HOW DOES THE JEREMIE PROGRAM AFFECT THE HUNGARIAN VENTURE CAPITAL MARKET?

Zsuzsanna Széles
University of Szent István, Hungary
E-mail: szeles.zsuzsanna@gtk.szie.hu

Zoltán Széles
IN21 Innovation Foundation
E-mail: info@in21.hu

István Miszori
IN21 Innovation Foundation
E-mail: info@in21.hu

─Abstract ─

In the 2007-2013 EU's budgetary period a new program was introduced for SMEs. JEREMIE - Joint European Resources for Micro to medium Enterprises - offers to EU Member States and regions the possibility to invest some of their EU structural funds allocations in revolving funds and so recycle financial resources in order to enhance and accelerate investments in enterprises.

The market for venture capital and private equity is relatively small in Central and Eastern Europe, but has matured during the past decade and yields are better than in Western Europe.

In 2009 Hungary got the first notification for the venture capital part of the JEREMIE program, and started to organize the channel to distribute this renewable source for Hungarian start-up and innovative (from micro to medium) enterprises. 2010 was the first year of the "JEREMIE venture capital funds" in Hungary. There are no tangible results yet, but a snapshot could be taken about how this program affects the Hungarian venture capital market.

Key Words: *venture capital, private equity, JEREMIE*

JEL Classification: G24

1. INTRODUCTION

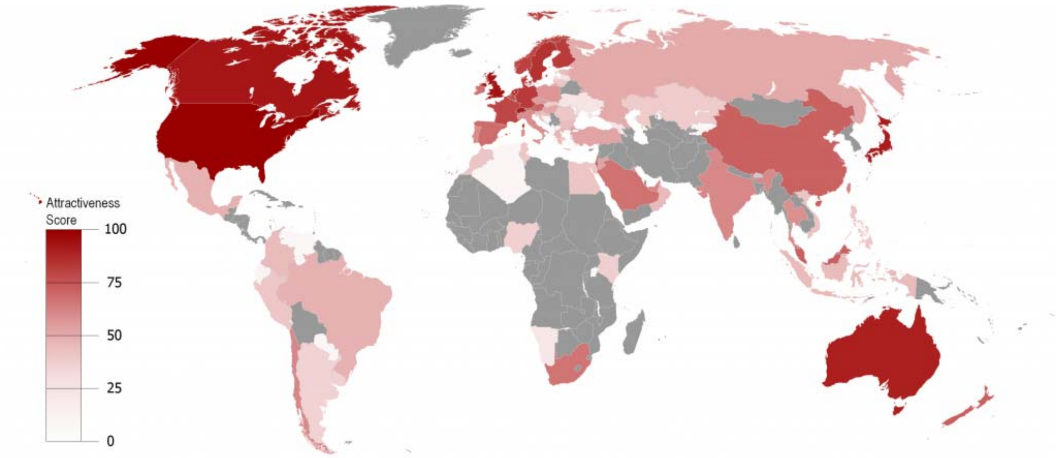
The aim of this paper is to give some background information to the venture capital and private equity sector (VCPE) in Central and Eastern Europe (CEE) and to introduce the JEREMIE (Joint European Resources for Micro to medium

Enterprises) program (its VC part) by the Hungarian example. In addition, we will analyze the effect of this state's role on the market, including the first year activities of these venture capital funds. Finally we will speculate on the effect of this state's tool in other CEE countries.

1.1 Historical background

Since 2008, when the financial crisis started, we have been hearing about the VCPE sector mostly from the regulatory point of view. This fact can show the importance of this part of the financial sector, but it must not be forgotten that its history is only a few decades old. Before the end of World War II., private equity was the domain of wealthy individuals in the USA. The former successful entrepreneurs had money, experience and inner motivation to provide financial capital to early-stage, high potential growth companies. The first two private equity (PE) companies – suiting today's terminology - were established in 1946, in the USA. During the last 60 years this sector has been financing mainly the technology orientated starting and expanding companies. The USA is still holding its lead position (see the map below).

