Venture Capital Funds in Albania – Is it the Right Time to Show Up?

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Abstract

In the age of innovation and technology there is a lot attention put into start-up business ideas. This is no surprise considering the great and unbelievable changes that happened in the last 50 years, because of companies like: Microsoft, Apple, Google, Amazon, Facebook (just to mention a few), all of which started as "garage" start-ups. What made it possible for these start-ups to make it though was not because they started small out of garages, but because they were able to find financing from Venture Capital and Private Equity funds.

Private Equity capital and specially Venture Capital funds are a crucial part of the start-up ecosystem as they specialise in providing financing to start-up companies and small businesses that are believed to have long-term growth potential and thus their presence in the economy promotes entrepreneurship, improves borrowing and also can strengthen the capital market.

Even though there have been some PE initiatives in Albania, for the time being, there are no established PE or VC funds. However, with recent years attempts to establish a functional capital market and with the prospective changes made to the legal framework, regarding the regulation and support for the innovative start-ups, etc. may be the time is right for us to witness the birth of Private Equity/Venture Capital Funds.

***Keywords**: private equity fund, venture capital, innovative start-up, capital market.*

Intro

There is no doubt whatsoever that innovation has been the biggest drive of economic growth and progress throughout the mankind history and we are for sure living in an era marked by spectacular innovation. The big technological achievements of the last century and specially in the last 50 years have been unbelievable and the transformation that happened in the world is unprecedented. The big technological changes have disrupted almost every aspect of the way people interact with one-another and the economy is at the core of it. Today it's hard to imagine a world without internet, free video communication, and powerful smartphones in your pocked able to get you connected in an instant with everyone, everywhere in the world, be it for business, educational or entertainment purposes, but this wasn't so a few decades ago. This ongoing transformation is demanding new more efficient ways of doing business and thus opening all new opportunities for everyone. So, in this new reality, at the peak of the "Third Industrial Revolution" a.k.a the "Digital Revolution", as OECD states "the capability to innovate and to bring innovation successfully to market will be a crucial determinant of the global competitiveness of nations over the coming decades" (OECD, 2007).

If innovation is what is needed than start-ups are where to find it. Even though we can't deny the crucial role of government programs which have financed some of the biggest R&D projects, it was actually the innovative genius and entrepreneurship of some random individuals which brought to light technologies or disruptive approaches which in turn transformed entire industries. These start-up businesses sometimes born in garages are accountable for non the less but a real social and economic revolution. (Apple, Microsoft, Amazon, Disney, Google, HP, Facebook… just to mention a few were all companies that started modestly in what is known as "garage" setup). There are several reasons why these start-ups brought more innovation than what big companies or governments which had resources to spare and large R&D departments, but what actually is more important to analyse is why and how did these start-ups made it. By doing so, by finding the reasons that helped bring these risky start-up ideas to life, we can than build a fertile environment which can spur innovation in the future.

A star-tup per se is any new business, but in the sense intended when the label is usually used, among different definition "A start-up is a company or project undertaken by an entrepreneur to seek, develop, and validate a scalable economic model (Startup company, 2021)."

According to Forbes (2019), citing data from the 2019 Global Start-up Ecosystem Report (GSER), the start-up global economy generated somewhere around $ 2.8 trillion in economic value over the last 2 years which was a 20% increase from the previous period. Although most of this growth is happening in already established top locations there is also tremendous growth taking place everywhere. The so-called start-up ecosystems are popping all around the world with various levels of success.

In literature there are different mixes to an ecosystem, but the main components we find in there are: Access to great ideas; Access to talent; Access to capital; Access to customers; etc. Even though all of them are important per se, one of the most important and crucial components is the access to capital. Without the proper funding a start-up can't make it and usually start-ups find difficulties in raising proper and adequate funding, especially from banks and capital market, this is mainly due to moral hazard and asymmetric information thus their options for financing are limited. Most of the time their options are in accordance to their respective stage of growth. In general, a start-up company at its early stages can benefit from pre-seed or seed funding (classification of stages and options is different in literature) and can go up to equity funding which happens usually in several funding rounds known as Series A, Series B and Series C, up to IPO. At every funding stage there are several types of investors of financing options and operators.

Seed capital – can be from own personal savings, credit cards, loans from friends and family, crowdfunding, etc.

Angel Investors – usually approach startups at early seeding stage and offer funding in exchange of equity. They are usually wealthy individuals who are using their own money.

