OECD CAPITAL MARKET SERIES

OECD Capital Market Review of Croatia 2021

Capital market reforms for recovery and improved business dynamics in Croatia

OECD

OECD Capital Market Review of Croatia 2021

Capital market reforms for recovery and improved business dynamics in Croatia

Please cite this report as:

OECD (2021), *OECD Capital Market Review of Croatia: Capital market reforms for recovery and improved business dynamics in Croatia*, OECD Capital Market Series.
http://www.oecd.org/corporate/OECD-Capital-Market-Review-Croatia.htm

This document was produced with the financial assistance of the European Union. The views expressed herein can in no way be taken to reflect the official opinion of the European Union.

This report is part of the *OECD Capital Market Series*. More information about the series is available at: www.oecd.org/corporate/capital-markets

O OVOJ REVIZIJI

Nakon razdoblja slabih ekonomskih rezultata uslijed globalne financijske krize iz 2008 godine, Republika Hrvatska je tijekom zadnjih pet godina imala snažan ekonomski rast. Republika Hrvatska je primila podršku kroz ambiciozne inicijative za reforme te je uspjela smanjiti zaduženost i poboljšati stanje javnih financija. Međutim, kao i u drugim državama, dosad nezabilježen ekonomski šok uslijed krize prouzročene bolešću COVID-19 narušio je taj napredak i rezultirao ozbiljnom recesijom. Naročito se mnoge inače stabilne hrvatske tvrtke suočavaju s financijskim problemima uslijed naglog pada prihoda i strožih kreditnih uvjeta.

Danas je osobito važno hrvatskom korporativnom sektoru osigurati pristup financiranju putem tržišta kapitala u cilju postizanja uspješnog i održivog oporavka. Dugoročno financiranje putem tržišta kapitala može hrvatskim poduzetnicima pomoći u smanjivanju ovisnosti o kratkoročnom financiranju i usklađivanju dugoročnih ulaganja s dugoročnim kapitalom. Razvijenije tržište kapitala također će kućanstvima pružiti bolje prilike za ulaganja radi uspješnijeg upravljanja štednjom i planiranja za mirovinu.

Ministarstvo financija Republike Hrvatske podnijelo je zahtjev za potporu Glavnoj upravi za potporu strukturnim reformama (DG REFORM) Europske komisije u cilju provedbe sveobuhvatne revizije tržišta kapitala u Hrvatskoj. OECD je imenovan provedbenim partnerom projekta. Preporuke navedene u ovom Izvješću imaju za cilj pomoći Republici Hrvatskoj u produbljenju njezinog tržišta kapitala kako bi to tržište moglo imati središnju ulogu u jačanju bilanci hrvatskih tvrtki pogođenih krizom bolesti COVID-19. Te preporuke također mogu pomoći Republici Hrvatskoj da iskoristi prednosti agende Unije tržišta kapitala EU-a, usmjerene na produbljivanje i integriranje tržišta kapitala 27 država članica EU-a.

Ova je revizija dio Serije o tržištima kapitala OECD-a na kojoj se temelje rasprave o politikama u pogledu načina na koji tržišta kapitala mogu djelovati u cilju ispunjenja svoje važne uloge usmjeravanja financijskih resursa iz kućanstava u produktivna ulaganja u realnom gospodarstvu. U cilju izrade Revizije tržišta kapitala u Republici Hrvatskoj, Tajništvo OECD-a provelo je opširno istraživanje i organiziralo je misije za utvrđivanje činjenica u Republici Hrvatskoj te održalo konzultacije s predstavnicima relevantnih organizacija, lokalnim tijelima vlasti i izvršnim direktorima korporacija. U dodatku su detaljno opisani proces konzultacija, izvori podataka te metodologija prikupljanja i analize podataka.

ABOUT THIS REVIEW

After a period of weak economic performance following the 2008 global financial crisis, Croatia has experienced strong economic growth over the 2015-2019 period. Supported by ambitious reform initiatives, the country has been able to reduce its indebtedness and improve its public finances. However, as in other countries, the unprecedented economic shock caused by the COVID-19 crisis has disrupted this progress and resulted in a severe recession. In particular, many otherwise sound Croatian businesses are facing financial challenges caused by a sharp decline in revenues and tightened credit conditions.

Today, it is particularly important to ensure that the Croatian corporate sector has access to capital market financing in order to achieve a successful and sustainable recovery. Long-term market-based financing can help Croatian entrepreneurs reduce their reliance on short-term financing and match long-term investments with long-term patient capital. A more developed capital market will also provide households with better investment opportunities to manage their savings and plan for retirement.

The Croatian Ministry of Finance has submitted a request for support to the Directorate-General for Structural Reform Support (DG REFORM) of the European Commission to undertake a comprehensive review of capital markets in Croatia. The OECD was designated as the implementing partner for the project. The policy recommendations in this report aim at assisting Croatia in scaling up its capital markets so that they can play a central role in strengthening the balance sheets of Croatian companies hit by the COVID-19 crisis. They would also help Croatia benefit from the EU Capital Markets Union agenda, which aimed at deepening and integrating the capital markets of the 27 EU Member States.

The Review is part of the OECD Capital Market Series, which informs policy discussions on how capital markets can serve their important role of channelling financial resources from households to productive investments in the real economy. To prepare the Capital Market Review of Croatia, the OECD Secretariat undertook substantive research, conducted fact-finding missions to Croatia and held consultations with representatives of relevant business organisations, local authorities and corporate executives. Detailed descriptions of the consultation process, data sources and the methodology for data collection and analysis are provided in the Annex.

Reviziju je pripremio tim predvođen Matsom Isakssonom, bivšim voditeljem Odjela za korporativno upravljanje i korporativne financije Odbora za financijska i poslovna pitanja OECD-a, i Serdarom Çelikom, vršiteljem dužnosti voditelja Odjela, s članovima tima Adriana De La Cruz, Alejandra Medina, Tugba Mulazimoglu i Yun Tang. Izvješće je izrađeno uz financijsku pomoć Europske komisije putem Glavne uprave za potporu strukturnim reformama (DG REFORM).

The Review was prepared by a team led by Mats Isaksson, former Head of Corporate Governance and Corporate Finance Division within the OECD Directorate for Financial and Enterprise Affairs and Serdar Çelik, Acting Head of the Division, composed of Adriana De La Cruz, Alejandra Medina, Tugba Mulazimoglu and Yun Tang. The report was produced with the financial assistance of the European Commission via the Directorate-General for Structural Reform Support (DG REFORM).

TABLE OF CONTENTS

FIGURES

TABLES

ACRONYMS AND ABBREVIATIONS

ACE	allowance for corporate equity
AGM	annual shareholder meeting
AUM	assets under management
CDCC	Central Depository and Clearing Company
CEE	Central and Eastern Europe
CERP	Centre for Restructuring and Sale
CPI	Consumer price index
CRA	credit rating agency
EBC	European Banking Coordination
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EDC	European Data Cooperative
EIF	European Investment Fund
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
EU	European Union
FESE	Federation of European Securities Exchanges
FGS	Economic Cooperation Funds
FIBEN	Fichier bancaire des entreprises
FINA	Financial Agency
GAAP	Generally Accepted Accounting Principles
GDP	gross domestic product
GDR	global depository receipt
HANFA	Croatian Financial Services Supervisory Agency
HAMAG-BICRO	Croatian Agency for SMEs, Innovations and Investments
HBOR	Croatian Bank for Reconstruction and Development
HNB	Croatian National Bank
HRK	Croatian Kuna
IFRS	International Financial Reporting Standards
IPO	initial public offering
IMF	International Monetary Fund
IOH	insolvency office holder
IOPS	International Organisation of Pension Supervisors
MAS	Monetary Authority of Singapore
MTF	multilateral trading facility
NPL	non-performing loan
NZD	New Zealand Dollar
NZVIF	New Zealand Venture Investment Fund
OECD	Organisation for Economic Co-operation and Development
PE	private equity
PEA	plan d'épargne en actions

R&D	research and development
REIT	real estate investment trust
RPT	related party transactions
ROE	return on equity
SEE	Southeast Europe
SEIS	Seed Enterprise Investment Scheme
SME	small and medium-sized enterprise
SOE	state owned enterprise
SPAC	special purpose acquisition company
SPO	secondary public offering (follow-on offering)
SPV	special purpose vehicle
SURE	European support to mitigate unemployment risks in an emergency
SWF	sovereign wealth fund
T2S	TARGET2-Securities system
UCITS	undertakings for collective investments in transferable securities
VC	venture capital
WEF	World Economic Forum
WFE	World Federation of Exchange
WTO	World Trade Organization
ZSE	Zagreb Stock Exchange

SAŽETAK

Kriza uzrokovana bolešću COVID-19 predstavlja velike izazove za hrvatsko gospodarstvo, za čiji je trajan oporavak potreban otporniji i dinamičniji poslovni sektor. Treba naglasiti da bi hrvatske tvrtke znatno profitirale od boljeg pristupa dugoročnom financiranju putem tržišta kapitala za ulaganja u inovacije i rast. Stoga je za hrvatske vlasti vrijeme da uvedu dugo očekivane strukturne reforme kako bi se poboljšalo funkcioniranje tržišta kapitala. Unatoč dobrim gospodarskim rezultatima prije krize, slabo okruženje tržišta kapitala, ograničena dostupnost dugoročnog financiranja i slabe prakse korporativnog upravljanja ostaju među najvećim strukturnim slabostima u Republici Hrvatskoj i sprječavaju konkurentnost korporativnog sektora i korporativnih ulaganja. Kako bi se povećala otpornost i dinamičnost poslovnog sektora radi potpore brzom oporavku od krize uzrokovane bolešću COVID-19, sada se središnja uloga treba dati reformama tržišta kapitala. Ova revizija sadrži analizu i preporuke koje će hrvatskim vlastima pomoći da postignu taj cilj.

Republika Hrvatska je od 2009. do 2014. bila u recesiji uslijed globalne financijske krize i krize državnog duga u Europi. Uz pomoć velikih prihoda od turizma i privatne potrošnje kao rezultata nižih poreza te zahvaljujući pozitivnim učincima ulaska u EU trgovinu, ekonomija se 2015. počela oporavljati od kriza. Tijekom sljedećih četiriju godina, do 2019., prosječna je stvarna godišnja stopa ekonomskog rasta iznosila oko 3 %. Tržište rada također se dobro oporavilo od kriznog razdoblja, pri čemu se stopa nezaposlenosti s maksimalnih 17,3 % u 2014. godini smanjila na 6,6 % u 2019. To je bila najniža stopa nezaposlenosti u posljednja dva desetljeća.

Unatoč tim poboljšanjima, značajno približavanje razine hrvatskih dohodaka onoj naprednijih europskih država koje se moglo primijetiti tijekom prve polovice 2000-ih nije se nastavilo tijekom narednog desetljeća. Država je između 2008. i 2018. imala najmanje povećanje BDP-a po glavi stanovnika od svih sličnih država članica i u odnosu na prosjek EU-a. Republika Hrvatska je u krizu uzrokovanu bolešću COVID-19 također ušla s nizom strukturnih slabosti, uključujući potrebu za diverzifikacijom svojeg poslovnog sektora izvan turizma, za obnovom kapitala gospodarstva te za uklanjanjem nedostataka u fizičkoj infrastrukturi. Već prije krize uzrokovane bolešću COVID-19 razina korporativnih ulaganja u istraživanje, inovacije i nove tehnologije bila je niska i hrvatske tvrtke nisu bile uspješno integrirane u globalne lance vrijednosti.

Danas, reforme koje povećavaju učinkovitost tržišta kapitala mogu Republici Hrvatskoj pomoći da prebrodi neke od tih strukturnih nedostataka tako što će tvrtkama pružiti dugoročni kapital, a ulagačima raznolike prilike za ulaganja. Republika Hrvatska je na kraju 2020. na burzi imala manje od pola tvrtki koje su kotirale 2009. Od 92 tvrtke na burzi, u 2020., samo je šest kotiralo na glavnom tržištu s najvišim standardima korporativnog upravljanja i objavljivanja informacija. Gotovo su sve tvrtke na burzi koje su u državnom vlasništvu bile u nižim segmentima burze. Rezultat toga je tržište obilježeno ozbiljnim problemima likvidnosti na kojemu prevladava trgovanje nekolicinom pojedinačnih dionica. U 2019. koeficijent obrtaja dionica na Zagrebačkoj burzi iznosio je samo 0,015, dok je na Varšavskoj burzi iznosio 0,19, na Praškoj burzi 0,09, a prosjek na burzama u Europskoj uniji iznosio je 0,58. Osobito je znakovito da, u rujnu 2020., 9 dionica koje kotiraju na tržištu tijekom prethodne godine uopće nisu bile predmet trgovanja.

Nakon globalne financijske krize iz 2008. godine tržišta korporativnih obveznica globalno su postala važan izvor financiranja dugova za nefinancijske tvrtke, kao alternativa bankovnim kreditima. Republika Hrvatska nije zahvaćena tim trendom jer je zadnjih godina samo nekoliko velikih tvrtki izdalo korporativne obveznice. Druga je važna značajka hrvatskog tržišta korporativnih obveznica ta da znatan dio korporativnih obveznica ne kotira na domaćoj burzi. Umjesto toga kotiraju na drugim europskim burzama, posebno na luksemburškoj i irskoj.

Ključne preporuke

Preporuke iz ove revizije imaju za cilj pomoći hrvatskim vlastima poboljšati pravni, zakonodavni i institucijski okvir za tržišta kapitala. Dok neke preporuke podrazumijevaju djelovanje Vlade, Hrvatske agencije za nadzor financijskih usluga i drugih javnih tijela, i akteri privatnog sektora, osobito burza, mogu igrati važnu ulogu u okviru djelotvorne primjene preporuka. **Stoga je nužno da Vlada jasno dodijeli ovlasti i funkcije javnim tijelima te da koordinira sudjelovanje drugih dionika u postupku**. Učinkovito tržište kapitala nije samo sebi svrha, nego predstavlja sredstvo za postizanje otpornog i dinamičnog poslovnog okruženja u kojem se i kućanstvima pružaju bolje prilike za alokaciju i diversifikaciju dugoročne štednje.

- **Poboljšavanje uvjeta za kotiranje na burzi:** kao i u drugim državama, financijska je snaga mnogih hrvatskih tvrtki narušena usporavanjem gospodarskih aktivnosti uslijed krize uzrokovane bolešću COVID-19. Već je prije krize velik dio hrvatskih tvrtki imao premalo kapitala, a upotreba financiranja putem tržišta kapitala bila je vrlo ograničena. Kako bi se postigao uspješan i trajan oporavak, posebno je važno hrvatskom korporativnom sektoru osigurati pristup dugoročnom financiranju putem tržišta kapitala, uključujući dionički kapital. Tržišta dionica mogu hrvatskim poduzetnicima pomoći u smanjivanju ovisnosti o kratkoročnom financiranju i usklađivanju dugoročnih ulaganja s dugoročnim kapitalom. Razvijenije tržište dionica također će kućanstvima pružiti bolje prilike za ulaganja radi uspješnijeg upravljanja štednjom i planiranja za mirovinu.

  Republika Hrvatska je znatno napredovala u pogledu postavljanja temelja za moderno tržište dionica. Međutim, tržište je trenutačno obilježeno smanjenjem broja tvrtki koje kotiraju na burzi, ograničenim sudjelovanjem i malih i institucionalnih ulagača te niskom likvidnošću. Važan početni korak modernizacije okvira tržišta dionica može biti pojednostavnjenje tržišne strukture burze smanjenjem broja reguliranih tržišnih segmenata. Hrvatska agencija za nadzor financijskih usluga (HANFA) i burza mogu razmotriti spajanje redovitog i javnog tržišta pod novi okvir uz istodobno poticanje dodatnih tvrtki na prelazak na primarno tržište. Da bi uistinu postalo privlačno tržište, primarno tržište mora dostići određeni opseg i promovirati dobre prakse korporativnog upravljanja tvrtki koje kotiraju na tom tržištu. Budući da bi za novo-pristigle tvrtke prednosti kotiranja na primarnom tržištu bile ograničene dok ono ne dostigne potrebni opseg, Vlada može razmotriti pružanje financijskih poticaja tvrtkama koje prelaze na to tržište ili počinju kotirati putem IPO-a. Podrška se može pružati u obliku dotacija kako bi se pokrio odgovarajući dio troškova kotiranja i ponavljajućih troškova. Tvrtke koje nemaju potrebni udio slobodnih dionica za trgovanje da bi prešle na primarno tržište također mogu profitirati od takvih financijskih poticaja prilikom provođenja sekundarnih emisija javnih dionica. Poput nekih uspješnih primjera iz drugih europskih država, kao što su Španjolska i Mađarska, Vlada zajedno s vanjskim pružateljem usluga također može pomoći burzi provođenjem kvantitativnog istraživanja tvrtki uvrštenih na burzu, koje bi bilo dostupno tržištu.

Istodobna poboljšanja okvira korporativnog upravljanja mogu povećati povjerenje ulagača. Jedan korak može biti provođenje određenih odredbi novouvedenog Kodeksa korporativnog upravljanja (*Corporate Governance Code*) kao obveznog za tvrtke koje kotiraju na primarnom tržištu. Osim toga, ključna uloga u odobravanju određenih transakcija povezanih strana treba se dodijeliti neovisnim članovima odbora radi zaštite interesa manjinskih dioničara. Drugi korak k povećanju prava dioničara mogu biti priznavanje sudjelovanja na daljinu na godišnjim sastancima dioničara i dopuštanje glasanja elektroničkim putem, što bi trebalo unijeti u Zakon o trgovačkim društvima.

Radi povećanja likvidnosti na tržištu i pružanja boljih prilika za štednje kućanstvima, Vlada treba razmotriti uvođenje sustava štednog računa za male ulagače koji obuhvaća oslobođenja od poreza na kapitalnu dobit kada se novac čuva na minimalno razdoblje. Ako se porezna prednost ne veže za razdoblje čuvanja pojedinačnih dionica i ulagačima dopusti aktivno upravljanje njihovim portfeljem na štednom računu, taj sustav može pomoći osigurati tržištu prijeko potrebnu likvidnost. Pored toga, pojednostavnjenjem obveznih obrazaca i izračuna poreza na kapitalnu dobit može se povećati sudjelovanje kućanstava na burzi.

Za potpunu integraciju Republike Hrvatske u globalna tržišta vrijednosnica potrebna je modernizacija određenih aspekata tržišne infrastrukture. Posebno su SKDD-u potrebna znatna ulaganja u tehničke kapacitete za unaprjeđenje poslovanja, povezanosti, učinkovitosti i sigurnosti. Dodatna integracija tržišne infrastrukture može olakšati taj proces. Pored financiranja iz privatnog sektora, treba razmotriti pribavljanje sredstava putem Mehanizma za oporavak i otpornost EU-a, koji za cilj ima omogućavanje digitalne tranzicije. To je također u skladu s hrvatskim Nacionalnim planom razvoja, koji je posebno okrenut digitalnoj tranziciji.

- **Kotiranje tvrtki u državnom vlasništvu – širenje opsega tržišta i poboljšavanje upravljanja:** Vlada Republike Hrvatske odredila je da su među glavnim prioritetima nastavak procesa privatizacije tvrtki u državnom vlasništvu i poboljšavanje njihovog upravljanja i učinkovitosti. Poput uspješnih primjera iz mnogih država, Republike Hrvatska putem tržišta kapitala može i smanjiti državni udio u vlasništvu i poboljšati upravljanje tvrtkama. Time bi se također proširio opseg domaćeg tržišta kapitala te povećala njegova atraktivnost i za privatne tvrtke i za ulagače. Važan je korak k ispunjenju tih ciljeva prijenos uvrštenih tvrtki u državnom vlasništvu s nižih segmenata burze na primarno tržište. Pored triju tvrtki koje već ispunjavaju uvjete veličine i udjela slobodnih dionica za trgovanje za uvrštenje na primarno tržište, Vlada može razmotriti provođenje sekundarnih javnih emisija dionica drugih tvrtki u državnom vlasništvu s nižim postotkom slobodnih dionica za trgovanje kako bi povećala njihov udio dionica dostupnih za trgovanje. Među tvrtkama u državnom vlasništvu koje nisu uvrštene na burzu ima puno velikih tvrtki koje bi se mogu razmotriti za uvrštavanje na primarno tržište putem IPO-a. Tvrtke u državnom vlasništvu koje kotiraju na primarnom tržištu i one koje se pripremaju za kotiranje trebaju zadovoljiti hrvatski Kodeks korporativnog upravljanja kao obvezan standard. Tvrtke u državnom vlasništvu koje ne ispunjavaju kriterije veličine za kotiranje na primarnom tržištu mogu se konsolidirati ili razmotriti za kotiranje na nižem segmentu ili alternativnom tržištu.

- **Iskorištavanje potencijala institucionalnih ulagača u Republici Hrvatskoj:** danas su mirovinski fondovi, osiguravajuća društva i investicijski fondovi najvažniji ulagači u globalna tržišta kapitala. Kao financijski posrednici, igraju važnu ulogu u usmjeravanju štednje kućanstava u realno gospodarstvo i pružaju ulagačima prilike za ulaganje u portfelje s diversifikacijom rizika uz niže troškove. Međutim, njihov je razvoj u Republici Hrvatskoj bio relativno sporiji u usporedbi sa sličnim državama. Osobito je znakovito da sredstva kojima upravljaju investicijski fondovi, koji su globalno najvažnija kategorija institucionalnih ulagača, čine samo 5 % hrvatskog BDP-a. Iako su se sredstva mirovinskih fondova znatno povećala od uvođenja sustava obveznog privatnog mirovinskog osiguranja, njihova ukupna imovina pod upravljanjem još uvijek čini samo polovinu prosjeka OECD-a dok je alokacija te imovine u dionice relativno niska.

U Republici Hrvatskoj je jedna od glavnih prepreka iskorištavanju potencijala institucionalnih ulagača niska ukupna razina aktivnosti na tržištima kapitala. Osobito, zbog ograničene upotrebe financiranja putem tržišta kapitala od strane hrvatskih tvrtki, institucionalni ulagači imaju slabe prilike za ulaganje. Visoko koncentrirana ulaganja mirovinskih fondova u mali broj uvrštenih tvrtki ne doprinose povećanju likvidnosti tržišta. Povećanjem broja uvrštenih tvrtki na burzi, posebno na primarnom tržištu, i promoviranjem emisija korporativnih obveznica na domaćem tržištu pomoglo bi se institucionalnim ulagačima u pružanju javnosti atraktivnijih proizvoda s boljim povratima i zaštitom mirovinskog dohotka.

Što se tiče mirovinskih fondova, vlasti mogu razmotriti procjenu strukture poticaja za društva za upravljanje mirovinskim fondovima kako bi bolje uskladile svoje poticaje s poticajima članova fondova. Trenutačna struktura poticaja dovodi do konzervativne alokacije sredstava jer su upravitelji mirovinskih fondova odgovorni za dio mogućih gubitaka od ulaganja. S obzirom na nisku kamatnu stopu u okruženju i povećavanje sredstava hrvatskih mirovinskih fondova, veća alokacija sredstava u ulaganja u dionice također može pomoći u ostvarenju većih dugoročnih povrata. Dakako, nedavne inicijative podizanja granica ulaganja u dionice za kategorije sredstava A i B te određivanja prve kategorije kao zadane za nova povezana društva doprinose ostvarenju tog cilja. Dodatna važna inicijativa može biti pružanje veće jasnoće u pogledu vrijednosnih papira dostupnih za ulaganje i smjernica za određivanje cijena. Umjesto trenutačnog sustava, u kojem za nelikvidne instrumente svaki fond odlučuje o svojem modelu procjene sredstava, regulator treba procijeniti je li prikladniji alternativni sustav u kojem sva društva za upravljanje fondovima svoje portfelje vrednuju istim cijenama. U pogledu investicijskih fondova, Republika Hrvatska se nije pokazala kao konkurentno sjedište upravljačkih društava, investicijskih fondova i stranih ulagača. Niži porez po odbitku bi mogao ubrzati rast industrije i pomoći joj da dostigne kritičnu razinu.

- **Financiranje dugoročnih dugova putem tržišta:** tržišta korporativnih obveznica imaju potencijal da postanu pouzdan izvor financiranja za hrvatske tvrtke, a korporativne obveznice privlačna klasa sredstava za domaće i strane ulagače. Takav prelazak s prekomjernog oslanjanja na kratkoročno financiranje putem banaka na dugoročnije korporativne obveznice proširio bi prilike ulaganja za institucije, osigurao potporu dugoročnim korporativnim ulaganjima i doveo do izgradnje otpornije strukture kapitala u korporativnom sektoru. Smanjenje tekućih troškova emisije obveznica na domaćem tržištu može biti važan početni korak k povećanju privlačnosti tržišta korporativnih obveznica za hrvatske tvrtke. Nedostatak aktivnosti na hrvatskom tržištu korporativnih obveznica osobito je ometao razvoj domaćih posrednika, što je također povećalo troškove posredovanja. Vlasti mogu procijeniti mogućnost pružanja financijske pomoći putem modela Vladine potpore za troškove nastale u tvrtki prilikom uvođenja obveznice na tržište i dobivanja ocjene kreditne sposobnosti. Nadalje, u cilju podrške razvoju i povećanju likvidnosti hrvatskog tržišta, Vlada može razmotriti provođenje emisija obveznica tvrtki u državnom vlasništvu na domaće tržište. Time bi se domaćim posredničkim institucijama pomoglo u dostizanju kritične veličine, a istodobno bi se pružile dodatne prilike za ulaganja institucionalnih ulagačima, poglavito mirovinskim fondovima.

S obzirom na nedostatak domaćih agencija za kreditni rejting, vlasti mogu također razmotriti alternativni mehanizam ocjene kreditne sposobnosti u kojem institucija pruža usluge kreditnog rejtinga. To može provoditi Financijska agencija (FINA), koja ima uspostavljenu opću infrastrukturu jer već pruža opću uslugu kreditnog bodovanja te posjeduje bazu podataka koja obuhvaća 95 % svih vlasnika hrvatskih poduzeća. Dodatna točka za razmatranje može biti uvođenje posebnog okvira za manje emisije obveznica poduzeća. Poput uspješnih primjera iz nekih drugih europskih gospodarstava, kao što je okvir tržišta mini-obveznica u Italiji, to se može izvesti u obliku namjenskih tržišta za privatna ulaganja ili tržišta mini-obveznica. Postojanje namjenskog tržišta za manje obveznice poduzeća na burzi može dodatno povećati privlačnost tržišta za ulagače. Vlada može razmotriti da agencija HAMAG-BRICO vodi razvoj takvog okvira te surađuje s drugim javnim tijelima i dionicima u privatnom sektoru.

- **Mobilizacija tržišta privatnog kapitala:** tržišta privatnog kapitala predstavljaju važan alternativan izvor financiranja za tvrtke koje su u potrazi za kapitalom radi ostvarenja planova razvoja novih proizvoda i proširenja poslovanja. Financiranje putem tržišta privatnog kapitala posebno je kritično za manje tvrtke s velikim potencijalom rasta jer još nisu dostigle veličinu potrebnu za pristupanje javnim tržištima. Povrh toga, tvrtke s velikim udjelom nematerijalnih sredstava ili negativnim novčanim tokom u početnoj fazi ne mogu se osloniti na financiranje putem banaka, koje inače prevladava u okruženju korporativnih financija Republike Hrvatske. Stoga privatni kapital može igrati ključnu ulogu u potpori nastojanjima Republike Hrvatske u pogledu diversifikacije njenih ekonomskih aktivnosti izvan sektora turizma i povećanja investicija u istraživanje i razvoj, inovacije i ljudski kapital. Za potporu razvoju hrvatskih tržišta privatnog kapitala potrebno je uskladiti nastojanja javnih tijela, privatnog sektora i istraživačkih ustanova.

  Putem hrvatske Strategije pametne specijalizacije (S3), koju je Vlada usvojila, već su utvrđeni klasteri specijalizacije koji odgovaraju potencijalu inovacija zemlje i mogu pojačati integraciju u globalne lance vrijednosti. Prioritet treba dati prihvatljivim tvrtkama unutar odabranih S3 klastera koje pokazuju velik potencijal rasta, s ciljem povećanja njihove mogućnosti širenja. To može obuhvatiti financijsku podršku u obliku dotacija, programa upravljanja i potpore pripremama strategije rasta. Budući da većini hrvatskih tvrtki nedostaje opseg potreban da bi privukle međunarodna ulaganja rizičnog kapitala, postojeći fondovi povezani s državom mogu dodatno naglasiti značaj financiranja početnog kapitala, koji se upotrebljava za potporu osnivanju udruženja većih tvrtki.

  Hrvatske vlasti također mogu razmotriti uspostavu programa suradnje koji promovira širenje veza između istraživačkih ustanova i poslovnog sektora. Taj program može obuhvatiti mogućnost pružanja financiranja istraživačkim ustanovama u područjima povezanima s S3 ciljevima te uspostavu platformi na kojima razvojne tvrtke (*start-up*) mogu predstaviti svoje ideje kako bi privukle početni kapital za svoje financiranje. Radi dodatnog poticanja integracije između sveučilišta i zajedničkih ulaganja, platforma za rad razvojnih tvrtki može se integrirati u akademski nastavni plan

- **Jačanje bilanci stanja tvrtki i poboljšanje okvira insolventnosti:** primijećeni nedostatak dioničkog kapitala u hrvatskim tvrtkama smanjuje njihovu mogućnost širenja i održivog oporavka od krize uzrokovane bolešću COVID-19. Radi podrške tvrtkama novim dioničkim kapitalom, Vlada može razmotriti procjenu prednosti uvođenja posebnog poreznog režima poput odbitka za korporativni dionički kapital. Trenutačnu krizu treba promatrati i kao važnu priliku za ubrzavanje procesa primjene nove direktive EU-a o insolventnosti i restrukturiranju. Time bi se Republici Hrvatskoj pomoglo u privlačenju ulagača iz drugih europskih gospodarstava. Posebna se pozornost treba posvetiti uspostavljanju mehanizama koji olakšavaju postupak restrukturiranja kako bi se spriječila likvidacija. Također se mogu poboljšati uloga i funkcije stečajnog upravitelja, na primjer određivanjem jednog regulatornog tijela za stečajne upravitelje, koje će djelotvornije nadzirati njihov rad. To tijelo također može biti odgovorno za primjenu odgovarajućih sankcija, pružanje zasebnog žalbenog postupka u vezi sa stečajnim upraviteljima te uspostavu kodeksa ponašanja za njih. Može se razmotriti i organiziranje obuke, kao i mogućnost certificiranja za stečajne upravitelje.

EXECUTIVE SUMMARY

The COVID-19 crisis poses major challenges to the Croatian economy where a sustained recovery requires a more resilient and dynamic business sector. Importantly, Croatian companies would greatly benefit from better access to long-term market-based finance for investments in innovation and growth. The time is therefore ripe for Croatian authorities to enact long-awaited structural reforms to improve the functioning of capital markets. In spite of strong economic performance before the crisis, a weak capital market ecosystem, limited availability of long-term financing and poor corporate governance practices remain among Croatia's major structural weaknesses, restricting the corporate sector's competitiveness and investment. In order to achieve a more resilient and dynamic business sector that will underpin a strong recovery from the COVID-19 crisis, capital market reforms should now be given a central role. This Review contains analysis and recommendations that will help the Croatian authorities achieve this objective.

Croatia was in recession between 2009 and 2014 following the global financial crisis and the sovereign debt crisis in Europe. With the help of strong tourism revenues and private consumption, induced by lower taxation, together with the positive effects of the EU accession on trade, the economy started to recover from the crises in 2015. In the following four years up to 2019, real economic growth averaged around 3% annually. The labour market also recovered well from the crisis period with the unemployment rate decreasing from its peak of 17.3% in 2014 to 6.6% in 2019. This was the lowest level of unemployment for two decades.

Despite these improvements, the strong convergence in income levels with more advanced European countries witnessed in Croatia during the first half of the 2000s did not continue over the subsequent decade. Between 2008 and 2018, the country experienced the lowest improvement in per capita GDP level compared to its peer countries and to the EU average. Croatia also entered the COVID-19 crisis with a number of structural weaknesses, including a need to diversify its business sector beyond tourism, to renew the economy's capital stock and to close the gap in physical infrastructure. Already before the COVID-19 crisis, the level of corporate investment in research, innovation and new technologies was low and Croatian corporations were not sufficiently integrated into global value chains.

Today, reforms that improve the efficiency of capital markets can help Croatia to overcome some of these structural shortcomings by providing companies with long-term capital and investors with diverse investment opportunities. At the end of 2020, Croatia had less than half of the number of listed companies that it had in 2009. Among the 92 listed companies in 2020, only six were listed on the main market with the highest corporate governance and disclosure standards. Almost all of the listed state-owned companies were in the lower segments of the stock market. The result is a market characterised by severe liquidity problems and dominated by trades in a few individual stocks. In 2019, the turnover ratio of stocks on the Zagreb Stock Exchange was only 1.5%, compared with 19% for the Warsaw Stock Exchange, 9% for the Prague Stock Exchange and an average of 58% for stock exchanges in the European Union. Notably, as of September 2020, 9 stocks listed in the market had not been traded at all over the past year.

After the 2008 global financial crisis, corporate bond markets have become an important alternative source of debt financing to bank lending for non-financial companies globally.

Croatia has not been part of this trend as only a couple of large companies issued corporate bonds in recent years. Another important feature of the Croatian corporate bond market is that a substantial portion of corporate bonds is not listed domestically. Instead, they are listed on other European exchanges, in particular on the Luxembourg and Irish stock exchanges.

Key recommendations

The recommendations in this Review are intended to help Croatian authorities improve the legal, regulatory and institutional frameworks for capital markets. While some recommendations require action by the government, the Croatian Financial Services Supervisory Agency and other public authorities; private sector actors, in particular the stock exchange, may also play an important role in their effective implementation. **It is therefore imperative that the government clearly assigns responsibilities and functions across public authorities, and coordinates the participation of other stakeholders in the process**. An efficient capital market is not an end in itself, but a means for achieving a resilient and dynamic business environment where households are also given better opportunities to allocate and diversify their long-term savings.

- **Improving conditions for stock market listing:** As in other countries, the financial strength of many Croatian companies has been hurt by the economic slowdown caused by the COVID-19 crisis. Already before the crisis, a large portion of Croatian companies were undercapitalised and the use of capital market financing was rather limited. In order to achieve a successful and sustainable recovery, it is of particular importance to ensure that the Croatian corporate sector has access to long term market-based finance, including equity capital. Equity markets can help Croatian entrepreneurs reduce their reliance on short-term financing and match long-term investments with long-term patient capital. A more developed equity market will also provide households with better investment opportunities to manage their savings and plan for retirement.

  Croatia has made important progress in putting in place the building blocks for a modern equity market. However, the market is currently characterised by a loss of listed companies, limited participation of both retail and institutional investors and low liquidity. An important initial step to modernise the equity market framework could be to simplify the market structure of the stock exchange by reducing the number of regulated market segments. The Croatian Financial Services Supervisory Agency (HANFA) and the stock exchange may consider merging the Regular and Official markets under a new framework while at the same time encouraging more companies to move to the Prime Market. To become a truly attractive market, the Prime Market needs to reach a certain scale and promote good corporate governance practices by its listed companies. Since the benefits of being listed on the Prime Market would be limited for newcomers until the market reaches the necessary scale, the government may consider providing financial incentives to companies that move to this market or list here through an IPO. This support could be provided in the form of grants to cover a certain portion of the listing and recurring costs. Companies that do not have the required free-float level to be transferred to the Prime Market could also benefit from such financial incentives when conducting secondary public equity offerings. Following some successful examples in other European countries, such as Spain and Hungary, the government could also support the stock exchange, together with an external provider, in providing quantitative research of listed companies that is made available to the market.

At the same time, improvements in the corporate governance framework can help improve investor confidence. One step could be to make certain provisions of the newly introduced Corporate Governance Code mandatory for companies listed on the Prime Market. Additionally, in the approval of certain related party transactions, a key role should be assigned to independent board members with a view to protecting minority shareholders' interests. Another step towards enhancing shareholder rights could be to recognise remote participation in annual shareholders' meetings and allow voting by way of electronic communications in the Croatian Companies Act.

To improve liquidity in the market and to provide households with better saving opportunities, the government should consider introducing a savings account system for retail investors that includes exemptions from capital gains tax when the money is held for a minimum period of time. By not linking the tax advantage to the holding period of individual stocks and allowing investors to actively manage their portfolio in the savings account, the system could be instrumental in providing the market with much-needed liquidity. In addition, efforts to simplify the required forms and calculation of capital gains taxes could increase household participation in the stock market.

The full integration of Croatia into global securities markets requires that certain aspects of the market infrastructure to be modernised. Specifically, the CDCC needs significant investments in technical capacity to enhance operations, connectivity, efficiency and security. Further integration of the market infrastructure may facilitate the process. In addition to private sector financing, funds from the EU's Recovery and Resilience Facility, which focuses on enabling a digital transition, should be considered. This is also in line with Croatia's own National Development Plan, which specifically focuses on the digital transition.

- **Listing of SOEs - Scaling up the market and improving governance:** The Croatian government has defined continuing the privatisation process of state-owned companies and improving their management and efficiency as a key priority. Following successful examples in many countries, Croatia could use capital markets both to reduce the government's holdings and to improve the governance of the companies. This would also help scale up the domestic capital market and make it attractive for both private companies and investors. An important step towards these goals would be transferring listed SOEs from lower segments of the stock exchange to the Prime Market. In addition to the three companies that already meet the size and free-float requirements to be listed on the Prime Market, the government may consider conducting secondary public offerings of other SOEs with lower free-float ratios to increase the portion of their shares available for trade. Within the portfolio of unlisted SOEs, there are many large companies that could be considered for listing on the Prime Market through an IPO. SOEs listed on the Prime Market and the ones preparing for listing should comply with the Croatian Corporate Governance Code as a mandatory standard. SOEs that do not meet the size criteria for a Prime Market listing could either be consolidated or considered for listing on the lower segment or the alternative market.

- **Unleashing the potential of institutional investors in Croatia:** Today, pension funds, insurance companies and investment funds are the most important investors in capital markets globally. As financial intermediaries, they play an important role in channelling household savings to the real economy and provide investors with opportunities to invest in risk-diversified portfolios at lower costs. Their development, however, has been relatively slower in Croatia compared to peer countries. Notably, the assets managed by investment funds, which is the most important category of institutional investors globally, account for only 5% of GDP in Croatia. While pension fund assets have grown significantly since the introduction of the mandatory private pension system, their total assets under management are still only half of the OECD average and their allocation to equity is relatively low.

A key challenge in Croatia for unleashing the potential of institutional investors is the low overall activity level in the capital markets. In particular, the limited use of capital market financing by Croatian companies leaves institutional investors with scant investment opportunities. The highly concentrated investment by pension funds in a small number of listed companies does not contribute to the efforts to improve the liquidity conditions in the market. Increasing the number of listed companies on the stock market, in particular on the Prime Market, and promoting corporate bond issuance in the domestic market would help institutional investors to provide the public with more appealing products that give better returns and protect retirement income.

