Available online at www.sciencedirect.com

ScienceDirect

Procedia Economics and Finance 30 (2015) 430 – 435

Procedia Economics and Finance

www.elsevier.com/locate/procedia

3rd Economics & Finance Conference, Rome, Italy, April 14-17, 2015 and 4th Economics & Finance Conference, London, UK, August 25-28, 2015

Effects of State-owned and Hybrid Venture Capital Funds in Hungary

Tamás Kovács[a], Julianna Vajay[a]

[a]*University of West Hungary, Erzsébet u. 9., Sopron, Hungary*

Abstract

State has got an important role in the venture capital industry in Hungary. On the one hand this study analyses the investments of three state investors in the middle of the previous decade. It presents location of target companies and effects on employment. The results show that state has got a positive role in job creation, but the indirectly job creation is very low at national economic level. Financing businesses in peripheral regions is a rational reason for the intervention of the state, but it was not realized. Activity of state investors which provide equity to firms directly was in the core economic region. On the other hand the study analyses the investments of JEREMIE Venture Capital Program. The investments of hybrid funds – thanks to the legislation – financed a higher proportion of SMEs operating in the country. The regional targets formulated as general objectives do not seem to have been fulfilled until the regulatory system does not separate specifically the outstanding capital in the centre and in the peripheral regions.

Peer-review under responsibility of IISES-International Institute for Social and Economics Sciences.
Keywords: venture capital; state; hybrid funds; JEREMIE; Hungary

1. Introduction

The significance of small and medium-sized enterprises and the financing problems some of them is well-known. The authors' aim in this paper by carrying-on a part of an earlier research to analyse the venture capital investments' role in the SME's financing and some impacts on the Hungarian economy. The number of investments of start-up or already operating businesses in Hungary is negligible. Behind many of the financing transactions aiming the early and expansive stages stood a public organisation in the middle of the previous decade. In the current decade the roleplaying

Peer-review under responsibility of IISES-International Institute for Social and Economics Sciences.
doi:10.1016/S2212-5671(15)01310-6

of state changed and the most active investors are the hybrid venture capital funds due to JEREMIE[*] Venture Capital Program. Due to the weight of these investments and the difficulties concerning complete mapping of private transactions the authors focused on the public and hybrid investments during the primary research.

2. Justification of the topic, objectives

The stimulation of economic growth, the rise of competitiveness, and the reduction of unemployment is expected partly from young firms with ability of strong growth, and it is an important thing for the economic politicians, that venture capital industry could offer a proper supply of capital for the development of these firms (Karsai, 2002). The state recognized early that the venture capital (VC) market will not solve itself the SME's financing, therefore it intervened.

The role of the state in venture capital industry is based on two suppositions. On the one hand, private sector does not assure a proper amount of capital for a specific section of firms, which are able to new, rapid growth, which are innovative or which run far away. On the other hand, another supposition is that government is able to revise this situation. It is capable to identify investment possibilities, which offer huge social benefits, and it can recommend to financial mediators (investors in private sector) to pay attention to these firms (Karsai, 2004).

The situation, when market members do not assure a proper amount of capital, is called equity gap. Equity gap can evolve for the sake of insufficient supply and inadequancies on the demand side (Lawton, 2002, Bergquist and Dahg, 2008). This equity gap is a typical problem for many enterprises, and one of the reasons can be the location of the business: business peripheral regions have less access to equity finance than those in central regions (Harrison and Mason, 2000). Makra (2007) documented this also in Hungary: venture capital industry was Budapest-centric.

The aim of the regional policy is to reduce the regional disparities and to catch up the peripheral regions. These objectives emerged by the studied Hungarian JEREMIE program[†] and state-owned organizations with different emphases. Regulation of JEREMIE contains these objectives the most definitely. There are eight funds[‡] and seven of them have to invest in peripheral regions.[§]

Another important goal of the economic policy is increasing the employment. The governments in power regard that attainable by inter alia solving the problems of the SME sector. In the target-setting of the investment implementing organizations and programs appears directly the intention of the increase in employment.

In the light of the above mentioned the authors examine whether the state got closer to some proposed objects (especially to employment and regional targets).

