Corporate and SME's Financing

FACTORS INFLUENCING A DECISION-MAKING PROCESS REGARDING CAPITAL STRUCTURE AS WELL AS BUSINESS DEVELOPMENT[1]

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Abstract

Decisions concerning capital structure and development projects represent the main long-term budget, capital and financial decisions of a firm. These decisions are affected by the choice of both methods and models of the capital structure optimization, economic efficiency of the project evaluation as well as many other factors. Following two factors influencing this decision-making process in Slovak enterprises are presented in this lecture by income tax and cost of capital.

Keywords: *capital structure, development projects, tax shield*

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1. Introduction

Decisions on the capital structure and company development projects are affected by the choice of methods and models of capital structure optimization, by evaluation of the economic efficiency of projects, economic climate and many other factors. In the paper, we are to present the impact of changes of two factors in the economic climate, namely income taxes and interest rates from long-term credits on these decisions in Slovak companies.

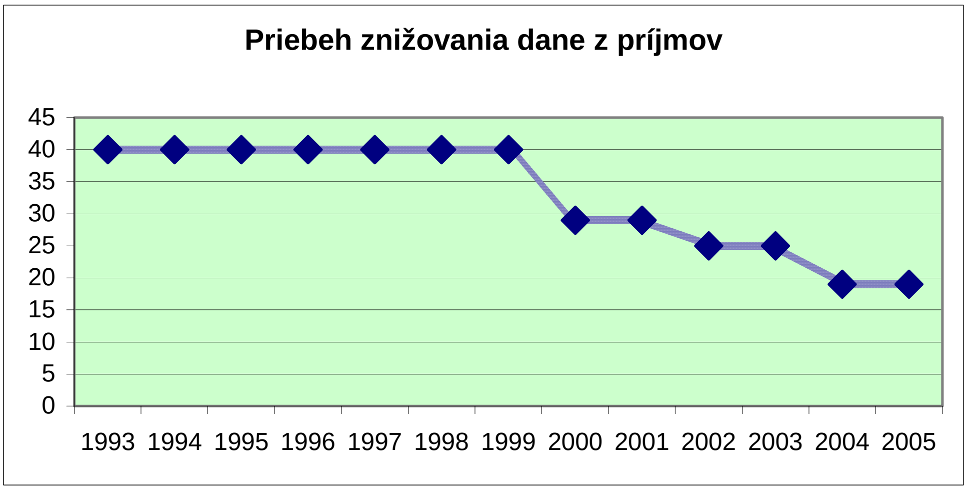
2. Development of the Income Tax and Interest Rates

The transformation process in the Slovak economy made it possible to create space for a gradual decrease of the tax burden of businesses from 1993 (establishment of the Slovak Republic) to 2004 and a decrease of interest rates on credits.

The rate on income tax of legal entities was between 40 and 19 %. The level of 40 % was effective up to 1999, in 2000 and 2001 it was 29 %, in 2002 and 2003 25 %. Since 2004, the rate of income tax valid in the Slovak Republic has been 19 %.

The level of the capital price is also affected by including interests in the company costs. Credit interests included in the company costs decrease the price of the foreign capital (tax shield). The impact of the tax shield in Slovak conditions has recorded a significant change of impact in the past decade. In 1993, the saving on taxes (40 % tax rate from about the 18 % interest rate) was not lower than 7.2 %, in 2004 only 1.3 %, in dependence on the analyzed sector (industries, private sector, etc.). Basically, it moves within the scale 1.0 to 2.0. The decisive fact is that the importance of this factor has gradually declined. Further dramatic fall is not expected in future.

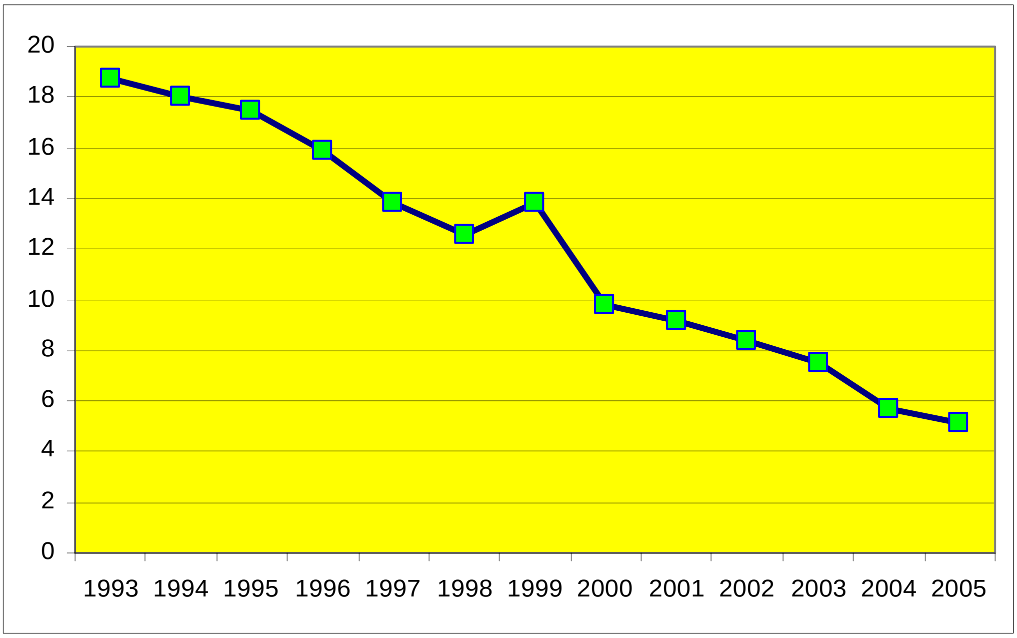
Diagram 1: Progress of the income tax decrease in 1993 – 2005 (in %)
Progress of the Income Tax Decrease



Source: www.drsr.sk

A significant fall has been seen also in the interest rates on long-term bank credits. Gradually, conditions and prerequisites for their decline have been created. The trend resulting from the Diagram 2 suggests a definite development up to the year of 2005 (till August). Due to the shortage of sources in the past, the interest rates were quite high which resulted in a disproportionate increase in the foreign capital and did not affect a support of company development favourably. At present, the level of the interest rates is much more acceptable. In the analysis, we only assess interests from long-term credits, and do not consider short-term credits part of the capital structure.

Diagram 2: Development of Interest Rates from Long-term Bank Credits in 1993 – 2005 in the SR (v %)



Source: www.nbs.sk

The income tax rate of legal entities and interest rates from long-term bank credits have significantly changed since 1993 (Diagrams 1 and 2). Their impact must be taken into account, therefore we assess it on a simplified model.

3. Impact of Changes of the Income Tax and Interest Rates on the Capital Structure and on Company Development Projects

By the example of the compromise theory, we are to present how the change (decline) of the income tax and interest rate from long-term credits determines decisions on the capital structure and company development projects. The authors of the compromise theory have linked the M-M access with the real market conditions (they took not only the influence of taxes into account but costs of financial difficulties of a potential bankruptcy as well), and showed the choice of the capital structure as a compromise between benefits of the interest tax shield and costs of financial difficulties.

Their pattern for the company value including debt is as follows:

$$V_Z = V_N + PVITS - PVCFDT$$

in which: V_Z – value of the company including debt

V_N – value of the company financed by its own capital

$VITS$ – present value of the interest tax shield

$PVCFDT$ – present value of costs of financial difficulties

The optimum capital structure is determined by a mutual relation between the tax benefits and costs of financial difficulties. With the increase of the debt the present value of the interest tax shield increases. At a slight state of indebtedness, the probability of financial difficulties is insignificant and benefits of the interest tax shield prevail. However, at a certain point of debt, the probability of financial difficulties increases fast, and costs of financial difficulties start to reduce a significant part of the company's value. The company reaches the theoretical optimum at the moment when the present value of the tax savings from further debt is compensated by the increase of the present value of the costs of financial difficulties. The costs of financial difficulties caused by a high level of debt (mainly the company's insolvency to settle up interests and debt instalments to their creditors) can be divided between direct and indirect ones. Among direct costs there are various charges and fees to lawyers or specialists the company has to pay when it goes bankrupt. The indirect costs are related to the company's way of management and its consequences. When financial problems arise, managers must usually accept suboptimal decisions. When a company, for example, has to sell part of its assets at disadvantageous prices in order to get liquid money, it must waive carrying out of profitable projects that do not lead to the immediate cash flow. It has to use a less effective but short-term projects instead, and to decrease expenses on training of its staff, on research and development, and reduces stock (it can mean loss of part of sales). Suboptimal financial decisions forced by financial difficulties due to a high level of debt can include necessity to accept other loans even on disadvantageous conditions (e.g. at higher interest rates), to gain other equipment on leasing, although a direct purchase seems to be more economic, to reduce the amount of paid dividends (it gives the financial market unfavourable signals and leads to a decline of the company's prices of shares), etc.

It is very difficult to quantify direct, and especially indirect, costs of potential financial difficulties due to a high level of the corporate debt. In literature, we can find various recommendations. For example, the authors H. Levy and M. Sarnat give a particular example for calculation of the impact of a company's financial difficulties, and they suppose that a company can insure against bankruptcy (in an insurance company), if they identify the annual amount of the insurance premium with costs of financial difficulties. The same philosophy is used in our example too.

Let us consider three variants of the company capital structure – A, B, C. The company achieves the profit before the interest of SKK 1,500 thousand out of the total capital of SKK 10,000 thousand. The market value of the company at 29 % income tax and 10 % interest rate are shown in the Table 1, line 11, and at 19 % income tax and 5.4 % interest rate in the Table 2, line 7.

Table 1 Calculation of the Market Value of a Company with Debt and a 29 % Tax (in thousands SKK)

Line		Variant A	Variant B	Variant C
1.	Own capital	10,000	7,000	4,000
2.	Foreign capital	-	3,000	6,000
3.	Profit (operating)	1,500	1,500	1,500
4.	Interests	-	300	600
5.	Profit before tax	1,500	1,200	900
6.	Tax 29 %	435	348	261
7.	Profit after tax	1,065	852	639
8.	Interest tax shield	x	87	174
9.	Interest tax shield capitalization	x	870	1 740
10.	Market value without debt	10,000	10,000	10,000
11.	Market value with debt	10,000	10,870	11,740

Table 2 Calculation of the Market Value of a Company in Debt and a 19 % Tax (in thousands SKK)

Line		Variant A	Variant B	Variant C
1.	Profit before tax	1,500	1,200	900
2.	Tax 19 %	285	228	171
3.	Profit after tax	1,215	972	729
4.	Interest tax shield	x	30.8	61.6
5.	Interest tax shield capitalization	x	308	616
6.	Market value without debt	10,000	10,000	10,000
7.	Market value with debt	10,000	10,308	10,616

The Tables 3 and 4 express the application of the compromise theory. Further to the Tables 1 and 2 we consider three variants of the capital structure – A, B, C, and two companies, X and Y, with a different level of the economic risk (expressed by probability of financial difficulties in the lines 4 and 8 of the Tables). We also suppose that the company can insure against bankruptcy, and the amount of the annual premium is SKK 1,000 thousand (SKK 710 or 810 thousand after taxes) multiplied by probability of bankruptcy, i.e., the higher the probability the higher the premium required by the insurer. Other information, and the calculation of the present net value of the companies X and Y (lines 7 and 11 of the tables), having taken "costs of financial difficulties" into account, are presented in the Tables 3 and 4.

Table 3 Application of the Compromise Theory at 29 % Income Tax (in thousands of SKK)

L.		A	B	C
1.	Company value with capitalisation of the tax shield	10,000	10,870	11,740
2.	Value of debt	x	3,000	6,000
3.	Of own capital value	10,000	7,870	5,740

Company X:

L.		A	B	C
4.	Probability of financial difficulties	1	5	20
5.	Insurance after taxes (SKK 710 thousand x line 4)	7.1	35.5	142
6.	Present value of premium (at 10 % discount rate)[2]	71	355	1,420
7.	Company net value (lines 1 – 6)	9,929	10,515	10,320

Company Y:

L.		A	B	C
8.	Probability of financial difficulties	5	15	30
9.	Insurance after taxes (SKK 710 thousand x line 4)	35.5	106.5	213

[2]Assumpion of perpetuity

10.	Present value of premium (at 10 % discount rate) [4]	355	1,065	2,130
11.	Company net value (lines 1 – 10)	9,645	9,805	9,610

Table 4 Application of the Compromise Theory at 19 % Income Tax (in thousands of SKK)

L.		A	B	C
1.	Company value	10,000	10,308	10,616
2.	Debt value	x	3,000	6,000
3.	Own capital value	10,000	7,308	4,616

Company X:

L.		A	B	C
4.	Probability of financial difficulties	1	5	20
5.	Insurance after taxes (SKK 710 thousand x line 4)	8.1	40.5	162
6.	Present value of premium (at 10 % discount rate)[2]	81	405	1,620
7.	Company net value (lines 1 – 6)	9,919	9,903	8,996

Company Y:

L.		A	B	C
8.	Probability of financial difficulties	5	15	30
9.	Insurance after taxes (SKK 710 thousand x line 8)	40.5	121.5	243
10.	Present value of premium (at 10 % discount rate)[2]	405	1,215	2,430
11.	Company net value (lines 1 – 106)	9,595	9,093	8,186

From the results shown in the Tables 3 and 4 are evident the following significant conclusions:

1. The original M-M model adjusted by the income tax leads to an extreme debt policy – the higher the share of debt in the capital structure the higher the company value.
2. Taken costs of financial difficulties also in conditions of the 29 % income tax rate and 10 % interest rate into account, the mentioned extreme solution loses. The companies X and Y have the optimum capital structure at the variant B (lines 7 and 11, Table 3). The variant C, with a higher debt share than the variant B, has a lower net value in both companies.
3. The companies X and Y reach the optimum value when financed by the own capital at 19 % income tax, and 5.4 % interest rate. It is generally true that the decline of the tax and interest rates results in a decline of the interest tax shield, and the optimum shifts to a structure with a lower debt.
4. The decline of the tax rate together with the decline of the interest rate from long-term credits has a favourable impact on debt costs, and when shareholders do not change their requirements, also on the own capital (shareholder's equity) yield and on average costs of the corporate assets (capital), and it affects the growth of the company market value.

As far as decision making on company development projects is concerned, the decrease of the income tax and the interest rate (from 29 % to 19 %, from 10 to 5.4 %) brings the following conclusions (supported by calculations of particular projects):

1. Decrease of the income tax influences favourably decisions on projects, the number of acceptable projects increases, and more space for investments and development is created. The same goes for cases of financing from the company's own sources.
2. Decrease of the income tax and interest rate (if the project is financed from other sources) leads to a decline of the present value of the interest tax shield but this decline does not influence the assessment itself, it is covered by the growth of the net profit as the basic component of the cash flow project.
3. If the primary decision of a company is a decision on the capital
4. structure – the target debt ratio –, decline of the tax and interest rates diminishes space for financing projects through debt.

4. Conclusion

Changes in the business climate in the Slovak Republic after 2000, and their impact on the two above mentioned important factors (income tax rate and interest rate from long-term credits) have favourably affected two significant areas of corporate long-term financial decisions and those related to the capital budget – decisions on optimum capital structure and company development projects.

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FINANCING OF SMALL AND MEDIUM SIZED ENTERPRISES IN TRANSITION ECONOMY: AN ESTONIAN CASE

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Abstract

The financial sector, and particularly the banking system played an important role in the process of transition and economic recovery in Central and Eastern European countries (CEECs). The main objective of this paper is to analyze main changes in financing decisions of Estonian companies in the period of economic transition from 1994 to 2004 before joining European Union. Empirical results of Estonian firms' interview study, undertaken annually during 1994-2003, are presented in the paper. The analyze concentrates on informal borrowing and lending in comparison of average interest rate being applicable on official lending from Estonian commercial banks. Firms can finance investment in two ways: with equity—which can be increased by issuing new shares or by reinvesting profits—and with debt. The financial frictions arise because of the following assumptions: (a) there is a cost or premium associated with increasing equity by issuing new shares, compared to reinvesting profits; (b) defaulting on the debt is costly. During the period of transition, availability of financing has changed dramatically. We can observe switch from informal borrowing and lending to the commercial banks and financial intermediaries. However, due to the protection of the shareholders' and creditors rights usage of direct borrowing from owners, including parent company, keeps large share in total financing of companies.

Keywords: *firms' financial behaviour, transition, contractual obligations, payment terms, informal borrowing*

1. Introduction

Restructuring the banking sector was part of the integration programme of the Central and East European transition economies with the European Union. Up to the end of 1980s the transition countries (including Estonia) had a centralised monobanking system. All the banks were owned by the state and through its branches the central bank just opened credit lines for state-owned enterprises. Transition to a market economy involved the introduction of commercial banking and competition. Today the transition period has lasted long enough to enable researchers to make profound analysis and draw conclusions, whereas few years ago the tendencies were for insiders (i.e. Estonians) somewhat politicized and not so easily interpretable.

2. Changes in the banking environment

Together with development of overall economic environment the financing decisions in Estonian firms have changed significantly. These changes have been so quick that sometimes companies do not recognize their own actions to obtain financing, even if reminded now. The current article describes main changes in the financing activities. Estonia is a small country in which banks are the prevalent financial intermediaries, with total assets accounting over 70% of GDP (see Table 1).

In the beginning of 1990-s, Estonia has just become free of planning economy, what efficiently happened in 1989. Although the state has been declared free, the legislative environment and business practice remained comparable to those in other parts of former Soviet Union. Major initiatives from legislative body were related to establishment of monetary system (Law on Estonian Central Bank) and first rules to financial intermediaries. Credit Institutions Act has been approved in 1999, and it has later been modernized several times.

Table 1. Growth indicators of commercial banks in Estonia

Year	*Number of operating banks**	*Total by the end of the year, bill. EEK*		*Per bank, bill. EEK*		*GDP (current prices, bill. EEK)*
		assets	*share capital*	*Assets*	*share capital*	
1992	*41*	*5.2*	*0.5*	*0.13*	*0.01*	*14.3*
1993	*22*	*6.4*	*0.4*	*0.29*	*0.02*	*21.8*
1994	*24*	*10.1*	*0.6*	*0.42*	*0.03*	*29.6*
1995	*18*	*14.9*	*1.1*	*0.83*	*0.06*	*40.7*
1996	*13*	*21.9*	*1.4*	*1.68*	*0.11*	*52.4*
1997	*11*	*38.8*	*2.4*	*3.53*	*0.22*	*64.3*
1998	*6*	*41.0*	*6.1*	*6.83*	*1.02*	*73.3*
1999	*7*	*47.1*	*6.3*	*6.73*	*0.90*	*91.8*
2000	*7*	*57.8*	*5.9*	*8.26*	*0.84*	*92.9*
2001	*7*	*68.4*	*9.0*	-	-	*104.4*
2002	*7*	*81.7*	*9.9*	-	-	*116.9*
2003	*7*	*98.6*	*11.2*	-	-	*127.3*
2004	*8*	*133.6*	*13.1*	-	-	*141.5*

* incl. branches of foreign banks
Source: Bank of Estonia.

The role of other financial intermediaries is rather moderate. The four largest banks have more than 95% shares in Estonian banks' assets, with two of over 80%. Major shareholders in the four largest banks are Nordic financial conglomerates, which are also active in other Baltic countries. Estonian banking has experienced two system crises, which has significantly decreased the number of banks and has shifted Estonian banking under the control of foreign capital. Similar processes can be observed in all transition countries where in the end of 1999 foreign banks managed 53% of assets. In 1995, the respective number was remarkably lower – 20%. This has also pushed the development of banking regulations and supervision.

Estonia's domestic financial system remains largely dominated by banks, but other institutions are growing rapidly. Banks' domestic credit (excluding loans to other financial institutions—mainly leasing companies) remains by far the largest source of domestic financing, equivalent to almost two-thirds of GDP in 2003 (Figure I.5). The stock market's recent bullish behaviour has boosted market capitalization to 40 percent of GDP, and by a further 8 percentage points in the first quarter of this year, but four-fifths of this is foreign owned. Leasing activities (for real estate, autos, commercial vehicles, and other items, provided by institutions almost wholly owned by Estonian banks), are unusually prominent in Estonia, and have grown rapidly in recent years. The bond market remains relatively dormant, and insurance premiums grew only somewhat faster than the overall economy. The assets of investment funds (again, largely owned by domestic banks), in contrast, while still relatively small, are surging, in part reflecting the creation of a fully funded second pension pillar. (IMF country report)

Researches on banking reconstruction in Estonia and other Baltic States show that the major banks of transition economy will reach the level of developed countries' banking in relation to the banks' trustworthiness, novelty of products and standards. This is also a claim of global economy for survival, which has been realized generally by the banking of transition economies. But the disadvantage of such development is the extreme concentration in banking, as a result of which competition, which is essential for ensuring stable development and stability of services and prices in the banking market, will gradually decrease.

The Estonian economy has been expanding rapidly, with per capita real incomes rising by 75 percent in the last decade. This was the result of high domestic investment rates; with the average investment share the highest among new EU members in recent years, and sizably above the shares in the old EU and in other large debtors, although recent shares have been temporarily inflated by a number of large, "one-off" projects. The saving rate, in contrast, has been average compared to those in other new EU members, but higher than then those in other high net external liability economies. (IMF country report)

3. Changes in financing activities of firms

In that paper are used some results of the special interview study of Estonian manufacturing firms undertaken annually in 1994-1999 and in 2003. Tallinn Technical University research group, headed by prof. Vello Vensel, has monitored Estonian economical behaviour of enterprises in frames of Monitoring of Business Environment.

The study is one part of larger joint research project of analysis of reforms in financial sector in Central and Eastern Europe transition economies. The study was financed by EU Phare program and Estonian Science Foundation support. The sample has not been very large (being during the period of monitoring from 40 to 68 firms), but it is representative in means of composition from different firms.

The main changes are decreasing share of state-owned enterprises and corresponding increasing share of private ownership due to the successful and rapid privatization process, if we compare distribution of firms by the ownership structure in different years. Share of state-owned enterprises (SOE) decreased from 18.1% in 1994 to 4.1% in 2000 and correspondingly share of domestically owned private ownership increased from 59.2% in 1994 to 73.8% in 2000 we can mention also increase of the share of mixed domestic and foreign private ownership (at an average 16.8%). The average share of foreign ownership in the last group of firms (12 firms responded in 2000) was 68.3%. Most of the sample firms started their business after 1992 and obtained their start-up financing mostly from own savings (at an average 58.1%) because their access to the loan market was limited.

Most of sample firms were medium size firms (at an average 49.6%) with the number of permanent workers 21-200, share of small firms with the number of workers 1-20 was at an average 37.2%. Quite clear trend was increase of the share of small firms (from 20.6% in 1994 to 52.9% in 2000) and respective decrease of the share of large firms (from 23.5% in 1994 to 4.0% in 2000). This phenomenon is result of restructuring the whole economy and start-up of new private small businesses. Average number of permanent workers in sample firms was about 50 in 2000.

As a generalisation, the results show that the sample mostly consists of small (at an average 37.2%) and medium-size (49.6%) domestically owned private (73.8%) joint stock companies (70.4%%) or limited liability enterprises (16.5%), which started their business on the basis of own savings (58.1%) after the year 1992 (64.1%), and which are operating in Tallinn (49.2%) and in North-Estonia (28.0%). Although the sample is not very big (at an average fifty firms responded every year) it is representative with respect to different distribution characteristics. As a feedback, more important results of the study and a short financial analysis results (for example, *Altman* Z-score and other financial ratios) on the basis of balance sheet and income statement information was given to responded firms. (Teearu and Vensel, 2001)

An enormously important source of private financing for start-ups and SMEs in both developed and developing countries is the venture capital industry. The availability of risk financing for new enterprises and SME expansion is organized around individuals and firms who seek such opportunities and market them to potential sources of capital. The venture capital industry is particularly important in countries where banks do not make equity investments. However, even under universal banking, banks often prefer customers with proven track records and shun new enterprises and longer-term commitments and risks that are hard to judge. Thus, the role of venture capital as a source of finance for activities with high risk and potentially large impacts on economic development cannot be understated. (BOFIT discussion paper)

Table 2. Sources of financing of Estonian Firms in 1994-2000 and 2003, percentage of total

Source of financing	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2003***
Own savings	57,9	63,6	51,6	57,4	50,3	56,3	69,7	60,1
Loan from domestic bank	10,5	11,4	10,9	1,0	6,2	5,7	3,5	10,1
Loan from relatives, friends	8,0	9,2	6,2	3,3	1,9	6,5	2,7	1,6
Loan from foreign bank	2,6	6,8	1,6	0,8	0,6	1,4	0,8	1,1
Loan from money-lender	10,5	4,5	4,7	3,7	1,5	2,2	1,1	1,0
Other sources	10,5	4,5	25,0	33,7	39,5	27,9	22,2	26,1

Source: Authors' calculations

Some of the results from the table 2 can be directly attributed to the tendencies in overall economy, e.g. increase of borrowing from relatives and friends in 1999, a year after financial sector has been hit by Russian crisis. Relatively big importance of "other sources" is indicative of increasing share of foreign investments to the Estonian companies.

Not surprisingly, getting a loan from an Estonian Commercial Bank depends on loan guarantees, total assets of the company and the time how long the company has been client of the bank. Because small companies do not have sufficient guarantees at starting the business, it is extremely difficult to access credit resources through bank loans. Many prefer to give direct loan instead of giving additional warranties. This is why the starting capital has been mainly collected from own savings, more than a half of resources of starting capital every year. Borrowing from moneylenders is not typical and that service does not have significant influence on financial market.

Also, together with increase of availability of formal financing from banks, the importance of lending from moneylenders has decreased. One of the reasons is their higher interest margins; another is their reputation of informal way of debt collection, if the payments were delayed.

Interesting fact is, that despite of increase of availability of formal lending, importance of own savings (including owners' equity) has remained high. It may be related to the "long-term survival" goal of managers. Taking financial obligations is still seen as more risky strategy than having large owners' equity. Somewhat this indicates also confidence of Estonian owners and managements to the economic environment: only small percent of companies have distributed dividends, thus believing that keeping the earnings in the business is more profitable than taking it out.

4. Possible causes of changes in financing decisions

The current Estonian income tax law supports having more equity in business. Because the income in the company is not taxed, there does not be usual income tax effect on borrowing and the profit of Estonian subsidiary of international group, if consolidated into parents' result, makes groups average income tax level lower. From one side it is disadvantageous to the lenders in banks, but the effect on total economy probably outweighs this disadvantage. The same reason may be behind the aggressive lending by banks to private persons: there simply may not be enough business to whom to lend the funds.

Also, one must note that the improvement in creditor rights protection plays important role in the financing decisions of companies. In the Table 3 below is provided analysis of the creditor rights indices. If transition economies had LLSV index value of 1.4 in an early stage of transition in 1992, the same is increased to 3.23 for 1998. In Estonia, the introduction of the Estonian Commercial Code was the factor mostly changing shareholder and creditor rights.

In CEE/Baltics can trace the formal legal systems primarily to German Law and the countries of South-Eastern Europe to the Ottoman Empire, which in turn was influenced by French law (David and Brierly 1985, Knapp 1972). In contrast the countries of the CIS failed to develop a modern formal legal system prior to a revolution.

Table 3. Creditor rights in comparison

	Average of creditor rights (LLSV cr)
World average	2.3
Common law family	3.11
French civil law family	1.58
German civil law family	2.33
Scandinavian civil law family	2
Transition economies 1992	1.4
Transition economies 1998	3.23

Source: Pistor, Raiser and Gelfer

Parallel to the reduction of state financing, economic reforms in transition also fundamentally altered the structure of ownership rights through privatisation. Privatisation methods have varied greatly across the region with potentially powerful implications for the availability of external finance. In a few countries, Hungary, Estonia, Latvia and more recently and to a lesser extent Bulgaria and Kazakhstan strategic sales to foreign investors have dominated the large enterprises. In these countries FDI has been an important source of external finance and the catalyst for corporate restructuring albeit concentrated among the top tier of the corporate sector. However, most governments in the region were constrained in a design and implementation of privatisation by the power of incumbent managers who had accumulated implicit control rights as a result of weak state monitoring under central planning. Privatisation often simply led to the explicit recognition of these control rights through the allocation of ownership titles to insiders (EBRD 1997).

Entrepreneurial financing runs the gamut from start-up funds to support the launching of new companies to growth financing for successful small and medium size enterprises (SMEs). Such transactions have important demand and supply components that are hardly unique to transition economies. On the supply side, the riskiness of these ventures is thought to make them unattractive to banks and, hence, these activities will be credit constrained. On the demand side, the adverse selection argument indicates that firms that are successful have no need to access external credit markets so that the only borrowers left seeking outside financing will be 'lemons.' Creditors fearing adverse selection refuse to lend to the entire pool of borrowers and banks maintain below market clearing interest rates and ration credit according to other criteria. These problems are endemic to entrepreneurial finance and various institutions to surmount them have evolved in developed capital markets. In many instances, market imperfections for the financing of SMEs lead to government efforts to provide subsidized programs for start-up financing and micro lending. Some of the literature on entrepreneurial finance in transition economies indicates that credit market imperfections are not serious impediments and that start-ups have succeeded without any apparent financing difficulties. For example, Czako and Vajda (1993) examined the sources of SME start-up and continuing financing in the early stage of the transition in Hungary and found that only about a quarter of the companies surveyed used either bank or concessionary loans for start-up financing. Furthermore, of the less than 20% of these Hungarian companies that reported the need for subsequent capital, only about 20% used concessionary financing while almost 45% attracted bank financing. (BOFIT discussion papers)

About half of the interviewed companies reported usage of overdraft facilities; most of them received overdrafts from one bank (81%) and others from 2 different banks (see Table 4).

We can not observe clear relationship between the actual average interest rate and the share of companies using bank financing. However, this can be explained by the large share of companies using parent company's or owners' financial support.

The share of "other" clearly indicates that the combination of well-protected shareholder and creditor rights together with the higher market interest rate than in developed countries is driving the tendency of financing companies through equity and owners' direct investment.

According to the IMF country report analysis, the share of FDI earnings reinvested in Estonia averaged 63 percent during 1996–2003, rising to 79 percent in 2003 (IMF report). This again proves that Estonia is exceptionally using large part of the earnings to enlarge the business. Recent data show that Estonia's foreign direct investments per capita are on a solid top 20 positions in the world, and as an indicator we can look at it as one more argument supporting good direct investment climate in Estonia.

Table 4. Borrowing from Formal Institutions

	1994	1995	1996	1997	1998	1999	2003
Share of firms (%) using:							
Overdraft facilities	41.9	42.9	45.5	56.3	43.3	45.7	42,7
Granted loans	33.3	38.7	47.9	55.1	50.7	63.8	65,5
Leasing contracts	22.2	32.6	47.5	60.0	68.7	61.4	62,3
Share of bank loans (by number)	76.9	74.3	75.2	74.8	73.3	65.0	73,1
Average annual interest rate	24.6	18.2	16.7	16.6	12.4	12.1	8,1
Average annual interest rate for companies	No data	No data	No data	16.29	17.01	9.49	8.78
Share of firms applying for loans, %	36.8	47.2	62.5	51.1	52.2	42.2	61.2
Share of accepted loan applications, %	92.9	89.1	76.6	88.0	82.9	89.5	94.3
Reasons why the firm did not apply:							
High interest rates	37.3	3.9	27.3	7.4	10.8	16.0	7.5
Do not wish to fall into the debt	20.8	19.2	27.3	18.5	10.8	4.0	4.1
Do not need a loan	16.7	42.3	36.4	40.7	56.7	48.0	52.2
Complicated application procedure	8.4	11.5	9.0	3.8	-	-	1.0
Insufficient collateral, probably will not be approved for a loan	8.4	23.1	-	29.6	5.5	12.0	10.1
Other reasons (parent firm is helping, already has a large debt etc.)	8.4	-	-	-	16.2	20.0	25,1

Source: Authors' calculations

The share of lease financing has had steady growth from 1994 to 1998. That can be explained with general legislation enabling to secure leases in better way than loans. Granted loans have been used more in late 90-s and were even more popular than financial leases in 1999. Lease financing has steadied after 2003 in Estonia, however, Estonian companies have started significant lease activities in CIS countries.

5. Informal borrowing and lending

Approximately an half of the companies have requested a loan from bank and nine tenths had received it. Firms, who received loans during the last year or during the last five years, reported more exact terms and conditions of loans. About 2/3 of institutional loans were bank loans, firms received loans also form non-bank financial institutions (for example, from credit unions), from government projects and foundations, from parent firms. The companies what did not apply the loan majority did not need financing outside the company. The second most important reason was lack of security to be pledged as collateral.

23.4% responded firms reported the usage of informal borrowing during last 3 years. The main reasons for informal borrowing (mainly fewer formalities and more favourable interest rate) are presented in the Table 5.

Relatives and friends, also owners and parent firm, were reported as main loan sources, moneylenders and suppliers or clients were also mentioned. To comment informal borrowing the most adequate conclusion is that personal relationship with the borrower is a reason why it is used.

Table 5. Informal Borrowing and Lending

Reasons	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2003***
1. Informal Borrowing:							
Share of firms using informal borrowing	18.7	21.2	16.7	24.5	23.9	23.4	20.3
Main reasons of informal borrowing:							
More favourable interest rate	33.3	41.6	12.5	8.3	37.5	36.4	10.2
More flexible repayment schedule	16.7	25.0	25.0	58.4	-	-	-
Less formalities	33.3	-	25.0	-	31.3	54.5	63.9
Collateral is not needed	-	16.7	25.0	8.3	12.5	9.1	12.3
Others (did not got a loan from a bank)	16.7	16.7	12.5	25.0	18.7	-	3.1
Main loan sources/lenders:							
Relatives and friends	50.0	58.3	37.5	50.0	77.4	36.4	61.0
Money-lenders	16.7	16.7	25.0	16.7	12.9	18.2	15.2
Informal groups	-	16.7	25.0	16.7	3.2	-	-
Suppliers or clients	-	8.3	12.5	-	-	18.2	-
Others (individuals, parent firm)	33.3	-	-	16.6	6.5	27.2	5.7
Average annual interest rate	28.4	22.3	19.8	16.3	11.1	8.1	8.4
Usage of collateral, %	16.7	22.5	37.5	25.0	25.0	9.1	10.3

2. Informal lending:							
Share of firms granted informal loans	23.0	34.2	29.6	35.8	37.3	31.1	29.6
Main loan recipients:							
Relatives and friends	14.8	27.8	5.3	3.2	8.0	14.3	3.3
Suppliers or clients	14.8	-	-	17.4	12.0	14.3	14.4
Employees	48.2	55.6	73.7	76.7	60.0	57.1	69.8
Other firms	22.2	16.6	21.0	2.7	20.0	14.3	5.0
Average annual interest rate	23.5	18.6	15.4	11.3	9.9	8.8	8.2
Usage of collateral, %	33.3	28.4	47.4	21.7	38.1	46.1	55.2

Source: Authors' calculations

Largest share in money lending have employees. It is probably related to policy of retaining employees in the business when salaries are relatively low. Although loans from banks have become available to many persons, lending from a company is still popular.

An important component of a state's economic policy is its financial policy. The financial sector, and particularly the banking system played an important role in the process of transition and economic recovery in Central and Eastern European countries (CEECs). Banks and other financial institutions are a unique set of business firms which assets and liabilities, regulatory restrictions, economic functions and operations establish them as an important subject for the study, particularly in the conditions of emerging financial sectors in CEECs. Banks and other financial institutions performance monitoring, analysis and control need special analysis of their operating and activities results. It can be done from the viewpoint of different audiences, like investors/owners, regulators, customers/clients, and banking managers.

There are several obstacles hindering the transformation of former centrally-planned economies into well-functioning market economies. The business environment in transition countries is dynamic and dramatically changing.

All these transition activities, such as appropriate institution-building, political democratisation, changes in value appraisal and behaviour of individuals and economic agents, cause rapid changes in the business environment influencing, among others, financing and investment decisions made by firms.

6. Conclusion

Small and medium sized enterprises in Estonia have different approaches to the financing. We can notice that large share of financing is provided by either the owners or by the parent company despite availability of different financial products from banks and other financial intermediaries. This tendency may have several reasons: influence of the unusual corporate income tax law, good protection of shareholders and creditors rights, owners' faith to the economic growth in Estonia and relatively good effectiveness of legal enforcement mechanism.

For SME-s borrowing from owners with less transaction cost and less formality is only outweighed by the use of owners' equity, i.e. retained earnings, as a main financing source. Use of own savings, including the equity, is remaining popular for businesses. This can change together with the change in tax system, which is expected after the transition period agreed with EU before accession in 2004 ends.

More profound studies are needed to analyse the reasons behind using of the informal borrowing and lending and the relationship between the shareholders rights and use of owners' equity as a primary source of financing.

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SUPPORT OF THE DEVELOPMENT OF SMALL AND MEDIUM-SIZE ENTERPRISES IN EAST SLOVAKIA[1]

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Abstract

The contribution deals with the institutional structure of the support of SMEs in Slovakia. It shows the situation in the field of support of the small and medium -size enterprises in East Slovakia. It also provides a picture of how the small and medium -size enterprises are informed about institutions of support, about using the services of these institutions, about the interest of SMEs to use the services of these institutions, about the interest of SMEs to cooperate with universities. The contribution is a part of the output from the solution of the Grant of the University of Economics in Bratislava, Project of Young Scientific Workers, No. 2330251/04 "Solution of Selected Problems of Regional Forms of Support of Small and Medium-Size Enterprises".

Keywords: *support of small and medium-size enterprises, support institutions of small and medium-size enterprises, using the services of the institutions for support of SMEs*

[1] The contribution is a part of the output from the solution of the Grant of the University of Economics in Bratislava, Project of Young Scientific Workers, No. 2330251/04 "Solution of Selected Problems of Regional Forms of Support of Small and Medium-Size Enterprises"

1. Introduction

Small and medium-sized businesses are an important part of the economy. Their development has a positive trend in Slovakia in the recent years. The number of small and medium-size businesses is increasing, the share of employment in small and medium businesses on total employment is growing, the volume of gross production in small and medium-size businesses is increasing but the share of SMEs on total gross production is decreasing.

In spite of this fact the share of SMEs in the total number of companies in Slovakia is comparable with the countries in the European Union.

