

# Northern Lights

## Hot companies are finally emerging from the cold Baltic States.

By Drew Wilson

**E**stonia may not be the first country that comes to mind when thinking about tech hotspots. But the technologically advanced nation was the birthplace of Skype—and it's home to more startups that could soon launch on the world stage.

Certainly, Estonians are big users of technology. People typically pay for parking with their mobile phones and bank online. An e-voting system is planned for this year and nearly all Estonian schools have adopted a software platform from an early-stage startup called E-School. The platform allows teachers to exchange grades and attendance reports with parents via computer or mobile phone. If a child is absent from school, parents get an instant message.

E-School is but one example of how the Baltic States are not only a testing ground for new tech products, but also are starting to generate innovations that can cross borders. Most famously, the technology behind Internet phone company Skype, which was acquired in 2005 by eBay for

\$2.6 billion, was developed in Estonia (though the company was officially registered in Luxembourg and founded by a Dane and a Swede).

Now, the techies behind Skype are hoping to finance other startups in the Baltics. A year ago, the software engineering team in Estonia that developed Skype created a Tallinn, Estonia-based venture capital firm called Ambient Sound Investments to mine tech advances in Estonia, Latvia, and Lithuania. And there is no shortage of opportunities.

"We haven't had any difficulty finding companies to invest in," says Ambient Chairman Toivo Annus, the former head of Skype's engineering team.

Ambient hopes to serve as a catalyst in a region that to date has seen little venture activity. Few foreign VCs have committed money to Baltic startups, and the handful of private equity houses in the region are mostly focused on large buyouts. After one year as a VC firm, Ambient's tech investments total €5 million (\$6.5 million) from a €100-million fund. They include Connecty, based



in Vilnius, Lithuania, which develops remote monitoring and control systems, and Tartu, Estonia-based Clifton Semiconductors, a developer of high-speed gallium arsenide semiconductors.

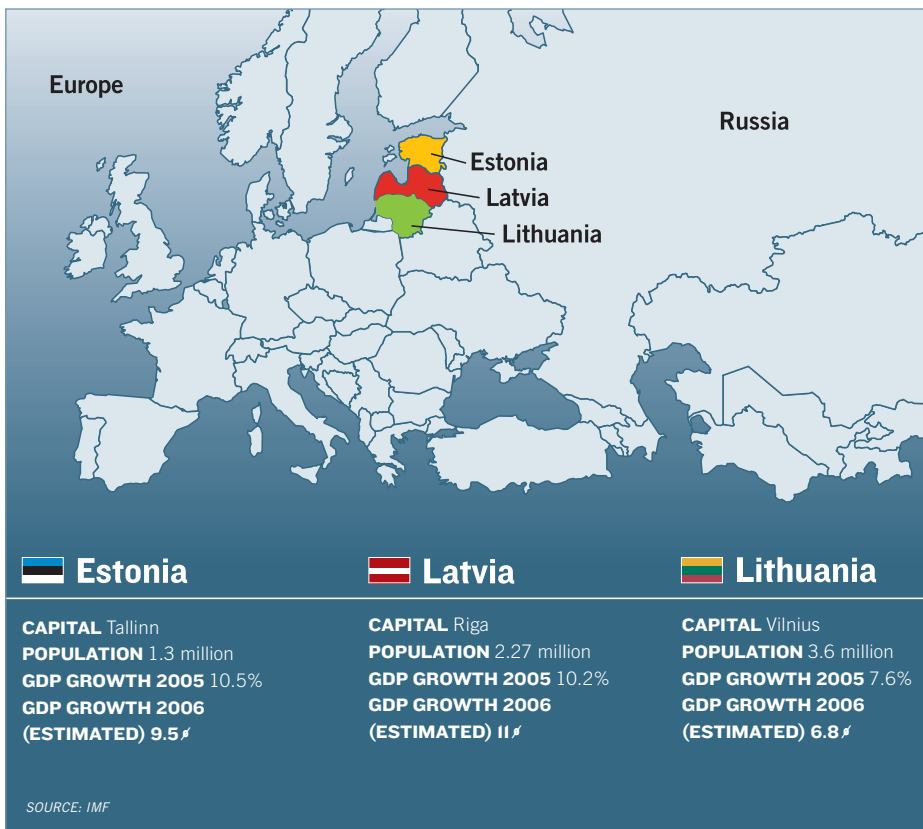
Five million euros may not sound like much, but in 2005, total startup investment in the Baltics was only €1.1 million (\$1.4 million), according to the European Venture Capital Association, based in Zaventem, Belgium. There are only a handful of Baltic-based VCs, including Ambient and BaltCap Management, and few foreign VC firms have set up shop, except for U.K.-based Imprimatur Capital, which has a branch office in Riga, Latvia.

That may be because few foreign firms see enough upside to establishing a base in the region. Martin Kodar, a partner in private equity and venture capital firm BaltCap Management in Tallinn, which has €90 million under management in the Baltics, explains that investments below €10 million (\$13 million) are not attractive to foreign companies. "A Swedish VC wouldn't make a €1-million investment here, because the cost of supporting it and understanding the local market is too high," says Mr. Kodar. BaltCap is currently raising a regional fund of €100 million that will mainly go after business expansions and buyouts.

