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Memo

TO:	Paulo Correa & Sebastian Penn, World Bank, Washington DC
FROM:	Tom Nastas, Innovative Ventures Inc. (IVI)
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RE:	**Project Aide Memoire: Early Stage VC Workshop & Creation of VC Fund in Croatia**

Paulo/Sebastian:

1st let me thank you for including me in the mission; an excellent trip with a GoForward Plan to build a thriving startup community in Croatia, complete with the money & institutional support for execution. Topics in this aide memoire include:

1. Current Status: the Private Equity (PE) Industry in Croatia—the Need for Venture Capital (VC)
2. Gaps in the Market Make Croatian Entrepreneurs Focus on Customers—+ Seek Capital from Outside the Country
3. Lack of Capital Impedes Growth of an Active & Self-Sustaining Startup Community in Croatia
4. Strategic Considerations: Designing the VC Initiative for Croatia
5. The GoForward Plan: Next Steps in Execution

As input into this project I interviewed several entrepreneurs of SMEs[1] after the WB/HBOR workshop: they operate in ICT, banking/financial services, recreational (electric bicycles) & communication sectors. Additionally I met with investors, incubators & service providers[2] active in the Croatia startup world + two universities[3] deploying programs to build a startup community in Croatia.

My purpose for these meetings was to understand (limited of course) on-the-ground experiences of entrepreneurs in raising capital and deploying their business models inside and outside the country (+ compromises made); inputs to the design of a VC fund for Croatia.

[1] SMEs include Five Minutes/ShoutEm, PandoPad, Payallo, Applicon, VisoBike, Stevica Habbits & UX Passion
[2] Vladimir de Franceschi (de Franceschi & Shefayee), Niksa Tomulic (Founder Institute), Jure Mikuz, RSG Capital, Slovenia & Nino Peran (Core Incubator, investors are the Royal Group & Mubadala Invest Group, Abu Dubai)
[3] Ana Kustrak & Mato Njavro/ZSEM (www.zsem.hr) & Dijana Drazetic & Goran Vlasic, Innovation Institute (http://www.innovation-institute.eu)

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Current Status: the Private Equity (PE) Industry in Croatia—the Need for Venture Capital (VC)

In 2010 the Government of Croatia launched a tender to seed the creation of a domestic institutional PE industry through a program called 'Economic Cooperation Funds (ECF).' It committed 1 billion kunas (≈$184MM/≈€139MM) to match 1 to 1 monies raised by Croatian fund managers from private and institutional investors (domestic or international).

In 2011 five (5) funds attracted the necessary co-finance and started investing in established companies with proven business models & proven management teams to generate quick (three-five years) and profitable (25+% IRR) returns for their investors. Investee companies operate in mainstream spheres of the economy, e.g., fast moving consumer goods, food & beverage, wholesaling, retailing, tourism and construction as examples. One of the fund managers Nexus consummated two transactions in the start-up space; a tourist company and the construction/build-out of a data center. With the exceptions of these two transactions, little money has flowed to start-ups or SMEs in the Croatian tech sector from ECF managers.

In 2013 HBOR restructured the agreement with the five funds, forcing this change to the investment agreement—management fees are now paid on ***capital invested* vs. *committed capital, i.e., fees paid on results achieved***—investments consummated.

This change was executed to increase ECF managers pace of investment into expansion stage companies. Since the bulk of their compensation is earned on exit values of investee companies, this change will not decrease the quality of their investment portfolio. It will encourage ECF managers to be more proactive in seeking investments including developing deal flow themselves, and being more creative and flexible in negotiating and structuring transactions. *IVI congratulates HBOR staff/management in their success in executing this change to the investment agreement.*

This development is good news for expansion-stage SMEs in Croatia. However startups and early stage tech SMEs still struggle to attract monies. *At this time in Croatia, there is no institutional source of seed and early stage venture capital to finance the development and growth of a vibrant and active technology startup community in the country.*

As you might expect, an economy needs an active VC industry to create, finance and nurture start-ups & early stage SMEs to increase the pipeline of companies for investors in the next link of the financing chain, PE funds. But more start-ups and early stage companies are required for much more than just this narrow sector of economic activity in a country; ***when they 'grow-up,' they are the clients of banks and financial institutions that are the heartbeat of a country's growth and development***. Without a steady stream of start-ups, early stage companies & entrepreneurs, all countries are at risk of economic stagnation and decline.

