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How attractive is central Eastern Europe for risk capital investors?

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A B S T R A C T

This paper addresses the attractiveness of Central Eastern European countries for risk capital investors by the construction of a tailored composite measure. Based on a survey among institutional investors, we define six key drivers that determine an emerging country's attractiveness for this type of investment. Using 42 socio-economic data series as proxies for these six key drivers, we benchmark the Central Eastern European countries with EU-15, Norway, and Switzerland and identify six tier groups of country attractiveness. We highlight socio-economic strengths and weaknesses of Central Eastern Europe and provide guidelines for policy improvements to attract more risk capital funding to spur innovation, entrepreneurship, employment, competitiveness and growth in the emerging region.

1. Introduction

The Central Eastern European (CEE)[1] countries are still in a transitional stage. EBRD (2005) emphasizes that improvements in governance, enterprise restructuring, and the financial sector have been the main features of the transition process in the last years. The CEE countries lessened the burden of business regulation, such as licensing and tax administration, and they progressed in

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[1] We define CEE countries as those Central Eastern European countries that lately (i.e., 2004 and 2007, respectively) accessed the European Union; namely Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, and the Baltic states including Estonia, Latvia, and Lithuania.

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reducing corruption and organized crime. EBRD (2006) highlights that the speed of the transition process varies in each country; some of them show strong attempts to reform, while others have decreased the pace of reform, partly influenced by recently-elected new governments. Unfortunately, EBRD (2007) remarks that reforms have lately slowed down since accession to the European Union, and that much of CEE lacks domestic political and social consensus, leading to fragile coalition governments which are less inclined to pursue difficult reforms.

Kolodko (2000) and Wagner and Hlouskova (2005) argue that the CEE countries are in a period of catch-up that might last for several decades. Süppel (2003) bases his view on the observation that per-capita GDP are still below average, while education in CEE countries is at a high level, and institutional structures have been converging for some time. The growth estimates above the European average, coupled with the political will to promote innovative enterprises should lead to a strong demand for risk capital in the CEE countries and hence, to a high attractiveness for Venture Capital and Private Equity (VC/PE) investors.

Venture Capital and Private Equity constitutes an asset class where institutional investors provide capital for non-quoted corporations. Financial intermediaries, the VC/PE funds, or General Partners, found Limited Partnerships, raise capital, and manage it. The term Venture Capital is used to describe investments that flow into young and start-up corporations with high growth potential. Private Equity defines investments to finance ownership changes of established businesses. The nature of these types of investment is return-driven. The institutional investors ask for an appropriate risk premium for their exposure.

Hellmann and Puri (2000) and Kortum and Lerner (2000) show that VC/PE-backed companies are more efficient innovators. Belke et al. (2003) and Fehn and Fuchs (2003) prove that they create more employment and growth than their peers. Levine (1997) documents well the role of VC/PE funds in fostering innovative firms, and indeed, there now exists a broad consensus that a strong VC/PE culture is a cornerstone for commercialization and innovation in modern economies. Hence, policymakers should focus on the creation of an adequate setting for a prospering VC/PE market to support Entrepreneurial Activities and growth, especially in transition countries. However, the risk capital supply is rather small compared to other European economies and relative to the expected growth opportunities in the CEE countries, even if institutional investors are increasingly looking internationally for new investment opportunities. The first funds were raised shortly after the fall of Communism. According to EVCA (2003, 2004, 2005, 2006), since then, and up to the initiation of our study, only a little more than €9bn has been raised in funds dedicated to CEE countries.

Foreign direct investments (FDI) were established immediately after the fall of Communism in CEE. This raises questions about the reasons constraining the development of the VC/PE market in that region compared to FDI. One could assume that VC/PE investments are similar to FDI. However, this is not the case: first, capital for VC/PE investments is provided by institutional investors as portfolio investments and not by corporations that follow a strategic rationale. Second, the investments are made via agents, the Venture Capital and Private Equity funds, and not directly: the institutional investors hold shares of a closed end fund as Limited Partners and do not directly take control of the finally financed corporation. This is the VC/PE funds' task. The General Partners are "active investors", and monitor and control the investee corporations. These characteristics lead to additional and more severe determinants for VC/PE allocations than for FDI: the VC/PE investments have to be liquidated after some time, to return the proceeds to the investors. Further, there has to exist an infrastructure and a network of finance professionals to perform and support transactions, and to finally divest. Additionally, there is no knowledge transfer from a parent company to a subsidiary. Hence, knowledge and strategies have to be developed and deployed by the investee corporation. Therefore, education, expected entrepreneurial management capabilities, and entrepreneurial culture in a host country receive a high importance in the international VC/PE allocation process.

In this paper, we address these issues and determine the attractiveness of the CEE countries for Venture Capital and Private Equity investors. We review the literature and search for factors that impact international VC/PE allocations. However, since there is no consensus about the relevance of the numerous determinants, we conduct a survey among Limited Partners: we simply ask the institutional