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THE IMPORTANCE OF STATE'S ROLE IN THE HUNGARIAN VENTURE CAPITAL MARKET

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─Abstract ─

The presence of state also has an indirect and direct effect on the developement of the Hungarian venture capital market. Indirect effect is realized through the law legislation and the direct one by the operate of the different venture capital firms and funds which invest public financial sources. The main purpose of the direct intervention is to finance the under-capitalized small and medium-sized start-up companies with equity.

The paper examines the Hungarian venture capital market from the aspect of state intervention. It starts with an European overview which summarizes the common and different attributes of state's role in the venture capital market between several European countries. The paper focuses on the Hungarian situation, it describes concisely the effect and efficiency of the governmental instructions which were taken for the legislation of the venture capital market. Using the results of a previous research the paper also examines the characteristics of the direct instructions. The paper decribes briefly the main details of the public-private initiative called JEREMIE-program, which started on the Hungarian venture capital market in the recent past.

Key Words: *venture capital, public policy, equity gap*
JEL Classification: G24

1. INTRODUCTION

1.1. Public intervention in the venture capital market

Several researches were carried out on the positive micro- and macro effects of the external, equity based corporate finance structures, so-called venture capital investments. Previous examinations of EVCA (European Private Equity and Venture Capital Association) gave an account of positive changes in the performance of venture-backed portfolio companies (EVCA, 2001, 2002). Other studies emphasized the economic stimulation effect of venture capital, referring to it's important role in stimulating innovation and increasing employment (Lawton, 2002 and McGlue, 2002). Nevertheless, the main reason why most of European governments think it is appropriate to intervene in the venture capital market, is the need of strengthening the small and medium sized enterprises (SMEs), which often struggle with financial problems. By achieving this aim, the state can promote the economic impulses mentioned above.

Public interventions mainly focus on improving the capital adequacy of start-up or early stage companies, as venture capital is least available for them.[1] In numerous researches, the insufficient supply of capital sources is often referred to as the 'equity gap'. According to Lawton (2002), this 'equity gap' occurs in cases where a company's demand for external capital is greater than those that can be met by the small deal specialised investors, but it is also not enough to arouse the interests of those equity providers who operate with larger transactions. This market imbalance can be explained by the unfavourable mismatch between perceived risk and perceived return or by information asymmetries on the demand side. The latter can be derived from the fact that companies, suffering from capital shortfall, are not aware of all the available financial sources, mainly the special constructions. McGlue (2002) and Murray (1999) also mention the lack of good quality projects on the demand side, which also widens the 'equity gap'. Several researches found a connection between the lack of capital and early stage technology-based companies, for which the 'equity gap' problem can be even more significant. Murray (1999) chose the United Kingdom's NTBFs (New Technology Based Firms) to demonstrate the reasons of the financial constraints which have to face these special companies. He stresses the deals' relatively low profitability, the extended investment duration, the managing partners' lack of

[1] The European based venture capital and private equity funds invested 23 billion euro in 2009, from which only 17% was devoted to start up and early stage companies. (EVCA, 2010).

expertise in the given technology field and the relatively high specific transaction costs (Murray, 1999).

After recognising the previously mentioned problems, the primary aim of different government actions should be the termination and continuous decrease of the 'equity gap'. These measures would advance the development of small and medium sized enterprises, primarily the technology based companies. Beside the lack of equity provision in the smaller sized deals, Lerner (2002) stress' the so called 'certification hypothesis' and the positive spillover effects reached by the support of R&D activities as the two main reasons of public interventions. The substance of the 'certification hypothesis' is that the private sector's confidence in so far least supported start-up or early stage companies should be inspired by successful public investment transactions implemented within the 'equity gap'. On the other hand, if the government promotes R&D activities, the benefits of this action could not only appear in the level of the beneficiary firms, but in social level as well.

Generally, regarding to the type of the programmes, public interventions in the venture capital market can be divided into direct and indirect actions. The aim of the first group is to increase the investment capacity of venture capital funds, while the latter ones focus on the development of the venture capital market and the enterprises' operational environment. According to McGlue (2002), the direct means contain different grants (e.g. for covering extra costs), guarantees that reduce the investor's risks, and also debts granted to investment funds. Among the direct measures, Murray (1999) also ranks state initiatives aiming to assume losses from private investors and ensure 'upside leverage' to funds to increase the pool of capital making follow-on investments possible. In contrast with direct actions, the objects of indirect programmes often surpass the development of venture capital market. For instance Aernoudt (1999), showing the deficiencies of the European entrepreneurial culture, sees the importance of indirect public interventions in changing the partners mentality (reduce the lack of confidence) and creating stable fiscal environment. According to Lawton (2002), indirect actions have to concentrate on increasing the transparency of the legislation system and facilitating the access to different financial sources.

