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PAD 1360

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EURO 20 MILLION
(US$21.92 MILLION EQUIVALENT)

TO THE

REPUBLIC OF CROATIA

FOR AN

INNOVATION AND ENTREPRENEURSHIP VENTURE CAPITAL PROJECT

June 12, 2015

Trade and Competitiveness Global Practice
Central/South Europe and Baltics Country Management Unit (ECCU5)
Europe And Central Asia Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective 30 May 2015)

Currency Unit	=	EURO
EURO1	=	US$1.096
EURO 1		HRK 7.6

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AIF	Alternative investment fund
AIFM	Alternative investment fund manager
AIFMD	Alternative Investment Fund Managers Directive
AUM	Assets Under Management
BEEPS	Business Environment and Enterprise Performance Survey ...
BERD	Business R&D
CITES	Convention on International Trade in Endangered Specie
CPS	Country Partnership Strategy
CRANE	Croatian Business Angel Network
CVCA	Croatian Private Equity and Venture Capital Association
DB	Doing Business
EIF	European Investment Fund
EMF	Environmental Management Framework
ENIF	Western Balkans Enterprise Innovation Fund
ESIF	European Structural and Investment Funds
EU	European Union
EuVECA	European Union Venture Capital Funds as defined by the European Union
FDI	Foreign direct investments
FINA	Croatian Financial Agency
GDP	Gross Domestic Product
GRS	Grievance Redress Service
HAMAG-BICRO	Croatian Agency for SMEs, Innovation and Investments
HANFA	Croatian Financial Services Supervisory Agency
ICT	information communication technology
IDD	integrity due diligence approach
IEG	Independent Evaluation Group
IFC	International finance corporation
IFI	International finance institutions

IFR	Interim Un-audited Financial Report
IMF	International Monetary Fund
IRCRO	Research and Development Program
IRR	Internal rate return
LLC	Limited liability company
M&E	Monitoring and evaluation
MIP	Macroeconomic Imbalances Procedure
MOEC	Ministry of Entrepreneurship and Crafts
MOF	Ministry of Finance
PAD	Project Appraisal Document
PB	project beneficiary
PCB	Polychlorinated biphenyl
PE	Private equity
PIU	Project Implementation Unit
PIU	Project Implementation Unit
POC	Proof of Concept Program
PPA	Public Procurement Act
PPS	Purchasing Power Standards
R&D	Research and development
RAZUM	Development Program for Knowledge-Based Companies
ROA	Return on assets
ROE	Return on equity
SE	Societas Europaea
SMEs	Small and Medium Enterprises
SOE	Statement of Expenses
STP	Science and Technology Project
STP II	Science and Technology Project II
TA	Technical assistance
TEHCRO	Infrastructure for Technology Transfer Program
UCITS	Undertakings for Collective Investment in Transferable Securities
VC	Venture capital
WEO	World Economic Outlook

Vice President:	Laura Tuck
Country Director:	Mamta Murthi
Senior Global Practice Director:	Anabel Gonzalez
Practice Manager:	Paloma Anos Casero
Task Team Leader:	Mariana Iootty de Paiva Dias

REPUBLIC OF CROATIA
Innovation & Entrepreneurship Venture Capital (P152130)

Contents

PAD DATA SHEET

Croatia

Croatia Innovation & Entrepreneurship VC (P152130)

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

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Report No.: PAD1360

Basic Information		
Project ID P152130	EA Category F - Financial Intermediary Assessment	Team Leader(s) Mariana Iootty De Paiva Dias
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]	
	Financial Intermediaries [X]	
	Series of Projects [ ]	
Project Implementation Start Date 07-Jul-2015	Project Implementation End Date 30-Sep-2021	
Expected Effectiveness Date 19-Jul-2015	Expected Closing Date 30-Sep-2021	
Joint IFC No		

Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Paloma Anos Casero	Anabel Gonzalez	Mamta Murthi	Laura Tuck

Borrower: Republic of Croatia - Ministry of Finance			
Responsible Agency: Hamag-Bicro			
Contact:	Nikola Dulcic	Title:	Head of Internationalization Sector
Telephone No.:	385912336993	Email:	ndulcic@hamaginvest.hr

Project Financing Data(in USD Million)					
[X]	Loan	[ ]	IDA Grant	[ ]	Guarantee
[ ]	Credit	[ ]	Grant	[ ]	Other

Total Project Cost:	21.92	Total Bank Financing:	21.92

Financing Gap:	0.00

Financing Source	**Amount**
Borrower	0.00
International Bank for Reconstruction and Development	21.92
Total	21.92

Expected Disbursements (in USD Million)

Fiscal Year	2016	2017	2018	2019	2020	2021	2022	0000	0000	0000
Annual	0.67	2.36	4.15	4.94	5.74	4.06	0.00	0.00	0.00	0.00
Cumulative	0.67	3.03	7.18	12.12	17.86	21.92	21.92	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Trade & Competitiveness

Contributing Practice Areas

Cross Cutting Topics

[ ] Climate Change

[ ] Fragile, Conflict & Violence

[ ] Gender

[X] Jobs

[ ] Public Private Partnership

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Industry and trade	General industry and trade sector	60		
Finance	Other non-bank financial intermediaries	40		
Total		100		

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	Micro, Small and Medium Enterprise support	60
Financial and private sector development	Other Financial Sector Development	40
Total		100

Proposed Development Objective(s)

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

Components

Component Name	Cost (USD Millions)
Component 1: Pilot Venture Capital Fund	17.10
Component 2: Seed Co-Investment Fund	2.74
Component 3: Technical Assistance	1.64
Unallocated amount	0.44

Systematic Operations Risk- Rating Tool (SORT)

Risk Category	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	High
5. Institutional Capacity for Implementation and Sustainability	High
6. Fiduciary	High
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Other	Low
OVERALL	Substantial

Compliance

Policy

Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any waivers of Bank policies?	Yes [ ]	No [X]
Have these been approved by Bank management?	Yes [ ]	No [X]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

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		X
Indigenous Peoples OP/BP 4.10		X
Involuntary Resettlement OP/BP 4.12		X
Safety of Dams OP/BP 4.37		X
Projects on International Waterways OP/BP 7.50		X
Projects in Disputed Areas OP/BP 7.60		X

Legal Covenants

Name	Recurrent	Due Date	Frequency
Project Steering Committee		11-Sep-2015	

Description of Covenant

Establishment of a Project Steering Committee which shall be maintained throughout the implementation of the Project.

Name	Recurrent	Due Date	Frequency
Safeguards	X		CONTINUOUS

Description of Covenant

The Borrower shall ensure that the Project is carried out in accordance with the Safeguards obligations as described in Section I of Schedule 2 of the Loan Agreement.

Conditions

Source Of Fund	Name	Type
IBRD	Subsidiary Agreement	Effectiveness

Description of Condition

The Subsidiary Agreement has been executed on behalf of the Borrower (through MoF and MoEC) and HAMAG-BICRO in a manner satisfactory to the Bank.

Source Of Fund	Name	Type
IBRD	Project Implementation Unit	Effectiveness

Description of Condition

HAMAG-BICRO has established a Project Implementation Unit

Source Of Fund	Name	Type
IBRD	Project Operations Manual	Effectiveness

Description of Condition

HAMAG-BICRO has adopted a Project Operations Manual.

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(a) the PVC Management Firm has been selected and hired;

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(b) the PVC Management Firm has been authorized by HANFA or has notified HANFA of its authorization by another European Union regulator;

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(c) the PVC Fund has been established;

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(d) the PVC Fund has been authorized by HANFA in a manner acceptable to the Bank;

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(e) private shareholders in the PVC Fund have committed an aggregate of at least four million Euros (€4,000,000);

Source Of Fund	Name	Type
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(f) the management agreement between the PVC Fund and the PVC Management Firm acceptable to the Bank, has been signed, and complies with the Borrower's Alternative Investment Fund Act;

Source Of Fund	**Name**	**Type**
IBRD	PVC Investments under Category (1)	Disbursement

Description of Condition

No withdrawal shall be made for Contributions to the PVC Fund under Category (1) of the disbursement table under Section IV of Schedule 2 to the Loan Agreement unless:

(g) a Private Placement Memorandum is in place for the PVC Fund.

Team Composition

Bank Staff

Name	**Role**	**Title**	**Specialization**	**Unit**
Mariana Iootty De Paiva Dias	Team Leader (ADM Responsible)	Economist	Economist	GTCDR
Antonia G. Viyachka	Procurement Specialist	Procurement Specialist	Procurement Specialist	GGODR
Lamija Marijanovic	Financial Management Specialist	Financial Management Specialist	Financial Management Specialist	GGODR
Adam Shayne	Team Member	Lead Counsel	Legal Counsel	LEGLE
Ana Florina Pirlea	Team Member	Consultant	Private Sector Specialist	GTCDR
Ana Paula Cusolito	Team Member	Economist	Economist	GTCDR
Andrew Christopher Myburgh	Team Member	Consultant	Private Sector Specialist	GTCDR
Antonia G. Viyachka	Team Member	Procurement Specialist	Procurement Specialist	GGODR
Barbara Weber	Team Member	Senior Operations Officer	Operations Officer	GPSOS
Camilo Mondragon Velez	Team Member	Senior Research Officer	Research Officer	CBCDI
Jasna Mestnik	Team Member	Finance Officer	Finance Officer	WFALA
Lamija Marijanovic	Team Member	Financial Management Specialist	Financial Management Specialist	GGODR
Ljiljana Tarade	Team Member	Operations Officer	Operations Officer	ECCHR
Natalia Mashaeva	Team Member	E T Temporary	Program Assistant	GTCDR

Natasa Vetma	Safeguards Specialist	Senior Environmental Specialist	Environmental Specialist	GENDR
Sanja Zivkovic	Team Member	Consultant	Private Sector Specialist	GTCDR
Shanthi Divakaran	Team Member	Senior Financial Sector Specialist	Financial Sector Specialist	GFMDR
Vera Dugandzic	Team Member	Senior Operations Officer	Operations Officer	GSURR

Extended Team

Name	Title	Office Phone	Location
Patricia Benavente			

Locations

Country	First Administrative Division	Location	Planned	Actual	Comments

Consultants (Will be disclosed in the Monthly Operational Summary)

Consultants Required ?	Consulting services to be determined

I. STRATEGIC CONTEXT

A. COUNTRY CONTEXT

1. **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[1]. 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 (Figure 1). The country kept its social indicators among the highest in Eastern Europe, while the share of population "at risk of poverty" declined substantially up until the global financial crisis of 2008. These achievements are even more impressive when considered in the light of the difficult political context experienced by Croatia during the 1990s.

2. **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.[2] The adverse economic situation of the past years is associated with a substantial increase in poverty, compared to the 2008 levels, and with a sizeable deterioration in market confidence. In December of 2012, the sovereign credit rating for Croatia was downgraded to non-investment grade - further raising debt servicing and financing costs. This reflected, in part, a worsening fiscal position. Since 2008, the public debt almost doubled and the country's external debt reached 105 percent of GDP.[3] Furthermore, consumption poverty incidence increased from 13.3 percent in 2008 to 18 percent in 2012 while the poverty headcount rate rose by more than 3.5 percentage points since 2010, suggesting that the protracted recession has led to a significant degradation in living standards.

3. **The prolonged crisis has evidenced the unsustainability of the previous growth pattern and the significant structural vulnerabilities of the Croatian economy.** Growth in income in the 2000's was fuelled by large inflows of cheap credit that boosted domestic consumption, investment and imports, leading to a growing current account deficit and increasing dependence on international finance. These conditions – if protracted over time – will undermine long-term sustainability of growth patterns in any country. In the case of Croatia, the EU Macroeconomic Imbalances Procedure (MIP) identified the following issues as the main sources of vulnerability: vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt - further exacerbated by low growth and poor adjustment capacity.[4]

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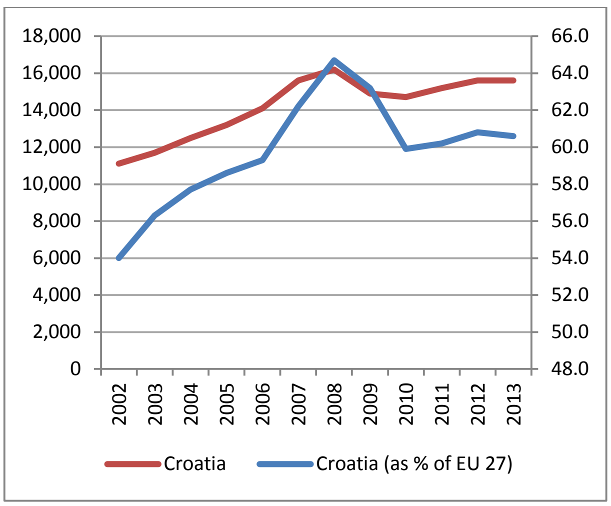
[1] World Bank classification. Gross national income per capita is calculated using the Atlas method.
[2] Based on current IMF estimates, Croatia's growth rate was a negative 0.8% in 2014 and will not surpass 2 percent before 2017 (IMF WEO 2014)
[3] World Bank. *Croatia Public Finance Review: Restructuring Spending for Stability and Growth* (June, 2014)
[4] http://ec.europa.eu/economy_finance/economic_governance/documents/2014-03-05_in-depth_reviews_communication_en.pdf

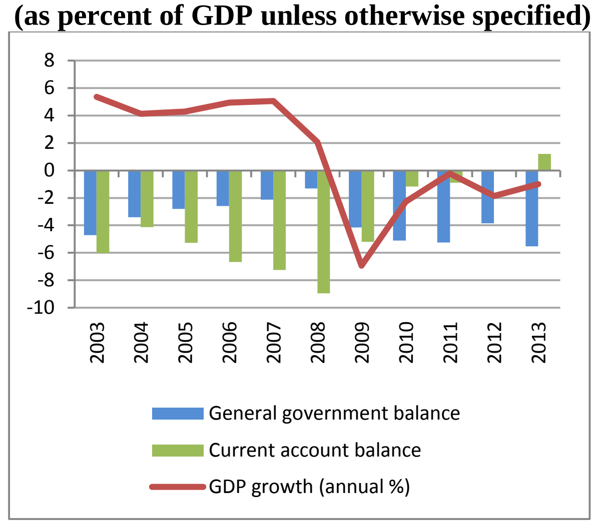
4. **The recession has led to a defensive restructuring of the corporate sector, which has in turn undermined labor market outcomes.** Labor force participation is only 50.9 percent for those 15 years or older, among the countries with the lowest level in the EU.[5] When the crisis hit, the initial impact on employment was modest due to government support measures. However, the pace of job destruction has accelerated subsequently. Total registered employment in 2013 fell by 13 percent since the peak in 2008 while average official unemployment rate exceeded 20 percent in 2013, driven mostly by construction and manufacturing layoffs. The survey-based annual unemployment rate stood at 17.3 percent by the end of 2013, the second highest among all EU10 member states. According to the MIP Review, this is partly due to underlying institutional and policy weaknesses. A sluggish corporate sector also contributes to poor employment performance. State-owned enterprises, which in some sectors still play a dominant role and which are in many cases un-restructured, are overall highly indebted and weakly profitable. In addition, on a wide range of standard indicators, Croatia's business environment ranks significantly below the average for central and eastern European Member States. The underperformance of the corporate sector is also reflected in the country's trade outcomes (Figure 2).

Figure 1: Croatia: GDP – PPS per inhabitant



Sources: Eurostat

Figure 2: Croatia: Macroeconomic indicators (as percent of GDP unless otherwise specified)



Sources: World Development Indicators; IMF WEO April 2014

B. Sectoral and Institutional Context

5. **Having been in recession for the past six years, export performance is critical for Croatia - a small country of some 4.3 million.** The channels through which export expansion enhances productivity and growth are well known: exports allow for specialization in a country's comparative advantage and thereby raise growth. Export expansion also includes dynamic efficiency gains in the more productive export sector engineered by higher competition, greater economies of scale, better capacity utilization, dissemination of knowledge and technological progress, and improved allocation of scarce resources throughout the economy. Moreover, increases in export revenue are linked to productivity gains that should lead to wage increases - when factors are paid their marginal product. Finally, increased export earnings relax current

[5] Ibid

account pressures by improving the odds of importing the necessary intermediate and capital goods and attracting foreign investment, stimulating growth through capital accumulation (Medina-Smith 2001; Mahadevan 2007). [6]

6. **However, 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. These factors explain Croatia's low export diversification, loss of competitiveness, lack of sophistication, and limited expansion of new products and new markets.[7] Yet, there are also some promising signs for the country's export competitiveness, as a fringe of small dynamic exporters is emerging in sophisticated niche products. Croatia's emerging niche product categories should not be made the focus of any strategy to "pick winners". They should instead be helped with horizontal policies that support entrepreneurship and market discovery. Establishing a culture of venture capital in the country is one key way to achieve this objective.

7. **To improve export performance, Croatia needs to shift more forcefully towards a productivity-based and innovation-driven growth model.**[8] As highlighted above, 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, as suggested by the World Bank 2009 EU Convergence Report for Croatia.

8. Innovative small and medium enterprises (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.[9]The largest share of the country's SMEs (67%) can be found in services. A particular sub-set of SMEs, those in innovation

[6] Medina-Smith, E. 2001. "Is the Export-Led Growth Hypothesis Valid for Developing Countries? A Case Study of Costa Rica." Policy Issues in International Trade and Commodities Study Series No.7, United Nations Conference on Trade and Development, Geneva; Mahadevan, R. 2007. "The Poverty Transition: When, How and What Next?" *Journal of International Development* 19 (8): 1099–1113.

[7] World Bank. *Croatia's Trade: Performance, Competitiveness and Potential* (background paper prepared for C*roatia Research and Innovation for Smart Specialization* Report, June 2014)

[8] Expanding and diversifying exports is closely related with increasing productivity and fostering innovation. The fact that the more productive firms are more likely to export has now been confirmed in studies for a large number of countries by Wagner (2007). On the other hand, exporters tend to be more productive than non-exporters, as documented by Bernard and Jensen (1995, 1999, 2004a and 2004b). A robust, positive relationship between firm level innovation and productivity as well as some innovation inputs, such as R&D and productivity has been documented by Hall (2011) and Hall et al (2011), respectively. Product innovations such as the upgrading of the quality of existing goods or services allow companies to escape competition by differentiating their products as discussed by Cusolito (2009)8 and Bloom, et al. (2012). Product innovations, like the creation of new goods, also help firms diversify their portfolios, conquer new markets, and reduce the effects of external shocks (Klinger and Lederman, 20068)

[9] Based on Eurostat data for 2012 (Structural Business Statistics). According to Eurostat, SMEs are firms that employ between 1-249 persons. The figures cover firms in industry (mining and quarrying, manufacturing, electricity, water, and construction), distributive trades, and services.

driven activities, namely young knowledge-intensive enterprises[10], 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 %of SMEs.[11]

9. 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. [12]

10. Entrepreneurship in Croatia also appears weak on other accounts. Croatia generates few new firms compared to what would be predicted by its income level. 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' (see Annex 2 for more detailed evidence).

11. A weak business environment is one of the reasons behind the overall poor entrepreneurship performance illustrated above. This is particularly true when it comes to solving insolvency, enforcing contracts, protecting minority investors and getting credit (see Annex 2 for more detailed assessment).

12. **Lack of risk capital financing is another important barrier to entrepreneurship. Few funding opportunities are available for innovative SMEs and startups in Croatia.** 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. Similarly, 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. While there is capital in the country potentially available for investments, the technology driven start-ups have not been a beneficiary.

13. **Evidence suggests that the supply of risk capital - venture capital, in particular –should be greater in Croatia.** The supply of venture capital is below that of countries at a comparable level of income. The angel investor community is still at infant stage, there is not a single existing venture capital fund registered in Croatia, and the existing international venture capital funds with activities in the country have made very few investments in the recent period. Also, there seems

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[10] Knowledge intensive SMEs (and startups) are understood to mean those SMEs (and startups) with a business model that emphasizes intellectual property as the main asset and include technology-based firms (e.g. IT firms), as well as firms that compete on the basis of product, process or service innovation. Innovation can be either incremental or radical, and either new to the Croatian market or new to the world.

[11] Figures based on Eurostat Structural Business Statistics, latest available data (2012).

[12] Strengthening policy governance in Croatia is also key for boosting research and innovation impact. The system is not fully functional as the technology and innovation policy is still fragmented leading to programs with overlapping objectives and non-rationalized resources. However, recent changes may improve matters when it comes to management of public resources. In 2013, a new model of dedicated institutional financing for science activity was introduced.

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 (see Annex 2 for more details).

14. **The lack of risk capital financing in Croatia is explained not only by 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 (see Annex 2), 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[13]. 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***.**[14] 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, 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 risk capital financing market.

15. **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

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[13] Croatia ranked 65th among 189 countries covered by the World Bank's Doing Business 2015 Report, which presents an improvement compared to the last year by two places on the ranking mostly due to the ease of dealing with construction permits and lower start-up costs. Croatia made the greatest improvement in the ease of dealing with construction permits by reducing the requirements and fees for building permits and carrying out the final building inspection more promptly. It made starting a business easier by reducing notary fees, and switched to an electronic customs system. In addition, progress has been made in the area of enforcing contracts and trading across borders. Croatia scored best in paying taxes (ranking 36th), enforcing contracts (ranking 54th), and resolving solvency (ranking 56th). The Croatian Government is continuously working on broad reform agenda and measures to further improve the business environment. As recommended by the European Council in the Country-Specific Recommendations, Croatia should take actions within 2014-2015 in the following business environment areas: (i) set a target for considerably lowering administrative requirements, including parafiscal charges; (ii) streamline administrative processes, and clarify the decision-making and accountability framework across various levels of government and at central government level between ministries and agencies; and (iii) improve administrative capacity and strategic planning of units entrusted with the management of European Structural and Investment Funds and provide them with adequate and stable staffing levels.

[14] Because innovation happens within a system where actors might have different incentives, there is always the risk that individual actors do not act in a coordinated way. Therefore, "..most (if not all) parts of the system need to be in place for it to function well, and missing parts may not emerge if some others are missing (World Bank (2014)).

towards venture capital vehicle and other risk financing instruments. 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.

16. **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.

C. Higher Level Objectives to Which the Project Contributes

17. **The overarching higher-level objective of this proposed Project is a stronger, more productive and competitive private sector. The project aims to accomplish this objective by strengthening risk capital financing for innovative SMEs and startups.** Because of their innovative potential, these firms are in a position to leverage the country's low cost base, to increase productivity and to export.[15] In addition, by supporting the provision of risk capital financing to these firms this project aims to stimulate the development of a more vibrant startup community which will benefit the country's science and technology sector.

18. **If an adequate number of successful start-ups and innovative SME growth stories are created, it demonstrates that investing in innovative entrepreneurs is possible.** This in turn would help create a spillover effect in terms of attracting foreign investment and bringing in more venture capital funds, creating additional business and growth to the broader supply chain, and building the startup ecosystem.

19. **All of which can help grow confidence in the economy and ensure sustainability and growth of the local private sector, one of the key targets of the FY14-17 Country Partnership Strategy (CPS) –** Report No. 77630-HR, discussed by the WBG Board of Executive Directors on June 30, 2013. The project is aligned with other government initiatives, such as the Smart

[15] Expanding and diversifying exports is closely related to increasing productivity and fostering innovation. In studies for many countries, Wagner (2007) confirmed that more productive firms are more likely to export; equally, exporters tend to be more productive than non-exporters (Bernard and Jensen 1995, 1999, 2004a, and 2004b). See Wagner, Joachin. 2007. "Exports and Productivity: A Survey of the Evidence from Firm-Level Data," The World Economy 30:1, 60-82; for Bernard and Jensen relevant studies please see: https://ideas.repec.org/e/pje75.html

Specialization Strategy, a development framework which, building on existing comparative advantages, aims to promote a larger contribution of the knowledge factor to economic growth. . Similarly, the proposed project is also aligned with other World Bank sponsored projects in Croatia, as the Science and Technology Project (STP) and Science and Technology Project II (STP II) which aimed to increase Croatia's ability to deploy funds to support business innovation.

20. **In addition, by increasing the sources of risk capital finance for innovative SMEs and startups with the final objective of financing innovation and productivity-enhancing activities, this Project can contribute to the World Bank Group twin goals in Croatia - specifically the goal to boost shared prosperity - through different channels.** First, firm productivity growth will deliver increases in wages and contribute to reduce poverty and foster shared prosperity.[16] A very recent study of developing countries conducted by the World Bank (Azevedo et al., 2014[17]) finds that increases in workers' earnings were relatively more important in reducing poverty and boosting shared prosperity than increasing the number of workers or the number of jobs.[18] Moreover, productivity changes in the same job have played a crucial role in helping households escape poverty, showing that not all transitions from poverty require a change in the type of work undertaken. Second, firm growth can foster job creation, and jobs remain the main determinant of living standards around the world, and are the main source of income for the majority of households. Labor-related events, such as starting to work, getting a better job, and earning more income, trigger household exits from poverty.

II. PROJECT DEVELOPMENT OBJECTIVES

A.PDO

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

22. Innovation in this context is defined as the creation of new (or upgrading of existing) products (good or services), processes and/or business models which are new to Croatian or to other markets.[19]

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[16] Latest numbers from ECA Data Lab shows that annualized growth rate of income/consumption of bottom 40% in Croatia was 2.91% in 2006-2009 period.

[17] *What accounts for changes in Poverty over the Past Decade?* by Azevedo, J.P., Inchauste, G., Van Nguyen, T., Olivieri, S and H., Winkler in Inchauste, G. et al. 2014. *Understanding changes in poverty*, Directions in Development – Poverty, Washington DC: World Bank.

[18] In ECA region, for instance in Romania, Slovak Republic and Poland, the contribution from labor earnings to the income growth of bottom 40% was the highest among the other components (demographics, effective tax rate,occupation, other non-labor income, pensions and transfers). Decomposition for Croatia is not available. See: http://spapps.worldbank.org/apps/eca/ECADataLab/Pages/RegionalDashboard.aspx#linkid=59

[19] Precisely, as defined in the "Oslo Manual", 3rd edition, 2005, innovation is defined as the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organizational method in business practices, workplace organization or external relations. Main types of innovation are defined as follows:

1) A *product innovation* is the introduction of a good or service that is new or significantly improved with respect to its characteristics or intended uses. This includes significant improvements in technical specifications, components and materials, incorporated software, user friendliness or other functional

B. PROJECT BENEFICIARIES

23. **The key beneficiaries of the proposed Project will be innovative SMEs and startups.** Due to their innovative potential, these firms are in a position to leverage the country's low cost base, to boost productivity and to export. However, as their track record and products are difficult to collateralize, these firms face a substantive funding gap. In this sense, to the extent that lack of risk capital financing undermines the innovation ecosystem by preventing innovative ideas with commercial potential from reaching the market, the proposed project seeks to fill this funding gap and strengthen the innovation and entrepreneurship system. See Annex 3 for a detailed description of an eligible investee company to receive finance through the funds to be established under the proposed Project.

C. PDO LEVEL RESULTS INDICATORS

24. **Project level Results Indicators that will be measured are**:

- Total number of firms receiving risk capital financing from the Seed Co Investment Fund
- Total number of firms receiving risk capital financing from the Pilot Venture Capital Fund
- Number of firms receiving investment that successfully introduced a new product, process, service or upgraded the quality of an existing product, process, service or quality.
- Training provided (to government staff, investors and potential investees) under the Project

25. **Though the Project has a limited and specific scope, it offers important learning opportunities.** In addition to tracking the above results indicators (in a gender disagregated way)[20], a survey will be conducted with both beneficiaries and non-beneficiaries and qualitative interviews with investors. This will enable the Project to undertake a comparative analysis of firms that have benefited from the program, and to assess whether the Project design and implementation need to be streamlined. A formal impact evaluation is not planned.

characteristics. Product innovations can utilize new knowledge or technologies, or can be based on new uses or combinations of existing knowledge or technologies.

2) A *process innovation* is the implementation of a new or significantly improved production or delivery method. This includes significant changes in techniques, equipment and/or software. Process innovations can be intended to decrease unit costs of production or delivery, to increase quality, or to produce or deliver new or significantly improved products.

3) A *marketing innovation* is the implementation of a new marketing method involving significant changes in product design or packaging, product placement, product promotion or pricing. Marketing innovations are aimed at better addressing customer needs, opening up new markets, or newly positioning a firm's product on the market, with the objective of increasing the firm's sales.

4) An *organizational innovation* is the implementation of a new organizational method in the firm's business practices, workplace organization or external relations. Organizational innovations can be intended to increase a firm's performance by reducing administrative costs or transaction costs, improving workplace satisfaction (and thus labor productivity), gaining access to non-tradable assets (such as non-codified external knowledge) or reducing costs of supplies.

[20] See Results Framework in Annex 1.

III. PROJECT DESCRIPTION

26. **The Government of Croatia under this proposed Project will establish and finance a program aimed at increasing the supply of risk capital financing for innovative SMEs and startups.** The Project encompasses both supply and demand side interventions. From the supply side, it will provide financing for sequential stages of the innovation phase - both at the startup/seed and early stages. This type of public involvement in supporting the supply of risk capital finance is a tested model used by many governments as a way to fill the financing gap for young innovative entrepreneurs (Annex 9 provides a list with recent examples). From the demand side, the proposed Project will provide technical assistance for the overall implementation of the program, which will include capacity building at the government level and also at the entrepreneurship community level.

27. **Investments financed by the Project will be made into innovative SMEs and startups with the locus of their activities in Croatia.** No attempt will be made at establishing priorities in terms of sectors. However, based on the composition of SME sector in Croatia (heavily concentrated in services) and also on worldwide experience with risk capital financing [21] it is expected that firms operating in sectors such as life sciences, consumer and computer electronics, and ICT are going to be important beneficiaries. The program will not invest in activities involving pure real estate and construction. A complete list of ineligible sub-activities that cannot be funded with the money of the proposed Project is included in the Project Operations Manual. None of the funds under the Project will invest in deals where there is a conflict of interest between the investees and investors.

A. PROJECT COMPONENTS

28. **The Project has a tenure of six years and will have three components**: a) a Pilot Venture Capital Fund b) a Seed Co-Investment Fund; and c) Technical Assistance (TA). The Project will be financed 100% through a World Bank loan to the Republic of Croatia. Each component is described as follows:

Component 1: Pilot Venture Capital Fund (€ 15.6 million)

29. The Pilot Venture Capital Fund ("Pilot VC Fund") will be registred in Croatia as a closed end fund established as a limited liability company in accordance with the Alternative Investment Fund (AIF) Act. The Fund will be supervised by the Croatian Financial Services Supervisory Agency (HANFA). It will be a 10-year euro-denominated fund, with an option for a two year extension. The Fund will consist of both public and private financing, in a ratio consistent with EU state aid regulation. It will be established with the purpose of providing financing, in the form of equity or quasi equity instruments, to innovative SMEs (including startups) with the locus of activity in Croatia.[22] The Fund will be managed by a private fund manager selected through an international tender process. The fund manager may decide to obtain registration as an European Union Venture Capital Fund (EuVECA) manager for the Fund - in accordance with the EuVECA Regulation. To

[21] In 2012, in the United States, 40% of venture capital investments were in the life sciences sector, followed by computer and consumer electronics (25.8%), while in Europe the life science share was 30% followed by computer and consumer electronics (19.0%) and communications (18%).See OECD- Entrepreneurship at a Glance, 2013

[22] Equity financing from the Pilot VC Fund will finance eligible firms (sub-projects) – see eligibility criteria in the Annex 3 – to carry out innovation investments.

ensure the commercial viability of the Fund, and its uptake by private investors, the Government of Croatia will provide financial contribution towards the Fund's structure. Up to €3.6 million of the loan will be used to cover management fees and the cost of establishing the Fund– in effect, lowering the cost to private investors from management fees -- to ensure the viability of the Fund structure. This means the net amount available for investment under the VC Fund is €12 million. Further details about the design of the Pilot VC Fund are presented in Annex 3.

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

30. This component will provide €2.5 million towards establishing a Seed Co-Investment Fund ("Co-Investment Fund"). The Co-Investment Fund will be an open-ended fund with initial capital of €2.5million that will be financed by proceeds of the World Bank loan. It will be administered by the implementing agency of the whole Project, HAMAG-BICRO. The objective of this component is to strengthen the early stage investing industry in Croatia by providing smaller amounts of risk capital financing alongside investors in the market such as angel investors and incubators. It is envisaged that the fund will provide smaller amounts of financing than will be made available by the Pilot VC Fund. The Co-Investment Fund is expected to provide a range from €30k- €200k (ticket size; €300k maximum per beneficiary) of flexible debt financing to innovative SMEs (including startups) with the locus of activity in Croatia.[23] Specifically, the Seed Co-Investment Fund will provide financing through loans that will be subordinated to other debt holders, and will not require collateral. The loan will be paid out of income from the investment over the 15 year life of the loan. The terms of the loan are envisaged to be that the initial income generated from the investment will be paid to the co-investor(s) and HAMAG-BICRO on a pro rata basis. Once the return on the investment has exceeded a hurdle rate (6 percent) the subsequent income will be distributed asymmetrically to the benefit of the co-investor(s). After the hurdle rate has been achieved HAMAG-BICRO would receive around 10 percent of any additional income from the investment. Further details about the design of this Co-Investment Fund are presented in Annex 3.

Component 3: Technical Assistance (€ 1.5 million)

31. 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. Further details are presented in Annex 3.

(a) Sub Component 3.1: The Global Advisory Network (€400 k). The objective of this sub-component is to establish a network of experts who will provide advice and guidance for the implementation of both funds designed under this Project (Pilot VC Fund and Co-Investment Fund).

