Small Innovative Business Promotion Network / SIB Net (EU 31398)

RESEARCH REPORT ON EARLY STAGE FINANCIAL SUPPLY

Riga
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Linking Estonia and Latvia
Part-financed by the European Regional Development Fund

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I. Executive Summary

The present report was drawn up at the end of 2010 by means of desk research and further interviews with experts/stakeholders from the financial supply system. The report concentrates on the available financial services and resources in Riga & Kurzeme region and the Southern Estonia for early stage businesses and how this offer meets the expectations of companies. Specifically, state support means, banking and venture capital services are covered. During the desk research relevant reports, statistics, public information from stakeholders was used. Taking the recent changes in economy into account accented efforts have been made to gather as much of the latest information on the topic as possible. It should be noted that regional outlook is often omitted in the report as it is impossible to distinguish national scale finance suppliers in the above mentioned regional scope.

The main difference between Latvia and Estonia is the perception of nascent entrepreneurs and start-ups as well companies in general with regard to the use of external financial sources. Latvians exceptionally prefer to rely on their own resources while Estonians - on the contrary. In the EU-27 context, the Latvian companies have the highest rate of internal funds usage that is almost three times higher than the average in the region, whilst Estonians are doing on an EU average. As a consequence, for the Latvian early-stage companies there is a risk to remain small and to lose ground for growth.

The state support, similarly in both countries, heavily relies on the EU funding and corresponds to common planning periods, i.e. the ongoing implementation of 2007-2013 activities. If compared to the previous period, good progress is made towards elaboration of support scheme's variety, the amount of funding. However, support to early-stage companies seems to be overridden by investments in growth, expansion phase companies. There are about 3 support schemes in Latvia that can be viewed as exceptionally targeted towards early-stage businesses while in Estonia there are 6. Accordingly, the allocated support is around 50 MEUR and 22 MEUR respectively. Theoretically, early-stage businesses can engage in wider range of schemes; however this can be embarrassing taking into account the limited capability and skills of the companies at that stage. Still the report views those means as the potential for some exceptional start-ups.

State support topics seem quite similar as for Latvia and Estonia, i.e. start-up, company growth, internationalization and innovation as well as financial split among them. There are slight differences like: more centralized advice services in Estonia than outsourced in Latvia and more regional preferences in Latvia. In both countries uncertainty in the implementation of support instruments can be observed, which is manifested mainly in postponement of implementation against what was planned. In Latvia this uncertainty is apparent to a larger extent, and such postponement is even included in planning documents. In Latvia one can often observe also changes in the criteria applicable to the recipient range and re-allocation of funds between support instruments.

The banking sector during recent years has changed noticeably in both countries. Previously banks could be in some way recognized as substitutes for risk capital, but now their policy is traditionally conservative, i.e. cash flow, collateral and credit history are the main constraints that do not allow access to finance for early stage entrepreneurs. So far state intervention by risk sharing has been the most effective mean of how to overcome this issue.

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During the recent years, Latvia has made exceptionally good progress in venture capital market growth. Although before 2006 both countries virtually did not have local venture capitalists that invest in innovative early-stage companies, currently Latvia, through risk sharing practice, has pushed the market to work. Three VC companies in Latvia with the total pool of 36 MEUR have invested in early-stage & growth companies within 2006-2009 and currently two VC's manage 50 MEUR for seed capital, early and growth companies for the coming two years. So far, Estonia has not managed to make the market work appropriately. Instead of private investment initiative, the state uses the Estonian Development Fund as the single national VCF for early stage investments. Both countries have established VC associations one of the aims of which is popularization of VC investments and facilitation of a proactive business culture. Several issues remain in the VC market; however, the main issue is small markets of appropriate ideas. It is obvious that both markets do have appropriate amount of funds for VC operation, like local pension funds and other institutional players.

For further improvements in the financial supply there is the need to address issues to all stakeholders in the market and particularly:

- public support could be revised prior to raising the overall awareness of innovative nascent entrepreneurs & start-ups, i.e. the reduction of "mentality clash" between investors and entrepreneurs, advice with regard to the preparation of adequate offers, growth oriented mindset, for example, both problems can be solved by means of investment readiness services. In Latvia's case it seems that the supply of resources exceeds the ability to absorb them in commercially smart manner,
- entrepreneur awareness and investment readiness skills issue should be addressed also to other stakeholders, like Universities, municipalities, business incubators and other intermediaries that deal with ideas and authors of ideas,
- limited pool of ideas call for the networking in the region; closer co-operation among originators of innovations can raise the number of ideas in the market as well as gain experience both for originators and nascent entrepreneurs/start-ups,
- pre-seed capital availability calls for particular attention in both countries as it appears to be close to absent,
- regulatory and support system could be improved with regard to the VC market; in Estonia, the case risk sharing practice introduction should be continued, and in both countries particular attention should be paid to limits set for pension funds involvement, as well as the role of stock exchanges could be revised,
- risk sharing practice should be considered as a continuous activity rather than an exceptional measure provided on a short-term basis; a consistent, foreseeable and less amount is a better approach than uneven market boosting; in this case, risk sharing means indirect national intervention in the VC market by investing funds into target group companies via privately managed funds thereby sharing risk with private funds, as opposed to no direct intervention where state solely invests into companies,
- as far as possible, it is necessary to assess the real outcome of support schemes in order not to mislead the resource allocations as each change is time consuming and burdensome,
- there is the need for regular, internationally comparable survey on nascent entrepreneurs and start-ups particularly with innovation degree, since currently the majority of surveys employ a small number of respondents as well do not cover issues related to the early stage; as a result, accurate policymaking misses facts for benchmarking and decision making; some good examples are the Panel Study of Entrepreneurial Dynamics (PSED), the Global Entrepreneurship Monitor (GEM).

