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PRIVATE EQUITY IN THE BALTICS: WHAT ROLE FOR PENSION FUNDS?

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Abstract

A key policy goal in the three Baltic countries is to bridge the productivity gap with Western Europe. This requires increased investments into corporate innovation and efficiency enhancement. While reinvested profits and bank credit will continue to be their primary source of funds, Baltic companies will find it desirable to diversify their financing instruments. Governments in the region expect that the recently introduced mandatory pension funds will eventually play a major role in the financing of private sector growth. Following the experience of some OECD countries, private equity may be an attractive vehicle to channel pension funds money into innovative firms. To do so, government policy could act as much on the supply as on the demand side by improving information flows between investors and investees, streamlining tax policy as well as adapting relevant pension fund regulations.

TABLE OF CONTENTS

1. POTENTIAL FOR COMPANY GROWTH.....	241
2. FUTURE FINANCING SOURCES AND INVESTMENT VEHICLES.....	248
3. FACILITATING PRIVATE EQUITY INVESTMENT IN THE BALTICS	256
References	260

Introduction

Pension reform in the three Baltic countries, like in most other Central and Eastern European countries, has involved the introduction of mandatory pension funds. In the short term, the fiscal costs of the transition from a pay-as-you-go to a funded system may crowd out pension fund investment in the private sector. However, governments in the region rightly expect that these funds will eventually play a major role in the financing of the private sector. They may seek inspiration in the experience of some OECD countries such as Australia, Canada and the United States, where pension funds are playing an increasingly important role in the financing of new ventures and helping to develop innovative technologies.

The private sector - and in particular newly created small-medium sized enterprises (SMEs)¹ - have been a powerful engine of growth in the Baltic countries by constantly outperforming privatised and restructured enterprises in terms of productivity, which in turn by far outperformed old enterprises (World Bank, 2002). SMEs are expected to play a central role in the common European market into which these countries will be integrated. High investment rates in these companies will be required over the coming years in order to bridge the productivity gap with Western Europe.

Finance will be of a great importance in this process. The European Observatory of SMEs survey results for 1999 and 2001 (EC, 2002) indicate that about 15 % of small firms² in the European Economic Area and Switzerland feel that finance is the major constraint to the development of their business. Moreover, in a survey carried out by Eurostat (2002), respondents, accounting for 28% of medium-sized firms and 22% of large firms, reported that a shortage of finance is holding back innovation in their enterprises³. Access to finance, therefore, seems to be a key factor determining the feasibility of corporate innovation and productivity enhancing investment. It is, therefore, crucial to consider ways to improve capital markets in the Baltics if these countries are to reach Western European levels of development.

It is often argued that to secure an adequate supply of capital to companies, countries should develop liquid capital markets with publicly traded securities as a culmination. The Baltic markets are far behind in achieving this goal: currently there are only 3 companies on the official list of the Riga Stock Exchange (RSE), and 6 in both the Vilnius Stock Exchange (VSE) and the Tallinn Stock Exchange (TSE). The two largest listings in Estonia (Hansapank and Eesti Telecom) account for around 70% of annual trade on the Baltic list. This may question whether the Anglo-Saxon model of financing companies

through dispersed public ownership and frequent trading is applicable to the Baltic markets, where most of companies fall under the international definition of SMEs. Instead, it is possible that efforts to improve access to finance for SMEs and, as a result, contribute to the economic growth, should be focused on the development of other financial instruments, such as private equity.

The goal of this paper is to assess the feasibility of developing a private equity market in the Baltics and of attracting the recently established mandatory pension funds as the primary source of finance. Section 1 presents the industrial landscape in the Baltics, the key features of the institutional environment, and the main sources of company finance. Section 2 discusses which financial instruments might be suited best to maximise the growth of the firms given available sources and taking into account global trends. It considers the potential role that pension funds and other institutional investors can play in the provision of company finance and their role is compared with that of banks, the traditional providers of external financing to companies in the Baltics. Section 3 provides some guidance to develop a better business and institutional environment in which private equity can thrive providing capital for firms' growth and channelling pension funds money into profitable investments.

1. Potential for company growth

1.1 A stable macroeconomic environment

The Baltic states have small economies that during the past decade and especially the last few years have shown healthy economic development. In 2002, Estonia's GDP was EUR 6.8 bln (EUR 4 857 per capita), Latvia's GDP was EUR 8 bln (EUR 3 333 per capita), and Lithuania's GDP was EUR 14.7 bln (EUR 4 200 per capita). Despite poor global economic conditions in 2002, the Baltic states recorded the highest growth rates in Europe - 5.5% in Latvia, 5.7% in Estonia and 6% in Lithuania (EBRD, 2002) - and these rates are expected to stay at similar or even higher levels over the next few years, according to the EIU 2003 country reports.

These high growth rates seem sustainable as inflationary pressures are well under control in all three countries. In 2002, the inflation rate was 2.7% in Estonia, 1.4% in Latvia, and close to 0% in Lithuania. Inflation has rapidly converged to euro levels - a practical consequence of the currency board regimes that the Baltics introduced as a nominal anchor and which they are expected to maintain until the adoption of the euro. A firm monetary policy has been accompanied by relative fiscal soundness, especially when compared to the rest of the CEE region. The Estonian government had a fiscal surplus of

1.2% of GDP in 2002, while in Latvia and Lithuania the fiscal deficits were respectively 3% and 2.1% of GDP (EIU, 2003a,b,c).

Economic performance in the Baltics is highly dependent on the external sector. Estonia's ratio of exports plus imports to GDP in 2002 was 128%, that of Latvia was 87%, and that of Lithuania was 97%⁴. The trade partners have been gradually diversified from the neighbours in the East, and now exports to the EU account for over 50% of total exports. The composition of exports, on the other hand, is still largely dominated by traditional industries, such as machinery, wood/paper and textiles. In recent years, higher value added sectors, such as telecommunications, biotechnology and software, have been gaining ground, accounting in 2001 for 19% of exports in Estonia and 3% and 5% in Latvia and Lithuania, respectively. Only Estonia, however, compares favourably with the EU average of 20% (UNDP, 2003).