(b) Sub Component 3.2: Capacity Building and Networking (€400 k). The objective of this sub-component are twofold. First, to develop human capabilities of the main actors involved in the risk capital financing industry in Croatia, such as HAMAG-BICRO staff, investors and entrepreneurs. Second, to strengthen social capital and networks –

[23] Loan from the Co-Investment Fund will finance eligible firms (sub-projects) – see eligibility criteria in Annex 3 – to carry out innovation investments.

both local and global among incubators, accelerators, business angel networks, matchmaking services, entrepreneurs and larger investors.

(c) Sub Component 3.3: Monitoring & Evaluation (€100 k). The aim of this subcomponent is to ensure accountability in the use of government's money, and provide guidance on how the program can be improved

(d) Sub Component 3.4: Project Management and Audit (€600 k). This subcomponent will finance necessary activities for establishment of the PIU, project management and implementation (including audit), and carrying out outreach activities.

B. PROJECT COST AND FINANCING

32. **The lending instrument will be an Investment Project Financing (IPF) loan of € 20 million provided under IBRD terms**. The Government of Croatia selected a variable spread loan with a total maturity of 10 years, including a grace period of 4 years, with level repayment linked to commitment.

33. The Project costs and financing are detailed in Table 1 below. All components will be fully funded by the loan. An unallocated category is introduced to pay for loan fees and to enable marginal adjustments with the project management.

Table 1:Project Financing Breakdown

Project Components	Project Cost (€ million)	IBRD Financing (€ million)	% IBRD Financing
1. Pilot VC Fund	15.6	15.6	100
2. Seed Co-Investment Fund	2.5	2.5	100
3. Technical Assistance	1.5	1.5	100
Sub-total	**19.6**	**19.6**	**100**
4- Unallocated	0.4	0.4	100
Total Project Cost	**20**	**20**	**100**
Total Financing Required	**20**	**20**	**100**

C. LESSONS LEARNED AND REFLECTED IN THE PROJECT DESIGN

34. **Government involvement in equity financing and grants can be found in many countries where the public sector needed to step in to fill a funding gap for innovative start-ups and SMEs.** The project design takes into account lessons learned from other World Bank operations in Armenia, Mexico, Lebanon, and a previous initiative to develop the risk capital market in Croatia.

35. **Two highly relevant examples of a World Bank equity investment projects are found in the Armenia E-Society for Competitiveness and the Innovation and Competitiveness project in Mexico.** The objectives of both the Armenia and Mexico pilot funds were to provide a demonstration effect of the commercial viability of early stage funds for technology and high

value-added start-ups helping attract other venture capital companies and creating a critical mass of early stage investments and market agents. A critical lesson learned from both projects is that private sector management based on performance fees does not align with the development objective of investing in seed and early stage ventures.

36. **Another relevant example is also the Lebanon Supporting Innovation in SMEs project which aimed to encourage the equity investment market to increase the supply of early stage investment finance for financially viable, new, and existing innovative firms.** This program encompassed a component which provided support for innovation in SMEs through concept development grants and early stage innovation financing. This program combined mentorship and technical support to early start-ups (US$20 million) with a US$50 million investment fund that aimed to make investments jointly with angel investors in the range of US$50,000 – US$1 million each in 200 start-up companies across some MENA countries.

37. **The proposed Project has also internalized the lessons learned from a previous initiative to develop the risk capital market in Croatia**. The VENCRO program, a component of the World Bank STP project, faced a number of challenges which will be mitigated through the design of the current proposed Project. For more specific lessons learnt taken into consideration for Project design, please see Annex 2.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

38. 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 be no counterpart contributions provided by the state budget through the Ministry of Entrepreneurship and Crafts (MOEC) or HAMAG-BICRO's budget allocations.

39. 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, Education and Sports, and Ministry of Regional Development and EU Funds).

40. MOEC will be in charge of supervising 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 as the planned closing date is September, 2021.[24]

41. HAMAG-BICRO is an independent agency founded by the Republic of Croatia in 2014. It results from the merger between the Business Innovation Agency of the Republic of Croatia (BICRO) and the Croatian Agency for SMEs and Investments (HAMAG INVEST). Pursuant to the Act on the Amendments to the Small Business Promotion Development (Official Gazette No. 56/2013) and the Agreement on the Merger of the Business Innovation Agency of the Republic of

[24] The World Bank is internally exploring the possibility to extend the implementation period up to seven years due to the Project design specifics.

Croatia (BICRO) with the Croatian Agency for SMEs and Investments (HAMAG INVEST) dated April 8, 2014, BICRO merged with HAMAG INVEST and therefore changed its name to the Croatian Agency for SMEs, Innovations and Investments (HAMAG-BICRO). HAMAG-BICRO is a non-profit legal person with the rights, obligations and responsibilities defined by the Act and its Statute. The issues that have not been otherwise regulated pursuant to the Act or the Statute of the agency are subject to the provisions of the regulations referring to limited liability companies. The Republic of Croatia ensures the fulfillment of the obligations of HAMAG-BICRO.

42. Monitoring and evaluation of HAMAG-BICRO's operations and programs is performed both externally and internally. Compliance with the Act, the Statute, the general acts of the agency, and the program of activities is supervised by the Management Board of HAMAG-BICRO. Financial supervision of the agency's operations is performed by the State Audit Office. The Annual Report on the agency's operations has to be prepared by the Executive Board, passed by the Management Board of HAMAG-BICRO and submitted to the Government and Parliament of the Republic of Croatia. In addition, the agency has in-house organizational units for Internal Audit, Expenditure Control, and Monitoring, Analysis and Reporting.

43. The institutional arrangements for the Project will be as follows:

(i) Prior to effectiveness, the MOF will sign a (tripartite) Subsidiary Agreement with the MOEC and HAMAG-BICRO to implement all three Project components: Pilot Venture Capital Fund, Seed Co-Investment Fund and Technical Assistance. The Subsidiary Agreement will set forth all the terms and conditions under which the Government of the Republic of Croatia is making the funds available to HAMAG-BICRO. In addition, a Project Agreement between the World Bank and HAMAG-BICRO will be signed; this Project Agreement will include the details on HAMAG-BICRO's obligations to the World Bank as the Project Implementing Unit (PIU), and references to governance, procurement, reporting and safeguard rules. It also refers to the Project Operational Manual which includes the detailed eligibility criteria, project implementation and management guidance.

(ii) Once the winning bid for the VC Pilot Fund Manager tender process has been awarded, HAMAG-BICRO will sign an Administration Agreement with the selected Fund management company, to ensure the VC Fund management company complies with the Project Operations Manual. Second, the VC Fund will be created through Articles of Association (shareholder agreement signed by HAMAG-BICRO and the other shareholders of the Fund). Finally, the VC Fund will sign a Management Agreement with the VC Fund management company to determine mutual roles and responsibilities; terms and conditions of this Management Agreement will have been negotiated under the Administration Agreement.

44. 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.

45. Financial management implementation arrangements for all three project components are 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.

46. 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.

47. The PIU will be created at HAMAG-BICRO and it would consist of HAMAG-BICRO's internal experts. External consultants for any specific functions could be engaged as well if needed. The PIU would be responsible for project management and supervision, including procurement, financial management, monitoring and evaluation, and reporting. In addition, the PIU would manage and implement several project activities, its marketing, relevant training and related outreach to the business ecosystem.

48. The PIU has to be in place and operational by the Project effectiveness date.[25]

49. As stipulated in its Statute, HAMAG-BICRO has the legal mandate for management of funds established for the purpose of SME development, promotion and attracting investments in entrepreneurship, financing of business operations and development of SMEs through the provision of loans under more favorable terms and other types of financial support, including quasi-equity. Therefore, Component 2 (Seed Co-investment Fund) will be exclusively managed and implemented by HAMAG-BICRO. In addition, HAMAG-BICRO will be responsible for the implementation of Component 3 (Technical Assistance). HAMAG-BICRO will be responsible for Component 1 (Pilot VC Fund), while the selected fund management company will be responsible for managing the Pilot VC Fund itself, in accordance with the guidance and the final version of the Project Operational Manual to be prepared by HAMAG-BICRO.

50. A draft Project Operations Manual, satisfactory to the World Bank was prepared by Project negotiations. The templates of all relevant agreements will be finalized prior to loan effectiveness. Signed (tripartite) Subsidiary Agreement, the establishment of the PIU, and the adoption of the final approved Project Operations Manual by the Management Board of HAMAG-BICRO – in a way satisfactory to the Borrower and the Bank - will be conditions of loan effectiveness. Additional details on institutional and project implementation arrangements are provided in Annex 4.

B. RESULTS MONITORING AND EVALUATION

51. **In order to assess the Project's performance in terms of design and implementation, a monitoring and evaluation (M&E) framework was developed.** The framework closely follows the guidelines used for the assessment of similar international interventions such as those

[25] 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.

in Scotland[26] and Denmark[27], as well as similar World Bank operations such as a 2014 project in Lebanon.[28] In accordance with World Bank's rules, the primary responsible for tracking results is the client, in this case, represented by HAMAG-BICRO. This institution will present an M&E report to the Borrower (through MOF and MOEC), and to the World Bank, on a semi-annual basis.

52. **The M&E framework relies on three pillars: results indicators; evaluation of fund management; and an indirect assessment of the investment strategy and returns of the funds.** Results indicators include input indicators, considered to examine implementation performance, and output indicators, included to assess the achievement of the final goals (e.g., fostering innovation, build capacity of the venture capital ecosystem). The evaluation of fund management (regarding efficiency, effectiveness, additionality) will be performed by an independent third party to guarantee the transparency of the process, based on focus groups discussions with managers, investors, beneficiaries, and non-beneficiaries (see Box A1-A3, Annex 1, for questionnaires). Finally, the indirect assessment of the investment strategy and returns of the funds will be based on information about the performance of beneficiary firms (e.g., revenues, operating margin, employment, exports, etc).[29]

53. **Results monitoring will be based on qualitative and quantitative information collected from Project's beneficiaries and non-beneficiaries, investors, and Project managers.** Firms that receive financing from the Seed Co-Investment Fund and the Pilot VC Fund will be obliged in their contracts with the Pilot VC Fund and the Co-investment Fund to provide performance data on a semi-annual basis. Details on the arrangements made for M& E can be found in Annex 1.

C. SUSTAINABILITY

54. The Project applies a financial structure that balances two levels of investment categories. The Seed Co-Investment Fund addresses firms that need smaller investments. These are typically younger firms. The Pilot VC Fund will tend to provide larger amounts of money for more established firms. Returns for both of these categories are expected to be relatively low compared to the risks and illiquidity of these investments. For this reason, the Project will provide concessional finance to these investors. This will increase private investors' returns while reducing returns for the Project. Due to the provision of concessional finance the Project is expected to lose money on the investments it makes. This is sustainable as the Government of Croatia is willing to absorb losses on its investments so as to achieve the Project's policy objectives. In the future it should be possible to provide additional funds to this program, or similar programs, with EU Structural Funds.

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[26] PACEC, 2012 "Scottish Enterprise Economic Impact of the of the Scottish Venture Fund" A report prepared by PACEC for Scottish Enterprise

[27] Murray, G and Cowling, M, 2014 "Evaluation of the Danish Growth Fund, Evaluation of activities, 2010–2012" DAMVAD

[28] International Bank for Reconstruction And Development, 2014 "Project Appraisal Document - Supporting Innovation in Small and Medium Enterprises Project" Document of The World Bank, Report No: 72377-LB.

[29] The World Bank team has decided not to include direct indicators of fund performance such as the internal rate of return (IRR) for two reasons. First, this operation is envisioned to be implemented in six years, which is a very short-period of time to assess the performance of equity funds. Second, since this is the first co-investment facility in the country for both seed and venture capital investments, there isn't a reference IRR in the market that can be used as a benchmark for this operation.

V. KEY RISKS AND MITIGATION MEASURES

A. OVERALL RISK AND EXPLANATION OF THE KEY RISKS

55. The overall risk rating of this project is *substantial*. The proposed Project is a means by which the Government of Croatia intends to promote risk financing to widen the access of financing to innovative start-ups and SMEs, a type of operation which involves by definition substantial risks. Overall, these risks were carefully assessed during appraisal stage. The risks rated as high and substantial which are associated with this proposed operation are related to: political and governance issues; the macroeconomic environment, the technical design of the project; fiduciary, and institutional capacity for implementation. The overall description of these challenges and the proposed mitigation measures follows below. A detailed description is presented in Annex 5.

Table 3: Risks and Mitigation Measures

Key risks	Mitigation measures
Political and Governance Issues (Rating=Substantial)	The implementing agency selected for this program is HAMAG-BICRO, a stable organization with a long term strategic planning horizon, with the caveat that the agency has recently been established. In the context of another activity (STP II), the World Bank is already working with the new HAMAG-BICRO. By leveraging the STP II experience the World Bank team can help to overcome any challenges to project delivery that may arise due to the recent merger process.
Macroeconomic (Rating=Substantial)	Croatia is slowly emerging from a multi-year recession and the country's fiscal position remains weak. This means the government's ability to fund science, technology and innovation programs out of its own resources will be constrained in the coming years. However, Croatia is expected to benefit from European Union ESI funds. A portion of these are expected to be spent on science, technology, and innovation. In addition, the Bank's STP II project is supporting activities in this area.
Technical design of the project (Rating=High)	The combination of the Seed Co-Investment Fund, which will provide finance to younger firms, and the Pilot VC Fund, which will provide follow on investments, limits the risk that funds available for follow on investments will be reduced by implementing the Project. For the VC Fund specifically, the uncertainty about the amount of deal flow in the market will be

	mitigated by investing in the VC Fund in stages, or closes. The incentives of the management firm (of the VC Fund) will be aligned with the investors through structuring (a) the fees paid for managing the Fund, (b) the "bonus" it is paid out of the Funds profits (the carry), and (c) the management firms staff's own investment in the Pilot VC Fund. Also, the Pilot VC Fund will be isolated from political decision making by ensuring through the governance arrangements (as set out in the Articles of Association (shareholder agreement) or AIF rules, according to the Croatian AIF Act, that investment decisions are independent of the investors in the Fund including the government. Finally, there are triggers to cancel the Pilot VC Fund (Component 1), which accounts for the largest part of the loan (15.6 million Euro). If the disbursement conditions applicable to funds to be used in VC investments have not been satisfied by two years after the loan is effective, then the VC Fund component is cancelled and the corresponding amount can be reallocated upon client request. This mitigates the risk that the largest part of the loan is not disbursed.
Institutional capacity for implementation and sustainability (Rating=High)	HAMAG-BICRO defined the implementation arrangements and assigned specific individuals who will be part of the PIU, and formally entrust them with the overall coordination, management and monitoring of procurement.
Fiduciary (Rating=High)	The World Bank fiduciary team in Croatia will work with HAMAG-BICRO to advise on how to build its capacity in fiduciary tasks. This will include capacity building in areas such as the preparation of withdrawal applications, reporting, preparing audited financial accounts and others.

VI. APPRAISAL SUMMARY

A. ECONOMIC AND FINANCIAL ANALYSES

Economic Analysis

56. **The Project will support the growth of innovative SMEs and startups in Croatia.** It will do this by strengthening the access to risk capital financing. A well-functioning innovation finance market has been found to be a prerequisite for triggering the potential that lies in innovative

companies. This makes venture capital a "catalyst for private sector growth and development, and an engine of increasing productivity".[30] The importance of early stage funding is also suggested by the impact generated in environments where early stage finance is relatively available. For example survey data shows that in Canada, angel investors and venture capital funds provided 90 percent of the equity financing received by innovative SMEs (compared with only 42.3% received by non-innovative SMEs).[31,32] In the US angel investors are estimated to have contributed to the creation of 250 thousand new jobs in 2009, which represented 5 percent of the total amount of new jobs in that year.[33]

57. **By increasing the supply of risk capital financing the project will spur innovative activities.** These activities are relatively difficult to finance using other types of finance such as loans from banks (see Hall and Lerner, 2009[34]). The importance of risk capital financing for science and technology is suggested by studies that have found that in the US an increase in venture capital activity in a region increases the amount of R&D as measured by patent activity[35].

58. **Programs similar to the one proposed under this Project have been found to increase access to risk capital.** Brander et al. (2014)[36] find that publicly supported venture capital augments privately provided venture capital. They find that that enterprises funded by both government-sponsored venture capital funds and private venture capitalists obtain more investment than enterprises funded purely by private venture capitalist. Markets with public support for venture capital have more venture capital funding per enterprise and more venture capital-funded enterprises. This result is supported by Kovner and Lerner (2012) who show that the presence of publicly and non-profit supported venture capital funds increase the likelihood that traditional venture capital funds will operate in the market. They find that each additional publicly supported venture capital funds investment results in an additional 0.06 new traditional VC funds in the market.[37]

59. **In terms of job creation, based on the financial simulation model that was developed for the project (Annex 6) it can be expected that these projects may lead to the creation of additional jobs as access to risk capital financing leads to the expansion of enterprises, and the launching of new ones.** The firms that will be created will tend to be relatively small and so relatively few jobs are expected to be created. The Project is expected to have an indirect positive impact on national job creation through spillover effects and business growth within the related

[30] Camilo Mondragon-Velez, "Private Equity and Venture Capital in Latin America" International Finance Corporation – World Bank Group

[31] Information based on the Survey on Financing of Small and Medium Enterprises (2004) compiled by Statistics Canada.

[32] OECD, 2010 "High Growth Enterprises: What Governments Can Do to Make a Difference, OECD Studies on SMES and Entrepreneurship" OECD Publishing

[33] Sohl, J. (2010), "The Angel Investment Market in 2009", Center for Venture Research, University of New Hampshire, United States.

[34] Hall, B and Lerner,J. (2009) "The Financing of R&D and Innovation,"NBER Working Papers 15325, National Bureau of Economic Research, Inc

[35] Korum, S and Lerner, J 1998 "Does Venture Capital Spur Innovation?" NBER Working Paper Series, Paper number 6846

[36] Brander, J; Du, Q. and Hellmann, T. , 2014 "The Effects of Government-Sponsored Venture Capital: International Evidence", Review of Finance (March)

[37] Kovner, A. and Lerner, J. 2012 "Doing Well by Doing Good? Community Development Venture Capital" Federal Reserve Bank of New York Staff Reports September 2012 Number 572

supply chain for goods and services. This will have a more significant economic and social impact but this would be difficult to capture and is beyond the scope of monitoring and evaluation of this Project.

60. **Based on the above, the economic impact of this Project will be seen in the longer term.** The creation of new start-ups and growth of existing knowledge intensive SMEs will generate spillover effect on the wider economy. These spillovers include attracting foreign investment, creating a higher volume of exports through upgraded market linkages, creating additional business and growth in the broader supply chain, increasing productivity and competitiveness, and building the risk capital finance ecosystem. All of these can help grow confidence in the economy and ensure sustainability, growth and strength of the local private sector leading to increased job creation.

Financial Analysis

61. A financial projection analysis (included in Annex 6) was conducted by the team with the help of investors who work in, and are familiar with the Croatian market.

62. Private investors are expected to make a positive return from their investments in part due to the provision of concessional finance. The concessional finance elements include that the project will largely pay for the costs of managing the venture capital fund. The Co-Investment Fund is structured to asymmetrically distribute returns to the benefit of the private co-investors. These concessional finance elements are expected to increase the returns experienced by private investors.

63. Concessional finance is provided by the program because the returns to providing risk capital financing in Croatia are projected to be relatively low. While returns are relatively low the investments made by the Pilot VC Fund and the Co-Investment Fund are expected to be both highly risky and illiquid. This suggests that the concessional finance elements are needed to make these investments attractive for private sector investors. Furthermore, the size of the Pilot VC Fund is expected to be relatively small which means that the costs of the (management) costs VC Fund would be a substantial proportion of the amount invested. Absent public support for the Pilot VC Fund's management fees the economics of such a fund would be very poor.

64. **Due to uncertainty about the demand for risk capital financing the Pilot VC Fund will established in a series of closes to ensure that it fits the size of the market.** The first close will be set at around €10 million. The management company will be able to start operating after this close. There could be additional closes which are envisaged to raise the committed capital to €20 million. To raise money from private investors the management company running the Pilot VC Fund will need to demonstrate that there is a pipeline of firms that it can invest in. The purpose of this is to ensure that the project does not result in an oversupply of venture capital financing to the market.

B. TECHNICAL

65. **The Project design is appropriate to the borrower's needs.** It targets a gap in the market to supply risk capital financing that has a particularly impact on innovative SMEs including startups. The Project will foster missing linkages and capacity between entrepreneurs and

investors. The Project builds on World Bank experiences with innovation projects in Lebanon, Mexico and Armenia.

66. **The project implementing entity is HAMAG-BICRO**. HAMAG-BICRO is an independent agency and non-profit legal person, has demonstrated expertise in the screening and selection process for similar seed-stage financing programs (such as RAZUM and INCRO) and has the capacity to monitor the Pilot VC Fund and to manage the Co-Investment Fund.

C. FINANCIAL MANAGEMENT

67. **An assessment of the financial management capacity was carried out by the World Bank in May 2015, at appraisal stage.** The assessment concluded that the financial management arrangements in PIU within HAMAG-BICRO are acceptable to the Bank and that the overall financial management risk is moderate with the application of the mitigation measures.

68. **The PIU will maintain a financial management system acceptable to the World Bank.** The Project financial statements, including SOEs and DA Statements, HAMAG-BICRO entity financial statements as well as Pilot VC Fund and VC Fund Manager financial statements will be audited by independent auditors acceptable to the Bank and on terms of reference acceptable to the World Bank. The annual audited financial statements and the audit report will be provided to the World Bank within six months of the end of each fiscal year. The PIU shall also prepare and furnish to the World Bank not later than forty five (45) days after the end of each calendar semester, interim unaudited financial reports for the project covering the semester, in form and substance satisfactory to the Bank. However in order to improve the existing financial management arrangement an action plan has been agreed with the HAMAG-BICRO (as described in Annex 4).

D. PROCUREMENT

69. **HAMAG-BICRO has no experience with fiduciary tasks and specifically procurement in accordance with the World Bank procurement policies and procedures**. A PIU shall be established within HAMAG-BICRO and it will be responsible for the overall coordination, monitoring, and fiduciary functions (including procurement, financial management and disbursement). The PIU may be incorporated in the HAMAG-BICRO structure, comprising its own staff. If needed, an additional external consultant(s) may be hired to provide technical assistance and support to the team with regard to the day-to-day coordination and management of the project procurement activities. Based on the assessment of capacity of the implementing agency to carry out and manage procurement, the Bank determines that the overall risk for procurement, after mitigation, is moderate.

70. **Given the nature of the project and in accordance with the detailed description of its three components, a complex procurement is not envisaged. Details with regard to procurement arrangements are provided in Annex 4 to this PAD, and will be further elaborated in the final version of the Project Operations Manual.** The World Bank team also provided recommendations for enhancement of a few areas in the process and they are elaborated in Annex 4. The Bank's procurement framework will remain the default procurement mechanism for the operation. All goods, works, non-consulting services and consulting services required for the activities of the project and included for financing from the Loan proceeds shall be procured

in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" dated January 2011, Revised July 2014 and "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" also dated January 2011, Revised July 2014; and the provisions stipulated in the Loan Agreement.

71. A **summary Procurement Plan covering at least the first 18 months of the Project was prepared during project appraisal and its final version was agreed at Project negotiations.** After loan negotiations, the Bank shall arrange the publication on its external website of the agreed initial procurement plan and all subsequent updates once it has provided a no objection. The procurement plan indicates the specific review arrangement for each contract. Contracts not subject to prior review by the Bank, will be post reviewed by the Bank's procurement specialist, assigned to the project. The specific procurement and review thresholds, applicable for the Project are defined in Annex 4**.**

E. SOCIAL (INCLUDING SAFEGUARDS)

72. **The social impacts of the proposed Project would primarily be positive.** The targeted beneficiaries of the project will be potential and existing entrepreneurs with new commercial ideas (early stage/new start-up enterprises) and existing SMEs that are on the verge of expansion. The project funds will be primarily invested in enterprises that are developing innovative products and processes information communication technology (ICT), life sciences, medical and health related fields, and biotechnology. Investment in these enterprises is expected to lead to job opportunities for local people, which eventually would help increase their income, diversify livelihoods, and contribute to poverty reduction.

73. **The project will not trigger OP 4.12 on Involuntary Resettlement.** No land acquisition, displacement of any third party (formally or informally occupying or using the land on which the sub-project will be implemented), or restriction of access to resources or income streams is expected under the proposed Project. As currently stated, the Project will not finance any new construction. Any sites presenting situations that would trigger OP 4.12, will be excluded from project consideration. Therefore, no potential beneficiaries can participate in the project if they would need land acquisition for the activities to be supported under this project. However, re-habilitation or reconstruction (which could involve demolition of no longer suitable structure and construction of a new one) of the existing buildings within the same footprint would be permissible. The EMF clearly states the above-referenced provisions.

74. **The Project Operations Manual to be adopted includes the negative list of activities for the project** (as described in the Environmental Management Framework) as well as the principles, criteria, procedures, and process of screening. The Project Operations Manual will also include a clause to ensure: i) both women and men have equal opportunities in access to financing; ii) the intended beneficiaries will not be over indebted; and iii) the labor health and safety issues concerned would be adequately addressed.

75. When it comes to gender dimension, Annex 8 provides a detailed analysis of the current state and trends of female entrepreneurship in Croatia. In summary, BEEPS 2013 data note that only 19% of firms have a woman as a top manager, and only 30% of companies have at least one woman among the owners of the firm. The firms characteristics observed are similar between women-managed and women-owned firms.[38] Lack of access to finance constitutes the most important obstacle to business operations for female managers as they tend to be in charge of small businesses, thus facing more challenges in accessing credit since bank requirements can be more difficult to meet by small firms. However, positive trends have been noted in the area of research and development (R&D) where female-run companies fare on a par or even better than male-run enterprises. [39][40]

76. **Project activities will benefit both male and female entrepreneurs through improved access to risk capital financing and capacity building activities.** The final version of the Project Operations Manual will include a clause to ensure that both women and men have equal opportunities in access to risk financing. In terms of promoting participation of women entrepreneurs, the project has target to achieve female participation of 10 percent in capacity building activities for potential investees. Results Framework has gender disaggregated data related to capacity building through training and advice provided activities.

77. **In addition, consultations have been held with potential investors, investees and key stakeholders.** In order to assess the financing gap and identify the main bottlenecks for the establishments of risk capital financing initiatives in Croatia, consultations have been held with potential investors in the Pilot VC Fund, such as pension funds, with existing innovative companies that have benefited from venture capital initiatives outside Croatia as well as with entrepreneurs that could potentially qualify to receive funding under the project. Also, key stakeholders were consulted, such as Croatian Business Angel Network (CRANE) and Croatian Private Equity and Venture Capital Association (CVCA). [41]

78. Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

[38] Of all companies managed by women, 83% are small firms and 14% are medium firms, whereas only 2.3% are large enterprises.

[39] Results indicate that a larger share of female-managed companies (51%) had introduced a new product or service in the previous 3 years, compared with firms with male managers (37%), suggesting that there may be a substantial amount of untapped potential for innovation among women entrepreneurs.

[40] While this Project has no control over the access to finance issue, it is expected that enhanced skills that this Project will provide to women entrepreneurs through training may help over time. The specific gender-indicators included in the M&E framework of this Project are related to capacity building activity. See Annex 1.

[41] Assuming that SME satisfaction is the best proxy for citizen engagement in the context of this project, the results framework includes the following specific indicator: "Number of SMEs/startups satisfied with quality of services provided under the Project". See Annex 1.

F. ENVIRONMENT (INCLUDING SAFEGUARDS)

79. **The Project triggers Environmental Assessment policy (OP/BP 4.01) and according to the policy is categorized as Environmental Category F.** The Environmental Management Framework (EMF) was prepared for the project prior to appraisal. The EMF defines environmental procedures and due diligence for the Pilot VC Fund (Component 1) and the Co-Investment Fund (Component 2). The Co-Investment Fund will be directly implemented by HAMAG-BICRO, while the VC Fund will be managed by the future Fund manager. The Project will not have any potential large, significant or irreversible impacts. Only environmental Category B and C sub-projects will be eligible, and investments with large scale impacts (Category A) are excluded, as described in the Environmental Management Framework (EMF) prepared for the Project. Environmental due diligence will be applied through the procedures defined in the EMF for the specific investments supported under Pilot VC Fund component and Co-Investment Fund component.

80. **The EMF looks into environmental impacts that could come from innovative companies to be supported under the Project and are expected to be predominately related to information communication technology (ICT), life sciences, medical and health related fields, and biotechnology.**[42] The EMF outlines the guiding principles of environmental screening, assessment, review, management, and monitoring procedures for the Pilot VC Fund component and the Co-Investment Fund. Depending on the impact, the following due diligence documents might be expected: EMPs and EMP checklists, for which criteria will be defined in EMF. Construction of any kind is not expected under the project; however the EMF will define procedure for such support if demand for high knowledge facilities occurs. The EMF also includes a list of the type of projects that will be excluded from support like Category A projects and those listed on IBRD non-eligible project list.

81. The environmental due diligence procedures identified in the EMF comply both with Croatian national and World Bank environmental safeguards procedures. According to the prepared EMF, the participants will be required to carry out the adequate type of environmental assessment set in the EMF of the proposed investments, to obtain environmental permits (if required) as prescribed by the national legislation and to comply with the World Bank Group safeguards policies. The participants will be guided by the trained environmental personnel in the HAMAG-BICRO. The draft Environmental Management Framework document along with an announcement of the public consultation meeting was disclosed in English and Croatian on the web-pages of the HAMAG-BICRO (http://www.hamagbicro.hr/poziv-na-javnu-raspravu/) on March 17, 2015. The hard copy of the document is also available at HAMAG-BICRO premises. The draft document, along with individual invitations was sent out to the key stakeholders in the Project. The Public Consultations presentation was held at the premises of the HAMAG-BICRO, on March 31, 2015. There were no attendees besides staff of HAMAG-BICRO on the presentation.

[42] Again no attempt will be made at establishing priorities in terms of sectors. However, based on the composition of SME sector in Croatia (heavily concentrated in services) and also on worldwide experience it is expected that firms operating in sectors such as life sciences, consumer and computer electronics, and ICT are going to be important beneficiaries.

Annex 1. Results Framework and Monitoring

Country: Croatia

Project Name: Croatia Innovation & Entrepreneurship VC (P152130)

Results Framework

Project Development Objectives

PDO Statement

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

These results are at	Project Level

Project Development Objective Indicators

		Cumulative Target Values									
Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	YR6	YR7	YR8	YR9	End Target
Total number of firms receiving risk capital financing from the Seed Co-investment Fund (Number)	0.00	1.00	2.00	5.00	8.00	11.00	15.00				15.00
Total number of firms receiving risk capital financing from the Venture Capital Fund (Number)	0.00	0.00	1.00	3.00	6.00	10.00	12.00				12.00

Number of firms receiving investment that successfully introduced a new product, process, service, or upgraded the quality of an ex isting product, process, or service (Number)	0.00	0.00	2.00	4.00	7.00	11.00	14.00				14.00
Training provided (to government staff, investors and potential investees) under the Project (Number)	0.00	40.00	73.00	100.00	113.00	127.00	133.00				133.00

Intermediate Results Indicators

		Cumulative Target Values									
Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	YR6	YR7	YR8	YR9	End Target
Total amount of risk capital financing provided from the Seed Co-Investment Fund and leveraged	0.00	0.27	0.82	1.64	2.74	4.11	5.48				5.48

from private investors (Amount(USD))											
Private sector investment leveraged by the Seed Co-Investment Fund (Amount(USD))	0.00	0.11	0.44	0.88	1.42	2.08	2.74				3.29
Co-investors in firms alongside the Seed Co-Investment Fund (Number)	0.00	1.00	1.00	2.00	4.00	6.00	8.00				8.00
Total amount of risk capital financing provided by the public sector through the Pilot VC Fund and by the private sector investing in the fund (Amount(USD))	0.00	0.00	1.64	6.03	11.51	18.08	21.92				21.92
Private sector investment leveraged into the Pilot VC Fund (Amount(USD))	0.00	0.00	0.66	2.41	4.60	7.23	8.77				8.77
Co-investors in the Pilot VC Fund	0.00	4.00	4.00	4.00	4.00	4.00	4.00				4.00

(Number)											
Training provided to investors under the Project (Number)	0.00	13.00	24.00	33.00	38.00	42.00	44.00				44.00
Training provided to potential investees (entepreneurs) (Number)	0.00	13.00	24.00	33.00	38.00	42.00	44.00				44.00
Training provided to government officials (Number)	0.00	13.00	24.00	33.00	38.00	42.00	44.00				44.00
Training provided to female investees (entrepreneurs) (Number)	0.00	1.00	2.00	3.00	4.00	4.00	4.00				4.00
Training provided to female government officials (Number)	0.00	1.00	2.00	3.00	4.00	4.00	4.00				4.00
Number of SMEs/startups satisfied with quality of services	0.00	8.00	15.00	20.00	23.00	25.00	27.00				27.00

provided under the Project (Number)											

Annex 1A. Results Framework and Monitoring (Detailed Description)

1. In order to assess the Project's performance in terms of design and implementation, a monitoring and evaluation (M&E) framework was developed. The framework closely follows the guidelines used for the assessment of similar international interventions such as those in Scotland[43] and Denmark[44], as well as similar World Bank operations such as a 2012 project in Lebanon.[45] In accordance with World Bank rules, the primary responsibility for tracking results belongs to the client, in this case, represented by HAMAG-BICRO. This institution will present an M&E report to the Borrower (through MOF and MOEC), and to the World Bank, on a semi-annual basis.