### New Concept

Venture capital is a recent development in the Baltics. Profit and private initiative were punished during the five decades of forcible incorporation in the Soviet Union, leaving a lingering misunderstanding of venture's role. The first appearance of VC in the region came when BaltCap set up shop in 1995, four years after the collapse of the Soviet Union—though the firm focused on buyouts since there were few startups to fund at that time.

"Ten years ago, businesspeople saw investment as an award—you could take credit and not





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give it back,” says Darius Calitis, chairman of the Latvian Venture Capital Association (LVCA) in the capital city of Riga. “Now that’s changed totally, but there is still little understanding of venture capital.”

As a result, the average startup is much less savvy than its U.S. counterpart, say local VCs. Baltic entrepreneurs understand the basics of what a VC expects in a business plan, but usually not specifics like how precise the numbers must be and how far to project financial data. “You have to do more due diligence and participate in the project to make it investment-ready,” says Ambient’s Mr. Annus.

Such disconnect between technical know-how and business prowess may well stem from history. At the same time that Soviet Moscow outlawed capitalism, it fully funded research institutions for defense work and built megafactories in the Baltics to supply military and consumer electronics to the entire Soviet Union. Latvia’s former radio electronics factory, known by the acronym VEF, employed 20,000, most of them telecommunication engineers. Lithuania’s research organizations developed lasers, optics, and measurement devices. And Estonia’s scientists worked for the state in several areas, including gallium arsenide semiconductor research.

After the Soviet Union collapsed in 1991, the Baltic research community dissolved or scaled down. Tens of thousands of engineers were thrown out of work, leaving a legacy of technical experts who hold a deep cynicism about the free market. Today’s Baltic landscape looks far different from the old one, however. Baltic economies are roaring, with annual GDP growth rarely below 6 percent since 2000.

Part of that surge stems from the willingness of Baltic citizens to embrace new technologies. “The Baltics are seen as a testing ground for new IT products,” Mr. Kodar says. BaltCap made an atypically small €200,000 investment in E-School, which currently has product tri-

als in Latvia, Lithuania, Germany, and Poland, because the firm believes E-School exemplifies the new Baltic startup—small, but with a novel product that could take hold abroad. With just four employees, E-School has raised €400,000 in total and is using office space in BaltCap’s Tallinn office, says CEO Sten Soosaar.

There are also signs that the technical expertise—and resourcefulness—of Baltic residents salvaged from the Soviet pas could translate into successful companies. Riga-based SAF Tehnika, a maker of telecom equipment, is the Baltics’ only technology IPO since the re-establishment of their stock markets after 1991 independence.

SAF Tehnika’s roots trace back to the early 1990s, when an engineer in a rural area in Latvia was told by the telephone monopoly that he had a six-year wait for a phone line. Fed up, he used his engineering skills to invent a workable microwave link to get telephone service, bypassing the landline. He then hooked up his neighbors, who in 1999 became founding partners in SAF Tehnika, which listed on Riga’s stock exchange in 2004 and now markets its telecom equipment in 43 countries.

“Baltic startups have practice in getting things done without spending a lot of money,” Mr. Annus says. “This is due to the background of the region being relatively poor, but relatively well developed technologically.”

Instead of denying it, today’s Baltic entrepreneurs are leveraging the Soviet past. Baltic startups often position themselves as a gateway to larger, risky Eastern markets such as Russia and Ukraine. Due to history, Baltic citizens know the language and mentality of their neighbors, while their land borders and seaports provide transport links.

“If a European VC wants to expand to Russia or Ukraine, the Baltics would be the best location to start,” LVCA’s Mr. Calitis says, adding that the presence of more foreign VCs would be most welcome. He believes the lack of seed

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funds has stymied the fledgling startup community. Local governments have stepped in to help a few startups, but their support hasn’t been enough to launch global technology contenders.

The state-funded Latvian Technological Center in Riga, for example, houses a few dozen startups and acts as a business incubator, but it offers little more than a low-cost infrastructure, contact with potential business partners, and encouragement. Due to lack of seed funds, LTC success stories are mostly trade sales. Biosan, an electronic lab instrumentation firm, was started by an engineer who raised seed money by selling furniture. In 2005, U.K.-based Grant Instruments bought a controlling share in the Riga-based firm.

“Startups often have to sell their technology to foreign companies and are not able to produce value-added product here,” says Janis Stabulnieks, managing director of the LTC.

Mr. Calitis hopes the Skype story will draw more foreign investment to the Baltics and encourage more people to take the entrepreneurial plunge. He points out that people who grew up in Soviet times have been forced to embrace a business mentality, with mixed results. But he has hope for the future. After all, those born after 1991 into a market economy will reach university age only in 2008.

“We have a new generation of businesspeople coming,” says Mr. Calitis.

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