With respect to the pension funds, the authorities may consider assessing the incentive structure for pension fund management companies in order to better align their incentives with those of the fund members. The current design results in a conservative asset allocation as pension fund managers are responsible for a portion of the potential losses from investments. Given the low interest rate environment and the growing size of Croatian pension funds' assets, a greater allocation to equity investments can also help achieve better long-term returns. Indeed, the recent initiatives to raise the equity investment limits for funds Categories A and B, and to make Category A the default one for new affiliates go in that direction. An additional important initiative could be to provide greater clarity related to the investable universe of securities and the pricing guidelines. Instead of the current system where each fund decides their asset valuation model for illiquid instruments, the regulator should assess whether an alternative system where all pension fund management companies use the same prices for valuing their portfolios might be preferable. In the case of investments funds, Croatia has not placed itself as a competitive residence for management companies, investment funds and foreign investors. A lower withholding tax may support the growth of the industry and help to reach a critical scale.

- **Long-term debt financing through markets:** Corporate bond markets have the potential to become a viable source of financing for Croatian companies and an attractive asset class for domestic and foreign investors. Such a move from over-reliance on short-term bank financing towards longer maturity corporate bonds would broaden investment opportunities for institutions, support long-term corporate investment and build a more resilient capital structure in the corporate sector. Decreasing the current costs of issuing a bond in the domestic market could be an important initial step to raise the attractiveness of the corporate bond market for Croatian companies. In particular, the lack of activity in the Croatian corporate bond market has hindered the development of domestic intermediaries, which has also resulted in higher intermediation costs. The authorities may evaluate the possibility of providing financial assistance through government support schemes for the costs incurred by a company when listing a bond and obtaining a credit rating. Further, in order to support the development of and liquidity in the Croatian market, the government may consider conducting bond issuances of state-owned companies in the domestic market. This would help domestic intermediary institutions obtain a critical size while also providing additional investment opportunities for institutional investors, in particular pension funds.

Given the lack of domestic rating agencies, the authorities may also consider an alternative credit rating mechanism where an institution provides rating services. This could be done by the state-owned Financial Agency (FINA), which has the general infrastructure in place since it already provides a general type of credit scoring service and has a database covering 95% of all Croatian business owners. Another consideration could be to introduce a special framework for smaller company bond issuances. Following successful examples in some other European economies, such as the mini-bond market framework in Italy, this could be in the form of specialised private placement markets or mini-bond markets. Having a dedicated market for smaller company bonds in the stock exchange could further help increase the attractiveness of the market for investors. The government may consider tasking HAMAG-BRICO with leading the development of such a framework, working with other public authorities and private sector actors.

- **Mobilising private capital markets:** Private capital markets represent an important alternative source of financing for companies seeking capital to realise new product development and expansion plans. In particular, private market financing is critical for smaller companies with high growth potential as they have not yet reached the size needed to access public markets. Moreover, firms with a large share of intangible assets or negative cash flows in the start-up phase cannot rely on bank financing, which otherwise dominates the corporate finance landscape in Croatia. Private capital can therefore play a critical role in supporting Croatia's efforts to diversify its economic activity beyond the tourism sector, and to increase investments in R&D, innovation and human capital. To support the development of Croatian private capital markets, coordinated efforts from the public authorities, the private sector and research institutions are needed.

  The Croatian Smart Specialisation Strategy (S3) adopted by the government has already identified clusters of specialisation that fit the country's innovation potential and can boost integration into global value chains. Priority should be given to eligible companies within the selected S3 clusters that show high growth potential with a view to improving their capacity for expansion. This could include financial support in the form of grants, management programmes and supporting the preparations of a growth strategy. Since most companies in Croatia lack the necessary scale to attract international venture capital investments, the existing government related funds may further emphasise seed capital financing that is used to support the creation of a pool of larger companies.

  The Croatian authorities may also consider creating a co-operation programme encouraging more links between research institutions and the business sector. The programme could include the possibility of providing funding to research institutions in areas related to any of the S3 objectives, and the creation of platforms where start-ups can present their ideas in order to attract the seed money to fund them. To further encourage the integration between universities and venture companies, start-up work experience could be integrated in the academic curriculum.

- **Strengthening corporate balance sheets and improving the insolvency framework:** The observed equity gap in Croatian companies hampers their ability to expand and to recover sustainably from the COVID-19 crisis. To support new equity capital injections into the companies, the government may consider evaluating the benefits of introducing a special tax regime such as the allowance for corporate equity

(ACE). The current crisis should also be seen as an important opportunity to speed up the process of implementing the new EU Directive on insolvency and restructuring. This would help Croatia attract investors from other European economies. Special attention could be given to providing mechanisms that facilitate the restructuring procedure to avoid liquidation. The role and functions of the insolvency office holder (IOH) could also be improved, for example by assigning a single regulatory body for IOHs that oversees their functioning more effectively. This body could also be responsible for applying proper sanctions, offering a separate complaint procedure and establishing a code of conduct for IOHs. Offering training and certification opportunities to IOHs may also be considered.

KEY CAPITAL MARKET INDICATORS: CROATIA

Overview of Economy	2011	2012	2013	2014	2015	2016	2017	2018	2019
GDP growth (%)	-0.3	-2.2	-0.5	-0.1	2.4	3.5	3.1	2.7	2.9
Unemployment rate (%)	13.7	15.9	17.3	17.3	16.2	13.1	11.2	8.4	6.6
Labour productivity growth (%)	3.8	2.3	2.9	-1.8	4.7	2.8	1.5	1.6	0.3
Gross public debt to GDP (%)	64	70	81	85	84	81	78	75	73
Non-performing loans to total lending (%)	12.3	13.8	15.4	13.6	13.0	10.7	8.8	7.3	5.2

Note: Data on non-performing loans are from Eurostat from 2014 onwards. Prior years (2011-2013) use IMF Financial Soundness data due to limited Eurostat coverage.
Source: OECD Economic Outlook 107 database 2020/1, Eurostat, IMF Financial Soundness Indicators, OECD Productivity Statistics, ECB, HNB Main Macroeconomic Indicators.

	Pension funds	Insurance companies	Investment funds	Banks
Total assets, as end of 2020 (billion EUR)	17	6	2	62

Source: HANFA, Croatian National Bank.

Non-Financial Corporate Sector	2011	2012	2013	2014	2015	2016	2017
Number of companies[1]	13 712	13 843	13 453	13 667	14 302	14 738	15 293
Return on equity (%)	3	2	2	2	4	5	1
Annual sales growth (%)	2	-3	-2	-2	5	4	6
Leverage (%) [2]	27	26	26	25	24	24	24
Share of loss making firms (%) [3]	30	32	28	26	24	20	21

Source: OECD-ORBIS Corporate Finance dataset.

Public Equity Market	# of listed companies	Market capitalisation (million EUR) (as of December 2020)
Listed companies (excl. investment funds and REITS)	**92**	**17 769**
Regular Market	66	8 493
Official Market	20	5 480
Prime Market	6	3 796

Note: Investments funds and REITs are excluded. Companies with more than one share class are only counted once.
Source: Zagreb Stock Exchange, Thomson Reuters Eikon, see Annex for details.

Public Equity Market									**(proceeds in 2019 EUR million)**
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Non-financial companies									
Number of IPOs	-	-	-	-	2	-	-	-	-
Total proceeds of IPOs	-	-	-	-	17	-	-	-	-
Number of SPOs	9	1	-	2	2	-	4	1	-
Total proceeds of SPOs	96	1	-	33	61	-	127	7	-
Financial companies									
Number of SPOs	1	-	1	2	-	-	-	-	-
Total proceeds of SPOs	2 166	-	4	31	-	-	-	-	-
Listings and delistings in the stock market									
New listings, including IPOs	0	0	0	1	2	3	1	2	2
Delistings	10	20	18	13	9	6	11	7	13
Number of listed companies	181	161	143	131	124	121	111	106	95

Note: Investment funds and REITs are excluded. Companies transferring from one segment to another are not considered as new listings. Companies delisting from the market and listing afterwards again are counted as one delisting and one new listing. Companies with more than one share class are only counted once.
Source: OECD Capital Market Series dataset, Zagreb Stock Exchange (information retrieved as of 15th March 2021), Thomson Reuters Eikon, see Annex for details.

Corporate Bond Market									**(proceeds in 2019 EUR million)**
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Non-financial companies									
Number of issues	4	6	-	4	2	1	-	-	4
Amounts issued	390	1 685	-	82	552	30	-	-	1 238
Financial companies									
Number of issues	2	1	1	-	1	1	1	1	1
Amounts issued	98	45	196	-	62	7	55	43	40

Source: OECD Capital Market Series dataset, Refinitiv, Bloomberg, FactSet.

Private Equity Market									**(amounts in 2019 EUR million)**
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Amounts raised	294	-	-	62	-	-	-	-	-
Amounts invested	22	55	22	44	13	43	3	83	94
Amounts of divestment	4	-	-	-	14	21	-	2	23

Source: Invest Europe / EDC.

EU benchmarking									
Croatia's share in EU…	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP (‰)	4.1‰	4.0‰	3.9‰	3.8‰	3.7‰	3.7‰	3.7‰	3.8‰	3.8‰
IPO proceeds (‰)	-	-	-	-	0.4‰	-	-	-	-
SPO proceeds (‰)	26.0‰	0.01‰	0.05‰	0.6‰	0.6‰	-	1.1‰	0.1‰	-
Stock market capitalisation (‰)	3.6‰	3.1‰	2.4‰	2.4‰	2.3‰	2.7‰	2.3‰	2.6‰	2.5‰
Corporate bond issuance (‰)	0.4‰	1.4‰	0.2‰	0.1‰	0.6‰	0.03‰	0.05‰	0.04‰	1.1‰
Private equity (‰)									
Fundraising (‰)	6.7‰	-	-	1.0‰	-	-	-	-	-
Investment (‰)	0.4‰	1.3‰	0.5‰	0.9‰	0.2‰	0.7‰	0.03‰	1.0‰	1.0‰

Source: Eurostat, OECD Capital Market Series dataset, ECB, Invest Europe / EDC

[1] See Annex for details.
[2] Total financial debt over total assets.
[3] The percentage of Croatian firms with negative net income in the total number of firms.

PART I

ASSESSMENT AND RECOMMENDATIONS

1. Improving conditions for stock market listing

The Zagreb Stock Exchange (ZSE) was created as a member-owned organisation in 1991. In 2016, in line with most other stock exchanges around the world, it became a for-profit corporation, listing its shares on its own Official Market. According to the ownership records as of July 2020, financial companies including banks and insurance companies hold 46.8% of the stock exchange's capital, followed by investment funds with 13.5%, pension funds 10%, the US corporation Baktun LLC 7.9%, the European Bank for Reconstruction and Development (EBRD) 5.2%. The rest is in the hands of individuals (Zagreb Stock Exchange, 2020).

The perceived benefits for stock exchanges of being for-profit corporations include better organisational performance and improved market infrastructure. The corporate structure is also considered to provide better governance with improved financial and operational transparency and accountability. In parallel to the international shift towards incorporated stock exchanges, there have been a large number of mergers and acquisitions where stock exchanges also linked their businesses with electronic trading platforms, financial information providers, financial index providers and asset management companies (OECD, 2016).

Activity on the regulated market

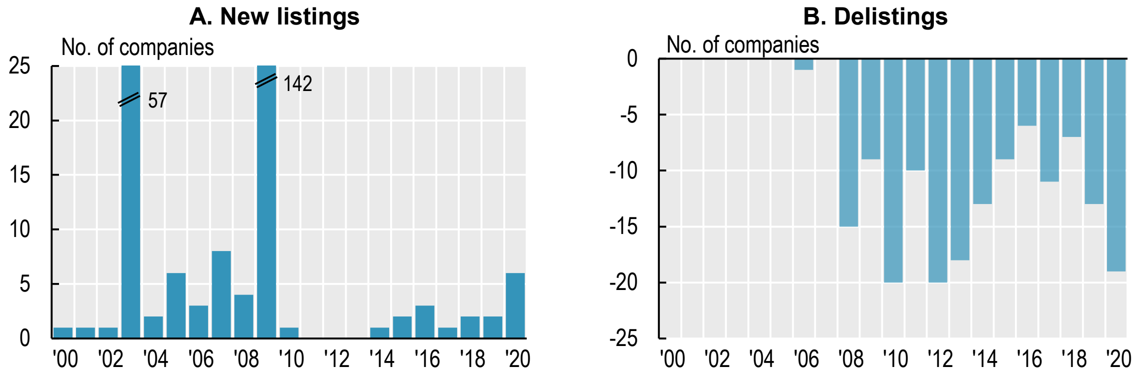
The Zagreb Stock Exchange has launched several initiatives since its demutualisation, such as the migration of its business to the new Xetra trading system, the integration into the SEElink platform, the improvements in the ZSE Trading Monitor application, the creation of Funderbeam South-East Europe, providing free research for issuers through the SME Research Hub sponsored by EBRD and the introduction of new stock indices. In spite of ambitious efforts, the stock market has not yet reached the scale required to serve as an efficient platform for fundraising for Croatian companies and investments in long-term securities for savers. The small number of both traded companies and participating investors also reduces the attractiveness of the market for potential newcomers (Grubišić Šeba, 2017). Indeed, the number of listed companies has been decreasing over time with net listings being negative every year since 2010 (Figure 1). In addition, the ownership concentration in listed companies remains high, indicating that the free-float of shares available for trading is limited. In Croatia, the average ownership of the single largest shareholder in a listed company is 49% of the company's capital. On average, the 3 largest shareholders hold 70% of the capital in listed companies (see Chapter II, section 2.6).

The direct costs when conducting an IPO include the underwriting, listing, legal and advisory fees. Some of these costs vary depending on the size of the company, whereas others have a fixed component, which becomes proportionally larger for smaller companies. In general, arrangement and underwriting fees are the largest direct cost, accounting for 60% of the total IPO costs (OECD, 2017a). Companies also incur additional costs after listing, such as new staff expenses for investor relations officers, costs related to the implementation of new financial reporting standards, auditor fees, compliance costs and market maker costs. These recurring costs after listing can be burdensome for listed companies, especially in Croatia where the median market capitalisation is only EUR 28 million. For example, the European Single Electronic Format (the implementation of which was delayed until January 2021) [1]

[1] EU Official Journal on 16 February 2021.

requires all listed companies to produce their annual reports according to a generic format, which has raised concerns among some Croatian companies with respect to the high implementation costs.[2] In order to encourage companies to list their shares or remain on the public equity market, several countries, such as Italy and Hungary, provide direct or indirect financing to corporations to cover part of the listing and recurring costs.

Figure 1. Number of new listings and delistings on the Zagreb Stock Exchange



Note: Excluding investment funds and REITs. Companies transferring from one segment to another are not considered as a new listing. Companies delisting from the market and listing again at a later stage are counted as one delisting and one new listing.
Source: Zagreb Stock Exchange, information retrieved on 15th March 2021.

The Zagreb Stock Exchange currently consists of three regulated market segments with different listing requirements. The Prime Market, which is considered to have the highest governance and transparency standards, requires a minimum free-float of 35% and at least HRK 500 million (EUR 67 million) in market capitalisation. Less strict rules apply to the companies listed on the Official Market. This market requires a minimum market capitalisation of HRK 8 million (EUR 1.07 million) and a 25% free-float. The least regulated segment, the Regular Market, requires companies to have a minimum of 15% free-float. In addition to the minimum disclosure standards set in the Capital Market Act for all companies (see Chapter II, section 2.3), companies listed on the Official and Prime markets should also have an investor relations function. Moreover, companies listed on the Prime Market are required to have an agreement with a market maker and at least one independent member on the board and one on the audit committee (Articles 102-104, Zagreb Stock Exchange, 2019).

Currently, the Regular Market lists 66 stocks, the Official Market 20 stocks and the Prime Market only 6 stocks.[3] Looking at the market capitalisation and free-float requirements, by the end of 2020, 5 companies on the Regular Market and 2 companies on the Official Market met the market capitalisation and free-float criteria required to be listed on the Prime Market. Additionally, 18 listed companies had the required size to list on the Prime Market but would have to increase their free-float ratio to do so. Taken together, these two groups of companies constitute a pool of almost 30 companies with the potential to be listed on the Prime Market. However, the Prime Market currently does not offer sufficient incentives for companies to upgrade their governance and transparency standards. For example, the Prime

[2] In December 2020, the European Parliament and the Council agreed to grant member states an option to delay the application of the European Single Electronic Format requirement by one year. However, as of January 2021, the European Parliament and the Council have not ratified the amendment to the Directive.
[3] According to ZSE information retrieved on March 15, 2021.

market does not provide more visibility and a larger pool of investors compared to the other regulated segments. In order to attract additional companies and obtain a critical scale, the benefits of listing on the Prime market need to outweigh the associated additional compliance costs.

Compared to market size and development, the design of the stock market structure in Croatia is relatively complex. Three regulated markets and one alternative market with different sets of requirements lead to a heterogeneous market structure with none of the components reaching critical size. With a view to standardising rules in order to provide better clarity to investors and facilitate enforcement, many countries have adopted a single segment market structure (e.g. Chile, Mexico) or a structure that includes only one regulated and one alternative segment for growth companies (e.g. Singapore, Peru, Viet Nam). Many European stock exchanges, such as the four exchanges of the Euronext Group, also have one regulated segment and additional alternative segments to accommodate smaller companies.

Corporate governance framework

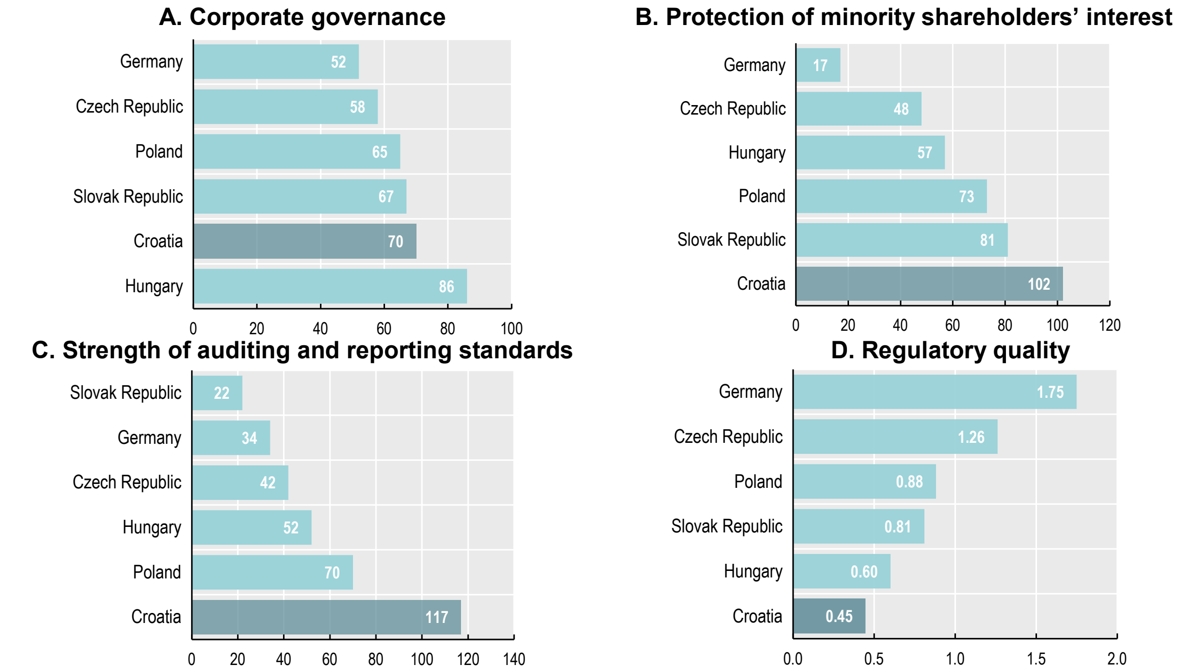
Good corporate governance facilitates companies' access to capital markets by reassuring shareholders and other stakeholders that their rights are protected. It has been shown that markets with a higher quality of corporate governance and greater minority shareholder protection are more resilient and liquid. For example, it has been documented that stock markets in emerging economies with higher overall minority shareholder protection have on average 15% higher liquidity compared to those with low minority shareholder protection (IMF, 2016a). Importantly, good corporate governance can also be seen as a shield against corporate scandals that undermine the general trust among both domestic and foreign investors.

Croatia ranked 70th in the quality of corporate governance, 102nd in terms of protection of minority shareholders' interest and 117th in the strength of auditing and reporting indicators in the World Economic Forum Global Competitiveness Index (Figure 2). Likewise, Croatia had the lowest score in terms of the regulatory quality index (World Bank Worldwide Governance Indicators) among its peer countries (Figure 2, Panel D). Similarly, the European Commission (EC) has pointed out that the regulatory environment in Croatia is burdensome and highly regulated to the point where it limits firms' access to capital, reduces economies of scale and restricts competition (EC, 2020a).

Given this background, and with a view to improving corporate governance, Croatia adopted a new Corporate Governance Code in October 2019. By increasing the corporate governance standards in the country, the new Code aims at boosting investor confidence and investment in the stock market. The Code introduced a number of important new recommendations, such as the ban on performance pay for supervisory board members, time frames for management board members to sell the securities received as remuneration and the development of a code of conduct for all employees and management bodies. The revised Code also requires companies to have proper channels of communication with minority shareholders. All companies listed on the ZSE have to comply with the new Code or explain in detail the reasons for non-compliance.

As stated in the *G20/OECD Principles of Corporate Governance*, effective corporate governance requires a sound legal and regulatory framework that typically comprises elements of legislation, regulation and self-regulatory arrangements. These legislative and regulatory elements can usefully be complemented by soft law elements based on the "comply or explain" principle such as the Croatian Corporate Governance Code in order to allow for flexibility. However, there is also evidence that the success of voluntary codes depends on the existence of interested and relevant monitors, and the extent to which soft regulation is a traditional means of control in the company law domain (Sanderson et al., 2010).

Figure 2. Quality of corporate governance framework and protection of minority shareholders



Note: Rankings for Panel A and C are for 2019 and for Panel Bare for 2017. Panel D measures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Values are for 2018 and range from -2.5 (weak) to 2.5 (strong).
Source: World Economic Forum Global Competitiveness Index (Panels A, B, C), World Bank Worldwide Governance Indicators (Panel D).

The OECD Corporate Governance Factbook 2019 shows that five jurisdictions adopt a mixed system with codes that provide some binding and some voluntary measures, namely Israel, Malaysia, Mexico, Saudi Arabia and Turkey. For instance, Turkey pursued a gradual transition from a "comply or explain" framework to a mixed one. Between 2003 and 2011, all companies included in the main Turkish index BIST-30 adhered to the Code. In 2011, to ensure investor confidence and to improve minority shareholder rights, Turkey made some of the principles of the code binding for BIST-30 companies, such as the ones related to information disclosure to shareholders and related party transactions. Subsequently, companies have been divided into groups by size with different binding principles applying to each group, where the largest companies are subject to the strictest rules.

One potential weakness in the Croatian corporate governance framework is related to audit committees. Audit committees play a key role in assisting the board to fulfil its oversight responsibilities in areas such as financial reporting, internal control systems, risk management systems and the internal and external audit functions. *The OECD Corporate Governance Factbook 2019* documents that 45 out of 49 jurisdictions require listed companies to establish an independent audit committee by law or regulation. Moreover, a majority of jurisdictions require the audit committee to have a majority of independent directors as members and to have an independent chair (OECD, 2019a). In Croatia, according to the Audit Act, entities of public interest, including corporations whose transferable securities are admitted to trading on a regulated market, are required to establish an audit committee. The audit committee can be organised as (i) an independent committee, (ii) as a committee of the supervisory board or (iii) as a committee of the board of directors of the audited entity, and must be composed of a minimum of three members, with at least one member skilled in accounting. The chair of the audit committee and the majority of the members should also be independent in relation to the audited entity, except when all members of the audit committee are members of the supervisory board (Article 65, Official Gazette, No. 127/2017). In addition, the recently revised Corporate Governance Code also recommends the creation of an audit committee in charge of monitoring the integrity and completeness of the financial statements and accounting policies of the company, among other functions.

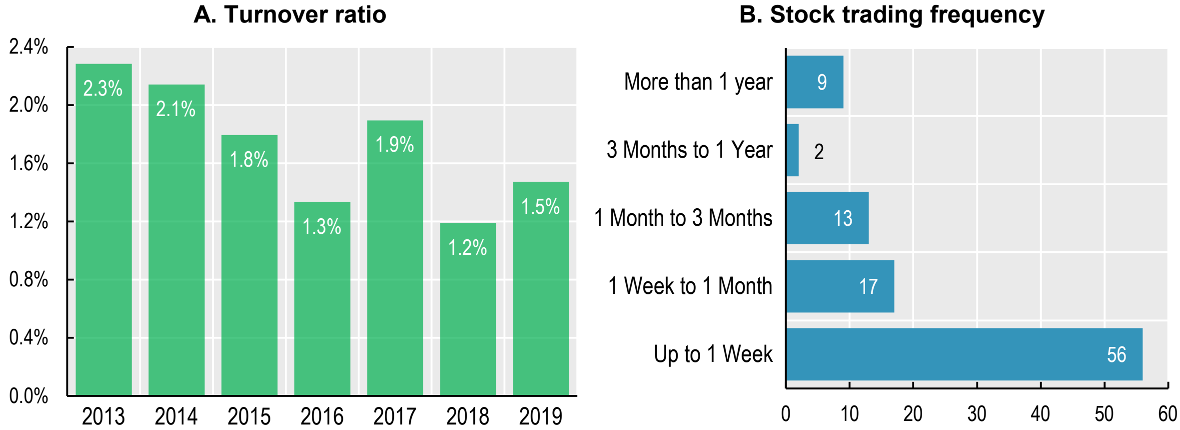
In 2019, Croatia introduced significant changes to the Companies Act and the Court Register Act. The amendments include the requirement of approval of related party transactions (RPT) by the supervisory board of the company when the sum of one transaction or all the transactions entered with the related party over a period of 12 months exceed 2.5% of the company's fixed and short-term assets from the last annual financial statements (Article 263d, Companies Act). In cases when the supervisory board does not approve the transaction, the management board may request approval from shareholders. It is noted that the interest of minority shareholders can still be at risk in cases where the board is mostly composed of representatives of the controlling shareholders or when the controlling shareholder holds enough votes to approve the RPT in a shareholder meeting, which is often the case in Croatia. The *OECD Corporate Governance Factbook 2019* reports that in 25 out of the 49 jurisdictions covered in the report, a key role is assigned to independent board members in reviewing the terms and conditions of related party transactions, often in their capacity as a member of the audit committee.

The *G20/OECD Principles of Corporate Governance* state that the regulatory framework should protect and facilitate the exercise of shareholders' rights such as participating in shareholder meetings and voting. The Principles also encourage efforts by companies to remove any artificial barriers that prevent shareholders' participation. In the past decade, many jurisdictions have adjusted their rules and regulations to encourage the use of digital technologies to improve the interaction with shareholders (OECD, 2021). E-voting and remote participation in annual general shareholder meetings (AGMs) became critical in 2020 due to restrictions related to COVID-19. In response, many jurisdictions lifted existing prohibitions for virtual/hybrid AGMs and clarified their regulatory frameworks. For example, Chile and Latvia advanced their current regulatory frameworks for remote participation in AGMs, and the e-voting process in shareholder meetings, including requirements for the certification of investor identity and for the secrecy of their votes. The Croatian Companies Act does not recognise the possibility of shareholders to participate remotely in AGMs and cast their votes digitally. However, such practices are possible if stated in the Articles of Association of the company, although they are subject to the discretional rights provided to the shareholders (Adriala, 2020).

Secondary market liquidity

The Croatian stock market is characterised by low levels of liquidity in the secondary market and is dominated by trades in a few individual stocks. The yearly turnover ratio[4] for stocks listed on the exchange is very modest and has been decreasing since 2013 (Figure 3, Panel A). In 2019, the overall turnover ratio for the three segments of the regulated market was only 1.5%. For the most liquid market, the Prime Market, it was only 3%. During the same period, the turnover ratio for peer stock exchanges was significantly higher with 19% for the Warsaw Stock Exchange, 9% for the Prague Stock Exchange and an average of 58% for all stock exchanges in the European Union. Low liquidity in the ZSE is driven by a large number of inactive stocks. Indeed, as of September 1 2020, almost 42% of the stocks had not been traded in the past week and 9 stocks had not been traded at all in the past year (Figure 3, Panel B).

Figure 3. Liquidity indicators for the Zagreb Stock Exchange



Note: For Panel B, stocks are assigned to trading frequency categories based on the number days between their last trading date and September 1st 2020.
Source: Zagreb Stock Exchange, OECD calculations.

Liquidity means that a stock at any given time can be traded at a going market price, which increases investor certainty and thereby decreases the risk premium of holding stocks. Conversely, low liquidity discourages investors and issuers from participating in the stock market. Low liquidity results in lower investor demand, a higher liquidity risk premium for issuers and an inefficient pricing system. Empirical evidence shows that low liquidity levels can increase the cost of equity for companies wanting to raise capital as investors require a higher expected return to compensate for the extra risk of reduced liquidity. For example, in the Chilean stock market illiquid stocks were associated with a 3.5% annual excess required return (IMF, 2016b).

Stock market liquidity can be supported by promoting more active participation of market makers who ensure the existence of a two-way market by providing investors with buying and selling prices at any point in time. However, in an illiquid market the incentives for market makers to provide these prices are low since the cost of finding trade counterparts increases (IMF, 2016b). The Zagreb Stock Exchange only requires companies listed on the Prime segment to have an agreement with a market maker. In 2019, the Prime Market was the most liquid market on the ZSE. Until 2018, the stocks listed on the Prime Market were listed on the

[4] Turnover ratio is measured as total value of shares traded over market capitalisation.

Official Market of the ZSE. However, since their transfer to the Prime Market there is no clear trend of improvement in their liquidity levels. This may be linked to the fact that the Prime Market has not yet reached a significant scale and has not attracted enough investors to provide better liquidity conditions.

The lack of secondary market liquidity on the ZSE can be explained by several factors, including the low free-float levels, the investment strategies and limitations of large investors and the tax structure. Importantly, pension funds, who are the largest institutional investors by assets under management (AUM) in Croatia, allocate only 11% of their AUM to domestic stocks corresponding to 9.4% of the total market capitalisation. At the same time, pension funds are not very important as liquidity providers as they typically trade less frequently compared to other investors.

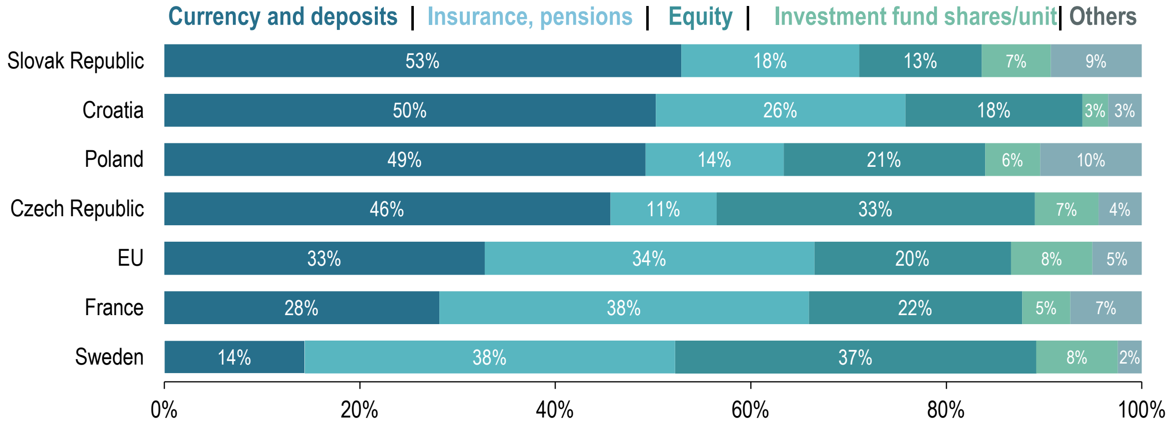
With respect to the tax structure, the capital gains tax on financial assets considerably influences investors' investment horizon and their decisions with respect to the allocation among different financial instruments. In Croatia, capital gains are taxed at 12% for physical persons. However, income from the sale of shares that are held more than two years are exempted from the capital gains tax (PWC, 2020). Therefore, the tax structure favours buy and hold strategies among retail investors in a market where the trading volumes are already low. Moreover, investors are responsible for keeping records, calculating all gains and losses for each transaction, and submitting the JOPPD form[5] to the tax authority each tax year. Particularly in the case of multiple transactions, investors need to keep records of the same type of financial assets according to the First In First Out method (Official Gazette, No. 115/2016). This procedure can be particularly cumbersome for frequent traders.

An analysis of the financial assets held by households in Croatia reveals that a high share is kept in bank accounts while participation in the stock market is modest. Indeed, half of Croatian households' financial assets are in the form of currency and bank deposits, whereas only 18% is held in equity[6] and 3% in investment funds (Figure 4). Moreover, the proportion of equity has been on a declining trend since 2007, decreasing by almost 10 percentage points. In markets where retail investors' participation in capital markets is high, such as France and Sweden, the share of deposits represents 28% and 14% of the total financial assets, respectively. According to Figure 4, Swedish households are the ones who allocate the largest share of their savings (37%) to equity.

[5] The JOPPD form is the central tax report on taxed and untaxed income submitted to the Croatian Tax Administration.

[6] Equity includes listed and unlisted equity.

Figure 4. Composition of households' financial assets, as of end 2018



Source: Eurostat.

Many countries have introduced policies to boost household participation in the stock market and support secondary stock market liquidity. One avenue has been to provide incentives to increase households' savings and facilitate the channelling of those savings to capital markets. For example, France has implemented a savings plan for retail investors called *Plan d'épargne en actions* (PEA) that provides capital gains tax exemption when the money is held in such an account for at least 5 years. There are two types of accounts, a classic PEA with a bank or insurance company to invest in French and other European stocks, and a PEA-PME dedicated to investing in securities issued by SMEs. The classic PEA allows the investor to save a maximum amount of EUR 150 000. The eligible instruments appear on the PEA account and are selected from a universe of shares, investment certificates and units of collective investment undertakings. The PEA-PME functions like a PEA but allows direct or indirect investments in instruments issued by SMEs and the contribution limit is set at EUR 75 000. The classic PEA can be combined with the PEA-PME, provided that the sum of both accounts does not exceed EUR 225 000. If investors keep their money invested for 5 years, the capital gains generated are tax-exempt. However, households do not need to hold any individual stock for a certain period in order to benefit from the tax advantage and may consequently continuously sell and buy individual stocks as they deem appropriate. The only condition is that they keep the money in the savings account and do not withdraw the principal or any gains for a five-year period. If the money is withdrawn before 5 years, the capital gains realised will be taxed at 12.8%. By the end of 2018, there were around 6.1 million PEA accounts in France totalling EUR 86 billion. With the same policy objectives in mind, Thailand has designed a different model by implementing educational programmes to promote retail investor participation and introducing a capital gains tax-exemption system for the transactions on the stock exchange. As a result, the Stock Exchange in Thailand doubled the number of retail investor accounts in 5 years and retail investors came to account for more than 55% of the total value traded on the market (Oliver Wyman and WFE, 2016).

Small company listings

The Zagreb Stock Exchange faces important challenges to attract smaller companies to the market. In order to improve the situation, in 2018 the ZSE introduced the multilateral trading facility Progress Market targeting SMEs in Croatia and Slovenia. Despite the relatively lower listing requirements, such as no obligation to issue a prospectus below a certain threshold, there were only four stocks listed on the Progress Market in Croatia by the end of August 2020. Moreover, the liquidity in the Progress Market – measured by the stock turnover ratio –

was only 0.1% in 2019. One reason behind the low liquidity has been the lack of research coverage for smaller companies. It has been documented that equity research can increase liquidity and make stock market participation more attractive to investors (FESE, 2020). However, investors are typically reluctant to pay for research for smaller companies, where they do not themselves have sizeable holdings. As a result, the research coverage for smaller listed companies is either limited or non-existent.

Some markets in other countries that face similar issues have provided the necessary support to generate small company research. In Spain, the stock exchange has an external research provider, Morningstar, which offers quantitative analysis for small and medium-sized companies. Importantly, this analysis is not only for companies listed on the Spanish BME Growth Market, but is also available for companies included in the IBEX Medium Cap (20 companies) and IBEX Small Cap (30 companies) indices. Another example is Hungary, where the state-owned stock exchange subsidises the research activity of the brokerage companies. Such initiatives can increase the attractiveness of the market for both investors and issuers and thus increase secondary market liquidity.

As described above, listing costs, both associated with the IPO and subsequent recurring costs, are important factors in a company's decision of whether to go (or remain) public. Since some components of the listing costs are fixed and independent of company size, smaller companies typically encounter higher costs relative to the proceeds of their offerings or their revenues. This has led many countries to introduce initiatives that contribute to cover the listing costs of smaller companies. In Hungary, for example, the Grant Fund covers up to 50% of the initial listing costs of SMEs. In Italy, the government set up a tax credit for SME listing costs that can be used for advisory and underwriting costs.

Stock market infrastructure

An important condition for an enabling capital market environment is to have a robust market infrastructure, such as clearing and settlement systems, central depositories and custodians. Croatia has already put such a system in place, with all securities dematerialised, recorded in the central depository and included in the clearing and settlement system. The company in charge of clearing and settlement in Croatia is the Central Depository and Clearing Company (CDCC). The company has established a subsidiary, SKDD CCP Smart Clear*,* that will provide clearing services. It should be noted that SKDD CCP Smart Clear is still in the process of acquiring an EMIR license. The CDCC is majority-owned by the State through the Financial Agency (56.6%) and the direct ownership of the Republic of Croatia (40.9%).

Within the 95 countries covered in the World Bank Global System Survey, two-thirds of the central securities depositories are operated by the private sector and one-third by central banks. In emerging and developing markets, clearing and settlement infrastructure has traditionally been developed for the government securities market and then expanded into other segments of the securities market. Indeed, the vast majority of central securities depositories operated by a central bank today only settle government securities. With the development of capital markets, many countries have moved towards fully or partially private ownership of the clearing and settlement systems.

Efficient clearing and settlement of financial instruments require that the responsible entity has the capacity to invest in the development of the market infrastructure and in new technologies. Market participants in Croatia have mentioned difficulties with respect to settling cross-border transactions owing to the lack of connectivity of the CDCC. This was also indicated as a factor hampering the functioning of the joint index ADRIAprime between the Zagreb Stock Exchange and the Ljubljana Stock Exchange. According to the latest records, Croatia is not connected to the pan-European TARGET2-Securities system (T2S). T2S is a platform where the exchange of securities and payments can happen simultaneously between investors from the 20 participating European markets. Since 2016, Croatia is connected to the TARGET2 system that settles bank payments, but has not yet integrated its central depository's framework into T2S. Full integration into the system requires significant investment in technical capacity, which may be facilitated by the participation of private sector financing.