2. Results monitoring will be based on qualitative and quantitative information collected from the Project's beneficiaries and non-beneficiaries, investors, and Project managers. Firms that receive financing from the Seed Co-Investment Fund and the Pilot VC Fund will be obliged in their contracts with the Pilot VC Fund and the Co-investment Fund to provide performance data on a semi-annual basis.

3. While M&E is extensively used as a single term, it comprises essentially two distinct, but complementary, activities. Following Khandker et al (2010)[46], setting goals, indicators, and targets for programs is at the heart of a monitoring system, and the resulting information and data can be used to evaluate the performance of program interventions. In contrast, evaluation is a systematic and objective assessment of the results achieved by the program. In other words, evaluation seeks to prove that changes in targets are due only to the specific policies undertaken.

4. As already stressed, HAMAG-BICRO will be responsible for the overall M&E activities. However, for the sake of transparency, the formal execution of these activities will be conducted by different agents. HAMAG-BICRO will monitor the Project indicators while an independent third party will perform the Project evaluation. The following sections present the envisaged approach for each one of these activities under the proposed Project.

1A.1 Overall Program Monitoring

5. Targets for indicators are based on the following projections: the total size of the Pilot VC Fund of €20 million (€12 million provided the government and €8 million leveraged from private investors), investing in 12 companies. The Seed Co-Investment Fund is expected to invest €5 million (€2.5 million provided the government and €2.5 million leveraged from private investors), in 15 companies, for a total number of investments of 27 in the Project. The training indicators are based on expectations regarding the number of people who are expected to receive training and

[43] PACEC, 2012 "Scottish Enterprise Economic Impact of the of the Scottish Venture Fund" A report prepared by PACEC for Scottish Enterprise

[44] Murray, G and Cowling, M, 2014 "Evaluation of the Danish Growth Fund, Evaluation of activities, 2010–2012" DAMVAD

[45] International Bank for Reconstruction And Development, 2012 "Project Appraisal Document - Supporting Innovation in Small and Medium Enterprises Project" Document of The World Bank, Report No: 72377-LB.

[46] Handbook on Impact Evaluation: Quantitative Methods and Practices, S. Khandker, G. Koolwal and H. Samad, World Bank, 2010

participate in network activities as part of the program. This is based on an estimated training cost per person of € 3,000. The expectation is that training will be concentrated in the early years of the Project. Of those potential investees (entrepreneurs) and government officials receiving training it is expected that 10 percent will be women. It is also projected expected that the 40 percent of the funds invested by the Pilot VC Fund will come from the private sector.

1A.1.a Beneficiary Profile and Performance

1. In addition to the Results Framework that is designed to specifically target the objectives of the project, HAMAG-BICRO will also monitor and report on specific indicators of beneficiary profile and performance. This information will be provided by Beneficiaries on a semi-annual basis, according to the contract signed between HAMAG-BICRO and beneficiaries for the Co-Investment Fund, and between the Pilot VC Fund and the companies it invests in.

i. Beneficiary Profile Data

NAME of SME/startup	
Owner(s) of the SME	
Owner gender	
Sector in which SME operates	
Geographic Area of operation	
Number of full time employees?	
Number of part time employees?	
How much financing did the firm apply for?	
How much financing did the firm receive?	
Rate how the firm's application was received from 1 to 4 1 = application rejected 2 = application was rejected but had positive aspects, 3 = application was accepted but the committee had reservations about certain aspects, 4 = application was accepted with no (few) reservations	
Does SME produce and report Annual Financial statements?	
If yes, are they using IFRS?	
Has the firm applied for a patent since establishment?	

ii. Beneficiary Performance

	Unit of Measure	Baseline	Cumulative Values**					Frequency	Data Source
			YR1	YR2	YR3	YR4	YR5		
Revenues	€								
Operating Margin	%							Annual	Survey
Exports (if any)	€							Annual	Survey
Employees									
No. of full-time employees	Number							Annual	Survey

Of which % women	%							Annual	Survey
Of which % youth (age<25 yrs.)	%							Annual	Survey
No of administrative /support/secretaries staff	Number							Annual	Survey
Of which % women	%							Annual	Survey
Of which % youth (age<25 yrs.)	%							Annual	Survey
No. of managerial level employees	Number							Annual	Survey
Of which % women	%							Annual	Survey
Of which % youth (age<25 yrs.)	%							Annual	Survey
No. of professional /technical employees (excludes managers and administrative/ support/ staff)	Number							Annual	Survey
Of which % women	%							Annual	Survey
Of which % youth (age<25 yrs.)	%							Annual	Survey
No. of indirect jobs (outsourced, contractors and sub-contractors, suppliers or others in value chain (estimate)	Number							Annual	Survey
Financing									
Connected to the program									
Financing from the co-investment fund	**€**							Annual	Survey
Financing from co-investment fund partners	**€**							Annual	Survey
Financing from the pilot venture capital fund	**€**							Annual	Survey
Unconnected to the program									
Loans from banks	**€**							Annual	Survey
Financing from Angel investors	**€**							Annual	Survey
Financing from Venture Capital Funds	**€**							Annual	Survey
Financing from other sources of external financing	**€**							Annual	Survey
Total investment in beneficiary SMEs	**€**							Annual	Survey
Number of firms innovating (new process, product or upgrading quality)	Number							Annual	Survey

1A.2. Program Evaluation

2. There will be two overall evaluations (reports) of the program, one at the end of two years and another at the end of the program (6 years). These two reports will be funded under Technical Assistance component. These reports will evaluate the efficiency and effectiveness of the program's management and its design. It is important to highlight that the developed framework does not allow for the additionality and causality-impact of the program to be to empirically measured. Specifically, a formal impact evaluation exercise cannot be conducted because only a small number of firms are expected to benefit from the proposed Project. This means that it is unlikely that an evaluation will have sufficient statistical power to establish causality.

3. The specific methodology to be used for the Project's evaluation has not yet been decided. However, the use of survey instruments appears to be an appropriate choice for the purpose of this Project. Specific questions and the format of the questionnaire to be used need to be further discussed. As an example, the following boxes present typical questions normally used to conduct evaluations of innovation financing programs.

Box 1A.1. Beneficiaries and non-beneficiaries survey

Basic Information

1. Name of the beneficiary/non-beneficiary
2. Sector
3. Stage of development
4. Characteristics of the firms (quantitative indicators that appear in the matrix)

Topic I. Efficiency of the submission process

1. Is the submission of a proposal for funding an easy procedure?
2. Is the amount of information requested reasonable?
3. How many days does it take to fill the documentation?
4. What is the cost of preparing the documentation?

Topic II. Transparency of the selection process

1. Do you consider that the selection process is transparent, rigorous, and fair?
2. If your proposal was rejected. What were the reasons for funding being refused?
    a. Investment too risky
    b. Investor didn't deal with the sector
    c. Company not investment ready
    d. Investor didn't deal with the scale of the investment
    e. Anticipated rate of return too low
    f. Investor lack capacity to evaluate deal
3. Is the time between proposal submission and selection acceptable? Why?

Topic III. Effectiveness of the support

1. Financial support
    a. How much money you received from the fund? (please describe per round)
    b. Is the financial support enough for the activities you want to finance? Why?
2. Non-financial support
    a. Do you receive non-financial support (e.g. advisory services)?
    b. Which type of support?
    c. Is this type of non-financial support useful?
        i. What have you learned?
        ii. What capabilities have you developed as a consequence of the investment that you wouldn't otherwise know?

Topic IV. Efficiency of disbursement (only for beneficiaries)

1. Is the process to request the funds easy? (Yes/No)
2. Is the amount of information requested reasonable?

3. How many days does it take you to fill the forms?
4. What is the cost of filling the forms?
5. Is the time between the submission of the request and the disbursement of the money reasonable?
6. Did you stop any activity because the funds didn't arrive on time?

Topic V. Efficiency of project reporting (only beneficiaries)

1. Do you consider project reporting reasonable? (YES-NO, explain)
    a. amount of information
    b. quality of information
    c. frequency

Topic VII. Signs of additionality

1. What is the likelihood of raising capital in the absence of support?
    a. Very good
    b. Good
    c. Poor
    d. Don't know

2. Beneficiaries: What would be the consequences if you had not received the financial assistance? You can select more than one option

    - I would have gone ahead with my business in the same way as if I had the financial assistance
    - I would have gone ahead with my business in a reduced scope, for example, hiring few workers
    - I would have gone ahead with my business in a reduced scope, for example, investing less in machinery and technology
    - I would have gone ahead with my business in a reduced scope, for example, conducting less R&D and innovation
    - I would have gone ahead with my business in a reduced scope, for example, not entering into new markets
    - I would have gone ahead with my business but it would have taken more time to have access to the market
    - I would not have gone ahead with my business

3. Applicant non-beneficiaries: What were the consequences of not receiving the financial assistance? Select the correct option:

    - I went ahead with my business in the same way as if I had the financial assistance
    - I went ahead with my business in a reduced scope, for example, hiring few workers
    - I went ahead with my business in a reduced scope, for example, investing less in machinery and technology
    - I went ahead with my business in a reduced scope, for example, conducting less R&D and innovation
    - I went ahead with my business in a reduced scope, for example, not entering into new markets
    - I went ahead with my business but it took me more time to have access to the market
    - I didn't go ahead with my business

Topic VIII. Signaling effects: Access to other external sources of finance

1. Do you consider the program has eased access to equity capital or debt finance from other private investors in successive rounds?

Box 1A.2 – Investor's survey

Basic Information

5. Name

Topic I. Participation in the fund

5. What were the main reasons that encourage you to invest in the fund?
    a. Sharing risk
    b. Increasing investment size

c. High expected returns

Topic II. Fund management

1. What do you think about the overall management of the fund? [assign a number from the scale of 1 to 5 with 1 the lowest performance and 5 the best performance]

- **a.** Transparency
- **b.** Efficiency
- **c.** Effectiveness
- **d.** Coordination among investors
- **e.** Communication with investors

Topic II. Investment portfolio

4. Do you agree with the way the investment portfolio has been managed? [assign a number from the scale of 1 to 5 with 1 meaning “I don’t agree” and 5 “I totally agree”]
    - a. Size
    - b. Risk
    - c. Return
    - d. Diversification
    - e. Sectors
    - f. Stage of development of the investee

5. Would you change something about the investment strategy? [Please specify]

Topic III. IRR and exit strategy (this could be after a couple of years)

1. Are you satisfied with the average internal rate of return?
2. What do you think about the exit strategy?
    - a. Timing
    - b. Mode

Topic IV. Signs of additionality

1. What would be the consequences if the public sector would haven’t created the new financing facility?
    - **a.** I would have gone ahead investing in the same way as if I have the public sector as a co-investor
    - **b.** I would have gone ahead investing but in a reduced scope
    - **c.** I would have gone ahead investing but taking less risk
    - **d.** I would have gone ahead investing but looking for higher internal return rates
    - e. I would have not gone ahead investing

Box 1A.3. Program Manager’s Survey

Basic Information

1. Name

Topic I. Identifying investment opportunities

1. Does the fund proactively search/identify investment opportunities?

2. Is there a good pipeline? Why?

Topic II. Selection process of beneficiaries

1. What are the criteria that the fund takes into account to make an investment?
    - o Risks
    - o Expected returns
    - o Management team
    - o Other (please specify)

1. How long does it take to conduct the due diligence process for an investment?
2. How long does it take between a beneficiary requests the funding and he/she gets it?

Topic III. Financial support

1. How many deals does the fund make per year at each stage (e.g. creation, growth, transmission)?
2. What is the average size of each deal at each stage (e.g. creation, growth, transmission)?

3. Is the fund's performance in terms of deals and average size of the deals in line with (i) what was originally expected, (ii) similar private funds? (Yes/No, why?)

Topic VI. Duration of the investment (this is after a couple of years)

1. How long (on average) has the fund invested in each company at each stage?
2. Is this a long enough period to obtain the expected returns?
3. What is the IRR (on average) at each stage?
4. What kind of exit strategy does the fund usually prefer? Why?

Annex 2: Detailed Country and Sector Context

2.1 - Sectoral and Institutional Context

1. **Having been in recession for the past six years, export performance is critical for Croatia—a small country of some 4.3 million.** The channels through which export expansion enhances productivity and growth are well known: exports allow for specialization in a country's comparative advantage and thereby raise growth. Export expansion also includes dynamic efficiency gains in the more productive export sector engineered by higher competition, greater economies of scale, better capacity utilization, dissemination of knowledge and technological progress, and improved allocation of scarce resources throughout the economy. Moreover, increases in export revenue are linked to productivity gains that should lead to wage increases - when factors are paid their marginal product. Finally, increased export earnings relax current account pressures by improving the odds of importing the necessary intermediate and capital goods and attracting foreign investment, stimulating growth through capital accumulation (Medina-Smith 2001; Mahadevan 2007). [47]

2. **Croatia has displayed an uninspiring export performance since the onset of the global crisis.** The current account balance turned positive in 2012 (Figure 2 in the main text) and continued improving throughout 2013 to reach 0.9 percent of GDP[48]. However, this result was driven purely by a contraction in imports, which is in line with the diminished purchasing power and increasing poverty rates in the country. Meanwhile export competitiveness has been declining in Croatia as a result of negative pull and push factors. But while Croatia and its regional peers all suffered from unfavorable sector specialization and a strong market orientation towards the EU (pull factors), only Croatia showed a negative supply-side contribution (push factors) to growth in export market share.

3. Unfavorable domestic elements became the determining factor in the loss of export market share after the onset of the recession. These factors explain Croatia's low export diversification, loss of competitiveness, lack of sophistication, and limited expansion of new products and new markets.[49] Croatia faces notable challenges in increasing its competitiveness in sophisticated regional markets and in sustaining the growth of complex products (pull factors). It lost export relevance in the EU-15 market due to increased market saturation and severe export competition. Croatia must overcome its mediocre performance on export sophistication: despite promising instances in niche products and sectors, the overall complexity and sophistication of its goods and services export basket have shown only modest gains over the past decade. In fact, the country is trailing all its regional peers on these two metrics.

4. **Yet, there are also some promising signs of for the country's export competitiveness, as a fringe of small dynamic exporters is emerging in sophisticated niche products.** Croatia's

[47] Medina-Smith, E. 2001. "Is the Export-Led Growth Hypothesis Valid for Developing Countries? A Case Study of Costa Rica." Policy Issues in International Trade and Commodities Study Series No.7, United Nations Conference on Trade and Development, Geneva; Mahadevan, R. 2007. "The Poverty Transition: When, How and What Next?" *Journal of International Development* 19 (8): 1099–1113.

[48] IMF estimates indicate that Croatia's CAB reached 2.2% of GDP in 2014 (IMF WEO 2014)

[49] World Bank. *Croatia's Trade: Performance, Competitiveness and Potential* (background paper prepared for *Croatia Research and Innovation for Smart Specialization* Report, June 2014)

emerging niche product categories should not be made the focus of any strategy to "pick winners". They should instead be helped with horizontal policies that support entrepreneurship and market discovery. Establishing a culture of venture capital in the country is one key way to achieve this objective.

5. **To improve export performance, Croatia needs to shift more forcefully towards a productivity-based and innovation-driven growth model.[50]** As highlighted above, 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, as suggested by the World Bank 2009 EU Convergence Report for Croatia.

6. 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.[51]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**[52]**, 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 %of SMEs.[53]

[50] Expanding and diversifying exports is closely related with increasing productivity and fostering innovation. The fact that the more productive firms are more likely to export has now been confirmed in studies for a large number of countries by Wagner (2007). On the other hand, exporters tend to be more productive than non-exporters, as documented by Bernard and Jensen (1995, 1999, 2004a and 2004b). A robust, positive relationship between firm level innovation and productivity as well as some innovation inputs, such as R&D and productivity has been documented by Hall (2011) and Hall et al (2011), respectively. Product innovations such as the upgrading of the quality of existing goods or services allow companies to escape competition by differentiating their products as discussed by Cusolito (2009)50 and Bloom, et al. (2012). Product innovations, like the creation of new goods, also help firms diversify their portfolios, conquer new markets, and reduce the effects of external shocks (Klinger and Lederman, 200650)

[51] Based on Eurostat data for 2012 (Structural Business Statistics). According to Eurostat, SMEs are firms that employ between 1-249 persons. The figures cover firms in industry (mining and quarrying, manufacturing, electricity, water, and construction), distributive trades, and services.

[52] Knowledge intensive SMES (and startups) are understood to mean those SMEs (and startups) with a business model that emphasizes intellectual property as the main asset and include technology-based firms (e.g. IT firms), as well as firms that compete on the basis of product, process or service innovation. Innovation can be either incremental or radical, and either new to the Croatian market or new to the world.

[53] Figures based on Eurostat Structural Business Statistics, latest available data (2012).

7. **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.[54]** Overall, Croatia has shown 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. Croatia BERD has continually underperformed both the EU 28 average and Slovenia (Figure A2.1), a neighbor country at a comparable level of income. Lack of innovation within SMEs is a main explanatory factor of the disappointing aggregate features. The R&D intensity of small firms in Croatia is at 0.34 percent (16th place in the EU) and the one of medium-sized firms stands at an abysmal 0.16 percent (21st place in the EU) (see Figure A2.2).[55] In fact, business investment in R&D in Croatia is concentrated within a few multinational companies, which appear to also have a relatively high research intensity (1.98 percent).[56] SME business R&D is low despite generous tax breaks and a reasonable level of infrastructure. The country provided in 2008 a tax break of about 35 percent for US$ 1 of R&D, second only to France (42 percent)[57]. A study of R&D tax incentives[58] shows that around 77 percent of state aid for R&D came from tax incentives in 2009 (€14.6 million). But although small firms are the majority of beneficiaries of tax incentives for research and development, it is the large firms which receive most of the benefits. When it comes to infrastructure to support business R&D**,** estimates indicate that Croatia has 27 regional development agencies, 44 entrepreneurial centers, 23 business incubators (most attached to regional development agencies) and 8 technology parks, including those of the Technology Infrastructure Programme (TEHCRO).[59]

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[54] Strengthening policy governance in Croatia is also key for boosting research and innovation impact. The system is not fully functional as the technology and innovation policy is still fragmented leading to programs with overlapping objectives and non-rationalized resources. However, recent changes may improve matters when it comes to management of public resources. In 2013, a new model of dedicated institutional financing for science activity was introduced.

[55] World Bank (2014) report on Smart Specialization in Croatia: Inputs from Trade, Innovation, and Productivity Analysis drawing from the last Community Innovation Survey (2010)

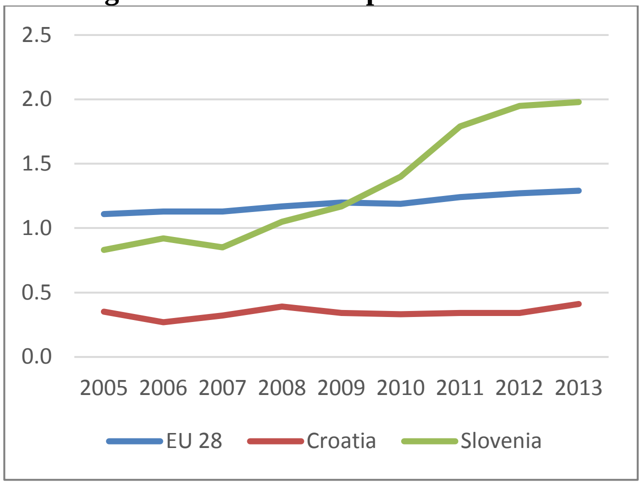
[56] Ibid.

[57] European Commission.2014. "ERAWATCH Country Reports 2013: Croatia"

[58] Švaljek, Sandra. 2012. "R&D Tax Incentives in Croatia: Beneficiaries and their Benefits." Paper presented at the Conference "Hidden Public Spending Present and Future of the Tax Expenses," pp. 117-130. Zagreb, Institut za Javne Financije.

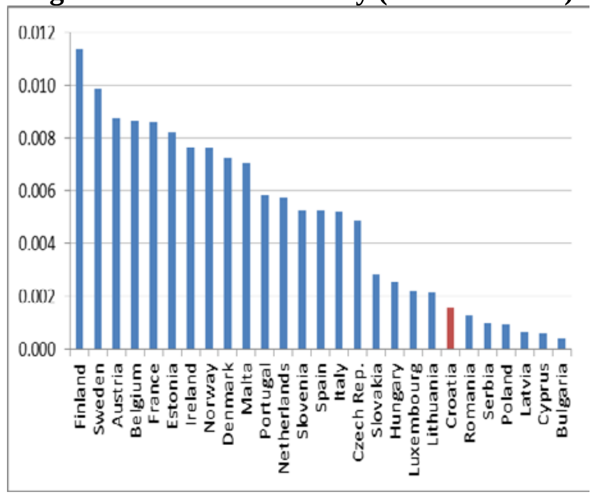
[59] WBC-INCO.NET, 2011, as cited in OECD (2014), OECD Reviews of Innovation Policy: Croatia 2013, OECD Publishing. http://dx.doi.org/10.1787/9789264204362-en

Figure A2.1: BERD as percent of GDP



Source: Eurostat

Figure A2.2: R&D intensity (medium firms)

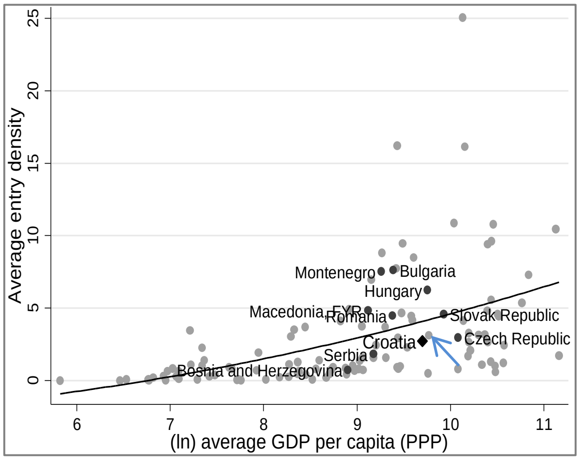


Source: Community Innovation Survey (2010)

8. **Entrepreneurship in Croatia also appears weak on other accounts.** Three pieces of evidence substantiate this assessment. First, Croatia generates few new firms compared to what would be predicted by its income level. Figure A2.3 below displays the relationship between the density in firm entry (measured by the average annual number of new limited liability firms registered per 1,000 working-age people during 2008–12) and the level of economic development (measured by the average per capita income for the same period) across 117 countries. As expected, firm entry is positively associated with GDP per capita, but Croatia's rate of entry density is substantially below what its income level would suggest. By contrast, regional peers – as Former Yugoslavian Republic of Macedonia (FYROM), Bulgaria, Romania, and Hungary –are located above the predicted line, displaying substantially higher entry rates. Lack of firm dynamism in Croatia is also evidenced by the fact that 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' (Figure A2.4).[60]

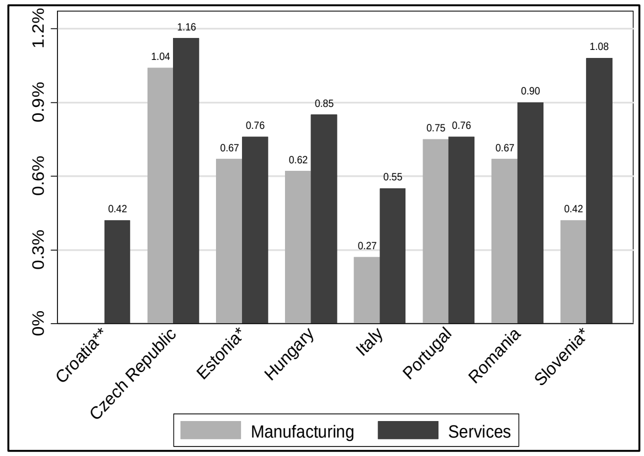
[60] These types of firms are of particular importance for two reasons. First, by their extraordinary growth these firms can make the largest contribution to net job creation, despite typically representing a small proportion of the business population. Recent studies have alerted policy makers to the importance of high-growth firms as job creators; for a survey, see Henrekson, M and Johansson, D.(2010) "*Gazelles as job creators: a survey and interpretation of the evidence*," Small Business Economics, Springer, vol. 35(2). Second, they are also recognized as an important source of innovation because their success often comes from innovation - such as product or process, or innovative approaches to marketing, distribution and organization, or from entering new markets.

Figure A2.3: Entry density and GDP per capita, 2008 – 2012



Source: authors elaboration based on data from World Development Indicators and World Bank Group Entrepreneurship Snapshots (WBGES)

Figure A2.4: High-growth firms rate (%) in 2010, measured by turnover growth



*Source: Iootty et al (2014)[61]. Note: rates are defined as the number of gazelles as a percentage of the population of enterprises with ten or more employees * For Estonia and Slovenia data is for 2009; ** for Croatia we did not identify any gazelles in 2010 (a sample of firms was used)*

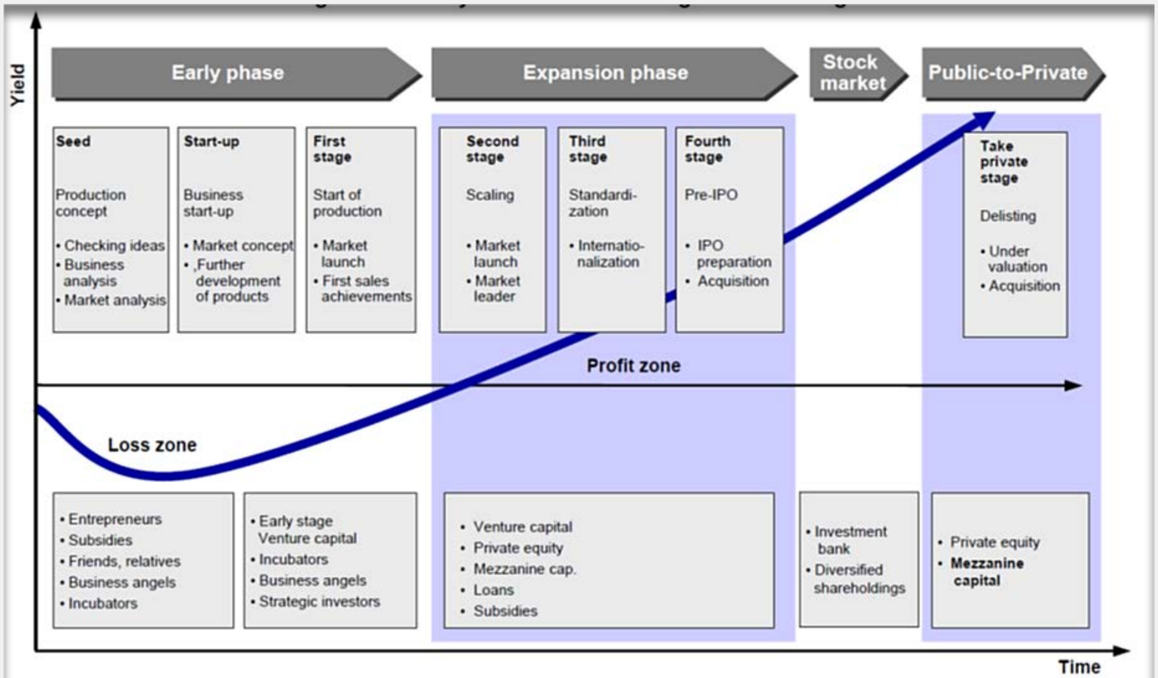
9. A weak business environment is one of the reasons behind the overall poor entrepreneurship performance illustrated above. This is particularly true when it comes to solving insolvency, enforcing contracts, protecting minority investors and getting credit. Although Croatia has been an active reformer in some administrative areas over the last decade, the country still under-performs on several measures related to the ease of doing business. Over the past decade, the country has managed to improve the regulatory environment in a number of key areas such as starting a business or paying taxes. Nevertheless, despite these improvements, Croatia still ranks low (65th place out of 189 countries) for the overall ease of Doing Business (DB) - 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 performers are resolving insolvency, protecting investors, or getting credit. Meanwhile, most EU peers, including Estonia, Latvia, Lithuania, and Slovenia tend to perform better than Croatia.

10. **Lack of risk capital financing is another important barrier to entrepreneurship, research, and innovation by Croatian SMEs.** 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". Figure A2.5 shows that 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 (see Box A2.1 for definition).

[61] Iootty, Mariana & Correa, Paulo & Radas, Sonja & Skrinjaric, Bruno, 2014. "Stylized facts on productivity growth : evidence from firm-level data in Croatia,"Policy Research Working Paper Series 6990, The World Bank.

Box A2.1: Life cycle of a firm and stages of financing

Different stages in a firm's development may require different types of financing instruments. As illustrated below, the initial phases of financing can be highly complex and can involve a mixture of financing methods.



Source: OECD (2013)[62]

The proposed intervention under this Project will focus on strengthening financing through the seed, start-up, and early expansion phases.

Factors indicating that a company is in the **seed stage** of development include that the initial concept of its business is being formed, prototypes or concepts of the company's products or services are being developed and the management team is beginning to form.

Factors indicating that a company is in the **start-up stage** of development include that the investment is necessary for product development, staffing, initial marketing and other start-up costs, or the company is setting itself up to sell its product or service commercially. The management team is substantially in place.

Factors indicating that a company is in the **early expansion stage** of development include that the relevant investment will provide necessary working capital to help launch the production and sale of the company's products or services. Typically, the company is not profitable and frequently will be cash flow negative. The early expansion stage can encompass an established business undertaking the commercialization of R&D activities, the size and scale of which results in the company being at a similar stage of development.

11. **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's implemented a number of programs (see Table A2.1) 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. Among these programs there are four (RAZUM, POC, IRCRO, and TEHCRO) that are particularly relevant for knowledge-intensive firms. The Proof of Concept

[62] OECD (2013d), "Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance", internal working document, Centre for Entrepreneurship, SMEs and Local Development, CFE/SME(2012)9/FINAL.

(POC) program supports entrepreneurs' pre-commercial activities and helps them develop new products, services and technological processes. The Development Program for Knowledge-Based Companies (RAZUM) provides support for the commercialization of R&D intensive products and services that are or may become internationally competitive. It financed a total of 24 projects (€15 million). The Research and Development Program (IRCRO), supports co-operation on R&D between SMEs and scientific and research institutions. The Technology Infrastructure Development Programme (TEHCRO), finances the development of Technology Incubators and Technology and Business Centers. It is reported that, by the end of 2010, 52 companies were residents of a TEHCRO incubator.[63] Some of these programs - precisely POC and RAZUM - were already evaluated (see World Bank 2012, for example), and evidence pointed to a positive impact on early-stage innovation.

Table A2.1: Support for commercial technologies and startups by HAMAG-BICRO (previously BICRO) (2007 – 2014)

Program	Projects supported	Contracted amount (million Euros)
POC	112	3,0
RAZUM	24	15,0
IRCRO	24	2,0
TEST	31	6,0
EUREKA	10	1,0
KONCRO	42	0,3
TEHRO	14	10,0
Total	257	37.3

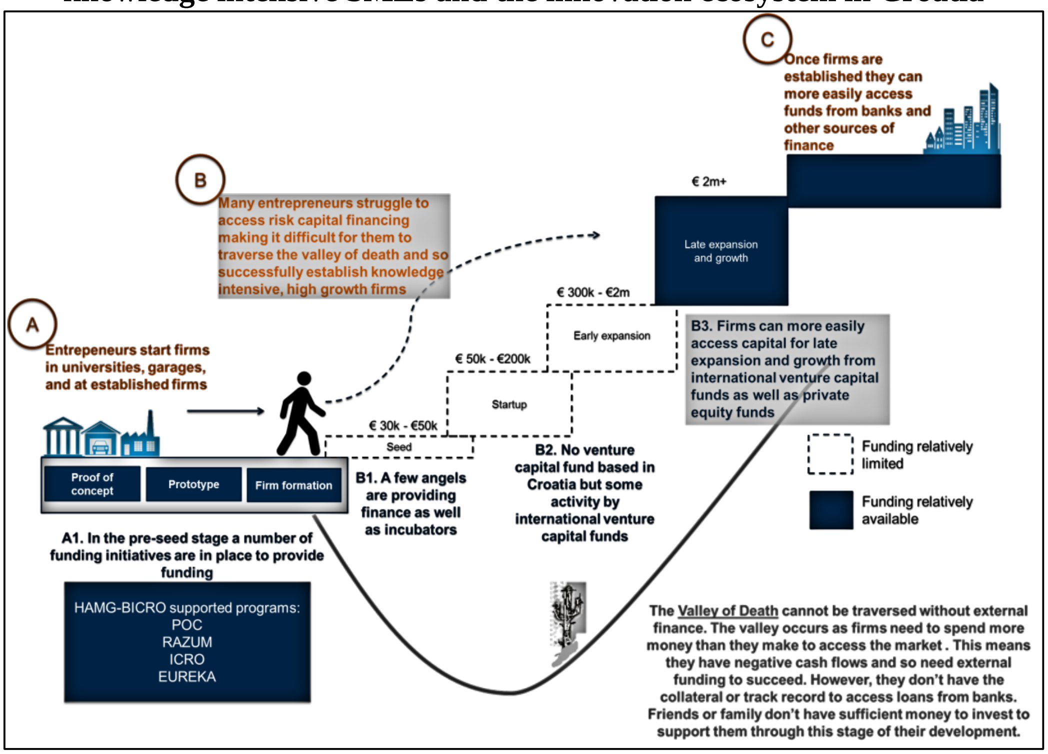
Source: Own elaboration based on data from Hamag-Bicro. Note that KONCRO and TEST are not currently active.