Figure-1: The Global Venture Capital and Private Equity Country Attractiveness Index - 2011 Annual



Source: Alexander Groh, Heinrich Liechtenstein and Karsten Lieser Global - Venture capital insights and trends report 2011, http://blog.iese.edu/vcpeindex/ [Accessed 19.03.2011]

1.2. Definition of the venture capital and private equity

VCPE definition could be found at the end of this question tree:

1. Is the source of finance inside or outside? ⇨ 2. If outside, it may be external capital (like loan) or equity (like shares) ⇨ 3. The equity may come from inside (present shareholders) or from outside (investors). The investor may be professional/strategic or financial. The strategic investor looks for the synergic points and sooner or later the investor's and the portfolio company's activities will be interlocked. The financial investor's professional field is the management of the stake in different companies and sometimes in different sectors, and their main target is to sell the bought/held stakes by profit. Looking at the route above, the VCPE investor could be defined as a financial investor who stakes in order to sell it later.

2. VCPE SECTOR IN CEE AND IN HUNGARY

Final numbers are not available about 2010, but what seems clear is that in 2009 the CEE region was much more attractive for investors than Western Europe (compared to previous years).

Figure-2: CEE and Hungary market shares in Europe, 2002-2009 (investments)

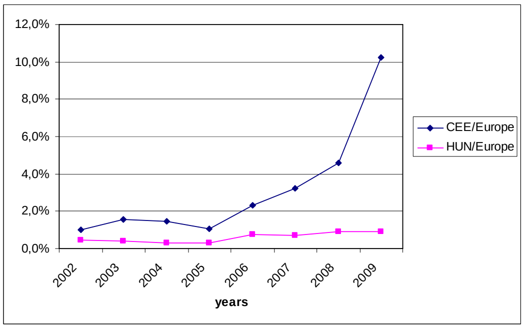


Table-1: VCPE market, 2002-2009 (investments)

	Europe	CEE	Hungary
	billion EUR		
2002	27,600	0,274	0,127
2003	29,100	0,448	0,117
2004	36,900	0,547	0,108
2005	47,100	0,510	0,131
2006	71,200	1,667	0,534
2007	72,000	2,340	0,491
2008	54,000	2,480	0,477
2009	24,000	2,460	0,214

Source: EVCA, HVCA

As the figure indicates, the CEE VCPE market was able to grow compared to the European market. The explanation of this fact is stagnation in CEE region (after the crisis started in 2008) and also, that on the European market there is significant fallback (as the numbers can show above). According to business experts the CEE region's future seems to be promising - its market share is expected to grow. (Karsai, 2009:6-10)

Table-2: SWOT Analysis - VCPE sector in CEE

Strengths	Weaknesses
• Generous tax incentives among most of the Eastern European countries • Strong stock market in Poland	• Generally weak capital market structure in the region • Lack of experience in structuring and completing complex transactions • Currency volatility in some countries
Opportunities	**Threats**
• Rising entrepreneurial culture and opportunities for VC investors • Ongoing privatization projects • Reform of legal systems provides increasing security and attractive environment for VCPE	• Funding can be difficult for local general partners • Less stable regulatory and enforcement environment than in Western Europe

Source: „The Global Venture Capital and Private Equity Country Attractiveness Index – 2011 Annual; (Margaret Dezse, 2011: 64)

Table-3: SWOT Analysis - VCPE sector in Hungary

Strengths	Weaknesses
• Competitive tax regime supporting investment and economic growth • Large cumulated FDI with significant new investments in the automotive sector and shared service centers • Post-privatization phase • Known to have grown talent and know-how in selected industries	• Volatile currency • Limited number of large potential investments • Underdeveloped stock market, resulting in limited market liquidity and poor exit opportunities
Opportunities	**Threats**
• Untapped midsize market, which is a priority in the government's economic policy • Growth potential of Hungarian companies which have already invested in neighboring countries; cross-border activity • Market consolidation in various industries, disposals, reorganizations of international players • Difficulty in raising finance for local players • Values to be created by improving corporate culture • Commencement of the EU-funded "Jeremie-Program"	• Reduced availability of debt financing • International investor confidence • Uncertainty regarding the government's macroeconomic policies

Source: „The Global Venture Capital and Private Equity Country Attractiveness Index – 2011 Annual; (Balazs Tuske: 2011, 126-127)

The Hungarian VC market moved with the European and not with the regional one in 2007-2009. Behind this fact there are macroeconomic problems. Firstly, Hungary has been under excessive deficit procedure since its EU accession in 2004. Secondly, Hungary was the very first country which fell back on IMF and EU bailout, ten weeks after the Lehman Brothers' bankruptcy in 2008, at the beginning of the crisis. And last but not least, Hungary's CDS (Credit Default SWAP) spread was highest in CEE region in the middle of 2009.

