

# *Private Capital Funds and their Role in Albanian Financial Market*

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## **Abstract**

*The prolonged stagnation bank credit expansion, especially after the outbreak of recent economic and financial crises, has produced a significant impact on the availability of new and long-term sources of business financing, mainly related to mid and large-size companies, but also to start-ups. Currently, all such categories of businesses find difficult to obtain long-term financing from banks and this has major implications on financing their investments and projects in the pipeline. In a time when, paradoxically, bank credit is becoming increasingly difficult and therefore, to score a significant influence on the economy and investment financing, and regardless of the existing liquidity abundance, establishing and developing Private Equity Funds (PE) can play an important contribution in this regard.*

*Despite the fact that such type of institutional investor is currently lacking within the Albanian capital market, some basic legal, institutional and economic premises do exist within the Albanian financial landscape, and which could provide grounds for such an actor to play its role in providing an alternative source of long - term financing for Albanian businesses. Consequently, their existence could pave the way for revitalization of the idea and attempts to put into operation a functioning capital market in Albania, which is still missing.*

**Keywords:** *Private equity capital, Securities, Long-term financing*

## Objectives

This paper aims to provide some key considerations about the role and importance of the existence and establishment of Private Equity Funds (PEF) within a country's financial market, as a source of alternative financing for companies, along with their special role in supporting and promoting innovation within economy.

Also, the paper aims to shed light on the existing Albanian reality, with regard to PE initiatives, as well as the legal and institutional framework, which may offer the hotbed for establishing and developing such institutional presence in Albania. Furthermore, it displays the key preconditions which need to be in place, in order to welcome and anticipate the emergence of such distinct financial ventures.

Specifically, the paper suggests that banks need to consider such untapped opportunity, in order to expand their loan portfolio, especially under current conditions and times, when they are faced with difficulties of building quality loan portfolio and expand it beyond the actual meagre credit growth rate, which in turn would be translated into positive and value-added investments in the economy and furthermore, contributing in sowing the seeds of a functioning stock & securities market in Albania.

Additionally, it offers some hints for interests the government to explore and consider all opportunities to offer proper facilities for such particular industry, in order to ensure a viable environment for their own activity, within Albanian financial market.

## Theoretical framework

Private Equity Funding/Venture Capital has been growing steadily during the last three decades, especially in US, but not only there. As a matter of history, Gompers and Lerner, (2001) affirms that the PE/VC development as an industry started in the United States in 1946 when MIT president Karl Compton, General Georges Doriot, and a set of business leaders established American Research and Development as a closed-end publicly listed fund. The idea of American Research and Development was to invest in firms that commercialized technology developed for World War II by the US military. In the years that followed, several similar firms emerged, and the first venture capital limited partnership formed in 1958 (Lerner and Tag 2013).

Also, they are becoming important players even in the local markets, because of their role and ability to create value. Kaplan and Stromberg (2008) identify

three main areas where private equity firms and investors add value: financial engineering, governance engineering and operational engineering. Also, Kohli (2007) explains that:

1. Financial engineering refers to steps to add value by making capital structure more efficient - that is, decreasing the cost of capital. Typically, this goal is achieved in buyouts by taking on leverage and bringing in outside capital.
2. Governance engineering refers to processes that create value by improving incentives and monitoring in the companies that private equity investor finance. These steps can include the imposition of formal monitoring techniques and compensation that links pay to performance.
3. Operational engineering refers to initiatives by private equity funds to improve the firms they finance through the provision of formal and informal consulting services to boost production processes, working capital management, marketing and product mix, and related areas.

Furthermore, Gompers et al. (2015) point that PE investors they place a heavy emphasis on adding value to their portfolio companies, both before and after they invest. The sources of that added value, in order of importance, are increasing revenue, improving incentives and governance, facilitating a high value exit or sale, making additional acquisitions, replacing management and reducing costs. Consistent with adding operational value, the PE investors make meaningful investments in employees and advisors who provide advice and help in implementing operating improvements.

Lerner and Tag (2013) argue that an active venture capital market can boost economic growth. Economic growth is driven by innovation, spearheaded by young entrepreneurial firms, where financing of these firms can be difficult because of moral hazard and asymmetric information. Venture capitalists specialize at solving these problems, thereby connecting idea-rich entrepreneurs with cash-rich investors. Ensuring funding for innovative firms has positive externalities on the economy, so it makes sense for governments to promote an active venture capital market. But startups and other innovative companies, which bring innovation in the market are not usually big and established firms, but instead they are mainly a produce of young entrepreneurs and small companies, which find difficulties in raising proper and adequate funding, especially from banks and capital market, duet to moral hazard and asymmetric information. Venture capital firms are experts at solving problems of moral hazard and asymmetric information and thereby earn their keep by bridging the gap between financiers and entrepreneurs (Lerner and Tag (2013)).