Joining the European Union means for the Slovak Republic an increasing competition pressure in the markets. In order to maintain the position of SMEs in the competitive markets, the Slovak Republic follows the policy of supporting the development of small and medium-size enterprises and in the effort of improving the entrepreneurial environment by programs of support to small and medium-size enterprise of Ministry of Economy of the Slovak Republic, other Ministries, financial and assistance institutions, interest societies and unions. An important role in this process is played by banks, which take part in co-financing of assistance projects of development of SMEs.

At present, attention to small and medium-sized businesses is given by institutions for support of the development of small and medium-size businesses as well as many scientific and research institutions, among them also universities.

The research project "Solution of Selected Problems of Regional Forms of Support to Small and Medium-Size Businesses" is aimed at examining the current state of SMEs in East Slovakia, analysis of current conditions and possibilities of the access of SMEs to capital for beginning and development of their entrepreneurial activities, determining and solving some of the main problems of supporting small and medium-size enterprises and designing a proposal of measures for improving the situation in this field in East Slovakia.

The aim of this contribution is to present the preliminary results of the research of young researchers and to show the situation in small and medium-sized businesses in East Slovakia.

2. Institutional Support of Small and Medium – Size Enterprises in Slovakia

In spring 2000 at the Lisbon summit, the EU set a new strategic goal: to become the most competitive and most dynamic economy in the world which would be capable of constant economic growth. At the meeting of the European Council in Feire in June 2000, the European Charter for Small Enterprises was issued ,which called upon the Member States and the European Commission to support the development of small enterprises. The Slovak Republic officially adopted the European Charter for Small Enterprises at the Conference of CC Best in Maribor on 23rd April 2002.

In compliance with the above mentioned Charter and further documents and recommendations of the EU, in Slovakia at present the following institutional framework for support of small and medium enterprises is built up. The guarantor and coordinator of all activities for the field of small and medium enterprising is the Ministry of Economy of the SR which in accordance with the Act of the Slovak Parliament No. 575/ 2001 on organizing the activities of the Government and organization of the central state administration,in the wording of later regulations, participates in the strategy of creating the entrepreneurial environment and supporting SMEs in the fields of industry, power engineering, mining, trade and tourism. The task of the Ministry is:

- creating the strategy of development of small and medium enterprising through state support programs which are carried out through
  - the National Agency for the Development of Small and Medium Enterprises,
  - the Slovak Guarantee and Development Bank, a.s.,
  - the Slovak Power Engineering Agency,
  - the Slovak Agency for the Development of Investments and Trade.
- providing support for establishing industrial parks.

The Ministry of Economy is the Directing body for the Sector operating program Industry and Services through which it is possible since the accession of the SR into the EU to get finances from the European Fund for Regional Development.

The National Agency for Development of Small and Medium Enterprises together with a network of Regional Counseling and Information Centers create the basic institutional tool for support and development of

SMEs which co-ordinate the activities to support them at international, national and local level.

The National Agency for Development of Small and Medium Enterprises was established in 1993 with the common initiative of the EU program PHARE and of the Government of the SR as a foundation. In 1997 it was transformed into an interest association of legal entities of non-profit character. The basic mission of the Agency is to support the development and growth of SMEs in Slovak Republic with regard to the state structural, industrial, technical, regional and social policy. The financial cover for support of SMEs is provided for from the state budget, from funds of PHARE and from funds of the EU.

The National Agency for Development of Small and Medium Enterprises with its financial programs enables:

- Support Loan Program which enables to gain loan funds for setting up or development of a small and medium enterprise, and whose aim is to strengthen the position of small and medium companies, to support their further development and to increase, or maintain employment.
- Micro-loan Program whose subject matter is making loan resources accessible for small entrepreneurs, and whose aim is:
    - to enable establishing/development of small businesses
    - to increase the survival rate of small businesses
    - to contribute to maintaining of employment and creating new jobs in single regions of the SR.
- Capital Starting Fund whose aim is to enable establishing and development of new companies, and to help develop the activities of existing ones in new fields of business by financial investments.

The program enables small and medium entrepreneurs access to capital for starting or development of their entrepreneurial activities through selected banks /Istrobanka, Unibanka, Slovenská sporiteľňa, Tatra banka, Ľudová banka, Všeobecná úverová banka/, Regional Counselling and Informatiom Centers, Entrepreneurial Innovation Centers and Seed Capital Company, s r.o. /established by the National Agency for Development of Small and Medium Enterprises as one of the forms of supporting financial programs – financial investments/.

Besides financial support programs of loan character, the National Agency for Development of Small and Medium Enterprises provides support to small and medium entrepreneurs in the framework of other programs, too, for example:

- additional programs
- counseling and educational programs
- information and institutional programs
- in the framework of pre-accession help of the EU
  - Industry Development Grant Scheme - IDGS
  - Tourism Development Grant Scheme – TDGS
- in the framework of EU help through structural funds – Innovations and Technologies Development Grant Scheme – INTEG
- Sector Operational Program Industry and Services
- and others.

Regional Counseling and Information Centers were established on the basis of partnership of public and private sector as non-profit institutions in the form of association of legal entities with the aim to support economic development at regional level through development of small and medium enterprising. They provide complex counseling, information and educational services, especially for beginning entrepreneurs, or for existing SMEs.

Business Innovation Centers /BIC/ were established with the aim to actively support selected entrepreneurial plans in the region and provide them with long-term care. They are independent legal entities which work out business plans and marketing plans for entrepreneurs , loan applications, accounting, provide services at implementing quality systems, technological and patent counseling, etc.

The above mentioned network of institutions for support of SMESs at regional level is supplemented by:

- Entrepreneurial Incubators which represent places where newly established businesses are concentrated in a limited space, and whose aim is to enhance the survival chance of these businesses, and to support their growth through providing:
  - rent of business premises at the lowest prices in the given location
  - common technical infrastructure
  - specialist counseling services and education.

In Slovakia, Incubators work in Banská Bystrica, Bratislava, Košice, Martin, Prešov, Rožňava, Spišská Nová Ves.

- Centers of First Contact whose services´ mission is to contribute to the improvement of the entrepreneurial climate, to support creating new jobs, to increase the competitiveness of target groups, to support cooperation in the framework of the EU, to present and make their regions visible.
- The Slovak Guarantee and Development Bank, a.s. was established by the Finance Ministry of the SR in 1991 as a state money institution, and in 2002 it was transformed into a stock company with 100% stake owned by the state with a special mission aimed at support of financing small and medium enterprises. It is carrying out its support programs for small and medium businesses in the form of providing guarantees, loans and non-returnable financial contributions. It also supports newly beginning small and medium entrepreneurs and self-employed businessmen who, as a rule, are not the target group of commercial banks. Since the end of the year 2000 it has been providing short-, medium- and long-term direct loans to entrepreneurs of operational and investment character. In cooperation with selected commercial banks, SZRB realizes loan products through loan programs.
- The Export-Import Bank supports export activities of exporters mainly into the EU and OECD countries with ensuring return on finances by minimization of risks which arise from insurance, loan, guarantee and financial operations. EXIMBANKA SR performs its functions and activities by financing and insuring export loans with the aim to increase the competitiveness of the domestic products, and support mutual economic exchange of Slovak Republic with foreign countries, especially EU and OECD countries.

Besides the Slovak Guarantee and Development Bank and Export-Import Bank SMEs are supported by the programs of further financial institutions and funds:

- Slovak-American Entrepreneurial Fund
- Fund for Support of Foreign Trade
- Micro-fund Integra
- Innovation Fund

as well as supporting institutions of SMEs :

- Slovak Chamber of Commerce and Industry
- Slovak Chamber of Entrepreneurs
- Slovak Agency for Development of Investments and Trade
- Slovak Agency for Tourism

- Agency for Support of Science and Technology, and many other institutions, associations and societies.

3. Reasearch Methods of the State of Support to Small and Medium-Size Enterprises

The research was carried out in September and first half of October 2005.

Questionnaires which were divided into six parts: Assistance to SMEs, Financing SMEs , Strategy of SMEs, Innovation activity of SMEs, Informatics and General information, were distributed in three ways:

- by sending e-mails with the request of participation in the research with the web site (www.euke.sk/vyskum), where the web form was put, which enables anonymous filling in the questionnaire,
- distribution of printed questionnaires by students to small and medium-size businesses, followed by copying the completed questionnaires into the form on the web site,
- distribution of printed questionnaires to small and medium-size businesses through the Slovak Post.

From the database file of small and medium-size businesses provided by the Statistical Office of the Slovak Republic by the method of random selection, enterprises were chosen which sent questionnaires. Companies where e-mail addresses were available were addressed by e-mail, to other companies the questionnaire was sent by post. With both ways of distribution, a quarter of the letters came back because of unknown recipient.

4. Preliminary Evaluation of the Results of the Research

4.1 Legal form of small and medium-size enterprises

The questionnaires were filled in by 129 companies. The following table 1 shows an overview of the legal form of companies participating in the research.

Table 1 Legal form of small and medium-size enterprises

Number of employees	Form of enterprises[2]					
	a.s.	**v.o.s.**	**s. r.o.**	**š.p.**	**živnosť**	**Total**
0 - 9	1	0	25	0	57	83
10 - 49	0	1	28	0	5	34
50 - 249	3	0	8	1	0	12
Total	4	1	61	1	62	129

Source: own research

4.2 State of being informed about the assistance institutions helping the small and medium-size businesses

The question "Do you know the institutions which support the development of SMEs?" was answered as shown in Table 2. To answer the question "indicate which" respondents listed institutions: National Agency for the Development of SMEs, regional consulting and information centers, the Ministry of Economy, bureau of labor and others, from which follows that at least some of the companies know the institutions which support the development of SMEs.

Table 2 Do you know the institutions which support the development of SMEs?

Number of employees	**Legal form[2]**	no	yes	total
0-9	*a. s.*	1		1
	s. r. o.	14	11	25
	živnosť	32	25	57
10-49	*s. r. o.*	13	15	28
	v. o. s.	1		1
	živnosť	1	4	5
50-249	*a. s.*	0	3	3
	š. p.	1		1
	s. r. o.	1	7	8

Source: own research

[2] a.s. – stock company, s.r.o. - limited liability company, živnosť – self-employed, š.p. – state-owned company, v. o. s. - public trade company

To the question “Do you use the services of the institutions supporting SMEs?” only 9 respondent gave a positive answer. The question “indicate which” was answered by: the interest association PO Kézfogás, Regional Counseling and Information Centers, courses – counseling – subsidies, mediation of business, state subsidies, working out entrepreneurial plans and grants and information about product promotion counseling, financial contribution for establishing new jobs, grant programs.

The question “Has anybody from your company taken part in an information event on possibilities of supporting SMEs?” was answered positively by only 8 respondents. They stated the following organizers:

- the town Košice
- the town Rožňava
- town authority Veľké Kapušany
- the Ministry of Economy
- the Ministry of Agriculture – 2 respondents
- Regional counseling and information center – directing quality,
- Regional counseling and information center Prešov,
- Regional counseling and information center Košice,
- Integra – course.

From the above mentioned it results that small and medium size enterprises know the institutions which support the development of SMEs but they do not use their services /apart from some exceptions/, and they do not take part in information events about possibilities of assistance to SMEs. However they are interested in using the services of institutions which support SMEs. The interest to use the services of these institutions was expressed by 30 micro-companies with the number of employees from 1 to 9, 14 small companies with the number of employees from 10 to 49 and 5 medium-size companies with the number of employees from 50 to 249.

4.2.1 Support of participation of small and medium size companies in the 6th Framework program of the EU

The 6th Framework program for science and research is an activity by which the European Commission contributes to achieving the aim to create from the EU the strongest economy. The community program is designed to ensure quick application of new information and technologies in the market especially through small and medium enterprises. For Slovak companies it is a way of gaining access to most progressive technologies and innovations of production.

Special attention is given to SMEs with the aim to support their participation in the activities in single thematic fields, especially in integrated projects. In excellence networks and in target oriented research, it is expected that small and medium size-enterprises will use this form to draw at least 15% of the budget of seven thematic priorities.

Further there are two specific schemes for small and medium size enterprises, which enable them to develop innovations actively without having their own research capacities. These are the “collective research” and the “cooperative research” schemes (CRAFT). Through these schemes can SMEs as well as entrepreneurial groups assign a research task to research institutions (research institutes, universities, etc.), and this way solve their own development and innovation problems.

We wanted to know if the companies know the possibilities offered to small and medium size enterprises by 6th skeleton program of the European Union. Only seven respondents answered positively, and they stated the following possibilities:

- support of selected entrepreneurial projects, also financial
- 15% of the budget of the skeleton program is devoted to the participation of SMEs in research, development and support activities from different countries
- micro-loan program
- support from the National Agency for Development of SMEs
- integrated projects
- creation of European research area.

It should be noted that the support from the National Agency for the Development of SMEs and the micro-loan program do not belong to the 6th skeleton program of the European Union.

4.2.2 Cooperation with universities

24 respondents expressed their interest to cooperate with universities in the fields of: research, tourism, quality management, service delivery, production technologies, optimal process directing, power engineering, construction industry, practical accounting, international accounting

standards, market research, marketing, counseling about the possibilities of gaining funds for doing business.

4.2.3 Suitability of sources for gaining information

Our object of interest was also to find out to what extent are single sources of information about support suitable for small and medium size businesses /the more suitable, the higher grade/. Table 3 presents the average of suitability of single resources of gaining information about support to SMEs according to size and legal form of companies.

Table 3 Suitability of sources for gaining information about support for SMEs

Number of employees	Legal[2] form	Daily papers	Periodicals	Subject specific magazines	Specialized publications	Internet	Information events
0 - 9	*a. s.*	7,00	7,00	9,00	8,00	10,00	3,00
	s. r. o.	6,20	6,44	6,28	6,56	8,36	6,24
	živnosť	6,09	4,93	6,00	5,61	8,07	5,50
10 - 49	*s. r. o.*	5,44	5,70	7,61	6,84	8,89	7,27
	v. o. s.	4,00	2,00	6,00	6,00	7,00	5,00
	živnosť	7,00	4,00	5,40	3,80	8,80	3,40
50 - 249	*a. s.*	7,33	6,00	9,67	8,00	10,00	6,33
	š. p.	9,00	6,00	6,00	5,00	10,00	10,00
	s. r. o.	6,33	5,00	7,11	7,78	7,56	6,78
Total		6,49	5,23	7,01	6,40	8,74	5,95

Source: own research and own calculation

5. Conclusion

There are many institutions in Slovakia which support the development of small and medium size enterprises. Small and medium-size enterprises in East Slovakia have information about their existence but as preliminary results of research are showing they do not use their services and do not take part in information events about possibilities of support for SMEs. It will be necessary to look for possibilities of improving this situation in East Slovakia.

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ROLE OF THE PROJECT MANAGEMENT IN SME'S FIELD AS A SUCCESFULL WAY TO OBTAIN FINANCING BY THE EUROPEAN FUNDS[1]

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Abstract

Project management and its methods are intended for wide and complicated projects leadership. Useful procedures save time and preparation and primarily cut business costs. Typical way, where to practice project management, is company development by European funds supporting policy. Many people, especially in SME's sector, are specialized only on application form, not for organizing, leadership in time of project realization. In this area you could cut your business costs the best. Second section is dedicated to SWOT projects analysis with pointing out on reasons, why the project wasn't being successful in the competition. Research work was realized in two regions – Moravian-Silesian and Ústí region to be able to compare current situation in Regional Business Centres for SME's support and Employment Agencies. Research presented in this paper was supported by internal grant system of Silesian University, IGS SU Nr. 18/2005.

Key words: *project management; business support; SME*

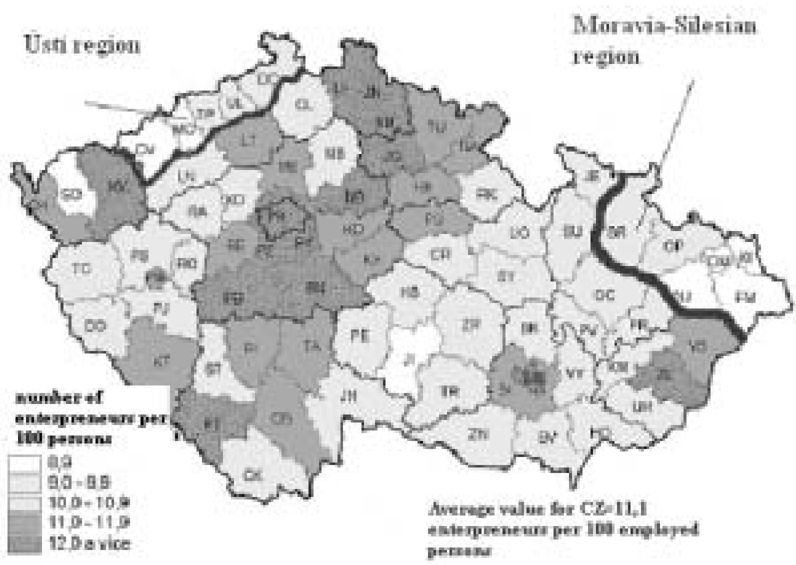
[1] Research presented in this paper was supported by Internal grant system of Silesian University, IGS SU Nr.18/2005

1. Introduction

Small and medium sized enterprise (SME) we could characterize as a dynamically growing section of the national economy, especially in number of enterprises. Their importance we could illustrate by the ratio on all subjects on the Czech market in 2004, it was 99.85%. This number says that number of large enterprises decreases strongly too. It means that SME's in the Czech Republic play a big role in regional labour market. Last year it had employed in these sector 61.5 % persons. Their contribution to the economy system is about 34.92 % of GDP; they made 52.15 % of total output and 52.9 % of added value in our republic. SME's are the most important subjects, who increase our foreign trade – 34.3 % of export operations and 52.5 % of import operations.

It was the main reason why is important to promote project management to be more successful in the project competition in Structural funds in the Czech Republic. The activity mainly depends on entrepreneurship intensity ratio. Both mentioned regions – Moravia-Silesian region and Ústí region suffered from high unemployment rate and the lowest entrepreneurship intensity ratio, which is illustrated on the map below.

Figure 1 Entrepreneurship intensity ratio



Source: http://www.czso.cz/csu/edicniplan.nsf/tab/3800373D29

Czech entrepreneurship is stable growing and developing, by the comparison – three or four subjects are established into one died. The trend you can observe many years. Absolute numbers are represented in Table 1.

Table 1 Comparison of number of founded and died enterprises

Year	New founded	Cut-off	Absolute value	Ratio: New founded: cut-off
2000	102 886	27 667	75 219	3.7:1
2001	92 322	30 694	61 628	3:1
2002	64 084	18 413	45 671	3.5:1
2003	99 915	26 781	73 134	3.7:1

Source: www.czso.cz, own calculation

Books define project management as an operation limited by time and finance sources, which needs wider cooperation between more departments. Simplified definition says that one team solves one complex object by the most effective way with minimum costs.

When we explain a definition in real life, it means two sides - project description and daily routine. We have to define clearly each work stage and operation sequences. They are existing basic team work rules to be successful. First of all you have to choose a team leader, who has two basic abilities – interpersonal and conceptual and technical skills, than you are able to prepare an implementation timetable and financial plan to be respected by all team members.

Finally all team members have to identify with the project and respect all rules in this time period. The best way to be successful is to support communication activities between all members to solve conflicts and problems during the project. After that you could say that you could the reap harvest the benefits of the project management.

2. Research methods and basic hypotheses

- SME's Analysis in competence of The Ministry of industry and trade 2001-2004, www.mpo.cz,
- Own research, which take place from February to July 2005.

[2] Analýza malého a středního podnikání ve Zlínském kraji, srovnání stavu MSP v ČR a EU, definování rozdílů v jeho různých segmentech http://extranet.kr-zlinsky.cz/vismo/dokumenty2.php?ID=120205

During above-mentioned period, we made a research between SME's in both regions Moravia-Silesian and Ústi, which was specialized on changes in business environment and main development barriers after the EU accession in 2004. Focus was on the local labour market. It was the reason why we use and compare SME's only from the number of employees view and we abstracted from total balance sheet or turnover, which was new defined by the European Commission from 1.1.2005. Another factor, who changed the research way was the fact, that entrepreneurs was not have a goodwill to write down these figures in questionnaire. It was tested on small entrepreneurship group and the main answer was blank questionnaire. It was the reason to modify main goals and the questionnaire type.

Main goals for the research were following:

- SME's structure in both regions, the capital and size of enterprises,
- Information sources about EU and their supporting policy programmes,
- Education opportunities for SME's,
- SME's Adaptability strategies.

2.1 Hypothesis based on information sources

Before questionnaire preparation, we have to formulate hypothesis based on previous projects and research, but with one change – now as a European Union member:

- "Micro" structure like self-employment person is dominating in regions mentioned above and in all the Czech republic as a way how to solve the unemployment problem,
- Main specialization is trade because of low request on capital, innovations and education,
- Entrepreneurs not use many supporting programs, they don't know about them and main information source is Internet web sites,
- Low rate of approved projects has influence in low rate of education, no counselling work of Business Centres,
- SME's have a high level of dynamics and adaptability to the new business environment; there is connections wit local labour market.

2.2 Methods of own research

We contacted 720 entrepreneurs in both regions to be able describe adequately characteristic attributes in their environment. We obtained only 172 responders, 122 from z Moravia- Silesian region (MSR) and 50 from Ústí region (ÚR).

Answers we record into spreadsheet program and we used standard statistical methods. Results of the research are explained into two ways – for each region separately followed by regional comparison, than as all results together by making a model of SME. Finally we use a standard research methods like self-induction and hypothetic deduction based on own secondary data analysis.

3. Comparative analysis, modelling project oriented SME

3.1 Moravia-Silesian region (MSR)

The Moravia-Silesia region is located in the north-eastern part of the Czech Republic, internally neighbouring the regions of Zlín and Olomouc. Externally, the outer boundary of Moravia-Silesia marks the Czech Republic's border with Polish Silesia and with Slovakia and the region of Žilina. Though it accounts for 7% (5 554 square km) of the country's area, it is home to 12.4% (1 262 660) of its population.

The region's territory is varied, with the Ostrava-Karviná conurbation at its core. This is a traditionally industrial area with a high proportion of heavy industries – primarily coal mining, metallurgy, heavy engineering and chemicals. Other major sectors include mechanical engineering, pharmaceuticals, electro technical manufacturing, paper, textiles and the food industry. Agricultural production is distributed throughout the region and is represented in the foothills of the Beskydy and Jeseníky mountains by forestry.

Since 1990, the region has undergone extensive economic restructuring, accompanied by lay-offs of tens of thousands of workers. From a nationwide perspective, Moravia-Silesia has been particularly hard-hit by the slump of heavy industry and by soaring unemployment. The region has ripe for the development of tourism; an advantageous geographical location in terms of transport routes; a relatively dense rail and bus transport network; an international airport close by the region's centre with huge development potential.

3.2 Ústí region (UR)

The Ústí Region lies in the northwest of the Czech Republic along its northern border with Germany, particularly with the Free State of Saxony. The Region's neighbours are also the Liberecký Region in the northeast, the

Karlovarský and partly the Plzeňský Regions in the west, and the Středočeský Region in the southeast.

The Usti Region has 46 cities, where is living 80.7 % of its inhabitants, and 354 villages. The villages up 500 inhabitants are representing 54 % of all villages in Region, but there is living only 5.8 % of inhabitants.

This location predestines the region a significant position in the international economic and cultural co-operation and seems to be an outcome for a wide range of activities of cross-border co-operation between both these neighbouring regions. The position of the Region is, in terms of its gradual integration into European structures, along with the close vicinity and accessibility of Prague and other regional centres, a significant factor of its development. In addition, the main European roads and railway lines on the axis from **Berlin to Vienna via Prague**, together with the Labe waterway, go through this Region. The concentration of industry and population is representing, in terms of the Czech Republic, important market, good accessible from Prague and from neighbouring Saxony.The Ústí Region is varied as for natural conditions as well as from the point of view of its economic structure, density of settlement and condition of the environment. Historically, economic importance of the Region is based on its raw materials, especially large deposits of brown coal, which lie close to the surface. The brown coal basin stretches under the hillsides of the Ore Mountains from the town of Ústí nad Labem to Kadaň. There are also other important raw materials in the Region, e.g. quality glass and foundry sands and building stone.Industrial activity from the past had and still has an unfavourable influence on the quality of the environment. Strongly developed surface mining distinctively damaged the natural face of the landscape, which gradually recovers only thanks to a costly re-cultivation. Well-known are also problems with the emission situation in the Region and high unemployment rate for many years.

3.3 Regional comparison

The questionnaire was sent to 720 entrepreneurs, from which we get only 172 responds. The main reason for their cooperation was a “help to somebody to make some thesis research” not for better cooperation with the university.

Table 2 Research sample in both regions

	MSR		ÚR	
	Amount	**Share per total**	**Amount**	**Share per total**
Fill-in Questionnaires	**122**	**30.5%**	**50**	**15.6 %**
Blank Questioners	**46**	**11.5%**	**34**	**10.6 %**
Without response	**232**	**58%**	**236**	**73.8%**
Total	**400**	**100%**	**320**	**100%**

Source: own research

Regional contrasts are not deep full. By the table comparison, we could illustrate the current situation in the business environment.

Actual figures (30.6.2005) said, that average number of entrepreneurs is on the low level in the Czech republic, because average number is 190 subject per 1 000 citizens and both regions have about 150 per 1 000 citizens. In average, we could say, that one entrepreneur have registered two and more specializations – two licenses. However, from own research in "Moravia" is only 1.1 licenses per 1 entrepreneur and 1.12 in "Ústí".

We made our research in Business centres too. We were able to make some simplified SME's definition (which use project management) from questionnaire data. The successful SME, financed by supporting EU funds isn't the same structure as "common SME" form second part of our research. You could compare it in two tables below.

Table 3 "Common" SME's model

	Moravia-Silesian region	Ústí region
Year of founding	**1992**	**1990**
Type of SME	**1-10 employees**	**1-10 employees**
Main specialization	**Trading company**	**Trading company**
Structure	**58% man** **42% woman**	**69% man** **31% woman**
Education		
Primary school	11.3%	34 %
Secondary education – practice schools, vocational schools without school leaving exam	36 %	38 %

Secondary education-colleges and other schools with the final exam	**40.7%**	**21%**
University degree	**12%**	**7%**
Language skills	**English and Polish**	**English or German**
Capital dominating	**95% Czech**	**90% Czech**
Form of cooperation	**70% nothing,** **30% trade chains**	**80% nothing,** **20% trade chains**
Foreign trade	**As a third SME**	**As a fifth subject**
EU Funds		
Money utilization	**New technology**	**New technology, development**
Funds contribution	**increase on market position**	**increase on market position**
Information source	**Internet**	**Internet**
Projects preparation	**By their self**	**Consulting company**
Main reasons for cut off the business	**Lack of capital, competition growth**	**Lack of capital, competition growth**
IT and utilization		
Internet connection	**87%**	**86%**
E-learning agreement	**41%**	**62%**
Main sections for education	**Law, accounting, marketing**	**Law, accounting, languages**

Source: own research

Table 4 „Innovative"SME's Model

	MSR	ÚR
Type of SME	**11-49 employees**	**11-49 employees**
Main specialization	**Industry**	**Building industry, industry**
Structure	**70% man** **30% woman**	**82% man** **18% woman**
Education		
Primary school	**10%**	**15%**
Secondary education – practice schools, vocational schools without school leaving exam	**10%**	**10%**
Secondary education-	**70%**	**50%**

colleges and other schools with the final exam		
University degree	**10%**	**25%**
Age	**26-50 years**	**26-50 years**
Money utilization	**New technology**	**New technology, development**
Information source	**Internet, consulting companies**	**Friends, Internet**
Projects preparation	**consulting companies**	**consulting companies**
Main reasons why project isn't accepted	**Many "similar" projects**	**Standing of a firm, many "similar" projects**
Main barriers	**Growth of administrative costs, minimum tax rate**	**Lack of capital, competition growth**
How many projects are successful?	**65%**	**90%**

Source: own research

We could say that model of "common" Czech SME is not corresponding with "innovative" Czech SME, as being represented by Business Centres. Successful project is mainly prepared with cooperation of the consulting company. Finally, we could say, that main way to get financial support from EU funds is to take advantage of project making specialists, who knows more about program objectives, rules, logical framework, feasibility study and actual law and regulations on the each markets and specializations.

4. Useful project management strategies

All projects, mainly for developing and growing SME's need a lot of preparation work, which includes analysis of pre-conditions a problem analysis, logical framework and dependence on actual business environment. Useful strategy application includes adaptability on new European environment after the enlargement in May 2004. So, we could talk about as a main used tool called "Euro strategy".

4.1 Euro strategy Application

Unified Euro strategy application needs more and more project management approach, which is a result of company department's cooperation in wide business environment. "Survival problem" is spread into wider array of factors in *European problem format*. If you are a businessman and you want to or not, European globalization trend and changes in business environment could catch you in the most underdeveloped region.

First step to use and prepare Euro strategy is classical SWOT analysis of the common SME in the unified European market approach. We could say the main strongness in this analysis is good knowledge about new EU members, but Czech is still oriented on old EU members. New members have one big advantage – more dynamical harmonization of EU standards and rules.

Table 5 SWOT analysis of the CZ business environment

STRENGTHS	WEAKNESSES
✓ The Government approval of the *Industrial Policy Concept of the Czech Republic* including various support possibilities applicable to SME's ✓ Rapid adaptation to market demands ✓ Introduction of new technologies ✓ Creation of new jobs with low capital costs ✓ Contribution to quicker development of towns and villages through entrepreneurial activities ✓ Support to structurally affected and economically weak regions ✓ Sound infrastructure network for SME's promotion – 7 Euro Info Centres, 29 Regional and Information Centres, five Business Innovation and Science and Technology Centres.	× Bureaucratic legal and administrative procedure of registering enterprises × Lower economic power than large enterprises × Lack of legal, economic, technical and managerial capacities × Higher sensitiveness to law enforcement and to administrative problems and lengthy process of business disputes × Insufficient orientation at foreign market × Lower awareness of negative impacts of production on environment

OPPORTUNITIES	THREATS
✓ Development of industrial production and industrial services ✓ Development of business relations with TNC's and wholesalers to become their suppliers ✓ Application of a innovative potential as a generator for added value production ✓ Creation of enterprise clusters ✓ Participation in the Multi-annual Programme for SME's could strengthen infrastructure of supporting capacity	× Higher competition as a result of market globalization × Conservative approach of enterprise managers to introduction of certificated systems of management, including production quality management × Lack of capital for development of entrepreneurial activities

Source: SMALL AND MEDIUM-SIZED ENTERPRISES IN COUNTRIES IN TRANSITION, UNITED NATIONS New York and Geneva, 2003, ISBN E.03.II.E.43, p.66

Then you are able to analyze your own company situation, main specialization and competitiveness on the market. You have to find original idea, which makes you more different from others.

All components and factors we could illustrate on picture below to be able analyze all factors and identify main goals of our Euro strategy.

Figure 2 Euro strategy components

Source: Vývoj průmyslu a podnikání, OHK Brno, available from www.ohkbrno.cz

After factors description we could make next step in Euro strategy application – a strategy definition by step by step method. Each step covers inside factors which could make it unsuitable for the company, this factors in each group we could include into risk strategy components. We need a lot of adaptability and dynamics in making strategy changes**.**

Table 6 Step by step Euro strategy formulation

Implementation procedure	Strategy type , main problems to solve
Step 1	• **Research in the new external business environment and conditions on the unified European market.**
Step 2	• **Business sector analysis – analysis of the firm's market (closer external environment),**
Step 3	• **SWOT analysis from the point of unified EU market view,** • **Firm's Opportunities and strongness comparison adapted on the new conditions,** • **Firm's threats and weaknesses comparison adapted on the new condition,** • **Find strategy opportunities,** • **Validity test of strategy opportunities.**
Step 4	• **Strategy choice – competitive strategy formulation**
Another steps	• **Adaptability strategy implementation on the new conditions with standard methods.**

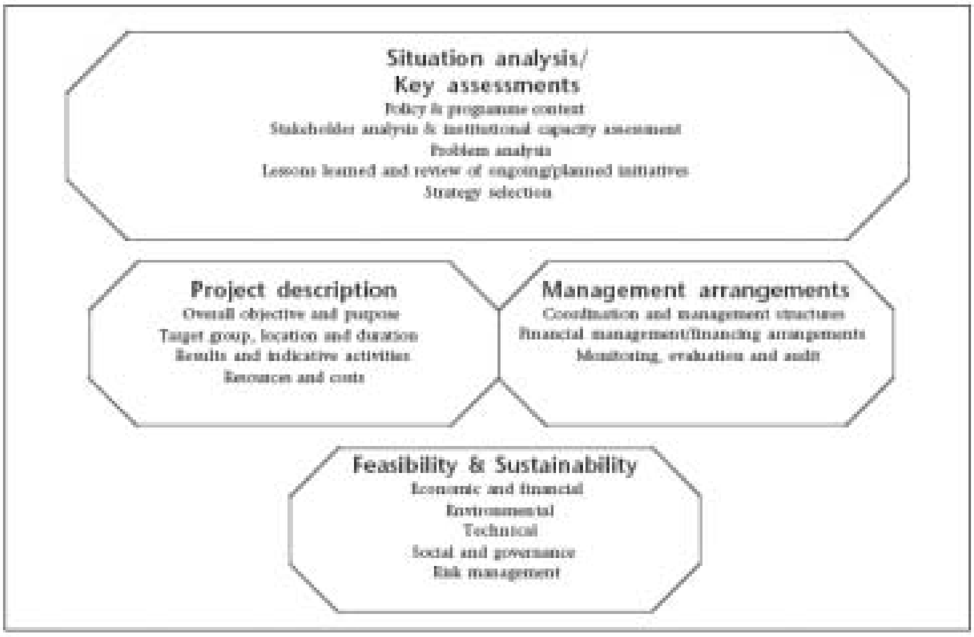
Source : Vývoj průmyslu a podnikání, OHK Brno, available from www.ohkbrno.cz

4.2 Project management cycle

The project cycle follows the life of a project from the initial idea through to its completion. It provides a structure to ensure that stakeholders are consulted, and defines the key decisions, information requirements and responsibilities at each phase so that informed decisions can be made at each phase in the life of a project. It draws on evaluation to build the lessons of experience into the design of future programs and projects.

Project Cycle Management we could define as a methodology for the preparation, implementation and evaluation of projects and programs based on the principles of the Logical Framework Approach.

Figure 3 Formulating Project Elements

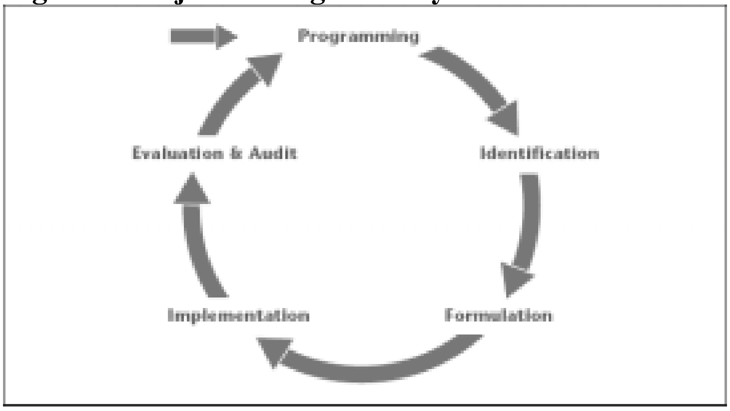


Source: Project cycle management guidelines, available from http://europa.eu.int/comm/europeaid, page 38

The idea of project cycle management is cooperating with Euro strategy implementation, which could improve SME’s competitiveness on the big European market. We could say that this moment is another step to be successful in projects supported by EU.

Project management cycle procedures we could simplify into figure below.

Figure 4 Project management cycle



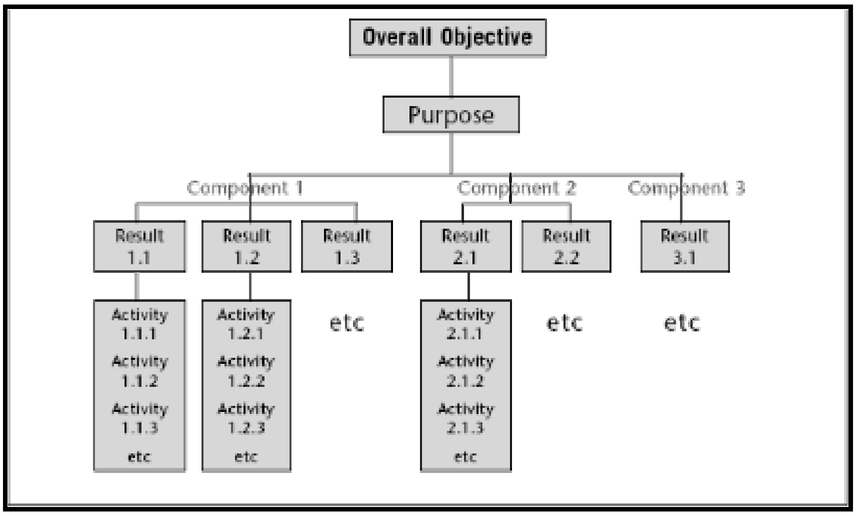
Source: Project cycle management guidelines, available from http://europa.eu.int/comm/europeaid, page 16

We could see five important stages in this approach. First of all we need to choose appropriate supporting program, which is fits the best on our entrepreneurship conditions. Than we have to identify our strategy goals (what will be the benefit of this type of financing support), prepare implementation program step by step and prepare pre-financing study for first phase, because in many cases SME's obtain loans or guaranties after that.

Very important thing is time to do auditing our effectiveness in this project. Is recommended to plan doing project in 1 – 1,5 year and make some time "fund" to make changes and administrative tools for project evaluation. It is the result from EU funds statute, that one project is time limited by the rule "*n+2*", what means "*You have to complete your project into two years from the project confirmation"*.

The problem could be solved by another tool – objective tree, you could plan your goals and activities which you need to get the biggest effect. This method we call MBO (management by objectives).