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II. Support schemes

In both countries the main source of state support schemes is the EU support co-financed by a local budget. The rationale of local support lies in National planning documents and both countries follow the EU planning framework (timeline); therefore it is possible to compare the support schemes in terms of activities and the amount of finance.

Generally, both countries have the same support themes and comparably the same financial split among them. However; there are some differences:

- Estonia has a more centralized approach (Enterprise Estonia) with respect to advice & mentoring support than it is in Latvia where the majority of these functions are performed by private companies/establishments,
- in Latvia, among support schemes more preferences can be found in prior to raising activities in the regions that are underdeveloped,
- it seems that the general uncertainty regarding the available funding in particular schemes in Latvia is higher than in Estonia, in the meantime, both countries suffer from delay in their implementation.

Taking the similarities among the support schemes into account, it will be valuable to compare the results (e.g. return on investment, survival rate for newly established companies, increase of turnover, exports, employment etc.) just to identify the best working approaches.

When comparing the previous planning period (2004-2006) to the current one, it is obvious that a good progress has been made in terms of the variety of support schemes as well as the quality and amount of financial support of schemes. Still, for the early-stage support the variety is less than it would be appropriate. Support schemes do not distinguish forms of nascent entrepreneurs, start-ups, micro companies, growth companies, expansion phase companies very well. On the other hand, thanks to this start-ups (companies without balance sheet) can apply for support meant primarily for growth and even expansion of companies.

When evaluating the public support schemes within a longer period of time, it can be seen that this process is not flexible enough towards the actual needs of enterprises; this should manifest as a support of an appropriate amount for the appropriate category/needs of undertakings. This is related to observance of certain bureaucracy procedures, planning and the concurrent actual/changing economical situation in the country (incl. availability of other financial sources). As a result, the introduced support schemes (conditions and amount) are changed shortly after they are offered on the market, whereas each change in practice means 1 year on average, which is a long period of time in rapidly changing market conditions. Partially this problem could be described as “learning by doing”. This problem is especially manifested in Latvia. From the entrepreneurs’ point of view, such changes burden the preparation of applications and planning of investments in a company. Obviously, the problem could be solved by trying to shorten the time of introduction of changes as far as possible, as well as by carrying out more accurate planning, market forecasting (incl. forecasts of availability of other financial sources in the medium term).

Public support schemes in both countries cover also banking and venture capital areas that will be explored in more detail in the next chapters. In these chapters the support schemes are grouped into the following categories:

- entrepreneurs/start-ups – this category includes nascent entrepreneurs and other natural persons who have not established their companies yet,
- new companies – newly-established companies, legal persons that have been operating in the market for less than a year,

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- high growth/expanding existing companies – the companies that have been operating in the market for at least one year,
- intermediaries – institutional market participants whose aim is facilitation and stimulation of high growth and innovative business activity.
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The Southern Estonia

Group	Support scheme – description
Entrepreneurs, start-ups	**Consultations & mentoring** Provided by Enterprise Estonia staff Target audience – start-ups, existing companies, public actors Total assignment – n/a **Loans for start-ups** Loan for investment & working capital Priority areas – self-employed person/company, newcomers in business, lack of collateral Loan between 2-54 thsd EUR, intensity 30-40%, 75% loan guarantee by KredEx Total assignment – 6 MEUR **Start-up and development grant** Grant in long-term assets (except buildings/estate), marketing Priority areas – self-employed person/company, export/growth oriented, newcomers in business Maximum start-up grant 6,4 thsd. EUR, intensity 80% Maximum development grant 32 thsd. EUR, intensity 65% Total assignment –7,5 MEUR **Engaging the creative industry** Provided by Enterprise Estonia Priority areas – awareness, skills, co-operation networks, incubators Total assignment – 6,3 MEUR
New companies	**Innovation voucher** Grant in innovation advice, research Priority areas – IP rights, product development process Grant 4 000 EUR, intensity 100% Total assignment – 0,19 MEUR **New product development** Grant in prototype, research Priority areas – export, high value-added Grant between 1 300 – 200 000 EUR, intensity 50-75% Total assignment – 4,9 MEUR **Development of knowledge and skills** Grant in in-service training, testing, international conferences & professional placement Priority areas – export, innovations, productivity Grant between 1,6-64 thsd. EUR, intensity 25-50% Total assignment –12,8 MEUR **Industrial technology investments** Grant in equipment, licenses Priority areas – company growth, export Grant between 0,06-3,2 MEUR, intensity 20-40% Total assignment – 21 MEUR **Attraction of development personnel** Grant in equipment, licenses Priority areas – new products, co-operation with R&D sector, international marketing, business strategy Maximum grant – 13 000 EUR, intensity 50%

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	Total assignment – n/a **Export marketing** Grant in certificates, trademarks, business visits, trade fairs, marketing etc. Priority areas – value added export Grant between 9600 – 160 000 EUR, intensity 50% Total assignment – 25,6 MEUR **Foreign trade fair** Grant for SME's, also umbrella organizations Priority areas – export Grant between 1 900 – 64 000 EUR, intensity 50% Total assignment – n/a MEUR **Joint marketing** Grant for export matchmaking, surveys, umbrella organisations Priority areas – export Grant between 2 600 – 64 000 EUR, intensity 50% Total assignment – n/a MEUR
High growth/ expanding existing companies	**Innovation voucher** (see above) **New product development** (see above) **Development of knowledge and skills** (see above) **Industrial technology investments** (see above) **Attraction of development personnel** (see above) **Export marketing** (see above) **Foreign trade fair** (see above) **Joint marketing** (see above)
Intermediaries	**Industry clusters** Grant in action plan, partner search, marketing, etc. Priority areas – not specified Grant margin is not specified, intensity 70-75% Total assignment – 6,4 MEUR **Competence centres** (completed) Grant for 8 centres Total assignment – 4 MEUR **Business incubators** Total assignment –1,8 MEUR **Management awareness programme** Provided by Enterprise Estonia Priority areas – management Internet portal, trainings, study materials, publicity Total assignment –n/a

