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THE SIGNIFICANCE OF VENTURE CAPITAL IN THE GROWTH OF THE SMALL AND MEDIUM BUSINESS SECTOR IN POLAND

Abstract. In this article, endeavours have been made to analyse and assess the significance of venture capital in the growth of small and medium enterprises in Poland. The venture capital market (risk capital market) encounters many barriers, not only in Poland, but also in the whole of Europe. It needs to be brought to attention that this is above all due to a lack of public policy. Until now, the Polish SME sector has taken advantage of venture capital in a very limited degree. The funds operating on the Polish market have relatively modest amounts of capital at their disposal, and seldom do they invest in undertakings at the early phases of development when capital is most imperative, and which meet with the greatest difficulties in acquiring such needed capital.

The analysis presented in the abovementioned case study shows that minimising the barriers limiting the access of risk capital finance should advantageously influence the expansion of the SME sector in Poland.

Key words: Venture capital, SME, investment and disinvestment

1. INTRODUCTION

The most developed venture capital market was created in the United States, where there existed many conducive factors, such as: ease of starting a new company, favourable conditions and strong motivation for the introduction of new methods and technology, a workforce with plentiful innovation-oriented managers, a developed capital market, etc. In European countries, however, for a long time taxation and administrative barriers had hindered the development of venture capital.

Among European countries, the earliest market to begin its development in this regard was in Great Britain (in the late 40s). In the countries of continental Europe, this type of finance only started to become common in the 60s. This delay was due to the re-building of war-torn economies, and political systems whose strong intervention limited the role of the market. Industrial policies concentrated mainly on supporting large and medium sized enterprises, while neglecting small firms with the naturally propensity for venture capital development.

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Social conditions were also significant, especially the greater traditionalism of European businessmen. Only in the 70s were there changes due to interventionism and liberalization of European economies, and these spurred on dynamic development of medium and large business, and created a stimulus for feeding the venture capital market.

Simultaneously, progressive globalization of business economies and greater acceptance of new financial agencies, as well as increasing competition, inclined European business to have a greater share in using the assistance of venture capital.

Whereas in the hindering economies of Central Europe, the small and medium business sector has until now lacked sufficient funds, which is one of the main reasons for its limited growth. The capital market is at the formation stage, and the relatively modest resources that are made available are mostly being invested in large, prospering companies. In turn, banks are limited in their capital and are too prudent to finance enterprises saddled with above-average risks. First in line on this market in such a situation are foreign venture capital funds, which are able not only to access capital from more developed economies, but they also have at their disposal the necessary know-how, the lack of which exists in the countries being discussed. Venture capital markets understandably began to expand first, in the countries of Central Europe in which economic restructuring was the most advanced. Presently, the beginnings of a venture capital market exist in Hungary, Czech Republic, Slovakia, Poland and Slovenia. However, financing by means of venture capital requires the development of favourable environmental conditions, which include: progress in the technological, economic, legal and social systems.

The decade of the 90s clearly exposed weaknesses in the European Union, particularly when compared with the United States. These included the slower rate of expansion and lower capabilities of creating and absorbing technology, as well as a slower economic growth, which was a factor that spurred on the Lisbon Strategy. Its main objective is to create a leading-edge world economy within the Union, by the year 2010. One of the requirements to help achieve this outcome is easier access to capital. The fourth section of the Blue Book is dedicated to the risk capital market. That is also why, in this case study, a trial has been undertaken to relate venture capital to the growth of competition of small and medium enterprises in Poland.

2. VENTURE CAPITAL IN THE LIGHT OF THE LISBON STRATEGY

According to the Lisbon Strategy, the source of the weakness of venture capital is seen in the lack of appropriate support from public policy. Another reason is a weak supply of capital from domestic sources, obstructed by overlyrestrictive regulations (this fact is often highlighted in reference to superannuation funds).

Public policy was an essential factor in stimulating the growth of this market in Western countries. This factor never pretended to be a substitute, taking the place of private capital. Rather, it played a supportive and complimentary role. In reference, however, to the supply of capital, the problem boils down to the fact that the venture capital segment is viewed as less attractive, when compared with other short-term investment opportunities. The primary drawbacks include: a young (not well organised) organisational culture, business immaturity in institutions and aversion to risk-taking.