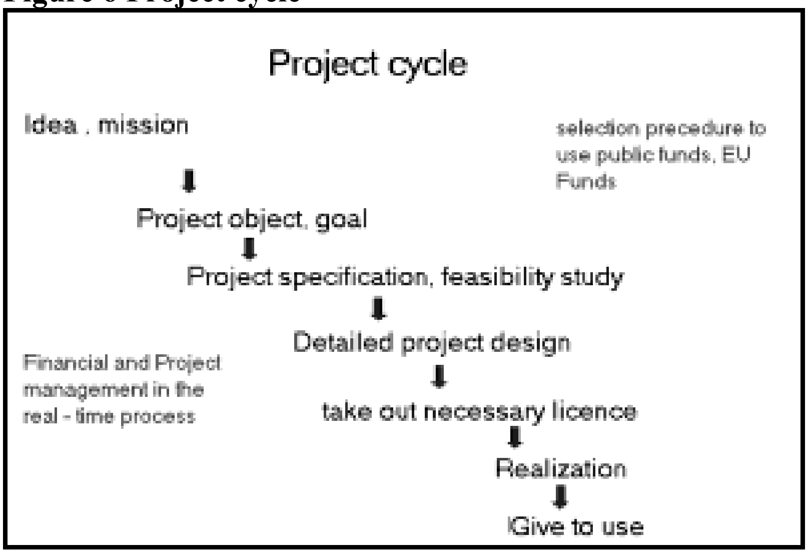
Figure 5 Objective tree



Source: Project cycle management guidelines, available from http://europa.eu.int/comm/europeaid, page 78

If we summarize our knowledge about preparing Euro strategy with project cycle management, we are able to define some “break points” on the way to our “project”. It is illustrated on the Figure 6.

Figure 6 Project cycle



Source: Příležitosti veřejného financování ze strukturálních fondů EU, PBA Group, Praha, www.jzp.cz/PrezentaceSFEU012004.ppt

It consists on external and internal procedures, which include many managerial skills as a project and financial management, influence of EU policy and development strategy. They are connected with each other and have big or small influence on our project. All the factors are in real time, so another factor which could make our project unsuccessful is “time lag”, when some new legislative regulations could change market conditions and we have to be dynamical to implicate it into project as a “business risk”.

5. Conclusion

Preparing a good project need to take a care about all document parts and choose a suitable supporting program not only for getting money, but the main reason must be a company development.

Successful project covers inside many types of analysis, the main points, which we could point out are:

- **Strategy, project goals** - we have to find answers for these following questions: Which is the main project goal and possibilities to fulfil it in the time? Is my project useful? (benefit analysis/ project’s profitability)
- **Financial management** – Which are our main costs? Which are the main cost items? Are we prepared for pre-financing project phase? (Considering *ex-post* EU funds financing) ? Which are the main risk sections?
- **Cooperation , project benefits** – Who is our project partner – does he help us or threaten us? Will be our project supported by the local government?

Finally, each project includes following sections:

- Financial and economical evaluation,
- Economical effectiveness analysis,
- Feasibility study (cost-revenues analysis, social-economic analysis of project benefit, marginal and risk analysis),
- Business plan,
- Environmental impact.

Projects prepared for EU financial support are very useful for SME’s development, but disadvantages are project parameters or program conditions, which could make our project work like lost labour on it.

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[7] www.czso.cz

BUSINESS ANGELS AS A FINANCIAL RESOURCE FOR SMALL AND MEDIUM-SIZED ENTERPRISES [1]

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Abstract

An increasing number of new small and medium-sized enterprises uncovers a long-term problem concerned with their financing. According to a literature seed-up and start-up firms have many possibilities of raising capital from different external sources. Reverse is true. On the one hand, many innovative business ideas and quality business plans, but without any collaterals or experiences on the other hand, do not fulfill desired conditions and so they are doomed to failure. In this bearing is maybe more actual than anytime before a question of private informal investors. One kind of these investors represents business angels. They are private investors who provide both financing and managerial experience, which increase the likelihood of start-up enterprises to survive. The aim of this paper is represented the most interesting findings of research which we carried out with the aim to show an importance of the business angels as informal investors offered a venture capital with a higher added value for small and medium-sized enterprises in a country with a long-term history of the active business angels – in Germany. Findings of our research are very similar to the findings of other researches. In generally we can say that business angels can influence a next development of firms with a good combination of a monetary and a non-monetary investment.

Keywords: *small and medium-sized enterprises; business angels*

[1] The paper is supported by a researched grant "Mlada veda 2330251/04 ".

1. Introduction

The latest survey notes that 18 % of European small and medium-sized enterprises (SMEs) regard the cost of finance, and 19 % the availability of long-term finance, as a barrier for their next expansion. This problem is worse particularly for seed-up and start-up firms. These young enterprises feel during early phases of their enterprising lack of the experiences, own capital and the collaterals. If a beginning firm cannot use any loans from the banks or other venture-capital associations due to these reasons, private investors in a form of business angels represent the perfect partners for them.

2. Business angels as a financial resource for small and medium – sized enterprises

Business angels (BA) are individuals who invest capital in, and bring entrepreneurial know-how and experience to enterprises with growth potential. Business angels can overcome the information problem plaguing banks and venture capital funds. They can make investment decisions using their knowledge of the field, and their appreciation of the potential of the firm they are investing in. Business angels' investments can be both early stage and expansion, and they can have a leveraging effect for other sources of funding, including bank loans and formal venture capital. They come from experienced businessmen, managers and solvent bank clients.

A term - business angel was used for the first time in USA in first middle of 60.$^{-th}$ years. It was connected with a movie industry. Its importance has increased together with an importance of an informal capital for last 25 years. The terms - private investors, informal investors and business angels were used as the synonyms at the beginning. It had a crucial impact on economists not only in USA but in the Great Britain and Europe as well. In German-spoken area a term business angel is used when we talk about the private investors offering an added value not only in a form of finance but in a form of business consulting as well.

2.1 Types of business angels

Due to an increased importance of this kind of private investors and their variety there are the efforts to classify them in a literature and in a practice too.

The business union from Germany (Neues Unternehmertum Rheinland e.V.) differentiate these three types of business angels:

- perfect business angels (offering capital, know-how and experiences),

- active business angels (offering more know-how, experiences and less capital),
- silent business angels (offering only capital).

According to the different sources we can business angels sort into these two groups:

- potential business angels:
    - virgin angels (complying with all conditions, but they still do not invest),
    - latent angels (have experiences with investments, but they are passive now),
- active business angels:
    - entrepreneurial angels (are business oriented and experienced),
    - income-seeking angels (seeking only a regular income),
    - corporate angels (through an investment they follow interests in own firms),
    - silent angels (offering only capital),
    - management angels (they are not really entrepreneurs but they offer managerial experiences and know-how)
    - consulting angels (offering only consulting services and contacts).

In practice it is often very difficult to sort business angels positively into mentioned groups. They mostly have characteristics of more type of them. Particularly according to these characteristics we should be able to recognize an original business angel from a false business angel / business devil.

2.2 Business angels in Europe

Informal investment has been around in Europe for a long time. These long-term experiences pointed out one problem. There was an information gap between private investors on one hand, and firms looking for potential financial resources on the other hand. A good solution to this problem represent a phenomenon - business angel networks. Business angel networks are organizations that are set up primarily to facilitate the matching of angels and entrepreneurs. Due to existing business angel networks the entrepreneurs find angels that would be interested in them, and the angels find enterprises that would fulfill their criteria. Established business angel networks make the matching process more efficient.

The pioneer among European national networks has been the National Business Angels Network (NBAN) in the United Kingdom, which has been the model for several other national networks. The development of business angel networks in Europe has accelerated since the establishment of the European Business Angel Network (EBAN) in 1998. The number of active business angel networks in Europe has grown rapidly in the last few years. Most countries have a national network and several regional ones. Most business angel network activity in Europe is concentrated in the United Kingdom, Germany and France.

Table 1 Business angel networks in Europe

Country	***1999***	***2000***	***2001***	***2002***	***2003***	***Mid 2004***
Austria	1	1	1	1	1	1
Belgium	2	6	6	7	7	5
Czech Republic	0	0	0	0	1	2
Denmark	0	1	4	6	8	8
Finland	1	1	1	1	1	1
France	3	13	32	48	48	40
Germany	1	43	36	40	40	40
Greece	0	0	0	0	0	1
Hungary	0	0	0	0	0	1
Ireland	1	1	1	1	3	1
Italy	0	5	12	11	10	12
Luxembourg	0	0	0	0	0	1
Malta	0	0	0	0	1	1
Poland	0	0	0	0	0	1
Portugal	0	0	1	1	1	1
Spain	0	1	1	2	3	11
Sweden	1	2	2	2	9	28
The Netherlands	1	1	2	2	3	3
United Kingdom	49	52	48	48	51	101
Total	60	127	147	170	184	258

Source: European Business Angels Network (EBAN), Statistical compendium*, October 2004.*

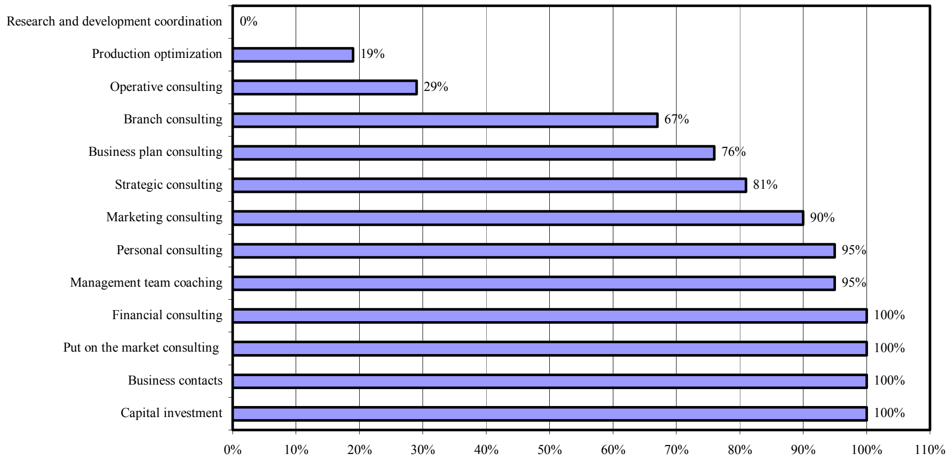
The sizes and methods of the national and regional networks vary between countries reflecting different local conditions. The rapid increase in the number of networks indicates that there has been a need for them, and that they are serving a purpose.

3. Business angels in Germany

We carried out a research with the aim to show an importance of the business angels as informal investors offered a venture capital with a higher added value for small and medium-sized enterprises in a country with a long-term history of the active business angels – in Germany (Emscher-Lippe Region). It was conduct in a form of a questionnaire from January to March 2005 on a research sample 21 business angels. The questionnaire consisted of 10 semi-opened, 1 opened and 3 closed questions divided into three parts: activities of business angels and their potential impact on economic prosperity of SMEs, a profile of target SMEs, a profile and a motivation of business angels. We present the most interesting findings from our research in this paper.

At the beginning, we were interested in the activities, which BA offered to help SMEs. Every from the questioned BA had some experience with a small-size beginning enterprise and at least once invest capital in. According to a literature, a financial investment does not present an unambiguous determinant indicating private investors - business angels. All the questioned BA (100 %) had experiences not only with a capital investment but with the non-monetary character activities such as business contacts, put on the market consulting, financial consulting (see Figure 1). They are followed by other activities such as management team coaching and personal consulting (95 %).

Figure 1 Business Angels Activities



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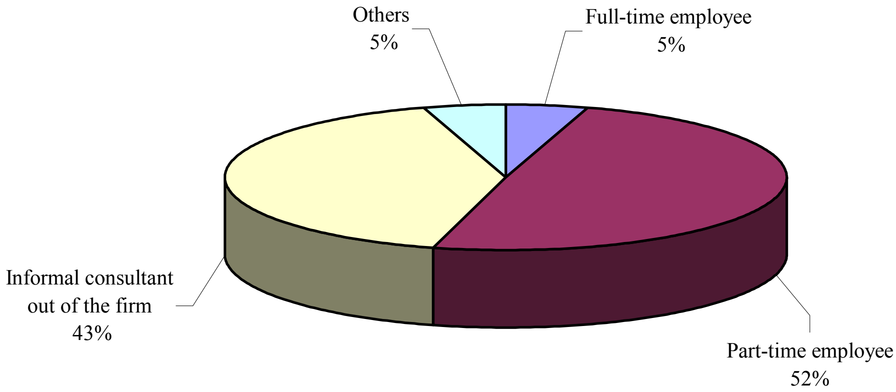
Source : data from the own research

As other important activities were mentioned marketing consulting (90 %), strategic consulting (81 %) and business plan consulting (76 %). These results are consequences of the fact that business angels come from a variety of the experienced businessmen and managers.

On the other hand, a relative small share of business angels´ activities belonged to the activities such as research and development consulting (0 %), production optimalization (29 %). This finding can be caused by a small number of production enterprises with which questioned BA had experience or a low intensity of their activities in that kind of firms. A marginal business angels´ activity presents an operative consulting (29 %) too. It can indicate a trend that for business angels it is more significant to play a role as a consultant or coach for strategic management than for operative management who deals with every day problems and existing details of the firm.

Another interesting finding was a way of which business angels participate in the firm (See Figure 2).

Figure 2 Business Angels Participation



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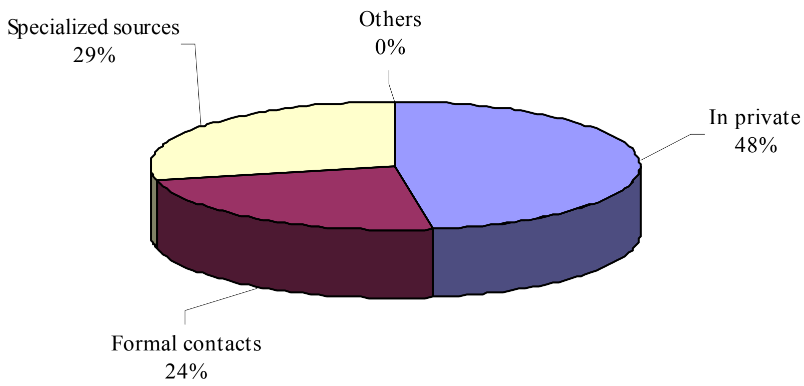
Source : data from the own research

Most of the questioned BA participate in the firm as a part-time employee (52 %). 43 % of them work as an informal consultant outside the firm. The reason for these results is predominate consulting character of these private investors´ activities. Only one of the questioned BA participated in the firm as a full-time employee and one of them used a different way of participation, but he did not state it.

A particular form of making contact between the business angels and the firm varied (See Figure 3).

Figure 3 Contact Between Business Angel and Firm



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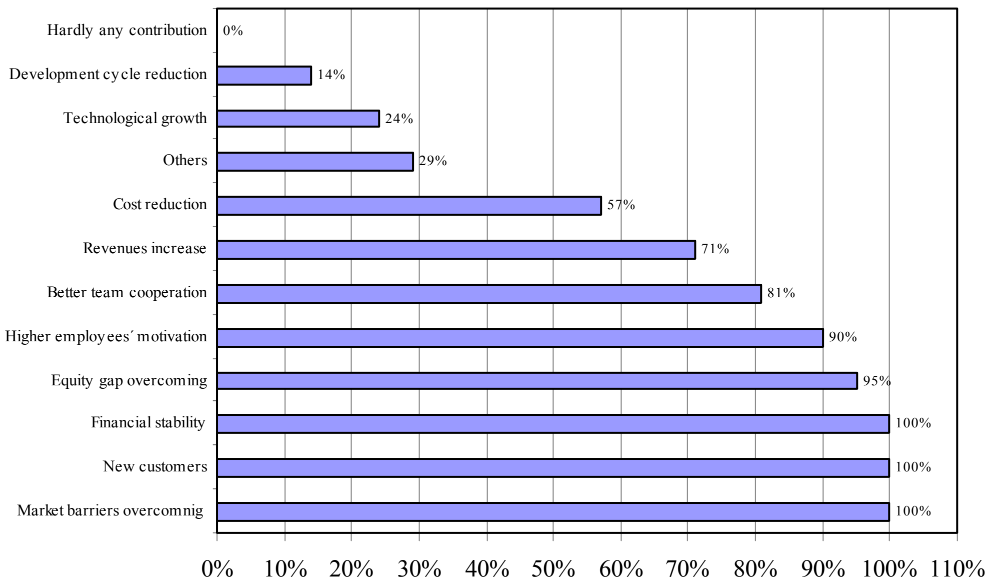
Source : data from the own research

Almost in a half of all cases, the first contact between the business angel and the firm was made in private (48 %), it means by private contacts or acquaintance´s recommends. 29 % of respondents used services of institutions specialized in an electronic or personal matching of the private investors on one hand and the resource finding beginning firms on the other hand. A form of these institutions differs in practice it can be BA stock market, BA organization, forum etc. In 24 % of all cases, the first contact was done by a way of formal contacts at banks, consulting, investment or business associations, universities etc. All of these institutions and centers represent places, where new enterprising ideas meet together with financial resources waiting for their relevant market opportunity.

Business angels activities developed in each firm can be considered to be potential sources of firms´ success. Business angels contributions to firms should be something more than only finance, coming from passive private investors waiting for their profits. It is particularly a case of various non-monetary contributions of business angels working in firms (See Figure 4).

Figure 4 Business Angels Contribution



Source : data from the own research

All of the questioned BA highlighted among their biggest advantages for firms:

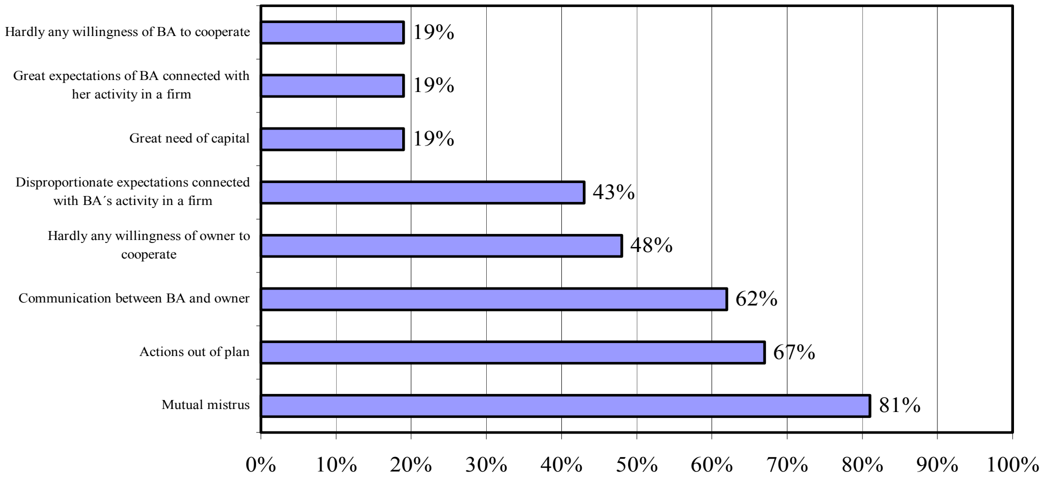
- overcoming early barriers connected with a market entrance,
- gaining new customers,
- increasing financial stability.

These contributions stem not only from their managerial and business experiences, but from their sector knowledge and large numbers of contacts as well.

To a frequent advantage belongs overcoming equity gap (95 %) using external resources in a form of formal venture capital, bank loans and another loans and grants.

A mutual cooperation between business angels and firms is equally as every human activity often connected with many problems, misunderstandings and barriers (See Figure 5).

Figure 5 Cooperation Barriers Between BA and Firms



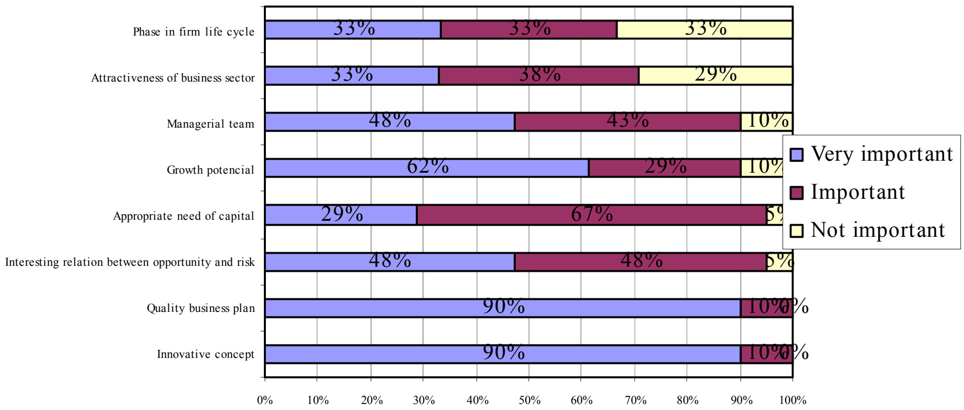
Source : data from the own research"

The biggest barrier is concerned with a lack of trust between involved sides (81 %). Every investment is a risk project that needs a mutual trust of both. This trust must last not only during a opening matching process but it must hold on during a whole cooperation as well. Other barriers are activities carried out of plan (67 %). A business plan plays a significant role in every firm as an instrument for controlling. Every activity out of it does this role impossible. Communication problems (62 %), hardly any willigness of interested firm´s owner to cooperate (48 %) or disproportionate expectations connected with BA´s activity in a firm (43 %) appeared as other barriers.

Among last but not least important barriers were mentioned a great need of capital, great expectations of BA connected with its activity in a firm and hardly any willingness of BA to cooperate (every 19 %). Particularly last one - hardly any willingness of BA to cooperate could represent potentially big problems connected with a new phenomenon – business devils. Business devils are private investors with a risk capital, which try to enforce their own opinions and ideas in the firm. These activities very often lead to a negative development of firm out of all plans.

In third part of our questionnaire we were interested in a motivation of business angels to help seed-up and start-up firms (See Figure 6).

Figure 6: Motivation of BA



Source : data from the own research

Innovative concept together with quality business plan belonged to the most important motivational criterions of BA to invest or not to invest. Another crucial criterions were an interesting relation between opportunity and risk, an appropriate need of capital and a growth potential. On the other hand, a phase in firm life cycle and an attractiveness of business sector were indicated as not important motivational criterions.

4. Conclusion

Findings of our research are very similar to the findings of other researches among active business angels. In generally we can say that business angels represent informal investors who can influence a next development of a seed-up or a start-up firm, with a good combination of a monetary and a non-monetary investment. They are very often the last and the only possibility of the firms to survive. To the most important forms of business angels´ support belong a support by coming onto market, marketing and other consulting, establishing business contacts or raising additional external financial resources.

All these activities bring many contributions to small and medium-sized enterprises such as overcoming equity gap, easier coming onto market, gaining new customers, increasing financial stability etc. Their contributions are visible among employees and their motivation too.

These results can give with a wrong interpretation impression of the business angels as a cure-all for all problems existing and appearing in firms. The reverse is true. Their wide and various knowledge are consequences of their previous and long-term experiences in business. According to European Union particularly business angels with their experiences and expanding the financing opportunities of entrepreneurs business angels contribute to growth and employment, and make European culture more entrepreneurial.

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[2] BRETTEL, M. *Deutsche Business Angels in internationalen Vergleich – Empirische Erkentnisse. (WHU-Forschungspapier Nr 84, November 2001).* Access from: < http://www.whu.edu/control/ Forschungspapiere/FP84.pdf >

[3] COVENEY, P., MOORE, K. *Business Angels. Securing Start Up Finance.* New York: John Wiley and Sons Ltd, 1998. ISBN 0471977187.

[4] EUROPEAN COMMISSION. *Benchmarking Business Angels – Final Report.* Access from: <http://europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/ benchmarking_ ba_en.pdf >

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VENTURE CAPITAL PRACTICES: A TURKISH PERSPECTIVE

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Abstract

Venture capital is a financing method to provide funds for entrepreneurs to establish new ventures. Venture capital firms and venture capitalists provide funds and consulting to entrepreneurs to develop new ideas, make innovations, establish new ventures and grow their ventures. Venture capital firms and venture capitalists receive the shares of these new ventures for financing and consulting that they provided. The fastest growing sector is high technology for venture capital financing in the world. This study first summarizes the concept, financing stages and global practices of the venture capital. Secondly, it explains venture capital practices in European Union member countries. Then, it focuses on venture capital practices in Turkey. It also provides recommendations for the future of venture capital funding in Turkey.

Keywords: *Venture Capital, Venture Capital Firm, Venture Capital Practices in Turkey*

1. Introduction

Venture capital is a financing method to provide funds for entrepreneurs to establish new ventures. It is an important financing method for new ventures. Venture capital firms and venture capitalists provide funds and consulting to entreprenurs to develop new ideas, make innovations, establish new ventures and grow their ventures. Venture capital firms and venture capitalists receive the shares of these new ventures for the financing and consulting that they provided. It is an investment to ventures that could have high growth potential.

Venture capital is defined as a professionally managed pool of money raised for making actively-managed direct equity investments in rapidly-growing companies with a well defined exit strategy. It has grown in most of the capital markets of the world. The fastest growing sector is high technology for a venture capital financing.[1] American National Venture Capital Association defines venture capital as a source of financing that is provided by professional who made investment to new and fast growing ventures.[2]

Venture capital is a partnership of entrepreneurs, venture capital firms and investors who provide financing for venture capital funds. Entrepreneurs are new business owners who get attention and expect high growth potential and profits for their ideas and products. Venture capital firms provide financing and expertise to entrepreneurs and ventures to get high profits. Investors can be rich people, large industrial enterprises, banks, institutional and foreign investors. They have financial expectations to get high profits.[3]

Venture capital firms are established as limited partnerships inwhich managers are unlimited responsible parties whereas investors are limited responsible parties. Most of the venture capital firms are management companies that represent different partnerships and have responsibility to manage different pools of funds. Unlimited responsible partners working as professional teams in these management companies, manage partnership

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[1] MEGGINSON, W. L. Toward a Global Model of Venture Capital? *Journal of Applied Corporate Finance.* 2004, vol. 16, issue 1, pp. 89-107.

[2] http://www.nvca.org

[3] BULUT, H. İ. Sermaye Piyasalarında Finansal Aracılar Olarak Risk Sermayesi Şirketlerinin Rolü, *İMKB Dergisi*, 2000, sayı 4, pp. 31.

funds provided by investors as their representatives to structure and manage the new investments for fees.[4]

Companies that are supported by venture capital firms are more prestigious in a IPO stage. Investors believe that they can trust the company and buy its shares. Venture capital firms share risks of entrepreneurs. They are experts in their areas and good at portfolio management. The following issues related the venture capital firms are important for the pricing of ventures in IPO stage: Investors trust ventures that convinced many venture capital firms to use their funds. These ventures are controlled by venture capital firms for a long time to be succesfull and they are more expensive for investors. Investors prefer ventures when venture capital firms are in their board of directors for a long time. They trust ventures inwhich venture capital firms have prior experiences in other ventures for IPO stage. Investors prefer ventures that used funds provided by large venture capital firms. They also trust ventures inwhich venture capital firms have big shares. It shows that venture is leaded for a long time and less risky for investment[5]

The quality of venture capital firm to observe and lead investments can be evaluated by following criterias: Venture capital firms need to focus on promising sectors that will offer the maximum values.[6] They provide financing to ventures based on their success to use the funds. They can motivate ventures to follow the milestone schedules and be succesfull while they are using funds.[7] They provide other services besides financing such as development of good image and business relationships with other companies, motivation and business training to ventures.[8] They need to establish investment consortiums with other venture capital firms to delegate risks, find more financing and get the advantage of their expertise.[9]

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[4] BYGRAVE, W.D. AND TIMMONS, J.A. Venture Capital at The Crossroads, Boston: Harvard Business School Press, 1992.
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[7] GOMPERS, P.A. Optimal Investment, Monitoring and The Staging of Venture Capital. *The Journal of Finance*. L (5), 1995, pp. 1461-1489.
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[9] LERNER, J. The Syndication of Venture Capital Investing. *Financial Management*. Autumn 1994, pp. 16-27.

The differences between venture capital and private equity are not very clear. Venture capital firms usually provide funds for new ventures that have high growth potential for seed capital, start-up capital and early stage financing. On the other hand, private equity firms usually provide funds for ventures for expansion investment, bridge financing, late stage financing, management buy-out and leveraged buy-out financing.[10] Private equity firms also provide management consultancy for formulating strategy, recruiting and developing relationships with stockholders such as fincial institutions, customers and suppliers.[11]

Kuratko and Hodgetts define venture capitalists as valuable sources for equity funding for new ventures. Venture capitalists provide capital for ventures during start-up and expansion phases. Entrepreneurs can consult venture capitalists for market research, strategy formulation, management audit and risk management. Venture capitalists can contact with customers, suppliers and other stockholders of the company. They can provide assistance in negotiating technical agreements. They can also help establishing accounting and management controls.[12] Venture capitalists focus on large returns on their investments to provide capital to new ventures.

According to one study surveyed over 100 venture capitalists, 28 criterias were determined to evaluate new venture proposals and they were grouped in six categories: Entrepreneur’s personality, entrepreneur’s experience, characteristics of the product or service, characteristics of the market, financial considerations and nature of the venture team. Ten essential criterias to evaluate new venture proposals are as follows: capabilty of sustained intense effort, familiarity with market, at least ten times return in 5-10 years, demonstrated leadership in past, evaluating and reacting to risk well, investment can be made liquid, significant market growth, track record relevant to venture, articulating venture well and proprietary protection. According to the same study venture capitalists could reject proposals when two of the mentioned criterias were missing.[13]

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[10] BOSUT, L. Girişim Sermayesi/Direkt Öz Sermaye Yatırımları, *Finans Kulüp Toplantı Notu*, 29 Mayıs 2003.

[11] ÖVEK, P. *Risk Sermayesi Yatırım Ortaklıkları ve Muhasebe Sistemi.* Marmara Üniversitesi Sosyal Bilimler Enstitüsü, Yüksek Lisans Tezi, İstanbul, 2003, p. 12

[12] KURATKO, D. F. AND HODGETTS, R. M. *Entrepreneurship: A Contemporary Approach*. The Dryden Press Series in Entrepreneurship, 3rd Edition. ISBN 9-780030-987243, p. 412.

[13] MACMILLAN, I. C., SIEGEL, R. AND NARASIMHA, P. N. S. Criteria Used By Venture Capitalists to Evaluate Venture Proposals. *Journal of Business Venturing.* 1985, vol.1, issue 1, pp. 119-128.

According to another study, venture capitalists decide to make investment in 6 minutes on initial screening and 21 minutes on the overall proposal evaluation. The requirements of the venture capital firm, long-term growth and profitability of the proposed venture are the critical factors for inital screening. The background of the entrepreneur and the characteristics of the proposal are other critical factors for initial secreening.[14]

According to one study, characteristics of the request (including business plan and amount), sources of advice (including technology, places to seek funding), characteristics of the enterprise (including location and industry) and characteristics of entrepreneurs (including experience and education) are factors that affect the success of entrepreneurs to acquire funds.[15]

The business plan need to include the following sections: summary, business description segment (includes description of the venture, industry, products and services), marketing segment (includes research and analysis related to market and marketing plan), research design and development segment (includes design and development plans, technical researches, research assistance needs, costs), manufacturing segment (includes location analysis, production requirements and costs, information related to labor supply, suppliers and transportation), management segment (includes information related to management team, board of directors, consultants and legal structure), critical risks segment (includes potential problems, risks and alternative solutions), financial segment (includes financial forecast, sources and use of funds, budgeting plans, stages of financing), milestone schedule segment (includes timing and objectives, deadlines and milestones, relationships of events), appendix and/or bibliography.[16]

The business plan is an important element to evaluate new ventures. Five aspects of the plan to be analyzed are the size of the proposal, financial projections, recovery of the investment, competitive advantage and management of the company.[17] The steps of venture capital financing are as follows: inital screening, evaluation of business plan, oral presentation, final evaluation (evaluation of the feasibility of the project and visiting suppliers,

[14] HALL J. AND HOFER C. W. Venture Capitalist's Decision Criteria in New Venture Evaluation. *Journal of Business Venturing*. 1993, vol.8, issue 1, pp. 25-42.
[15] HUSTEDDE, R. J. AND PULVER, G. C. Factors Affecting Equity Capital Acquisition: The Demand Side. *Journal of Business Venturing.* 1992, vol. 7, issue 5, pp. 363-374.
[16] KURATKO, D. F. AND WELSCH, H.P. *Entrepreneurial Strategy: Text and Cases*. Fort Worth: Dryden Press, 1994. ISBN 9-780030-975790, pp. 111-114.
[17] Kuratko and Hodgetts, p. 421

customers and consultants), signing the invetment contract, realisation of investment and exit from the investment.

Entrepreneurs need to evaluate venture capitalists as well. They need to choose the venture capitalist that will add value to the new venture beyond the financing especially for high-innovation ventures. [18]

Although, venture capital is also defined as a long term investment that is made by investors who have excess capital to SME's with high growth potential, investors prefer new ventures that could be profitable in short term to make investment. Venture capital investment can be risky because the investee company may not have enough experience and financing may not be sufficient for operations. Risk factors of venture capital are as follows: technological risk, management risk, financial risk, production risk, marketing risk and risk related to products and services be out of date before reaching to required profits.

2. History of Venture Capital

Venture capital is an important financial instrument for the effects of knowledge era on the financial system both in Anglo-American countries and in the countries of the European Union. Venture capital provides funding for the development of new technology oriented companies not to be restricted due to the lack of risk capital. Venture capital fund raising is growing fast in US and Western Europe compared to most developing countries. This growth is expected to continue in the near future as well. [19]

Venture capital became popular in US, U.K., France, Japan, Germany and Holland after the World War 2.[20] The first modern venture capital firm, "American Research and Development" was established in 1946. Digital was one of the firms that American Research and Development made investment. It received $70.000 funds at the beginning. The market value of Digital reached $10 billion after its merger with Compact in 1998.[21] Apple Computer, Federal Express, Intel, Sun Microsytems are other companies that received venture capital at the beginning and became global leaders.[22]

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[18] Ibid., p. 423.

[19] SCHOEFER, P AND LEITINGER, R. Framework for Venture Capital in the Accession Countries to the European Union, *This paper is based on a research study of the University of Applied Sciences "FH bfi Wien", Austria.*

[20] Övek, p.3.

[21] TTGV, Risk Sermayesi Semineri, *TTGV Teknoloji Yayınları Dizisi-1*, 2000, p.12.

[22] Övek, p. 10.

Venture capital funds help entreprenurs to develop new and innovative ideas for technological improvements to be leaders in global markets.[23]

3. Types of Venture Capital Firms

3.1. Private Venture Capital Firms

They are institutionalized private partnerships to provide venture capital. They were family businesses in the past. Venture capitalists are in the board of these companies. Partners in the management get 2.5-3% of capital as a management fee and 20% share from profits. Vakıf Risk is a private venture capital firm in Turkey.

3.2. Venture Capital Firms as a Subsidiary of Financial Institutions

They are established by commercial banks and insurance companies to provide financing to profitable companies that do not fit their credit requirements. Commercial banks and insurance companies are limited responsible partners of these venture capital firms that are not established in our country yet.

3.3. Venture Capital Firms as a Subsidiary of Nonfinancial Institutions

They are established by large industrial enterprises. Their goal is to develop new products to be strong and competitive in the market.

3.4. Small Business Investment Companies (SBIC)

There are almost 400 public and private SBIC in US. There are two types of SBIC: Lending Oriented and Equity Oriented. They are established with at least 1 million USD capital. Equity Oriented SBICs are established with 2 million USD capital. They use government resources intensively. SBICs can use 33% of their portfolio for real estate investments. They can't make investments abroad. They can take on debt 3 times of their equity from Small Business Administration (SBA) so they focus on giving credits instead of venture capital financing. SBICs are private capital institutions that provide credits to small businesses. Kobi Yatırım A.Ş. established by TOBB,

[23] SARIASLAN, H. *Orta ve Küçük Ölçekli İşletmelerin Finansman Sorunları, Çözüm İçin Bir Finansal Paket Önerisi*. Ankara: Türmob Yayınları, 1994, p. 66.

TESK, Halk Bank, KOSGEB and 16 chambers of industry to provide financing to SMEs in Turkey is an example of SBIC in Turkey. Its goals are helping development and economic activities of SMEs, improving their contributions for industrialization, providing capital, consulting and training to SMEs, encouraging investment projects of SME'S by establishing partnerships.[24]

The fund resources of venture capital vary in different countries such as US, U.K. and Turkey because of different financial systems used. R&D applications that cause high uncertainity and risk affect venture capital investments of companies. Long term investments with negative cash inflows in the first years affect fund resources badly.

Table 1. Comparisions of Organizations That Provide Venture Capital Funds in US, U.K. and Turkey

US	U.K.	Turkey
• Private venture capital partnerships • Subsidiaries of companies focusing venture capital • Business development companies • Small business investment companies • R&D partnerships • Private funds and incubators	• Funds provided by banks • Funds supported by investment companies • Business Expansion Funds • Funds provided by companies and other organizations in private sector • Funds of semiofficial organizations	• Private venture capital firms • Units of companies focusing venture capital • Companies making investment in SME's • Private R&D partnerships • Units of banks focusing venture capital

Source: http://www.kobinet.org.tr/hizmetler/bilgibankası/finans/003d.html - 59, Risk Sermayesinin Dünya ve Türkiye'deki Uygulamaları

4. The Financing Stages of Venture Capital

4.1. Seed Capital

Venture capitalist provides funds for new venture projects after its feasibility study. The research and development of the project is usually financed by venture capital.[25] The idea of the new venture is developed but its business plans are not prepared at this stage. Professional venture capitalists do not usually prefer seed capital because it is a very risky

[24] http://www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html

[25] VERMA, J.C. *Venture Capital Financing in India*, New Delhi: Response Books, 1997, p. 28-29.

investment. Although, there is a high uncertainity related to the application of the project, high profits can be received. Seed capital usually starts 2-3 years before the start-up of the venture and it requires 10 years at average to liqidate the investment of the venture capitalist.

