How do Venture Capital Funds support value addition to portfolio companies? Case of Latvia

Anita MATISONE, Natalja LACE
Faculty of Engineering Economics and Management, Riga Technical University
6 Kalnciema Str., Riga, LV-1007, Latvia

Alexei V. DANILCHENKO
Belarusian National Technical University
65/18 Nezavisimosti Ave, Minsk, 220013, Belarus

ABSTRACT

The paper presents the results of a study on value adding assistance (VAA) provided by Latvian venture capital Funds (VCFs) to their portfolio companies. There are very few studies regarding venture capital (VC) in Latvia and no papers have focused on the value-adding activities of Latvian VCFs.

Previous research on VC in general suggests that the small size of VC funds and dependency on public resources (as is the in case in Latvia) are limiting factors that decrease the amount of time VCF managers devote to their portfolio companies.

As part of the study, the researchers conducted a survey of currently active VCF managers. It revealed an additional factor restricting the non-financial impact of VCF managers on their portfolio companies in Latvia. The unwillingness and fear of Latvian entrepreneurs to let VCFs acquire equity in their companies very often results in the recourse to mezzanine funding instead. Mezzanine loans decrease the motivation as well as the rights of VCF managers to provide value adding assistance to portfolio companies.

Keywords: Venture Capital, Value Adding Assistance, Influencing factors and Latvia

1. INTRODUCTION

The European Commission back in 2013 recognised the necessity to boost small and medium enterprises (SMEs) in order to stimulate recovery of the European economy. The Entrepreneurship 2020 Action Plan was approved. It was acknowledged that SMEs lack financing, but that banks are not in a position to this need for financing given their need to see a track record of profitability in order to lend. Venture capital was mentioned as an important component in efforts to provide better access to financing for entrepreneurs. The Capital Markets Union, the Single Market Strategy and the Digital Single Market policies launched later also stressed the need to build a framework to benefit startups in Europe and provide better access to finance, with venture capital presented as important option.

What is venture capital? Invest Europe, the association representing VC on the European level defines it as “a type of private equity focused on companies... with innovative ideas for a product or service.” The British Private Equity & Venture Capital Association’s definition explains VC more precisely emphasizing the high growth potential of companies that are targets for private equity and VC investments in particular. Some sources use the term private equity to refer to both private equity (PE) and VC, while others use venture capital to refer to both VC and PE. The difference between VC and PE is in the stages of companies they finance. VCFs invest in companies in the first stages of their development. In turn, PE denotes later stages when companies have stabilized their operations and are looking for a way to develop further.

PE target companies, as being mature, have several possibilities to find needed funding. Therefore, this paper will focus only on VC, which is very often the only available funding for recently founded companies.

If venture capitalists use funds attracted from other investors for investments in portfolio companies in addition to their own money, they are required to set up special fund structures and to register or obtain a licence (depending on the legislation of the country in which they were established). EU venture capital funds legislation is based on the Alternative Investment Fund Managers Directive. Under its conditions, all VCFs are set up in the form of Alternative Investment Funds and they are managed by Alternative Investment Fund managers.

It is a common understanding supported by studies that in addition to financing venture capitalists also provide their portfolio companies with non-financial benefits. Strengthening management skills and expertise, providing access to wide networks of suppliers, customers and next stage investors, and help defining company strategy are some of the non-financial contributions provided by venture capitalists that add value to their portfolios. Studies show these nonfinancial benefits help companies grow faster [3] as in case when just financial support is provided.

Studies reveal a different level of non-financial benefits provided by various VC funds. Among suggested reasons for the divergence are the maturity of the VC market, the size of the fund, the focus stage of the fund, and others. Cultural differences and the institutional framework of the particular country/region also influences the amount of VAA provided by funds [11; 15].

Latvia belongs to the Central and Eastern European group of countries which seriously lags behind the rest of Europe in features influencing entrepreneurial activity [1]. Not only financing opportunities but cultural support, startup skills, opportunity perception etc. are low. This is a likely indication that the full potential of VC is not being realized in the region.

The current research was done with the aim of determining which value adding activities are being provided by VCF managers in Latvia. An additional objective was to determine which factors influence the level of value adding assistance provided.

This article is organized as follows: the next section provides an overview of the VC industry in Latvia. The third section introduces the conceptual framework for the research. Section 4 describes the research design. Section 5 discusses the research results. Section 6 presents the main conclusions.

