# PROJECT INFORMATION DOCUMENT (PID)
# APPRAISAL STAGE

Report No.: PIDA23908

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|---|---|
| **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)** | Micro, Small and Medium Enterprise support (60%), Other Financial Sector Development (40%) |
| **Lending Instrument** | Investment Project Financing |
| **Project ID** | P152130 |
| **Borrower(s)** | Republic of Croatia - Ministry of Finance |
| **Implementing Agency** | Hamag-Bicro |
| **Environmental Category** | F-Financial Intermediary Assessment |
| **Date PID Prepared/Updated** | 26-May-2015 |
| **Date PID Approved/Disclosed** | 30-May-2015 |
| **Estimated Date of Appraisal Completion** | 29-May-2015 |
| **Estimated Date of Board Approval** | 18-Jun-2015 |
| **Appraisal Review Decision (from Decision Note)** | |

## I. Project Context

### Country Context

Croatia's accession to the European Union on July 1, 2013 represented the culmination of a broadly successful period of development since the 1990s. From 2003 to 2008 gross national income per capita increased, reaching USD 13,790 - which placed 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 had decreased to 61 percent in 2013. However, since the global economic crisis, the Croatian economy has deteriorated substantially. GDP contracted over 12 percent in cumulative terms between 2009 and 2013. Not only is Croatia the only country in the EU, besides Greece, to have experienced six consecutive years of recession thus far, but current forecasts also suggest that Croatia's recovery will be rather slow.

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

Croatia has displayed 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**

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.

Innovative SMEs (including startups) play therefore a key role for lifting Croatia out of recession and back into sustained growth. In the case of Croatia, SMEs account for a large share of both total number of firms and employment. Recent numbers from Structural Business Statistics, Eurostat, show that SMEs represent more than 99 % of the total number of firms and account for 68% of employment. The largest share of the country's SMEs (67%) can be found in services. A particular sub-set of SMEs, those in innovation driven activities, namely young knowledge-intensive enterprises, can leverage the country's low cost basis to sustain long periods of substantial export growth. They do so by innovating: they create new goods (products or services) or significantly upgrade existing ones, implement new processes, or introducing new marketing strategies. In Croatia, innovation driven sectors as computer programming, architectural and engineering activities; technical testing and analysis, scientific activities and research, and manufacturing of computers, electronic, and electrical equipment, account for approximately 8 percent of SMEs.



Unfortunately, innovative SMEs are still an exception in the Croatian entrepreneurial landscape despite a generous tax break system and a reasonable infrastructure to support business R&D. 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-28 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. Croatia generates few new firms compared to what would be predicted by its income level. Moreover, 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'.

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 where Croatia's performance lags significantly behind that of the best performer include resolving insolvency, protecting minority investors, or getting credit.

Lack of risk capital financing is another important barrier to entrepreneurship, research, and innovation by Croatian SMEs. Different stages in a firm's development may require different types of financing instruments. The initial phases of financing can be highly complex and can involve a mixture of financing methods. Available evidence suggests that Croatian firms have access to financing for the initial (pre-seed) stage, as well as for the expansion stage, but limited funding is available for the critical phase in between these two points of development, the so-called "valley of death". In Croatia entrepreneurs have access to funds for pre-seed and late expansion and growth stages. However, they have few sources for funding in the seed, start-up and early stages

For the pre-seed stage, and partially for the seed phase, there are programs managed by Croatian Agency for SMEs, Innovation and Investments (HAMAG-BICRO) to help start-ups with the development of new technologies with commercial potential. HAMAG-BICRO has 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 in the 2007-14 period, constituting an important channel for the development in Croatia of knowledge-intensive business-ideas.

For the late expansion phase, funds are available, often provided by private equity funds; however these have not trickled down to finance innovative 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 four 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. Fourth, technology based startups constitute a typical risky investment , as the technological and market uncertainty of innovation activities makes the returns to investment highly uncertain, creating significant problems for standard risk adjustment methods.

After the pre-seed stage and before they are able to access growth or expansion capital, there is limited risk capital financing available for firms. The angel investor community is still at infant stage and the existing venture capital funds in Croatia have made very few investments in the recent period. 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 €1.3 million, with individual investments between €50k and €200k. However, CRANE appears relatively small compared with organizations in peer economies. For example, the angel network in Slovenia comprises more than 70 members. In addition, according to Croatian Financial Services Supervisory Agency (HANFA), there is not a single existing venture capital funds registered 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.