One source of possible instability is the growing trade deficits, a natural consequence of catch-up growth in an open economy. All three Baltic countries have been running current account deficits over the last decade. In 2002 the deficit reached 12.6% of GDP in Estonia, 7.8% in Latvia, and 5.3% in Lithuania. These deficits were mainly covered through privatisation related FDI. Between 1997 and 2001 annual FDI flows averaged 8.2% of GDP in Estonia, 3.4% in Latvia and 4.5% in Lithuania. Due to the positive economic outlook and the lowered risk ratings for Estonia and Lithuania⁵ the Baltic region can continue to attract FDI. As the privatisation process gradually comes to a halt, however, deficit financing may have to rely increasingly on the more volatile portfolio capital. One major policy challenge is therefore to further improve the business environment to attract non-privatisation related FDI and to encourage domestic savings in order to replace part of FDI by local capital such as that of pension funds.

1.2 A slowly emerging high tech sector

In 2001, the private sector's share of GDP was 75% in Estonia, 66% in Latvia and 70% in Lithuania⁶. In all three countries the economy is dominated by the service sector, which accounted for over 65% of GDP in all three countries. Manufacturing accounts for over 20% of GDP, while less than 10% of GDP comes from agriculture (EIU, 2003a,b,c).

The average number of employees per enterprise in the Baltics is larger than in the rest of Europe, but a larger share of Baltic companies are SMEs and these account for a larger share of employees and revenues than in the average EU country (SME Observatory). Current SMEs are mainly involved in

commerce, and they are unlikely to achieve high growth rates due to small fragmented markets.

Employment in high-tech sector was still well below the EU average of 4.8% in 2000. Except for telecoms, where large companies prevail, SMEs are leading in the high tech sector. Some of the industries where SMEs have a marked presence are biotechnology and software. These are typically attractive sectors for private equity investors.

1.3 Entrepreneurship and the knowledge based economy

An entrepreneurial culture and the ease with which new companies can be set up has long been recognised as a fundamental aspect of some of the most successful OECD economies. These, in turn, depend not only on the entrepreneurial spirit of the population, but also to a large extent on the government policies towards innovation and institutional environment⁷.

The success of innovative entrepreneurship is determined to a large extent by investment in human capital and research and development (R&D). An explicit target of the Lisbon Process (March 2000), in which accession countries are already benchmarked, is to increase total expenditure on R&D in the EU to 3% of GDP by 2010. The Baltics countries are far behind this target spending an average of 0.5% compared to the EU average of about 2% in 1998-2000, and, except for Estonia, this spending is little structured (World Bank, 2003a). Receipts of royalties and license fees in 2001 were USD 0.1 per inhabitant in Lithuania, USD 0.4 in Latvia and USD 0.8 in Estonia compared to well above USD 100 per inhabitant in the United States and Western Europe (UNDP, 2003).

Human capital endowments in the Baltics are usually considered to be a competitive advantage. Labour costs are still relatively low compared to the EU⁸, while educational attainment is quite high. In 2000, the proportion of full-time employees with a university degree was 25% in Lithuania, 22% in Latvia and 17% in Estonia compared to an average 13% in CEE and 18% in Sweden (OECD, 2003). However, without increased investment into developing professional management capacity and technological education this advantage is likely to deteriorate. Some of the skills acquired before 1989 need to be upgraded to meet the needs of the market economy.

The Baltics have a substantially lower proportion of scientists and engineers working in R&D compared to advanced economies: in 1996-2000 scientists and engineers accounted for slightly over 1000 per million inhabitants in Latvia, over 2000 per million inhabitants in Estonia and Lithuania, compared

to over 4000 per million inhabitants in the United States and 5000 in Finland (UNDP, 2003). Moreover, with the eventual liberalisation of labour flows after accession into the EU, brain drain is likely to present a serious threat if these countries do not offer attractive conditions to the most qualified people.

The Baltic countries, therefore, face an opportunity and a challenge. They have the necessary basic requirements in terms of human capital to trigger sustainable growth in high technology sectors, but they lack adequate managerial training and R&D investment. Developing financial instruments like private equity that are recognised for positive spillover effects on managerial education and innovation support may help these countries capitalise their human resources into economic well-being. The introduction of performance related executive compensation and employee stock option plans could also help develop a professional management culture.

1.4 Institutional challenges

1.4.1 Legal infrastructure

Though the government has lagged behind the progress made in the private sector in developing the legal framework and institutions, the basic infrastructure for successful private and financial sector growth is in place. In Estonia and Latvia the commercial code is largely in accord with the German code and conforms to EU standards. Though Lithuania was slower in meeting the EU standards, it has also recently adopted new laws on financial institutions, foreign currency, labour, takeovers and public trading and securities, which makes capital markets more efficient and in line with the EU *acquis communautaire*.

Studies (which do not reflect enforcement standards) show that already back in 1998 the Baltics had higher levels of creditor and shareholder protection than in most of the EU countries (Pistor, 2000; La Porta et al., 1999). Recent surveys on investment climate show that investors in the Baltics come third in CEE after the Czech Republic and Hungary in their confidence degree that their contractual and property rights will be defended under the legal system (Synovate, 2003a,b).

1.4.2 Corporate governance

The Baltic countries have a low ratio of publicly to privately held firms, closer to that of small countries such as Austria or Belgium (10%) than Germany (50%) or indeed the United Kingdom (close to 100%) (La Porta et al., 1999). Ownership concentration is very high - often over 50% of company

shares belong to one largest investor - with a strong presence of financial groups. This situation has been largely determined by the privatisation-led FDI boom of the mid to late 1990s and a view of the firm that tends to put great emphasis on the balance between stakeholders, rather than being exclusively focused on maximising shareholder value.

The main shareholders are banks. In all three countries, commercial banks may establish enterprises, be co-owners or shareholders, subject to basic prudential regulations⁹. Due to the reliance on bank financing, managerial decisions are heavily influenced by them. This situation resembles that of many continental EU countries.