Beside the accessible benefits, Lerner (2002) draws attention to public interventions' distortion effect, which may occur when the state execute investments with soft conditions compared to the market or if it prefers to support companies linked to personal interests of several officials' who participate in the decision-making process. In order to avoid crowding out the private sector, Lerner (2002) stresses that public programmes should be structured with market conditions, and in the case of implementation, it should be useful to cooperate with the more experienced private partners.

2. PUBLIC VENTURE CAPITAL PROGRAMMES IN EUROPE

The enforcement of regional approach could help to implement public interventions more efficiently in the venture capital market. As the 'equity gap' is not at the same level in every region it is necessary to consider this difference when structuring public programmes. Actions also have to encourage cooperation between local identities, such as investors, businesses looking for capital resources, universities and research institutes (Sunley et al. 2005). USA is considered as a role model of this cooperation where venture capital market evolved through the clusterization of local partners and enterprises (Heger et al., 2005). Decentralisation of public policies could be an important tool of mitigate regional disequilibrium and establish a more vigorous small and medium sized enterprise sector. The followings describe several public venture capital programmes (some of them with regional focus) including the case of Germany, United Kingdom and Hungary.

2.1. The case of Germany and United Kingdom

The government played a crucial role in developing and strengthening the German venture capital market primarily in the mid 1990s. Public interventions are mainly implemented by direct financing in different ways, such as providing guarantees, refinancing loans and subordinated loans. The two most important participants of these programmes are publicly owned institutions, namely the Kreditanstalt für Wiederaufbau (KfW) and the Deutsche Ausgleichsbank (DtA). After the merger of the two banks in 2003, only the previous one operates as legal successor. KfW's main profile is to ensure public guarantees and refinancing loans especially for German Small and Medium Sized Enterprises. Albeit the bank's role in the venture capital market decreased significantly, its subordinated institution, the Mittelstandsbank is still carrying out investments. The so-called 'SME-Bank' offers financial sources via various programmes for enterprises with revenues under 50 million euro. Within the framework of the ERP Participation Programme, the bank could grant refinancing loans up to 1 million euro for private investors who make investments in early stage companies. Beside the time period ranging 10 to 15 years, the conditions of these loans are far more favourable than the market ones. Along with the programme in 2008 and 2009, Mittelstandsbank allocated 65 and 66 million euro in the German economy through private investors (KfW, 2009). The bank also runs a ‘co-investment’ structured fund, called the ERP Start-Up Fund, which executes equity funding solely in early stage, technology-based SMEs with the partnership of Lead-Investors. Only the half of the required amount can be covered by the Fund with the conditions defined by the private investor. In 2008, the amount invested from the Fund reached 63 million euro, which increased slightly to 71 million euro in 2009 (KfW, 2009).

Researches made in the UK about equity dearth among early stage and mainly technology-based enterprises identified not just the existence of the ‘equity gap’ but its approximate size as well. According to the estimation of the Department for Business, Innovation and Skills (BIS) in 1999, the ‘gap’ existed in the investment range up to £500.000, which was broaden to £2.000.000 (with the lower limit of £250.000) in 2003 (NAO, 2009). The uneven regional distribution of venture capital investments in the UK is also noticeable, which made the BIS to came up with a new, regional oriented public venture capital programme in 1998-99. At the implementation of the concept between 2002 and 2003, new funds (Regional Venture Capital Funds-RVCFs) with a maturity of ten years, were established in each of the nine regions of the UK, aiming to execute venture capital investments in the lower end of the ‘equity gap’. With the positive return gained by the funds the government wanted to incentivise private investors to make deals also in the ‘equity gap’. The 9 RVCFs totally raised £226,5 million, within public contribution of £74,4 million. The remaining amount was provided by the private sector, mainly by banks and pension funds. The funds’ size varied between £12 and £46 million managed by privately-backed general partners (NAO, 2009). Investments were executed in the first five years of the funds which were made mainly in sectors such as information technology, communication and media, other services and manufacturing and consumer goods. The RVCFs funded 356 enterprises with the average deal size of £373.000. Based on data from 31 December 2008, out of the 356 companies a total of 18 profitable exits and a total of 91 write-offs have been made while 247 investee firms were still in the portfolio (NAO, 2009).

