The potential role of private investors in financing rural entrepreneurship and SMEs in Serbia

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Abstract

This paper will address issues within the thematic component of Regional development – management of rural entrepreneurship. The authors will elaborate the financing of entrepreneurship through the development and attraction of private investors. In the second part they will consider aspects relating to specific characteristics of business angels. The third part of the paper will address the development of a model of financing rural entrepreneurship through stock exchanges.
By character this is a research paper. Through the analysis of documentation related to the financing of entrepreneurship the paper will assess the current capacity for sustainable and local development of rural regions, with a focus on Serbia and other economies in transition. In a case study undertaken in Serbia with semi-structured interviews of carefully chosen representatives of local authority and active third sector stakeholders in rural development, authors of the paper will then examine the specific possibilities of increasing the currently insufficient role of private investors and will extend for discussion a model for benchmarking stock exchanges as a prerequisite for stock exchange based financing of rural entrepreneurship.
Research from this paper will nominate for further discussion a thesis that exchanging visits to key stock exchanges in the region of South East Europe is one of the avenues to attract investors to rural regions.

Keywords: financing, entrepreneurship, rural development, benchmarking, exchanges, investors.

JEL Classification: R11, L26

1 Introduction

The hard reality of economic development is that private investors may potentially have a crucial role in financing rural entrepreneurship and SMEs and that this is currently not the case in some transition economies. This paper will elaborate the possible contribution of private investors to the regional and rural development of Serbia and other economies in transition. Private investors can be classified as internal, meaning peasants and other residents of rural areas, and external, meaning investors from external sub-rural or urban environments. By definition, both categories of investors search for entrepreneurial projects which normally offer both profits and risks, but there is a significant difference between them.

Family estate in rural environment, as opposed to *agricultural family estate* or *peasant estate* as an independent agricultural and social unit based on ownership and/or usage of product resources and family management in *agriculture*, is both the place of living and the place of rural entrepreneurial activity. These facts affect the selection and appraisal of investments in rural environment in many ways. A peasant, i.e. internal investor, is at the same time an owner of an estate, the manager and a worker on the estate.

In other economic sectors, the director is a manager of the company, shareholders are the owners and many other experts also work in the company. This means that the choice of criteria for appraisal of investments in rural environment does not consider only profit maximization. Indeed, countryside investments often serve to improve social status (e.g. a purchase of a new tractor), or working conditions on the estate, or they can represents the realization of an old dream on revitalizing traditional crafts which no longer have a secure market.

However, considering the development of rural entrepreneurship and the theory of profit [1], a peasant's aim should be investment of his own or borrowed sources of finance in order to achieve greater profit than investment in an alternative activity and greater than interest on savings. The interest on savings in relation to rate of profit on investments is considered as a borderline criterion for entrepreneurial ventures.

There is always a risk for a peasant's investment, especially if it is an investment in agricultural production because of its specifics (weather conditions, biologic potential of plants and animals, and finally the market of agricultural products). Most peasants avoid risky investments because they know that in the case of bankruptcy, they can lose, not only 'enterprises', but the business as a whole and even their estates.

For potential external private investors in rural environments, there are certain other pre-conditions, or limits which, by the example of development in Serbia, preclude faster capital flow to small enterprises in rural regions.

Stemming from the semi-structured interviews carried out in four Serbian districts (Šumadija, Pomoravlje, Jablanicas and Pčinja) the identified pre-conditions of investing into rural SME are hereby classified as follows [2]:

1. The arrangement of production factors and available infrastructure in rural environment is a crucial factor without which, under unchanged other circumstances, further preconditions cannot be expressive enough. Besides capital, we particularly have in mind land, workforce and the organization which was originally emphasized by Alfred Marshall as the fourth production factor [3]. In the sense of this paper an organization represents entrepreneurs with entrepreneurial skills and abilities prepared to take risk when forming a legal entity and undertaking an investment.
2. Unregulated land and uneducated workforce preclude investments into non-agricultural activities and this is one of the main aims of integral rural development in most countries including Serbia.
3. It is known that financial markets, including credit markets, enable the process of transferring sources of finance and knowledge towards profitable projects. The

financial market in Serbia, for example is rudimentarily developed and as such it does not enable financing of entrepreneurships and efficient transformation into an SME, particularly in rural environments.