1.4.3 Taxation

In Estonia, corporate tax rate is 26%. In Latvia, since 2003 corporation tax has been at 19% and will be lowered to 15% in 2004. In Lithuania, corporate tax and capital gains are taxed at 15%. In Estonia and Latvia reinvested capital gains are not taxed until the actual or hidden distributions.

Some tax breaks are offered to SMEs and high tech industries. In Estonia, investments into high-tech industries are encouraged on a governmental level through the activities of the Agency of Technology of the Enterprise Estonia. In Latvia, taxes on small companies (<25 employees) will be reduced to 10% by the end of 2003. The Latvian Government also offers tax breaks for large investment projects in excess of EUR 18mln, on a case-by-case basis. In Lithuania microenterprises (<10 employees) are taxed at 13%.

The tax treatment of financial instruments tends to favour banks. In all three countries, income earned from bank deposits is tax-free. Income from interest and fees related to leasing and factoring activities is subject to VAT, resulting in double taxation of this income and, therefore, placing them at a disadvantage relative to bank financing. Private equity investors are taxed at various levels: the private equity fund itself, the investee company and the investors (through dividend and capital gain taxes).

1.5 A bank-based financial system

Bank credit is the main source of finance in the Baltics. Despite its key role and increased availability of banking services, the banking sector is still small relative to the size of the economy. At end-2001, the ratio of total banking assets to GDP was 73% in Latvia, 72% in Estonia and 32% in Lithuania, compared to the 265% of the euro banking system (IMF, 2003). In 2001, less than half of banking assets went to non-financial private sector, accounting for

27.3% of GDP in Estonia, 23.2% in Latvia and 11.5 % in Lithuania compared to 139% in the UK (World Bank, 2003b). In Estonia 41% of loans outstanding at end-2001 were real estate loans, and only 16.2% were loans to industry. In Latvia, banks primarily fund the trade sector (23%) and manufacturing (18%). Lithuanian banks provide 26% of loans to manufacturing and 24% to trade (IMF, 2003).

A heavy foreign presence is bringing about necessary improvements in management and a clear separation between shareholders and borrowers. Efforts are also well under way to modernise the supervisory framework for the banking system. A sign of improving efficiency in the Baltics' banking systems are the declining net interest margins which are down to historically low levels, though they are still higher than in most OECD countries. Latvia had the lowest margin in 2001 - 3.3% - while Lithuania and Estonia had a margin close to 4%¹⁰.

Leasing. The Baltics, in particular Estonia, experienced a surge in lease financing, with leasing often directly substituting bank loans (mainly financial leasing). It accounts for 12.7% of GDP in Estonia, 4% in Latvia and 3% in Lithuania (IMF, 2003).

Market debt. The capitalisation of bond markets in the Baltics is rather small: in Estonia and Latvia it is 5%, and in Lithuania only 4%¹¹. Only in Estonia, corporate debt instruments dominate the market (because the government is constitutionally barred from running budget deficits). Both in Latvia and Lithuania, government securities accounted for about 95% of total capitalisation at the end of 2000 (ECB, 2002).

Equity markets started developing in the Baltics after the 1995 banking crises in Latvia and Lithuania. The authorities aimed at diversifying the sources of financing for firms and reducing their indebtedness. It was also believed that the creation of incorporated companies would improve corporate governance and, therefore, encourage companies to operate more efficiently. However, in reality, stock exchanges contributed less to the development of a sound financial system and economic growth than they were expected to.

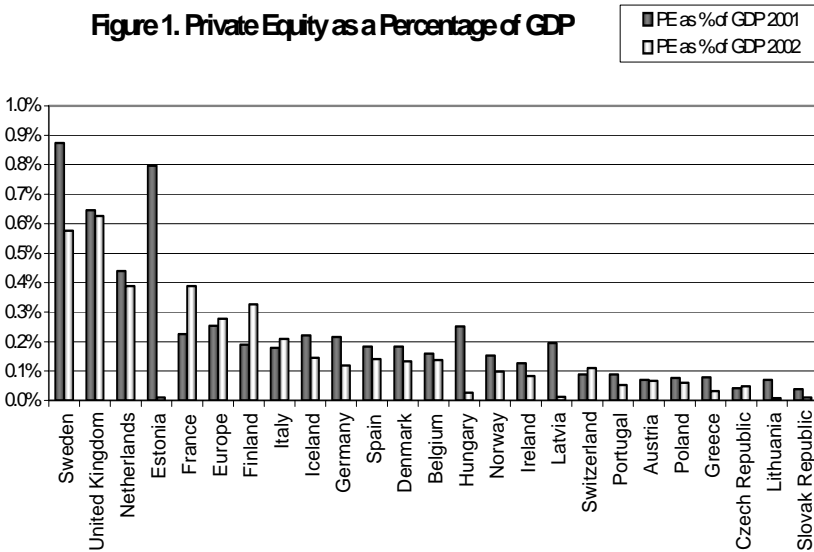
The Baltic stock markets saw a rapid increase in listings and active trading early on (reaching 607 listed companies in Vilnius in 1997) but soon lost momentum. A delisting process started in the late 90s as foreign companies bought out recently privatised enterprises. There have been no new IPOs since 2000. The stock markets in 2002 looked as follows¹²:

	Tallinn	Riga	Vilnius	London
Market capitalization as % of GDP	34%	9%	25.3%	115%
Average daily turnover (EUR mln)	1.1	0.7	0.7	15 878
Nb of listed companies	14	62	46	2 272

Currently the Baltic equity markets have little short of stalled. Trading is at very low levels and dominated by the largest companies. This experience is similar to that of other CEE countries.

Private equity is rather insignificant in the Baltics as a source of company finance (see Figure 1). In 2001, Estonia received EUR 36.5 per capita of private equity investment, Latvia EUR 9.1, and Lithuania EUR 2.6 compared to an average of EUR 9.8 in CEE countries and EUR 64.56 in the EU. This totalled to EUR 51.155 mln in Estonia, EUR 21.914 mln Latvia and EUR 9.602 mln in Lithuania.