3. Results of state-owned investors in the previous decade

Kovács (2013) analysed the activities and transactions of certain public organisations. These organisations are:

- Corvinus Venture Capital Fund Management Ltd. (CKTA, its managed fund: Corvinus First Innovation Venture Capital Fund, CELIN),
- Information Technology Venture Capital Fund Management belonging to Regional Development Holding Co (IKTK, its managed fund: IT Venture Capital Fund, IKTA)
- Hungarian Development Bank (MFB)

Investments were made between 2004 and 2007, and to my knowledge, in the case of CELIN and IKTA all transactions are included (4 and 11 investments). CELIN and IKTA transactions were chosen because they were active

[*] Joint European Resources for Micro to Medium Enterprises.
[†] JEREMIE venture capital program.
[‡] There are four rounds of JEREMIE in Hungary. Eight funds were established in the first one in 2010.
[§] Seats of target companies are not in Central Hungary.

around the same time and implemented direct state investments. In addition according to some researchers[**] they were the closest to the "real" market venture capital organisations.

The SME Development Capital Investment Program of MFB which started in mid-2003 came to focus. These businesses differ from the characteristics of market investments in many points, however, these are presented in the statistics of the Hungarian Private Equity and Venture Capital Association (HVCA) that is why Kovács (2013) paid attention to the programme. According to the survey of HVCA and the annual reports of the MFB the complete list of companies was prepared. The extent of the amount to be used directly for capital increase was between 50 and 500 million Hungarian forint by companies, however, shortly after the start according to an individual decision there was an opportunity for investments exceeding 500 million. These businesses because of their size and nature, for example Ganz Transelektro Rt., were included among the analyzed target companies. So, the author studied 19 companies, among which a couple of companies were in a group, as well as, their capital increase were at the same time. By the statistical analysis these were operated as a unit, so the sample size is 17.

To assess the impact on employment is not an easy thing. Firstly, if it is an investment in a new business, it is already a job creation. That is positive in itself. If the new company actually had predecessor or if it is a long-established company, at first it may be expediential to look at the changes of data after the join. If the increase of the employees number's average is not visible even it can be asked what would happened if the state did not invest in. Because if the company did not get capital it might had bankrupt and jobs ceased early. This examination is very difficult, almost impossible. So the author observed wether the number of employees[††] increased or not after the year of public investment. Among the 13 analysed companies of IKTA and CTKA [‡‡] there was an increase in staff level only in 4 cases but this increase were significant. Whereas in the other companies except one the number of employees was in low level (1-6 person) and the accidental decreases were not high in absolute terms so the number of employees has increased in net sense too. There is a similar situation in the case of MFB SME Development Capital Investment Program as well. In 7 target companies the average of the number of employees has increased. In the year of 2011 the headcount was 5.8% more than in the year before the investment[§§]

The role of the state – in case of the three analysed organisations, dealing with direct capital investments – had a positive effect on employment. On the level of the national economy the direct, net job creation is not significant, but this is also due to the relatively low investments.

As businesses in the periphery have less access to capital than the centrally located ones [***], Kovács (2013) examined wether geographic concentration at public investment exists. The seats of the direct public

[**] E.g. Kovács (2011).

[††] To follow this is difficult too; just think about the possible demergers or outsourcings to subsidiaries or another subcontractors. In addition the impact on employment may appear the supplier companies too.

[‡‡] The reports of two companies were not available.

[§§] Given the fact that at terminated companies the workplaces had already ceased during the liquidation process. In addition, there are at least two reasons why the number is probably a low estimate of job creation. At the CBSZ despite the steadily increasing orders and revenues the number of employees decreased until 2010 and only reached again the level of 2004 in 2011. In the sector it was widespread to use long subcontracting chains. Subcontracting chains could not apply for orders after the amendment passed by the Parliament in March 2011, only one subcontractor was allowed (Fabók, 2011). According to the opinion of the author all of these are confirmed by value changes of contracted services (or from 2006 due to the reclassification the mediated services) over the years. We assume the underestimation of employment growth rate also because the Organica – VWS was separated from the Organica Környezettechnológiák in mid-2007. The employees of Organica – VWS are not included in statistics.