As for the VCPE market, there was a huge expectancy for the VC part of the Hungarian JEREMIE program. After 1.5 year-negotiation with the EU Committee, Hungary got the program notification at the beginning of 2009. The Hungarian Holding Fund manager (see the program structure later) set the tender's (for VC management companies) deadline for April. Later the tender process was stopped before the final results. The Holding Fund started a new tender process and the end of this procedure was in Dec. 2009. This delay may have caused that the market players postponed some of their investments in 2009, because they were waiting for their results of this tender.

In addition, what we can see on the VC market in Hungary – from the SME's point of view – is that there was a market gap in the 1-4 million EUR investment range. During the last 5-6 years there were only 1-2 early stage investments in Hungary (see the figures below).

Figure-3: Hungarian VCPE investments in 2002-2009 (million EUR)

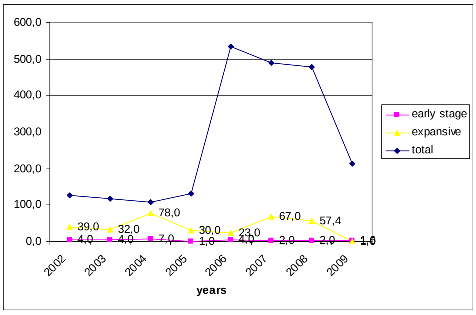
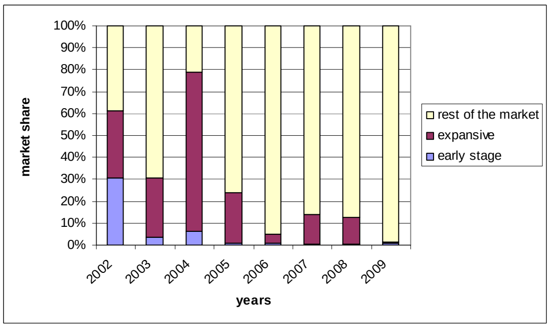


Figure-4: Determinative segments of the Hungarian VCPE market (2002-2009)



Source: HVCA

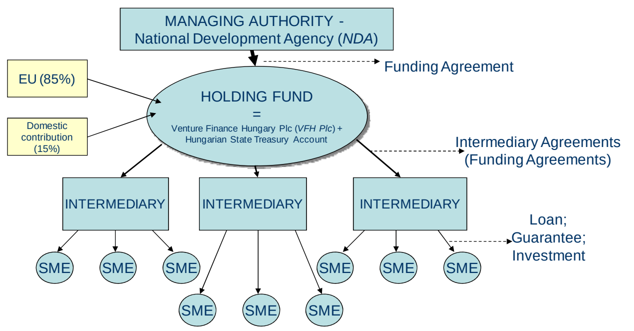
The facts above can make the huge expectation for JEREMIE VC part in Hungary in 2009 understandable.

3. THE HUNGARIAN JEREMIE (VC PART) AND ITS ANTECEDENTS

From the transition (1990) until 2000 the Hungarian state's role on VC market was prevailed by the state-owned development bank's (MFB) activities. Most of the transactions were connected to the privatization process, and the investment decisions were motivated by politics in many cases. (Karsai, Judit. 2004: 15-19) After 2000 until the JEREMIE start in 2009, more than twenty (state-owned) legal entities were involved in organizing the state's role (both country-wide, and regionally). During this period the conception changed, and the state's role structure was reorganized many times. The final result is inconsiderable; we can see less than 50 million EUR realized investments.

JEREMIE Program in Hungary – overview

In the case of venture capital part of the program, the partners (intermediaries) of Venture Finance Hungary Plc. (VFH) are venture capital fund management firms.



Source: Venture Finance Hungary Plc.

Two types of VC funds were established according to the rules of the final tender. One of them is the "Joint Fund" and the other one is the Co-investment Fund. Both of them had to be registered in Hungary.

