

# VENTURE CAPITAL *in* LATVIA

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in collaboration with

**Alf Vanags**

TeliaSonera Institute Discussion Paper No 1

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## Foreword

This is the first discussion paper of the TeliaSonera Institute which is located at the Stockholm School of Economics in Riga. The Institute, generously supported by TeliaSonera, aims to promote applied economic research in areas such as entrepreneurship, regulation, and many other aspects of market economics. This discussion paper, on Venture Capital in Latvia, was prepared by Vitas Dijokas (in collaboration with Alf Vanags) for a half-day workshop on venture capital held at SSE Riga in May 2004 and organized together with BICEPS and TeliaSonera. Themes for future discussion papers include: entrepreneurship in Latvia from a comparative perspective, and the new EU telecommunications regulatory framework in the Baltic context.

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## 1. Introduction

As a member of the EU, Latvia is committed to the Lisbon Strategy, which aims to make the EU the 'most competitive and dynamic knowledge based economy in the world'<sup>1</sup>. A critical factor for the success of this strategy is the way in which capital is mobilised to support entrepreneurship and innovation. This is true for the EU as a whole and also for Latvia in particular. In Latvia the overwhelming majority of enterprises are private companies who meet their capital needs either internally or in the form of bank loans. However, for fast growing or innovative companies these sources of finance may be inadequate. In such cases a special type of financing is often appropriate, namely venture capital (VC). Venture capital is a small but emerging sector of the Latvian capital market and the aim of this survey paper is to describe and evaluate the current situation of the venture capital market in Latvia.

### 1.1 Issues Addressed

In order to achieve the objective the following issues will be addressed:

- a) To characterize the venture capital market (or in a broader sense the private equity (PE) market), in Latvia, by identifying the suppliers of VC or PE, and also examining what the demand side of the market looks like.
- b) To attempt to estimate the size of the market: how much capital is available to invest as venture capital in Latvia, and how much capital is potentially required by enterprises and projects.
- c) To identify other stakeholders that are important for market development and to analyse their role in the development process.
- d) To address the particular question of whether and how the coming "inflow" of EU structural funds into the Latvian economy will influence the VC (PE) market in Latvia.

### 1.2 Starting Point: Existing Research, Methodology, and Limitations

During the initial stage of the research it became clear that no officially collected and publicly available statistics (or any other quantitative data) on the Latvian venture capital and private equity industry are available. This limits the scope to undertake analysis of important aspects of the market based on solid and verified numbers. Accordingly, this paper is based on two unofficial sources of information:

#### 1) *Existing research in this area.*

The only recent research study on the Latvian PE (VC) market is Maximova and Jafarov (2003). This is their Master thesis "Private Equity Investments in Latvia" submitted to the Gotland University Baltic Sea Management Academy. The authors conclude that the Latvian market is at an emerging stage and outline the factors limiting the development of PE (VC) activities in Latvia. They also compile a list of 35 private equity funds, whose investment focus includes the Baltic States. Another source is Kaasik and Kodres (2000) "The viability of venture capital based financing in Estonia", which provided a framework for the present paper. The aims of Kaasik and Kodres were similar ("exploration" of the market). Moreover, the situation in the Estonian market is, in general, very similar; therefore, the results of the Estonian survey served as a good basis for analysis of the industry in Latvia.

#### 2) *Interviews with market participants.*

Interviews were undertaken with the managers of PE (VC) funds, entrepreneurs, representatives of the banking sector, government officials, and other experts, who shared their knowledge and opinions about development of the PE (VC) market in Latvia. They also provided information about their own activities in this market. This data and their opinions serve as the basis for much of the analysis in this paper. A list of interviewees is provided in Appendix 1.

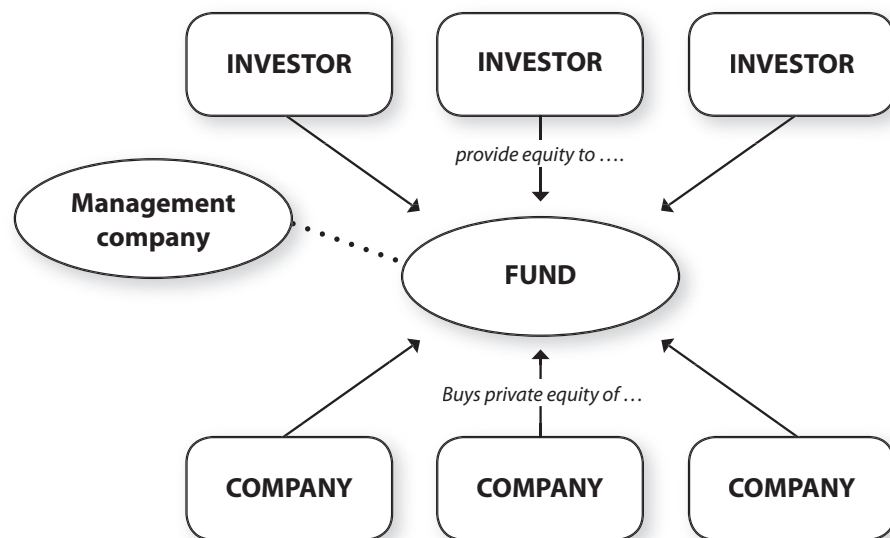
Despite the lack of official statistical data, this paper attempts to create a snapshot of the current market situation, drawing attention to its most important aspects. The aim of the research is to attract the attention of stakeholders in the market, facilitate their discussions about market development, as well as, possibly, create a basis for further in-depth quantitative and qualitative research of particular aspects of the VC (PE) market in Latvia.

<sup>1</sup> The Lisbon Strategy, see The EU on-line portal < [http://europa.eu.int/comm/lisbon\\_strategy/index\\_en.html](http://europa.eu.int/comm/lisbon_strategy/index_en.html) >

## 2. Venture Capital and Private Equity: Some Definitions

As a starting point it is important to understand what is meant by the notions ‘Venture Capital’ and the broader concept of ‘Private Equity’.

**Private Equity.** The simplest definition of private equity capital is: resources invested in the equity of unlisted companies. See Figure 1 for the typical route of capital from various investors into the equity of companies. The capital provided by investors is usually gathered into private equity funds, which are managed by a professional management company. One management company may run several funds simultaneously, thus minimizing the management cost of each fund.



**Figure 1: Many investors reaching many firms: private equity investments through funds.**

Source: Lawrence W. Carter (1996)

The primary aim of investors and the task for managers is to earn high capital gains from such an investment. This means that the equity bought must be sold for a higher price in the process of disinvestment. This could occur after a company changes status from unlisted to listed, or in the case of a trade sale to a strategic investor. Investment in an unlisted company is associated with higher risk, as compared to other types of financing (loans, listed shares), since the private equity investor effectively “freezes” the capital in the company and cannot withdraw funds (as a creditor) or transfer it to another investor through simple sale of shares on a stock exchange (as with listed shares).

An important difference between private equity investment and investment in equity of listed companies (by buying securities on a stock exchange) is that fund managers take an active part in the general management of investee-companies: for example, they may sit on the company board; provide finance, marketing, technology, and strategic advice; advise on composition of and carry out recruitment of management (or key employees) team of the company. Therefore, from the point of view of investee-companies, the value-added of private equity investment is much higher than other types of financing e.g., initial public offerings (IPOs), commercial loans, bonds: they receive business and management expertise as well as additional capital.

**Venture Capital** is a subset of private equity capital with several special features. There is no single definition of venture capital, but Bartlett (1999) suggests using General Doriot’s rules of investing with the idea that an investment process following these rules is, by definition, a venture-capital process. General Doriot and others organised American Research & Development in 1946, the first public corporation specialising in investing in illiquid securities of early stage issuers. It is generally agreed that the modern venture capital era began with the formation of AR&D, which was for many years an exemplary venture-capitalist for the industry. Therefore, the rules of investment applied by (AR&D) can be considered as defining a venture-capital investment.

Investment considered by AR&D involved:

- 1) new technology, new marketing concepts, and new product application possibilities;
- 2) a significant, although not necessarily controlling, participation by the investors in the company’s management;
- 3) investment in ventures staffed by people of outstanding competence and integrity (the rule often referred to in venture capital as “bet the jockey, not the horse”);
- 4) products or processes that have passed through at least an early prototype stage and are adequately protected by patents, copyrights, or trade-secret agreements (the latter rule is often referred to as investing in situations where information is “proprietary”);
- 5) a situation that shows promise of maturing within a few years to the point of an IPO or sale of the entire company (commonly referred to as the “exit strategy”);
- 6) opportunities where a venture capitalist can make a contribution beyond the capital dollars invested (often referred to as the “value-added strategy”).

An important feature of VC, not explicitly mentioned in the AR&D definition, is the “high growth” potential of an investee-company. Both academicians and practitioners use the “high growth” potential in most definitions of venture capital: the high risk must be matched by high return. While venture capitalists usually make investments into companies or projects, whose high return has not yet been proved, it is important for investors to see, and for the investee-company to show, the potential for high growth of the value of the company.

The major difference between venture capital and general private equity is that in the first case there is a willingness to invest into early stage companies active in new technology sectors, with high innovation potential such as bio-medical and bio-technology, IT&T, electronics, chemistry. The size of VC funds as well as their investments into the equity of companies is usually smaller (Carter (1996)) than those of PE funds.

Gompers and Lerner (1999) claim that, besides its quite short history<sup>2</sup> the US “...venture capital industry today is a well established ... industry.”<sup>3</sup> Other countries, especially those in Western Europe and South East Asia have also seen their PE (VC) industries grow and mature. The PE (VC) closes a gap in the funding market by providing financing to companies that cannot otherwise obtain funds from “traditional” sources, such as bank loans or other debt instruments.

