# THE VENTURE CAPITAL MARKET IN THE SLOVAK REPUBLIC

**Ing. Jaroslava Hečková – Ing. Zuzana Hrabovská**
**Business Management Faculty in Košice, University of Economics in Bratislava**

**Along with the current worldwide trend towards a knowledge economy – much of the value of which should be ensured by the generation, diffusion and utilization of knowledge – it is important that financial support is provided for research, development, and innovation. Given the considerable constraints on public funding for research and development, venture capital is in advanced countries the most widespread and most important form of innovation financing. This article was compiled as part of the project VEGA 1/2582/05 Development Trends in Sources of Financing for Slovak Enterprises following EU Accession.**

## Venture capital as a specific source of innovation financing

Venture capital is invested by professional venture capital firms in the start-up, development, or transformation of private companies that show growth potential. Venture capital may also provide value added in the form of advice on the company's overall strategy. The relatively high risk inherent in the investment is compensated by the prospect of high returns.

In essence, venture capital consists exclusively of an investment in the share capital of a company with growth potential. For what is often a sizeable investment, the investor acquires a significant interest in the share capital of the company, keeps it there for the long term, and, in cooperation with the company's management, seeks to increase its value substantially. In this way the investment appreciates, and the investor is then in a position to sell it for a profit and recycle the money in other projects. Returns are reaching a limit of around 30% per year and that is even in countries where the price of capital fluctuates in the region of 10%. Therefore the coexistence between a company and venture investor is a process of several years.

Investments in venture capital may be broken down according to several aspects (the development stage of the target company, the specialization which the venture capital is oriented towards, the method of divestment). Most frequently, venture capital is broken down by the stage of the target company's development. The breakdown of venture capital by development stage is summarized in Table 1.

As regards the financing of research and innovation, the key venture capital investments in the stages of the innovation cycle are seed capital, start-up capital, and expansion capital.

Since banks in the European Union generally have a very limited understanding of the specific needs of start-ups, the high-risk investments in such ventures must be found elsewhere. In the private sector, this involves equity or venture capital invested on the principle of high risk and profit. From the various types of venture capital investments, the most optimal for start-ups is early stage development capital, comprising seed

**Table 1 Characteristics of different types of venture capital investments**

| Purpose of investment in company | Type of investment | Duration (years) | Expected return (% per annum) | % of companies offering this type of financing |
|---|---|---|---|---|
| Initial activities | *Seed Capital* | 7 – 12 | up to 100% | 1 – 2% |
| | *Start-up Capital* | 5 –10 | 35 – 50% | 5% |
| | *Early Stage Development Capital* | 4 – 7 | 30% | 10% |
| Expansion, development | *Later Stage Development-Expansion Capital* | 2 – 5 | 25% | 50% |
| Survival | *Rescue Capital* | This is not a standard type of venture capital investment. It is used in combination with debt replacement capital. | | |
| Change of ownership | *Acquisition Capital* Management buyouts | 2 – 4 | 20 – 25% | 100% |

Source: European Venture Capital Association, http://www.evca.com.

capital and start-up capital. Seed capital is provided for the early stages of a business (market surveys, business plans, selection of a management team, establishment of the company), often with the company as such still not in existence, while start-up capital is used to finance the initial activities of an established company. This basically involves the financing of companies which have been in business for less than three years and are not making a profit, but which have the potential for further growth. These are mainly new technology-based firms (NTBFs). Cooperation between the management and the venture investor can substantially ease the start-up's breakthrough into the market and shorten the time until it begins to turn a profit. From the venture investor's view, seed capital and start-up capital represent a considerable risk. That is why this type of financing is engaged in by only a very small proportion of venture capital firms (according to EVCA, around 1-2% provide seed capital, and approximately 5% start-up capital). For investment in the expansion and further development of functioning companies that have high potential to penetrate new territories, there is later stage capital (development-expansion), which is, according to EVCA, the most usual focus of venture capital. This method of financing is provided by as much as 50% of the entities in the EU venture capital market.

