



PRIVATE EQUITY AND BUSINESS BUDGETING

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Abstract:

This study investigates the connection between private equity funds and business budgeting. The study is based on the data from SEAF South Balkan Fund B.V., a private equity fund, which, during the 2006 to 2010 period, analyzed 483 companies in Serbia. To that end, the first part of the study presents the conceptual framework, as well as different private equity funds, such as venture capital funds, leveraged buyout funds, mezzanine funds, etc. The second part of the study shows different types of budgets, their features and characteristics, as well as different budgeting processes, methods and strategic approaches. In the third part, the connection between private equity investing and business budgeting is established. Lastly, the conclusion is drawn that the business budgeting is an important factor in creating successful companies, but that many business owners, in Serbia, do not realize its importance, or perform it.

Key words:

private Equity,
budgeting,
investments.

1. INTRODUCTION

Private equity is of great importance to all transition countries regardless of their level of development. According to the Emerging Markets Private Equity Association, just in 2013, private equity funds had close to \$40 billion reserved for investing in emerging markets [5]. Taking into account the available financing, and the fact that certain economic issues can be resolved by the means of efficient investments by private equity funds, such as: development of small and medium size enterprises, development of corporate governance, establishment of the budgetary equilibrium, economic allocation of capital, and raising of the operational discipline, many countries in the Central and Eastern Europe, such as Poland, Czech Republic, Hungary, Romania, and Bulgaria have intensified their efforts in creating conditions for such investments [13]. Unfortunately, Republic of Serbia is lagging behind in the process of creation of the conditions in which private equity funds can operate. As far as it can be determined, only a small number of funds operate in Republic of Serbia, such as: Blue Sea Capital, Innovation Fund, EMSA CEE Private Equity Fund, EMSA Special Situations Fund, Mid-Europa Fund III [14], and RSG Capital, with limited investment activities or an insufficient volume of the assets. One of the exceptions is SEAF South Balkan Fund, a Washington-based fund, which has intensified its investment activity and has invested in many companies [15]. Given the number of funds and their volume of investments during the previous period, it is clear that the significance of these funds has not yet been recognized.

A certain justification for the condition can be found in the fact that alternative investments are complex in nature and are not suitable for an average investor. It is well known that private equity investments in emerging and developed markets are highly profitable and have a low correlation with other investment classes, such as the investments in bonds or shares, thus objectively increasing the diversification level of a particular portfolio [13]. Furthermore, the transition countries have certain advantage relative to the developed countries, which have recently faced a drop in profits due to the oversupply of private equity investments. However, the transitional countries require accelerated institutional reforms, appropriate laws on the protection of the private ownership, fiscal discipline, and monetary stability [12].

The research shows that a change in the capital structure of companies causes numerous changes in the concept of management, organization, and financial performances [15]. It causes reengineering of the organizational processes and activities at almost all levels and structures [14]. The budgetary process is no exception - it is moving from the traditional concept, to the budgetary process capable of dealing with capital market changes, increased competition, and consumers' requirements, in respect to the products and services' quality, variations, and prices. The decrease of expenses and the mechanical implementation of the adaption process are no longer the only aim. The aim is broadened to achieve the general focus on buyers of goods and services. The transformation of economic entities into modern companies, among other things, leads to the usage of services of the investment funds and the conceptualization of the budgets based on the new approaches and assumptions.

2. PRIVATE EQUITY FUNDS

2.1. Types of Private Equity Funds

Private Equity funds include:

- ◆ venture capital funds,
- ◆ leveraged buyout funds,
- ◆ mezzanine funds,
- ◆ special situation funds i.e. distressed funds, funds of funds, secondary funds, and other special situation funds [13].

Venture capital funds are investment companies that invest their capital in new firms, or developing firms. They invest during the seed-stage, start-up stage, or early stage. When investing in the expansion stage, they are more like development funds, having similar structures and investment methodologies. Venture capital funds have mostly closed forms, focused on investments in high-risk firms that are potentially capable of achieving above the average development and profit. They are the most important source for financing operations of small firms. In addition, they have a significant role in providing assistance to developing necessary strategic and business plans, attracting new partners and potential investors, and educating and preparing the management to lead firms more efficiently [16].