In Europe, large enterprises contributed a few percent of the total capital (8.9% in 1998–2002). However, in Poland these investments are practically absent, and big changes in this regard cannot be expected in the near future. Large enterprises do not make their own capital available to funds, nor do they themselves undertake these types of investments, therefore, due to their resources, banks become a more attractive source. Statistically speaking however, banks are second after superannuation funds as a source of capital in Europe. Their average share in supply in the period 1998–2002 amounted to 25.7%, however, the Polish market only received a token share of this figure. Until now Polish banks, to a small degree, participated in funding classic venture capital funds. The reasons for this are varied. Polish bank law allows all banks to make capital investments, however, the utilisation of these opportunities meets with considerable obstacles. Standards of caution allows the bank to commit up to 25% of its own capital to investment capital (upon approval from the NBP - National Bank of Poland, up to 50%). Currently, in most cases, banks' own capital is relatively not too high. In relation to the high risk associated with venture capital investment, Polish banks, similarly to those in other Western countries, are not prone to making direct investments in companies. Besides this, to guarantee the success of such an investment, it is indispensable to give support to its management, for which banks are not always prepared, from a personnel aspect. In these situations, only very few banks, namely, those which have essential experience in the privatisation and restructuring of companies, decide on direct investment. A solution to venture capital finance is being able to exchange credit due for company shares. Among others, Bank Handlowy w Warszawie S.A. conducts such operations.

According to the European Private Equity and Venture Capital Association (EVCA) a barrier hindering the development of the discussed market is the obligation to prepare consolidated financial statements, which in the European Union from 2005, applies to companies and venture capital funds, as well as private equity. According to the EVCA, these statements will show entities investing in funds an unrealistic value (lowered investment value), which could discourage interested parties from participating in investment funds.

Another capital resource is found in savings kept in OFE (Open Superannuation Funds). There is significant hope for these resources with regard to the venture capital market. In Poland, these funds are currently the largest storehouses of investment capital. At the end of 2003, these assets were valued at 44.8 billion PLN. It is estimated that in 2010 this sum will be close to 168 billion PLN. Research outsourced by the EVCA shows that institutional investors should, to gain the optimal risk/reward ratio, invest approximately 5–10% in venture capital and private equity, which would have a great impact on this market[1]. According to EVCA, if OFE capital becomes accessible, it will first of all be directed to less-risky markets, such as private equity. Nevertheless, this market is showing signs of capital saturation, not a lack of it. The consequence of such a saturation is the consistently high transaction value, that is, the investment in more and more mature businesses. A phenomenon of the withdrawal of funds not invested could also be a result of this trend. Therefore, how should these be introduced onto the OFE market, so as to bring the most benefit? One of the answers to this question may be Fund of Funds (FOF), that is, funds collecting money from various investors, invested in venture capital, which in turn are further invested in portfolio companies. A benefit of these funds is the consolidation of large amounts of capital under the awl of the FOF system, through which a single investor benefits from significant risk distribution, and the decision process associated with the allocation of FOF assets is active and centralised. Using the FOF, a part of the OFE funds can be invested in the venture capital market without constituting a large risk to the entire OFE portfolio, or any side effects for private equity.

Therefore, it would be beneficial to encourage institutional investors to take advantage of the FOF market, and to invest in companies not on the stock market. The concept of the Fund of Funds, however, doesn't solve the problem of the underdevelopment of the venture capital market. FOF fills the role of a shock absorber, making it easier for institutional capital to enter the market.

Another negative influence on the venture capital market is the Polish economy, which offers many opportunities for fast profits with a not-too-large risk factor, e.g. investing in bonds, which finance budgetary deficit. This situation does not encourage investors to make more risky investments, even if these were to bring somewhat higher profits.

The problem with the revival of the venture capital market doesn't only rest on the supply of capital. Substantial also is the problem of a lack of high quality managers. Professionalism and credibility of a fund manager creates a climate and environment that attracts capital. Funds that have existed until now in Po-

[1] Performance Measurement and Asset Allocation Private Equity Funds, EVCA, March 2004

land, have not had a dedicated management company. An influx of fund managers on the market, that is, people with the right composition of financial, business and technological skills, is a problem to acquire in the whole European venture capital industry. This fact was highlighted in a European Commission news release dedicated to providing small and medium enterprises access to finance, in which it was noticed that, one of the strengths of Silicon Valley was the ease of the flow of people between technological companies and venture capital funds (http://www.pfsl.pl).

