JEREMIE will boost innovation

Judit Karsai on development in the venture capital market

The market for venture capital (VC) and private equity (PE) – essential financing tools for innovation – may still be relatively small in Central and Eastern Europe, but has matured a lot over the past decade and yields better results than in Western Europe. The new "JEREMIE program", initiated by the EU and to be introduced this year, should also give a boost to financing opportunities for small innovative start-up firms.

"Venture capital and private equity are essential for the innovation of an economy," says Dr. Judit Karsai, a well-known expert in Hungary on the issue. Karsai is senior research fellow with the Institute of Economics of the Hungarian Academy of Sciences and heads the statistics committee of the Hungarian Venture Capital and Private Equity Association (HVCA).

Judit Karsai: "VC/PE funds essential for the innovation of an economy." > Photos: Bianca Otero

Start-up and buyout

One of the most important functions of venture capital, she explains, is to enable start-up and early-stage companies to develop and expand after the initial stages of founding the company. Enterprises concerned are mostly innovative and small, coming from all kinds of sectors of the economy, from manufacturing, industrial products and services, and medical and health care, to the computer industry and communications.

PE funds are mainly involved in buyouts, enabling these kind of companies to change their ownership structure in order to grow further. For example, they take over from the original owner after the initial start-up phase if the owner wants to go on and do something new. Funds can also buy out a state-owned financial backer which helped the company in the first development stage or assist a family-owned company which experiences succession problems. And they step in when a big firm wants to sell off a spin-off company. "Banks just provide loans, but do not assist in finding new owners, while VC/PE funds do," says Karsai. Funds generally assist an early-stage company for maximum five to seven years, taking care it's in good shape, and then sell again, either directly (to the original owner, to management, to a third party) or via the stock exchange.

Recently, PE funds in Europe are also becoming more and more involved in "exits", where enterprises listed on a stock exchange are being delisted, reorganized and/or split up so they become more valuable, and then sold – in parts or as a whole – to a trade investor or brought back to the stock exchange. A recent example is Hungarian BorsodChem, which was bought up in 2006 by investment fund Permira.

The number of venture capital and private equity investment deals in Hungary and the total amount concerned has been consistently growing over the past decade. The top year until now was 2006, when VC/PE deals were good for 0.596% of GDP in Hungary. This is only half or a

> Academic in a world of business

Academic Judit Karsai is the foremost expert on venture capital and private equity in Hungary, playing a prominent role in the Hungarian Venture Capital and Private Equity Association (HVCA) and advising parliament, government and companies on issues concerned (such as the new regulation introduced in 2006 and the current introduction of the Jeremie program). By her own account, it was the right decision at the right time which brought her to this prominent position.

"In 1994, I wrote my dissertation on management buyout activities in Hungary after the change of system in 1990, which was an important form of privatization in those days. That got me in touch with the venture capital phenomenon, which is also instrumental in buy-outs. I noticed that nobody else in Hungary was dealing with this subject. There was no data, no research, nothing. So I decided to specialize in the issue and with a lot of success for me personally."

Her position as head of the statistics committee of the HVCA since 2000 is advantageous to both sides, she says. "My independence is vital for the association, while for my scientific work it is very good to be in touch with all the main players in the market, through conferences and interviews, and to have access to all the data, a lot of it confidential."

Karsai has been a senior research fellow at the Academy of Sciences since 1982, after graduating at the then Karl Marx University of Economics, and has participated in numerous joint international research activities, and several projects supported by the World Bank and the EU. When asked whether she herself ever considered going into business, she declines. "You have people who like to read and research, and people who can make snap decisions and go for it. I'm not a business kind of person."

Two subjects currently feature high on her working agenda. Firstly the association has started cooperating more closely with the European Private Equity and Venture Capital Association (EVCA), setting up a new, European database. "It is a lot of extra work, but it will mean we will have more and more accurate data to our disposal," Karsai says. In her research she wants to focus on the position (or lack thereof) of institutional investors in the VC/PE market in Hungary.

Judit Karsai: "My independence is vital"

third of deals in countries like Sweden, and Britain, but it is on the same level as Belgium or Ireland and considerably more compared to Spain or regional peers like the Czech Republic and Poland.

In 2007 VC/PE funds in the Central European region had amassed €2.8 billion for investments, double the amount in 2006. In that year there were 39 transactions in Hungary with a total worth of €534 million, while from January to October last year there were 12 transactions to the amount of €366 million. And though the final data on 2007 is not known yet, "I do not exclude that the total worth of transactions will be close to the 2006 figures," Karsai says.

