a single enterprise will be made to finance the enterprise's product or to explore, evaluate, and develop the initial concept of a business idea; to develop products and conduct initial marketing; and to expand the enterprise's activities by increasing its production capacity, penetrating into markets and developing its products (LGA Announced a Tender…, 2012).

The number of scientists and engineers is relatively small in Latvia. This is a well-known problem, yet, the situation cannot be changed in one or two years. The challenges of Latvia's higher education are to

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increase the international role of its higher education as well as a greater focus has to be placed on science education programmes.

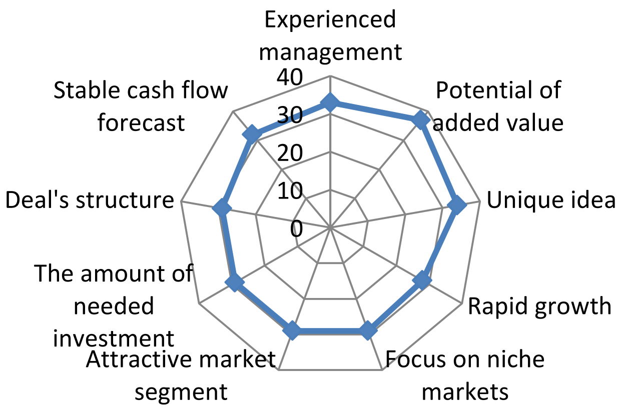
Venture capital as an industry is historically poorly developed in Latvia, which is evidenced by the amount of venture capital investment – EUR 51 million – in Latvia in the period of 2002-2012. It is a relatively low amount compared with the countries where the venture capital industry is more developed.

Among the Baltic States, Latvia is unique, as more than 80% of its economic activity is concentrated in one city – the capital city of Riga. Such a situation may not be regarded as successful, as large regional differences emerge. If the situation does not change, the smallest regional towns will become underpopulated and, thus, economic activity in these towns will be critically low.

The situation in the venture capital industry may be best explained by the people who are daily engaged in it, who deal with it. To identify the opinions of these individuals, the authors conducted a survey of professionals dealing with venture capital investors, of financial experts, experts in education, entrepreneurs and business incubator specialists. In total, 20 experts were questioned. The survey was anonymous.

Next, the findings of the survey are set out and presented graphically.

Question: **In your opinion, what are the necessary qualities/factors of the company to attract venture capital investors?**

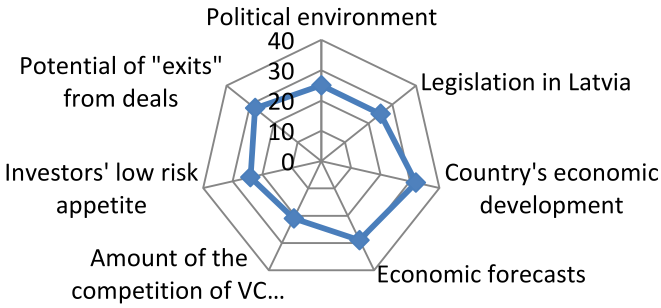


Source: authors' construction based on data of the survey of experts, 2012

Fig.2. **Expert opinions on the factors needed for attracting venture capital investors to Latvia**

As regards the necessary qualities/factors of the company to attract venture capital investors, according to the experts, all the reply options were considered to be essential. However, the experts referred to "potential of value added" as the most essential. Based on venture capital theory, venture capital investment transactions – investments in an enterprise with high potential of value added, which would be able to generate high returns on investment within a relatively short period – are best characterised by this reply.

Question: **What are the obstacles for venture capital development in Latvia?**

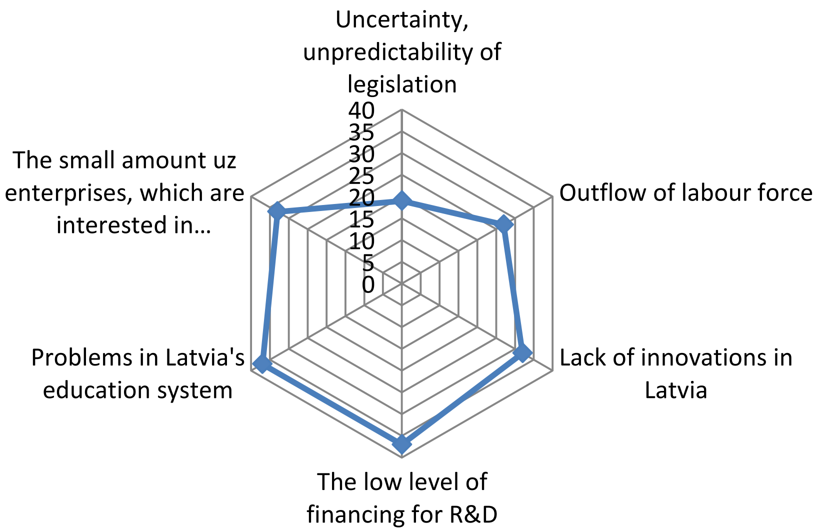


Source: authors' construction based on data of the survey of experts, 2012

Fig.3. **Expert opinions on the factors and conditions hindering the development of venture capital in Latvia**

According to the experts, the country's economic development was the main one from among the factors and conditions hindering the development of the venture capital industry in Latvia. Economic forecasts and the potential of "exits" from deals were also considered essential conditions. The authors believe that these conditions are adequate to the current situation in Latvia. The legislation in Latvia and the competition of venture capital investors were mentioned as the least hindering factors of the development of the venture capital industry. The authors think that the legislation considerably affects the entry of foreign investors, including venture capital investors, into Latvia.