Venture capital or private equity is especially needed:

- if there is uncertainty about the company’s idea, product, research: there is no market for it, competition is unknown; and there is no clear strategy as to how to make it a success;
- if there is a problem of asymmetric information: i.e., where the potential investee-company has access to information not generally available. By gaining access to the board of the company the venture capitalist also acquires the privileged information;
- if the company or the entrepreneur has no substantial tangible assets that can be used as collateral. Most of the assets are as yet intangible at the stage when large funds are needed to turn them into a working business (e.g., an idea, a description of new process or product, a patent, unique information about a niche on the market with high growth potential).

**Investment process.** The description of a typical venture capital process may be found in Carter (1996). An amended version supplemented by the author appears in Box 1.

#### Box 1: The Private Equity (Venture Capital) Process: Entering, Managing and Exiting Investments

**PE (VC) process.** A typical venture capital investment process (or Private Equity process in general) involves three major stages: Entering, Managing and Exiting Investments:

- 1) **Screening and entry:** VC fund managers screen investment proposals by assessing a) expected return and when it might be realised; b) investment size (too many small investments are expensive to manage); c) technology and market sector; and d) stage of development. Firms may need outside venture capital at two main stages of their development:
  - “early stage”: seed stage (financing provided to research, assess and develop an initial concept before a business has reached the start-up phase), start-up stage (financing for product development and initial marketing; companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially, and will not yet be generating a profit), and other early stage financing to initiate commercial manufacture;
  - “expansion stage”: this stage financing provides capital for a company which is producing but may not be making a profit; later stage financing may be used for production capacity and/or market expansion, product development; and bridge/mezzanine financing for companies that expect to go public within a year, or raise term-debt;
  - “replacement, the next stage, is usually financed by private equity rather than by venture capital. Replacement consists of financing of purchase of shares from another investor or reduction of leverage via the refinancing of debt. Purchase of shares may be made by management (management buy-out or buy-in), institutional buy-out,

If a prospective deal passes initial screening, more detailed due diligence takes place. PE (VC) funds typically give the investee firms’ management quality and commitment the highest weight in evaluation. If it passes this evaluation, the deal will be structured, priced, and negotiated.

- 2) **Value enhancement and operations.** PE (VC) funds provide funding and management guidance to their investee companies. As mentioned above, this is often through board participation and direct assistance with financial planning and marketing. Fund managers usually have contacts with other financial institutions, and so can help firms raise additional capital. They may also have contacts with other industrial companies, which can provide technical advice or even act as joint-venture partners. The need for close monitoring means that a) PE (VC) firms tend to be physically near to their clients; and b) each PE (VC) manager typically looks after less than 10 investee firms.

- 3) **Divestment (exit).** Given the illiquidity (the equity is not traded on the securities market) of PE (VC) investments, equity exit strategies are essential:
  - IPO, where shares are sold to the public. This is usually the most profitable and sought-after exit route;
  - acquisition of the investee firm by another company. This has been a common exit mechanism in the developed market;
  - repurchase of the fund’s shares by the investee firm or founder;
  - secondary purchase of the fund’s shares by a third party;
  - write-off: the least desired, but in practice nevertheless most relevant mode of exit is to write-off the investment (in case of company failure).

The length of the investment process in one company (from investment to exit) is on average 3 to 6 years, depending on (e.g.) the stage of company development, funding policy, conditions at exit. Typically, PE (VC) funds have a ten-year life, which may often be extended for several years.

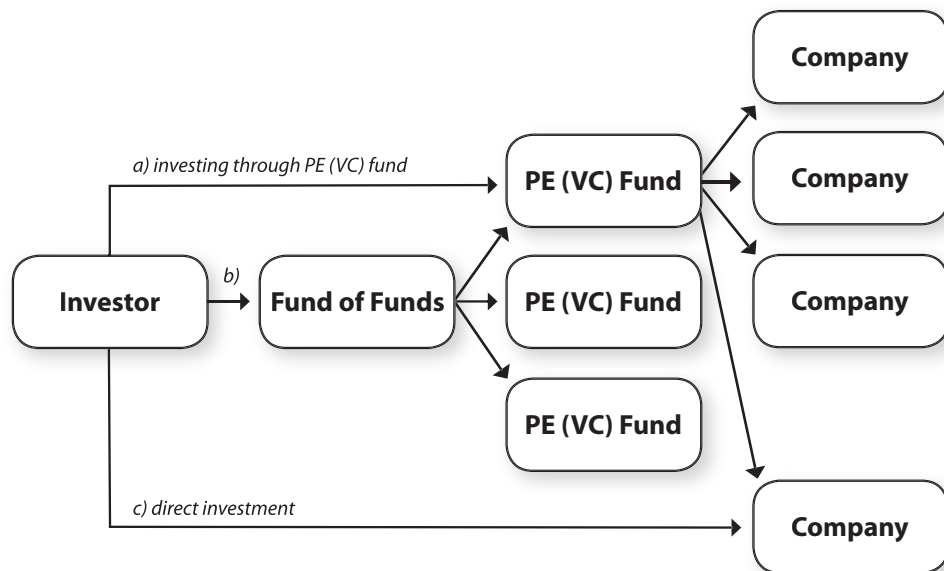
Source: Carter, (1996).

<sup>2</sup> Examples of investments that can be regarded as venture capital date back to ancient times. As Gompers and Lerner (1999) state: “Venture capitalists’ role is an old one. Entrepreneurs have long had ideas that require substantial capital to implement but lacked the funds to finance these projects themselves... Solutions to their problems date back at least as far as Babylonian partnerships at the time of Hammurabi.”

<sup>3</sup> Gompers and Lerner, 1999, page 5.

## Participants in the PE (VC) market

Figure 2 shows the principal channels by which PE(VC) investments reach investee-companies. The investor may choose to invest in company equity either (a) through a PE (VC) fund, (b) through a fund of funds, which itself invests in various PE (VC) funds, or (c) directly, by becoming a shareholder in the investee-company.



**Figure 2: Different investment processes in the PE market**

Sources: European Venture Capital Association; Maximova and Jafarov (2003).

**Investment in funds** (a and b in Figure 2). Venture capital funds, or more generally private equity funds and funds of funds, receive their capital for investment from various sources. There are two sources of investors: private and institutional investors, where institutional investors include commercial banks, pension funds, insurance companies, corporations, government agencies, funds of funds, university endowment funds. Another source of finance is capital gains realised from previous investments made by PE (VC) funds. Banks and pension funds are the major sources of PE (VC) finance in Europe, followed by insurance companies and corporate investors. In the United States the largest investors are pension funds.

Direct (c) individual<sup>4</sup> investors who provide both finance and business expertise to an investee company are called business angels. They are high net worth, usually self-made individuals with entrepreneurial experience. Angels are considered to complement the venture capital industry as they tend to invest smaller sums in projects at their seed, start-up and early stages, which have

relatively little interest for PE (VC) funds because of their high risk and relatively high transaction and management costs (see Cowie (1999)). They may often precede VC funds' investments, which enter companies at a later stage.

As will be developed below, it seems that in Latvia only a tiny part of private equity investment has the features of venture capital, so it makes sense to discuss the private equity industry in general without explicitly looking at the venture capital sector.

Therefore, for the purpose of this paper, a PE (VC) investment in Latvia is defined by two main features:

- 1) it is investment in non-listed companies;
- 2) besides provision of capital, an investor participates in the business, by providing strategic, marketing, and financial competence to the company.

No specific limitation is introduced as to the stage of company development or industry focus.

<sup>4</sup> Direct investments can be also made by institutional investors.



### 3. The Private Equity and Venture Capital Industry in Latvia: Current Situation

In this section the general development of the Baltic PE (VC) industry is described in the context of developments in Central and Eastern Europe (CEE). A description of participants (stakeholders) of the industry in Latvia follows.

#### 3.1 General Development

The development of the private equity and venture capital market in Latvia (and in the Baltic countries in general) can be divided into 3 stages, according to Toby Moore, Head of EBRD representation in Riga<sup>5</sup>:

- 1) **By 1995 to 1997** the Latvian economy had been stabilised and the Baltic region emerged as a promising region with high economic growth potential in the eyes of international investors. The region began its catching up process with the developed industrial countries and Latvia, Lithuania and Estonia embarked on the goal of joining the EU and NATO. These developments signalled to foreign investors that the Baltic countries were on the right track. Therefore in this period the first PE funds were set up for the Baltic region. Mostly institutional foreign investors, including the EBRD, the US government, and US and Scandinavian institutional investors, established funds. The first fund focusing exclusively on PE (VC) investment in Latvian enterprises (SMEs) was the Norway Latvia Business Development Fund, established in 1995.
- 2) **From 1998 to 2001.** In 1998 the Russian crisis seriously hit many Latvian enterprises exporting to the Russian market, as they lost their competitiveness due to devaluation of the rouble. These enterprises could not re-orientate rapidly to other (western) markets, and as a result their output fell sharply. Since the share of companies oriented to eastern markets was relatively high, prospects for the Latvian economy looked gloomy. Foreign investment funds lost confidence in the transition countries after the Russian crisis, and pulled back from the CEE and CIS region. In addition, at that time, the IT and internet markets took off in the US and Western Europe, promising extraordinarily high returns on investments. This caused an even higher outflow of capital from markets in transition.
- 3) **After 2002.** In 2001 the IT and Internet capital market in the US collapsed, again causing international investors to search for high-growth and high-return potential markets. The CEE region and, in particular, the booming Baltic countries (GDP growth over 6-7%, stable inflation, orientation to EU markets) attracted their attention again. Since that time several new PE (VC) funds have been established. In the light of EU and NATO accession the economies of the Baltic countries look especially attractive, and several new funds with investment focus on the Baltic States, currently in the process of being established, are expected to become operational in the near future.