According to a survey made by the BIS among businesses that received equity finance through the RVCFs it turned out that most of the firms were satisfied with this form of financing in several ways. They thought that participating in the programme was the only solution for their initial problem and the received venture capital helped them to reach further financial sources. They also mentioned that after the funding, they could expand their revenues, the numbers of their employees, their export activity and the expenses of their R&D (BIS, 2009).[2] An interim evaluation was also made about the performance of the funds, which showed a -15,7% average internal rate of return among all RVCFs at the end of 2008. In comparison to privately-backed funds with the same structure, the average internal rate of return was -0,4%, far more better, than in the case of RVCFs (NAO, 2009). The negative performance can be explained with several factors. According to NAO (2009) the most important factor was the limit of the investment size fixed by the BIS firstly at the amount of £500.000 and then at the level of £660.000 from 2006. Due to the upper limit of individual investments the number of fundable projects was narrowed down making follow-on investments unviable. As the funds' sizes were too small this led to high operational costs which made the maintenance of the programme expensive for the government as well.[3] Although the accurate evaluation of the funds' performance cannot be done until 2013 (at the end of the last fund's maturity) according to NAO (2009), the expedience of the program is already questionable. This is confirmed in interviews made by the BIS (2009), referring to the fact that the programme failed to achieve its initial aim. Although a high amount of capital was allocated to the lower end of the 'equity gap' the RVCFs couldn't draw private investors' attention sufficiently to finance start-up and early stage transactions.

2.2. The case of Hungary

Considering the whole Central Eastern European Region, Hungary has one of the most well developed venture capital market. Taking venture capital investments as a percentage of GDP, in 2007-2008 the Hungarian data exceeded, in 2009 almost reached the average of the Central Eastern European Region's level. In 2007 the annual investment value was 491 million euro, which decreased slightly to 477 million euro in 2008, and decreased with more than half to 214 million euro in 2009, which reflects the negative effects of the 2008-2009 economic downturn (Table 1). Table 1 also indicates that the Hungarian venture capital market is strongly segmented. Buyout deals dominate the value of the investments, while considering the numbers of transactions the levels among the

2 The survey was based on interviews among 90 RVCF investee companies and 15 managing partners.

3 In 2008 the RVCFs' cumulative fund management costs were £46.1 million, 36% of the total amount invested (NAO, 2009).

two stages are far more balanced. According to Karsai (2007), the under-represented case of early stage ventures can mainly explained by the relatively smaller size of the Hungarian venture capital market, the almost total lack of the informal segment and the insufficient regional knowledge of the internationally focused venture capital firms.

Table 1: Several data of the Hungarian and Central Eastern European venture capital market (2007-2009)

Name	2007	2008	2009
Venture capital investments as a percentage of GDP (%)			
Central Eastern European Region	0,19	0,201	0,239
Hungary	0,208	0,422	0,223
Value and number of venture capital investments by stage in Hungary (million euro, [pc])	491 [26]	477 [25]	214 [12]
early stage	2 [6]	2 [4]	1,6 [4]
buyout	422 [9]	455,8 [5]	202,4 [3]

Source: EVCA (2010); HVCA (2010/a); HVCA (2010/b)

With the purpose of alleviating the shortage of equity in early stage enterprises, the Hungarian government also intervened in the venture capital market. The main forms of these policies were direct measures targeting deals under 2,5 million euro. In the mid-2000s, the proportion of publicly backed early stage venture capital investments exceeded both in value and number the proportion of privately backed deals made in the same investment stage (Karsai, 2007). The central institution of government-coordinated venture capital programmes was the publicly owned Hungarian Development Bank Plc., which undertook direct investments until 2005-2006. At present, after some organizational changes, there are several specialised public investment firms and funds which are engaged in implementing venture capital financing. Most of these were established in the early 2000s with an investment focus on deals between 0,04-1,7 million euro to small and medium sized enterprises. The financing period varies fairly among 3-8 years, with the absence of sectoral orientation, although one of the public funds can invest only in the information technology (IT) and communication sector declared. In order to decentralize the public commitments to venture capital investments in the different Hungarian regions, a holding company was also established ensuring financial sources to seven affiliated investment firms with different regional involvement. Albeit these facts prove the state’s strong commitment to maintain a sufficient level of equity on the supply side the efficiency of these direct actions can be questioned. According to Karsai (2007) and the results of a series of interviews made among the most important publicly backed investment firms it is verified that the conditions of public venture capital transactions differ a lot from the terms used by private actors. The investment period is fixed in advance just as the expected rate of return. It is also typical to require collaterals from investee firms and the absence of active monitoring mainly due to the state's minority share of portfolio companies. The commonly used exit method by public investment firms is the sale to the original owners of the enterprises which decreases considerably the prospects of high returns.