Figure 1. Private Equity as a Percentage of GDP



Source: EVCA, 2002a, 2003

Baltic private equity funds have almost no local capital compared to the EU funds where domestic investors provide well over 50% of capital (EVCA, 2002a, 2003). The main providers of risk capital in the Baltics are multilaterals (EBRD, IFC, EIF; US and EU institutions) and Nordic financial institutions. Such financing structure creates an unpredictable, difficult fundraising environment - foreign investors are more likely to pull out during a global

market downturn. Furthermore, few of the private equity funds that invest in the Baltics have a local presence, making the investment process inefficient.

Most private equity funds are subsidiaries of larger financial services groups – independent partnerships or common equity funds are rare. This structuring of the Baltic funds makes financing of start-ups negligible since risk is less tolerated by established parent corporations – almost 100% of investments in the Baltics go to the expansion stage (IMF, 2003). Funds in the Baltics mainly invest into common equity since other forms of equity or quasi-equity are either not allowed or not enforced by the Baltic legal system (World Bank, 2003a). In general, Baltic private equity funds rarely have a particular industry focus. For example, in Latvia in 2002 the few private equity funds with low activity mainly had real estate investments and made some small investments in the communications, services, and chemicals industries. Exits from investments tend to take place through private equity sales (mainly trade sale to a strategic investor and less often buybacks with an MBO element or sale to financial institutions) rather than IPOs¹³. Even in Estonia, the most liquid Baltic market, the local stock exchange is considered reserved for established companies.

2. Future financing sources and investment vehicles

Over the past decade economic growth in the Baltics derived mainly from a reallocation of existing factors of production - that is, increases in efficiency by restructuring the economy. This process relied more on privatisation-related investments, especially in the form of strategic investors, and internally generated financing rather than on the financial system itself. However, now that the privatisation process is almost completed, future sustained productivity growth will depend on how new technologies are being adopted. The financial system will play a central role in this regard, determining the allocation of capital in the economy. This chapter looks at the main sources of capital in the future and evaluates two key players, foreign targeted capital and local pension fund savings.

2.1 Financing sources in the future

2.1.1 Foreign capital

Joining the EU implies that accession countries will benefit from the free movement of capital by either raising it abroad through foreign issues, or by getting it in home countries from foreign investors. This should reduce financing costs, in particular for SMEs. The European Union has recently approved a simplified prospectus for new issues of less than EUR 50 000, which

will particularly benefit SMEs. Also, for bond issues in excess of EUR 1 000, the issuer can now choose the country in which the prospectus will be approved, which can then be used in any EU country. The move to adopt a common European platform for payments and settlements is expected to further reduce costs for securities transactions.

For foreign investors, the adoption of a unified framework and common enforcement rules will bring significant economies of scale in obtaining information on the small Baltic countries, and this will eliminate the risk premium caused by institutional differences. As a result, more foreign investors may invest in the Baltics, reducing the cost of capital. However, foreign portfolio institutional investors such as pension and mutual funds are likely to prefer larger, more liquid markets. To the extent that they invest in the Baltic markets, their preference will be for the more liquid, larger listings. Nonetheless, foreign institutional investors may still be attracted by already proven investments in high growth companies which private equity funds may wish to divest.

2.1.2 Local capital

As a result of the mandatory nature of the new funded pension systems, local pension funds will soon become the second most important financial institution after banks in terms of financial assets under management. The relatively low level of income implies that households are unlikely to substantially increase their voluntary savings under the third pillar. Under the second pillar, however, expected pension capital accumulation by the end-2003 is expected to reach EUR 64 mln in Estonia, EUR 50 mln in Latvia but only EUR 1 mln in Lithuania. Though it is tiny as a percentage of GDP¹⁴, it is expected to grow to over EUR 2 bln in 10 years in Latvia and Estonia and more than twice that amount in Lithuania¹⁵. Since the pension reform has taken place at a time when the domestic capital market is substantially underdeveloped, some concerns may arise over the market's ability to absorb the new funds. Pension fund investment into the stock market could put substantial upward pressure on asset prices. A lenient investment regulatory framework could help deflate these pressures by offering alternative investment opportunities to the pension funds both at home and abroad.

Foreign investment has been permitted in Estonia and Lithuania from the inception of the new pension systems. Estonia imposes no restrictions on whether the funds are invested domestically or abroad, as long as the investment takes place in the euro area. According to Lithuania's legislation, passed in 2002, pension funds will be free to invest abroad. In Latvia, on the other hand, pension fund investment in foreign assets was not permitted during the first one

and a half years of operation. Thereafter a ceiling of 15% of total assets will apply and there will also be a currency matching rule of 70%.

All three countries have limits on domestic investments by asset class, but in general they are not very restrictive (they are still under discussion in Lithuania). In Latvia, pension funds can invest in government securities, time deposits in domestic banks, mortgages, or deposit certificates. Public equity investments limits are 50% in both Estonia and Latvia. Investment in corporate bonds is limited to 35% in Estonia, and 50% in Latvia, and there are no limits on government bonds in Latvia. Portfolio allocation to investment funds is limited to 30% in Estonia, and 50% in Latvia. Also, in Latvia, pension funds can invest up to 20% of their portfolio in IPOs but this is not the case in Estonia. On the other hand, pension funds cannot invest in non-listed equity.

Baltic pension funds are also subject to diversification requirements and ownership limits. The first are limits on the percentage of a pension fund that can be invested in a single issuer or issue (5% in the equity investments in all three countries). The second are limits on the percentage of the market value of a company's debt or equity that a pension fund can own. The latter regulations can restrict the ability of pension funds to influence a company's management board and are typical in non-Anglo-Saxon OECD countries¹⁶. Their primary goal is to ensure a high degree of liquidity in pension fund portfolios. Nonetheless, such a goal may not be compatible with the needs of a small economy with an underdeveloped financial system and subject to the vagaries of volatile foreign capital. Pension funds may also miss out on investment opportunities in the high growth end of the business sector, where unlisted SMEs tend to predominate.