Everywhere in the world, both developed and developing one, PE/VC are emerging as an important source of capital and those initiatives are not coming

as stand-alone companies; even banks are getting involved in such endeavors. Fang, Ivashina & Lerner (2012) point out that banks' involvement in private equity investments provides significant cross-selling opportunities. The bank's engagement as a private equity investor could carry a positive signal about the quality of the deal to outside (debt) investors. Also, banks are surprisingly large players in the private equity market.

On the other hand, for PE/VC to exist and develop in a certain financial system some preconditions must exist. Ribeiro et al. (2006) show that there are several factors which impact heavily the PE/VC industry, like: legal system, tax procedures, bureaucracy and corruption, infrastructure and stock market. The lack of proper stock market means high direct and indirect costs in raising capital from the market. Healthy stock markets are essential for PE/VC, allowing investment managers to exit successfully and entrepreneurs to regain control (Gompers and Lerner, 2002). On the other hand, Jeng and Wells (2000) underscored that stock market development, in terms of number of IPOs, correlates strongly with active venture capital activities, following venture capital investments between 1986 and 1995 in 21 countries.

Additionally, Groh et al (2008) identify six key drivers determining the attractiveness of an individual country for VC/PE investors: economic activity, size and liquidity of capital markets, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial opportunities. PEF/VC has some distinct advantages, compared to other classic investments. Similarly, Lerner and Tag (2013) add that the legal environment, financial market development, the tax system, labor market regulations, and public spending on research and development seem to matter.

Ballta (2015) affirms that an investment fund has a very close shareholder – employee – customer relationship. Employees feel more motivated to serve customers, as they are treated very differently, so there is greater trust and greater responsibility put with employees, by shareholders.

## **Private Equity Funds within Albanian reality**

Albanian and its respective financial system has not experienced any typical functioning of private equity funds, at least in the form known and applied in US, or anywhere in the world, in terms of the full value chain pursued, up to IPO in the capital market. However, separate shackles of the whole chain have been established and functioning since 20 years ago. Truly, there are substantial institutional elements which have been and are currently missing, that could tie up together those separate shackles and which in turn could create a full operational line of PE/VC in the Albanian financial market.

When it comes to the Albanian business environment is not discriminatory and hostile against the existence of Private Equity Funds. As above-mentioned, the Albanian financial system has not witnessed the establishment of any typical PE/VC, or otherwise in a pure classical way as those in developed economies, capable of conducting any classical or core activity in this regard. The lack of an established and functioning stock exchange in Albania could have been perceived as an obstacle of creating and operating such initiatives, within the financial market. Normally, the presence of PE/VC require a functioning capital market od stock exchange, as they are supposed to be the final destination of companies funded and supported by PE/VC, and in the same time, the market is the best evaluator of PE/VC's performance. But the existence of the capital market alone is not the only pre-requisite for a successful activity of PE/VCS, as the existence of the market itself does not guarantee proper functioning of the PE/VC industry. Additionally, as Gompers and Lerner (2000) point out, risk capital flourishes in countries with deep and liquid stock markets. Practically, the presence of an organized stock market is a pre-requisite for PE/VC to enter the financial market, as well as to measure their respective success and contribution toward value-added within the national economy and financial market.

### *Legal & Regulatory framework*

The existing legal framework in Albania does not hinder investors and banks to establish any PE/VC, or otherwise impose any tight restrictions on their operation. Rather, the legal framework does not offer any precise coverage with proper and full-scale acts and regulations.

Typically, Article 42 (5) of the Law "On Securities" (2008) prescribes activities related to transactions with securities, such as: "financing an issue, including the organization, preparation and implementation of issuance of securities for the issuer and related subscription and payment of all securities or only unsubscribed titles, for their further sale to potential investors". On the other hand, banking legal framework does not prescribe any special regulation, or foresee particular articles, pertaining to PEF/VC activity, as part of commercial banking. The Article 54(2.f.vii) of the Law "On Banks in the Republic of Albania (2006), permits banks to engage in "participation in issues of all kinds of securities including, underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues".