Big hopes for the revival of the venture capital segment, in particular with reference to the financing of the early phases of enterprise development, are tied to the start-up resources from the European Regional Development Fund (ERDF). The possibility of utilising such structural funds were foreseen in the Sector Operation Program's objective: "Increase of Company Competitiveness". In line with this program, a sum of 174 million euro was appointed, to which an additional 45 million EUR is to come from domestic public resources. These resources are to benefit at least five seed capital funds. The resources are to be made available in the form of a grant through the Polish Agency for Enterprise Development. There is also the concept of the distribution of these resources with the help of the Domestic Capital Fund (KFK), which would serve as a Fund of Funds. It is foreseeable that individual projects will be able to utilise anywhere between 5 and 50 million PLN, and no more than 50% of qualified expenses. Funds receiving assistance cannot invest more than 5 million PLN in any single project.

When deliberating the aforementioned, we must also include corporate venturing, that is, venture capital investments made by large corporations for either financial or entity purposes. We can incorporate the stimulation of entrepreneurship and the strengthening of internal innovation through investment in existing employees by means of start-ups and access to technologies. These, in turn, in the future could become a core element of the mother company. The venture capital phenomenon began to expand in the mid-60s of last century. The peak of its expansion was in the year 2000, at the height of internet fever on the stock market. However, the current recess on the corporate venture market has caused a suppression of many investment programs, and this has left only the most mature players on the market, such as: Intel Capital, Johnson&Johnson, Nokia and Xerox. In Poland we can observe only the very beginnings of this market. Corporate venturing can contribute to the internal revitalisation of corporations, as well as a rise in creativity. It could also assist in the marketing process of intellectual resources from the R&D sector. Corporate venturing can be considered a very important module for the co-creation of the venture capital market, however, support from independent venture capital funds is required.

An important issue in the expansion of the venture capital market is investment readiness. This is not only a problem in Poland, but also in the more developed markets, such as the one in Britain. Investment readiness is made up of 3 main elements: a general propensity of entrepreneurs to use share capital as finance, lack of the necessary skills needed to prepare the necessary documents (plans, projects, etc) and other contributory investment readiness factors (extent of reaching investors' expectations, which is made up of: potential of management, rate of return, and the ease of disinvestment).

While analysing the organisational barriers suppressing the growth of the venture capital market, it's important to note that all funds functioning in Poland up until the present were registered abroad.

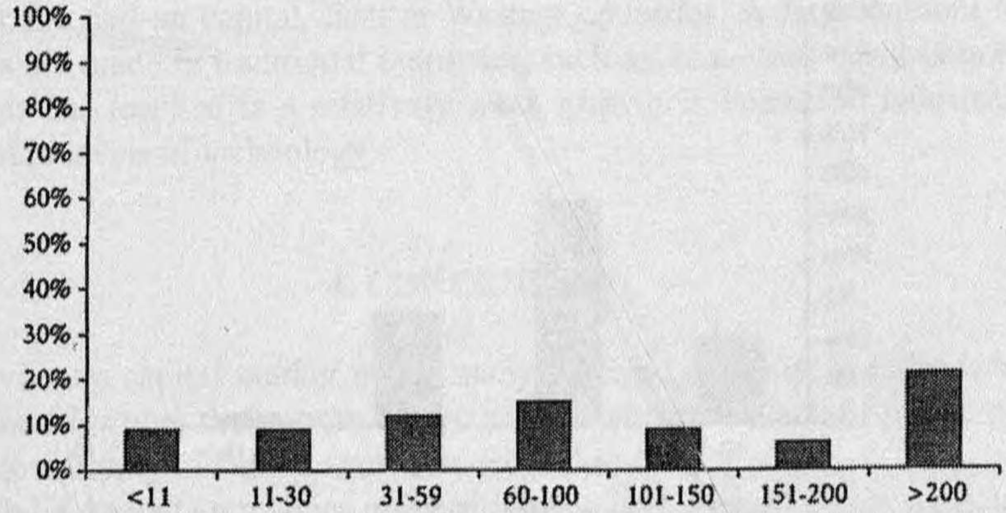
3. VENTURE CAPITAL IN POLAND

For the expansion of the venture capital market, a range of conditions must be met, so as to create the aspects of demand, supply and functionality. Only a situation in which all three factors emerge simultaneously will put in motion venture capital financing.