Venture investors in the USA historically invested 1st capital in start-ups and young companies in the technology sphere with money spent to develop & launch products/services, build out the business model & the management team, develop the infrastructure, establish production facilities, implement sales and marketing. The amount of investment/transaction varies to the size and needs of the company, usually from $250,000-$5,000,000, and the amount of money managed by the VC fund. VC funds finance SMEs with revenues that range from $0.0 (start-up) to $25 million. Venture investors will typically invest up to 10% of assets in any one company. Historically VC funds manage between $10MM-$75MM.

Gaps in the Market Make Croatian Entrepreneurs Extra Lean—+ Seek Capital from Outside the Country

Some Croatian entrepreneurs are able to create business models which generate *revenues immediately* from customers (local, regional or international) like UX Passion, PandoPad & Applicon as three examples. In execution they're focusing all energy/talent to one objective; generate revenues to finance operations and grow step-by-step. This single-minded dedication results in only the most essential cost centers funded to produce-deliver-sell-service customers.

A few entrepreneurs raised money from regional/US investors. ShoutEm raised $1.2MM from Slovenia VC fund RCM. Two Croatian startups raised $50k each from 500 Startups, [4] a Silicon Valley seed investor—in 2011 Farmeron[5] a provider of cloud-based solutions to dairy farms and in 2012 WhoAPI (Rijeka), a seller of search engine software to hosting companies. In 2012, Farmeron raised $1.4 million from NextView Ventures, SoftTech VC, Seedcamp, 500 Startups, Accelerator Group and Naval Ravikant (founder of Angelist).

Lack of Capital Impedes Growth of an Active & Self-Sustaining Startup Community in Croatia

While these successes are role models for entrepreneurs, they are exceptions vs. the rule with the startup community in Croatia starved for capital. Moreover it's estimated that over 1000 Croatian ICT SMEs fight for the business of 100 customers[6] in the country. Too few domestic customers results in intense price competition and little free cash flow to invest in R&D and pursue customers outside Croatia. Without local sources of capital these SMES remain small, internally focused and unable to expand beyond the borders of the country. And without the prospects for rapid growth, attracting management talent needed in business development, marketing and sales to drive international growth remains but a hope & a dream.

In some economies, angel investors fill this gap to finance entrepreneurs and start-ups, but this group is still forming in Croatia, and is not prepared to make such investments in the amounts needed to finance the start-up of Croatia. Without an intervention to capitalize a VC fund in Croatia with the risk appetite for start-ups and early stage companies, these SMEs will stagnate and/or die as their promoters and entrepreneurs seek jobs and projects that will meet their personal financial needs.

[4] See http://500.co. 500 Startups invests small amounts of equity (≈$50-$250k/SMEs) globally in Internet, software & mobile startups. Organized by 500 Startups, Geeks on a Plane is an invite-only tour for startups, investors, and executives to learn about technology markets worldwide

[5] Located in Osijek, Croatia & Willingham, Delaware. Read their story in Forbes

[6] Source, Goran Radic, Board Member and VP Sales at Applicon, Co-founder of PandoPad, Payallo & Applicon Tours + Board Member of Croatian Independent Software Exporters (CISEx)

Strategic Considerations: Designing the VC Initiative for Croatia
A need exists for a dedicated VC fund in Croatia to finance development stage companies, startups and early stage SMEs. Workshop participants, speakers and organizers all agree that the time is right for a venture fund to fund the development and growth of a startup community in Croatia. Additionally the political will exists in the country for Government support to co-finance a venture fund with a capitalization of $50-$65 million, making equity investments in the range of $250k-$2 million to finance start-ups and early stage SMEs.

But considerable debate was generated in the afternoon session of the workshop with multiple unresolved issues around three uncertainties:

1. *Should the fund target existing demand, i.e., is the startup community generating the quality and quantity of investment opportunities required for the selectivity required in consummating profitable investments?*
    - If yes, what are the 'investment themes' which might guide the strategy?
    - Alternatively or in some combination with financing existing demand, can new investment opportunities/themes be developed, linked to national priorities of Croatia—to drive more innovation into the local market and sell into int'l markets?

