



**Expert evaluation network  
delivering policy analysis on the  
performance of Cohesion policy 2007-2013  
Year 2 – 2012**

**Task 1: Financial engineering**

**Czech Republic**

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**A report to the European Commission  
Directorate-General Regional Policy**

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## List of abbreviations

- CMZRB Czechomoravian Guarantee and Development Bank
- EC European Commission
- EEC European Economic Community
- EEN Expert Evaluation Network
- ERDF European Regional Development Fund
- FEI Financial Engineering Instrument
- MA Managing Authority
- OP Operational Programme
- VC Venture Capital

## Executive summary

- Two forms of Financial Engineering Instruments (FEIs) are currently in use in the Czech Republic: Loan Fund and Guarantee Fund, which are used in three (sub)programmes (START, GUARANTEE and PROGRESS).
- Altogether approx. 10% of Operational Programme (OP) Enterprise and Innovation has been allocated to these 3 (sub)programmes; 2,399 SMEs have received support from these funds so far (2,057 guarantee, 342 loan); both schemes are popular among SMEs - the demand greatly exceeds supply.
- The main challenge of sub-programmes using FEIs is to set up an acceptable rate of risk – if set too low, commercial banks could take over, if set too high – huge losses emerge.
- The authorities responsible for operation of FEIs do not see a significant difference in administrative costs between FEIs and standard non-refundable instruments (grants).
- Currently, the Venture Capital Fund is in its final stages of preparation.
- No targeted evaluation of these instruments has been performed so far.
- Due to a dispute concerning legal issues over the implementation mode of FEIs between the Managing Authority (MA) and the European Commission (EC) because the intermediary body (Czecho-Moravian Guarantee and Development Bank) has not been selected via public tendering procedure despite the fact it is partly privately owned, none of these schemes is now open for applications. Nevertheless, the data available as well as interviews carried out confirmed that FEIs previously operated successfully.

## 1. Use of financial engineering instruments

The use of FEIs dates back to the 1990's when these instruments were used within the national business support scheme. Since the 1990's the Czechomoravian Guarantee and Development Bank (CMZRB), serving as a professional body operating as a kind of implementing agency under the supervision of the Ministry of Industry and Trade, has been charged with providing these FEIs.

In the programming period 2004-6, soft loans were used within the (sub)programme KREDIT and START, and since the start of programming period 2007-2013, the use of FEIs has been extended to cover also (sub)programme PROGRESS. Moreover, in addition to loans, the spectrum of FEIs has been expanded by offering guarantees as well. Therefore, in the sphere of business support, the FEIs are currently being used in three (sub) programmes that operate within OP Enterprise and Innovation (sub)programmes START, PROGRESS and GUARANTEE) and two funds have been established: the Loan Fund (EUR 175.5 million) and the Guarantee Fund (EUR 203.6 million). (Sub)programme START aims at providing support to newly established SMEs, while (sub)programme PROGRESS aims at supporting further expansion of existing SMEs. Finally, (sub) programme GUARANTEE is focused on the expansion of SMEs located in assisted areas via provision of guarantees to commercial loans.

Altogether approx. 10% of OP Enterprise and Innovation has been allocated to these 3 sub-programmes; 2,399 SMEs have received support from these funds so far (2,057 guarantee, 342 loan); both schemes were popular among SMEs - the demand significantly exceeded supply. Nevertheless, due to a dispute between the MA and EC over the selection of the intermediary body (i.e. CMZRB), none of these programmes is currently open for applications.

In 2010, there was a partial reallocation of financial resources in favour of the Guarantee Fund after a revision of the OP in response to the impacts of the global economic crisis.

In addition, currently, a Venture Capital (VC) Fund aimed at supporting innovative SMEs in the form of risk capital is under preparation. The following support is envisaged:

1) priority axis 1: Establishment of Firms (start-up/early-stage venture, for firms 5 years old or younger): EUR 31.79 million excluding private co-investor sources, which should amount to at least 30% of the supported projects. In the case of very small projects, the cooperation (co-investment) with private VC fund has not been set as a condition.