Apart from the above, the legal framework does not stipulate any specific regulations or clauses, which would serve as a basis for establishing, running and monitoring the PEF activity. In current situations, such lack of proper regulatory coverage of such institutional establishment within the financial system may be

considered as a missing piece of the integral institutional framework mosaic, which could fill in the existing credit and funding powerhouse of the whole system for the national economy.

On the other hand, the national legal & regulatory framework matters a lot, when it comes to contract enforcement, especially in the area of capital market and stock exchange. Lerner and Schoar (2005) have found a clear correlation between the legal environment and the contractual use of convertible preferred stock with covenants. When the legal environment is weak and contracts are hard to enforce, private equity firms tended to rely more on direct ownership stakes in firms rather than using more complex contracts, such as using convertible preferred stock. Moreover, they found that investments in firms operating in weak legal environments tended to have lower returns and valuations.

When it comes to Albania, this could be deemed as an obstacle for the private equity industry, as the contract enforcement is not one of the strongest points, in terms of attracting foreign investors. According to World Bank (2016) Although Albania scores very high in terms of protecting the minority investors (4th place according to WB - Doing Business 2016), it is still positioned at mid-table, when it comes to enforcing contracts (ranked 96th). This may call for further improvement, in order to lay strong foundations for the private equity industry to flourish and establish, accordingly.

### *Taxation*

Taxation affects entrepreneurship in general and the private equity industry, in terms of stimulating or discouraging it. Taxation policy in Albania does not contain any tax holiday or special treatment, in terms of investments in capital market. Practically, there is no tax holiday for companies which could consider any IPO, or capital market financing. Furthermore, tax treatment for capital gains and interests from investment in securities, like corporate bonds, is the same as those on interest and corporate tax. Such treatment does not encourage venture capitalists, as their income from divestiture will be taxed in the same way as incomes generated in a passive way, like investments in government papers or bank deposits. In this way, they are not rewarded for their success so such tax treatment hinders entrepreneurship in this regard.

### *The Albanian practical experience with Private Funds*

Several institutional-level initiatives have been introduced in the Albanian financial market. The Albanian Reconstruction Equity Fund (AREF) was set up by the EBRD and the Italian Government, with a total capital of US\$ 14 million to support the restructuring and expansion of private enterprises (OECD 2003).

Also, Albanian American Enterprise Fund (AAEF), funded by the US government through a USAID grant, provides finance to medium and large-scale firms (US\$ 30 million). Although incorporated as a not-for-profit organization, the AAEF is managed as a private investment fund to maximize risk-adjusted returns. During its activity in Albania, the AAEF has invested in a wide array of private enterprises. In addition, AAEF provides its portfolio investments with training to establish best business practices that incorporate acceptable financial reporting standards, as well as guidance in enhancing management capabilities, recruiting skilled personnel and strategic planning<sup>1</sup>.

However, the most successful PE initiatives in Albania have been those of purchasing BKT, the establishment of the American Bank of Albania (now part of Intesa SanPaolo Bank - Albania) and the American Bank for investments.

In 2006 BKT became a portfolio company of Çalik-Seker Konsorsiyum Yatirim A.S, Turkey, which owns now 60% + 2 of BKT shares<sup>2</sup>, along with IBRD and IFC, which own 20%, respectively. By 2015 BKT is the biggest bank in the Albanian banking systems, in terms of assets.

The American Bank of Albania was established in 1998, and according to AAEF itself, it grew to be the second largest financial institution in Albania and was a pioneer in offering corporate and individual customers innovative products. In June 2007, Intesa Sanpaolo and AAEF signed the majority participation of Intesa Sanpaolo into the ABA for \$156.9 million, a multiple of 3.7 times the net equity. In August 2009, the AAEF completed the exit from ABA, which now is Intesa Sanpaolo Bank Albania<sup>3</sup>.

### *The case of the American Bank for investments and NCH Capital*

The American Bank of Investments, ABI, emerged within the Albanian banking system as the rebranded ex - Credit Agricole – Albania, which was sold in 2015 by the French banking group itself to “TRANZIT Finance”, an Albanian non-bank financial institution, and a portfolio company of NCH Capital Inc, where the latter is one of the largest American investors in Eastern Europe with over USD 3 billion under management. Since its founding in 1992, the firm has built a successful investment track record in Eastern Europe. NCH’s funds over the last 24 years have acquired, founded or co-founded numerous companies in Eastern Europe including Russia, Romania, Ukraine, the United Kingdom, Latvia, Bulgaria, Moldova, Brazil, Greece and Albania<sup>4</sup>. The firm has invested in several banks and non-bank financial institutions in Albania, Romania, Moldova and Latvia that have quickly and consistently grown their balance sheets and improved their

<sup>1</sup> Albanian American Enterprise Fund. See: <http://www.aef.com/>.