#### 3.2 Stakeholders in the Latvian PE (VC) Market

During the survey the following important stakeholders of PE (VC) market in Latvia have been identified:

Stakeholder	Role / impact on PE (VC) market in Latvia
PE and VC funds and fund management companies	suppliers of PE (VC) capital
European Bank of Reconstruction and Development (EBRD)	1) provider of capital for PE (VC) funds 2) direct equity investor 3) promoter of PE (VC) industry
Business angels (private high net worth individuals)	suppliers of PE (VC) capital
Commercial banks	1) substitute for PE (VC) funds (provide loans); 2) potential supplier of PE (VC) funds.
Intermediaries, such as business and financial consultants, investment banks	1) serve as a link between enterprises seeking financing and funds searching for possibilities to invest; 2) they may also serve as fund managers.
The state	1) Affects environment (macro, micro, legal) 2) Supplier of PE (VC) – state VC support programme 3) Substitute for PE (VC) through state guarantees, subsidies, loans
Target enterprises	demand for PE (VC) capital

Each will be now discussed in more detail.

#### 3.3 PE (VC) Funds

The major and easily recognisable players on the supply side of the PE (VC) market are organised PE (VC) funds and fund management companies. This survey has identified 12 organised PE (VC) funds active in Latvia at the moment. These funds are listed in Appendix 2, together with a summary of some of the important facts about their activities and investments. This list, however, is not an exhaustive list of all funds that have flagged their intention to make PE (VC) investments in Latvia. For example, Maximova and Jafarov (2003) identify 35 funds that claim to be dealing with private equity operations in Latvia (see Appendix 3 for list of funds). In practice many of these funds have not made any investment in Latvian companies so far and can be deemed only as potential suppliers of PE (VC). Accordingly, our main list is limited to those funds that either have made an investment in a Latvian company or are likely to do so in the foreseeable future. These would include funds with projects at the preparation stage, or with a physical presence in Latvia, which indicates that these funds are likely to be actively searching for opportunities to invest in Latvia.

**Ownership.** Most funds are owned or sponsored by foreign institutional investors. Most of these are entities from Scandinavian countries or the USA. Only one fund, EKO Investors, has been established and is owned entirely by Latvian private individuals. Another fund, LHV Ventures, was established by the Estonian investment bank Lõhmus Haavel & Viisemann (LHV). LHV is a partnership of its employees, all Estonian citizens.

**Geographical focus.** Most of the funds focus on investment in all three Baltic states, or define their investment region even more broadly, by including e.g. Russia and Poland, or all Central and Eastern European countries. Only two active funds focus entirely on Latvia: the Norway-Latvia Business Development Fund (NLBDF), and EKO Investors. Significantly, these two funds are relatively small,

<sup>5</sup> Personal communication, 2 April 2004.

if compared to funds with a broader geographical focus. New Century Holdings Advisors Latvia (NCH) has its entire focus on Latvia too, but its main concentration recently has been in the real estate sector only, which is not usually regarded as a PE (VC) activity. The state-owned Latvian Mortgage Bank and NLBDF have recently founded the SMEs Support Fund, another fund with a focus on Latvia, but it has not yet made any investments.

**Types of investment.** Most funds invest in company equity, and only rarely in equity-like instruments, such as convertible loans, or use a combination of debt and equity. One fund, Hanseatic Capital, specializes exclusively in mezzanine financing, usually issuing subordinated loans, but only rarely share options, convertible debt, and preferred shares. Most investments of Latvian PE (VC) funds are used to finance companies at their expansion stage, or to finance buy-outs (MBO/MBI, LBO). Most funds claim either that no investments are made in start-ups or, in practice, are reluctant to finance companies at that stage. LHV Ventures and EKO Investors are the only two funds that have made investments primarily in start-ups. LHV Ventures specializes in IT, e-commerce, and Internet start-ups, while EKO Investors made its investments in environmental projects (e.g., recycling, waste-management). It must be noted that due to the relatively high costs of running investments in start-ups, LHV Ventures plans to change its investment profile, to invest in companies at their expansion stage, with a new fund soon to be launched for this purpose.

**Size of investments.** Funds can be divided into two groups according to the size of the average investment into one company:

- 1) less than EUR 100,000
- 2) more than EUR 100,000.

The first group includes NLBDF, LHV Ventures, EKO Investors, and the proposed SME Support Fund. Average investments made by these funds are in the range: EUR 10,000 to EUR 200,000, and one may assume that these funds target SMEs in Latvia, which usually need rather small (under EUR 50,000) investments. The Baltic Small Equity Fund focuses on investments in SMEs, but looking at their minimum investment scale (USD 100,000) one may assume that medium-sized Latvian companies, rather than small and micro ones, are the primary focus for this fund. The Baltic SME Fund run by BaltCap has made one investment so far, the amount is not known, but the average size of investments made by this fund in Estonia and Latvia has been around EUR 400,000 (according to EBRD data<sup>6</sup>), which indicates that its target enterprises are medium-sized (under Latvian conditions), and not small and micro companies. The second group of funds have their investments in the range between EUR 300,000 and over EUR 1 million.

**Number of investments and industry focus.** Table 1 shows statistics of investments made by identified funds. The numbers in the cells indicate the number of companies that have received PE (VC) funds. The horizontal row indicates the sector to which a receiving company belongs, with the column indicating the year in which the fund made the investment. Some managers were reluctant to reveal information for reasons of confidentiality, so some investments may have been missed. However, the overall picture is clear and some conclusions may be inferred. Firstly, the majority (around 50%) of investments have been made in manufacturing companies, more than

<sup>6</sup> Personal communication, 2 April 2004.

half of which operate in the food processing sector (e.g., beverages, bakeries, milk-producers). Secondly, a very small fraction of funds has been invested in hi-tech industries. In fact just three IT and Internet companies received investments. Most investments have been made in traditional industries; therefore, one may conclude that strictly speaking the venture capital industry in Latvia remains almost non-existent<sup>7</sup>.

Industry	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 (I-III)	n/a	TOTAL
Mining & extraction											1	1
Ecology, waste management, recycling							1		2	3		6
Utilities (energy)	1						1	1			1	4
Construction		1										1
Manufacturing, incl.:	4	8	3	2	2	4	1	2	2	1	4	33
<i>Food</i>	3	5	2		1	3	1	1	2		1	19
<i>Electronics</i>								1			1	2
<i>Tools and machinery</i>		1			1						1	3
<i>Printing</i>						1						1
<i>Paints</i>		1										1
<i>Metal processing</i>		1		1								2
<i>Light manufacturing</i>	1		1							1		3
<i>Wood processing</i>				1	1							2
<i>Artificial fibres</i>											1	1
Wholesale			1					1				2
Retail, catering				1					1			2
Mobile applications						1						1
Information, media					1							1
Finance (banks, insurance, etc)									1	1	3	5
IT, Internet, e-commerce					1	2						3
Entertainment, sport				1								1
Management						1	1					2
Real estate development								1				1
Professional (PR, research)							2					2
Services		1										1
<b>TOTAL</b>	<b>5</b>	<b>10</b>	<b>4</b>	<b>4</b>	<b>4</b>	<b>8</b>	<b>6</b>	<b>5</b>	<b>6</b>	<b>5</b>	<b>9</b>	<b>66</b>

**Table 1: Distribution of investments by PE (VC) funds in Latvian companies by year of investments and industries.**

Sources: data provided by fund representatives interviewed, Internet-sites, Dienas Bizness daily archive. Note: Where information on year of investment was lacking the company is placed in the n/a column.

<sup>7</sup> This conclusion is based on the definition of VC as proposed by AR&D (see Section 2 of the paper). Several experts opposed to this point of view suggested that in Latvian conditions an investment in private equity of "traditional industries", such as e.g. food producing companies, implies high risk, and a lot of room for managerial, technological, and marketing improvement, which can be considered as an innovation given the general poor level of businesses and production practices in this region; therefore, they suggest that the majority of PE investments made in Latvian companies are in fact VC investments.

Only 66 companies received equity financing from PE (VC) funds in Latvia over the period from 1995 to early 2004. In almost half of them (32 companies) the investing fund was NLBDF, which has a relatively small capital and typically has modestly-sized investments.

Moreover, according to data provided by the EBRD the total number of companies in the Baltic States that have received investments from PE (VC) funds sponsored by the EBRD comes to 56. Of these, only 9 companies were of Latvian origin, 27 of Estonian origin, and 20 of Lithuanian origin.

This data supports the impression gained from interviews with fund managers and experts that Latvia has to date received fewer investments from PE (VC) funds as compared with Lithuania and Estonia. This is another reason to consider that the Latvian PE (VC) market is underdeveloped.

However, one should note that the number of companies that received investments in the first quarter of 2004 amounts to 5. This is as many as have been observed in previous years for an entire year. Moreover, several funds confirmed current new projects at the preparatory stage, and that investments will follow before the end of the year. This perhaps indicates the emergence of market growth.

**Investment funds of foreign origin.** In addition to the previously discussed PE (VC) local funds, many European and American funds that regard the Baltic region as potentially attractive for investments have some funds already earmarked for developing countries and economies in transition (including the Baltic states). However, a number of interviewees stated that these funds consider the Baltic market too small to set up their offices in the Baltic States. One interviewee suggested that these funds may rather co-invest in projects initiated by local PE (VC) funds. Several local PE (VC) funds already attract co-financing from foreign funds for various projects, and it is likely that more connections will be established in the future. Therefore, one may speculate that in principle the capital of many foreign funds is available for investments in the Baltic PE (VC) industry. What constrains expansion is a combination of insufficient demand (from target companies) and the inability of local fund managers to attract these investments. Development of these factors will determine how much capital will be supplied by these foreign funds.