The investment of venture capital in order to rescue a company – rescue capital – is not a standard venture capital investment. This type of financing is typically combined with other types of venture capital, for example, with management buyout financing. This is often also related to debt replacement capital, a high-risk investment made in companies whose high share of borrowed funds is having a strongly adverse effect in terms of interest expenses and is thereby causing a cash-flow collapse.

The type of venture capital investment also depends on regional differences. This fact is influenced above all by the economic and political situation in a region and the degree of risk which the venture investor is willing to undertake.

Seed capital is used to a very small extent in continental Europe. One reason why this type of venture capital investment has so far had little success is the type of national financial system. In the EU, except in the United Kingdom and the Netherlands, it is banking institutions that provide the major share of finance for business investments. As has already been mentioned, banks are not willing to fund start-ups, mainly owing to the high risk of undercapitalization, or insufficient expertise in handling bank loans. Likewise, no commercial bank in the EU is ready to accept intangible assets, e.g. intellectual property, as a guarantee for a loan. Unlike banks in the EU, banks in the United States have their own specialists for start-ups (especially for NTBFs), who cooperate with "business angels" (informal venture capital) as well as with institutional investors (formal venture capital).

Venture capital investments have developed over recent years into an intricate and complex investment instrument demanding a high degree of risk management. Developed venture capital markets involve a large number of entities, which may be categorized in a simplified way into three groups:

• Venture investors – including institutional investors,[1] private persons (business angels),[2] corporate investors,[3] and the state or government-supported organizations.[4]

• Customers – the actual target groups seeking sources of financing.

• Venture capital funds – active venture investors serving as a link between the previous two groups. The venture capital market could not exist without such funds.

In the European Union, as a rule, informal venture capital[5] (private persons and firms) appear mainly at the early stage of the investment and innovation cycle, while formal venture capital (institutional investors) enters only at the expansion or closing stages of the cycle. This is related with regulations on portfolio diversification and risk management for institutional investors.

Results from the European Union and the United States indicate above-average returns for venture capital funds over the long run. The returns on risk investments come mainly in the form of capital income, and to a smaller extent as share in profit, or dividends. The higher appreciation of venture capital investments reflects the greater degree of risk in a company that has a higher probability of failing or going into bankruptcy. Nevert-

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1 Institutional investors operating on the risk capital market include banks, pension funds, and insurance companies. These financial institutions invest funds entrusted to them into venture capital funds or they themselves establish such funds.

2 Business angels are natural persons making investments with their own capital. This type of investor is often the only hope for highly eligible start-ups.

3 This concerns cases where large enterprises take a venture capital-like approach to the company's internal environment, or they invest money with specialized venture capital funds (e.g. funds investing in new technologies).

4 Government-supported organizations are entities that have obtained funding either directly or indirectly from state sources. They are mainly entities tasked with supporting small and medium-sized enterprises.

5 In the United States, the volume of informal venture capital is 20 to 40 times higher than that provided by institutional investors. It should be added that as stress is being placed on the liquidity of investments in regard to investors, so a shift can be seen towards a larger share of formal risk capital. By comparison, the greatest volume of informal risk capital is concentrated in the United Kingdom, where it is applied in the closing stages of the investment cycle.

heless, venture capital represents the most widespread form of financing for research and innovation.[6]

## The position of venture capital in Slovakia Characteristics and potential of the Slovak market

At present, fewer than ten venture capital firms are registered and active in Slovakia. The first companies established for the purpose of making venture investments were the Slovak-American Enterprise Fund (SAEF) and the Seed Capital Company, s.r.o. At their initiative, the Slovak Venture Capital and Private Equity Association (SLOVCA) was established at the end of 1995. This was made possible with a grant from the SAEF. The main objective of SLOVCA was to raise awareness about the accessibility of venture capital among business people, investment and banking institutions, economic, political and administrative bodies, and the rest of the public in Slovakia. Given the minimal use of venture capital in Slovakia, it did not carry out its activities between 1998 and 2001.

The venture capital funds currently registered in Slovakia are shown in Table 2.

