

VENTURE CAPITAL FUNDS AS SOURCE OF ALTERNATIVE FINANCING THE GROWTH AND DEVELOPMENT OF STARTUP COMPANIES IN THE REPUBLIC OF SERBIA

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ABSTRACT:

Startups as economic entities are characterized by a high degree of innovation, the potential for rapid and large growth, but also significant business risk, so investing in startups represents a special kind of challenge. Taking into account the growing potential of the Serbian startup innovation ecosystem and the increasing number of startups, the paper analyzes venture capital funds as effective alternative source of financing the growth and development of startup companies in the Republic of Serbia. The fact that financing is one of the most significant challenges faced by Serbian startups also indicates the importance of venture capital funds for the development and increase of the competitiveness of the domestic startup ecosystem, which was recognized and institutionalized in previous years through state regulation. Their business creates new ways of financing for startups, but also reduces the risk for investors, and with the global success of several Serbian startups, the increasing presence of foreign investors in the form of venture capital funds is more noticeable.

Keywords: *venture capital fund, startup, startup innovative ecosystem, startup financing*

1. INTRODUCTION

In recent years, the Serbian innovation startup ecosystem has been characterized by constant rapid growth, which brings with it economic development and an increase in the number of new employees. Startup companies not only contribute to economic development and unemployment reduction, but with their new ideas, products and services, innovations, knowledge and creativity of company members, contribute to the initiation of technological and economic changes in the national economy of the Republic of Serbia. This exponential growth of the domestic startup innovation ecosystem brings with it great challenges of access to funding, internationalization and expanding business into a new markets and employment staff with adequate skills [1]. Serbian innovation startup ecosystem is still relatively young, entering a mild phase of scaling, so venture capital funds can play a more serious role to solution of domestic startup's financing challenges than before.

The Republic of Serbia has been taking significant steps to promote entrepreneurship, startup economy and innovation in recent years. The government has introduced several programs and initiatives aimed at attracting foreign investment and supporting local venture capital funds. However, the venture capital industry in Serbia is still in its infancy compared to other European countries.

2. VENTURE CAPITAL FUNDS

The concept of venture capital funds is rooted in the economic theory of risk and return - investors are willing to invest their money in high-risk ventures because they expect to earn a higher return on their investment if the venture is successful. Venture capitalists use this theory to make investments in high-potential startups, hoping to generate exponential returns. Venture capital funds also play a key role in the innovation economy - they are often the first investors in new technologies and business models, providing the necessary funding to commercialize new ideas.

Venture capital represent *the professional asset management activity that by rising money from wealthy individuals and institutional investors invest into new ventures with risky ideas, but also with a high potential to grow* – it's professionally managed pool of capital that is invested in private ventures at various stages in their development [2].

Venture capital has five main characteristics [3]:

1. A venture capital is a financial intermediary, meaning that it takes the investors capital and invests it directly in portfolio companies,
2. A venture capital invests only in private companies, meaning that once the investments are made, the companies cannot be immediately traded on a public exchange,
3. A venture capital takes an active role in monitoring and helping the companies in its portfolio,
4. A venture capitals primary goal is to maximize its financial return by exiting investments through a sale or an initial public offering, and
5. A venture capital invests to fund the internal growth of companies.

The venture capital fund's investment stakes all the risk of business success in the amount of the investment itself – the failure of the startup company means loss of investment for venture capital funds. If the startup company achieves business success the fund usually comes out of the ownership structure through the sale of shares, which makes a profit in the form of investment/profit difference.

The lucrative returns on venture capital funds invested in the past, have created high expectations regarding future investment returns, which has led to great pressure to identify future winners between different startups that can provide quick and high returns. In fact, anywhere from 40% to 75% of the startup companies that received venture capital financing never return monies to their investors [4]. This pushback means that venture capital funds are more selective so it can be difficult for startup companies to use this source of financing.

Due to the size of the investments, venture capital funds are much more actively involved in the development of business concept, have greater management control and very often takes a significant percentage of the company's stake - that's why they have a greater interest in the startup company to continue successfully growth.