JEREMIE

A clear negative trend in the 2007 figures for Hungary is the sharp fall in the number of small deals (under €1 million). There were 32 in 2006 and only seven last year. But this is solely due to the temporary fall in support from the state, which is traditionally very much involved in this financially most-risky segment of the market, Karsai says. The five state organizations concerned, the Hungarian Development Bank among them, had depleted their financial resources for this goal, set aside in 2002/2003, she explains, but because revenue of these investments hadn't yet come in, "they had few funds to spend in 2007."

This was obviously bad for start-up companies, but the situation will probably be different this year. Beside the old state-owned funds' activities in this field the EU-initiated JEREMIE program (Joint European Resources for Micro to Medium Enterprises) is being set up. Under JEREMIE, money from the EU and the Hungarian state will go into a "fund of funds", which in turn will divide it among five to ten new funds, explains Karsai. These last funds, which need to acquire 30% of private financing as well, do the actual selection of small companies to invest in. There is Ft 40-50 billion in EU support set aside for JEREMIE projects in Hungary for the period 2007-2013, and each selection fund will handle a maximum of Ft 5 billion with a ten year duration.

"It is a good development because it means an end to a situation where state officials were deciding whether a new company is viable or not, though they often didn't have the competence to do so," Karsai says. "These officials were also not able to give start-up companies assistance in other fields, like contacts, management advice or an entrance to other sources of finance, and these new funds will. Finally, there will be competition for financial sources, which should improve the quality of projects financed. All in all, the JEREMIE program should make the venture capital market for small investments more sustainable and boost innovation."

JEREMIE may also be more accessible to the more risky start-up investments, says Karsai. The old state-supported funds shied away from these, she says, while there are also not many business angels – private investors willing to take big risks with their money for projects they believe in – on the Hungarian scene. Business angels are important in that they prepare these kind of start-up companies for institutionalized VC funds, which typically only step in when there is some track record to go by. "There are some business angels in Hungary, but not too many and they stay out of the limelight," says Karsai. In Western Europe there are not only many more, but there are even networks operating, selecting projects and matching start-ups with the right financial supporters. "It is a question of time until this will be the case in Hungary, too," says Karsai, "a question of maturity of the Hungarian economy."

Institutional investors

The first law in Hungary dealing with the subject came into force in 1998, but that was "an incredibly bad law, impossible to abide by and with a lot of disadvantages for funds wanting to invest," says Karsai. "Frankly speaking, politicians had no clue what venture capital was about." New and very much improved legislation was introduced only in the beginning of 2006. This new law changed those regulations which were hostile to VC/PE funds. A supplementary government decree also allows institutional investors – pension funds and insurance companies – to invest up to 5% of their capital in venture capital funds. It was hoped that this would lead to a boost in development of Hungarian funds, and in turn to more VC investments in Hungarian companies requiring between €2.5 and €10 million, the mid-size segment of the market which is still very much underdeveloped. "But until now expectations haven't come true. These institutions are still not interested in these kind of risky businesses," Karsai says.

Higher returns

For years, Hungary was the leading country in the region as far as VC/PE was concerned, mainly because the country was the first to start with large-scale market-based privatizations. It meant VC/PE funds – big international funds like Advent International, Mid Europe, Riverside, or AIG New Europe – established offices in Budapest first, Karsai explains. "After the other countries started privatizing too, in the late '90s, these countries started catching up, and investment funds opened offices all over the region.

Today, Poland clearly provides the best opportunities for venture capital. It is the biggest market in the region and the Warsaw Stock Exchange is much more active then the Budapest Stock Exchange, which is important for the exit strategy of funds." Hungary maintained an important position in the region as the country with the longest experience with VC/PE, Karsai says, but today funds are all operating on a regional scale.

Western Europe still has a much bigger VC/PE market: more deals, more money involved, more experience. But the competition is much stronger too, so Pan European funds, many of them based in London, had to look for new markets and came down here to invest.

In fact, many funds have recently allocated bigger staff to their regional offices, Karsai says. "The region turns out to be a very promising emerging market, where big and exclusive deals can be made and returns are higher than in Western Europe, as EBRD statistics show. Also, the distance to the home country is not too big, the business culture and the legal backgrounds are alike, and we're within the EU. We might now be entering a new stage of development, in which global funds like Blackstone, KKR and Permira will start pressuring the regional ones for the biggest deals."

Judit Karsai: "Big and exclusive deals can be made and returns are higher"

> Henk Hirs