Hybrid Venture Capital Funds in Lithuania: Motives, Factors and Present State of Development

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Substantial body of academic literature agree that the financial constrain is the core problem in developing early stage small and medium sized enterprises (SMEs). Therefore, venture capital through financing and providing value added services is considered to be an effective tool in increasing regions innovation capacity, fostering economic growth as well as job creation. Thus, financing such promising young ventures, especially those with technological background, is encouraged in many countries through various Governments’ initiatives.

A wide range of research explores public programmes in enhancing venture capital markets development in various countries either through direct (when Government invest directly in fund) or indirect (for instance, tax relief, etc.) measures. Therefore the present paper focuses on the direct Government intervention in venture capital market development, through investing in venture capital funds (as the co-investor or limited partner) in order to facilitate SMEs through financing its early stage of development. Venture capital funds, pooled by Governments’ sources, private and institutional investors, aiming to boost investments in early stage innovative companies, are considered as hybrid venture capital funds in this paper.

The article deals with the development of hybrid venture capital funds in Lithuania, which were forced by the European Union (EU) initiative Joint European Resources for Micro to Medium Enterprises (JEREMIE) seeking to increase access to finance the development of SMEs through facilitation of venture capital markets development in various EU regions.

There is lack of research focusing on the factors for efficient public policy intervention in the developing hybrid venture capital funds in order to facilitate early stage SMEs. Thus, the problem of the paper covers the question: what are the motives, factors and present state of development of hybrid venture capital funds in Lithuania.

The present paper will explore the Government’s initiative in Lithuania in terms of JEREMIE initiative. Therefore the paper aims to contribute to research dealing with hybrid venture capital funds’ role in boosting regional economies through the financing the SMEs in their early stage of development.

The paper finds that Lithuanian venture capital market is in its infant stage, and the Governments’ initiative towards creation hybrid venture capital funds definitely will increase the investments in SMEs. Moreover, supply-side, demand-side and macroeconomic factors should be taken into account in the venture capital markets development. And still cautious actions should be set along with the public initiative in order to overcome the negative aspects of venture capital investments, such as lack of transparency, money laundering, etc.

Keywords: Hybrid venture capital fund, small and medium sized enterprises, European Union support, JEREMIE initiative.

Introduction

SMEs have a significant attention in many countries’ policies as it is considered to be an engine for Economic prosperity. Lack of asset, liquidity, information asymmetries are among the focal problems which early stage business encounter with (Sahlman, 1990). Thus, it is the main reason why banks’ loans are not acquirable in this stage of the SMEs development. Therefore venture capital through provision of capital and other value added services plays a significant role in fostering economic growth.

Many scientists agree that Government can foster the economy by creating efficient frameworks for venture capital support (Cumming, 2007; del-Palacio, Zhang, & Sole, 2010), despite that, there are controversial opinions too. Some studies conclude that the Governments’ intervention in venture capital market should be considered more cautiously in terms of facilitating SMEs, not the venture capitalists (Florida & Smith, 1993; Lerner, 2010).

Despite of many researches in the field of venture capital, there is no unique definition of venture capital. Some studies (for example prepared by European Private Equity and Venture Capital Association – EVCA) the terms “private equity” and “venture capital” use interchangeably. The differences between these two terms are significant in the context of the United States (US), because in this perspective, the venture capital refers to equity investments in start-up and early stage investment in private companies, and private equity investments cover later stage investments and buyouts (Cowling et al., 2008; Plage, 2006). Thus, in this article we refer to venture capital investments as a part of private equity investments.