Table-4: Characteristics of the two types of funds

"Joint Fund" structure	"Co-investment" structure
VFH acquires a stake of up to 70% of the Joint Fund. VFH's contribution was between approximately EUR 2.5 million to EUR 18 million. The maximum maturity of the Joint Fund is 10 years.	VFH launched a wholly independent legal entity venture capital fund (Co-investment Fund). The Co-investment Fund executes investments only with private co-investors, agreeing investment terms with them on a deal by deal basis. The maximum maturity of the Co-investment Fund is 10 years. The share of the Co-investment Fund in each individual investment is a maximum of 70%.

Source: Venture Finance Hungary Plc.

The intermediaries had to be registered fund manager firms which had to be entitled to manage venture capital funds according to the Hungarian Act on capital markets on the territory of the Republic of Hungary, possess appropriate professional references, and had to be capable of drawing in the necessary private resources.

The fund manager firms' compensation consists of a fixed fee based on the volume of the fund and a success fee. Fixed fee: established in the course of the fund managers' tender, maximized at 3% of the registered capital per year. Success fee: applicable after the termination of a fund, if the fund generated annual profit above the agreed hurdle rate. Private investors should be independent (meaning independent from the target company the fund invests in), whose resources to be invested do not come from public finance subsystems.

4. STATE OF PLAY (DEC 2010)

After the successful tender in the first quarter of 2010, seven Joint Funds were established with 148 million EUR (including about 100 million EUR - the holding fund's contribution). They were designed for investing in the Hungarian convergence regions.

For the Central Region (including Budapest) the only Co-investment fund was established with about 14.5 million EUR capital (the same amount as the holding fund's contribution).

As for the "private" characteristic of VCPE business, the availability of public data is deficient, but this is what we know about the first year (2010) of this market segment:

- the "JEREMIE funds" (the seven Joint Funds and the one Co-investment) stake in 14 SMEs;
- the total investment is about 12,3 million EUR;
- the fourteen target companies were mostly new establishments, and most of the deals were technology orientated projects;
- The eight JEREMIE funds have to invest their remaining money in 2011-2013, because of the European regulation beyond this program. On a yearly a basis it means 50 million EUR for a VCPE market segment where in 2002-2009 there were 2-4 million EUR investments/year.

5. INTERNATIONAL TRENDS BEHIND THE HUNGARIAN EXAMPLE

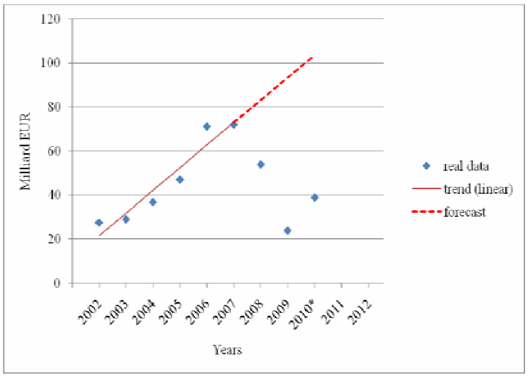
The research has been conducted on the basis of the secondary data. The data was available from the European Private Equity & Venture Capital Association

(EVCA) and Hungarian Venture Capital and Private Equity Association (HVCA) databases.

The analytical trend calculation is the most often used way of the trend calculation. The permanent tendency of the time series can be expressed by certain well-fitting function. In the course of fitting the function, similarly to the regression calculation, using the least square method we search for the trend best fitting to the values of the time series. So the analytical trend is the specific function, where the differences of the square amounts between the values of the same dates in the time series and the function's own values is the least. (Szűcs, 2004:352)

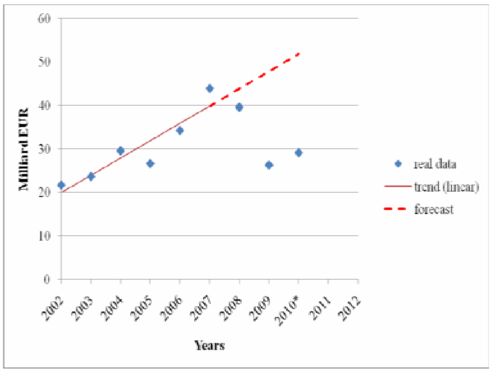
The general form of the linear function:
where $\hat{y}$: the value of the trend
x : the values of the time changes equidistant from each other
a and b: the unknown parameters of the function
The aim is to estimate the parameters that can be determined with the standard equations. The standard equations are the equations where the
$\sum (y_i - \hat{y}_i)^2 \Rightarrow \min$. function's primary partial derivates are equalised with 0. (SZŰCS, 2004:353)