4.2. Start Up Capital

It is a stage where an investment idea is started to be implemented, a firm is established and a venture capitalist tries to make the new venture successfull. The business plan of the entrepreneur is scanned carefully by venture capitalist. The real information related to market, targeted market share, growth of business and management of new venture need to be gathered at this stage. The venture capitalist helps the entrepreneur with its knowledge and skills. The start up capital is usually 5 years in average.[26]

4.3. Early Stage Financing

The firm reaches to a substantial size at this stage. It has some products and services but does not have a brand image and big market share. The venture develops its prototypes but it requires funds for production and marketing of its products. Ventures do not usually gather funds from banks because of not having enough caution money. Ventures do not usually gather funds from the capital market either at this stage. Ventures may have some managerial problems that can be solved with the financial and managerial support of the venture capitalist.[27]

4.4. Expansion Investment

The venture can market its products and services at this stage successfully but it requires additional financial resources to develop new products, to have effective distribution channels and competitive strenght.

4.5. Bridge Financing

Ventures that plan to go public in 6 months and a year require the bridge financing.

4.6. Late Stage Financing

It is a financing to save the unprofitable venture to be profitable again. It is also used to sell the shares of partners before going to public.

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[26] Övek, p. 38
[27] Ibid., p. 39.

4.7. Management Buy-Out

It is a financing to help the managers buy out the company not to be bancrupted. It is profitable and less risky investment.

4.8. Leveraged Buy-Out

The venture capital firm provides financing to entrepreneurs who do not have enough funds to buy a business. The venture capital firm prefers entrepreneurs who have required skills, education and work experience to be successfull.

4.9. Exiting From Investment/Divestment At Cost

It is the final step to end the venture capital investment. The purpose of the venture capital firm is to sell its shares in venture when they reach to the profitable level. The venture capital firm gets profits when the venture ends its technological and economical growth and reaches to a substantial size. The types for exiting business are as follows:

1. Going public (Selling stocks of the company to public)
2. Selling venture to another company
3. Selling the shares of the venture capital firm to the venture
4. Selling the shares of the venture capital firm to another company
5. Restructuring the venture
6. Liquidation of the venture[28]

Table 2. Venture Capital Financing Model

Investment Type	*Time (Year)*	*Risk*
Early Financing:		
• ***Seed Financing***	**7-10**	**Very High**
• ***Start up Capital***	**5-10**	**Very High**
• ***Early Stage Financing***	**3-7**	**High**
Late Financing:		
• ***Expansion Investment***	**1-3**	**Medium**
• ***Bridge Financing***	**1-3**	**Low**
Buy-out/Buy-in	**1-3**	**Low-High**
Late Stage Financing:	**3-5**	**Medium-High**

Source: Vefa Toroslu, "Risk Sermayesi Finansman Modeli", Activeline, Number 2, May 2000.

[28] Ibid., p. 42.

Venture capital financing instruments are share certificates, founding share certificates, shares without voting rights and convertible bonds.[29]

5. Venture Capital Practices in US

Venture Capital financing model started in US in 1946 for the first time by establishment of American Research and Development Corporation of Boston.[30] U.S. government also encouraged venture capital financing. Small Business Investment Company (SBIC) established in 1958 is a venture capital firm. Its capital was provided by government. It is managed by private sector. It encourages investors to invest in small businesses. Its funds are used to give credits to small businesses. Venture capital firms can receive financing from the govenrment and private sector. Government finances 1/3 of funds that are more than 15 million USD and 1/2 of funds that are higher than that amount. Government gets 2% fee for the funds used. Companies that purchase stocks from venture capital firms are tax free. The largest source of venture capital firms are pension funds and partnership shares. Small Business Administration (SBA) also guarantees 75% of credits of small businesses up to USD 500.000 to get from commercial banks. The credit term can be up to 25 years. Small businesses pay 2% of guarantee fee to SBA.[31]

SBIC (Small Business Investment Companies) that are public-private partnerships, provide venture capital financing in US. They provided long-term credits with interest rates to ventures at the begining. Since, this financing method was not successfull, SBIC focused on venture capital financing.

The growth of venture capital financing caused the growth of stock exchange markets in US. US Congress asked "US Securities and Exchange Commission" to start NASDAQ Stock Exchange Market and helped the growth of venture capital financing in US. Companies that received the venture capital financing start to trade their stocks in Stock Exchange Markets in the growth stage. Pension funds are also important to form venture capital funds in US. Nowadays, US venture capital firms acquire half of their funds from pension

[29] Ibid., p. 46-47.
[30] ARK, A. H., Risk Sermayesi: Tarihsel Gelişim ve Türkiye Ekonomisinin Yeniden Yapılandırılmasında Potansiyel Rolü ve Önemi, *Active Bankacılık ve Finans Dergisi*, 2002, sayı 23.
[31] http://www.evca.com/images/attachments/tmpl_8_art_166_att_795.pdf

funds.[32] The pension funds can buy stocks of venture capital firms and this helps the growth of venture capital financing in US. The successfull growth of venture capital financing in US leaded to implement it in other countries.[33] Small Business Investment Law, tax discounts and incentives caused the shift of private sector funds to venture capital financing. Modifications in FRSA laws in 1978 and usage of 2.5% of pension funds for venture capital supported the growth of venture capital financing.[34] Venture capital financing was structured in US. Almost 80% of venture capital investments were managed venture capital firms that are limited partnerships.[35] Venture capital investments focus on software, biotechnology, telecommunications, networking and equipment, medical devices and equipment, semiconductors sectors.[36]

Table 3. The Venture Capital Investments in US Companies

Year	*Number of Deals*	*Investment Amount Million USD*
2000	7819	1005004
2001	4453	40811
2002	3046	21681
2003	2840	19396
2004	2910	21341
2005 (First 2 Quarters)	1453	10646

Source: www.pwcmoneytree.com

[32] ESER, S. *Küçük ve Orta Büyüklükteki İşletmelerin Sermaye Piyasasından Finansmanı ve Risk Sermayesi (Venture Capital)*. Ankara: SPK Yeterlilik Etüdü, 1990.
[33] Övek, p. 59.
[34] ARK, A. H., Risk Sermayesi: Tarihsel Gelişim ve Türkiye Ekonomisinin Yeniden Yapılandırılmasında Potansiyel Rolü ve Önemi, *Active Bankacılık ve Finans Dergisi*, 2002, sayı 23.
[35] ROBBIE K. AND WRIGHT M. Venture Capital and Private Equity: A Review and Syntheses. Journal of Business Finance and Accounting, 1988, vol. 25, issue 5, pp.521-570.
[36] http://www.pwcmoneytree.com

Table 4. Stages of Venture Capital Financing in US Companies

	Startup/Seed Nb. Of Deals	*Startup/ Seed Inv. Amount (Million USD)*	*Early Stage Nb. Of Deals*	*Early Stage Inv. Amount (Million USD)*	*Expansion Nb. Of Deals*	*Expansion Inv. Amount (Million USD)*	*Later Stage Nb. Of Deals*	*Later Stage Inv. Amount (Million USD)*
2000	664	3103	2829	25616	3660	60107	664	16179
2001	254	711	1285	9099	2391	23022	523	7978
2002	157	278	855	4002	1592	12560	442	4842
2003	194	390	770	3411	1337	10264	538	5329
2004	173	370	844	3898	1219	9715	674	7358
2005 First 2 Quarters	78	531	395	1611	567	4113	413	4392

Source: www.pwcmoneytree.com

6. Venture Capital Practices in The World

Venture capital firms acquire funds from financial institutions, industrial enterprisesand public. They provide management and marketing support besides capital to companies.[37] Venture capital investment partnerships are experts to make investments in most industries in the world. The establishment of stock exchange markets for SME's caused the success and widely usage of venture capital financing in the world. NASDAQ in US is the best example for stock exchange market for SMEs. The deals are made electronically for SMEs. ESDAQ in Europe, JASDAQ in Japan, Alternative Inverstment Market (AIM) in U.K., Neue Markt in Germany, Nouveau Marche in France and Vencouver Stock Exchange Market in Canada are other examples of stock exchange markets for SMEs.[38] There are tax discounts up to 100% for venture capital investors to encourage them to make investments in Australia.[39]

Japan was not as succesfull as Western countries and US about venture capital financing model at the beginning. There are larger companies instead of SME's in Japan and they provide financing for their technology improvement investments. Their work ethics encourage Japanese to work in their first job in the rest of their lives instead of starting their own business. Venture capital financing focus on companies that operate in electronic and

[37] http://www.dto.org.tr/bilgi/kaynak/risksermayesi.html
[38] http://www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html
[39] Övek, p. 71.

IT sectors in Japan.[40] The government gives guarantees to long term bank credits that are taken by new ventures during the start-up phase in Japan.[41] The secondary markets were established to trade stocks of companies to provide venture capital financing in 1985.[42] Venture capital firms were established with the support of government institutions at the begining. Banks and stock broker companies started to establish venture capital firms afterwards.[43] Venture Enterprise Center was established in 1974 to encourage the establishment of small companies and provide financing to new ventures.[44] It goes bail for 80% of investment credits of SME's given by banks. Japanese venture capital firms focus on late financing whereas US venture capital firms focus on early financing.[45]

7. Venture Capital Practices in European Union Member Countries

U.K. has the most established venture capital practices in Europe. Holding companies, banks and local organizations are sources of venture capital in U.K. Banks become partners to SMEs with growth potential by buying their stocks to provide the required capital.[46] Private and government organizations support the growth of venture capital financing in U.K.. Investment in Industries was established by Bank of England after the World War 2 encourage industrial enterprises to improve their technology. Equity Capital for Industry is a private venture capital firm that provide funds to new ventures in U.K.. There are many private venture capital firms in U.K..[47] The legal format was prepared for "Stock Exchange of The Unlished Securities Market" in 1980 in U.K. to ease the trade of stocks of small companies in the capital market.[48] The funds of venture capital consist of pension funds, foreign private companies, insurance companies, public, industrial enterprises and British Banks in U.K..[49] Business Start-up Scheme and Business Expansion Scheme are private venture capital funds established by British

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[40] Övek, pp. 70-71.
[41] KAYA, A. Genel Olarak Risk Sermayesi Yatırım Ortaklıkları Mevzuatı ve Değişiklik Önerileri, Ankara: SPK. Access from: <www.turkvca.org/articles/AAbdullahKaya_20020924.doc >
[42] Övek, p. 70.
[43] www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html-59
[44] CLARK, R. *Venture Capital in Britain, America and Japan.* London: Croom Helm, 1987.
[45] http://www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html
[46] Ibid.
[47] Övek, p.67.
[48] Clark, 1987, pp.71-77.
[49] MILFORD, B. G. *Venture Capital International Comparisions.* New York: Billing- Sons Ltd., 1991.

Government. British Technology Group was established in 1981 to provide credits and support to small ventures that operate in high tech industries[50] British Venture Capital Association and a magazine called Venture Capital Reports act to improve venture capital in U.K. They publish promising business plans to attract venture capital firms and improve the venture capital model.[51] The investments made by British private equity companies increased 5% to 1566 in 2004 in the world. The total value of worldwide investments also increased 52% to £9,679 million. The number of companies financed increased 2% to 1301 in UK and investment in the UK increased by 31% to £5,336 million in 2004.[52]

Banks usually provide venture capital financing in France. [53] There is a tax discount up to 25% on revenues from investments in stocks in France. There are also tax discounts to public and companies for their revenues of stock investments in Belgium. Ventures in high-tech industries do not pay corporate taxes in Belgium. There are also tax discounts for investors who provide venture capital in Belgium. Revenues from investments in stocks are tax free in Denmark. [54]

Governments also encourage venture capital in European Union Member Countries. Investment Company Flanders established by Belgium government in 1980 is managed by private sector that has 25% share. It provides financing to high tech projects in Flaman region. Three funds were established to finance high tech projects in 1996 in Holland. The partners of the funds are Holland government (25% of shares) and regional development companies. SOFARIS that 42% of its capital belonged to French government was established in France to finance SME's. It guarantees 50% of credits that SMEs get from banks. The maximum credit guarantee limit is 5 million FF. TBG that makes technology investments is supported by German Government Bank in Germany. BTU was established in 1995 to provide financing to small businesses in high tech sector by German Government. It provides financing to companies that have more than 50 workers and have been established less than 10 years ago. German Development Bank provides long term credits with low interest rates. ERP that is a subsidiary of Federal Ministry for Education and Research also provides credits to small businesses in technology sector. German Economic Development Agency guarantees

[50] Övek, p. 68.
[51] (Abdullah Kaya, Genel Olarak Risk Sermayesi Yatırım Ortaklıkları Mevzuatı ve Değişiklik Önerileri)
[52] www.bvca.co.uk
[53] http://www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html
[54] Övek, p. 71.

90% of credits that venture capital firms get from commercial banks. Venture Capital Trust, Enterprise Investment and Business Expanison Scheme (BES) were established to provide financing to ventures in U.K. by the support of governement. BES encourages investors to invest in small businesses. Enterprise Investment Fund (EIF) lets investors not pay taxes up to 20% of their investments. Revenues from investments to EIS stocks are tax free for 5 years. Bank of England also guarantees 70% of new credits that are more than £100.000 and taken by ventures. European Commission is responsible for credit programs of venture capital firms in European Union. European Seed Capital Fund Scheme (ESCF) gives credits to ventures for start up capital and early stage financing. Ventures get interest-free credits for 10 years up to 50% of their business costs for 5 years. The capital of European Investment Fund is provided by funds of European Commission, European Investment Bank and other banks. It encourages stock investments in small businesses. It also guarantees credits taken by small businesses from financial institutions. Credits can cover 50% of investment, portfolio credit insurance and late stage financing. Also, 10% of regional development bank resources are used to finance small businesses.[55]

Venture capital is also provided by banks in European Union member countries. Banks usually provide debt credits instead of receiving the stocks of the venture for not taking risks. Start-up investment increased 13% and reached €2.2 billion in 2004. The amount invested in high tech companies increased 6.5% and reached €7.4 billion. Funds allocated to funds increased 32% and reached €8.8 billion in 2004. In terms of total amount of invested, buyouts, expansion and start up investments all increased. Buyout is the largest proportion with 70% or €25,7 billion. Investment in expansion stage is second with 21% or €7.9 billion and start up investment is third with 6% or €2.2 billion. On the other hand, seed investment is 0,4% with €148 million. When looking at number of investments, expansion is first with 45%, start up investment is 30% and buy outs is 18% of total number of investments. The UK has the largest share of amount invested interms of country of management with 52%, France second at 14%, Germany third at 10% and Spain fourth at 5%.[56]

The UK accounted for 26% of the amount invested in terms of country of destination, with France and Germany achieving larger proportions of investments with 17% and 14% respectively. The Netherlands is fourth at 9%. Consumer related businesses is the highest proportion of

[55] http://www.tubitak.gov.tr/btpd/btspd/btyk/kararlar/karar11.html
[56] http://www.evca.com/images/attachments/tmpl_8_art_166_att_795.pdf

amount invested at €8.5 billion (23%), followed by other services with €5.1 billion (14%) and communications with €4.9 billion (%13). The average investment size reached reached €3.6 million. The average size for buyout investments rose to €14 million, the expansion stage investments reached to €1.7 million and start-up investments rose to €733,871. On the other hand, the average size for replacement investment decreased to €2.5 million and seed investments to €364,867. The majority of investments, 86% by number and 65% by amount of investment, were made in local country. Cross border investments within Europe by number were down to 10%. The fundraising is between €25-28 billion. The funds for buyouts decreased to 65% whereas the funds for venture capital increases 32% of total funds raised. Exits were €19.6 billion with 5917 exits. Trade sales is one fourth of all divestments by amount at €4.6 billion. Divestments by public offering (IPO and sales of quoted equity) increased to €2.3 billion.[57]

8. Venture Capital Practices in Turkey

Although there are efforts to accelerate venture capital practices in Turkey since 1980, these efforts are not enough for the time being. The legal arrangement for venture capital practices have been made corcerning venture capital investment companies based on Capital Market Law since 1993. The last Communiqué on Amending the Communiqué Regarding The Principles About Venture Capital Investment Companies Serial: VI, No:16 was published in the Official Gazette dated 7 January 2004, numbered 25339. Its details are presented in Appendix 1. It sets principles regarding the founders and formation procedures of venture capital investment trusts, registration to the board and public offering of venture capital investment trusts' shares, management and the required qualifications of the managers, scope of activities, portfolio restrictions and disclosure requirements of venture capital investment trusts.

The requirements for foundation are as follows: Venture capital investment trusts should be formed in accordance with the foundation procedure. Besides, companies with different activities should be transformed into venture capital investment trusts by amending their Articles of Association pursuant to the provisions of the Law and this Communiqué. For the approval of foundation of or conversion to venture capital investment trusts by the Board the following requirements must be fulfilled: In case of immediate establishment: must be incorporated as a registered capital corporation, initial capital should not be less than TL 5 trillion, shares must

[57] Ibid.

be issued in return for cash, the trade name of the company must contain the "Venture Capital Investment Trust" phrase, the Articles of Association must comply with the provisions of TCC, the Law and this Communiqué, board members of the legal entity shareholders which have more than 10% of the shares of the corporation shall meet the requirements specified under Article 5 of this Communiqué, application must be made to the Board for dealing with activities listed under portfolio operations specified in subparagraph (f) of first paragraph of Article 30 of the Law and at least one of the founders must be a leading shareholder.[58]

According to this Communiqué, the investments to be made in venture companies by corporations shall be made under the framework of an agreement to be executed by and between the parties. This agreement shall have provisions mainly about the management of the venture company and rights and obligations of the venture commpany. The venture companies must aim to manufacture or develop, vehicles, tools, material, services or new products, methods, systems and production techniques having industrial and agricultural application potential as well as marketing potential or have the capacity to realize the specified objectives with management, technical or capital support. The corporations can be shareholders of venture companies or may purchase debt bonds to be issued by venture companies. The corporations may make investment into securities issued by other venture capital corporations within the framework of the provisions in this article.[59]

Venture capital financing are provided in Turkey since 1991. Banker Trust and Turk Petrol made an agreement in 1991. Then, the financial politics of Banker Trust changed and 50 million USD was returned as a result of this agreement. Some banks established venture capital firms in 1993 because of the support of government. Vakıf Risk A.Ş. is the only company that survived in these companies. Sparx Asset Management invested 40 million USD in 7 ventures in agriculture, textile, packaging, banking, leasing, electronic and biotechnology sectors in 1995. It exited from 2 companies via IPO after two years. One of the investment was unsuccesfull on the other hand. Fiba Holding established Girişim Holding as a private equity fund that made only one investment to Gima supermarkets by buying its majority shares from Dedeman Holding. Merill Lynch made investment to Termo Teknik that was a steel radiator manufacturer. It then sold its shares to a double price to British Caradon Company. Lehman Brothers made 70 million USD investment to Superonline that was a ISP and online services provider.

[58] http://www.cmb.gov.tr
[59] Ibid.

İşbank established İş Venture Capital to provide financing to medium size enterprises that had growth potential.[60] Venture capital firms focus on SME's and companies that operate in IT, software, biotechnology, medical technology, energy, telecommunication and service sectors to make investments.

There were 40 venture capital investments between 1996-2003 in Turkey. They provided 200 million USD funds to companies. There have been few private equity investments in Turkey. Some of the private equity investors were Sparx Asset Management, Merrill Lynch+Bank of America, Safron Capital, AIG Blue Voyage, EMEA, Citicorp and Lehman Brothers. Private equity investors are still partners in some of these investments. Some of the companies that used private equity are as follows: GSD Holding, Biomar, Rant Leasing, Eka Elektronik, Aba Ambalaj, Termo Teknik, BIM, Jumbo, Galatasaray Sportif, AFM Movie Theaters, Gorbon Işıl, Merko Gıda, Işıklar Ambalaj, Superonline.

Venture capital financing are provided by few Turkish venture capital firms in Turkey. Most of the entrepreneurs and owners of SMEs are not aware of and not using venture capital financing. Turkish SMEs focus on receiving credits from commercial banks, government incentives, credits and incentives provided by KOSGEB.

KOSGEB is a non-profit, semi-autonomous organisation responsible for the growth and development of SMEs in Turkey. KOSGEB's Board consists of more than fourty members from the Government of Turkey and half of them are from the private sector representative organizations. The primary objective of KOSGEB is to improve SMEs share and efficiency in Turkish economy and enhance their competitive capacity. In order to accomplish this objective KOSGEB has assumed responsibility for the following functions; developing SMEs' technological skills, improving their training and information level, providing appropriate financial mechanisms and improving their managerial infrastructure.[61]

Venture capital firms have limited funds and hesitate to take risks. They do not want to grow the venture capital market. They just evaluate ventures that applied to themselves. They prefer to invest in very promising projects. They do not try to attract entrepreneurs and owners of SMEs to provide venture capital financing. They do not have experts in their

[60] http://www.kobinet.org.tr/hizmetler/bilgibankasi/finans/003d.html
[61] http://www.kosgeb.gov.tr/KOSGEB/Index.asp

organizations to evaluate the growth potential of ventures from different sectors. Some of the venture capital firms focus on corporate development projects not to take risks. As an overall evaluation, Turkish venture capital firms are behind of other venture capital firms in the developed countries. The venture capital firms in Turkey and their limited practices are as follows:

8.1 İş Venture Capital

İş Venture Capital was established in 2000 by İşbank Group with advisory support of World Bank. Current partnership capital of the company is as follows: 39,92% Public, 20,08% İş Investment, 16,89% TSKB, 11,11% TTGV, 6,67% Anadolu Insurance, 4,44% Milli Reassurance, 0,89% İş Factoring. Its goal is to support and help entrepreneurs build their companies into market leaders. İş Venture Capital seeks out companies from most promising sectors with the highest growth and return due to the dynamic nature of the Turkish economy. It has USD 60 million funds. It usually invests from $1 million to $6 million. It invests up to 10-15% of their investment assets in any one company. İş Venture Capital prefers to have a minority stake with shares having special rights on operational and strategic decisions. It requires to be represented on the Board of Directors of the investee company. The expected holding period for investments is 2-5 years. The preferred exit options of the company is a strategic sale, IPO or sale back to the original shareholders. İş Venture Capital is interested in equity and fixed income investments. It focuses early stage, expansion stage and privatization investments. Although bridge stage, management buyout and workout/turnaround investments are rare in Turkey, İş Venture Capital considers them as investment alternatives. İş Venture Capital evaluates new ventures based on their business plans. It invested in Probil, ITD, Nevotek, Cinemars, and Step companies. Probil is in a IT sector providing technology and business focused solutions to companies. ITD is in a IT sector focusing on voice and payment products and solutions with e-business in Middle and Eastern Europe. Nevotek conveys dynamic and value-added solutions for Cisco IPT infrastructure. Cinemars is a chain of movie theaters in Turkey. 3-D movies can be shown in its movie theaters. Step is a carpet, home textile and accesories retail company that has stores in Turkey and abroad.[62]

8.2 Vakıf Venture Capital

Vakıf Venture Capital was established in 1996 as a subsidiary of Vakıf Bank. It is the first venture capital firm in the sector. More than half of

[62] www.isrisk.com.tr/English

its stocks are traded in İstanbul Stock Exchange. The objective of the company is proving venture capital financing to projects from different sectors to convert the technology based knowledge into a commercial product or service. It has provided financing to three companies: Teknoplazma, Inova Biotechnology and TR.Net. Teknoplazma locates in Technopolis in Ankara manufactures a coating reactor that is used to make high calibre coatings of cutting tools and moulds for the first time in Turkey. Inova Biotechnology produces metallic nanoparticles, antigens, antibodies and conjugation of them to manufacture rapid diagnostic tests for the determination of pregnancy and infectious diseases like HIV. TR.Net is the first internet service provider (ISP) set up in
Turkey. It is still the biggest corporate service provider.

8.3 Esas Holding

Esas Holding established in 2000 has strong financial structure, good market reputation, management and industrial experience to provide assistance to the investee companies. It provided venture capital financing to 6 companies in 3 industries namely food, transportation and health care. It evaluates feasibility, growth potential, competitive strengths, characteristics of entrepreneur and management team of investment projects to make investment decisions. It invests to ventures in a start up stage as well as other stages. It considers company size, financial structure, market position of the venture. It also considers capital requirements and usage to achieve goals for growth of the venture. [63]

8.4 İLAB

İlab Holding is an investment company that focuses on providing financing to companies that make business via internet. It targets playing a major role in a digitalizing process in Turkey. It has made investments in 7 companies in chemical-plastic, iron-steel, insurance, human resource consulting, e-buiness consulting and software sectors. All of these companies use internet technologies to make business and provide value added services in their sectors. İlab Holding establishes new ventures in its holding group as well as it provides financing to other ventures out of its group that need venture capital. Sigortam.net (gives service as first Turkish insurance e-market), BesOnline.net (personal retirement system expert providing information and solutions about retirement), Treda (expert on E-business

[63] www.esas.com.tr

projects to provide solutions), Chem Orbis (chemical and plastic e-market for companies) and Steel Orbis (İron steel e-market for companies) were established by İlab Holding. Kariyer.net (the most improved Turkish human resource web site) and Kariyerakademi.net (first Turkish reservation web site that helps the meeting of training companies with people and companies that want to get training). İlab Holding targets to be a reliable business partner that has the same rights with other co-partners instead of playing operational role in investee companies. It transfers its experiences in areas such as strategy formulation, management and marketing.[64]

8.5 Koç Information Group

Koç Information Group has provided financing to 12 companies that are in Koç Holding. These are Koç Sistem, Ultra Kablo TV Koç.net, Bilkom, Koç Bryce, GVZ, Biletix, Promena, Kangurum, Kotonline and. Tanı. Koç Information Group focuses on corporate development instead of venture capital financing for the time being.[65]

9. The Financial Problems of SMEs in Turkey

The source of capital is usually savings in SME's and they are added to equity. SMEs hesitate debt financing. They prefer deferred payments provided by their suppliers or customers. They can not use the banking system efficiently because the current system can not provide financing urgently. The lack of financing is the main problem of manufacturing companies. Finding short term early financing is a problem for entrepreneurs that provide their own capital for their ventures. There are problems to get credits from banks. Costs of long term credits are high. Banks require caution money from entrepreneurs as the same amount of credits they provide. Most of SMEs are not institutionalized to receive financing from capital markets.

İstanbul Stock Exchange Market established The Regional Market and The New Companies Market for SMEs. It is important to attract investors to these markets by improving their trusts. Venture capital financing is an important financial instrument to develop new financial stock exchange markets for SMEs. The growth of venture capital financing in Turkey will help the growth of new stock exchange markets.[66] The Regional Market was designed for SMEs to find financing in capital market. SMEs

[64] www.ilab.com.tr
[65] www.kocbilgi.com
[66] Bulut, pp. 53-54.

need to have profits in the last two years and paid capital of €470.000 to be traded in The Regional Market. The New Companies Market was designed for technology companies in information technology, computers, internet, high technology and telecommunicaton and related sectors to find financing in capital market.[67]

10. Conclusion and Recommendations

Private equity is an industry that attracts professional risk takers. They invest directly rather than lend money and target privately owned companies. As a result, these transactions are privately negotiated and they receive an equity stake for their investments. Of the different types of private equity, the most publicized is that of venture capital. Venture capital firms tend to focus on technology related companies, with some specializing in biotechnology.

Venture funds are usually set up as limited partnerships that use money from corporations and from traditional institutional investors such as insurance companies and pension funds to fund start-ups. The VCs who run these funds are the general partners who receive a management fee based on the size of the fund. Venture capital clearly serves as an important source for economic development, wealth job creation, and innovation. Venture-backed companies grow more quickly and create far more value than nonventure-backed companies. Similarly, venture capital generates a tremendous number of jobs and boosts corporate profits, earnings, and workforce quality. Finally, venture capital exerts a powerful effect on innovation

Good investment strategies should utilize; detailed due diligence and deal screening based on intensive industry knowledge, syndication of investments to gather more information and diversity risk, equity ownership and incentive compensation for senior management to directly link the interests of investors and the entrepreneur, carefully thought out boards of directors that provide oversight, strategic advice, and credibility to the company. Venture capitalists help entrepreneurs start businesses and then sell those businesses to the public market in an initial public offering or to more established companies wishing to buy the start-up.

Exit possibilities for investors is a critical issue. Sufficient exit opportunities are fundamental for private and institutional investors prior to investing in new companies. In Turkey, although the national stock market in Istanbul offers some exit possibilities, the impact has generally been limited.

[67] http://www.imkb.gov.tr/halkaarz/bolum10.htm

The exit market is immature, and the industry has experienced only few successful exits, where most of the trading takes place in very large issues. Similar to other emerging markets, IPO has hardly been the most likely exit route in Turkey.

The most important obstacles for Turkey in the previous years were the lack of capital and high interest rates. Due to the political instability and lack of confidence, the government was borrowing short-term and at high interest rates. In this environment, domestic capital invested in high interest government bonds or transferred their capital to international markets. Turkey has always attracted very low inflows of FDI relative to other comparable countries. Several reasons for this low performance can be listed as structural barriers, heavy bureaucratic requirements, macroeconomic and political instability.

Turkish Government has made reforms since 2002 to attract foreign investors, improve investment environment and provisions for foreign and domestic investors. Subjects handled within the reform framework include Company Establishment, Employment, Sectoral Permits, Investment Location, Taxes and Incentives, Customs and Standards, Intellectual Property Rights, Investment Regulation, Investment Promotion and SMEs. During next few years with the wind of the EU membership, Turkey should reach the level of venture capital funding seen in Eastern European countries. More ambitious target could be pursued if Turkey decides to adopt a program to develop the industry.

SME’s constitute 99,5% of total companies in Turkey. They have financial problems.They are lack of capital for their equity. Being lack of capital cause not to get the advantage of leverage affect for SME’s. There are investment instruments for SME’s such as leasing, short and long term bank credits. On the other hand, venture capital is an alternative investment instrument especially for Turkish SME’s. It helps entrepreneurs to share their financial risks with venture capital firms and investors. Venture capital financing need to be used extensively in Turkey. Entrepreneurs need to be aware of it and do not hesitate to get theadvantage of it. New venture capital firms need to be established and investors need toencouraged to make investments in ventures in every stage. Our study is important toemphasize the importance of venture capital financing for Turkish SME’s. The new stockexchange markets need to be developed for Turkish SME’s. They will help legalarrangements for venture capital financing that will expand financial markets and causefinancial deepening in Turkey.

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Appendix 1

COMMUNIQUÉ REGARDING THE PRINCIPLES ABOUT VENTURE CAPITAL INVESTMENT COMPANIES

1) (Communiqué on Amending the Communiqué Regarding The Principles About Venture Capital Investment Companies Serial: VI, No: 16 was published in the Official Gazette dated 7 January 2004 numbered 25339.)

Repealed Communiqué

(Communiqué No: 10 Serial: VI published in the Official Gazette dated 6 November 1998 numbered 23515 is overruled by a new Communiqué Serial: VI, No: 15 carrying the same name.)

Serial : VI

No : 15

SECTION ONE

PURPOSE, SCOPE, LEGAL BASIS AND DEFINITIONS

Purpose and Scope

ARTICLE 1 - The purpose of this Communiqué is to set the principles regarding the founders and formation procedures of venture capital investment trusts, registration to the board and public offering of venture capital investment trusts' shares, management and the required qualifications of the managers, scope of activities, portfolio restrictions and disclosure requirements of venture capital investment trusts.

Legal Basis

ARTICLE 2 - This Communiqué has been based on Article 22/(o), Article 36, and Article 39 of the Capital Market Law numbered 2499.

Definitions

ARTICLE 3 - For the purposeS of this Communiqué, the following definitions shall apply;

a) Board: Capital Markets Board,

b) Ministry: Ministry of Industry and Trade,

c) Law: Capital Market Law numbered 2499,

d) TCC: Turkish Commercial Code,

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e) TTRG: Turkish Trade Registry Gazette,

f) Corporation: Venture capital investment trust,

g) Venture capital investment: The investments which comply with the principles explained in Article 20 of this Communiqué,

h) Venture capital investment trust: The corporation which is incorporated as a registered capital company and directs its capital to venture capital investments,

i) Venture firm: The firm established or will be established in Turkey, which has potential for growth and needs resources.

j) Portfolio value: The total market value of venture capital investments, other securities traded at secondary markets and reverse repo contracts that the corporation has in its assets.

k) Leading shareholder: The shareholder/s who has %25 of the venture capital investment trust's shares and fulfils the requirements listed at Article 5, and 6 of this Communiqué,

l) Sophisticated investor: Mutual funds, pension funds, investment companies (securities / venture capital / real estate), brokerage houses, banks, insurance companies, special finance institutions, portfolio management companies, pension and aid funds, foundations, institutions founded based on Provisional Article 20 of Law Numbered 506, associations, other investors which will be considered by the Board as similar to these mentioned ones, and the investors that have at least 1 trillion Turkish Liras of securities at the time of public offering of venture capital investment trust's shares.

SECTION TWO

PRINCIPLES REGARDING FOUNDATION AND CONVERSION

Requirements for Foundation

ARTICLE 4- Venture capital investment trusts should be formed in accordance with the foundation procedure. Besides, companies with different activities should be transformed into venture capital investment trusts by amending their Articles of Association pursuant to the provisions of the Law and this Communiqué. For the approval of foundation of or conversion to venture capital investment trusts by the Board the following requirements must be fulfilled;

A- In case of immediate establishment,

1) Must be incorporated as a registered capital corporation,

2) Initial capital should not be less than TL 5 trillion,

3) Shares must be issued in return for cash,

4) The trade name of the company must contain the "Venture
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Capital Investment Trust" phrase,

5) The Articles of Association must comply with the provisions of TCC, the Law and this Communiqué,

6) Board members of the legal entity shareholders which have more than 10% of the shares of the corporation shall meet the requirements specified under Article 5 of this Communiqué,

7) Application must be made to the Board for dealing with activities listed under portfolio operations specified in subparagraph (f) of first paragraph of Article 30 of the Law,

8) At least one of the founders must be a leading shareholder,

B- In case of conversion,

1) Must have adopted the registered capital system or have applied to the Board for this purpose,

2) Paid-in (or initial) capital must be at least 5 trillion TL,

3) Application must be made to the Board for amending the trade name of the company so that it contains the "Venture Capital Investment Trust" phrase,

4) Application must be made to the Board for amendment of the Articles of Association according to provisions of TTK, the Law and this Communiqué,

5) Board members of the legal entity shareholders which have more than 10% of shares of the corporation shall meet the requirements specified under Article 5 of this Communiqué,

6) Application to the Board for dealing with activities listed under portfolio operations specified in subparagraph (f) of first paragraph of Article 30 of the Law,

7) At least one of the current shareholders must be leading

shareholder,
The requirements listed in sub article (a)/6 and sub article (b)/5 shall not be relevant for public institutions and other institutions which are considered to be like public institutions. (This provision is added by the Communiqué numbered Serial: VI, No: 16)
All amendments in the Articles of Association after foundation or transformation of the company will also be also subject to the Board's approval.

Qualifications of The Founders

ARTICLE 5 - At venture capital investment trusts;
a) Founders, and other shareholders who directly or indirectly hold 10% or more of the corporation's shares shall not have due debts to the taxation authority and the public pension system.
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b) Founders who will have 10% or more of the corporation's shares, shall obtain the required financial resources through their own commercial, industrial or other legal activities without any disputes.
c) Shareholders who are natural persons;
1. and the institutions of which they are general partners must not be insolvent,
2. must fulfil the requirements listed at sub article (d) of first paragraph of Article 9 of the Communiqué Regarding Intermediary Activities and Intermediary Institutions.

Special Requirements for the Leading Shareholder

ARTICLE 6 - Leading shareholders shall have the financial strength, reputation and experience necessary to be founder and shareholder of a venture capital investment trust.
If the trade name of the corporation contains the name or trade name of natural or legal persons or if it contains a phrase which denotes that the corporation has a relation with those natural or legal persons, then those natural or legal persons are required to be leading shareholders.
Leading shareholder shall have at least 25% of the total shares of the corporation and those shares shall be registered to the name of the leading shareholder.

Foundation and Conversion Procedures

ARTICLE 7-The corporation requesting foundation or conversion shall apply to the Board with the foundation/conversion application form and the documents mentioned at the form.
The application package shall include a feasibility report which contains information on the target industries, the planned periods when the capital will be increased and shares will be offered to public, amount of planned capital increases, consultancy services which will be provided by or for the corporation, the investors targeted for public offering of shares.
The Board inspects the application in terms of compliance to provisions of the Law and this Communiqué and in case no contrary matter is found out, foundation or conversion request shall be approved.
In case the Board approves the application, then an application for approval of foundation or approval of the amendments at the Articles of Association and the certificates proving that the capital has been paid in accordance with the provisions of this Communiqué and other required documents shall be submitted to the Ministry.

The corporation established according to immediate foundation, shall be incorporated upon registration to trade registry pursuant to related provisions of TTK following foundation approval of the Ministry.
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The companies to be converted into venture capital investment trusts shall convene general assembly of shareholders or if required, general assembly of preferred shareholders pursuant to provision of Article 389 of TCC in order to obtain approval of general assembly for amendment of the Articles of Association following approval of the Ministry. Upon approval of the amendments and registration to trade registry, conversion procedures shall be competed.

License for Portfolio Management Activity

ARTICLE 8 - While licensing the corporation for engaging in portfolio management activities, the Board evaluates the existence of sufficient physical space, hardware, employees, organization and managers, and finally if it becomes sure that the corporation can successfully engage in portfolio management activities, the Board gives the license to the corporation.

Within fifteen days, licenses shall be registered to Trade Registry and disclosed at TTSG. Any amendment related to the license shall also be registered and disclosed in the same way.

The corporations that didn't submit the application for portfolio management license within six months after the registry of foundation or amendments to the Articles of Association of the corporation, and the corporations of which the Board rejected the application, shall not operate as a venture capital investment trust anymore.

Following the end of the six month period or the date when the corporation is informed about the Board's rejection decision, the corporation shall apply to the Board to amend its Articles of Association so that it can not operate as a venture capital investment trust and to exit the registered capital system within three months. In case the corporations do not apply for these amendments, they will be considered annulled as stated in the second and sixth sub articles of first paragraph of Article 434 of TCC.

SECTION THREE

Principles Regarding Registration of The Shares By The Board

Application for Registration

ARTICLE 9 - Within three years from the registry of portfolio management license to Trade Registry, a corporation that is founded as a venture capital investment trust or converted into a venture capital trust shall compose its portfolio and apply to the Board with the request of having its shares registered so that they can be offered to public.

The corporation that didn't submit the application for registration of its shares to the Board within three years after the registry of portfolio
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management license to the Trade Registry, and the corporations of which the Board rejected the application, shall not operate as a venture capital investment trust anymore.