2. THE VENTURE CAPITAL INDUSTRY IN LATVIA

VC and PE were unknown in Latvia until the early 1990s. After Latvia regained independence VC financing started to become available through entities established outside of the country which were supported by international financial institutions. VC didn't become popular as there was no understanding of its benefits and there was also no experience with it in the country. Because of that, and the scarcity of appropriate funding until 2004, there was only one local VC firm operating in Latvia: BaltCap [4].

The emergence of regional VC funds started in 2004 when funding from EU Structural funds become available. So far there have been six publicly financed programs for VC and PE funds in Latvia (Table 1). The fourth program covers all Baltic region and is devoted primarily to PE funds. Other programmes aimed to provide funding for VC, but there were few deviations (e.g. Eko Investors). The sixth program started operations in 2017, and during 2018 seven new funds backed by European Regional Development Fund will commence their activities.

Table 1

Public VC/PE programmes in Latvia

No/vintage year	The programme	Public Funding	Min private Funding	VC funds
1st/2005	Entrepreneurship and Innovation	EU Structural funds 11.25 MER; Government of Latvia 3.75 MER	34%	TechVentures Funds management company, EKO Investors, ZGI Capital
2nd/2010	JEREMIE	EU Structural funds 21 MER; Government of Latvia 7 MER	33%, except for Imprimatur seed fund (0%)	BaltCap, Imprimatur Seed fund, Imprimatur Start-up fund
3rd/2012	Investment fund for investments in guarantees, credit guarantees, venture capital and financial instruments	EU Structural funds 30 MER; Government of Latvia 10 MER	33%	ZGI Capital, Imprimatur Capital, Excap, FlyCap
4th/2012	Baltic Innovation Fund under European Investment Fund	Each of three Baltic States – 26MER, EIF – 52MEUR.	50%	BMP, Baltcap (Private Equity Fund II and Growth Fund), Livonia Partners, Karma Ventures
5th/2013	Soft loans for start-ups	LGA 2MEUR	0%	Imprimatur Capital
6th/2017	Growth and employment	EU Structural funds 75 MEUR	10-40% (rate differs for different kind of funds, in total 30 MEUR)	7 new funds (6 VCF managers already chosen)

(Source: [4] and authors)

The funds established and currently operating in Latvia are running under one of the programmes mentioned above. There are no local VC funds without public capital. Two foreign private VCFs have branches in Latvia. There are no signs that during the next few years any considerable private VC fund will be established in Latvia.

Three of the active funds may be considered PE funds (managed by SIA "BaltCap AIFP" and AS "EuVECA Livonia Partners") and were not reviewed as part of this study. (SIA "BaltCap AIFP" within this study was considered to be PE manager because of the two reasons. First, it is part of BaltCap group focused on PE investments in the Baltic region. Second, notwithstanding the fact that the fund under the management of SIA "BaltCap AIFP" in Latvia was launched as part of VC program, the investments were done primarily in very mature companies). The other five are VC funds, and the survey of their value adding activities will be discussed in the following sections. The typical size of VCF in Latvia is 15 MEUR.

There are several factors behind the lack of self-sufficiency of the Latvian VC market. The major ones are the small size of venture capital funds, the unattractiveness of local VC market in the eyes of foreign investors, the immaturity of the market and its participants and the shortage of companies suitable for VC financing [17;18].

Despite recognizing the above-mentioned factors constraining the success of VCs in Latvia, the EU through Structural Funds and the Latvian government support the development of the market. The studies confirm the necessity of public support to distribute VCFs more evenly around the globe. Without market correction measures VCFs tend to be located around major financial centres [9]. As a consequence, companies from distant areas have restricted access to VC funding because VCFs tend to invest in companies located close to them. The distance influences a company's attractiveness for VCFs because assistance requires regular physical presence of VC investors in the companies.

The next section deals with conceptual framework of the value adding assistance provided by VC funds.