**Table 2 Venture capital funds registered in Slovakia**

| Name of fund | Portfolio volume | Disposable funds | Capacity of fund |
|---|---|---|---|
| Post-Privatization Fund / EFM | SKK 900 m | SKK 900 m | SKK 1,800 m |
| Slovak-American Enterprise Fund | SKK 400 m | SKK 600 m | SKK 1,000 m |
| Seed Capital Company, s. r. o. | SKK 150 m | SKK 150 m | SKK 200 m |
| Genesis | SKK 148 m | – | – |
| SMEs Development Fund | SKK 40 m | SKK 80 m | SKK 120 m |
| Value Growth Fund | – | – | SKK 680 m |

Source: Slovak Venture Capital and Private Equity Association (SLOVCA), http://www.slovca.sk.

Funds registered outside Slovakia which are interested in investing in the country are listed in Table 3.

Considering the amount invested through venture capital firms, and the number of entities which have used this form of investment, the Slovak market can be summed up as being considerably unsaturated with large potential growth.

According to figures from EVCA and SLOVCA, the amount so far invested in this field in Slovakia stands at SKK 16.5 billion spread among 60 companies. Over the past 7 years, the Seed Capital Company[7] has received requests from SMEs for amounts totalling SKK 9.1 billion, including a highest annual total of SKK 6.3 billion in 2002. Requests for up to SKK 5 million per project accounted for a largest 47% share of the total number, while fully 38% of applicants sought between SKK 5 million and SKK 20 million per project, despite having been informed that the investments were capped at SKK 10 million.

**Table 3 Venture capital funds registered outside Slovakia which are interested in investing in the country**

| Name of fund | Capacity of fund |
|---|---|
| AIG New Europe Fund | SKK 1,800 m |
| Czech – Slovak investment Cooperation | SKK 1,050 m |
| Central Eastern Europe Power Fund | SKK 860 m |
| Advent Central Eastern Europe II | SKK 800 m |
| DGB Ost Europa Holding | SKK 460 m |
| Advent Private Equity Fund | SKK 450 m |
| Accession Mezzanine Capital | SKK 325 m |
| EU/EBRD – GIMV Czech – Slovak SME | SKK 300 m |
| Renaissance Fund | SKK 150 m |
| Raiffaisen EU Enlargement Fund | SKK 70 m |
| Euroventures Danube | SKK 15 m |

Source: Slovak Venture Capital and Private Equity Association (SLOVCA), http://www.slovca.sk.
European Venture Capital Association, http://www.evca.com.

The SLOVCA data[8] is shown in Table 4, providing an overview of investment activities and the total volume of investments in 2002 and 2003 broken down according to three criteria.

As the data makes clear, venture capital is represented to a still relatively small extent in Slovakia; this is evident from the comparatively small number of investments and the total pre-invested amount. It is also apparent from the data that investors have been seeking to increase the share of their investments in high-tech projects. The most important role in the investment of venture capital in the Slovak market has so far been played by state agencies. SLOVCA has not yet recorded

[6] This is confirmed by detailed research carried out in the United States and EU countries by Coopers & Lybrand (PricewaterhouseCoopers).

[7] The Seed Capital Company s.r.o. was established in 1994 by the National Agency for the Development of Small and Medium-Sized Enterprises for the purpose of administering the Start-up Capital Fund under the programme PHARE. It is now administering three funds. In addition to the Start-up Capital Fund, it is in charge of the Start-up Capital Regional Fund, which provides financial support to SMEs in the regions of Banská Bystrica, Košice, and Prešov; the other fund is the Microcredit fund, which is used to finance entrepreneurs in selected districts of Bratislava and Trnava regions. The investments basically consist of direct investments in the share capital of companies.

[8] It is necessary to state that the summarized SLOVCA data do not represent precise statistic in the given area, since several larger funds refuse to disclose their information, or they make investments directly from abroad in individual companies in Slovakia (without SLOVCA's knowledge). The total volume of investments may therefore be higher. According to EVCA's figures, risk capital investments in Slovakia in 2003 amounted to EUR 4.475 million.