2. *Who might be the fund manager (with the skills, the talent, risk appetite and know-how in transacting early stage tech investments)?*

3. *Who are the investors for the Fund and the mix of domestic and international money? And who should lead this Initiative?*

Answers to each of these questions are needed as inputs in the design of the VC initiative. Discussion points on each issue to generate conversation and debate are presented below.

1. *What is the demand for capital in Croatia? Can—should deal flow be developed & if so how?*

Participants in the workshop expressed confidence that sufficient deal flow exists for the fund to target existing demand from startups and early stage SMEs. Yet until detailed evaluations are conducted on existing deal flow, cataloged and ranked by quality and quantity, participants' opinions may differ significantly from realities as to the investment potential of existing demand.

Given the deep talent of Croatians in fundamental sciences (physics, chemistry, mathematics, etc.), this human capital is employed in ICT SMEs (many of the current successes in Croatia tech are in ICT). Moreover since Croatia is a country of only ≈4.5 million citizens and with so few (apparent) domestic customers for technology, it is anticipated that a significant % of new deal flow will target international markets as other low population countries like Israel, Ireland and others did to overcome limited domestic demand for technology.

Yet is ICT for international customers the investment theme for the Croatian VC fund? Or do alternatives exist? Fund managers at the workshop and those I met with believe that they should be given the freedom to be 'opportunistic' in consummating tech investments. The concern of such an approach is that it can lead to a 'hodge-podge'[7] of investments which are inconsistent with one another, do not advance exponential learning required within the fund management team and the local market for profitable venture investing.

Alternatively perhaps we might develop an 'investment thesis' over the next few months which will guide an investment strategy called 'thematic investing.' Themes are typically:

- Horizontal in nature
- Often based on an underlying protocol, standard, or market trend that a fund manager believes is on the cusp of widespread adoption with the potential to drive a cycle of innovation and company creation for at least a ten year period.

Fund managers invest in themes and their underlying technologies that are ready to be rolled out to consumers (B2C) or the enterprise (B2B) and are well beyond the science-experiment phase. Themes strongly guide the investment activity of the fund and while a fund manager must not be a 'slave to its themes,' more often than not it rejects investments that don't fit into one of its buckets of investment themes. This saves both the fund manager and entrepreneur much time & energy.

Naturally success in a thematic approach to investing is dependent on the experiences of the fund manager since staff typically has deep domain experience in a theme, either through years of direct investment accomplishments and/or direct work experience in the industries consuming such technologies.

Themes offer direction to the market since entrepreneurs know which investment opportunities are sought/transacted, and is one solution to 'directing' the development of deal flow in Croatia.

But it is not the only solution to encouraging the creation of economic growth in targeted directions.

Another is to 'engineer' the deal flow through a 'deal flow' fund; deal flow funds are organized to finance new technologies around a single product or service that solve significant technical challenges and market needs; GameChanging technologies disrupt industry standards to increase the quality and quantity of deals for venture investors. Every county needs to increase the quality and quantity of investment opportunities for investors, and Croatia is no different.

Gamechanging technologies create excitement, interest, attention, networks, etc., to attract the very best scientific minds, attract the very best and most networked investors, and catalyze networks for collective learning and collaboration in VC, entrepreneurship and knowledge creation to Croatia.

The BlackBerry Partners Fund™ (Research in Motion, Blackberry, Canada), the iPhone Fund (Kleiner Perkins, Caufield & Perkins, California) and the Google Android Developer Challenge (Google, California) are examples of deal flow funds organized around a single product or service. In just 12 months from their inception, these three groups evaluated over 4,800 business plans & funding applications, and invested a total of $56.55 million into 27 SMEs and

[7] 'Hodge-podge' is a term used to describe a confused or disorderly mass or collection of things

developers. ***Such results demonstrate the value, attraction and industry creation that deal flow funds have in the market to stimulate new ideas, new SMEs, new innovation and more entrepreneurship.*** These deal flow initiatives are role models and point the way to create deal flow funds for the creation of new innovation, technology and SMEs.