3. LITERATURE OVERVIEW

There are many different sources of external financing. Banks are undoubtedly the best known. Family and friends are the easiest to approach. Crowdfunding is the most fashionable at the moment. Other sources are a stock exchange listing, subsidies, business angels and venture capitalists. All of them may be divided into two groups depending on the benefits they bring to the companies. The majority of investors are passive or generalists [3]. They provide the necessary financing, but there are no non-financial benefits from having relationships with them. In addition to investments, active investors or specialists bring to their portfolio companies knowledge, expertise, network and other benefits often called added value. Business angels and venture capitalists are the most typical representatives of the active investor group and therefore are also called value–added investors [6].

It is widely accepted that value added by VCs is an essential component of the success of their portfolio companies [2;3;10], even it comes at a high cost for an entrepreneur (losing part of the equity). As VC target companies are young they typically lack necessary competencies and resources in strategy, finances and marketing. Therefore, VCs very often provide the missing knowledge and expertise [13;14].

Activities undertaken by VCs to promote the growth of their portfolio companies and their value are called value adding assistance (VAA). Research [2;19] shows that, in general, funds are most active in providing support on financial, managerial and human capital issues. Less attention is paid to the assistance in building necessary contacts. The lowest amount of support is provided for operational activities.

The interests of the founders and a company do not always align. Therefore, some VAA may not be appreciated by the portfolio company's founders, e.g. replacement of the founder-CEO. The "hard" aspect of the VC [10] is faced when a conflict situation between the representatives of the VC Fund and the founders occurs.

VCFs monitor their investments in addition to providing VAA. Monitoring activities are performed to ensure the security of investments [2;12]. Typical examples of monitoring are periodical checks of financial statements and onsite visits to production plants/warehouses. Monitoring activities are pretty the same for all fund managers and are not determined by either fund or human capital characteristics [12]. They also do not differ from the general supervisory practices of generalist investors. Studies conducted up until 1995 mainly focused on the monitoring function of VCFs [10]. Later papers strictly divide monitoring from VAA and emphasize the role non-financial input of VCFs in the growth of their companies.

Unlike monitoring, the intensity and variety of VAA depends on a lot of factors and differs considerably between funds [19]. Studies conducted before the 1990s suggested that VCFs actions depend on the needs of their portfolio companies [14]. Later studies revealed several factors which are mentioned below.

The influencing factors may be divided into groups depending on: 1) VCF characteristics; 2) portfolio company features; 3) regional cultural and institutional features where the VCF is based.

The factors driven by VCF features are the previous experience of its managers, the fund type, the specialization of the fund and the size of the fund. Knockaert, M. et al. (2006) found that VCF managers with experience in a particular business sector are the most involved in the provision of VAA. Corporate and public VCFs are less involved in VAA than independent VCFs. Studies provide different explanations for it: i) lesser motivation of the funds employees [12], ii) additional goals besides the growth of portfolio companies [5] and iii) administrative burden [15]. The diversification of the fund portfolio has a negative correlation with the involvement of its employees in VAA provision [12]. The size of the fund also influences VAA. Medium-sized funds (25-100 MEUR) provide the highest level of assistance, while smaller and bigger ones are less involved in VAA [7].

The factors driven by the portfolio company's features are the stage of its development and the entrepreneur's willingness to cooperate or the entrepreneurs' receptivity [3]. Early stage companies usually lack staff and knowledge in management and finances. Companies in this stage in general need and attract the most assistance from VCFs [11]. The willingness of entrepreneurs to cooperate with the investor positively correlates with the amount of VAA provided by the VCF [3].

The third factor influencing VAA is the regional cultural and institutional features. For example, Knockaert, M. and Vanacker, T. (2013) found that Scandinavian funds provide an above average level of VAA in Europe. Milosevic, M. & Fendt, J. (2016) observed that the institutional context of a particular country influences the activities of the funds.

The studies on VAA reviewed by the authors of this paper are based on data provided by VCFs. Still, Luukkonen, T., & Maunula, M. (2007) point to the existence of studies from the viewpoint of portfolio companies. The previous research shows similarity in both sides' perspective regarding what funds do. The difference is how they evaluate the importance of this contribution: funds rate their influence higher than portfolio companies.

Based on the previous studies it may be concluded that Latvian VCFs have several limiting factors to providing a high level of VAA. They are: the small size of the funds that they are mainly publicly financed and lack of specialization in a particular business area. Therefore, it may be assumed that Latvian VCFs, unlike those providing a high level of assistance are less involved in management team formation and the operational activities of their portfolio companies [7].