Question: **What are the main obstacles for the foundation and development of new, innovative companies?**



Source: authors' construction based on data of the survey of experts, 2012

Fig.4. **Expert opinions on the factors hindering the emergence of new, innovative enterprises**

The authors believe that within the context of venture capital investment, it is important to focus on the emergence and development of new, innovative enterprises. The experts recognised problems in Latvia's education system and the low level of financing for research and development (R&D) as the two most essential factors. The authors believe that this is a very reasonable rating. The funding allocated for research and development compared with other countries, is low. Besides, calls for reforming Latvia's higher education system and, especially, the vocational education system have been often made in Latvia's public arena. The lack in innovations in Latvia, the small number of enterprises that introduce innovative solutions and the outflow of labour force were recognised as relatively insignificant factors. The uncertainty, unpredictability of Latvia's legislation, according to the experts, was the least significant factor. As mentioned before, this factor mainly relates with investments made by foreign investors in Latvia.

The experts' free comments on the processes necessary for developing the venture capital industry reveal the real situation and confirm the above-mentioned problems and drawbacks.

Analysing the respondents' replies, the authors identified an interesting fact that indicates a "gap" between entrepreneurs and venture capital investors. An entrepreneur who is engaged in import/export transactions noted in his replies that the trust of venture capital investors in entrepreneurs is important. On the contrary, some entrepreneurs who work in the banking industry admitted that venture capital investors have to be trusted to a greater extent.

Several respondents admitted that a significant increase in confidence in the economic environment and trust in its participants is needed. Entrepreneurs with a long-term vision, instead of "one day businessmen", are necessary, who can create internationally competitive and profitable projects.

Significantly greater activities of investment bankers, competences and abilities to attract investors for the projects initiated by domestic entrepreneurs are also needed. In parallel with raising the competences of investment bankers, according to the respondents, it is necessary to educate entrepreneurs on the availability of venture capital because entrepreneurs lack education and an understanding of how to cooperate with venture capital investors, thereby, benefiting one's own enterprise.

In Latvia, technology-based investments are small and fragmented, which prevents venture capitalists from making investments. It is complicated to ensure that venture capitalists have adequate competences for evaluating such investments. This situation might be alleviated and solved by concentrating research directions and setting priorities in the national education system. It would ease the comprehension by and work for venture capital investors.

Given the above-mentioned, the result would be easier to achieve if entrepreneurs, investors and national institutions cooperated. In Latvia as a post-socialism country and in its society, many areas are underdeveloped and are some kind of "deformed" ones. It is a poor situation that many opportunities are missed because of insufficient interest and incompetence. Positive results would be easier to achieve by taking over the experience of more developed countries, cooperating, uniting all the interested parties, and initiating active discussions.

Conclusions, proposals, recommendations

1. In the period of 2002-2012, the members of the Latvian Venture Capital Association made investments worth EUR 51 million in 30 enterprises. In the result of investments, the turnover of the enterprises rose from EUR 127 million to EUR 377 million, and additionally 1741 new jobs were

created. Presently, five venture capital funds are regarded as active in Latvia. These funds manage assets worth approximately LVL 82.93 million.

2. The strengths of the venture capital industry, compared with other European countries, are the stable macroeconomic situation as well as the functioning of the JEREMIE programme in Latvia.
3. There are many factors that hinder the development of the venture capital industry in Latvia – the size of the economy and market, its historical background, an imperfect tax system, bureaucracy etc. At the same time, there are many opportunities to be implemented – research and innovative development, development of competences, improvement of the legislation, availability of LGA assistance, education reforms etc.
4. The development of the venture capital industry depends on demand and supply – the demand creates the supply and vice versa. Additional support is necessary for the foundation of small and medium enterprises that specialise in developing innovative goods or services with high value added. More funding is needed for science and research. Supporting this industry would result in greater interest in sciences and in developing innovative solutions and goods or services with high value added. By attracting venture capital investments, such projects would lead to establishing successful enterprises.
5. Venture capital investors are reluctant to invest in enterprises at their early or start-up stage of development, which, in many cases, might be crucial in the enterprise's development. In such cases, greater activity and higher risk "appetite" from investors is desirable as well as government support is needed.

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