PROJECT INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: PIDC16812

Project Name	Croatia Innovation & Entrepreneurship VC (P152130)
Region	EUROPE AND CENTRAL ASIA
Country	Croatia
Sector(s)	General industry and trade sector (60%), Other non-bank financial intermediaries (40%)
Theme(s)	Other Private Sector Development (60%), Other Financial Sector Development (40%)
Lending Instrument	Investment Project Financing
Project ID	P152130
Borrower(s)	Ministry of Entrepreneurship and Crafts
Implementing Agency	HAMAG – BICRO
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/ Updated	05-Dec-2014
Date PID Approved/ Disclosed	09-Dec-2014
Estimated Date of Appraisal Completion	
Estimated Date of Board Approval	18-Jun-2015
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context
Country Context

1. Croatia's accession to the EU in 2013 represented the culmination of a broadly successful period of development but the economy has been in recession since the financial crisis. From 2003 to 2008 GNI per capita increased, reaching USD 13,790 and placing the country in the group of highly-developed economies. GDP measured as PPS per inhabitant increased from 56 to 65 percent of the overall EU average by 2008, but has decreased to 61 percent in 2013. Since the global crisis, the economy deteriorated substantially and recovery is expected to be slow. GDP contracted over 12 percent in cumulative terms between 2009 and 2013 and living standards have suffered significantly.

The prolonged recession has revealed the unsustainability of the past growth pattern and the significant structural vulnerabilities of the economy, which include: sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, exacerbated by low growth. Average official unemployment rate exceeded 20 percent in 2013.

2. Croatia has shown an uninspiring export performance since the onset of the global crisis. Unfavorable domestic elements became the determining factor in the loss of export market share after the onset of the recession and they explain Croatia's low export diversification, loss of competitiveness, lack of sophistication, and limited expansion of new products and new markets. The country lost export relevance in the EU-15 market due to increased market saturation and severe export competition.

Sectoral and Institutional Context

3. To improve export performance, Croatia needs to shift more forcefully towards a productivity-based and innovation-driven growth model. One of the most promising signals for the country's export competitiveness outlook stems from the existence of a fringe of dynamic small exporters in innovative niche sectors. Supporting such firms is consistent with putting in place a new growth model based on employment and productivity increases, exports and innovation.

4. Young, knowledge-intensive SMEs (including startups) play therefore a key role for lifting Croatia out of recession and back into sustained growth. This type of firms can leverage the country's low cost basis to sustain long periods of substantial export growth. They do so by innovating: they create new products, implement new processes, or introduce new marketing strategies and business models. They are often in high tech fields such as biotechnology, clean energy, and software development or they commercialize knowledge developed by the country's research community.

5. Unfortunately, the innovative, export oriented SMEs are still an exception in the Croatian entrepreneurial landscape. Overall, Croatia shows a lackluster performance in business research and innovation. Statistics point to a low level of business R&D (BERD) as percentage of GDP, compared with the average of the EU-27 region. Lack of innovation in SMEs is a main explanatory factor of the disappointing aggregate features. The R&D intensity of medium-sized firms place the country on 21st place in the EU and in fact, in Croatia business investment in R&D is concentrated within a few multinational companies. Entrepreneurship also appears weak on other accounts. First, Croatia generates few new firms compared to what would be predicted by its income level. Lack of firm dynamism is also evidenced by the fact that the share of population declaring to be engaged in early stage entrepreneurial activity (selling a product or service that is new to at least some customers in 2012) is, again, lower than its income level would suggest. Finally, Croatia also lags behind EU peers in entry rates in a critical segment of the firm landscape: high growth firms, particularly young ones, known as 'gazelles.

6. A weak business environment is one of the reasons behind the overall poor entrepreneurship performance. Croatia still ranks low (65th place) for the overall ease of Doing Business - the second poorest performance by an EU member. According to the most recent DB data (2015), the areas which drive the disappointing performance include a number of issues such as dealing with construction permits, resolving insolvency, or getting credit.