Following the end of the three year period or the date when the corporation is informed about the Board's rejection decision, the corporation shall apply to the Board to amend its Articles of Association so that it can not operate as a venture capital investment trust and to exit the registered capital system within three months. In case the corporations do not apply for these amendments, they will be considered annulled as stated in the second and sixth sub articles of first paragraph of Article 434 of TTK. On the other hand, upon the request of the corporation, the Board can grant a one year extension for the three year period in case of significant problems that occurred in the market where the shares of the corporation are supposed to be offered to public.

Public Offering

ARTICLE 10 - In public offering of shares, the Board's general regulations on public offering and sale of shares shall be applied, where there is no relevant provision in this Communiqué.

Registration by the Board

ARTICLE 11- The Board shall evaluate application for registry of shares in terms of public disclosure, in particular whether the offering documents contain the information required under the regulations about the corporation and the shares.

In case the Board gets the opinion that the offering documents are not sufficient and do not reflect the truths and therefore cause abuse of the public, then the registry of the shares to the Board may be rejected.

Registry of the shares to the Board does not mean that issued shares and the trust will have been guaranteed by the Board and cannot be used for advertisement purposes.

Quotation to The Stock Exchange Market

ARTICLE 12 - The corporations shall apply to the Board for issuance of certificates required for quotation of issued shares to Stock Exchange Market within 15 days from end of sale period. Within 15 days following the date of these certificates, corporation is obliged to apply to stock exchange market with the request of quotation of the shares.

Notification to The Board

ARTICLE 13 - The corporations shall be obliged to notify the following to the Board within six business days subsequent to:

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a) the announcement date of Articles of Association of the Foundation, one copy of TTSG,

b) the publishing date, statement, circular, announcement regarding sales and advertisements about public offering,

c) the end of sale period, the information about new shareholders structure and sale results occurred after sale,

d) the signing date, one copy of agreement about investment to venture firms,

e) end of the quarter, quarterly portfolio table containing investments in trust portfolio.

In addition, the resolution of the board of directors about investment to venture firms shall be notified to the Board and the Stock Exchange Market where the shares are under transactions through the fastest communication means until 9:00 of the next business day.

Transfer of Shares

ARTICLE 14 - Before public offering, transfer of shares shall be subject to the permission of the Board regardless of any ratio. Transfer of shares within the framework of the provisions in this article the new shareholders must fulfil the restrictions of the founders.

Issue of Preferred Shares

ARTICLE 15 - The corporations cannot issue any securities providing privileges other than privilege to nominate 2/3 of candidates for members of the board of directors or privilege for dividend. If the number of 2/3 of board of directors is not an integer, the closest integer will be taken into account. After public offering, no privilege, including nominating members for the board of directors and dividend, can be created.

SECTION FOUR

Principles Regarding the Management of the Corporation

Member of the Board of Directors and General Director

ARTICLE 16 - The members of the board of directors and the general director must have the qualifications specified under article 5, paragraph (a) and (c) of this Communiqué.

Scope of Activities

ARTICLE 17- The corporations,

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a) can be shareholders of venture firms within the framework of the provisions in this Communiqué,

b) may take part in the management of venture firms, may offer consulting service for the mentioned firms,

c) may make investments in securities being transacted in secondary markets in order to have varieties in their portfolio,

d) may use short term credit ,which have a maturity of less than 1 year, in the amount of half of their equity capital, long term credit, which have a maturity of more than 1 year, in the amount of two times of their equity capital.

Investment Restrictions

ARTICLE 18 - The corporations,

a) can not make investment into firms where the shareholders with more than %10 of the capital or the voting rights, members of board of directors and general director separately or collectively have more than 10% of the capital or the voting rights of corporation,

b) can not invest more than 50% of its portfolio value on securities other than the ones issued by venture firm and the being operated at secondary markets, investment to venture firms are considered as this kind of investment after ten years since the investment date,

c) can not invest more than 10% of its portfolio value on securities issued by one firm specified under subparagraph (b) above.

d) can not have more than 5% of voting rights or capital of one single firm specified under subparagraph (b)

e) can invest in securities appropriate with their investment objectives with the purpose of hedging of portfolio against currency, market and interest rate risks provided that their articles of association have a provision in this line, this issue mentioned in disclosure documents, and approved by the Board, for hedging purposes invest in forward, options and futures contracts.

Obtaining Consulting Services

ARTICLE 19 - The corporations can obtain consulting services from specialized persons and foundations in connection with the matters related to their activities provided that their articles of association have a provision in this line and a resolution for this purpose has been taken by the board of

directors.
One copy of contract with specialized persons and foundations must
be notified to the Board within six business days following the signing date. If no staff will be assigned to the related departments within the period of contract, the contract must be approved by the Board.
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Investment in Venture Firms

ARTICLE 20 - The investments to be made in venture firms by corporations shall be made under the framework of an agreement to be executed by and between the parties. This agreement shall have provisions mainly about the management of the venture firm and rights and obligations of the venture firm.
The venture firms must aim to manufacture or develop, vehicles, tools, material, services or new products, methods, systems and production techniques having industrial and agricultural application potential as well as marketing potential or have the capacity to realize the specified objectives with management, technical or capital support
The corporations can be shareholders of venture firms or may purchase debt bonds to be issued by venture firms.
The corporations may make investment into securities issued by other venture capital corporations within the framework of the provisions in this article.
The corporations can make;
a) Contracts that give to the corporations the option to sell the shares of venture firms to the shareholders or the employees of venture firms,
b) Contracts that give the option to the shareholders or the employees of venture firms to buy the shares of venture firms,
c) Contracts that give the shareholders the option to buy the shares of venture firms,
d) Futures contracts regarding the sale of shares of venture firms to the shareholders or the employees of venture firms,
e) Futures contracts regarding the sale of shares of venture firms to the corporations by the shareholders or the employees of venture firms, and other options and futures contracts regarding the investment activities of the corporations.
These kinds of contracts are considered as venture capital investments.
For these kinds of contracts corporations must obey the rules determined by the Board regarding the obligations of the parties, valuation principles of investment on venture firms, the scope of public disclosure, investment amount and etc.
Sufficient information about options and futures contracts must be disclosed in the disclosure documents.
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SECTION FIVE

OTHER PROVISIONS

Principles Regarding The Sale of Shares To Sophisticated Investors

ARTICLE 21 - If the shares of corporations will be sold only to sophisticated investors provided that their articles of association have a provision in this line and this issue mentioned in disclosure documents, the following principles would be valid.

a) Corporations have to obtain and keep regularly persuasive data and documents about the investors proving that they meet the sophisticated investor criteria within the framework of this Communiqué.

b) All the shares must be written down on its behalf. These shares can only be sold to the sophisticated investors. Corporations must obtain persuasive data and documents about the investors proving that they meet the sophisticated investor criteria. The sale of shares to the investors that does not meet the sophisticated investor criteria can not be registered to the share register.

c) In case of foundation and conversion the paid-in or initial capital must not be less than 1 trillion TL.

d) Corporations are not obliged to have a leading shareholder and the provisions regarding the leading shareholder are not valid for these corporations.

e) There is no need to have an investment portfolio prior to registration to The Board however the corporations that does not meet the specified criteria under article 18, paragraph (b) of this Communiqué within one year following the registration can not operate as a venture capital investment trust. Following the end of the one-year period, the corporation shall apply to the Board to amend its Articles of Association so that it can not operate as a venture capital investment trust within three months. In case the corporations do not apply for these amendments, they will be considered dissolved as second and sixth sub articles of first paragraph of Article 434 of TTK.

f) Article 12 and the last paragraph of article 13 of this Communiqué are not valid for these corporations.

g) In case of public offering paragraph (b) of article 5 and third subparagraph of article 6 of Communiqué On Principles Regarding Registration With The Capital Markets Board And Sale Of Shares Serial: I, No:26 published in Official Gazette dated 15/11/1998 and numbered 23524, second subparagraph of first paragraph of article 3 of Communiqué on Principles Regarding the Sales Methods of Capital Market Instruments Through Public Offering, Serial: VIII, No: 22 published in Official Gazette dated 27/10/1993 and numbered 21741 are not valid for these corporations.

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h) There is no need of auditing, notification to the Board and disclosure for the six-month results of the corporations. However, year end financial statements and audit report must be submitted to the Board and disclosed at TTSG within one month following the date of annual general assembly.

Board can differentiate the public disclosure requirements of these corporations.

Being Subject to Related Regulation

ARTICLE 22 - The corporations shall be subject to regulations of the Board in connection with the matters such as financial tables and reports, profit distributions, announcements and advertisements. In case this Communiqué does not have any provisions about a specific matter, then the regulations of the Board about publicly-held firms and other regulation provisions shall be applied.

The Fee to Be Deposited to The Fund
ARTICLE 23 - Before the registry of the shares of corporation, the registry fee under Article 28 of the Law shall be deposited to the account of the Board in advance.
Documents Determined By The Board
ARTICLE 24 - Board can determine the format, scope and principles of notification to the Board of prospectus, articles of association, application forms and portfolio tables mentioned in this Communiqué.
Amounts Determined By The Board
ARTICLE 25 - Board can determine the amounts mentioned in the articles 3,4 and 21 of this Communiqué.
Evaluation of The Applications By The Board
ARTICLE 26 - Documents regarding the application must be submitted fully to the Board in order to evaluate the application. Other documents and information to be requested must be submitted within the period determined by the Board.
Repealed Provisions
ARTICLE 27 - "Communiqué Regarding the Principles About Venture Capital Investment Corporations" Serial: VI, No: 10, published in Official Gazette dated 6/11/1998 and numbered 23515, being in effect before this
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Communiqué has been terminated.
Temporary Article - The principles regarding the leading shareholder and minimum paid-in capital will not be valid for the corporations founded before publishing date of this Communiqué.
Entry into Force
ARTICLE 28 - This Communiqué shall enter into force on the day of its publication.
Execution
ARTICLE 29 - The provisions of this Communiqué shall be executed by the Board.

PRIVATE EQUITY AND VENTURE CAPITAL – THE NEW IDEA FOR GAINING CAPITAL IN CENTRAL AND EASTERN EUROPE[1]

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Abstract

In the contemporary world, the capital market in Central and Eastern Europe (CEE) is spreading further and further. Young and emerging enterprises not only need but also acquire capital for developing themselves and entering new markets. Following this path the assets class grows and matures, and at the same time the number of transactions on the secondary market obviously keeps increasing. Due to this reason, we should take into consideration the subject of private equity and venture capital. Private equity and venture capital are the forms of investing in unquoted securities of new, small or medium-sized enterprises. After a certain period of investing equity the shareholders could sell back their shares in order to maximise yield or minimise losses. The goal of this working paper is to present the market of private equity and venture capital in Central and Eastern Europe countries (especially in Poland, the Czech Republic) as well as its possibility for the future development in Europe.

Keywords: *Private equity; venture capital; Central and Eastern Europe*

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1. Introduction

When we look at companies such as Euronet, Computerlan, Google, or Hewlett Packard, it is usually easy to indicate in what market sector they operate or what their main product is. However, it is not commonly known just how they managed to gain the leader position in their fields. The key to their success was the intriguing way of acquiring external capital in the form of Venture Capital (VC). The form that focused on the human factor, his creativity and will to take up risk. Unfortunately, this does not mean yet that the mentioned source of financing is available for everyone, at least not yet in the CEE countries.

The beginning of VC dates back to the '80, when the USA faced an extreme increase in the financing of investments in infrastructure using this method. The value of VC investments in the USA has risen since 1980 from USD 5 billion to USD 180 billion in 2000.

This study acquaints the reader with the main definitions of PE/VC as well as presents the development of PE/VC in Europe. However, the most interesting part is about the changes being introduced in this field in the CEE countries. Surely, the accession into the EU will cause the VC market in the CEE countries to be regulated, and therefore will give a chance to develop and become competitive to many small and medium-sized enterprises.

2. Main aspects of private equity and venture capital

2.1 The nature of PE/VC funds

Today, private equity and venture capital funds are one of the specific forms of financing the development of enterprises. The idea of private equity and venture capital is very simple. There are always two sides of a transaction: wealthy investors (a sponsor or moneylender, who finances a new idea or project) and originators (who know how to improve the financial state of the company to acquire a huge profit). Nowadays, even very expensive projects or ideas can find a moneylender willing to take a risk in return for a high reward – the future profit. This is the reason why such forms of financing are very often called high risk capital. However, not only does the moneylender contribute his money to the company, but also his know – how, high –tech, low – tech and no- tech as far as the management of the company is concerned. This transfer of capital helps investors to manage the company as well as to enter the market with a specific product. This kind of private investor, who not only provides the company with capital, but also with business expertise, is known as **business angel**. [TAMOWICZ P., *Venture Capital – Kapitał na Start*, PARP Publishing, Gdańsk 2004, pp. 66 – 67. ISBN 83-88802-90-9]

Private equity (PE) is a medium or long-term form of financing investments. This form is provided to an unquoted company in return for an equity stake in potentially high growth of such company. Moreover, the term "private equity" is used to describe the industry as a whole that is "venture capital" (the seed to expansion stages of investment) as well as management buy-outs and buy-ins.

Private equity backed companies usually grow faster than other types of companies. The private equity firms will seek to increase a company's value to its owners, without taking day-to-day management control. Although the company may have a smaller "slice of cake", within a few years the same „slice" should be worth considerably more than the whole "cake" was before

As far as the idea of **venture capital (VC)** is concerned, it should be stressed that this is the same form of financing as private equity. However, venture capital is provided to a company, which is very new and is just starting to position itself on the market. Due to this fact, the risk of putting up capital to such an enterprise is higher. Following this path, there is a popular belief that the future profit from such companies is also higher, but this is not a rule. Moreover, venture capital provides capital to companies, which are not listed on the stock market. Venture capital refers mainly to management buyouts, management buy-ins, replacement capital as well as venture purchase of quoted shares.

Investments are usually carried out by acquiring shares, but their amount depends on individual agreements between originators and investors. Thus the investor becomes the company co-owner. After financing the proper project the investor withdraws his capital and sells his stocks and shares. This is also a very important feature of venture capital (VC), which concerns companies that are not listed on the stock exchange. Therefore, VC is recognized as a part of the nonpublic or private capital market. [The Polish Private Equity Association, Yearbook 2003, pp. 41 – 45]

In fact, venture capital (VC) is an element of private equity, which is contributed to the company by an external investor to a small or middle-sized enterprise for the period from five to ten or even fifteen years. This period depends on the time, which is necessary to obtain appropriate development in the early stage of the venture (speed and start-up phases) or expansion of the business.

Taking the PE/VC structure into account, it seems to be very interesting that some collaterals (like mortgages), which are usually required in the credit procedure, are not needed in this form of financing. According to this statement, the only collateral in the PE/VC form is only the share of the company's equity as well as the rights, which results from this share.

These are:

- Voting rights;
- Access to financial information;
- Control system.

In most cases, the investor resigns from taking the monthly profit margin in order not to charge the budget of the enterprise. Actually, PE/VC is an award itself for the company and a proof of its success. Hence the more company is worth, the more investors earn from shares.

As far as the idea of PE/VC is concerned, there are two kinds of investments in this structure. They differ from each other in legal requirements as well as in their structure. These are:

- **Direct investment in PE/VC**
- **Indirect investment in PE/VC**

Direct investment in PE/VC takes place when an investor buys shares of a company. The investor is a private person or group of people, who might come from among a circle of families or the entrepreneur's friends. However, it should be taken into account that the financial possibilities of friends or family are limited, and can not bankroll all phases of production. Therefore, the possibility of direct investment runs out, when the company starts to produce goods on a large scale. Overall, the direct form of investment was once very popular in the private equity structure, but now it is not as popular as the indirect form.

The second form of investment is indirect investment in PE/VC. Such a form of financing the process of investment is by far much more complicated as well as profitable than the direct form. The idea of indirect investments relies on using specialized institutions -private equity investment funds. This is a special legal structure, which symbolizes the accumulated capital managed by experts, called **fund managers** or **investment managers**. The fund manager is responsible for researching and selecting markets, sectors and industries to invest in, deciding how much to invest in each sector, when to buy or sell etc. In other words, the private equity investment fund is a vehicle that enables raising capital from several investors, and then invest this capital in equity-related securities of companies - **investee companies**. These are usually private companies not listed on any stock exchange. Nevertheless, the fund could also take a form of a company or an unincorporated entity such as a limited partnership. [CIEJPA-ZNAMIROWSKI*, K., Zagrożenia i perspektywy rozwoju polskiego rynku* *kapitałowego,* KUL Publishing, Lublin 2002, pp. 14 – 16. ISBN 83-228-0821-6]

The legal structures needed to establish these funds might be different in various countries due to the differences in tax systems or legal regulations.

Entities that are mostly interested in setting up venture capital funds are:

- Pension funds,
- Banks,
- Insurance companies,
- Huge corporations.

The above mentioned entities have large capital resources. For this reason, they want to invest their capital in the fund and at the same time achieve better profits from this transaction. On the one hand, the type of investors in a fund is not significant, but on the other hand it truly could be. For example funds, which are established by banks, might be much more aware of investing in better-positioned and more secure companies. Obviously, investments in such companies will take less time, than in companies in the speed stage.

2.2 The idea of fund of funds

As the idea of private equity and venture capital develops, the case of the fund of funds should not be avoided.

In the developed financial markets, local institutional investors are typically providers of private equity capital. In most European Union countries (like the UK, France, Hungary, Austria) more than half of all private equity capital is provided by banks, pension funds etc. However, not all counties in Europe are so lucky…for example Poland. In comparison with European countries, the Polish private equity (PE) market is characterized by a low level of financing from local, domestic sources. Despite this fact, the Polish institutional investment market is rising quickly. Polish pension funds currently control a capital of PLN 58 billion. Moreover, the value of the assets of insurance companies in 2004 exceeded PLN 61 billion and market investment funds accounted for a further PLN 32 billion.

Unfortunately, in spite of such a considerable capital, Polish financial institutions are not allowed to invest in the local private equity market. In fact, the local private equity market is effectively cut off from sources of local financing. The reason of this situation is quite simple – the Polish law system. Due to the regulatory constraints, pension funds can not invest directly into non-listed foreign investment entities. Under these circumstances, this form of investment includes private equity funds, which use the non-listed foreign investment entities to maximize their tax efficiency. Actually, foreign pension funds, banks as well as insurance companies are still one of the leading PE investors in Poland.

However, there is a solution to this problem in the Polish legal regulation. This solution is called the **fund of funds**.

Today, funds of funds are quite a popular form of investment vehicles on the private equity market. At the end of 2003, there were approximately 125 funds of private equity that managed around USD 130 billion all over the world. In other words, globally, funds of funds account for about one fifth of the overall private equity capital. Taking into consideration the European market, this ratio is slightly lower and reached around 14% in 2003. This situation makes funds of funds the fourth biggest provider of private equity capital on the European market.

The idea of the fund of funds is really simple to explain. A fund of funds is an investment vehicle that pools money from investors to invest in a selected portfolio of private equity funds. Particularly, a fund of funds usually acquires a portfolio including from 10 to 20 selected PE funds. When the life of these selected funds ends or if the funds expire, cash from divestments is transferred to the fund of funds and returned to its investors. Therefore, a **divestment** is a point at which the private equity fund ends its involvement in a business and takes its profit. [The European Private Equity and Venture Capital Association (EVCA), Yearbook 2005, pp. 202 – 203]

There are many advantages of the fund of funds:

- **Access to the best funds (top-tier funds)** – funds of funds want to generate the best return from the selected best private equity funds (e.g. funds from the top-quartile funds like these, which have a return on investment at the level of 25%). The demand for these top-performing funds is very high on the market, and may even exceed supply. As a result, not all investors can take part in such profitable funds. However, due to the power of funds of funds, for example its management skills or market expertise, it may provide access to the leading private equity funds.
- **Cost effectiveness** - An institutional investor, who would like to allocate for example 10% of his assets to private equity as well as wants to reduce his risk by investing that capital in a number of funds, should bear the costs of employing a team of private equity professionals, to construct and manage a portfolio of private equity funds. Investing into a fund of funds allows the investor to outsource

all mentioned tasks, and at the same time save time as well as money. In fact, a selection of investment opportunities or tasks to be performed, which are connected with monitoring and reporting the portfolio, requires both the investor's knowledge and constant monitoring of the investments. Therefore, the choice of a fund of funds is the best solution for an institutional investor.

- **Diversification** – investment risk in the fund of funds substantially goes down through portfolio diversification. Thus the fund of funds diversifies its portfolio across:
    - Funds,
    - Sectors,
    - Strategies

  The reason of this solution is to diversify portfolio risk. As a recent research of the PE shows, funds of funds are the least risky form of allocation in private equity. Whereas the risk of capital loss in the case of a direct PE investment in a business is 42%, the risk of a loss going up from an investment in a single private equity fund (whose portfolio may consist of shareholdings in 10 – 20 companies) is substantially reduced, but still significant at around 30%. When investing through a fund of funds the risk of capital loss is just 1%. Moreover, the risk of total loss of capital during investing through a funds structure was found to be zero.
- **The possibility of investments with limited capital** – a potential investor in a private equity fund should provide a substantial threshold. Consequently, if the investor wants to build his own portfolio of PE funds, he must have a significant sum of money to enter into several funds. Investing via a fund of funds has the advantage of allowing an investor with relatively limited capital to gain access to a large spectrum of private equity funds. An institutional investor who allocates less than EURO 500 million for investments in private equity will participate only through funds of funds vehicles.

2.3 Stages of financing investments

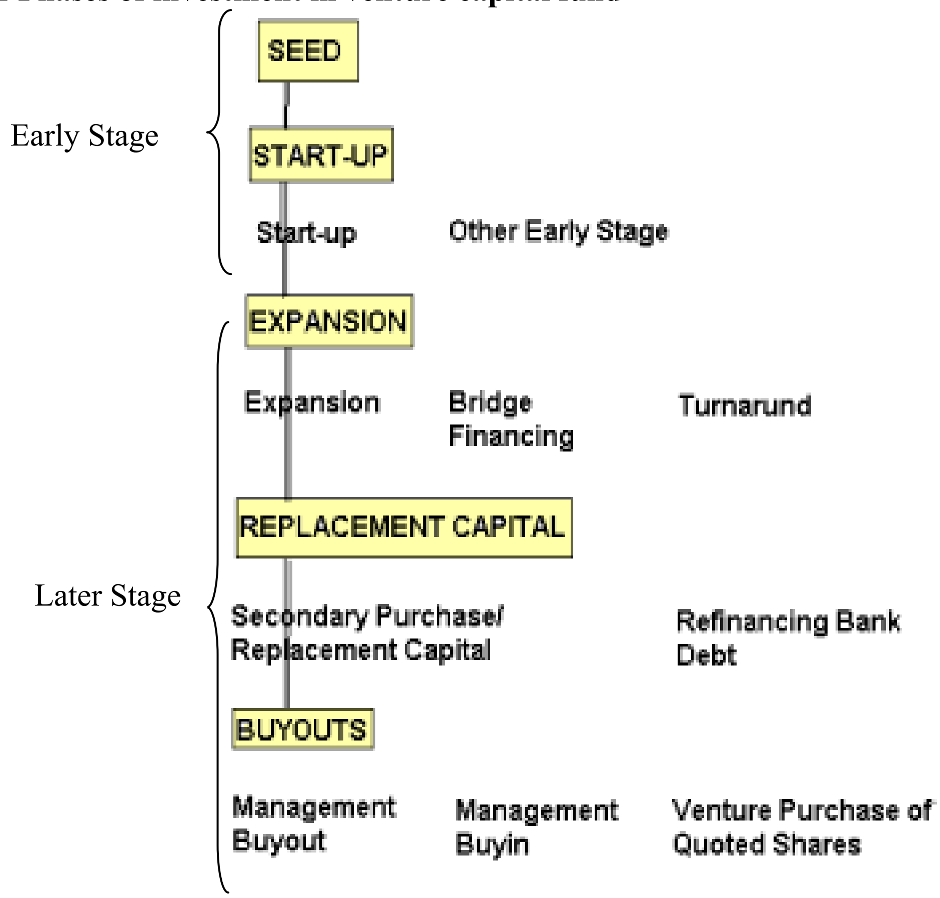
The financial quotation of a venture capital fund is very diverse. In practice, VC funds could finance all phases of business development as well as some specific situations, that may exist in the enterprise e.g. a turnaround (restructuring), or a buyout (a transaction, in which a business unit or company is acquired from the current investors).

In fact, there can be distinguished many phases in the financial offer of VC funds. Seed and start up phases should be diversified according to the business, which will be operating in the future. Therefore, both of these phases are used to finance the early stages of the investment project's development. Clearly, this advance financing involves projects from several to several tens of dollars.

The seed stage includes financing, which is important to investing in promising and profitable ideas, research or concepts, before a business has reached the start-up phase.

The start-up stage should take into account companies, which are in the process of being set up or have been in a business for a short time, but have not sold their product commercially yet. In fact, this stage of financing should be acquired by enterprises that must invest in product development as well as in initial marketing. [COMPERS P., LERNER J., *The Venture Capital Cycle,* MIT press, London 2000, pp. 33 – 45. ISBN 0-262-07194-0]

Figure 1 Phases of investment in venture capital fund



Source: Personal elaboration

Because of the experience of the company and the position on the market, the investment risk as well as financial return from investment is playing an important rule for the fund. In practice, financing ideas and entering the market are by far the most risky as well as expensive investments for the VC funds. This is the reason why funds expect very high rates of return. Unfortunately, there are few companies, which could accept such conditions and provide so profitable rates of return. In fact, the VC funds are not very interested in financing seed and start-up phases. However, the initiative of governments can be a good solution for this problem. In some countries, for example Great Britain, Netherlands, Slovakia or Poland, governments aid the developing funds that invest in seed or start-up stages.

In practice, there are much more early stages. These stages focus on companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales.

The expansion capital stage is also called the development capital phase. In this phase all funds are allocated into the growth and expansion of the company. The capital may be used to finance increased production capacity, develop and market the product as well as provide additional working capital. An interesting phase in this stage is bridge financing. Such form of financing could be a good solution for companies in the period of transition from being privatively owned to being publicly quoted. Another interesting phase that belongs to the expansion stage is turnaround. The turnaround is one of the forms of PE/VC financing, which helps companies to exist within a branch, while financial problems or insolvency start to occur. Due to this solution, enterprises have a new chance to re-establish prosperity.

The replacement capital stage (secondary purchase) concerns the purchasing of existing shares in the company from another private equity investment organization, or from another shareholder or shareholders. Another phase, which is called refinancing bank debt, rarely takes place. This phase is used, when the company’s level of gearing must be reduced.

The last stage of investment includes management **buyout, management buy-in and venture purchase of quoted shares.** The management buyout (MBO) is a buyout in which the target company’s management team acquires the business from the current shareholders, with the support of private equity investors. The management buy-in (MBI) is a buyout in which external managers take over the company. However, the group of managers or a manager could not have enough money to carry out such a target. In fact, financing from PE/VC investors enables them to reach this point and buy the company. The last phase is connected with de-listing the company, which could go bankrupt or which one of the products was withdraw from the list of production. It is a purchase of quoted shares with the purpose of rebuilding or de-listing the company.

2.4 How to choose the best fund

To explain the below case, it could be a good idea to assume that the form of financing of a new investment has just been chosen, but not a concrete venture capital fund. Moreover, the situation is much more complicated, because there are many available VC funds in a country.

However, the investor should take into consideration five features:

- Branch specialization,
- Financing specification,
- Investor's requirements for investment limits,
- Localization of a fund,
- Reputation of a fund

The first criterion is by far the most important. Most of the funds describe themselves as universal, which operate in all branches. However, there is a group of branches, which are avoided by venture capital funds. These branches are usually regarded as dangerous, because of political, social as well as economical reasons. To the most crucial branches belong sectors, which produce and trade arms, tobacco, high percentage alcohol, means of abortion or drugs. Furthermore, due to the fact that VC funds admit responsibility for the activities they invest in, they do not invest in companies that destroy or poison the environment. That is why there are many funds, which invest only in the internet technology, communication or commodity food processing industry.

Table 1 The most popular Polish investment offer of PE/VC funds in 2004, regarding brands.

PE/VC fund	Sectors	Amount of investment (million PLN)
3TS Venture Partners	Electronics, IT, Internet, media, telecommunication,	9 - 27
Advent International	Media, IT, telecommunication, chemistry, food processing industry	40 – 120
Argus Capital International	No preferences	20 - 100
Dresdner Kleinwort Capital	Telecommunication, media, IT, logistics, medical services	12 - 100
Enterprise Investors	Production and services for industry, IT, telecommunication, health care, environment protection	12 – 120
DBG Eastern Europe	Consumer goods, media, IT, services, telecommunication, transport	13 - 54

Source: The Polish Association of Capital Investors, http://www.psik.org.pl

Another important feature, which has a huge influence on choosing a PE/VC fund is its financial specification. It means that the investor should check first, whether the VC fund specializes in financing projects that are in the early stages of investment development. There is a possibility that the VC fund majors in management buys-in or turnarounds. In fact, if the fund does not finance the seed stage, sending documents about the project is just a waste of time.

Speaking about the selection of funds, the case of investment limits must be taken into consideration. The limits of investment are strictly connected with the size of the PE/VC fund. The larger the fund, the higher value of investment is required by such a fund. In other words, if we have a project, which is worth PLN 2 million, we should only choose funds that finance projects from approximately PLN 1 to PLN 5 million. As it is, the value of investment as well as investment limits required by PE/VC funds must be known in detail.

The last two features are much easier to understand. The localization of the fund is not a very influential matter in the contemporary times, in which telecommunications are so well developed and keep expanding even more. In practice, the cooperation between the fund and originator, even at a long distance, is currently unimportant. However, if the entrepreneur wants to realize a small and locally situated project, this factor could be meaningful

The reputation of a VC fund is a quite interesting case, when the originator wants to eliminate unfortunate surprises. Reputation means both experience as well as knowledge how to manage a fund and cooperate with the originator. Such cooperation may last even several years. As a matter of fact, it is better to gather information about the chosen fund e.g. on web sites.

2.5 The structure of investment process

The whole process of investment, which begins from the first contact with the project and ends when the shares of the company are sold, is called the investment cycle. This cycle may be divided into three parts:

- Preparation of investment, when the capital is contributed,
- Cooperation with the company to increase of investment's value,
- Completion of investment and the withdrawal of involved capital.

These phases consist of specific operations and objectives, which are taken up in both the VC fund (its managers, financial advisers etc.) as well as originator of the project.

First phase focuses on a detailed analysis of the prepared project. When the project is be acceptable and viable to perform, the stages of negotiating and settling the conditions of the agreement are sign. However, to the most significant and influential factors of this phase belong the in-depth analysis due diligence. This kind of analysis makes a detailed and careful assessment of the financial, commercial, legal and technical fundaments of the business targeted for investment. After that, the VC managers prepare a term sheet and finally establish such terms of the transaction, which will satisfy both parties. In this phase the originator is obliged to present the project, business plan as well as all negotiation or problem areas. At the same time, the VC fund has to prepare an in-depth analysis of the company and law records.

The time of preparation of all conditions depends on the size of the project as well as its level of problematic areas. Usually, the time needed to finish the first phase of the investment process takes from 3 weeks to even 5 months. By far the most time-consuming and at the same time most expensive is the due diligence process. [TAMOWICZ P., *Venture Capital – Kapitał na Start*, PARP Publishing, Gdańsk 2004, pp. 9 – 10. ISBN 83-88802-90-9]

Another stage concentrates on the effective process of carrying out of the project. It is the longest process among all the mentioned phases, which can last from three to seven years. Considering this stage, it is very hard to separate concrete phases or activities. Nevertheless, there occur special sequences of cooperation between the fund and entrepreneur in order to reach a high rate of return from invested capital.

The last stage starts, when the VC managers feel that the company is close to reaching its agreed ceiling of value. This stage lasts from 2 to 11 months. To the most important functions belong:

- Preparing the company to withdraw from the fund,
- Searching a purchaser,
- Implementation of the transaction.

This stage is as expensive as the first stage of financing the investment, because the VC specialists have to prepare an assessment of the company as well as its informational memorandum for future investors or clients.

3. The world of PE/VC funds in Europe

3.1 The region of changes

Over the last decade Central and Eastern Europe (CEE) has undergone major structural changes. Due to this process, especially new EU members have become an attractive source of private equity investment opportunities. The rate of improvement as well as the level to which opportunities for investment have increased is surprising and striking. Under any circumstances, CEE is exceptionally positioned to reach significant returns for investors in private equity that may outshine performance in the more mature markets of the old EU members.

As far as the private equity is concerned, the roots of PE development in CEE have a lot in common with the development of Western Europe. Twenty years ago, the private equity industry in most of Western Europe countries was still in its infancy. However, thanks to the meaningful changes in taxes, business climate or other regulations in the west, the PE forms could be established. The situation in CEE countries was similar; the process of harmonization with the European Union has provided structural changes that have in turn improved private equity opportunities.

Structural changes, reforms as well as willingness to develop the PE industry since the early 1990s in Western Europe have accelerated the development of the PE industry in the CEE region.

According to the Baring Corilius Private Equity report, investments in Europe have reached the record level of EUR 36.9 billion in the end of 2004 in comparison to EUR 29.1 billion in 2003. Moreover, that was an even better result than in 2000, when the level of investments reached the point of EUR 35 billion. Experts predict that in the end of 2005 the level of investments in Europe will go up to approximately EUR 42 billion. The largest amount of funds was in the UK in 2004 with EUR 10.1 billion, or 37% of the European total, although this was down a third from 2003, when UK funds represented 55% of total European funds. The second position was taken by Sweden with EUR 3.7 billion and the third by The Netherlands with EUR 3.2 billion. It is a very interesting fact that the amounts increased, in each individual country, very significantly from year to year. This was especially easy to observe in some smaller markets, where only a few new independent funds may be raised each year. [*SOBIŃSKA K., Nasz Rynek Kapitałowy, Coraz bliżej unijnego poziomu,* vol. 6, no. 174, pp.40 – 43]

The most influential deterrent of PE development in Europe (in the last 20 years) was the process of privatization as well as law changes. Considering only the CEE market, the privatization process has played also a meaningful role in building up roots of a stable economy. The financing of turnaround processes was for a long time one of the most typical activity carried out by private equity funds. On the one hand such process were a strong catalyst for PE funds, and on the other hand could aid privatized companies to come into the reality of free market economy.

In any case, in the beginning of 1990s privatization has played the most important role for the establishment of the private equity market in the CEE region. However, this impulse did not overheat in the end of decade, because new factors, which support growth and development of PE funds, have appeared

To present all structural or legal changes in Europe that have influenced the contemporary situation of PE/VC funds, another written assignment should be taken. However, the table on the next page can help understand the most influential points.

Table 2 Comparison of factors affecting PE development in Western Europe and CEE

Countries	UK	France	Germany	Central Europe (CE)
SUPPLY OF OPPORTUNITIES				
Need to solve the problem of family succession	Moderate need	High need	High need	Low need
Need to restructure diversified groups	Established patterns throughout period	Became established in 1990s	Becoming established from mid-1990s	Increasing established in early 2000s
Need to privatize state-owned companies	Well established program from 1980s;now complete	Less extensive than in UK	Former GDR apart, relatively little	Bulk of privatizations completed
Scope for going-private transaction	Large stock market; few initial deals, now significant	Steady flow but often complicated by family control issues	Relatively small number of quoted companies	Many candidates; specific opportunities must grow
Development stage of merges and acquisitions (M&A) markets	Highly developed	Relatively active	Becoming active	Relatively active
DEMAND FOR PRIVATE EQUITY				
Attitude to entrepreneurial risk	Became very positive from early 1980s	Moderate	Traditionally cautious, changing slowly	Positive and growing
Willingness of managers to buy	High	Moderate	Starting to develop	High, but lacking financial means
INFRASTRUCTURE TO COMPLETE DEALS				
VC market	Grew rapidly from early 1980s	Grew from late 1980s but many small players	Traditionally small & not MBO-oriented	Small but developing
Supply of debt	High	Moderate	Tradition of high leverage	Low but growing
Favorability of legal framework	Favorable	Favorable	Moderately favorable	Favorable
Favorability of taxation regime	Favorable	Favorable	Reforms in progress	Moving to favorable with EU reforms
Intermediaries	Highly developed	Moderately developed	Fragmented	Highly developed

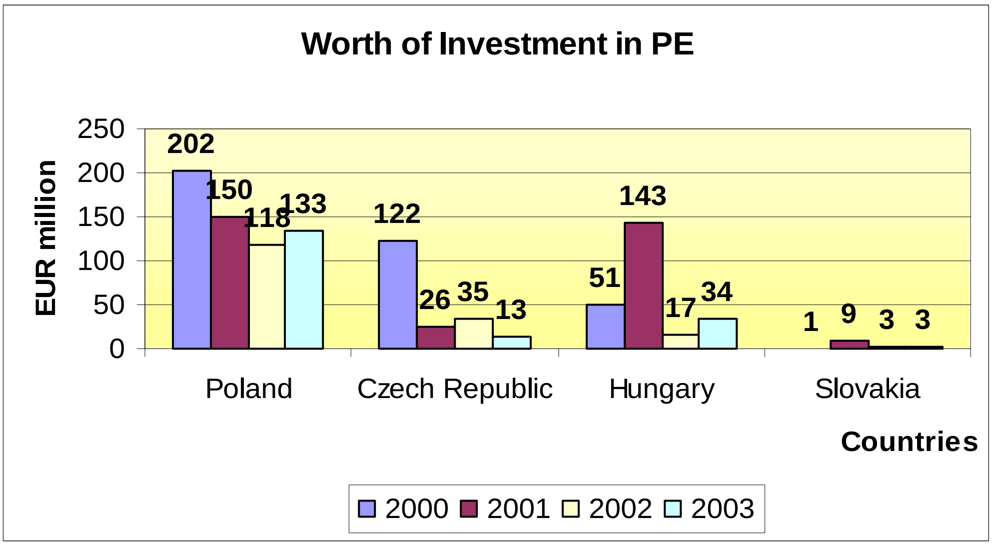
REALIZATION OF GAINS				
Stock markets	Receptive to PE companies from mid-1980s;now more difficult	Development of second market	New issues sparse	Growing domestic capital pool and appetite(demand)
Trade sales	Highly active	Becoming more active, especially for partial sales	M&A market developing	Highly active
Secondary buyouts/turnaround	Increasing interest	Favored exit route	Possible exit route	Possible exit route

Source: SOBOŃSKA K., Nasz Rynek Kapitałowy, Coraz bliżej unijnego poziomu 2005, pp. 44

Nowadays the possibility to access the European Union has played the main role in developing the PE/VC market in Central and Eastern European Countries. Due to the harmonisation and implementation of the EU law to the CEE region, the new EU members could develop conditions to enter the PE/VC market. To the most influential features, which helped to open and intensify the development of private equity in CEE belong:

- Deal flow that is adequate to the size of PE funds,
- Supply of educated as well as capable managers, who understand the motivation of establishing PE funds,
- Access to professional legal and consulting services,
- Infrastructure, which support the development of capital market,
- Expansion and diversification of the PE fund divestment (exit) from a business

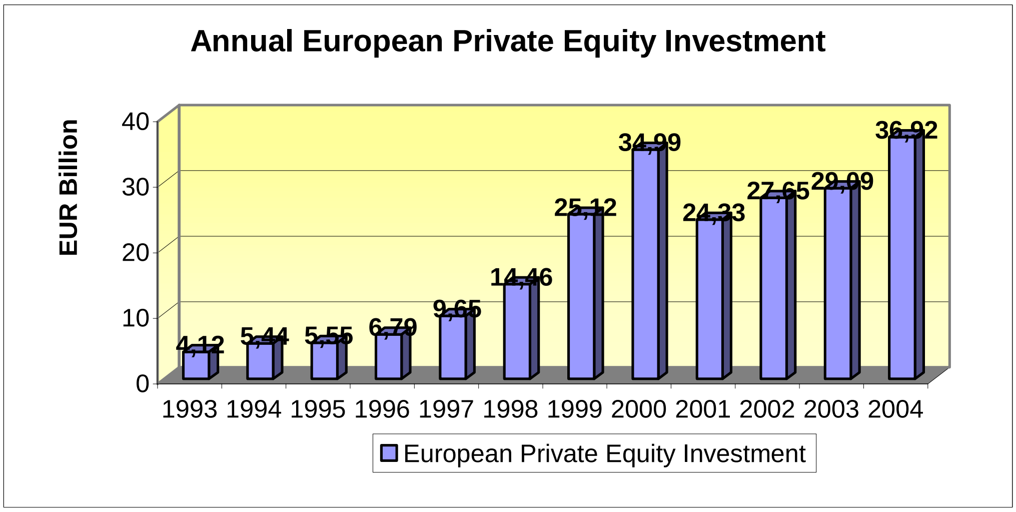
Figure 2 The worth of investment in private equity in CEE



Source: The Polish Private Equity Association, Yearbook 2003, pp. 57 - 59

The view of CEE countries as a real market of possibilities for PE funds has developed in 2004s. The accession to the EU has opened great opportunities for new members to become not only an emerging market for PE, but to approach, in the short run, the average level of the old EU members. The eight new members from CEE are populated by 73 million people. Their total Gross Domestic Product (GDP) is approximately EUR 420 billion and their average GDP growth rate is 4%. It is much higher than the average growth rate in the old EU members (1.6%). According to A.Sormani from European Venture Capital Journal, new countries that accessed EU in 2004s have markets, which could be classified in the low- and medium category. However, such markets have so huge and dynamic financial potential that may push away countries like: Greece, Portugal or Spain. The accession made the CEE markets much more mature, no more exotic for potential investors.

