Financing Innovative Businesses in Transition Economies: The Role of Venture Capital – Opportunities and Challenges

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Drawing on the Experiences of the Enterprise Fund’s Hungarian Innovative Technologies Fund
Issues in Creating PE/VC Funds for ECA Region

• Achieving critical mass of capital
  – To attract and support investment professionals
  – To cover operating costs
  – Blend VC and PE strategies in single fund?

• Structure of Fund and geographical scope

• Is Ecosystem/Institutional Infrastructure sufficient to support venture investing?

• Sources of capital in face of undefined risks
  – Need for public capital as a “catalyst”

• Enough success stories
Central Europe – circa 1989

- Developed Industrialized Economies
- Strong Educational Traditions in Science, Math, Engineering and Medicine
- Great Universities / Skilled Technicians
- Command Economy Inefficiencies
- Risk Averse Citizenry, but Some Entrepreneurial
- Absence of Business Management Skills and Capital

Capital, Professionally Employed, Was Needed to Fuel Local Business Growth
USG’s Enterprise Fund Model

• $240 million of public money for PAEF and $60 million for HAEF

• As privately-managed investment firms to finance emergent entrepreneurs with equity and debt capital

• In PAEF’s 10 years of operations,
  -- it invested $200M equity in 50 Polish companies
  -- provided $300M in loans to 10,000 SMEs
  -- extended $180M in loans to over 30,000 “microenterprises

• By 2006, PAEF’s “privatized” management team had raised ~$1.6 billion in private institutional capital for investment in Poland and region – plus, PAEF’s successes attracted competing funds!

• Raising additional $40M in private capital, HAEF put to work nearly $125 million in the Hungarian economy, and created Hungarian Innovative Technologies Fund to demonstrate possibilities in high-tech venture capital investing
Investors in Transitional Economies Face Daunting Challenges

• “No Roadmaps” and “Collapse of Timeframe”
  – Lack of info/unknown risks/due diligence difficult
  – Difficulty pricing deals, securing and valuing assets

• Little Ecosystem/Institutional Infrastructure
  – Laws/regs, judicial enforcement, tax regime
  – Unsophisticated entrepreneurs, lacking management
  – Business practices not conducive

• Underdeveloped Capital Markets
  – How to achieve Capital Appreciation and get EXITS?

And for VCs, Great Science Does Not Always Translate into Success
Entrepreneurs-Innovators Do Not Succeed in a Vacuum

• Market-Driven Demand

• Institutional Infrastructure and Incubation
  – Conducive laws and regs, judicial enforcement, taxes
  – Facilitation, support and guidance
  – Managerial skills, MIS and good business practices
  – Building relationships/linkages/networks

• Venture Capital Properly Employed

Compare Conditions in World’s Greatest, Most Successful Economies
Hungarian Innovative Technologies Fund Model

• HAEF launched HITF was with developmental funding in 1999 to establish professional venture capital investment capabilities and prove concept — “That there is real opportunity in Hungary (and by extension the CEE region) for seed/early stage equity financing for smaller entrepreneur-innovators developing new technologies with global market potential.”

• By HAEF’s wind-down in 2003, HITF had:
  • Generated over 400 proposals, ~65 in biotech
  • Closed 7 deals
  • Co-invested with major international investment funds
  • Established a solid reputation in its niche
Role of Professional Venture Capitalist

• Not only Bring Capital
• Identify Best Ideas
• Support and Create Management
• Add Commercial Judgment
  – International contacts
  – Marketing and sales
  – Good management practices (financial, HR, etc.)
  – Fundraising

Rewards Have to Be Commensurate with the Risks
Technology Knows No Borders

→ Competition Is Global

• Products/services can be conceived in one country, produced in second and sold in third country

• HITF sought to overcome limitations in Hungarian market by:
  • Focusing on new technologies with **Global Market Potential**
  • **Partnering** with larger international investment funds
    • Intel Capital
    • Soros-affiliated funds
    • Techno Venture Management (TVM)
  • Investing through off-shore parent corporation with R&D focused subsidiary located in Hungary
    • N-Gene in USA
    • AXXIMA in Germany

Creating Disciplined, Professional Investment Organization Made these Deals Possible
Some Lessons Learned from EFs and HITF Experience

- Private sector approach, backed by public capital, often needed to take early risks – especially in high-tech – and to accelerate development by assessing needs of private sector and designing market-responsive solutions.

- This catalyst at micro-economic level supports workable policy framework, lays foundation for investing and demonstrates opportunity attracting private capital.

- Fundamentals are same whether in Budapest or Boston; in ECA or USA.

- Critical mass of capital is needed.