**Table 4 Investment activity and volume of venture capital investments in Slovakia in the years 2002 and 2003 (EUR thousands)**

| Criterion | 2002 | | | | | | 2003 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| of investment breakdown | Volume of invest. | % | Number of invest. | % | Number companies | % | Volume of invest. | % | Number of invest. | % | Number of com. | % |
| ***Type of investor*** | | | | | | | | | | | | |
| Independent | 179 | 6.3 | 3 | 16.7 | 2 | 12.5 | 0 | 0 | 0 | 0 | 0 | 0 |
| Dependent | 2 082 | 72.8 | 7 | 33.3 | 7 | 37.5 | 2 791 | 100 | 16 | 100 | 11 | 100 |
| Semi-dependent | 323 | 11.3 | 3 | 16.7 | 3 | 18.8 | 0 | 0 | 0 | 0 | 0 | 0 |
| Public sector | 274 | 9.6 | 7 | 33.3 | 6 | 31.3 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total investments** | 2 859 | 100 | 20 | 100 | 18 | 100 | 2 791 | 100 | 16 | 100 | 11 | 0 |
| ***Investment stage*** | | | | | | | | | | | | |
| Seed | 218 | 7.6 | 3 | 16.7 | 3 | 18.8 | 0 | 0 | 0 | 0 | 0 | 0 |
| Start-up | 564 | 19.7 | 3 | 16.7 | 3 | 18.8 | 0 | 0 | 0 | 0 | 0 | 0 |
| Expansion | 2 077 | 72.7 | 14 | 66.7 | 12 | 62.5 | 2 791 | 100 | 16 | 100 | 11 | 100 |
| **Total investments** | 2 859 | 100 | 20 | 100 | 18 | 100 | 2 791 | 100 | 16 | 100 | 11 | 100 |
| ***Geographical breakdown*** | | | | | | | | | | | | |
| Domestic market | 2 859 | 100 | 20 | 100 | 18 | 100 | 2 791 | 100 | 16 | 100 | 11 | 100 |
| European countries | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Non-European countries | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total investments** | 2 859 | 100 | 20 | 100 | 18 | 100 | 2 791 | 100 | 16 | 100 | 11 | 100 |
| ***of which high-tech projects*** | 541 | 18.9 | 3 | 15 | 3 | 16.7 | 2 012 | 72.1 | 5 | 31.3 | 3 | 27.3 |

Source: Slovak Venture Capital and Private Equity Association (SLOVCA), http://www.slovca.sk.

any significant investment from natural persons (business angels), who could participate mainly in the financing of new companies and especially start-ups. Another issue is that institutional investors, such as insurance companies and pension funds, have a strict ban on investing in start-ups.

Slovakia lags behind the EU average not only in the structure of risk investors, but also in the ratio of domestic funds to foreign funds designated for risk investment, and in the ratio of risk investments made to GDP.[9]

## Conclusion

The provision of venture capital may still be summed up as insufficiently developed and not meeting the needs of companies. With a lack of saturation and high growth potential, the Slovak venture capital market would be able to accept such funds worth tens of millions of koruny. Given that a large percentage of Slovak companies are permanently undercapitalized – substantially restricting their scope for using borrowed funds in the form of bank loans – the supplementation of companies' own funds through venture capital could be an appropriate solution.

Alongside the improved business environment, clarification of ownership relations, upgraded infrastructure, and also Slovakia's membership of the European Union, the interest of foreign investors in Slovak projects has recently been growing. What seems prospective from the view of venture capital are certain manufacturing industries, specifically the chemical, pharmaceutical, engineering, and electrotechnical industries, and also the services sector.

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[9] In 2002, the volume of risk capital in Slovakia stood at 0.011% of GDP, a figure that was by far the lowest among European countries and behind Hungary's 0.026%. In first place was the United Kingdom, where the ratio of risk capital to GDP represented 0.63%, while the European average amounted to 0.28% of GDP. In 2003, the volume of risk capital in Slovakia was already up to 0.016% of GDP and the country moved from last to second last among Central and Eastern European countries (Croatia had the lowest figure of 0.011% of GDP). In 2004, Slovakia reported an increase in risk capital investments, to 0.021% of GDP, and, among EU countries, came ahead of the Czech Republic, Lithuania, Estonia, and Greece. The EU average for 2004 stood at 0.321% of GDP.