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Recovery of Western Balkans firms: Crowding in private investment and expanding access to advisory support

SPOTLIGHT



Spotlight: Recovery of Western Balkans firms: Crowding in private investment and expanding access to advisory support^{1,2}

Overview

The COVID-19 crisis has caused businesses in the Western Balkans region to suffer substantial revenue losses. Based on data collected during the crisis, at least 50 percent of firms surveyed in each country have been forced to close at least partly, and business was minimal for those that remained open. Micro and small firms suffered more than medium and large firms. The impact on services and tourism was more severe than on the rest of the economy. Across the region, disappearing market demand was reported as the number one challenge. Throughout the region firms confronted by liquidity constraints have responded differently by country on whether to seek new credit or renegotiate current loans.³

Firms in the region must now adapt their business models to the new post-COVID-19 normal while also overcoming structural barriers to competitiveness and innovation.⁴

Their immediate priorities must be to restructure their operations and logistics chains to make them more resilient to future shocks like COVID-19; accelerate digitalization throughout value generation chains; increase the efficiency of investment and operational costs; accelerate introduction of new work models (remote work, automation); and speed up development and production of new products and services to respond to the inevitable rapid changes in demand from their clients (McKinsey 2020). Given the importance of innovation to improving productivity, adopting new approaches to processes, and building managerial capabilities (Cirera and William F. Maloney 2019) will be crucial to heightening competitiveness and supporting post-COVID-19 recovery for firms—which could then drive job creation and economic growth.

To achieve these objectives, firms need access to financing and advisory support. While there are programs in the region to support firms in doing so, they generally rely on grants from government. Reliance on government funding to support the private sector puts a heavy burden on limited government resources, which have been severely stretched by the COVID-19 crisis.

Regulatory obstacles in the region make it difficult to set up investment mechanisms in support of firms, such as private equity and debt instruments, venture capital, crowd-funding platforms, or business angel groups. And even when such private funding does exist,

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2 This spotlight was funded with UK aid from the UK Government.

3 For further information, please see <http://documents.worldbank.org/curated/en/444031591289647448/pdf/The-Economic-and-Social-Impact-of-COVID-19-Private-Sector.pdf>

4 The crisis has added to the region's pre-existing structural challenges. Generally, business environment barriers in the region disincentivize market entry, exit, and growth, and firms lack innovation and entrepreneurship (I&E) capabilities and capacity to improve productivity; they are unable to translate ideas into goods and services that will satisfy buyers. Moreover, because firm managerial and technical capabilities are generally low, they are not prepared to adopt new technologies and digital economy business models. The region has a poor track record of innovative output; it also suffers from brain drain, little public and private research and development (R&D) spending, and the poor quality of its formal R&D (scientific publications and patents). In sum, few local firms can compete globally.

firms find it easier to access government grants than to tap into private financing, which often has more stringent conditions and monitoring.

Moreover, there is currently little support for firms seeking much-needed soft investments.⁵ Soft investments are especially critical today so that firms can adjust their operations to the post-COVID-19 reality by adopting new technologies or accessing new inputs and markets. But there is little support to firms in areas such as improving investment readiness, upgrading processes, managerial innovation, export readiness, acquiring licenses, and adopting digital solutions—all of which are critical if firms in the region are to compete, domestically and internationally, and to adapt to the post-COVID-19 environment. Based on interviews with firms, lack of funds to access such services or even where to find them are serious constraints in the best of circumstances, much less post-COVID-19. Moreover, qualitative data collected from interviews show that the culture of the private sector in the Western Balkans has little if any appreciation for soft investments or paying for advisory support; and investors in the private sector have little interest in financing soft measures.