4. RESEARCH DESIGN

Drawing on examples of previous studies [8; 12] a semi-structured questionnaire was developed. The first part of the questionnaire was devoted to establishing the characteristics of the particular VCF management company. The second part was consecrated to the respondent's experience and involvement in VAA. The third part contained questions regarding the reasons for failed investments and in the last part sought to determine the possibility for digital solutions to lighten the duties of fund managers so they would have more time to devote to VAA.

All active VCF management companies in Latvia were approached – in total four (SIA "Expansion Capital AIFP", SIA "FlyCap AIFP, "SIA "ZGI Capital', SIA "AIFP

Imprimatur Capital Fund Management"). All of them provided one of their managers to respond to the questionnaire.

The questionnaires were filled in during the personal interviews. Such a method was chosen to have a possibility to explain questions/definitions used if necessary. All the meetings took place in March 2018.

To evaluate a degree of a possible bias in answers of VCFs representatives, when possible their responses were compared with information from other sources. The data from the Latvian State Finance development agency ALTUM regarding the size of the VCFs and the number of their portfolio companies was used. Also publicly available information on the representatives' experience was checked. No deviations in the answers of the respondents were found.

Most of the questions on the questionnaire were closed-ended, requesting answers "yes" or "no" or particular data, for example the number of funds under management in EUR. A qualitative analysis of the data was carried out. The data were aggregated in tables. Likert scale was used to present the level of each type of VCF assistance to portfolio companies. Because of the personal interactions a lot of comments/explanations underlying the factual data were made by respondents. These comments were interpreted by the qualitative content analysis method.

5. RESEARCH RESULTS

The average amount under management of Latvian VCF management companies is 15 MEUR (Figure 1). All except one, which is running two funds, have one currently active VCF. The primary source of the funds (on average 93% with tiny deviations) is public finance.

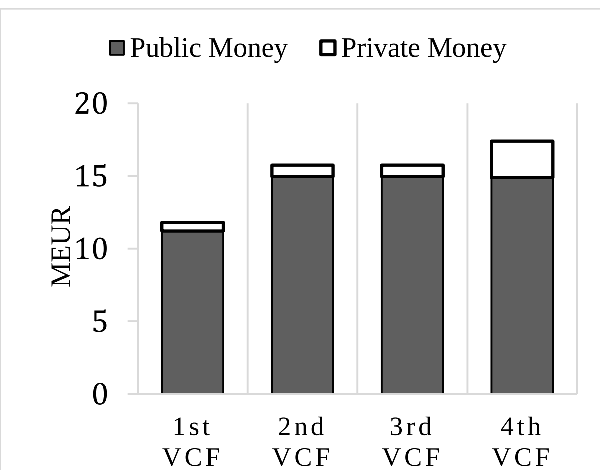

Figure 1 Funding sources and amount under the management of Latvian VCF management companies

Two companies have five years of experience in running VC funds, and the currently active fund is their first one. The other two have 12 and 13 years of experience and had managed other funds before. The average number of employees is 5 including 3 at the partner level. Only one fund manager has a person responsible solely for monitoring portfolio companies and other duties related to accounting and reporting and is not involved in VAA. All employees of the other companies are involved in both monitoring, value adding activities and also other tasks of the companies. Typically, an individual is responsible for around 8 portfolio companies. This number is in line with previous studies suggesting that public VCFs have a larger number of portfolio companies per manager. Still, Latvian managers have more portfolio companies per person than in Finland [14] where partners of public VCFs have on average 5 companies under their management and nonpartners have 8.

There is a difference between more experienced and younger VCFs concerning the distribution of responsibilities between partner and nonpartner employees. In the oldest ones, nonpartner level employees have portfolio companies under their personal responsibility. In the youngest ones, nonpartner level employees help partners and are not in charge of any portfolio companies.

Three of the VCFs invest predominantly in later stage ventures, one – in very early stages. None of the Latvian VCFs have a specific industry focus.

Two of the respondents had relatively little experience in the VC industry (4 and 5 years). The other two had worked in the industry more than 10 years (11 and 14). Previous experience consisted of a few years in consulting (2 respondents), banking (2 respondents), business management (2 respondents) and entrepreneurial activities (2 respondents).