12. **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.** While there is capital in the country potentially available for investments, the technology driven start-ups have not been a beneficiary. 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. The Croatian government, as public investor, committed 1 billion kunas (approximately U$184 million or €139 million) to invest alongside private investors in private equity and venture capital funds and thus to push for a significant increase of the potential venture capital supply in Croatia. The initiative was designed according to a number of key parameters. The Government total funds (of 1 billion kunas) had to be complemented by private equity funds. The latter had to secure a minimum of €10 million from private investors and could apply to receive up to 50% additional funds from the state. Thus, the resulting Economic Cooperation Funds were endowed with investment amounts ranging from €20 million to €80 million, in which the Croatian Government participated as pari-passu investor, providing 50% of the total fund size. The Croatian fund managers could raise

[63] Erawatch "TEHCRO - Infrastructure for technology transfer "[http://erawatch.jrc.ec.europa.eu/erawatch/opencms/information/country_pages/hr]

money from private and institutional investors, domestic and/or international. The program contributed to a dramatic increase in overall capital committed for venture capital funding in Croatia. When the program was launched total capital committed was less than €100m, and it had been at this level for a number of years. In the year the program of Economic Cooperation Funds was launched capital committed increased to more than €300million,[64] 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.

Figure A2.5: Gaps in risk capital financing undermine the development of young knowledge intensive SMEs and the innovation ecosystem in Croatia



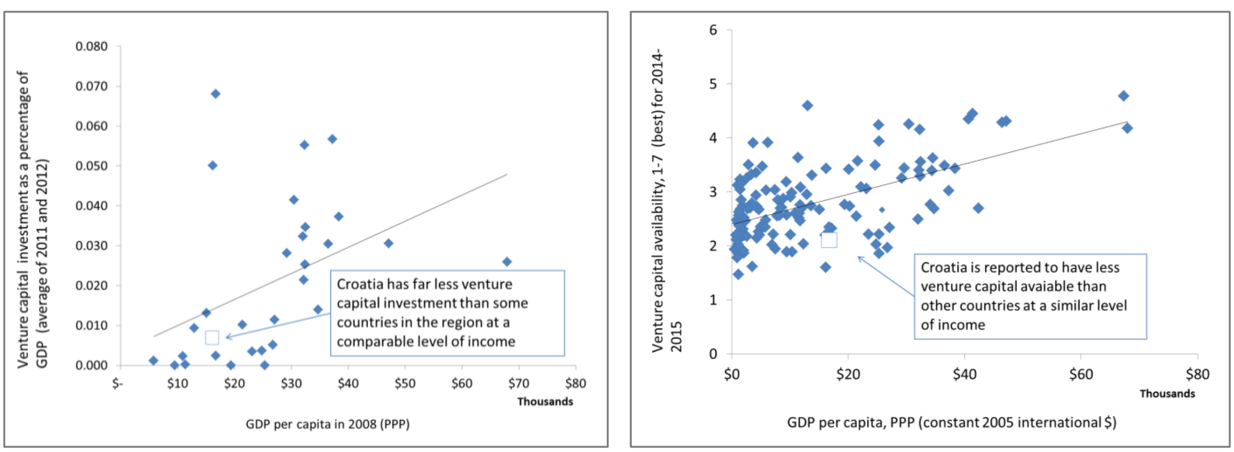
13. **After the pre-seed stage and before they are able to access growth or expansion capital, there is limited risk capital financing available for firms. The angel investor community is**

[64] Hrvoje Krstulovic and Marko Makek, 2013 "Investment Funds in Croatia, an overview to potential business partners and project intermediaries" http://www.ccbn.hr/repository/investment_forum_presentations/Croatian]

still at infant stage and the existing international venture capital funds with activities 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 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.

14. **Evidence suggests that the supply of risk capital - venture capital, in particular –should be greater in Croatia.** The supply of venture capital is below that of countries at a comparable level of income. This is shown in Figure A2.6. The left hand side panel shows that Croatia has less venture capital available as a percentage of GDP than a number of other countries in Europe at a comparable level of income. The right hand side panel presents results from the World Economic Forum's Global Competitiveness Report which shows that executives in Croatia report lower levels of venture capital availability than most other countries. Results from the Global Competitiveness Report rank Croatia at 114th in the world for the availability of venture capital.

Figure A2.6: Venture capital investment and availability in Croatia relative to GDP per capita



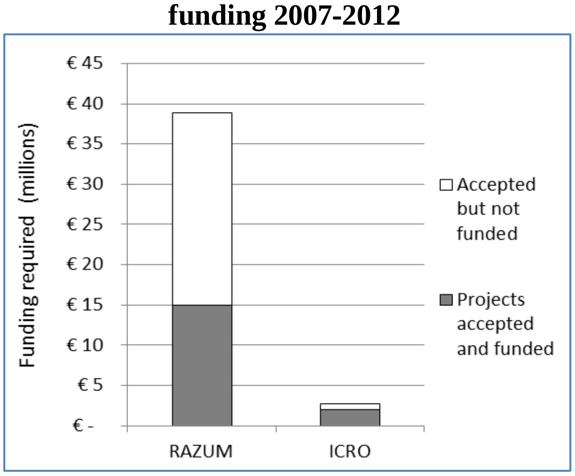
Source: Own elaboration based on data from World Development Indicators, the World Economic Forum Global Competitiveness Report 2014, the European Private Equity and Venture Capital Association (EVCA) and the Croatian Private Equity and Venture Capital Association (CVCA)

15. **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[65] shows that four

[65] Deloitte, 2014 "Technology Fast 50 Powerful connections" Technology, Media and Telecommunications Central Europe 2014

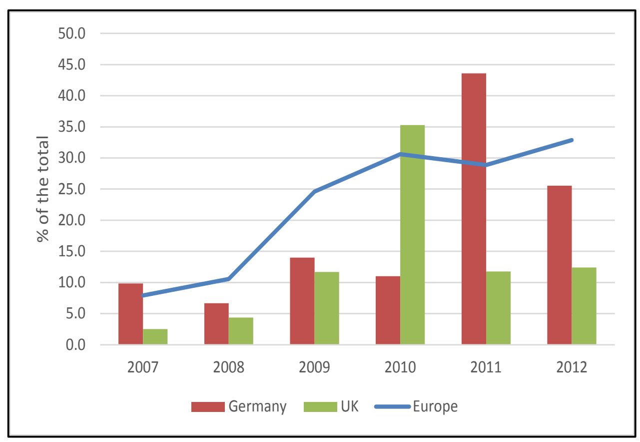
Croatian companies are listed among the 50 fastest growing technology companies in Central Europe. On average, these companies grew by more than 700 percent over the last year.[66] Another indication of the financing gap is that companies that have proven themselves successful internationally on knowledge-based products and services have mainly received supported from international sources of funding. Box A2.2 provides a list of noteworthy examples. 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. Figure A2.7 illustrates how much RAZUM spent and how much it could have spent if it had been able to provide funding to all eligible projects. Overall, HAMAG-BICRO considers 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.

Figure A2.7: Projects that were accepted by HAMAG-BICRO (RAZUM program) but could not be supported due to lack of funding 2007-2012



Source: Own elaboration based on data from HAMAG-BICRO

Figure A2.8: Venture funds provided by government agencies in Europe (2007-2012)



Source: Own elaboration based on data from European Private Equity & Venture Capital Association

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[66] Infinum, for example, is ranked 9th in Central Europe. It is a software design and development company specializing in the provision of mobile and web development services for banks, insurance companies, mobile phone companies and media publishers. Another Croatian company in the list, Nanobit, is a mobile games producer with 15 games played by more than five million active users.

Box A2.2: Examples of Croatian startups that have received early stage funding from international sources

Degoridan develops social media software products. It has developed ShoutEm, a software product that enables users to quickly and inexpensively launch their own social network. ShoutEm focuses on apps for iPhone, BlackBerry and Android. ShoutEm has offices in New York for business development and sales, and a core development team in Croatia. The company has received financing from a venture capital fund based in Slovenia.

Repsly, is a four-year-old Croatian 'software-as-a service' company focused on managing company representatives (reps). This includes reps doing sales, field marketing and merchandising. Companies use its software to analyze issues such as product performance and service delivery. Its customers include Nike Golf, L'Oreal and Kia. A large proportion of its customers are based in the United States. The company has received venture capital investment from VC funds based in the USA (Boston) and is relocating its marketing division and head office there.[67]

RiMac Cars produces high performance electric vehicles, drivetrain and battery systems. The company has developed the "world's first $1million [electric] supercar". It has developed and produced a number of new technologies and 24 patented innovations.[68] The company has received €6 million for the development of electric cars and bicycles from a Chinese investor.

Teddy The Guardian is a company that produces a teddy bear that looks like a normal plush teddy but is able to track the vital signs of a child including heart rate, oxygen saturation, body temperature, and stress level. This overcomes the problem of unreliability in the readings of children's vital signs because of children's tendency to react with higher stress levels to the use of unfamiliar medical sensors. The owners of the company have developed the product and have a large number of pre-orders. They were able to raise finance from angel investors in the United Kingdom (London) where they registered their company. They expect to raise additional finance internationally to scale up production.

Who API provides a service that enables companies to check information about domain names such as website addresses. The founders were previously operating a web hosting service called GEM Studio and identified the need for information about domain names. To fill this market gap, they decided to create the above mentioned service. The company was established in the founder's hometown of Rijeka, and the premises were established in the government supported Rijeka Science and Technology Park.[69] The company received US$40 thousand from Croatian business angel Mihovil Barancic, president of the Croatian business angel network, CRANE.[70] Subsequently WhoAPI received funding from US based 500 Startups.[71]

16. **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 (see Figure A2.8). 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

[67] David Harris, 2014 "Repsly relocates from Croatia to Boston, raises $1.25M for field activity software" Boston Business Journal June 16, 2014

[68] Johnson, Bailey, 2012 "World's first million-dollar electric supercar". CBS News September 4, 2012

Zuzana Fedorková, 2011 "WhoAPI raises angel round and tells us how they got there" [http://www.eastist.com/2011/12/whoapi-raises-angel-round-and-tells-us-how-they-got-there/]

[70] Natasha Starkell, 2011 "Finally news from WhoAPI: angel investment raised" [http://goaleurope.com/2011/12/12/croatia-innovation-startup-eastern-europe-finally-news-from-whoapi-angel-investment-raised/]

[71] BizSpark, 2012 "WhoAPI, A Croatian BizSpark Company Gets Investment from 500 Startups" http://blogs.technet.com/b/bizspark_group_blog/archive/2012/09/27/whoapi-a-croatian-bizspark-company-gets-investment-from-500-startups.aspx

appropriation risks[72]). 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[73] (see Hall and Lerner, 2009[74])

17. **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 (see Section 2.4 in this Annex), 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[75]. 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***.**[76] 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

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[72] Information asymmetry between the inventor and the potential investor about how promising an innovation project is. As a result there is a gap between the return of private innovation and the cost of capital, which is translated into a reduced willingness to finance new ideas/process. Appropriation risks are related to externalities that prevent inventors to capture all the returns of their invention. As a result the social return to innovation investment is higher than the private return and markets tend to invest less than is socially optimal.

[73] In principle, innovation activities are more difficult to finance than other types of investment for several reasons. The most important are: i) the fact that innovation produces an intangible asset that does not typically constitute accepted collateral to obtain external funding; and ii) the technological and market uncertainty of innovation activities makes the returns to investment highly uncertain, creating significant problems for the standard risk adjustment methods used by providers of funds.

[74] Hall, B and Lerner,J. (2009) "The Financing of R&D and Innovation, "NBER Working Papers 15325, National Bureau of Economic Research, Inc

[75] Croatia ranked 65th among 189 countries covered by the World Bank's Doing Business 2015 Report, which presents an improvement compared to the last year by two places on the ranking mostly due to the ease of dealing with construction permits and lower start-up costs. Croatia made the greatest improvement in the ease of dealing with construction permits by reducing the requirements and fees for building permits and carrying out the final building inspection more promptly. It made starting a business easier by reducing notary fees, and switched to an electronic customs system. In addition, progress has been made in the area of enforcing contracts and trading across borders. Croatia scored best in paying taxes (ranking 36th), enforcing contracts (ranking 54th), and resolving solvency (ranking 56th). The Croatian Government is continuously working on broad reform agenda and measures to further improve the business environment. As recommended by the European Council in the Country-Specific Recommendations, Croatia should take actions within 2014-2015 in the following business environment areas: (i) set a target for considerably lowering administrative requirements, including parafiscal charges; (ii) streamline administrative processes, and clarify the decision-making and accountability framework across various levels of government and at central government level between ministries and agencies; and (iii) improve administrative capacity and strategic planning of units entrusted with the management of European Structural and Investment Funds and provide them with adequate and stable staffing levels.

[76] Because innovation happens within a system where actors might have different incentives, there is always the risk that individual actors do not act in a coordinated way. Therefore, "..most (if not all) parts of the system need to be in place for it to function well, and missing parts may not emerge if some others are missing (World Bank (2014)).

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, 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 risk capital financing market.

18. **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.[77] 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.

19. **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.

[77] The venture capital facility is planned to be a 50-50 funding match with private investors

2.2 - Lessons Learned From Other Bank Projects Taken Into Consideration for Project Design

a) Focus of public sector support to venture capital funds should be on the early stage, to support start-ups and SMEs to grow to a point where they can access commercial equity finance;

b) Traditional lending and investment mentality of state agencies is very risk averse. Therefore, in order to achieve impact in kick-starting start-ups and innovation, it is important to integrate private sector assessments and to aim that the majority of funding comes from private investors thereby ensuring that proper due diligence is conducted;

c) Financial support through venture capital funds is particularly crucial for knowledge-intensive firms, such as those in the ICT sector, where the assets are mostly intellectual and collateral is scarce;

d) Grants for concept and business development are an important mechanism to create a deal flow for venture capital funds as well as a good early filtering mechanism to disqualify non-viable ideas;

e) Venture capital funds are part of a broader ecosystem, and thus for innovative enterprises to become successful it is critical to also tap into the ecosystem to enhance linkages between funding and R&D institutions, skills development, and mentoring.

2.3 - Lessons Learned From a Previous Initiative to Develop the Risk Capital Market in Croatia

20. The VENCRO program, a component of World Bank STP project, faced a number of challenges as described below. These areas are less problematic for the proposed Project or will be mitigated through the design of the program.

(a) Poor financial market conditions due in part to the onset of the financial crisis in 2008/09 contributed to the difficulty that fund managers found getting commitments from private investors. Mitigating factors for the current program: Market conditions have been improving although funds raised still remains below pre-crisis levels.

(b) A limited pipeline and low expected returns as there were concerns that the venture capital firm would not be able to profitably invest the money it raised. In part this was due to poor returns in the venture capital industry the EU in general, as well as to the underdevelopment of the Croatian venture capital market and to the relatively small number of startups that were in a position to receive venture capital financing. Mitigating factors for the current program: As a result of investments by the government in young, knowledge intensive firms, the supply of viable investments has increased in recent years. The supply of potential projects will be further increased by the co-investment fund which will support investors such as angel syndicates and through a scheme to provide an upside boost to private investors in the fund.

(c) Little known venture capital management firm. The venture capital firm employed by VENCRO was not well known to the market which made it difficult for it to raise funding. Mitigating factors for the current program: The private equity and early stage financing markets are still nascent but have developed substantially since 2008 both in Croatia and the region. There is, therefore, a greater pool of potential fund managers. Furthermore, the support for management fees, and the provision of an upside boost will make the venture capital fund more attractive for potential venture capital management firms.

2.4 - Legal and Regulatory Framework for Private Equity and Venture Capital Funds in Croatia

21. Since the 2007-08 global financial crisis there has been a trend in increasing oversight of previously unregulated entities such as private equity funds, hedge funds etc. At the G20's November 2008 summit, the decision was taken to require all significant financial market participants to be regulated to preserve financial stability and to ensure investors are protected.

22. In line with this decision, the Alternative Investment Fund Managers Directive (AIFMD) or Directive 2011/61/EU[78] was adopted by the EU to regulate and supervise alternative investment fund managers (AIFMs) who manage alternative investment funds (AIFs), including private equity (PE) funds, VC funds, hedge funds etc. operating in the EU. The scope of the AIFMD is applicable not only to 1) EU AIFMs which manage EU AIFs but also to 2) EU AIFMs which manage non-EU AIFs; 3) non-EU AIFMs which manage EU AIFs and; 4) non-EU AIFMs which market EU AIFs or non-EU AIFs in the EU. The Directive defines AIFM as a legal person whose regular business is managing one or more AIFs. Apart from managing AIFs, the Directive lays down additional permitted AIFM activities; managing of UCITS, portfolio management, investment advice, safe-keeping and administration in relation to shares or units of collective investment undertakings and reception and transmission of orders in relation to financial instruments. The Directive sets rules for authorizing AIFMs, and for the ongoing operation and transparency of AIFMs that manage or market AIFs in EU. While the focus of the Directive is on regulating the fund manager rather than the fund, the Directive indirectly impacts fund operations by setting guidelines on leverage limits, fund risk profiles, portfolio liquidity etc. In return for compliance with the Directive, the AIFM gains a "passport" to manage and market AIF across the EU. The Directive came into force in July 2011 and EU member states were required to transpose the directive into national legislation by July 2013. In addition, in 2012 the EU issued regulations related to AIFMs which are considered binding and applicable to all Member States, and does not require transposition.

Transposition of EU Directive on Alternative Investment Fund Managers to Croatian national legislation

23. Prior to joining the EU, the Croatian legal and regulatory framework for investment funds was overseen by the Croatian Investment Funds Act of 2005, which governed both publicly offered

[78] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

funds and funds offered to qualified investors. The first private equity (PE) fund was formed in 2006; followed by PE funds formed in 2010 under the government-sponsored FGS scheme.

24. Croatia transposed the EU's AIFM Directive into national legislation in January 2013 when the Alternative Investment Funds Act (NN 16/2013; the Act) was adopted by the Croatian Parliament, prior to Croatia joining the EU in July of the same year. This primary legislation laid the conditions for establishing and operating alternative investment funds and alternative investment fund managers, including marketing and distribution of such funds, the delegation of duties to third parties and supervising and managing AIFMs, AIFs and depositaries and those marketing AIFs. All existing alternative investment fund managers in Croatia were required to submit to the HANFA application for authorization of the AIFM and the AIFs it manages in accordance with the provisions of the Act within a period of 12 months from the day of entry into force of the Act (i.e. by 1st of July 2014). Following the receipt of the complete application, HANFA had a period of 6 months to adopt a decision on the applications, which is to verify AIFMs compliance with the Act.

25. The previous Croatian Investment Fund law of 2005 has therefore been replaced with two separate legislation sets, one on mutual funds-UCITS (Act on Open-Ended Investment Funds with Public Offering of 2013and other regulating alternative investment funds (Alternative Investment Funds Act of 2013). Both of these Laws were adopted on 25th of January 2013 and entered into force on the day of the accession of Croatia to the EU (i.e. 1st of July 2013). Other laws applicable to investment funds include the Capital Markets Act, the Companies Act, and the Law for the Prevention of Money Laundering.

Special guidelines related to smaller fund managers, VC funds, Social Entrepreneurship Funds

26. The EU AIFM Directive provides for less stringent requirements for three types of AIF fund managers. In the first case, if the fund managed is <u>below €500 million (unleveraged); or below € 100 million (leveraged)</u>, the regulatory requirements are less stringent; however, following the less stringent requirements does not give the manager a passport for EU-wide management or marketing (although the AIFM can opt-in if they want.). The EU also issued a 2013 regulation (EU Regulation 345/2013) [79] on VC funds, which is part of a special proposal for managers of European Venture Capital Funds, complementing the AIFMD. Again, this is a regulatory initiative which is less onerous than AIFMD and seeks to improve access to finance for SMEs. These regulations provides a marketing passport for VC firms in return for compliance with rules on investment portfolio, investment techniques, eligible undertakings etc. and applies to managers of AIFs with Assets Under Management (AUM) below € 500million, unleveraged, closed-end AIFs[80] where at least 70% of capital commitments have to support young and innovative companies. EU VC fund managers are not required to follow this special regulation (in which case they would instead follow AIFM directive). The third case where the EU Directive provides less stringent requirement is for Social Entrepreneurship Funds with AUM below euro 500mn. This vehicle can be marketed across EU, but it is not compulsory to be set up under these regulations.

[79] REGULATION (EU) No 345/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 April 2013 on European venture capital funds

[80] Applies on a fund by fund basis

27. Since assets under management of each AIFM in the Croatian market fall below the €500 million unleveraged/ €100mn leveraged threshold, in order to ensure appropriate investor protection and prudent regulatory framework for Croatian market, the Croatian 2013 AIF Law did not provide less stringent provisions for managers of smaller funds. However, during the application of the 2013 AIF Law that entered into force on 1st of July 2013 practice has shown that less stringent provisions for sub-threshold AIFMs should be prescribed, in order to facilitate market development through removal of disproportionate requirements. Consequently, Croatian Ministry of Finance has worked closely with HANFA on this matter, and Croatian government has recently adopted amendments of the 2013 AIF Law, which include, among others, provisions that provide exemptions for small AIFMs (AUM below the €500 million unleveraged/ €100 million leveraged threshold) offered to professional investors. Act amending the 2013 AIF Law entered into force on 11th of December 2014.

28. Specifically, mentioned provisions (Article 5.b of the Act) provide relief for sub-threshold AIFMs in terms of application of:

a) *Article 15. paragraph 2. of the Act*; small AIFM can perform activities other than those stipulated in Article 13. of the Act, for which AIFM does not need to obtain Agency approval,
b) *Article 36. paragraph 1. point 8. of the Act*; member of the board of the small AIFM is allowed to carry the same function in any other company,
c) *Article 57. of the Act*; small AIFM is not obliged to adopt and implement remuneration policies,
d) *Article 65. paragraph 1. of the Act*; small AIFM may delegate the functions for which it is responsible to third parties without prior notification of the Agency,
e) *Articles 68. to 76. of the Act*; change in members possessing qualifying holdings in the AIFM,
f) *Article 77. paragraph 2. of the Act*; small AIFM can transfer AIF management activities to another AIFM without obtaining the approval from the Agency,
g) *Articles 91. to 95. of the Act*; obligations for AIFMs managing AIFs which acquire control of non-listed companies or issuers.

29. Furthermore, small AIFMs are excluded from the application of the *article 110. paragraphs 2. to 7.* of the Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

30. Small AIFMs are required clearly and unambiguously to indicate in all materials intended for investors that their activity is not fully in compliance with the provisions of the Act and regulations adopted pursuant to the Act, as well as the risks arising there from.

31. According to the article 5. paragraphs 2. to 5. of the Act, small AIFM has to obtain an authorization from the Agency. The provisions of the Act regulating the authorization of the full-scope AIFMs apply accordingly to the authorization of the small AIFMs. Accordingly, HANFA shall decide on the application for authorization to take up the business within 3 months of the date of receipt of a complete application. As part of the request for the authorization, small AIFMs shall:

i. identify themselves and the AIFs that they manage,
ii. provide information on the investment strategies of the AIFs that they manage,
iii. submit the statement that units or shares of AIFs that they manage shall not be offered to retail investors.

32. The Agency has adopted an ordinance (NN 26/2015) and published this in the official Gazette, specifying the content of the application for granting the authorization for small AIFMs and additional documentation to be submitted with the request.

33. The cost for regulatory compliance consists of the authorization fee for establishing an AIF in Croatia which amounts 20,000.00 kuna (appoximately €3,000). There is also annual supervisory fee that amounts 0,3‰ of the total asset of the particular AIF.

Croatian investment funds regulator

34. HANFA as the regulator for Investment Funds has to authorize both an AIF manager set up in Croatia as well as AIF established in Croatia. Currently no venture capital funds exist in the Croatian ecosystem, although about 7 PE funds operate here.[81] AIFMs may be formed in Croatia as a joint stock company, a limited liability company (LLC) or Societas Europaea (SE). Closed ended AIFs can be formed in Croatia as a joint stock company or an LLC. The fund proposed under this Project will be established as an LLC. Current PE funds operating in Croatia are registered as open-ended AIFs with private offering and their AIFMs are all registered in Croatia as limited liability companies.

Legal/regulatory framework applicable for proposed project applies specifically to Pilot VC Fund (Component 1)

35. For the proposed project, the AIF legal and regulatory framework applies only to the Pilot VC Fund component. The €2.5 million Seed Co-Investment Fund will not be formed as a fund vehicle or be managed by an AIFM, but rather by the PIU, HAMAG-BICRO, and will therefore not fall under the AIF regulatory framework.

36. The ideal fund manager for the Pilot VC Fund is one that can attract a blended global-local team. The fund manager also needs to be able to fund raise from both international and domestic institutional investors.

Eligible investors

37. When it comes to investors who are eligible to invest in such AIFs, it is important to distinguish two possible scenarios:

a) sub-threshold AIFM established in accordance with Croatian AIF Law -> units of AIFs can be offered <u>only to professional investors which are defined within Croatian Capital Market Act</u>. In order for these AIFs to be available to qualified investors and/or to retail

[81] There are about 5 PE management companies (e.g. Nexus, Quaestus) registered and based in Croatia managing 7 PE funds. These include funds formed through FGS, a government sponsored PE scheme (where the government was 50% shareholder), which established 3 new private equity management companies.

investors, and to market units across the EU, a sub-threshold AIFM has to opt-in with the AIFMD (as a full scope AIFM).

b) EuVECA manager**,** or a manager that is established as EuVECA (in accordance with EuVECA regulation as of 17th of April 2013, National Gazette No 345/2013) may market units of venture capital fund in accordance with Article 6. of EuVECA regulation (i.e. not only to professional investors but also to the investors that: (a) commit to investing a minimum of EUR 100 000; and (b) state in writing, to be concluded for the commitment to invest, that they are aware of the risks associated with the envisaged investment). In this way, EuVECA regulation allows sub-threshold managers to market venture capital funds across EU and to offer units of such funds to broader spectrum of investors (that would otherwise have to opt-in with the AIFMD in order to be allowed to do that).

Excerpt from AIF Law on AIFM activities

38. Article 13. of the AIF Law defines permitted full-scope AIFM activities as follows:

a) establishment and management of an alternative investment funds (AIF management),
b) establishment and management of UCITS subject to obtaining authorization in accordance with the UCITS Law (UCITS management),
c) portfolio management in accordance with the provisions of the Capital Market Act (portfolio management)
d) investment advice concerning financial instruments specified in the Capital Market Act (investment advice),
e) safe-keeping and administration in relation to units in the investment fund (safe-keeping and administration).

39. Sub-threshold AIFM must obtain HANFAs approval as a full scope AIFM in order to perform activities from b) to e) above.

40. Given this flexibility, three options are considered (in all cases, the fund would be closed-ended and registered in Croatia as an LLC):

- If an existing local AIF manager is selected for the tender, they would already be authorized and supervised by HANFA.
- If an international fund manager is selected for the tender, in order to operate in Croatia, they would need to hold an EU AIFM passport. The fund would need to be registered in Croatia and the AIFM would have to notify HANFA of its intent to operate in Croatia.
- If a local consortium team that is yet to form a management company wins the tender, they would need to set up a management company in line with the AIF Law and regulations, and be authorized and supervised by HANFA.

2.5 - State Aid Considerations

41. One of the explicit objectives of the Project is to prepare the Croatian government to receive EU funding for venture capital. The design of the Project must thus be compatible with EU guidelines on state aid. State aid general principle is that private sector financing must co-finance

investments, but that public sector financing must be capped. This is expressed in the General Block Exemption Regulation (GBER), Rule 651, specifically Article 21 on Risk Finance Aid. The MOF should give positive opinion on the design of the Project – including the ratio of private to public financing in each of the components; target investments; size of financing, and instruments used.

42. Commission Regulation (EU) No 651/2014 of 17 June 2014 (General Block Exemption Regulation) declares certain categories of aid compatible with the EU internal market. The Article 21 – Risk Finance Aid and Article 22 – Aid for start-ups were the most relevant took into consideration when designing the Project.

43. The eligible final recipients for both Pilot VC Fund and Seed Co-Investment Fund shall be SMEs defined as per annex 1 to Commission Regulation (EU) No 651/2014. Moreover, eligible undertakings shall comply with requirements established under article 21 (for the Pilot VC Fund) or article 22 (for the Seed Co-Investment Fund) of Commission Regulation (EU) No. 651/2014 (on a deal by deal basis).

44. Undertakings in difficulty as per article 2 Regulation (EU) No 651/2014 are excluded. Other cases of exclusion will apply as listed under articles 1 and 13 of the same Regulation[82]. The following activities shall not be financed:

i. Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, such as pharmaceuticals, pesticides/herbicides, ozone depleting substances, PCBs, wildlife or products regulated under CITES.
ii. Production or trade in weapons and munitions.
iii. Production or trade in alcoholic beverages (excluding beer and wine).
iv. Production or trade in tobacco.
v. Gambling, casinos and equivalent enterprises.
vi. Production or trade in radioactive materials. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.
vii. Production or trade in unbounded asbestos fibers. This does not apply to purchase and use of bonded asbestos cement sheeting where the asbestos content is less than 20%.
viii. Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.

45. Eligible final recipients will be legal persons registered in Croatia and will have the locus of their activities in Croatia at the date of the signature of the investment. However, as companies develop, their locus may shift outside the country. Eligible final recipients can be owned by foreigners.

46. In addition, an eligible investee firm shall meet the financial requirements, as defined by Croatian Government, including: has no outstanding liabilities to the state; their individual owners and linked persons by means of ownership and control have settled liabilities to the state; is not in the process of pre-bankruptcy settlement, bankruptcy or liquidation; their individual owners are

[82] In case of blending of WB funds with EU funds, the other cases of exclusion listed in the Regulation (EU) No 1301/2013 art. 3, shall be considered.

not in the process of pre-bankruptcy settlement, bankruptcy or liquidation; and, its direct transfer account has not been continuously blocked for more than 30 days in the last 6 months. The eligibility criteria shall be met by each final recipient at the date of the signature of the investment.

Component 1: Pilot Venture Capital Fund

Aid to investors

47. The Guidelines on State aid to promote risk finance investment (2014/C 19/04) provides for the following: items 31-32: the investment should be effected pari passu between public and private investors. However, according to the above quoted guidelines items 80-81, certain exceptions are possible if justified by demonstrated market failure (as it is the case with the ex-ante assessment of financial instruments carried out by an independent expert contracted by the Government of Croatia, 3rd draft, January 2015).

48. A key requirement for the compatibility of non pari-passu investment between public and private investors is that the selected financial intermediaries are managed on a commercial basis, in compliance with Regulation (EU) No 651/2014, article 21.15 which specifies the conditions to be fulfilled to satisfy this requirement.

49. In this respect, it is recommended that the stipulations of Regulation (EU) No 651/2014 art. 21.15 (e) about Governance are included within the description of the scheme (see also section Aid to Fund Manager, below).

50. Item 33 of the Guidelines on state aid to promote risk finance investment (2014/C 19/04): the investments by public and private investors must be done simultaneously.

51. Items 107-108-109 of the Guidelines on state aid to promote risk finance investment (2014/C 19/04): asymmetric distribution of returns to the private sector can be compatible with the internal market. However, according to item 110, non pari-passu loss-sharing features eventually borne by the public investor shall be capped.

52. Overall, the envisaged non pari-passu investment between public and private investors (40% private sector 60% public sector), can be considered compatible with the Regulation (EU) No 651/2014 provided that all conditions under Regulation (EU) No 651/2014 are fulfilled, specifically conditions under article 21.15 are fulfilled by the selected financial intermediary (or financial intermediaries) and, in case the final recipient is eligible according to article 21, the percentages of additional finance leverage from independent private investors comply with Regulation (EU) No 651/2014 article 21.10 (and 21.11 whenever applicable) at all times.

53. If follow-on investment is made in SMEs already intervened by the Fund after the 7-year period mentioned in Regulation 651/2014, paragraph 5(b) [7 years following SME first commercial sale], leverage finance from independent private investors must reach 60% of the total risk finance per investment provided to the eligible undertaking.

54. Under article 22 (of the Regulation (EU) No 651/2014) no minimum leverage from independent private investors is required.

Aid to Fund Manager (financial intermediary and/or its manager)

55. Based on Regulation (EU) No 651/2014 article 21.14, the scheme shall also specify that investments within an eligible SMEs have to be profit-driven meaning that the following conditions will be fulfilled:

i. The financial intermediary is established according to the applicable laws;
ii. The entity entrusted with implementation of the measure (HAMAG-BICRO) shall provide for a due diligence process in order to ensure a commercially sound investment strategy for the purpose of implementing the risk finance measure, including an appropriate diversification policy aimed at achieving commercial viability and efficient scale in terms of size and territorial scope of the relevant portfolio investment[83];
iii. Risk finance provided to the eligible undertakings shall be based on a viable business plan, containing details of product, sales and profitability development, establishing ex-ante financial viability;
iv. A clear and realistic exit strategy shall exist for each equity (and quasi-equity) investment.

56. Based on Regulation (EU) No 651/2014 article 21.15, financial intermediary shall be managed on a commercial basis. This requirement is considered to be fulfilled where the financial intermediary and fund manager fulfil the following conditions:

v. (a) They shall be obliged by law or contract to act with the diligence of a professional manager in good faith and avoiding conflicts of interest[84]; best practices and regulatory supervision shall apply;
vi. (b) Their remuneration shall conform to market practices. This requirement is presumed to be met where the manager or the financial intermediary is selected through an open, transparent and non-discriminatory selection call under the public procurement applicable legislation, based on objective criteria linked to experience, expertise and operational and financial capacity;
vii. (c) They shall receive a remuneration liked to performance, or shall share part of the investment risks by co-investing own resources so as to ensure that their interests are permanently aligned with the interests of the public investor;
viii. (d) They shall set out an investment strategy, criteria and the proposed timing of investments;
ix. (e) Investors shall be allowed to be represented in the governance bodies of the investment fund, such as the supervisory board or the advisory committee.