Other institutional investors are insignificant in the Baltics and likely to remain so in the short term. Insurance companies' assets amounted to 2.5% of GDP in Estonia, similar in Latvia, and slightly less in Lithuania at the end 2001 (IMF, 2003). Also, being more conservative even in developed countries (Thompson, 2002) they are likely to abstain from risky investments such as private equity. Total investment fund assets in the Baltics are EUR 330 mln or 1.1% of the region's GDP, 80% of which is in Estonia.

2.2 Investment vehicles

2.2.1 Debt finance

Historically bank credit has been the most important type of external financing instrument for companies in the Baltic countries. Increased competition in the banking sector as a result of entry by foreign players could

make such financing even more attractive, particularly for SMEs. Moreover, if banks in the Baltics properly adopt the Advanced Internal Rating Approach of Basel II, capital charges on SMEs could become lower¹⁷. An even greater dependence of company finance on bank credit may be welcome, as long as appropriate regulations and supervision are in place. Indeed, both market and bank-based financial systems can be conducive to economic growth. Rather than the financial structure per se, the growth channel appears to function through the overall development of the financial system and the presence of a sound legal framework, including contract enforcement and investor protection (Levine, 2002).

However, lack of diversification of financial instruments can be risky, especially if it leads to the development of monopolistic banking structures that are inefficient and expensive, and can increase the likelihood of systemic failure at times of financial fragility. In addition, in the absence of developed corporate debt markets, firms have to rely on the generally shorter term funding provided by banks. By doing so, they may either incur sizable maturity mismatches, or they may tilt their investment portfolios towards short-term projects, which may hamper growth prospects (BIS, 2002). Furthermore, banks do not tend to engage actively in improving the practices of company management. Though today many SMEs in the Baltics are well suited to bank financing (industries with low growth and predictable profit margins), bank capital is less fit for innovative start-ups that have a high, but volatile long-term potential.

2.2.2 Public equity

Stock exchanges are important financial tools in developed markets because they help allocate savings, share risks among investors, and price securities. They give publicity and a heightened profile for companies, offer them access to the public market for future capital increases and acquisitions, provide incentives for employees through stock options as well as present a liquidity exit for investors. However, there is increasing evidence that the standard paradigm of dispersed stock ownership and liquid markets do not apply equally well to all countries and all companies¹⁸.

Moreover, experience has shown that even in developed markets stock exchanges rarely impose tougher disclosure or corporate governance requirements than national law and regulations require because tough requirements and monitoring discourage firms from listing and directly hit revenues for stock exchanges. Also, majority shareholders might be interested in delisting companies if the minority shareholders become too active and their protection is enforced. Recent corporate scandals in the United States shed

further doubt on the superiority of public equity markets in terms of transparency and corporate control.

The Baltics are relatively small economies by international standards, and so are their companies. On the Baltic list, consisting of only 15 largest companies, the average capitalisation is EUR 0.2 bln compared to the average of all companies on the London Stock Exchange (LSE) of EUR 1.7 bln and the EUR 6.1 bln on the LSE international list. An ideal traded company must have turnover big enough to have credibility with potential investors and be able to present a convincing future growth story. In the Baltics, except for a handful of big players, most companies are likely to remain local SMEs or limited niche players.

Due to the narrow investor class and the relatively small size of companies, market liquidity is likely to remain low. The small size of the majority of Baltic companies does not allow them to gain necessary economies of scale to be listed¹⁹. Further, a small number of companies listed does not allow the brokerage community and the financial press to reach economies of scale in conducting regular research on listed companies and to provide adequate coverage. As a result, the flow of information to investors that creates an interest is very limited and shares cannot be actively traded. In turn, foreign investors are shunned off from these markets, preferring instead the larger, more liquid emerging markets. This vicious circle is compounded by high ownership concentration in the Baltics, which discourages outside investors afraid of being exploited by insiders. Finally, relative deficiencies in innovative financial products and advanced credit rating services consequent of small market size will also deter larger and more sophisticated investors from small exchanges.

Given these prospects, the move to some degree of consolidation in stock markets may be welcome. Consolidation will benefit large corporations with a global orientation, who will have greater access to pools of capital in international exchanges. The EU integration comes as a solution to the Baltic Exchanges by accelerating this process. In 2001, the HEX acquired a majority stake in TSE and in 2002 in RSE. After OM AB joined HEX, OM HEX will integrate Nordic and Baltic markets for listing, trading, clearing, settlement and the securities depository. The VSE is expected to be privatised soon and will join Euronext via the Warsaw Stock Exchange. Listing on international exchanges will give Baltic companies additional benefits such as more liquidity and more credibility with investors. However, companies need to assess carefully the costs of listing abroad.

The development of pension funds could help improve liquidity in the integrated Baltic Stock Exchanges through their trading strategies. The pension

fund industry in small countries, however, tends to be highly concentrated, and there is a high degree of herding in investment strategies which may increase volatility. Nonetheless, in Latvia, where workers will be able to choose investment portfolios, the right conditions may be created for a market with a large number of small investors, with differentiated opinions, and hence more market trading.