Note:

- *all the support schemes relate to the financing period of 2007-2013 (if no remarks are provided),*
- *applicants can apply for virtually all the support schemes more than once if fulfilling de minimis rule.*

Riga and Kurzeme planning regions

Group	Support scheme – description
Entrepreneurs, start-ups	**Motivation program** Enforced by LIDA Teaching capacity (universities & secondary schools) Entrepreneurship & innovation spirit Total assignment – 3 MEUR (2009–2014) **Start program** Enforced by LHLB Nascent entrepreneurs, newly-established companies Training, advice, loan, grant and loan grant Maximum loan – 77 thsd. EUR, maximum grant – 5000 EUR, intensity for loan – 90-100% Total assignment – 11,6 MEUR (loans), 2,1 MEUR (training, advice) **Employee skills** (see below) can be viewed as intrapreneurship support
New companies	**Start program** (see above) **Business incubators I** 4 incubators in Riga & Kurzeme region Newly-established SMEs (less than 2 years old) Use of infrastructure, office services, advice Intensity 10-85% Maximum grant – 0.2 MEUR Total assignment –28,7 MEUR (8 incubators) **Business incubators II** 8 incubators in Riga & Kurzeme region Newly-established SMEs (less than 2 years old) Use of infrastructure, office services, advice Intensity – n/a Total assignment –1,6 MEUR yearly (8 incubators) **Support for underdeveloped areas** Coverage – around 80% of Kurzeme and 35% of RPR Grant in long term assets Priority areas – production, IT, R&D Maximum grant 0,2 MEUR, intensity 55% Total assignment – 30 MEUR **Employee skills I** Grant in short-term training (general & specific) Should be a part of association (grant recipient) Maximum grant 0,25 MEUR, intensity 35-80% Total assignment – 17 MEUR **Employee skills II** Grant in short-term training (general & specific) Individual company Maximum grant 0,2 MEUR, intensity 35-80% Total assignment – 32,6 MEUR **Export markets** Grant in exhibitions, matchmaking events

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	Maximum grant 11 000 EUR monthly, intensity 55% Total assignment – 23.5 MEUR **Hi-tech investment** Grant in long term assets Priority areas – ITC, R&D, export Minimum grant 4,3 MEUR, intensity 45% Total assignment – 110,8 MEUR **New product development** Grant in R&D Maximum grant 0,5 MEUR, intensity 25-70% Total assignment – 11,9 MEUR **New products in production line** Grant in equipment & patents/licenses Priority areas – ITC, R&D, export, own elaboration, innovation track-record Maximum grant 0,5 MEUR, intensity 25-35% Total assignment – 55,6 MEUR **Enforcing IP rights** Grant in patenting, application Maximum grant 28 thsd EUR, intensity 35-45% Total assignment – 1,4 MEUR **Attraction of advanced specialists** (completed) Grant in equipment & patents/licenses Priority areas – R&D/innovation experienced doctors Maximum grant 0,2 MEUR, intensity 40-50% Total assignment – 0.3 MEUR
High growth/ expanding existing companies	**Start program** (see above) **Support for underdeveloped areas** (see above) **Export markets** (see above) **Employee skills** (see above) **Hi-tech investment** (see above) **New product development** (see above) **Enforcing IP rights** (see above) **New products in the production line** (see above) **Attraction of advanced specialists** (see above)
Intermediaries	**Centers of competence** Alliance of scientific organizations and operators in the sector Grant in fixed assets, R&D Maximum grant 51,9 MEUR, intensity 25-70% **Technology transfer contact points** Universities & institutes Maximum grant 3 MEUR.

Note:

1. *all support schemes relate to the financing period of 2007-2013 (if no remarks are provided),*
2. *applicants can apply for virtually all the support schemes more than once if fulfilling de minimis rule*

III. Banking sector

Crediting from the part of commercial banks to new and innovative companies has always been complicated, since banks generally prefer financing creditworthy companies with collateral over innovative projects. Under the influence of the crisis (2008-2010) the situation has worsened even more. Since 2010, the overall crediting has improved slightly, yet the possibilities for newly-established and innovative companies of receiving a loan are still poor. In both countries commercial banks publicly support innovative companies, yet in practice they limit the credit availability for newly-established, innovative companies by setting increased interest rates and the amount of collateral. As a result, the conditions of the offered loan, in most of the cases, cannot be fulfilled or are too unattractive. This problem has been mentioned by several organizations that have studied the availability of financing to new, innovative companies, for example, the European Central Bank (Bank Lending Survey 2010), JOSEFIN (Needs of innovative SMEs in the BSR 2010), etc. There is no significant difference in the crediting policy between Latvia and Estonia, since these markets are being dominated by one and the same banks.

Recent interviews with the largest banks have revealed that in the region they will maintain a conservative crediting policy for the coming years that will include issuing of loans exceptionally to companies having a stable and sufficient cash flow, positive and existing credit history. Loans for newly-established companies virtually will not be available both in Latvia and Estonia. Without external risk sharing private operators will not engage in early-stage business financing for a foreseeable period.

This chapter looks at the commercial banks and state organizations from which individually separated credit funds are available to new, innovative companies. It has to be noted that all the credit instruments mentioned below are implemented using the risk sharing practice. However, credit instruments financed by banks to new, innovative entrepreneurs are not currently offered in the market; i.e. if they exist, they are offered as part of a common credit offer. In case of a common credit offer the conditions are evaluated individually by the commercial banks by establishing the degree of the potential credit risk, therefore it is impossible to characterize and accordingly consider such conditions in the present document.

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The most important organization in Estonia supporting enterprises in getting of loans is the Credit and Export Guarantee Fund KredEx. It was founded in 2001. The overview of the financial vehicles provided by KredEx is presented in the Table below.