### 3.4 The EBRD

The EBRD's role in the Latvian PE (VC) market may be considered as quite significant. Firstly, it provides roughly 20% of the capital for six pan-Baltic PE (VC) funds. Secondly, the EBRD has made direct investments into the equity of Baltic companies. Thirdly, understanding the growing importance of developing entrepreneurship and financial markets and the stimulation of foreign direct investments in the Latvian economy, the EBRD works closely with the Latvian government, financial institutions, and, in particular, with PE (VC) funds. For example, the EBRD is assisting in development of the State programme for support of venture capital for SMEs in Latvia (this programme will be addressed below in more detail).

**The Latvian Venture Capital Association.** In early 2003, at the initiative of the EBRD, representatives of the industry (fund managers) from Latvia, Estonia and Lithuania gathered together to discuss the creation of a pan-Baltic Venture Capital Association, which would facilitate development of the industry in the Baltic states. The need for a regional association was stressed as all three countries are often considered as a single market by investors, and by the PE (VC) funds themselves. However, to date only the Latvians have proceeded with the initiative by establishing the Latvian Venture Capital Association (LVCA) in the autumn of 2003. Currently, the association has 7 members. Its aims are to:

- a) inform entrepreneurs and society about risk capital financing options,
- b) promote the exchange of opinion and sharing of experience between its members,
- c) represent (lobby) opinions and interests of members in negotiations with state institutions,
- d) organise and maintain co-operation with international and other countries' PE/VC associations.

The association has just commenced activities with the creation of a web-page and a booklet on basic information about risk capital, and in April 2004 organised an informative seminar "Venture Capital in Latvia", where representatives from banks, consultants, journalists, and other professionals were offered an introduction to the industry and to the members of the association. The association is developing a handbook on venture capital, which will be distributed among entrepreneurs.

### 3.5 Business Angels

This group of participants in the venture capital market is almost invisible, but, as confirmed by industry representatives interviewed, definitely exists. This group of PE (VC) suppliers are typically high net worth individuals; most are entrepreneurs who started their businesses in the early years of Latvian renewed independence. They have either developed their businesses almost from scratch and recently sold them, thereby receiving large fortunes in cash, or still run their businesses, which generate profits and much free cash, which is potentially available for re-investment. In addition to entrepreneurs, there is a group of people who inherited real estate as a result of de-nationalisation of land and buildings after Latvia regained its independence, then sold it, thereby obtaining large amounts of free cash, which can potentially be invested.

It is hard to identify precisely who among such people are seriously active as **business angels** (although experts interviewed have named several particular individuals). Moreover, it is hard to predict the exact amount of venture capital supplied by this group.

One rough way to evaluate the potential amount of capital available for investment in PE (VC) from this source is by taking the list of Latvian millionaires from the Latvian magazine *Klubs* and hypothesising that each of them may invest roughly EUR 50,000 to 100,000 in the PE (VC) industry. These amounts were the guesstimates of several interviewees. The experts regarded these as the maximum sums that such individuals may risk in the event of project failure. Other experts believe that the amount of capital for investment by business angels could represent roughly 10-20% of the total committed capital provided by existing PE (VC) funds. Another way of estimating the potential of business angels may be to examine the experience of other countries and adapt it for Latvian conditions.

Apart from Latvian business angels, foreign individuals should also be considered as part of this group. For example, Russian (CIS) citizens seek stable markets to invest fortunes earned in Russia. At the moment large sums are flowing into Latvia from Russia. These funds are mostly invested in real estate (land purchase and development projects). Close links between individuals from both countries, knowledge of Latvia by former USSR citizens, and a good knowledge of the Russian language by the local population combine to give Latvia an advantage as a destination for funds from Russia. As good opportunities and reliable intermediaries emerge in Latvia, Russian private money seeking investment opportunities in Latvia may also be used to finance ventures in Latvia.

Another group of foreigners are Westerners (mostly Scandinavians and Germans), who following Latvian accession to the EU will increasingly pursue opportunities to invest in growing Latvian businesses.

Raimonds Aleksejenko, Head of the Investment and Finance Department of the Economics Ministry, believes that sooner or later private investors will get together in a Business Angels Network (similar to those existing in developed countries) and that they should be addressed by the state as a valuable source of capital for the development of SMEs and the economy in general. At the moment the attitude of the state towards high net worth individuals and their groups (holdings) is not always very welcoming. The tax authorities view them with suspicion, for example, querying whether they have paid all taxes, while there is speculation as to whether their schemes are legal or not. The experts at the Economics Ministry believe that it is critical to treat high net worth individuals as an important source of capital for the Latvian economy<sup>8</sup>. They should be openly addressed and their capital mobilised by a collective effort (private + public) towards promising areas and sectors of the Latvian economy.

<sup>8</sup> Personal communication, 16 April 2004.

### 3.6 Commercial Banks

The commercial banks play two roles in the Latvian PE (VC) industry. Firstly, by offering substitutes for PE (VC) capital they act as competitors. Most Latvian companies think of banks as the only possible source of external finance. At the same time competition between banks and their desire for market share gives clients high bargaining power. This has led to a situation where the banks provide loans to very risky projects, which in other countries would not get loans, but rather qualify for equity financing. It was argued by representatives of the investment funds that in this way Latvian commercial banks, as lenders, are in fact direct competitors to equity financing because banks satisfy a part of demand for PE (VC) funds. This situation (although in reality abnormal) is regarded as tolerable since macroeconomic conditions and EU accession provide a strong basis for overall optimism. Nevertheless, there are potential dangers. A crisis may be triggered by a variety of events: for example if the current boom shows signs of slowing-down. Or the banks themselves may impose self-discipline and stop their chase for more credits, thereby clearing the way for equity financing of risky (from the standpoint of normal bank lending policy) projects.

Secondly, banks may become genuine PE (VC) suppliers by either establishing their own PE (VC) funds or by investing in existing PE (VC) funds. At present, banks do not invest in these funds for a variety of reasons. Firstly, there is a lack of expertise – very few bank managers have knowledge or experience of the PE (VC) industry. Secondly, issuing ordinary loans still provides many opportunities for banks to earn good profits. Thirdly, the banks are simply reluctant to start PE (VC) activities because of the small number of potentially feasible projects. Finally, financial regulation means that a bank may provide only a limited fraction of its own equity (15%) as loans to enterprises (including PE (VC) funds) in which it holds more than 10% of shares. This clearly limits the potential for bank involvement in equity finance. Nevertheless, there is oral evidence that some banks, when they see a high return potential in a project and have the necessary expertise to seriously help the company, will invest directly in companies seeking PE (VC) capital (subject to the 10% limit), in parallel with providing loans. In this way the bank acts as a genuine PE (VC) fund.

Two exceptions to the minimal active involvement by banks in the PE (VC) market identified during the survey are:

- 1) Parex Bank, which intends to establish its own PE (VC) fund in the near future with a total capital of USD 20 million. This fund is primarily meant as an alternative “high-risk, high-return profile” investment asset offered to clients of Parex Asset Management. The fund will invest in target companies at expansion and later stages, but no start-ups and seed stages will be financed. The idea is to exploit expertise and knowledge about potential target companies accumulated by the Parex corporate finance division, and to use the ability of its asset management division to raise funds.
- 2) Latvian Mortgage and Land Bank, a state-owned commercial bank, together with NLBDF has established the SMEs Support Fund in spring 2004. This fund is established with the aim of investing in SMEs by using good coverage of potential clients of the bank and the experience of the NLBDF professionals. The fund managers plan to participate in the upcoming state support programme (see description of the programme in Section 3.8).

### 3.7 Intermediaries and Other Potential Suppliers

**Intermediaries.** Companies that provide a variety of professional services, such as transaction support in mergers and acquisitions, restructuring and privatisation, strategy and financial advice, typically have broad networks of contacts with both potential target companies and potential providers of capital. Such companies have considerable potential in the PE (VC) market because of their ability to link the demand and supply sides. Moreover, some may have accumulated substantial resources, which are available for investment, i.e. these intermediaries become suppliers of PE (VC) capital in the market. An example is Prudentia, which operates mainly as financial advisor and transaction supporter for mergers and acquisitions. On the basis of its core activities, Prudentia has identified a number of target companies and has invested substantial funds in their equity. In the opinion of the partners of Prudentia the role of professional services providers in the Latvian PE (VC) market may increase in the future as their expertise, connections, and free cash accumulate.

**Insurance companies.** To date no investments in PE (VC) have been made by Latvian insurance companies. However, their total accumulated capital is increasing, and, following the practice of their counterparts in developed EU countries, Latvian insurance companies may consider investing a small fraction of their resources in PE (VC) funds for the purpose of portfolio diversification. In the opinion of experts this may not be for another 5 to 10 years; moreover, a necessary prerequisite is the existence of a well-developed PE (VC) market with good investment opportunities in place.

Legislation does not set any limits on such investments for insurance companies. For pension funds current Latvian legislation does not permit investments in non-listed companies. Moreover, Latvian pension funds have been established only quite recently, which means that their total accumulated capital is comparatively small and to date no investments in private company equities have been made. Thus the pension funds may be rather limited as potential suppliers of PE (VC) capital. In the course of time their accumulated capital will grow, but in the opinion of experts, Latvian pension funds are unlikely to start considering investments in PE (VC) funds earlier than 10 to 15 years time.

