Structuring of Growth Funds with the Purpose of SME’s Evolution under the JEREMIE Initiative

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Abstract: Recent surveys in regards to Country’s economy development and especially SME’s progress in the past few years, shows the decline in development. The recovery and restructuring of the economy would go through rehabilitation and modernization of long-term value creating industries. Continuous development of already established SME’s in some of the analysed sectors of the economy is backed by the identified potential for above average growth. Initially targeted favourable sectors, subject of investments would be under the main focus for investments in the upcoming future by any structured fund under the JEREMIE initiative, but will not limit the exploration of other opportunities depending on market developments.

1 INTRODUCTION

Between 2000 and 2008 Bulgaria faced its first real boom period for the last 25 years. The EU accession plan, the currency board and western oriented governments combined with booming banking industry and cheap credit resources created an investor friendly business environment that attracted in total more than EUR 25 billion of FDI and assured steady growth of the economy with rates double than the EU average. Unfortunately more than 70% of these investments went into non-productive, highly speculative and cyclical businesses or were triggered by arbitrage opportunities in privatisation deals. Manufacturing and service industries (excl. financial services) did not benefit proportionally from the growth. Looking back in a period of 25 years Bulgaria has lost more than 50% of its light and heavy industry production and more than 60% of agriculture production, turning from a net exporter into net importer for many goods.

Statistics show that the next growth wave in the country will be driven by the rehabilitation and modernization of long-term value creating industries led by the manufacturing sector, which will profit from a boost in the local agriculture sector and foreign demand (e.g. exports are surpassing pre-crisis levels). Modernization of production assets is closely related to the implementation of Government’s initiative for energy affiances improvements. Service industries, excluding financial services and telecom, are currently underdeveloped, and will grab higher share of the economy and outperform.

Manufacturing was heavily hit in the last few years due to strongly decreased internal and external (export) demand, out of date business processes and weak financial management. The liquidity reserves of the sector decreased significantly, fresh liquidity is scarce on the local market and hinders the fast recovery of the sector from the crisis. This situation creates good entry opportunity at low-to-reasonable valuations enabling investors to extract maximum return on the provided capital.

Bulgaria slowly recovers from the crisis; signs of recovery in selected industries are already visible. The Bulgarian government expected GDP to rise by 3.7% in 2011; foreign institutions and banks were more moderate and forecasted an average annual growth of 1.5%. Even though prognoses for a new Recession in Europe is close to becoming a reality, our expectancy is that after 2013 a partial recovery and additional growth of the export goods demand from Western Europe will be anticipated. Combined with recovery of local consumption and resumed capital inflows this should result in an average GDP growth of 5.0% yoy over the next 10 years.
Manufacturing output growth is forecasted to be faster than GDP growth over the next decade. Manufacturing output is expected to rise by 9.6% in 2012 and on average by 7% yoy over the next 10 years.

As a result, the share of manufacturing output in GDP is projected to rise from 18.0% in 2009 to 20.9% by 2014 and rise to 21.1% by 2019. Over the same period, the share of service sector output in GDP is expected to fall from 63.4% in 2009 to 61.0% in 2014 and rise to 61.5% in 2019. (Oxford Economic Forecasting)

Figures show that the timing for investment in Bulgarian SME’s growth from the manufacturing sector is perfect for the following reasons:

- Rising external demand for the manufacturing sector is already visible in the increase of exports which surpassed pre-crisis peak levels. The decrease in local demand is slowing down to zero, and the reverse trend is already visible in the past year, along with pick up process expected to continue in 2012. This means that the economic cycle will support the investments.
- Most of the companies in the targeted industries have been privatized or established in the period 2001-2007, which makes them attractive for different kinds of growth investments categorised mainly into 2 types: a) expansion – e.g. in production or product range, b) developing the company to the next level – e.g. vertical or horizontal integration or new markets strategy.

The service sector growth prior to the credit crunch was dominated by financial services, telecommunications, and real estate related activities. This led to disproportionate allocation of capital and investments leaving other promising segments of the sector underinvested. Each fund’s management should see the potential for above average growth coupled with demand for capital in two major industries, namely: energy efficiency and healthcare.

2 TARGETED MARKET SEGMENT AND ENERGY EFFICIENCY

The analysis seeks to locate and target the most attractive for investments, important and
underdeveloped segment of all sectors of the economy, including several major industries within these sectors. The development of these industries will support sustainable growth in the country’s economy in general. The segment will be in the main focus for investments in the upcoming future by any structured fund under the Jeremie initiative, but will not limit the exploration of other opportunities depending on the market developments.

The Energy Efficiency space is an attractive investing segment due to the enormous lag of Bulgaria to achieving EU-wide standard and the active supporting policies implemented over the last years. The government, in line EU targets and initiatives, has provided financial and legislative incentives for improving energy affiance, lowering overall energy consumptions and increasing renewable energy in the total consumptions mix. The country occupies one of the places in terms of energy intensity in Europe with energy intensity coefficients of the GDP standing approximately 90% above EU averages.