Figure 3 Annual European Private Equity Investments



Source: EVCA 2004, pp. 43

Total amounts invested by European private equity firms reached a record number of EUR 36.9 billion in 2004. This result reflects a 27% increase compared to the amounts invested in 2003, when the amount of investment reached EUR 29.1 billion. This is a surprising new record, which was at first set in 2000 when the level of PE investment boom reached EUR 35 billion. The number of investments declined slightly to 10,236 from 10,375 in 2003. The average investment size therefore increased to EUR 3.6 million from EUR 2.8 million in 2003. These investments were made in 6,985 portfolio companies so that the average financing per company grew to EUR 5.3 million (comparing to EUR 3.9 million in 2003).

3.2 Previous and future tendency for the PE/VC development in Europe

The CEE region is by far the fastest growing and developing area in Europe. Moreover, most analysts are sure that the level of growth in this region will outperform the rest of Europe. Considering the matter of PE/VC funds, the situation seems to be similar. As a rule, economy growth as well as the communists' heritage cause capital scarcity. Following this path, a big demand for PE/VC will be generated in the following years

The fall of the Berlin Wall has unleashed a boom in entrepreneurship's development as well as established a new generation of managers, which are very often much more open to new ideas for businesses than their colleagues from the west. Furthermore, teams are currently much more valued in supporting private equity than individuals. For example in Poland, foreign direct investment exceeded USD 65 billion between 1990 and 2002. Leading investors include GE, Volkswagen, GATX, Tesco, France Telecom, Citibank, Deutsche Bank and Rodamco. Investments generated by these entrepreneurs have been backed by training management teams, which operating today and represent both a vibrant exit route as well as source of new deals.

To meet such a big demand, the mature private equity industry is evolving. Thus local banks (foreign-owned) start to offer specialized leveraged finance capabilities for mid-market deals. Team work gives better possibilities to activate mezzanine debt for a larger part of investors. Mezzanine finance is a quite new element in CEE markets. Its procedure consists of loan finance, but includes elements of both equity and secured debt. However, generally, it is usually unsecured and requires a higher interest rate than secured loans. Moreover, it often carries an option to give the lender a stake of equity.

In fact, the development of debt market (especially mezzanine finance and junk bonds) in the CEE region has begun the buyout activity not only in such region, but also in Western Europe. Moreover, the continuing harmonization with EU regulations is creating an increasingly positive environment for investment, and at the same time for private equity.

As it was earlier mentioned, banks are still the largest single source of capital in Europe, at approximately EUR 5.1billion in 2004. Pension funds contributed an amount of EUR 4.5 billion in 2004, down by 8% at 19% of total funds raised. Funds of funds reached the value of EUR 3.2 billion, which was 14% of all funds, down by 24%. The fourth largest source were funds from insurance companies at 12%, up by 27% from EUR 2.2 billion in 2003.

Some 57% of the funds raised in 2004 came from domestic sources, at EUR 15.7 billion. Funds raised from other European countries represented 19% of funds raised at EUR 5.2 billion. Funds from non-European countries also went up in 2004 and contributed 24% at EUR 6.6 billion.

Table 3 shows that banks are the largest group, which provides capital in the CEE region. In 2004, banks reached the level of EUR 180.7 million, compared with approximately EUR 114.3 million in 2003 in this region. In fact, this tendency is strengthening in the CEE countries, contrary to the Western countries. The second position in 2004 was taken by pension funds, which contributed the amount of EUR 162.5 million, in relation to EUR 6 million a year earlier. The situation of the fund of funds seems to be very surprising. In 2003, the fund of funds reached the level of EUR 11.2 million, while in 2004 it did not provide any such capital in the CEE region.

Table 3 Private equity raised by type of investors

	CEE		European Union (15)		CEE/EU(15)	
	2003	2004	2003	2004	2003	2004
	Amount*		Amount		%	
Corporate Investors	9,17	2,91	1204,65	1645,98	0,761	0,177
Private Individuals	21,67	1,70	804,17	1778,47	2,695	0,096
Government Agencies	85,98	35,82	1727,46	1442,34	4,977	2,483
Banks	**114,34**	**180,66**	**5435,52**	**5090,88**	**2,104**	**3,549**
Pension Funds	**5,98**	**162,55**	**4922,15**	**4534,19**	**0,121**	**3,585**
Insurance Companies	0,00	28,47	2214,31	2812,11	0,000	1,012
Fund of Funds	**11,20**	**0,00**	**4153,69**	**3163,84**	**0,270**	**0,000**
Academic Institutions	0,00	0,00	384,84	345,866	0,000	0,000
Capital Markets	0,00	0,00	85,2	506,32	0,000	0,000
Not Available	11,67	3,79	4378,67	2165,81	0,267	0,175
Subtotal New Funds Raised	**260,01**	**415,89**	**25310,66**	**23485,81**	**1,027**	**1,771**
Raised Capital Gains	8,18	14,10	1709,06	3965,4	0,479	0,356
Total Funds Raised	**268,19**	**429,99**	**27019,72**	**27451,21**	**0,993**	**1,566**

*Amount in EURO x 1,000

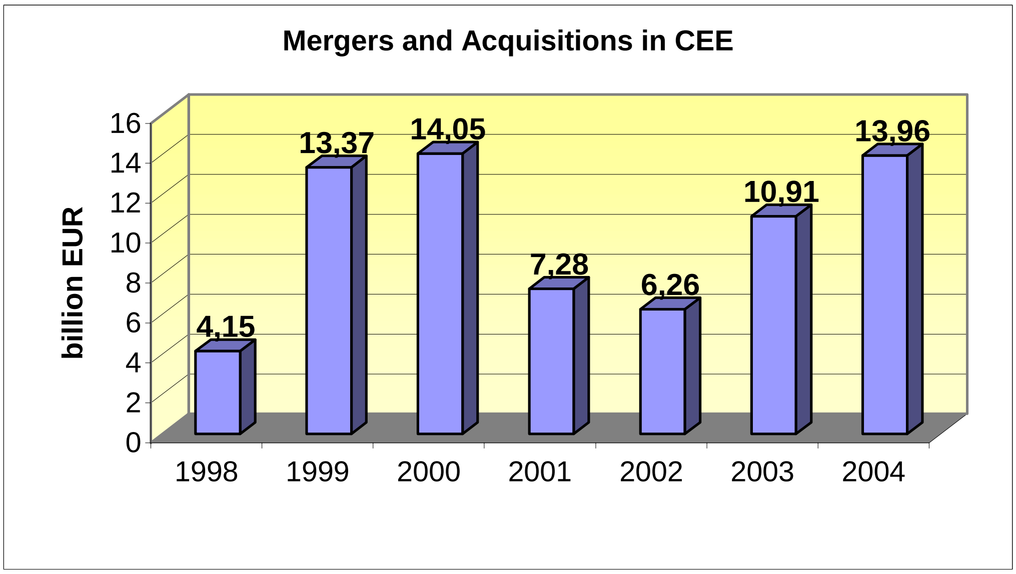
Source: Author's calculation, using EVCA and CMBOR Reports from 2004

As it results from the above shown table, the share of CEE pension funds in the pension EU funds total is increasing. In 2003 it was only 0.121%, while in 2004 – 3.585%. The role of CEE banks is also rising, from 2.104 % of the total amount contributed by the European Union banks in 2003 to 3.549% in 2004. The third greatest player on this market were the insurance companies of the CEE region. Although in 2003 they have not generated any capital for private equity, in 2004 they covered 1.012% of the total value for European Union insurance companies.

Speaking about tendencies in CEE, the subject of mergers and acquisitions (M&A) must be mentioned, due to the fact that it represents the side of deal opportunities, which are by far the most important factor of the PE/VC development. In the last two years, M&A activity has shown stronger resilience in CEE than in many other Western European markets. Moreover, it a slowdown in the world trend can be observed in this sector. In 2004, there occurred steep falls of even 30% worldwide and 40% in the USA. This is additionally a reason, why CEE may be proud.

As the figure 4 shows, there is an upswing in M&A operations. In 2004, M&A generated approximately EUR 14 billion, which was 22% more than in 2003. Nevertheless, this result did not exceed the level reached in 2000, when there was a boom on the M&A market.

Figure 4 M&A in Central and Eastern Europe



Source: SOBIŃSKA K., Nasz Rynek Kapitałowy, Coraz bliżej unijnego poziomu, vol. 6, no. 174*,* pp. 43

According to the CMBOR prediction, this level, however, should be outperforming in the end of 2005. Clearly, the activity growth for the M&A market is significant especially in Poland, the Czech Republic and Hungary, and could reach approximately USD 22.5 billion in the medium term, based on US levels of activity. Besides, countries like Poland and the Czech Republic are poised to enjoy further significant economic forecasts in PE investment as they will catch up with Western Europe. If, for instance, Poland reaches the levels in PE investment comparable to Italy or Spain, the value of M&A activity will double the recent level. Let's go further, if Poland achieves a PE investment matching the EU average, such activity will perhaps triple… Such optimistic forecasts can be made as the EU accession increases opportunities for buy- as well as build-strategies. Moreover, companies and management teams have established proven track records, in which investment risk in the CEE markets is sharply going down. At the same time, opportunities to realize gains in the CEE region are developing. The amount of exits is increasing. As the M&A market grows, **trade sales** remain the dominant exit route. It should be taken into account that regulatory, logistical as well as administrative problems are solved much faster than e.g. five years ago, this contributes also to increasing the rate of realizing gains and transactions.

As far as **local strategic buyers** are concerned, they become more and more active. Due to the fact that PE exits can be strictly local affairs, which is the new way of exits opportunities in this region. Today it amounts to the highest value among all PE/VC exits. However, as far as domestic capital bases grow and the liquidity of the institutional investor base expands the **public market** begins to play the main role in exits. As it is predicted, this market can generate the highest capital from PE/VC exits.

3.3 The Polish Private Equity market

Today Poland has one of the most developed PE/VC markets in the CEE. There are 34 fund managers active on the Polish market. Most of the capital is managed by regional funds with investments involved in (almost only) large transactions.

The crucial point for the Polish PE market, as well as the ones of the other seven CEE countries, was the day of 1st May 2004. Thanks to the accession to the European Union, Polish legal and regulatory environments could be harmonised. Following this path, new established rules have improved conditions for investments as well as exits in the Polish PE market.

Everything has started to focus on the number of 19%...The overall business and investment climate has improved significantly, because of reducing the corporate income tax from 27% to 19%. The same 19% flat tax rate is also applied to personal tax of small business owners. Moreover, profits from investments are taxed with the same 19% flat rate. On the whole, this rate is used for the capital gains tax, tax from dividends and interest income.

Furthermore, all new law regulations have made the overall business environment much more attractive for foreign investors. The most meaningful changes include:

- The establishment of the one-stop-shop facility (the first professional contact point for small and medium sized businesses), which simplifies the process of setting up a company, reducing the annual number and duration of tax inspections etc.,
- The Polish government initiative to support venture capital that will be able to finance the seed and start-up companies, by offering the establishment of a government-supported investment vehicle, which is called **the National Capital Fund**. However, the initiative of setting up the NCF is still in a beginning phase.

The focus of attention on larger investments is visible throughout Europe and Poland is following this trend. Unfortunately, only large and profitable investments…The early stage transactions, which are signed by young companies, are not able to attract private equity investment because of a lack of credit liability or adequate means. A young company may have a great project to introduce a new technology in order to improve management of the enterprise, increase production, and at the same time achieve better profits. However, a bank does not have permission to finance such projects because of banking law, which guards the bank from the possible entrepreneur's insolvency. According to this statement, the bank is not able to grant a credit or bank loan, due to the high rate of risk from such a transaction. In fact, a capital gap appears on the market. In rich countries, the business angels (capital angels) are one of the best solutions for this situation. These are private investors with a large capital that can be invested directly into the company even if the project seems to be risky e.g. Bill Gates is one of the most powerful business angels. Actually, there are fewer business angles in Poland and that is the reason why VC funds are much more popular from placing capital. Nevertheless, Polish VC funds invest only in operations over EUR 10 million. Obviously, young enterprises do not have any possibility to develop and become competitive on the Polish market.

Due to this reason, the government wants to establish a fund of funds, called the National Capital Fund (NCF). The works on setting up the NCF are just in the beginning phase. Recently, the government is putting forward a bill to enact the NCF. A mission of the Polish fund of funds is to improve the situation and image of small- and middle-sized enterprises (S&M). Today, approximately 3.5 million S&M Polish firms have been established, half of them are very active on the market, and generate 49% of the GDP. Moreover, these enterprises employ 67% of all people in working age. However, according to the Lisboan strategy this situation must be improved and incentives should be made for S&M companies to generate a higher rate of return as well as invest into know-how and some innovating financial or technical solutions. As some of analytical experts have estimated, the preparation of an investment of PLN 1 million requires the same costs as the preparation of a project worth PLN 9 or even PLN 10 million. Consequently, VC funds are more interested in financing bigger enterprises. [The Act dated on 4th March 2005 about the National Capital Fund, which is available on: http://ks.sejm.gov.pl/prock/ustawy/3226_u.htm]

According to the bill about the NCF, the NCF is to be set up by the Bank Gospodarstwa Krajowego, which is the main shareholder and operates in agreement with commercial law. The authorized share capital of this fund is set on the level of PLN 20 million. The role of an advisory board will be held by the Investment Committee. The NCF is going to secure VC funds by putting a project out to tender. As it is assumed in the bill, the country's budget as well as structural funds will be the main sources of supporting the NCF. However, contributions from the budget are going to include only the period from 2005 to 2008. In 2005, the Polish government has invested PLN 23.300 million into establishing this fund of funds. Till the end of 2008 the NCF should accumulate a total amount of PLN 450 million. This will be PLN 370 million from the budget and PLN 80 million from the structural funds.

However, many economists are against the fact that the budget will be giving subsidies only till the end of 2008. They argue that the accelerated sum of capital is not enough to make this fund profitable. On the other hand, opponents of this view are convinced that the NCF should generate PLN 2.400 billion from investments into S&M enterprises to the end of 2013. Moreover, they add that all simulations as well as economical forecasts have been carried out using the most pessimistic calculations. They have also calculated that one zloty from the budget gives 28.50 zloty of return. In fact, this is a very high as well as profitable financial leverage. Following this path, thanks to the NCF and new investments the amount of new workplaces should fluctuate from 18.000 to 50.000.

All small- and medium-sized enterprises, which are situated in Poland and settle their incomes no matter where they were acquired, may receive aid from the NCF. However, firms, which intend to invest into new solutions, technologies, and then implement them, have the biggest possibility to use the NCF.

Fund-raising activity in Poland is still being maintained at a high level. Total funds raised reached the amount of EUR 303.88 million in 2004, compared to EUR 25.74 million in the previous year. This situation resulted from investments made by both Polish- and foreign-based private equity investors.

Polish-based private equity firms invested EUR 130 million in 2004, which is 2,4% less than in 2003 (EUR 133,2 million). Foreign-based private equity investors located EUR 48.27 million in 2004. The average value of transactions was on the level of EUR 3 million in 2004, in relation to EUR 2.1 million in 2003.

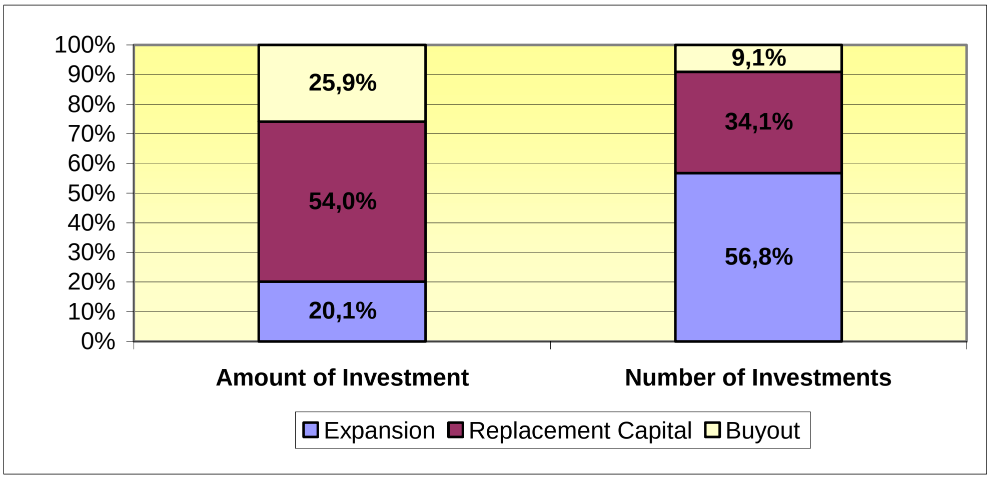
Initial investments generated EUR 93.8 million in 2004, which was 72.1% of the total investment amount (that was EUR130.03 million), compared to EUR 122.4 million (91.9%) in 2003.[*Krajowy Fundusz Kapitałowy – jako uzupełnienie systemu wspierania rozwoju sektora MSP,* Published by Ministry of Economic Affairs and Labour, http://www.nsrr.gov.pl]

The largest volume of investment in Poland was made in the later stages of their development. According to this statement, buy-out and replacement capital transactions generated the greatest amount of capital. These later stage investments increased in total investments and achieved 79.9% in 2004, compared to 68% in 2003. There was a decline in seed and start-up investments, and in the end of 2004 there were no VC shares in this area. In fact there were two results of this situation:

- The lack of seed transactions assigned to the limited number of funds, which were focused on this segment;
- The limited supply of seed capital investment opportunities.

However, this situation may change, because of the setting up of the National Capital Fund (NCF), which will perhaps reduce this equity gap.

Figure 5 Stage distribution of investments in Poland in 2004



Source: EVCA, Yearbook 2005, pp.2004

In 2004, the most popular group that invested in PE were pension funds. These funds generated EUR 159.24 million in 2004, which was the first year of making profits by these entities. The second position was taken by banks, which invested an amount of EUR 109,49 million in 2004, up by 1262% compared to 2003 (EUR 8.04 million). Next position was dominated by insurance companies, which invested 9.5% (EUR 28.47million) of total investments by amount in PE in 2004.

As far as the patterns of sectoral investment is concerned, the Polish-based PE fund managers invested approximately EUR 43.96 million in 2004, which was 11.2% more than in 2003 (EUR 39.51 million). Another attractive investment sector in 2004 was the construction branch, at EUR 22.73 million, in relation to EUR 1.99 million in 2003. In fact, the amount of investment in this sector was 11.4 times more than in 2003. The third position in the sectoral distribution of investments was taken by financial services with an amount of EUR 21.56 million in 2004, compared to EUR 31.53 million in the previous year. The high-tech sector attracted 33.8% of total investment in 2004, which was 9.4% more than in the previous year.

Table 4 Sectoral distribution of investments in year

Sectors	**Amount of Investment in 2003 (EUR million)**	**%**	**Amount of Investment in 2004 (EUR million)**	**%**
Communications	39,51	29.7	**43,96**	**33.8**
Consumer Related	33,88	25.4	5,26	4.0
Financial Services	31,53	23.7	**21,56**	**16.6**
Energy	6,92	5.2	3,67	2.8
Medical/Health Related	6,16	4.6	1,05	0.8
Construction	1,99	1.5	**22,73**	**17.6**
Chemicals and Materials	1,78	1.3	2,25	1.7
Other	11,412	8.6	29,55	22.7
Total Investment	**133,182**	**100.0**	**130,03**	**100.0**
Subtotal High - Tech	**41,19**	**30.9**	**43,96**	**33.8**

Source: International Investment Position – annual data, the National Bank of Poland, Warsaw 2005, http://www.nbp.pl

The subject of exiting from business should also be mentioned. There is a decreasing tendency of divestment in Poland. The amount of total divestment reached the value of EUR 88.69 million in 2004, which was approximately 23% less than in 2003, when divestment amounted to EUR 115.16 million. The most popular form of divestment in 2004 was trade sale, which accounted for 30.8% of the total divestments. Divestment through buy-back reached EUR 8.7 million (9.9%) in 2004. The level of write-offs went up by 21%, from EUR 14.12 million to EUR 17.10 million in 2004. The role of public equity market has also increased significantly. Actually, exit through IPO (Initial Public Offering) is the new idea on the Polish private equity market. As a consequence, the role of the Warsaw Stock Exchange for local IPOs is increasing. Moreover, due to a steady inflow of foreign capital, the liquidity of the Warsaw Sock Exchange can be strengthened. Considering the number of IPOs, the Warsaw Stock Exchange was ranked on the second position in Europe, after the London Stock Exchange.

Overall, the markets of many sectors in Poland are fragmented. It may be predicted that as their structure is currently different to the one of the old EU countries, in the future strong consolidation trends may be observed (after taking the local development conditions into consideration). Due to these trends, the Polish market may be able to catch up with the old EU countries. Even now, the beginning of the foreseen consolidation trend is visible in the CEE countries.

3.4 Some aspects of the Czech Republic private equity market

Due to the fact, the Czech Republic joined the European Union on 1 May 2004, the new Act on Collective Investment has been signed on this date. The new Act has regulated the activities of VC funds in the Czech Republic. According to this Act, VC funds are represented by special funds, which may be set up as closed- (open-) end unit funds or closed-end investment funds.

An open-end fund is a fund, which is operated by an investment company. Such a company raises money from shareholders and invests in a group of assets, in accordance with a stated set of objectives. Open-end funds raise money by selling shares of the fund to the public. Then the funds take the money they receive from the sale of their shares (along with any money made from previous investments) and use it to purchase various investment vehicles, such as stocks, bonds and money market instruments. In return for the money, they give to the fund (during purchasing shares), shareholders receive an equity position in the fund and, in effect, in each of its underlying securities. For most open-end funds, shareholders are free to sell their shares at any time, although the price of a share in an open-end fund will fluctuate daily. This depends on the performance of the securities held by the fund. Benefits of open-end funds include diversification and professional money management. Open-end funds offer choice, liquidity, and convenience, but charge fees and often require a minimum investment

Closed-end funds generally do not continuously offer their shares for sale. Funds sell a fixed number of shares at one time (in the initial public offering), after which the shares typically trade on a secondary market. Actually, funds are not obligated to issue new shares or redeem outstanding shares as open-end funds are. The price of closed-end fund shares is determined by the market and may be greater or less than the shares' net asset value (NAV). Moreover, close-end funds are those whose portfolios are still owned by earlier investors and are still actively managed as always, but they no longer sell shares at NAV rates to new investors.

A difference between an investment fund and unit funds, is that the first manages its own assets, while the unit funds assets are managed by a separate Czech management company or by a management company with a European Union passport.

The Act on Collective Investment has assumed that the minimum share value of a VC fund should be CZK 1 million at the issue date as well as the minimum investment of the entity should amount CZK 2 million. . [The American Chamber of Commerce in the Czech Republic, the Czech Republic Report 2005, pp.5-8, http://www.amcham.cz]

Dividends, profit distribution, the sale of funds` share in companies or liquidation of companies are the parts, from which VC funds realize their income. It is an interesting fact, that Czech VC funds are not visibly used in fiscal policy. For instance, revenues achieved by funds are subject to tax at the level of the fund, (not the level of revenue). Furthermore, dividend income from a Czech company is excluded from the tax base of funds. Additionally, there is no separate capital gains tax in the Czech Republic. In fact, the capital gains from the sale of shares are subject to 5% tax rate, which is the standard corporate tax rate for funds.

Due to these mentioned legal and fiscal facilities, the Czech Republic is one of the most attractive and active PE markets in the CEE region. However much must be still done to develop this emerging market. There was a significant decline of total fund raised in 2004. The total funds raised amounted to EUR 4.84 million in 2004, which was 19.4 times less than in the previous year. Investment made by Czech PE/VC companies went up by 51% from EUR 13.3 million in 2003 to EUR 20.1 million in 2004, while the number of investments dropped from 13 to 10 in the same period. At the same time the number of firms investing in PE/VC funds decreased by 20%, which was from 10 to 8.

Table 5 Sectoral Distribution of Investments in year

Sectors	Amount of Investment	%	Amount of Investment	%
	2003		2004	
Communications	5,63	42,2	12,84	63,8
Biotechnology	0,62	4,6	0	0
Consumer Related	6,5	48,7	7,27	36,2
Financial Services	0,59	4,5	0	0
Total Investment	**13,34**	**100**	**20,11**	**100**
Subtotal High-Tech	**6,24**	**46,8**	**12,84**	**63,8**

Source: EVCA, Yearbook 2004

As table 5 presents, communication and consumer related companies were ranked as the best position in all sectors. The situation in biotechnology as well as financial services also seems to be interesting. Almost 4.6% of all investment went into biotechnology companies in 2003, while there were no investments in this area in 2004. A similar situation occurred in financial services, which generated 4.5% of total investment in 2003, and 0% in the next year.

4. Conclusion

Due to deep and dynamic structural changes, CEE has become an attractive place for PE/VC investments. This refers mainly to countries, which have recently entered the EU. Despite a certain level of risk, PE investments in CEE have a great chance to give better results than investments in the old EU. The possibility to utilize means from structural funds opens an enormous chance for development for these countries. The question is, whether they will be able to effectively use this help.

The data presented in the study allows to come to some basic conclusions concerning the future development of PE/VC funds in CEE:

- The increase in the number of CEE managers with international experience, which positively influences the demand factors of VC funds;
- The higher experience in running privatized and new companies during the last 10 years;
- The development in the field of investment risk management, which has an impact on the ability of effectively locating capital;

- The prediction of the future increase of the PE/VC market in Hungary and Poland.
- The outlook for the increase of the M&A market

During the recent years, several CEE countries noted a considerable rise of their GDP. The prospect of a GDP increase makes the country more attractive for investors. It was particularly high in Poland, 4.7% in 2003 and 5.8% in 2004. The EU membership may bring a further increase of this indicator. Investors are also drawn due to the prospect of acquiring cheap and increasingly better educated labor force, not only to Poland, but to the whole CEE region.

The bill about enacting the NCF in Poland seems to be a very interesting idea to not only multiply the value of VC funds, but also to develop the investments in small and medium-sized companies. The fund will be aided by structural funds as well as the country's budget.

Currently there is a trend in the CEE countries that favors the rise of PE/VC funds. In spite of this fact, many questions about PE stay unanswered. The most important seem to be: How long will this tendency be maintained in the CEE countries? Can the statement wrote by W. Shakespeare "Men that hazard all, do it in hope of fair advantages." be true?

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BARRIERS TO MAKING USE OF VENTURE CAPITAL FUNDS IN POLAND.

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Abstract

The paper presents the pace of venture capital market development and barriers for its further growth. Venture capital funds exhibit much higher dynamics in Poland than in other CEE countries. However, when venture capital investments are expressed as the GDP percentage, Poland is still lagging behind other European countries. The main impediments for venture capital market development are: low quality of management, low innovativeness of Polish economy, administrative and legal barriers, taxation of capital gains, supply barriers and no support from the government.

Keywords: *venture capital, venture capital market in Poland, development financing*

1. Introduction

Choosing the financing sources always gives rise to the enterprise's problems and is dependent on many factors, like - among other things – a type of goals to be achieved (operational, investment ones), the enterprise development level, its financial status, capital costs. Big enterprises have more freedom in choosing their financing sources and are able to issue stocks and bonds, to use credits, loans or leasing. For small companies only starting their operation, getting the capital is not easy. The capital suppliers are not convinced by a good business philosophy and growth prospects. Such companies burdened with a greater risk have no credit reliability; thus, the banks either are not eager to credit them or the credit offered is expensive and substantial securities are required. Furthermore, the current service of credits within the initial period of the company operation may be difficult. A good financing source for such companies can be the venture capital fund.

Such funds have a long standing history in the United States and in the developed EU countries. In Poland, the funds appeared after 1990 only. Although the development level is higher than in other Central and Eastern Europe countries, they still face various barriers to their growth.

The paper shows the rate of and the barriers to the growth of venture capital funds in Poland.

2. Venture Capital nature and features.

Venture Capital is invested in the companies at the early stage of their growth or just starting their market operations.

J. Węcławski (1997) describes VC as the own capital to be - for a limited duration – contributed by outside investors to small and medium-size enterprises having an innovative product, manufacturing method or service, such companies not having yet been verified by the market and thus bearing risk of the investment failure. The high risk is in contrast to the expected higher than average profits to be gained by selling the company shares.

The investments described as VC are for the companies just being set up or at the early stage of their growth, very innovative ones, but risky, which - with the manager and capital support – promise a high return rate on the invested capital (Schofer, Leitinger 2002).

VC is one of private equity investments, i.e. a medium- or long-term investment, based on shares, usually on a non-public market. The above definitions are in compliance with the American Venture Capital standard suggested by the National Venture Capital Association (NVCA) wherein VC function is to finance the early stages of enterprise operation and growth, and the funds called Venture Capital are involved in the business concepts being commercialized and in supporting the growth of new companies, specially in the highly innovative areas (Sobańska, Sieradzan 2004) .

In Europe, there is no clear differentiation between the Venture Capital and the Private Equity financing. By the definition of the European Private Equity and Venture Capital Association (EVCA) it is assumed that VC funds are to supply the start-up capital to start business operation, to finance the early stage of enterprise development, its further expansion, or even to finance the projects related to the enterprise restructuring or ownership transformations. This might include financing a new product, technology, working capital increase or lab our reduction (EVCA 1995). Actually, the funds are sometimes involved in financing the mature enterprises too. In the statistics, VC/PE funds are presented together.

In order to understand better the nature of VC, the characteristic features of such investment process are worth showing. These include:

- investment risk high
- medium– and long-term investments, 3-7 years
- funded project highly innovative
- return rate on the investment expected 36-60 per cent
- investments in companies with big growth potential, non-listed on the stock-exchange
- investor (VC fund) being a participant in the company management, not only the capital supplier
- capital contributed being of proprietary nature
- current capital costs non-existing, the funds waiving their dividends and re-investing the profits.

VC are being directed mainly to companies with a chance for higher than average growth and a dynamics increase in their value. Frequently, these are high-tech companies initiating new solutions in various areas of industry and economy, but also companies which are not related to the area but have an innovative solution, product or service. Such companies are flexible enough to be able to implement even the most unconventional projects in an effective way. VC funds support such companies in the management, supply financial, organization or marketing know-hows. VC have wide contacts with business and with financial institutions, they know consulting companies and lawyers, and thus are able to provide full assistance and to add to the company’s reliability. Moreover, they are monitoring the company operation financially, which enables to identify the problems just in time and to look for their solutions together.

3. Venture capital market in Poland.

Venture capital funds appeared after 1990. The Polish economy opening and the system transformations resulted in the inflow of both the government capitals and aid capitals from other countries.

According to the history of their growth and to the ways the VC funds are set up, three main market segments can be singled out (Tamowicz 2001):

1) funds based on the aid institutions' capitals or on the government resources (foreign ones mainly);
2) funds based on the domestic and international private institutions' capitals:
   a) funds set up by the banks
   b) funds based on the general privatization program
   c) funds continuing the ones operating since 1994 – Enterprise Investors Group, Renaissance Capital, Innovo,
   d) funds arisen in the wake of interest in Internet: MCI Management, Internet Investment Fund
3) transregional funds investing all over Eastern Europe, Poland included.

In VC market arising and growth in Poland, the key part was played by foreign resources, both public and private ones. Due to them, many investments have been implemented, both on local and on national level.

VC and Private Equity sector in Poland and in the neighbor countries (Czech Republic, Slovakia, Hungary and Baltic countries) is now growing very fast. According to EVCA estimation, within the period of 1990-2004 there was an inflow of nearly 7 billion Euro to the countries of Central and Eastern Europe, and over 60 equity type funds have been set up, while out of the 900 investments funded over 400 have been completed (EVCA 2002).

In 2004, the said funds' investments in Poland reached 9000 million PLN which is 15 per cent more than in the preceding year. As shown by Table 1, in 2001 the investments amounted to 386 million PLN (105 million EUR).

Table 1. Amount of VC/PE investments in Poland within 2001 – 2004.

Specification	2000	2001	2002	2003
Investment volume, million PLN	386	529	779	900
million EUR	105	137	177	213
Dynamics, per cent	100,0	130,4	201,8	233,2

Source: EFCA & Polish Association of Foreign Investors, Yearbooks 2004, p.24

Within the subsequent years, the commitment of funds in the Polish economy was quite strong. In 2003, there was a growth in the funds' investments by 47,2 per cent as compared to the preceding year, while in 2004 the increase was over 15 per cent as compared to 2003.

As compared to other East European countries, the VC market in Poland is best developed. The capital inflow to this market is higher than to other EU regions. It is illustrated by Table 2.

Table 2. VC/PE investments in the Central and Eastern Europe countries within 2002 – 2003 (million EUR)

Countries	2002	2003
Czech Republik	27,4	39,4
Hungary	75,7	110,8
Poland	137,2	177,2
Roumania	18,0	82,0
Slovakia	4,7	4,5
Baltic countries	2,9	10,0
Other countries*	7,7	24,6
Whole region	273,7	478,4

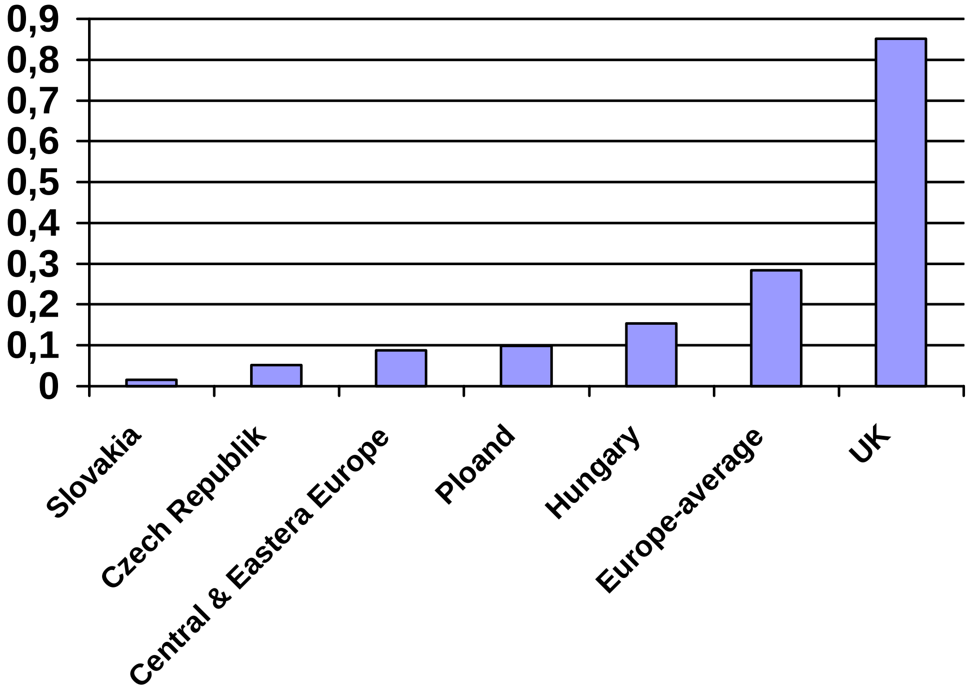
* Bulgaria, Croatia, Slovenia

Sources: EVCA Special Paper 2004, Central and Eastern Europe Success Stories, www.evca.com, p.7

The total volume of investments was in 2003 increased by 75 per cent as compared to the preceding year. The biggest – by as much as 4.5 times – increase was in Romania. The highest value of investments was in Poland. However, the comparison of amounts of funds made use of is not a complete illustration of their commitment in the economy. They have to be referred either to GNP or per capita. (Graph 1).