**European Union PE (VC) funds.** By becoming a member-state of the EU, Latvia becomes automatically eligible for various EU-based PE (VC) funds. However, it is difficult to evaluate the likelihood of active participation of such funds in the Latvian PE (VC) market, or the amount of funds available for investment in Latvian companies. It can be presumed that these funds will increase the supply side of the PE (VC) market in Latvia.

### 3.8 The State

The state influences the industry in three ways: (1) by affecting the economic and legal environment; (2) by participating in the industry as a supplier of PE (VC) funds; (3) by providing substitute financing, such as loan guarantees and subsidies.

**Environment.** There are no specific legal constraints on PE (VC) funds and investments, apart from the regulations mentioned above for banks and pension funds. The Latvian government and the Central Bank have established a stable macroeconomic environment, which exerts a positive effect. On the other hand, at a micro level, existing legislation does not provide an effective enforcement mechanism for the protection of the rights of minority shareholders. This means that funds are obliged to become either majority shareholders or to secure veto rights in the companies they invest in. This clearly limits financing possibilities for companies seeking minority PE (VC) investors.

**The state programme “Support SME Venture Capital”.** With EU accession Latvia can take advantage of the EU structural funds. Within this framework the Latvian Investment and Development Agency and the Economics Ministry have developed a programme, under which resources will become available to PE (VC) funds for investment in SMEs. It is anticipated that LVL 11.6 million will be available under this scheme (25% financed by the state and 75% by the EU Structural Funds) and that around 3 to 4 PE (VC) funds will be created. The state will provide up to 70% of the total capital of those funds, two of which will receive up to LVL 4 million each from the programme. Other funds will receive smaller amounts.

Strict eligibility criteria will apply to companies wishing to receive investment from funds under the scheme. The most important of these are: an applicant-company must have 75% private capital, it cannot employ more than 250 people, and its annual turnover may not exceed LVL 23 million or its total assets cannot exceed LVL15 million. In other words eligible companies must be SMEs according to the Latvian definition. The size of investment in any one company will be limited to LVL 300,000 - 400,000<sup>9</sup>.

The proposed scheme also provides an incentive to invest in more risky projects (seed and start-up stages) by providing some downside protection: if a fund incurs losses at the end of its life span (5 to 10 years as defined in the programme) it may recover some of its initial investment. To limit the risk of adverse selection and moral hazard, this compensation will be limited (maximum 75% of the sum invested in a fund by the state). Additional incentives for private co-investors are provided as well: besides profit on own investments, private managers will also receive a share of the profit from funds invested in by the state<sup>10</sup>.

<sup>9</sup> The programme is currently in the process of development, hence all numbers are indicative.

<sup>10</sup> Exact numbers have not yet been defined, but are in line with worldwide practice, according to Raimonds Aleksejenko, Head of Finance and Investment Department of the Economics Ministry.

A key question is: who will select the fund managers? It is not clear whether state officials are qualified to do this. Nevertheless, the state support programme is a positive development for the following reasons:

- a) the scheme provides an element of risk sharing with suppliers;
- b) it creates an example for the industry. If it works well, i.e. funds are managed professionally, investments are in fact made, companies blossom, and funds exit from equities with solid profits, then potential investees will be encouraged;
- c) the scheme establishes locally financed PE (VC) funds;
- d) it will educate local fund managers by learning through doing. Not everyone agrees on the wisdom of this. In the opinion of the EBRD, it would be better to postpone the programme if no good managers can be found. This would avoid bad experience and negative publicity for PE (VC) funds and the industry as a whole, which in turn may hinder the development of the industry in Latvia.

**Substitute financing and other types of state support for SMEs.** The state provides SMEs with alternative finance such as loan guarantees through the State Guarantee Agency (SGA) and also through state subsidies. Such schemes partially satisfy SMEs' demand for PE (VC) investment. Loan guarantees may be provided to companies wishing to obtain bank loans but lacking sufficient collateral. These guarantees cover a maximum of 70% of total amount of the loan but are limited to LVL 21,000. To date only six companies have received such guarantees but it is expected that numbers will increase as the SGA receives financing from the EU structural funds. Another type of state support for SMEs (for various purposes) is direct subsidies either from the state itself or the EU Structural Funds. Approximately LVL 100 million overall will be available for businesses in Latvia for the period 2004-2006.

### 3.9 Demand Side: Target Companies

**Large companies.** There are very few large companies in Latvia – only Latvenergo, Lettelekom, LMT, Latvijas Gaze, and a few others come to mind. These companies are very well known; their owners are well informed about their options and have a great deal of choice regarding the financing of their projects. They could certainly attract PE (VC) financing if they so wished. Currently, there are PE (VC) funds ready to make large investments (EUR 5 to 20 million) in Latvian companies. However, the large Latvian companies view PE (VC) financing as too expensive and prefer bank loans especially because big loans are available on the best terms. Hence among large companies there is very low demand for any considerable PE (VC) investments.

**Medium size.** According to industry experts, medium-size companies usually need investments of EUR one to two million. These companies are the target for most existing PE (VC) funds. At the same time there is a sufficient number of such companies seeking PE (VC) investment. Thus, in this segment, there is a match between demand and supply.

**Small and medium (SMEs).** SMEs and micro companies constitute 99% of economically active enterprises in Latvia and are regarded as facing the most serious lack of financing. However, most existing funds are unwilling to offer venture capital to this segment, because the management costs

of such investments are too high in relation to capital gains generated. Thus, few existing funds have been making investments in SMEs. At the same time banks may also be reluctant to provide loans to small and micro-companies because they lack collateral and have a short credit history. Thus, business angels are likely to be the main source of finance for SMEs. Currently, demand and supply of business angels is matched through informal networks (contacts family/friends/business partners). It is unlikely that informal networks ensure an efficient market, where demand and supply are equalised quickly and with a high degree of trust between partners. If informal networks are insufficient it may be necessary to create a more formal mechanism that brings together companies and business angels.

The potential demand for external financing among SMEs and micro enterprises is fairly large. However, in practice the demand for PE (VC) investments is much smaller than the potential for several reasons. Firstly, few Latvian entrepreneurs are aware of financing through PE (VC) funds. Secondly, lack of trust means that owners are often reluctant to give away a share (even a minority one) of their companies and they are even more reluctant to give away control. Thirdly, the entrepreneurship culture in Latvia differs from that in developed countries. Owners regard their business as a life-long commitment in contrast to American and Western European owners, who are more likely to see their businesses as temporary projects to be undertaken and then sold on. Thus, Latvian owners do not see the attraction of PE (VC) funds. Fourthly, although SMEs and micro companies in Latvia make up 99% of enterprises, their number per 1000 residents is around 20, whereas in Western Europe this fraction amounts to roughly 50. Thus, the entrepreneurial spirit appears to be less evident in Latvia than in the EU-15. Finally, providers of venture capital seek investment opportunities in highly innovative companies, but, arguably, there are few such companies in Latvia. A study undertaken by the Latvian Investment and Development Agency and the consulting company EUREKA (LIDA, EUREKA (2003)) reveals several sectors of high innovation potential, such as applied physics, applied mathematics and computer science, chemistry, and bio and medical technologies, with considerable numbers of individuals and laboratories with a strong scientific background. These individuals possess substantial knowledge and the ability to develop potentially commercial ideas in their respective sectors, but may lack the vision and the business skills necessary to turn an idea into a working business.

Thus there is a lack of "effective" demand for PE (VC) investments among many Latvian enterprises. This suggests there is scope for an active role by the Latvian state through "soft" measures to promote demand, such as entrepreneurial education to inform people of venture capital as an alternative source of financing, or to counteract distrust of venture capital, or to promote the entrepreneurial spirit and encourage individuals to start their own businesses. However, according to Raimonds Aleksejenko<sup>11</sup>, "soft" measures are regarded as politically less attractive than provision on the supply side because supply measures are more visible: e.g. X money is invested by the state, which promotes creation of Y funds with additional Z capital now available in the market. This, however, does not stimulate demand.

<sup>11</sup> Personal Communication, 16 April 2004.

The LIDA and the Economics Ministry have made a start on the innovativeness issue through participation in the ESTER<sup>12</sup> programme. This is an EU programme aimed at learning from the success of Israeli state programmes for the promotion of innovativeness and venture capital financing undertaken in the 1990s. The Israeli programmes resulted in the establishment of one of the biggest and most successful VC industries in the world, which had the effect of stimulating the development of innovation and high-tech entrepreneurship in Israel. Box 2 outlines the Israeli success story. The state programme for support of VC for SMEs in Latvia, mentioned above, contains features from the Yozma programme in Israel.

#### Box 2: Promoting VC: the Israeli Success Story

**Promoting VC:** Israel at the end of the 1980s had the background conditions needed for the emergence of VC funds, but lacked venture and seed capital funds. At the same time government subsidies to industrial R&D had begun to be questioned. A group of experts studied developed VC markets, and came to the conclusion that private investors would be much more effective than the state in providing capital to companies with high potential for growth. Therefore a programme called Yozma was launched: this envisaged state investment of ~USD 100 million in VC funds. The programme was designed in the following way: (1) prevention of monopolisation of state investments in the hands of one fund, (2) the new funds, which received state capital, were managed by private companies, (3) the state was supposed to withdraw from the programme after 7 years (investors had an option to buy state shares), (4) the investor's team had to have an experienced foreign VC partner as well as a local financial partner. The programme was a success. In particular the following has been achieved:

- new funds and fund management companies have been established,
- new VC professionals (partners and employees) have been educated,
- a number of highly reputable VC organisations entered the Israeli VC market,
- 256 high-tech firms received capital from Yozma funds,
- high IRRs have been achieved by the funds,
- a high number of successful exits were achieved,
- total capital under fund management grew to more than USD 3.4 billion by the end of 2002,
- all the management companies are still in existence (100% survival rate),
- the government contribution of USD 100 million to the VC industry in 1993 was a major trigger to a total allocation of almost USD 10 billion during 1993-2001,
- start-ups financed by the Yozma funds outperformed (in growth) other high-tech companies in Israel.