Yet practically speaking, given Croatia's still nascent ecosystem, how might we employ such a deal flow fund as an investment thesis to build demand for startup/early stage capital? And how might Croatian government institutions contribute to this outcome—to do more—faster?

One approach is to link one or more national priorities in Croatia to the financing of technology creation, development and its commercial deployment. The linking of technology execution to a country's national priority helps assure local financiers that innovators deploying the tech have a market and paying customers. It's this matching of tech solutions to customers that harmonizes the risk behavior of local investors to the risks of start-ups and early stage SMEs.

For example, rumor is that the Croatian Government seeks not only to further exploit its tourism assets along the Adriatic Sea to capture more tourist money, but transform selected coastal locations into high value hubs in transportation & logistics. Accomplishing this feat economically feasible and environmentally responsible mandates new technologies in the design and construction of physical assets, innovations to manage physical assets effectively/efficiently, and the marrying of innovators in architecture and engineering + entrepreneurial talent to rethink the thousands of solutions required in logistics and transportation.

If the rumor is true and political will truly exists for execution, perhaps this (potential) national priority might qualify as an investment thesis which we can build upon to stimulate new thinking for innovation and entrepreneurial business models for execution?

It was a like-solution which Rwanda and Burundi implemented in the creation of their 'national coffee strategy' with technology deployment required to participate/compete in the high end, value added premium coffee segment in the global market.

Their national coffee strategy did not emphasize technology creation but technology absorption & its execution since the relevant innovations to compete in the specialty coffee segment are well known and deployed around the world. Each country did not seek to emulate Silicon Valley but rather leverage local strengths with healthy doses of entrepreneurial & investment vision. In Rwanda's case, its national coffee strategy included identifying foreign mentorship, over $100 million worth of investments to improve coffee washing, production, capacity and marketing to establish its product in the global premium coffee market. The Government of Rwanda established partnerships among agricultural institutes in Rwanda + US universities Texas A&M & Michigan State University to bring technical solutions and technology execution to Rwanda.

The results of their efforts are impressive:[8]

- Rwanda coffee commands price premiums of $15-$25/kilo vs. commercial-grade coffee (which Rwanda historically produced). In a notable achievement, in September 2007 importers paid $55/kilo for the best Rwandan coffee
- Export revenues increased four-fold with more than 500,000 farmers growing & selling coffee beans at higher prices. Farmers who sell premium coffee cherries (the beans) to washing stations increased their annual expenditures/adult by 17% as compared with farmers who sell commercial grade coffee. Incomes rose 2x for approximately 50,000 households with 2,000+ jobs created at coffee washing stations
- Prices paid to farmers for premium coffee cherries (beans) rose from 60-80 Rwandan francs in 2004 to 160-180 Rwandan francs by 2008
- Coffee receipts rose an average of 30% per year between 2002 and 2006

While the national coffee strategy used tech absorption vs. tech creation as its lever to impact the Rwandan economy, this success demonstrates the merits of linking national priorities to technology to generate big gains in economic growth.

2. *Who is the candidate to manage the fund?*

The answer to this question is debatable since several of the ECF managers seek to manage this capital (& collect additional management fees). While it's relatively easy to transact deals, it's uncertain if they have the skills, talents and networks to grow investees to a profitable exit—the measure of success in VC. Certainly detailed due diligence needs to be made on each ECF manager which express interest to be the VC fund manager.

Discussions in the roundtable surfaced the need to have a team with an understanding of Croatia and experience in the culture of Croatia and its impact on investing. There is little that needs to be added to this discussion at this time with one exception: Whoever the team is which leads the fund management company, all decision makers from the fund must live, invest and work hand-in-hand with local entrepreneurs in Croatia. 'Fly-in' fund managers do not acquire the necessary understanding of the local market when they are not present 100% in-country + they are unable to resolve on-the-ground issues which inevitably cause teams to implode.

3. *Who are the investors for the Fund and the mix of domestic and international money? And who should lead this Initiative?*

Certainly leadership and capital from HBOR is needed to advance early discussions of the fund into the GoForward plan and the raising of co-investment from pension funds and insurance companies in Croatia, with money sourced from the EIB &/or EIF.