Figure 5: VC investments in Europe



y=10,24x+11,46
R^2=0,914

Figure 6: VC Investments in the USA



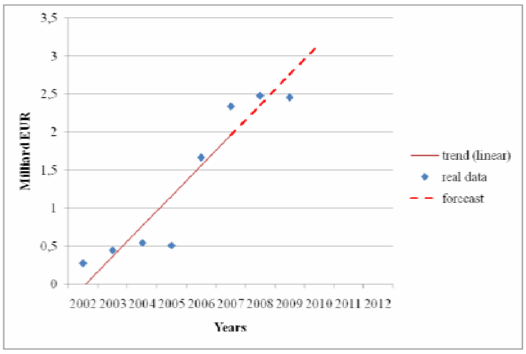
y=3,986x+16,01
R^2=0,841

Figure 5 shows VC investments in Europe between 2002 and 2010 (*data is preliminary from 2010). The linear trend is solid line between 2002 and 2007, the forecast (interrupted line) is from 2008 to 2010. The fitting of the trends are close.

The average yearly VC investment increase is 10.24 Milliard EUR. The VC investments are decreased in Europe. We can see big differences between before and after crisis for example VC investments have been 40 Milliard EUR in 2010 and the forecast is 100 Milliard EUR. It is huge go-down.

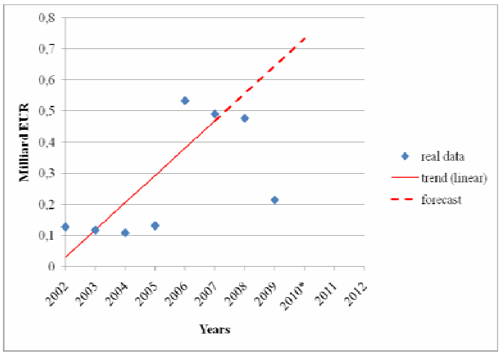
Figure 6 shows VC investments in United States of America between 2002 and 2010 (*data is preliminary from 2010). The fitting of the trends are close. The average yearly VC investments increase is 3.986 Milliard EUR. It is less than like in the Europe.

Figure 7: VC investments in CEE



y=0,398x-0,431
R^2=0,792

Figure 8: VC investments in Hungary



y=0,088x-0,058
R^2=0,661

Figure 7 shows VC investments in the Central-Eastern Europe between 2002 and 2009. The linear trend is solid line between 2002 and 2007, the forecast (interrupted line) is from 2008 to 2010. The fitting of the trends are close. The average yearly VC investment increase is 0.398 Milliard EUR. If we compare this data to data from Europe (10.24 Milliard EUR) this is so small, but the decreasing hasn't been so big like in Europe and in the USA at the deep crisis (2009).

Figure 8 shows VC investments in Hungary between 2002 and 2009. The fitting of the trends are close, but not as close as in the data from Europe, USA or CEE countries. The average yearly VC investments increase is 0.088 Milliard EUR. In 2009, the third part of the value of investments just realized, as compared to the crisis occurs.

6. CONCLUSION

As for the Hungarian VC market statistics, we can see an underdeveloped early stage segment. Since 2002 there have been 2-4 million EUR investments on a yearly basis. In 2011-2013, the new JEREMIE funds have to invest their money (approximately 50 million/year) mostly in early stage, innovative companies. Now we may say that these partly state-owned funds "will form the market" in this segment. Therefore, there is a chance for a lack of good potential target companies. These facts could cause problems in the market, but after the bad experiences with state's role on this field, JEREMIE is a promising development. Compared to any EU co-financed grant, it seems to be a practicable mix (state and market) tool. It would be worth researching all of the involved countries, how the VC markets are affected in various market environments. The results could be used to plan the structural funds for the next budgetary period in the EU.

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