**Technological Incubators Programme (TIP):** In the wake of massive immigration of skilled personnel from the former USSR the Israeli government decided in 1990 to establish the TIP, with the aim of both helping immigrant scientists and engineers find employment in their field of expertise, and creating new high-tech and export oriented companies. Between 1991-93 28 new incubators were established. An incubator is a not for profit organization providing financial support, office space, and professional consultation to each incubated project. As of end of 2001 23 incubators remained operational (5 merged with larger ones), 200 projects were operating, 735 projects had already "graduated" from the incubators. The program was successful, but to a lesser extent (if compared to the Yozma programme); nevertheless, a number of lessons have been learned and adjustments made. For example, the "incubated" projects had lower sales revenues than an average high-tech company in Israel. However, it was acknowledged, that the main result of the programme is creation of a continuous flow of projects which have passed the seed stage and are ready for investment from the VC industry. The state, by financing the incubators, thus closes a gap that the private VC industry usually fails to cover.

#### Box 2: Promoting VC: The Israeli Success Story (continued)

To summarize, the main features of these programmes in Israel, which led to success, were:

- 1) Public intervention may be necessary for the establishment of seed and venture capital funds.
- 2) Venture Capital for the high-tech industry is an instrument suitable only for a mature situation, i.e. for regions that already feature a strong potential for high-tech spin-offs and some demand for private equity.
- 3) The state should play a passive role in venture capital schemes. Any decisions about investments should be made by professional and private entities.
- 4) If no special reasons exist to employ incentives aimed at specific sectors, horizontal instruments should be used.
- 5) Any targeted programme must be inserted into a context of innovation policy, which is integrated and interdisciplinary. For this purpose it is advisable to involve an ad hoc agency able to manage policy for the high-tech industry.

Sources: Vittorio Madena et al. (2002), Viesturs Sosars (personal communication).

### 3.10 Size of the Market in Latvia

This section attempts to estimate the overall supply/demand situation in the Latvian PE(VC) market.

The supply side may be calculated as follows:

**Supply = PE (VC) funds + business angels + banks + state supported funds**

The amount supplied by PE (VC) funds is calculated as total funds committed by funds provided in Appendix 2 less investments already made by these funds. It must be stressed that the capital provided by pan-Baltic PE (VC) funds is calculated in full, i.e. it is assumed that capital available for investment in all three Baltic States may in principle be fully invested into Latvian companies. Total supply coming from PE (VC) funds in Latvia is approximately EUR 175 million.

The total amount supplied by business angels in Latvia was calculated by applying the methods described in detail in section 3.5. In that way the total supply provided by business angels is estimated in the range ≈ EUR 15 to 35 million. To get a single point estimate a simple average of these figures was taken, i.e. EUR 25 million.

Since only one bank intends to establish a VC fund, it is assumed that the total supply provided by banks is limited to the Parex fund, i.e. USD 20 million or ≈ EUR 17 million.

The Latvian state under the Support Programme is expected to supply LVL 11.6 million, which constitutes up to 70% of the total capital of the funds that will take part in the support programme (the rest, min 30%, will be provided by private co-investors). Thus, a total amount of capital available for investment will amount to at least LVL 16.6 million or ≈ EUR 25.5 million.

Thus the total supply of PE (VC), comes to ≈ **EUR 243 million** for the period 2004-2006.

<sup>12</sup> Viesturs Sosars, personal communication, April 2004.

The demand side of the market may be characterized as follows. Actual current demand is given by the amount of currently invested PE (VC) funds. Two ratios may then be calculated – one is PE (VC) / GDP and another is PE (VC) investment per capita. These are shown in Table 2 below:

Country	Invested PE (VC) funds, EUR mln.	GDP, EUR mln.	Ratio (PE (VC) funds / GDP)	Population, mln	Ratio (PE (VC) per capita)
Latvia (2003)	16.5	9 104	0.18%	2.3	7
Hungary (2002)	643.3	111 667	0.58%	10.1	64
Finland (2002)	1 773	139 800	1.27%	5.2	341

**Table 2: Measures of venture capital in selected countries**

Data sources: Hungary and Finland Venture Capital Associations, statistical bureaus of Latvia, Hungary, and Finland.

It is clear that the absolute level of PE (VC) activity is very low in Latvia. In Hungary it is nearly forty times bigger, while in Finland more than one hundred times bigger. When deflated by GDP Latvia still lags behind with PE (VC) over GDP in Latvia at 0.18%, which is roughly one third of that of Hungary (0.58%) and one seventh of that of Finland (1.27%).

Kaasik and Kodres (2000) suggest comparison of PE (VC) investments *per capita* is a better means of international comparison than PE (VC) investments per GDP. Calculation of PE (VC) *per capita* figures reveals that Latvia is even further behind Hungary and Finland.

One may speculate that the Latvian demand for PE (VC) funds is potentially higher than the current investment of EUR 7 *per capita*. Somewhat arbitrarily it is here assumed that the Latvian market is potentially able to absorb an invested PE (VC) *per capita* ratio in the range of 50% to 100% of that in Hungary, i.e. EUR 32 – 64 *per capita*. Multiplying the *per capita* ratio range of EUR 32 – 64 by the total number of Latvian residents, less the EUR 16.5 million invested, yields a demand estimate amounting to ≈ EUR 60 - 130 million.

Thus,

**SUPPLY (EUR 243 million) > DEMAND (EUR 60 – 130 million)**

#### Is there a gap in the market?

Bearing in mind that the calculations are subject to a margin of error, one may still make the following conclusions:

- 1) there is probably an aggregate oversupply of PE (VC) in Latvia (supply exceeds demand by a factor of 2 or more);
- 2) however, analysing the structure of PE (VC) supply, we know that supply is directed to larger companies leaving SMEs and micro companies aside. At the same time SMEs and micro companies constitute the largest part of the potential demand side. Thus, it is possible that the supply of PE (VC) for the needs of SMEs is not sufficient;

- 3) nevertheless, the PE (VC) sum available from business angels and state supported funds, which primarily aim at investments in SMEs and micro companies, totals EUR 50.5 million according to the calculations shown above. Assuming that the calculated potential demand figure of EUR 60 – 130 million indicates the potential needs of SMEs and micro companies, then it may be concluded that this demand could be satisfied partly or in full in an efficient market. However, there may remain a gap in the SME and micro-enterprise segment in the absence of both a formal Business Angels Network (BAN), which is so important for efficient matching of supply and demand for SMEs and micro companies, and while the State Support Programme remains to be launched.

Recently, the Lisbon Review 2004 of the World Economic Forum revealed Finland as not only the most competitive economy in the EU<sup>13</sup>, but also one enjoying a total ranking (an average of several measures of competitiveness) even higher than that of the US, which is recognised as one of the most competitive economies in the world. Finnish policy makers have succeeded in promoting economic growth by stimulating R&D, promoting knowledge, and exploiting the risk capital industry through its national fund for research and development, called SITRA. See Box 3 for some details of SITRA and its activities.

<sup>13</sup> Schwab, Lopez-Claros (2004).



**Box 3: Finnish Example: Sitra**

SITRA, the Finnish national fund for research and development, is an independent public foundation under the supervision of the Finnish Parliament. Its activities are designed to promote the economic prosperity of the Finnish people. The means used to achieve this are research and training, innovations and business development, and venture capital. SITRA's activities are financed by the yield from its own endowment capital and the return on its venture-capital investments.

The Fund was set up in conjunction with the Bank of Finland in 1967 in honour of the 50th anniversary of Finnish independence. The Fund was transferred to the Finnish Parliament in 1991.

**SITRA - aims to further economic prosperity in Finland**

- by developing new and successful business operations
- by financing the commercial exploitation of expertise
- by promoting international competitiveness and co-operation

**SITRA - an autonomous pioneer**

- enjoys economic independence
- acts with courage and initiative
- initiates operations designed to break new ground

**SITRA - an impartial opinion-shaper**

- provides new research information
- anticipates and identifies future challenges
- develops new solutions

**Fields of Operations:** SITRA offers a range of services in development and funding:

- to entrepreneurs intending to set up a company and to existing companies at the seed or start-up stage of their operations (*PreSeed*).
- to technological and commercial enterprises in the early stages of their existence who want to go international and that have new products, services or models of operation (*SITRA Industry Ventures*).
- to newly started small and medium-sized companies in traditional industry that intend to enter the international arena (*SITRA Industry Ventures*).
- to new companies in the fields of biotechnology and medicine that wish to expand on to international markets (*SITRA Life Sciences*).

SITRA provides funding for high-risk enterprises that are just getting started or experiencing radical changes when market-based services are not sufficient or private capital is unavailable.

**Venture Capital**

The principal focus of SITRA's venture-capital operations is promising technological and commercial enterprises that have just started or are in crisis and networks of small and medium-sized enterprises in traditional industries. SITRA provides funding for these companies when the markets do not yet function or where adequate private capital is not available.

Since its inception SITRA has invested in more than 200 hi-tech companies. SITRA has a wide network of international funds with which it cooperates. It has invested in more than twenty venture-capital funds that specialise in newly started technology companies in Europe and the USA. Investment in international funds has provided information and knowledge about Finnish opportunities in the world. Via its international contacts SITRA is able to evaluate development trends in technology and establish business and funding contacts to help Finnish companies wishing to expand to international markets. In addition to the European Union and the United States a network of contacts has been built up with Finland's near neighbours. One of the aims of this is to develop new forms for joint ventures.