2) priority axis 2: Development of Firms (later-stage venture - for firms over 5 years old): EUR 21.19 million, excluding private co-investor sources, which should amount to at least 50%. Investment should always be made jointly with a private venture capital fund. Altogether, the number of investment projects supported is about 100 cases in both stages.

## 2. Rationale for using financial engineering instruments

The main reason for the use of FEIs rather than grants is the difficulties that SMEs experience when seeking external forms of financing. This is particularly pressing in the case of young innovative enterprises and innovative enterprises in general. Therefore, the Loan Fund enables SMEs to obtain a loan even in cases when the commercial banks refuse to provide the loan due to a high risk rate.

Nevertheless, the data available show that SMEs really prefer to apply for a bank guarantee than for a loan. One of the interviewees with an extensive knowledge of the business environment in the Czech Republic observed that this might be attributable to the fact that the guarantee scheme is used in addition to the loan provided by the commercial bank which is less restrictive than loans provided by CMZRB.

The responsible authority (Ministry of Industry and Trade) gives three main reasons for the setting up of the VC fund: i) vigorous support to innovations (i.e. a new financial mode for the financing of “good ideas” enhancing the competitiveness of the Czech economy, ii) provision of a strong impetus to the development of the venture capital market in the Czech Republic and also to raise the awareness of Czech entrepreneurs about this mode of financing innovative projects, iii) an effective and efficient use of public resources by designing such a revolving financial instrument. Moreover, given that the state Fund always cooperates with the private venture capitalists, a partnership between the state authorities and the managers of the venture capital funds is expected to develop which, in turn, will stimulate more investments of this type in the Czech economy.

In addition, a market failure study was performed during the preparatory phases of this Fund. The study concluded that in comparison to other European Economic Community (EEC) countries and to the rest of Europe, the threshold of minimum investment in the current venture capital market is relatively high, i.e. the financial gap concerns predominately relatively small projects (up to approximately EUR 2.5 million) of SMEs. Moreover, the VC market in the Czech Republic suffers from a lack of demand as regards early-stage financing (i.e. seed and start-up). On the other hand, the innovative enterprises often seek venture capital investments only for a few million CZK<sup>1</sup> which are then accompanied by a provision of high quality know-how, business contacts, and assistance with market penetration/expansion. In addition, entrepreneurs find it difficult to prepare a sound investable business project (i.e. “Investor Ready Business Plan”). Sometimes, entrepreneurs have unrealistic expectations of the potential return rates of their envisaged project and are not always willing to sell a share in their enterprise to VC investors. CzechInvest has prepared a special project (CzechEkoSystem) for entrepreneurs to address these weaknesses.

The main perceived benefit of FEIs for the policy makers is the support to potentially promising young SMEs whose risk rate is not acceptable for commercial banks.

According to our interviewees, administrative and other costs connected with the provision of FEIs do not differ significantly from the costs linked to grants.

### **3. The effectiveness of financial engineering instruments: selected examples**

According to interviewees, the Managing Authority exerts a significant influence upon CMZRB which implements FEIs in all relevant (sub)programmes (i.e. START, PROGRESS and GUARANTEE). Firstly, there is a written agreement between the MA and CMZRB specifying the duties of both parties. Secondly, the calls, including specific details, such as criteria for project selection are prepared by the Managing Authority. Therefore, the strategic orientation of the support scheme is decided by the Managing Authority itself. Secondly, the final beneficiaries need to fulfil a set of criteria in order to receive support from the funds. For example, in the case

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<sup>1</sup> 1 EUR=25 CZK

of programme START, 21 basic binary criteria have to be met, such as “applicant has not received support under program START previously” or “guarantee provided does not exceed 80% of the loan”. In addition, the applicant has to prove that his/her project has been considered as investable by the commercial bank.