In 2009, KredEx guaranteed and financed 409 enterprises with subordinated loan and project-based loan reasource, including 50 starting companies, in total amount of 1,3 billion EEK. The support from KredEx enabled companies to attract also additional funds from banks. In addition to the previous ones, 470 new guarantee agreements were signed with banks to finance the oblications of 370 enterprises in the amount of 804 million EEK. Guarantees of investment loan were issued in total for 265 million EEK, guarantees of working capital loan or overdraft for 329 million EEK, leasing guarantees for 17 million EEK, and guarantees of bank guarantee for 194 million EEK. 15,4% of guarantee amounts went to micro companies (1-9 employees) in 2009. 2009 brought also along an increase of internest in export guarantees.

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Group	Financial vehicle
Entrepreneurs, start-ups	**Loans for start-ups** (see also the section on Support Schemes) Loan for investment & working capital Priority areas – self-employed person/company, newcomers in business, lack of collateral Loan between 2-54 thsd EUR, intensity 30-40%, 75% loan guarantee by KredEx Total assignment – 6 MEUR
New companies	**Business loan guarantees** Provided by KredEx Maximum guarantee – 1,9 MEUR, intensity – 75% Costs – starting from 1.7% of the guarantee balance per year + 1% contract fee Total assignment – 96 MEUR **Export guarantees** (not active) Provided by KredEx Priority areas – virtually all countries Maximum guarantee – n/a Total assignment – 192 MEUR
High growth/ expanding existing companies	**Business loan guarantees** (see above) **Export guarantees** (see above) **Subordinated Loan** Provided by KredEx Purpose: assets, new product/business strategy introduction Loan – 0,06-1 MEUR, up to 10 years Total assignment – 25,6 MEUR

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Riga and Kurzeme planning region

The latest information available shows that the overall interest in credit guarantee means is high; i.e. since 2009 until the first half 2010 the GAL issued 407 guarantees to 130 companies with the total value of 70,6 MEUR (on average – 0,17 MEUR per guarantee). The most requested were current asset guarantees (54%) and investment guarantees (35%). Guarantees were mainly issued to manufacturing companies (70%).

Interest in export guarantees is modest so far. In the first half of 2010, the GAL received 19 applications out of which 18 were approved for the total amount of 1.5 MEUR. The majority of guarantees secure export transactions to the CIS countries.

Loans. By September 2010, MLBL has issued 44 loans (competitiveness loan) at the total amount of 72 MEUR. By the same time 193 nascent entrepreneurs and start-ups have received a total amount of 4 MEUR; almost all of these recipients received a grant envisaged in the Start Programme at the total amount of 1.2 MEUR.

Group	Financial vehicle
Entrepreneurs, start-ups	**Start program** (see section Support Schemes)
New companies	**Credit guarantees** Guarantee Agency of Latvia Investment & leasing (up to 10 years), current assets & factoring (up to 3 years) Priority areas – new prospective projects Maximum guarantee – 3 MEUR, intensity – 80% Costs – 1.2% Total assignment –86.4 MEUR (2009-2010) **Short term export credit guarantees** Guarantee Agency of Latvia Priority areas – virtually all countries Maximum guarantee – 1 MEUR, intensity – 90% Total assignment – 86.4 MEUR (2009-2015) **Loans for competitiveness** Mortgage and Land bank of Latvia Priority areas – microcrediting and growth, competitiveness Investment and current asset loan Maximum loan – 11 MEUR Total assignment – 300 MEUR (2009-2013) **Swedbank** Investment (up to 5 years), current asset loan (up to 3 years) Priority areas – SME's, manufacturing, export Maximum loan – 0,88 MEUR Total assignment – 44 MEUR (2010-2012), incl. 21 MEUR EIF support **SEB Banka** Investment (up to 5 years), current asset loan (up to 1 year) Priority areas – SME's, manufacturing, export Maximum loan – 1,6 MEUR

	Total assignment – 60 MEUR (2010-2012), incl. 30 MEUR EIF support
High growth/ expanding existing companies	**SEB Banka** (see above) **Swedbank** (see above) **Citadele** (in approval process) Investment (up to 10 years), current asset loan (up to 2 years) Priority areas – SME's, manufacturing, export Maximum loan – 12,5 MEUR Total assignment 100 MEUR, backed by the European Investment Bank

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IV. Venture Capital

The basis for VC activity in the region is closely related to the overall macro economical & structural attractiveness of a country compared to other countries. 3 development phases of VCF can be distinguished in Latvia and Estonia – the first interest in VC in the Baltic during 1995-1997, the economic downturn period (1998-2001) and the interest outflow to other regions and the return of interest since 2001.
According to Biceps in 2004 there were 12 venture capital funds practically operating in Latvia. By the 1995-2004 (Biceps 2004) period 66 investments were made (on average 6-7 investments per year). In Estonia, according to the EBRD and interviews, the number of investments during the corresponding period was slightly higher. None of these investments was made in start-up phases, mostly in expansion phases. One of the main reasons is the high costs of running investments compared to investments in the expansion stage. Particular investments more likely suggest that these can be perceived as “blue chip” deals or low risk investments in stable business areas. Therefore, it is questionable whether the operation of VC corresponds to the classical VC fund definition.

A significant role in both countries’ VC market development is played by the EU Jeremy initiative that allows the member states to invest from National and EU Structural funds (2007-2013) into pools that later finance SME’s in a flexible and innovative way. In 2008, Latvia was included in the list of the countries where the European Investment Fund acts as a holding fund. The overall capital amount had been agreed approximately at 183 MEUR from the Operational Programme “Entrepreneurship and Innovation”; while in 2009 this assignment was reduced to 91 MEUR. Estonia is included in the list of the potential countries where the EIF could act in the same manner. So far there is no final decision yet. One of the reasons is the lack of funding. Currently Estonian public sector employs a single national VC fund concept (the Estonian Development Fund) instead.