Source: SITRA web site, [www.sitra.fi](http://www.sitra.fi)

**Factors affecting the size of the PE (VC) industry.** This has been investigated by a number of studies of PE (VC) industries in various countries. See Box 4 for a summary of the findings of recent research. Expert opinion suggests that the factors influencing the PE (VC) industry in Latvia are similar to those found by Kaasik and Kodres (2000) for Estonia (see Box 4). However, one additional factor seriously hindering development of the industry in Latvia, not mentioned by the Estonian survey, was consistently mentioned by nearly all the experts interviewed, namely the lack of knowledge and understanding among Latvian entrepreneurs and managers (i.e. demand side) about PE (VC) as a possible means of company financing.

**Box 4: Factors Affecting the Size of the PE (VC) Industry: Empirical Evidence**

**The world:** Several researchers have conducted econometric analysis of factors influencing development of the venture capital markets in USA and Europe. In the most recent study, Romain and Pottelsberghe De La Potterie (2003) analysed panel data from 16 OECD countries, and found a significant correlation between 3 major groups of factors and the intensity of venture capital. The intensity of VC is measured as the amount of demand, i.e. investments made, in a period of time, and amount of supply, i.e. total capital raised by VC funds. The groups of factors found to affect the intensity of VC are:

- 1) **macroeconomic conditions:** (GDP growth and short-term interest rates),
- 2) **research efforts and technological opportunity** (growth rate of R&D investments, the stock of knowledge, number of triadic patents), and
- 3) **entrepreneurial environment** (corporate tax rate; labour market rigidities, which reduce the impact of GDP growth; minimum level of entrepreneurship required in order to have a positive effect on the available stock of knowledge).

Results of the study are similar to results of studies conducted by Gompers and Lerner (1998) for the US industry, and those of Jeng and Wells (2000) on the data of 21 countries.

**Box 4: Factors Affecting the Size of PE (VC) Industry: Empirical Evidence** *(continued)*

**Comparison of results of the recent research** (“+” sign indicates positive correlation between a factor and VC industry size (growth of supply or demand, or both), “-” - negative correlation, 0 – no correlation, shaded cells – the factor was not tested):

	Jeng and Wells (2000), 21 countries, Panel data and cross section	Gompers and Lerner (1998) US industry aggregate data	Romain and Pottelsberghe De La Potterie (2003), 16 countries, panel data
<b>Macroeconomic conditions</b>			
Gross Domestic Product	0	+	+
Interest rate 1 year		+ at aggregate level and – at state level	+
Interest rate 10 years			0
Difference between 10 year and 1 year interest rate			-
Private Pension Funds	+ Over time 0 across countries	+ Over time	
<b>Entrepreneurial environments</b>			
Corporate income tax rate	0	-	-
Labour market rigidities	- at early stage 0 at expansion stage		- reduces the impact of GDP and R&D on VC
Initial Public Offering	0 at early stage across countries + at expansion stage	0	
Stock Market Opportunities	(Market Capitalisation Growth) 0	(Equity Market Return) +	
Level of entrepreneurship			+ Increases the impact of R&D on VC
<b>Technological opportunity</b>			
Number of Triadic Patterns			+
Business R&D growth		+	+
Stock of knowledge		+	+

In analysing the results Romain and Pottelsberghe De La Potterie (2003) suggest an important policy implication, in that public decision makers can better stimulate VC by providing knowledge and improving the entrepreneurial environment rather than by providing money.

**Estonia:** Kaasik and Kodres (2000) analyze the following factors influencing the VC market in Estonia: 1) restrictions on investments for institutional investors, 2) tax rates, 3) macroeconomic indicators; 4) industry structures, 5) government programmes, 6) exit opportunities. They find that: (1) institutional investors are yet not active. Also a legal restriction exists for pension fund investment in VC funds, (2) overall level of taxation is low and is rather favourable for VC, (3) good macroeconomic conditions are in place in Estonia to support growth of the VC industry; (4) there exist good (for VC investments) industry sectors in Estonia with high development potential, such as IT, gene-research, (5) government support, which must be co-ordinated and well-targeted, was lacking in Estonia at that time (1999-2000), (6) exit opportunities are limited to trade sale (to a strategic investor), as Tallinn Stock Exchange is not an efficient (low liquidity) market for IPO's.

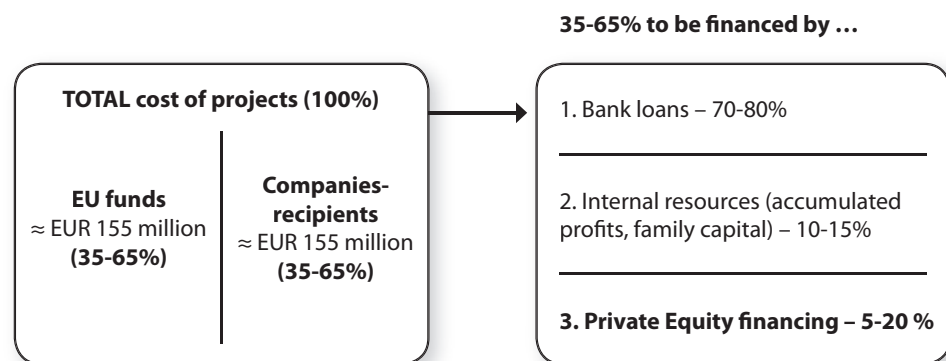
## 4. EU Structural Funds: Will They Influence the Industry?

This section considers how the PE (VC) industry will be influenced by inflow of European Union Structural Funds after Latvia's entry into the EU.

According to opinions of experts interviewed, EU funds will influence the industry in both negative and positive ways. Since there are no quantitative studies it is hard to estimate which effects will prevail on balance. However, most experts are optimistic, expecting a mainly positive effect on the industry. Some of the likely effects of inflow of EU Structural Funds on the PE (VC) industry are analysed below:

- a) **Negative:** EU funds will substitute PE (VC) in Latvia. Banks are ready to finance with loans up to 100% projects supported by EU funds. After completion of a project and receipt of the EU money, a part of the loan (e.g. 50%) is to be repaid immediately, thus leaving a project/enterprise with a good (from the banks' point of view) equity-to-total assets ratio. In this way, EU money will effectively substitute PE (VC) funds;
- b) **Positive:** Demand for PE (VC) in Latvia will increase, because one of the requirements for companies to be eligible for EU financing is that a company's equity must be not less than 30% of the company's total assets. Not all companies wishing to apply for projects will meet these requirements. In addition, some banks while financing EU funded projects with loans may require a company to provide some fraction of total project costs from its own capital (i.e. equity). If the total cost of the project is higher than current assets of the company, the company may lack sufficient equity for co-financing. Thus, to meet the criteria of EU structural funds and the requirements of banks companies may seek additional equity capital in the PE (VC) market;
- c) **Positive:** the State Programme for Support of SME Venture Capital will be financed by EU money up to 75%. It is possible that the programme would not have been developed at all if there were no EU Structural Funds apportioned for support of venture capital for SMEs;
- d) **Positive:** Additional inflow of money (for the period 2004-2006 more than EUR 620 million) into the economy of the country from the EU will facilitate improvement of the overall economic climate, which in turn may create more possibilities for businesses, thus potentially increasing demand for PE (VC) investments.

EU Structural Funds will finance between 35% and 65% of the total cost of a project. Thus, the company itself must finance 35% to 65%. Assuming that on average the banks do not provide 100% loans for project financing, the company itself must seek additional funds to be able to get compensation from EU Structural funds in the amounts defined above. A guesstimate is that on average banks will provide 70-80% of total project costs, while perhaps another 10-15% will be provided by the companies from their own resources (e.g. accumulated profit, working capital), with the rest 5-20% having to be obtained from external sources other than banks. These sources may be PE (VC) funds. On this basis, the demand for PE (VC) funds in order to co-finance EU Structural Funds may amount to in the region of EUR 7.75 - 31 million for the period 2004-2006 (if the total amount of EU Structural Funds available for business enterprises in Latvia in this period amounts to  $\approx$  EUR 155 million<sup>14</sup>).



<sup>14</sup> According to data provided by LIDA.

## 5. Conclusions

The PE (VC) market in Latvia is clearly at an early stage of development, as indicated by the very low amount of PE (VC) investment per capita as compared with other countries and the very low total number of investments made in companies' equity.

Overall there appears to be an oversupply of PE (VC) available for investment in Latvia, as provided by various suppliers, such as: PE (VC) funds, which are mostly foreign-owned/sponsored, local business angels, and intermediaries, and potentially the state. Latvian domestic institutions, such as insurance companies, pension funds, and banks are not active players in the PE (VC) industry in Latvia. With Latvian entry to the EU more foreign PE (VC) investors, both institutional and private, are likely to appear on the market.

However the observed oversupply of PE (VC) relates to large and medium scale projects (more than EUR 1 million). Analysis of the structure of demand suggests that market friction in that demand by SMEs is yet not matched by supply, because most PE (VC) providers are reluctant to invest in SMEs and micro companies. This is mostly due to the relatively high management costs of small-scale investments. Mobilising and organising business angels may correct this. One step in the right direction will be the proposed government Support Programme that is expected to target SMEs and micro enterprises.

Several problems hindering the growth of demand for PE (VC) were identified. These include:

- insufficient knowledge about funds among many Latvian entrepreneurs,
- lack of trust in external equity providers,
- the entrepreneurial culture in Latvia,
- relatively low number of businesses in Latvia;
- failure adequately to commercialize innovative ideas, despite the availability of scientific resources (specialists) and scientific tradition in high-tech areas with potential for commercial success.

