Local Insights Into Latvian Venture Capital

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Scope of the Presentation

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Scope of the Study: Reasoning

The EU Perspective

Innovaton

Our capacity to build on the growth and innovation potential of small and medium-sized enterprises (SMEs) will therefore be decisive for the future prosperity of the EU.
(The Small Business Act for Europe (European Commission, 2008, p. 2)

Financing

The EU and the Member States should facilitate SMEs' access to finance, in particular to risk capital, micro-credit and mezzanine finance and develop a legal and business environment supportive to timely payment in commercial transactions.
The Small Business Act for Europe (European Commission, 2008, p. 11)

Latvia – Stylized facts

- Latvian entrepreneurship weak in innovation (Estonia scoring much better).
- Lack of financing the second most quoted reason for business discontinuation.
- Perceived need for financing at all stages, starting with pre-seed funding.
- Lack of funding restricts Latvian competitive-ness and hence welfare.

Sources: Global Entrepreneurship Monitor Latvia Report 2012; Latvia Competitiveness Report; Baltic Journal of Economics 2013:1.

Objective: What has happenned in Venture Capital industry prior today?

Methodology and RQs

Methodology

- **Shortage of previous evidence and no unified method** detecting market failure;
- **Quasi-case study;**
- **19 stakeholders interviewed (in 22 in-depth interviews) and 11 opinion interviews**;
- Secondary data from **EVCA, LVCA, MoE, MoF, tender documentation**;
- **Extensive literature** and **comparative evidence review.**

Research Question and Sub-questions

RQ: How far do public venture capital programmes stimulate venture capital market development in Latvia?

SQ1: To what extent there was a **need** for public support to venture capital market in Latvia?

SQ2: How far are **aims** and expected outcomes for public venture capital programmes achieved?

SQ3: How did public venture capital programmes' **structure and financing** evolve over time?

SQ4: What is public venture capital programmes' backed funds' **performance** as of Q1 2013?

SQ5: How far public venture capital programmes have ensured venture capital funding for **full investment life-cycle**?

SQ6: What **improvements** public venture capital programmes and additional policy measures could be implemented from different stakeholders' perspective?