57. No discrimination between financial intermediaries will be made on the basis of their place of establishment or incorporation in any Member State (as per Regulation (EU) No 651/2014 article 21.12.

[83] However, the entity entrusted with implementation of the measure (HAMAG-BICRO) shall not be involved in any individual investment/divestment decision taken.
[84] Their governance structure will allow for decisions concerning investments, divestments and risk diversification to be made transparently and independently, in line with relevant market practice. The financial intermediary will be economically and legally independent from the investors and the body entrusted with implementation of the measure.

58. The remuneration of the financial intermediary shall reflect the current market remuneration in comparable situations, which is the case when the financial intermediary has been selected through a competitive tender and no other advantages are granted by the state. It shall include a base remuneration and a performance-based remuneration[85].Since under other EU Regulations in force until year 2020 the European Commission has capped the aggregate amount of management costs and fees in case of financial instruments providing equity at 20% of the total amount of public contributions paid to the financial instruments, this threshold can be considered as the current market remuneration (based on experience in the EU until 2013) for a financial instrument providing equity over the eligibility period of an Operational Programme. However, the above mentioned threshold could exceed 20% in case its amount is determined on the basis of competitive tendering.

Component 2: Seed Co-Investment Fund

Aid to investor

59. Under article 22, additional leverage from independent private investors is not a requirement.

Component 3. Technical Assistance

Training for entrepreneurs

60. Training for entrepreneurs (potential investees) shall be subject to State aid rules (most likely under de minimis Regulation, with public funds covering 100% training costs).

[85] The thresholds for annual base remuneration and performance-based remuneration of bodies implementing financial instruments, for financial instruments providing equity, are established by Commission Delegated Regulation (EU) No 480/2014, article 13.2(a)(i) for the base remuneration and article 13.2(b)(i) for the performance-based remuneration.

Annex 3: Detailed Project Description

1. The Government of Croatia under this proposed Project will establish and finance a program aimed at foster innovation, entrepreneurship, and private sector growth by stregthening the risk capital financing for innovative SMEs (including start-ups).

2. The project has a tenure of six years and will have three components: a) a Pilot Venture Capital Fund b) a Seed Co-Investment Fund; and c) Technical Assistance. The Project will be financed 100% through a World Bank loan to the Government of Croatia.

3. The following factors contributed to the design of the overall Project and its components

(a) The project is structured to be implemented in a phased and flexible approach. The project will start with the provision of Technical Assistance and the establishment of the Seed Co-Investment Fund. This sequence of actions will lay the foundations needed for the development of the Pilot Venture Capital Fund. This Fund will be developed so that its size reflects demand for venture capital in the economy. This will be done by raising private investments for the fund in stages. The phased and flexible approach that is being proposed allows for learning and adaptation throughout project implementation.

(b) Loan disbursements will take place in line with the government's need for the funding. The initial disbursement will include financing to establish the Seed Co-Investment Fund and the Technical Assistance. The resources for the Pilot Venture Capital Fund will be disbursed as this Fund is established and starts operating.

(c) The project also takes into consideration the need to reallocate financing between components in case either the Seed Co-Investment Fund and the Pilot Venture Capital Fund cannot be set up or deploy capital.

(d) In addition, since Croatia is an EU member state, Project components are compliant with EU state aid regulations.

4. Each component is described as follows:

3.1. - Component 1: Pilot Venture Capital Fund (€ 15.6 million)

5. This component will finance public contribution towards establishing a Pilot Venture Capital Fund ("Pilot VC Fund").

6. The objective of this component is to take the first steps towards establishing a venture capital industry in Croatia. It will provide a demonstration effect of the commercial viability of early stage financing for innovative SMEs, helping to attract other venture capital companies and creating a critical mass of early stage investments and market agents.

7. *Key structural features.*

8. The Pilot VC Fund will be registered in Croatia as a closed end fund established as a limited liability company (LLC) in accordance with the Croatian Alternative Investment Fund Act. The

Fund will be supervised by HANFA. It will be a 10-year euro-denominated fund, with an option for a two year extension. The Fund will consist of both public and private financing, in a ratio consistent with EU state aid regulation. It will be established with the purpose of providing financing, in the form of equity or quasi equity instruments, 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. The Fund Manager may choose to obtain registration as an EuVECA manager for the Fund, in accordance with the EuVECA Regulation.[86] To ensure the commercial viability of the fund, and its uptake by private investors, the Government of Croatia will provide financial contribution towards the Fund's structure (up to €3.5 million of the loan will be used to cover management fees – in effect, lowering the cost to private investors from management fees -- to ensure the viability of the fund structure). This means the net amount available for investment under the VC Fund is €12 million.

9. Eligible investees. An eligible investee company to receive finance by the Pilot VC Fund is the one that, on the date of the signature of the initial investment:

(a) is classified as an "SME" or small and medium-sized enterprise – as defined in Annex I to Commission Regulation (EU) No 651/2014 which uses a combined criteria of staff headcount combined with annual turnover or annual balance sheet.[87]

(b) is engaged in *innovative* activities with the aim of creating new (or upgrading existing) products (good or services), processes and/or business models which are new to Croatian or to other markets.

(i) According to (EU) 651/2014 art. 2 (80), 'innovative enterprise' means an enterprise:

(1) that can demonstrate, by means of an evaluation carried out by an external expert that it will in the foreseeable future develop products, services or processes which are new or substantially improved compared to the state of the art in its industry, and which carry a risk of technological or industrial failure, or

(2) where the research and development costs represent at least 10 percent of the firm's total operating costs in at least one of the three years preceding the granting of the aid or, in the case of a start-up enterprise without any financial history, in the audit of its current fiscal period, as certified by an external auditor.

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[87] *Article 2 (*Staff headcount and financial ceilings determining enterprise categories).

[87] *Article 2 (*Staff headcount and financial ceilings determining enterprise categories).

1. The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.

2. Within the SME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million.

3. Within the SME category, a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

(c) is at the *early expansion stage* of its business development[88]

(i) According to (EU) 651/2014 art 21 (5), eligible undertakings shall be undertakings which at the time of the initial risk finance investment are unlisted SMEs and fulfil at least one of the following conditions:

(1) they have not been operating in any market;

(2) they have been operating in any market for less than 7 years following their first commercial sale;

(3) they require an initial risk finance investment which, based on a business plan prepared in view of entering a new product or geographical market, is higher than 50 percent of their average annual turnover in the preceding 5 years.

(d) is a legal entity registered in Croatia and has the locus of their activities in Croatia; this includes companies owned by foreigners but which are based in Croatia. However, as companies develop their locus may shift outside the country.

(e) is not classified under the negative list of activities as described in the overall Program Operations Manual. Specifically, the following list of activities cannot be financed:

(i) Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, such as pharmaceuticals, pesticides/herbicides, ozone depleting substances, PCBs, wildlife or products regulated under CITES.

(ii) Production or trade in weapons and munitions.

(iii) Production or trade in alcoholic beverages (excluding beer and wine).

(iv) Production or trade in tobacco.

(v) Gambling, casinos and equivalent enterprises.

(vi) Production or trade in radioactive materials. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.

[88] As defined in Box 1, factors indicating that a company is in the *early expansion stage of development* include that the relevant investment will provide necessary working capital to help launch the production and sale of the company's products or services. Typically, the company is not profitable and frequently will be cash flow negative. The early expansion stage can encompass an established business undertaking the commercialization of R&D activities, the size and scale of which results in the company being at a similar stage of development.

(vii) Production or trade in unbonded asbestos fibers. This does not apply to purchase and use of bonded asbestos cement sheeting where the asbestos content is less than 20%.

(viii) Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.

(f) is not an undertaking in difficulty as per Article 2 Regulation (EU) No 651/2104. Other cases of exclusion will also apply as listed under Articles 1 and 13 of the same Regulation.

10. Also, an eligible investee firm shall meet the financial requirements, as defined by Croatian Government, including: has no outstanding liabilities to the state; their individual owners and linked persons by means of ownership and control have settled liabilities to the state; is not in the process of pre-bankruptcy settlement; bankruptcy or liquidation; their individual owners are not in the process of pre-bankruptcy settlement; bankruptcy or liquidation; and, its direct transfer account has not been continuously blocked for more than 30 days in the last 6 months).

11. In addition, the Project Operations Manual will include a clause to ensure that both women and men have equal opportunities to access risk financing.

12. *Target investments, portfolio diversification, financing and instruments.* The Pilot VC Fund is expected to make investments in the forms of equity or quasi equity instruments to young knowledge intensive SMEs as defined above. The Fund shall make several investments; the consolidate portfolio of investment is expected to have an average ticket size of €500k. The Fund may provide follow-on financing for existing portfolio companies, up to a maximum of 10 percent of the fund in total financing per company. The Fund is expected to make approximately 10-15 investments. Initial investments in firms are are expected to be made within the first 5 years of the fund's life. It is envisaged that the Fund may make follow on investments in years 6-7, only in companies that have already been invested in by the Fund during the investment period. The investments made from this initial capital are expected to be fully exited over a 10-year period (with a possible extension to 12 years). Investments financed by the Pilot VC Fund would have to comply with commercial practices acceptable to the World Bank as described in the Projects's Operation Manual and with environmental and social safeguards as referred to in the Project's Environmental Management Framework.

13. In terms of EU state aid rules, conditions in terms of total amount of risk finance shall apply, on a deal by deal basis, in line with Regulation (EU) No 651/2014 article 21 or article 22, i.e. article 21.9 or article 22.3(c), this latter combined with article 22.5 whenever applicable. In line with the above, for eligible SMEs that have been operating in any market for less than 7 years following their first commefcial sale, the total amount of risk finance shall not exceed € 15 million per eligible undertaking. Also, the use of funds will be in line with all the other conditions under article 21 or article 22 (depending on which one is applicable to each individual investment), e.g. provisions for replacement capital will comply with article 21.7 of the above mentione Regulation.

14. Likewise, in line with EU State aid rules [Regulation (EU) No 651/2014 article 21.14], investments within an eligible SMEs shall be profit-driven meaning that the risk finance provided

to the eligible undertakings shall be based on a viable business plan, containing details of product, sales and profitability development, establishing ex-ante financial viability. Also a clear and realistic exit strategy shall exist for each investment.[89]

15. Also in line with EU State aid rules, if follow-on investment is made in SMEs already intervened by the Fund after the 7-year period mentioned in Regulation 651/2014, paragraph 5(b) [7 years following SME first commercial sale], leverage finance from independent private investors must reach 60% of the total risk finance per investment provided to the eligible undertaking.

16. *Investors*. The Pilot VC Fund would comprise capital from a mix of public and private investors as shareholders. The Government of Croatia's (public sector) contribution of up to € 12 million in equity, financed under the Project, would comprise up to 60% of the total fund, in compliance with EU state aid guidelines to promote risk finance investment (2014/C 19/04).[90,91]

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[89] Specifically, Regulation(EU) No 651/2104 article 21.14 says "Risk finance measures shall ensure profit-driven financing decisions. This is considered to be the case where all of the following conditions are fulfilled:

(a) financial intermediaries shall be established according to the applicable laws.

(b) the Member State, or the entity entrusted with the implementation of the measure, shall provide for a due diligence

process in order to ensure a commercially sound investment strategy for the purpose of implementing the risk

finance measure, including an appropriate risk diversification policy aimed at achieving economic viability and efficient

scale in terms of size and territorial scope of the relevant portfolio of investments;

(c) risk finance provided to the eligible undertakings shall be based on a viable business plan, containing details of

product, sales and profitability development, establishing *ex-ante* financial viability;

(d) a clear and realistic exit strategy shall exist for each equity and quasi-equity investment.

[90] As regards the expected contribution 40% private sector 60% public sector, the Guidelines on State aid to promote risk finance investment (2014/C 19/04) provides for the following: items 31-32: the investment should be effected *pari passu* between public and private investors. However, according to the above quoted guidelines items 80-81, certain exceptions are possible if justified by demonstrated market failure (as it is the case with the ex-ante assessment of financial instruments carried out by an independent expert contracted by the Government of Croatia, 3rd draft, January 2015).In addition, item 44 of the Guidelines should be considered and enforced (investment decisions based on a purely commercial logic). The overall conclusion is that in principle, the aid to the investor can be considered compatible with the internal market.

[91] Private capital is expected to come mostly from local institutional investors – that is, the four Croatian pension funds. Croatian pension funds are allowed to allocate up to 10% of assets under management to alternate investments, such as private equity and venture capital. When investing in private equity and venture capital funds, their investment cap is 10% of total fund size. This implies that the maximum expected contribution from the Croatian pension funds will amount to 40% of the Pilot VC Fund size. The World Bank's interviews with potential private sector shareholders revealed a general positive reception towards the design of the project, in particular the selection of the fund manager through an international tender process; emphasis on no public sector influence on the investment decision making process; and the involvement of a supranational institution such as the World Bank in the design and supervision of the overall project. Investor concerns included the limitation of the fund's investments to SMEs located in Croatia and the possibility that a small SME fund making 10 – 15 small investments could incur significant fund management fees that would cut into investor returns. While regional investments would not align with the scope and objectives of this project, the design of the project anticipates investor hesitation over high management costs by making available a government contribution towards enhancing investor returns (See below on Management Company selection process).

The external fund manager expected capital contribution of 1% will be reflected within the private sector contribution.

17. *Eligible investors.* Eligible investors shall not be the subject of a conviction by final judgment for one or more of the following criminal acts: associating or the purpose of perpetrating criminal offences, accepting a bribe in business activities, offering a bribe in business activities, abuse of position and official powers, abuse in performing governmental duty, illegal intercession, accepting a bribe, offering a bribe, fraud, computer fraud, fraud in business activities and concealing unlawfully obtained money.

18. *Expected fund size*. The Croatian government's initial capital contribution to the Pilot VC Fund will be committed at the time of first close, with €6 million in investment from the Croatian Government (using money from the World Bank loan) and at least €4 million of private sector financing, in compliance with EU state aid guidelines to promote risk finance investment (2014/C 19/04). There is a possibility of a second close, envisaged to entail an additional contribution from the Croatian Government of up to €6 million from this Project and at least €4 million from the private sector - adding up to approximately a €20 million total fund. The maximum total Fund size shall not exceed €30 million. The government has also allocated up to €3.5 million of the loan to cover management fees – in effect, lowering the cost to private investors from management fees -- to ensure the viability of the fund structure (discussed below on tender process).

19. *Fund management company and its remuneration*. The VC Fund will be managed by a private fund manager selected through an international tender process. Based on the EU State aid rules [Regulation (EU) No 651/2014 article 21.15], the VC Fund shall be managed on a commercial basis. This requirement is considered to be fulfilled where the fund manager fulfil the following conditions:

(a) They shall be obliged by law or contract to act with the diligence of a professional manager in good faith and avoiding conflicts of interest[92]; best practices and regulatory supervision shall apply;

(b) Their remuneration shall conform to market practices. This requirement is presumed to be met where the manager or the financial intermediary is selected through an open, transparent and non-discriminatory selection call under the public procurement applicable legislation, based on objective criteria linked to experience, expertise and operational and financial capacity;

(c) They shall receive a remuneration linked to performance, or shall share part of the investment risks by co-investing own resources so as to ensure that their interests are permanently aligned with the interests of the public investor;

(d) They shall set out an investment strategy, criteria and the proposed timing of investments;

[92] The Fund manager's governance structure will allow for decisions concerning investments, divestments and risk diversification to be made transparently and independently, in line with relevant market practice. The financial intermediary will be economically and legally independent from the investors and the body entrusted with implementation of the measure.

(e) Investors shall be allowed to be represented in the governance bodies of the investment fund, as defined in the Articles of Association (shareholder agreement) or AIF rules.

20. The Government of Croatia will contribute up to €3.6 million towards the total costs of operating the Pilot VC Fund; €3.5 million for management fees and €100k to cover the costs of establishing the VC Fund.

21. *Selection process of the VC Fund management company*. The selection of a suitable fund management company, and the financial structure of the VC Fund, are arguably the most important elements of this component since they will directly impact the uptake by private investors and the potential for demonstration effect. The Project therefore seeks to allow a market mechanism, embedded within the procurement process, to define the most optimal structure for this public private partnership. Specifically, the fund management company will be selected through a competitive international tender process (following the Consultant procurement guidelines of the World Bank) which would outline the broad contours of the fund and its objectives, but allow the fund structure and other detailed parameters to be outlined by the bidding fund managers.

22. The broad contours outlined by the tender will be the following:

(a) Overall objective of program

(i) To demonstrate the potential for a commercially viable early stage/ start-up venture capital industry in Croatia

(ii) To effectively address financing and capacity constraints for new Croatian companies which are commercializing research and development

(iii) To develop local fund management experience in the Croatian startup/ early stage venture capital industry.

(b) Eligible fund managers: according to the standard Funding Agreement that the Managing Authority proposes for ERDF funds the following provisions are valid "Financial Intermediaries (management companies) that are in one of the following situations will not be selected, provided that such situation would, in the professional opinion of the entrusted Body, affect their ability to implement the financial instrument:

(i) they are bankrupt or being wound up, are having their affairs administered by the courts, are the subject of proceedings concerning those matters, or are in any analogous situation arising from a similar procedure provided for in national legislation or regulations;

(ii) persons having power of representation, decision-making or control over them have been convicted of an offence concerning their professional conduct by a judgment which has the force of res judicata, which would affect their ability to implement the financial instrument;

(iii) they have been the subject of a judgment which has force of res judicata for fraud, corruption, involvement in a criminal organization or any other illegal activity, in each case where the above was detrimental to the Union's financial interest;

(iv) they are guilty of material misrepresentation in supplying information required for selection as a Financial Intermediary;

(v) they are listed in the central exclusion database set-up and operated by the European Commission under Commission Regulation (EC, Euratom) No 1302/2008 of 17 December 2008 on the central exclusion database;

(vi) they are incorporated in territories whose jurisdictions do not cooperate with the Union in relation to the application of internationally agreed tax standard, or their tax practices do not follow the principles of the Commission Recommendation of 6 December 2012 regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters (C(2012)8805).

(c) Eligible investees: as described above. Where there is doubt as to whether a company is an eligible investee company the fund manager can apply to the HAMAG-BICRO for a determination. If needed, HAMAG-BICRO will seek the advice of the Project Steering Committee, but HAMAG-BICRO's decision is final.

(d) Eligible instruments: equity and quasi equity

(e) Targeted financing range and portfolio diversification: portfolio of investments will have an average ticket size of €500K; maximum of 10% of Fund invested in one investee, with a possible increase to 15% (contingent on permission from the Fund's Advisory Committee, as defined in the Articles of Association (shareholder agreement) or AIF rules

(f) Maximum public sector commitment to Fund is €12 million and expected private sector leverage (regardless of fund size) will be at least 40% of the overall fund size, in compliance with EU state aid guidelines to promote risk finance investment (2014/C 19/04).

(g) Expected two Fund closes

(h) A minimum amount required for first close of €10 million, including both public and private sector contribution in a ratio of 60/40, in compliance with EU state aid guidelines to promote risk finance investment (2014/C 19/04).

(i) Hurdle rate of 6%

(j) Returns from the Fund will be distributed to public and private shareholders on a pro-rata basis based on their respective investments in the Fund

(k) Costs for establishing the Fund: HAMAG-BICRO will reimburse up to €100 k to cover the costs of establishing the Fund.

(l) Management fees:

(i) In line with EU state aid rules, the remuneration of the financial intermediary (management company) shall reflect the current market remuneration in comparable situations, which is the case when the financial intermediary has been selected through a competitive tender and no other advantages are granted by the state.[93] *It shall include a base remuneration and a performance-based remuneration*[94].

(ii) Government of Croatia will contribute up to €3.5 million towards the total costs of operating the Pilot VC Fund.

(iii) It is envisaged that up to € 3.5 million in management fees will be paid by HAMAG-BICRO for Year 1-5 in accordance with the following schedule:

Year 1: up to 2,5% of committed capital

Year 2: up to 2,5% of committed capital

Year 3: up to 1,5% of committed capital and 1% of invested capital

Year 4: up to 1,5% of committed capital and 1% of invested capital

Year 5: up to 1% of committed capital and 1% of invested capital

Management fees for Years 6-10 will be paid by all investors proportionately to their share in the Fund in accordance with the following schedule:

Year 6: 2% of invested capital

Year 7: 1,5% of invested capital

Year 8: 1% of invested capital

Year 9: 0,5% of invested capital

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[93] The actual amount charged by the Fund Manager will be defined under the tender process. Since under other EU Regulations in force until year 2020 the European Commission has capped the aggregate amount of management costs and fees in case of financial instruments providing equity at 20% of the total amount of public contributions paid to the financial instruments, this threshold can be considered as the current market remuneration (based on experience in the EU until 2013) for a financial instrument providing equity over the eligibility period of an Operational Programme. However, the above mentioned threshold could exceed 20% in case its amount is determined on the basis of competitive tendering. This is exactly the case of the current proposed Project, as the exact amount of management fees to be charged will be decided under the tender selection process.

[94] The thresholds for annual base remuneration and performance-based remuneration of bodies implementing financial instruments, for financial instruments providing equity, are established by Commission Delegated Regulation (EU) No 480/2014, article 13.2(a)(i) for the base remuneration and article 13.2(b)(i) for the performance-based remuneration.

Year 10: 0,5% of invested capital

(m) HAMAG-BICRO has the authority to make decisions in relation to the administration of the Pilot VC Fund and is responsible for:

(i) obtaining recommendations and advice from the Project Steering Committee on matters of technical merit, and proposals for variations to governing documents

(ii) being part of the Independent Evaluation Committee in charge of the tender process (see details below) providing HAMAG-BICRO's Management Board[95] with a recommendation on the winning bid post the tender selection process of the management firm

(iii) entering into agreements on behalf of the Republic of Croatia with the Fund Management Firm applicants whose eligible application and subsequent offer has been accepted

(iv) requesting withdrawals from the Designated Account under Treasury of Republic of Croatia

(n) The Fund Manager must be willing to comply with mandatory World Bank reporting and monitoring and evaluation requirements of investments as described in the Project's Operation Manual, and safeguards guidelines as described in the Project's Environmental Framework.

(o) Potential investors will be evaluated before they are allowed to invest in the fund using processes that mirror the IFC's integrity due diligence approach (IDD).

(p) Investee companies are required to provide financial and non-financial information, as required by reporting requirements, to the Fund Manager on a regular basis as defined in the Sub-financing Agreements to be entered into between the Fund and the Beneficiaries (investees companies).

23. The tender process will also clearly outline the selection criteria and the weights assigned to each criterion.

(a) Letter of intent from prospective private shareholders

(b) Committed capital by Fund Management Company or prospective Fund Management Company (to be formed by consortium)

(c) Quality of investment team

(i) track record

[95] HAMAG-BICRO's Management Board is chaired by the Deputy Minister of Entrepreneurship and Crafts and has representatives from several Ministries and other Stakeholders. It is responsible for appointing Members of the Executive Board, approving HAMAG-BICRO programs and supervision of HAMAG-BICRO.

(ii) blended team – i.e. with local and global experience in well-established venture capital markets

(iii) experience and skills of the proposed team in investing, managing and exiting investments

(d) Proposed investment and exit strategy, consistent with objectives of program, including

i. potential pipeline
ii. level and structure of management fees
iii. exit strategy

(e) Location of management team, such that the fund can effectively invest in, and work with, local entrepreneurs in Croatia.

24. The winning bid would be selected through a ranking which would assess the financial proposals and the technical quality of the bids. This mechanism is expected to reduce some of the information asymmetries inherent in the process (such as the cost of managing the fund) and reveal a more optimal public-private partnership arrangement which discloses the costs the private sector are willing to take on and the required contribution from the government to make the fund viable. The bids will be evaluated by an *Independent Evaluation Committee* of private sector experts, selected under the Global Advisory Network (sub-component 3.1), and a representative from HAMAG-BICRO. This *Evaluation Committee* will be constituted by HAMAG-BICRO in line with the Project's Operation Manual, and will assess the bids and provide a recommendation to HAMAG-BICRO's Management Board on the proposed Fund Manager. The highest ranked proposal would then be invited to negotiate the Administration Agreement. If the selected Fund Manager does not successfully constitute a fund within 6 months of being awarded the bid and raise requisite private financing , the runner up in the tender process will be automatically selected in its place. Overall, if two years after the loan effectiveness the Fund Manager is not selected (or any of the conditions - as described under disbursement conditions for this component – is not fulfilled) then the VC Fund component will be cancelled and the Project will be consequently restructured (with the possibility of reallocating the money to other Project components upon the request of HAMAG-BICRO and MOF).

25. Operation Manual, Articles of Association (shareholder agreement) and flow of funds. The draft by-laws and investment guidelines would be reviewed by the World Bank. The full description of Fund governance, eligible investments and expenditures, and flow of funds will be further defined in the Project's Operational Manual and related documents such as the Articles of Association (shareholder agreement) or AIF rules. The Articles of Association (shareholder agreement, or AIF rules) will outline the strategic objectives of the Fund, and key operational aspects of the Fund, such as defining the role of the manager versus the other investing partners; the governance structure (including an Investment Committee and Advisory Committee); the management fees structure; return distribution; reporting requirements/ performance evaluation etc. The Articles of Association (shareholder agreement) will be informed by best practices such as those outlined in the EU regulation on Venture Capital Funds. This component will be managed by the selected Fund Manager on the basis of a Administration Agreement to be signed between the Fund Manager and HAMAG-BICRO. Terms and conditions of the financing to be provided by the Fund will be outlined in the Project's Operational Manual and detailed in the corresponding Sub-financing Agreements to be entered into between the Fund and the Beneficiaries (the investees).

26. *Disbursement conditions for this Component*. Before the Pilot VC Fund receives capital infusion for the VC investments[96] from the Croatian government, provided by the World Bank loan, disbursement conditions need to be met, which include the following (as defined in the Loan Agreement of this Project[97]):

> *(a) "the PVC Management Firm has been selected and hired as provided in Section I, Part B, paragraph1(b)(ii) of this Schedule ;*
>
> *(b) the PVC Management Firm has been authorized by HANFA or has notified HANFA of its authorization by another European Union regulator;*
>
> *(c) the PVC Fund has been established as provided in Section I, Part B, paragraph 1(b)(iii) of this Schedule, with by-laws acceptable to the Bank;*
>
> *(d) the PVC Fund has been authorized by HANFA in a manner acceptable to the Bank;*
>
> *(e) private shareholders in the PVC Fund have committed an aggregate of at least four million Euros (€4,000,000);*
>
> *(f) the management agreement between the PVC Fund and the PVC Management Firm acceptable to the Bank, has been signed, and complies with the Borrower's Alternative Investment Fund Act; and*
>
> (g) *a Private Placement Memorandum is in place for the PVC Fund*."

27. In addition, both initial and follow-on disbursements for capital calls will only be made if the requisite capital from the private sector has been raised, and a pipeline of investable deals[98] has been identified. Any funds not invested under this Fund prior to the closing of the Project would be either allocated to other Project componentns or cancelled and returned to the World Bank. Proceeds from the VC Fund will be reverted to State budget.

28. *Conditions to cancel the VC Fund:* If the conditions set forth under disbursement conditions for the VC Fund component (as described above) have not been satisfied by two (2) years after the loan is effective the VC Fund component (and the VC Fund, consequently) will be cancelled and the corresponding amount could be reallocated to other Projetc's components upon client request. Also, if shareholders vote (at any time) to shut down the partnership, then the VC Fund component (and the VC Fund, consequently) will be cancelled.

29. *Governance*. The governance arrangements will include the institutional arrangements as well as a set of governance documents outlined primarily in the Project Operations Manual and the Articles of Association (shareholder agreement) or AIF rules of the VC Fund. A Management

[96] There are no disbursement conditions for VC management fees and for costs of establishing the VC fund.
[97] As defined in the Loan Agreement, PVC refer to Pilot VC Fund
[98] Provided in the form of a Table, Schedule, or Appendix.

Agreement between the Fund's shareholders and the Fund Manager will also be signed. This document will set out terms such as the management fees due to the manager.

a. *Key principles*. The key governance principles include the following:

i. The governance structure of the Pilot VC Fund is designed to assure investors that the Fund will be operated on a commercial basis following best market practices. The Fund will operate within the parameters set forth in the RFP.

ii. The Fund would have to comply with commercial practices acceptable to the World Bank, as defined in the Project's Operation Manual, as well as the environmental and social safeguards as defined in the Project's Environmental Framework.

iii. The governance documents will include default provisions relating to the fund manager and the overall financial position of the Fund. The governing documents will detail sanctions if operational or contractual requirements are not met. These sanctions may include the Fund manager being removed. The governing documents will also impose addition conditions relating to the Fund license, such as if the Fund Manager becomes/ may become insolvent; or there is a change in the key personnel or executive directors of the Fund Manager.

b. *Key responsibilities.* In line with these principles above:

i. The Fund Manager will be solely and exclusively responsible for investment and exit decisions. The government as a shareholder (and other investors) will <u>not</u> have any influence on the investments and exit decisions. A separate *Investment Committee*, constituted by the Fund Manager (including principals and any independent experts appointed by the Fund Manager), will have the authority to make all investment decisions. The *Investment Committee* would report to the *Advisory Committee* (see below) for information only. This assurance of commercial orientation will be particularly important for potential investors in the Fund as well as prospective venture capital firms that are considering submitting tenders. The VC Fund Manager would also be responsible inter alia for actively seeking deals; presenting them to the investment committee; monitoring performance of approved investments; supporting portfolio companies.

ii. The Fund would have an *Advisory Committee* comprised of a small number of voting representatives of the investors. The *Advisory Committee* will be responsible for overall oversight for this component in line with the original objectives of the Project, the Project's Operations Manual and Administration Agreement. The *Advisory Committee* would also be responsible for ensuring that transparency in information and decision criteria is achieved within the limits of commercially sensitive disclosure.

However, the *Advisory Committee* will not influence investment decisions. The Advisory Committee will also include international experts (funded under the Technical Assistance Component). HAMAG-BICRO, as the secretariat of the *Advisory Committee*, will convene these meetings and represent the Republic of Croatia (as investor) on the *Advisory Committee*.

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

30. This component will finance the public contribution towards establishing a Seed Co-Investment Fund ("Co-Investment Fund").

31. The objective of this component is to strengthen the early stage investing industry in Croatia. This component will typically cover *pre-revenue* knowledge intensive startups at the seed stage. The Co-Investment Fund will help firms develop to the stage at which they are able to demand the larger amounts that venture capital funds typically invest in. It will also support angel investors, thereby addressing the findings from the IEG Report on the World Bank Group's support for innovation and entrepreneurship that:

> "*venture capital funds are more likely to succeed where there is an adequate supply of start-ups and high-growth SMEs emerging from earlier stages in the innovation process. Start-ups and innovative SMEs that have graduated from early financing sources, such as angel investors …… are more likely to generate sound investments and deal flows*."[99]

32. The Co-Investment Fund will be an open-ended fund with initial capital of €2.5million, financed by proceeds of the World Bank loan. It will co-invest alongside eligible investors In order to comply with EU state aid regulations, the proportion that the Fund will be allowed to invest as a proportion of the total investment will depend on the age of the firm, the nature of the investment as well as other factors in compliance with relevant EU Regulation No 651/2014 on the application of Article 22).

33. *Eligible investors.* The category of eligible investors consists of: business angels, business angel, corporative investors, venture capital funds and other natural persons. The requirements for eligible investors will include the following[100]:

(a) has no outstanding liabilities to the Government of Croatia,

(b) are not in the process of pre-bankruptcy settlement, bankruptcy or liquidation,

(c) their direct transfer account has not been continuously blocked for more than 30 days in the last 6 months.

[99] World Bank, 2013 "World Bank Group Support for Innovation and Entrepreneurship An Independent Evaluation" World Bank, September 2013

[100] In addition, eligible investors shall not be the subject of a conviction by final judgment for one or more of the following criminal acts: associating or the purpose of perpetrating criminal offences, accepting a bribe in business activities, offering a bribe in business activities, abuse of position and official powers, abuse in performing governmental duty, illegal intercession, accepting a bribe, offering a bribe, fraud, computer fraud, fraud in business activities and concealing unlawfully obtained money,

34. Also, eligible co-investors shall not be the subject of a conviction by final judgment for one or more of the following criminal acts: associating or the purpose of perpetrating criminal offences, accepting a bribe in business activities, offering a bribe in business activities, abuse of position and official powers, abuse in performing governmental duty, illegal intercession, accepting a bribe, offering a bribe, fraud, computer fraud, fraud in business activities and concealing unlawfully obtained money.

35. *Eligible investees*. An eligible investee company to receive finance by the Pilot VC Fund or the Seed Co-Investment Fund is one that, on the date of the signature of the initial investment

(a) is classified as an "SME" or small and medium-sized enterprise – as defined in EU law: EU recommendation 2003/361; which uses a combined criteria of staff headcount combined with annual turnover or annual balance sheet.[101]

(b) is engaged in *innovative* activities with the aim of creating new (or upgrading existing) products (good or services), processes and/or business models which are new to Croatian or to other markets.