Venture capital funds offer not only financial investment, but also valuable intangible assets based on their experience and networks - this aspect of investment is critical, as startups in early stages often lack both financial and intangible resources, including past experience and knowledge, which are necessary for them to develop their business. However, only a limited number of startup companies have been successful in attracting venture capital funds investment and the timing of receiving investments ranges from the initial stage to the later stage of startup growth [5].

3. VENTURE CAPITAL FUNDS IN SERBIA

The venture capital and startup ecosystem in Republic of Serbia are underdeveloped in comparison to the EU member states, which benefit strongly from favorable economic collaboration and supportive policy regulations. However, the economic growth and innovation in the region of Western Balkan seem to expedite during last few years, with many public and government projects that stimulate entrepreneurship and startup economy.

It's very important to be taken into account that the majority of Serbian startups were founded in the last few years, which means that most of them are in the early stages of growth. Main characteristics of Serbian startup innovation ecosystem is a relatively low percentage of startups that are in the later stages of development which indicates that there are smaller number of scale-up companies in the ecosystem that are in a phase of mature growth and potential expansion.

Considering the current economic crisis in Europe and the world and the lack of Serbian startup companies that are in A, B or C funding rounds, it's not surprising that only 8.4% investments in Serbian startups during 2022 came from venture capital funds [1], which is a slight increase compared to the previous year 2021 in which 7.9% investments came from venture capital funding [6]. Another challenge for venture capital funds in Republic of Serbia is the shortage of experienced entrepreneurs and management teams. Many startup companies lack experienced leaders who can take their businesses to the next level which often leads to difficulties in attracting investors and scaling their businesses.

There is a growing number of highly educated and talented young people in Republic of Serbia who are interested in entrepreneurship, with many individuals that are returning from abroad and bringing new ideas and skills with them. This trend is creating a more favorable environment for startups and venture capital funds. Venture capital funds in the Republic of Serbia can play an important role in future with further development of startup innovation ecosystem, in supporting innovative ideas and technological innovations offering financial support to startups engaged in the development of new innovative products and services.

The growth of venture capital funds market in Republic of Serbia can have a significant impact on the venture capital industry and startup innovative ecosystem itself. The industry would become much more competitive, with more players entering the market increasing pressure to generate high returns from investing in domestic startups companies.

Venture capital funds are recognized in the state legislation of the Republic of Serbia in the past few years. According to the Law on alternative investment funds **Venture capital funds** are *alternative investments funds with a private offer whose assets, in accordance with the alternative investments fund's business rules, are mainly invested in business entities that are newly founded or are in the initial stages of business, and show potential for growth and business expansion.* [7] At least 70% of venture capital fund assets must be invested in this type of companies, while up to 30% of its assets can be invested in other properties, in accordance with the investment policy.

The Republic of Serbia has also recognized the importance and possible impact of venture capital funds and supported their establishment and development through state's Innovation fund. *Serbia Ventures* program is designed to incentivize private investors, high net worth individuals and institutions to engage in financing startup companies with high growth potential by incorporating venture capital funds. Through this program, the Innovation Fund invest into newly established venture capital funds in Republic of Serbia in the role of a limited partner and help these funds generate a significant market impact on Serbia's startup innovation ecosystem. Amount of financing is up to 5 million EUR per each individual venture capital fund, provided the mandatory precondition that the selected venture capital fund has already raised or has generated commitments from its limited partners/investors to raise at least the same amount of capital within 12 months of achieving its first close [8].

First corporate venture capital fund in this part of Europe was established in 2021 by Serbian state-owned telecommunications operator Telekom Srbija with primary goal to support and invest in technological and business solutions, which due to their innovation in the market can lead to rapid and major transformations [9]. *TS Ventures* with yearly budget worth 5 million EUR, help domestic startups in the pre-seed to early stage, to developing a minimum viable product and scaling the business. During 2022 *TS Ventures* invested in nine domestic startup companies.

Additionally, there is plan to open two new venture capital funds in 2023 which will be supported by government subsidies and their investments will be primarily focused on the Serbian startup ecosystem and region of Western Balkans [1]. It can initiate additional growth of the startup ecosystem and the emergence of a greater number of new innovative startups, which additionally increases the attractiveness of the domestic innovative ecosystem. In addition to *TS Ventures* and two new venture capital funds, there is a number of foreign and regional private venture capital funds interesting in local ecosystem, which indicate that domestic startup innovation ecosystem is becoming more attractive and that can be expected more venture funds to enter domestic startup ecosystem in future.

