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CATALYZE ENGINES OF GROWTH (EoG)

CATALYZE LEARNING BRIEF:
Private Equity and Venture Capital

The USAID CATALYZE Engines of Growth (EOG) Activity supports the resilience, growth, and job creation of small- and medium-sized enterprises (SMEs) in the Western Balkans by improving their access to and use of appropriate finance. EoG helps mobilize capital to sustain distressed, but viable, SMEs and jobs in the wake of COVID-19 in the near term and promotes improved SME growth financing in the long term. The EoG Activity engages market actors and other stakeholders in a co-design process to identify key opportunities and challenges to access to finance.



The Private Equity and Venture Capital Learning Event in Belgrade included Private Equity and VC Experts, CATALYZE Staff, USAID representatives, FI and bank representatives, IFC, EOG partners, SMEs/Beneficiaries, Associations. Photos: Brian Oh/Palladium

EoG works with local partners to address the following two main objectives:

1. Mobilize capital and/or restructure debt to otherwise viable but distressed SMEs that have been adversely impacted by COVID-19 to sustain them, retain/rehire workers, and preserve capacity for future growth.
2. Facilitate additional alternative financing to high-growth potential SMEs in the Western Balkans to enhance their growth, productivity, and job creation.

BACKGROUND

The CATALYZE EoG Activity is guided by its Activity Monitoring, Evaluation, and Learning Plan (AMELP). The AMELP explicitly includes the Learning Questions assigned to CATALYZE for contribution to USAID's Blended Finance Learning Agenda. CATALYZE actively works to answer its learning questions through an iterative process of generating spaces for knowledge exchange and dialogue among CATALYZE staff, implementing partners (e.g., financial intermediaries and Business Advisor Service Providers (BASPs¹), private and public sector actors, civil society, and small-, medium-, and large-sized enterprises involved in program implementation. The EoG Learning Agenda explores and helps identify opportunities to leverage blended finance to promote SMEs' resilience, recovery, and growth in the current context of the Western Balkans.

¹ BASPs identify investable firms or projects, provide TA to SMEs and producer associations seeking financing, structure and secure financing.

This learning brief on Private Equity and Venture Capital highlights lessons learned from EoG's regional learning events held in Serbia and Albania in October 2022. The findings can be used by USAID and the private sector to explore ways to mobilize private capital collaboratively to achieve development objectives and grow the local market for financing. The Private Equity and Venture Capital Learning Event addressed, in part, the following key Learning Questions to guide and inform EoG's methodology and activities.

LEARNING QUESTIONS



- 1 Why aren't Financial Institutions already providing financial products and services relevant to high-growth potential SMEs? Is it a matter of capability, opportunity, perception, or motivation?
- 2 Are existing products and services provided by Financial Institutions relevant to SME needs? What new products and services are being introduced to meet needs?
- 3 What obstacles do high-growth potential SMEs face in securing financial products and services? Is it a matter of capability, opportunity, perception, or motivation?

PROCESS METHODOLOGY

As part of its learning activities, EoG organized forums with partners and key stakeholders to examine the barriers and enablers to developing financial products (alternative or otherwise) in the Western Balkans, with a special focus on W-SMEs. EoG organized two regional events in Serbia and Albania on three different topics: Private Equity and Venture Capital; Fintech; and W-SME Access to Finance. EoG collaborated with partners, stakeholders, and donor representatives to organize the learning events. Topics were selected based on EoG's objectives and the potential for transforming the financial markets in the region. The events brought together 65 ecosystem stakeholders (including 34 women) from the Western Balkans who openly shared their experiences and recommendations in an interactive discussion with one another. EoG uses learning events to provide opportunities for networking among CATALYZE partners, USAID, and private sector actors. At the events, EoG's partners share knowledge and data to determine progress, answer learning questions that help guide the progress of the Activity, uncover best practices, and surface practical suggestions on how to better mobilize private capital for development.



CHALLENGE

SMEs in the Western Balkans need new sources of financing to stay resilient in the aftermath of COVID.



OPPORTUNITY

Private equity and venture capital offer SME owners a financing solution to scale and sustain companies.

KEY TAKEAWAYS AND LESSONS LEARNED

In the Western Balkans, SMEs comprise 99% of the economy. Most of these companies finance their growth through retained earnings or through traditional bank loans. Post-COVID, the region's economy has become unpredictable. As a result, companies need to manage and take advantage of new sources of financing to survive. When exploring new financing or investment options, company owners must consider their exit strategy. One-third of business owners in the Western Balkans do not have succession plans in place when they retire or are no longer capable of working. Almost two-thirds of business owners in the Western Balkans plan to give the company to their children, although they are not certain how this will take place. Equity investment offers SMEs a financing solution when faced with succession issues and enables the company to stay in business even after the owner has exited the company.

Raising awareness around the potential of private equity and venture capital is crucial for the region. Together, investors, SMEs, and legal and financial experts need to identify the challenges and opportunities they face when looking for financing. Because individual countries in the Western Balkans are too small to attract sustainable sources of equity financing, stakeholders must share knowledge, information, and contacts to build the regional private equity/venture capital ecosystem.

The PE/VC ecosystem is still in its infancy in the Western Balkans, and donor help is crucial in developing capacity and promotion of the industry. To date, USAID is the only donor that has recognized equity finance as a key tool for diversifying access to finance in the Western Balkans.