In the context of recent recession, the private equity investment is slightly going up, since the sharp decrease in the third quarter (Q) of 2008. EVCA Quarterly Activity Indicator Q2 2010 depicts that European private equity investments increased in 16 percent, despite that it is still far from the 2007 peak. Meanwhile, the indicator of funds raised remained low and reached the level of Q4 of 2009 (PEREP_AnalyticsTM, 2010). Therefore Government could play an important role in facilitating SMEs through the investments in venture capital funds.
Governments’ intervention in venture capital market was analyzed by many scientists (Bottazzi & Da Rin, 2002; Cumming, 2007; Cumming & Johan, 2009; Da Rin, Nicodano, & Sembenelli, 2006; Jääskeläinen, Maula, & Murray, 2007; Lerner, 2001, OECD, 1997), but still there is lack of research concentrating on the factors for efficient public policy in the developing hybrid venture capital funds for the facilitation of early stage SMEs. Thus the problem of the paper covers the following question: **what are the motives, factors and present state of development of hybrid venture capital funds in Lithuania?**

The paper focuses on the developing of hybrid venture capital funds in Lithuania, which were forced by the EU JEREMIE initiative. In this paper, hybrid venture capital funds refer to pooled money from private and public sources (European Investment Fund (EIF) and Government’s investment) in order to increase venture capital investments in early stage SMEs.

**Purpose of the article** is to explore motives, factors and the present state of developing hybrid venture capital funds in Lithuania in the context of EU JEREMIE initiative.

**The object of the article** covers hybrid venture capital funds development in Lithuania.

**The objectives of the article are as follows:**

1. To reveal the main motives for creation and developing hybrid venture capital funds as the tool to facilitate early stage SMEs.
2. To explore factors influencing the creation and development of hybrid venture capital market.
3. To indentify prerequisites of developing venture capital market and the current state of hybrid venture capital funds in Lithuania.

Research methods cover the comparative analysis of scientific literature, documents and reports as well as statistic data.

The paper is organized in the following manner: first section explores the theoretical background of the paper; section 2 outlines the main factors for developing hybrid venture capital funds and section 3 presents the prerequisites and the current state of venture capital market development in Lithuania, focusing on the JEREMIE initiative. Finally, the paper ends with conclusions.

**Theoretical background: motives for the creation and development of hybrid venture capital funds**

Empirical evidences depict that due to its exceptional feature to provide money and value added services, venture capital became an important agent in the US innovation system (Ferrary & Granovetter, 2009). **Financial gap and market imperfection are the main barriers** for SMEs development (del-Palacio, Zhang, & Sole, 2010; Mason & Harrison, 2003). Financing aspects of SMEs in Lithuania were analyzed by Adekola, Korsakiene and Tvaronaviciene (2008), Adamoniene and Trifonova (2007), Tamosiunas and Lukosius (2009), Daugeliene (2008), and Snieska and Venckuviene (2009, 2010).

The mentioned problem is forced due to the recent recession perspective. Due to economic crisis in many countries lots of investors have lost their ability to cash out their investments, for this reason they are more cautious in investing their money in risky business. For example, Lerner (2010) contends that “(...) financial crisis appears to have had a substantial negative effect on investors’ willingness to finance innovative entrepreneurship”. Therefore the main motives for the establishment and development of hybrid venture capital funds are to eliminate the existing barriers for early stage SMEs. Recent research report on the impact of publicly financed support schemes on firm performance explores that “Hybrid venture capital schemes backed by both private and public sector funding play an increasingly important role in the risk capital funding of early-stage firms with the potential for significant growth” (Nightingale, Murray, Cowling, Baden-Fuller, Mason, Siepel, Hopkins & Dannreuther, 2009).

The growing number of literature in the field of public venture capital financing programs indicates the importance of Governments’ role in enhancing venture capital markets. Small business innovation and research program (SBIR) was scrutinized by Lerner (1999), The Australian Innovation Investment Fund (IIF), which aims to enhance the financing of small high tech companies was analyzed by Cumming (2007), the UK Enterprise investment scheme and Venture capital Trust program were analyzed by Cowling et al. (2008).

According to Florida and Smith (1993), venture capital market does not need help especially from government. They argued that “Federal policy can help stimulate innovation and the growth of high-tech startups - but not by interfering in capital markets” (Florida & Smith, 1993). Having in mind that US venture capital investments are the leading ones worldwide, the government intervention should be addressed more cautiously, but in small countries like Baltic States, the venture capital investments are scares, thus the Governments’ intervention could enhance venture capital investments in early stage SMEs. Research of 15 EU members’ emphasized, that “Larger public participation is correlated with smaller VC industries” (Leleux & Surlenont, 2003). Recent study prepared by Lerner (2010) analyses the entrepreneurial aspects in the context of current recession and it concludes that “(...) the most effective policies are likely those that focus on increasing the efficiency of private markets over the long term, rather than providing a short-term funding boost during periods when the market is already active”.