In order to reduce the cost and risk of settling securities, one approach has been to consolidate both functions across borders, such as the Euroclear system. In some other cases, vertical integration between the stock exchange and the clearing and settlement company has also provided a solution (Tapking and Yang, 2006). It is also common that stock exchanges integrate horizontally with exchanges across borders, such as the Euronext Group. In Croatia, the Zagreb Stock Exchange has stepped up its efforts to become a regional exchange group by fully acquiring the Ljubljana Stock Exchange in 2015 and a minority stake in the Macedonian Stock Exchange in 2019. These efforts could benefit from further integration of the market infrastructure. For example, the stock market index, ADRIAprime, jointly created by the Zagreb Stock Exchange and the Ljubljana Stock Exchange, would become more functional if there was full integration of the clearing and settlement systems between the two markets through T2S.

Recommendation: As in other countries, the financial strength of many Croatian companies has been hurt by the economic slowdown caused by the COVID-19 crisis. Already before the crisis, a large portion of Croatian companies were undercapitalised and the use of capital market financing was rather limited. In order to achieve a successful and sustainable recovery, it is of particular importance to ensure that the Croatian corporate sector has access to long-term market-based finance, including equity capital. Equity markets can help Croatian entrepreneurs reduce their reliance on short-term financing and match long-term investments with long-term patient capital. A more developed equity market will also provide households with better investment opportunities to manage their savings and plan for retirement.

Croatia has made important progress in putting in place the building blocks for a modern equity market. However, the market is currently characterised by a loss of listed companies, limited participation of both retail and institutional investors and low liquidity. An important initial step to modernise the equity market framework could be to simplify the market structure of the stock exchange by reducing the number of regulated market segments. The Croatian Financial Services Supervisory Agency (HANFA) and the stock exchange may consider merging the Regular and Official markets under a new framework while at the same time encouraging more companies to move to the Prime Market. To become a truly attractive market, the Prime Market needs to reach a certain scale and promote good corporate governance practices by its listed companies. Since the benefits of being listed on the Prime Market would be limited for newcomers until the market reaches the necessary scale, the government may consider providing financial incentives to companies that move to this market or list here through an IPO. This support could be provided in the form of grants to cover a certain portion of the listing and recurring costs. Companies that do not have the required free-float level to be transferred to the Prime Market could also benefit from such financial incentives when conducting secondary public equity offerings. Following some successful examples in other European countries, such as Spain and Hungary, the government could also support the stock exchange, together with an external provider, in providing quantitative research of listed companies that is made available to the market.

At the same time, improvements in the corporate governance framework can help improve investor confidence. One step could be to make certain provisions of the newly introduced Corporate Governance Code mandatory for companies listed on the Prime Market. Additionally, in the approval of certain related party transactions, a key role should be assigned to independent board members with a view to protecting minority shareholders' interests. Another step towards enhancing shareholder rights could be to recognise remote participation in annual shareholders' meetings and allow voting by way of electronic communications in the Croatian Companies Act.

To improve liquidity in the market and to provide households with better saving opportunities, the government should consider introducing a savings account system for retail investors that includes exemptions from capital gains tax when the money is held for a minimum period of time. By not linking the tax advantage to the holding period of individual stocks and allowing investors to actively manage their portfolio in the savings account, the system could be instrumental in providing the market with much-needed liquidity. In addition, efforts to simplify the required forms and calculation of capital gains taxes could increase household participation in the stock market.

The full integration of Croatia into global securities markets requires that certain aspects of the market infrastructure to be modernised. Specifically, the CDCC needs significant investments in technical capacity to enhance operations, connectivity, efficiency and security. Further integration of the market infrastructure may facilitate the process. In addition to private sector financing, funds from the EU's Recovery and Resilience Facility, which focuses on enabling a digital transition, should be considered. This is also in line with Croatia's own National Development Plan, which specifically focuses on the digital transition.

2. Listing of SOEs: Scaling up the market and improving governance

Among the main objectives in the Croatian government's 2020 Management Plan are to continue the privatisation process of state-owned companies and to improve the management of identified special interest entities (Republic of Croatia, 2020). These objectives will be pursued through reducing the state property portfolio managed under the Ministry of State Property and Centre for Restructuring and Sale (CERP); improving the efficiency and monitoring the operations of SOEs; strengthening the competitive position of the special interest entities; and refining the criteria that define special interest entities. These measures also seek to alleviate the financial pressure that these entities impose on the government budget.

Data from the OECD-ORBIS Corporate Finance dataset identifies 631 Croatian companies as state-owned by the end of 2017. This constitutes just 0.54% of the total number of companies in the corporate sector. However, their combined assets amounted to EUR 32.6 billion (25.7% of total assets), their revenues were EUR 7.8 billion (10.1%) and they employed a total of 89 003 people (Table 1). The total revenue generated by SOEs accounted for 16% of GDP, and their total employment represented 9.4% of the Croatian workforce. The revenue-generating capacity of SOEs in Croatia is low as they held 25.7% of the total assets in the corporate sector but generated only 10.1% of the total revenues.

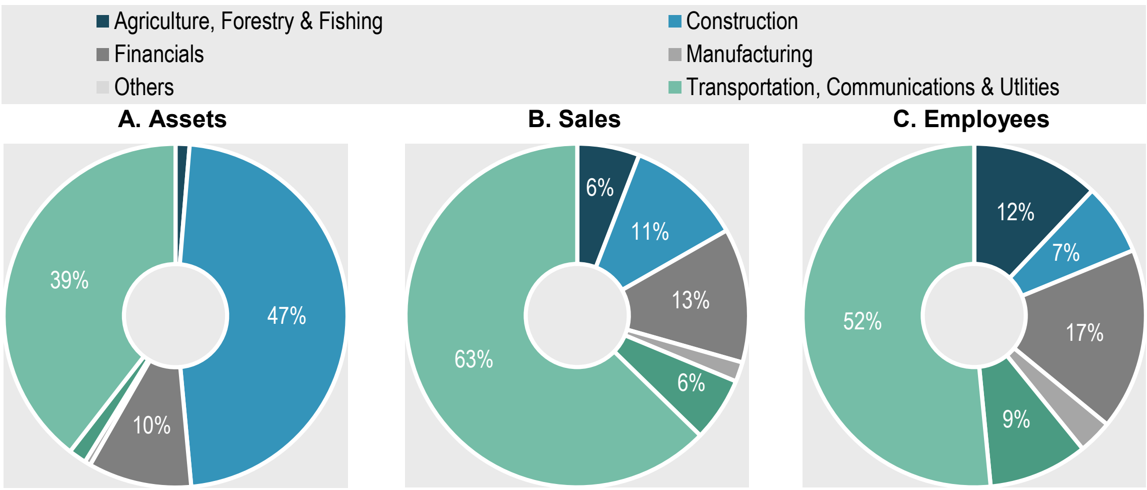
Table 1. Size of the SOEs in Croatia

	SOEs size			SOEs' share in…			
	Assets € B	Sales € B	Employment	Assets	Sales	Employment	Number
2007	34.6	9.9	97 348	25.0%	11.7%	10.9%	0.57%
2008	36.4	10.5	98 447	24.8%	11.9%	10.7%	0.56%
2009	37.8	9.1	80 875	25.1%	12.1%	9.1%	0.54%
2010	36.3	9.0	77 708	26.1%	12.9%	9.7%	0.56%
2011	34.9	9.6	89 387	25.4%	13.2%	10.9%	0.56%
2012	33.4	9.0	82 927	25.0%	12.8%	10.2%	0.56%
2013	32.6	8.7	88 073	25.5%	12.6%	10.9%	0.55%
2014	32.5	8.2	91 843	24.7%	11.7%	11.1%	0.58%
2015	32.8	7.9	90 940	24.6%	10.7%	10.3%	0.57%
2016	33.6	7.6	91 651	24.9%	10.0%	10.0%	0.57%
2017	32.6	7.8	89 003	25.7%	10.1%	9.4%	0.54%

Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Within the group of unlisted SOEs, the largest ones – measured by assets, revenues and employees – are companies operating in transportation, communications and utilities (electricity, gas and sanitary services). In 2017, these companies employed 52% of all employees in unlisted SOEs, accounted for 39% of the assets and generated 63% of unlisted SOE's total revenues (Figure 5). While SOEs in the construction industry make up 47% of total unlisted SOE assets, they only employ 7% of the total number of unlisted SOE employees and account for 11% of total revenues. Financial SOEs are also important in the government's SOE portfolio as they account for 17% of unlisted SOEs employees.

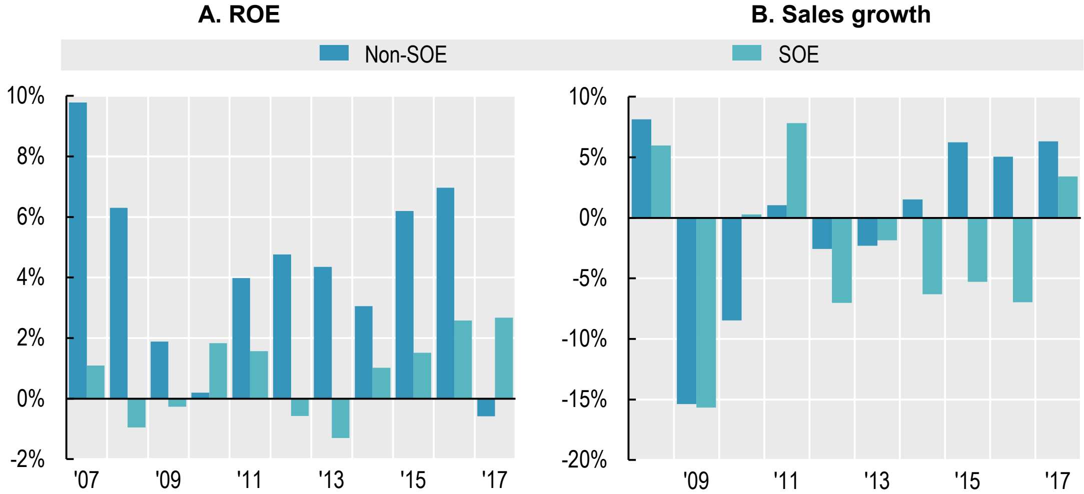
Figure 5. Unlisted SOEs' industry composition



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Previous OECD research has shown that in many markets, corporations with a high degree of government ownership are associated with lower company performance (OECD, 2018). As illustrated in Panel A of Figure 6, Croatia is not an exception. In 9 out of 11 years between 2007 and 2017, SOEs had a lower return on equity (ROE) compared to non-SOEs. Importantly, the performance of SOEs fluctuated around zero between 2007 and 2013, before rising to around 3%. With respect to sales growth, both SOE and non-SOEs suffered a significant contraction in 2009, during the global financial crisis (Panel B). However, SOEs experienced a stronger recovery in the following two years compared to non-SOEs. Particularly in 2011, driven by the strong performance of INA Group, the national oil company, SOEs' total revenue grew by 8%. After 2013, non-SOEs outperformed SOEs in all years with respect to sales growth. Indeed, SOEs had a negative sales growth for five consecutive years up to 2017.

Figure 6. Aggregate performance for SOEs and non-SOEs



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

The Croatian government holdings can be classified into two categories: strategic assets, also known as enterprises of special interest, and non-strategic assets. At the end of 2018, there were 33 SOEs of special interest under the management of the Ministry of State Assets. These enterprises managed a total of HRK 214.5 billion assets (EUR 28.9 billion) and generated total revenues of HRK 50.2 billion (EUR 6.8 billion) and a total profit of HRK 3.6 billion (EUR 0.48 billion). As a result, it is the larger of the two categories in terms of both assets and revenues.

Besides the enterprises of special interest, the non-strategic entities are centrally managed by the Centre for Restructuring and Sale (CERP). The portfolio managed by CERP also includes the shares and participation in non-strategic companies owned directly by the government. The institution also manages the holdings of the Croatian Pension Insurance Institute, the Croatian Deposit Insurance Agency. The total assets managed by CERP consist of 316 companies with a total of 68 201 employees (Table 2). In 2017, these companies had over EUR 13 billion of assets and generated more than EUR 6 billion of revenue.

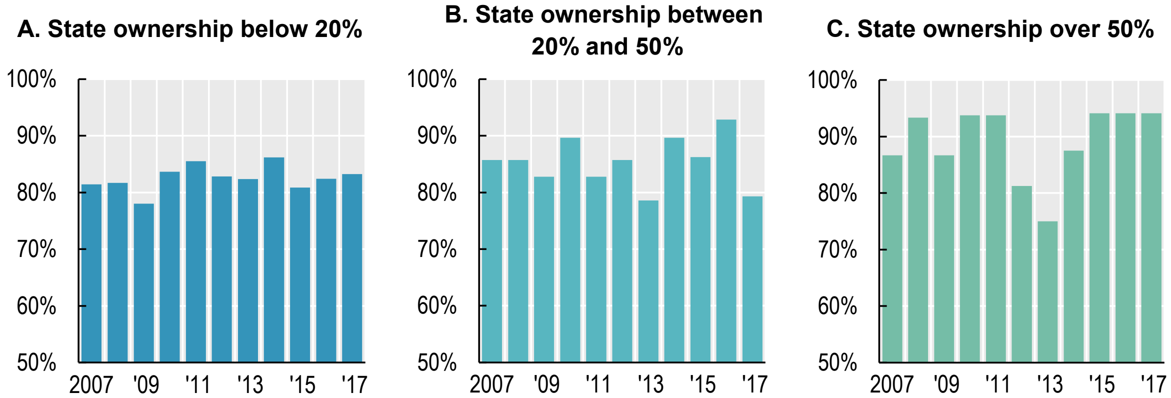
Table 2. CERP holdings of non-strategic companies in 2017

Government ownership	Number	Assets € M	Sales € M	Employment
Below 20%	267	11 600	6 030	62 368
Between 20% and 50%	30	845	213	2 563
Over 50%	19	839	155	3 270

Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Since the overall performance of Croatian SOEs is mainly driven by large companies classified as strategic assets, the analysis of CERP portfolio companies presented in Figure 7 provides additional information about its interests in smaller and in most cases partially state-owned companies. The figure classifies companies into three categories according to government ownership level and compares their performance with the industry medians. In almost all years, more than 80% of the SOEs had an ROE below the industry median. In general, higher government ownership seems to be associated with state-owned companies having weaker performance than their industry peers.

Figure 7. Share of SOEs with ROE below industry median



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

The Croatian capital markets lack the scale to operate efficiently and to serve Croatian companies and savers effectively. In many markets around the world, listing of state-owned companies has substantially helped stock markets obtain a critical scale and become attractive for both private companies and investors. As a result, more than 8% of the world's listed companies have public sector ownership that exceeds 50% of the equity capital. Additionally, in 11% of the companies, the public sector holds between 10% and 49% of the equity capital (De La Cruz, Medina and Tang, 2019). Listing of SOEs can also help companies improve their transparency and operational efficiency, thereby contributing to a higher performance and less negative pressure on the state budget and public debt.

Fourteen Croatian SOEs were listed on the domestic stock exchange at the end of 2019. Out of these 14 companies, only one was listed on the Prime Market, considered to have the highest governance and transparency standards. Among the remaining companies, 6 were listed on the Official Market and 7 on the Regular Market. Based on 2019 data, 3 companies currently listed on the Official Market actually comply with the requirements both in terms of market capitalisation and free-float to be listed on the Prime Market. Moreover, 6 additional companies out of the 14 listed SOEs, meet the market capitalisation requirement for being eligible on the Prime Market. Transferring listed SOEs to the Prime Market will not only help scale-up the market and improve liquidity conditions, but also improve their governance. Importantly, by adopting good corporate governance and disclosure standards, the State as an owner can set the tone and encourage the private sector to follow better practices. This is also in line with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* which state that SOEs should always comply with the national corporate governance code, irrespective of how "binding" they are (OECD, 2015).

Since only fourteen Croatian SOEs are listed on the stock market, there is a large pool of possible candidates for listing that would help build a stock market of critical size, improve liquidity as well as corporate performance and efficiency. Importantly, out of the top ten largest SOEs, only two are publicly listed. Within the category of strategic assets that are under the management of the Ministry of State Assets, only five of the thirty-three enterprises are listed.

An important example of a large unlisted SOE is Hrvatska Elektroprivreda, the national power company engaged in electricity production, transmission and distribution. Listing electricity companies has been a common practice around the world as a way to improve their efficiency. By the end of 2018, 38 out of the largest 50 electricity companies worldwide were listed or had listed subsidiaries (Prag, Röttgers and Scherrer, 2018). Similarly, out of 20 special interest SOEs operating in the transport and communications industry only Croatia Airlines is listed. Hrvatske Autoceste, the Croatian toll road company, has become the second largest special interest SOE by assets after merging with HAC ONC. In recent years, many toll road operators have become listed, such as the ones in Italy and France. Being listed can be a suitable way to raise capital to meet the growth demands and also increase the efficiency to manage road concessions. In addition, once listed, companies can carry out secondary public offerings to raise additional funds when new concessions are to be financed.

The portfolio of companies under CERP administration contains several non-strategic companies where the government could put in place a plan for either divesting these assets or partnering with private investors through either public or private equity financing. In order to relieve the pressure on the government budget, some of these companies could access the debt market through corporate bond issuance (see Part I, section 4). A group of companies, given their size and industry, might be eligible to list their shares on the Regular Market of the stock exchange. For example, Plinacro and Zrakoplovno Tehnicki Centar, could potentially benefit from listing on the Progress Market or receive private equity financing. The CERP portfolio also contains an export-oriented company, Lipovica, which could benefit from a listing on the Regular Market to raise capital and continue to expand its operations.

Other governments with large portfolios of SOEs have received the help of privatisation intermediaries in their efforts to reduce their corporate holdings. The privatisation intermediary would support the government in preparing any transaction the government is planning. For example, they can assist governments in organising, evaluating and executing any divestment, privatisation or debt issuance. By using a well-qualified intermediary, governments are able to attract more investors, increase the level of foreign investment, improve privatisation results and increase the transparency of the process. In recent experiences, Bulgaria was supported by a privatisation intermediary in handling 170 transactions (Górzyñski, et al., 2000).

Recommendation: The Croatian government has defined continuing the privatisation process of state-owned companies and improving their management and efficiency as a key priority. Following successful examples in many countries, Croatia could use capital markets both to reduce the government's holdings and to improve the governance of the companies. This would also help scale up the domestic capital market and make it attractive for both private companies and investors. An important step towards these goals would be transferring listed SOEs from lower segments of the stock exchange to the Prime Market. In addition to the three companies that already meet the size and free-float requirements to be listed on the Prime Market, the government may consider conducting secondary public offerings of other SOEs with lower free-float ratios to increase the portion of their shares available for trade. Within the portfolio of unlisted SOEs, there are many large companies that could be considered for listing on the Prime Market through an IPO. SOEs listed on the Prime Market and the ones preparing for listing should comply with the Croatian Corporate Governance Code as a mandatory standard. SOEs that do not meet the size criteria for a Prime Market listing could either be consolidated or considered for listing on the lower segment or the alternative market.

3. Unleashing the potential of institutional investors in Croatia

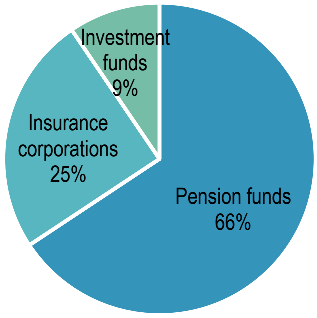
The largest categories of institutional investors in Croatia are pension funds, insurance companies, and investment funds. In 2020, their combined assets under management were HRK 192 billion (EUR 25 billion) or 52% of Croatian GDP. Pension funds is by far the largest category among these traditional institutional investors, accounting for 66% of their total assets under management at the end of 2020, with HRK 126 billion (EUR 17 billion) managed by 5 fund management companies (Table 3). Insurance corporations is the second largest category with 25% of the total assets under management amounting to HRK 47 billion (EUR 6 billion). The total assets under management by investment funds were HRK 18 billion (EUR 2 billion) or 9% of traditional institutional investors' AUM.

Table 3. Traditional institutional investors in Croatia

A. Total AUM and number of companies, as of end 2020

	Assets under management ***(billions)***	Number of companies
Pension fund management companies	HRK 126 (EUR 17)	5
Insurance corporations	HRK 47 (EUR 6)	15
Investment funds	HRK 18 (EUR 2)	24

B. Asset distribution



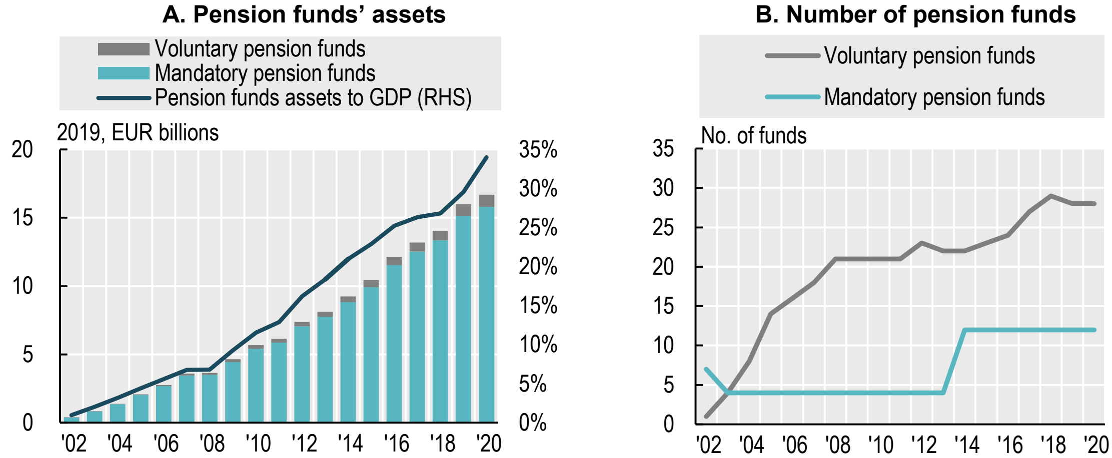
Note: Investment funds refer to UCITS and excludes alternative investment funds. Pension fund management companies offering mandatory and voluntary funds are included.
Source: HANFA.

The dominant role of pension funds is to a large extent the result of the political decision in 1998 to reform the pension system, in effect since 2002. Importantly, the pay-as-you-go system (first pillar) was complemented by mandatory and voluntary private pension schemes. The mandatory private pension scheme (second pillar) is based on individual capitalised savings accounts and is funded by individual defined contributions paid on all taxable earnings from employment and self-employment. As in many OECD countries, contributions and investment returns are tax-exempt while the pension benefits are taxed (i.e. Exempt-Exempt-Taxed system). The voluntary private pension schemes (third pillar) are offered via open-ended and closed-ended funds, and rely on voluntary contributions from individuals and/or their employers (IOPS, 2019).

When the pension system entered into force in 2002, employees under the age of 40 were required to join the new system, while those between 40 and 50 were given the option to choose between the former and the new system. Employees over the age of 50 remained in the old system. For those who join the new system, contributions to the mandatory system amount to 20% of their gross salary, of which 15% goes to the first pillar and 5% to the second pillar. The contribution to the individual account is relatively low compared to the OECD average. In the 17 OECD countries with mandatory defined contributions schemes, the average contribution rate in mandatory and auto-enrolment plans is 8% (OECD, 2019b).

Since the start of the new system in 2002, assets under management of the mandatory second pillar have increased considerably, showing a 22% annualised real growth rate. By the end of 2020, the mandatory system included 4 pension fund management companies offering in total 12 pension funds with AUM totalling almost EUR 16 billion (Figure 8). This increase partly reflects the fact that during the first years of the new system, outflows in the form of pension payments were low compared to the inflows. Voluntary pension fund assets have also been growing over time, reaching EUR 894 million and 28 funds offered by the end of 2020, although their size and scope remain modest compared to the second pillar.

Figure 8. Pension funds in Croatia



Source: HANFA.

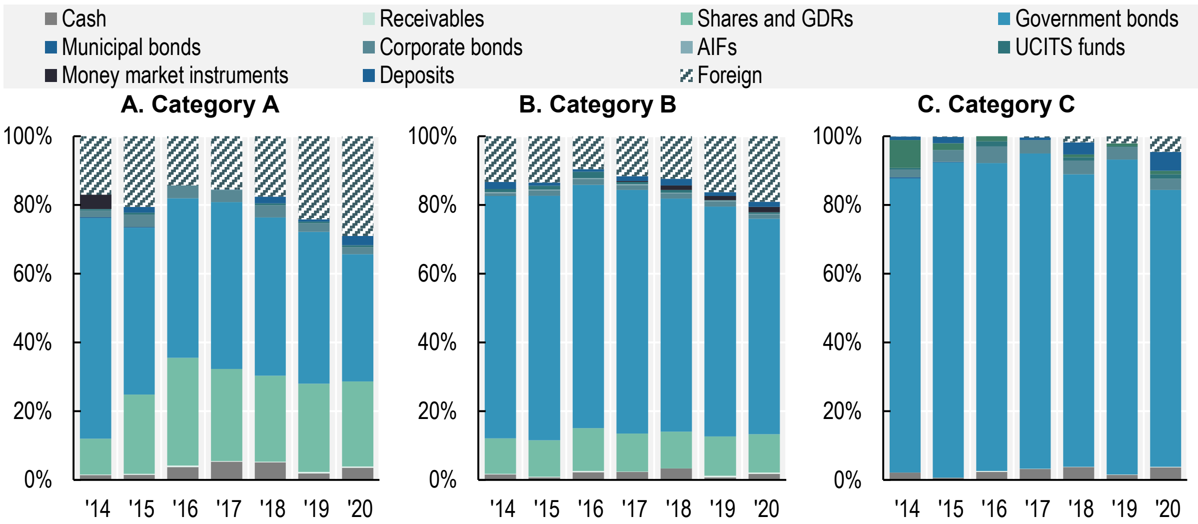
Today there are three pension fund categories in the system with different risk profiles and investment strategies, with Category A carrying the highest risk and Category C the lowest risk. In Category C, a minimum of 70% of assets must be invested in Croatian government bonds, decreasing to 50% in Category B and 30% in Category A. Moreover, while equity investments are not permitted in Category C, in Category B the equity allocation must not exceed 40% and in Category A it must not exceed 65%. Likewise, the upper limit for corporate bond investments is set at 50% for Category A, 30% for Category B and 10% for Category C. In all three fund categories, investments in corporate financial instruments are restricted to financial instruments issued by companies incorporated either in Croatia, in another EU country or in an OECD member country.

In 2018, new amendments were introduced to the Mandatory Pension Funds Act (Official Gazette, No. 115/2018). Of particular interest are the changes introduced to Article 91, which determines how insured persons that have not selected a pension fund management company should be assigned by the Central Register of Insured Persons. Before the amendment, the allocation of insured persons was executed by assigning an equal number of persons to each pension fund management company. However, the new system allocates an equal share of insured persons to each management company and leaves a residual share that is assigned to the company that showed the highest risk-adjusted return in the previous year.[7] The new allocation system aims at increasing competition across pension fund management companies to attract more insured persons as their main revenue comes from the fees paid by each insured person. In addition, pension fund management companies' fees were reduced, making Croatia one of the countries with the lowest management fees (OECD, 2019b). Annual management fees in 2019 were 0.338% over AUM and will be gradually reduced by 7% every year until reaching 0.3%.

[7] The share is calculated as $\frac{1}{n+1}$ where n is the number of management companies.

In 2020, 93% of the total assets in the mandatory second pillar were allocated to Category B, 6% to Category C and only 0.82% to Category A. Figure 9 shows the investment allocation for the three categories of funds over time. Funds in Categories B and C show a stable portfolio composition over time dominated by government bonds. Both Category B and C funds hold significantly more government bonds than required. Category B funds have allocated 63% of their assets to government bonds compared to the required minimum allocation of 50%, while Category C funds have allocated 81% compared to the minimum allocation of 70%. However, funds in Category A have increased their allocation to shares and global depository receipts (GDRs) from 10% in 2014 to 25% in 2020. Foreign investments by Category A funds have also increased from 17% in 2014 to 29% in 2020. The allocation to shares and GDRs by Category B funds was about 11% in 2020, and their foreign investments increased from 13% to 19%, while the allocation to foreign investments by Category C currently is around 5% of their assets.

Figure 9. Mandatory pension funds' investment structures



Source: HANFA.

Although the limits for equity investments were recently increased for funds in Categories A and B, their equity allocations remain limited. In 2020, the equity allocation of funds in Categories A and B was 25% and 11%, respectively. The average allocation to equity among pension funds in the OECD area was 27% in 2019. In some emerging market economies with similar second pillar systems, such as Chile and Peru, the allocation to equity was almost 40% in 2019 (OECD, 2020a).

Croatian pension funds invest in 26 domestic stocks according to the 2019 ownership records. Half of these stocks were listed on the Regular Market and 8 were listed on the Official Market. Importantly, pension fund management companies invest in all five stocks listed on the Prime Market. In total, pension fund investments in domestic stocks correspond to 9.4% of the total market capitalisation of the ZSE. However, there are certain restrictions on how much the pension funds collectively and individually can own in an individual company. Each pension fund category is limited to holding a maximum of 20% of the share value of an individual company and the combined ownership by all fund categories managed by the same pension fund management company cannot exceed 20% of the value of an individual company.[8] However, in three listed companies all pension funds together hold almost half of the market capitalisation.[9] In another 12 stocks, pension fund holdings vary between 10% to around 30% of the capital. Moreover, there is a negative correlation between the turnover ratio of a stock and the share of that stock held by pension funds: as the share of pension funds holdings increases, the turnover ratio for a stock decreases.

The allocation to corporate bonds by pension funds has also remained modest. Corporate bond investments represent on average 1.5% of all assets under management across the three fund categories of the second pillar scheme. While investment rules for corporate bonds in Croatia define the issuers' origin (Croatia, EU and OECD countries), no criteria is found with respect to rating categories, currency, maturity or other key characteristics. For example, in Korea and Mexico, the defined contribution retirement pension plans allow for corporate bonds investments only if the issuer is rated as investment grade (OECD, 2019c). It is possible that the lack of explicit directives about the type of corporate bonds in which pension funds are allowed to invest creates legal uncertainty for pension fund management companies.

The limited allocation to stocks and corporate bonds in pension funds' portfolios could be related to the illiquidity in the domestic market and the rules for the determination of net asset values.[10] For securities that trade regularly, the calculation of the value of the funds is straightforward. However, for illiquid stocks, bonds and other instruments in their portfolio, pension fund management companies are required to create their own evaluation techniques. Since there is no defined calculation method provided by the regulator or in the law for illiquid instruments, companies in Croatia use their own evaluation techniques which may lead to different valuations of the same security. To avoid this problem, the regulators in, for example, Mexico ask pension funds to get pricing services from an external provider whereas in Chile the pension regulator provides a pricing list, dedicated to pension fund managers only, for all securities on a daily basis.

The second pillar of the Croatian pension system is a defined contribution system where the ultimate retirement income depends on how well the pension fund performs. In order to alleviate temporary negative fluctuations in fund performance it includes a minimum return guarantee for capital market losses during the accumulation phase. This guarantee defines a reference return – as the weighted average return of all mandatory pension funds by category in a 3-year period – assuring each fund member the reference return minus 12%, 6% and 3% for Categories A, B and C respectively. When this formula results in a negative value, the guarantee is triggered and should be covered with the guarantee deposit and the capital of the fund management company. For this purpose, pension fund management companies are required to maintain a guarantee deposit of HRK 1 million (CPI indexed) for each 10 000 fund affiliates above an initial threshold of 50 000 affiliates. The return guarantee system was designed as a measure to allow a smoother transition from the pay-as-you-go system to a

[8] Exceptionally, Article 126 paragraph 3 the Mandatory Pension Funds Act allows pension funds to acquire a greater percentage (over 20%) of a single issue of transferable equity securities issuer provided that any such investment does not exceed 2% of the pension fund's net asset value and further provided that in total such assets do not exceed 5% of the pension fund's net asset value.

[9] Namely Podravka (listed on the Prime Market), Koncar Elektroindustrija (listed on the Official Market) and Imperial Riviera (listed on the Regular Market).

[10] Ordinance on determining the net asset value and the value of the unit of account of the mandatory pension fund and its amendments: https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_128_2924.html https://narodne-novine.nn.hr/clanci/sluzbeni/2018_12_114_2228.html

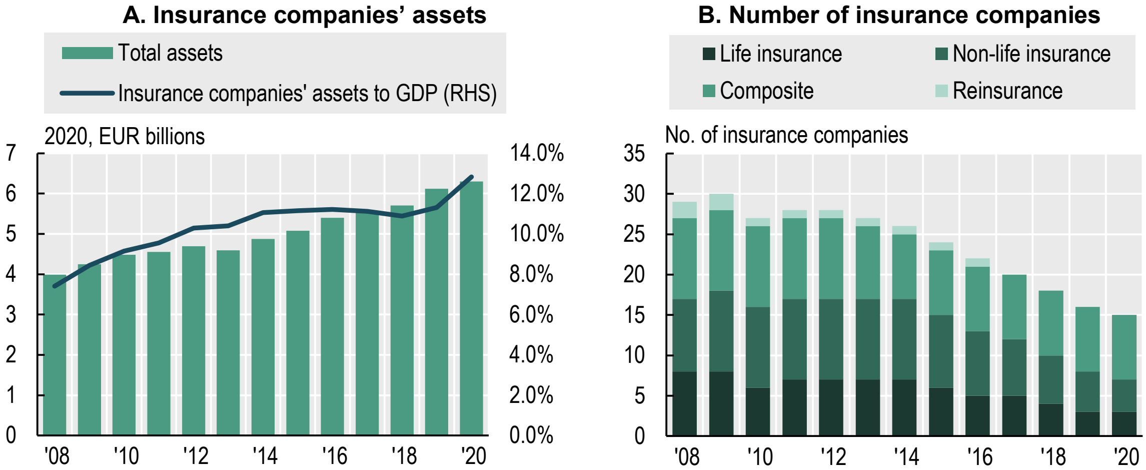
defined contribution system. Although the conditions for those guarantees have been eased over the years, pension funds are still liable to fill a potential gap in case of insufficient guarantee deposits with up to 50% of their share capital (Matek and Galic, 2017). The return guarantee system, among other factors, has incentivise pension fund management companies to adopt conservative investment strategies as they are responsible for a portion of potential losses. In general, in cases where the guarantee provider controls the investment strategy to some extent, there is an incentive to reduce the investment risk (Antolín et al., 2011).

An alternative design to better align incentives of pension fund management companies with their members has been to establish obligatory reserves. The Chilean pension system went through a similar pension reform introducing multiple fund categories. After the initial transition phase a new system was introduced where the pension fund management companies were required to have obligatory reserves equivalent of the 1% of total AUM and invest these reserves replicating the investment strategy of the funds they manage.

At year-end 2020, Croatian insurance companies managed about EUR 6.3 billion. Contrary to pension funds, insurance companies have experienced only modest growth in terms of total assets under management, with the total assets-to-GDP ratio increasing by only 5.4 percentage points from 7.4% in 2008 to 12.8% in 2020 (Figure 10, Panel A). Over the same period, the number of insurance companies has also declined from 29 to 15. In 2008, there were 8 life insurance, 9 non-life insurance, 10 composite and 2 reinsurance companies whereas in 2020, half of the companies were composite and there were no reinsurance companies (Figure 10, Panel B).

In 2018, the Croatian Parliament adopted the Act on Amendments to the Insurance Act implementing the Insurance Distribution Directive (EU, 2016/97), which, among other things, introduced or reinforced rules with respect to product management and cost and fee transparency towards customers (HANFA, 2018).

Figure 10. Insurance companies in Croatia

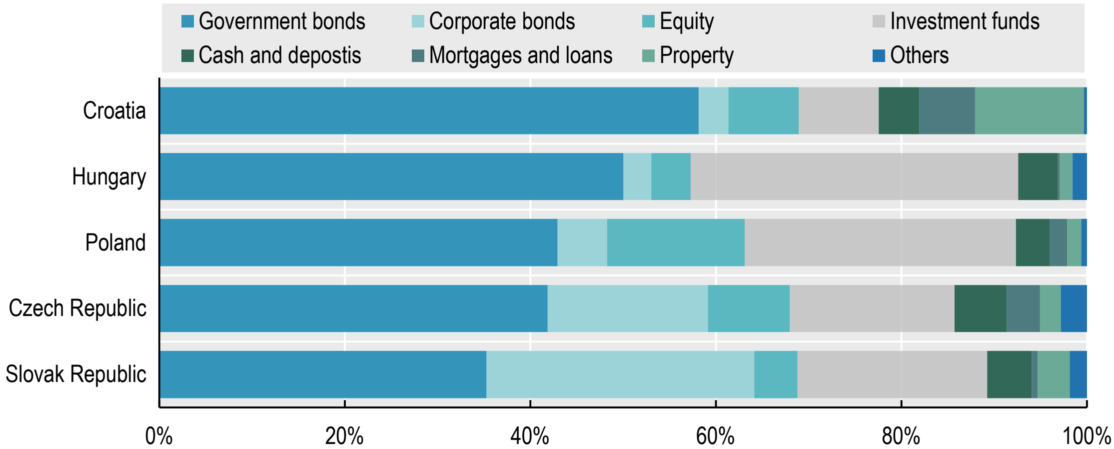


Source: HANFA.

The asset allocation of Croatian insurance companies differs significantly from that of insurance companies in European peer countries. As shown in Figure 11, the share of assets allocated to investment funds is only 9% for insurance corporations in Croatia, compared to

35% for Hungary and 29% for Poland. Insurance companies in Croatia allocate 8% of their assets directly to equity, whereas in Poland the corresponding figure is 15%. Similarly, insurance corporations in Croatia allocate only 3% of their assets to corporate bonds, whereas in the Czech Republic and the Slovak Republic this ratio is 17% and 29%, respectively. As a result, the combined allocation to equity, investment funds and corporate bonds of Croatian insurance companies totals only 19%, less than half of peer countries. Government bonds and property investment together account for 70% of the total assets of insurance companies, which is significantly higher than in peer countries.

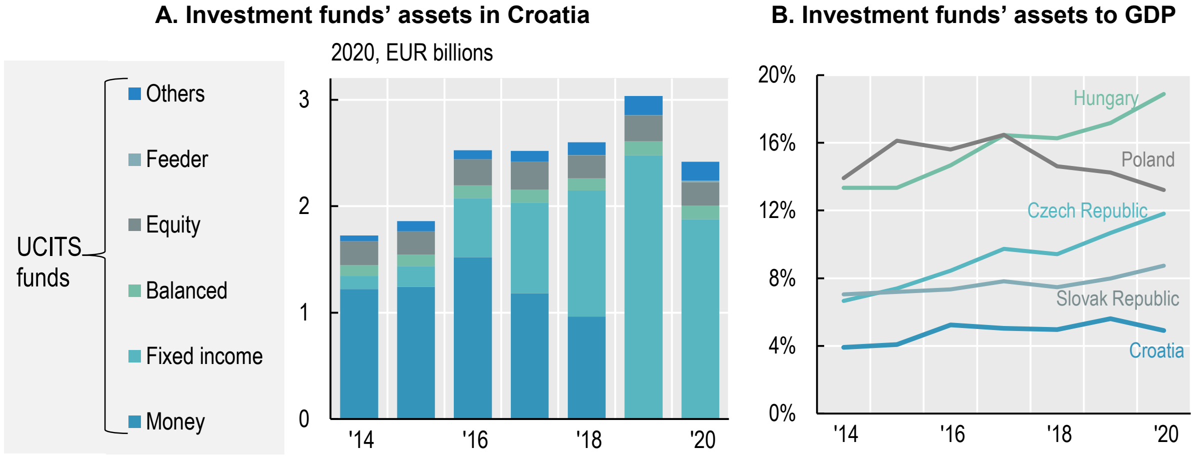
Figure 11. Asset allocation of insurance corporations across countries



Source: EIOPA Solvency II statistics.