4. Building saving habits and an increase in long-term savings in banks as a long-term source of finance represents a special factor of more successful financing of rural SMEs.
5. The number and power of financial mediators is an important factor for linking free sources of finance with appropriate demand among investors. Alternative financial institutions, discussed hereinafter, are also seen as important factors of strengthening financial markets.
6. Stability and security of the regulatory environment directly decreases the risk of private investments. Bearers of economic policy should therefore pay special attention to this matter.
7. Availability and quality of rural development plans and various profitable investment projects in rural environments.

In what follows we shall elaborate more specifically the role of business angels, private investment funds and stock exchanges in financing rural entrepreneurship.

2 The potential role of "Business Angels" in financing expansive entrepreneurship

When elaborating institutions and infrastructure for financing entrepreneurship and small enterprises, it is essential to mention the so-called business angels. On one hand, these institutions do not have any connections with angels, literally. Thus, it is not about immortal spiritual human guardians. On the other hand, angels as financial benefactors of small enterprises provide a development capsule and have a certain protective role in existence of enterprises and their further development. Business angels are defined as rich individuals who have already become successful in business and entrepreneurship, and they appear as investors in the early phases of business development.

At the same time, in Anglo-Saxon economies they are seen as the only external investors of the early phases of business development and this makes their role extremely significant for small enterprises. Business angels usually invest capital on an informal basis and into projects which are similar to their former entrepreneurial experience. In the USA for example, the presence of business angels is a stepping stone in business development. There are significant investments of business angels in this country and their amount is usually between $50,000 $500,000 [4]. Using the Atlas Method, which is the World Bank's official estimate of the size of economies by which the US GNI per capita is 8.33 times larger than that of Serbia [5] it derives that, ceteris paribus, business angels, as currently missing financial institutions in Serbia, could approximately invest between $6,000 and $60,000 per one investment.

One of the key reasons why there are not enough business angels in Serbia, except a few of them in major cities, is the fact that entrepreneurship, as such, exists for a relatively short period of time. In 1988 [6] the first enterprise law was enacted legalizing market forces as the basis for regulation of economic life and proclaiming profit as the main aim of enterprises. Therefore, entrepreneurs have not had enough time to make a more surplus capital which would be available for investment in new entrepreneurial ventures.

The situation is similar in many other developing and transition economies which try to compensate this by forming the so-called micro credit organizations to finance early business development phases. Contribution of microcredit organizations has obviously been quite significant in some countries such as Bosnia and Herzegovina [7].

As it is not exclusively reserved for the business early development phases, the timing of business angel appearance is shown best in the table below.

Table 1. Timing of business angel appearance

SME sources of finance in different phases of life cycle	Savings, friends partners	Business angels, risk capital, leasing	Credits, factoring and leasing	Securities	Public debt Acquisition and possible sale
1. Development and start-up	**x**				
2. Early growth	**x**	**xx**	**x**		
3. Accelerated growth and consolidation		**xx**	**x**	**x**	
4. Aging			**x**	**x**	
5. Transfer or succession				**x**	
6. Leaving a project				**x**	**x**
7. Death					**x**

Source: the author's own presentation

Not all the business angels appear in the early financing phases. The moment of entering a business depends on inherent risk and the rate of return of invested risk capital. Those business angels who invest capital during *the mezzanine phase* [8] are exposed to less risk of losing an investment than in earlier phases because there are chances for appreciation of company's founding capital at the time of initial public offering and appearance on the stock exchange. None of the financing phases are exclusively reserved for only one sources of finance. Since the appearance of business angels and *mezzanine sources of finance* [9] is typical for the early phases of company's development, initial public offering and appearance on the stock exchange occur later because it requires company's maturity and a change of ownership of capital. Stock financing is comfortably linked with appearance of business angels. In addition, it enables further growth of company's own capital and ensures its overall development.

Business angels may be a co-financing source during the development business phase when an entrepreneur already manages to get underwritten or bank financing and in this case, it is so-called *hybrid financing.* This term implicates presence of different financial resources which give an entrepreneur a comfort to optimize the capital structure and to diversify risk[10].

At the end of this consideration, let us reflect on main problems with the sources of finance in Serbia and other transition economies.