The literature review indicates the positive aspects of venture capital market. Nevertheless, the recent actions taken in US towards tightening regulation of private equity firms’ showed, that despite positive effects venture capital is also related to lack of transparency, money laundering, etc. Still this aspect in literature is scarcely addressed. Thus, the cautious regulation framework for the implementation of public frameworks towards enhancing venture capital market must be foreseen, in order to get the best expected outcome.

To sum up, various Governments’ initiatives around the world seek to enhance the entrepreneurial environment and improve the access to capital for SMEs. Moreover it is the main motive for Government to invest in venture
capital funds. Despite many scientists’ interest in Governments’ role in the development of venture capital market, there is still a gap in this research scope in terms of factors influencing this process. Thus, the next section will explore the factors for the development of hybrid venture capital markets through the Government’s intervention.

Factors for the development of hybrid venture capital market

Three level factors, which have possible impact on the development of a hybrid venture capital market is discerned and presented further (see Figure 1). Firstly, the venture capital supply-side factors will be presented, and then continued with the venture capital demand-side factors, and finally the macroeconomic factors affecting both venture capital supply and demand will be discussed.

1) Venture capital (VC) supply-side factors. Venture capital supply is the quantity of investors willing to invest in early stage SMEs. The adequate venture capital supply is important factor for driving venture capital funds. The quality of the funds is more important than quantity. For example, Cumming and Johan (2009) emphasized that “(...) impact of government sponsored VC funds depends not only on the design of the program but also on the selection of the VC managers carrying out the investments.” (Cumming & Johan, 2009). Thus, qualified and experienced venture capital funds’ managers are important factor as well (Keuschnigg, 2003; Plage, 2006), because this feature is crucial in the ability to raise fund. Additionally to that del-Palacio et al. (2010) contends that along with previous experience of investors the size of investors is important too.

Recent research by Ferrary and Granoveter (2009), focuses on the role of venture capital in the Silicon Valley complex innovation system and it indicates that venture capital acts like the trigger for interaction between agents (like universities, large firms, research laboratories, VC firms, law firms, investment banks, commercial banks certified public accounts, consulting groups, recruitment agencies, public relation and media) in the innovative cluster.

Active participation of venture capitalists in their portfolio companies was emphasized by Keuschnigg (2003) too. ‘Active involvement’ covers the value added services to a portfolio company in terms of consultation in business development issues, providing business contacts, monitoring (Gompers, 1995), influencing investee’s internationalization (Lockett, Wright, Burrows, Scholes, & Paton, 2008) and professionalization (Hellmann & Puri, 2002).

Recent study (Nightingale et al., 2009) indicates that profile of a company, the scale of the fund and fixed costs have impact on the return on investment (ROI). For example, smaller investment funds encounter with such problems like less risk diversification across the portfolio companies and high fixed costs (which occur during the screening, selection and contracting period) (Nightingale et al., 2009).

![Diagram](image)

**Figure 1.** Factors influencing hybrid venture capital funds development

2) Venture capital demand-side factors. In theoretical discourse one of the main factors for the development of active venture capital markets in order to seek the economic benefits is the demand of venture capital (Plage, 2006; Gompers & Lerner, 1998). The venture capital demand is the number of entrepreneurs willing to acquire venture capital finance. Further, the demand-side factors which have possible influence on the hybrid venture capital funds’ success are outlined.

Qualified personnel and qualified management team are important factors for the companies innovation capacity (Hellmann & Puri, 2002). The ‘critical mass’ of specialists in venture can spur innovativeness and lead to successful implementation of research and development.
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taking the floor through the EU JEREMIE initiative (Radzeviciute, 2010).