Investment funds is the smallest category of traditional institutional investors in Croatia, accounting for 9% of the total assets of under management. Investment funds can be split into two categories: UCITS (undertakings for collective investments in transferable securities), which are EU regulated mutual funds, and alternative investment funds (excluded in Figure 12). In 2020, there were 96 UCITS funds in Croatia, of which 41 were pure fixed income funds and 24 pure equity funds. In terms of assets under management, fixed income funds dominate the UCITS, representing 78% of the total (Figure 12, Panel A). With respect to the equity allocations of UCITS, there has been a decreasing trend in recent years from 14% in 2013 to 9% in 2020. As shown in Panel B of Figure 12, Croatia has the smallest investment fund industry in relation to GDP of its European peer countries. While total investment fund assets in Croatia accounted for 5% of GDP in 2020, they accounted for more than 10% in Hungary, Poland and the Czech Republic.

Figure 12. Investment funds in Croatia and selected peers countries



Note: Investment funds refers to UCITS and excludes alternative investment funds.
Source: HANFA, ECB.

In 2013, the size of the investment fund industry in Croatia did not differ much from that of the Czech Republic. After years of strong growth, however, the total investment fund assets to GDP ratio in the Czech Republic has reached a level almost twice as high as that in Croatia. An important driver of this growth has been the legal changes introduced in 2013 which transformed the Czech Republic's investment fund landscape into a more attractive residency for management companies and foreign investors. The most important measure implemented was the 5% fixed income tax rate for all types of investment funds compared to the 19% income tax on corporations (Deloitte, 2017). Croatia has no such differentiation between investment funds and corporations. At the same time, at 12%, investment funds in Croatia are subject to a higher withholding tax than that applicable to dividends and profit shares.

Recommendation: Today, pension funds, insurance companies and investment funds are the most important investors in capital markets globally. As financial intermediaries, they play an important role in channelling household savings to the real economy and provide investors with opportunities to invest in risk-diversified portfolios at lower costs. Their development, however, has been relatively slower in Croatia compared to peer countries. Notably, the assets managed by investment funds, which is the most important category of institutional investors globally, account for only 5% of GDP in Croatia. While pension fund assets have grown significantly since the introduction of the mandatory private pension system, their total assets under management are still only half of the OECD average and their allocation to equity is relatively low.

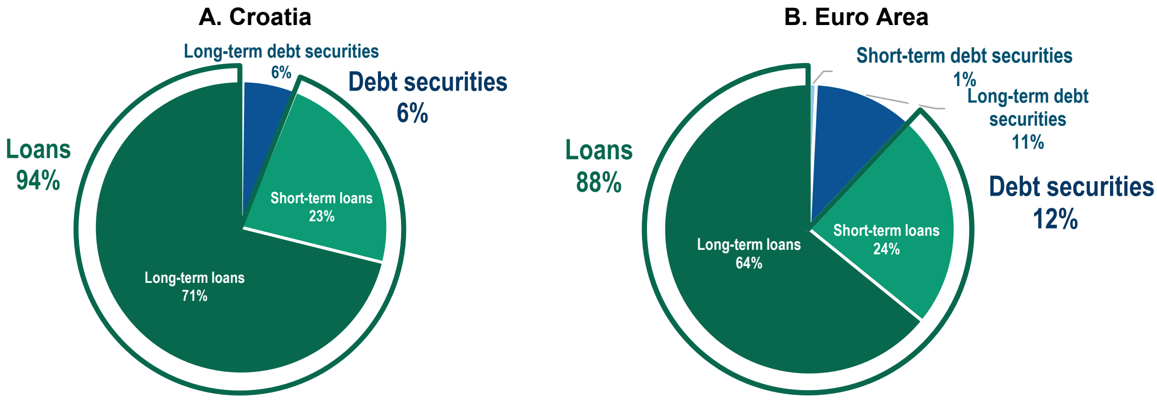
A key challenge in Croatia for unleashing the potential of institutional investors is the low overall activity level in the capital markets. In particular, the limited use of capital market financing by Croatian companies leaves institutional investors with scant investment opportunities. The highly concentrated investment by pension funds in a small number of listed companies does not contribute to the efforts to improve the liquidity conditions in the market. Increasing the number of listed companies on the stock market, in particular on the Prime Market, and promoting corporate bond issuance in the domestic market would help institutional investors to provide the public with more appealing products that give better returns and protect retirement income.

With respect to the pension funds, the authorities may consider assessing the incentive structure for pension fund management companies in order to better align their incentives with those of the fund members. The current design results in a conservative asset allocation as pension fund managers are responsible for a portion of the potential losses from investments. Given the low interest rate environment and the growing size of Croatian pension funds' assets, a greater allocation to equity investments can also help achieve better long-term returns. Indeed, the recent initiatives to raise the equity investment limits for funds Categories A and B, and to make Category A the default one for new affiliates go in that direction. An additional important initiative could be to provide greater clarity related to the investable universe of securities and the pricing guidelines. Instead of the current system where each fund decides their asset valuation model for illiquid instruments, the regulator should assess whether an alternative system where all pension fund management companies use the same prices for valuing their portfolios might be preferable. In the case of investments funds, Croatia has not placed itself as a competitive residence for management companies, investment funds and foreign investors. A lower withholding tax may support the growth of the industry and help to reach a critical scale.

4. Long-term debt financing through markets

Companies in the euro area rely heavily on loans for debt financing instead of corporate bonds and other debt securities. In the case of Croatian non-financial companies, the reliance on loan financing is particularly strong. As illustrated in Figure 13, loans made up 94% of the total debt financing of Croatian non-financial companies compared to 88% in the euro area as a whole. As a result, the use of debt securities by Croatian non-financial companies only represents 6% of their total debt financing, which is half of the euro area average.

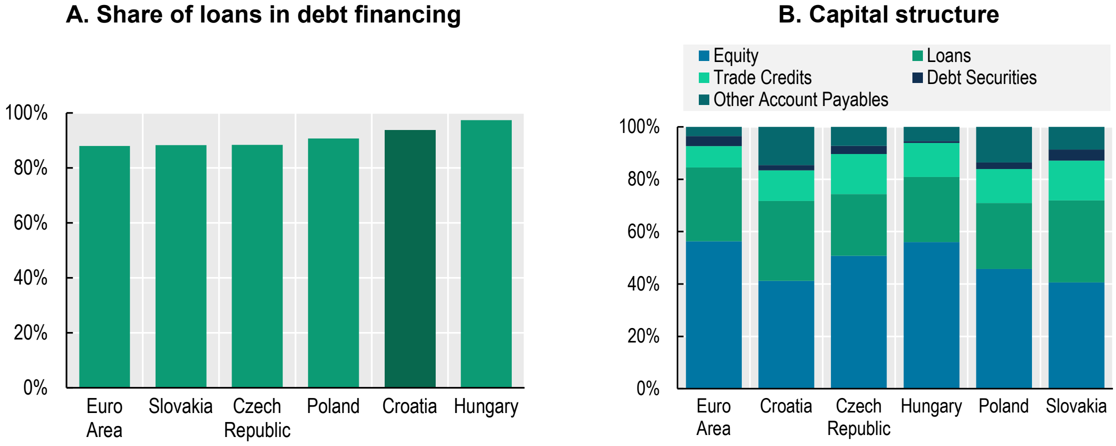
Figure 13. Sources of debt financing for non-financial companies, as of end 2019



Source: The ECB Statistical Data Warehouse Euro Area Accounts/National Tables

Within the Central and Eastern Europe (CEE) region, Croatia and Hungary have the highest share of bank lending in their debt financing structures (Figure 14, Panel A). The heavy reliance on bank financing by non-financial Croatian companies can also be seen in the capital structure when looking at corporate balance sheet data. Total liabilities account for almost 60% of the balance sheet of non-financial companies in Croatia, and more than half of it is in the form of bank loans. While the share of debt securities in the capital structure is only 2% in Croatia, the euro area average is 4% (Figure 14, Panel B).

Figure 14. Composition of liabilities of non-financial corporations, as of end 2019



Source: The ECB Statistical Data Warehouse Euro Area Accounts/National Tables

Banks generally tend to tighten credit standards during crisis periods when companies are in need of financing. In addition, banks in some economies are also constrained by accumulated non-performing loans on their balance sheets following periods of economic instability. Evidence shows that the availability of market-based financing instruments helped mitigate the impact of the bank loan contraction following the 2008 financial crisis. Moreover, bank credit shocks, unlike other sources of finance, are found to have a more significant and persistent negative impact on economic activity (Aldasoro, 2017). Additional evidence shows that the economic impact of the financial crisis and subsequent recessions was larger in bank-based financial systems than in market-based systems (Gambacorta, Yang and Tsatsaronis, 2014). Over-reliance on bank lending can therefore be an important obstacle to recovery for economies that have experienced a significant downturn.

While corporate bonds have become a significant source of corporate financing globally since the 2008 financial crisis, their use in Croatia has been minimal with only a couple of large companies issuing a few bonds during the last two decades. Between 2000 and 2019, Croatian companies raised EUR 8.7 billion through corporate bond issuances. In line with European corporate bond market trends, where non-financial companies dominate bond issuances, in Croatia non-financial companies' issuances account for 70% of this amount.

State-owned enterprises are not only important actors in the Croatian economy with revenues equivalent to 19% of GDP, they also play a crucial role in the capital markets. Importantly, one-third of the total value of corporate bonds issued between 2000 and 2019 was issued by state-owned enterprises. They were also responsible for four out of the ten largest bond issuances in the same period. The most frequent corporate bond issuers have been the non-financial SOEs – the Croatian national energy company HEP and the Croatian postal agency HP Hrvatska Posta. The only financial issuer has been the Croatian Bank for Reconstruction and Development. However, no Croatian SOE has raised capital through corporate bonds since 2015 and the largest amounts raised were by HEP on the Luxembourg Stock Exchange in 2012 and 2015 (Table 4).

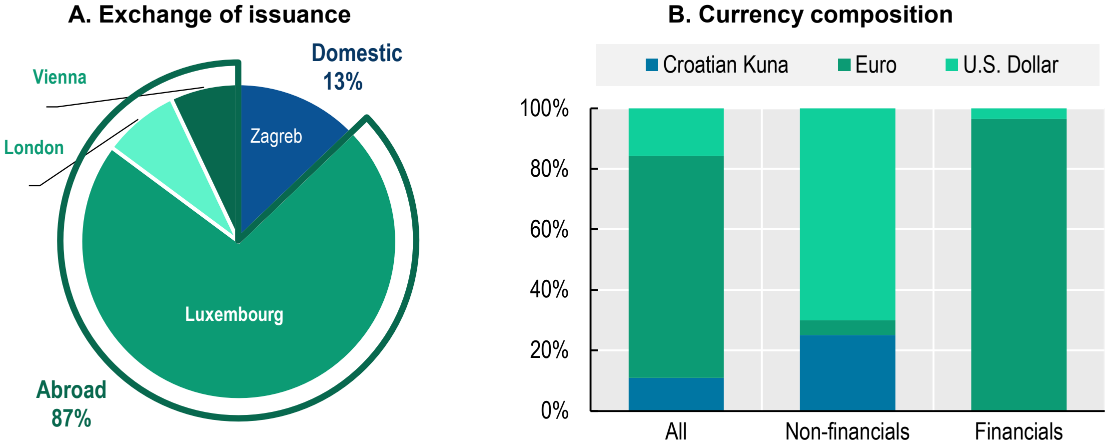
Table 4. Bond issuances by Croatian SOEs

Stock Exchange	Name	Year of issuance	Amount raised (2019, EUR million)	Currency	Industry
Luxembourg	Croatian Bk for Reconstr Dvlp	2001	49	USD	Financials
Luxembourg	Croatian Bk for Reconstr Dvlp	2002	127	EUR	Financials
Luxembourg	Croatian Bk for Reconstr Dvlp	2004	448	EUR	Financials
Luxembourg	Croatian Bk for Reconstr Dvlp	2007	370	EUR	Financials
Luxembourg	HEP dd	2012	497	USD	Utilities
Luxembourg	HEP dd	2015	522	USD	Utilities
London	Croatian Bk for Reconstr Dvlp	2006	218	EUR	Financials
Vienna	Croatian Bk for Reconstr Dvlp	2013	196	EUR	Financials
Zagreb	HEP dd	2006	85	HRK	Utilities
Zagreb	HEP dd	2007	115	HRK	Utilities
Zagreb	SC Visnjik doo	2008	11	EUR	Consumers
Zagreb	Rijeka Promet dd	2008	30	HRK	Industrials
Zagreb	HP Hrvatska Posta dd	2009	48	EUR	Industrials
Zagreb	Jadrolinija	2012	12	EUR	Consumers
Zagreb	HP Hrvatska Posta dd	2014	58	HRK	Industrials
Non-listed	HP Hrvatska Posta dd	2012	58	HRK	Industrials
Non-listed	Rijeka Promet dd	2014	20	HRK	Industrials

Source: OECD Capital Market Series Dataset.

Most Croatian SOEs have chosen a foreign venue to issue bonds. In terms of value, 87% of all bond issues have been listed abroad and only 13% on the Zagreb Stock Exchange (Figure 15, Panel A). Most bond issuances by Croatian SOEs have been listed on the Luxembourg Stock Exchange. Non-financial SOEs have issued bonds in euros, dollars and Croatian Kuna, whereas financial SOEs have only issued bonds denominated in euros and dollars (Figure 15, Panel B).

Figure 15. Main features of bonds issued by Croatian SOEs



Source: OECD Capital Market Series Dataset.

Many private Croatian companies have followed the same model, issuing bonds abroad and listing them on foreign exchanges. During the 2000-2019 period, almost one-third of the amount issued through bonds by private corporations was listed on the Luxembourg Stock Exchange and one-fifth on the Irish Stock Exchange. During the same period, only one-fifth was listed on the Zagreb Stock Exchange. It is noteworthy that foreign bond issuances are larger than domestic ones. The median foreign bond issuance is almost 10 times larger than the domestic median.

An important motive for issuing bonds abroad is access to a larger pool of investors. Another factor may be the cost of a domestic issuance compared to a foreign issuance. Table 5 provides the listing and maintenance fees for a corporate bond of EUR 500 million with a maturity of 5 years listed on different markets, namely the Luxembourg, Zagreb and Prague stock exchanges. As seen in the table, the Zagreb Stock Exchange has the highest listing and maintenance fees compared not only to Luxembourg, but also to the Prague Stock Exchange. Issuing and listing a bond on the Zagreb Stock Exchange is twice as costly as it is in Prague and three times more costly than issuing the same bond in Luxembourg. Some countries have introduced schemes to support issuers with the costs associated with listing a bond. For example, the Monetary Authority of Singapore (MAS) runs two schemes to incentivise listings, the Asian Bond Grant Scheme and the Sustainable Bond Grant Scheme, where listing and rating fees by can be partly covered by the authority for certain issuers (MAS, 2021a; MAS, 2021b). The European Commission has suggested National Promotional Banks can play a role in developing local corporate bond markets, and encourages the involvement of local industry associations, as well as support requests to the Structural Reform Support Service in the form of technical assistance (EC, 2017a).

Table 5. Cost of listing a EUR 500m bond with a 5 year maturity on different stock exchanges

	Luxembourg	Prague	Zagreb
Approval fee (EUR)	2 500	1 900	-
Listing fee (EUR)	1 200	-	13 000
Maintenance fee (EUR)	3 500	9 500	9 750
Total	**7 200**	**11 400**	**22 750**

Note: For simplification purposes, costs are calculated for a first time listing on the official markets of Zagreb Stock Exchange and Prague Stock Exchange.
Source: Zagreb Stock Exchange, Prague Stock Exchange and Luxembourg Stock Exchange websites.

Company size is also a key factor when evaluating corporate access to different financing options. While larger companies typically have continuous access to capital markets and other financing sources, SMEs are more restricted in their use of market-based financing. As a result, they mainly rely on banks for debt financing and are more exposed to a tightening in bank credit conditions compared to larger companies. In order to expand the financial options for smaller companies, many countries have developed debt markets dedicated specifically to SMEs. One example is the private placement markets that are used mainly by medium-sized companies in the United States, Germany, France and the United Kingdom. In addition, Italy has created a special framework, called the mini-bond framework, which enables unlisted SMEs to issue bonds with less strict requirements, i.e. without a rating and with a less costly issuance process compared to traditional bonds. Issuers can also list their mini-bonds on a segment of the stock exchange reserved for qualified investors (ExtraMOT Pro). The mini-bond market, which was established in 2012 has shown persistent growth, and during the first 6 years it allowed SMEs to raise EUR 10.6 billion. Mini-bonds have also been securitised through special purpose vehicles, helping to create a diversified pool of companies available for institutional investors. One example is the Basket Bonds supported by the ELITE program of the London Stock Exchange. Moreover, the mini-bond market framework has also enabled the creation of specialised debt funds targeting SMEs.

Bond issuances are typically accompanied by a credit rating that provides investors with information about the creditworthiness of the issuer. In general, easy access to rating firms and familiarity with the rating process significantly increase companies' ability to use long-term debt securities. While global rating agencies generally are focused on rating large corporations, domestic credit rating agencies provide services mostly to medium-sized companies. In

Europe, there are several domestic rating agencies registered by the European Securities and Markets Authority (ESMA). By the end of 2019, no credit rating agency (CRA) was registered in Croatia. This may to some extent be overcome by alternative credit rating systems dedicated to servicing smaller and medium-sized companies. For instance, in France, the central bank has introduced the FIBEN system (*Fichier bancaire des entreprises*) that collects and integrates all available financial information about individual firms and provides credit scores to investors or lenders for a certain fee paid. The system is accessible for credit institutions, insurance companies and asset management companies, among others. The central bank also performs an independent risk analysis of French enterprises that allows lenders to assess credit risks of potential clients at a low cost, which facilitates access to finance, in particular for small and mid-sized companies. In Croatia, this service could reasonably be provided by FINA, a state-owned agency which already offers general credit ratings and manages a database covering 95% of all business owners in Croatia (FINA, 2021).

Given the dominant role that SMEs play in the Croatian economy and the ambition to upgrade their competitiveness and integration into global value chains, the government created the Agency for Small Business, Innovation and Investment (HAMAG-BICRO) in 2014. The objective of this agency is to encourage the establishment and development of small businesses, investment in small businesses and more importantly to provide financing to such businesses. The financing options provided by HAMAG-BICRO are currently through traditional banking facilities such as loans and guarantees, and does not include debt securities.

The lack of activity in the Croatian corporate bond market also hinders the development of domestic intermediaries that can play a supporting role in promoting the use of corporate bond markets by non-financial companies. Market intermediaries, such as investment banks and investment firms, provide arrangement/underwriting services, analyse and disseminate information about bond-related risks to the market as well as provide derivative products to hedge against different risks. They also guide companies in preparing the necessary documentation for bond offering and in pricing the securities. In accordance with the Capital Market Act, the Croatian Financial Services Supervisory Agency (HANFA) keeps a register of firms authorised to provide investment services and perform investment activities. By the end of June 2020, there were 27 registered investment firms, credit institutions and fund management companies, of which thirteen were authorised to underwrite and/or place financial instruments. However, due to the very low activity levels in the market, they had almost no revenues generated through arrangement/underwriting of corporate bonds.

With respect to the ability to provide financing, the Croatian pension funds have the size to support the development of the domestic corporate bond market. However, their investments are mainly concentrated in government debt securities and the allocation to corporate bonds represented only 1.6% of AUM in 2019. Similarly, for insurance corporations, their allocation to corporate bonds represented only 3% of their total investments. In addition to the limited supply of corporate bonds, another factor that limits the exposure of large domestic institutional investors to the corporate bond market could be the uncertainty about rules related to investment limits. To provide clarity in this respect, some markets have established rating-based limits allowing pension funds to only hold investment grade corporate bonds (for example Korea and Mexico); or limits preventing pension funds from investing in corporate bonds not admitted to trading on regulated markets (for example Spain and Sweden) (OECD, 2019c).

Recommendation: Corporate bond markets have the potential to become a viable source of financing for Croatian companies and an attractive asset class for domestic and foreign investors. Such a move from over-reliance on short-term bank financing towards longer maturity corporate bonds would broaden investment opportunities for institutions, support long-term corporate investment and build a more resilient capital structure in the corporate sector. Decreasing the current costs of issuing a bond in the domestic market could be an important initial step to raise the attractiveness of the corporate bond market for Croatian companies. In particular, the lack of activity in the Croatian corporate bond market has hindered the development of domestic intermediaries, which has also resulted in higher intermediation costs. The authorities may evaluate the possibility of providing financial assistance through government support schemes for the costs incurred by a company when listing a bond and obtaining a credit rating. Further, in order to support the development of and liquidity in the Croatian market, the government may consider conducting bond issuances of state-owned companies in the domestic market. This would help domestic intermediary institutions obtain a critical size while also providing additional investment opportunities for institutional investors, in particular pension funds.

Given the lack of domestic rating agencies, the authorities may also consider an alternative credit rating mechanism where an institution provides rating services. This could be done by the state-owned Financial Agency (FINA), which has the general infrastructure in place since it already provides a general type of credit scoring service and has a database covering 95% of all Croatian business owners. Another consideration could be to introduce a special framework for smaller company bond issuances. Following successful examples in some other European economies, such as the mini-bond market framework in Italy, this could be in the form of specialised private placement markets or mini-bond markets. Having a dedicated market for smaller company bonds in the stock exchange could further help increase the attractiveness of the market for investors. The government may consider tasking HAMAG-BRICO with leading the development of such a framework, working with other public authorities and private sector actors.

5. Mobilising private capital markets

Using private capital markets is an increasingly important financing alternative for companies around the world, in particular for mid-sized companies that do not have the scale and resources needed to access public markets. Private capital providers, including venture capital (VC) and private equity (PE) funds, not only provide companies with long-term funding, but also support them in improving management practices and operational efficiency.

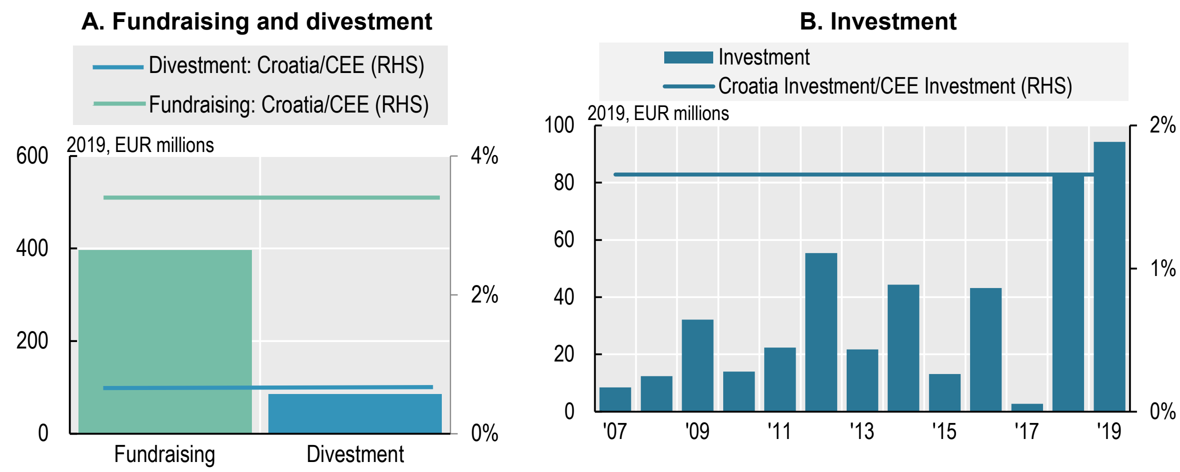
Despite the global trend, domestic private capital markets in Croatia remain underutilised and are dominated by a few actors. With respect to the fundraising stage of private equity, Croatia's share was 3.4% of the total funds raised in the CEE region, which is comparable to its share in GDP. By the end of 2019, five domestic PE funds were operating under the supervision of HANFA and established under the regime of Economic Cooperation Funds[11]

[11] Economic Cooperation Funds were established under the Law on Investment Funds (Official Gazette, No. 150/2005) and the Regulation for the participation of the Croatian Government in the establishment of the Economic Cooperation Funds (Official Gazette, No. 21/2010). FSGs were set up in 2010 and the government injected HRK 1 billion into the co-investment programme with the goal of increasing investor confidence in private equity markets.

(FGS) managing HRK 685 million (EUR 92 million) in total assets. In 2020, two additional PE funds[12] were established with the support of the Croatian Growth Investment Programme, which was funded by the European Investment Fund (EIF) and the Croatian Bank for Reconstruction and Development (HBOR). The programme was created in 2019 with a total investment of EUR 70 million and aimed at supporting Croatian SMEs and small midcaps.

Looking at the investment and divestment activities of private equity funds during the 2007-2019 period shows that the size of the Croatian market is small compared to its peer countries in the CEE region. For example, private equity investment and divestment in Croatia account for 1.7% and 0.66% of the total private equity activity in the CEE region, respectively, which are significantly lower than Croatia's 3.5% share in total regional GDP (Figure 16). Private equity investments in Croatia accounted for EUR 34 million per year on average, with a recent surge driven by a few large buyout transactions.

Figure 16. Private equity activity in Croatia (2007-2019)

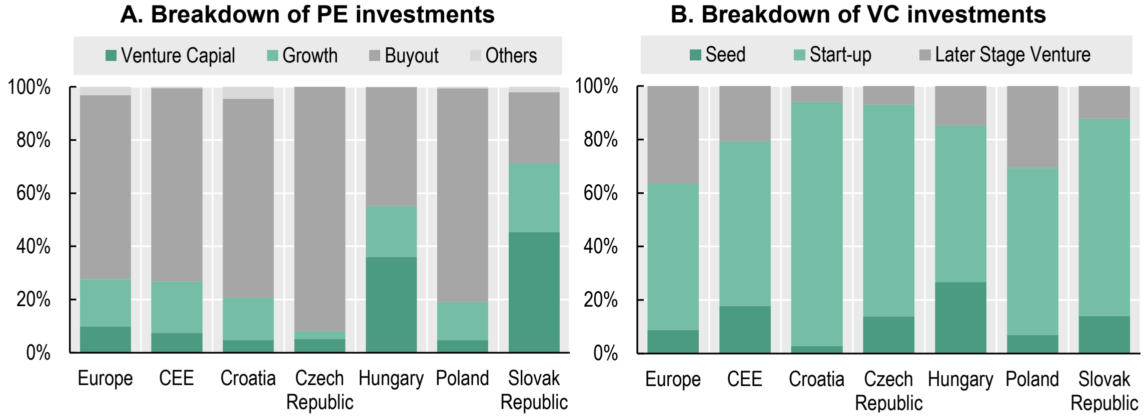


Source: Invest Europe / EDC.

Panel A of Figure 17 shows the breakdown of private equity investments by investment types in Croatia, in a number of other CEE countries as well as the averages for Europe. As seen in the figure, venture capital investments have generally been weak in Croatia compared to both the European and CEE averages. Particularly, in the last five years, the aggregate amount invested by venture capital funds was only EUR 11 million, amounting to only 5% of the total investments in Croatia. Most VC investments are concentrated in the start-up stage (91%), with only 3% in the seed stage and 6% in later stages (Panel B).

[12] The two newly set up PE funds are Prosperous Growth Fund and the Adriatic Structured Equity Funds.

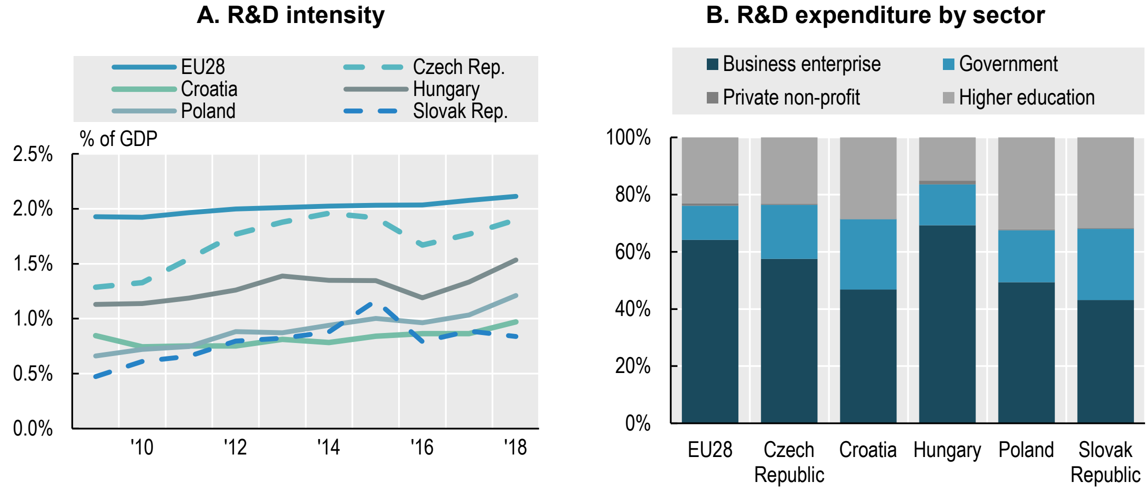
Figure 17. Type of investment in Croatia and selected European countries (2015-2019)



Source: Invest Europe / EDC.

The lack of a well-functioning ecosystem for venture capital financing in Croatia can also be seen as a barrier to corporate investments in research and development (R&D). According to the 2020 European Innovation Scoreboard, Croatia ranked 26th out of 28 countries in the EU (EC, 2020b). As seen in Panel A of Figure 18, R&D expenditure as a percentage of GDP is significantly lower than most peer countries. Despite a slight increase in recent years, total R&D expenditure in 2018 accounted for only 0.97% of GDP, compared to 1.9% for the Czech Republic and 1.5% for Hungary. Moreover, less than half of the R&D expenditure is related to business enterprises, with the government contributing to almost 30% of the spending (Figure 18, Panel B).

Figure 18. R&D intensity and distribution by sector



Source: Eurostat.

The Croatian Smart Specialisation Strategy (S3) for 2016-2020 identified the underdeveloped capital market, the low levels of business investment opportunities and the lack of divestment opportunities as the root of the limited VC industry in Croatia. The report identifies a number of reasons why VC funds are unable to provide early stage funding, namely the lack of more established companies to invest in, the longer time frames needed for investments in younger start-ups and the fact that the funds that private equity firms will use for their investments are too large for start-ups. In addition, the lack of adequate links between research institutions and the business sector has also been identified as a major barrier for corporate sector innovation in Croatia.

Against this background, the Croatian government and the European Investment Fund (EIF) jointly created the Croatian Venture Capital Initiative in 2018 to improve access to finance for SMEs and to develop the entrepreneurial ecosystem in Croatia. Following this initiative, the EIF and the Croatian Bank for Reconstruction and Development (HBOR) founded the venture capital fund Fil Rouge Capital, with EUR 42 million in fund capital. The aim of the fund is to invest in start-ups and to cultivate an entrepreneurial ecosystem. By the end of July 2020, the fund had made 50 investments.

Many successful venture capital markets around the world have been underpinned by government support in the early stages of development. Generally, there are two forms of government initiatives that can be employed in combination to encourage venture capital activity. The first is to create an economic environment and a regulatory framework that are supportive of entrepreneurship and VC activity, and the second is the establishment of publicly sponsored VC funds or fund-of-funds.

With respect to structural reforms aiming to improve the functioning of the venture capital ecosystem, countries have been using a range of different policy tools, including regulatory changes that facilitate foreign investor participation, entrepreneurship training programmes and tax incentives. Tax incentives are commonly implemented by governments to increase the supply of VC funds by reducing the cost of investing in such funds. The incentives can be provided in different forms, including tax deductions and tax exemptions. The most used form of tax incentive to promote the use of venture capital in EU countries is a tax credit (EC, 2017b). Another example of a tax regime that is designed to encourage venture capital investment is the UK's Seed Enterprise Investment Scheme (SEIS), which provides tax incentives in the form of income tax and capital gains tax reliefs. SEIS uses a set of criteria such as age and size to identify entrepreneurial firms that are eligible for investment by SEIS funds. The fund investors can claim back up to 50% of the investment they make in the SEIS funds in the form of income tax relief, benefit from a capital gains tax deferral for reinvestment, as well as loss relief in the case of poor performance. Since the SEIS was first launched in 2012, over GBP 1 billion has been raised and invested in 12 040 companies (HM Revenue and Customs, 2020).

For the second form of support, where the government provides funding for venture capital investments, one model is that funds are created and managed directly by public authorities. Alternatively, some governments have established fund-of-funds in order to co-invest with private investors in venture capital funds that are instead managed by private investors. This has been seen as an efficient way to attract capital from private investors and increase the efficiency of the use and management of public funds. For example, Israel and New Zealand have adopted this mechanism and set up government-sponsored venture capital funds-of-funds. These funds-of-funds have invested in private venture capital funds with a certain ratio to investment by private investors. The New Zealand Venture Investment Fund (NZVIF) invests on a 1:2 ratio in other funds, which means that for 1 New Zealand dollar (NZD) invested by NZVIF, another 2 NZD are required to be invested by private investors. Requiring matching funds from private investors ensures that governments can better allocate their funds in accordance with the needs and priorities of the market. Private investors have an additional incentive to participate in these funds, since they have the option to acquire the government's fund shares at nominal value plus a fixed pre-defined interest after the initial investments.

With respect to the tax treatment of private equity investments in Croatia, private equity and venture capital funds are subject to different tax treatment depending on their beneficiaries. For individual investors, both capital gains and dividends are subject to a withholding tax of 12%. For corporate investors, the tax treatment differs between foreign and domestic investors. While domestic corporate investors are subject to a corporate income tax of either 18% or 12% depending on the revenue, foreign corporate investors are subject to a withholding tax of 12%.

Recommendation: Private capital markets represent an important alternative source of financing for companies seeking capital to realise new product development and expansion plans. In particular, private market financing is critical for smaller companies with high growth potential as they have not yet reached the size needed to access public markets. Moreover, firms with a large share of intangible assets or negative cash flows in the start-up phase cannot rely on bank financing, which otherwise dominates the corporate finance landscape in Croatia. Private capital can therefore play a critical role in supporting Croatia's efforts to diversify its economic activity beyond the tourism sector, and to increase investments in R&D, innovation and human capital. To support the development of Croatian private capital markets, coordinated efforts from the public authorities, the private sector and research institutions are needed.

The Croatian Smart Specialisation Strategy (S3) adopted by the government has already identified clusters of specialisation that fit the country's innovation potential and can boost integration into global value chains. Priority should be given to eligible companies within the selected S3 clusters that show high growth potential with a view to improving their capacity for expansion. This could include financial support in the form of grants, management programmes and supporting the preparations of a growth strategy. Since most companies in Croatia lack the necessary scale to attract international venture capital investments, the existing government related funds may further emphasise seed capital financing that is used to support the creation of a pool of larger companies.

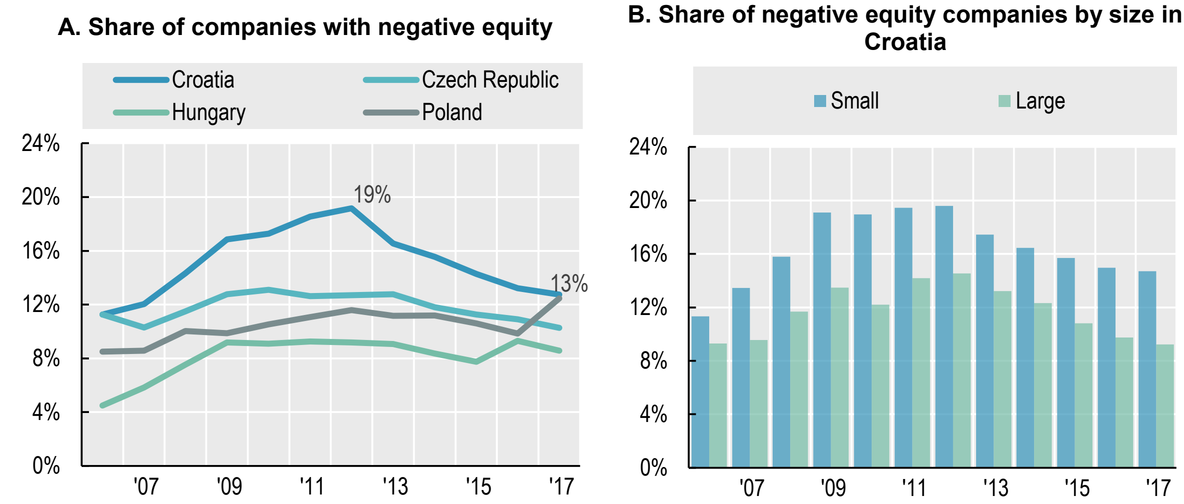
The Croatian authorities may also consider creating a co-operation programme encouraging more links between research institutions and the business sector. The programme could include the possibility of providing funding to research institutions in areas related to any of the S3 objectives, and the creation of platforms where start-ups can present their ideas in order to attract the seed money to fund them. To further encourage the integration between universities and venture companies, start-up work experience could be integrated in the academic curriculum.

6. Strengthening corporate balance sheets and improving the insolvency framework

A large number of Croatian companies receive no external finance and rely solely on their own equity buffers and retained earnings as sources of funding. This is particularly the case for smaller companies. The share of companies without any type of financial debt on their balance sheet grew from 17% in 2006 to 31% in 2017. This also includes 11% of the large unlisted companies. At the same time, their low return on equity does not allow them to finance investments in human capital and physical assets that are necessary to achieve higher productivity, increased profits and expansion (see Chapter I, section 1.4). This leaves many Croatian companies in a static state with equity capital provided only by the owners and their family and/or friends. There are also many companies with zero or negative equity.

In Croatia, the share of companies with negative equity was higher than in European peer economies in every year between 2006 and 2017. Following the 2008 global financial crisis, their share reached a peak of 19% of the total number of companies in 2012. Despite a declining trend since then, at the end of 2017 13% of companies still had either no or negative equity on their balance sheets (Figure 19, Panel A). There are more companies with negative equity among the smaller companies with total assets below the median asset size (Figure 19, Panel B). In most cases, negative equity on the balance sheet is a result of accumulated losses from previous periods. Negative equity does not mean that the company is in technical insolvency, but may significantly limit its ability to raise any additional capital even if there are good investment opportunities.