Evidence suggests that the supply of risk capital - venture capital, in particular –should be greater in Croatia. 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.

In addition, there seems to be a healthy demand for early stage financing in Croatia, which combined with the current lack of supply points to a substantial early-stage financing gap. Although there is always considerable uncertainty about how much demand there is for venture capital financing, there are indications also stemming from the demand side that suggests there is shortage of risk capital. To start with, 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 is that companies that have proven themselves successful internationally on knowledge-based products and services have mainly received supported 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. In addition, it seems that HAMAG-BICRO currently underfinances because of lack of funds. For example, through the RAZUM program (at seed stage), it approved a number of projects but it could not finance them due to a funding shortfall. Overall, HAMAG-BICRO consid ers that it could absorb five times more funding in the 2014 to 2018 period than it spent in the 2009 to 2012 period. Should this be the case, Croatia would experience a dramatic increase in the supply of knowledge intensive projects. This could also create a positive feedback loop, where the experience of successful project financing would further increase additional demand for risk capital financing in Croatia.

The lack of early stage financing is not a Croatian specific issue. Recent evidence suggests the proportion of early finance provided by government (as opposed to private investors) has increased significantly in the last few years, even in relatively large and well established markets, like Germany and United Kingdom. While it is still not clear whether these recent numbers are partially cyclical, the fact is that innovation tends to be underfinanced even in well-functioning markets due to structural market failures (as asymmetric information and appropriation risks). This problem is more apparent for new entrants and startups as they lack track record to signal their ability to investors, and because they produce an intangible asset that does not typically constitute accepted collateral, as well as due to the intrinsically risky nature of innovative ventures.

However, in Croatia, the lack of risk capital financing is exacerbated, and this is due not only to the reduced size of economy but also to significant institutional and, more important, coordination failures. Apart from the typical challenges associated with risk financing, specific institutional market failures are present in Croatia. Though the regulatory framework for establishment of venture capital in Croatia is considered to be sound, there are other institutional failures – including inefficient insolvency regulation and weak framework for protecting investors, as illustrated by recent Doing Business figures – that contribute to damage access to finance for innovative firms.

Fixing these underlying conditions is a long term goal and Croatia has in fact been working to solve them.

However, even more important are the predominant coordination failures which are translated into a lack of a proper risk capital culture, which constitutes a typical “chicken and egg” problem. Unless the market is fully developed, it will not be able to support the development of a robust and continuous pipeline of promising startups. In turn, this would stall the emergence of a strong business angel community which can back innovative companies in the earlier stages, of lawyers able to negotiate venture capital deals and IP agreements, while sufficient experienced investment professionals and developed exit markets will struggle to emerge. In addition, until venture capital funds have been investing in the country for a relatively longer period of time, there will be no history of returns. But without a history of returns, limited partners (venture capital investors) are reluctant to invest, even when underlying investments may offer the potential for healthy returns. Against this backdrop, a publicly supported risk-financing initiative, targeting both supply and demand side interventions, can seed the development of a sustainable market.

The supply of early stage financing in Croatia is expected to increase in the coming years with funding coming from European Structural and Investment Funds. However, unless the country has a risk capital culture already in place this money will not be fully absorbed. In the next few years, Croatia is expected to be the recipient of substantial European Structural and Investment Funds (ESIF) from the European Union. A portion of these funds will be allocated towards supporting science, technology, innovation and entrepreneurship; this will include funding towards venture capital vehicle and other risk financing instruments. Preliminary figures indicate that €20 million will be allocated for venture capital in Croatia from structural funds (ERDF) during the upcoming period under Thematic Objective 3 of the Operational Programme Competitiveness and Cohesion 2014-2020. 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 allow the absorption and effective use of the expected inflow of EU funds.

Against this backdrop, the Government of Croatia - under this proposed World Bank project – seeks to establish and fund a program that will include both supply and demand side interventions as a way to strengthen risk capital financing for innovative SMEs and startups, while laying out the foundations for Croatia to use ESI funds for venture capital. The program plans to not only provide risk financing to innovative SMEs and startups but also to follow an integrated approach that exploits the linkages between important actors in the innovation system, and that makes use of any synergies with the already existent measures to support different stakeholders, as well as the networks that connect them. As will be detailed later, the proposed project will provide financing for sequential stages of the innovation life cycle - both at the seed stage, through a co-investment fund, and at the following stage of early commercialization stage, through a public-private venture capital fund. It will also provide technical assistance for the overall implementation of the program, which will include developing human capabilities at the government level and also at the entrepreneurship community level, targeting both potential investors and potential investees as a way to increase the entrepreneurial skills as well as the quality and sourcing of deals.