The venture capital industry in Serbia is relatively young, with the first regional venture capital fund *South Central Ventures*, based in Belgrade, with offices in Belgrade, Ljubljana, Zagreb and Skopje. South Central Ventures seeks to invest in seed, early, and growth-stage companies operating in financial technology, agriculture technology, advertising technology, and SaaS sectors, with focus on tech startup companies in the Southeast Europe. The majority of the fund is allocated for early stage and growth investments of up to 5 million EUR per company [10]. Their last investment was in February 2023, startup tech company Mily Technologies has secured 1 million EUR in pre-seed funding, led by South Central Ventures and supported by a non-equity grant from Katapult Accelerator.

ICT Hub Ventures stand out as one of the two most important domestic venture capital funds in the region, along with South Central Ventures. ICT Hub Ventures was created in 2017 as an initiative of ICT Hub - one of the pioneering startup incubators in Serbia. Its mission is to strengthen the regional startup and venture capital ecosystem. Initial support for startups including an investment of up to 50,000 EUR in exchange for a 5-15% stake in the startup companies. The IST Hub Ventures is ready to back pre-seed or seed startups, developing software solutions in the Southeast Europe region, with a team of no more than 5 members, a developed minimal viable product (or a prototype), a client base, and market knowledge [11]. In turn, ICT Hub provides capital, mentorship programs with industry experts, networking capabilities, guidance, and dedicated support through all development stages of backed startups.

In addition to the first venture capital funds, such as South Central Ventures, ICT Hub Ventures and TS Ventures, which have been financing local startup companies for several years, *Fifth Quarter Ventures* is currently in legal proceeding to become the fourth alternative investment fund ever established in the Republic of Serbia. Fifth Quarter Ventures is an early stage venture capital fund focused on investing in startup companies from the Western Balkan [12].

With the right support and investment, the venture capital industry in Republic of Serbia has the potential to drive significant economic growth and job creation in the coming years. Despite the current modest size of the venture capital industry in Republic of Serbia, there have been some notable successes in recent years. For example, during 2022 Serbia-based creative ads automation startup company *Hunch* raised 4 million EUR in a round, led by venture capital fund Catalyst Romania, backed by 3TS Capital Partners, alongside co-investors Euroventures, North Base Media, Seed Blink and South Central Ventures.

With the success of several domestic startups, the Serbian startup innovation system is gaining more interest even outside the country's borders, which has led to presence of few EU venture capital funds like *ZAKA Ventures* based in Czech Republic, with office in Belgrade or *Elevator Ventures* corporate venture capital entity of Raiffeisen Bank International based in Austria, both with primary focus in Central East Europe regions. The arrival of foreign investors is key to strengthening competitiveness and developing innovative technologies. Through cooperation with foreign partners, local venture funds can help improve technical knowledge and management in startup companies.

4. CONCLUSION

Serbian startup innovative ecosystem has been developing rapidly and there is a large potential for further growth and development. This exponential growth brings with it great challenges of access to funding, expanding business into a new markets and employment staff with adequate skills. Most Serbian startup companies see funding as the most significant problem for further scaling so venture capital can be key solution for it. Currently most startups are in early stages of development so it is not surprising that less than 10% of them had used venture capital as source of funding in recent years. The Republic of Serbia has also recognized the importance and possible impact of venture capital funds and supported their establishment and development through programs like Serbian Ventures or first public corporate venture capital fund TS Ventures. Alongside with TS Ventures there are two more domestic venture capital funds – South East Ventures and ICT HUB Ventures which played important role in last several years. With the success of several domestic startups, the Serbian startup innovation system is gaining more interest globally, which has led to presence of few venture capital funds outside the country's borders. Taking into account that the majority of Serbian startups were founded in the last few years, it can be assumed that venture capital funds will play an even more important role in the future with the transition of startups to scaling phases and the need for more significant investments in development.

5. LITERATURE

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