<sup>2</sup> Banka Kombëtare Tregtare. See: <http://www.bkt.com.al/>.

<sup>3</sup> Ibid.

<sup>4</sup> American Bank of Investments. See: <http://www.abi.al/>.

performance<sup>5</sup>. In 2007, NCH Capital started investing in the Western Balkans region and established a regional office in Tirana, Albania.

The purchase of a bank by a non-bank financial institution like “TRANZIT Finance”, part of an international portfolio investor, marked a new phenomenon for the Albanian financial market, which was accustomed to “natural” bank purchases by banks, themselves. Such atypical purchase could establish for the first time a new custom or practice in Albania, in terms of modeling the financial institutions’ activity in a developing market like Albania, which could aim the inter sectorial & institutional synergy. The presence of a private equity capital fund like “NCH Capital” with two institutions, a commercial bank and a non-bank institution, specialized in debt and bad loan collection, creates the first precedent of a strategic alliance of two activities of mutual cooperation and benefit. Typically, “TRANZIT Finance” intends to help the bank toward easing its operational activity, with regard to problem loans and taking new risks in the market, by way of granting new loans. Meanwhile, the bank may assist “TRANZIT Finance” with a much larger clientele basis, through cross selling its products and services, thus increasing the operational efficiency, flexibility and profit margins

### **Why PE/VC in Albania?**

The active presence and functioning of PE/VC in the Albanian financial market could produce some positive outcome for the financial industry and the economy as a whole.

As above-mentioned, the intertwining of bank and non-bank activities, specialized in the debt collection issue, in the case of NCH Capital (ABI Bank and “Tranzit” Finance) may be the relevant key for a substantial contribution in terms of relieving banks from the burden of non- performing loans. This is a thorny issue for the Albanian banking industry and such solutions could create added value in this regard, thus contributing to a revival of loan-making process.

Banks may see creating PE/VC entrepreneurship, or teaming up with them, in order to expand their loan portfolio, especially under current conditions and times, when they are faced with difficulties of building quality loan portfolio and expand it beyond the actual meagre credit growth rate, which in turn would be translated into positive and value-added investments and employment in the economy.

Additionally, such private equity funds may fill in the empty spaces for funding start-ups and innovative ideas, which usually are not funded by established financial institutions. PE/VCS are more prone to accept such risks which are translated in large rewards, once the entrepreneurship results in a breakthrough. Nevertheless,

<sup>5</sup> NCH Capital. See: <http://www.nchcapital.com/>



reaping such rewards would unavoidably call for the establishment and functioning of a capital market (even a modest one), as the final destination for implementing the sale of the company through IPO.

The presence of such institutions in the Albanian financial market can also give rise to the introduction of new and pioneer services and practices, linked with asset management, business restructuring and turnaround, stock market divestitures, investment banking and securities brokerage, a functioning stock exchange, the establishment and functioning of the secondary market for troubled assets, the securitization process, etc.

The above arguments may be deemed and seen as a contribution towards the deepening of the Albanian financial system.

## **Conclusions and Recommendations**

Legal framework in Albania needs still to be completed, in terms of providing better regulation and monitoring the activity of private equity/venture capital entrepreneurship. This would enable the system to energize and plug in a new source of funding. Additionally, any relevant changes may be considered at Albanian tax legislation, which could allow tax breaks or holidays for such specific industry, within the Albanian financial system.

Banks need to consider and explore the opportunity of opening and starting to provide PE/VC services to their existing, or new clients, as a new way to expand their loan portfolio and ensure successful cross-selling and better quality loans. The existing Albanian experience dictates such entrepreneurship, as a viable synergy, at least to avoid bad loans, or otherwise help in reducing the bad loans portfolio.

The government and other stakeholders, apart from banks, may consider setting up and providing initial capital for PE/VC initiatives, as a way to promote such undertaking and create the critical mass for their successful activity within Albanian financial system.

Additionally, those stakeholders must promote and support institutional and private initiatives to establish and operate the stock exchange in Albania, along with helping in establishing the lacking payment and clearing infrastructure for private securities, especially corporate bonds. This, in turn, would pave the way for a more substantial role for private equity/venture capital funds within the Albanian financial system, along with being a helpful hand of improving the existing level of corporate governance within Corporate Albania, ensure more presence of portfolio investors and proper valuation of them, through the capital market and the stock exchange.

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