The JEREMIE (Joint European Resources for Micro to medium Enterprises) program announced by the European Union's initiative raised the possibility of a more efficient public intervention in the venture capital market. Hungary also declared its intention to participate in the program, which aims to create the possibility of making private-public joint-investments in SMEs in early or expansion stage with high growth potential by establishing (partially) Community committed holding funds. The amount allocated for the programme by the European Union is closely 116,7 million euro, but it must be topped up with an additional 30% from private investors selected by a transparent tender procedure, the so-called 'scoring system'. Considering the previous numbers the total amount of capital raised for the initiative is expected to reach 166,7 million euro (HVCA, 2010/b). The JEREMIE, under the name of New Hungary Venture Capital Program was launched in October 2009 as the 8 winning private management firms were selected. In 2007 for the appropriate allocation of amounts arriving from the Structural Funds, the Hungarian government established the Venture Finance Hungary Plc. (VFH Plc.), which also had the task to build up a strong collaboration with the private fund managers. Two forms of cooperation were realized, the first one was called the 'Joint Fund' and the second one was the structure of 'co-investment'. Joint Fund can be a Hungarian registered venture capital fund, with the maximum maturity of ten years. Up to 70 percent of the fund's raised capital is provided by VFH Plc. (with the minimum of 2,6 million euro and the maximum of 18,5 million euro) and the remaining part is ensured by the given private investor. The allocated amount from the European Union to create Joint Funds totalled at 135,2 million euro for the use of making investments outside Budapest and Pest county. Referring to the program's conditions, several Joint Fund can operate simultaneously, but only one 'co-investment' fund can exist beside them. 'Co-investment' fund is an independent venture capital fund with the maximum maturity of ten years similarly and it is totally owned by the VFH Plc. As a 'pledge fund', it executes investments with private investors providing up to 70% of the total amount required project by project. To create this structure of cooperation, the European Union allocated an amount of 14,8 million euro and it is declared that the fund can only search for investment opportunities in Budapest and Pest county. The remuneration received by fund managers consists of a fixed management fee at 3% based on the fund's current registered capital and a success fee (carry) payable after the termination of the fund if it generated a sufficient level of profit. Financing can happen in the form of equity investment or loan with an upper limit of 1,5 million euro received by the beneficiary company not more than three consecutive years. In order to incentivise the private sector, the public partner limits its rate of return at 15% and also ensures liquidation priority to private partners in the case of winding up portfolio companies. As the tender procedure ended in 2009, the size of the nine funds raised scatter between 14,8 and 23 million euro each. Nevertheless, it is uncertain that funds with the size range mentioned above will be able to finance efficiently the small and technology-based projects which are treated as the priorities of the JEREMIE program (Karsai, 2007).

3. CONCLUSIONS

Although venture capital could play a crucial role in improving capital adequacy of enterprises, it is also obvious that only a few companies can benefit from it, raising the necessity of public interventions in this segment of the financial structure. This need is mainly based on the existence of the 'equity gap', which causes capital dearth especially to early stage, technology-based enterprises. Nevertheless, it is crucial to find the appropriate method and timing of public interventions. Aspiring to avoid the 'crowding-out effect' and other distortions, government has to appear not as a direct investor, rather as a dependable partner who facilitates the operation of private actors. This can be achieved with the resign of decision making to private investors and with other direct measures such as fund leveraging, undertaking a given part of losses and covering a portion of the operational costs. It is important to note that public actions should support not just the demand but the supply side of the market as well encouraging firms to reach the 'investment-ready' status. Indirect means could be useful in this case, considering the creation of business angel and other investor networks, introduction of fiscal incentives and the development of financial structure, which may contribute to the appearance of more good quality projects and to meet the demand and supply side of the venture capital market. It would be also useful to assert the regional approach in order to handle local equity dearth more efficiently.

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