Venture Capital Funds - focus on high-growth prospects and scalability. They, as well as business angels, are considered 'value-added' investors, who in addition to the supply of funding also contribute industry-specific knowledge and access to business networks (Carpenter and Petersen, 2002)

Mezzanine Financing - is a hybrid of debt and equity financing usually helps expansion toward new markets, merger & acquisitions, or preparing for an IPO

IPO - going public is an option which opens new ways to access to finance through direct access to capital markets making it easier to expand further, but it can also be an exit strategy for some of the equity investors which want to cash out.

The focus of this study is on start-up funding options in the Albanian market and specifically on the private equity / venture capital (VC) as an important part of the start-up ecosystem.

Thus, the objectives are to:

Assess the demand - Is there a need for Private Capital Funds and specially Venture Capital Financing in the Albanian market, especially from startups?

Review History - Have there been PE/VE funds or attempts to

Identify obstacles and challenges.

Theoretical framework

In the classic quest to find the main drivers of economic growth and prosper, many researchers have identified innovation to be one of the main factors. Innovation itself is frequently associated with entrepreneurship since the early works of Schumpeter (1934). We find especially entrepreneurial start-ups to be strongly ambitious for growth and innovation by continuously spotting and exploiting opportunities, as opposed to rent-seeking small conservative businesses (Burns, 2016; Carland, 2015; Murphy et al., 2019; Sonfield & Moore, 1990).

By definition Startups are new innovation-driven entrepreneurial ventures seeking a scalable business model (Blank, 2013), that have been in business for less than 10 years, were created by individuals as a "stand-alone firm" (OECD/Eurostat, 2018). Even though new ventures and small businesses share several characteristics and constraints, what differentiates start-ups is their entrepreneurial nature and their capacity to create, discover, and exploit opportunities to create new products, services, or business models (Alvarez & Barney, 2013; Burns, 2016; Foss & Klein, 2017; Shane & Venkataraman, 2000; Zahra et al., 2006). 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).

Also, Lerner et.al (2012) stress that venture capital involves long-term investments in risky, young companies, often with unproven management teams addressing new technologies in uncertain markets. Yet, the innovation that occurs in these small companies is an important force in moving a country into the knowledge economy, which can balance a prior dependence on resources or extraction. In addition, it can attract talented nationals who were educated elsewhere and are eager to return to either start or invest in exciting companies in their home country.

According to Bottazzi (2009), venture capitalists are financial intermediaries who organize limited partnerships to finance their activity by raising funds from institutional investors, such as pension funds, insurance companies, or endowments that are passive limited partners.

Gompers et al. (2015) point that PE investors 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.

On the other hand, 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.

Innovation coming from start-up businesses is higher than that done by big corporations which spend considerably more funds on R&D. According to Gompers and Lerner (2001) a dollar of venture capital appears to be about three to four times more potent in stimulating patenting than a dollar of traditional corporate R&D.

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 is such endeavors.

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 heavily impact 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.

Local start-ups ecosystem

During the 20th century, a significant part of innovation in the high-tech industry was carried out within medium and large organizations (Chesbrough, Vanhaverbeke, and West 2008). While the development cycles, from idea conception to product commercialization, within large companies and traditional technology transfer mechanisms typically last from 5 to 10 years (Ries 2011) due to the inherent bureaucracy and lack of agility associated with large, structured organizations, in the Internet-age, innovative ideas can be developed, tested and adopted in 1 or 2 years and, in some extreme cases, in a matter of a few months (Benkler 2006; Goldman and Gabriel 2005).

A small start-up founded by two or three entrepreneurs with a handful of employees can produce and test the feasibility of tens of possibilities for a new business idea, producing a viable product in a matter of a few months (Kon et. al. 2014). This agility fosters the creation of thousands of startups around the world annually. Based on the largest start-up database (Crunchbase 2014), there has been more than 200,000 founded startups in the last 10 years.

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Even though there are different mixes to an ecosystem the main components we find in there are:

- Access to ideas
- Access to talent
- Access to capital
- Access to customers

Also, in an optimal start-up ecosystem we find some key players operating in at least one of the components.

- Incubators – This category serves as ideas and talent discovery structure and it usually includes shared office spaces, accelerator programs, formal educational curriculum, etc.
- Entrepreneurs – Here you are looking for people dare to push ideas forward, building teams and running the start-up businesses. They must be equipped with skills in strategy, administration, marketing, technology, etc.
- Mentors – experienced leaders who can mentor first time entrepreneurs up the learning curve, trying to teach them not to make the same mistakes of their predecessors.
- Investors - Any type of them from family and friends, to business angels, VC, etc. the important is to have the money needed to get through different stages of business growth.
- Universities – with a focus on cultivating an entrepreneur mindset, universities can be a cradle where big business ideas are born. Active research and successful technology transfer process can produce ideas and monetize them.