2.2.3 Private equity

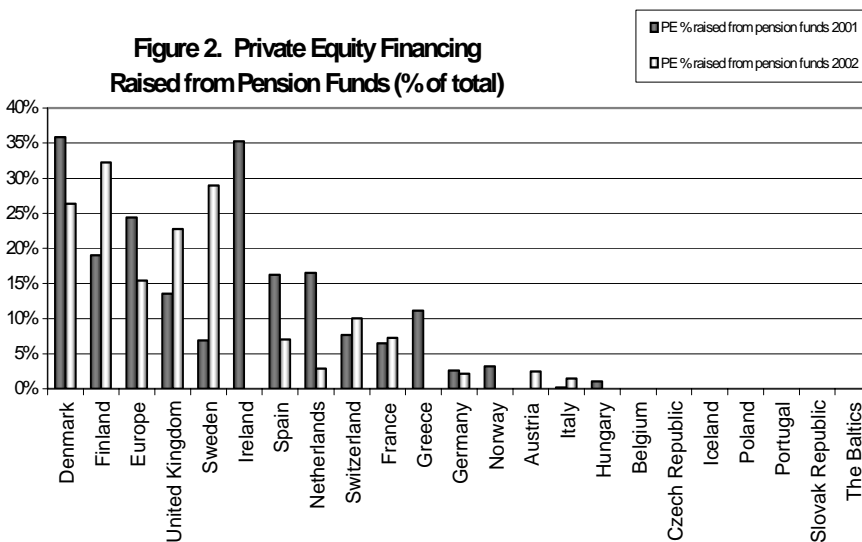
In the absence of developed public markets the long-term capital needed for companies to grow could be obtained through private equity. Private equity tends to require concentrated ownership structures that reduce agency costs for controlling shareholders and therefore lead to more effective monitoring of company management. Private equity is also an efficient business solution since it provides new businesses with strategic advice, management ideas and employee training while larger businesses can solve through it the issues of strategic fit, succession difficulties, or spin-offs without destroying value. Regardless of economic cycle, private equity helps to restructure the economy, leading to better than average performance and competitiveness, and increased employment²⁰.

Today in the Baltics, lack of strong demand for private equity is one of the major obstacles for the development of the industry. Only a few high tech companies in the Baltics are benefiting from investment by private equity funds. Similar to other European countries the main recipients of these funds are later stage projects, particularly in the common goods and industrial products sectors. This situation contrasts with the United States, where most venture capital is channelled into high tech. A broader role for private equity could be envisaged for early stage projects in the Baltics.

Lack of funding sources in the Baltics is another reason for underdeveloped private equity finance. For foreigners, the main impediment to invest in the Baltic private equity is the small size of countries, which makes the cost of obtaining information too high. The low liquidity of secondary markets and the last financial crisis have also helped to keep investors away from new markets. Though foreigners might eventually come into the markets after the Baltics join the EU, the presence of domestic sources makes fundraising more predictable since local venture capitalists understand better the local investment environment as well as investment strategies, and it is easier to forge relationships with local fund managers. Therefore, the development of domestic risk capital sources will be crucial in boosting the Baltic private equity market and, together with it, technological innovation and economic growth.

The experience from the OECD countries shows that pension funds can have a positive effect on the development of the private equity industry boosting fundraising²¹ and shifting investment strategies towards early stage projects. The most important source of private equity finance in the United States in 1995-2000 were pension funds accounting for 46.7% of the total (Thompson, 2002). In other Anglo-Saxon countries such as Australia, Canada, New Zealand, and the United Kingdom, pension funds accounted for between one third and one half of the total funds raised for private equity between 1995 and 2000.

In Europe, on the other hand, banks have historically played a more important role, and private equity capital raised from them accounted for 26.3% of the total in Europe in 2002. Except for 2001, when pension funds overtook banks, the share of private equity raised from pension funds' is rather small and volatile in the majority of European countries (See Figure 2). A possible explanation for the bias towards later stage investment in Europe may be the bigger role played by banks, who tend to be subject to stricter investment regulations than pension funds. Moreover, the private equity operations of banks tend to be more attracted to buyouts and investments close to the IPO stage, since they generate related revenues for the banking group through traditional capital market transactions (Thompson, 2002).



Source: EVCA 2002a, 2003

The lesser role played by pension funds in European private equity market cannot only be explained by the size of the pension fund industry. In countries such as the Netherlands and Switzerland the pension fund industry is as developed as in Anglo-Saxon countries (pension fund assets represent over 110% of GDP), yet pension funds accounted for less than 12% of total funds raised in 2002.

Part of the explanation for the limited interest among pension funds in these countries may be solvency regulations that force pension funds to maintain a high degree of matching between their assets and liabilities and to correct any underfunding situation in a relatively short period (Thompson, 2002). In fact, in these countries pension funds are regulated in a similar way as insurance companies. In the Netherlands, pension funds are required to maintain a buffer above their technical provisions for equity investments, including private equity. Funding rules are also present in Anglo-Saxon countries, but in general there is much more flexibility in cases of underfunding and no additional capital requirements are applied on equity investments. Nonetheless, some observers consider that minimum funding standards may reduce the attractiveness of private equity for pension funds. In the United Kingdom, these rules have been heavily criticised for their likely negative impact on private equity (Myners, 2001).

The outlook for private equity investment by pension funds in EU countries will be also determined by investment regulations. The recently approved European Directive on pension funds (called Institutions on Occupational Retirement Provision) will force countries to at least permit investment in private equity. Countries will not be able to restrict investments in unlisted securities below 30% of the pension fund's assets. The role of investment regulations, however, should not be overemphasised. Currently, several European countries have limits on equity investments and in unlisted equity, but these limits were well above the extremely small amounts currently invested in venture capital. Pension fund investment in private equity as a percentage of assets under management is also much higher in the United States than in the United Kingdom (8% vs. 1%) despite the fact that they both apply a prudent person rule principle to investment regulations.

Other possible determinants of the role of pension funds in private equity investment are maturity of the plan and the extent of individual choice in defined contribution plans. More mature plans tend to have greater liquidity needs, while individuals may be more risk averse than the trustees of defined benefit plans (which are in case backed up by the capital of the sponsoring employer).

The growth of pension funds in the Baltics could boost the financing available for private equity. However, regulators need to overcome their

preoccupation with local public market liquidity and acknowledge the alternative of private equity for long-term investment. Pension funds cannot invest directly in non-listed equity, except IPOs on the official list in Latvia and Lithuania. Pension funds can, however, invest in non-listed equity through funds. The start up cycle of 5 to 10 years, into which private equity funds invest, could, in principle, correspond to a pension funds' investment horizons. However, in the Baltics, as in most other CEE countries, pension funds resemble more mutual funds that compete for members with one another rather than the large funds of Anglo-Saxon countries or the Netherlands and Switzerland that are limited to a particular employer or a group of employers (industry wide funds). Therefore, pension funds in the Baltics, are likely to focus on a short-term performance. This will create a bias against private equity funds, even if they could achieve higher rates of return than through less risky investments²².