Leveraged buyout funds are present in both developed and under-developed countries. They are increasingly present in various markets, since they contribute to more efficient allocation of capital, development of an economic system, strengthening of the private sector, and creating responsible management [9]. The practice shows that leveraged buyouts are of greater importance for the transition countries, since they could have positive effects on management and employees' productivity and motivation, development of corporate governance, budgetary equilibrium, and provision of funds for investment [12]. Leveraged buyout funds select firms that can create added value by using standard procedures of efficient and effective management. However, prior to entering a leveraged buyout, it is necessary to identify the reasons for it, namely: potential lack of funds, simplicity of conducting a privatization, desire for security, or tendency to avoid other buyer [9].

Mezzanine funds provide a hybrid type of financing, using a subordinate loan, preferred stock, or various types of options, such as warrants. In terms of the risk level, it is similar to the investment in shares. It is based on the various standards, such as '60-30-10', which means that the guaranteed loan accounts for 60% of the total capital, 30% of the mezzanine capital, and 10% of the share capital [17]. Mezzanine funds invest to close the gap between two financings, to close the gap in the firm capital structure, or to close the gap in a leveraged buyout [1]. When investing, they expect high profits, since a subordinate loan has higher interest rate than the interest rate of a regular loan, while it can also include options. Despite the fact that a subordinate loan could be under collateralized, it has an obvious payment schedule and could imply membership in a board of directors [13].

Special situation funds include: distressed funds, funds of funds, secondary funds, and other special situation funds [13]. Distressed funds are known as 'vultures,' since they invest in subordinate, low quality and high risk bonds, which can potentially realize high yields. On the other hand, funds of funds do not invest directly in firms, but in other investment funds, such as venture capital funds, leverage buyout funds, mezzanine funds, and special situation funds. By investing in many different funds, the risk is spread and the expectations are increased. Secondary funds buy shares from investment funds in order to profit from it. They do so with investment funds which are near the end of their investment cycle, mostly applying 20% to 50% discount, shortening the investment period, and increasing the internal rate of return (IRR) [13]. Other special situation funds, which use wide range of investment strategies, are workout/turnaround funds, crossover funds, and interval funds.

3. BUSINESS BUDGETING

3.1. Budgeting Processes and Approaches

The budgeting process is a systematic and complex procedure of including and relating various factors in order to obtain a unity, as a possible and the total reflection of the reality and events, which are evolving, or, sometimes, dramatically changing. It implies the ability of the management, when leading an economic entity, to identify short-term and long-term goals related to the maximization of customers' satisfaction, reduction of operating costs, increase of a market share and profit, and the movement between possible and desirable performances, within the specific cycle.

According to Rasmussen and Eichorn, when creating a budget, the management of economic entities can choose between three main approaches: the top-down approach, the bottom-up approach, or a combination of these two approaches - the top-down/bottom-up [10]. In the top-down procedure, managers at the upper levels of the organizational structures and hierarchy

perform the process with very little input from the management of the lower operational units or departments. Here, the budget is simply forwarded to the lower organizational units, which follow its development or operational execution. In the bottom-up approach, the lower management levels have active roles. They create the budget and forward it to the higher management levels. In the combined approach, the two approaches are brought together and certain cooperation is realized, and the requirements, interests, and demands of the higher and lower management levels are harmonised [2&10].

