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THE ROLE OF THE VENTURE CAPITAL AND PRIVATE EQUITY FUNDS IN THE FINANCING OF SMALL AND MEDIUM-SIZED ENTERPRISES IN CROATIA IN THE PERIOD 2021-2025

Emanuel Pelajić, mag.oec.

emanuelpelajic@gmail.com

Mr.sc. Zrinski Pelajić

Illyricum savjetovanje d.o.o., Samobor, Hrvatska

zrinski.pelajic@gmail.com

ABSTRACT:

Venture capital (VC) and private equity (PE) funds are essential for driving economic growth, particularly in the early stages of small and medium-sized enterprises (SMEs). This study aims to investigate the impact of VC and PE funds on SMEs in Croatia from 2021 to 2025. By conducting primary research through structured interviews with five active VC and PE funds in Croatia, the study will provide insights into the role of risk capital financing in SMEs' development and funding requirements. Additionally, the article will explore the broader context of VC and PE funding in Europe, including the industries that receive primary investments and the preferences for disruptive technologies. The research will also examine the stages of companies that attract investments, the average investment size, the average return on investments, and the future outlook for VC/PE investments. The findings will contribute valuable insights into the potential of VC and PE funds in supporting the growth and development of SMEs in Croatia.

Key words: risk capital, venture capital funds, private equity funds, small and medium-sized enterprises, financing

1. DEFINITION OF RISK CAPITAL FINANCING

In the upcoming chapters, the author will delve into the concept of risk capital, which pertains to funds invested in start-ups and SMEs exhibiting high growth potential. Venture capital (VC) represents a specific type of equity investment made in young companies by dedicated venture capital funds, wealthy individuals known as angel investors, and institutions like pension funds. On the other hand, private equity (PE) encompasses a broader category that includes all institutional investments made into risk capital with a medium to long-term perspective (Manigrat & Sapienza, 2017).

While VC is a subset of PE investment, it is commonly defined as the infusion of capital stock or convertible securities into unlisted companies showing promising growth prospects. One of the key advantages of risk capital financing is the commitment to business development with a focus on the medium to long-term investment horizon. This approach provides these companies with a solid and flexible capital base for future growth. However, it's important to consider the limitations, such as relinquishing some control over decision-making and the necessity to share ownership with the investing fund.

The two main types of venture capital are informal and formal risk capital, with the latter further divided into VC and PE. These stages of risk capital financing encompass the journey from pre-seed funding to the eventual exit of the investment. Funding sources include self-funding, support from family and friends, business angels, and institutional investors like VCs and PEs.

While private equity and venture capital are often used interchangeably, they have distinct differences. Venture capital is a subset or cluster within the broader concept of private equity. VC involves injecting capital stock or convertible securities into unlisted companies with high growth potential, with a focus on developing new products, services, technologies, and market strategies in the medium to long term. Professional investors take on risk equity investments in such companies to create value and generate rewards in the form of capital gain and dividend yield. The ownership share is temporary, minority, and aims at fostering the company's growth and increasing its overall value.

On the other hand, private equity refers to all institutional investments made into risk capital with a medium to longer-term perspective. The primary goal is to enhance the company's value over time, leading to a greater capital gain upon disposal. These definitions can vary depending on the entrepreneurial system and market development, providing a wide array of investment opportunities. Although there have been attempts at terminological harmonization in recent years, older definitions still hinder a comprehensive understanding of the differences between private equity and venture capital globally (Gallo & Verdoliva, 2022).

2. IMPORTANCE OF THE SMALL AND MEDIUM-SIZED ENTERPRISES FOR EU AND CROATIA

Smaller companies play a crucial role in driving economic development worldwide by creating jobs, introducing new products and services, and contributing to overall economic growth. In Europe, these smaller firms make up 99.8% of non-financial businesses and employ around 100 million people, accounting for more than half of Europe's GDP. They are essential in every sector of the economy and bring innovative solutions to challenges such as climate change, resource efficiency, and social cohesion. SMEs are known for their agility and ability to adapt to change quickly, making them key drivers of innovation. Many of these enterprises have high growth potential and offer fresh ideas and compelling products or services. The COVID-19 pandemic has accelerated the need for digitalization, and European firms are striving to catch up. Additionally, climate change impacts and limited access to funds have hindered investment for some companies. To address these challenges, targeted financial incentives can promote transformative investments in digitalization and climate change, ultimately enhancing Europe's competitiveness.