(i) According to (EU) 651/2014 art. 2 (80), 'innovative enterprise' means an enterprise:

(1) that can demonstrate, by means of an evaluation carried out by an external expert that it will in the foreseeable future develop products, services or processes which are new or substantially improved compared to the state of the art in its industry, and which carry a risk of technological or industrial failure, or

(2) where the research and development costs represent at least 10 percent of the firm's total operating costs in at least one of the three years preceding the granting of the aid or, in the case of a start-up enterprise without any financial history, in the audit of its current fiscal period, as certified by an external auditor;

(c) is at the *start-up or seed stage*[102].

(ii) According to (EU) 651/2014 art 22, eligible undertakings shall be unlisted small enterprises up to five years following their registration, which have

[101] *Article 2 (*Staff headcount and financial ceilings determining enterprise categories).

1. The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.

2. Within the SME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million.

3. Within the SME category, a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

[102] As defined in Box 1, factors indicating that a company is in the *start-up stage* of development include that the investment is necessary for product development, staffing, initial marketing and other start-up costs, or the company is setting itself up to sell its product or service commercially. The management team is substantially in place.
Factors indicating that a company is in the *seed stage* of development include that the initial concept of its business is being formed, prototypes or concepts of the company's products or services are being developed and the management team is beginning to form.

not yet distributed profits and have not been formed through a merger. For eligible undertakings that are not subject to registration the five years eligibility period may be considered to start from the moment when the enterprise either starts its economic activity or is liable to tax for its economic activity.

(d) has the locus of their activities in Croatia; this includes companies owned by foreigners but which are based in Croatia. However, as companies develop their locus may shift outside the country.

(e) is not classified under the negative list of activities as described in the overall Program Operations Manual. Specifically, the following list of activities cannot be financed

(i) Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, such as pharmaceuticals, pesticides/herbicides, ozone depleting substances, PCBs, wildlife or products regulated under CITES.

(ii) Production or trade in weapons and munitions.

(iii) Production or trade in alcoholic beverages (excluding beer and wine).

(iv) Production or trade in tobacco.

(v) Gambling, casinos and equivalent enterprises.

(vi) Production or trade in radioactive materials. This does not apply to the purchase of medical equipment, quality control (measurement) equipment and any equipment where IFC considers the radioactive source to be trivial and/or adequately shielded.

(vii) Production or trade in unbonded asbestos fibers. This does not apply to purchase and use of bonded asbestos cement sheeting where the asbestos content is less than 20%.

(viii) Drift net fishing in the marine environment using nets in excess of 2.5 km. in length.

36. *Administration by HAMAG-BICRO.* The Seed Co-Investment Fund will be administered by the implementing agency of the whole Project, HAMAG-BICRO will review and approve investments by co-investors. The investments will be proposed by the co-investor, as well as the entrepreneur (investee). In its review of prospective investments HAMAG-BICRO will focus its evaluation on the thoroughness of the due diligence performed by the co-investor. Where prospective co-investors establish a track record HAMAG-BICRO would consider investing alongside them without requiring pre-approval of the investments.

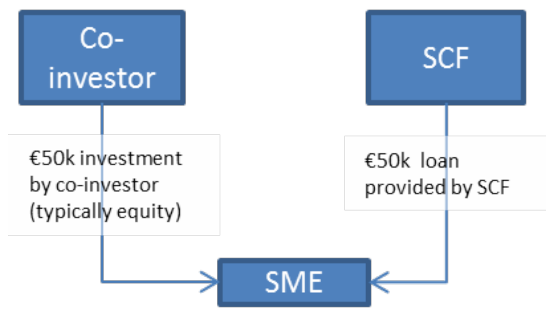
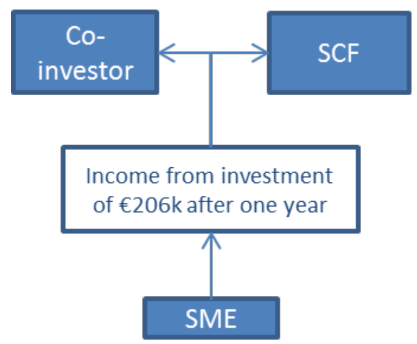
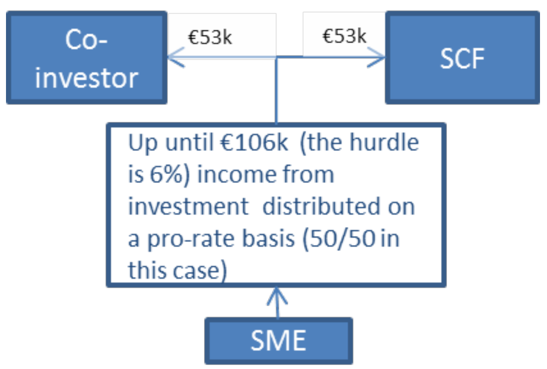
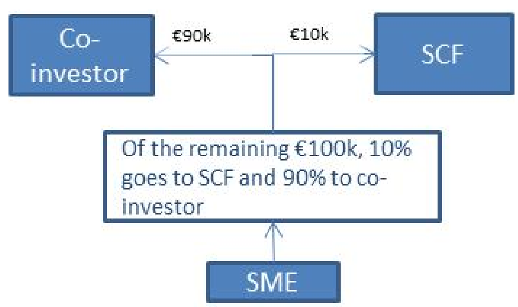
37. HAMAG-BICRO is established as an independent agency and non-profit legal person. HAMAG-BICRO has demonstrated expertise in the screening and selection process for similar seed-stage financing programs (such as RAZUM and IRCRO) and has the capacity to administer and monitor this Co-Investment Fund. Given that HAMAG-BICRO is expected to manage the Co-Investment Fund in-house, this will be not set up as a a separate legal entity or contractual fund. The Co-Investment Fund will not be regulated by the Croatian capital markets authority, HANFA. Some experts, selected under the Global Advisory Network (sub-component 3.1), will provide strategic guidance to HAMAG-BICRO to implement the Fund, undertake investments and facilitate exits. HAMAG-BICRO will manage the Co-Investment Fund in a manner that is consistent with the Program Operations Manual.

38. *Target investments; financing and instruments*. The Co-Investment Fund is expected to initially provide financing in the range of €30k to €200k. Companies may receive follow-on financing up to a maximum of €300k per company. Investments financed by the Fund would have to comply with commercial practices acceptable to the World Bank, environmental and social safeguards and the negative list contained in the Co-Investment Fund Operational Manual to be cleared by the World Bank.

39. The Seed Co-Investment Fund will provide financing through a financial instrument similar to one that has been used to provide financing through co-investment funds in the Netherlands, Portugal and has similarities to an instrument used in Denmark. The financial instrument will operate in a manner that is similar to an equity instrument that is convertible to debt. However, it will be structured as a loan that will be paid out of income from the investment over the 15 year life of the loan as illustrated in Figure A3.1 below. The loan will be subordinated to other debt holders, and will not require collateral. The terms of the loan are envisaged to be that the initial income generated from the investment will be paid to the co-investor(s) and HAMAG-BICRO on a pro rata basis. Once the return on the investment has exceeded a hurdle rate (6 percent)[103] the subsequent income will be distributed asymetrically to the benefit of the co-investor(s). As a result, after the hurdle rate has been achieved HAMAG-BICRO will only receive around 10 percent of any additional income from the investment. How this could work in practice for a particular investment is shown in Figure A3.1.

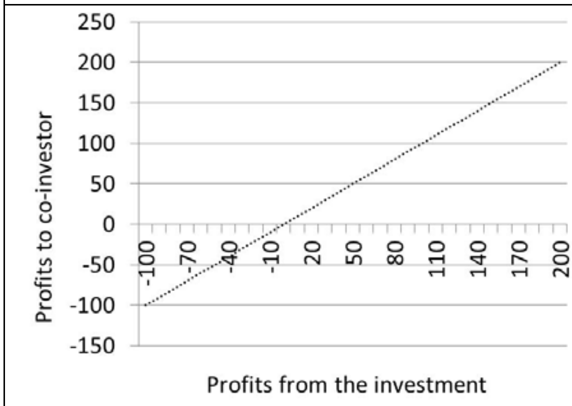
[103] This figure is set at the average of the interest rates paid from June 2008 to May 2014 on ten year Croatian government debt. The data is reported by the European Central Bank.

Figure A3.1 Illustration of the cash flows from a hypothetical transaction by the Seed Co-Investment Fund (SCF)

If the SME needs a total investment of €100k the SCF provides €50k and the co-investor €50k	After a year the investment in the SME generates a return of €206k
	
The first €106k is distributed on a pro-rata basis between the SCF and the co-investor	The remaining €100k of returns are distributed asymetrically with 90% being paid to the co-investor and 10% to the SCF
	

40. In practice, co-investors alongside the Co-Investment Fund will provide returns to investors that are comparable to what they would have earned had the Co-Investment Fund provided equity that is convertible to debt. This is illustrated in Figure A3.2. It shows that at lower levels of returns the co-investor earns similar returns as if the Co-Investment Fund provided equity. At higher levels of returns the co-investor earns returns that are closer to those that would have been provided had the Seed Co-Investment Fund provided debt financing.

Figure A3.2 Returns to a co-investor co-investing alongside the Seed Co-Investment Fund

<table>
<tr>
<td>Benchmark: This graph (block dots) shows the benchmark case in which the co-investor makes a equity investment without any co-investment.</td>
<td>Pure equity co-investment: The investor makes the same size size investment as before. The graph below shows that the profits provided if the co-investment fund provided equity and a small contribution to due diligence costs. The line with blue dots shows that the returns of the co-investor increase in lockstep with the profits from the investment. The Scottish Co-Investment Fund is an example of a co-investment fund that typically provides equity using a structure similar to this.</td>
</tr>
<tr>
<td>
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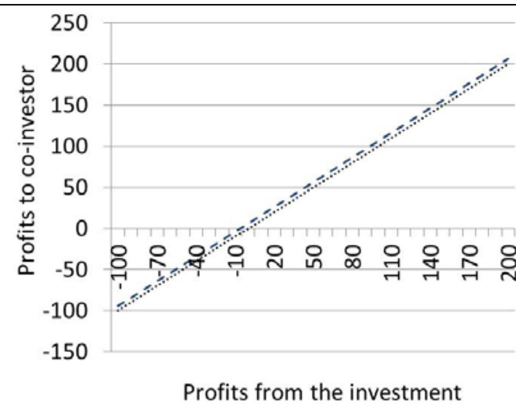
<td>
</td>
</tr>
<tr>
<td>Conventional loan “co-investment”: This graph shows the returns that the co-investor earns when a loan is provided over a five year term charging 15% interest. For returns above 15% the co-investor earns higher returns than with an equity co-investment, but for returns below 15% returns are reduced dramatically. A subordinated loan similar to this is provided by the Danish Growth Fund.</td>
<td>The envisaged loan structure that mimics equity convertible to debt: As shown by the green line at lower levels of returns (below 6 percent) the returns are similar to those if the SCF provided equity. For returns above 6 percent the co-investor earns returns that have a similar structure to those provided if the SCF had provided a conventional loan with a interest rate of 6%.</td>
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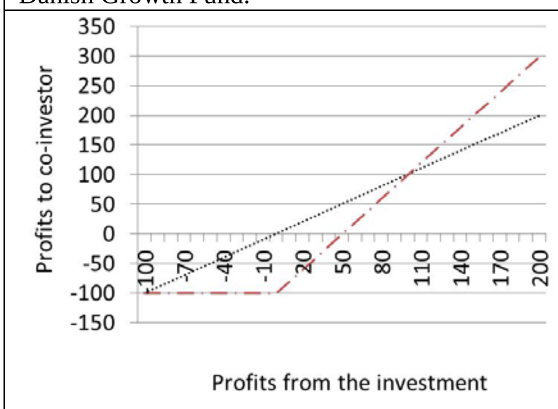
<tr>
<td>
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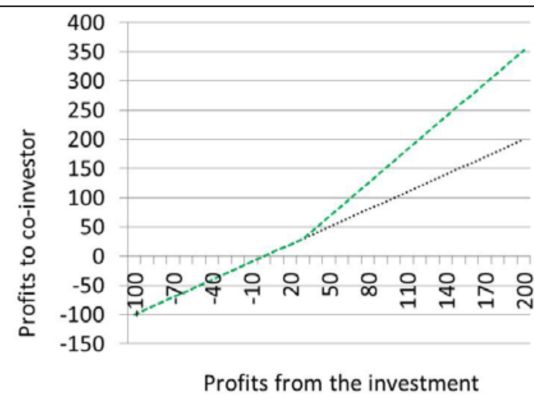
<td>
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41. *Operation Manual and flow of funds.* The Project Operational Manual includes a section on the Co-Investment Fund, which describes, among other items, the approach to reviewing investments, the structuing of co-investment and how to monitor and manage these investments. The Manual also defines eligible investments and expenditures, and flow of funds. This activity will be managed by HAMAG-BICRO on the basis of a Subsidiary Finance Agreement to be signed between HAMAG-BICRO and the Borrower (through MOF and MOEC). Terms and conditions

of the financing to be provided by the Co-Investment Fund are outlined in the Project Operational Manual and detailed in the corresponding Sub-financing Agreements to be entered into between HAMAG-BICRO and the Beneficiaries (the investee companies). Investee companies are required to provide financial and non-financial information, as required by reporting requirements, to HAMAG-BICRO on a regular basis as defined in the Sub-financing Agreements to be entered into between the Fund and the Beneficiaries.

42. *Exits and reinvestment*. Co-investments will be exited simultaneously with the co-investor(s) at the initiative of the co-investor(s). Proceeds from exits will be re-invested in the Fund and may be used to provide financing following the same terms and conditions.

43. *Disbursement conditions for this Component* There are no disbursement conditions for this component.Disbursement towards the Co-Investment Fund may be initiated immediately after the World Bank loan is effective. Any advanced funds not invested prior to the closing of the Project will be returned to the World Bank.

3.3 - Component 3. Technical Assistance (€ 1.5 million)

44. **This component of the program would be established to assist in the creation and operation of the program**. The funds would provide for the following sub-components:

45. **Sub component 3.1: Global Advisory Network (€ 400k).** The objective of this sub-component is to provide advice and guidance for the implementation of both funds designed under this Project (Pilot VC Fund and Co-Investment Fund) throughout the Project whole implementation period. It will specifically comprise a number of international experts in early stage financing, portfolio exits, and entrepeneurship and technology. They will provide support for: i) the Pilot VC Fund (through the Advisory Committee); ii) the staff of the HAMAG-BICRO in charge of managing the Co-Investment Fund. The individual members of this Network will be recruited globally and hired as consultants (under the Project) in in consultation with the World Bank. They shall from time to time, as requested by the manager of the Pilot VC Fund and HAMAG-BICRO staff in charge of managing the Co-investment Fund, and based on their competence profile and availability: (a) advise in assessing prospective investments;(b) contribute to the development and implementation of potential business plans – for both Funds - of the portfolio companies liaising them to their network; and, (c) advise about the exit strategy of the VC Fund. HAMAG-BICRO will be in charge of the overall selection process of these consultants; this process will be subject to World Bank review.

61. **Sub component 3.2: Capacity building and networking (€ 400k).** The objective of this sub-component are twofold. First, to develop human capabilities of the main actors involved in the risk capital financing industry in Croatia; such as HAMAG-BICRO staff, investors and entrepreneurs. Second, to strengthen social capital and networks – both local and global among incubators, accelerators, business angel networks, matchmaking services, entrepreneurs and larger investors. While many policies have focused on the supply side, other public and private activities have focused on demand-side actions which aim to increase the quality and quantity of deals. The

demand side is often overlooked in favour of supply side actions which may be perceived as being more visible and direct. (OECD, 2013)[104]. Specifically, this component will provide:

a) *Financing for HAMAG-BICRO, the PIU, to be trained and develop capacity through study tours and knowledge exchange programs*. This is envisaged to include a twinning program between HAMAG-BICRO and a institution such as the Danish Growth Fund in Denmark that has substantial experience in programs that are similar to this Project.

b) *Financing for training*. Training will focus on entrepreneurs, as well as investors. It is envisaged that more than 130 people will be trained.

i. *Potential entrepreneurs* are often unsuccessful in raising finance because they are not familiar with the options for external sources of financing, are not adequately prepared to present to investors, or because they don't know how to develop their business plans. For this reason the proposed Project aims to train more than one hundred entrepreneurs. Training could be in the form of "boot camps" run at universities, incubators/accelerators or other relevant institutions. The training could cover: sources of finance; presentation skills, and business plan development. This type of training is expected to (help to) address the entrepreneur's side of the information asymmetry issue by helping entrepreneurs better understand the expectations and needs of investors and prepare themselves accordingly, which in turn can result in greater success in securing funding. Specific attention will be devoted to addressing the training needs of women entrepreneurs.

ii. *Investors* will also be provided with training. It is envisaged that this includes providing training to institutional investors on how to invest in venture capital funds, and manage their investments once they have made them. It will also include training for investors such as angel investors on how to make investments in startups, manage them and exit them. This training will include support for the development of angel groups. These groups play an important role in successful entrepreneurial ecosystems. Consideration will be given to sponsoring investors to partake in international schemes such as the Kauffman Fellowships. It is envisaged that more than forty providers of risk capital financing will be provided with training under the program.

c) *Financing for network development*. This type of activity help link investors and entrepreneurs and, in many cases, provide additional support and mentoring services; it can also help building links between investors, entrepreneurs and larger companies which leads to more successful "exits" of ventures in the future by creating links with potential later stage investors and corporate partners. The project will run or establish two or more networking events per year.

46. **Sub component 3.3: Monitoring and evaluation (M&E) system (€ 100k).** The objective of this sub-component is to ensure accountability in the use of government's money, and provide

[104] OECD, 2013 "Policies for Seed and Early Stage Finance: Findings from the 2012 OECD Financing Questionnaire"

guidance on how the program can be improved. This will include standalone evaluations by independent third parties, and a M&E framework. The framework for the M&E system builds on the results sought from each component and develop indicators to assess accomplishments against the development objectives (see Annex 1). The design of the M&E framework is in proportion to the relatively modest loan size, and driven by the need for the appropriate M&E capacity. The M&E of project components, sub-components, and activities will be a streamlined, integrated aspect of project implementation and management.

47. **Sub component 3.4: Project Management and Audit (€ 600k).** This component will finance necessary activities for establishment of the PIU, project management and implementation, and carrying out outreach activities.[105] It will include provision of goods, consultants' services, including audit, and financing of Incremental Operating Costs, and Incremental Fees.

[105] Outreach activities will be largely focused on publicizing the program to entrepreneurs who are seeking risk capital financing. It will also publicize the program to prospective co-investors alongside the Seed Co Investment Fund.

Annex 4: Implementation Arrangements

4.1 – Project Institutional and Implementation Arrangements

1. 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.

2. 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, Education and Sports, and Ministry of Regional Development and EU Funds).

3. 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.[106]

4. HAMAG-BICRO is an independent agency founded by the Republic of Croatia, and the entity BICRO that was recently merged with this agency has a significant experience in the implementation of past and current World Bank Science and Technology Projects (STP and STPII). Pursuant to the Act on the Amendments to the Small Business Promotion Development (Official Gazette No. 56/2013) and the Agreement on the Merger of the Business Innovation Agency of the Republic of Croatia (BICRO) with the Croatian Agency for SMEs and Investments (HAMAG INVEST) dated April 8, 2014, BICRO merged with HAMAG INVEST and therefore changed its name to the Croatian Agency for SMEs, Innovations and Investments (HAMAG-BICRO). HAMAG-BICRO is a non-profit legal person with the rights, obligations and responsibilities defined by the Act and its Statute. The issues that have not been otherwise regulated pursuant to the Act or the Statute of the agency are subject to the provisions of the regulations referring to limited liability companies. The Republic of Croatia ensures the fulfillment of the obligations of HAMAG-BICRO.

5. The Management Board of HAMAG-BICRO is composed of 15 members and its role is defined in the Act on the Amendments to the Small Business Promotion Development, HAMAG-BICRO's Statute and other regulations. The President, Vice President and Members of the Management Board are appointed and removed by the Government of the Republic of Croatia. The Government of the Republic of Croatia appoints the Minister, Deputy Minister or Assistant Minister of MOEC as President of the Management Board. The Government of the Republic of Croatia appoints the Minister, Deputy Minister or Assistant Minister of Ministry of Science, Education and Sports as Vice President of the Management Board. Furthermore, the Government of the Republic of Croatia appoints the Members of the Management Board so that each of the following persons proposes appointment of one Member of the Management Board: MOEC, Minister of Science and technology, MOF, Minister of Regional Development and EU Funds,

[106] The World Bank is internally exploring the possibility to extend the implementation period up to seven years due to the Project design specifics.

Minister of Foreign and European Affairs, Minister of Labor, Minister of Tourism, Minister of Agriculture, Minister of Economy, President of the Croatian Chamber of Commerce, President of the Croatian Chamber of Crafts and Trades, President of the Croatian Association of Cooperatives and President of the Croatian Employers' Association.

6. Monitoring and evaluation of HAMAG-BICRO's operations and programs is performed both externally and internally. Compliance with the Act, the Statute, the general acts of the agency, and the program of activities is supervised by the Management Board of HAMAG-BICRO. Financial supervision of the agency's operations is performed by the State Audit Office. The Annual Report on the agency's operations has to be prepared by the Executive Board, passed by the Management Board of HAMAG-BICRO and submitted to the Government and Parliament of the Republic of Croatia. In addition, the agency has in-house organizational units for Internal Audit, Expenditure Control, and Monitoring, Analysis and Reporting.

7. The institutional arrangements for the Project will be as follows:

(iii) Prior to effectiveness, the MOF will sign a (tripartite) Subsidiary Agreement with the MOEC and HAMAG-BICRO to implement all three Project components: Pilot Venture Capital Fund, Seed Co-Investment Fund and Technical Assistance. The Subsidiary Agreement will set forth all the terms and conditions under which the Government of the Republic of Croatia is making the funds available to HAMAG-BICRO. In addition, a Project Agreement between the World Bank and HAMAG-BICRO will be signed and; this Project Agreement will include the details on HAMAG-BICRO's obligations to the World Bank as the project implementing entity, and references to governance, procurement, reporting and safeguard rules. It also refers to the Project Operational Manual which includes the detailed eligibility criteria, project implementation and management guidance.

(iv) Once the winning bid from the VC Pilot Fund Manager tender process has been awarded, HAMAG-BICRO will sign an Administration Agreement with the selected Fund management company, to ensure the VC Fund management company complies with the Project Operations Manual. Second, the VC Fund will be created through Articles of Association (shareholder agreement signed by HAMAG-BICRO and the other shareholders of the Fund). Finally, the VC Fund will sign a Management Agreement with the VC Fund management company to determine mutual roles and responsibilities; terms and conditions of this Management Agreement will have been negotiated under the Administration Agreement.

Oversight

8. 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.

9. 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.

Implementation of the Activities

10. 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.

11. The Project Implementation Unit (PIU) will be created at HAMAG-BICRO and it would consist of HAMAG-BICRO's internal experts. External consultants for any specific functions could be engaged as well if needed. The PIU would be responsible for project management and supervision, including procurement, financial management, monitoring and evaluation, and reporting. In addition, the PIU would manage and implement several project activities, its marketing, relevant training and related outreach to the business ecosystem.

12. 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.

13. In addition to hiring any external PIU staff, the funding for this component will cover the PIU's implementation expenses and operating costs, certain project related incremental legal fees, etc.

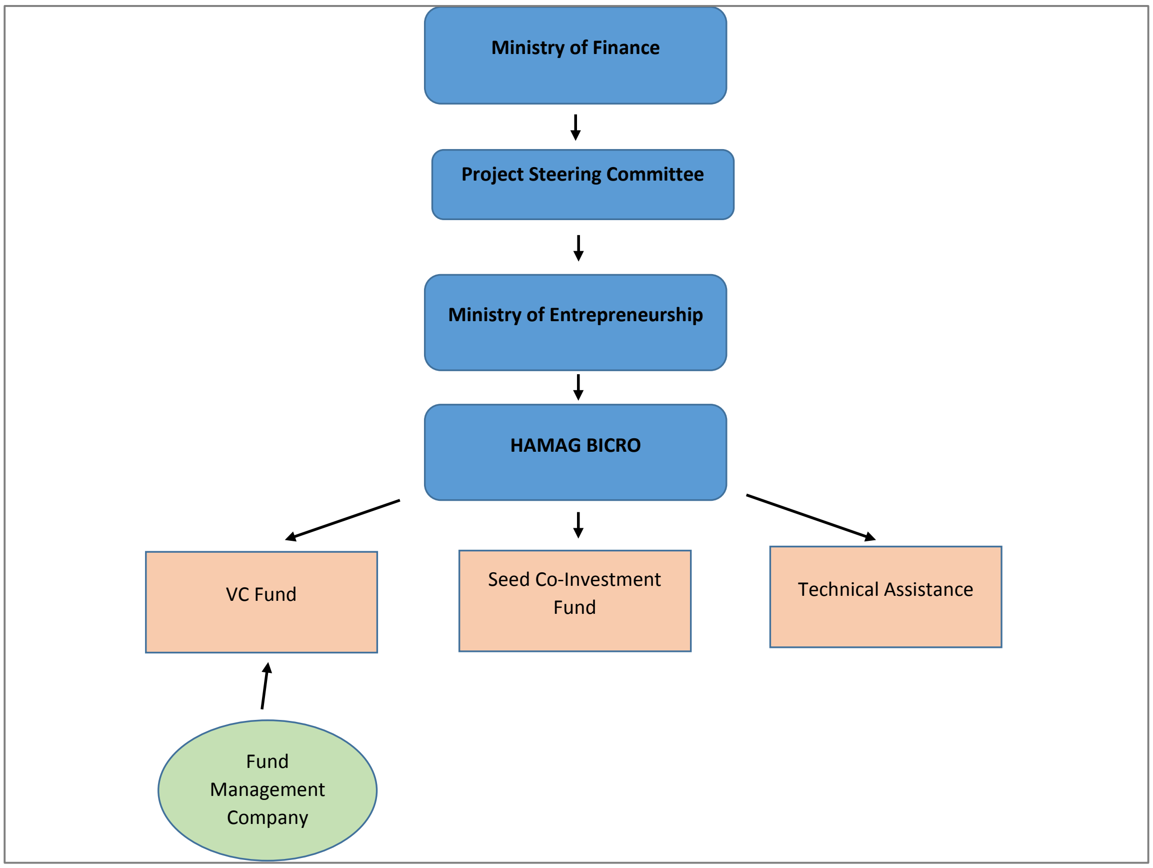
14. As stipulated in its Statute, HAMAG-BICRO has the legal mandate for management of funds established for the purpose of SME development, promotion and attracting investments in entrepreneurship, financing of business operations and development of SMEs through the provision of loans under more favorable terms and other types of financial support, including quasi-equity. Therefore, Component 2 (Seed Co-investment Fund) will be exclusively managed and implemented by HAMAG-BICRO. In addition, HAMAG-BICRO will be responsible for the implementation of Component 3 (Technical Assistance). HAMAG-BICRO will be responsible for Component 1 (Pilot VC Fund), while the selected fund management company will be responsible for managing the Pilot VC Fund itself, in accordance with the guidance and Project Operational Manual prepared by HAMAG-BICRO.

15. A draft Project Operations Manual, satisfactory to the World Bank was prepared by Project negotiations stipulating the operational structure, financial management, governance, the decision-making process, selection, and eligibility (including negative list) criteria for the project components, and all other processes related to project implementation. The templates of all relevant agreements will be finalized prior to loan effectiveness. Signed (tripartite) Subsidiary Agreement, the establishment of the PIU, and the adoption of the final approved Project Operations Manual by the Management Board of HAMAG-BICRO – in a way satisfactory to the Borrower and the Bank - will be conditions of loan effectiveness. For components 1 (Pilot VC Fund) and 2

(Seed Co-investment Fund), clear transparent governance structure and accountability measures should be specified in the Project Operations Manual, specifically with regards to the eligibility and criteria for the evaluation, review, due diligence, and selection process. These measures embody the principles of responsible governance and transparency by assuring the independence of the selection process from the application or review process.

16. Below is the chart that represents the proposed implementation arrangements.

Figure A4.1 – Project implementation arrangements



4.2. - Financial Management, Disbursements, Procurement, Environmental and Social

Financial Management

17. The overall financial management risk for the project is substantial before mitigation measures, and with adequate mitigation measures agreed, the financial management residual risk is moderate. The Inherent Risk of the project is rated as moderate, while the controls risk is rated as substantial before the mitigation measures. After introduction of mitigation measures such as having a short-term financial management consultant to train and build capacity in PIU as well as having a private audit firm to audit both Project and HAMAG-BICRO, as well as the VC Fund Manager and the VC Fund itself.

18. **Budgeting and Counterpart Funding Arrangements**. Annual budgets as well as budgets for 3 years are prepared by HAMAG-BICRO. The Project budget is prepared following the State Budget Act and it is integrated in the MOEC budget. It is published in the Official Gazette after Parliament approval. There is no government counterpart funding envisaged for this Project.

19. **Flow of Funds**. The implementation of project activities will be under the HAMAG-BICRO. The HAMAG-BICRO PIU will manage project implementation and will be responsible for such functions as: procurement, financial management, monitoring and evaluation, and reporting. The fiduciary functions would be conducted by financial and accounting department of the HAMAG-BICRO with a help of a short-term FM consultant. The funds for payments related to the Pilot VC Fund (Component 1) will flow from the Designated Account to the VC Fund Manager account following successful fulfilment of the disbursement conditions provided in the Project legal documents. The funds related to management fees will flow from Designated Account to the VC Fund Manager account. Contributions to the VC Fund for investment would be disbursed based on the VC sub-financing agreements signed between the VC Management Firm and VC beneficiaries The VC Fund/VC Fund Manager bank account will be held in a commercial bank acceptable to the World Bank following a competitive tender procedure. For the Seed Co-Investment Fund (Component 2) the funds will flow from the Designated Account to the investee company provided that the funds from angel investor had been initially provided in line with a tripartite agreement concluded between investee, investor and HAMAG-BICRO.

20. As for the Technical Assistance (Component 3) the funds will flow from the Designated Account to the suppliers following regular procedures determined in the Project Operations Manual.

21. **Staffing**. HAMAG-BICRO's monitoring, analysis and reporting department will be in-charge of the financial management arrangements for the project. Currently, the department has 5 employees on open-ended contract (1 head of department, one senior analyst, 1 administrator for monitoring analysts and reporting, and 2 administrators). The staffing of the PIU is appropriate however in order to strengthen the FM capacity and build capacity in WB funded project a short-term FM consultant will be engaged for the Project.

22. **Accounting and Maintenance of Accounting Records**. All accounting records under the project, under World Bank categories will be kept in the KONTO software, developed specifically for the HAMAG-BICRO. The HAMAG-BICRO reports to FINA (quarterly, semi-annual), MOEC (monthly, semi-annual), MOF, SAI and FINA (annual reports). In addition HAMAG-BICRO prepares medium-term budget plan for three years (for the upcoming year and plan for 2 subsequent years) and such plans are submitted to the MOF and MOEC.

23. Based on the PIU report, MOEC books monthly the summary of project expenditure, under Croatian state budget economic classification, in its SAP system.

24. Accounting policies to be applied to the project include the following: accruals accounting as the basis for recording transactions; ii) reporting done in the currency of the loan, and iii) IFRs prepared for all components, including all Project funds (VC Fund and Seed Co-Investment Fund). The Project financial statements will be prepared on accruals basis, i.e. events will be recognized

when they occur. The Project accounting policies are described in the financial management chapter of the draft Operational Manual.

25. **Internal Controls and Internal Audit**. The PIU has adequate internal controls for the Project, including regular reconciliation of bank accounts, adequate segregation of duties, proper accounting policies and procedures and monthly reconciliation of disbursement summaries of the World Bank with Project accounting records is performed.

(i) There are regular reconciliations in the PIU: SOE are reconciled with the excel project data for every withdrawal application, Designated Account reconciliation is also performed with SAP treasury records, client connection figures are reconciled monthly with the project accounting records. The PIU maintains a list with all the payments made out of the Designated Account, which is used for SOE reconciliation.

(ii) The access to the HAMAG-BICRO accounting software is password protected; there is only accounting staff access to the systems. The journal entries cannot be altered once they are made. Any changes can be done only with reversal of the initial journal and posting the correct one. The software cannot produce any reports that can be used for reporting purposes; instead, manual IFRs will be prepared based on a trial balance for Project that can be printed out of the system.

(iii)The PIU will maintain in excel spreadsheets tables for each contracts, where all the payments are monitored, including the reception protocol. Payments are approved by the Project Manager and assigned person from MOEC, after they have been checked by the project FMS.

26. **Periodic Financial Reporting**. The PIU shall prepare and furnish to the World Bank not later than forty five (45) days after the end of each calendar semester, consolidated interim unaudited financial reports for the project covering the semester, in form and substance satisfactory to the Bank. HAMAG-BICRO will be in-charge of the consolidation of IFRs in order to be able to include the IFRs of the VC Fund and VC Fund Manager. The PIU has been up to date with the submission of the quarterly Interim un-audited Financial Reports (IFRs) for the STP2 project. The IFRs have been submitted on time to the Bank and were acceptable.

27. **External Audit.** The PIU will be responsible for the timely compilation of the annual project financial statements for the independent external audit. Project financial statements (including SOE and Designated Account activities) will be audited by an independent auditor acceptable to the Bank. Each audit of the Financial Statements shall cover the period of one (1) fiscal year of the Borrower, commencing with the fiscal year in which the first withdrawal was made under the Loan. The terms of reference for the audit have been agreed with the Bank, and will be attached to the Minutes of Negotiation. In addition, the auditors are expected to deliver management recommendation letters in relation to the project. Each management recommendation letter will identify internal control deficiencies and accounting issues, if any.