The latest Energy Strategy drafted by the government in line with European 20/20/20 goals envisages reduction in green-house emissions, raising the share of RES contribution to 16% of the final consumption, and reducing energy intensity of GDP by 50% by 2020. The interim target for reducing energy intensity of GDP is 25% reduction by the year 2013. The state plans to reduce the energy intensity of GDP from 913 toe/M€05 in 2005 to 456 toe/M€05 by 2020. According to different estimates, the country needs to invest approximate BGN 4.2-4.5 billion to reach the outlined targets and to lower the overall energy intensity of the economy. The achievement of the targets requires implementations efficiency and savings solutions and investments in industry (38% share in total consumption), households (21.8%), transportation (28%), and services (9.4%) and it has opened a market niche for business with above average growth opportunities.

Energy efficiency in Bulgaria is a segment, which is below the average in the EU, not only because it has not received the much needed improvement, but also because priority development was given to targeted industries that are generally energy intensive.

The market of energy efficiency solution providers and services companies is relatively fragmented and consists primarily of SMEs in earlier stages of development, thus offering ample opportunities for investment in innovative technology applications, engineering companies, and complex service providers specialized in the household and industry projects.

Prioritized SMEs in terms of energy efficiency improvement will be businesses, focusing on investments into new machinery, equipment, technologies of higher-energy class, and reduced emissions, along with companies looking for energy efficiency achievement by switching fuel consumptions (gas, etc.). (Bulgarian Small and Medium Enterprise Promotion Agency)

3 INVESTMENT STRATEGY

The individual investments in each fund’s portfolio should be selected based on the combination between the mandatory and at least on of the optional criteria:

Mandatory Criteria:
- Management team and human resources’ potential;
- Profound market and industry knowledge;
- Business model scalability;
- Distinctive competitive advantages;
- Double digit growth potential of the companies revenues;
- Clear Exit Route.

Optional Criteria:
- Value-adding opportunities through process optimization, strategy fine-tuning;
- Market scalability of the products (export);
- Potential for horizontal or vertical integration.

The majority of SME companies in Bulgaria experience difficulties in maintaining a normal life cycle and tend to suffer from early maturity and decline without being able to materialize its full potential. There are many reasons for this, with the most common being – poor management and lack of financing. The Fund will aim in this cases at eliminating these factors with different optimization strategies, so the company converges to its natural development path and then seek expansion opportunities. Companies that have already accomplished this stage of their life cycle will be prepared for the next level.

Business cycle stage of the investment targets:

By providing equity financing, business expansion and optimization can be achieved primarily through the implementation of various strategies: production capacity expansion; new product or a new line of products launch;
commercial network development, process improvement and efficiency.

More than 80% of the companies are managed with outdated structures, based on personal skills and single person’s authority. We believe that implementation of modern business processes and process management would increase significantly profitability.

Optimization of the marketing strategy and establishment of adequate financial management will be in most of the investment cases the other substantial driver for successful expansion.

- Upgrading to the next level

The step to the next lifecycle stage of the company will be achieved by providing equity capital and financial structuring of the implementation of one or several of the following strategies:

- Organic growth for companies with interesting and multipliable business models;
- Non-organic growth, horizontal integration;
- Non-organic growth, vertical integration across the value chain;
- Creating regional leaders and consolidation plays.

## 4 EXPECTED NUMBER OF INVESTEES COMPANIES

### PLANNED INVESTMENT RATE INCLUDING FOLLOW-ON POLICY AND ENVISAGED STRATEGY FOR RISK DIVERSIFICATION OF FUND’S CAPITAL

The size of established Funds under the JEREMIE initiative should be between EUR 45-60 million, thus utilizing the whole amount available from the OP Competitiveness. The amount of the funds should be planned to be at the maximum level in order to fulfill the main targets of each Fund manager, with a main focus on:

- Fund diversification to be aimed at mitigating the various risks.
- Private investor commitment – based on the already confirmed participation by private investors (Banks, Insurance Companies, Mutual Fund and local companies) – the indication should be that the overall commitment of Private Investors will exceed EUR 30 million for each fund.
- Built – in Pipeline- the fund managers will dispose with an immediate pipeline of 15 potential deals with total investment of near EUR 70 million, which should be the base
for the first few executed deals in the first year. In our case the pipeline is partially represented by the described investment cases.

- The demand for financial growth instrument in the SME segment is at its peak. Traditional bank financing remains currently hardly accessible for SMEs, due to the ongoing cautious approach by the banks to lend investment loans with longer tenors following the continuing process of deterioration of the banks’ loan portfolios. Banks are currently predominantly focusing their efforts in consumer and mortgage lending.

Therefore, it is considered that managers of each fund should be in a position to grow private equity portfolio of companies within 3 years surpassing the set target of the growth fund of EUR 60 million.

Investing in growth capital in the SME sector involves substantial risk in general and particularly in emerging markets like Bulgaria.