On average the respondents spend slightly more than 50% of their working time providing VAA to their portfolio companies. The remaining time is divided between administrative issues (e.g. reporting), office work, fundraising, ensuring exits of the portfolio companies, networking and knowledge acquisition. Two respondents monitor their portfolio companies during provision of VAA. Two keep it separate from VAA and estimate that it takes more than 10% of their time. All respondents consider their involvement in VAA as typical for other employees in the VCF they work for. The only exception is the VCF with the biggest staff, where 2 partners are not full time and therefore are more focused on strategic issues of the company than on particular work with portfolio companies.

There are considerable variations regarding the number of portfolio companies where VCFs admitted to having a passive role (contribution of the capital and monitoring, no VAA). Three of VCFs are passive in portfolio companies which are considered to be loosed investments and in very stable companies to whom funds provided a mezzanine loan. The number of such companies variated between 10%/ 23% and 37% correspondingly. The fourth fund manager claimed to have no passive role at all as even in companies severely underperforming VCF he represents tries to do the best to have most from liquidation proceeds. Similar differences in attitude regarding "loosed" investments (active and passive) were found in previous studies [7].

VAA provided by different VCFs varies (Figure 2). But there are common features for all Latvian fund managers: they don't execute tasks of their portfolio companies; they are rarely involved in management recruitment and other operational issues. In other words, like a study showed of Finland's VCFs [14], their role is rather an advisor than a person in charge for reaching a portfolio company's goals.

The essential non-financial benefit from Latvian VCFs is their assistance in obtaining additional financing. Help in strategic planning, introductions to potential customers and suppliers and knowledge sharing through access to the VCFs network are next most significant contributions by VCFs to their portfolio companies.