28. Furthermore there is a requirement for audit of HAMAG-BICRO government agency. In addition to the Project and HAMAG-BICRO audit, the audit of the VC Fund Manager and the VC Fund itself will be required. The audit fee for HAMAG-BICRO and Project audit may be financed from the loan, while the audit of VC Fund Manager and the VC Fund itself is expected to be covered out of VC Fund management fee.

29. The audit reports, audited financial statements and management recommendation letters will be delivered to the Bank within six months of the end of each fiscal year. The following table summarizes the overall audit requirements.

Table A4.1: Overall Audit Requirements

Audit report	**Due date**
Continuing Entity financial statements– VC Fund and VC Fund Manager The financial statements include (i) Statement of Financial Position, (ii) Statement of Comprehensive Income, (iii) Statement of Changes in Equity, (iv) Statement of Cash Flows, and (v) notes, comprising a Within six months of the end of each fiscal year/reporting period after the first deposit into the VC Fund is made, and also for the reporting period when the project was closed summary of significant accounting policies and other explanatory information.	Within six months of the end of each fiscal year/reporting period after the first deposit into the VC Fund is made, and also for the reporting period when the project was closed
Continuing Entity financial statements–HAMAG-BICRO financial statements prepared in accordance with the Croatian Laws and regulations for budget organizations. A complete set of financial statements includes the following:(i) Balance sheet, (ii) Statement on revenues and expenditures, receipts and spending, (iii) Statement on Realized Own Revenues and Expenditures, (iv) Changes in Value and Range of Assets and Liabilities and (v) Notes.	Within six months of the end of each fiscal year/reporting period after the first deposit into the Designated Account is made, and also for the reporting period when the project was closed
Project financial statements (PFS). The PFS include (i) Project Balance Sheet, (ii) Sources and Uses of Funds, (iii) Uses of Funds by Project Activity, (iv) SOE Withdrawal Schedule, (v) Designated Account Statement, (vi) Notes to the financial statements.	Within six months of the end of each fiscal year and also at the closing of the project

30. The audited Project Financial Statements and HAMAG-BICRO Financial Statements will be made publicly available in a timely fashion, and in a manner acceptable to the World Bank. The audited Project Financial Statements and HAMAG-BICRO[i] Financial Statements will be published on a web site one month after the Bank has sent official audit acknowledgement letter.

31. There are no overdue or due audit reports for the STP2 Project. The first audit reports were due on 30 June 2014, and such audit reports included the financial statements covering FY 2012 and 2013 (combining the audit of a PPA and loan). The appointed audit firm KPMG Croatia issued unmodified (clean) opinion on the Project financial statements for the period from 10 July 2012 to 31 December 2013. The audit has been performed in accordance with the International Standards on Auditing.

32. Furthermore, the auditors KPMG Croatia have issued a disclaimer of audit opinion (were not able to express an opinion) in relation to the Business Innovation Croatian Agency (BICRO) financial statements with an emphasis of matter paragraph.

33. The reasons for disclaimer were as follows:

(i) The BICRO was not able to provide the auditors with representations relating to existence and completeness of the transfer of assets and liabilities from BICRO doo and HIT doo (according to the Decree on establishing the Business innovation Croatian Agency BICRO);

(ii) Receivables as at 31 December 2013 include loans to domestic companies outside the public sector in the amount of HRK 32,140 thousand for which the Agency has not maintained adequate accounting records and for which the auditors were not able to determine the amount of adjustments necessary.

34. The World Bank urged HAMAG-BICRO to undertake actions in order to resolve the above issues. HAMAG-BICRO will have the task of preparing an action plan in order to explain how the issues that have led to disclaimer will be rectified in the coming period. A joint solution needs to be identified with the MOF during the Project implementation phase.

Disbursements

35. There will be one Designated Account opened for HAMAG-BICRO for the loan proceeds. The Designated Account will be opened in the single treasury account held at the Croatian National Bank. Loan funds will flow from the World Bank to the Designated Account and then from Designated Account to VC Fund Manager bank account (for Component 1), from the Designated Account to the investee company (for Component 2), or from the Designated Account to contractors (Component 3) on the basis of the approved transactions and/or invoices and in line with disbursement conditions determined in the loan agreement. There will also be a possibility to use direct payments methods from World Bank to contractors for larger payments as indicated in the Disbursement Letter. HAMAG-BICRO will prepare the application for withdrawals to be submitted to the Bank and the payment orders for suppliers. Such procedure is described in detail in the FM chapter of the Project Operational Manual.

36. Disbursement from the Loan Account will follow the traditional method, either through reimbursement, direct payment to suppliers, or advances to Designated Account. Withdrawal applications will be sent to the Bank directly using the e-disbursement facility by the HAMAG-BICRO based on need for loan funds.

37. Supporting documents for SOEs will be retained by the HAMAG-BICRO and VC Fund Manager and made available to the Bank during Project supervision. Disbursements for expenditures above the SOE threshold levels will be made against presentation of full documentation relating to the expenditures. The reimbursement of expenditures from the Designated Account may be made on the basis of certified SOEs, based on the SOE thresholds defined in detail in the Disbursement letter. The ceiling and authorized allocation for the IBRD Designated Account will be defined in the project Disbursement Letter. The Designated Account will be denominated in EUR.

38. There is no government contribution under the Project envisaged, and the front-end fee will be paid by the Borrower from their own resources.

39. **Disbursement conditions**. Expenditures for VC investments under Component 1(VC Fund) will have the following disbursement conditions, as defined in the Loan Agreement of this Project[107]:

[107] In the Loan Agreement, PVC refer to Pilot VC Fund.

(a) “the PVC Management Firm has been selected and hired as provided in Section I, Part B, paragraph1(b)(ii) of this Schedule;;

(b) the PVC Management Firm has been authorized by HANFA or has notified HANFA of its authorization by another European Union regulator;.

(c) the PVC Fund has been established as provided in Section I, Part B, paragraph 1(b)(iii) of this Schedule, with by-laws acceptable to the Bank k;

(d) the PVC Fund has been authorized by HANFA in a manner acceptable to the Bank;

(e) private shareholders in the PVC Fund have committed an aggregate of at least four million Euros (€4,000,000);

(f) the management agreement between the PVC Fund and the PVC Management Firm acceptable to the Bank, has been signed, and complies with the Borrower’s Alternative Investment Fund Act; and

(g) a Private Placement Memorandum is in place for the PVC Fund.”

40. There are no disbursement conditions envisaged for expenditures on VC Fund management fees and costs with VC Fund establishment (under Component 1). There are no disbursement conditions for Component 2 and Component 3, except the procedure determined in the disbursement letter in respect of documentations details.

Table A4.2:- Withdrawal of the Proceeds of the Loan[108]

Category	Amount of the Loan Allocated (expressed in Euro)	Percentage of Expenditures to be financed (inclusive of Taxes)
(1) PVC Investments	12,000,000	100%
(2) PVC Management Operating Costs	3,600,000	100%
(3) SCI Subprojects	2,500,000	100%
(4) Consulting Services, Training and Operating Costs	1,500,000	100%
(5) Unallocated	400,000	
TOTAL AMOUNT	20,000,000	

Table A4.3: Financial Management Action Plan

Action	Deadline	Responsible
Prepare FM section for the Project Operations Manual	Effectiveness	HAMAG-BICRO

[108] In the Loan Agreement, PVC refer to Pilot VC Fund and SCI refer to Seed Co Investment.

Engage or appoint 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;	Effectiveness	HAMAG-BICRO
Financial management assessment of the VC Fund Manager to be conducted by the bank FMS	As soon as VC Fund Manager had been selected	World Bank
Prepare a joint action plan with involvement of MOF in order to rectify issues that have led to audit disclaimer for FY 2013	Implementation	HAMAG-BICRO and MOF

41. **Implementation Support and Supervision Plan**. The World Bank will apply a risk based approach in undertaking project supervision activities that will include reviews of periodic reports and Withdrawal Applications and site visits (at least once each year). Implementation support will be provided in the form of briefing/orientation of key financial management staff; review of IFRs and audited annual audited financial statements together with auditors' management recommendation letters; monitoring implementation of agreed remedial actions; and addressing emerging issues in collaboration with HAMAG-BICRO. Other specific activities to be included in the FM supervision plan will include an assessment of FM arrangements of the VC Fund Manager.

42. **Contract management.** In the PIU will maintain technical and financial database of all project contracts. The technical database shall be updated by procurement staff on a regular basis. Such database will have available all information on contracts, any annexes which were concluded as well as any payments made up to date. The FM managers will maintain an overview overall Project-related payments and thus control and are able to prevent any overpayments.

43. **Use of country systems**. The project will use elements of country systems such as: staffing, accounting, treasury, partially internal controls etc.

Procurement

44. **Overall public procurement environment in the country.** The public procurement environment in the Republic of Croatia is defined by the Public Procurement Act (PPA) as of January 1, 2012 and amended in June and November 2013. The PPA regulates the procedures for award of public contracts and framework agreements for the procurement of supplies, works or services, legal protection in relation to those procedures and the competences of the state central administration body competent for the public procurement system. The public procurement legislation is aligned with EU acquis communautaire, and the Government of Croatia is working further to aligning it with the new EU Directive 2014/24/EU on public procurement. Pursuant to the above referenced PPA, the Government has adopted several subordinate regulations with regard to drafting tender documents, issuing procurement notices, use of common procurement vocabulary, and control over implementation of the PPA. The State Commission for the Supervision of Public Procurement Procedures is the autonomous and independent government body, responsible for considering appeals in connection with public procurement procedures, concession award procedures and procedures for selection of private partners in public private partnership projects.

45. **Assessment of Implementing Agency's capacity for procurement**: The implementation of project activities will be under HAMAG-BICRO. A PIU shall be established within HAMAG-BICRO and it will be responsible for the overall coordination, monitoring, and fiduciary functions (including procurement, financial management and disbursement). It may be incorporated in the HAMAG-BICRO structure, comprising its own staff. If needed, an additional external consultant(s) may be hired to provide technical assistance and support to the team with regard to the day-to-day coordination and management of the Project procurement activities.

46. Part of the funds under Component 1 Pilot VC Fund (€ 15.6 million) of the proposed Project will be used for financing of the Venture Capital Fund Manager Contract. A private firm would be selected for that purpose in accordance with the applicable Consultant Guidelines and as agreed in the summary Procurement Plan and the estimated cost envisaged for this activity is about €3.5 million. The detailed procurement arrangements, as well as the roles and responsibilities with regard to procurement management under Component 2 - Seed Co-Investment Fund (€ 2.5 million) - and Component 3 - Technical Assistance (€ 1.5 million) - will be elaborated in the Project's Operations Manual. Procurement of goods, works, non-consulting and consulting services, as relevant, under Component 2 will follow the provisions on procurement and selection of consultants in loans to financial intermediary institutions and enterprises as defined in the respective Procurement and Consultant Guidelines. Component 3 envisages financing of mainly non-complex technical assistance/consulting services contracts, capacity building activities, and training. Currently, there is no experience within BICRO-HAMAG with fiduciary tasks and specifically procurement in accordance with the World Bank procurement policies and procedures. Although there is a specific person assigned for the procurement function under the project, who is knowledgeable and has a certification in public procurement, there is a need for enhancement the capacity with regard to managing procurement under the World Bank procurement policies and procedures. Based on the assessment of capacity of the implementing agency to carry out and manage procurement, the Bank determines that the overall risk for procurement, after mitigation, is moderate. Attached below is the summary risk assessment, including description of risk, mitigation measures and relevant rating of risk:

Table A4.4: Summary of Procurement Risk Assessment

Description of risk	Rating of risk	Mitigation measures	Rating of residual risk
Lack of experience with World Bank procurement policy and procedures.	**Substantial**	• Coordinated implementation support by the World Bank's team, including procurement training in selected areas (eg. selection of consultants) and contract management. • Procurement staff attending formal procurement training organized by the World Bank in the region or provided by a training institution, acceptable to the Bank. • Use of appropriate standard bidding/proposal document and proper implementation support by Bank's team.	**Moderate**
Need to formalize the Project Implementation Unit (PIU) structure within the implementing agency.	**Substantial**	• Issuing a formal decision on composition and establishment of a PIU • Prepare and agree on a terms of reference. • Prepare inputs for the Project Operations Manual on detailed arrangement, roles and responsibilities with regard to procurement management.	**Moderate**
Private sector or commercial practices under component 2 shall be acceptable to the Bank.	**Substantial**	• The Project Operations Manual elaborates on the basic guiding principles and acceptable procurement procedures to be observed by the project beneficiaries under Component 2.	**Moderate**

47. **Applicable Guidelines.** The Bank's procurement framework will remain the default procurement mechanism for the operation All goods, works, non-consulting services and consulting services required for the activities of the project and included for financing from the Loan proceeds shall be procured in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" dated January 2011, Revised July 2014 and "Guidelines: Selection

and Employment of Consultants under IBRD Loans and IDA Credits & Grants by the World Bank Borrowers" also dated January 2011, Revised July 2014; and the provisions stipulated in the Legal Agreement. A summary of the various items under the different expenditure categories are summarized further in this Annex. A **General Procurement Notice (GPN)** for the project will be published after project negotiations in United Nations Development Business (UNDB), the World Bank's external website, in Narodne novine and on the implementing agency's websites. The Bank will assist with its publication in UNDB and on the Bank's external website. **Anti-corruption measures.** The implementing agency through its Project Implementation Unit (PIU) will follow the World Bank's anti-corruption measures and will not engage services of firms and individuals debarred by the Bank. The list of such debarred firms and individuals is located at http://www.worldbank.org/html/opr/procure/debarr.html**Summary Procurement Plan.** A summary Procurement Plan for the proposed Project, covering at least the first 18 months of the Project was prepared during appraisal stage and its final version was agreed at Project negotiations. It includes as a minimum (i) a brief description of the goods, works, non-consulting services and consulting services required for the project ; (ii) the proposed method of procurement; (iii) the Bank's review requirements; (iv)timeline for initiation of procurement, contract commencement and completion. After loan negotiations, the Bank shall arrange the publication on its external website of the agreed initial procurement plan and all subsequent updates once it has provided a no objection.

Table A4.5 - Summary Procurement Plan

1	2	3	4	5	6	7	8
Ref. No.	**Description**	**Type (Goods/Consulting Services)**	**Procurement Method**	**Review by Bank (Prior/Post)**	**Contract Signing**	**Contract Completion**	**Comments**
1	Fund Management Company	Consulting services	QCBS	Prior	Apr-16	Jan-26	The allocated funds for this contract will be used for the duration of the project, i.e. until September 2021. Funds from the Government's budget would be used to finance the contract between September 2021 and January 2026
2	Global Advisory Network	Consulting services	Individual Consultant (IC)	Prior	Feb-16	Sep-21	Multiple contracts - about four (4)
3	Capacity building and networking	Consulting services	To be determined	TBD	Jan-16	Sep-21	Multiple contracts, representing standard training courses, study tours, etc. This line item might be taken out from the procurement plan and detailed information provided in a training plan.
4	Monitoring and evaluation system	Consulting services	CQS	Prior	Jun-16	Sep-21	
5	Project management	Consulting services	To be determined	TBD	Oct-15	Sep-21	Multiple contracts, representing additional consultants and training in specific areas.
5.1	Project financial audit	Consulting services	LCS	Prior	Mar-16	Jan-22	

48. **Summary Procurement Plan and Procurement Decisions Subject to Prior Review by the Bank.** The summary Procurement Plan indicates the specific review arrangement for each contract. Contracts not subject to prior review by the Bank, will be post reviewed by the Bank's procurement specialist, assigned to the project. Post review of contracts shall be carried out once a year. At a minimum 1 out of 10 contracts will be randomly selected for post review. The specific procurement and review thresholds, applicable for the project are defined in the tables below: The final version of the Project Operations Manual will elaborate on the supervision and oversight arrangements for Component 2, for the procurement to be carried out by the beneficiaries, in order to ensure compliance with the agreed private sector methods and commercial practices under the relevant financing to the beneficiaries.

Environmental and Social (including safeguards)

49. HAMAG-BICRO is the main implementing agency for project management, which includes safeguards management for all three Project components. Currently, HAMAG-BICRO is the only Project beneficiary (PB), however during project implementation a VC Fund will be established which will be managed by a tender-selected company with the primarily purpose to ensure equity investments for innovative SMEs and startups (Component 1).

50. Responsibilities of HAMAG-BICRO, amongst other include responsibility for adherence to all fiduciary and safeguard requirements of the World Bank for final borrowers for the Component 2 (Seed Co-Investment Fund). For the Component 1 (Pilot VC Fund), the responsibility for fiduciary and safeguard requirements lies before the VC Fund Manager, which will be a tender-selected company running the VC Fund. HAMAG-BICO will make sure that the safeguards requirements stipulated in EMF become part of the operating practice of the VC Fund.

51. In order to participate in the Project, both, HAMAG-BICRO and VC Fund Manager, commonly called PB, will identify a person or a team in charge of environmental due diligence during the project. Training will be provided for the staff in charge of the safeguards issues. The main purpose of this training is to enhance the capacity of a PB to successfully review sub-project applications, perform environmental screening of proposed projects and monitor implementation of environmental requirements set in environmental due diligence documentation. HAMAG-BICRO staff underwent safeguard trainings in Belgrade in 2011 and Dubrovnik 2015 while for VC Fund Manager staff the training will be organized upon the appointment.

52. PB will conduct environmental review of all investments and sub-loans under the Project, including HAMAG-BICRO co-investment (under the Co-Investment Fund) and venture capital investments (under the VC Fund). Prior to environmental review sub-borrower will provide required information through previously prepared forms defined in the EMF. Subsequent sub-beneficiaries' (sub-borrowers) applications processing will include an environmental screening, environmental categorization which determines the sub-project's eligibility, scope of environmental assessment, emissions permitting and other environment related documentation required for sub-project approval and implementation. Approval procedures will include categorization procedures and documents/questionnaire. Environmental specialist of World Bank will closely work with HAMAG-BICRO and VC Fund Manager during sub-project categorization, providing assistance and advice. PBs will conduct appraisal of sub-projects, in the case the application was successful.

53. The World Bank will assist PBs in screening procedures according to EMF. In addition, World Bank will perform environmental evaluations and review procedures on ad-hoc basis. World Bank

will perform: a) a prior review and clearance of all sub-projects falling in category B+ requiring EIA and/or full EMP, prior review of first five (5) category B- sub-projects under each PB; as well as those involving use of mutagenic, teratogenic or cancerogenic substance and b) post review for all other projects.

54. PBs will be expected to monitor sub-borrower's compliance with EMPs and report to the MOEC and World Bank on the environmental performance of their clients as an integral part of their regular reporting on the status of portfolio. Environmental work of PBs will be subject to the review by the World Bank supervision missions. Table below briefly describes responsibilities of project participants in the implementation process.

Table A4.6 - Responsibilities of Project Participants in the Implementation Process

Participant	Activity	Supporting Documentation
Sub-beneficiary	Submission of sub-project concept to PB Arrangement and financing of environmental due diligence documents Obtain required permits/licenses Implementing and financing of environmental due diligence	Copies of permits, licenses Clearance statement Periodic reports and sub-project completion report
Project Beneficiary (PBs)	Finalize the environmental screening form, assign the environmental category Review of sub-loan application package for required environmental documentation and licenses/permits from the State authorities Maintain complete files of environmental documentation for review by the PIU and WB Monitoring compliance with mitigation plans (if necessary)	Include environmental information with sub-loan application Include environmental monitoring / supervising information in regular portfolio reporting to PIU Include environmental documentation in normal PB records Periodic monitoring / supervising reports (if necessary)
PIU	Distribution of Operational manual to PBs Assist to the PBs about environmental requirements Verification that PBs have followed EA procedures	Include environmental category and EA status in normal periodic reporting activities
WB	Organize training for PB and PIU staff regarding environmental review procedures Carry out prior and post reviews Identification of problems/ issues and proposal of solutions	Provide assistance Document status of project implementation in Implementation Status and Results reports and the mission Aide-Memoires

Annex 5: Detailed Explanation of Risk Rating and Mitigation Measures

1. The overall risk rating of this project is *substantial*. The proposed Project is a means by which the Government of Croatia intends to promote risk financing to widen the access to finance for innovative start-ups and SMEs. This is a type of operation which involves by definition substantial risks. Overall, these risks were carefully assessed during appraisal stage. The risks rated as high and substantial which are associated with this proposed operation are related to: political and governance issues; the macroeconomic environment, the technical design of the project; fiduciary, and institutional capacity for implementation. The overall description of these challenges and the proposed mitigation measures follows below.

- **<u>Political and Governance Issues</u>**

2. *Recent merger of BICRO with HAMAG*. The Business Innovation Center of Croatia (BICRO) and HAMAG (the Croatian Agency for SMEs) have recently completed their merger. Although each individual institution has a long history and standardized internal mechanisms, the new organization is currently in the process of setting in place its procedures and governance framework. This process may diminish somewhat, at least in the initial phase of the project, the capacity for implementation. ***Mitigation***: In the context of another activity (STP II), the World Bank is already working with the new HAMAG-BICRO. By leveraging the STP II experience the World Bank team can help to overcome any challenges to project delivery that may arise due to the recent merger process.

3. *The need for a long term commitment.* A venture capital fund lasts at least ten years. This means that the program will operate over a number of government administrations. This creates the risk that future administrations will try to prematurely close the fund, add new terms and conditions to investment or inject other sources of interference which is likely to cause it to fail, slow down or stop investment decisions and undermine the development of a venture capital market in Croatia. ***Mitigation***: The Project should be placed under a stable organization with a strong record, and a long term strategic planning horizon. The implementing agency selected for this program is HAMAG-BICRO which largely fulfills these requirements, with the caveat that the agency has recently been established.

4. *Perception that repayment of loan is conditional on Pilot VC Fund returns.* ***Mitigation****:* The government is aware the VC Fund may not make positive returns, and the loan repayment is not conditional on the Fund's success.

- **<u>Macroeconomic</u>**

5. *Croatia is slowly emerging from a multi-year recession and the country's fiscal position remains weak.* This suggests that the government's ability to fund science, technology and innovation programs out of its own resources will be constrained in the coming years. This suggest that the supply of technologies that can be commercialized may be reduced which could dampen the demand for risk capital from young knowledge intensive firms. ***Mitigation***: Croatia is expected to benefit from European Union ESI funds. A portion of these are expected to be spent on science, technology, and innovation. In addition, the Bank's STP II project is supporting activities in this area.

- **Technical design of the project**

6. *Crowding out effects.* Any public intervention geared to narrow the equity gap has the risk of crowding out private resources. Since there is a limited number of investment opportunities available in the market, an oversupply of public resources oriented to finance them can imply less investment opportunities for the private sector. Overly large interventions not only reduce investment opportunities for the private sector, but also decrease their returns, as competition for projects forces investors to offer better financial terms to SMEs.[109] ***Mitigation***: By investing alongside investors the Co-Investment Fund is a mechanism to stimulate private sector participation rather than crowd it out. The risk-sharing characteristic of the Co-Investment Fund attracts investors, who without the Fund would either not invest at all or allocate their resources to less risky investments. The Co-Investment scheme allows partners to spread risk by increasing the size and scope of their financial activity, which allows them to diversify their portfolio. In addition, the design of the Pilot VC Fund aims to ensure that the size of the fund is in line with the demand for risk capital financing. This reduces the potential of an oversupply of risk capital financing and thus the risk that the Project will crowd out the private sector.

7. *Displacement effect.* The main objective of the Seed Co-Investment Fund is to provide early-stage funding. However, by attracting investors to fill the equity gap, the intervention can induce reallocation of private resources from follow-on investment to new ventures, thus creating displacement effects. These effects tend to be larger the more limited is the supply of risk capital However, displacement effects are not automatically created, since investors sometimes tend to secure later-stage funding when providing early-stage capital. ***Mitigation:*** The combination of the Seed Co-Investment Fund which provides finance to younger firms and the Pilot VC Fund which will provide follow on investments limits the risk that funds available for follow on investments will be reduced by implementing the Project.

8. *Focus of the Pilot VC Fund*. The Pilot VC Fund may have a tendency to invest in late stage startups rather than in early or seed stage startups. Later stage investments are often more attractive for because they are lower risk and the fund can sell its stake in the company more quickly. ***Mitigation***: There are a number of measures that together seek to ensure that the proposed VC Fund will invest in early stage ventures. First, through the proposal received in the initial RFP process, where the selection of fund manager is dependent on commitment to adhere to the investment objectives outlined. In addition, the parameters specify that HAMAG-BICRO's determination on the eligibility of investee companies is final . Second, through the investment mandate agreed by the shareholders (while the government's contribution to the fund is subject to the entrance of private shareholders, the government remains the anchor shareholder in this fund, with most likely the majority capital contribution). Lastly, if, as is likely, the Fund Manager opts for the EuVECA regulations, the fund will have to adhere to investment guidelines that require it to invest in qualifying investments in order to maintain its passport.

9. *Lack of co-investors in the Seed Co-Investment Fund*. The Seed Co-Investment Fund needs to invest alongside early stage investors in the Croatian market. Currently there are relatively few

[109] The potential for crowding out is offset by the possibility of crowding in. Early stage investors find it more attractive to invest alongside other investors. Investing alongside another investor reduces risk and transaction costs and so increases risk adjusted returns. As a result, public policies to increase risk capital financing can crowd in private finance, rather than crowd it out.

investors in the market and therefore there is likely to be a slow take up of the fund. Experience with similar co-investment funds shows that it takes time for the fund to attract co-investors. ***Mitigation***: Technical assistance will be provided to provide capacity building for investors in early stage firms. This will include training on investing in early stage firms, as well as using technical assistance to support the development of angel syndicates. The Co-Investment Fund will also be able to co-invest alongside foreign investors as long as foreign investors are investing in firms registered in Croatia.

10. *The Seed Co-Investment Fund may end up with relatively low quality investments*. Co-investment funds can attract low quality investments from co-investors. This can be due to the provision of subsidy and because of the potential for some investors to keep the best investments for themselves, while referring the "lower-quality" investments to the Co-Investment Fund. This "lemons problem" can reduce returns. ***Mitigation***: This tendency can be offset by the choice of instrument and the process used to review proposed projects The risk that the fund will be lumped with poor investments will be mitigated because HAMAG-BICRO will conduct due diligence on investors and proposed investments.

11. *Insufficient deal flow for the Pilot VC Fund, and difficulty exiting investments*. There is a risk that there may be weak investable demand for the Pilot VC Fund, and the Fund may struggle to sell the stakes in the companies it does invest in. Estimates are that there is demand for a fund that has committed capital of between €5 and €20 million. ***Mitigation*****:** The uncertainty about the amount of deal flow in the market will be mitigated by investing in the VC Fund in stages, or closes.[110] To further mitigate the risk of too little deal flow the VC Fund will be allowed to invest in companies that are willing to relocate to Croatia. In addition, deal flow can be further supported by continued government investment in innovation in universities, research institutions, and startups. Access to ESI funds offers an opportunity to boost investment in these areas. Other mechanisms to increase investable demand will be implemented including providing technical assistance to potential investees, and the establishment of the Seed Co Investment Fund to further increase the amounts of capital in the market.

12. *Pilot VC Fund size is below the minimum efficient scale*. Launching the Pilot VC Fund in stages leads to the risk that the VC Fund will not be large enough to provide sufficient management fees for the management firm to operate effectively. In particular, a €10 million Euro fund may not be sustainable on a standard management fee of 2 percent of committed capital. ***Mitigation:*** As discussed below this risk will be mitigated by using public resources to support the management firm's operating expenses up to € 3.5 million (to the extent this is needed).

13. *The incentives of (Pilot VC Fund) management firm may not be aligned with those of the investors in the Fund and those of the Croatian government*. The management firm of the Pilot VC Fund has substantial latitude in the operations of the Fund and so it's important that its incentives are aligned with those of the investors including the government. ***Mitigation***: The

[110] To illustrate, the VC Fund management company would have to demonstrate sufficient deal flow to attract private investors to invest €4 million in the Pilot VC Fund. This will make for a €10 million first close. The Fund manager could then start investing this first tranche of capital. If the manager can successfully invest in a number of good companies and thus demonstrate a pipeline of additional transactions, a second close could be raised. It is envisaged that this second close will be €20 million which will require an additional €6 million from the Project and an additional €4 million from the private sector.

management firm's incentives will be aligned with the investors through structuring the (a) the fees paid for managing the fund, (b) the "bonus" it is paid out of the funds profits (the carry), and (c) the management firms staff's own investment in the Pilot VC Fund. The fees will be set to ensure that the Pilot VC Fund has sufficient resources to manage the fund but does not make excessive profits merely for managing the fund. Rather, the VC Fund management firm's profits will only come if the Pilot VC Fund makes a profit. In this case the management firm will be paid "a bonus" or carry that comes out of these profits. In addition, the management firm will contribute with at least one percent of the Pilot VC Fund from their own resources. Thus, if the Pilot VC Fund is €20 million they will invest at least €200 k, providing them with an incentive to avoid losses.

14. *Politicization of investment decisions under the Pilot VC Fund*. If investment decisions are made on a political, rather than commercial basis, the VC Fund is likely to fail. International experience suggests that a publicly supported venture fund is likely to succeed only if it is operated an arms-length basis from political decision making. ***Mitigation***: The Pilot VC Fund will be isolated from political decision making by ensuring through the governance arrangements (as set out in the Articles of Association (shareholder agreement) or AIF rules, according to the Croatian AIF law, that investment decisions are independent of the investors in the Fund including the government.

15. *Attracting a good firm to run the Pilot VC Fund*. The success of the Pilot VC Fund will largely depend on how effective the firm running the Fund is. The issues discussed above of market size, deal flow, possibility of political interference, and the size of the fund will make it more difficult to attract an effective venture capital management firm. ***Mitigation*:** The approaches described above all have the effect of making the proposed Pilot VC Fund more attractive for prospective management firms. The Project will ensure that the Articles of Association (shareholders agreement) and other contracts are drawn up and implemented on a commercial basis free of political interference. In addition, the management firm will be selected through an international tender.

16. *Readiness for implementation*. The largest part of the loan (Component 1, Pilot VC Fund, amounting 15.6 million Euro) is subject to disbursement conditions, which include: selection of Fund Manager, Fund Manager is authorized by HANFA or has notified HANFA of intent to conduct activities in Croatia, VC Fund has been created by Articles of Association (shareholder agreement) with by laws acceptable to the World Bank, etc (see Annex 3 for further details). There is a risk that these conditions, however well founded, will not be met and therefore the largest part of the loan would be not disbursed. ***Mitigation***: there are triggers to cancel this component; if the disbursement conditions have not been satisfied by two years after the loan is effective, then the VC Fund component is cancelled and the corresponding amount can be reallocated upon client request. This will help mitigate the risk of having relatively large undisbursed balances. The other two components - Seed Co-Investment Fund, amounting 2.5 million Euro, and Technical Assistance, amounting 1.5 million – could start operating and disbursing right after effectiveness.

- **<u>Institutional capacity for implementation and sustainability</u>**

17. Currently, there is no experience within BICRO-HAMAG with procurement in accordance with the World Bank procurement policies and procedures. ***Mitigation***: HAMAG-BICRO will

formally define the implementation arrangements and will assign specific individuals who will be part of the PIU, and formally entrust them with the overall coordination, management and monitoring of procurement. The World Bank procurement specialist carried out a capacity assessment for procurement and defined the specific procurement arrangements for the Project, as well as the mitigation measures for the risks identified. Procurement and prior review thresholds are defined in the summary Procurement Plan. The Project Operations Manual will describe the basic guiding principles and acceptable procedures applicable to the loan.

- **Fiduciary**

18. *The PIU in HAMAG-BICRO has no experience in fiduciary tasks per se*. BICRO has been a Project’s beneficiary for STP II project but have not had the role of a PIU before. In light of this limited experience, HAMAG-BICRO needs to develop its capacity in areas including: (i) the preparation of withdrawal applications from the World Bank, and (ii) financial reporting. In an audit performed in accordance with the International Standards on Auditing it was found that the "BICRO was not able to provide the auditors with representations relating to the existence and completeness of the transfer of assets and liabilities from BICRO doo and HIT[111] doo (according to the Decree on establishing the Business innovation Croatian Agency BICRO)" . The auditor's report of BICRO found that as of the 31st of December 2013 adequate accounting records were not kept for receivables. In the audit of BICRO the auditors issued a letter specifying that: (i) the Agency is not carrying out review of loan receivables and measuring loan impairment if any, (ii) the auditors did not get a formal statement evidencing that all the transfer of assets and liabilities from BICRO d.o.o and HIT d.o.o had been completed (according to the Decree on establishing the Business innovation Croatian Agency BICRO), and (iii) BICRO had not ensured that it had sufficient funds available if the repayment of loans received from BICRO doo and HIT doo were less than expected. ***Mitigation***: The World Bank fiduciary team in Croatia will work with HAMAG-BICRO to advise on how to build its capacity in fiduciary tasks. This will include capacity building in areas such as the preparation of withdrawal applications, reporting, preparing audited financial accounts and others.