To support firms in this effort Western Balkan governments need to (a) crowd in private financing (debt or equity) to facilitate hard investments by firms; and (b) shift the focus of scarce government resources more towards facilitating soft investments like business development and advisory support. To the extent that governments need to continue supporting hard investments (at least until private investment picks up), their programs should be redesigned to include a mix of hard

investment and capability upgrading by making hard investments available conditional on soft upgrades. This approach would be necessary for businesses at different stages of their development, from young firms at the pre-seed, seed, or venture stages to mature firms.⁶

Current Situation and Development Gaps through a Company's Life Cycle

For young, innovative firms at the pre-seed stage,⁷ access to funding and advisory support is limited, as are the possibilities for attracting private investment through, e.g., crowd-funding or business angels. In the Western Balkans firms in this stage fund their activities primarily from savings, friends and family, employment agency grants, refundable grants, or pre-investment support from government agencies. For example, in North Macedonia, the Fund for Innovation and Technological Development (FITD) supported innovative startups at the pre-seed stage through small reimbursable grants before and during the COVID-19 crisis. Some private investment exists in the region: fledgling business-angel networks exist in each country, but their development is complicated by legal and regulatory deficiencies.⁸ Similarly, a small number of crowd-funding platforms are operational in Albania, BiH, Serbia, North Macedonia and Kosovo with varying levels of traction but the development of platforms registered locally is limited in a number of countries in the region by the lack of a legal and regulatory framework. Generally, support for advisory services for pre-seed firms takes the

5 See Acur et al. 2003, which demonstrates the importance of soft investments for optimal development of firms internationally.

6 Mature firms are those that are five years and older, while young firms are below five years.

7 Defined as innovative startups less than three years old.

8 For example, legal barriers to convertible loans and the absence of regulation for trust structures.

form of very small, discrete programs that are limited in scope. For example, in Albania and BiH, some small donor-supported programs provide training and mentoring for startups. In Albania, the Workshop Entrepreneurship & Innovation Lab has an annual accelerator program for tech startups; Yunus Social Business Balkans is an accelerator for social businesses; IDEA is a project for young entrepreneurs run by the German Agency for International Cooperation (GIZ); and Startup Grind Tirana is a community for founders and entrepreneurs to share best practices. In North Macedonia, the FITD has supported young firms with advisory services provided through accelerators and its entrepreneur-in-residence program. In BiH, programs funded by a range of donors support startups with innovation and entrepreneurship programs, particularly incubators and accelerators.⁹ One serious issue is that many programs in the region call themselves “accelerators” but do not combine intensive mentoring with early-stage investment.

Similarly, innovative firms at the seed and venture stage¹⁰ have little access to funding and advisory services, especially private financing for startups and young SMEs.

In the Western Balkans, funding at this stage usually originates in business-angel groups, accelerators, grants for commercializing innovation, and a few seed and venture capital funds. For example, in North Macedonia there are a few business angels and small unregulated investment funds. In Serbia, companies at the seed and venture stage can access subsidized loans and grants from a variety of public

sources, such as the Development Fund and Serbia Development Agency, but there is little private investment. In BiH, there is no venture and seed capital available, and though there are a number of incubators, they mainly provide co-working spaces, some support in setting up and running a business, and some networking opportunities. Throughout the region, regulatory deficiencies explain in part why the private sector is reluctant to invest in this space, and some countries have started to address the issue. For example, while the regulations in Republika Srpska foresee the formation of venture capital funds and the Strategy for SME development envisions activities of this type, none yet exist. Serbia has a new Law on Alternative Investment Funds.¹¹ Albania has also recently passed a new Law on Collective Investment Undertakings that is aligned with the EU Alternative Investment Fund Managers Directive, enabling the establishment of private equity funds.¹² North Macedonia is starting to reform the legal foundation for supervising the private equity and venture capital industry.¹³ Finally, advisory services are available in most Western Balkan countries, but their scope and coverage are limited. Some countries are trying to provide more such support to

⁹ Examples are HUB387, Intera Technology Park, Spark Business Park, Innovation Centre Banja Luka, BIT Centar, QLAB, Mozaik and Networks Foundations, Restart, and Ant Colony.

¹⁰ Defined as startups and small and medium enterprises (SMEs) less than five years old.

