EFICIENCY OF INVESTMENTS FUNDS ÎN THE GROWING OF SMES CAPITALIST

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Abstract

Equity Finance is an essential funding type for innovative companies that have the potential for rapid growth and are willing to accept investors in the company's capital from outside shareholders. Statistically, these firms are a minority, but have the potential to turn into big companies. In general, equity financing is used by 3% of European SMEs. Innovative SMEs use equity financing more often than non-innovative enterprises (4% innovative versus 2% of non-innovative enterprises).

Keywords: *investment funds, innovation, small and medium enterprises, profit, development*

JEL Classification: O30, P12

Introduction

The lack of a capital investment culture, the lack of transparency between information between companies and investors, the fragmentation of the market and the high costs generated by these deficiencies appear to be among the main reasons for the lower risk capital funds in some Member States. The severe reduction of European private equity (PE) activity in 2008/2009 was followed by a partial recovery, although recovery resulted in losses. Despite some improvements, levels of activity in this area are still very low.

Literature review

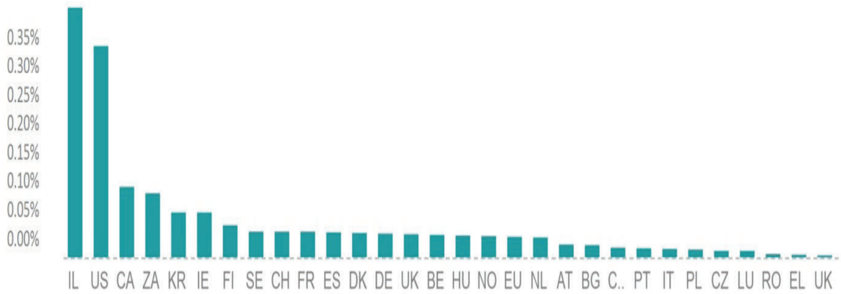
Opreana (2015) presented a new perspective on investment modeling at EU level, and Romero-Martínez et.al. (2008) assessed the European Union's support for innovation for small and medium-sized enterprises in Spain. De Bondt (2007) approached the role of the euro on corporate bond markets in the euro area. Ebner and Bocek (2015) have developed a set of good practices on how to support investment in intangible assets. In another article, Moraru and Rusei (2012) studied business incubators as a medium conducive to the development of small and medium-sized enterprises, and Mas-Verdú (2015) resumed the issue by analyzing the role of business incubators in surviving the firm. Okhrimenko and Manaenko (2014) described the principles and mechanisms underlying the decisive factors of investment support.

Research methodology, data, results and discussions

At EU level, fundraising, investment and sales did not reach almost the pre-crisis level. In 2016 private equity investment in European companies declined moderately by 2% to 52.5 billion euros, according to Invest Europe statistics. On the other hand, venture capital venture capital investments, which are of particular importance for financing innovative young companies with high potential for growth, increased by 2% to 4.3 billion euros.

Share of investment funds as a percentage of GDP 2016

Figure 1



Source: Invest Europe, OECD 2016. Data interpreted by the author

While the level of activity of investment funds is still below the pre-crisis levels, some of the differences were occupied by private business angels. Approximately 90% of all venture capital fund managers are concentrated in eight Member States: the United Kingdom, Germany, Sweden, Denmark, Finland, the Netherlands, France and Spain. In relative terms, as a percentage of GDP, there are also significant differences between countries. The risk capital markets are the least developed in Romania, the Czech Republic and Slovakia.

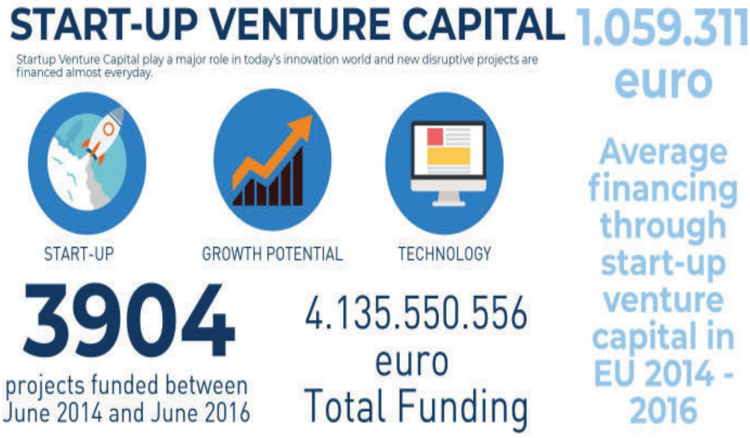
Venture Capital is an equity investment that aims to support businesses in the pre-launch, launch and early-stage stages. Even if it is considered to be the main source of seed financing and early stage financing, most venture capital firms are at a more advanced stage of development, with investment values between 3 and 5 million euros, while the financial market for Early stages are targeted by informal investors such as Private Investors.