Main Findings from Literature review

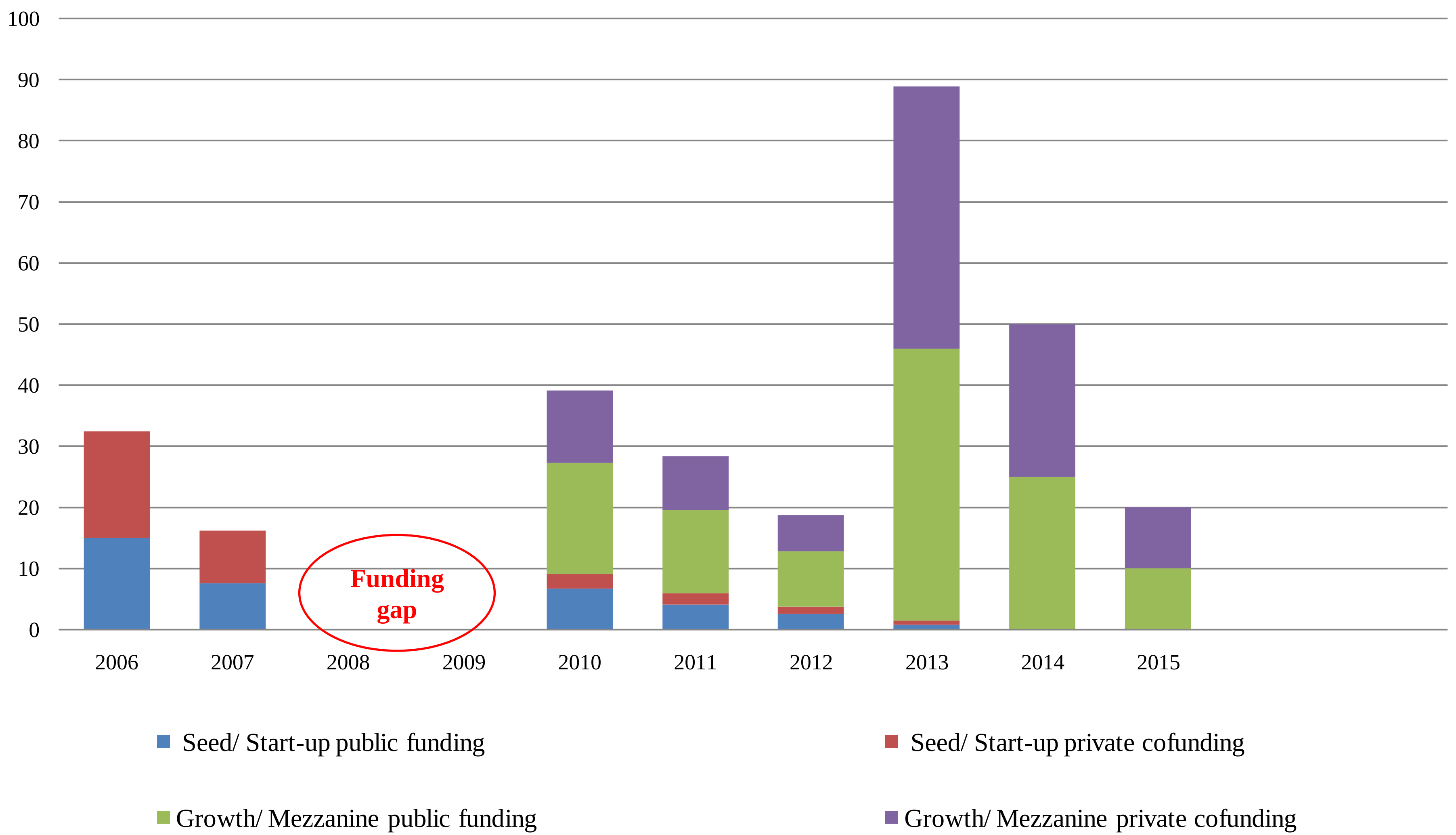
VC around the world

- **Perceived market gaps are**:
  (1) Early stage start-up companies; (2) technology-based companies;
- **Governments can overshoot with:**
  (1) Direct funding; (2) Too generous risk sharing;
- **Key drivers for country's attractiveness for VC investors:**
  (1) *Economic Activity; (2) Capital Markets; (3) Taxation; (4) Investor Protection; (5) Corporate Governance.*
- **Suceess factors for European PVCPs:**
  (1) funds are allowed to reinvest; (2) Incentive based remuneration; (3) Investments are based on funding gap; (4) Tax incentives; (5) Flexible regulation for institutional investors for high risk asset class investments; (6) Comprehensive policy mix