3.2. Budget Creating Methods: Strategic Choices

The choice how to start creating the budget depends on many factors: a size of an economic entity, organizational scope, technology, type and level of sophistication, organizational level, chain of command, communication, range of control, experience, and culture [2]. The conceptual reengineering in the budgetary methodology introduced the following budgetary methods: Zero Based Budgeting, Rolling Budget, Activity Based Budgeting, Balanced Score Card, and Beyond Budgeting Model [2]. In respect to Zero Based Budgeting, the management must completely evaluate its programmes and activities, so that the budgetary projections would start from zero. The management also needs to identify decision-making units, to appropriately describe them, and to relate them to the possible outcomes, while conducting allocation of available resources in line with the conceptual framework [2]. Having taken in consideration the fact that it starts from zero, this conceptual approach is time and funds consuming, often implying resignation and resistance from managers at various levels, and creating potential threats to existing projects. The necessity to implement a Rolling Budget is determined by the explicit request that an organization can survive in modern market conditions only if it is capable of adapting to the new market requirements and increased customers' demands [2]. They allow constant interventions, interferences, and changes in line with the current information and innovations. Activity Based Budgeting concept focuses on activities: it is designed as a managerial process in which the following activities' are the key ones: a planning process related to and derived from the strategic goals of an organization, a usage of techniques for analysis of activities, an identification of opportunities for reduction of expenses, an introduction of participating control processes and continuous improvement, etc [2]. Balanced Scorecard method is a type of a multidimensional approach focused on the measurement of performance and on the management, which is naturally connected to the selected strategies. Kaplan and Norton, in their model of the translation of the vision and strategy, introduced the balanced perspectives: finances, buyers, business processes, and learning and growth [6]. Its advantage, compared to other choices, is the fact that it provides variability of the observations - it is focused on the critical processes, and it forces the management to translate the mission of the organisation into measurable parameters [6].

4 PRIVATE EQUITY INVESTING AND BUSINESS BUDGETING

4.1. Impact of Private Equity on the Business Operations of Economic Entities

The investments of private equity funds have a positive impact on the development and business operations of economic entities [13]. First, investments have a significant modifying effect on the management of economic entities. They formally and legally oblige the management to fulfil its obligations in a timely manner and with due care, such as: to prepare and present the



main budget, to make necessary business plans and adequate business projections, to submit regular reports and suggestions for the solution of the actual problems. Certain research shows that, through investment by private equity funds, new solutions in the concept of division of work, units grouping, authority delegation, and control range are sought. In the first stage of change, a relatively authoritarian structure is constituted based on the new requests: threats and opportunities. In the second stage, the organization is consolidated and is taking the shape that equally insists on effectiveness and efficiency.

The investments by private equity funds also influence economic entities to make their business operations more transparent [15]. It can be simply accomplished by the reengineering of the enterprise resource planning (ERP) system: creating and presenting business reports on budgeting, capital structure, manner in which funds are spent, financial situation, investments, dividends, etc. Furthermore, private equity funds stipulate the obligation of entities to provide information on movable assets, mortgages and pledges, leasing agreements, loans, and the like. Therefore, through investments by private equity funds, a new balance between the control mechanisms and the distribution of the authority is introduced. In the first stage, the control systems apply strict accounting methods and mechanisms of protection of the joint property, in order to prevent any possible illegal transfer via channels of procurement, sales, compensation, abuse of authority, or harmful agreements [13]. In the second stage, there is a strengthening of the control units and an improvement of the control system through participation in a creation of the control plans and techniques. The control is improved by application of the international standards and formatted documents in all segments, and at different organizational levels [15].

4.2. Impact of Private Equity Investments on the Budgeting Processes

There are various and complex connections between investments by private equity funds and budgeting in economic entities. In the traditional approach to budgeting, for example, sales goals are, in a certain sense, semi-fixed starting values. With private investments, the changed capital structure implies a more ambitious approach to these assumptions, which may be brought in connection with the benchmarks [15]. An improved capital structure should be managed based on its role in creation of new values through the investment life cycle, and not based on the short-term allocations. Thus, the relevant budget item has the form of a changed function and has a redefined position and role.

When assessing the expenses of the management, their evaluation, specification, and role in creating new added value are the starting points, not the fact whether they should be increased compared to the previous business year. The change of ownership structure brings additional elements of motivation and responsibility to the management for development of an organization, and its efficiency in the market. In addition to the changes in the organization, there are changes in the coordination concept that crosses and goes through functions and parts regardless of the fact whether the budget independence of the organizational units (i.e. departments) is jeopardized. Thus, an independence of certain units is relative and advantage is given to the business efficiency and economic management.