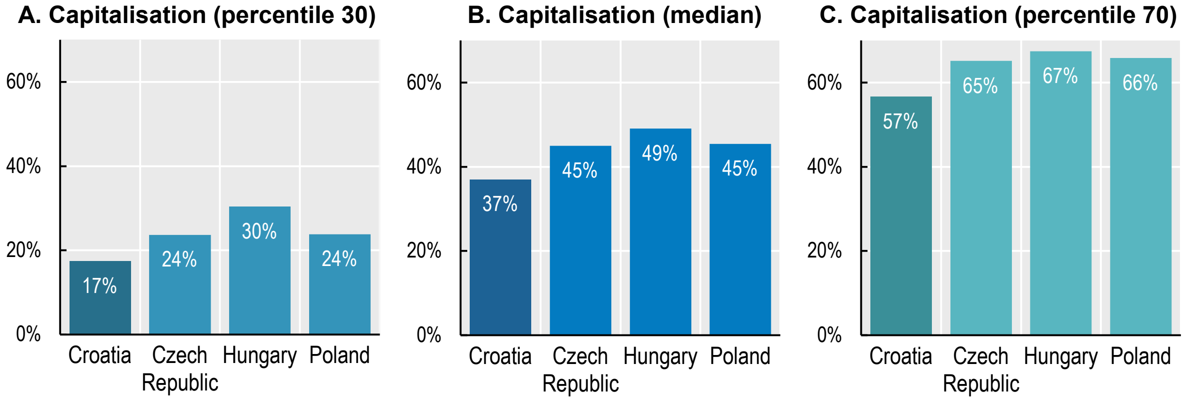
Figure 19. Negative equity companies



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

In addition to the large share of companies with negative equity, Croatian companies that have equity on their balance sheets also show low levels of capitalisation compared with companies in peer countries. Figure 20 provides a cross-country comparison of the 2017 levels of capitalisation for companies that correspond to percentiles 30, 50 (median) and 70 of the distribution of companies in each country. Across the distribution, Croatian companies exhibit lower levels of equity capital on their balance sheets compared to the peer countries.

Figure 20. Equity capital levels at the company level



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Many countries, including Belgium, Italy and Norway, have adopted special tax regimes on equity capital to level the treatment of debt and equity financing. One of these special regimes is the allowance for corporate equity (ACE), a form of which was also adopted by Croatia between 1994 and 2000 (IMF, 2006). The ACE corrects for the differential tax treatment of debt and equity by providing a deductible allowance for corporate equity when calculating the corporation's taxable profits (OECD, 2007). Similar to the tax shield provided by debt interest payments, the ACE allows the company to deduct from its taxable income an amount equivalent to a predefined nominal interest rate over the equity capital. In Italy, for example, the benefit was granted to new equity capital injections. Evidence from the Italian manufacturing sector shows that the introduction of the ACE system did lower the leverage of the companies that benefitted from it (Branzoli and Caiumi, 2018).

The amount and terms of the capital provided to companies by external capital providers, both in the form of equity and debt, are dependent on the regulatory framework that protects investors and lenders, and sets the conditions for restructuring when companies face difficulties in honouring their commitments. In Croatia, the Bankruptcy Act (Official Gazette, No. 71/2015) is the main law governing insolvency and restructuring procedures. The framework offers two separate regimes for firms that are experiencing liquidity and/or insolvency issues. A voluntary pre-bankruptcy settlement procedure exists, and is initiated by debtors (companies) in the early stages of liquidity and/or solvency problems. The debtors' main objective is to restructure their obligations and execute a restructuring plan. The formal bankruptcy procedure under the Bankruptcy Act is intended for businesses that are not able to reach an agreement with their creditors. After going through the procedure of the Bankruptcy Act, companies can either be liquidated or restructured following a plan agreed by the majority of their creditors (EBRD, 2016).

Among the main actors involved in the pre-bankruptcy procedure, the insolvency office holder (IOH) plays the role of the pre-bankruptcy trustee or insolvency trustee. An IOH is appointed by the court upon receiving the motion for pre-bankruptcy settlement proceedings. There is s list of certified IOHs, which may co-manage the debtor and supervise its disbursements. In the bankruptcy procedure, the IOH is known as the insolvency trustee and is appointed by the court. In this case, the creditors can elect a replacement insolvency trustee. The IOH represents and exercises the rights of the debtor's management body and manages the debtor's business. The IOH is supervised by the court and the creditors. However, it has been pointed out that some aspects of the framework on how IOHs operate in Croatia can be improved. For example, there is no single body regulating IOHs and probably this is what has led to the lack of proper sanctions for IOHs, of a separate complaint procedure regarding IOHs, and of a code of conduct for IOHs, as well as the fact that their appointment does not require the inputs of other stakeholders. In addition, their qualifications can be made more suitable and training can be offered (EBRD, 2016).

In a global comparison, Croatia ranks 26th in the insolvency regulatory framework and 77th in insolvency recovery rate out of 139 countries in the 2019 Global Competitiveness Index produced by the World Economic Forum (WEF). In comparison, the Czech Republic and Poland both rank 9th in insolvency regulatory framework and have the 27th and 38th places in insolvency recovery rate, respectively. The low recovery rates in Croatia may be related to the limited flexibility provided to the company management to operate under the insolvency framework. According to the Bankruptcy Act in Croatia, during pre-bankruptcy procedures the debtor is only allowed to make regular payments necessary for regular operations and is prevented from engaging in other operations. In some other countries, such as the United States and the United Kingdom, companies may obtain unsecured credit and incur unsecured debt during the insolvency process. The Croatian framework does not provide for the possibility of the debtor to obtain credit after the insolvency proceedings are initiated (Official Gazette, No. 71/2015).

The sharp drop in sales that large parts of the corporate sector experienced in the wake of the COVID-19 pandemic has caused acute liquidity pressures and growing insolvency concerns. Against this background, on April 30th 2020, the Act on Intervention Measures in Enforcement and Bankruptcy Proceedings during Special Circumstances was adopted and came into effect on May 1st for the duration of three months, which was later extended for another three months until November 1st. According to this Act, insolvency events arising during special circumstances such as the COVID-19 crisis would not be a prerequisite for filing petitions for insolvency proceedings. In addition, the government introduced a standstill that suspends the execution of enforcement proceedings against all debtors.

The lack of a common insolvency framework has long been seen as one of the main barriers to the development of a more integrated European capital market. Given this background, the Directive on restructuring and insolvency was adopted by the European Union in mid-2019 as part of the Capital Markets Union agenda. The Directive includes two features that are particularly relevant in the context of the COVID-19 crisis (i) a cross-class cram-down mechanism whereby the plan might be forced on dissenting creditors in a class and across classes and (ii) protection for new financing that comes in as part of the restructuring plan.

Recommendation: The observed equity gap in Croatian companies hampers their ability to expand and to recover sustainably from the COVID-19 crisis. To support new equity capital injections into the companies, the government may consider evaluating the benefits of introducing a special tax regime such as the allowance for corporate equity (ACE). The current crisis should also be seen as an important opportunity to speed up the process of implementing the new EU Directive on insolvency and restructuring. This would help Croatia attract investors from other European economies. Special attention could be given to providing mechanisms that facilitate the restructuring procedure to avoid liquidation. The role and functions of the insolvency office holder (IOH) could also be improved, for example by assigning a single regulatory body for IOHs that oversees their functioning more effectively. This body could also be responsible for applying proper sanctions, offering a separate complaint procedure and establishing a code of conduct for IOHs. Offering training and certification opportunities to IOHs may also be considered.

PART II

CORPORATE SECTOR AND THE CAPITAL MARKET LANDSCAPE IN CROATIA

CHAPTER I. THE CROATIAN CORPORATE SECTOR

Since the early 1990s, Croatia has undergone a transition from a centrally planned system to an open market economy. In 2000, Croatia joined the World Trade Organization (WTO) and in 2013 became a member of the European Union. Prior to the 2008 global financial crisis and the subsequent sovereign debt crisis in Europe, a strong growth performance helped Croatia converge with more advanced European economies in terms of income levels as well as the quality of legal and institutional frameworks.

However, the economy was strongly affected by the global financial crisis and was only able to reach positive growth rates again in 2015. Maintaining positive growth rates between 2015 and 2019 helped the country reduce its indebtedness and improve its public finances. Solid budget management and sound Central Bank policies during this period contributed to employment growth, wage growth and subdued inflation.

Despite these improvements, Croatia entered the COVID-19 crisis with some structural weaknesses in the economy, including a need to broaden the economic activities beyond tourism, to renew the economy's capital stock and further invest in physical infrastructure. Importantly, already before the crisis, the level of corporate investment in research, innovation and new technologies was low and Croatian corporations were not sufficiently integrated with global value chains.

In order to achieve a more resilient and dynamic business sector that will underpin a sustainable recovery from the COVID-19 crisis, it will be essential to improve the conditions for Croatian companies' access to long-term market-based finance. In the effort to facilitate this, it is essential to first understand the characteristics of the Croatian business sector and how it is financed. Therefore, this chapter provides indicators and analysis on non-financial Croatian companies' demographics, capital structure and performance. Although some data in the chapter represent the pre-COVID-19 landscape, they still provide useful insights for understanding some of the underlying structural challenges.

1.1. Overview of the economy

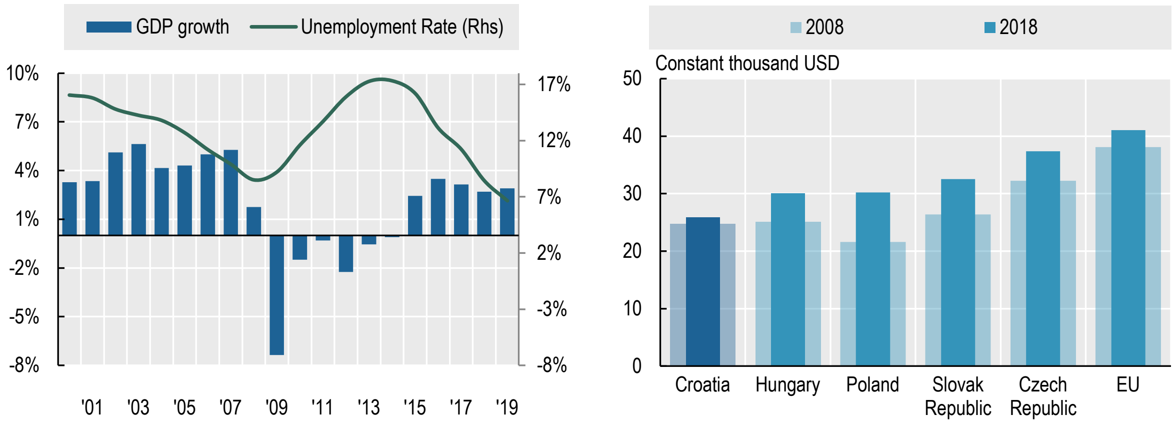
Similar to most other European economies, Croatia was in recession between 2009 and 2014 following the global financial crisis and sovereign debt crisis in Europe. With the help of strong tourism revenues and private consumption induced by lower taxation together with the positive effects of EU accession on trade, the economy started to recover from the crises in 2015 (IMF, 2020). In the following four years up to 2019, real economic growth was around 3% on average (Figure 21, Panel A). However, the COVID-19 outbreak at the beginning of 2020 and the subsequent containment measures introduced by the authorities led to a rapid and significant decline in the economic activity during the first half of the year. This decline was to a large extent driven by the decline in the tourism industry, which represents an important part of the economy. It is estimated that the country's GDP contracted by 8.9% in 2020 (EC, 2021).

Croatia's strong convergence performance in terms of income levels with more advanced European countries in the first half of the 2000s did not continue during the past decade. As illustrated in Panel B of Figure 21, Croatia showed the lowest improvement in per capita GDP level compared to its peer countries and to the EU average between 2008 and 2018. Despite improvements in GDP growth between 2015 and 2019, per capita GDP levels remained far behind the EU average and other peer economies.

The labour market has recovered very well from the crisis period with unemployment rate decreasing from its highest level of 17.3% in 2014 to 6.6% in 2019. This was the lowest level of unemployment during the last two decades (Figure 21, Panel A).

Figure 21. GDP and unemployment in Croatia, and comparison with per capita GDP in Europe

A. GDP growth and unemployment **B. GDP per capita at constant prices**

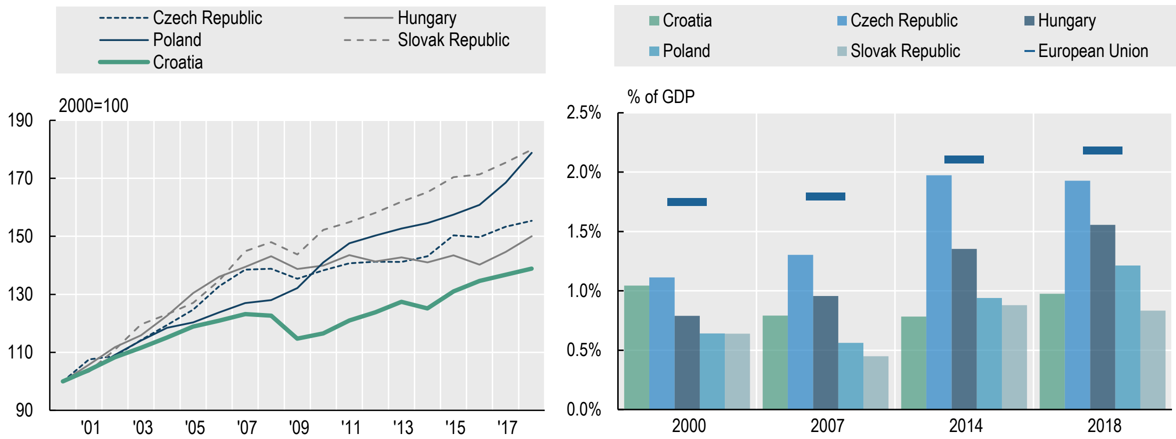


Source: Croatian National Bank Statistics Main Macroeconomic Indicators, OECD National Accounts.

In terms of labour productivity, measured as the GDP contribution per hour worked, Croatia lags behind its peers and remains well below the EU average. By the end of 2018, labour productivity in Croatia was on average around 65% of that in the European Union. Moreover, in terms of the labour productivity growth, since 2000, Croatia has had the lowest improvement among its peer countries (Figure 22, Panel A). One possible explanation for the lower productivity level is that the Croatian economy relies mostly on the low productivity tourism sector (OECD, 2019d). Importantly, the country faces demographic challenges with regard to its labour force, which is expected to decline significantly in the upcoming decades mainly as a result of low birth and high mortality rates, and continued outward immigration (EBRD, 2018).

Figure 22. Labour productivity and R&D expenditure

A. Labour productivity growth **B. R&D expenditure**

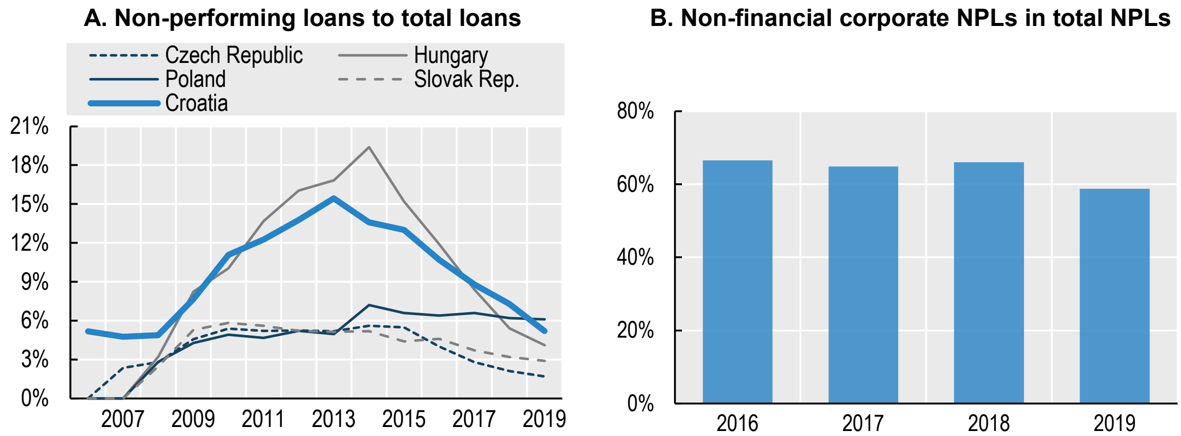


Source: OECD Productivity Statistics, World Bank.

An important contributing factor to the long-term productivity growth and business sector dynamism is the level of research and development (R&D) expenditure in an economy. The total R&D expenditure in Croatia as a percentage of GDP was 0.97% according to 2018 data. This level puts Croatia, together with the Slovak Republic, at the bottom of the R&D intensity ranking among peer countries (Figure 22, Panel B). In addition to low R&D intensity, skills shortages and weaknesses in the business environment have also been offered as other factors contributing to low productivity growth in Croatia (EC, 2020a).

Over the past decade, an additional factor that has been discussed in the context of the low productivity growth in Croatia is the non-performing loans (NPLs) in the banking sector. It has been claimed that the increasing level of corporate NPLs had a strong negative impact on the overall productivity growth between 2006 and 2014 (EBRD, 2018). Particularly, in times of economic instability, high levels of NPLs and provisions set aside to cover future losses can significantly hamper the credit supply and therefore the economic growth in general (EBC, 2012). With the help of policies introduced, including with respect to the sales of NPLs, Croatia significantly decreased its overall NPL ratio by 8 percentage points from 14% in 2014 to 5% in 2019 (Figure 23, Panel A). However, as shown in Panel A of Figure 23, banks in Croatia still had a relatively high NPL ratio compared to European peer countries at the end of 2019. Importantly, the NPL ratio for corporations is more than twice that of households, 13.7% and 5.9% respectively. As a result, NPLs of non-financial corporations represent around 60% of the total value of NPLs in the banking sector (Figure 23, Panel B).

Figure 23. Bank loans and non-performing loans in Croatia

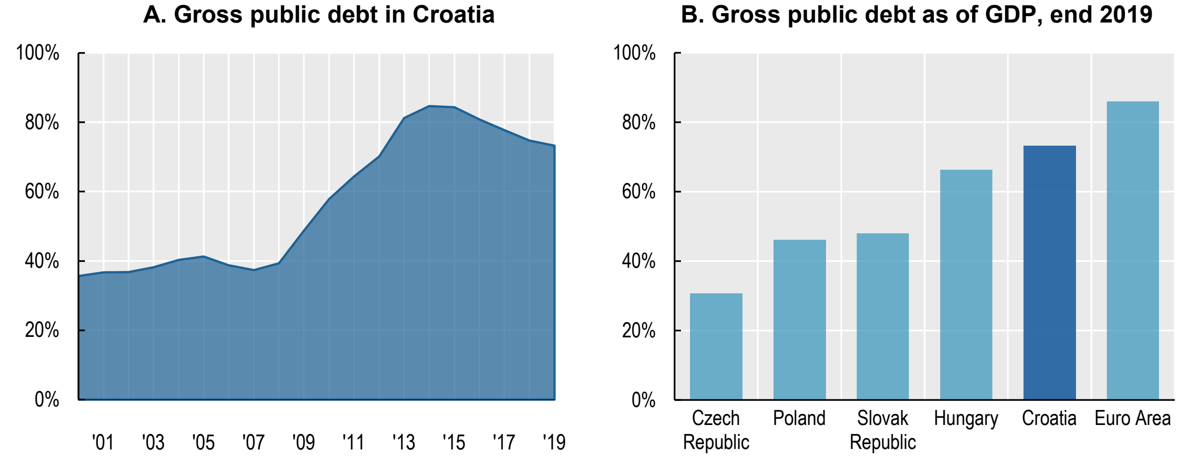


Note: For Panel A, data from 2014 onwards come from Eurostat. Prior years use IMF Financial Soundness data. For the Czech Republic, IMF data is also used for 2014 and 2015 due to limited Eurostat coverage.
Source: Eurostat, IMF Financial Soundness Indicators, Croatian National Bank Statistics.

Another important development in Croatia since the 2008 global financial crisis has been the significant increase in public debt. Public debt to GDP more than doubled between 2007 and 2014, and reached 85% at the end of 2014 (Figure 24, Panel A). Following the fiscal consolidation in recent years, the debt-to-GDP ratio has declined by more than 10 percentage points reaching 73% of GDP in 2019. As a result of the efforts to reduce debt levels, balance the budget and improve economic growth, in 2019 Croatia's sovereign debt was upgraded from non-investment grade to investment grade status by two major rating agencies.

Nevertheless, Croatia's public debt level remains elevated compared to other European peer countries. As seen in Panel B of Figure 24, the Czech Republic, Poland and the Slovak Republic recorded significantly lower levels of debt compared to Croatia at the end of 2019. The Euro area as a whole shows greater levels of debt as many investment grade European economies are highly indebted. Following the COVID-19 crisis, it is forecasted that Croatia's general government debt will increase along with other European countries. At the same time, public finances will also worsen as a result of the considerable fiscal package aimed at supporting businesses and households hit by the COVID-19 crisis. The combined effect is expected to increase Croatia's general government debt up to 90% of GDP by the end of 2020 (EC, 2020d).

Figure 24. Gross public debt in Croatia and selected European countries



Note: Refers to the Maastricht criterion gross public debt.
Source: ECB Statistical Data Warehouse, OECD Economic Outlook 107 database.

1.2. Business demographics

Business demographics in Croatia show some differences when compared to its peer countries. In Table 6, companies are classified into four categories according to their number of employees: micro (1 to 9 employees); small (10 to 49 employees); medium (50 to 249 employees); and large (over 249 employees). Small and medium-sized enterprises (SMEs) account for over 99.7% of the number of companies in all countries. In Croatia, micro firms accounted for 90.9% of all non-financial firms, while small and medium-sized enterprises accounted for 7.6% and 1.3% in 2017, respectively. Croatia has the highest share of large companies compared to its peer countries with 0.3% of all Croatian firms having more than 250 employees.

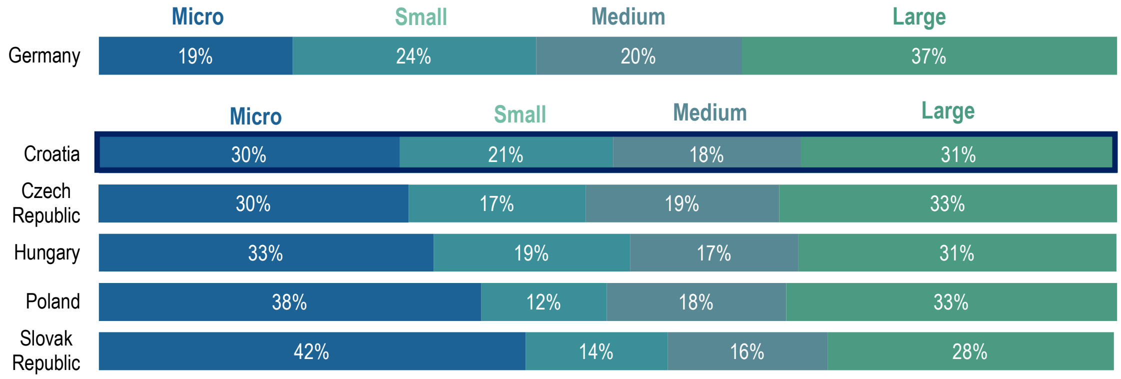
Table 6. Distribution of companies by firm size, 2017

	Croatia	Czech Republic	Hungary	Poland	Slovak Republic
SMEs	**99.7%**	99.8%	99.8%	99.8%	99.9%
Micro	**90.9%**	96.0%	94.1%	95.8%	97.0%
Small	**7.6%**	3.2%	4.9%	3.1%	2.4%
Medium	**1.3%**	0.7%	0.8%	0.9%	0.5%
Large	**0.3%**	0.2%	0.2%	0.2%	0.1%

Source: OECD SDBS Structural Business Statistics.

Although SMEs as a group account for more than 99.7% of the companies in all European countries shown above, there are some differences with respect to their share in total employment and productivity levels as well as the distribution of SMEs among different sub-groups. For example, micro firms in Croatia, together with Hungary and the Czech Republic, account for around 30% of total employment, whereas in Germany, micro firms account for only 19% of employment (Figure 25). Large firms in Croatia and all other peer countries account for around 30% of total employment, but 37% in Germany.

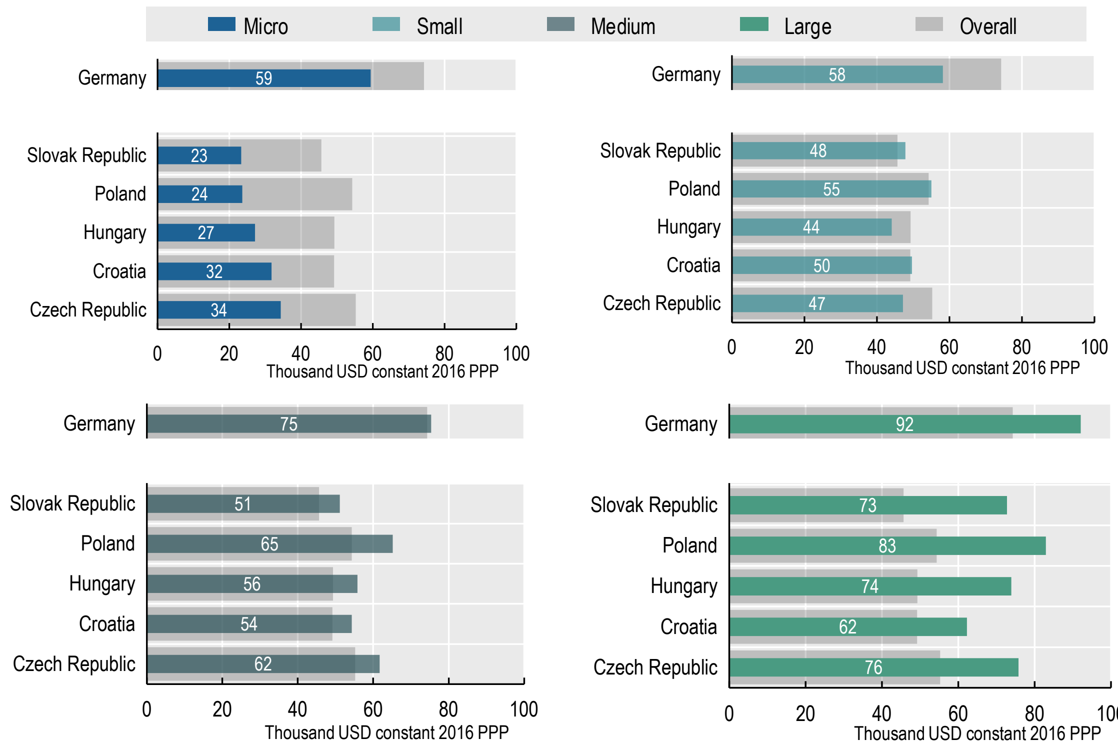
Figure 25. Employment distribution by firm size, in 2017



Note: The figures correspond to the sector "Business economy, except financial and insurance activities" according to the International Standard Industrial Classification of All Economic Activities (ISIC) Rev. 4.
Source: OECD SDBS Structural Business Statistics.

Importantly, companies of different sizes exhibit different levels of productivity. Large companies have the highest productivity levels across countries (Figure 26). Although Croatia has the highest share of large companies among its peers (see Table 6), their productivity level at USD 62 thousand per person employed is by far the lowest. Croatian micro and small firms, on the other hand, have the second highest level of productivity among their peers in other countries. Germany, shown as a benchmark, has the highest productivity levels across all company size groups.

Figure 26. Labour productivity by firm size, in 2016



Note: 2016 productivity values are provided for the country comparison. The figures correspond to the sector "Business economy, except financial and insurance activities" according to the International Standard Industrial Classification of All Economic Activities (ISIC) Rev. 4.
Source: OECD SDBS Structural Business Statistics

When decomposing companies by size and industry, companies from three industries represent the majority of companies in terms of the number of firms in Croatia: *wholesale and retail trade*; *professional, scientific and technical activities;* and *accommodation and food service activities* (Table 7). These three industries together account for almost 55% of the total number of companies in Croatia and have the highest share of micro companies. However, in *manufacturing* with *wholesale and retail trade activities*, small, medium and large companies account for the large majority of companies.

Table 7. Distribution of Croatian firms by industry in 2017
(as per cent of total number of companies in each size category)

	Micro	Small	Medium	Large	All
Accommodation and food service activities	13.6%	13.0%	6.8%	7.0%	13.5%
Administrative and support service activities	5.1%	4.0%	5.2%	6.5%	5.0%
Construction	12.0%	14.1%	12.5%	6.0%	12.2%
Electricity, gas, steam, cold and hot water and cold air	0.5%	0.4%	0.7%	1.4%	0.5%
Information and communication activities	4.7%	4.6%	4.1%	4.1%	4.7%
Manufacturing	11.9%	24.5%	34.8%	40.1%	13.2%
Professional, scientific and technical activities	18.2%	8.3%	4.9%	1.2%	17.2%
Real estate activities	3.5%	1.3%	0.4%	1.0%	3.2%
Transportation and storage	5.8%	5.7%	5.9%	7.7%	5.8%
Water supply; sewerage, waste management and remediation activities	0.3%	2.4%	5.7%	3.1%	0.6%
Wholesale and retail trade; repair of motor vehicles and motorcycles	24.4%	21.5%	19.0%	21.7%	24.1%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Note: In accordance with the International Standard Industrial Classification of All Economic Activities (ISIC) Rev. 4, the total corresponds to the Business economy, except financial and insurance activities.
Source: OECD SDBS Structural Business Statistics.

With respect to the employment distribution, the top three industries employing most of the Croatian workforce are *manufacturing; wholesale and retail trade;* and *accommodation and food service activities*. In total, almost 60% of the workforce is employed in these industries (Table 8). Within the group of small, medium and large enterprises *manufacturing,* and *wholesale and retail trade activities* employ over 48% of the total number of employees in each group. While for micro companies *wholesale and retail trade* is followed by *accommodation and food service activities,* and *professional, scientific and technical activities*.

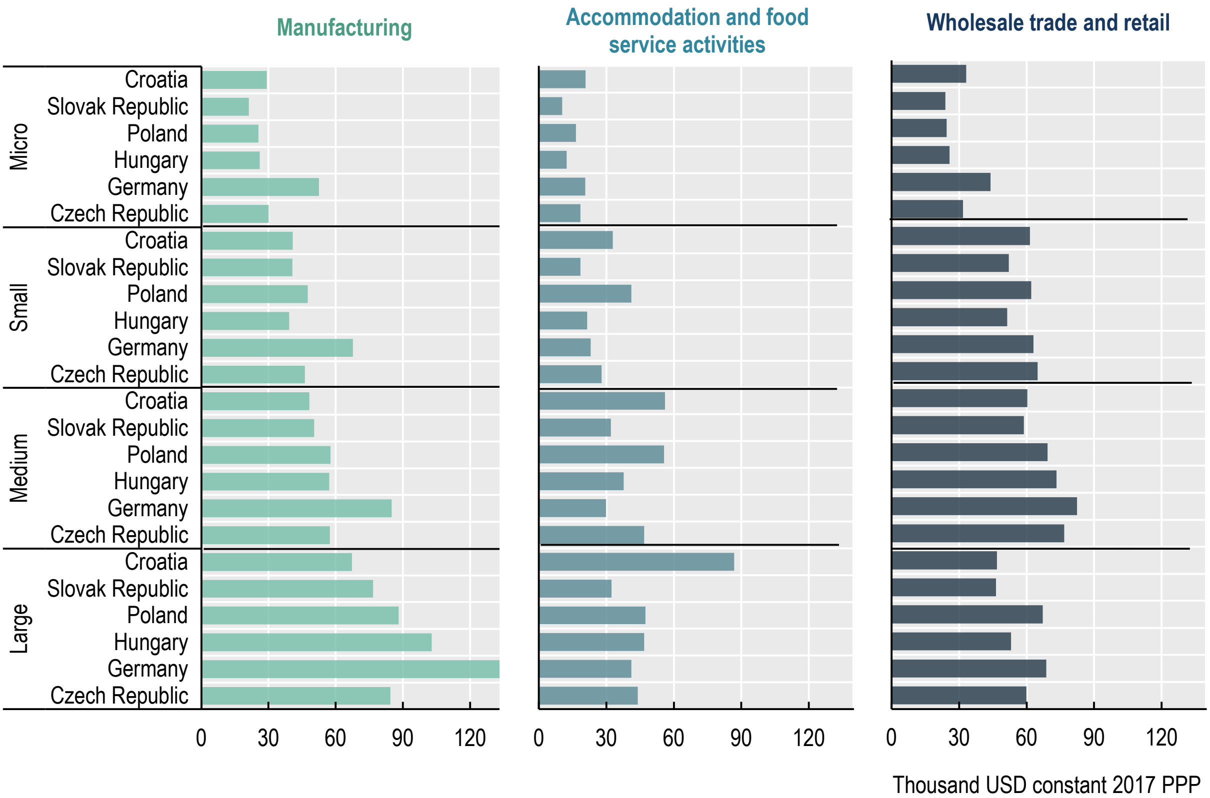
Table 8. Employment distribution in Croatia by company size and industry in 2017
(as per cent of total employment in each size category)

	Micro	Small	Medium	Large	All
Accommodation and food service activities	16.6%	11.5%	6.5%	6.0%	10.4%
Administrative and support service activities	4.4%	4.2%	5.4%	7.8%	5.6%
Construction	12.9%	14.1%	11.9%	3.6%	10.1%
Electricity, gas, steam, cold and hot water and cold air	0.3%	0.5%	0.6%	3.8%	1.5%
Information and communication activities	4.0%	4.5%	3.9%	4.2%	4.2%
Manufacturing	13.3%	26.6%	36.3%	33.0%	26.4%
Professional, scientific and technical activities	15.9%	7.7%	4.4%	0.9%	7.4%
Real estate activities	2.3%	1.3%	0.4%	0.8%	1.3%
Transportation and storage	5.8%	5.6%	6.5%	13.5%	8.3%
Water supply; sewerage, waste management and remediation activities	0.4%	3.0%	6.1%	1.7%	2.4%
Wholesale and retail trade; repair of motor vehicles and motorcycles	23.9%	21.0%	17.9%	24.8%	22.5%
Total	**100%**	**100%**	**100%**	**100%**	**100%**

Note: In accordance with the International Standard Industrial Classification of All Economic Activities (ISIC) Rev. 4, the total corresponds to the Business economy, except financial and insurance activities.
Source: OECD SDBS Structural Business Statistics

In order to explore in detail the labour productivity levels in the dominant industries, Figure 27 plots the labour productivity in Croatia by firm size and compares it with European peer countries. Productivity levels across different size classes show a very similar trend to the overall picture provided in Figure 26. In Croatia, larger companies show higher levels of productivity, except for the large segment of companies operating in *wholesale trade and retail*. Notably, large Croatian companies operating in the *accommodation and food service activities* industry are 1.6 times more productive than the medium-sized ones operating in the same industry and over 4 times more productive than their micro peers. While Croatian SMEs operating in the *wholesale trade and retail* industry are more productive than SMEs operating in the other two industries, the opposite is true for large firms as they show the lowest productivity. With respect to size categories, the productivity gap is particularly marked between micro firms and the rest in all countries. For example, productivity levels of medium-sized firms are almost 2 or 3 times that of micro firms in all countries. Considering that almost one-third of Croatian employment is in micro firms, this creates a major drag on overall national productivity compared with, for example, Germany where 19% of all employment is concentrated in micro firms where productivity is also higher.

Figure 27. Labour productivity by firm size for selected industries



Note: Sectors classification is in accordance with the International Standard Industrial Classification of All Economic Activities (ISIC) Rev. 4.
Source: OECD Structural Business Statistics.

1.3. Company categories in Croatia

This section describes how companies are classified and grouped for the analysis that follows. Using financial and ownership information from the ORBIS database, sections 1.4 and 1.5 present an analysis of business dynamics in Croatia and compares it with selected European peer countries. The analysis includes only non-financial companies with more than 10 employees. The rationale for choosing a size threshold of 10 employees is twofold: first, data coverage typically increases with firm size meaning that the coverage for smaller firms is less reliable which hampers comparability. Second, the focus of this report is on market-based financing and micro-firms are, in general, unlikely to tap capital markets.

The OECD-ORBIS Corporate Finance dataset includes financial and ownership information for non-financial companies between 2006 and 2017. To evaluate the representativeness of the data against the official statistics, Table 9 compares the coverage of the OECD-ORBIS Corporate Finance dataset with the Eurostat business statistics. The OECD-ORBIS dataset generally has similar coverage as Eurostat for small firms and a higher coverage for medium and large firms. Moreover, the distribution of firms across different size groups is also similar for both datasets.

Table 9. Comparison of the OECD-ORBIS Corporate Finance dataset and the Eurostat universe

	Small		Medium		Large	
	No. of companies	*Share in total*	*No. of companies*	*Share in total*	*No. of companies*	*Share in total*
Croatia – Eurostat	11 250	83.2%	1 861	13.8%	416	3.1%
Croatia – ORBIS	12 911	83.4%	2 112	13.6%	462	3.0%
Czech Rep. – Eurostat	32 292	79.1%	6 895	16.9%	1 619	4.0%
Czech Rep. – ORBIS	26 298	75.5%	6 852	19.7%	1 684	4.8%
Hungary – Eurostat	27 775	83.6%	4 516	13.6%	935	2.8%
Hungary – ORBIS	32 398	82.0%	5 872	14.9%	1 223	3.1%
Poland – Eurostat	52 955	73.6%	15 501	21.6%	3 464	4.8%
Poland – ORBIS	48 519	71.0%	15 527	22.7%	4 306	6.3%
Slovak Rep. – Eurostat	11 154	78.3%	2 517	17.7%	581	4.1%
Slovak Rep. – ORBIS	15 496	80.4%	3 095	16.1%	674	3.5%

Note: The table shows figures by end-2017.

Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

One potential weakness of analysing the investment and financing structure of the business sector in an economy is treating the whole non-financial corporate sector as one entity without taking into account differences with respect to key characteristics, such as size, listing status and industry. From a corporate finance perspective, it may also be important to know if a company is part of a larger company group. To overcome these shortcomings, non-financial companies in Croatia and peer countries are divided into four categories:

Category 1: Listed companies

This category includes, on average, about 180 non-financial listed corporations per year with median assets of around EUR 40 million (Table 10). Corporations that were listed on multilateral trading facilities (MTFs) are also included in this category. Listing status may have a strong impact on a corporation's financing conditions, since being listed on a stock exchange requires the implementation of certain transparency and disclosure standards as well as other corporate governance practices. A listed company typically passes a certain threshold in terms of its formal and institutional structure, which may make outside investors more willing to provide funds and facilitates access to a wide range of financing options, including private equity as well as public and private debt markets. However, it should be noted that since the number of listed non-financial companies is low and the listed corporate sector is mainly dominated by a few large companies, in some cases, the results for listed companies presented in the following sections may be driven by a small number of companies.

Category 2: Large unlisted companies

This category includes, on average, about 90 large non-financial corporations with assets larger than EUR 87 million (USD 100 million) in 2019 real terms. Their median asset size was EUR 151 million in 2017 (Table 10). Compared to publicly listed companies, less information is available for large unlisted companies, reducing available financing options or potentially resulting in less favourable financing conditions. However, companies in this category can generally be classified as professionally managed, formal companies.

Category 3: Small and mid-sized companies part of a group

This category includes all small and mid-sized enterprises controlled by a listed (Category 1) or a large unlisted corporation (Category 2). SMEs based in Croatia but controlled by a non-Croatian company are also included in this category. Category 3 contains, on average, 1 035 companies per year with median assets of EUR 4 million (Table 10). Since the financial results of *SMEs part of a group* are consolidated into a parent company, unconsolidated accounts are used in the analysis to identify their own structure. In general, the information available for SMEs is relatively limited, but being part of a group can help subsidiaries to access financing on better conditions compared to independent SMEs. By creating an internal capital market, an economic group can also improve the available financing options for group companies.