[111] HIT was the Croatian Institute of Technology. It was merged into BICRO

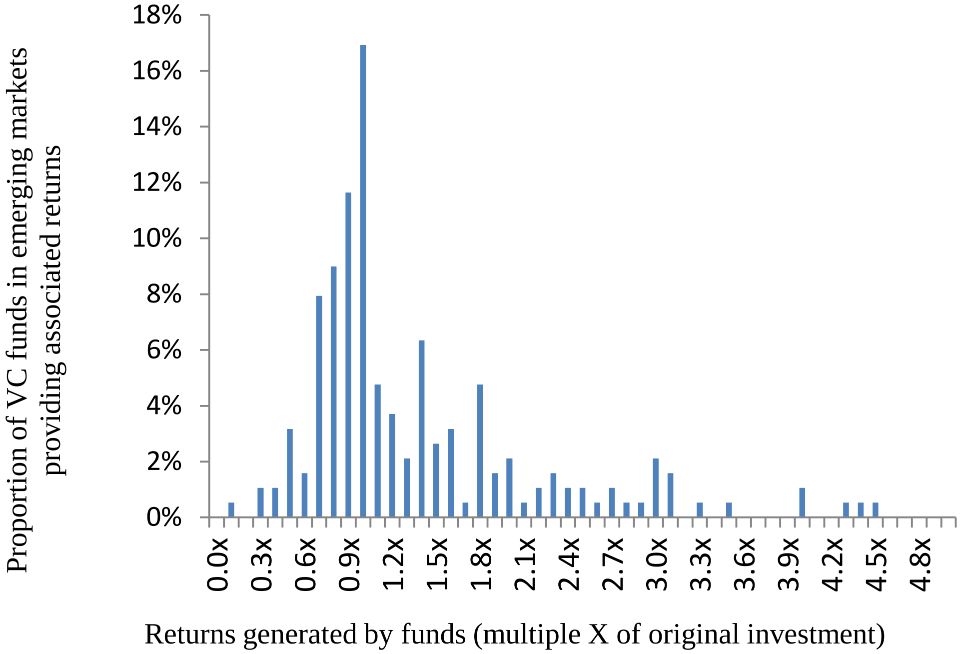
Annex 6: Project Financial Analysis

1. **The financial analysis suggests that private investors investing in, and alongside the project could earn positive expected returns on their investments**. This includes the private investors in the Pilot VC Fund (private shareholders) and those co-investing alongside the Seed Co-investment Fund (co-investors). In part, the positive returns for the private shareholders arise from the provision of concessional finance for the private investors which increases their returns at the expense of the public sector (the public sector shareholders). While investors are expected to earn a positive return, the nature of risk capital financing is that losses happen regularly and so there is a high likelihood that private investors will lose money on their investments. The projections that underpin these findings, reflect the findings of a financial analysis that was based on investors' experiences in Croatia and the region.

2. **Risk capital financing of the kind made by angel investors and venture capital funds provides the possibility of high returns but comes with the risk of substantial losses**. Successful investments can pay 5 to 100 times more than what was initially invested. However, these high returns are relatively rare. Less than 20 percent of investments are expected to earn high returns. These investments also come with high risk, with as many as thirty to fifty percent of venture capital funds' and angel investors' investments losing all the money invested. Both VC funds and angel investors attempt to mitigate this risk by investing in a portfolio of companies. Portfolios have lower risk than individual investments but even so these portfolios have a high variance in returns. This is illustrated in Figue A6.1 which shows the returns for venture capital funds in emerging markets. A large proportion of funds don't pay investors back what they invested (a multiple of less than one). There are also some funds that provide large returns. Overall the venture capital funds in emerging markets have earned returns of around 10 percent. These returns are relatively low in light of the risk and illiquidity of these investments. Current research suggests that returns earned by angel investors are broadly comparable in risk and return to those earned by venture capital funds and so their returns could be expected to follow a similar pattern to those shown in Figure A6.1.[112]

[112] Wiltbank, R, 2009 "Siding with the Angels, Business angel investing – promising outcomes and effective strategies" NESTA Research report: May 2009 *and* Wiltbank, R, Boeker, W, 2007 "Returns to Angel Investors in Groups" Ewing Marion Kauffman Foundation and Angel Capital Education Foundation. The data used for the analysis is from Preqin which is a provider of data on alternative investments including venture capital and private equity funds. Preqin collects its data from regulatory filings, requests using the Freedom of Information Act typically of public pension funds, as well as news sources. Preqin suggests that because it does not rely on self-reporting from fund management companies its data is less reliant on self-reporting than some other sources of data on venture capital fund performance, and so less susceptible to self-reporting bias. Self-reporting bias can arise because fund management companies only have an incentive to report their results if the funds they manage are relatively successful. As a result databases that rely on self-reporting are thought to have an upward bias in their returns they report.

Figure A6.1: Descriptive Statistics on Venture Capital Funds in Emerging Markets



Source: Preqin database[113]

3. **There is an inherent uncertainty about the returns to providing risk capital finance in Croatia, an uncertainty that will be reduced during the implementation of the project.** This uncertainty arises because there is relatively little investment occuring in Croatia currently and so there is little experience with the returns generated. This uncertainty will be reduced during the project. Prospective managers of the Pilot VC Fund will need to provide estimates of the returns they expect to be able to achieve, and how they will achieve them. They will need to do so when the apply to manage the fund, and when they seek to attract private investors to the fund. They will need to persuade private investors that they can generate healthy returns, and so attract private investors to invest in the fund, before the fund will start operating. The Seed Co-investment Fund will reduce uncertainty by facilitating investments in the market which will build up experience in the market of the returns that can be expected from this asset class in Croatia.

6.1. Pilot VC Fund

4. **The Pilot VC Fund's expected returns are projected to be relatively low but positive.** While there is a substantial likelihood of losses this is offset by the possibility of relatively high returns.

5. **The expected returns of the fund reflect the experience of investors in Croatia and is informed by the historical performance of venture capital funds in emerging markets**. As shown in Table A6.1 venture capital funds in emerging markets earn relatively low returns (a internal rate of return of less than 10 percent). This is true for venture capital funds in emerging markets in general. It is also true for venture capital funds in the seed, startup and early stages

113 Multiples are reported to be net of fees

"early stage funds" which earn a multiple (x) of 1.4 as well as funds that have invested in ECA "ECA funds" that earned a multiple(x) of 1.5. The risk for investors of not getting their money back is high. Around 50 percent of funds in all categories failed to return investors capital after fees were taken into account.

Table A6.1: Projected Returns for the Pilot VC Fund compared to historical performance of VC funds in emerging markets

		Benchmark from historical returns		
	Expected return for Pilot VC Fund	**Venture capital in emerging markets**	**Seed, startup and early stage venture capital funds in emerging markets**	**All venture capital funds investing in ECA**
Multiple (X)	1.3	1.5	1.4	1.5
Internal Rate of Return (IRR)	3%	10%	4%	7.5%

Source: Analysis and the Preqin database[114]

6. **The high risk and comparatively low expected returns of the Pilot VC Fund suggests a rationale for providing concessional finance to attract private investors into the fund**. This includes providing support for costs of managing the fund. The fund manager will start operating after the first close which may entail a relatively small commitment of capital of €10 million. Charging a benchmark fee (around 2 percent of committed capital) may provide too little money for the fund manager to operate effectively. This will make the Pilot VC Fund unnattractive for prospective fund managers. In addition, private shareholders are often wary of paying fees to a fund manager that does not have a track record of investing effectively in the prospective market. To ameliorate these risk the government will cover a substantial proportion of the fund manager's operating costs.

7. **The impact of these interventions is shown in Figure A6.2.** This figure shows the return profile for investors under different concessional finance options. Panel I shows the participants returns if no concessional finance is provided and so a benchmark structure is used that is similar to the structures used by purely private sector venture capital funds. Under the benchmark structure the fund manager is unlikely to earn a positive return. Panel II shows how the fund manager's returns are affected when the public shareholder supports the fund manager's management costs by paying more than it would under the benchmark structure. This means that the fund manager earns a positive return as long as the fund makes a profit. Panel III shows the change in returns when the public shareholder covers a large proportion of the fund manager's management costs saving money for the private shareholders. This increases returns for the private shareholders (from 3 percent to 4 percent).

8. **Table A6.2 shows the returns that are expected to be earned by the investors in the Pilot VC Fund.** The private shareholders are expected to earn a IRR of around 4 percent. This is higher than the IRR of 3 percent that they would have received absent concessional finance. The private fund managers are expected to earn a relatively large return on their investment in the Pilot VC

[114] Multiples are reported to be net of fees. There are relatively few funds that report figures for IRR which explains apparent differences between the IRR and Multiple (x) averages.

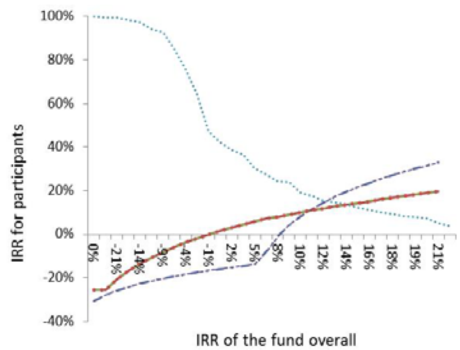
fund. While there is potential for the fund managers to earn a high return, the compensation to the fund manager will be determined through the tender and broader procurement process and so the fund manager's expected returns could differ substantially from those shown in Table A6.1.

Table A6.2. Expected returns for investors in the Pilot VC Fund

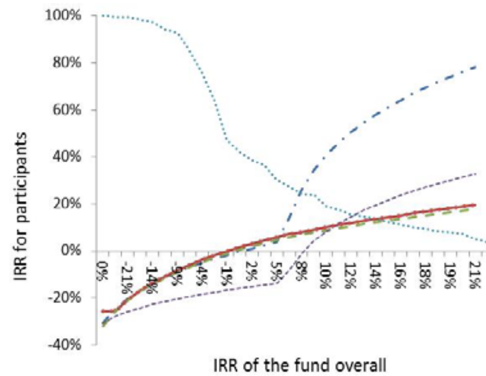
Returns from investments	**IRR**	**Multiple (x)**
Fund overall	3%	1.3
Public shareholder	1%	1.2
Private shareholders	4%	1.3
Fund managers	17%	5.6

Figure A6.2. Returns to investors in the Pilot VC Fund using different compensation structures

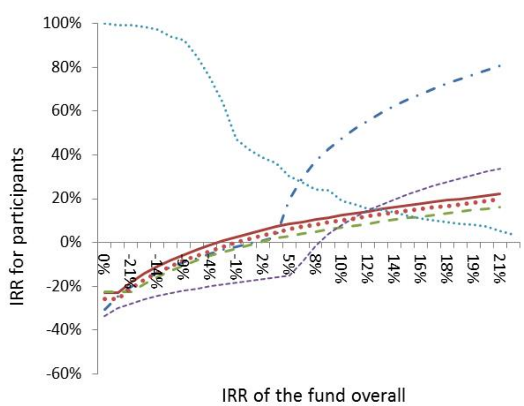
I. **Returns for private shareholders and prospective fund managers would be low using the benchmark structure.** In particular, potential fund managers would lose money even if the fund was relatively successful (return above 8 percent). This would make the fund unnattractive for most prospective fund managers.



II. **Providing support for the management fees means** that the fund manager makes a profit as long as the fund succeeds.



III. **In addition, the public sector shareholder pays a substantial proportion of management costs** which reduces costs for private shareholder and so increases their returns. Paying for management costs means that the fund manager receives carry at a lower level of return because the support for management costs does not come out of the profitability of the fund



GP returns
Public LP Returns
Returns to GP using benchmark structure
Private LPs returns
Proportion of funds that historically received this return or higher
Private and Public LPs returns with benchmark

6.2 Seed Co-Investment Fund

9. **Returns on the investments that the seed fund expects to support are expected to be relatively low**. The expected returns are expected to be in the region of 1 percent. In part these low returns arise because these are expected to be young, innovative firms. Investments in these firms have a high failure rate of around 30 percent.

10. **Investors that invest alongside the Seed Co-Investment Fund will be provided with an upside boost to their returns.** The rationale for doing this is the risk, and the low expected returns of providing seed financing. The co-investment fund will transfer 90% of returns above the hurdle to the private co-investors. As a result, this is expected to increase the returns for private co-investors from 1% to 8%. This will lead the seed co-investment fund to earn back 70c for every euro contributed. Table A6.3 shows the returns that are expected to be earned by the investors in the Seed Co-Investment Fund.

Table A6.3: Expected returns for investors in the Seed Co-Investment Fund

Returns from investments	**IRR**	**Multiple (x)**
Returns on seed-investments	1%	1.1
Private co-investors	8%	1.3
Seed co-investment fund	-7%	0.7

Annex 7. Implementation Support Plan

1. **The Bank will carry-out two main semi-annual implementation support missions, but will mostly rely on monthly follow up by the TTL and the Zagreb WB office.** A Mid-term Review (MTR) mission will be fielded in early 2018. The precise timing will depend on the progress in implementation and the potential emergence of structural implementation challenges, the resolution of which would require an in-depth analysis and restructuring.

2. **The project procurement, FM and safeguards missions could be undertaken as part of the periodic fiduciary support conducted concurrently across operations in Croatia of all Bank sectors (the PS, Environmental Specialist and Social Safeguards Specialist are based in the country office, and the FMS in Europe).** An exception to the principle of autonomous supervision by the safeguards and fiduciary specialists would be the, MTR and Implementation Completion Report (ICR) missions, where it is likely that the entire task team will participate. Procurement prior reviews will be ongoing whereas post reviews will be semi-annual during the first year.

3. **FM Supervision.** As part of project implementation support the Bank will conduct risk-based financial management implementation support within a year from the Project effectiveness, and then at appropriate intervals. During the Project implementation, the World Bank will support the Project's financial management arrangements in the following ways: (a) review the Project's semi-annual IFRs and the Project's annual audited financial statements and auditor's management letters and remedial actions recommended in the auditor's management letters; and (b) during the Bank's on-site missions, review the following key areas (i) project accounting and internal control systems; (ii) budgeting and financial planning arrangements; (iii) disbursement arrangements and financial flows, including counterpart funds, as applicable; and (iv) any incidences of corrupt practices involving project resources. As required, a Bank-accredited Financial Management Specialist will participate in the implementation support and supervision process.

4. **Bank team guidance is not specifically needed, due to the relative ease of applying the Results Framework shown in Annex 1.** However, the World Bank team may assist with putting in place the reporting mechanisms and in drafting the first format of consolidated semi-annual project report. As for safeguards, the Client will closely follow implementation of the EMFs, EMPs, RPFs (if applicable) through the following:

(i) Ensure that the EMP checklists have been prepared on time for all new locations, in line with the EMF and RPF.
(ii) All EMP checklists will be included in respective bidding documents both for new civil works contracts. These will include provisions binding the hired party to implement the EMP measures and/or to supervise them, with adequate reporting submitted to the Client and therefore to the WB.
(iii) The World Bank environmental specialist will conduct regular implementation support of EMF and RPF implementation providing comments and inputs directly to the Client, including site visits and on-the-spot checks with both the contractor and supervisor during ongoing works.

(iv) The World Bank's communication associate from the Zagreb office will contribute to the oversight of the social aspects of the project, will provide a communications watch of the sector reform given its political and reputational implications, and will also contribute to the preparation and implementation of the communication strategy related to the project.

Table A7.1: Main focus in terms of implementation support

Time	***Focus***	***Skills Needed***	***Resource Estimate***	***Partner Role***
First 2 years	Start of implementation of TA (Component 3), Co-Investment Fund (Component 2), selection process of VC Fund manager, and establishment of the VC Fund (Component 1).	Project management Operational Economic analysis Financial analysis IT FM Procurement Environmental safeguard M&E	$100,000	
After year 2	Implementation of the VC Fund	Financial Specialist Economist	$ 40,000	
	Aggregate	All above, at different junctures	$ 140,000	

Table A7.2: Skills Mix Required

Skills Needed	***Number of Staff Weeks***	***Number of Trips***	***Comments***
TTL	8/year	4	HQ staff
Financial Specialist	6/year	3	HQ staff
Operational Analyst/Specialist	10/year	Local trips	Local staff
Procurement Specialist	4/year	Local trips	Local staff
Financial Management specialist	4/year	Regional trips	Local staff
Environmental Specialist	3/year	Local trips	Local staff
Social Development Specialist	1/year	Local trips	Local staff
Communication Associate	2/year	Local trips	Local staff

Annex 8. Women's Entrepreneurship in Croatia

1. A recent report on female entrepreneurship in Croatia found that widely held notions of womens' roles in the society and their abilities have a negative impact on womens' perceptions of entrepreneurial opportunity and their attitude to managing businesses (Sulejmanovi, 2008).[115] A female entrepreneur was quoted as saying that "women frequently do not have the support of their families or community to engage in risky pursuits that entrepreneurship entails". As a result women give up their entrepreneurial ideas before they have even had a chance to develop them. Consistent with this view is that of the five companies profiled in Box A2.2 only one is owned by women. The report suggested that these perceptions reduced women's involvement in entrepreneurship. This was despite the relatively high levels of unemployment for educated women in the country. Women make up 63% of those with a higher education who are unemployed, 79% of unemployed office workers and 75% of unemployed retail and service workers. These statistics suggest that educated women are an untapped source of entrepreneurial potential for the Croatian economy.

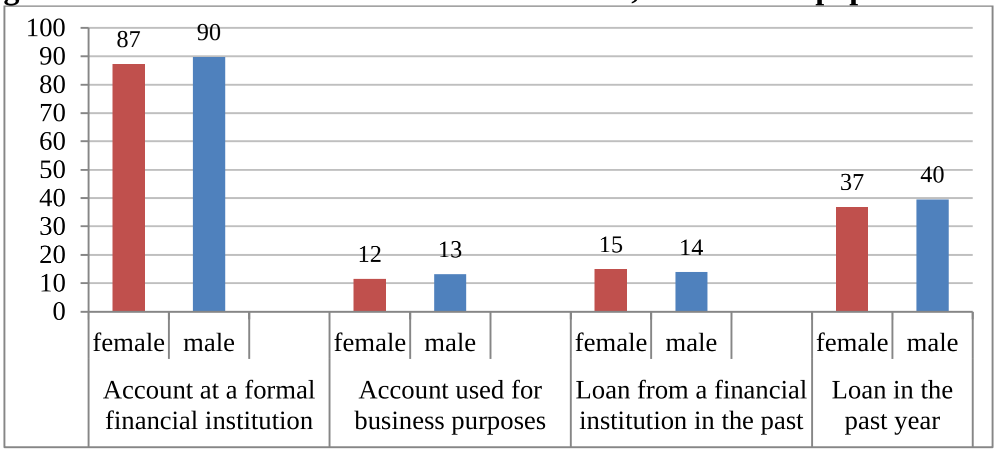
2. In fact, firm-level survey data from the World Bank Enterprise Surveys (BEEPS) confirms that Croatia has few women entrepreneurs. Based on BEEPS 2013, only 19% of firms have a woman as a top manager, and only 30% of companies have at least one woman among the owners of the firm. The firms characteristics observed are similar between women-managed and women-owned firms. Female-run enterprises are overwhelmingly small. Of all companies managed by women, 83% are small firms and 14% are medium firms, whereas only 2.3% are large enterprises. In terms of sectoral distribution, most of them operate in retail (26%) and wholesale trade (21%), followed by construction (11%), hotels (5%), food (4.5%), and precision instruments (4.3%). Women managers appear to dominate among firms in publishing (59%) and precision instruments (74%).

3. Within the general population, men and women appear to make relatively similar use of financial instruments, according to information from the Global Financial Inclusion Database (FINDEX). For indicators such as account at a formal financial institution, account used or business purposes, loan from a financial institution in the past year, and loan in the past year[116] the share of the population above the age of fifteen appears generally similar between men and women (Figure A8.1).

[115] Lilijan Sulejmanovi, 2008."Female entrepreneurship in Croatia" Report sponsored by the World Bank and Harvard Business School May 2008

[116] From any of the following sources: a formal financial institution, a store by using installment credit, family or friends, employer, or another private lender.

Figure A8.1. Use of Financial Instruments: 2011, share of the population 15+

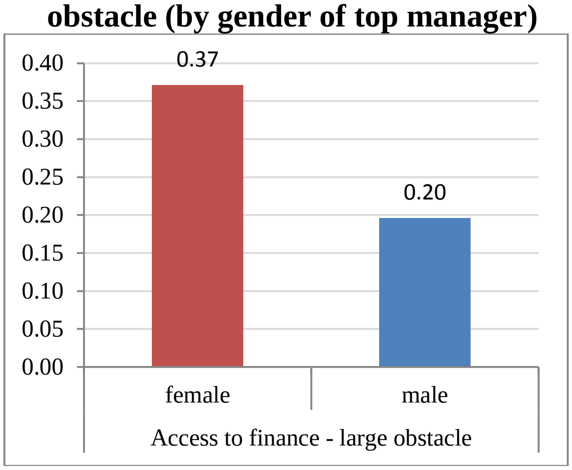


Source: Elaboration based on FINDEX database

4. However, lack of access to finance constitutes the most important obstacle to business operations for female managers. BEEPS results show that a significantly larger share of female managers (37%) consider access to finance to be a large obstacle, compared with male managers, out of which a much smaller proportion (20%) have the same perception (see Figure A8.2 for 34% of female managers (and the most important overall), compared to male managers (19%). As, for the most part, women managers tend to be in charge of small businesses, it is perhaps not surprising that they may face more challenges in accessing credit, since bank requirements can be more onerous and more difficult to meet by small firms.

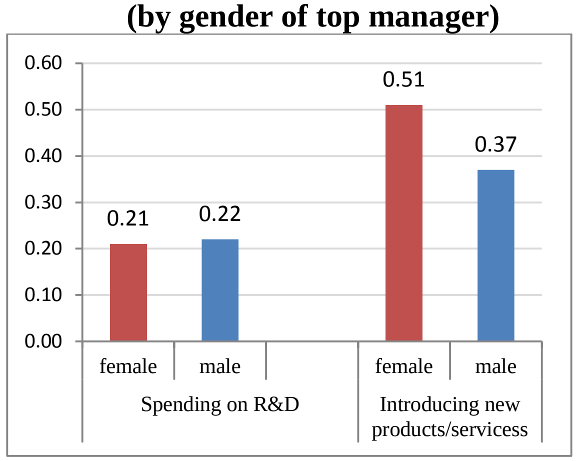
5. In spite of these difficulties, when it comes to research and development (R&D), female-run companies fare on a par or even better than male-run enterprises (see Figure A8.3). Results indicate that a larger share of female-managed companies (51%) had introduced a new product or service in the previous 3 years, compared with firms with male managers (37%), suggesting that there may be a substantial amount of untapped potential for innovation among women entrepreneurs.

Figure A8.2. Access to finance - a large obstacle (by gender of top manager)



Source: Elaborations based on BEEPS 2013 firm level data

Figure A8.3. R&D activity (by gender of top manager)



Source: Elaborations based on BEEPS 2013 firm level data

Annex 9. List of current equity policy instruments by country

1. This Annex contains a list of the seed and early stage financing programs currently in place and managed at the national level and draws on the OECD, 2013 "Policies for Seed and Early Stage Finance: Findings from the 2012 OECD Financing Questionnaire"

AUSTRALIA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Department of Industry, Innovation, Science, Research and Tertiary Education			
	Innovation Investment Fund (IIF)	1997	Equity: Co-investment
	Innovation Investment Follow-on Fund (IIFF)	2009	Equity: Co-investment
	Renewable Energy Venture Capital Fund (REVC)	2011	Equity: Co-investment
	Pre-Seed Fund (PSF)	2001	Equity: Co-investment
	Renewable Energy Equity Fund (REEF)	2000	Equity: Co-investment

AUSTRIA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Austria Wirtschaftsservice GmbH			
	Venture Capital Initiative (VCI)	2002	Equity: Fund of funds
	Cleantech Initiative (CI)	2010	Equity: Fund of funds

BELGIUM- Flanders

Organisation responsible	Instrument name	Year Launched	Instrument classification
PMV			
	Vlaams Innovatiefonds (Vinnof)	2005	Equity: Direct
	Flanders' Care Invest	2011	Equity: Direct
	Investments in VC funds (Vesalius, Capricorn, Aescap)		Equity: Fund of funds
ARKimedes Management NV			
	ARKimedes fonds I (ARK I)	2005	Equity: Fund of funds
	ARKimedes fonds II (ARK II)	2010	Equity: Fund of funds

BELGIUM-Wallonia

Organisation responsible	Instrument name	Year Launched	Instrument classification
SOWALFIN			
	Spin-offs funds	2006	Equity: Direct
S.R.I.W.			
	SOFIPOLE\S.R.I.W. Fund Investments	2005	Equity: Fund of funds

CANADA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Business Development Bank of Canada			
	BDC Venture Capital Direct Investing		Equity: Fund of Funds
	BDC Indirect VC Investments	1975	Equity: Direct
Regional equity programmes			
Government of Alberta			
	AVAC Limited	1997	Equity: Direct
Investissement Québec			
	Teralys	2009	Equity: Fund of funds
The Government of British Columbia			
	The British Columbia Renaissance Capital Fund	2009	Equity: Fund of funds
Northleaf Capital Partners			
	Ontario Venture Capital Fund	2008	Equity: Fund of funds
Alberta Ministry of Enterprise and Advanced Education			
	Alberta Enterprise	2008	Equity: Fund of funds
Ontario Capital Growth Corporation			
	Ontario Emerging Technologies Fund	2009	Equity: Co-investment
The Federal Regional Development Agency of Southern Ontario			
	Investing In Business Innovation	2010	Equity: Co-investment

CHILE

Organisation responsible	Instrument name	Year Launched	Instrument classification
CORFO			
	K1	2008	Equity: Co-investment

CZECH REPUBLIC

Organisation responsible	Instrument name	Year Launched	Instrument classification
Český Rozvojový, Uzavřený Investiční Fond, A.S.			
	SEED	2013	Equity: Co-investment
	VENTURE	2013	Equity: Co-investment

DENMARK

Organisation responsible	Instrument name	Year Launched	Instrument classification
Vaekstfonden (VF)			
	VF Venture group	2007	Equity: Direct
	Dansk Vækstkapital (Danish Growth Capital)	2011	Equity: Fund of funds
	VF Funds	2001	Equity: Fund of funds
Danish Agency for Science, Technology and Innovation (DASTI)			
	Innovationsmiljøer (IM)	1998	Equity: Direct

ESTONIA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Estonian Development Fund			
	Seed capital	2007	Equity: Direct
	Start-up capital	2007	Equity: Direct

FINLAND

Organisation responsible	Instrument name	Year Launched	Instrument classification
Veraventure Ltd			
	Finnvera Seed Fund	2005	Equity: Direct
	Veraventure	2003	Equity: Fund of funds
	Finnvera Seed Fund (co-investments with business angels)	2008	Equity: Co-investment
Finnish Industry Investment Ltd (FII)			
	Finnish Industry Investment	1995	Equity: Direct
	Finnish Industry Investment	1995	Equity: Co-Investment
	FoF Growth	2008	Equity: Fund of funds

FRANCE

Organisation responsible	Instrument name	Year Launched	Instrument classification
CDC Entreprises (CDC Group)			
	Fonds de Co-Investissment pour les Jeunes Entreprises (FCJE)	2002	Equity: Co-investment
	Angel Source	2012	Equity: Co-investment
	Fonds pour la Société Numérique (FSN-PME)	2011	Equity: Co-investment
	Ecotechnologies	2012	Equity: Co-investment
	Fonds National d'Amorçage (FNA)	2009	Equity: Fund of funds
	InnoBio	2009	Equity: Direct

GERMANY

Organisation responsible	Instrument name	Year Launched	Instrument classification
EIF			
	ERP/EIF Fund of Funds	2004	Equity: Fund of funds
	LfA-EIF Facility (part of ERP/EIF FoF)	2009	Equity: Fund of funds
	European Angels Fund (EAF)	2012	Equity: Co-investment
KfW			
	ERP-Startfonds	2004	Equity: Co-investment
High-Tech Gründerfonds Management GmbH			
	High-Tech Gründerfonds (HTG)	2005	Equity: Co-investment

GREECE

Organisation responsible	Instrument name	Year Launched	Instrument classification
TANEO S.A.			
	ERDF	2003	Equity: Fund of funds
JEREMIE Holding Fund- EIF			
	Early Stage ICT Venture Capital Fund Financial Instrument - JEREMIE	2011	Equity: Co-investment
	Seed/Technology Transfer ICT Fund Financial Instrument - JEREMIE	2011	Equity: Co-investment

HUNGARY

Organisation responsible	Instrument name	Year Launched	Instrument classification
Corvinus Venture Capital Fund Management Ltd.			
	Corvinus First Innovation Venture Capital Fund	2005	Equity: Direct
IT Venture Capital Fund Management Ltd.			
	IT Venture Capital Fund	2002	Equity: Co-investment
Venture Finance Hungary Plc.			
	New Szechenyi Risk Capital Programme	2009	Equity: Co-investment

NORWAY

Organisation responsible	Instrument name	Year Launched	Instrument classification
Enterprise Ireland			
	Innovative High Potential Start Up Funding (HPSU)	2008	Equity: Direct
	Innovation Fund Ireland	2010	Equity: Fund of funds
	Seed & Venture Capital Scheme	2007	Equity: Co-investment

ISRAEL

Organisation responsible	Instrument name	Year Launched	Instrument classification
	Minority Fund	2010	Equity: Co-investment
	Bio-Technology Fund	2011	Equity: Fund of funds

ITALY

Organisation responsible	Instrument name	Year Launched	Instrument classification
SIMEST SpA			
	Start Up Fund for Internationalization (Law no. 99/2009 - Article 14)	2009	Equity: Direct
Fondo Italiano Investimento (FII)			
	Italian Investment Fund	2010	Equity: Fund of funds
Ministry of Economic Development			
	National Fund for Innovation	2009	Equity: Co-Investment

KOREA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Small and Medium Business Administration			
	Income tax deduction for angel investor		
Korea Venture Investment Corp			
	Korea Fund of Funds	2005	Equity: Fund of funds-

MEXICO

Organisation responsible	Instrument name	Year Launched	Instrument classification
Nacional Financiera S.N.C			
	MEXICO VENTURES I, Venture Capital Fund of Funds	2010	Equity: Direct
	MEXICO VENTURES I, Venture Capital Fund of Funds	2010	Equity: Fund of funds
	Co-investment fund Seed Capital SE-NAFIN Startup Mexico	2012	Equity: Co-investment

NETHERLANDS

Organisation responsible	Instrument name	Year Launched	Instrument classification
AgentschapNL			
	TechnoPartner \ SME+ Seed Capital Scheme	2005	Equity: Co-investment
	BioPartner Start-up Ventures (BPSV)	2000	Equity: Co-investment

NEW ZEALAND

Organisation responsible	Instrument name	Year Launched	Instrument classification
New Zealand Venture Investment Fund Limited			
	Venture Investment Fund (VIF)	2002	Equity: Fund of funds
	Seed Co-Investment Fund	2005	Equity: Co-investment

NORWAY

Organisation responsible	Instrument name	Year Launched	Instrument classification
Investinor AS			
	Investinor	2008	Equity: Direct
Ministry of Trade and Industry			
	Argentum Fondsinvesteringer AS	2001	Equity: Fund of funds
Innovation Norway			
	Nationwide Seed Capital Scheme (NSCS)	1998	Equity: Co-Invest

POLAND

Organization responsible	Instrument name	Year Launched	Instrument classification
Krajowy Fundusz Kapitałowy SA			
	Krajowy Fundusz Kapitałowy (KFK)	2005	Equity: Fund of funds

PORTUGAL

Organisation responsible	Instrument name	Year Launched	Instrument classification
PME Investimentos			
	PME investimentos - QREN\FINOVA	2010	Equity: Fund of Funds
	PME investimentos - QREN\FINOVA	2010	Equity: Co-investment
Portugal Ventures			
	Portugal Ventures	2011	Equity: Co-investment

SLOVAK REPUBLIC

Organisation responsible	Instrument name	Year Launched	Instrument classification
EIF			
	JEREMIE Holding Fund (SZRF)	2012	Equity: Fund of funds
NADSME			
	Risk Capital Programme	2004	Equity: Direct
	Fund of Funds	1994	Equity: Fund of funds

SLOVENIA

Organisation responsible	Instrument name	Year Launched	Instrument classification
Slovene Enterprise Fund (SEF)			
	Holding fund within SEF	2009	Equity: Fund of funds
	PVCC - Capital investments in private Venture Capital companies	2010	Equity: Co-investment

SWEDEN

Organisation responsible	Instrument name	Year Launched	Instrument classification
Fouriertransform			
	Fouriertransform	2008	Equity: Direct
Almi			
	Almi Invest	2009	Equity: Direct
	Almi Invest	2009	Equity: Co-investment
Industrifonden (IF)			
	Industrifonden	1996	Equity: Direct
	Industrifonden	1996	Equity: Co-investment
AP6			
	AP6	1996	Equity: Fund of funds

TURKEY

Organisation responsible	Instrument name	Year Launched	Instrument classification
Government Agencies (IVCI's shareholders) and EIF			
	Istanbul Venture Capital Initiative (iVCi)	2007	Equity: Fund of funds
Technology Development Foundation of Turkey (TTGV) "Teknoloji Yatirim A.S."			
	TTGV\ Teknoloji Yatirim A.S.	2007	Equity: Co-investment

UNITED KINGDOM

Organisation responsible	Instrument name	Year Launched	Instrument classification
Capital for Enterprise Ltd (CfEL)			
	UK Innovation Investment Fund (UKIIF)	2009	Equity: Fund of funds
	Enterprise Capital Funds (ECF)	2005	Equity: Co-investment
	Angel CoFund	2011	Equity: Co-investment

Source: OECD Questionnaire Seed and Early Stage Financing (DSTI/IND(2013)5/ANN) and further research (official websites).