During this study (2010) 6 stakeholders were interviewed that are important for the VC market and specifically 2 pension funds operating in the Baltic, 2 of the leading VC companies in the Baltic, and Stock Exchanges in Latvia and Estonia. During the interviews with relevant stakeholders several issues were identified, particularly:

State support to VC. International experience shows that VC funds that invest into early-stage high-risk companies (except for US) usually show low profitability or even operate with losses. In such conditions public support is essential. The interviews confirmed that in Latvia and Estonia private investors (pension funds) would participate only in case with state risk sharing. Stakeholders note that support should be consistent and long-term rather than an occasional measure; otherwise, the early-stage investment market can stop again. This pool raising (and state support) should be proportional to demand.

Due-diligence in state supported VC. In case of state support investors recognize as the next issue the due-diligence process where operators of VC are selected. Investors do their own evaluation; however appreciate an internationally experienced company/institution. In the case of Latvia the EIF’s role was significant as it is regarded as the most experienced VC expert in the EU; therefore involvement of the EIF in the future would encourage investors.

Number of business ideas. The main disincentive for VC investments in the Latvian and Estonian markets is the lack of sufficient pool of ideas. According to experts, around 400 good ideas are needed to run one VC fund. There is no particular survey carried out on the topic of how many ideas have been screened by VC so far, but it may be at least half less because of several reasons. Firstly, it is related to the small markets of Latvia and Estonia,

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and secondly, the lack of competence of commercially viable idea formulation. Increase of commercially viable ideas is a complex and long-term process; therefore, the existing VC funds broaden the idea pool by looking for ideas outside the market, i.e. the Eastern Europe and Russia. Experts operating in the VC field admit that the lack of ideas pushes to do investments less choosey than normally in large markets. Some numbers appear here like 1 against 400 in large markets and 1 against 15 in the case of Latvia. This surely increases the risk to be unprofitable.

Number of technology based ideas. This issue comes with another implication to just lack of ideas. Experts from VC state that science based ideas suffer from authors' lack of skills to formulate an idea in an adequate form (vision of business, accuracy and commercialization means). In practice a small portion of investment recipients have a science based idea or innovative technology content. In the meantime, according to VC experts, there is a "clash of mentalities" between investors and scientists. In number of cases when an idea would be potentially interesting for the development negotiations with investors it stops at the point when discussing risk sharing and investor contribution in profit and equity shares. Experts admit that persuasion and explanation takes too much time from an investor's perspective, and therefore the limited pool of innovative, technology content ideas shrinks even more. A similar problem, yet to a lesser extent, exists also in regular idea cases.

Sector development irregularities in the economy. High profitability and booming non-production sectors, like real estate and trading, also negatively reflects on the birth of ideas, since large part of the potential entrepreneurs prefer to engage in sectors with relatively high profit and ease of doing business there. This was particularly observed in the period before 2008 when booming sectors stopped sharply.

Economic development cycles. The profitability of VC in changing markets strongly varies as making of investments in times when the economy experiences fast growth takes higher costs for the investors and – to the contrary - makes less profit when doing exit in market slowdown. Normally this is a private investor decision and risk taking; however in case of state support it should be taken into account when setting up conditions for support in order to make an optimum stipulation.

Locally available financial resources. The situation analysis shows that the internal funds of countries are more than sufficient for the local market demand. For instance, in Latvia there are around 800 MEUR available from pension funds, while in Estonia – 330 MEUR.

Legislative framework for the investors. Currently private equity industry enjoys virtually no regulation or control and it differs from the developed countries' practice. In Latvia and Estonia there are no statutory provisions for the operation of venture capital funds, investments, transactions and business conduct. This can be the cause for fraudulent or over-risky deals. For example, at present most of the VC funds operate as limited liability companies that are not affected by the transparency requirements, as it would be in the case of public funds.

On the other hand, limitations for institutional investors exist in the market. For example, so far pension funds were allowed to invest in VC with a 5% limitation in Latvia and 20% limitation in Estonia (previously 10%) of their net assets. Insurance companies are not allowed to invest in VC funds. Experts in Latvia note that the 5% corridor in Latvia is too narrow for operation, for instance, for larger pension funds asset fluctuations can exceed the limit 5% easily in case of investments done before. Taking into account other countries' examples and the necessity, this limitation could be increased up to 20%. Legal aspects of VC operation are truly important and call for a separate discussion.

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In the EU, this problem of equity fund regulation became topical in 2006. On the one hand, the EU endeavors to achieve higher competitiveness of VC on a global scale, but on the other, its purpose is to protect retail investors, as well as the national finance systems in general from the risks arising in cases of non-regulated markets. As a result, in 2010 the EU Commission developed a draft directive, the Alternative Investment Fund Managers Directive (2009/0064/COM) that would be applicable to all the Member States. Although it contains a lot of improvements that could benefit the VC market, it has nevertheless received strong critics from the European Private Equity & Venture Capital Association (EVCA). The EVCA points towards several problems that would have an adverse effect on the VC market, for example, the costs of ensuring transparency of the information, higher capital guarantee requirements for VC funds, extra costs due to outside depositaries and independent valuation agents, etc. In any case, the adoption of this Directive will introduce substantial changes to the VC market, including in Latvia and Estonia

Vehicles for VC exit strategies. Several common exit strategies for the VC exist in the markets – IPO, investee acquisition by another company, repurchase of shares by an investee, repurchase of shares of other party and write-off. In the meantime, the most promising form for the VC's is the IPO exit strategy as it is assumed to be the most profitable. In Latvia case experts admit that the IPO strategy is only at the 4th place of preference, just before write-off.