Figure 2 bellow depicts a private equity investment (these data represent aggregate data of an early stage investment, later stage investment and buyouts as well) in three Baltic States (Lithuania – LT; Latvia – LV; Estonia – EE). The highest peak of private equity investment was reached in 2007, which was coincident with the boom in European private equity market (mentioned in the Introduction), and in 2008 and 2009 the investments in private equity have significantly reduced.

![Figure 2](image)

Figure 2. Private equity investments as a percentage of GDP in Baltic States (data source: EVCA Central and Eastern Europe Task Force (2008; 2010))

Thus, it is possible that due to EU JEREMIE initiative the investment in private equity particularly in early stage SMEs will improve in upcoming years.

JEREMIE initiative provides financial instruments for SMEs through financial intermediaries (Banks, venture capital firms). The instruments are as follow: microcredit, guarantees, and venture capital and equity type instruments. Important aspect of JEREMIE is the recycling of funds, repayments from financial intermediaries will be invested further (European Investment Fund, 2010). It will set the background for the self sustainable venture capital market in Lithuania.

Implementing JEREMIE initiative debt instruments and equity instruments already have been launched in Lithuania. For the implementation of debt instruments three Banks were selected (AB Staalų bankas; AB SEB bankas and “Swedbank”, AB). Total planned amount for these instruments is 294 million Euros (half of this amount will be provided from EIF). For equity instruments in Lithuania three financial intermediaries are selected: BaltCap, LitCapital and the consortium of “STRATA and MES invest”. The first two intermediaries are for the management of venture capital funds, and the latter is for the management of Business Angels Co-investment Fund.

As Table 1 presents, the total amount of 48.4 million Euros is foreseen for equity instruments. The biggest share of money will come from EIF. It is no doubt that with the help of JEREMIE initiative the supply of venture capital for SMEs will increase significantly in Lithuania.

But still the target SMEs should be selected cautiously in order to seek the biggest effect of public initiative. Recently launched fund “Business angels’ fund I” by the consortium “STRATA and MES invest” already have made two investments in UAB “ART21” and UAB “Nuostabioji Technologija”.

The principal aspect in business angels’ investment scheme is the investment in new equity emission, the maximum amount for one company is around 400 thousands Euros (47.5 percent provided by EIF, 2.5 percent provided by fund manager’s, and 50 percent by business angel) (Radzeviciute, 2010).

Venture capital instrument has not made any investment yet, but as outlined in the official internet websites of funds’ managers’, the business plans evaluation process is started. And few investments will be made soon.

Table 1

| Planned amount for the Equity Instruments of JEREMIE initiative in Lithuania |
|------------------|------------------|-----------------
| **Funds’ Name** | **Equity Instruments** | **Million EUR** |
| Lithuania SME Fund | BaltCap (Fund’s manager) and other sources | 6 |
| | EIF (JEREMIE Holding Fund) | 14 |
| LitCapital fund | LitCapital (fund’s manager) and other sources | 6 |
| | EIF (JEREMIE Holding Fund) | 14 |
| 2) Business angels investments | Business Angels Co-investment Fund (manager Consortium of STRATA and MES invest) | 8.4 |
| **Total** | 48.4 |

To sum up, the venture capital market in Lithuania is in the infant stage and to talk about the present effect on the economy is too early. Secondly, the Government’s role and the EU support in developing a venture capital market is huge, but as literature review revealed it should be just an initiator and not the main actor.

Conclusions

The literature review shows the importance of venture capital market in boosting region’s economy in terms of financing new prospective ventures. In the perspective of recent economic recession the financial gap for SMEs is even bigger. Thus, the vitality of the venture capital markets could be increased by initiating hybrid venture capital funds, where governments’ and private investments are pooled in order to finance early stage business.

Recent researches emphasize that the main motives for the creation of hybrid venture capital funds are to increase investments in early stage SMEs in order to fill the financial gap and overcome market imperfection. Substantial amount of research highlighted that public programs for the inspiration of a venture capital market in order to provide capital for SMEs, must satisfy clearly the target SMEs seeking to overcome the competition problems in the market.

The model presented in the paper revealed that three level factors which have possible influence on the development of hybrid venture capital funds’ are: venture capital demand-side factors; supply-side factors and macroeconomic factors.