In Poland, the correlation of venture capital funds to GNP is much lower than the European average, but higher than in other Central and Eastern Europe countries which followed the transformation path similar to Polish economy. The higher ratio is in Hungary. It is emphasized by the bibliography that the direct reasons for this are a lack of legal solutions suited to the specifics of high risk investments, the complex administration procedures, as well as tax incentives missing.

Graph 1. PE/VC investments referred to GNP in the selected European countries, in 2003.



Source: EVCA Special Paper 2004, Central and Eastern Europe Stories. www.evca.com

One reason seems to be the specifics of projects to be funded. In Poland, the VC/PE investments are in privatization, in restructuring and in reform projects, and only next in the most up-to-date projects in the area of telecommunication or internet. In the developed countries, the VC/PE funds are oriented on new technological and biotechnological solutions at the early project stages.

4. Company financing stages.

The bibliography differentiates between several stages of company financing, depending on the company development level. Most often, they are:

- Seed capital.
- Start-up capital.
- Development stage, initial growth.
- Expansion stage.
- other VC investments.

Seed capital are the resources needed to finance the very early development stage of a new project. Frequently it happens that scientists or technologists with a good idea of an innovative product or service are unable to get funds from conventional financial institutions because of a high risk related to such project. However, such risk is acceptable for specialized investors who manage a Venture Capital. Such investors' operations are described as "incubation", i.e. reducing the time needed for the product to enter the market. A Venture Capital is a supplier of resources for the activities prior to set up the company, i.e. to study the market potential, the legal solutions and restrictions, the competition level in the relevant area, acquisition of patents, licenses, etc. Within this stage, a probability is determined of the specific business to be accepted by the market, while the resources spent are reasonable.

The start-up capital is used to break the barriers faced by the company when entering the market. Within this stage, the expenses are related to a test batch of goods and services being prepared, to the trade mark recognisability being created. Venture Capital makes the resources needed at this stage available only when the project is attractive and high rate of return from the invested capital can be anticipated. The investor is striving to participate in the management so that his risk is limited.

Within the Company development stage, the VC funds enable it to create a solid basis for expansion or to get the market share as big as possible, to diversify its production pattern, to get contracting parties, to strengthen the managing staff. It is all very capital consuming. The staff tries to get VC funds even on the expense of loosing some of their shares to the benefit of such funds. Using credits within this stage could result in the loss of financial liquidity.

Within the expansion stage, companies search for VC capital to fund their key action for further development. Included in such actions are (Sobańska, Sieradzan 2004):

- to outdistance the competition, and to maintain the position of market leader or one of the leaders in the relevant line.
- to extend the range of products or services offered, as well as the distribution network and the geographically new sales markets,
- to strengthen the managing staff, to create a solid executive level and to delegate specific functions to them
- to raise efficiency of the company employers through a proper motivating system.

It has to be emphasized that within the expansion stage VC funds are obtained by such companies which either are profitable or reach the break-oven point, while their main goal is to outrun the competition.

VC funds are involved also in other investment types. Usually, these are, projects related to ownership and organization restructuring of the companies, etc.; and particularly:

- Management Buy-Out
- Management Buy-In, MBI
- bridge financing
- restructuring of enterprises facing financial problems (turnaround, recovery)
- Venture Management
- enterprise financing by means of hydride securities, mezzanine capital.

The structure of company financing, by VC/PE funds at various stages is illustrated by Table 3.

Table 3. Value of investments at various stages of the company development in Poland, within 2003-2004, millions PLN.

Company development stages	2002	2003
Seed capital Start-up Dynamic development Refinancing (Buy-out)	38 38 244 209	1,0 12,0 176 590
Total:	529	779

Source: based on the Yearbooks of Polish Association of Capital Investors, 2003 & 2004.

In 2003, the highest percentage of funds (46%) was committed in the companies at their dynamic growth stage, and in the mature companies (nearly 40%). The widest interest of the funds in 2003 was in the mature companies needing capitals for their further market expansion. 76 per cent of the total resources were spent for such companies, while 23 per cent for the companies at the stage of their dynamic growth. By such way of financing, the risk is reduced with the rate of return being relatively high and the resources being recovered sooner. The share of VC/PE funds in financing companies at their initial growth stage fell from 38 down to 1,0 million PLN, while for the ones at their start-up stage from 38 down 12 million PLN. It shows an obvious drop of interest in the young companies to the benefit of fund investments in mature companies. According to A. Kornasiewicz (2004) , there are several reasons for such trend:

- VC funds, specially the big foreign ones, are involved in the process of enterprise privatizations and restructuring, where great chances of fast and higher profits are existing, with the risk being lower,
- at the big, well-known and successfully restructured companies, the disinvestment process is more efficient than with small companies of no renown and with chances to establish their market position after years only.
- low qualifications of the management staff at small companies, their mistrust towards outside investors and reluctance to share their profit do not add to the aura which would foster popularization of VC funds at such group of enterprises.

VC type financing is of strategic importance at the initial stages, when a company is starting to grow, when capital and manager's support are needed. Later on, it is easier to get financing from the conventional financing institutions, i.e. banks.

5. Barriers to the Venture Capital development in Poland.

Despite the relatively high increase in VC/PE funds investments as discussed earlier, many barriers restraining their development can be identified in the Polish economy. The factors directly affecting the Venture Capital market growth in Poland and restraining it are mostly considered to be institutional, supply, legal and tax factors, as well as the ones related to the investing aura. The Funds' top managers, when asked about the barriers, most often state the following impediments:

- poor quality of the manager staff
- low innovativeness of the Polish economy
- separate legal regulations on high risk funds missing
- legal and administration barriers
- tax system solutions

- supply limitations
- poor support from the national authorities.

Apart from the above restraints, what the funds miss on the Polish market is an aura fostering VC funds popularization; what they are hindered with is a poor information and difficult access to technical solutions which might be interesting for VC fund, as well as the problems with backing out of the investments.

The main barrier to the growth of the Venture Capital market in Poland is the poor quality of the manager staff at the enterprises looking for financial support. The entrepreneurs willing to make use of new technical solutions commercially are usually not prepared to get the resources from Venture Capital Funds. Frequently, they do not understand the principles being the basis of the funds' operations; only rarely they have experience in operating their business in the way which would be expected by the funds. After a certain stage of the company growth is reached, ownership should be separated from management; the company owner having to search for a professional manager. Such manager will be more than the owner himself eager to finance by means of a share capital; he would understand that the funds expect a particular return rate on the capital and are willing to supervise its getting.

Another barrier restraining the growth of Venture Capital funds is low innovativeness of the Polish economy. Usually, VC funds are involved in the initial stages of the enterprise development – in creating its project, solid operation basis, gaining the market position. Thus, the investors search for innovative companies wherein the risk will be compensated by the return rate being high enough. In Poland, the main problem is that there is no supply of such projects, the expenditures on research and development which would result in such project arising being too low. Thus, the country innovativeness and economic competitiveness are adversely affected. In Poland, the expenditures on R&D are as low as less than 1 per cent (0.7) of GNP, while in OECD countries the average accounts for 2.3 per cent. Higher expenditures for research and development are in Czech Republic (1.3%) and in Hungary (1.0%).

The developed countries assign relatively much for R&D; thus, in reference to GNP it is: 4.3% in Sweden, 3.4% in Finland, 3.1% in Japan, 3.0% in South Korea. The biggest amounts to this purpose are assigned in the United States; in 2002, 285 billion US $ were spent (2.8%GNP); and in Japan – 104 billion US $ (OECD 2003).

The structure of expenditures on research and development works in Poland is very unfortunate. The majority, cà two thirds, are the expenditures from the national budget, while in the developed countries a big percentage of funds is from the enterprises (e.g. 90% in Luxembourg, 70% in Sweden, cà 65% in Ireland, Germany, Belgium and the USA). Due to such structure of R&D financing, what is prevailing in Poland is basis research, not related to enterprises and not usable practically. Even such projects which would be possible to be introduced are not initiated in practice, because of the managing persons' marked reluctance to any risk. In the developed countries, the research and development projects financially supported by the companies are better suited to their needs, and they are sooner introduced at the enterprises raising their competitiveness. It is noteworthy that a substantial portion of scientific and research organizations is owned by the State.

In Poland, we have no separate legal regulations on high risk funds, which would contain stipulations on – among other things – the conditions to set up various types of PE/VC funds, the requirements on the structure of their share portfolio, or on the criteria of access to the public resources. Such solutions appear worldwide, their goal being a better transparency and security of the fund operations (Rogoziński 2003).

Along with the financial market growth, the situation in this area is changing too. In 2004, the new law on investment funds has come into force (Journal of Laws of 2004) ; however, it provides no solution for the problems of high risk subject functioning. Now types are introduced, like the non-public capital fund and the fund of funds (FoF). FoF's are a popular form of investing resources in the West Europe countries. Their difference from the ordinary funds is that the main portion of their portfolio are not shares, bonds or bills, but participation units of other funds. The Private Equity fund of funds collects capital from the investors and is then investing it in the private equity funds of choice. Due to this, a client – despite of having purchased a single fund only – becomes a shareholder of many, thus limiting his risk. Most often, the FoF portfolio is composed of 10-20 PE funds. When any of them cease to operate, the resources got from the portfolio of companies being disposed are transferred by them to the fund of funds, which returns them to its investors.

The inhibitor to the growth of the Venture Capital market in Poland are considered to be the existing legal solutions. They incorporate the regulations of the commercial partnership code, of the bankruptcy law and of the civil code. Among other items, the regulations are on the limitations in granting the shareholders rights in connection with the preference shares, share redemptions on request, raising target capital, or regulations of the stockholders' share in the event a company is liquidated. The limitations on the preference shares prevent the share preference construction which would entitle the holder to get a specific amount of dividend to the company status notwithstanding, which is frequently done by private equity funds abroad. An important limitation of leverage (debt supported) transactions are the regulations of commercial partnerships code barring the stock companies from financing acquisition or from assuming the stock issued by them (Sieradzan 2004).

An indispensable condition to be met in order that funds are willing to be committed in the investments on VC market is the law enforceability, specially the enforceability of ownership titles or debtor's claims. Now in Poland, the time needed to recover the receivables is cà 1000 days which is the lengthiest in Europe. Quite often, an outcome of ambiguous, hardly enforceable legal solutions are the administration barriers from the conduct of administration workers who delay the administrative decisions.

Legal restraints to VC/PE fund operations in Poland are closely related to the tax barriers. A lack of incentives and the current fiscal solutions are the reason that some funds operating in Poland are registered abroad. This is due to a lack of explicit regulations making possible that the income is taxable only once. When this would be the case, a private equity fund would be exempt of income tax, taxation taking place at the investors. This is the case with investment funds, but only with those buying into securities in public circulation and getting their resources from individual investors. Because of strict information duties and of the supervision by Securities & Exchange Commission, such solution is unacceptable by the VC/PE funds.

The funds expect such legal solutions with tax exemptions and write offs or high risk investments taken into account in order to avoid dual taxation. Privileges might be enjoyed both by the fund itself as well as by the investors depositing their assets therein.

One important limitation of the growth of VC/PE funds market are the supply limitations. Worldwide, the Venture Capital funds are a significant part of the asset portfolio of many investors. Those are pension funds, investment funds, banks, financial institutions. In Poland, capital supplies from the pension and the investment funds are actually nonexistent. The major portion of domestic capital is from banks and financial institutions, as well as from manufacturing companies. It has to be noted here that the domestic capital accounts for as little as 3 per cent only of the Venture Capital funds' resources.

The bibliography shows three groups of reasons restraining the share of the Open Pension Funds (OPF) in the high risk capital, and namely:

- investment quotas,
- - reference index,

- information policy – track record.

The range of allowable OPE deposits is strictly regulated by Polish law, and it is very different as compared to the way such funds are functioning on the European or American market. Pension funds can deposit their assets only in the stock partnership stocks in public circulation, in the National Investment Funds' (NIF) stocks, in participation certificates and in the investment certificates of investment funds. There are, however, some restrictions. Thus, for example, they can possess in their portfolios 40% max of stock-exchange listed stocks and NIF shares, 40% max of municipal bonds not in public circulation, 10% max of deposit receipts or investment certificates. Such restrictions do not allow any meaningful involvement of pension funds in the private equity market.

An important factor discouraging the pension funds from investing on the private equity market is the measuring method of their investment results and the mechanics of the bonus for results. Such techniques enable to compare and – to some extent – to control the results of various OPF's. The techniques accentuate good results to be achieved within a short time. Thus, the managers tend to avoid the risky – but in long-term more effective – investments, the ones related to Venture Capital included.

Till 1st April 2004, the funds were obliged to calculate the return rate for the last 24 months by the end of each quarter and to report it to the Supervision Committee for Insurance and Pension Funds, as well as to make it public. Now, the benchmark of pension funds is the 36-month weighted average return rate to be calculated twice per year. The rate is an average rate of return achieved by various funds, a weighted arithmetic mean of the given fund share in the market as of the day preceding the 36-month period and as of the day the said period is ended. The focus on good results to be achieved within short period is enhanced also by the method of rewarding for the results. The managers are given resources from the bonus account as of the moment the ranking prepared according to the return rate is constructed. Hence, they are not motivated to diversify the risk. They are rather interested in presenting good results as of the moment the examination is made.

The growth of Polish private equity market is also obstructed by the information policy of many funds. The managing companies are quite reluctant to show their results achieved. They do not make available at all any information on their investments, even the ones successfully completed. By the lack of information, the potential capital suppliers are deterred. The potential investors would like to be sure their resources entrusted to the managers will generate a return rate higher than average. Confidence can be gained provided the information is complete.

Supply restraints as a barrier to the Venture Capital market growth are also related to poor commitment of banks. In the countries with a developed equity market, the important capital suppliers for VC/PE funds are – apart from the pension and the investment funds – the banks. In Poland, their share of the market is marginal. There are many reasons for it. Nearly all banks in Poland are listed on the stock-exchange, which means a pressure on short-term results. On the other hand, commitment in VC/PE funds means that in short-term there is a drop in the investment portfolio value, by which the bank's result is directly affected.

In Poland, restricted supplies of the high risk capital is best perceivable at the sector of small and medium-size enterprises, where the venture capital is to finance the "sowing" and the start-up phases mainly. The high risk of committing the resources into such phases results in the funds being involved in the initial phases of the companies' growth to small extent only. The source of insufficient financing of small subjects by the high risk capital is the limited role of the State in supporting such funds.

In the developed countries, the tremendous role of VC/PE sector as a driving force of the economic growth, of raising the innovativeness level and of export stimulation had been understood long ago; also, the venture capital funds are an important instrument for old enterprises restructuring. Therefore, the growth of VC/PE market in those countries was stimulated by the legal, the tax and the promotion solutions. In Poland, due to the existing barriers to the Venture Capital market growth, active involvement of the State is absolutely needed as well as, support of such growth through due initiatives by the Government.

In conclusion, it has to be emphasized that within the recent years the growth of VC/PE investments is fairly strong as measured both in the absolute values and in reference to GNP. However, the gap between the equity funds market in Poland and in the developed countries still remains wide. This is for various reasons. The most important one seems to be the low innovativeness and competitiveness of Polish economy against the Western countries, the managing staff not being prepared as appropriate, and a lack of special regulations on the equity market operation in Poland. Many barriers inhibiting the enterprise growth are still existing (red tape, corruption, instability of the law, etc.). There are no motivation systems, no relieves or preferences which would encourage a risk of having an own company.

However, along with the economic growth, the barriers will be removed and they will less and less concern the investors on VC/PE market.

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FINANCING OPPORTUNITIES AND CONSTRAINTS FOR ROMANIAN SMALL AND MEDIUM ENTERPRISES

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Abstract

The development of SMEs is essential for the future of Romania despite the background of economic, social and political changes. This sector is needed to ensure continued economic growth and thereby to enable economic development, employment and improvement of living standards. Romania has made considerable progress over the past decade in setting up an extensive policy framework to support the SME sector. A range of institutions, policy instruments, regional tools and resources exist, all of these assisting Romanian SME development. In fact, Romania is involved in discussions concerning fundamental problems and coherent strategies, emphasizing the support that European Union gives to Romanian SMEs, but also the self-efforts that have to be done. One of the main problem for Romania is the foundation of entrepreneurial abilities specialized on SME sector definitely, measured by the growth in input ratios and output ratios of firms on the market. But these rates should face the birocracy and the conservativeness which can be associated with a state of inadaptability. The most important accomplishments are in the legislative domain, and the hardest problem remains the problem of enterprising, financing, fiscality and training population in order to do small business.

Keywords: *SME's, financing, globalization, opportunities, constraints*

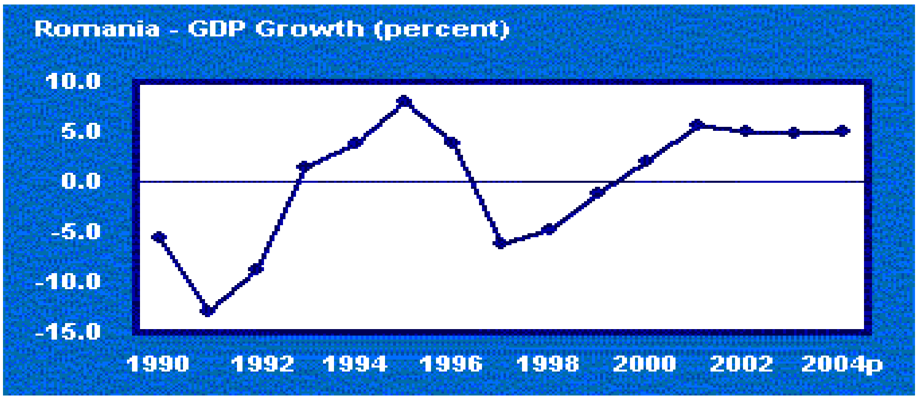
1. Revitalization of SME Sector after 1990 in Romania

1.1. Macroeconomic trends

Romania's transition, starting in 1990, was in many respects more difficult than in the other countries of Central and Eastern Europe. This was partly because by the late 1980s, the country's economy was on the verge of collapse after 40 years of rigid central planning that emphasized self reliance, an excessive focus on heavy industry and large, uneconomic infrastructure projects. Over the past ten years, the Romanian economy has been characterized by a series of stop-and-go reform attempts that have resulted in a highly cyclical growth pattern. Like most transition countries, Romania experienced a sharp recession during the early 1990s, followed by a period of steady growth and declining inflation from 1993 to 1996. Against all expectations, the Romanian authorities averted a liquidity crisis in mid-1999 and adopted a new set of economic policy measures to stabilize the economy as part of a three-year, Stand-by Loan Arrangement (SBA) with the IMF.

After three years of negative growth and rising unemployment, the policy corrections resulted in GDP growth of 1.6% in 2000 (Figure-1). The recovery was led by high industrial output growth (up 8.7% in 2000 compared to 1999) and exports, stimulated by a large devaluation of the ROL. GDP growth accelerated in 2001 (to 5.3%), thanks to a rebound in domestic demand. Real GDP growth slowed to 3.5% in 2002 from an estimated 5.3% in 2001, as a result of a more severe global slowdown post-September 11th and a domestic policy correction.

Figure 1. GDP Growth (percent)



Source: National bank of Romania, Yearly Report 2003

In an attempt to minimize the social costs of transition the Romanian government initially hesitated to impose tight fiscal constraints and privatize large loss-making enterprises. In the late 1990s, attempts to impose macroeconomic stability without full structural support led to negative economic growth, and poverty increased sharply, doubling from 20 percent in 1996 to 41 percent in 1999.

Since 2000, the Government has implemented macroeconomic policies which are supportive of growth. A disciplined fiscal policy, which complemented a tight monetary policy and was augmented by strong advances in structural reform, led to improved financial discipline in the enterprise sector and has placed public finances and the financial system on much firmer footing.

This resulted in GDP growth for three consecutive years. In addition, inflation and interest rates declined steadily, the fiscal deficit was brought under control, foreign exchange reserves increased to historic highs, and the external balance was held to comfortable levels. Export growth remained vigorous, fuelled by private investment and the initial competitive depreciation of the currency. The competitiveness of the enterprise sector was boosted by productivity gains. Romania is now a visible and attractive destination for international investors as a result of better sovereign ratings and improved access to international capital markets.

The country is comprehensively reforming and restructuring its economy with a view to joining the EU in 2007. As part of this, the Government seeks to build institutions and design and implement public policies to fundamentally transform Romania's economy and society. This requires strong political commitment, considerable expertise and resources, as well as popular and external support.

Despite economic growth in the past three years, important challenges remain. Further structural reforms are crucial to build a competitive market economy capable of withstanding the pressures of EU integration.

1.2. Trends in Private Sector Development

Romania, like most transition economies, inherited from the communist regime an industrial sector dominated by large state-owned enterprises, in particular in the petrochemical and mining sectors. The trade and service sectors were underdeveloped and the financial sector was unable to respond to the needs of the enterprise sector.

A central issue of importance during the transition process has been the restructuring of the large, unprofitable and uncompetitive state-owned enterprises. Since the start of the transition, various administrations have taken a cautious approach with respect to restructuring because of the fiscal and social costs that this process would entail. To offset the social costs, these governments have followed the strategy of fostering the development of the private sector by accelerating privatization and promoting FDI and entrepreneurship, in particular new SMEs. Under the guidance and with the support of the IMF and the World Bank, the Romanian Government has taken a new approach to industrial and financial restructuring. The State Ownership Fund was dissolved and replaced by the new Authority for Capitalization the State Assets (AVAS) in 2000. An agreement with the World Bank was reached on a second Private Sector Adjustment Loan program targeting the restructuring and privatization of 18 State-Owned Enterprises.

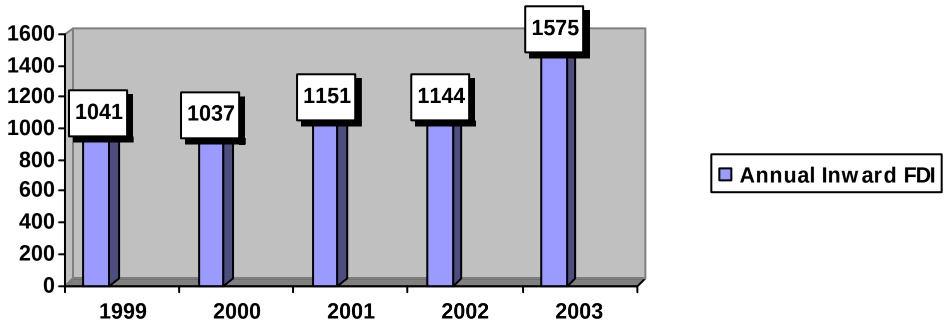
The privatization process has encountered setbacks in the past. The subsidies to loss-making enterprises have acted as a drag on national finances and hampered the development of the SME sector. The vast majority of privatizations completed have involved smaller enterprises and the process has been complex. Some contracts have had to be cancelled due to the low quality of the strategic investor and, in some cases, the process has not been entirely transparent. There is a very large number of disputes associated with past privatizations, with about 15,000 court cases still pending.

Staring with 2000, the government renewed its commitment to the privatization process. So, it tried to improve the transparency and speed of the privatization process, together with the monitoring of the post-privatization developments. Also, the government, transferred the responsibility of selling state shares in large utilities and key public companies to the relevant ministries.

Over the last years Romania has made significant progress towards macro-economic stabilization and has achieved high rates of economic growth. As a result of greater political and economic stability and of the implementation of economic reforms, the investment climate has started to improve and international investors are looking at the region with a much more positive attitude, seeing Romania as a possibility for increasing their trade on the regional market.

According to the statistical data provided by the National Bank of Romania, in 2003 the inward FDI reached USD 1575 million, compared to the same period last year, when the inward FDI registered the value of USD 1141 million (Figure -2). The figures reveal an increase of 37.6 % of FDI inflows in 2003 against the value reached in 2002, practically 2003 being the first year since 1999 when the FDI inflow registered a significant increase.

Figure 2. Annual Inward FDI in Romania



Source: Romanian Statistical Yearbook 2003

FDI evolution in Romanian economy emphasizes the positive trend Romania is on, the improvement of Romanian business climate, as well as our country attractiveness to foreign investors. In addition, it's worth mentioning finalizing land restitution process supporting Greenfield projects development, solving utilities network legal situation, developing industrial parks, granting incentives to foreign investors, elaborating policies for local authorities aiming at attracting and encouraging foreign investment, as well as developing domestic capital as a significant element in attracting new investment through economic relations development.

Due to all favorable shifts, the foreign investors started to change their position towards Romania, perceiving it as a more friendly business environment and becoming more confident in the Government's investment policy. The increased interest of foreign partners towards Romania as a destination for foreign investments is revealed as well by the number of commercial companies registered during 2003 (6594), according to the data provided by the National Trade Register Office - Ministry of Justice.

Romania has been relatively successful in attracting small and medium-sized foreign investments, particularly in labour intensive sectors located in the north-western part of the country. These investments are driven mainly by location and relative labour cost considerations. They have contributed to the rebalancing of the industrial structure and to the reorientation of trade flows towards the European Union.

1.3. Small and Medium-Sized Enterprises

The main impediments to business development in Romania are considered to be as follows: inflation, taxes and regulations, political instability and access to financing. These are the conclusions of a survey conducted by the European Bank for Reconstruction and Development (EBRD) and World Bank, which confirm the results of similar surveys and studies.

The conclusions of the survey of Romanian enterprises, consisting mainly of SMEs, are basically accordinlgly with those of other SEE countries. Overall, Romanian enterprises appear to be more concerned about inflation and policy instability compared to the overall SEE average. Also, lack of financing is marginally less important than the tax and regulatory constraints.

Table 1. Main impediments to business development in Romania

Micro Environment	Macro Environment	Law and order
Finance	Political Instability	Functioning of the Judiciary
Taxes and Regulations	Inflation	Corruption
Anti-competitive Practices	Exchange Rate	Organized Crime
Infrastructure		Street Crime

Source: EBRD (1999) and http://www.worldbank.org.ru/survey/front2.htm

The emerging private sector is responsible for a significant share of the economy. Its contribution to GDP has increased annually from 15% in 1989 to 65% in 2001, according to the EBRD studies.

The SME sector has grown very rapidly during the years of transition. The period 1990-1995 can be characterized as having witnessed rapid increases in the number of registered companies. The recession of 1997 to 1999 affected the SME sector (Table 2). In 2000, the SME sector accounted for 57% of the number of employees within the private sector and 46.9% of the total number of employees within the national economy.

Table 2. Evolution of Private SMEs (1992-2002)

Years	Active SME	Weight of staff in active SME	Weight of SME turnover in the turnover of total enterprises
1992	126549	12.3	30.9
1993	214349	17.8	33.8
1994	283697	20.1	41.3
1995	301781	23.9	46.7
1996	309454	29.1	48.3
1997	314183	32.9	45.2
1998	315970	37.8	52.8
1999	316593	42.5	54.0
2000	306073	46.9	55.9
2001	309303	48.5	57.2
2002	313159	50.7	55.9

Source: Romanian Statistical Yearbook 2003

At the end of 2002 the total number of small and medium enterprisers was of 313159 with 1.,1% more than the previous year (309303). The birth ratio of SMEs was 5.6% in 2000, 5.6% in 2001 and 7.5% in 2002, and the mortality ratio dropped from 1.2% in 2000 to 1% in 2001; in 2002 it was registered a spectacular growth of the mortality ratio to a value of 19%, due to the great number of SMEs erased in 2002, which didn't increase the social capital within the limits of legal term. The trends are dropping for the mortality ratio and increasing for the birth ratio.

At the beginning of the year 2004, statistic data show that other many SMEs should be erased due to not presenting on time the annual financial situations. This shows the difficulties that Romanian SMEs still confront with.

In general, the micro-enterprises dominate the SME sector. This is not dissimilar to other countries. Ninety-three per cent of all firms in the EU are micro-enterprises, and 99.8% of all firms are SMEs, accounting for 90% of all employment.

The high concentration of SMEs in the trade sector (65.7%) reflects the fragmentation of the distribution and retailing industry in Romania (see Table 3). The data also suggest that the service sector, although still relatively underdeveloped, has a good deal of potential for development.

Table 3: SME Industries and Size Categories (2002)

Sector	SME distribution	Micro	Small	Medium
Industry	11.2	79.8	16.1	0.4
Agriculture	1.7	82.5	14.1	3.3
Construction	2.9	71.7	20.9	7.4
Trade	65.7	95.6	4.0	0.3
Tourism	0.5	83.5	11.7	4.9
Transport	2.9	92.4	5.7	1.9
Services	15.1	94.0	5.1	1.0
Total SMEs	100	92.5	6.3	1.2

Source: Romanian Statistical Yearbook 2003

Regarding the SMEs distribution on domain of activity; the situation is:

- trade is the area in which most SME are involved 65.7 % in 2002;
- the second area was the one of services, with 15.1% in 2002;
- industry is area in which 11.2 % in 2002.

These three sectors concentrate more than 90% of total SMEs, situation resembling with the one in EU countries.

Concerning the form of ownership, the next data were registered:

- most of SMEs (99.3%) have integral private capital;
- SME with public capital and mixed capital represent less than 1%, thus SME are based on private capital in great majority.

Analysis on the territorial distribution of SMEs **brings more new information about their development; the statistic data presented are focused on the eight Romanian regions of development.**

Firm's development distinguishes significant disparities between the eight regions of development in Romania concerning density, turn over, profitability and economic results.

Table 4. The repartition of private capital SMEs on regions of development - %-

	Regions of development	2000	2001	2002
1	North-East	11.6	11.7	11.7
2	South-East	13.2	13.3	13.0
3	South-Muntenia	11.8	11.4	11.5
4	South-West Oltenia	9.5	9.0	8.3
5	West	8.4	8.7	9.0
6	North-West	13.6	13.7	14.0
7	Center	11.8	12.1	12.6
8	Bucharest-Ilfov	20.1	20.0	20.0
9	Total sector SMEs	100.0	100.0	100.0

Source: Processed by the Romanian Statistical Yearbook 2002, page 353-355 and data offered by www.mimmc.ro

It is observed that the highest density of SMEs is registered in Bucharest-Ilfov region, and the lowest in South-West Oltenia region (where the firms' density is 170% lower than in Bucharest-Ilfov region). Approximate 18% of medium firms spotted in Bucharest–Ilfov region, while in South-West region their number represents 6,7% of the total.

The statistic situation registered in 2002 indicates a relented economy, being also the positive evolution in the dynamic of private sector. Thus:

- the growth of working places in SMEs sector from 1797206 in 2000 (38% of the total number of employees in Romania) to 1844312 in 2001 (40% of the total number of employees in Romania), respectively 1876938 in 2002 (50.48% of the total number of employees in Romania);
- the growth of SMEs in the service field; in the industrial sector and in the construction field;
- SMEs generate around 60% of the gross internal product of Romania.

1.4. Results Obtained by SME's in Romania

1.4.1. Turnover

Regarding the turn over the greatest number of SME's with a turn over higher then 2000 billion lei is registered in Bucharest Ilfov region, 35%

of the total, the South West region gain a percentage of 5.7% (the lowest value at national level).

The statistic situation registered in 2002 shows the growth of SME's turnover from 634250.4 billion lei in 2000 to 916014.3 billion lei in 2001 (44%), respectively 1513528.6 billion lei in 2002 (65%).

Table 5: The structure of turnover achieved by SMEs sector with private capital by size and development regions - %

Development regions	2001 Total	Micro	Small	Medium-sized	2002 Total	Micro	Small	Medium-sized
North-East	10.2	9.9	9.7	11.4	10.0	9.7	9.8	11.0
South-East	11.0	11.9	10.3	10.5	10.8	11.7	10.2	10.3
South	10.4	10.2	9.8	11.5	10.3	10.3	9.7	11.1
South-West	6.0	6.9	5.6	5.0	6.0	6.6	5.7	5.3
West	8.3	7.4	8.7	8.9	9.0	8.0	9.5	9.7
North-West	12.0	11.1	13.0	11.9	12.6	11.6	13.6	12.8
Centre	11.5	10.5	12.2	12.2	11.4	10.5	11.7	12.5
Bucharest-Ilfov	30.7	32.1	30.8	28.4	29.9	31.7	29.8	27.1

Source: Processed by the Romanian Statistical Yearbook 2001-2002 and data provided by www.mimmc.ro, National Agency for SMEs and Co-operatives

Also as regards turnover, Bucharest-Ilfov scores the highest number of SMEs with turnover higher than ROL 2.000 billion – 20% in total, with South West region scoring for a modest 6.75% (the lowest value at national level).

1.4.2. Profitability indicators obtained by SME's in Romania

Profitability indicators obtained by SME's in Romania are presented on regions of development in Table 6.

Table 6. Profitability indexes at SME on regions of development

	Regions of development	Commercial profitability ratio		Economic profitability ratio		Financial profitability ratio	
		2000	2001	2000	2001	2000	2001
1	North-East	0.92	2.01	3.35	4.68	6.74	14.70
2	South-East	2.14	2.01	6.22	5.44	27.79	27.29
3	South-Muntenia	1.85	3.04	5.52	7.28	14.02	23.57
4	South-West Oltenia	0.44	1.93	2.69	4.78	4.49	15.00
5	West	1.94	1.47	4.85	3.63	14.08	12.31
6	North-West	2.11	3.39	5.90	7.48	18.45	28.93
7	Center	2.09	3.13	5.22	6.53	15.39	24.18
8	Bucharest-Ilfov	-0.37	2.56	1.24	4.89	-5.00	35.81
9	Total SMEs	1.09	2.53	3.45	5.47	10.33	24.26

Source: Processed based on data provided by www.mimmc.ro

It is noticed the commercial profitability ratio (Profit/Turnover), economic profitability ratio (Profit/Assets) and financial profitability ratio (Profit/Equity Capital) have registered upwards evolutions along the two years, and as regions, South-Muntenia, North-West and Center regions stand out. Higher profitableness rates registered SMEs from services and constructions sectors.

Economic profitability of micro-enterprises is 9 times higher than national average in South Muntenia region and 162 higher than in South West. While Bucharest-Ilfov accounts for the largest number of companies in retail trade, construction and research, North East is strong in the textile sector. South West in tourism and waste recycling. North West region scores the relative highest number of companies in transport and metallic production. South in agriculture, Centre region for wood processing.

1.5. The financing of SMEs in Romania

In the most cases, Romanian enterprises perceive financing as an important compulsion concerning the start or development of their business. To fight-back this situation, a series of measures and financing instruments, like communitary programs and credit access, were elaborated.

For the growth of the SMEs access at financing, financial-banking and administrative institutions have to actively cooperate for identifying and promoting the most adequate actions at microeconomic level. Also, a higher priority has to be given to the needs of new and small firms through traditional means, reducing interest rates and securities, and encouraging the micro-credit.

New instruments of improving access to financing were proposed, like *capital grant scheme*- that takes into analysis the following issues:

- the lack of bank credit due to the lack of securities or to the incapacity of getting more than one credit at once;
- the necessity of taking rapid decisions concerning financing;
- the necessity of finding means of control for the grey market, especially concerning turnover and occupation.

The scheme of capital granting will represent, partly, at the same time, *a pilot scheme for future accessing of Structural Funds*. Thus, it will have the following characteristics: specific co-financing from the beneficiary; transparent selection criteria; clear and countable objectives; relatively short period paying capacity; a clear auditing process and capacity of avoiding fraud.

1.5.1. Financing Through Communitary Programs

In the 2000-2006 period, 16 billion Euro of structural funds were allocated for the financing of SMEs oriented projects. Approximate a third of this amount was allocated for a consulting and a business services, like incubators, networks and clusters. In the candidate countries also, an important part of the pre-aderation funds was oriented toward SMEs. Many other programs, such as LIFE (the financial instrument for environment) and Eco-label, are mostly addressed to small firms.

In 2001, the Phare contribution for all candidate countries was 104 million Euro and 54.7 million Euro in 2002, going through more than 19 programs. The overall of communitary programs had a number of 29, which weren't all opened to the participation of candidate countries. National co-financing is different from country to country, being determinate by the effective moment of entering these communitary programs.

It is noticed that Romania has been the beneficiary of many communitary programs, but its participation at these programs is varied. thus, for frame programs specific to certain domains, the sums allocated by the EC are smaller, as compared to Research and Development Frame Programs and Leonardo da Vinci and Socrates Programs, at which allocated amounts are a lot bigger, considering the scope of the actions taking place in these programs.

Table 7 presents Romania's participation in communitary programs, which reveals that in the year 2001, the national contribution represented more than half of total allocated budget, and in 2002, the national contribution reduced at less than half.

Table 7. Participation of Romania in communitary programs mil. Euro

	Participation of Romania in communitary programs	Total Budget	National Contribution
1	2001 - 8 programs	35,6	20
2	2002 – 16 programs	38,5	16,7
3	2003 – 15 programs	in progress	in progress

Source: Processed based on data provided by www.mimmc.ro

Romania concentrated its effort for sustain the SMEs sector through the specific programs which are financed by the budget and external funds.

- In order to support this sector, in 2002-2003, the state budget allocated over 3158 billion lei and brought a contribution of 24.02 millions Euro, representing the co-financing from the Romanian state of a Phare component with a budget of 75.07 millions Euro (for investment, the access to the consulting and training services, for the export promotion);
- Increase the efforts to gather external financing sources for the SMEs which represent over 100 million Euro, in the period 2002-2003, from BERD, BEI;
- The development of the component „SME facility" in Romania gathered over 1050 millions EURO;
- The diversify of the multiyear national programs financed by the state budget.

1.5.2. Financing through credit

There is a significant and hard to satisfy demand for financing SMES trough credit. Thus, is necessary to continue and supplementary extend the present credit lines at which SMEs are aiming, by using the example of different financing schemes implemented so far, (especially through MIROBANK, BERD credit line, USAID help for credit and KfW credit line).