VC in Latvia

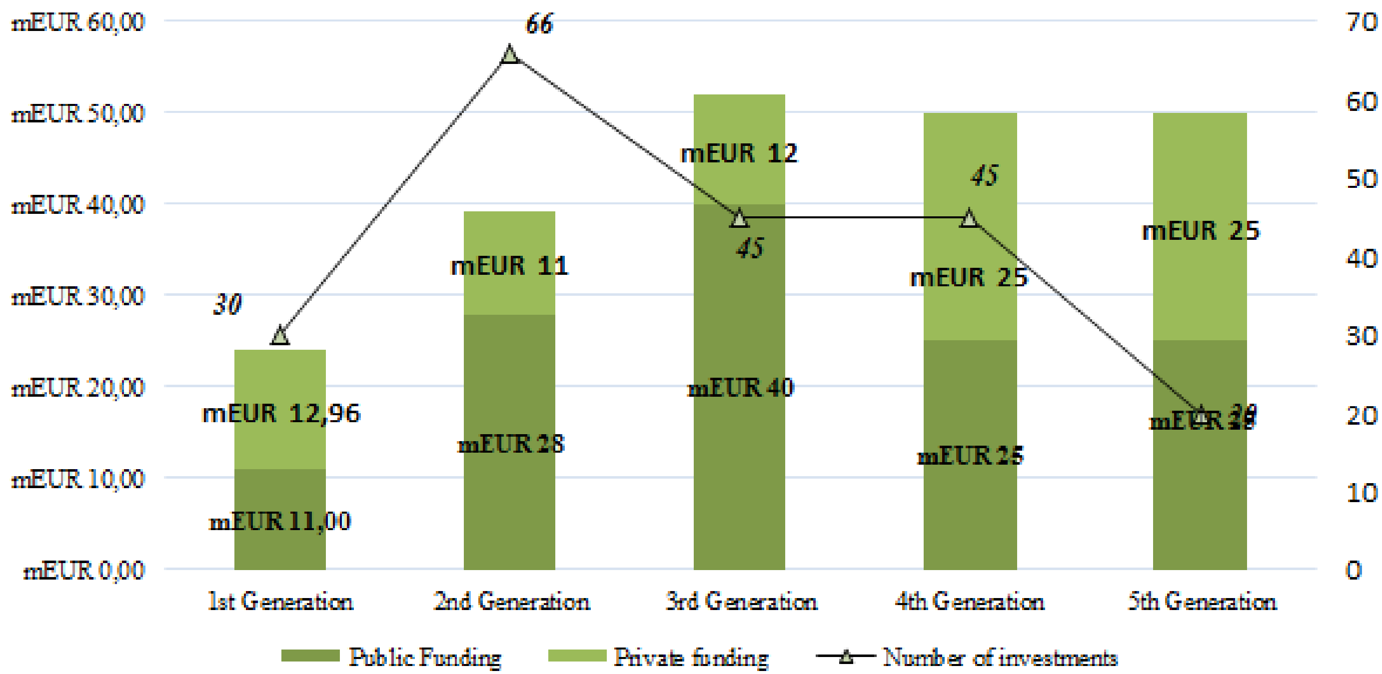
- **Ranked #59** in global VC attractiveness index (2012)
- Vanags, Stasevska & Paalzow (2010) reported total supply 295m EUR - is overestimated;
- Cumulative inv. by 2008 is 63-68.2mEUR: *Supply values do not match even in official documents*;
- Since 2006 Baltics - "quasi-experiment" test ground for extensive use of Financial Engineering Instruments; Yet there is no decent market gap assessment.
- Vanags & Moore (2012): **Problems with PVCP implementation**;
- Notable PVCP funding for 2014-2020: 100m EUR locally, 200m EUR pan-Baltic fund + COSME programme 0.69bn EUR;

Aggregated supply of Venture Capital



* BIF excluded

Aggregated supply of Venture Capital



Total Committed Capital and # of Investments

- **5 PVCPs**;
- Amount of **invested capital** in **Latvia's SMEs (2006-2018):**
    - ***Public Funding*** **129m EUR**
    - ***Private Funding*** **86.20m EUR**
- ***Total*** amount of ***investments*** – **206**
- **Total** amount of **capital invested in Latvia**

  215.2m EUR

Main Insights

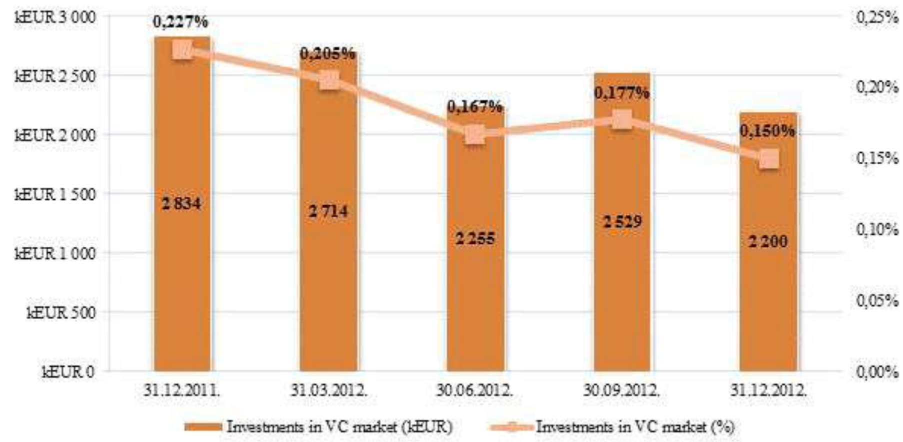
- **Generation I:** If no PVCP, no VC market; lessons learned on PVCP design; agency problems.
- **Generation II:** The Best PVCP; Experienced fund managers, many successful investments, Seed and Start-up funding.
- **Generation IV:** 1st large scale fund of funds in Baltics. Massive amount of capital available; Huge support to the VC market.