## II. Proposed Development Objectives

The project development objective is to strengthen risk capital financing for innovative SMEs and startups.

## III. Project Description

**Component Name**

Unallocated Amount (€0.5 million)

**Comments (optional)**

An unallocated category is introduced to pay for loan fees and to enable marginal adjustments with the project management.

**Component Name**

Component 1: Pilot Venture Capital Fund (€15.5 million)

**Comments (optional)**

The fund will be established with the purpose of providing financing, in the form of an equity instrument, to innovative SMEs (including startups) with the locus of activity in Croatia. The Fund will be managed by a private fund manager selected through an international tender process.

**Component Name**

Component 2: Seed Co-Investment Fund (€2.5 million)

**Comments (optional)**

The fund will be established with the purpose of providing smaller amounts of risk capital financing (than will be made available by the Pilot VC Fund) to innovative SMEs (including startups) with the locus of activity in Croatia. Investments will be made alongside investors in the market such as angel investors and incubators.

**Component Name**

Component 3: Technical Assistance (€1.5 million)

**Comments (optional)**

This component of the program would be established to assist in the creation and operation of the program. This component will have four sub-components:
(a) Component 3.1: The Global Advisory Network (€400 k), (b) Component 3.2: Capacity Building and Networking (€400 k), (c) Component 3.3: Monitoring & Evaluation (€100 k), (d) Component 3.4: Project Management (€600 k).

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## IV. Financing *(in USD Million)*

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

| **For Loans/Credits/Others** | **Amount** |
|---|---|
| Borrower | 0.00 |
| International Bank for Reconstruction and Development | 20.00 |
| Total | 20.00 |

## V. Implementation

The Ministry of Finance (MOF) will sign the Loan Agreement and receive the World Bank loan on behalf of the Republic of Croatia as the Borrower. There will not be counterpart contributions provided by the state budget through the Ministry of Entrepreneurship and Crafts (MoEC) or HAMAG BICRO's budget allocations.

The overall responsibility for the broad coordination and strategy of the Project is delegated to the Project Steering Committee. The Project Steering Committee will be chaired by the MOEC, and with representation of other relevant ministries (MOF, Ministry of Economy, Ministry of Science and Technology, Ministry of Regional Development and EU Funds).

MOEC will be in charge of supervision of the Project, while HAMAG BICRO will be in charge of overall Project implementation. HAMAG BICRO will be the implementation agency for this Project. The implementation period is expected to be six years, starting September 2015, with a closing date of September, 2021.

The MOEC will have broad oversight of the Project and will receive full reporting from HAMAG-BICRO regarding project activities on a semi-annually basis.

The MOF will monitor all financial transactions initiated by HAMAG-BICRO that will go through the Designated Account opened at the Croatian National Bank to ensure that all the terms and conditions of the project loan are met prior to any disbursements. Financial management implementation arrangements for all three project components will be defined in details in the Project Operational Manual. In terms of financial reporting, HAMAG-BICRO will report to the World Bank as indicated in the financial management section of the current document and as reflected in the Project Operations Manual.

Project implementation is guided by two sets of rules: (i) the single Project Operational Manual for all three project components outlines roles, reporting lines, communication procedures and fiduciary, monitoring and safeguards responsibilities; and (ii) guidelines for the implementation of project components establish objectives, eligibility criteria, conditions and implementation rules – including the governance of the selection process.

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The PIU has to be in place and operational by the project effectiveness date. It will include: a) a project manager with the requisite qualification and experience in equity or quasi-equity investments who will be responsible for the overall management of the Project, organization and coordination of all activities between parties involved in the Project, reporting toward the Government and the World Bank, as well as other institutions involved; and monitoring the performance of project components; b) a financial expert who will be responsible for the Project's financial management arrangements, such as planning and budgeting, project accounting and reporting, internal controls, disbursements and external audit arrangements; c) a procurement expert who will be responsible for overall coordination, management and monitoring of procurement; and d) a safeguards expert who would follow and coordinate preparation of environmental due diligence documents.

## VI. Safeguard Policies (including public consultation)

| Safeguard Policies Triggered by the Project | Yes | No |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | x | |
| Natural Habitats OP/BP 4.04 | | x |
| Forests OP/BP 4.36 | | x |
| Pest Management OP 4.09 | | x |

| | | |
|---|---|---|
| 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 | | × |

**Comments (optional)**

## VII. Contact point

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