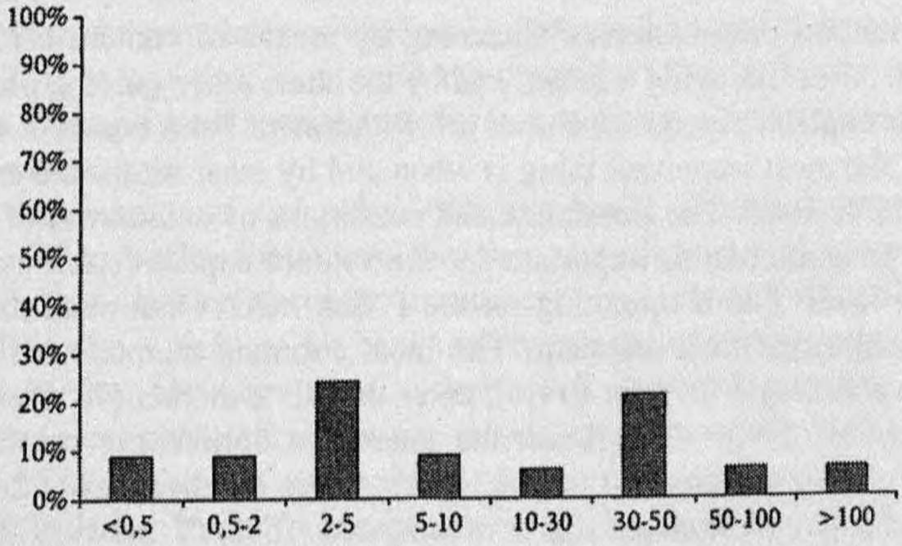
In Poland, the conditions allowing for expansion of this market are gradually emerging. Apart from the fact that venture capital usually invests in undertakings with a higher-than-average risk factor, in Poland there exists an even higher general investment risk. In relation to this, issuers of venture capital use more caution in their investment strategies than in countries with a more stable economy. For this reason a number of the funds invest only in already-existing enterprises and strive to widely diversify their investments. There exist 37 venture capital funds on the Polish market, most of which were created by means of foreign entities having had private and public capital. Only one fund (TISE) dominates the domestic capital market, but its volume, even if we take into consideration that it is based on companies in the commencement phase, is very modest. There is, however, a lack of private venture capital funds.

Only 21% of venture capital funds on the Polish market administers capital of over 200 million PLN, 15% operates with capital of between 60 and 100 million PLN, and 12% controls capital of between 31–59 million PLN. More information about capital value controlled by funds is shown in Graph 1.

One quarter of the funds prefer investments of 2 to 5 million PLN, and another quarter of the funds invests between 30 and 50 million PLN. Only 6% invests more than 100 million in any single investment. Graph 2 shows the value of preferred fund investment amounts on the Polish market.

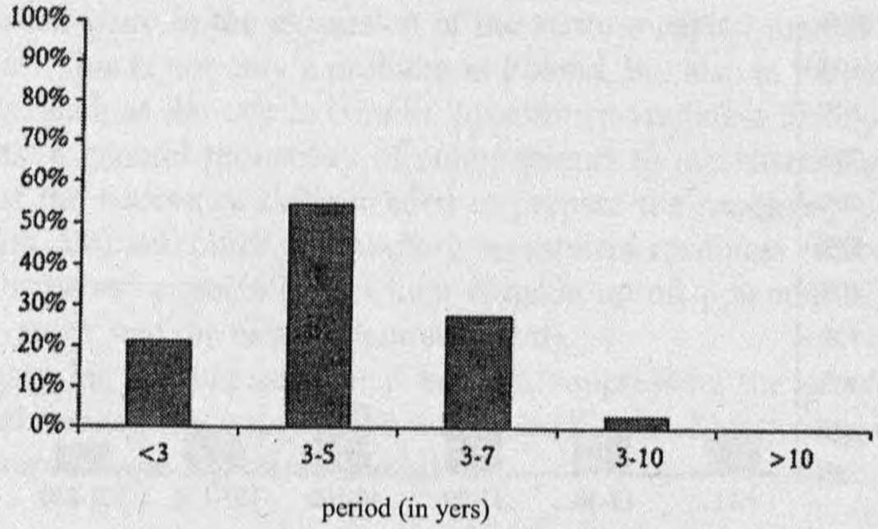


Graph 1. Value of capital controlled by venture capital funds on the Polish market (in mln zl)
S o u r c e: own calculations based on data by: Tamowicz, Rot 2002.