However we inadvertently omitted two potential sources of capital into our discussions; Croatian corporates and the family offices of rich Croatian families. Each has selfish and unselfish reasons to see Croatia develop.

[8] Summary of Skype interview with Daniel Clay, chief agricultural innovation specialist, Michigan State University. Daniel was one of the primary implementers of the national coffee strategy in both Rwanda & Burundi, technology selection, technology deployment and training

Historically it was wealthy families whom provided the venture capital which financed entrepreneurship in the USA & Europe with corporations quickly following suit; only later did pension funds, insurance companies and endowments invest. In the former Soviet Union early wealth & their corporate structures were the 1st private capital which invested in growth companies in the region and abroad; these entities capitalized the 1st private PE funds in the CIS and paved the way for the myriad of PE & VC funds that now operate in Russia, Kazakhstan, Ukraine and the Baltics.

Croatians were some of the early immigrants to Chile with many now the wealthiest families in the country—in shipping, banking, telecoms, food/beverage, mining and minerals. The wealthiest family is the Luksic[9] group and recently the family's grandson Davor Luksic returned to Zagreb to seek business opportunities in the country; we should engage with Davor to determine his business interests and if they are aligned with ours.

In Slovenia, the VC fund RSG Capital was capitalized with money from Slovenia corporations with the local Chamber of Commerce as the lead investor. Corporate participation in the fund is promising as it may be a path and precedence for us to attract Croatian corporates to be co-investors in the fund.

The GoForward Plan: Next Steps in Execution (not in order)

1. Define who will assume the leadership for the creation and execution of the fund, presuming we receive a GoForward approval. Obtain their commitment/concurrence including staff assigned to the initiative, responsibilities and budget.

2. Detail the strategy of the fund, target sectors for investment, stage of SME development (development, start-up, 1st revenue, etc.), amount of investment/SME, follow-on investing, country or regional investment focus, etc., + evaluate the deal flow in Croatia. Define the investment thesis of the fund. Explore if one investment thesis might be created to a Croatian national priority as a deal flow investment mandate and the possible linkages to this priority and that of the fund.

3. Detail the qualifications sought for the fund manager. Conduct due diligence on the ECF managers, their capabilities and interests to be the fund manager. Solicit interest from other potential fund managers, in Croatia, the region &/or international.

4. Engage investors in Croatia and outside, e.g., family offices of rich Croatians and others, corporations, pension funds, insurance companies, banks, EIB/EIF and DFIs (IFC, EBRD, KfW, FMO, Proparco, SIFEM, etc.) to gage their interest and support to the fund.

5. Engage the entire entrepreneurial stack that exists in Croatia and members in the ecosystem (Startup Weekend, Founders Institute, etc.)—their contributions to advance fund creation and execution + solutions to improve the deal flow in Croatia, and actions to build successful startups and early stage SMEs.

[9] Representatives from the Luksic family are one of the participants in my program which I'll do in Santiago 'Scaling Up Investment' so I'll engage with them to explore ideas for their possible involvement in Croatia

6. One additional intervention required: Croatian startups and early stage SMEs are staffed with founders and teams with deep technical capabilities required for R&D, prototyping, product development & productization, talents needed to bring innovation to market.

   But these SMEs are weak in business development, sales & marketing—competencies equal in importance to technology and required for successful commercialization and profitable investments. This talent mismatch must be solved.

   Our challenge and the challenge to building a startup community in Croatia are to create initiatives which attract the professionals with needed talents in biz dev., sales/marketing, quality control, after sales/service, etc., to investee companies. For example, we might think forward on programs and incentives to attract talent from Croatian and int'l tech corporations operating in Croatia like Siemens, Deutsche Telekom, Alcatel, Johnson & Johnson, Abbott Labs, Microsoft, HP, Oracle, etc. Managers from int'l corporations are especially attractive since its staff is exposed to int'l cultures with many having the operating experiences in int'l revenue generation.

Questions or comments; please write or call (I'm in the USA now, Michigan). Next week I'll send you the final report for comments, revise and then you can send the final to HBOR and other interested parties.

Tom Nastas