Pension fund attraction to private equity will also depend critically on the liquidity of these assets. Lack of exits for private equity investments could be an obstacle for the development of the industry. The integration of the European market could partially solve this problem for the most successful companies who will qualify for listing abroad²³. Trade sales could also be a viable alternative for exiting these investments.

3. Facilitating private equity investment in the Baltics

Private equity has as yet received little attention in the three Baltic states. Neither foreign capital nor local institutional investors have met the right conditions to invest in new growth companies. Private equity funds manage negligible amounts of money. By depriving companies from access to risk capital, this situation hinders new business creation and growth. Moreover, firms cannot benefit from spillover effects created by private equity such as improved managerial capacity and competitiveness that can drive up profitability. Based on the experience of OECD countries, private equity could be an important financial tool to enhance companies' growth and innovation - key goals for economies that will be soon integrated into the European Union. Whether private equity takes off in the Baltics will depend to a large extent on a set of policy preconditions that we now turn to²⁴.

3.1 Fostering entrepreneurship and innovation

Policymakers can facilitate the creation of investment opportunities by improving the general business climate, and in particular establishing the right conditions for entrepreneurship to thrive. Private equity funds in the Baltics find few projects that meet investment criteria. The main problems that fund managers

have identified are lack of managerial talent and market-oriented innovation. While the Baltics have a high proportion of scientists and engineers, only a minority works in R&D in companies or universities. Bringing this skilled workforce into innovative activities requires a concerted effort by the private sector and the educational establishments. Professional management education and targeted technological training are essential for high value added business creation.

Communication between entrepreneurs and the private equity community should be encouraged. The owners/managers of Baltic companies are often reluctant to dilute their control and typically do not perceive the potential value addition of private equity investment groups. This is due partly to their lack of experience in dealing with the investors' community.

Regulations also play a central role in the process of establishment of new businesses. The legal environment can sometimes place an excessive administrative burden on entrepreneurs, particular in registration, patent protection and liquidation procedures. These institutional rigidities create transaction costs that reduce returns on risk capital, especially early stage venture capital.

Finally, tax policies can be designed so as to encourage entrepreneurship and risk capital investment. Several reforms may help promote investment into innovative businesses. First, company tax rates for SMEs can be further reduced in order to enable domestic entrepreneurs to accumulate the capital for restructuring and development. Second, fiscal incentives can be provided for R&D. Third, stock options should be taxed only when capital gains are realised.

3.2 Developing the private equity industry

The current legal framework in the Baltics, and in particular tax policy, is biased towards bank credit. Equity financing is only attractive for large, publicly listed companies. Neither instrument, however, is ideal for the high-growth, knowledge-based companies that these countries wish to promote.

There are several hurdles to the development of the private equity industry in the Baltics. First, for funds established domestically, taxation occurs at several levels. The lack of suitable domestic structures (or impractical fund structure) encourages private equity firms to establish in offshore tax heavens to stay competitive. This is inefficient, costly and questions the fund's credibility. A more transparent tax structure that avoids multiple layers of taxation would be more appropriate. An optimal tax policy towards private equity funds should also take into account their role in matching entrepreneurial talent with new growth sectors and the spillover gains from bringing high skilled workers into innovative activities.

Further, private equity funds in the Baltics can invest only in common equity, because other forms of equity such as preference shares, convertible debt or warrants are either restricted or not enforceable. Private equity firms have therefore less flexibility to mitigate risks and this makes it more difficult for investee companies to raise capital. Stock options are little used, which does not allow start-ups to attract talent and align incentives, which makes them less attractive for investors.

Finally, markets in seed and early-stage SME finance are less than perfect and require an effective protection of investors' rights. Regulatory reform can bring about the necessary improvements in corporate control and bankruptcy to improve the allocation of capital in the economy.

3.3 Channelling long term finance into private equity

With the recently implemented pension reforms, the Baltic states have a new type of institutional investor that could be expected to play a central role in the development of private equity markets. Pension funds will quickly accumulate a sufficient level of assets that will permit them to diversify away from fixed income securities and search for higher yielding assets, such as private equity. Pension fund investment regulations, however, tend to be geared towards liquid assets, which in the case of Baltic equity investment can leave the pension funds highly exposed to a very small group of companies and sectors. A trade-off needs to be found between the need for liquidity and diversification within domestic markets.

Pension funds are particularly well suited for risk capital investment because of their long term, relatively illiquid liabilities. Yet, current regulations set limits to the percentage of a company's capital that can be owned by pension funds. These regulations can hamper the role of pension funds in corporate governance. Pension funds in the Baltics could become a powerful voice in corporate affairs only acting as a group, especially in companies with highly concentrated shareholdings.

The relationship between pension and private equity funds is complex even in the developed markets. Pension funds tend to be subject to strict disclosure requirements, particularly with respect to their performance. Public disclosure among private equity funds, on the other hand, tends to be rather poor. If private equity funds are to attract pension funds they need to deliver performance, build a reliable track record and become more transparent.

Conclusion

Capital market development is one of the key policy goals shared by the three Baltic countries. The growth of capital markets is expected to improve the allocation of capital in the economy and spur growth and innovation. However, the optimal structure of capital markets in small open economies like those in the Baltic countries may not be necessarily similar to those of large developed economies. In particular, in the Baltic countries most industrial output and employment is accounted for companies that fall under the EU definition of SMEs. For these companies, access to the international financial markets may not be always feasible. Instead, private equity may be an attractive source of finance to complement bank credit, the main source of external financing.

Private equity is particularly suited for early stage projects, since it requires a medium to long term commitment from the part of investors while ensuring close control over the activity of the new venture. Technological start-ups in the United States and other OECD countries tend to be financed in this way. While currently there are few companies in the Baltics working on high tech, there is a large pool of skilled labour. The development of the private equity industry in the Baltic countries could, therefore, help capitalise on the existing pool of human capital, and shift resources towards technological innovation.