In order to support the SME's for demanding credits, it is recommended the possibility of practicing attractive interests credits granted from the unemployment insurance budget, by the National Agency of Work Force Occupation (Ministry of Work, Social Solidarity and Family) as well as granting such credits for other categories of potential enterprisers that could initiate and develop business, as, for example, students.

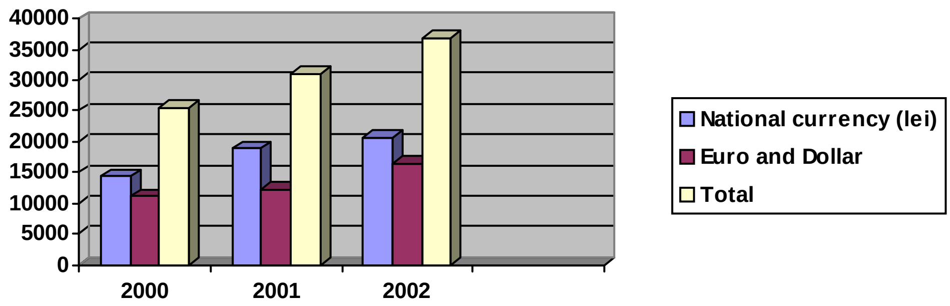
From the banking sector view, the SMEs represent a strategic sector towards should be focused, from the following reasons:

- the SMEs insure a good risk dispersion;
- the SMEs accept the standard costs (interests, banking fee and commissions) insuring a high efficiency in this sector.

Even the SMEs represent an attractive market with a high potential for the banks, there are some factors which act against the SMEs credit, such as: the low offer of the banks for this kind of credit, the lack of the SMEs training regarding the credit documentation, the lack of the customer (SMEs) financial information for the banks; the lack of a regional network for the banks.

In this circumstances, the credits for SMEs got in 2002 just to up 36.51% from the total corporate credits.

Figure-3. The credits granted to SMEs (2000-2002)

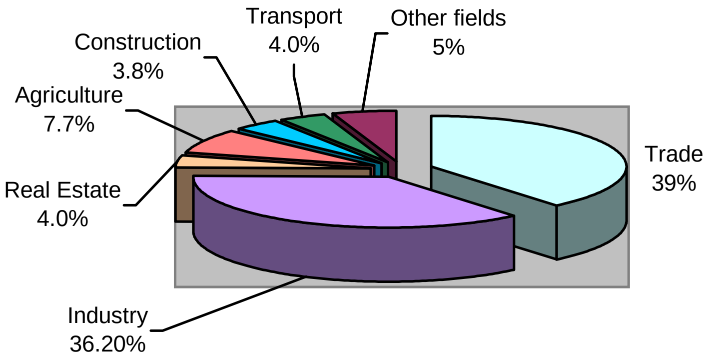


Sursa: Study National Bank of Romania, "Creation of the necessary frame for development of some banking product and services" (2003), pg. 67

Even in the analyzed period, there was registered an increase of the SMEs credits from 26743.2 mil. lei in 2000 to 36966 mil. lei in 2002, this increase did not satisfy the market demand. Regarding the credit distributions in function of the enterprises size, there was a reorientation of the banks towards the medium firms, and the micro-firms.

Concerning the destination of the credits granted to the SMEs the situation in 2003 is presented in the figure-4.

Figure-4. The destination of the credits granted to the SMEs (economic fields)



Source: Romanian Statistical Yearbook 2003

The weight of the credits for SMEs are directed towards the trade (39%) and industry (36,2%) from the total credits for SMEs.

The distribution of the credits granted to the SMEs by regions of development reveals the credit concentration at the Bucharest area where in 2002 were placed 37% from the beneficiary firms, which is much higher that the other counties (with an average of 4% from the credits). The main reason which determined this situation is the low level of development for the banking infrastructure the regional level.

Table 8. The distributions of credits granted to private capital SME's by size classes and regions of development

	Regions of development	2001 Total SMEs	Micro	Small	Medium	2002 Total SMEs	Micro	Small	Medium
1	North-East	6,7	5,9	6,8	7,1	7,5	5,4	8,5	9,1
2	South-East	8,3	9,0	8,0	7,9	8,4	9,7	6,9	8,2
3	South-Muntenia	7,8	7,3	8,4	7,7	8,1	5,9	10,0	8,9
4	South-West Oltenia	4,5	4,7	4,4	4,5	4,6	4,2	4,4	5,2
5	West	7,7	5,9	6,7	10,0	11,1	10,9	9,1	13,1
6	North-West	8,0	6,9	10,4	6,8	9,2	6,5	12,2	9,8
7	Center	11,8	6,7	10,4	16,8	11,0	6,9	13,6	13,7
8	Bucharest-Ilfov	45,3	53,6	44,9	39,3	40,1	50,4	35,4	32,0
9	Total SMEs	100	100	100	100	100	100	100	100

Source: Processed based on data provided by www.mimmc.ro

Concerning the distribution of credits granted to SMEs on regions of development, the SMES in Bucharest-Ilfov region have obtained and average of credits four times bigger that SMEs in other regions.

Considering the high present level of interest rates on credits, it will also be considered the possibility of interest subsidizing for certain domains of activity.

For the improvement of SMEs's access to financing, the following *actions* will be taken:

- the continuance of obtaining financial allowances for SMESs, from the state budget and external sources, for the development and implementation of multi-annual financing instrument of the SMES sector at national level (credit and granting schemes for supporting the investments of start-up firms and of the existing ones, promotion of export, investments in prioritary economic sectors, innovation, transfer of technology and Know-how, sub-contracting);
- promotion of Multi-annual Program, with national applicability which corresponds to the firms development stage, by: implementing multi-granting schemes; implementing scheme of granting associated with; promoting schemes of micro-credit;
- the continuing of apply the credit program for SMEs and its monitorising;
- promotion of setting-up and developing risk capital funds;
- the development of a permanent system of monitorising and periodic evaluation of the way of finance use and fiscal facilities received by SMEs;
- the efficient promotion of present financing programs;
- the assurance of Romania's participation - in the communiatry programs, - within Financial Instruments component of the Multi-annual Program (2001-2005) for Firms and Enterprising, especially for SMEs, with the support of EC;
- creating a database with information on financing opportunities for SMEs, unrepayable financially, guarantee funds; commercial banks, risk capital funds;
- the elaboration of the action plan for improving the SME's access to financial services, as a part of the Technical Assistance - Institutional Construction program, financed through Phare 2001 program;
- the elaboration of banking settlements due to encourage SMEs financing by the financial-banking institutions, the opening of special departments within banks which can offer such services.

2. European integration and the Romanian SME sector

One of the main economic policies within European Union is to develop as rapidly as possible the SMEs sector, because it is considered that small enterprises are the “back-bone” of the future integrated economy. It is emphasized the idea that united Europe’s efforts will reach success only if small business will be brought to number one within theory and economic practice.

EU shows a special attention to small and medium firms, in present member states of EU, as well as in the rest of the European countries that sooner or later will be integrated within the union.

At the EU executive level there were already adopted a series of documents establishing key domains for supporting and encouraging small business. The most important is The European Chart of Small Firms, adopted at the European Council in Santa Maria Feira in June 2000, establishing 10 key domains.

Romania is involved in discussions concerning fundamental problems and coherent strategies with impact on SMEs sector, starting from the support that EU gives to Romanian SMEs.

2.1. Theoretical Fundaments

I. The European Charter for Small Enterprises calls upon Member States and the Commission to support small enterprises in ten key areas:

- Education and training for entrepreneurship;
- Cheaper and faster start-up;
- Better legislation and regulation;
- Availability of skills;
- Improving online access;
- Getting more out of the Single Market;
- Taxation and financial matters;
- Strengthening the technological capacity of small enterprises;
- Making use of successful e-business models and developing top-class small business support;
- Developing stronger, more effective representation of small enterprises’ interests at Union and national level.

These ten key areas demonstrate the difficulties for SMEs to take many political measures and full advantages for economy

We consider that these domains are connected with the rethinking of the optimal dimension concept of all business, on the founding of present phenomenon which cannot be ignored anymore, such as:

- the stressed dynamic of all economic activities;
- the danger of some natural resources' exhaustion;
- the necessity of quick finding some innovative solutions for humanity, in terms of decision transparency, without subjective interventions which can distortion normal evolutions.

Experience has proved that only in states with a great mobility and diversification of small business (the best example are still the US) can be reached the selection and affirmation in maximum objectivity conditions of truly useful and efficient activities for human society. Because of that, above the appreciations that SMESs are the locomotive of present society or very sensitive barometers of economic, social or political evolutions, we consider that it will far more correct the idea according to which the small firms' high "birth rate and mortality" phenomenon represents a true economic test of objective selection for enterprisers. This test is less expensive, talking about low resources, but has essential effects on identifying and expanding some efficient activities.

SMEs development is closely in connection with enterprising problems, starting from the premises that enterprising is the engine of economic growth, of competitively and of the creation working places, as well as from the discrepancy which still exists in the field of enterprising between Europe and the United States. In this context, European Union has decided to support the force of enterprising in a most efficient way, identifying those priorities that can affirm the enterprising initiative. The European Commission has published in January 2003 The Green Book of Enterprising in Europe, discussing people's attitudes concerning enterprisers or the actual number of enterprisers, dynamism within enterprising activity and enterprisers' performance.

The analysis of the SMEs sector has to emphasize the advantages, as well as the disadvantages, especially through a comparison with advantages and disadvantages of big firms.

The advantages of SMEs sector are connected to present trends of globalization, hard competition and mobility within the economic process, thus:

- SMEs have a great flexibility and adaptability, practically under all aspects (financing, production, marketing, human resources), when economic circumstances modify rapidly, especially when these become unfavorable;

- SMEs need more reduced financing resources (based mostly on equity capital), using more efficiently the resources that they can rely on;
- SMEs are much more active on the work market, creating very rapidly working places, often in new areas, the costs connected to creating a working place being much more reduced than the ones registered by big firms;
- SMEs influence the efficiency of internal markets, these finding or creating quicker or easier or market shares for certain products or services;
- SMEs are perceived as an element of economic growth and stability, through the assertion of the trends of a healthy long term economic growth.

The disadvantages or week points of SMEs sector appear in front of big firms, as well as because of extra economical reasons, like:

- SMEs have a reduced access to local and international capital markets, involving a vicious circle, meaning that small enterprisers are often excluded because they are small, but cannot become bigger and they disappear, because they can't cover the high costs of making their projects;
- SMEs are strongly affected by the incidence of institutional and settlements compulsions, especially if they want to enter the external market;
- SMEs are sensitive to any type of "barriers" (national or international, economic or extra economic), transposed in several high costs of transaction;
- SMEs are characterized by a weak representation of their own interests, including through access to advertising or representation in different organisms, making them vulnerable, especially in competing whit big firms.

In reality, in a modern economy coexist firms of different sizes, but it is noticed that their start-up and their development have the next evolution: usually, it starts from a small firm, and if this one is viable and efficient, than it develops to a middle dimension, big or very big. In modern economies are working networks of enterprises (clusters), in which the competitive position of the firm mostly depends on the suppliers' efficiency. That is why, the competitivity of SMEs affects the competitivity level of the overall economy.

2.2. Methods and Results

2.2.1. Comparative Elements of SME in Romania Against SME in Member and Candidate States of the European Union

An enterprise is registered in the SME category (it can be micro, small or medium sized) if it fulfils all the conditions regarding: employed personnel, turn over and right to vote.

Observing the definition of the SME in Romania and in the European Union, as table no.9 shows, the next comparative elements are distinguished:

- concerning the number of personnel, there are no differences;
- from turnover point of view, the Romanian definition is more restrictive, its maximum level being of 8 mil. Euros compared to the similar condition in the EU, which establishes a maximum level of 7 mil. Euros for small firms and 40 mil. Euros for the medium ones;
- in Romania, there are no restrictions regarding maximum capital of SMES. In EU there are restrictions, but these are progressive: 5 mil. Euros for small firms and 27 mil. for medium size firms.

Table 9. The definition of the SMEs in Romania and in the European Union

	Conditions for SMEs	Micro	Small	Medium
1	ROMANIA			
2	Number of employees	<10	<50	<250
3	Turnover	<8	<8	<8
4	Other conditions (owners equity/ voting power of other firms)		25%	25%
5	EUROPEAN UNION			
6	Number of employees	<10	<50	<250
7	Turnover (mil. Euros)	n/a	7	40
8	Current Liabilities (mil. Euros)	n/a	5	27
9	Other conditions (owners equity / voting power of other firms)	n/a	25%	25%

Source: Processed based on data provided by www.mimmc.ro

It is observed that the Romanian definition is in accordance with the one recommended within European Union.

Most of the SME in Romania, as well as in candidate countries, are micro-firms. in Romania, of the total number of SMES, 91,2% have been micro-firms. In Romania, of the total number of SME, 91,2% have been micro-firms at 2001 level.

From the point of view of the *employed working-force weight* in the SME sector in the total working force employed in economy, the situation is the following:

- in EU countries, including EFTA, the weight of the personnel registered in SME is of 66% of the total;
- in candidate states, it weight is of 72%;
- in Romania, 40%.

The average of employees in small and medium firms is 5,5 employees in EU, including EFTA, 6,9 in candidate states and 4,8 employees in Romania, a level under the European average. There is a difference between SMES average in candidate states and member states. In Malta, Cyprus and Turkey – 3 candidate states which don't have a command state economy, the no of SMES is situated at the same level as countries within the EU. The South part of the continent represented by Greece, Italy, Spain and Portugal is characterized through a higher weight oh micro-firms.

The situation of ***the distribution of SME on areas of activity*** is presented in Table no. 10.

Table 10. The distribution of SME on areas of activity

	Areas of activity	Romania	Candidate States	Europe-19 (EU+EFTA)
1	Industry	11.6%	12%	10%
2	Agriculture	2.0%	-	-
3	Construction	3.3%	16%	13%
4	Trade	63.0%	19%	25%
5	Tourism	0.5%	5%	6%
6	Transport	3.6%	12%	6%
7	Services	16.1%	36%	30%

Source: Processed based on data provided by www.mSMEc.ro

The percentage of SMEs in service area within candidate states and those in Europa-19, also includes small and medium firms activating in financial services domain (banking services, insurance and securities).

Comparatively the weight of Romanian SMEs compared to SMEs in candidate states and SMEs in Europe-19, the next particularities of SMEs in Romania appear:

- the percentage of SMEs in industry is 11,6%, compared to the one registered in Europe-19 (10%) and in candidate states (12%);

- tourism is weakly represented, by only 0,5% compared to 5%, respectively 6%, which means 10 times weaker;
- SMEs percentage in constructions is over 4 times lower than the European average registered in candidate states and in the Europe of 19;
- most of SMEs in Romania are involved in commerce activities, the percentage at European level being lower more than 2,5 times.

2.2.2. Work Productivity

The work productivity obtained by SME's in Romania compared to countries in the European Union at 2001 level is presented in table 11.

Table 11. Average Value of Work productivity on types of SME's, in 2001

		very small	small	medium	TOTAL
1	**Europe – 19**	**40000**	**75000**	**105000**	**65000**
2	**Romania**	**2688**	**3688**	**3542**	**3278**

Source: Processed based on data provided by www.mimmc.ro

It is noticed that average value of work productivity registered by small and medium firms in Romania, overall, as well as on size classes, is over 19 times lower the one registered at European level. When evaluating these results it has to be considered the fact that the definition of small and medium firms in Romania is not identical to the one in EU, considering the turnover. From this point of view, the Romanian definition is more restrictive, establishing a maximum level of 8 mil. Euros for turnover, compared to the similar condition in EU, establishing a maximum level of 7 mil. Euros for small firms and of 40 mil. Euros for medium firms.

2.3. Constraints on business formation and growth

The SME sector is still small and weak relative to the EU as well as to other transition economies.

This might be explained by a number of constraints:

- The entrepreneurial culture is generally weak;
- The regulatory and tax environment is burdensome. There is a confusing array of taxes and regulations with which SMEs must comply. The enforcement of regulations is often patchy leading to allegations of corruption;
- Banks in general do not address start-up businesses and infant companies, and make demand on collateral to the other businesses which is

often hard to met by undercapitalized SMEs who owners also lack sufficient personal assets to collateralize bank loans. Other forms of financial support (venture capital and leasing) are in their infancy;

- Sources of advice, training and information are inadequate, though there is a real need and demand for support services for SMEs. These are services that would be publicly subsidized in EU countries;
- Long-life learning is not yet a popular concept among Romanian companies and individuals. As a result, there is a growing mismatch between labour skills and market requirements;
- Both ownership and actual availability of premises is a problem. A total of 40 industrial / business parks were identified in early 2003, totaling 1,246 hectares of business infrastructure space equipped for enterprise establishment. The amount of space devoted in Romania to industrial / business park development is very small when compared with Poland, Hungary, or the Czech Republic;
- Little support is available for early stage innovation activities, due to lack of contact with universities, special premises, ability in technology transfer. Most SMEs remain in conventional sectors where competition is more intense;
- Supplier linkages between large enterprises and SMEs remain weak, due to insufficient technological endowment of SMEs as well as high risk for SMEs to deal with large state-owned enterprises affected by financial problems. Largest foreign investment could have a very positive effect on the development of Romanian enterprises.

2.4. Priorities of the SME Strategy in the context of European Integration

Romania's long-term plan is to achieve a stable economic growth faster than the EU average, within the context of a balanced development of its territory, and especially the reduction of rural versus urban disparities. Therefore, the long term National Development Strategy was formulated to support investment in sectors with growth potential, thus also supporting employment creation and safeguard.

As this National Development Plan 2004-2006 covers a three-year scale, this period of time shall not be sufficient to implement a comprehensive national development policy. The purpose of this Plan is therefore to target the major issues raised in the socio-economic analysis, in order to progressively reduce the current gaps between Romania and the EU countries.

From SMEs' point of view, the strategy aims to support growth in both qualitative and quantitative terms and to further diversify its productive basis in order to provide further developing opportunities to the productive system. It was composed a loan guarantee scheme to support SMEs' capital investment and of grant programs to promote investment in new technologies and know-how and to assist internationalisation. Preference is given to SMEs entering in activities unexplored before in Romania, with a strong technological component and subject to international competition. *Ad hoc* promotion of FDI-led supply-related clusters will also be possible. These schemes is complemented by an initiative capitalising on existing labour-intensive handicraft traditions with a view to better exploit their potential in the international and local markets. All schemes are directly targeted at entrepreneurs and are managed at the national level, in one case with the assistance and direct involvement of the banking system. The different schemes differently contribute to the different intermediate objectives. While the loan guarantee scheme and support to craftsmanship are mainly a tool to expand the entrepreneurial basis, technological grants are expected to have a more direct impact on the added value and diversification of the productive basis, while internationalisation-related measures are directly linked to SME global competitiveness.

The SME Strategy highlights the priorities:

1. Improvement of the Business Environment for the Stimulation of the SME Sector by:

- Improving the institutional framework and public-private dialogue;
- Simplifying and improving the legislative framework;
- Reducing bureaucratic barriers to SMEs;

2. Development of Economic Activities and Increase in the Competitiveness of SMEs by:

- Improving access to financing for SMEs;
- Creating a friendly tax system, aimed at stimulating investment;
- Developing business infrastructure and a national market for consulting services for entrepreneurs;
- Improving access to business information;
- Facilitating access to public procurement;

3.Improvement of he SME Access to External Markets by:

- Elaborating a strategy to support SMEs with export potential;
- Supporting regional collaboration;
- Supporting SMEs via international fairs and exhibitions;
- Providing training on marketing techniques for external markets;

- Supporting access to information on external markets;

4. Promotion of an Entrepreneurial Culture and Stimulation of New SMEs by:

- Supporting training programs focused on entrepreneurship;
- Supporting entrepreneurs' access to consulting services;
- Improving managerial education in secondary schools and universities;
- Involving mass media in generating a positive image of entrepreneurs.

All these kinds of action will require a combination of improvements in the regulatory and administrative environments and the provision of an adequate mix of "soft" incentives accordingly with the European aquis. The SME sector should be greatly expanded in both size and scope, as well as better integrated into the international economy and technologically enhanced.

The problems SMEs currently face in accessing medium-long term credit for investment must be adequately addressed, and this is even more so in the light of the possible consequences of the Basel banking regulations on the SME sector. Direct support measures will have to be targeted accordingly. Finally while the development levels of the manufacturing and business-service sectors can be broadly assumed to progress in parallel and to be mutually supportive of each other, there are a few areas where a more proactive stance is needed to provide the necessary "size effects" and foster the start of an autonomous growth process. This is especially the case for the opportunities opened by Romania's endowment of potential tourism attraction currently heavily underexploited and by the e-revolution that, if properly supported, could capitalise on the existing flourishing Romanian IT service industry.

SMEs are expected to remain the larger suppliers of jobs in the future. Together with a general purpose SME guarantee scheme aimed at easing the well-known problems SME have in accessing medium-long term credit for investment purposes a number of grant programs will be devised for SMEs specifically investing in hi-tech or entering the international markets. Technological priorities will reflect trends in the world markets and include, among others, biotechnology, new materials, environmentally friendly techniques and products, micro-technologies. In order to diversify the country's productive basis and foster possible imitation phenomena, a preference will be given to enterprises entering into new sectors.

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SMEs AND THEIR FINANCIAL SOURCES IN ZLÍN AREA ACCORDING TO THEIR NEW POSSIBILITIES IN EU

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Abstract

Strong saving tendence, preference to some traditional and financial instruments and distribution flows, mainly in some bank branches – these are the main specific features of a typical Czech customer and also are connected and closed to the small and medium enterprices (SMEs). One of the most important history bussines problem in the Czech Republic is the existence of some „elephant socialist“ enterprices unable to survive without the government help. There are SMEs support programmes in contrast to them. There have been announcend many discussions about some help activities before 2000. For example education development and maybe also a sort of financial help from EU. Zlín area is a specific bussines area with many SMEs. They cope also with financial problems as other SMEs in the Czech Republic. Talking about theit support after the year 2000 we have to mention the support of their competitiveness. There was provided the research between them to realize SMEs positives and negatives and their financial problems. The results can recognize SMEs weak and strong sides in financial questions and also can show the direction of their bussines future.

Key words: *small and medium entreprises (SMEs), financial sources, support, competitiveness, Europe union (EU).*

1. Introduction

The liberalization of economic activities is the world trend. The integration of economic and financial activities, too. All these developments indicate freer flows of goods and services. During the past 15 years or so, academics as well policymakers have turned their attention to the internationalization of small firms, especially SMEs (small and medium entreprises). There are changes in the institutional framework governing world trade and production, combined with rapid advances in communication and information processing technologies. The inability to control prices because of lack of market power, a dependency upon a relatively small customer base – there are some typical features for Czech SMEs. The financial resources available to SMEs can act as a considerable constraint in developing an international orientation.

This can take two forms:

- Lack of finance may hinder the firmś ability to identify opportunities arising from the opening up of national markets while.
- Inadequate financial resources may restrict the exploitation of opportuinities already identified.

Additional constraints derive from the management time and expertise may be in very short supply. At a consequence, there are significant problems in the acquisition of market information, in the coordination of the actual management effort. The lack of SMEs financial sources was the reason of the SMEs survey. This survey was proceeded in Zlín area to show up the SMEs world common features with an emphasis to financial problems.

SMEs cope with plenty of problems. This article should take out all their most important especially financial problems and go through the part of their financial management also with a note about their personal questions. The aim of the survey is to specify the SMEs financial sources in area Zlín. The article is gradually proceeded in the following steps:

- the recent SMEs situation and their definition
- SMEs financial sources in Zlín area
- strong saving tendence
- personal influence in SMEs management
- competitiveness
- survey results – positives and negatives
- discussion
- conclusion

There was proved by the questionnaire also the hypothesis from financial management area and personal influence. *The first hypothesis* expresses the idea that SMEs do not effectively use external financial sources. *The second hypothesis* is directed to personal influence and expresses the idea that SMEs do not follow carefully all necessary information directed to SMEs and their personal influence could improve SMEs competitiveness**.** SMEs cope with a lack of financial sources, thatś why with a lack of employees and consequently with problems in personal influence.

There has been used some economic and statistics methods – as induction, deduction, analysis, synthesis including the SMEs survey. The survey was provided at VOŠE Zlín in area Zlín [8] and its surrounding. It started in 2001 and finished in 2004.

2. SMEs, their definition and specific features

2.1 The recent SMEs situation and their definition

In all the short history of modern business there is well known that larger companies have the traditional belief in the rightness and power of size. Rationalisation, standardisation and concentration are the watchwords. In 1969 a Commitee of Inquiry on Small Firms was set up (The „Bolton“ Committee). Another „Wilson“ Committee on the Financing of Small Firms, in 1979, updated the Bolton turnover requirements. [1] This brought the definitions temporarily in line. In the EEC small firms [3]are usually categorised by employees, but there is no general agreement on the number that is covered by the term „small“. Businesses were split into medium-sized and small (though) in practical terms both would normally be regarded as small. (see table No.1).

Table 1: SMEs definition

Types of entreprise	**Number of employees**	**Turnover**	**Balance sheet total**
micro	Less than 10	to 250 mil. CZK	to 180 mil. CZK
small	10-49	to 7 mil. EURO to 1 450 mil. CZK	to 5 mil. EURO to 980 mil. CZK
medium	50-250	to 40 mil. EURO to 250 mil. CZK	to 27 mil. EURO to 180 mil. CZK

Source: European Comission definition (7.2.1996) [8]

There are given many *SMEs definitions*. The table 1 shows one of them. The economic definitions make a great of sense. It has three parts:

- market share
- independence
- personal management

The characteristic of a small firmś *share of the market* is that it is not large enough to enable to influence the prices or national quantities of goods sold to any significant extent.
Independence means that the owner has control of the business himself. It therefore rules out those small subsidiaries which, though in many ways fairly autonomous, nevertheless have to refer major decisions (e.g. on capital investment) to a higher level of authority.

Personalised management [4] is the most characteristic factor of all. It implies that the owner actively participates in all aspects of the management of the business, and in all major decision-making processes. There is little devolution or delegation of authority. One person is involved when anything material is concerned.

One owner – manager has to manage everything. Unlike the chief executive of a large corporation who can employ a secretary, a financial director, a treasurer, a solicitor and an accountant, all well informed in their own professional fields, and all willing and able to advise him, the small business proprietor has to be himself, a „man for all season". It is obvious that this has been the case for many years. SMEs cope every day with personal, economic and mainly with financial problems.

2.2 SMEs financial sources in Zlín area

Trying to sort out a part of SMEs especially financial problems, there has been started the SMEs research at VOŠE Zlín in 2001. This project has taken till 2004. The main achievement was to realize what is the reason of SMEs problems and go through all parts of SMEs financial management to their personal influence. The questionnaire for SMEs was spread in Zlín area. The main aim of the questionnaire were the SMEs financial sources.

Every year was spread 300 questionnaires to SMEs in Zlín area. The best returnability was in 2001 – 54 per cent. The questionnaire has been given to SMEs in region Zlín every year since 2001. In 2002 the returnability was only 32 per cent and in 2003 only 27 per cent. The research finished in 2004 with the returnability 29 per cent.

Table 2: Financial sources (in per cent)

Internal sources (the owners)	33
Profit	21
Leasing	19
Loan	17
From friends, family	3
Silent Partner	2
Grants	1

Source: *research at VOŠE Zlín* [8]

It was proved that SMEs in Zlín area prefer internal financial sources to external by the research at VOŠE Zlín. (see the table No. 2). The respondents used grants only a little (1 per cent). From external sources is the most favourite leasing (19 per cent) and then loans from the bank (17 per cent). At the beginnig of this research was said, that *SMEs do not use effectively external sources*, especially bank products and services.

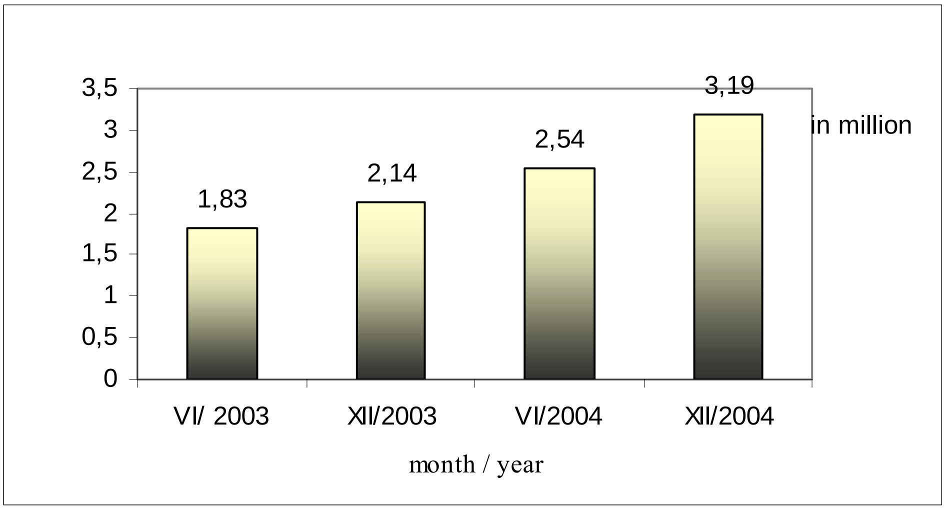
2.3 Strong saving tendence and growing number of loans

But there is the fact – the amount of Czech crowns is growing up in Czech banks. It is in an absolute agreement that SMEs prefer internal financial sources to external ones. As was proved by the research. SMEs prefer internal financial sources – „own“ sources. They like „to keep“ cash. Thatś why they prefer to operate with their accounts.

The following discussion should help SMEs to believe that bank products and services are for SMEs helpful and useful and effectively used also can improve SMEs effectiveness and competitiveness.

For example the number of loans in the Czech Republic is growing up as seen in graph No.2.

Graph No.2 The development of bank loans in the Czech Republic



Source: CCB [12]

Discussing external financial sources Czech SMEs prefer leasing and loans when using bank products and services. As was also prooved by the financial sources research. The reason is in a very good rate conditions. The discount rate is falling down. The economists do not expect its rising yet. Banks offer every day loans. They push their clients to use loans for their activities. The economists also refer to very good loan conditions as seen at the graph No.1. [12]

The research proved the hypothesis that SMEs do not effectively use external sources, as bank products and services. They did not understand the necessity of external sources in their cash flow, they did not believe in fact, it could *improve their effectiveness* and put up their competitiveness. Even Czec economists trust all Czech SMEs.

2.4 SMEs and the information

The most important problem in this research was the *information* spread. The respondents were not interested in further information. It was proved the the luck of information is also the reason of financial problems in SMEs. We can say it is an absence of personal influence. The questionning [8] was provided with 300 respondents every year from 2001 - 2004.
The absence of information could be also the reason of SMEs problems. That is the „whole“ in their personal influence, which should be filled up. With all

necessary information for their production and other activities SMEs could rise their effectivenes and competitivenes. Czech SMEs do not survive on the remote island. They work a cope with „everyday“ problems. Good managers should look after a good running. They run their business and try to make their profit by using all necesities as financial, producers´ or personal. There are shown some personal advices for SMEs managers bellow.

2.5 Personal influence in SMEs management

The research at VOŠE Zlín [8] proved that SMEs in Zlín area do not effectively work with information. There is a lack of personal influence in SMEs management. This is the space that has to be filled up. SMEs managers should improve their personal attitudes. While improving them that is the way of rising up SMEs competitiveness at the SMEs market.
What kind of attitudes do the managers and employees in SMEs need to have, what kind of management system would encourage such attitudes? Mr. Masaaki Imai in his book, „Kaizen“, very simply but eloquently explains that there are three categories [6] of work. The first is maintenance work, meaning doing the prescribed work very well, following the standards and procedures. The next is improvement based on the past experience. You should not be doing your job the same way year and year out. And the last and final category is „innovation.“ While improvement is based on past work doing it better, innovating is something entirely new. You should be thinking of new ideas and new methods for future growth. And as you go up the managerial ladder, more time and effort should be devoted to the second and the third category of work.

There are five important attitudes by Etsu Inaba [2] that the successful manager in the 21st century should possess:

- Search for problems - „problem should be a key word to describe what you must seek
- „Steal“ knowledge - Do not wait for others to teach you
- Apply ideas - Learn how to use unrelated ideas for your organizational benefits
- Report for credibility - Remember, Report, Inform and Consult, without being asked
- Be at the center of communication - Be close to your subordinates. Let knowledge flow up as well as down.

Some people think that it is not difficult to recognize a good manager. The personal influence [5] seemed to be important even at the first interwiew asking for a new job. But there are many modern methods for managers´ and successful workmen´s choice. They were used since the first world war. At these days were first used the psychological tests for american soldiers. Using of this method was widered also in many american companies as Ford. Also in Czech conditions have been started these choice methods with Tomáš Baťa company in Zlín. It was even established The Masaryk Labour Research Institute. These methods highly improved better probability of good decisions in personnel questions.

A good manager [11] should obtain confidence not only by his hard-working, outlook, calm and peace, firm decisions in difficult situations, his character features but also by his appreciation. There could be answered the question, if there is any difference between a good manager of a large company and of a small or medium entreprise. The theory usually gives many advices and management methods with no differences.

2.6 Competitiveness for SMEs

Competitiveness is the important aspect of all industrial pruducers and all business companies not only in Zlín but also in all other regions in the Czech Republic. The approaches to competitiveness of industrial producers were not presented in the Czech Republic till 1990. Considering creation and strengthening of stability of regional policy, including other influences, tendencies and typical regional aspects of macro and micro economic tools, competitiveness could stay side by side those factors. [9]

Definition of competitiveness

The economists in the Czech Republic did not find a convenient definition of the expression „competitiveness“ yet.

- producerś competitiveness and its definition does not exist yet
- competitiveness is a part of trade market
- competitiveness is also a possibility of some business undertaking advantage
- as a tool of competitiveness can be used for example low cost, product diferention and funktion diferention
- producers shall be able to use their competitiveness in their economic and product growth

Competitiveness is made by using best approaches from all business areas and processes as organization, new product methods, marketing, research, production, service and others.

Considering competitiveness and its sources we can talk about two factors: external and internal.

External factors:
- sources, price and access
- trade area
- law and administrative regulators

Internal factors:
- production proceses
- production instruments
- production programme
- management
- employees
- information systems

As the important part of small and middle-sized companies competitiveness is their place and part at the market. Region Zlín has quated a luck of businessmen at recent time. Zlín was a model of business development 10 years ago. Company and business closing can show that region Zlín as former model of Czech business activities rapidly got down. Zlín was considered as the richest business centre in the Czech Republic 10 years ago. This fact was influenced mostly by the agriculture cooperative Slušovice and its position at the trade market in the communist Czechoslovakia. There were many important business experiences which have been probably already all forgotten for ever. Unfortunately.

3. Survey results

By using all methods mentioned above there have been proved by the SMEs survey in Zlín area two hypothesis [8]:

- SMEs do not effectively use external financial sources
- SMEs do not follow carefully all necessary information directed to SMEs and their personal influence could improve SMEs competitiveness.

It was proved that the SMEs financial and personal management is identical for SMEs and also large entreprises with some exceptions. SMEs should work more with all information. They are not interested in new technologies, new equipments because of their financial problems. They prefer in financial management internal sources to external ones (see table No.2). They are not aware of the fact that external sources could improve their effectiveness and competitivenes. SMEs should take care more about personal management which is the space for their improvement. Their personal influence could help them for example to find out white places in the market or to be more flexible.

3.1 Discussion

Considering competitiveness and its sources we can talk about two factors: external and internal. *External factors*: sources, price and access (trade area, law and administrative regulators). *Internal factors*: production processes (production instruments, production programme, management, employees, information systems).

As the important part of small and medium entreprises competitiveness is their place and part at the market. Region Zlín has quated a luck of businessmen at recent time. Zlín was a model of business development 10 years ago. Company and business closing can show that region Zlín as former model of Czech business activities rapidly got down. Zlín was considered as the richest business centre in the Czech Republic 10 years ago. This fact was influenced mostly by the agriculture cooperative Slušovice and its position at the trade market in the communist Czechoslovakia. There were many important business experiences which have been probably already all forgotten for ever.

The unemployment in Zlín is growing up. The unemployment extent is about 0,3% higher in Zlín than the republic average with 9,28 per cent. Businessmen in Zlín realized some important approaches [5] which could be useful in looking for the conclusions:

- first they think that the cooperation between them and universities or other school could help for looking for financial sources for small and middle-sized companies
- secondly there should be built „a new transport channel" to the Slovak Republic because it could help in business cooperation increase
- thirdly there could be wider cooperation in goods and service exchange with our east neighbours.

There could be mentioned also some entrance steps towards these activities for business support, but not only in the area Zlín [7]:

- region economy
- region policy
- region development with all producers´ activities with their strategies and aims. They are made by their long period achievements and strategies and by business development purposes and projects.

Also the Czech Republic came with the support for the small and medium entreprises. There was established Českomoravská záruční a rozvojová banka in 1992 as an institution for financial support for small and medium entreprises. Unfortunately the businessmen say that to get subsidies or grants takes a long time and usually is not very succesfull. But there is appearing another new possibility for all areas in the Czech Republic – new information centres for small and medium entreprises (RPIC). They are called The regional information centres. They seem to be very useful and furtunable. [10]

Another help came from EU funds. Bussines could follow web pages with information about EU funds. This financial help is usually specified to direct business positions, to special business activities. While using these funds SMEs can obtain new external financial sources. They could also support their competitiveness. It is necessary to choose a convenient programme for their business activities. Recently the most popular area is the nature, enviroment support and the education support.

4. Conclusion

The SMEs survey proved two hypothesises. SMEs prefer internal sources to external ones. Thatś why they have problems with improving their effectiveness and competitiveness. SMEs do not effectively use all necessary information and the personal influence is not the main part of the SMEs management. There were shown some steps for improving SMEs management, especially in personal influence. Even the size of SMEs could be their advantage. For example because of their elasticity or their quick reaction on market demands.

In order to create a favourable enviroment for the small and medium entreprises the government could lay down certain policies. In education and training, savings and investment in primary resources, foreign trade, or others, etc. For example investors are missing not only in Zlín. All these factors (including macro and microeconomic influences) have been considered and have been considering since the Czech Republic entrance to the Europe Union.

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