3. VENTURE CAPITAL AND PRIVATE EQUITY FUNDS MARKET TRENDS IN CENTRAL & EASTERN EUROPE

Over the past two decades, the private equity (PE) and venture capital (VC) industry in Central and Eastern Europe (CEE) has experienced steady growth, despite facing challenges like the global financial crisis. Now, the sector is poised for further development, benefiting from the region's strong growth potential and integration with the EU single market. CEE offers a unique set of advantages for investors, including a skilled and cost-competitive labor force, opportunities for intra-regional consolidation, and proximity to Western European markets. Additionally, the stability and legal certainty provided by the EU membership of all 11 CEE countries make the region an attractive destination for PE and VC funds compared to both more mature Western European markets and more volatile emerging markets in other regions.

The rapid growth of the PE and VC industry in CEE can be attributed to the region's robust economic performance, abundance of talented workers, and appealing investment prospects. The 11 EU member states in CEE collectively have a substantial GDP of €1.3 trillion and a population exceeding 100 million. Furthermore, their EU and NATO membership ensures access to development funding, rule of law guarantees, and political and economic stability. Nevertheless, the region does face some challenges, such as less developed infrastructure, more complex regulatory environments, and the impact of the conflict in Ukraine. These factors can influence the attractiveness and profitability

of PE and VC investments in certain sectors and countries, necessitating careful consideration of risks and opportunities by investors to tailor their strategies accordingly.

According to Bain & Company's report, PE investments in CEE have been on a steady rise since 2014, following the global financial and eurozone crises. However, they have not yet reached the levels observed in the global PE market, suggesting potential for convergence toward international benchmarks. Despite this, the CEE region's maturing PE ecosystem, characterized by experienced general partners (GPs), entrepreneurs, and managers, is better equipped to accommodate capital. As a result, emerging opportunities will contribute to the deal flow for both regional and international GPs.

4. EMPIRICAL RESEARCH ON THE ROLE OF VENTURE CAPITAL FUNDS AND PRIVATE EQUITY FUNDS IN THE FINANCING OF SMALL AND MEDIUM-SIZED ENTERPRISES IN CROATIA IN THE PERIOD 2021 – 2025

Data in this research were collected through a structured interview and questionnaire to respondents from VC and PE funds out of the selected sample. The sample consisted of VC and PE fund management companies registered in Croatia, which invest in Croatian SME's.

The author of the article conducted qualitative and quantitative primary research on the topic of the Role of Venture Capital Funds and Private Equity Funds in the financing of Small and medium-sized enterprises in Croatia in the period 2021 – 2025.

The research was conducted through holding online and in-person structured interviews with five (5) Venture capital and Private Equity funds; i.e., with the partners and representatives of the VC and PE funds. Hereby, it is shown in detail the structured questionnaire which was created to guide the partners and representatives of the VC and PE funds in order to get the best possible answers and primary research results. The structured questionnaire consisted of a total of 18 questions intended for representatives of VC/PE funds that participated in the research. It offered respondents the possibility to give one or more answers.

In the following sub-chapter 4.1., a total of 11 answers are presented with textual interpretation.

Sub-chapter 4.2. presents the remaining 7 responses from representatives of VC/PE funds in textual form.

Venture capital and Private equity funds, that participated in the empirical research, and which operate in Croatia were:

1. Feelsgood Capital Partners,
2. South Central Ventures,
3. SQ Capital,
4. Fil Rouge Capital,
5. Prosperus Invest.

4.1. RESEARCH RESULTS – PART ONE

VC/PE funds mostly invested in Software and IT services, while Healthcare, Media and Entertainment, Consumer Products and Services, and Biotechnology were a bit less represented by investments but are also important in the research sample. One fund also invests in Longevity sector, and one fund investment orientation is sector agnostic.

While mostly invested industries that are represented in the primary research sample were Software and IT services, regarding disruptive technologies there was a bit more diversified portfolio of investments. Mostly funds were invested in AI & machine learning, Fintech and Supply chain technology, but also important technology industries that are represented in the model are Healthtech, Property tech, Agritech, Adtech and above-mentioned Longevity.

When it comes to SME's development stages, interviewed VC and PE funds mostly invested in Seed, Series A and Pre-seed stage. In some smaller amount they also invest in Series B, Series C & beyond stage, but there was also one fund which declared itself stage agnostic.

During structured interview, two of the VC/PE funds outspoke that the average size of their investments in SME's was from 100.000 EUR to 500.000 EUR, and two other VC/PE funds said that their average size of investments was 500.000 EUR to 1.000.000 EUR. One VC/PE fund stated that their average size of investments was above 5 million EUR.

Regarding VC/PE fund's average return on investment in SMEs they've invested in over the past 5 years. Return on investment was shown in the form of Internal Rate of Return (IRR). Three out of five VC/PE funds had Internal Rate of Return (IRR) 15-20%, one of them had IRR 10-15%, while one of them declared it had IRR 5-10%. None of them had IRR less than 5%.