The issue of IPO is the same for Latvia as for Estonia – public stock markets are not being considered as a promising place to make investments and, vice-versa, to acquire capital. So far stock exchange as exit strategy has been used only once – in Latvia (SAF Tehnika case in 2004). As a result, both Riga Stock Exchange and Tallinn Stock Exchange experience low turnover. The average monthly turnover in 2010 in the Riga Stock Exchange was around 2 MEUR, The turnover of Tallinn Stock Exchange was significantly larger, like 25 MEUR. It would be valuable to investigate what measures and actions could be implemented in order to raise awareness of Stock exchanges and attract more companies from both sides – investors and investees. For example, one way to raise the stock exchange value is to list there some good state owned companies and probably to gain critical mass. This is partly realized in Estonia where several states's owned companies were listed thus raising the popularity of Tallinn Stock Exchange. However, this does not answer the question about the IPO as an exit strategy for VC; therefore there is much more that has to be done in order to create an efficient exit strategy vehicle.

Banks as substitute for VC. If earlier it was stated in different report that retail banks act as substitutes for risk capital, then since 2008 the only private risk investment operators are VC funds and business angels; therefore special attention must be paid to the operation of VC.

The Southern Estonia

As of 2010, in the field of early investment 3 companies operate – Estonian Development Fund, Ambient Sound investments and Martinson Trigon Venture Partners. Other companies more likely have characteristics of expansion phase investors, while the public information is not sufficient to make a definite categorization. Currently fundraising is in the process for EIF supported Martinson Trigon Venture Partners.

Group	Financial vehicle
Entrepreneurs, start-ups	**Estonian Development Fund, national venture capital fund** seed-stage and start-up stage Priority areas – global growth potential, biotechnology, ICT, renewable energy etc. Average investment – 0,2-3 MEUR Total assignment – 35 MEUR
New companies	**Estonian Development Fund** (see above)
High growth/ expanding existing companies	**Martinson Trigon Venture Partners** (pending fund raising) Growth companies Priority areas – n/a Average investment – n/a Total assignment – 60 MEUR (15 MEUR as EIF support) **Ambient Sound Investments** early-stage Priority areas – R&D content Average investment – 0,5 MEUR Total assignment – n/a **BaltCap** Growth, expansion investment Priority areas – growth companies, fast growing sectors Average investment – 1 MEUR Total assignment - n/a (10 MEUR EIF support) **WNB Project** early-stage Priority areas – technology companies Average investment – n/a Total assignment – n/a **Astrec Invest** Early-stage Priority areas – telecommunications and the media Average investment – n/a Total assignment – n/a

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Taking into account the interest and competition from the potential VC regarding state support in 2007, it is clear that the initial conditions from the public side were at least favorable. Two companies out of 3 offered higher co-finance than the requested minimum, i.e. 50% and 70% against the 30% required. This shows that VC capital companies would engage in the business if risk sharing conditions would be less favorable to private investors. The main risk sharing conditions in 2006 from a private investor perspective were: co-finance at the minimum of 30%, return of 100% of the initial capital before the state receives 25% of the initial capital, receipt of the 6% margin before the public receives the remaining initial capital, and the modest 6% margin as the final payment to the public.

VC support scheme launched in 2006 was oriented mainly towards the investments in growth stage companies skipping the pre-seed and partly the start-up phase investments. Later support scheme envisages a portion of investment to be made in pre-seed and start-up and pure technology projects.

As of 2010, 3 VC funds operate in the Latvian market that deal with early-stage investments. Previously active funds have discontinued their investment operations on the market, since the allocated funds have been invested. Companies administrate the existing investments.

Group	Financial vehicle
Entrepreneurs, start-ups	**Imprimatur Capital** Proof of Concept, pre-seed, seed fund Priority areas – science based ideas Testing, prototype, evaluation of idea (special cases) Investment size – 15 000 – 100 000 EUR Total assignment – 3 MEUR (2010-2013), Jeremy support.
New companies	**Imprimatur Capital** Start-up fund Priority areas – new technologies Investment size – up to 0,4 MEUR Total assignment –17.4 MEUR, (2010-2013), incl. 11.7 MEUR as Jeremy support
High growth/ expanding existing companies	**BaltCap Management Latvia** Growth, expansion phase investment Priority areas – manufacturing, services, energy, ITC etc. Average investment – 0.3-3 MEUR Total assignment – 30 MEUR (2010-2013), incl. 20 MEUR as Jeremy support

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V. Business angels

In both countries, Latvia and Estonia, the BA segment is only at its starting phase of development and it has more common characteristics than distinctions. In Latvia, unlike Estonia, formal Business Angel Network (BAN) organizations have been established; yet it is difficult to evaluate the result of their activity, since in practice there are no investments in early-stage and technology ideas. At present, BAN in Latvia carry out measures of highly informative character, such as popularization of the BA culture and advisory measures.

The most significant common feature in both countries is the very low-developed BA investment culture with regard to innovations and technologies. Until 2007, BAs were mainly operating in high-revenue and quick capital flow sectors, especially in the field of real estate, hence at present BAs no not have real experience in investing in innovative and technology projects.

In both countries public support for the development of BANs is planned; however, in Latvia this support scheme was postponed due to the lack of funds.
The structural changes in these sectors (under the influence of the economic recession) in both countries should be assessed positively, since they encourage looking for investments in other fields as opposed to the trade and real estate sectors that have been popular up to date. However; at the same time the economic recession has reduced the amount of free monies and, obviously, also the range of investors themselves.

One of the methods that could help improve the situation is the development of these BANs and their involvement in the international circulation thereby acquiring mainly the experience of the Western European countries and contacts with other BAs. Public support is valuable, yet obviously this field should be developed mainly by the investors and other intermediary organizations themselves.

The Southern Estonia

According to the 2010 survey by the Baltic Innovation Agency (BIA) there were around 50 business angels operating in the field of finances in Estonia, but the total amount of investments and the number of investment cases is not known clearly. No studies have been carried out regarding the sectors and stages of development in which such investments have been made. Yet it is obvious that there are very few investments in innovative, technology-oriented projects, including the early stage. After the economic recession in 2010, in Estonia, unlike Latvia, there have been more investments by BAs in innovative ideas/companies, but the number of investment cases is not more than 5-7.