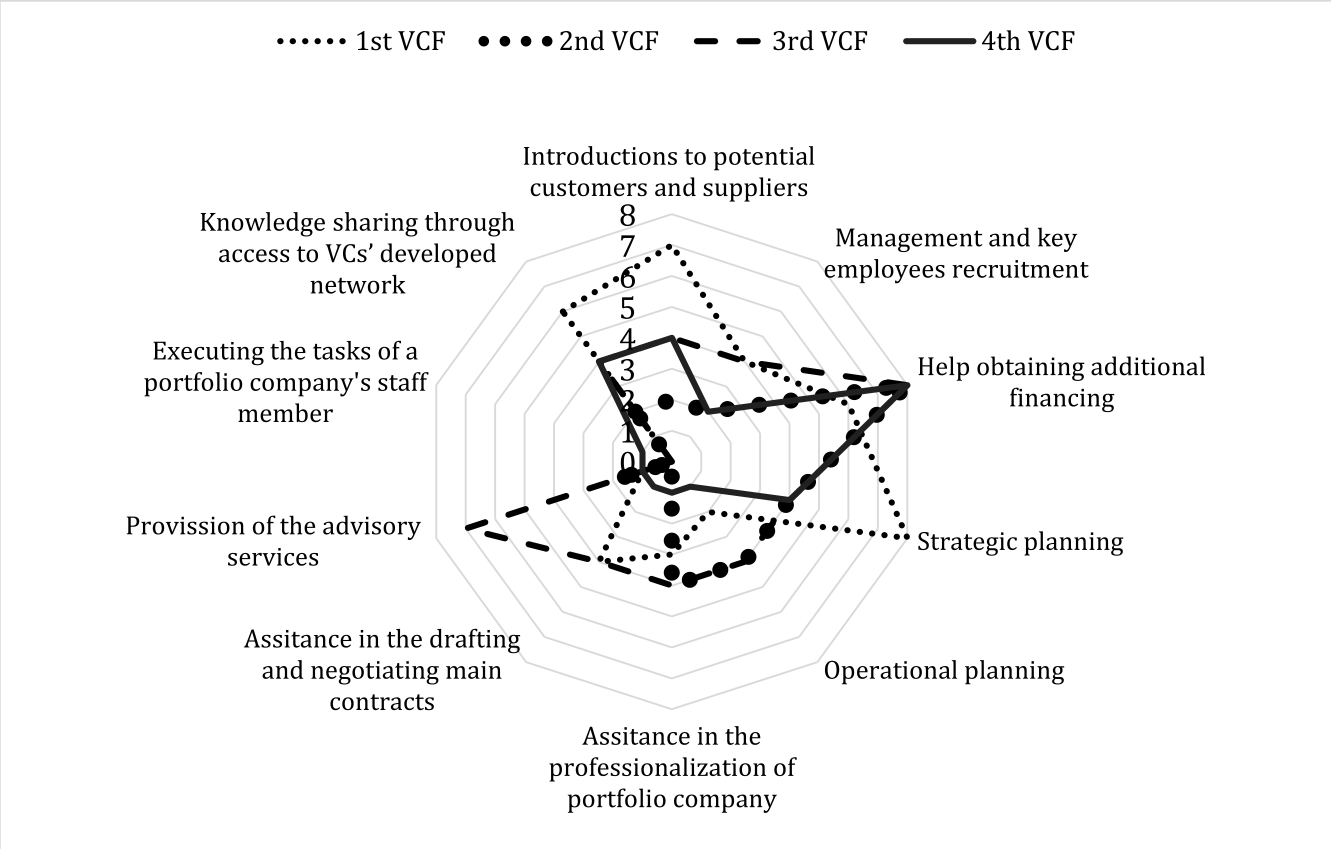

Figure 2 VAA provided by Latvian VCFs

The factors influencing the amount of VAA provided are set out in Table 2. Most of them are in line with findings from previous studies. Still, two factors that were revealed (a type of investment and the willingness of portfolio company to receive the assistance) are novel or at least not as emphasized in previous research.

Table 2

The factors influencing the level of VAA of VCFs in Latvia

Categories mentioned by VCFs managers	Frequencies of categories
Experience, knowledge and network of the Fund manager	3
Type of investment	4
Rights to influence portfolio company	3
The amount of other Fund manager's duties	4
Current urgent necessities of the portfolio company	4
Willingness of portfolio company to receive the assistance	2
Performance of portfolio company	3

In particular, the way the investment is provided influences the level of VAA substantially. Usually, VC portfolio companies receive money from the funds as an equity investment or convertible loan. It is possible only when a fund and a portfolio company have agreed on a valuation of the company, and owners are in fact ready to part with a stake in the company in exchange for the investment. All respondents mentioned that reaching an agreement regarding the valuations of the companies is very hard and often impossible in Latvia. Entrepreneurs evaluate their ideas unreasonably high. The other problem is that Latvian entrepreneurs have fear of outside shareholders and therefore, in general, refuse to sell stakes in their companies to VCFs. As a result, in many cases mezzanine loans are used instead. All respondents mentioned that the amount of time spent with mezzanine loan recipients is less than with other portfolio companies. The reasons are limited rights under the loan agreements to influence these companies and also limited motivation for VCFs to work with them. In the case of equity funds the aim is to raise the value of the company as high as possible in order to receive the highest possible return. In contrast, with mezzanine loan recipients, VCFs need only to ensure that a company is performing sufficiently well to repay the loan.

The other widespread factor reducing the provision of VAA is the unwillingness (intentional or unintentional) of the portfolio companies to receive assistance from funds. All respondents mentioned that they work more with companies which are asking for some support and are willing to let VCFs be more involved in a company operations.

To sum up, as per the classification of Elando et al (1995), Latvian VCFs belong to the group of funds providing a medium level of assistance. Still, with slightly more than 10 hours per month per portfolio company, they are near the bottom in this group. They are neither passive investors nor have a hands-on approach. A portfolio company can influence the amount of non-financial benefits received from their VCF.

6. CONCLUSIONS

The study conducted by the authors of this article confirms the assumption drawn from previous studies that Latvian VCFs don't provide a high level of VAA to their portfolio companies. As funds are created as part of EU support for small and medium-sized enterprises, it would be useful to maximise their impact on the growth of portfolio companies.

The results indicate three possible ways how to increase the non-financial benefits provided by VCFs in Latvia and also in similar markets with predominantly small and publicly-financed funds. The first is to reduce the administrative burden of the fund management companies to allow them to spend more time with their portfolio companies. Second, raising the awareness of the benefits of active cooperation with VCFs managers and having them as shareholders among entrepreneurs running potential VC target companies. The third possibility is identifying some tools which are easy to use and share that would digitalise part of the monitoring and communication activities with portfolio companies, again saving VCFs managers time for more productive activities. The study showed that VCFs in Latvia don't use any special platforms/programs to work with portfolio companies' data or communicating with them. The reason behind this is a scarcity of resources to purchase specialised software and also the unwillingness of portfolio companies to use any unusual tools.