Indeed, venture capital funds usually invest in SMEs that have already accessed funding from Private Investors. They usually come in after a business or product idea has been successfully tested by the market and is to finance large-scale production and marketing. Sometimes, venture capital funds can also intervene to finance product development when the associated costs are quite high, such as clinical trials in the biotechnology industry.

Venture capital investments are formally achieved by setting up a fund managed by a Principal Partner with the aim of investing in the early stages and expansion of SMEs with high potential for growth. Usually, venture capital funds raise financial resources from insurance companies, pension funds, or individuals with significant wealth. These secondary partners pay management fees to the Principal Partner, generally between 1-2% of the amount paid to cover the operating costs and for the fund's engagement of a group of professionals.

The average value of Startup Venture Capital investment funds in Europe 2014-2016

Figure 2



Source: SME Access to Finance - ECSIF 2017

The portfolio of a venture capital fund includes several classes of assets, such as shares, bonds and real estate. Venture capital funds are part of the alternative funding pool with higher-risk asset classes, from which investors expect to receive higher incomes. Venture capital funds invest in a portfolio of SMEs knowing that some will succeed and others will fail and others will have medium or sub-mediate performance.

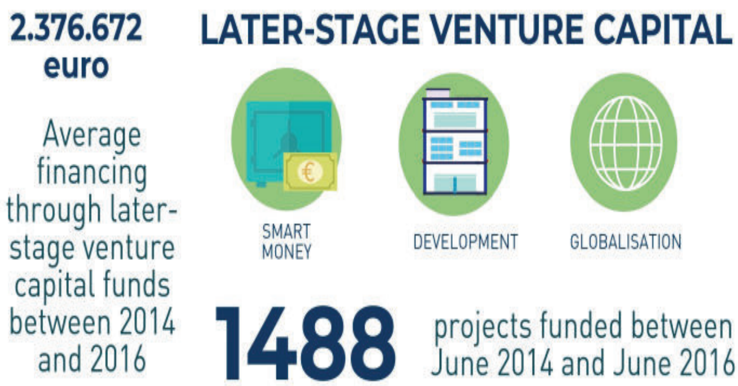
Usually the life of a venture capital fund is for 10 years, at the end of which the partnership dissolves and distributes its assets to partners. In some cases, if the partners agree, the fund's funding period may be extended to 15-20 years. Typically, start-up SME investments take place in the first 3-4 years, following additional investment in the portfolio of companies in the coming years. Generally, for companies in early development stages, the rule is that the initial investment round is followed by additional investment. In order to be able to make multiple funding, the venture capital fund must be of a certain size. In the mid-life of the fund, when the first results of the investments are already being collected, the Principal Partner can attract new financial resources or reuse the receipts received or introduce new secondary partners. For most of the SMEs in the portfolio that receive funding, investment incomes are usually made by exiting in 4-10 years.

Venture capital companies are specialized on development stages (startups, product development, revenue generating, profitable) or on investment rounds (seed, initial, secondary, or late). As a rule, the longer the funding round is, the higher the amount invested. In the last years of life of the fund, it usually invests in later development stages because these companies are closer to the exit, which allows them to obtain higher potential gains faster.

The selection of transactions is critical for a venture capital fund. They make thorough assessments and analyzes of companies before making any investments using objective data, analyzes, but also their own intuition and creative thinking. The procedure is extremely selective, especially for companies that have a high growth potential that can bring high returns on a medium-term investment horizon.