Graph 2. Preferred investment value by venture capital funds on the Polish market (in mln zl)
S o u r c e: own calculations based on data by: Tamowicz, Rot 2002.

Over half of the funds (55%) invest in ventures for a period of between 3–5 years and 21% in ventures for a 3–7 year period. There are no investors in ventures for a period of over 10 years. The preferred investment duration of funds operating in Poland is depicted in Graph 3.



Graph 3. Preferred investment duration

S o u r c e: own calculations based on data by: Tamowicz, Rot 2002.

The natural progression of financing by means of venture capital is disinvestment. After achieving a target, and by the same token gaining position on the market through an enterprise, shares are withdrawn. For a typical venture capital investor, the most important thing is when and by what means the expected profits will be realised. The timeframe and conditions of withdrawal of shares from the enterprise are just as important for the venture capital contributor as for the company itself. Funds operating on the Polish market can avail themselves of a few methods of disinvestment. The most common methods are to sell their shares to a strategic investor (94%), enter the stock market (73%) or sell shares to employees (45%). Oftentimes, the latter two options are combined, where a part of the shares are sold to employees, while another part is floated on the stock exchange. Seldom are shares depreciated (15%) (Tamowicz, Rot 2002).

Until now, most investments were made in large enterprises and companies that had been on the market for a long time, that is why 73% of disinvestments are carried out through the stock exchange. In the case of small and medium enterprises, this type of share sale becomes a barrier, due to the lack of niche market services to process SME shares.

That there is a need for venture capital in Poland can be seen from the fact that, over the past 5 years, the company Enterprise Investors, which manages the capital of the Polish-American Entrepreneurial Fund and the Polish Private Capital Fund, has received thousands of applications, from which number about 1000 were analysed and 46 fulfilled (Krajewski 1995).

It is characteristic of the Polish market, that there exist no venture capital funds which could finance the propagation stage. With regard to the higher risk involved, funds from abroad which invest in Poland expect a much higher rate of return for the tied-up capital, than in Western countries. A large amount of investments are made in traditional industries, such as: chemical, construction and retail. This has resulted in a relatively weak growth in Poland in industries involving high levels of technology.

4. CONCLUSION

The venture capital market meets many barriers, not only in Poland, but in the whole of Europe, the reasons being, among others, the lack of public policy and the slow supply of capital from domestic sources.

Polish banks and companies up until now have to a small extent participated in classic venture capital funding. The combined capital amount brought into these funds from Polish shareholders has been until now approximately 5 million USD. Banks, which have a traditional attitude toward funding of companies' operations, are very cautious when it comes to financing innovative ventures, and this is due to the principles of caution in bank policies and their aversion to risk-taking. This means that, even with opportunities of a high rate of return, banks do not invest without special security (e.g. national guarantee) in new and innovative undertakings.

Besides this, bank laws and policies impose limits on investments in company shares. Often banks don't have the trained personnel and know-how to make a foresighted decision about the investment prospects and risks of product innovation. It is also a problem for banks to change their existing valuation systems or to take into consideration the shorter life cycle of products, and the shorter development phase of innovative businesses. Above all, banks prefer a running operation of the tied up capital with regular repayments and interest. It's more difficult for banks to accept returns of invested capital after a few years, especially when the market where shares can be sold is under-developed (Büschgen 1985).

Domestic venture capital is important, not only for business, but also for the whole economy, as it fills an existing gap for financing innovative enterprises instantiated in the SME sector. Private venture capital investors as well as companies and financial institutions that make investments of this kind, look for situations in line with their criteria and goals. Yet, this does not fully meet the needs of providing venture capital to innovative enterprises. In particular, companies that are at the preliminary stages of their project expansion, have difficulty in finding funds for their ventures, however, these are not of interest to larger enterprises.

In the practicalities of a country's operation, more often than not, licenses are issued to companies created through private entities. In return for adhering to the legal requirements in the setup phase, these are assured access to public funds, tax concessions and other assistance. These types of operations are undertaken by specific countries as well as by trans-national enterprises. An example of the latter is the European Seed Capital Fund Scheme, put into force at the beginning of the 90's by the European Commission, which gave support to funds that invested in companies in stages of early development, and helped fund the management of share companies. A country can have an active influence on the development of small and medium enterprises by setting up institutions that support innovation. These create an environment in which typical problems faced by innovators, encountered in the first phase of the development of a concept, can be easily overcome, before they are able to handle them in the framework of their own independent company.