To sum up, few common implications for Lithuania and other Baltic States countries must be made. Government’s role in developing venture capital market is huge, but as literature revealed it should be just an initiator and not the main actor and the regulation towards venture
capital market should be taken into account, because despite positive effects of venture capital market on economy, there are negative aspects as well, for example, money laundering, lack of transparency and etc. However, this negative aspect in literature is very scarcely addressed.

References


Atlikti tyrimai parodė, kad daugelis mokslininkų analizuojančių vyriausybines programas (Keuschning, 2003; Plage, 2006), kurios skatina rizikos kapitalo rinkos plėtrą. Šio straipsnio tikslas – išsiaiškinti mišrūs rizikos kapitalo fondų steigimo motyvus, veiksnius ir pasekmes Lietuvoje. Objektas – mišrūs rizikos kapitalo fondai Lietuvoje. Įsikišti šie uždaviniai: 1) atskleisti pagrindinius mišrų rizikos kapitalo fondų steigimo ir plėtojimo veiksnius, siekiant sukurti pažangių aplinką MVĮ; 2) išsiaiškinti veiksnius, sąlygojančius mišrų rizikos kapitalo fondų veiklą; 3) išskirti sąlygas ir dabartinę rizikos kapitalo rinkos plėtros stadiją Lietuvoje JEREMIE iniciatyvos kontekste.

Atlikti tyrimai parodė, kad pagrindinis klūties su kuriomis susiduria smulkių ir vidutinės įmonės ankstyvamajame plėtros etape, yra šios: finansavimo stoka ir rinkos netobulumas (del-Palacio, et al., 2010; Mason ir Harrison, 2009). Todėl pagrindiniai mišrų rizikos kapitalo fondų motyvai - panaikinti šias klaidas versliui, sudarant sąlygas lėnaugti finansavimą ankstyvamajame plėtros etape, ir taip suburtinant rinkos konkurenciją. Atlikus rizikos kapitalo rinkos plėtros sąlygojančių veiksnių analize, šie veiksniai buvo suskirstytys į šias grupes: rizikos kapitalo pasiūlos darantys įtaką veiksnių; rizikos kapitalo paklausa darantys įtaką veiksnių; makroekonominiai veiksnių, kurie turi įtakos šioms diemų veiksnių grupėms. Remiantis literatūros analize, rizikos kapitalo pasiūlos (investuotojai norintys ir galintys investuoti į naujas, ankstyvojo plėtros etapo inovatyvią įmones) veiksniui yra šie: rizikos kapitalo paklausa (Plage, 2006), kvalifikuoti ir turintys patirties rizikos kapitalo fondų valdytojai (Keuschning, 2003; Plage, 2006), fondo dydis (del-Palacio et al., 2010) bei investuotojo aktyvus dalyvavimas portfelio įmonės valdyme (Keuschning, 2003), antrepreniškių įmonių pasiūla, fiksuotas sąnaudos (Nightingle et al., 2009). Rizikos kapitalo pasiūlos (įmonės, norinčios gauti rizikos kapitalo finansavimą) veiksniui yra šie: rizikos kapitalo paklausa (Plage, 2006; Gompers ir Lerner, 1998), kvalifikuota vadovų komanda ir kvalifikuotas įmonės personalas (Hellmann ir Puri, 2002), portfelio įmonės inovatyvumas (Caselli et al. 2009), augimui skirta įmonės strategija. Makroekonominiai veiksnių daro įtaką rizikos kapitalo pasiūlos susiformavimui. Remiantis atliktais tyrimais, galima išskirti šiuos makroekonominius veiksnius: makroekonominis likusias stabulumas, viešosios politikos keliamos tikslai, kuriant antreprenišką kultūrą šalyje, teisine ir mokesčiine aplinka (Armour ir Cumming, 2006); aktyvi ir stipri akcinė rinka (Black ir Wilson, 1998; Jeng ir Wells, 2000); finansinio sektoriaus ypatumai, efektyvi švietimo sistema ir struktūrinė Europos Sąjungos parama.