Thirdly, there are several mechanisms of exerting monitoring and managerial control over CMZRB such as internal audits, regular evaluations, meetings of the monitoring committee etc. Nevertheless, the individual cases of project applications are handled exclusively by the CMZRB. The key indicators of performance of CMZRB as regards the implementation of FEIs are: the demand for these instruments and the number and share of projects which turn out to be unsuccessful during their implementation phase.

In case of the VC fund of the OP Enterprise and Innovation which is currently in preparation (according to the latest news - mid June –, the Fund will be operational before the end of 2012) the following observations are particularly relevant:

- The VC fund will be profit oriented as it will be managed by a professional manager, whose remuneration will be linked to the performance of the Fund. On the other hand, the other objectives of the Fund, such as attracting more private capital to the VC market and supporting the development of innovative enterprises, are not typical of private venture capital funds.
- The main criteria for final recipients will be: the quality of the business plan, the character of envisaged innovation, profit potential etc.
- The recipients will be innovative SMEs located in the Convergence regions (all Czech regions except for Prague).
- The two main criteria for performance assessment of the Fund are: i) the amount invested in innovative enterprises and ii) the profit from exits.
- Specific quantified targets: the projects approved should yield at least 15% p.a.; hurdle rates in case of fund manager’s exit: 6% p.a. (early-stage) and 10% p.a. (later-stage). If the rates of return do not exceed hurdle rates, the manager shall not obtain any success fee from such investments.
- Reporting shall be carried out by the fund manager. Independent company shall audit the accounts of the Fund.

#### **4. Main problems in using financial engineering instruments**

The major problem encountered when designing and implementing FEIs is the setting up of an acceptable risk rate. If the state support scheme were to be set up in such a way as to eliminate the risk as much as possible the very rationale of public support would be lost (i.e. commercial banks could fully replace such a scheme). Alternatively, if the state support scheme supported even high risk projects the scheme would inevitably induce high losses. Therefore, setting an acceptable risk rate is a real challenge. In the Czech case the acceptable rate was set up during negotiation of the OP Enterprise and innovation. In any case, the current support scheme operates in the SMEs considered too risky by commercial banks. Therefore, a clear market gap is being addressed.

The main problem investing the VC Fund under preparation is an inadequate legal Framework. The Czech legislation (namely budgetary rules) does not envisage purchasing shares in

investment funds with public money. The problem has been overcome by establishing a 100% state-owned investment fund managed by a professional manager selected on the basis of an open public tendering procedure. The private capital and the Fund's capital should merge at the level of individual projects.

Secondly, to guarantee a reservoir of suitable (investable) projects, a programme for the development of these projects has been launched and a prominent consultancy body to provide these services has been selected in a recent tender procedure (South Moravian Innovation Centre).

## **5. Evaluations of financial engineering instruments**

No targeted evaluations have been carried out so far. However, the sub-programmes using the FEIs have been covered by a transversal mid-term evaluation which is now in its concluding stages (April 2012). Currently, there is no plan to perform any specific evaluation on FEIs. Therefore, currently, the perception of FEIs by the MA is based upon internal audits, meetings of the monitoring committee and upon two key indicators: i) the demand for these instruments, ii) the number and the share of projects which turn out to be unsuccessful during their implementation phase.

## **6. Concluding remarks**

The interviewees observed that one of the key components of a successful scheme using FEIs is the very fact that it represents a sort of alternative to the other standard support instruments such as grants. In other words, according to them, a sound business support scheme should offer a reasonable variety of support instruments thus allowing individual applicants to select the one best fitted to the specific needs of a particular company. Therefore, while interviewees appreciate the role of FEIs as an additional form of business support, they were rather sceptical of a potential significant shift in favour of FEI instruments in the next programming period. While the FEIs are considered an important vehicle for dealing with some types of market failures (mentioned in §3), a fundamental fact should not be overlooked: FEIs are - in contrast to direct grants - "only" a repayable form of public assistance, while entrepreneurs generally prefer grants to loans.

## References

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## Interviews

The author would like to thank the following people for their insights; however, opinions in this Report remain the sole responsibility of the author:

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