7. Lack of risk capital financing - often provided through angel investors and venture capital funds - is another important barrier to entrepreneurship, research, and innovation by Croatian SMEs. Numerous studies have showed that innovation activities are more difficult to finance than other types of investments, and this problem is more apparent for new entrants and startups. Due to

pervasive market failures private financing is typically unavailable to bring new ideas on to full commercial scale. This gap in early stage financing is known as the "valley of death", and the most suitable financial instrument to help innovative startups to overcome it is risk capital. This type of financing is often provided through angel investors and venture capital funds, typically in the form of equity (or convertible loans). Compared to venture capital, business angels tend to invest small amounts and focus on market demonstration (start-up) stage of the innovation process. Venture capital funds, on the other hand, normally focus on larger investments at commercialization and scaling up (early stage/early expansion) stage of the innovation process.

9. The Croatian Agency for SMEs, Innovations and Investments (HAMAG-BICRO) manages programs to help start-ups in. initial (pre-seed) stage. HAMAG-BICRO's implemented a number of programs aimed at supporting commercial technologies and startups supported more than 250 projects for a total of close to €40 million in funding, constituting an important channel for the development in Croatia of knowledge-intensive business-ideas.

10. The funds available for the late expansion phase, often provided by private equity funds, have not trickled down to finance technology-driven SMEs. Thus, the private sector is not currently a reliable channel for financing technology driven startups in need of early-stage financing. Following the pension system reform in 2011, five private equity funds started operating in Croatia. They have been publicly supported by the Croatian government through the Economic Cooperation Funds program, an initiative to support the development of private equity and venture capital markets in Croatia. In the year the program of Economic Cooperation Funds was launched capital committed increased to more than €300m, a three-fold increase in a single year. However, these funds have only made one single investment in a technology driven start-up. There are three main reasons that Croatian private equity funds indicate for not having invested in technology-based startups. First, early stage investments are riskier than those typically made by private equity funds. These funds tend to seek the safety and capital preservation that comes from investing in more established companies with proven business models and management teams. Second, private equity funds invest over shorter periods. They plan exit from their investments after three to five years. This is shorter than the time-period needed for investments in startups, which tend to last seven to ten years. Third, they seek to make investments (ticket size) that are too large for startups. Private equity funds seek to make relatively large investments in each firm they invest in, and these amounts are far larger than startups need, or are able to absorb.

11. There is limited risk capital financing being provided for firms after the pre-seed stage and before they are able to access growth or expansion capital. The angel investor community is still at an infant stage and there is no venture capital fund based in Croatia. Angel investors are organized into the Croatian business angel network (CRANE) which was established in 2008. The members of CRANE (15 individual investors) are reported to have made around 13 investments in Croatia since 2009, totaling about 3.1 million Euros. CRANE appears relatively small compared with organization in peer economies; angel networks in Slovenia comprises more than 70 members. A number of incubators are active in Croatia but they have relatively little funding available for investment. There is no venture capital fund based in Croatia. However, there are some international funds that have conducted deals in Croatia. The Croatian Private Equity and Venture Capital Association (CVCA) reports that international venture capital funds have made investments of around €3 million per year between 2007 and 2012.

12. Evidence suggests that the supply of venture capital in Croatia should be greater. Based on GDP

per capita the supply of venture capital is below that of countries at a comparable level of income. Results from the Global Competitiveness Report also rank Croatia at 114th in the world for the availability of venture capital.

13. In addition, demand side elements suggest that in Croatia there is a gap in venture capital financing. Although there is always considerable uncertainty about how much demand there is for venture capital financing, there are indications stemming from the demand side that suggests there is shortage of risk capital. There are successful companies in Croatia that would be eligible for risk capital financing. For example, a recent report by Deloitte shows that four Croatian companies are listed among the 50 fastest growing technology companies in Central Europe. On average these companies grew by more than 700 percent over the last year. Another indication of the financing gap that this project proposes to address is that companies that have proven themselves successful internationally on knowledge-based products and services have mainly received support from international sources of funding. Resorting to international markets imposes extra-fixed costs and organizational constraints that not all innovators and would-be entrepreneurs are ready to afford. Yet, these very same companies – if adequately financed in the critical phase of the ‘valley of death’ – could become successful contributors to the Croatian economy.