Stemming from the already mentioned semi-structured interviews carried out in four Serbian districts following is our classification of identified problems with sources of finance:

1) unfortunately, the shown model of financing entrepreneurship and small enterprises has not still become popular enough; 2) basically, the only exceptions are the large cities such as Belgrade, as extremely urban area with developed bank network and other financial infrastructure; 3) even in the Serbian urban areas, there cannot be mention of different kinds of non-bank hybrid sources of finance; 4) as a result rural environments drop far behind when sources of finance and financial infrastructure are concerned; this often leaves rural entrepreneurs without sources of finance. This was also appropriately observed by Smallbone D., based on Zucchini's research from 1997 that "…while the stock exchanges in progressive countries of transition developed relatively fast, the national markets of risk capital are literally non-existent whereas the bank system is very inadequate…".[11]; 5) in most rural areas of Serbia, there is only one or two bank branches and the only mitigating circumstance is that for smaller credits these banks do not have to ask for approval for from the main office in Belgrade.

In short, arrival of business angels in rural environments will depend on the following few main factors:

- The level of financial risk versus potential profit in rural environment;
- Rate of diffusing financial innovation from urban to rural environment;
- Capability of urban and rural environments to form a savings pool and to build synergistic effects of between development capital and risk capital;
- Availability of profitable entrepreneurial ideas in rural environments;
- Level of education rate and entrepreneurial abilities of rural managers.
- Finally one more feature of business angels must not be forgotten: they invest in committed and educated entrepreneurs who know what they want in business and they perform monitoring and control of their business. After all, it has to do with investment of own capital.

Unless these conditions are fulfilled, it seems unrealistic to expect sustainable expansion of small and medium enterprises in rural environments of Serbia, and likewise faster development of these areas also seems unlikely.

3 Private investment funds and venture capital funds as a potential sources of finance for expansive rural businesses

Private investment funds represent a special form of investment that differs significantly from both opened and closed investment funds. Their business is often not regulated by the securities law, but rather by company law and/or law on investment funds. They are organized as limited liability companies and are available only for large individual investors, since the minimal start-up investment is €50.000 in Serbia[12], whereas this limit is bigger in other countries. Generally, a smaller number of investors exists within these funds: rich individuals, investment banks, private or public pension funds, foundations, corporations, or other institutionalized investors. Capital collected in this way can be invested further, in expansive rural companies which are too risky for standard capital markets and bank loans, or perhaps they do not have long enough business history to be acceptable for bank credits. Therefore, an alternative for rural bank credits is *equity*, a financing method for enterprises that is often more suitable than a typical bank credit. Arrival of private investment funds in rural environments will depend on similar conditions already mentioned for business angels, but we leave aside these details and explain the functioning model instead.

Private investment funds function by investing in a part of companies' capital (ownership,) at different development phases, acquiring a minority or majority stake, aiming to increase company value and sell its shares at an appropriate medium term. These funds almost never stay more than ten years, and usually, they come out after 5 to 7 years in order to achieve a multiple return on invested capital: the average internal rate of return (IRR) is 20-25% per annum. Profits of private investment funds depend on increase of value of the recipient company. It is therefore important to make a right choice of a company for investment. After all this is also the crucial issue when choosing formerly described securities. Activities which private investment funds undertake in order to increase the company's value relate to restructuring, often requiring huge investments, provision of know how that will allow further company expansion, development of new technologies, optimization of costs and strengthening of company's financial position.

Private investment funds perform detailed analyses on how different companies do business before making an investment and define entry and exit strategies as well as the various activities required to achieve desired goals. Some of the exit strategies include: initial public offering and listing in stock exchanges, selling a company, or a joint venture. These forms of investment certainly represent a chance for development of perspective and expansive rural enterprises which lack development capital as described above, but at the same time they represent a limiting factor for private investment funds since they frequently own the entire share in a company. However, as the share of capital is not standardized like with companies on the stock exchange private investment funds can dispose with their investment more flexibly than on stock exchanges.

Very popular funds are the so-called *venture capital funds*, funds which invest in start-up companies and offer the possibility of expert advice and consulting services. The risk they take in this case is very high, but higher profit can be expected once the company becomes established.

Venture capital funds actively take part in company management enabling the recipient company to use their human resources, i.e. professionals who take part in daily operations and company's development, thus helping the entrepreneur to stand out against competition. When investing, venture capital funds also make an effort to diversify risk by developing a portfolio of several valuable young companies creating a unique venture fund. In many cases, they co-invest with other VC companies. Frequently, the capital of several such companies is invested on the same project. Examples of a few world renowned companies which used this form of finance include: *Apple*, *Federal Express*, *Intel*, and *Microsoft*.