A significant portion of this risks results from the lack of business ethics in the market and a legislation, which doesn’t support in particular this kind of investments. Several cases from the experience of international PE players in Bulgaria have shown that even a complete loss of the investments is possible due to fraud and weak legal execution. We believe that the combination between the accumulated experience in each fund’s team, combined with previous successful financial deals in the local business environment and the necessary understanding of the peculiarities of the execution of financial deals in Bulgaria will be crucial for mitigating the legislative and fraud risk.

In order to mitigate the business and industry risks, it is necessary to achieve a relative diversification in stages/ types of investment, industries, size and number of portfolio companies. We believe that each fund needs to be able to invest in no less than eight companies in its total lifetime and not more than twelve at any moment of it.

The main purpose of these funds per definition is to support SME growth and not to takeover companies. Therefore the general intention under the initiative of the fund is to hold not more than 50% of the company’s equity. Although, as the mentioned negative experience of other PE investors in the country shows, even as minority shareholder it is appropriate to implement irrevocable control mechanisms over the decisions process of the company’s management as guarantee that the invested capital is used for its original goals.

Attendance in the management board meetings of each company will be just one of these mechanisms.

Generally the management processes of the companies will be reviewed and if needed adjusted. Preferable to invest in companies that have already existing or are willing to implement modern business and management processes, which are detached and independent from individual talent skills and single persons authority. The latter is unfortunately still the business standard for the majority of SMEs in Bulgaria, and bares a high potential business risk in the cases of disloyalty of this key people. (Bulgarian Small and Medium Enterprise Promotion Agency, Bulgarian National Bank).

As funds will be investing in growth, the equity investments as a general rule should be done as a capital increase and not as a partial or full shareholders exit. Exceptions to this rule can be evaluated if one or some of the shareholders hinder the development of the company.

Considering the required experience of each developed structure and the targeted industries, the ideal investment sizes should be between EUR 1.5 million (smaller investments) and EUR 8 million (large). This numbers show the initial investment size. For follow-up capital increases funds are advised to keep special reserves of 10% to 15% of the total fund capital. Ideally, capital injections should be scheduled in tranches tied to performance and/or investment cornerstones.

The general holding period of an investment is projected to be around 5 years, depending on the industry, life cycle of the company and the general economic cycle. Overall targets should be an IRR of 18%. Some of the companies might need to be prepared for acquisition by international buyers due to the natural limitation of the local market. Such companies need to have grown to a size and stage that will make such acquisitions possible.

Additional investment rules have to be made applicable, in order to cover the principles described above:

- A single investment should not exceed EUR 10 million, and if it does, then a decision of the supervisory board will be needed. Single investments below EUR 1.5 million will be not evaluated.
- To assure diversification of companies, Top 4 investments should not exceed EUR 30 million.
- To assure diversification in the targeted industries, the limit per single industry will be 30% of one funds capital.
A balance (50/50) between the two types of investment will be targeted.

Each fund is to aim and complete at least 3 deals from different industries and different investment types within the first year of structuring. The investment cases show a generalized summary of some of the existing projects/deals under the specific pipeline. In the following years, performance speed should be kept at 3-4 deals per year (set as target). (Bulgarian Small and Medium Enterprise Promotion Agency, Investor.bg)

5 CONCLUSIONS

It’s been proven that given the development stage and nature of the SMEs in Bulgaria the most suitable instruments created by Funds management have to be as plain and simple as possible. Sophisticated financial products generally create mistrust on the local market. Thus each Fund must intend to use for its investment needs primarily direct participation in the companies via investing in common stock and in certain cases through a combination with investments in preferred stock of the company.

Structured Funds under JEREMIE most likely will aim at purchasing a significant portion of a particular company in order to be able to have a larger influence in its governing and to speed up its growth via the experience and know-how of its investment team. Typically Funds will seek to participate via a capital increase aiming at further strengthening the shareholder’s equity, and support the continued growth through acquisitions as well as organic growth.

In order to protect its investment each Fund might seek also participation through preferred stock as it has many advantages including a greater claim of the assets than common stock thus limiting the downside of the investment.Buying preferred stock could include the option of converting them into common stock at any point of time, in which case the owners will lose the right of a dividend, but will gain the ability to participate in the decision taking process. Preferred stocks could be flexible in terms of the dividend rates that they hold, which could be adjusted along the way so that it does not interfere with the company’s sustainable growth.

In limited number of cases each Fund have to aim at lending different types of hybrid loan products, suited to best fit the business needs of each company. A common type of debt product that Funds will be looking at will be the convertible debt, where the loan is secured via the right to convert it to common stocks at certain predetermined conditions. This will reduce both the risk to each Fund and the requirement to the company to provide collateral, which as we have mentioned before proves to be a major obstacle for the SMEs on their way to receiving a proper financing.

Each structured Fund must target an investment with a clear potential to generate above 30% internal rate of return (IRR). As some of them could be expected to not realize their full potential and reach all financial targets at the predefined time horizon, managers should expect that the overall performance that one Fund will be able to achieve will be equivalent to IRR of 18%.

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