Regarding the ESG (environmental, social, governance) paradigm, 80% of VC/PE funds (four VC/PE funds included in the research) implement ESG into their business activity while investing into SME's and one VC/PE fund declared that it does not care about ESG sustainable goals due to the reason that it raised capital from private investors.

Most of the VC/PE funds mainly use combination of following risk management and risk mitigation methods when investing

- Diversification of portfolio
- Method of carefully evaluating the potential for success
- Method of investing in industries with stable market conditions
- Method of investing in SME's with experienced management teams with proven track-record.

Some of the VC/PE use only some of the above-mentioned methods in order to manage and mitigate risk when they invest in SMEs.

Methods by which VC/PE funds measure the performance of their fund managers was questioned through:

- Financial returns
- Fund size and assets under management
- Investment portfolio composition

Three of the VC/PE funds measure the performance of the fund managers through financial returns that are gained through investments, two of the funds measure it through investment portfolio composition, while one VC/PE fund uses the method of the fund size and assets under management, managed by fund managers.

Regarding the outlook, 80% of the VC/PE funds are positive and optimistic about the future after the so called „Nuclear Winter“ in the VC/PE investments (caused by the pandemic of the COVID-19 virus, disruptions in supply chains, the political crisis caused by the war in Ukraine, energy crisis, high inflation etc.), while cautiously optimistic is 20% of the researched sample.

Two of the VC/PE funds are already implementing modified investment strategies, while two of them are not considering to modify investment strategies at all. One of the VC/PE funds is planning to modify investment strategy and will try to assimilate investment strategy to existing business environment as best as possible.

Most of the preferred exit strategies are in the following sequence:

1. Strategic sale/corporate acquisition (80%)
2. Sale to another fund (40%)
3. All the above (20%)

It is indicative that none of the surveyed VC/PE funds mentioned Secondary sale or IPO as one of the exit strategies. It can be assumed that the reason lies in the fact that interviewed VC and PE funds mostly invest in Seed, Series A and Pre-seed development stage of SME's.

4.2. RESEARCH RESULTS – PART TWO

Roles of the people engaged and responsible in the performance of the VC and PE funds who were interviewed in the primary research through structured interview are:

- **Partners:** play a crucial role in the success of VC and PE funds. They are typically experienced professionals who oversee the overall investment strategy and decision-making process. Partners are responsible for identifying potential investment opportunities, conducting due diligence, negotiating deals, and providing strategic guidance to portfolio companies. Their expertise and network of contacts are instrumental in driving the fund's performance.
- **Principals:** also known as investment principals or investment managers, hold a significant responsibility within VC and PE funds. They work closely with partners and are involved in the day-to-day management of the fund's investment activities. Principals participate in deal sourcing, evaluation, and execution, conducting detailed financial analyses, market research, and due diligence. They contribute to investment recommendations and assist in negotiations with potential portfolio companies.
- **Analysts:** provide essential support to partners and principals. They are responsible for gathering and analyzing data, preparing financial models, conducting market research, and assisting with due diligence. Analysts play a vital role in assessing investment opportunities, performing industry and competitive analysis, and generating investment reports and recommendations. Their contributions help inform investment decisions made by partners and principals.

The structured interviews conducted during the primary research were primarily held online, utilizing digital communication platforms. However, some interviews were also conducted through face-to-face meetings, allowing more in-depth discussions and personal interactions with the interviewees. This mix of online and in-person interviews provided a comprehensive understanding of the roles and responsibilities of the individuals involved in the performance of VC and PE funds, market trends of the VC and PE market in Croatia, and the role of VC and PE funds in the financing of SME's.

What percentage of your investments in VC/PE funds are allocated to SMEs?

When asked this question, respondents from all VC/PE funds answered that it was more than 40%, which was the highest percentage offered. The above can also be considered as proof of the correct selection of the target group of respondents.

How do you evaluate the potential for growth and success of SME's when considering investment opportunities?

When asked this question, respondents from all VC/PE funds answered that they evaluate the potential for growth and success of SME's when considering investment opportunities based on financial projections, industry analysis, management team evaluation and market trends.

How important is the involvement of the management team in your investment decision in SME's through VC/PE funds?

When asked this question, respondents from all VC/PE funds answered that the involvement of the management team in their investment decision in SME's is extremely important.

How do you stay informed about the latest trends and developments in the VC/PE industry when investing in SME's?

When asked this question, respondents from all VC/PE funds answered that they stay informed about the latest trends and developments in the VC/PE industry when investing in SME's by all of following means: Industry publications and conferences; Networking with peers; Online research and analysis.

What role does diversification play in your investment strategy when investing in SME's?

When asked this question, respondents from all VC/PE funds answered that diversification does play very important role in their investment strategy when investing in SME's because: diversification is important in reducing risk; diversification helps to maintain a balance between risk and reward and because it increases exposure to a wider range of opportunities.