The finding of the study that nonequity investment is a factor reducing the level of VAA being provided should be explored in detail in following studies.

7. ACKNOWLEDGEMENTS

The authors would like to thank Krisjanis Zarins former representative of European Investment Fund and Latvian Guarantee Agency for comments on the draft of the article.

The paper has been elaborated within the project 5.2.2 "The Development of Innovation and Entrepreneurship in Latvia in Compliance with the Smart Specialization Strategy" of the National Research Programme EKOSOC-LV.

8. REFERENCES

[1] Acs, Z. J., Szerb, L., & Lloyd, A. (2017). **The global entrepreneurship and development index.** In Global Entrepreneurship and Development Index 2017 (pp. 29-53). Springer, Cham.

[2] Alperovych, Y., & Hübner, G. (2013). **Incremental impact of venture capital financing.** Small Business Economics, 41(3), 651-666

[3] Andrieu, G., & Groh, A. P. (2018). **Specialist versus generalist investors: Trading off support quality, investment horizon and control rights.** European Economic Review, 101, 459-478.

[4] Avots K., Strenga R., Paalzow A. (2013) **Public venture capital in Latvia. Baltic Journal of Economics** 13(1) (2013) 3-30

[5] Benson, D., & Ziedonis, R. H. (2009). **Corporate venture capital as a window on new technologies: Implications for the performance of corporate investors when acquiring startups.** Organization Science, 20(2), 329-351.

[6] Cumming, D. (2006). **Adverse selection and capital structure: evidence from venture capital.** Entrepreneurship Theory and Practice, *30*(2), 155-183.

[7] Elango, B., Fried, V.H., Hisrich, R.D, & Poloncjek, A. (1995). **How Venture Capital Firms Differ.** Journal of Business Venturing, 10, 157-179

[8] Gorman, M., & Sahlman, W. A. (1989). **What do venture capitalists do?**. Journal of business venturing, 4(4), 231-248.

[9] Harrison, R. T., & Mason, C. M. (1992). **International perspectives on the supply of informal venture capital.** Journal of Business Venturing, 7(6), 459-475.

[10] Hellmann, T., & Puri, M. (2002). **Venture capital and the professionalization of start-up firms: Empirical evidence**. The journal of finance, 57(1), 169-197.

[11] Invest Europe, **2016 European Private Equity Activity**. https://www.investeurope.eu/media/651727/invest-europe-2016-european-private-equity-activity-final.pdf

[12] Knockaert, M., & Vanacker, T. (2013). **The association between venture capitalists' selection and value adding behavior: evidence from early stage high tech venture capitalists.** Small Business Economics, 40(3), 493-509.

[13] Knockaert, M., Lockett, A., Clarysse, B., & Wright, M. (2006). **Do human capital and fund characteristics drive follow-up behaviour of early stage high-tech VCs?.** International Journal of Technology Management, 34(1-2), 7-27.

[14] Lockett, A., Wright, M., Burrows, A., Scholes, L., & Paton, D. (2008). **The export intensity of venture capital backed companies.** Small Business Economics, 31(1), 39-58.

[15] Luukkonen, T., & Maunula, M. (2007). **Non-financial value-added of venture capital: a comparative study of different venture capital investors** (No. 1067). ETLA Discussion Papers, The Research Institute of the Finnish Economy (ETLA).The role of coachee characteristics in executive coaching for effective sustainability. Journal of Management Development, Vol. 32, No. 3, pp. 277 – 294.

[16] Milosevic, M., & Fendt, J. (2016). **Venture capital and its French exception: Explaining performance through human capital, policy and institutional failures.** Science and Public Policy, 43(5), 660-679.

[17] Prohorovs A. (2014) **The Volume of Venture Capital Funds of Latvia and Their Financing Sources**. China-USA Business Review, vol. 13, issue 4 (1537) pp. 217-234

[18] Prohorovs, A., & Jakusonoka, I. (2012). **Financing of Innovation System Development and Attraction of Private Capital.**

[19] Proksch, D., Stranz, W., Röhr, N., Ernst, C., Pinkwart, A., & Schefczyk, M. (2017). **Value-adding activities of venture capital companies: a content analysis of investor's original documents in Germany.** Venture Capital, 19(3), 129-146.