4.3. SEAF South Balkan Fund B.V. and Budgeting

SEAF South Balkan Fund, an expansion private equity fund, during the 2006 to 2010 period, analyzed 483 companies in Serbia [15]. The companies were geographically disbursed in the

Republic of Serbia, and were based in more than 100 different town and cities, including: Aranđelovac, Arilje, Bačka Palanka, Bajina Bašta, Beograd, Bor, Čačak, Crvenka, Gornji Milanovac, Indija, Ivanjica, Jagodina, Kikinda, Knjaževac, Kragujevac, Kraljevo, Kruševac, Kula, Leskovac, Loznica, Lučani, Mladenovac, Niš, Nova Varoš, Novi Pazar, Novi Sad, Odžaci, Palić, Pančevo, Paraćin, Pirot, Požarevac, Požega, Prokuplje, Šabac, Sombor, Subotica, Svilajnac, Užice, Valjevo, Vladičin Han, Vrčac, Zrenjanin, etc. The companies also operated in more than 100 different industries, including: Advertising, Aerospace, Agriculture, Apparel, Communications, Construction, Dietary Supplements, Education, Electronics, Energy, Engineering, Entertainment, Financial Services, Food and Beverage, Health, Hospitality, Household Appliances, IT/Telecommunication, Media, Oil and Gas, Packaging, Pharmaceuticals, Plastic, Publishing, Real Estate, Recycling, Renewable Energy, Software, Textiles, Tourism, etc. The SEAF South Balkan Fund data, based on analyzing the 483 companies [15], showed that: a) out of the 483 companies, only 9 performed budgeting (or 1.9% of the total), and b) the owners of the companies not performing budgeting did not realize the importance of budgeting, or had a limited knowledge in order to implement it (as required by the above mentioned modern budgeting theory). After investing in a selected number of companies, SEAF South Balkan Fund trained their employees, and it implemented different budgeting methods [15]. After that, all the owners agreed that the budgeting was useful, and that it improved the performances of their respective companies. The Table 1 shows the selected portfolio companies and whether they performed business budgeting, pre and post investment [15]:

Company	Budgeting (pre-investment)	Budgeting (post-investment)	Viewed as useful
<i>Adore</i>	No	Yes	Yes
<i>ET Servis</i>	No	Yes	Yes
<i>Finera</i>	No	Yes	Yes
<i>Gomex</i>	No	Yes	Yes
<i>Logo</i>	No	Yes	Yes
<i>PC Centar</i>	No	Yes	Yes

Table 1: Private Equity Fund's Portfolio Companies and Budgeting

CONCLUSION

Based on the experience and the data of the private equity fund, only 1.9% of companies in Republic of Serbia perform business budgeting. Under the pressures of private equity funds, economic entities are forced to redesign their budget philosophies. The companies, which received the financing from the fund, perform business budgeting and found it to be effective. Any future studies could analyze why companies in Republic of Serbia do not perform business budgeting. Furthermore, further studies could focus on the methods, which private equity firms use to implement business budgeting. Lastly, they could analyze the link between budgeting and company performance.

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PRIVATNI INVESTICIONI FONDOVI I BUDŽETIRANJE U PRIVREDNIM SUBJEKTIMA

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Apstrakt:

U radu se istražuje veza između privatnih investicionih fondova i budžetiranja u privrednim subjektima. Studija se bazira na podacima SEAF South Balkan Fund B.V., privatnog investicionog fonda, koji je, u periodu od 2006. do 2010. godine, analizirao 483 kompanija u Srbiji. U vezi s tim, u prvom delu rada izlažu se konceptualni okvir i sadržaj različitih privatnih investicionih fondova, kao što su fondovi preduzetnog kapitala, fondovi kreditne kupovine, fondovi mešovito finansiranja i drugi. U drugom delu izlažu se vrste budžeta, njihove osnove i karakteristike, kao i procesi budžetiranja, metode i strategijski prilazi. U trećem delu uspostavlja se konekcija između ulaganja privatnih investicionih fondova i budžetiranja u privrednim subjektima. Na kraju se izvlači zaključak da je budžetiranje bitni činilac uspešnog poslovanja, ali da vlasnici mnogih kompanija u Srbiji nisu svesni značaja budžetiranja, kao i da ga ne sprovede.

Ključne reči:

privatni investicioni fondovi, budžetiranje, investicije.