Startup companies are more likely to be early adopters to equity financing as they recognize its importance as an additional source of financing. Startups are part of the modern business culture and more open to new sources of financing compared to traditional companies. They have also been exposed to new access to financing support through different initiatives, such as the Serbian government-sponsored Innovation Fund. Initially, the Innovation Fund only provided grants

to startups. After the launch of the Serbian Ventures program, this institution will support establishment of two new VC funds that will invest in Serbian and Western Balkans startups.

Traditional family-owned companies in the Western Balkans are generally managed and owned by one sole owner and legal representative. Unfortunately, most of these owners have not considered what will happen if they are no longer capable of running the company. Often, they assume that their children will take over. In many instances, this is not the case. Most of the company owners are hesitant to relinquish partial ownership to a third-party investor because they are not familiar with equity investments, nor do they have examples in the market that they can consult. Moreover, corruption has eroded trust in financing as many people in the Western Balkans lost money and savings in recent decades during the transition from a state to a market-driven economy.

Traditional companies need to understand that 1.) equity financing provides additional capital that can promote faster growth and 2.) an equity partner participates in the management of the company and shares in the risk of the business. Relying only on debt financing is an option when a company is growing, however, in a crisis when profitability is decreasing, it can lead to over-indebtedness, which could result in bankruptcy.

Education and promotion are key pillars in building the ecosystem. The promotion of successful private equity transactions encourages companies to seek out equity investments while also attracting investors to the market. In Serbia alone, around 17.5 billion euros (€) of private money that could be channeled into productive venture capital investments idles in bank accounts.

“It was really hard to accept equity partners. When we reached a point that we could, it was again hard to make such a decision. At the time, my brother and I were already co-owners, we weren’t just the sons of the owner. We had a good opportunity. A strategic partner contacted us and agreed not to change the company’s name and instead promote its legacy, which was very important to us. Those were some of the reasons we entered into the process in the first place. During that period, I was also lucky to have known people who had gone through a similar situation. Every single one of them told me that I should either sell a minority part (of the company) or sell it all, since it is very difficult for an owner to sell a majority part of their company, and to remain working there. That is simply not possible in the Western Balkans.”

— Milos Perovic, Former Owner of Termovent



Private Equity and Venture Capital Learning Event in Belgrade, Serbia.

The availability of equity financing is significantly lower in the Western Balkans compared to other Eastern European countries due to the difficulty of attracting anchor investors to the region. Usually, anchor investors are institutions, such as the European Investment Fund (EIF) in Europe, or domestic institutional investors, such as insurance companies, pension funds, and banks. The European Union (EU) through the EIF, for example, placed a significant amount of funds through the Jeremiah Program, which has channeled €100 million in private equity and venture capital funds in Romania and more than €200 million in Bulgaria. Other countries that have recently become EU members also benefitted significantly from such initiatives, leaving Western Balkan countries with few to no anchor investors.

Legal barriers slowed the private equity industry's growth in the Western Balkans. Insurance companies and pension funds, traditionally the primary first investors, are prohibited from investing in VC and PE funds.

Western Balkan countries are too small to attract investments on their own. Growth in the equity financing industry requires a regional approach to attract anchor investors or pioneers eager to share in the early successes in the Western Balkans. Western Balkan countries are too small to attract investments on their own. A regional opportunity would help encourage institutional investors to seriously consider investments.

IMPACT

CATALYZE EoG surpassed Year 2 targets and expects to meet overall project private capital mobilization (PCM) targets:

\$46M
Private Capital Mobilized in
Total

\$5.8
Private Capital Mobilized to
W-SMEs

RECOMMENDATIONS:



- Raise awareness around equity financing. For the market to function properly, all parties involved need to understand what equity financing is and what it is not. This includes education on the private equity transaction process as well as financial literacy activities designed for non-institutional investors (companies) and the (target) companies.
- Reform regulations to remove constraints that forbid institutional investors (insurance companies, pension funds, banks) from investing in private equity and venture capital funds. A legal market assessment study can be a useful basepoint for the coordination of regulations in the Western Balkans.
- Introduce tax incentives for legal entities, similar to existing ones for physical persons.
- Share and promote SME success stories to increase uptake of equity investments. This can encourage companies to seek out this type of investment and attract investors interested in finding productive investment opportunities.
- Build the ecosystem using a regional approach (Western Balkans) to attract investors. It will take time for private individual investors and companies to recognize the potential in PE and VC funds. Institutions, such as the Innovation Fund in Serbia and regional programs like EoG, can play a key role in catalyzing the ecosystem in the Western Balkans.

USAID CATALYZE (2019-2027) is a \$250 million contract designed to mobilize \$2 billion in private capital towards underserved sectors, geographies, and populations across 28 countries in Africa, Asia, Latin America and the Caribbean (LAC), and Europe.

CATALYZE, implemented by Palladium, co-creates with Missions, Bureaus, and Independent Offices (MBOs) to design multi-year, results-based activities that are managed by Palladium and implemented by a broad network of principally locally led implementing partners.

FOR MORE INFORMATION

Contact CATALYZE:

catalyze.comms@thepalladiumgroup.com

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