Category 4: Independent small and mid-sized companies

The last category includes all SMEs identified to be controlled by individuals and those with no ownership information available. For this group, only unconsolidated accounts are reported. The group of *Independent SMEs* is the largest in terms of number of companies (an average of 10 096 companies per year), but the smallest in terms of size (median assets around EUR 0.77 million). The information available for these companies is limited and unlike *SMEs part of a group*, *Independent SMEs* do not benefit from the financing advantages related to a group structure.

Table 10 below shows the distribution of these four categories of non-financial companies in Croatia with respect to their number and their median assets.

Table 10. Company categories of the non-financial business sector in Croatia

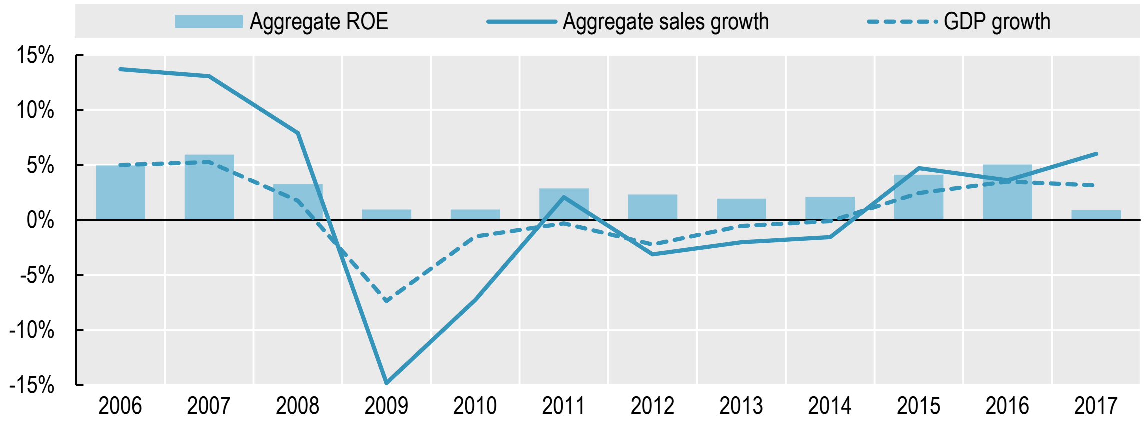
	Category 1: Listed companies		Category 2: Large unlisted companies		Category 3: SMEs part of a group		Category 4: Independent SMEs	
	No. of companies	*Median assets (EUR K)*	*No. of companies*	*Median assets (EUR K)*	*No. of companies*	*Median assets (EUR K)*	*No. of companies*	*Median assets (EUR K)*
2006	216	35 696	75	163 377	880	4 395	10 333	870
2007	252	37 219	89	157 559	919	4 318	10 975	874
2008	249	38 487	96	175 625	1 023	4 430	11 526	876
2009	225	38 822	104	171 258	1 078	4 466	11 486	856
2010	196	41 732	99	162 150	1 080	4 367	10 591	806
2011	188	42 626	90	156 167	1 127	4 602	10 531	767
2012	182	42 516	84	149 193	1 114	4 225	10 716	723
2013	159	43 718	81	146 143	1 051	4 001	10 511	686
2014	152	41 977	85	143 235	1 027	4 078	10 777	673
2015	146	43 289	89	148 457	1 044	4 176	11 367	662
2016	138	48 593	97	150 840	1 027	4 245	11 888	662
2017	122	58 342	94	151 058	1 055	4 181	12 455	669

Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

1.4. Non-financial company performance and profitability

The performance of the Croatian business sector has been sluggish during the last decade. The business sector in Croatia experienced a 15% decline in sales in 2009 after the global financial crisis, which was associated with a 7% drop in GDP. At the same time, the aggregate return on equity (ROE) fell from 5% in 2006 to 3% in 2008 and further to 1% in 2009. The economy contracted in all years between 2009 and 2014, when the aggregate sales growth remained negative and ROE fluctuated around 1% to 2% except for 2011. Starting from 2015 and driven by strong tourism activity and private consumption, the economy has seen a strong recovery with a 3% annual GDP growth, along with an average of 5% sales growth and 3% ROE for Croatian non-financial corporations. In 2017, the low aggregate performance of the non-financial sector in terms of ROE was largely affected by significant losses of a few large companies.

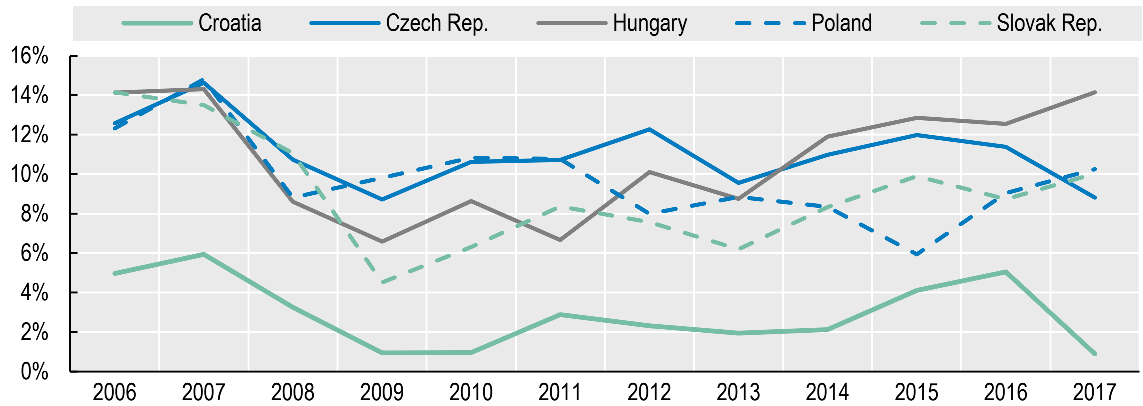
Figure 28. Sales growth, performance and GDP growth in Croatia



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Country comparisons show a significant and persistent gap in the aggregate return on equity between Croatia and its peer countries (Figure 29). Between 2006 and 2017, the average ROE of Croatian non-financial corporations was consistently 5 to 10 percentage points lower than in peer countries.

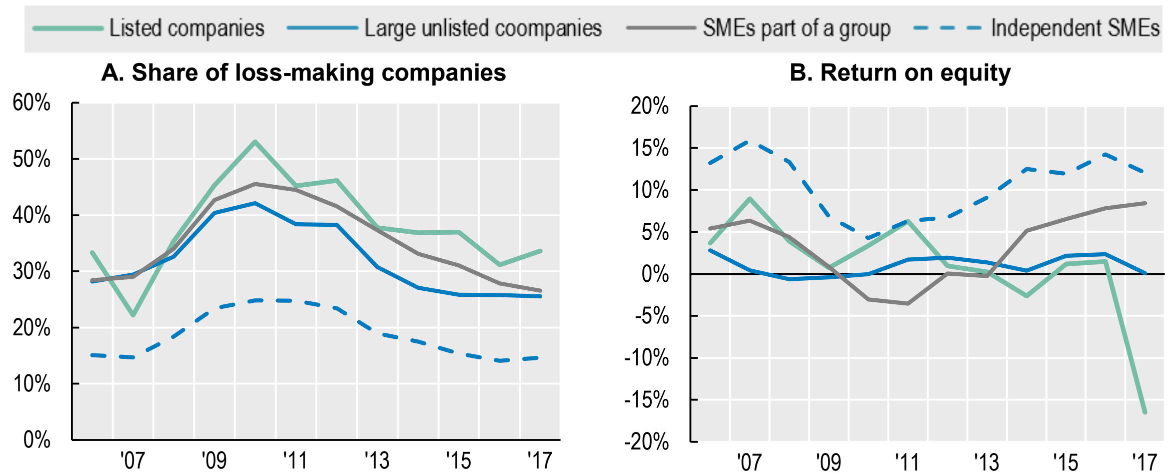
Figure 29. Performance (return on equity) of corporations across countries



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

A closer look reveals that the overall low performance in the corporate sector is driven to a large extent by the high share of loss-making companies, particularly within the two groups of large companies (listed and unlisted). As shown in Figure 30, in 2010, the share of companies making a loss (negative net income) exceeded 40% of all companies in the categories of listed companies, large unlisted companies and SMEs that were part of a group. In recent years, there have been fewer companies reporting losses but both listed firms and large unlisted firms have still been showing an overall poor performance. Moreover, there has been a consistent gap between SMEs and large firms. Particularly, the group of independent SMEs show the lowest share of loss-making companies and at the same time highest ROE throughout the period. This observation can be seen as an indication that the economic recovery in recent years has been largely driven by strong growth in SMEs.

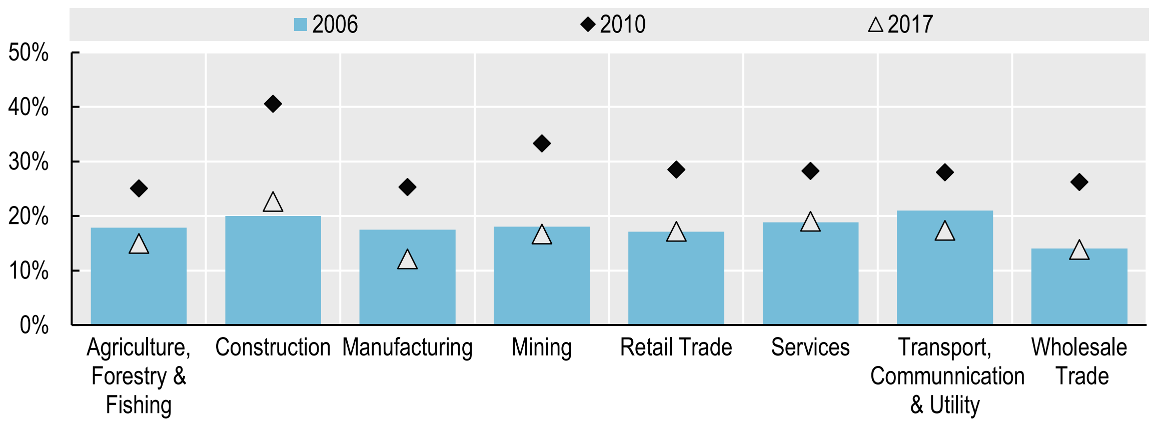
Figure 30. Performance (return on equity) of Croatian corporations across categories



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

The cross-industry comparison shows that the share of loss-making companies differs from one industry to another (Figure 31). In 2010, following the global financial crisis, the share of loss-making companies increased dramatically across industries. Particularly, industries such as construction and mining had 41% and 33% of companies reporting losses in 2010. With the strong recovery in recent years, the ratio of loss-making companies across industries decreased significantly in 2017. Still, industries such as construction had more loss-making companies in 2017 than in 2006.

Figure 31. Share of Croatian loss-making companies across industries



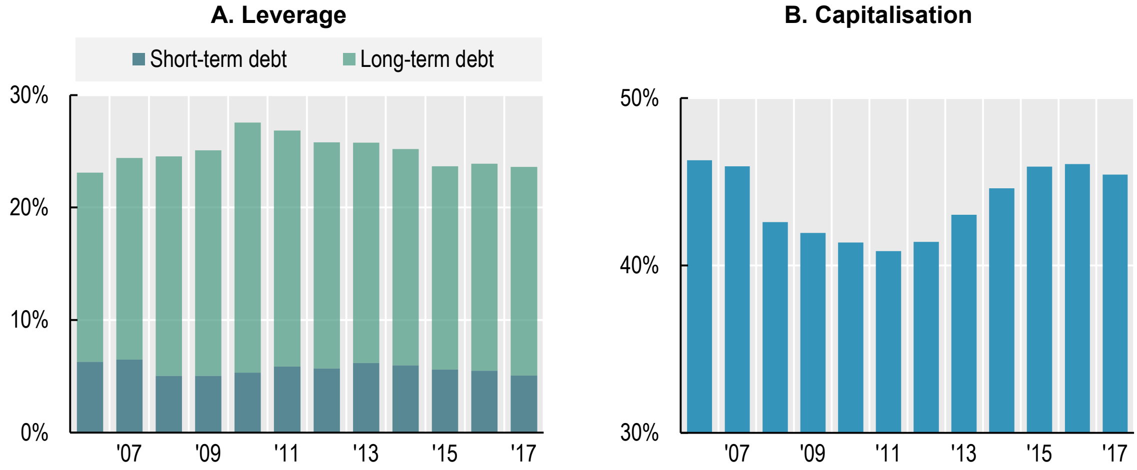
Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

1.5. Leverage and capitalisation levels

Croatia's corporate sector has traditionally been highly dependent on bank lending and the aggregate leverage level – defined as total financial debt over total assets – in the non-financial corporate sector reached a peak level of 28% in 2010. As a result of a deleveraging process since 2010, the leverage ratio declined by 4 percentage points to 24% in 2017 (Figure 32). This process has been coupled with the significant progress Croatia made in reducing the non-performing loan ratio in the banking sector from 14% in 2014 to around 5% in 2019 (see Figure 23). The level of short-term debt remained constant throughout period, meaning the entire decline can be attributed to decreases in long-term debt.

It has been argued that higher dependence on debt and low capital levels increase the fragility of the non-financial corporate sector (OECD, 2017b). Higher levels of debt expose companies to the risk of a credit shortage and low levels of capital reduce their capacity to overcome sharp drops in revenues. As seen in Panel B of Figure 32, the level of equity – measured as equity over assets – in non-financial corporations in Croatia has increased significantly since 2012, reaching 45% in 2017, which is about the same level as before the financial crisis.

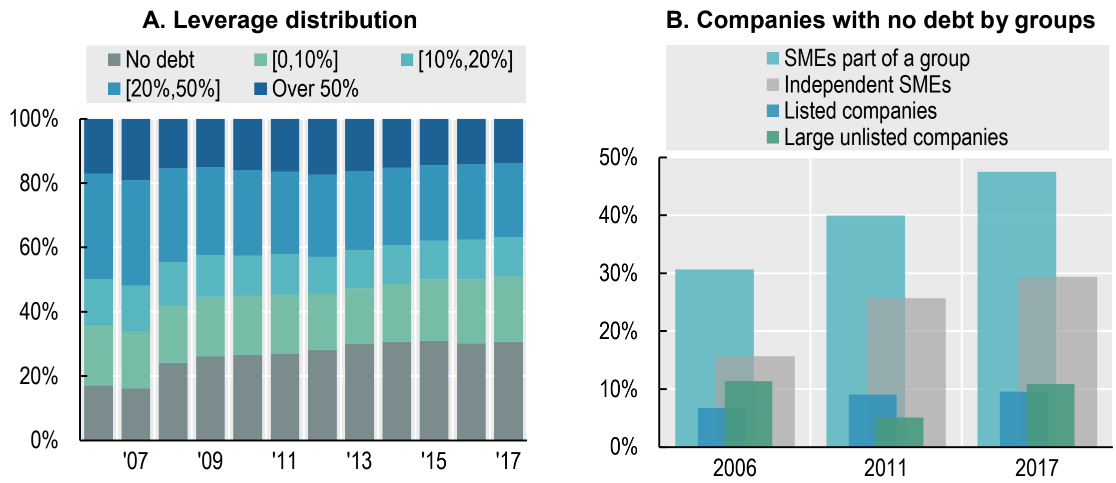
Figure 32. Leverage and equity capital for Croatian non-financial corporations



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

To explore in more detail the leverage levels in the Croatian corporate sector, Panel A of Figure 33 plots the share of companies in the economy with different levels of debt. The figure illustrates that one-tenth of the companies had considerable amounts of debt with a leverage ratio of over 50%. It also shows that a large share of companies in the economy did not report any financial debt. Their share in the corporate sector grew from 17% in 2006 to 31% in 2017. This trend may be driven by the high share of SMEs in the economy that face difficulties in accessing a loan or lack enough collateral to be granted a loan (Kovač, Šesnić and Krišto, 2018). These companies are instead often forced to rely on trade payables, personal loans or wealth as a mean of financing. On the other hand, companies with high leverage (over 50% of assets) slightly decreased over the 2006-2017 period.

Figure 33. Distribution of levels of debt



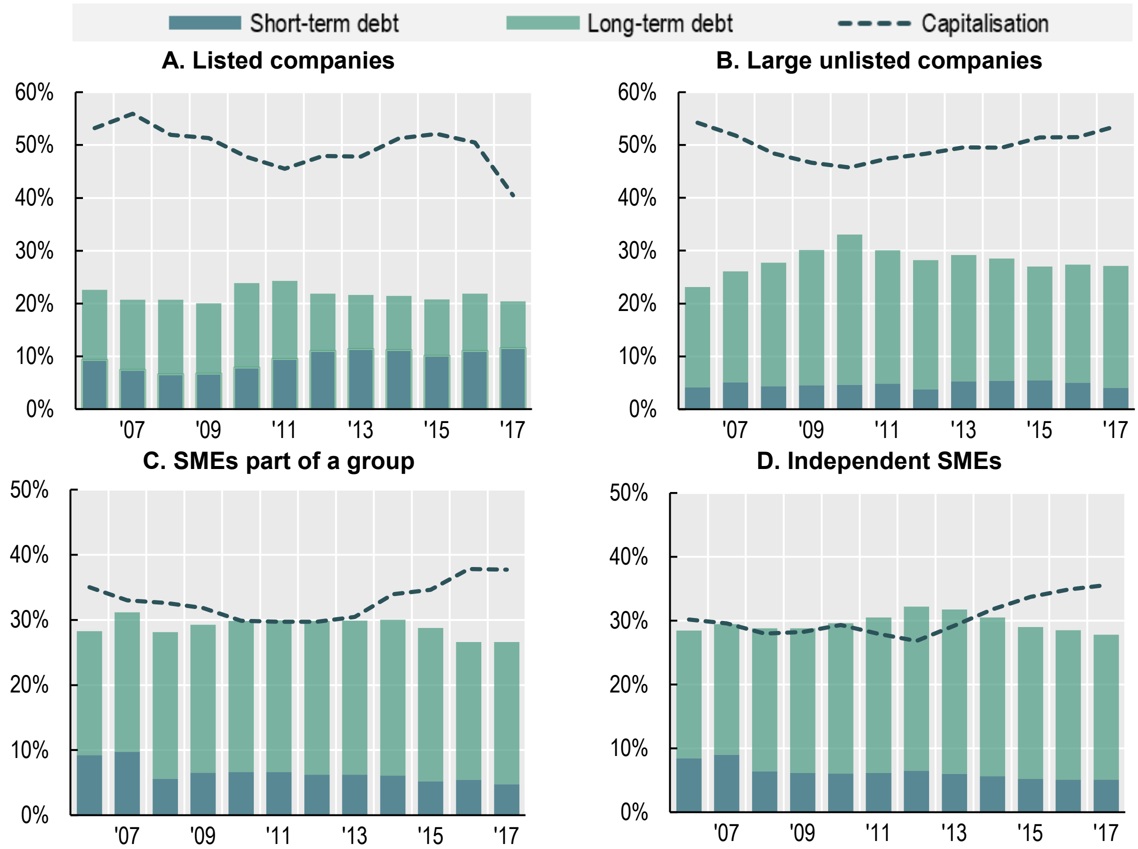
Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

The large share of companies with no debt in their financing structure mostly corresponds to small and medium-sized companies (Figure 33, Panel B). Acknowledging the fact that the ownership structure could affect the lending ability of corporations (Lin, et al., 2011), the figure shows the share of companies with no debt according to the group classification defined in section 1.3. In Croatia, the largest share of companies with no financial debt is observed within SMEs that are part of a group. In fact, almost 47% of the companies in that group had not reported any debt in 2017 compared to only 29% of independent SMEs. In addition, around 12% of the large unlisted companies in Croatia did not report any form of financial debt in their balance sheet in 2017.

The heterogeneity observed in using or having access to debt financing at the category level, is also observed when analysing the maturity profile of debt and capitalisation. When analysing only companies reporting financial debt, listed companies exhibit lower leverage – 4 percentage points on average – throughout the period compared to large unlisted companies (Figure 34). More importantly, the share of short-term debt has been increasing over time for listed companies while it has been decreasing since 2014 for large unlisted companies. One interpretation could be that large unlisted Croatian companies use debt for long-term financing purposes, such as investments, whereas listed companies mainly rely on debt financing for working capital needs. In addition, the capitalisation levels of listed companies deteriorated over the recent years, dropping to 42% of the total assets at the end of 2017. The fact that they had lower financial debt levels and low capital levels at the same time suggests that they had significant liabilities other than financial debt.

The two groups of SMEs show comparable capital structures. The total level of debt shows a downward trend since 2011 in SMEs that are part of a group and since 2012 for independent SMEs (Panels C and D, Figure 32). Similarly, long-term debt has been declining since 2013 for both groups. With respect to the level of equity capital on their balance sheets, SMEs that are part of a group have experienced a decrease in their level of equity between 2006 and 2011. After plateauing for a few years, equity levels started improving in 2014 and reached 37.7% of their balance sheets value by the end of 2017. Independent SMEs also experienced an improvement in their level of capital since 2012, reaching 35.6% of their balance sheets by the end of 2017.

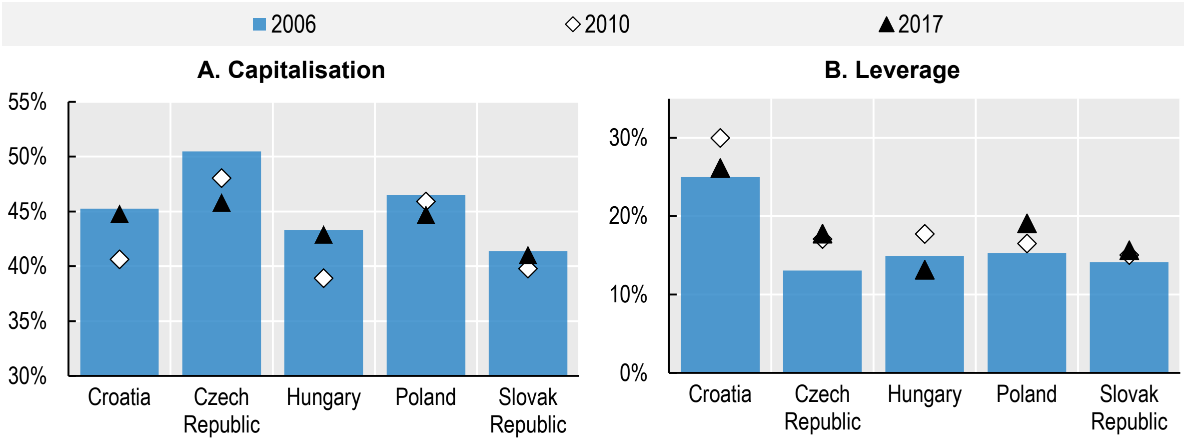
Figure 34. Debt, capitalisation and cost of debt for company categories in Croatia



Notes: Capitalisation level is defined as shareholders' funds as a share of total assets. Debt levels are also presented as a share of total assets. Calculations include only companies that reported financial debt. Unconsolidated financial statements are used in the calculations for SMEs part of a group and independent SMEs. Calculations for long-term and short-term debt include only financial debt (interest bearing debt) and exclude other forms of financing received from the parent company by SMEs part of a group.
Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Figure 35 compares debt and capitalisation ratios across a number of CEE countries including Croatia. In 2017, the leverage ratio in the Croatian non-financial corporate sector was substantially higher than in the other four countries shown in the figure. For example, it was more than twice the level in Hungary. On the other hand, the capitalisation levels of Croatian companies were in line with the levels observed in other countries as of end 2017.

Figure 35. Capitalisation and debt levels across countries



Notes: Capitalisation level is defined as shareholders' funds as a share of total assets. Debt levels are also presented as a share of total assets. Calculations include only companies that reported financial debt.
Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

1.6. Non-viable firms and capital misallocation

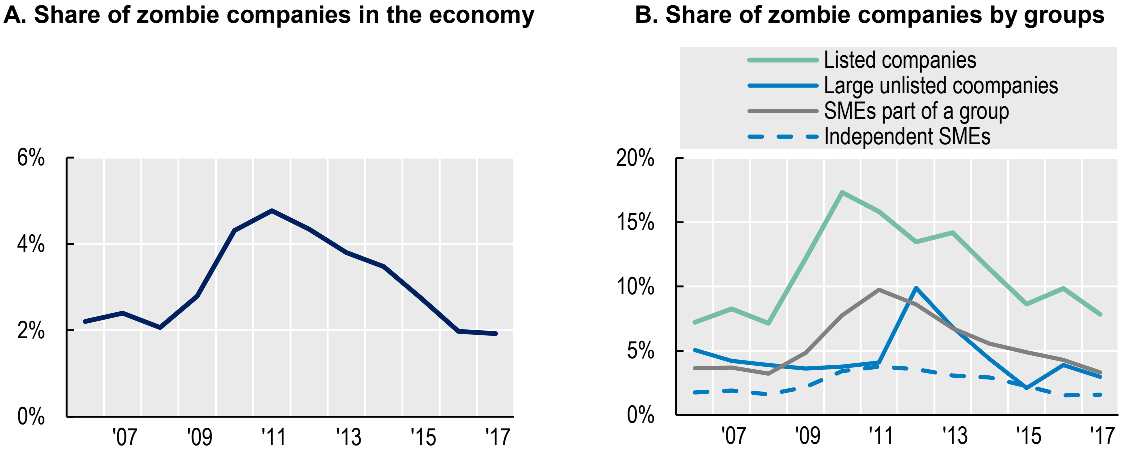
Recent years have seen an increasing number of mature non-financial firms that for an extended period have been unable to cover their debt servicing costs, so-called zombie firms. Zombie firms have shown to be less productive but more importantly, they can crowd out investment and employment that could have been generated by other firms (Banerjee and Hofmann, 2018). Many non-viable zombie firms are kept alive because weak banks continue rolling over loans to these firms instead of writing them off from their balance sheet and assuming the loss (Storz et al., 2017). Zombie lending results in a productivity drag for economies and can lead to slower overall growth.

Croatia has a bank-centric financial system similar to many other European countries where companies rely heavily on loans to finance their investments and activities. After being hit by the global financial crisis, Croatia experienced a prolonged recession and its companies suffered significant losses. As a result, the banking system witnessed an increasing share of non-performing loans. It has also been documented that a portion of the non-performing loans that were rolled over after 2008 corresponds to zombie lending (Broz and Ridzak, 2017). However, the sale of NPLs since 2014 has helped Croatian banks to clean up their balance sheet (IMF, 2017). Overall, as seen in Figure 36, the share of zombie firms[13] has decreased after 2011 along with a gradual economic recovery and a reduction in NPLs.

The share of zombie companies differs considerably between the different groups of companies. Particularly, the portion of zombie firms among listed companies increased to over 15% in the aftermath of the global financial crisis (Figure 36, Panel B). Despite the decreasing number of zombie companies in the economy for all categories, listed companies still had a high proportion of zombie firms at the end of 2017. However, the results have to be interpreted with caution, as the number of listed firms is small and the aggregate ratios can be highly effected by a few companies.

[13] Following Storz et al. (2017), zombie firms are identified as those firms with negative returns and investments, as well as low debt servicing capacity. These three criteria have to be met for at least two consecutive years to be identified as zombie firms.

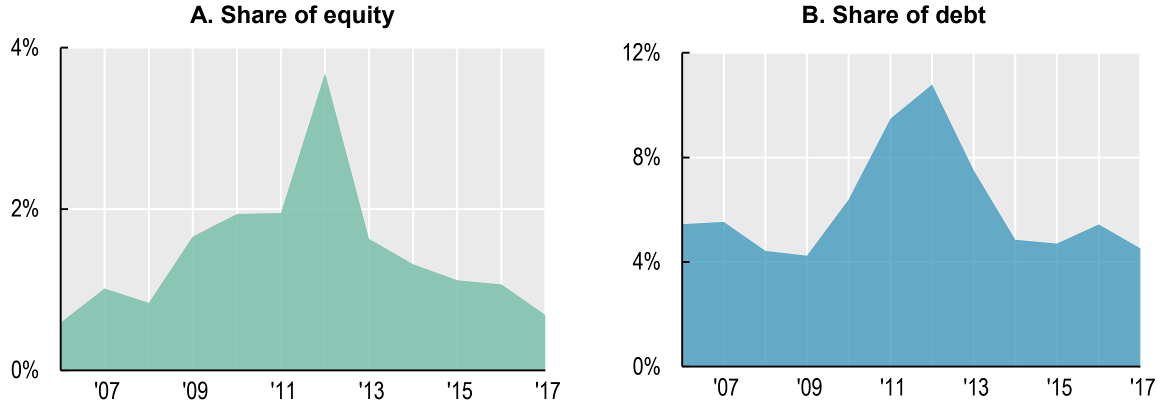
Figure 36. Share of zombie companies in the Croatian business sector



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

Zombie companies not only hold human and physical capital, but also equity capital and debt financing that could potentially be allocated to more productive companies. The share of total equity and total debt sunk in zombie companies peaked in 2012, reaching 4% and 11% respectively. As non-performing loans and the share of zombie companies have gradually declined, so have the shares of equity and debt allocated to zombie companies. In fact, in 2017 the portion of total equity and debt held by zombie companies was at its lowest levels since the financial crisis, representing 0.7% of the total equity and 4.5% of total financial debt of the Croatian corporate sector (Figure 37).

Figure 37. Share of equity and debt sunk in zombie companies in Croatia

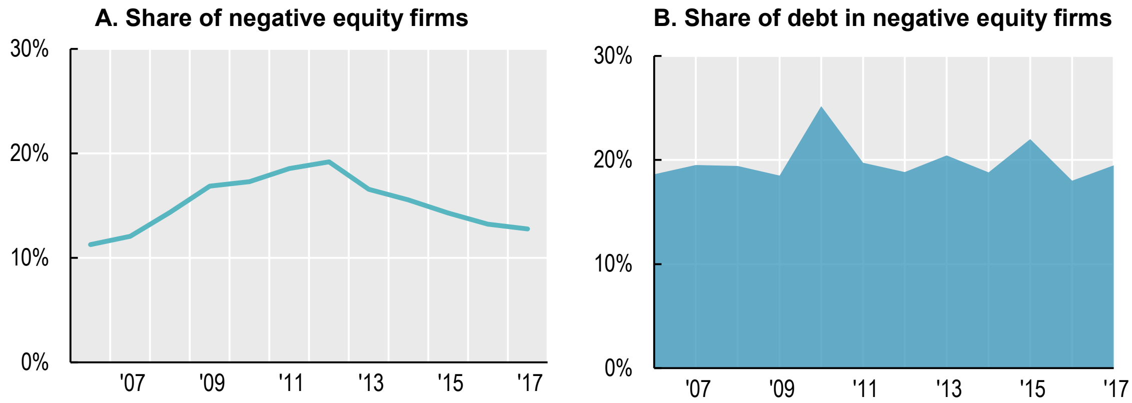


Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

The post-2008 crisis period also saw a drastic increase in the proportion of firms with negative equity. These are the companies that have lost all their equity capital – i.e. who have higher liabilities than total assets on their balance sheets – as a result of long-lasting financial losses. Since there is no shareholder capital left in the company, their owners have stronger incentives to take more risk. This may lead to higher bankruptcy risks and costs that can spread also to other companies in the economy and ultimately to the financial system (Urionabarrenetxea, San-Jose and Retolaza, 2016).

In Croatia, the share of negative equity companies increased dramatically after 2007, reaching 19% in 2012 (Figure 38, Panel A). Despite the drop in recent years, in 2017 13% of companies had negative equity, accounting for almost 20% of the outstanding financial debt.

Figure 38. Negative equity firms and its corresponding share of debt



Source: OECD-ORBIS Corporate Finance dataset, see Annex for details.

1.7. COVID-19 impact on the corporate sector

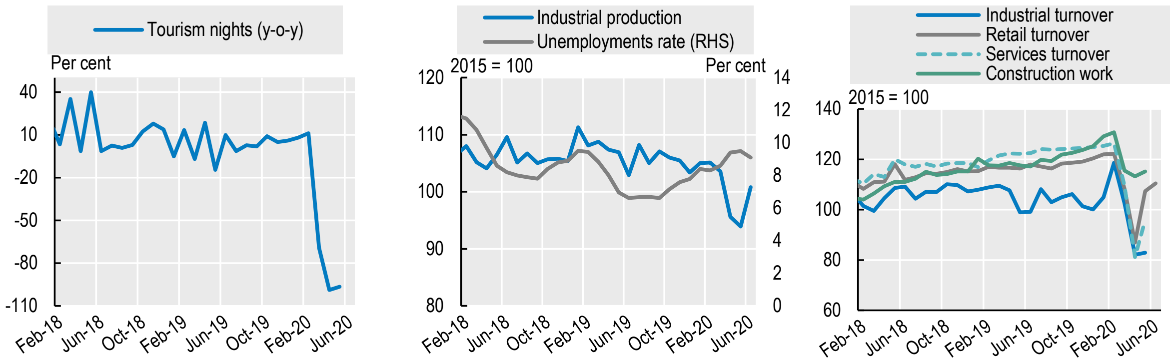
The coronavirus pandemic is having an unprecedented impact on the economies around the world. Measures such as social distancing, travel restrictions and prohibitions to engage in social activities implemented to tackle the health crisis led to a widespread shutdown of businesses in the initial phase of the pandemic resulting in a record slowdown in economic activity worldwide. The sharp drop in sales experienced by the corporate sector has also caused acute liquidity pressures and growing insolvency concerns in many economies and industries. This shock came at a time when there was already widespread concerns about the high-levels of debt in the corporate sector and the declining quality of the outstanding stock of debt around the world.

Prior to the COVID-19 crisis, GDP in Croatia grew at 2.9% in 2019. In addition, unemployment was relatively low at 6.9% and the country recorded a budget surplus of 0.9% of GDP. The pandemic has significantly reversed these trends and has worsened economic forecasts around the world. Importantly, Croatia's economic activity heavily relies on tourism, which has been one of the industries most affected by the pandemic. In fact, tourism accounts for around 25% of GDP in Croatia and the European Commission estimates an 11% decline in Croatian GDP for 2020 (OECD, 2020b; EC, 2020c).

Recent activity data presented in Figure 39 show that tourism nights dropped 96.6% y-o-y in June and unemployment rose from 139 924 persons in January (8.4%) to 151 445 persons in June (9.1%). At the same time, industrial production suffered a strong contraction in May followed by a slight recovery in June. Reported industrial, services and retail sales, and construction volume experienced sharp declines in April and started to show signs of recovery in June.

Figure 39. Sectoral activity and unemployment

A. Tourism nights | **B. Industrial production and unemployment** | **C. Sectorial turnover**

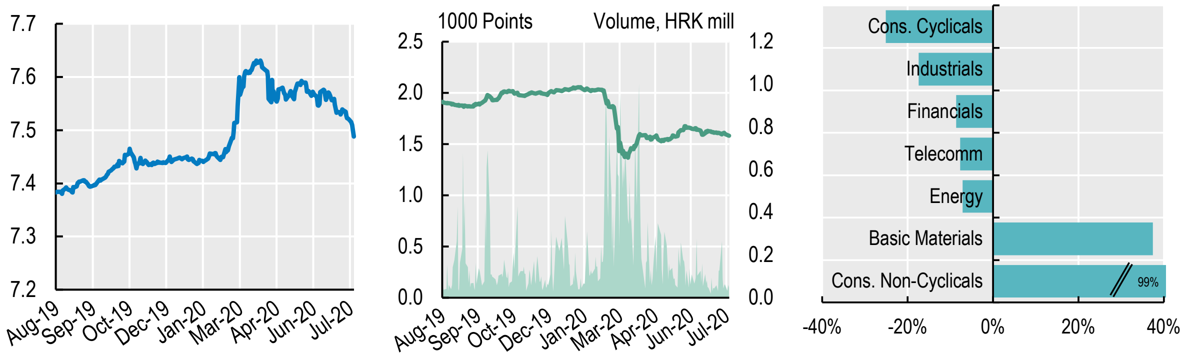


Note: Series in Panels B and C are seasonally and working-day adjusted indices, 2015 = 100.
Source: Croatian Bureau of Statistics.

Some of the financial sector indicators started showing early signs of deterioration already in March. The Croatian Kuna depreciated against the Euro during March and April, but had re-gained some of its value by the end of July (Figure 40, Panel A). The value of the domestic stock index CROBEX suffered a 28% drop from January to March (Figure 40, Panel B). The volume traded rose during March and April, reflecting investors' fears during the onset of the pandemic. Following the government announcements about economic measures, the stock market index recovered some of its losses with a 7% increase between March and July. The measures announced by the Croatian government, and by governments and central banks around the world, have increased investor confidence in the governments' capacity to contain the economic consequences of the pandemic. However, many uncertainties remain about the duration of the pandemic and the future economic consequences.

Figure 40. COVID-19 impact and financial indicators

A. Exchange rate (HRK/EUR) | **B. CROBEX index and volume traded** | **C. Industry market value changes (Jan-July)**



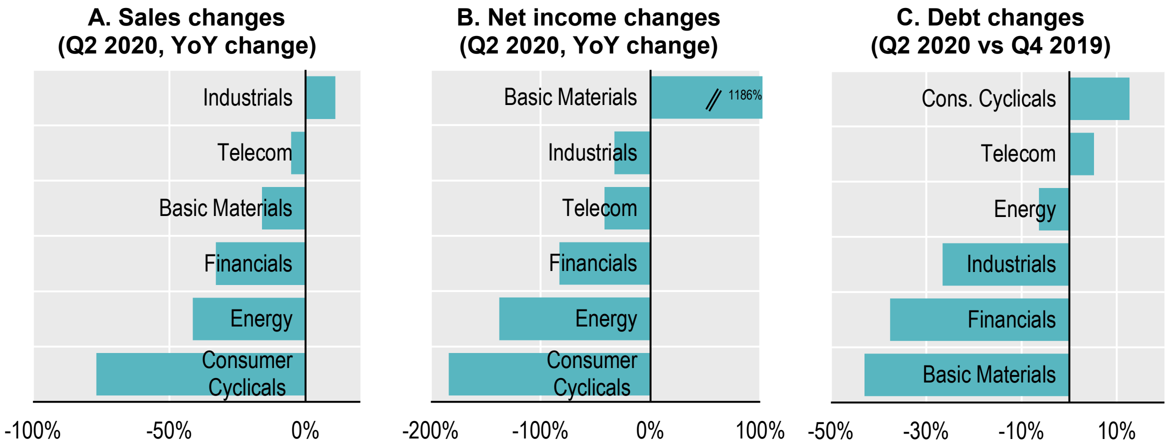
Source: Bloomberg.

Not every industry had suffered a contraction in its valuation when comparing numbers between the end of 2019 and the end of July 2020. On the positive end, consumer non-cyclicals and basic materials companies had experienced an increase in their valuations (Figure 40, Panel C). Consumer non-cyclicals listed companies in Croatia mostly correspond to food processing companies, and there is only one company operating in the drug retailer segment, one in food retail and distribution, one in household products and one in distillers and wineries. For these companies, the pandemic has generated increased valuations. The basic material industry is represented by only one company, Petrokemija that has also shown an increase in its valuation, as COVID-19 did not negatively impact the demand for fertilizers and the company benefited from lower natural gas price.