Main Conclusions

Entrepreneurs Perspective

- **Lower investment per reviewed project rate** than in EU;
- ***Dumb money*** and ***Lemon's problem***;
- **Funding gap** for *pre-Seed stage*;
- **PVC funds have some monopoly power** *due to lower cost of capital*;
- **Later stage companies** with stable cash flows and growth opportunities tend to be **reluctant to give away equity**;
- ***Anecdotal evidence***: there is **demand for pre-seed investment**, ***smart money* for early stage** and **mezzanine investments**;
- **Only late stage as current priority***

State and private funded pension funds



- **State Pesnsion Funds**: (1) Only **0,2% (2.2m EUR)** of available **capital is invested;** (2) Unrealised potential of **60m EUR; (3)** Large willigness of investing in VC funds (4) Many legislative supportive iniatives
  To increase allowed percentile invested in VC funds from **5% to 10%**
  To increase allowed percentile of share invested in one fund from **30% to 100%**
- **Private Pension Funds:** (1) Only **0,24% (0.46m EUR)** of available **capital is invested;** (2) Unrealised potential of **7.6m EUR**

Main conclusions and Suggestions/Practical Implications

RQ: How far do public venture capital programmes stimulate venture capital market development in Latvia?

- **PVCPs have kick-started VC industry** (still to few players leading to some monopoly power)
- Intended **artificial** stimulus for **competition** in later stage deals may **create *money chasing deals*** effect.
- **There is still a funding gap** for **pre-seed** and **early stage funding**
- **PVCPs need to be continued in 2014-2020** to **ensure self-sustainability of VC industry**, combined with broader policy measures.

SQ1: There is general agreement in literature and in between industry stakeholders **in Latvia** on a **funding gap for early stage and growth funding**. **PVCPs kick-started VC industry in Latvia**; at least *2 to 3 additional PVCP generations are needed to make the market self-sustainable*;

SQ2: Divergent stakeholder views on main stage focus of PVCPs and on importance of «subsidized learning» , thus a broader discussion is needed to allign aims and expected outcomes;

SQ3: *1st generation funds had multiple flaws in* **design** and **implementation,** and **agency problems**; that is perceived to be a necessary lesson learned;

SQ4: The 1st generation **VCFs' performance from financial perspective is rather poor as of mid-2012**; in comparative terms. ***Only one*** *fund generated* ***positive economic outcome*:**

SQ5: VC funding gap for early stage companies will increase after 2015 if no other PVCPs or policy measures are implemented;

SQ6: Only funding supply has been used as policy measure; we **suggest** a more comprehensive approach including ***support for pre-seed stage funding***, ***investment readiness*** and ***tax-incentves for private investors***.

Main conclusions and Suggestions/Practical Implications

1. **PVCPs have kick-started VC industry**
2. ***Money chasing deals*** effect.
3. **Funding gap** for **pre-seed** and **early stage funding**
4. **PVCPs need to be continued in 2014-2020**
5. ***Broader discussion is needed to allign aims and expected outcomes***
6. More comprehensive approach for policy measures:
    1. **support for pre-seed stage funding**;
    2. **investment readiness**;
    3. **tax-incentves for private investors**.

Further Reasearch and Practical Implications

We **aimed** to **fill existing gap in academic literature** and **make a strong and sound reference points for stakeholders**; few particular topics fell out of our scope.

Suggestions for further research:

- Effects and role of foreign VCF investment supply in Latvia and broader SME funding opportunities;
- Proposed policy measures such as investment readiness, pre-seed programmes and tax incentives should be analysed in more comprehensive manner to predict the level of expected effects;
- Quantitative performance evaluation could be done in 2014/2015.

Next Steps:

We plan to initiate wide stakeholder discussion based, on our findings, to agree on best policy measures for Latvia's VC industry further development.

Next Steps

TeliaSonera

Working Papers Series, December 2013:

Updated Research including:

(1) Karen Wilson comments;

(2) Stakeholder discussion's results;

(3) Latvian Venture Capital Success Stories.

Thank You Very Much For Your Attention!

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