# Private Equity Funds/Venture Capital – A New Role and Opportunity in the Albanian Economy and Financial Market

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## Abstract

The prolonged stagnation bank credit expansion, following the outbreak of recent economic and financial crises of 2008, and now the complex situation during the pandemic, 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 difficulties in obtaining 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 complex and 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/Venture Capital Funds (PE/VC) 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 rudimentary and non-active, and furthermore, helping in ensuring a sustainable long-term economic growth.

**Keywords:** Private equity capital, Venture Capital, securities, long-term financing

**JEL Classification:** G100, G21, G23, G24, G28.

## Introduction

### 1. Objectives

This paper aims to provide some key considerations about the role and importance of the existence and establishment of Private Equity/Venture Capital 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/VC 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 may 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.

## 2. Theoretical framework

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.

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) affirm 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 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.

Gompers and Lerner (2001) conclude that venture funding does have a strong positive impact on innovation and that, on average, a dollar of venture capital appears to be three to four times more potent in stimulating patenting than a dollar of traditional corporate R&D.

Bottazzi (2009) affirms that VCs concentrate on start-up firms and use their knowledge of industries and markets to evaluate and mentor entrepreneurs. The role of venture capital in this context is potentially very important.

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.

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. But startups and other innovative companies, which bring innovation in the market are not usually big and established firms, but instead thy 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 is 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 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. 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.

Also, Romain & Pottelsberghe de la Potterie, (2003) conclude that, in order to stimulate VC in a country, demand-side factors have to be taken into account. The most important factors affecting the demand of VC are the stock of knowledge, innovative outputs, and interest rates.

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.

## 3. Private Equity Funds within Albanian reality

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. 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 ion 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.

### 3.1. Legal & Regulatory framework

Regarding 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.

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.

The actual legal framework, which regulated the financial/capital markets 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.

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 (2020), Albania does not score well in terms of protecting the minority investors (111$^{th}$ place according to WB - Doing Business 2020); also it is still positioned far from mid-table, when it comes to enforcing contracts (ranked 120$^{th}$). This may call for substantial improvement, in order to lay strong foundations for the private equity industry to flourish and establish, accordingly.

With regard to the startups ecosystem in Albania, as well as in relation to respective markets for ensuring their relevant financing, it is a fact that Albania poses significant shortcomings. Practically, Albanian government has taken some steps, regarding the increase of grants to SME businesses but it still lacks a national strategy to address such issue. Grants for start-ups and their financing are made by various international projects, but none of them intends to link startups with private equity/venture capital financing. According to European Commission Report on Albania (2020), although Albanian Investment Development Agency (AIDA) continued to offer funding instruments to stimulate start-ups and entrepreneurship in tourism, handicrafts and innovation, as well as competitiveness, access to finance remains a serious challenge for businesses. Start-ups find quite difficult to obtain bank financing, because they require collateral and, consequently, given their specific nature of the enterprise, they remain underfunded. On the other hand, 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. In these way, and since Albanian corporates have a practical little interest in innovation, it makes talented young entrepreneurs to find a non-existing market to develop in Albania; therefore they are focused mainly on finding an international market, by making competitiveness their and their ability to survive in the market an unsurmounted challenge.

On the other hand, the Albanian legal framework still lacks a dedicated law/legal basis, which regulates the innovative startups and their respective ecosystem. Also, there does not exist any government institution, which could take care of them, in the form of training or funding. In addition to these legal challenges, there is a significant lack of fiscal incentives even for "business angels", as in case of private equity/venture capital. Both forms of startup financing are considered, like all other businesses making Albania, less competitive.

However, the Albanian Government has recently proposed (November 2020) a new draft law on supporting and developing the innovative start-ups. The draft law aims to create a regulatory and institutional framework, which supports and favors the establishment and development of new businesses with high growth potential, in the field of technology and innovation (better known as Innovative Startups), which realize ideas, new business models, products and processes, and that could bring significant innovation and improvement in every area of the economy. As above mentioned, such draft law aims to fill the existing legal gap, as in Albania until today, there have been no provisions or legal basis which regulates the issues related to innovative startups.

Additionally, 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 Startups;

- 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.

### 3.2. 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 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.

### 3.3. The Albanian practical experience with Private Equity 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[1].

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[2], 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[3].

### *3.3.1 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[4]. 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[5]. In 2007, NCH Capital started investing in the Western Balkans region and established a regional office in Tirana, Albania.

The purchase of 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

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[1] Albanian American Enterprise Fund. See: http://www.aaef.com/.
[2] Banka Kombëtare Tregtare. See: http://www.bkt.com.al/.
[3] Ibid.
[4] American Bank of Investments. See: http://www.abi.al/.
[5] NCH Capital. See: http://www.nchcapital.com/

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.

## 4. 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 baking 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, 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.

## 5. Conclusions and Recommendations

Legal framework in Albania needs still to be completed, in terms of providing better and proper regulation, as well as supporting 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, 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, which the new draft law on supporting and developing the innovative startups is expected to provide for them.

The Albanian government may consider allocating dedicated funds to several ministries and state agencies, in order to support and finance innovative startups, thus serving as key private equity/venture capitalist, thus creating the "good example" for the rest of stakeholders to follow suit. Practically, 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.

Alternatively, the Albanian government could consider that such financing powerhouse to be established as a wealth management fund, which may be entitled to support and finance such innovative ideas, through startups, in the capacity of the key private equity/venture capitalist in the country.

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, with the clear focus of providing ease of funding to innovative and breakthrough ideas.

Academia and universities, which provide study programs in engineering & technology, business & finance and agriculture, must create basic infrastructure, in the form of business incubators and research labs, in order to facilitate the brainstorming and practicing new ideas and technologies. This approach would offer a supportive platform for startups, may attract interest from corporates, entrepreneurs and business organizations to finance, partly or totally, the research and development, along with the academia, itself.

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.

Additionally, the newly created payment & clearing infrastructure for private securities, especially corporate bonds, could in turn, 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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