What are your expectations about fundraising in the period until 2025?

When asked this question, respondents from all VC/PE funds answered that fundraising in the period until 2025 will improve.

What are your expectations about investment opportunities in SME's in the period until 2025?

When asked this question, respondents from all VC/PE funds answered that their expectations are that investment opportunities in SME's in the period until 2025 will increase.

5. CONCLUSION

Research on the transformation of Croatian SME's in new market conditions shows that Croatian startup ecosystem is still at an early stage of development, bearing in mind that almost 90% of startups have been operating for five years or less and have up to ten employees, with 62% of startups having received investment to develop their business and 50% generating income. Notwithstanding of that, there are examples of extremely successful startups such as two unicorns Infobip and Rimac Cars and over 30 scaleups, which have triggered increased interest from the VC/PE funds on other successful Croatian startups and SME's. These shows that the Croatian startup ecosystem has great potential for future growth. The research suggests that the state should facilitate the creation of additional VC sources to finance startups and provide programs for greater global connectedness and market access (Gasparac et al., 2020).

The data shows that in the period 2018-2020, VC/PE investments in Croatia amounted to 323 million euros, which represented a significant growth compared to the period before that. The growth trend continued in the following years. Additionally, total of 31 Croatian startups have received VC/PE investments between 2017 and 2020. However, there is a lot of room for improvement and further growth. Proof of this is the fact that Croatia ranked 17th out of 32 European countries in terms of the share of private equity investment as a percentage of GDP in 2020 with a share of 0.293% compared to the best-ranked Estonia with a share of 1.282% (Invest Europe, 2021).

The aim of this article was to explore how VC and PE funds affect the SME's by conducting primary research on the role of VC and PE funds in financing SME's in Croatia from 2021 to 2025. Data in this research were collected through a structured interview and questionnaire to respondents from VC and PE funds out of the selected sample. The sample consisted of VC and PE fund management companies registered in Croatia, which invest in Croatian SME's. The structured questionnaire consisted of a total of 18 questions intended for representatives of VC/PE funds that participated in the research.

The research results highlighted the importance of alternative funding sources such as VC/PE in addition to traditional forms of financing for SME's in Croatia. Based on research results, it is expected that the VC and PE market in Croatia is only going to improve in the following period and be of a great importance in funding of the Croatian SME's.

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ULOGA FONDOVA RIZIČNOG KAPITALA (VC I PE FONDOVA) U FINANCIRANJU MALIH I SREDNJIH PODUZEĆA U HRVATSKOJ U PERIODU 2021.-2025.

SAŽETAK RADA:

U ranoj fazi, mala i srednja poduzeća koja su financirana fondovima rizičnog kapitala (VC i PE fondovi) imaju važnu ulogu u poticanju gospodarskog rasta. Ovaj stručni rad temelji se na primarnom istraživanju provedenom putem strukturiranih intervjua kako bi se istražio utjecaj VC i PE fondova na rast i razvoj malih i srednjih poduzeća u Hrvatskoj. Također, analizira perspektive financiranja takvih poduzeća u razdoblju od 2021. do 2025. godine od strane VC i PE fondova. Financiranje rizičnim kapitalom donosi mnoge prednosti i ograničenja za mala i srednja poduzeća, što ovisi o njihovoj razvojnoj fazi i financijskim potrebama. Razumijevanjem različitih vrsta i izvora rizičnog kapitala, poduzetnici mogu donositi informirane odluke o mogućnostima financiranja i postaviti se na put dugoročnog poslovnog uspjeha. Metodologija istraživanja uključuje strukturirane intervjue s pet VC i PE fondova koji aktivno posluju u Republici Hrvatskoj. No, rad također razmatra šire perspektive financiranja malih i srednjih poduzeća putem VC i PE fondova u Europi i privlačnost zemalja za privlačenje takvih investicija. U okviru ovog rada istražuju se industrijski sektori koji najviše privlače ulaganja VC i PE fondova, proučavaju se njihove preferencije za investiranje u inovativne tehnologije koje mijenjaju poslovne modele (poput disruptivnih tehnologija) i daju se primjeri malih i srednjih poduzeća koja su već financirana od strane VC i PE fondova. Nadalje, analizira se u kojoj fazi razvoja se nalaze poduzeća u koja fondovi ulažu, kakvi su prosječni iznosi ulaganja, prosječni povrat na ulaganja i perspektive za buduća ulaganja VC i PE fondova. Rezultati ovog istraživanja pružit će korisne uvide u potencijal VC i PE fondova za podršku rastu i razvoju malih i srednjih poduzeća u Hrvatskoj u razdoblju od 2021. do 2025. godine.

Ključne riječi: *rizični kapital, VC fondovi, PE fondovi, mala i srednja poduzeća, financiranje*