Average Later-Stage Venture Capital Investments in Europe 2014-2016

Figure 3



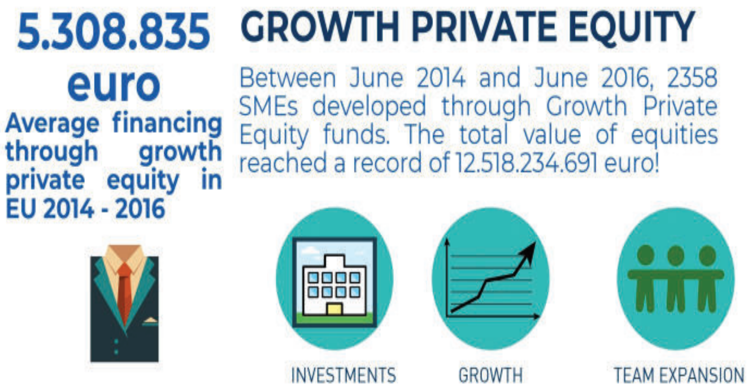
Source: SME Access to Finance - ECSIF 2017

In addition to funding, venture capital funds also bring managerial and technical expertise and many other services such as strategic, management, marketing, human resources, financial planning, and exit strategies, as well as case consulting which business fails. Experience has shown that venture capital funds have a decisive contribution to the professionalisation of funded start-ups. They can also impose direct control over management and often require top management changes.

On the other hand, entrepreneurs are looking for a venture capital partner that can come in addition to funding with expertise, experience, contacts and reputation. Associating with venture capitalists adds added value to the funded company because the latter can have more direct and faster access to market information, a highly skilled human resource, partners, and the opportunity to call on experienced IPO consultants at the time of the exit. Specialist literature also mentions that many entrepreneurs are willing to give a bigger discount to their own business valuation if the venture capitalist who will provide funding is renowned. Thus, for a capital venture, the experience, contacts, networking networks, assistance it is able to offer to the entrepreneur are important factors for its success.

The average amount of funding from Growth Private Equity Capital Investments in Europe 2014-2016

Figure 4



Source: SME Access to Finance - ECSIF 2017

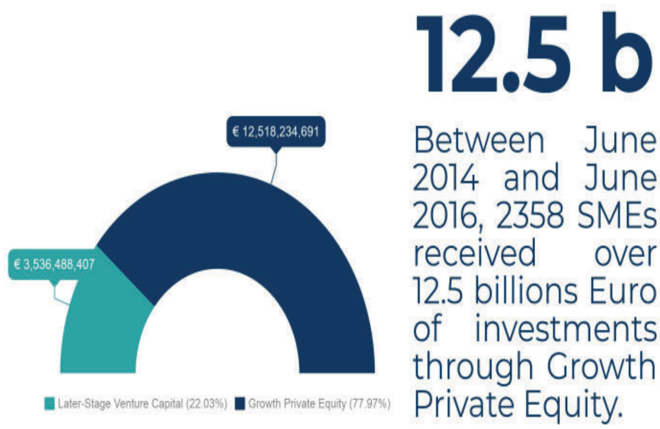
The venture capitalist way of capitalizing on the investment made in a company is largely based on the exit, the latter being a determining factor for the initial investment itself. Usually the exit takes the form of an Initial Public Offering (IPO) when the company sells its shares to the general public on the capital market or through acquisitions and mergers when investors receive shares or cash from the company. Acquisition typically involves a strategic buyer, such as a vendor, distributor or competitor in the same industry as the SME, and less a buyer who buys only for the value of the investment. Among strategic buyers, large companies play an important role in market prospecting to identify startups of venture capitalist ventures with the aim of finding those new companies that can bring radical innovations or new business models that can later be scaled or represent an important partner for the Open Innovation Strategy.

Progress in IPO, mergers and acquisitions has an important effect on the venture capital industry, as has been the case since the 2008 financial crisis when the reduction of exit opportunities has discouraged many venture capitalists.

Venture capitalists cover the financing gap needed for innovative SMEs due to information asymmetry. Financial constraints are usually more acute for young firms because they have limited internal funds and poor capacity to present their potential to investors. The problem is also compounded by the lack of collateral guarantees that can be made available by the startup and the extremely risky nature of these entrepreneurial initiatives. Indeed, the lack of collateral, which is a widespread problem among SMEs in all sectors of activity, is all the more important for businesses whose business model is predominantly based on intangible assets, such as in the case of research and development .