The remaining industries have all seen their valuations decrease to different degrees. Of particular importance is the sharp fall in the consumer cyclical industry (Figure 40, Panel C). The industry mainly consists of companies operating in the tourism industry, such as hotels, motels and cruise lines. Some auto vehicles, leisure and recreation companies, as well as apparel and accessories also contributed to the decline of the overall valuation. Moreover, the large drop experienced by industrials was mainly driven by companies operating in the transport or related services sectors.

In addition to market valuations, one can also observe the initial impact of the COVID-19 crisis on the corporate sector by looking at the financial statements of listed companies for the second quarter of 2020. By the end of July, only 20 companies had released their 2020-Q2 financial statements, all of which are included in the analysis presented in Figure 41. In the second quarter of 2020 all sectors except industrials experienced a significant drop in sales compared to the same period in 2019 (Figure 41, Panel A). Net income suffered an even sharper drop compared to sales, driven to some extent by high fixed costs in most industries.

Figure 41. COVID-19 impact on listed corporations



Note: The financial statements were reported in HRK and no exchange rate conversion has been applied.
Source: Thomson Reuters Eikon.

In Panel C of Figure 41, the stock of financial debt reported in the second quarter 2020 is compared to the value reported by the end of 2019. The consumer cyclical and telecommunications industries increased their level of financial debt by 13% and 5% respectively. All other industries saw a reduction in their debt levels.

1.8. Government relief programmes to the corporate sector

The Croatian government has implemented several measures to alleviate the pressure on the corporate sector. Starting in March 2020, it announced a HRK 30 billion (EUR 3.9 billion) programme to support the economy. The measures mainly included interventional procurement of critically important sanitary equipment, deferral in tax payments, purchasing of surpluses of potentially threatened businesses (agriculture, food processing industry, medical equipment and similar strategic goods), measures to support the tourism industry and aid for preserving jobs in affected sectors.

To alleviate and ease the liquidity needs of corporations, the authorities provided a payment deferral of public obligations without interest penalties for three months and possibly for three more months if deemed necessary. Parafiscal charges were also suspended. In addition, companies' tax obligations will be reduced or written-off depending on their sales and losses. Entrepreneurs with an annual income of less than HRK 7.5 million (representing 93% of all firms) whose revenue declined by more than 50%, will be exempted from income tax. Companies with an annual income above the threshold will be partially exempted. The collection of VAT payments will not be carried out until the payments from customers are received.

To help companies maintain their workforce, a minimum wage subsidy was implemented for three months with the possibility to extend it for another three months (IMF Policy Tracker, OECD Policy Tracker). Eligible industries and employers are hospitality, food and beverage, transportation and logistics, labour-intensive activities within the manufacturing industry (textiles, clothing, footwear, leather, wood and furniture), employers unable to carry out their activities in accordance with the decisions of the Civil Protection Service and other employers who can prove the impact of special circumstances caused by COVID-19. On June 2020, the government announced the possible introduction of a short-time work programme, financed by the EU Support to mitigate Unemployment Risks in an Emergency (SURE), to help businesses with more than 10 employees to cover part of their workers' wages and thus safeguard jobs.

To help companies access financing, the government has allocated funds to extend micro-loans, and has introduced measures to facilitate faster disbursements of loans with lower interest rates and larger partial risk guarantees. The country has also established a moratorium for three months on obligations to banks. However, during the moratorium, regular interest payments need to be made or the loan maturity might be extended to fit monthly payments according to the clients' prospects. Companies active in the tourism sector have been granted a deferral in loan repayments until the end of June 2021. In addition, the Croatian Bank for Reconstruction and Development (HBOR) granted a moratorium on debt services for three months and provides liquidity loans, export guarantees and also restructures obligations. The HBOR export loan insurance program for SMEs is currently set at EUR 150 000 and will take on 95% of the risk of non-payments by foreign buyers. In addition, the Croatian Agency for SMEs, Innovations and Investments (HAMAG-BICRO) has extended loans to support working capital of small businesses that helped around 900 businesses, representing a total of HRK 343 million (EUR 95 million) until end of June 2020 (OECD, 2020b).

To help companies operating in the tourism industry, on May 2020, the government and the Croatian Tourism Union announced a program to reopen the country for tourism during summer. Tourists from a list of selected countries were allowed to visit Croatia. By the end of July, according to figures from the Ministry of Tourism, with over 1 million tourists, Croatia reached 44% of the volume compared to the same period in 2019. Tourism industry revenues are expected to reach 30% of 2019 levels in 2020.

CHAPTER II. THE CROATIAN PUBLIC EQUITY MARKET

Equity markets play an essential role in mobilising savings to finance large established companies as well as new and innovative enterprises. They help entrepreneurs reduce reliance on short-term financing and match long-term investments with long-term patient capital. At the same time, more developed equity markets also offer households better opportunities to benefit from the growth of the business sector and diversify their savings. An additional important feature of the public equity markets is that they allow shareholders to sell their stocks to other investors without reducing the company's equity capital.

This chapter starts with an overview of stock market developments in Croatia and the current infrastructure available to support its functioning. It then presents trends in initial and secondary public equity offerings by Croatian companies since 2000. The chapter ends with a detailed description of the ownership structure of the Croatian listed companies and the investor landscape in the public equity market.

2.1. Stock market developments in Croatia

The Zagreb Stock Exchange (ZSE) was established in 1907 as the Commodities and Valuables Division of the Chamber of Commerce. The exchange was active until 1911, reopened in 1919 after World War I. The Zagreb Commodities and Valuables Exchange was popular among foreign investors from Vienna and Prague conducting some of their financial transactions through the exchange. However, export restrictions in the country weakened the commodities business of the exchange and currency restrictions diminished further the role of the exchange. Eventually, its operations were suspended in 1945. In 1991, the exchange took up its operations again as the central place of securities trading in Croatia when 25 banks and two insurance companies established the Zagreb Stock Exchange.

In 2007, the Zagreb Stock Exchange merged with the Varaždin Stock Exchange consolidating the country's two exchanges. The exchange was established as a membership organisation, but in 2016 incorporated and listed its own shares on the Official Market. According to the ownership records of July 2020, financial companies including banks and insurance companies hold 46.8% of the stock exchange's capital, followed by investment funds with 13.5%, pension funds 10%, Baktun LLC a US corporation 7.9%, the European Bank for Reconstruction and Development (EBRD) 5.2% and the rest is in the hands of individuals.

The exchange introduced electronic trading systems in the 1990s and, since 2010, also incorporated a market making structure and started trading structured products. In May 2014, jointly with the Bulgarian Stock Exchange and the Macedonian Stock Exchange, the Zagreb Stock Exchange established the SEE Link. Supported by the EBRD, it was created as an infrastructure for trading securities listed on the six regional markets. The system became operational since early 2016. Currently, 26 brokers have joined SEE Link by signing the inter-brokerage agreement[14] and six markets are using it: Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Slovenia.

[14] Information from SEE link website http://www.see-link.net/for-brokers/10

In 2015, the Zagreb Stock Exchange acquired the Ljubljana Stock Exchange by taking over 100% of its shares from the CEE Stock Exchange Group. In September 2016, the exchange also entered into a joint venture with Funderbeam to create Funderbeam South-East Europe (SEE), headquartered in Zagreb. The ZSE initially acquired a 20% stake in the joint venture, which was also backed by the EBRD. In 2020, the ZSE raised its participation in the company to 30%. Funderbeam is a global fundraising and trading platform for early-stage companies and aims at helping investors gain liquidity for their investments. Following the same model of the Funderbeam global, the regional joint venture has also established a Special Purpose Vehicle (SPV) that receives all the funds raised from investors and acts on their behalf. The objective is to minimise the costs and regulatory burdens of both investors and entrepreneurs. Companies from Croatia, Slovenia and Serbia have already used the Funderbeam SEE platform for fundraising. Nine Croatian companies raised EUR 4.7 million on Funderbeam SEE during the first half of 2019 (Domikulić, 2019).

In 2019, the Zagreb stock market experienced several important changes. At the start of the year, the Croatian Financial Services Supervisory Agency approved the registration of the Progress Market as an SME Growth Market. The ZSE also released a new index for the stocks listed on its Prime segment, CROBEXprime. In June 2019 was launched the joint index between Zagreb and Ljubljana, ADRIAprime. In addition, HANFA and the Zagreb Stock Exchange introduced a new Corporate Governance Code that was officially adopted in September. By the end of the year, the exchange also acquired a 5.3% stake in the Macedonian Stock Exchange.

2.2. Stock market infrastructure

An advanced and effective market infrastructure that supports the functioning of the public equity market is of critical importance in the issuance, trading, clearing and settlement of securities. Croatia has already established the key infrastructure institutions for capital markets and made significant investments in improving their capacity and performance. The country has also joined several regional networks to support capital markets.

The Central Depository and Clearing Company (CDCC) is a joint-stock company established in 1997. The CDCC is the operator of the central depositary of dematerialised securities, the clearing and settlement system and the investor protection scheme. It keeps electronic records of issuers, securities, securities accounts and holders of securities. The CDCC operates primarily under the Capital Market Act and is supervised by HANFA. The company is majority-owned by the State with direct holdings of 41% in addition to the 57% of the capital owned by the Financial Agency (FINA), which is a state-owned enterprise.

In December 2014, the CDCC established a company named SKDD-CCP Smart Clear Inc. dedicated to creating a central counterparty assuming the responsibilities for clearing of on-exchange transactions of financial instruments. A central counterparty is a legal entity which interposes itself between counterparties in contracts traded in one or more financial markets, acting as the buyer to every seller and the seller to every buyer. The purpose is to protect each party from the other’s default and reduce the counterparty risk when entering into a transaction. However, SKDD-CCP Smart Clear is still in the process of acquiring an EMIR license to operate as a central counterparty.

According to the Croatian Capital Market Act, all securities issued through public offerings must be issued and offered in a dematerialised form. As the CDCC serves the depository function in Croatia, it holds all dematerialised and registered securities. At the CDCC, a custodian holds the securities in three types of safekeeping accounts: omnibus account, account in the name (segregated) and numbered account.

The trading system used by the Zagreb Stock Exchange is Xetra since July 2017. Xetra is also the trading system of Deutsche Börse, distributed and operated by the Vienna Stock Exchange for the CEE region. The Xetra trading system and other Vienna Stock Exchange services are used by several stock exchanges in the CEE region, including the Ljubljana Stock Exchange, which is also owned by the Zagreb Stock Exchange.

2.3. Segments of the regulated market in the exchange

The Zagreb Stock Exchange has three market segments on which companies are offered to list and trade their shares. These three segments constitute the regulated market of the stock exchange. Until October 2018, the exchange also managed an alternative market – the CE ENTER Market – but subsequently decided to close it.

Table 11 summarises the key listing requirements for all three segments of the exchange. The general terms for listing include, among others, an efficient transaction settlement (dematerialised, entered in the central depository and included in the clearing and settlement system) as well as a prospectus and disclosure of certain information. According to the EU legislation, public offerings of securities below EUR 8 million can be exempted from the obligation to publish a prospectus (Regulation (EU) 2017/1129). In Croatia, the Capital Market Law requires issuers of securities between EUR 4 and 8 million to prepare an information document and make it available for investors or the public (Official Gazette, No. 17/2020).

The less regulated segment, the Regular Market, requires companies to have a minimum of 15% free-float and issuers have to comply with the minimum information required by the Capital Market Act. Companies listed on the Official Market are subject to additional requirements, such as a minimum market capitalisation of HRK 8 million (EUR 1.1 million), having an investor relations function in place and a minimum of 25% free-float. The market with the highest listing requirements is the Prime Market, which requires a minimum free-float of 35% and at least HRK 500 million (EUR 67 million) in market capitalisation. In addition, companies listed on the Prime Market need to follow higher transparency and disclosure standards, such as developing and disclosing their dividend policy, compared to the other two market segments. They also need to appoint at least one independent board member to the audit committee.

Table 11. Key listing requirements in the different regulated segments of ZSE

Regular Market	
▪ Minimum free-float: 15% (exceptions apply, shares may be listed even if the company does not meet the minimum free-float)	
▪ General terms (art. 89. Exchange Rules)	
Official Market	
▪ Minimum free-float: 25% (distributed to at least 30 shareholders). Exceptionally shares may be listed even if they do not meet the free-float requirement, if at least 10% of the issue or total value of shares is held by 50 shareholders	
▪ Minimum market capitalisation: HRK 8M	▪ Investor relations function in place
▪ General terms (art. 89. Exchange Rules)	
Prime Market	
▪ Minimum market capitalisation: HRK 500M	▪ Supervisory board with at least one independent member
▪ Minimum free-float: 35%	▪ At least one independent member in the audit committee
▪ At least 1 000 shareholders	▪ Audit report with unqualified opinion
▪ Investor relations function in place	▪ Market making agreement with at least one market maker
▪ Total fees received by the statutory auditor or the audit firm should not exceed the threshold set in Article 4(3) of Regulation (EU) No 537/2014	▪ The issuer of shares must not have imposed a market protection measure under the Exchange Rules for a period of 1 (one) year prior to the date of submission of the Prime Market listing application (art. 106. Exchange Rules)
▪ General terms (art. 89. Exchange Rules)	▪ Develop and disclose the dividends policy to the public

Source: Zagreb Stock Exchange.

Moreover, a listed company on the Zagreb Stock Exchange has to comply with ongoing listing requirements stipulated by the Capital Market Act as well as the Market Abuse Regulation (EU, 596/2014). Those post-listing requirements, encompass the different disclosure requirements such as financial reporting, corporate governance rules as well as ownership disclosure (Table 12). Similar to the initial listing requirements, the ongoing obligations are more extensive for companies listed on the Official Market and on the Prime Market. For instance, a company listed on the Prime Market is obliged to disclose its dividend policy and its calendar of events.

Table 12. Post-listing requirements in different market segments

Regular Market	
▪ Financial reports (annual, semi-annual, quarterly)	▪ Acquisition/disposal of own shares
▪ Notification of changes in the rights attached to issued securities	▪ Notification of major holdings (exceeds or falls below the thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% of voting rights in an issuer of shares)
▪ Notification of total number of shares and/or voting rights	▪ Corporate Governance Code (compliance questionnaire)
▪ Corporate Actions requirements	▪ Invitation to the General Assembly and notice on the resolutions adopted by the General Assembly
▪ Home Member State notification	▪ The choice of Official register of regulated information notification
▪ Managers' transactions	▪ The choice of media for disclosure of regulated information notification
▪ Public disclosure of inside information in accordance with the Market Abuse Regulation (EU, 596/2014)	

Continuation Table 12

Official Market	
Obligations of the Issuer of Shares Listed on the Regular Market +	
▪ Management and Supervisory Board Meetings	▪ Listing obligation for any new issues of shares
▪ Information disclosure in Croatian and English	
Prime Market	
Obligations of the Issuer of Shares Listed on the Official Market +	
▪ Information on the independent status of the supervisory board	▪ Disclosure of the outcome of the audit committee discussion of the threats to the independence of the statutory auditor
▪ Information on the independent status of the audit committee	▪ Presentation of the annual report to interested financial analysts and representatives of the media
▪ Dividend policy	▪ Calendar of events
▪ Audit report with unqualified opinion	

Source: Zagreb Stock Exchange.

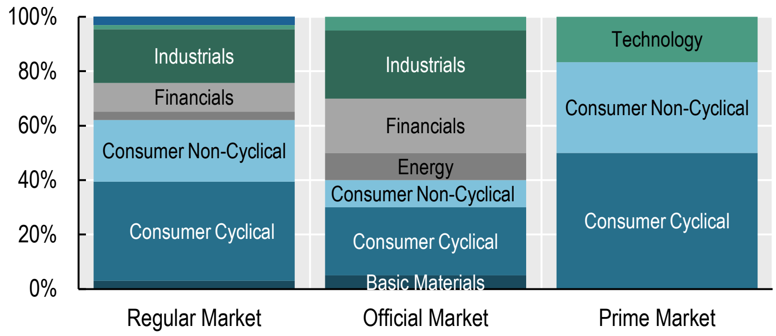
By the end of 2020, the Zagreb Stock Exchange had 92 listed companies, of which 66 were listed on the Regular Market, 20 on the Official Market and 6 companies on the Prime Market (Figure 42). The industry composition of the listed companies differs across segments. Consumer cyclical companies account for 36% of the Regular Market followed by consumer non-cyclicals and industrials. The Official Market has a more even distribution among industries with a slight dominance of industrials and consumer cyclicals. Out of the 6 companies listed on the Prime Market, 3 operate in the consumer cyclical industry, 2 in the consumer non-cyclical industry and 1 in the technology industry.

Figure 42. Listed companies, as of December 2020

A. Number of listed companies

Segment	Listed companies
Regular Market	66
Official Market	20
Prime Market	6

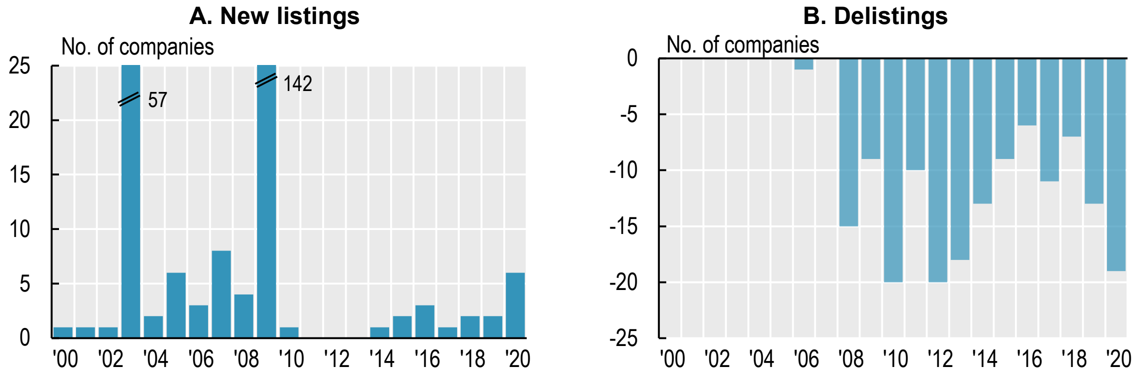
B. Industry composition, by number of companies



Note: Investments funds and REITS are excluded from the listed company universe. Companies with more than one share class are counted as one listed company.
Source: Zagreb Stock Exchange.

Taking a closer look at the Zagreb Stock Exchange listing activity, a significant jump in activity is noticeable from 2003 to 2009 when 222 companies got listed on the exchange. The large number of newly listed companies was a result of the changes introduced in the Securities Market Act (Official Gazette, No. 84/2002). The new rules defined a public joint-stock company as a company that either issues shares through a public offering or has more than 100 shareholders and a total share capital of at least HRK 30 million. Consequently, in 2003, the listing for the aforementioned companies became mandatory on the Regular Market together with the preparation of an abbreviated prospectus.

Figure 43. Newly listed and delisted companies

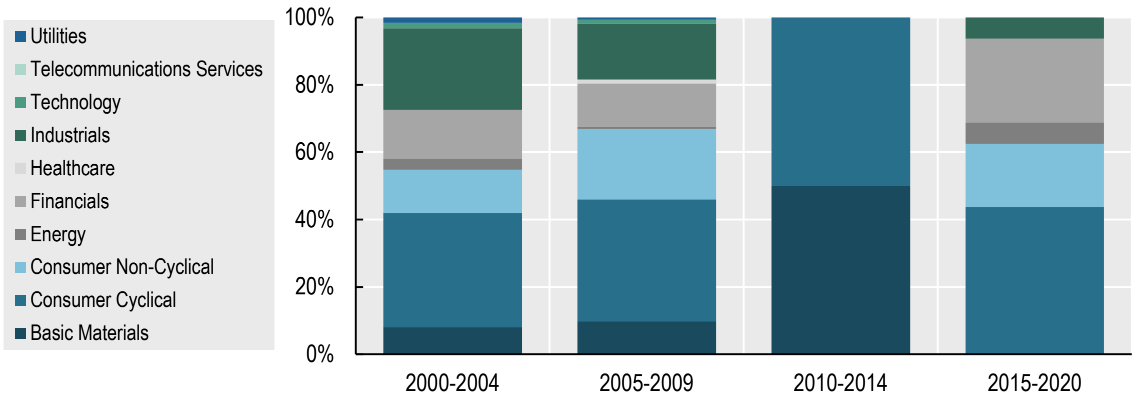


Note: Investment funds and REITs are excluded. Companies transferring from one segment to another are not considered as new listings. Companies delisting from the market and listing afterwards again are counted as one delisting and one new listing.
Source: Zagreb Stock Exchange, information retrieved as of 15th March 2021.

Over the 2010-2014 period, there were only two new listings on the Zagreb Stock Exchange (Figure 43, Panel A). Since 2015, the listing activity has resumed with 16 new listings, of which 6 occurred in 2020. As seen in Panel B of Figure 43, since 2006, there have been 173 delistings from the stock exchange, mainly from the Regular Market. This delisting trend coupled with a low rate of new listings has resulted in a net decrease in the number of listed companies every year since 2010.

The industry distribution of the new listed companies from 2000 to 2020 shows a dominance of consumer cyclical companies, representing 36% of the total number of listings. Industrials companies listed mostly during the first two periods, accounting for 19% of the number of listings over the two periods. Interestingly, the stock market in Zagreb has not attracted many technology and healthcare companies. With the exception of the IPO of Hrvatski Telekom, this holds true also for telecommunications companies (Table 13).

Figure 44. Industry distribution of newly listed companies, by number of companies



Note: Excluding investment funds and REITs.
Source: Zagreb Stock Exchange, Thomson Reuters Eikon, see Annex for details.

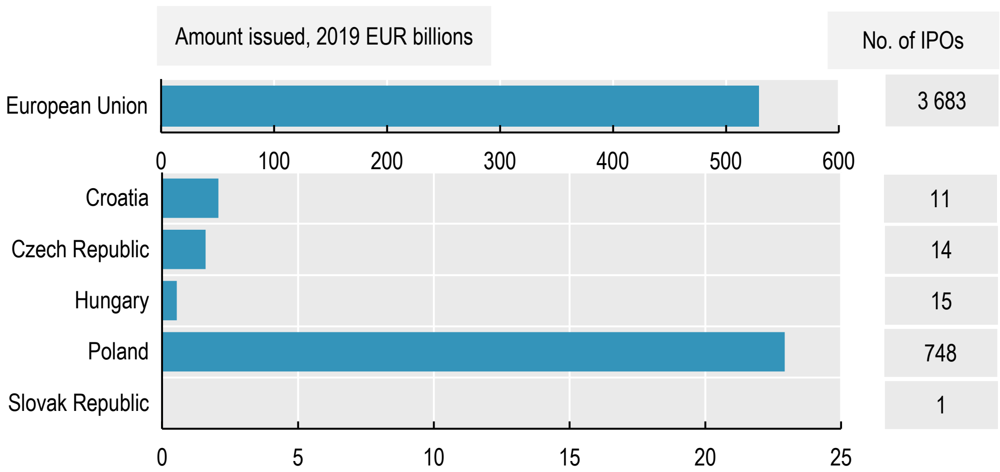
After the closure of CE Enter Market, in 2018 the Zagreb Stock Exchange introduced a new multilateral trading platform, the Progress Market that targets SMEs in Croatia and Slovenia. The Progress Market rules, set pursuant to the provision of Article 352(3) of the Capital Market Act, have less demanding disclosure standards for issuers compared with the regulated market. For example, companies are not required to issue quarterly reports, and when the capital raised is under EUR 8 million, there is no obligation to publish a prospectus. Moreover, compared to the regulated market where the minimum free-float is 15%, companies admitted to trading on the Progress Market are only required to have a minimum free-float of 10%. In November 2019, the Progress Market obtained the SME Growth Market Status set under MiFID II. In August 2020, there were four companies listed on the platform, amounting to a market capitalisation of HRK 1.05 billion (EUR 139 million). However, it is important to note that the turnover ratio in this market is quite low, at only 0.1% in 2019.

2.4. Trends in initial public offerings

In order to raise equity capital from the public markets, a company typically conducts an initial public offering (IPO) to list its shares on one or more exchanges for trading. All IPOs result in the listing of the company's shares, but not all listings include fundraising. Indeed, most new listings in the Croatian market described above (see section 2.3.) did not involve any fundraising.

The IPO activity in Croatia and peer European countries such as the Czech Republic, Hungary and the Slovak Republic has remained weak during the last 20 years. The amount raised through IPOs accounts for EUR 2.1 billion (in real terms) in Croatia, where only 11 companies have conducted an IPO between 2000 and 2019. This is comparable with the total amount raised by Czech companies but higher than the total amount raised by companies from Hungary and the Slovak Republic, where proceeds for the entire period were EUR 544 million and EUR 28 million respectively. However, the IPO activity in Poland has been much more dynamic with almost 748 IPOs totalling around EUR 23 billion raised. As a result, Polish companies accounted for one-fifth of all European IPOs between 2000 and 2019.

Figure 45. Initial public offerings, 2000-2019



Source: OECD Capital Market Series dataset, see Annex for details.

Almost all IPOs conducted by Croatian companies took place during the 2005-2007 period, with one of them conducted on the UK stock exchange. According to Grubišić Šeba (2017), some of these IPOs occurred only for the purpose of offering incumbent investors an exit strategy and not for raising new capital. They took place as a result of the state divesting some of its stakes in corporations and private investors exiting their holdings. There have been only two IPOs after 2007, which were done by a consumer non-cyclical and an industrial company, raising respectively EUR 12 million and EUR 4 million in 2015.

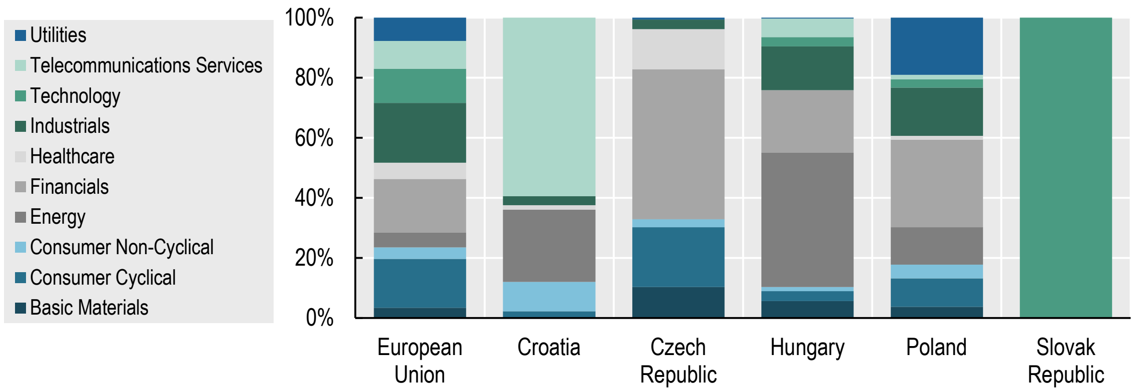
Table 13. Croatian IPOs

Issuer name	Country of exchange	Economic sector	Year	Proceeds EUR M
Hrvatski Telekom dd	Croatia	Telecommunications	2007	1 005
INA Industrija Nafte dd	United Kingdom	Energy	2006	411
Atlantic Grupa dd	Croatia	Consumer Non-Cyclical	2007	103
INGRA dd	Croatia	Industrials	2007	48
Magma dd	Croatia	Consumer Cyclical	2007	40
Kaštelanski staklenici dd	Croatia	Consumer Non-Cyclical	2005	38
Optima Telekom Ltd	Croatia	Telecommunications	2007	35
VETERINA Animal Health Inc	Croatia	Healthcare	2007	26
Viro Tvornica Secera dd	Croatia	Consumer Non-Cyclical	2006	17
Granolio dd	Croatia	Consumer Non-Cyclical	2015	12
Tankerska Next Generation dd	Croatia	Industrials	2015	4

Source: OECD Capital Market Series dataset, see Annex for details.

The IPO of Hrvatski Telekom, previously a state-owned enterprise, alone accounts for 58% of the total IPO proceeds by Croatian companies over the past two decades. As a result, the industry distribution of IPOs is dominated by the telecommunications industry followed by energy companies with a 24% share. While there was no financial company IPO in Croatia over the period, they represented 50%, 29% and 21% of the total proceeds raised in the Czech Republic, Poland and Hungary, respectively. In Hungary, energy company IPOs account for 45% of the total amount raised and in the Slovak Republic, only a single IPO was conducted by a technology company. The industry composition of the total proceeds raised in IPOs at the European Union level is more evenly distributed. Moreover, it is noticeable that industrials, financials and consumer cyclicals rank at the top in terms of capital raised.

Figure 46. IPOs industry distribution by total proceeds, 2000-2019



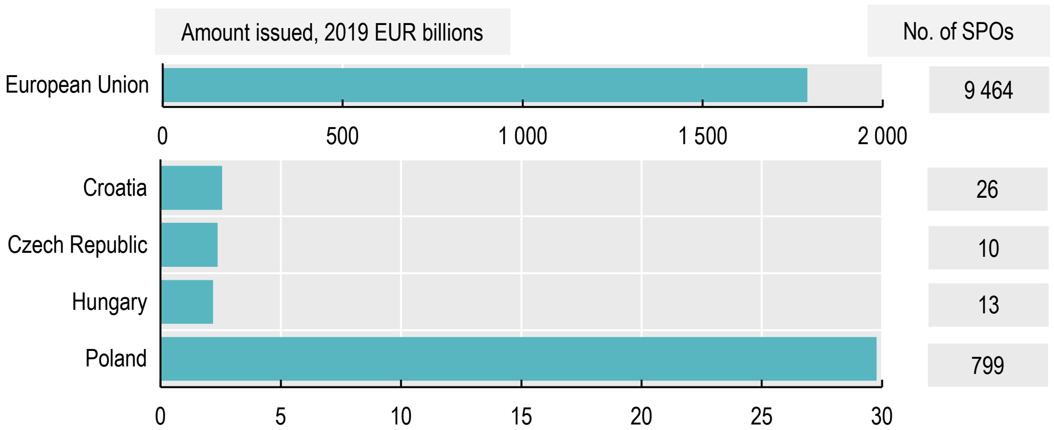
Source: OECD Capital Market Series dataset, see Annex for details.

2.5. Trends in secondary public offerings

An already listed company planning to raise additional equity capital can conduct a secondary public offering (SPO), or so-called follow-on offering. While an SPO can be used to finance new investments and acquisitions, it can also offer an exit channel for a strategic investor wanting to off-load a large stake. Despite the low number of IPOs in Croatia, the number of companies that can potentially conduct an SPO is relatively high owing to the large number of listings following mandatory listing requirements for certain companies. However, the SPO activity has also been weak in the country, with only 26 companies raising a total amount of

EUR 2.6 billion over the 2000-2019 period. Importantly, the SPO conducted by Zagrebacka Banka, a privately owned bank, in 2011 accounts for 84% of the total volume.

Figure 47. Secondary public offerings, 2000-2019

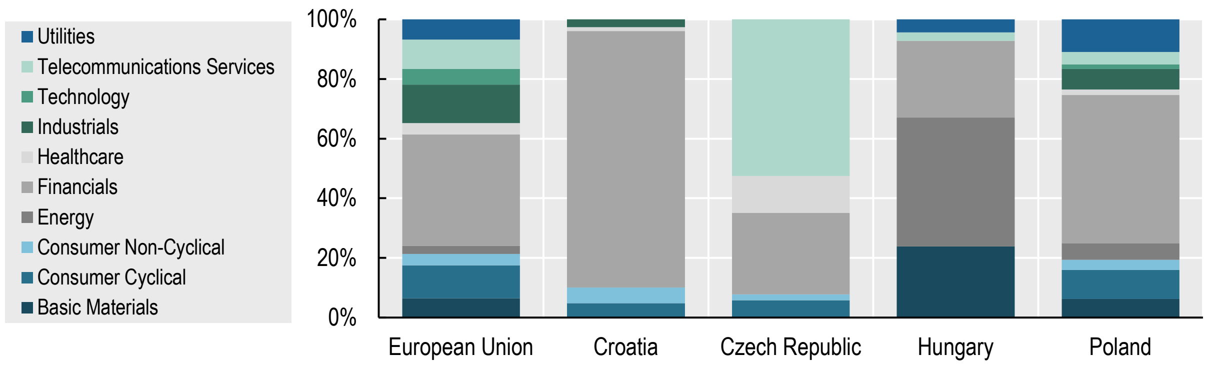


Source: OECD Capital Market Series dataset, see Annex for details.

In terms of volume, the level of SPO activity in Croatia was comparable to the levels in the Czech Republic and Hungary, where on average EUR 2.3 billion were raised throughout the period. Companies in Poland are more active in raising capital through SPOs. Over the same period, almost 800 Polish companies raised a total of EUR 30 billion.

As mentioned before, 86% of the SPO proceeds were raised by one financial company in Croatia. The remaining share of proceeds were raised by 25 companies. Cyclical and non-cyclical companies follow behind accounting for 10% of the total SPO proceeds. Financial SPOs are important at the European Union level, accounting for 37% of the total proceeds raised, as well as in Poland, the Czech Republic and Hungary where it represents an average of 34% of the total proceeds. In the Czech Republic, telecommunications SPOs have accounted for more than half of the proceeds and in Hungary 43% of the SPO proceeds were been raised by energy companies.

Figure 48. SPOs industry distribution by total proceeds, 2000-2019



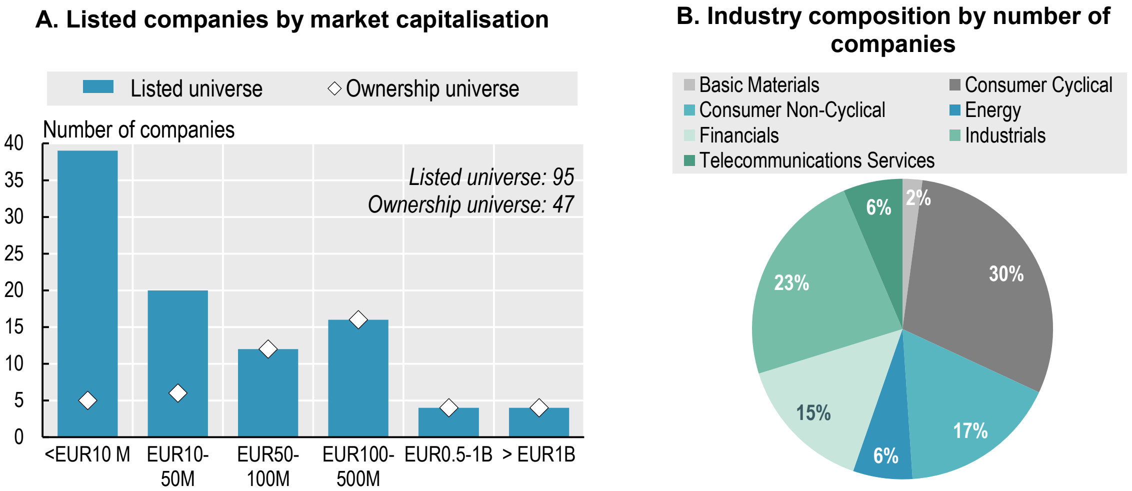
Source: OECD Capital Market Series dataset, see Annex for details.

2.6. Investors and ownership structure in the Croatian stock market

A key characteristic of a stock market is the ownership structure of the companies it lists. Understanding who owns and how they own these listed corporations is of critical importance to make the regulatory system fit for purpose and to develop an efficient corporate governance framework. As shareholders in the public equity market have diverse business models and incentives, the ownership structure of an individual company affects how it is governed and how its shareholders engage in the decision-making process.

At the end of 2019, there were 95 listed companies on the Zagreb Stock Exchange with a total market capitalisation of EUR 18.7 billion. Out of these 95 listed companies, 59 had a market capitalisation of less than EUR 50 million. For the ownership analysis, detailed information was available for 47 companies, mostly corresponding to the category of companies with over EUR 50 million in market capitalisation (Figure 49, Panel A). The combined market capitalisation of the companies included in the ownership analysis represents 98% of the total market capitalisation in Croatia. Consumer cyclical companies, mostly tourism companies, is the largest group accounting for almost one-third of companies covered in the ownership analysis. Industrials companies follow with 23% and consumer non-cyclicals with 17% of the total. Next in importance ranks the financial sector that represents 15% of the companies (Figure 49, Panel B).

Figure 49. Universe of listed companies in Croatia



Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters Eikon, Bloomberg; see Annex for details.

Following the methodology in De La Cruz, Medina and Tang (2019), the owners of listed companies in Croatia are classified into 5 categories: *Private corporations and holding companies* that include listed and unlisted private companies, their subsidiaries, joint ventures and operating divisions; *Public sector* that includes direct ownership by central governments, local governments, public pension funds, state-owned enterprises (SOEs) and sovereign wealth funds (SWFs); *Strategic individuals and families* that refer to physical persons that are either controlling owners or members of a controlling family or block-holders and family offices; *Institutional investors* that refer to pension funds, insurance companies, mutual funds and hedge funds; and *Other free-float* that refers to the shares in the hands of investors that are not required to disclose their holdings, including retail investors.

The largest investors in Croatia are private corporations, who own 55.6% of the equity of listed corporations. Usually such large ownership by private corporations indicates the presence of company group structures. More importantly, 84% of the corporate holdings are in the hands of other listed companies. The public sector is also an important shareholder in 33 listed corporations in Croatia. Most of the public sector ownership (79%) corresponds to direct government ownership. The participation of institutional investors in Croatia is modest compared to their participation in other peer markets and to the broader European level. In Croatia, institutional investors own 9.8% of the listed equity, versus 38.3% at the European level. Out of the total holdings of institutional investors in the Croatian market, 74% corresponds to pension funds, followed by endowments (11.8%) and asset managers (11.6%).

Table 14. Ownership structure by investor category (%)

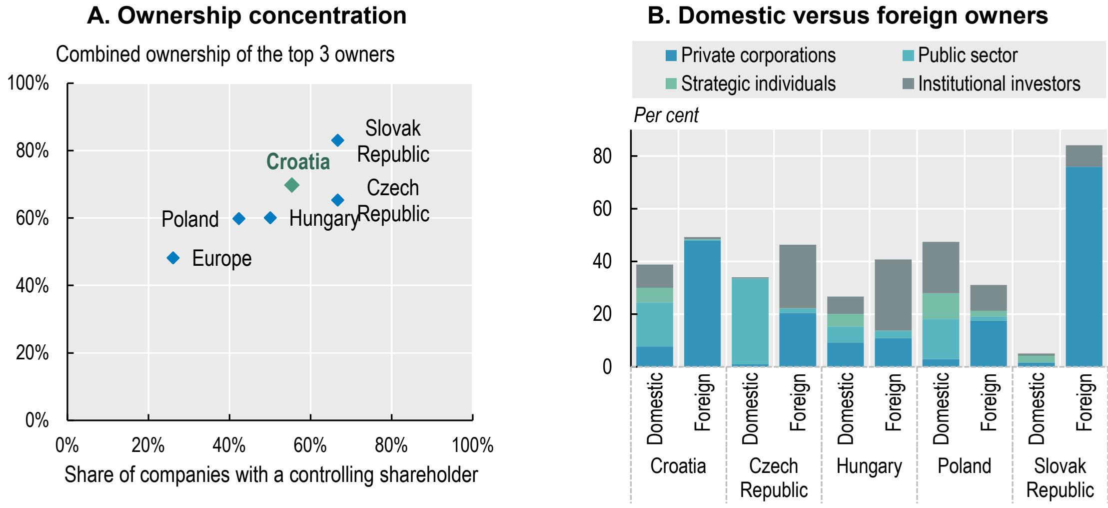
	Private corporations	Public sector	Strategic individuals	Institutional investors	Other free-float
Croatia	55.6	17.0	5.7	9.8	11.9
Czech Republic	21.5	34.0	0.3	24.6	19.6
Hungary	20.2	8.9	4.8	33.7	32.5
Poland	20.4	16.9	12.0	29.2	21.5
Slovak Republic	77.6	0.0	2.6	8.9	10.9
Europe	*13.2*	*7.6*	*8.6*	*38.3*	*32.4*

Note: Values are market capitalisation-weighted averages.
Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters Eikon, Bloomberg; see Annex for details.