- Professional Fund Managers with an equity stake in the deals are COMMITTED to protecting the capital – they are not short-term “project managers”.
Some Lessons Learned from HITF Experience (con’t)

• Technology has no borders, so investment should not be restricted geographically, but by capability to manage it

• Small markets offer a shortage of experienced co-investors, and limited strategic investors are interested in buying local technology firms – making it difficult to achieve EXITS

• Overwhelming majority control needed to influence change; otherwise, the financial investors are at mercy of owner-managers, who control both internal operations and oversight of their activities

• Transition economy entrepreneur-innovators frequently lack experience in building-up and selling their businesses for substantial capital gains. Thus, they see equity capital as a “cheap loan,” and use it without appreciating value in growing the business with a partner who shares in risks and benefits
Challenges Facing Armenian and ECA Entrepreneurs – circa 2007

- **Need Access to Capital** to Grow their Businesses
- **Need Support of Seasoned Business Professionals** with Stake in Success
  - Marketing advice and guidance
  - Business and financial management advice
  - Preparation for possible IPO
- **Need Means to Access Global Markets**
  - Attract strategic investors
  - Position venture offshore to market locally-developed IP

Local SME Entrepreneurs Are “Engine of Growth”
Potential Sources for Establishing ECA and Armenian VC Funds

• Indigenous Efforts
• Diaspora-Inspired
• National Government Capitalized, modeled on the Enterprise Funds
• Donor Financed
  – EBRD, European Investment Fund, etc.
  – regional, bi-lateral

Achieving “Commercial Objectives” Must Ultimately Drive Decision-Making
Issues in Creating PE/VC Funds for ECA Region

- Achieving Critical Mass of Capital to Attract and Support Investment Professionals – and have clout!
- VC and PE Blended in Single Fund, or Separated?
- Limited Local Capital Markets to Support EXITS
- Structuring Flexible Approach/Geographical Scope
- Ecosystem/Institutional Infrastructure Sufficient to Support
- Enough Success Stories
- Ultimately, “Rewards Commensurate with the Risks”
ECA Region – circa 2007 – Is Poised

- Heritage Foundation’s Index of Economic Freedom
  - Business, Trade, Fiscal, from Government, Monetary, Investment, Financial, Property Rights, from Corruption, Labor
  - Ranking above 60% in “Economic Freedom” out of 157 countries
    - Armenia # 32, Georgia # 35, Bulgaria, Romania, Kazakhstan
- Strong Educational Traditions in Science, Math, Engineering and Medicine
- Increasingly Entrepreneurial Societies Driven by Demands of Marketplace
- Capital Market Development Coming

Capital, Professionally Employed, Still Needed to Fuel Local Business Growth
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Appendix on Enterprise Fund Concept
USG’s SEED Act of 1989

“ENTERPRISE FUNDS,” capitalized initially with $240 million for Poland and $60 million for Hungary, were conceived to promote:

(1) development of the Polish and Hungarian private sectors, including small businesses, the agricultural sector, and joint ventures …, and

(2) policies and practices conducive to private sector development in Poland and Hungary, through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees, and other measures.
USG’s Enterprise Fund Model

- Private sector vehicle capitalized with public funding to execute developmental mission
- Focus was on business-to-business, providing financing on commercial terms and supporting private business growth
- Public-sourced capital entrusted to independent Board
  -- defines strategy
  -- given flexibility to set direction and take action to achieve objectives without gov’t bureaucratic approval/interference
  -- hires professional management to take RISKS and execute
- Capital not dissipated in “expenditures,” but is “invested” in private enterprises, and remained an ASSET
- Realities of investing drove policy reform and demonstrated investment opportunities attracting competing investment firms and parallel private capital managed by EF team
Enterprise Fund Achievements in Poland and Hungary

**PAEF**

- In PAEF’s 10 years of operations with $240 million base, it invested $200M equity in 50 Polish companies.
- Provided $300M in loans to 10,000 SMEs.
- Extended $180M in loans to over 30,000 “microenterprises.”

- By 2001, PAEF had completed its mission and returned $120M to the USG and capitalized a “legacy” foundation PAFF with an initial $120M – by 2006, increased to over $250M.

- First time a US foreign assistance program returned its funding since Finnish Gov’t repaid Marshall Plan loans 50 years before.

- By 2006, PAEF’s “privatized” management team had raised ~$1.6 billion in private institutional capital for investment in Poland and region – plus, attracted competing funds!
Enterprise Fund Achievements in Poland and Hungary (con’t)

HAEF

• HAEF with its expanded $62M capital base had
  -- put to work nearly $125M in the Hungarian economy
  -- provided direct equity to over 50 companies
  -- participated in 8 IPOs on BSE, London’s SEAQ and NASDAQ
  -- provided SME and micro loans to 200 businesses
  -- raised additional $40M in private capital to manage
  -- trained a generation of Hungarian investment professionals
  -- created Hungarian Innovative Technologies Fund to demonstrate possibilities in high-tech venture capital

• By 2004, HAEF had completed its mission, began returning its capital to the USG and established as its “legacy” a Scholarship Fund to bring top Hungarian graduates to USA for internships in America firms
Expanding the EF Initiative and Adapting It to Other Countries

- EFs in Poland and Hungary concentrated on private equity “buy-out” deals, privatizations, small business lending programs, and in Hungary particularly – high technology

- In ensuing years, EFs created for Czechoslovakia, Bulgaria, Baltics, Romania, Albania under SEED Act, for Russia, Western NIS and Central Asia under Freedom Support Act

- Most have attracted parallel private equity, established intermediary financial institutions to make commercial loans, mortgages and the like, and created small/micro business lending facilities to reach smaller entrepreneurs broadly across economy.

- Strategies of each dictated by local needs and conditions

- Now, similar funds created for southern Africa, Georgia, North Africa and Middle East and by EBRD and others
The CEE Enterprise Funds: Accomplishments Overall

• Current Asset Base of Funds exceeds the $1.3 billion in US Gov’t grant funding

• Thus, the EFs’ capital has been at work in CEE host countries growing private businesses, building capacity, facilitating development of conducive institutional infrastructure for commercial activity and creating a professional cadre; yet, the capital base remains intact