Value of later stage venture capital vs. equity growth in the EU 2014-2016

Figure 5



Source: SME Access to Finance - ECSIF 2017

Venture capital funds are targeting that small group of SMEs with high growth potential that have the ability to generate high returns in a short time. The venture capital industry is highly selective and focuses on sectors with high growth potential that generate scalable innovative business and disruptive business models. Only a few SMEs can attract the attention of venture capitals and only some of them will be able to attract the requested funding.

Typically, venture capital-funded SMEs require a firm commitment from the contractor to invest their own capital alongside the external financier. These SMEs are typically characterized by high market potential, high revenue forecasts over a short period of time, approximately (35-40% IRR), important spending in the R & D area, a team of strong and experienced management, and the entrepreneur's acceptance of giving up a significant share of his social capital.

For these reasons, venture capital funds usually focus only on a few industries: the digital economy (ICT, Internet, electronics), the health sector (biotech, medical technologies, life sciences). In ICT, software accounted for 70% of venture capital funding. The preference for venture capitals for consumer and ICT services can be explained by immediate and direct contact with the consumer, allowing for a quick feedback on the possibility that the investment will have a quick result. Also, the medical field is very popular in more mature markets, such as America and Europe, where the older and more wealthy population is a source of income.

Very innovative SMEs are usually spin-offs from research institutes and are very close to the academic environment, which allows them to market those innovative results. Companies with high growth potential can also be found in larger spin-offs that use the technology and market knowledge of parent companies to launch business.

The sectoral and technological dimension of innovative opportunities for the development of venture capital financing is very important. In fact, the venture capital industry can only develop when there is a steady stream of business opportunities with high potential for growth. The statistics show that ICT has provided the most opportunities over time, which justifies the high concentration of venture capital investments in this area.

In Romania, private equity (PE) / venture capital (VC) investments are estimated to have amounted to EUR 70 million in 2013. As regards the share of PE / VC investments in GDP, an important benchmarking indicator industry, Romania continues to show poorly, with only 0.049% compared to 0.253% at European level, while other Central and Eastern European countries perform 1.5-2 times better on the same indicator (Poland 0.098%, Czech Republic 0.090%, Baltic countries 0.071%, Hungary 0.058%). Romania has, however, a better indicator than Bulgaria (0.028%).

The situation is even less advantageous for the Romanian market when considering only venture capital investments. In the case of Romania, there is a total of 0,002% of GDP, compared to an average of 0,024% of GDP at EU level. Similar to Europe and in line with previous years, the investment type PE and VC for 2013 in Romania was also dominated by buyout investments.

Among the largest investments made in Romania in 2013 are:

- The Emerging Europe Accession Fund, managed by Axxess Capital, acquired Deutek SA, a company active in the manufacturing and marketing of decorative dyes and paints, from the Advent International PE Fund;
- The US investment fund Francisco Partners bought the entire stake of the e-commerce provider Avangate, part of the GeCAD group, owned by Romanian businessman Radu Georgescu and CTS 3TS Fund;
- JEREMIE 3TS Catalyst Romania invested in Intelligo Media, the owner of the Avocatnet portal and the developer of the legal site solutions www.superlege.ro;
- Purchase of WorldClass fitness center by Resource Partners (2013 - 2014);
- Purchase from Carlus courier company from DHL (by Abris Capital Partner).
- At the beginning of 2014, the following local transactions were also announced:
- The investment made by the JEREMIE 3TS Catalyst Romania fund in the local mobile solutions developer Simartis;
- Early Bird and iEurope Capital have invested in Tjobs online recruitment firm;
- Purchase of Fan Courier by Abris Capital Partner;
- Emerging Europe Accession Fund, managed by Axxess Capital, has bought a Star Star package, a provider of data archiving solutions.

Conclusions

Venture capitalists cover the financing gap needed for innovative SMEs due to information asymmetry. Financial constraints are usually more acute for young firms because they have limited internal funds and poor capacity to present their potential to investors. The problem is also compounded by the lack of collateral guarantees that can be made available by the startup and the extremely risky nature of these entrepreneurial initiatives. Indeed, the lack of collateral, which is a widespread problem among SMEs in all sectors of activity, is all the more important for businesses whose business model is predominantly based on intangible assets, such as in the case of research and development .

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