- Corporations – Can find solution to their problem through local startups which can find and develop ways or innovative products by taking advantage of their flexibility and creativity not binded by corporate bureaucracy. Often corporations may serve also as exit strategies for startups that have become large in size.
- Associations/Events – within the ecosystem there are needed several activities and events to promote new startups to the potential investors or collaborators. Competition or pitching events are usually best practise for this.
- Government – The role of the government can be very important. By providing tax incentives, by having friendly laws for startups, financing directly or through VC funds, it can contribute for a better ecosystem.

When looking for these components in the Albanian start-up ecosystem we find that for the most part of the list we have a good presence for quite some time now. But there is one missing piece which happens to be a very important one which is the investors. As mentioned before due to moral hazard and asymmetric information usually start-ups find difficulties in raising adequate funding, especially from banks and capital market and thus their financing options are limited and the presence of PE/VC funds is crucial for the local startups ecosystem.

Private equity funds presence in Albania

In the post-communist era, Albania 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 (Meka, 2021).

Although there have been several institutional-level initiatives 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), incorporated as a not-for-profit organization, the AAEF is managed as a private investment fund, with the primary purpose to promote private sector development. Funded with a grant from US government program USAID, 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 (AAEF, web n.d.).

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 (BKT, web n.d.), 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.

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 (ABI, web n.d.). 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. 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 performance (NCH, web n.d.). 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.

Obstacles and Challenges

The presence of PE/VC funds in Albania as we analysed before is not yet established because for PE/VC to exist and develop in a certain financial system some preconditions must exist. According to Ribeiro et al. (2006) there are several factors which heavily impact the PE/VC industry, like: legal system, tax procedures, bureaucracy and corruption, infrastructure and stock market.

Stock markets

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 or 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 (Meka, 2021).

Additionally, as Gompers and Lerner (2000) point out, 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.

In this context although previous attempts to establish an operating stock marked in albania hasn’t been able to achieve their objectives, the latest attempt by the Albanian Security Exchange (ALSE), a private capital enterprise licensed in 2017, has the potential to finally fill the lack of a functional market (stock exchange), where domestic businesses can raise capital as an alternative capital to the banking sector. In February 2018, ALSE started to officially trade Government securities (T-bills and T-bonds) (ALSE, web n.d.) and hopefully soon it will start trading corporate securities.

Legal framework & taxation

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. 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, contract enforcement is not one of the strongest points, in terms of attracting foreign investors and this could be deemed as an obstacle for the private equity industry. This may call for substantial improvement, in order to lay strong foundations for the private equity industry to flourish and establish, accordingly.

In addition to these legal challenges, private equity/venture capital is quite underdeveloped, as there is no fiscal incentive for them to finance and they are not exempted from taxes, in order to be competitive. 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.

Furthermore, tax treatment for capital gains and interests form 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 need for a dedicated law/legal basis, which regulates the innovative startups and their respective ecosystem, has been addressed for quite some time now by several organizations and initiatives and finally a new draft law on supporting and developing the innovative start-ups has recently (November 2020) been proposed.

The draft law aims to accomplish the following objectives:

- establishing fiscal incentives, programs and measures that support Innovative Startups, in the initial phase of business (incubation period) and the creation of a favorable ecosystem for them in Albania;
- establishing relevant government bodies and their relevant tasks & competencies, particularly the creation of "Startup Albania" - the National Agency for Start-ups;
- defining criteria, rules and procedures that apply to the certification, support, evaluation and monitoring of Innovative Startups.

In its entirety, the draft law is considered as a milestone in the road towards creating a supportive environment for private equity/venture capital entrepreneurship in Albania.

Conclusions and Recommendations

There is an undisputed need for PE/VC funds in the Albanian market specially in regard to fill this important missing piece in the startup's ecosystem so important for funding new startup companies with innovative ideas, which are otherwise unfundable by established financial institutions. For this to happen the legal framework in Albania needs to be completed, in order to provide better and proper regulation, as well as supporting and monitoring the activity of private equity/venture capital entrepreneurship. Also, relevant changes must be considered in the Albanian tax legislation, which could allow tax breaks, or holidays for such specific industry, within the Albanian financial system.

The establishment and functioning of a capital market is also a prerequisite as it offer the final destination of the exit strategies which VC pursue through an IPO. The large rewards reaped in such cases are the very reason why VC accept such risks when invest in start-up companies.

The Albanian government can establish directly or through ministries and state agencies government founded PE/VC which will support and finance innovative startups, thus creating the "good example" for the rest of stakeholders to follow suit.

Investment funds and other stakeholders, either institutional or private individuals in Albania, may explore the opportunity to allocate limited funds to innovative startups, following the established international practice,

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.

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