[***] For example in 2005 84.6% of the private venture capital investments occured in companies in Central Hungary. Just two company's seats were in another region. One of the Budapest based companies had got a branch in Central Transdanubia Region (Monostorapáti).

investment in the middle of the last decade in case of CKTA and IKTA are the followings: 12 companies (80.0%) are based in Budapest and 3 ones (20.0%) are in rural settlement.[†††]

In terms of the seats at the time of investment the Central Hungarian companies are in the majority in MFB's portfolio too. 9 out of 19 were in the capital, other 3 were in Solymár (County Pest). This means 63.16% of all the companies. (Figure 1)

According the HCSO's database 50-51% of the active corporate enterprises were in Central Hungary between 2004 and 2007.

In the next step the author examined the location of branches too. In only 14 of the 34 cases (41.18%) can be said that the seat of the target companies or at least one place of branch was in peripheral regions.

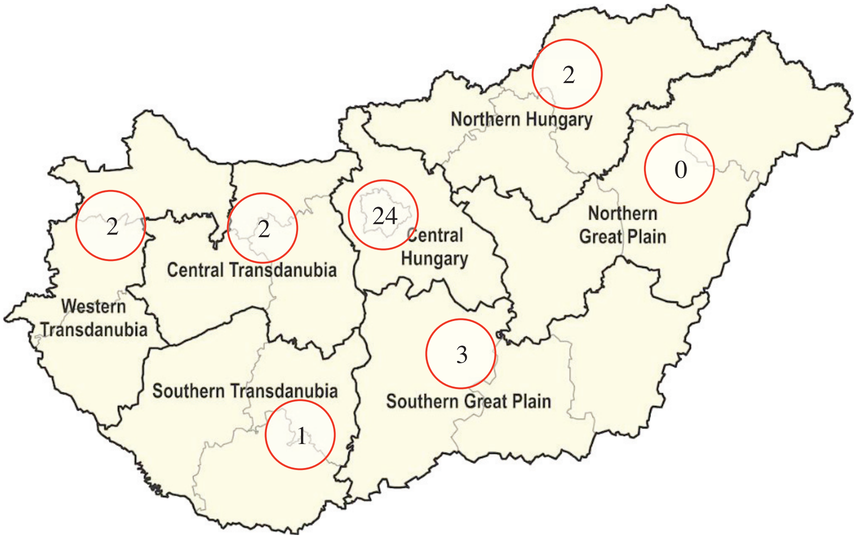

Fig. 1. The seats of IKTA, CKTA and MNB companies

Source: Own adjustment based on copies of register in database of Ministry of Public Administration and Justice

So in case of public investments in vast majority the central located or central started companies got capital and therefore the stimulation of peripheral areas was not realised.

Methods

Methods are similar to the ones of previous study for the sake of comparability. The sources of the determining the companies, the characteristics of businesses, the analysed data:

- press news,
- company information databases:
  - Ministry of Public Administration and Justice Company Information and Electronic Company Proceeding Service (copies of register, reports)
  - company database of céginfo.hu
- websites of target companies.

[†††] Indeed the Gergi Háló's seat is in the capital city but there are branches in Bátonytenyere and Dorogháza. The networking activities and services are performed in County Nógrád so the author placed it later in the statistical analysis in the „rural" category.

By the data concerning the employment the authors used the average statistical number of employees‡‡‡ in the notes to the financial statement. We do not think it is the best data with which the possible impact on employment can be analyzed. Beside its background the number itself normally rounded to the nearest whole number must be provided by the companies, but we didn't find obtaining other data as viable option.

First investments were in the second half of 2010 and fund management firms had to make the last investment decision at the end of 2013. There has been far too little time to assess the full scale of the impact on job creation. Furthermore the last available reports were made for 2013. Hence employment data were analyzed at companies were financed in 2010 or 2011. Research includes ceased companies and subsidiaries but there were not any employment data in some reports.

The location of companies' seats was taken into consideration in the moment of the investment and before the investment.

4. Results and discussion

Number of analyzed target companies is 88.§§§ Seat of only 15 companies (17.0%) is in Central Hungary (most of them in the capital). Figure 2 shows number of companies in the regions.