Government policy could act as much on the supply as on the demand side. On the demand side, policymakers can help facilitate closer co-operation between industry and the educational establishment, helping to identify high tech projects that could have commercial viability. Tax policy can promote investment in R&D and facilitate financing for SMEs. On the supply side, an important development has been the establishment of mandatory pension funds systems. In principle, pension funds could play an important role in private equity financing, as they do in many other OECD countries. However, investment regulations and the competitive structure of the industry could discourage such investments. It is, therefore, not obvious that pension funds will emerge as a natural investor in private equity in the Baltics.

Finally, regulators will need to weigh the advantages of private equity in terms of diversification and high long-term returns against liquidity concerns. They will also need to assess the responsibility of pension funds in corporate governance and consider whether pension funds could play a more active role as minority or even controlling shareholders. These are issues that OECD countries are also tackling, as their markets emerge from a period of upheaval.

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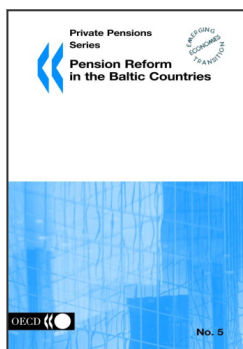
NOTES

- 1 Defined as enterprises with less than 250 employees.
- 2 Less than 50 employees.
- 3 For most companies, financing difficulties were only secondary to lack of skilled labour. The majority of SME identify human capital as the key impediment to a successful business performance.
- 4 Lithuanian Department of Statistics; Latvian Development Agency; Bank of Estonia.
- 5 S& P's long term foreign currency rating for Estonia is A-; for Lithuania BBB+, and for Latvia BBB+.
- 6 Statistical Office of Estonia, Central Statistical Bureau of Latvia, Department of Statistics of Lithuania.
- 7 Regulations, tax treatment and other institutional features are treated in the next section.
- 8 Gross wages averaged to less than EUR 400 in the Baltics compared to the EU average of over EUR 2300 (EIU, 2003a,b,c).
- 9 In Estonia, the limit on equity holdings in non-financial enterprises is 60% of capital, maximum exposure to single borrower is 25%, and related party lending limits is 25%. In Latvia, the total investments cannot exceed the total funds of the credit institution and at least 30% of assets should be in liquid assets. In Lithuania, investments in non-financial firms should not exceed 40% of banks assets, or 10% of banks assets in one company.
- 10 World Bank Financial Structure Database, 2001.
- 11 Stock Exchanges of the Baltic States
- 12 Stock Exchanges of the Baltic countries, Securities Commission of Lithuania, the World Federation of Exchanges
- 13 This is in line with European practice. According to the EVCA/PriceWaterhouseCoopers survey (EVCA, 2003), the major exit mechanism in Europe since 1998 was divestment by trade sale, accounting for over 36% during the period 1998-2002, compared to less than 15% of divestments through IPOs.
- 14 Less than 1% in the most developed economy – Estonia - compared to 148% in UK Source: Ministries of Finance of the Baltics
- 15 Zilite (2003). Projections for Lithuania and Estonia are made by the author based on official GDP and salary projections and legislated contribution rates.

- 16 In the US, institutional investors and in particular pension funds use their ownership concentration as a powerful instrument to raise corporate governance standards.
- 17 Hommel and Schneider (2003) and Dietsch (2003) argue that The Basel II proposal would lead to a lowering of capital requirements on loans to SMEs through two channels. First, SME lending will be treated as part of retail credit portfolio for exposures of up to EUR 1 mln. Retail credit requires lower capital requirements than corporate credit due to their greater scope for risk-reducing diversification. Second, the revised proposal introduces new formulae for the computation of default correlations. SME loans will tend to have lower default correlations and hence lower risk weights.
- 18 La Porta, Lopez-de-Silanes, and Shleifer (1999) show that except in a handful of countries such as United Kingdom, Japan and United States even the largest publicly traded firms have a controlling shareholder (controlling more than 20% of the votes). Concentrated ownership and ultimately delisting is also seen often by securities analysts as a sign of commitment and therefore tends to improve long term financing prospects.
- 19 The costs include listing and annual fees as well as time consumption for compliance such as the due diligence procedures for listing and the preparation of quarterly reports.
- 20 An OECD study (1996) shows a positive strong correlation between private equity and R&D investments. Kortum and Lerner (1998) show that venture capital investments accounted for 15% of industrial innovations in the past decade in the United States. An EVCA study (2002) shows that European private equity backing helps firms to enhance their employment, R&D and investment at all stages.
- 21 Gompers and Lerner (1999) show that venture funds in the US grew significantly after pension fund restrictions were eased. Jeng and Wells (2000) found evidence that capital provided by pension funds boost significantly the overall volume of new funds raised over time.
- 22 The long-term returns of private equity represent a premium to the performance of public equities. This has been the case in the United States for over 20 years and also in Europe, following an increase in the number of private equity funds, for over 10 years. (EVCA, 2002c)
- 23 A study by Jeng and Wells (2000) indicates that IPOs are the strongest driver of private equity investing. However, IPOs have no effect on early stage venture capital investing across countries, but are a significant determining of later stage venture capital investing.
- 24 Jeng and Wells (2000) show that along with the levels of IPOs and private pension fund levels for some countries, government policies have the strongest impact on the development of the private equity industry in all countries.

TABLE OF CONTENTS

Review of Recent Pension Reforms in the Baltic Region	
David C. Lindeman.....	7
Comparing the New Pension Systems of the Baltic States	
Edward Whitehouse.....	25
Developments in the Estonian Pension System	
Kadi Oorn	59
Review of Pension Reform in Latvia	
How it was carried out and what the results show in 2003	
Laima Zilite	87
The Development of Private Pensions in Lithuania	
Teodoras Medaiskis & Audronė Morkūnienė	147
Pension Funds and their Role in the Future	
of the Baltic States' Economies	
Valdemaras Katkus.....	179
Private Equity in the Baltics: What role for pension funds?	
Sigita Strumskyte.....	239



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