Companies also have the facility of acquiring finance from assistance programs. However, there exist certain limitations. Most assistance programs are geared toward supporting only specific fields of technological progress, funds for these types of programs are usually allocated for research and development, and relatively seldom do these offer the capital needed to setup production or to introduce products onto the market. Often, the taking advantage of the funds offered by these programs includes the necessity to self-fund a portion of the investment, a complicated process of bureaucratic procedures deterring innovators and a long period of processing the results of whether a project should be financed, means that the innovator loses time as a weapon against opposition (Werde 1987).

We can ascertain that funds allocated by the government for the support of innovative businesses only cover a portion of the self-funded capital they require. There are at least 3 reasons for this: limited funds, formal restrictions in fund allocation and restrictive procedures applied in accessing the funds. A field of activity is opening up for venture capital funds benefiting from private capital. Venture capital contributors must have guaranteed ability to easily cash-in their shares when they want to access profits. The market must be absorbent enough for investors to be able to sell their shares at any moment required, without necessary delay. Without such a market, venture capital will not appear, because the investor will not have a good chance of cashing in on the expected profits. The expansion of a market on which both small and medium enterprise shares operate would enable not only easy disinvestment, and an increase in the volume and rate of such shares, but it would at the same time also create a demand for new stocks, through which new venture capital incentives would enter. A secondary market on which large companies are listed would not be conducive to the turnover of small and medium enterprise stocks. This is due to: high standards for companies striving to enter the stock market, a time-consuming list of procedures before allowing companies to make stock transactions, high costs associated with stock market admission, as well as stringent reporting requirements in association with keeping investors informed about the financial status of a public company. SME's represent a lower level of share market maturity, and are not in a position to meet these requirements. That is also why, to have the ability to make the stocks of these enterprises available for public turnover in the EU, special market segments have been created for this purpose where milder entry requirements and lower issue costs have been established. When speaking about the dealing of stocks issued by small and medium enterprises, it is understood that this refers to trading on these specially designed markets. A Pan-European stock market designed for enterprises with large growth potential, will contribute to the solving of the issue of disinvestment in European Union countries. This will increase the amount of listed companies and a greater flow of listings through the access to a larger potential capital market.

Financing by means of venture capital needs the formation of favourable conditions, which include technological advancement, and economic, law and social systems. An economic system benefiting a venture capital market includes, above all, economic growth. Such growth creates a need for new technologies, products and services, expansion in the financial market, on which firstly capital reserves appear, and secondly, it allows for the sale of shares after the finance period has ended. Legal elements that influence financing by means of venture capital include: legal standards for the setup of a company, protection of intellectual property and innovation, taxation regulations favourable to the financing of business activities, and legal assistance programs for innovative individuals.

As a summary, it can be affirmed that the Polish SME sector has taken advantage of venture capital in a very limited capacity. Funds on the Polish market have only limited capital resources, and seldom invest in enterprises at the beginning stages of development, that is, those which require the most financial assistance, and which have the most difficulties in acquiring such capital. The results of the herewith study show that reducing the abovementioned barriers limiting the access of risk capital finance should advantageously affect the growth and increase the competitiveness of the SME sector in Poland.

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ZNACZENIE *VENTURE CAPITAL* W ROZWOJU SEKTORA MAŁYCH I ŚREDNICH PRZEDSIĘBIORSTW W POLSCE

W artykule podjęto próbę analizy i oceny znaczenia *venture capital* w rozwoju sektora małych i średnich przedsiębiorstw w Polsce. Rynek *venture capital* (rynek kapitału ryzyka) napotyka na wiele barier nie tylko w Polsce, ale również w Europie. Należy tu wskazać przede wszystkim na brak odpowiedniej polityki publicznej. Dotychczas polski sektor MSP w niewielkim stopniu korzystał z venture capital. Fundusze działające na polskim rynku dysponują stosunkowo skromnym zasobem kapitału i rzadko inwestują w pierwszą fazę rozwoju przedsiębiorstwa, w której najbardziej potrzebuje kapitału i w której napotyka największe trudności z jego pozyskaniem.

Z analizy przeprowadzonej w niniejszym opracowaniu wynika, że zmniejszenie barier ograniczających dostęp do finansowania kapitałem ryzyka powinno korzystnie wpłynąć na rozwój sektora MSP w Polsce.

Słowa kluczowe: venture capital, sektor MSP, inwestycje i dezinwestycje.