Evidence from elsewhere, e.g. Israel and Finland, suggests that the state has a significant role to play in developing the PE (VC) market, by promoting "soft" measures which stimulate demand as well as funds for SMEs through its proposed state support programme.

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<a href="http://www.nvca.com">www.nvca.com</a>	National Venture Capital Association (USA)
<a href="http://www.evca.com">www.evca.com</a>	European Venture Capital Association
<a href="http://www.sitra.fi">www.sitra.fi</a>	SITRA, Finnish National Fund for Research and Development
<a href="http://www.csb.lv">www.csb.lv</a>	Latvian State Bureau of Statistics
<a href="http://www.hvca.hu">www.hvca.hu</a>	Hungarian Venture Capital Association
<a href="http://europe.eu.int/">http://europe.eu.int/</a>	The EU portal on-line
<a href="http://www.db.lv">www.db.lv</a>	Dienas Bizness (Business of the Day, daily)

## Appendix 1: List of interviewees

Company / Organisation	Interviewee	Web-address	Comments
NCH Advisors Latvia	Kārlis Čerbulis		PE fund, mostly real-estate
Hanseatic Capital	Pauls Dzintars Kalniņš	<a href="http://www.hanseaticcapital.net">www.hanseaticcapital.net</a>	Mezzanine loans
Baltcap Management Latvia	Dagnis Dreimanis	<a href="http://www.baltcap.com">www.baltcap.com</a>	PE, pan Baltic
Prudentia	Girts Rungainis	<a href="http://www.prudentia.lv">www.prudentia.lv</a>	Financial consulting, Investment bank
Hansabanka	Kaspars Dēliņš, Aleksandrs Šiperkovskis	<a href="http://www.hansabanka.lv">www.hansabanka.lv</a>	Commercial bank
Nordea Bank Finland Plc. Latvia branch	Eriks Plato	<a href="http://www.nordea.lv">www.nordea.lv</a>	Commercial bank
Parex Assets Management	Roberts Idelsons	<a href="http://www.parex.lv">www.parex.lv</a>	Parex Group
EBRD	Toby Moore	<a href="http://www.ebrd.org">www.ebrd.org</a>	EBRD representation in Riga
Latvian Venture Capital Association, SMESF, NLBDF	Dairis Čalītis	<a href="http://www.lvca.lv">www.lvca.lv</a> <a href="http://www.mvkaf.lv">www.mvkaf.lv</a> <a href="http://www.nluaf.lv">www.nluaf.lv</a>	Small and Medium Enterprises Support Fund, The Norway-Latvia Business Development Fund
EUREKA	Viesturs Sosars	<a href="http://www.eureka.lv">www.eureka.lv</a>	Business strategy and development consultants
Latvian Investment and Development Agency (LIDA)	Mārtiņš Zemitis, Ralfs Kļaviņš (former employee)	<a href="http://www.liia.gov.lv">www.liia.gov.lv</a>	
Ministry of Economics	Raimonds Aleksejenko	<a href="http://www.me.gov.lv">www.me.gov.lv</a>	
Trigon Capital	Anna Goljanska	<a href="http://www.trigoncapital.com">www.trigoncapital.com</a>	Investment bank
LHV Ventures	Taavi Lepmets	<a href="http://www.lhv.ee">www.lhv.ee</a>	Venture capital firm based in Estonia
Eko Investors	Jānis Janevics		Venture capital firm

## Appendix 2: PE/VC Funds Active in Latvia

(active funds are deemed those, which either have investments in Latvian companies or consider such investments in near future)

Company / Fund, year of foundation	Sponsor / owner	Focus (CEE, Baltic, LV)	Type of investment	Size of typical investment	Capital under management (committed capital)	Capital invested	Capital invested in Latvia	Number of investments in Latvia	Comments
<b>New Century Holdings Advisors Latvia</b> , 1993	US institutional investors	Latvia	Investment in equity, no early stages	min USD 500,000	USD 10 m (equity in non-real estate projects)	USD 10 m	USD 10 m	~ 7 to 10 (non-real estate)	Invests mostly in real estate projects, total investments in Latvia USD ~80 m
<b>The Norway-Latvia Business Development Fund</b> (NLBDF), 1995	owned by Latvian Development Agency, sponsored by Norwegian gov-nt and Alcatel Telecom Norway	Latvia	Invests in equity of SMEs	LVL 20,000 - 175,000	EUR 2.66 m	EUR 2.4 m	EUR 2.4 m	32	
<b>BaltCap</b> : (4 funds under management: Baltic Investment Fund-I, -II from 1995, -III from 2000, and Baltic SME Fund from 2001)	Owners: Sitra, CapMan, Suprema, private individuals; investors: EBRD, EIF, leading Scandinavian insurance companies	Baltic	Equity (sometimes preferred share or convertible loan) financing for early or expansion stage	EUR 0.3 - 7.5 m	total funds EUR 90 m	EUR 35 m	EUR 4.1 m	3	2 investments in Latvia were made from the Baltic Investment Fund III, and 1 from the Baltic SME fund.
<b>Baltic Small Equity Fund</b> , 1997	SEAF, EBRD, BaIAEF, BSIF	Baltic	Equity of growing enterprises (SMEs)	USD 100,000 - 400,000	EUR 8.9 m	EUR 5.6 m	EUR 2.3 m	7	
<b>LHV ventures</b> , 1999	private individuals from Estonia	Baltic	Investment in equity of innovative start-ups (IT, Internet, e-commerce)	min EUR 50,000	EUR 5 m	EUR 5 m	EUR 2 m	4	A new fund is to be raised (EUR ~35 m) for equity finance of expansion stages, no start-ups in the future
<b>Eko Investors</b> , 2000	private individuals from Latvia	Latvia	Investment in equity of innovative start-ups	LVL 20,000 - 200,000	LVL 1 m	LVL 1 m	LVL 1 m	10	Majority of current investments are in companies with environmental projects
<b>Askembla Growth Fund</b> (managed by Askembla Asset Management) in 2002	SEB group, EBRD, Länsförsäkringar Liv, Skandia Liv, AFA, AXA UK Pension Trustees, BSIF, Askembla Asset Management	Baltic	Equity for expansion in high growth companies	EUR 1 m	EUR 80 m	EUR 6 m	0	0	Invested in Estonian and Lithuanian food, construction materials and data distribution companies
<b>Amber Trust S.C.A.</b> (under joint investment advisors Danske and Firebird), 2002	blue chip investors from Europe, the US, Asia	Primarily Baltic, to a lesser degree elsewhere in the CEE region, incl. Russia	Equity for expansion (in domestic and export markets)	more than EUR 1 m	EUR 50 m	EUR 30 m	EUR 2.9 m	1	1 investment has been made in Parex Bank in Latvia
<b>East Capital Amber Fund</b> (managed by East Capital Private Equity), 2002	Swedfund (major investor)	Baltic, Russia, Ukraine	Equity of SMEs in consumer goods sectors	n/a	EUR ~ 9.3 m	n/a	n/a	2	Total committed funds SEK ~85 m, 3 investments have been made: 1 in Russia, 2 in Latvia
<b>Hanseatic Capital</b> , 2003	US government, IFC (subordinated debt), Hansabanka (senior debt)	Baltic	Mezzanine (subordinated loan, share options, convertible debt, preferred shares) for expansion stage, MBO/MBI, LBO, equity restructuring	USD 0.5 - 1.5 m	EUR 20 m	EUR 6.2 m	0	0	Two Latvian projects are at the preparation stage (term-sheets signed for EUR ~ 1.6 m)
<b>Trigon Direct Investments</b> (managed by Trigon Capital), 2003	private individuals from Scandinavia	Baltic, Poland, Russia	Equity investments in skilled labour intensive sectors	up to EUR 2 m	EUR 2 m	0	0	0	with successful launch of this fund, more funds are to be raised
<b>SMEs Support Fund</b> (MVKAF), 2004	Latvian Mortgage and Land Bank and NLBDF	Latvia	equity of SMEs	LVL 5,000 - 200,000	LVL 210,000	0	0	0	established with the aim of receiving the state Risk Capital Support Programme funds, total planned cap LVL 5.2 m

### Appendix 3: Funds Dealing with PE in Latvia

The list of funds that deal (i.e. either invest or announced that they will invest in PE in Latvia) with private equity operations in Latvia. The list is defined by Maximova and Jafarov (2003).

Fund	Fund size, million USD
Baltic Rim Fund	50
Bancroft Eastern Europe Fund L.P	95
Information for Agribusiness Partners International	95
AlG Brunswick Millennium Fund	289
Allied Small Business Fund	20
Aqua International Partners Fund	222.75
First NIS Regional Fund	200
Global Environment Emerging Markets Funds I and II	70 and 120
New Century Capital Partners	250
The CEENIS Property Fund	n/a
The CEENIS Property Fund, L.P	240
New Century Capital Partners	250
DEG German Investment and Development Company	750
Baltic Investment Fund	n/a
East European Food Fund	n/a
First NIS Regional Fund	n/a
EBRD direct Equity finance for small and medium-sized projects in central and eastern Europe and CIS	n/a
Central and East European environmental investment fund	50
FinnFund (Finnish fund for industrial cooperation Ltd.)	n/a
Netherlands Development Finance Company (FMO)	n/a
Foretagskapital AB	n/a
The Investment Fund for Central and Eastern Europe	n/a
Environmental Investment Facility for Central and Eastern Europe	n/a
Baltic-American enterprise fund (BalAEF)	30
Baltic Small Equity Fund	n/a
New Century Capital Partners, L.P, NCH	n/a
Norway – Latvia business development fund	n/a



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