14. The supply of risk capital financing is also expected to increase in the coming years. Yet, lack of venture capital culture may lead to unsatisfactory results. The proposed World Bank project can serve as a pilot and platform for successfully absorbing and utilizing these funds. In the next few years, Croatia is expected to be the recipient of substantial European Structural and Investment Funds (ESI) funds from the European Union. A portion of these funds will be allocated towards supporting science, technology, innovation and entrepreneurship; this will include providing support for young, knowledge intensive SMEs including startups. Preliminary figures indicate that 20 million Euros will be allocated for venture capital instrument in Croatia from structural funds in the upcoming period. Another initiative supported by the European Union is the development by the European Investment Fund (EIF) of a regional venture capital fund for the Western Balkans – the Western Balkans Enterprise Innovation Fund (ENIF). This fund will invest in countries across the region, which will likely include Croatia. As the country will make larger investments in research and innovation systems as part of its integration process in the EU and is preparing itself to receive EU funding, developing a sound mechanism for early-stage financing is even more pressing. There is therefore a need for preparing a framework that will help creating a venture capital culture and allow the absorption and effective use of the expected inflow of EU funds.

15. Against this backdrop, there is at least one government agency in Croatia - HAMAG BICRO - that would be capable to manage the public involvement in this financing initiative. HAMAG BICRO has previous experi ence in implementing WB projects more specifically they have experience in implementing WB safeguards policies through the First and Second Science and Technology Project. Furthermore, some members already participated in the WB organized Safeguards Training in Belgrade 2011.

Relationship to CAS

16. The project is consistent with Pillar II the FY14-17 Country Partnership Strategy (CPS) – Competitiveness – whose premise is that to achieve private sector-led growth and faster EU convergence, specific actions are needed to jump start new business creation and facilitate the restructuring of the economy towards a model based on knowledge, innovation and services. Within this pillar, one of the specific areas for the World Bank Group engagement includes the facilitation

of private sector activities in the areas of energy efficiency and renewable energy, FDI, small and medium enterprises (SME), and R&D and innovation support. The proposed operation will support these objectives by increasing the supply of risk capital financing to innovative startups.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

24. The project objective is to help foster innovation, entrepreneurship, and private sector growth by increasing the supply of risk capital financing for young knowledge intensive SMEs (including start-ups).

Key Results (From PCN)

25. This project will support the following key results:

• Increase in access to finance for young knowledge intensive SMEs:
Total number of firms receiving risk capital financing and of investors leveraged
Total amount of risk capital financing received (leveraged) through the project, and investors leveraged

• Level of Innovation:
Number of new and improved products and processes offered by beneficiary firms.
Number of new start-ups created under the project.

• Growth of beneficiary SMEs:
Growth in sales and turnover of beneficiary SMEs. Due to the small size of the beneficiaries the number of jobs is not one of the intended key results. The project is expected to create indirect jobs due to spillover effects especially through growth externalities (to be discussed in Section II.B “Economic Analysis”). However, measuring this is beyond the monitoring scope of the project.

III. Preliminary Description

Concept Description

19. The €20 million operation will be implemented over ten years and will have three components: a) a pilot venture capital fund ; b) a seed co-investment fund; c) technical assistance. The proposed program follows up from the STP and STP II programs by assistingthe government to close the risk capitally financing gap for young knowledge intensive SMEs. It will do this by three means. It will contribute to creating a venture capital segment interested in financing knowledge-based, innovative SMEs; it will contribute to generate deal flow from such firms; and it will increase the Croatian government's ability to spend European Structural and Investment funds on supporting young, knowledge intensive SMEs including startups going forward.