In Estonia still no formal BAN organization has been established. Informally, in 2009 the Estonian Business Angels Group was established that currently carries out at last measures of informative character. Also the Estonian Private Equity and Venture Capital Association (EstVCA) and Connect Estonia perform BAN functions, yet to a lesser extent.

In the planning period of 2007-2013 public support to the development of BAN in Estonia in the form of training, mediation and internationalization has been planned. The total budget awarded for these activities within the period is 0.49 MEUR.

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It is hard to find a reliable evaluation of how large the overall fund for investments of business angels is, and similarly there is also no evaluation about how many such investors there are.

In 2004 the BICEPS study (based on expert interviews) offered 3 ways how to assess this amount of investments. i.e.:

- by converting the publicly known list of millionaires into money by assuming that each of them could eventually allocate from EUR 50,000 to 100,000 for investments in private equity (in 2010, according to the Latvian Private Investors Association, – EUR 4,300 to 57,000),
- by assuming that BAs provide a capital of around 10-20% in relation to the overall capital of the VC funds;
- by adapting other countries' experience to the conditions in Latvia.

Taking the large degree of uncertainty into account, the study does not mention indicative capital amounts. However, in the 2010 interview the study shows the characterization and origin of these investors. According to the study, these are successful economic operators of a local origin, owners of denationalized buildings, investors from the CIS and Scandinavia and Germany. The study indicates also on the typical field of investments, i.e. real estates. 6 years have lapsed since the study, and during this time positive as well as negative changes have occurred in the national economy:

- the availability of the competing/supporting financial sources has diversified (public support, VC and bank loans),
- the profit margin in several sectors has changed (incl. the attractiveness of investments in the real estate sector has reduced substantially);
- the economic recession in 2007-2008 has reduced the amount of free funds for investments and changed the range of the prosperous population;
- BANs have been established and awareness of the BAs as the potential investors has increased, and the BA investment culture has started to develop with regard to innovative, technological companies through various publicity activities.

However, the aggregate of these changes is still not positive for economic operators – in 2010, the early-stage financing is actually not available to economic operators. There are two publicly functioning BANs in Latvia: the Latvian Private Investors Association (LPIA) and Connect Latvia. As has been recognized by the LPIA management, at present it is practically impossible to acquire the early-stage financing from BAs in Latvia; BAs help more with information and support for the existing business. This situation is certified also by interviews of various finance experts.

Considering the large significance of BANs in the financing of entrepreneurs, the country had experienced the support from this instrument, yet in 2008 this activity was terminated due to the economic recession and the lack of funds. At present BANs in Latvia have not integrated into the international arena, for example, the European Business Angel Network or European Trade Association for Business Angels; however there is still cooperation in individual cases.

To sum up, it can be concluded that in present in Latvia the early-stage investments are very inactive, besides the previous experience of BAs has been gained in the fields of quick flow of funds (for example, real estate). As a result, the existing BA culture differs strongly from the typical BA culture of the Western European countries that is based on investments in

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technologies and the intellectual capital. As a result in Latvia currently there is the lack of trust and skills to invest in innovative, technology ideas, and often there is the lack of awareness of the essence of the BA culture.

VI. Conclusions, Lessons and Recommendations

Conclusions

The development of financial supply both in Latvia and Estonia has experienced significant changes since the regaining of independence. During this time one can observe changes in the attitude and perception of all the stakeholders. While the earlier times are mostly associated with a lack of early stage financial supply, the recent years showed a more positive situation.

Currently in both countries early stage entrepreneurs have access to finances other than own capital. This is mostly thanks to public intervention by state supported mechanisms.

The state support system, especially in Latvia, rarely meets the needs of entrepreneurs/economic situation. Usually assignment among support schemes is inadequate in terms of the amount; therefore additional corrections are done frequently while each change is time consuming (1 year on average). The situation seems to be "learning by doing" and this negatively reflects the process of how entrepreneurs can prepare themselves for applications. Yet it has to be noted that the diversity of public support instruments has increased, although the focus on companies that are markedly early-stage oriented is small (the number of instruments and the amount of support). The support instruments are basically planned for companies in the growth stage.

Banks transformed from negative attitude players into high risk investors, while since 2008 banks have been positioning their activities in a conservative manner. Today in a common situation early stage entrepreneurs can not expect to receive a loan for business start-up. Receipt of a loan can be burdensome also in cases of growth companies where higher risk is involved. It is likely that banks left risky financing for other market players like the state, venture capital and business angels. However, taking into account the recent history banks can engage in riskier financing if the overall situation in the economy calls for that.

Inadequate pre-seed venture capital amount and number of operators. Since it is a high risk operation, there are no expectations that private investor initiative would be a sufficient mean to resolve the issue. This turns to state intervention in the market by consistent and long-term initiative. The financial resources and the willingness to invest through venture capital funds seem to be sufficient while there are some issues apart from the small market size of ideas:

- private operators assess the risk as being too high and, most likely, will not invest without any external risk sharing support,
- legislative burdens to invest into VC's by local pension funds; in Latvia it is 5%, while in Estonia 20% from pension assets,
- virtually non-existent practice of IPO exit strategy for VC in Latvia and Estonia that lies in the underdeveloped stock exchanges of both countries.

The main market failure seems to be the lack (of a sufficient number) of viable and growth oriented business ideas, both in Latvia and Estonia. This particular problem does not facilitate the activity of private investors, like venture capital, banks and business angels. For instance, for a reasonable operation of one VC fund it is necessary to screen about 400 good quality ideas, while on average in Latvia and Estonia 200 ideas per VCF (incl. the questionable ones) are screened. This situation may indicate on unsuccessful national policy by supporting first the VC instruments rather than ensuring a sufficient deal-flow beforehand.