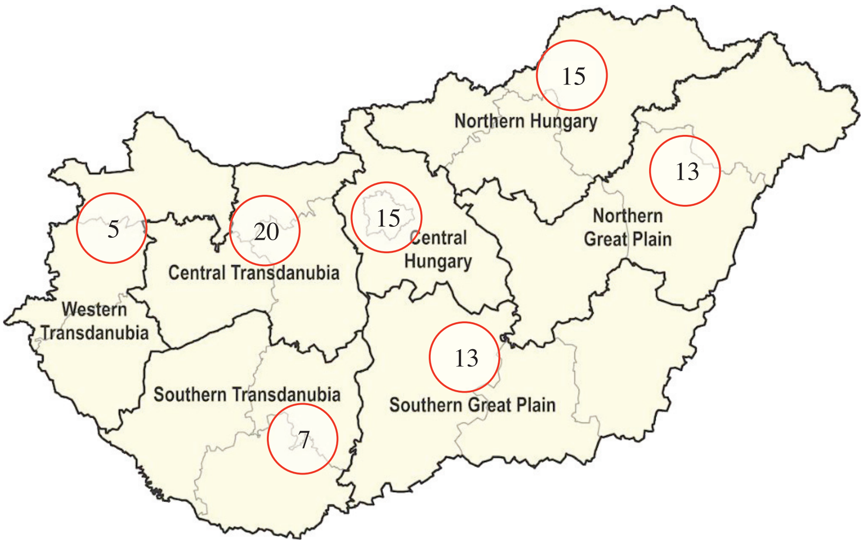

Fig. 2. The seats of JEREMIE companies

Source: Own adjustment based on copies of register in database of Ministry of Public Administration and Justice

There is a significant difference among peripheral regions but regional policy seems to achieve their goal: 83% of target companies are in peripheral areas. But the picture is more nuanced because there are two tricks and some venture capital fund management firms can evade the regulation. These tricks are the next:

- Target company changes its seat before the investment process (Papp, 2012).
- Management firm establishes a company in a peripheral regions and this new one increase in target company's capital.

‡‡‡ An indicator of Hungarian Central Statistical Office (HCSO).

§§§ About 90-91 firms were financed in JEREMIE 1 but the authors could not get acquainted with 2-3 ones.

We tried to assess these tricks and we found that 39.8% of the real target companies could be tied to Central Hungary.

We already referred to problems of measuring job creation (e.g. just think about the possible demergers or outsourcings to subsidiaries or another subcontractors. In addition the impact on employment may appear the supplier companies too). We observed wether the number of employees increased or not after the year of investment. Among the 18 analyzed companies there was an increase in staff level only in 8 cases but this increase were significant and net job creation was positive. The average increase of the number of employees was 7.2%.

Of course we know this value is not relevant because of the short term and the low number of analyzed companies. We have to wait and continue the research a few years later. Furthermore we would like to extend it and analyze other indicators and aspects (e.g. investment value in regions, exits).

Reference

BERGQUIST, C. and DAHG, L. (2008) The impact of the financial gap on growth and development for SMEs. A case study of Sweden with the UK as a reference object. Stockholm: Stockholm University.

FABÓK, B. (2011) Pintér szelleme hajtja a száguldó birodalmat. Origo. [Online] 14th November. Available from: http://www.origo.hu/itthon/20111111-cegportre-pinter-sandor-belugyminiszter-excegerol-a-civil-biztonsagi-szolgalatrol.html [Accessed: 22nd April 2015].

HARRISON, R. T. and MASON, C. M. (2000) The role of the public sector in the development of a regional venture capital industry. Venture capital. 2 (4): p. 243-253.

KARSAI, J. (2002) What business does the state have on venture-capital markets? State funding of risk capital in Hungary. Economic Review. Vol. 0(11), p. 928-942.

KARSAI, J. (2004) Can the state replace private venture capital investors? Public financing of venture capital in Hungary. MTA KTK Discussion Papers. MT–DP. 2004/8.

KOVÁCS, B. (2011) Governmental Venture Capital in Financing SMEs. Dissertation. Győr: SZE RGDI.

KOVÁCS, T. (2013) The impact of venture capital on the economy. Dissertation. Sopron: University of West Hungary Faculty of Economics.

LAWTON, T. (2002) Missing the target: assessing the role of government in bridging the European equity gap and enhancing economic growth. Venture Capital 4(1) p. 7-23.

MAKRA, Zs. (2007) Informal venture capital investors in Hungary. Dissertation. Pécs: PTE KTK.

PAPP, G. (2012) Financing of innovative firms in JEREMIE Program. Budapest: Budapest Stock Exchange.