¹¹ Though this law is generally aligned with international good practices and addresses most of the previous regulatory gaps, other laws raise difficulty, notably the Law on Foreign Exchange Operations, which deters investment by international investors. Also, the law transposes the EU Alternative Investment Fund Managers (AIFM) Directive but does not regulate venture capital fund managers with lower assets under management than the threshold set by the Directive.

¹² Similarly, Albania's new law transposing the AIFM Directive would apply to above-threshold funds but not below-threshold funds outside the scope of the Directive. Therefore, this law would not apply to the below-threshold venture capital fund managers who are likely to be the vast majority (if not all) of the fund managers setting up new in the region; a separate law is needed to regulate below-threshold fund managers.

¹³ In North Macedonia, expected reforms include both transposition of the EU AIFM Directive and the European Venture Capital Regulation into North Macedonia's regulations. There, the startup community has already requested amendments to laws and regulations to allow establishment of trusts and the extension of convertible loans, and to better regulate the responsibilities of minority investors and founders.

firms. For example, the Serbia Innovation Fund is preparing to introduce an accelerator program that will emphasize mentoring, and the National Employment Service and regional development agencies offer training for new companies. Some international financial institutions (IFIs), such as the European Bank for Reconstruction and Development (EBRD), provide advisory services that are not just for innovative firms.

Mature firms¹⁴ also have difficulty accessing private financing because (1) banks, although liquid, are risk-averse, and (2) few countries provide an adequate legal foundation for private equity, although Serbia and Albania have made progress to regulate managers of funds above a certain threshold. There are few advisory services, and links between academia and mature firms are generally weak. In the Western Balkans support for funding for these firms usually consists of limited loans from banks; investments by international private equity and debt funds; reimbursable grants for technology development and extension, and commercialization of innovation; and competitiveness programs funded by donors. For example, in Montenegro, the main government financial support instrument is the Investment and Development Fund, which offers subsidized loans, which vary depending on the type of SME. In 2017 its loan portfolio amounted to about €175 million—comparable to larger domestic commercial banks. In Kosovo, there are more than 25 active donor MSME projects and activities, with an estimated value of 1.5 percent of GDP. Intervention strategies vary, but as part of their support most donors provide matching grants for capital purchases of productivity improvements. Support is largely

directed to expansion of existing MSMEs. In BiH, however, government and donor support for innovation is directed to potential entrepreneurs, which, while addressing a need, leaves current entrepreneurs to struggle for themselves. Support for advisory services in the region may also originate in technological extension services and SME advisory services, supported by IFIs. For example, the Western Balkans Enterprise Development and Innovation Facility, supported by the EU and the EBRD, provides, in addition to access to financing, advisory services for small businesses on accounting, financial reporting, marketing, sales, strategy, and human resource management. However, advisory services are not widely used and few cover such areas as export readiness, digitization, and technology adoption.

Recommended Interventions by Business Stage

For pre-seed firms, it is important to crowd in private investment through better access to crowd-funding and business angel platforms. The governments in the region could do a great deal to help in the following areas:

- a. **Absence of a legal structure for crowd-funding and business angels.** A priority is regulations that cover both lending and equity crowd-funding, to be issued by securities exchange commissions that adhere to best international practice, and to amend laws and regulations to allow for convertible loans and establishment of trusts for business angels.
- b. **Limited development of domestic crowd-funding and business angel platforms.**

¹⁴ Firms more than five years old.

There is a need for business angel and crowd-funding co-investment facilities, where government agencies co-invest in platforms once the required legal structure is in place.