The systemic model of a functioning VC company can be depicted as follows:

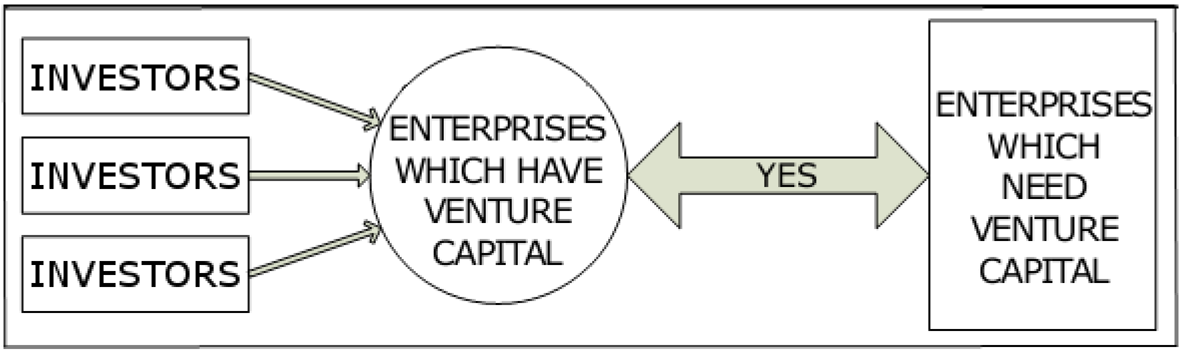

Illustration 1. A functioning model of VC company
Source: the author's own presentation

It is important to notice the level of risk which these funds have to bear, since, as opposed to typical bank loan, venture capital funds achieves their profit by increasing the profitability of the recipient company. Therefore, profits of venture capital investors exclusively depend on the recipient company's success. Contrary to that, in the case when a bank lends its capital, the risk is quite lower and the bank is entitled to charge lending rates and be refunded as contracted, regardless of the recipient company's market success.

4 Development of a model of establishing the stock exchange financing of rural entrepreneurships and SME

With the gradual development of rural businesses and growth of productive capability of rural SMEs, it becomes essential to focus attention on well functioning stock exchanges that can serve these clients as well and not only businesses in urban areas. Following is a scheme for the development of a functioning model of stock exchanges also serving expansive rural SMEs:

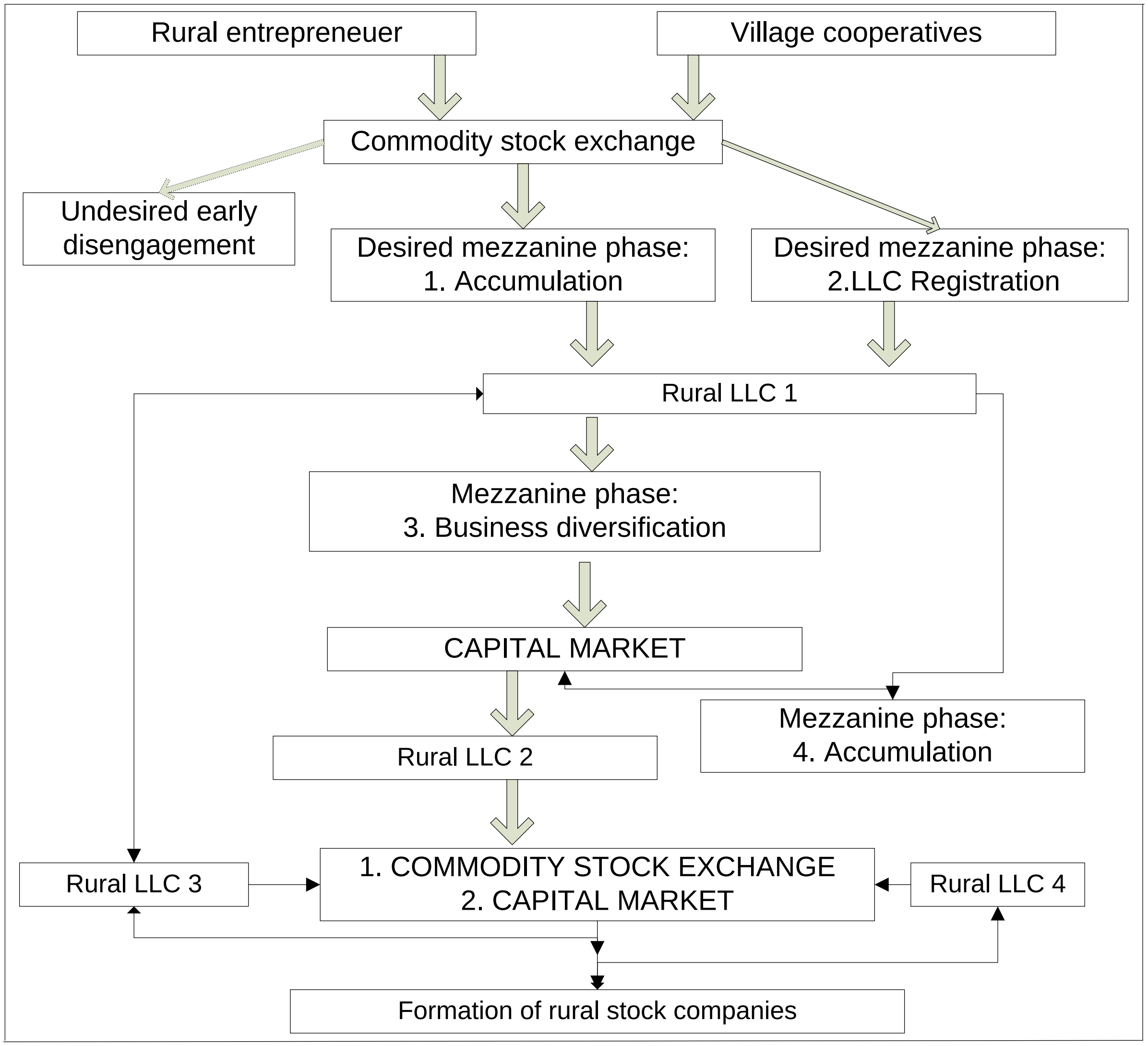

Illustration 2. A model for establishing the stock exchange based financing of SMEs in the function of rural development

Source: the author's own presentation

It can be clearly seen from the above illustration that the model for establishing stock exchange based financing of SMEs in the function of rural development is a gradual one which requires several steps including business diversification, company registration and appearance on both commodity and capital exchanges.

4.1. Visiting leading stock exchanges in the region for benchmarking and further development of stock exchange based financing of rural entrepreneurship

Raising awareness about possible models of stock exchange based financing is the best way to improve the strategy and investment capacity of national stock exchanges. Ministries of Finance, associations of banks and other financial organizations should organize a few well targeted visits to leading stock exchanges in transition for the purpose of benchmarking. In the context of stock exchange based financing of rural entrepreneurship *Benchmarking* represents systematic and continuous processes of measurement and comparison of stock exchange processes and activities of one stock exchange in relation to business processes and activities of a selected stock exchange. Normally the selected benchmark is a leader in the region or in the world, in order to obtain information that will assist organizations to improve their stock exchange performances. Benchmarks to be used are valid current/historic conditions and indicators on capital markets.

It is essential that preparation of benchmarking visits includes providing detailed information to host countries about the visitors, stock exchange products that would be interesting, planned financial infrastructure, etc., but also the contacts at the highest level with the public sector, entrepreneurs and companies. This would help the visitors from transition economies such as Serbia to develop a deeper understanding of crucial success factors in these countries. The idea to return benchmarking visits should be supported as this is a way to build markets.

One of the main results of benchmarking visits would be creation of information frameworks on stock exchanges in the countries of the region, and would enable various market players to collect and analyze activities of the main stock exchange events and related opportunities for rural entrepreneurship. The information framework can relate to market materials, solutions for communication infrastructure, promotion and marketing activities, government regulations and possible rural development subsidies.

Following is our conceptual model for benchmarking stock exchanges that can be applied to attract and develop private investment for rural entrepreneurship.

4.2. Conception model for a general approach to benchmarking stock exchanges as a pre-condition for development of stock exchanges