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Lessons and recommendations

State support

In the case of Latvia and Estonia, notwithstanding the general public financing for R&D as well as the contents of the educational system, the most significant task is to ensure a sufficient deal-flow and to subordinate to this amount support instruments corresponding to the next commercialization cycles (growth and mature stages). Up to now it was observed that the amount of the growth support stage instruments has exceeded the actual demand.

Traditionally instruments for the early-stage development are tax incentives and subsidized loans. Matching grants, for example, the SBIR Program (US) and the Start Program (Australia) have turned out to be very successful.

At present in both countries pre-seed funding instruments operate to a limited extent, which have not actually been available previously. Positive examples of such support are the Symbion Capital I (Denmark), MAZ level one (Germany), Galileo SGR (Italy), Startfinanzierung (Austria), Proof of Concept Fund/Connect Scotland (UK), etc.

Significant early-stage promotion measures are attributable to the development of business incubators, business angel network, spinoff and spillovers from multinational companies.

Taking into account that part of the ideas is discarded as unfit due to the author's inability to convince the investor (especially in the cases of VC financing), it is essential to pay attention to investment readiness services that include both the capacity building training and the investment readiness training. These measures are partially carried out already in Latvia and Estonia with or without public support, yet possibly to an insufficient extent and too dispersedly without focusing on the target group. A good example is Ready4growth led by Greater London Enterprise, Fit4finance (UK), InvestorNet, etc.

With regard to all the support instruments, considering the previous experience, it is important for a country to realize that the instruments must be as focused to market gaps as possible, and it is desirable to reduce bureaucracy and reduce the time periods related to introduction or making of corrections, as far as this is possible. In the case of Latvia this problem is of a special concern, as well as the keeping in line with the development documents drawn out in the country.

In the issue of focusing on the target groups the country should consider the possibility to focus on the high-growth entrepreneurship (the so called "gazelles") to a larger extent than the currently dominating approach of focusing on the SMEs generally. No doubt, such an approach is much more complicated, but it might possibly provide much better results. This focusing means that a sufficiently wide range of issues, such as the national economy development policy, support instruments and improvement of the business environment. Partially, such approach in making of support instruments has been introduced already, for example, combining of public and private resources, R&D loans and innovation grants, VC, training directed towards international and organizational growth, experience-based advice in the attraction of financing, etc. However, at present in both countries the beneficiaries of financing are determined on the basis of the principle of equality, i.e. the range of beneficiaries is usually characterized by the size of the undertaking, fields of activity and other general descriptions that allow involvement of a large range of enterprises. Whereas, the gazelle selection approach substantially limits the range of these beneficiaries based mainly on the assessment of the growth potential, and accordingly the support granted is larger and of a better quality. This approach has been implemented within the Scottish Enterprise Account Management Process program.

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Banks

In practice, involvement of banks in the early stage financing is only thanks to the risk sharing and competence using methods, since the basic activity of banks is sufficiently conservative from the point of view of risk assessment. In Europe 3 types of cooperation models are mainly used:

- independent fund management by regional finance institution, for example, national loan fund co-financed by ERDF/ESF,
- Micro-credit and guarantee scheme, where micro-crediting from the part of commercial banks is only thanks to the public guarantee scheme,
- the Interregional umbrella fund or the JEREMY fund.

In Estonia and Latvia the two latter support forms are used.

Venture Capital

Taking into account the situation in Estonia and Latvia (sufficient resources for VC activities), the country should reconsider the conditions and extent of its participation to ensure that the VC amount corresponds to the actual deal-flow, i.e. by reducing the amount of investment and/or reducing the degree of risk in these partnerships, since currently the conditions for private VC partners are too favourable.

It is essential to evaluate also the previous operation and efficiency of VC in order to choose the best model of financing. This would particularly refer to Estonia where the VC functions are performed by a public organisation rather than by a private partner.

From the VC perspective, it would be important to ensure a larger deal-flow, as described under the State Support section. In additional, more attention should be paid to deal-flow continuity participants and their existence on the market. Universities and scientific institutes, from the point of view of VC funds, are the most attractive sources where to gain unique innovative ideas and inventions; however, VC funds usually give preference to review of these ideas by their network representative which ensures the continuity of deal-flow, for example, technology transfer centres, faculty staff.

One has to note also the effect of the developed Alternative Investment Fund Managers Directive on the development of the local VC funds. Currently the interests of VC funds are lobbed by the VC associations of the Western countries, but, if needed, this should be done also on a national scale. It has to be noted that the current version of the Directive provides for limitations with regard to "third country" investments that relate eventually to the increase of the idea pool towards the CIS. The current legal framework is also worth a discussion, for example, with regard to the control of market participants and limitations on institutional investors.

Business Angels

Currently in Latvia and Estonia the only public support measures are related to the development of the BAN; yet in the global practice countries may use also other instruments like fiscal incentives (Capital gain or loss exemption from tax and Equity guarantees); currently the most attractive conditions in Europe are provided in the UK where the income

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tax rebate equals to 20% for investments of up to 0.6 MEUR, exemption from capital gains on Angel investments applies, and the income tax relief equals to 40% for failed investments.

In the country's cooperation with other stakeholders and the stakeholders themselves may continue the development of BAN:

- by implementing the international integration in other BAN organisations of the European scale, such as the European Business Angel Network or European Trade Association for Business Angels,
- by creating Business Angel Academies where would-be and novice angels can acquire the necessary knowledge to invest successfully in the future; a good example is the UK where, by following the USA's practice, several such academies have been established;
- by popularising the Code of Conduct to members to promote the best practice and transparency across the industry,
- by continuing pro-active popularisation of business angel investments, having a dialogue with public organisations, extending the cooperation with various related companies, establishing various experience-exchange contacts, etc. A good example is the activities of the Portuguese Gesentrepreneur,
- by popularising/using the syndication investment forms that unite several business angels in order to make larger investments and reduce the risk, for example, the Halo Business Angel Network in Ireland.

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