Firms at the seed and venture capital stage need more effective accelerator programs, broader access to advisory services to commercialize their ideas, and crowding in private investment through a Fund of Funds. Here Western Balkan governments could help them to address these obstacles:

- c. **Startups graduating from accelerator programs are not ready for investment.** Such firms need pre-investment support before seeking investment. It is also important to ensure that the accelerator programs are in fact serving their intended purpose.
- d. **There are minimal links between accelerators and investors because investment partners are not included in the selection of accelerator participants;** they therefore have little incentive to invest in accelerator graduates. It would be advisable to include investment partners in sessions in which firms pitch their eligibility for acceptance by accelerators.
- e. **Startups cannot afford to pay for advisory services for commercializing their ideas.** It is therefore important to provide grants to attract firms to pre-investment support.
- f. **Access to private financing is limited.** It is therefore critical to support the development of fund of funds (FoF) for early stage finance. These funds not only bring in additional financing from the private sector, they also

attract “smart capital” that understands technology trends, specialized marketing strategies, financial management skills, and potential international client networks far better than government agencies helping to commercialize innovation. Western Balkan governments could sponsor the establishment of hybrid FoFs which would combine public and private capital to invest in individual seed and venture capital funds that have private fund managers.¹⁵ These seed and venture capital funds would then invest through equity or quasi-equity (convertible debt) in startups and young SMEs (qualified portfolio undertakings) in the region. It would take some time for such a FoF to be fully operational; the number of early stage funds that could immediately be targets of FoFs in the region are still few and new funds will take time to emerge.

Mature firms need more access to advisory services and private sector financing, such as commercial lending and private equity and debt funds, to facilitate collaboration between academia and industry. Governments in the region could help them address these pending challenges:

- g. **Many SMEs will continue to have difficulties adjusting their operations to the post-COVID-19 normal; many do not export because their products and services are not competitive, their managerial practices are inadequate, and they need support if they are to enter new markets.** Governments need to design

¹⁵ Some criteria for establishing a FoF are needed to ensure that they follow international best practices. For example, it would need to be treated as a minority limited partner with private investors as general partners registered and licensed as domestic venture capital fund managers (below the threshold of the EU AIFM Directive) in the countries of the region.

support instruments to provide advice to firms on better managerial practices, investment in digital transformation, heightening product quality, obtaining any necessary certification, reducing costs through automation and economies of scale, providing market analysis, and facilitating market links.¹⁶ It would also be useful to redesign government programs that support hard investments so that funding for hard investments is conditional on firms making soft upgrades.

- h. **Private financing is rarely used for technology upgrades and other productivity improvements because banks in Western Balkans are risk-averse and the private equity and debt fund industry is embryonic.** Partial credit guarantee facilities could therefore be established to share risks with financial institutions. Establishing a partial credit guarantee fund would help leverage capital available in the banking system, which is currently out of reach partly due to bank risk-aversion but also because SMEs lack collateral. Also, emergence of domestic private equity and debt funds could be encouraged if regional governments put in place the appropriate legal structure, aligned with the EU *Acquis Communautaire*.
- i. **The development of firms in the region suffers from lack of innovation and R&D.** It is therefore critical to improve the instruments of technology extension to support collaboration on innovation and technology adoption between firms,

academia, and other knowledge providers. It is also important to reform public R&D institutes and universities by creating a governance and incentive structure that facilitates collaboration with the private sector.

Conclusion

As they emerge from the COVID-19 crisis and begin to adjust to the new economic normal in the medium term and as Western Balkan countries become more integrated into the EU single market in the longer term, firms in the region will benefit from access to a broad range of advisory and financing instruments. These must be carefully tuned to the specific needs of businesses at various stages of their life cycle, and carefully balance market validation and financing and public support.

¹⁶ Instruments they might find useful are vouchers for business and pre-investment advice; reimbursable matching grants for upgrading and innovation; and reimbursable matching grants for collaboration in innovation and technology extension.

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Coins

by Faton Dermaku (Kosovo)

Faton Dermaku is a young Prishtina-based visual artist, with a prolific portfolio of abstract graphic art. He completed his graduate and post-graduate studies in fine arts at the University of Prishtina Academy of Arts (the Graphics Department) in 2008 and 2010, respectively. Faton has showcased his work in various collective exhibitions and organized personal exhibitions in Kosovo and Switzerland. Faton experiments with his imagination of history through modern art, with an emphasis on cultural intersections in historic imagery.

People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, the cover of this report and following editions will feature art from the Western Balkan countries.