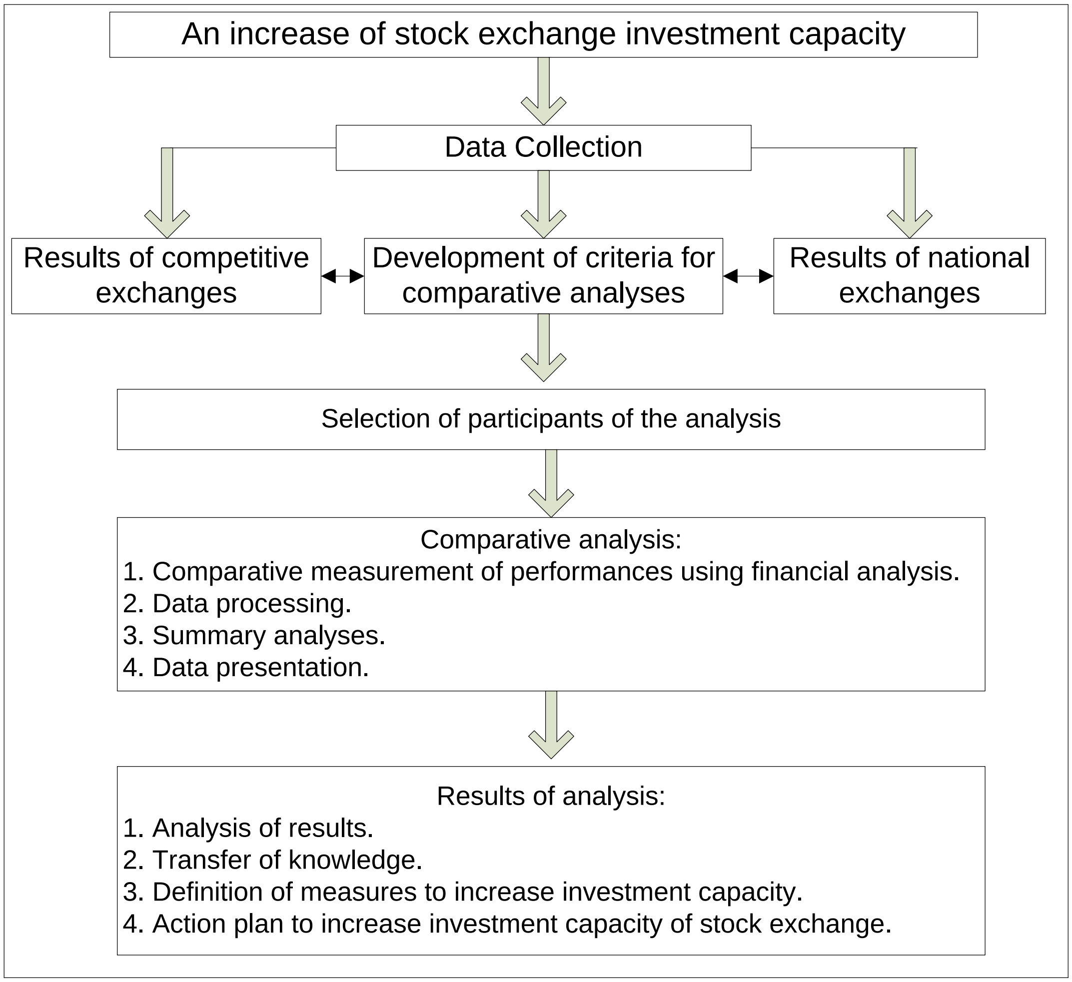

Illustration 3. Model of benchmarking stock exchanges

Source: the author's own presentation

It clearly proceeds from our illustration that the key to successful benchmarking of stock exchange investment capacity for rural development is to analyze national and competitive exchanges side by side using comparative financial analysis [13] and to transfer appropriate knowledge.

5 Conclusion

It could be said that the basis of development of all other product and service markets is the platform of financial market, both money market and capital market, which is set in high-quality. While, through money markets, enterprises obtain resources to maintain current liquidity, through capital markets, they acquire resources which are necessary to finance their business development and therefore it is said that a well functioning capital market is the engine of economic development.

Developed capital markets facilitate the connection of subjects which have excesses of financial resources to the subjects which lack financial resources, i.e. they connect two significant macroeconomic categories – savings and investments.

Capital markets enable normal and undisturbed function of a national economy [14]. All the events in real processes of social reproduction are reflected on them. They represent one of the main postulates of market economy. In its extent, various financial institutions do business. The institutions can be classified into deposit ones, such as banks, savings and credit associations, etc., and on the other hand, there are so-called non-deposit institutions, like insurance companies, pension funds and finally, investment funds which bring freedom on the market. Investment funds and business angels exist in the developed western economies for more than half a century now and their expansive development followed the globalization of the world capital markets and the world economy in general. As such investment funds represent very significant intermediary financial organizations or institutional investors which collect disposable resources from their investors and then place them into short term and long term investments and different financial forms. Their appearance will certainly accelerate the reform and development of the financial sector in Serbia and other developing economies, and their overall process of restructuring, privatization and transition.

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