20. HAMAG-BICRO will be the implementing agency for the project management, financial management and the procurement of the overall program. HAMAG-BICRO is an independent agency founded by the Republic of Croatia under the Ministry of Entrepreneurship and Crafts. The Ministry of Entrepreneurship and Crafts will appoint a Project Implementation Team (PIU), which would consist of HAMAG-BICRO’s experts and consultants for specific functions. The entity BICRO - which was recently merged with HAMAG as part of the current agency - has experience in the implementation of past and current World Bank Science and Technology Projects (STP and STPII).

21. A brief description of the three components is presented below. Funding allocation for each component is indicative at this stage.

22. Component 1 (€14.5 million): The venture capital fund will be a pilot that takes the first steps towards establishing a venture capital industry in Croatia. It is envisaged that it will be initially a €29 million fund with €14.5 million from the loan (through HAMAG-BICRO) and up to a further €14.5 million to be raised from private sources (which might include pension funds, and IFIs). The fund will be privately managed by a firm to be selected by tender; the selected firm will be responsible for raising the additional €14.5 million from the private sector. The mandate of the venture capital fund will be to invest in young, knowledge-intensive SMEs. The fund managers will seek projects with the potential to earn standard returns typically sought by venture capital funds. Initial investments are expected to be in the range of €100,000-€1.5 million.

23. Component 2 (€2.5 million): The establishment of a seed co-investment fund is envisaged in order to strengthen the early stage (seed) investing industry in Croatia. The fund will be €2.5 million (from the loan) and will be managed by HAMAG-BICRO. It will co-invest (in a pari-pasu basis) alongside pre approved investors (as angel syndicates, venture capital funds, accelerators and incubators). The fund's mandate is to invest in young, knowledge-intensive SMEs. Investments made by the fund are expected to range from €30k to €100k.

24 . Both Component 1 and Component 2 aim at providing risk capital financing to knowledge intensive SMEs (including startups). The firms are expected to be less than ten years old and relatively small (less than 50 employees). For both funds, no attempt will be made at establishing priorities in terms of sectors. However, given the type of finance the funds will provide, the firms are expected to operate in sectors such as, for example, information communication technology (ICT), life sciences, medical and health related fields, and biotechnology. They are expected to invest in non-tangible assets. Both funds will not invest in certain sectors, which will be determined subsequently. This negative list will follow World Bank Group Safeguards practices and, drawing on international best practices as well as ICF guidelines. To ensure that investments occur in knowledge intensive firms the list may include activities such as hospitality, retail and real estate. The fund will also not invest in deals where there is a conflict of interest between the investees and investors. The venture capital fund will be expected to be in compliance with the Equator Principles and not invest in projects on the IFC's exclusion list as well as the additional restrictions the IFC applies to Financial Intermediaries (FI).

25 . Component 3. Technical Assistance (€ 3 million): This component would be established to assist in the creation and operation of the program. The funds would provide for: (i) Payment of the venture capital firm management fees; (ii) Advisory Board staffed with international experts to provide guidance and support to HAMAG-BICRO's staff on the implementation of the program; (iii) Capacity building for investors, entrepreneurs and universities; (iv) M&E system to ensure accountability in the use of government's money, and provide guidance on how the program can be improved; (v) Other: this could include assistance with technical due diligence and studies on targeted regulatory and policy reforms.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD

Environmental Assessment OP/BP 4.01			×
Natural Habitats OP/BP 4.04		×	
Forests OP/BP 4.36		×	
Pest Management OP 4.09		×	
Physical Cultural Resources OP/BP 4.11		×	
Indigenous Peoples OP/BP 4.10		×	
Involuntary Resettlement OP/BP 4.12		×	
Safety of Dams OP/BP 4.37		×	
Projects on International Waterways OP/BP 7.50		×	
Projects in Disputed Areas OP/BP 7.60		×	

V. Financing (in USD Million)

Total Project Cost:	20.00	Total Bank Financing:	20.00
Financing Gap:	0.00		

Financing Source	Amount
Borrower	0.00
International Bank for Reconstruction and Development	20.00
Total	20.00

VI. Contact point

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