Another important feature of the corporate ownership landscape is the concentration levels. When a company has a dispersed ownership structure, it is generally assumed that the structure generates a principal-agent problem between the executive manager and small shareholders who have limited capacity to monitor management. However, when ownership is concentrated in the hands of a controlling shareholder or blockholders, the conflict is rather between the minority shareholders and the controlling shareholder(s) who could gain undue advantages to the detriment of minority shareholders, for example, through abusive related party transactions. It has been documented that in half of the world's listed companies, the three largest shareholders hold more than 50% of the capital (De La Cruz, Medina and Tang, 2019).

A closer look at concentrations patterns in Croatia reveals that ownership is slightly more concentrated than in peer countries. Panel A of Figure 50 shows the share of companies in the market where the largest shareholder owns more than 50% of the equity capital on the x-axis; and the average combined ownership of the top 3 shareholders on the y-axis. In Croatia, 26 out of the 47 companies (55%) have a single shareholder owning more than 50% of the capital of the company. At the same time, the top 3 shareholders in Croatia own on average 70% of the equity, much higher than the 48% recorded for all European companies. Only the Slovak Republic shows a higher level of concentration in the hands of the 3 largest shareholders and also on the share of companies with a controlling shareholder.

Figure 50. Ownership concentration and domestic versus foreign ownership

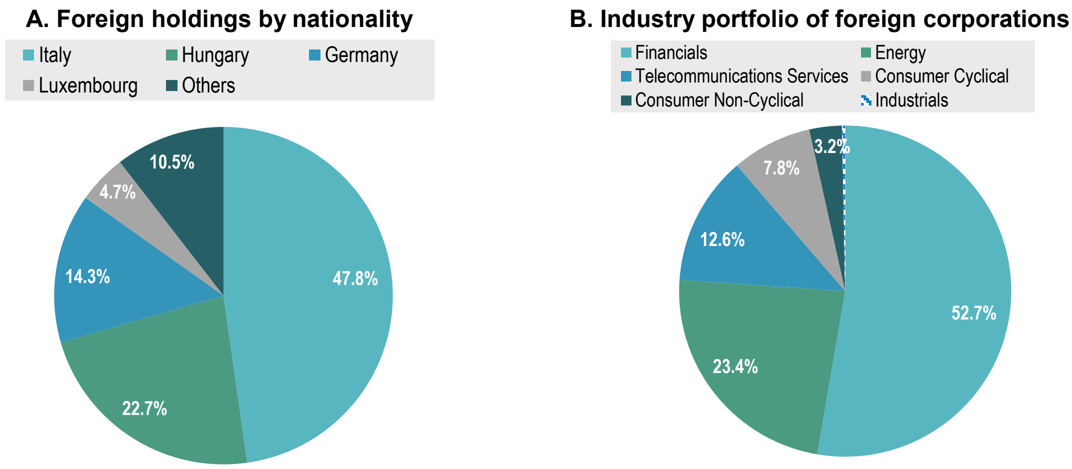


Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters Eikon, Bloomberg; see Annex for details.

The participation of foreign investors in the Croatian public equity market is mostly driven by private corporations both in the form of controlling and strategic investments. Non-domestic corporations own 48% of the listed equity in Croatia. Similarly, foreign corporations also own important stakes in the Slovak Republic and to a lesser extent in other peer countries. At the same time, the participation of foreign institutional investors in the Croatian market is almost negligible (Figure 50, Panel B). This contrasts dramatically with the levels of foreign institutional ownership observed both in other European markets and worldwide.

The majority of foreign investors participating in the Croatian market are European corporations. Italian investors account for 48% of the total foreign investments in Croatia, followed by Hungarian and German investors (Figure 51, Panel A). Out of the total foreign holdings in Croatia, about 97% is owned through private corporations. As illustrated in Panel B of Figure 51, their investments are mostly in the financial sector. The energy companies listed on the Croatian market also attract almost a quarter of the foreign corporate investment.

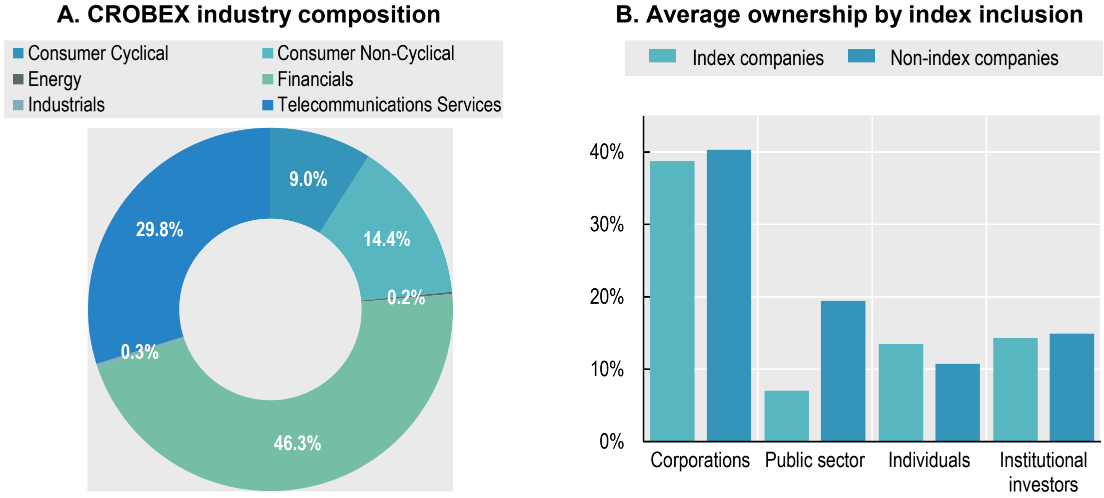
Figure 51. Foreign holdings



Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters Eikon, Bloomberg; see Annex for details.

The national stock index CROBEX was established in July 1997. CROBEX is a market capitalisation-weighted index that can include between 15 and 25 stocks according to their contribution to free-float market capitalisation. By the end of June 2020, the index included 21 stocks. In order to be eligible for the index, companies have to be listed on the regulated market and be traded more than 75% of the total number of trading days during the 6-month period preceding the index revision date. The CROBEX is heavily weighted towards financials and telecommunications companies, which account for 46.3% and 29.8% of the value of the index, respectively. Consumers companies account for 23.4% of the index.

Figure 52. The CROBEX index and ownership in index/non-index companies



Source: OECD Capital Market Series dataset, FactSet, Thomson Reuters Eikon, Bloomberg; see Annex for details.

As many institutional investors follow investable equity indices to allocate their investments, their investments are usually concentrated towards companies whose shares are included in a major index. However, the scant presence of international institutional investors in the Croatian market and the dominance of domestic pension funds result in a situation where there is no significant difference with respect to institutional investors' holdings in companies included in the index and those not included. The public sector, however, holds significantly higher stakes in non-index companies (Figure 52, Panel B).

CHAPTER III. CORPORATE BOND MARKET IN CROATIA

Corporate bond markets can provide companies with an alternative source of financing and therefore help decrease companies' reliance on bank loans. While companies generally use ordinary bank loans to finance short-term working capital needs, corporate bonds usually provide capital for medium to long-term investments and offer investors, particularly institutional investors facing long-term liabilities, additional investment options. On the one hand, corporate bonds require a lower level of collateral compared to bank loans, but on the other hand, the issuer may need to have obtained a certain credit rating to be able to borrow from the market on favourable terms.

Companies issue new bonds on primary markets either through private placements or public offerings where the instruments can be traded on the secondary market. One key characteristic of a well-functioning secondary market is the level of liquidity. Liquid markets provide high-quality price formation for current and future instruments. Moreover, they also provide investors with the ability to buy and sell without having to suffer a large discount. In general, large and medium-sized companies have access to the public market, while smaller companies typically use private placements or other alternative markets specifically created for their segment.

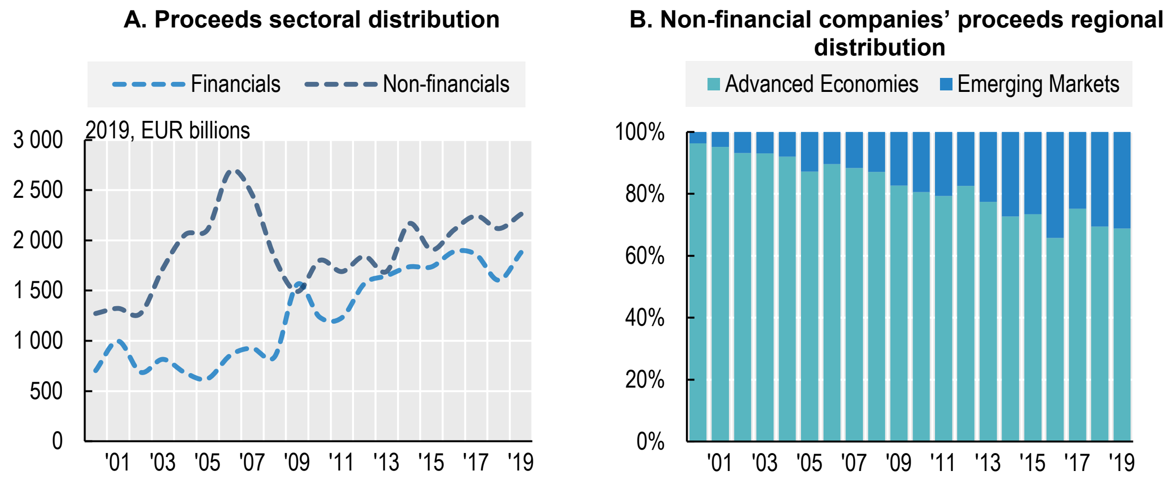
This chapter provides an overview of the trends in corporate bond markets both in Croatia and at the global level. It also presents selected features of the corporate bonds issued by Croatian companies, such as the maturity structure, currency composition and the market of listing.

3.1. Trends in corporate bond issuance

After the 2008 global financial crisis, there was a significant contraction in bank lending globally and as a result, companies in search of funds have increased their use of corporate bonds. For many corporations, bonds have become an important alternative source of debt financing to bank lending. In 2019, the total amount of funds raised both by financial and non-financial companies doubled compared to early 2000s (Figure 53, Panel A). In particular, while on average non-financial companies raised around EUR 800 billion annually between 2000 and 2007, this increased to EUR 1.6 trillion between 2008 and 2019.

During the past two decades, non-financial companies from advanced economies have been the largest users of corporate bonds with the highest amount raised by companies from the United States. On average, between 2000 and 2019, non-financial companies from the United States and Europe annually raised around EUR 500 billion and EUR 300 billion from the corporate bond markets, respectively. Over the same period, non-financial companies from emerging markets increased their share in the total amount of capital raised through corporate bonds from 4% in 2000 to 31% in 2019 (Figure 53, Panel B). This increase has been mainly driven by the large issuance activity of Chinese non-financial companies. Between 2000 and 2019, the share of European non-financial corporations in global non-financial proceeds almost halved from 34% in 2000 to 19% in 2019.

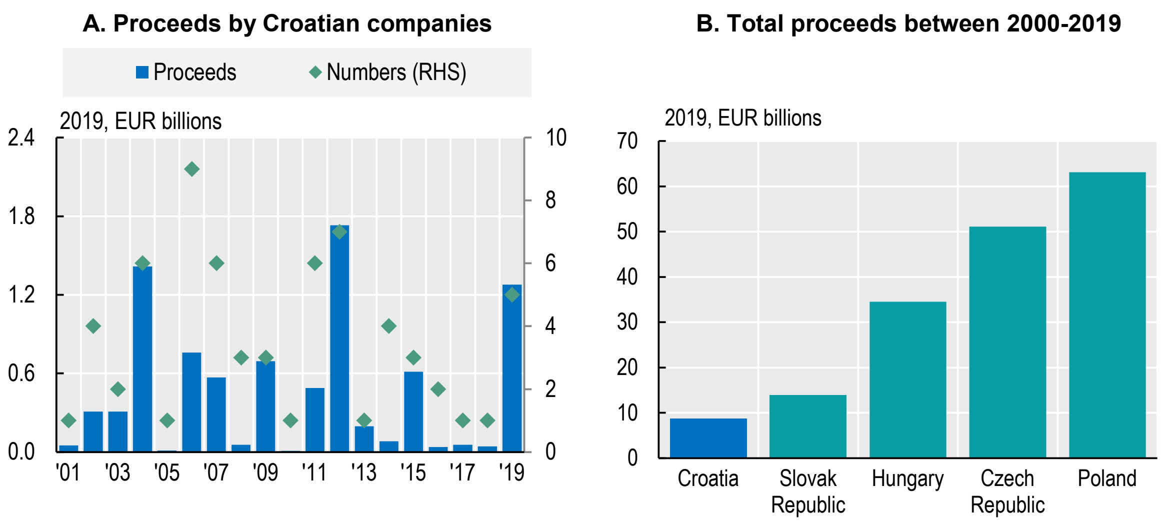
Figure 53. Global corporate bond issuances



Source: OECD Capital Market Series Dataset. Thomson Reuters Eikon, see Annex for details.

Corporate bond markets in the Central and Eastern European region are less developed compared to the rest of Europe. Croatia is not an exception. Indeed, only a small number of companies issued corporate bonds over the past two decades (Figure 54, Panel A). Although the macroeconomic conditions have been favourable since 2015, both the number of issues and the amount raised by Croatian companies have been minor. Between 2000 and 2019, Croatian companies raised a total of EUR 8.7 billion through corporate bond issuances, 70% of which was raised by non-financial companies. Over the same period, companies from Hungary, Poland and the Czech Republic all raised more than four times as much as Croatian companies did (Figure 54, Panel B).

Figure 54. Corporate bond issuances in Croatia and selected European countries



Source: OECD Capital Market Series Dataset, Thomson Reuters Eikon, see Annex for details.

3.2. Characteristics of corporate bonds in Croatia

One of the important features of corporate bonds is the longer maturities they can offer compared to bank lending. However, the maturity of the instrument is generally associated with the both the risk profile of the issuer and of the country in which it is domiciled. This, in turn, creates differences in the maturity profile of corporate bonds issued by non-financial companies across countries and regions, and also over time. The maturity of the corporate bonds issued by Croatian companies between 2000 and 2019 generally fluctuated between 5 to 10 years for financial and non-financial companies[15] (Figure 55, Panel A). Exceptionally, in 2003, the maturity for non-financials was close to 20 years which was mainly driven by a single large issuance. As a comparison, the average maturity of non-financial corporate bond issuance in the United States was 13 years in 2019.

Most corporate bond issuers in Croatia have chosen to issue euro-denominated bonds (Figure 55, Panel B). Overall, the share of euro-denominated corporate bonds represents 73% of the amount issued by Croatian corporations, followed by 16% issued in US dollars. The proportion issued in euro is higher for financial companies. In fact, 89% of all the corporate bonds issued by the financial sector were denominated in euro, versus 67% for non-financial issues. Local currency bonds only represented 11% of the total proceeds. The ECB's ongoing expansionary monetary policy, coupled with the low interest rate environment can be mentioned among the reasons driving the large amount of emerging markets issuances in euros since the global financial crisis (Velandia and Cabral, 2018). In the case of Croatia, its EU membership since 2013 and the progress made in joining the euro area have also been important factors contributing to the high share of euro-denominated issuances.

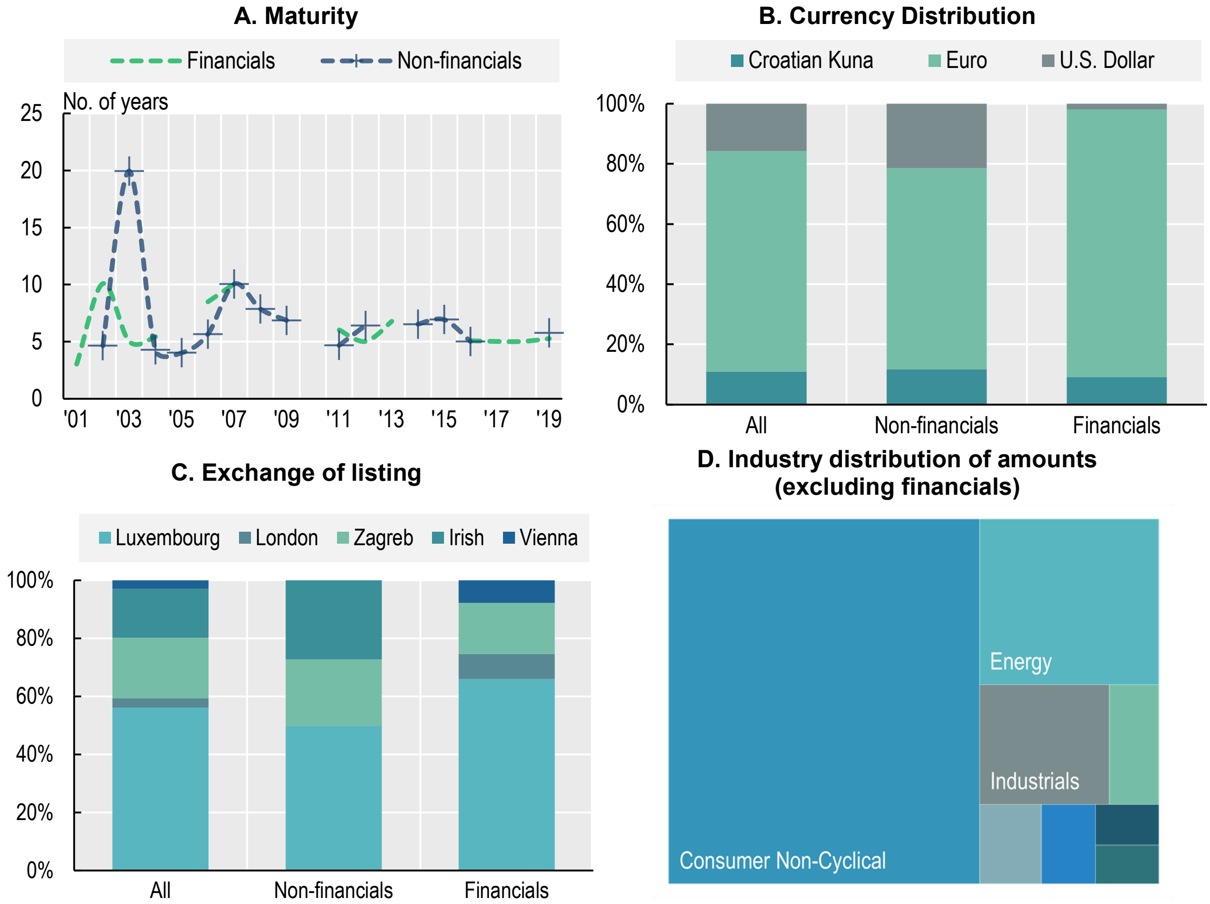
Another important feature of the Croatian corporate bond market is the important portion of corporate bonds that is not listed locally on the Zagreb Stock Exchange. Instead, corporate bonds are mostly listed on the Luxembourg Stock Exchange (Figure 55, Panel C).[16] Moreover, the higher the proceeds of individual bond issuances, the more likely it is that the bond is listed on a foreign exchange. While the average amount of proceeds raised in the domestic market is around EUR 35 million, the average amount raised through listings on foreign exchanges is almost EUR 300 million for Croatian companies.

In line with the European trend, non-financial Croatian issuers' share in total proceeds accounted for 70% of the total proceeds between 2000 and 2019. The industry composition of non-financials issues is highly concentrated in companies operating in consumer non-cyclicals, energy and industrials (Figure 55, Panel D). Moreover, during the entire period, there was not a single technology company that raised funds via corporate bonds, and healthcare companies represented only 2% of the total non-financial proceeds from corporate bond issuances. In contrast, the share of corporate bonds issued by European technology and healthcare companies increased over the last two decades and accounted on average for 7% of total annual proceeds.

[15] Maturity refers to value-weighted maturity at issuance.

[16] Companies listing their bonds on the Luxembourg Stock Exchange are: Zagrebacka Banka, Croatian Bank for Reconstruction and Development, HEP., BINA-Istra and Agrokor .

Figure 55. Characteristics of corporate bonds issued by Croatian companies between 2000 and 2019



Source: OECD Capital Market Series Dataset, Thomson Reuters Eikon, see Annex for details.

CHAPTER IV. PRIVATE CAPITAL MARKETS

Over the past decade, there has been a rising number of alternative types of institutional investors such as private debt and private equity funds. Particularly, private equity (PE) has become a significant source of external financing for non-financial companies. In 2019, the deal volume of private equity reached USD 1.47 trillion globally (McKinsey, 2020).

Private equity, including venture capital, represents an important alternative source of financing for companies seeking capital to support their investment plans. This source of funding is especially critical for companies with high growth potential that require a substantial amount of capital to seize growth opportunities, but have not yet reached the required size to access public markets. Bank financing is especially difficult to obtain for firms with a large share of intangible assets or those with negative earnings in their early stages. Moreover, private equity firms can play an active role in improving the management of the acquired companies as well as initiate value-adding operational enhancements.

This chapter provides an overview of private equity trends in Croatia and compares it to selected peer European countries. It presents a detailed analysis of the three main stages of private equity activity: fundraising, investment and divestment. The analysis addresses issues relevant to the geographical and institutional source of the funds raised, the industry distribution of investments and divestment forms among others.

4.1. Overview of the private equity activity in Croatia

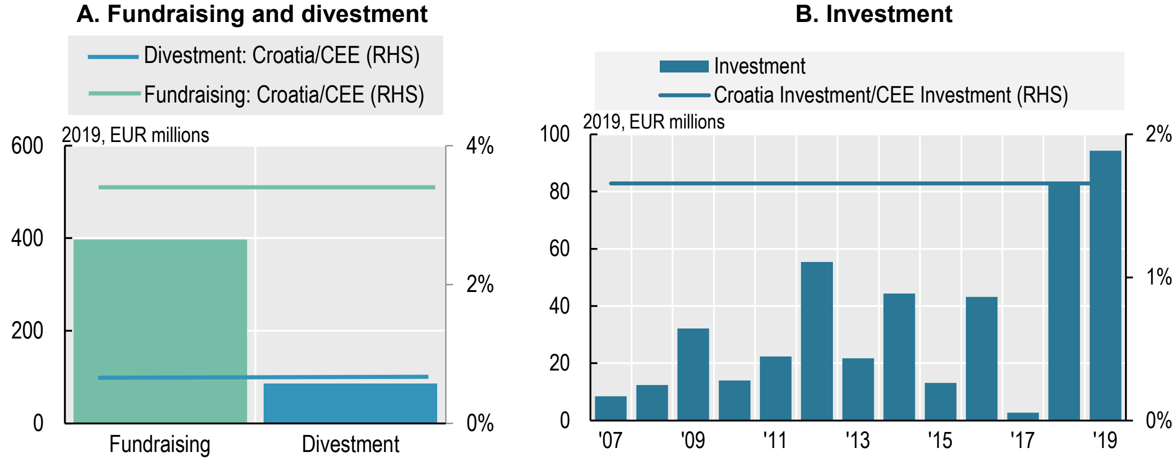
There are mainly three stages involved in the cycle of private equity investments: fundraising, investment and divestment. At the first stage, *fundraising,* general partners of the private equity firm solicit funds from a range of investors known as limited partners, including institutional investors, banks and high-net-worth individuals. Typically, there is a target amount to be raised before the funds are closed and funds are set up with a fixed term of 10 years or more. The second stage is *investment*, in which the private equity firm uses the funds raised to invest in companies. Private equity funds generally have a definite investment horizon within which they need to exit their investments and liquidate the fund, which leads to the third stage, divestment. During the *divestment* stage, private equity firms can choose to exit their companies through different forms including sale through public offerings, sale to other private equity firms or financial institutions, buyback by managers or owners, repayment of preference shares/loans and write-off.

During the 2007-2019 period, EUR 400 million were raised by private equity funds in Croatia (Figure 56). This represented 3.4% of the total amount of private equity capital raised in the Central and Eastern European region.[17] This is about the same portion as Croatia's share in CEE GDP (3.2%) in 2019. However, the activity is sporadic and funds were raised only in three years (2008, 2011 and 2014). In addition, over 70% of the total funds were raised in a single year, when five private equity funds started to operate under the regime of the Economic Cooperation Funds (FGS) initiated by the Croatian government in 2011.

[17] CEE countries include: Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Macedonia, Moldova, Montenegro, Poland, Romania, Slovak Republic, Slovenia, Serbia, Ukraine.

PE investments in Croatia have been on average EUR 34 million per year, accounting for 1.7% of the investment value in CEE countries over the 2007-2019 period, which is only half of Croatia's share of CEE GDP. However, 2018 and 2019 showed a significant increase in investments, amounting to over EUR 80 million each year. Divestment, keeping in mind that PE is still in an early stage of development, amounted to a mere EUR 86 million for the whole period, less than 20% of the total investment and representing only 0.66% of divestment in CEE countries.

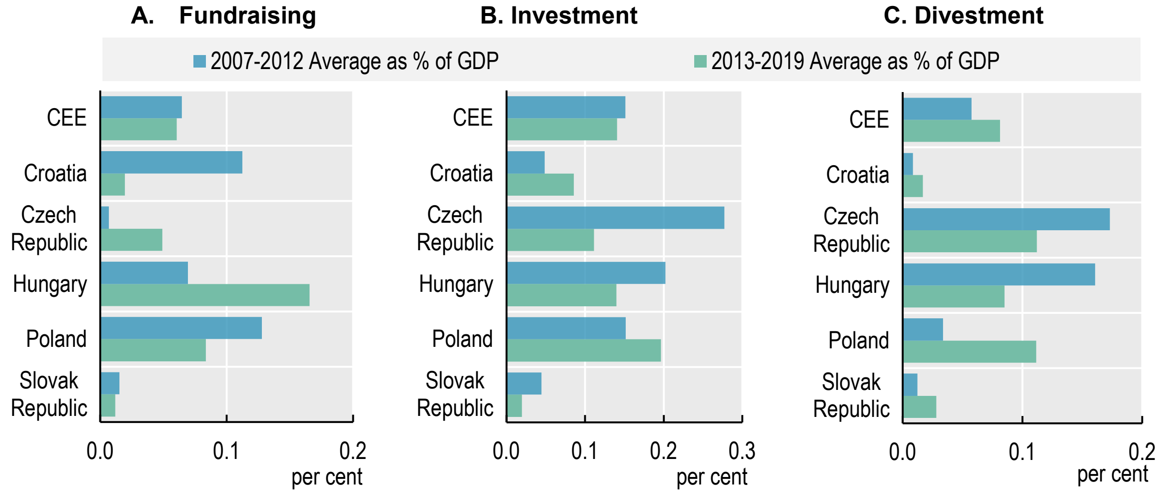
Figure 56. Private equity activity in Croatia (2007-2019)



Source: Invest Europe / EDC.

Compared to selected peer countries, Croatia lags behind in its PE activity – measured as percentage of GDP – particularly regarding investments and divestments (Figure 57). For countries such as the Czech Republic, Hungary and Poland, PE investments on average represent between 0.17% and 0.19% of their GDP, while they represent only 0.07% in Croatia. Moreover, PE divestments account for only 0.01% of Croatia's GDP compared to the CEE average of 0.07%. The exception is fundraising, for which Croatia is at the same level as the CEE average. However, most of the fundraising happened during the first period between 2000 and 2012 and, in recent years, the total amount of fundraising has been negligible.

Figure 57. Private equity activity in Croatia and selected European countries (2007-2019)



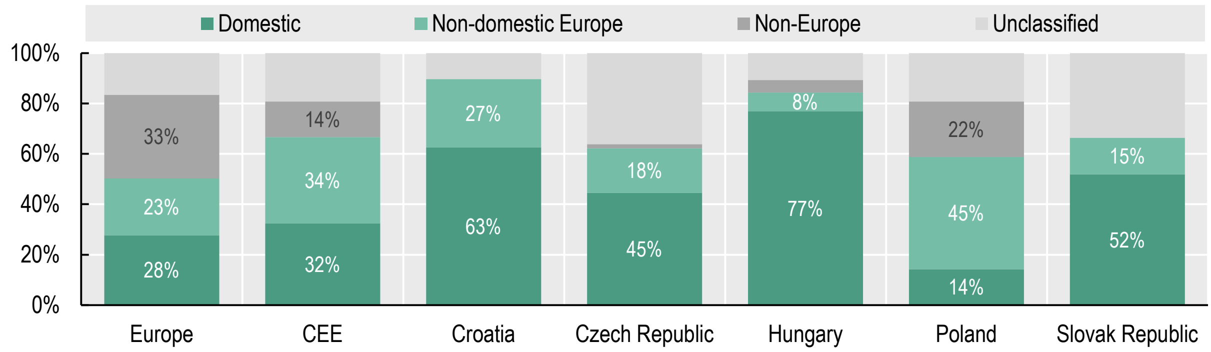
Source: Invest Europe / EDC.

4.2. Fundraising, investment and divestment trends

Private equity funds are typically organised as limited partnerships for a fixed period, with private equity firms providing services as general partners of the funds. As private equity firms do not have permanent capital, they need to continuously raise new capital every three to six years.

Croatian private equity firms rely heavily on the domestic market to raise funds, with 63% of the committed capital coming from domestic investors over the 2007-2019 period. This domestic dependence is almost twice as high as the share of domestic funds observed in the CEE region. Moreover, no funds have been raised outside of Europe, while for the CEE region, as a whole, around 14% of funds were raised from non-European investors. In Poland, 45% of the funds were raised from investors located in other European countries and another 22% from non-European investors. Generally, CEE countries depend heavily on the domestic market and on other European markets, who together account for 66% of total funds raised, compared to 51% in Europe as a whole.

Figure 58. Private equity fundraising in Croatia and selected European countries (2007-2019)

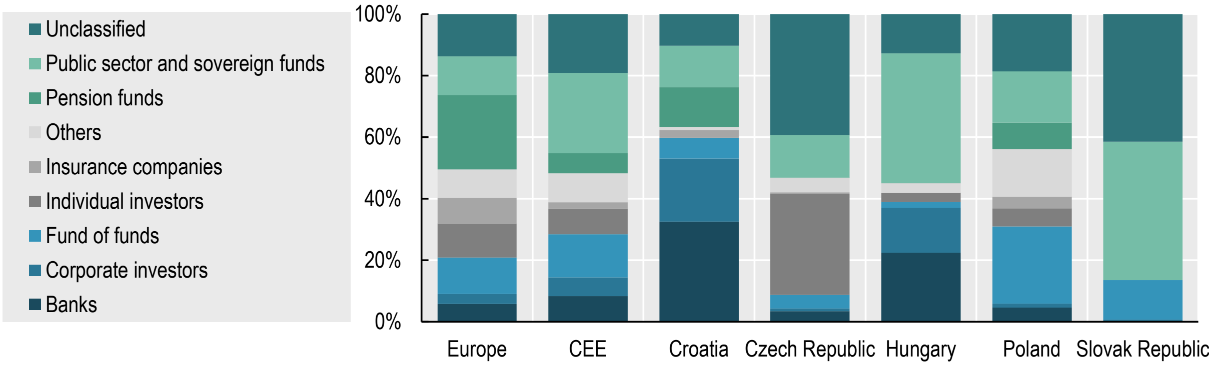


Source: Invest Europe / EDC.

One-third of Croatia's private equity fundraising comes from banks. Other categories of investors, including corporations, pension funds, public and sovereign funds, represent another 47% of the funds raised. Importantly, individual investors and funds-of-funds, which otherwise play a significant role in PE fundraising, only represent 7% of the funds raised in Croatia.[18]

[18] National development banks, such as Croatian Bank for Reconstruction and Development, are classified under the category "Public sector and Sovereign funds".

Figure 59. Private equity fundraising by type of capital providers in Croatia and selected European countries (2007-2019)

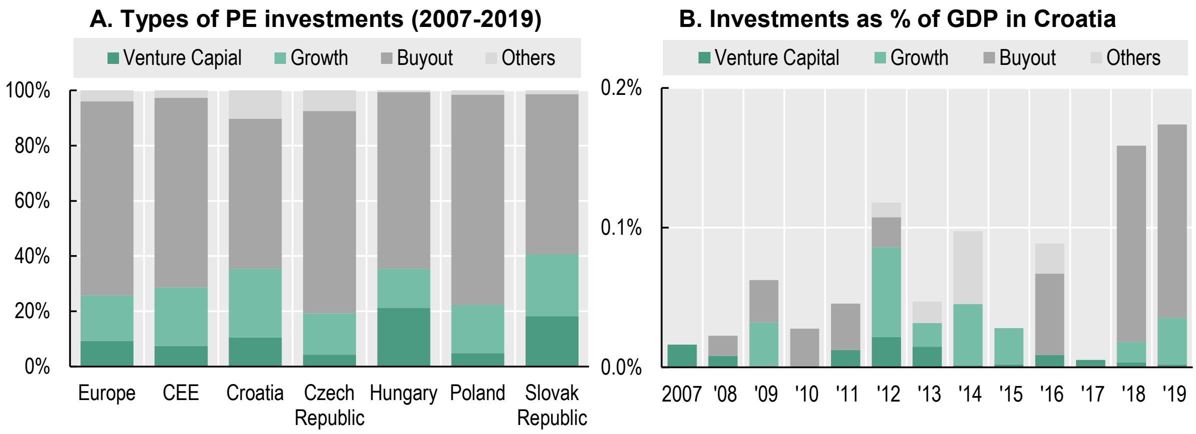


Source: Invest Europe / EDC.

A cross-country comparison between Croatia and peer countries confirms that the share of buyout deals in investments (54%) is relatively low compared to its peers (Figure 60). A buyout transaction normally involves high levels of debt financing, with the aim of acquiring a controlling share of the company to facilitate the restructuring process. In Europe, buyout deals account for almost 70% of the total PE investment value. While Croatia experienced a significant increase in buyout deals in 2018 and 2019, it was the result of a few large deals, e.g. in 2019 one single buyout transaction of EUR 75 million was carried out.

Growth investment, which is a minority investment in relatively mature companies that require capital for expansion, accounts for 25% of PE investments in Croatia. This is slightly higher than that in peer countries. It is also worth mentioning that despite the fact that the share of venture capital stands at 11% of total investments for the whole period, venture capital activity has been sluggish over the last five years, with an average total investment of less than 0.01% of GDP.

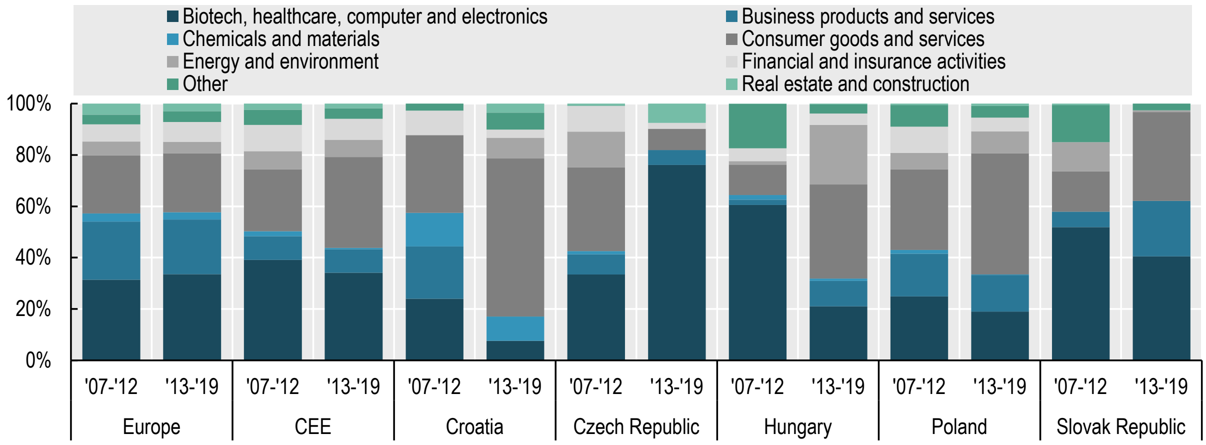
Figure 60. Private equity investments in Croatia and selected European countries



Source: Invest Europe / EDC.

Both at the EU and CEE levels, most PE investments are concentrated in three industries: consumer goods and services; technology including biotech, healthcare, computers and electronics; and business products and services. These three industries account for more than 75% of the total investments both at EU and regional levels. In Croatia, the largest industry is the customer goods and services which attracted 62% of the PE investments during the 2013-2019 period. Different from the EU and CEE trends, chemicals and materials is an important industry for PE investments in Croatia representing 11% of the total investment value.

Figure 61. Private equity investments by industry, 2007-2019

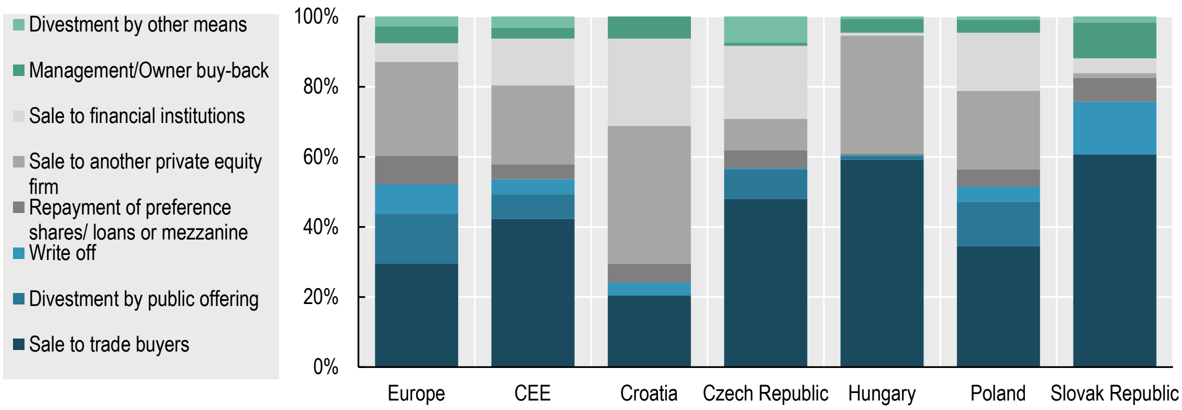


Source: Invest Europe / EDC.

The last stage of private equity investment is divestment, where private equity funds exit the investment at the end of the fund's lifecycle. There are several forms of divestments, including sale through public offerings, sale to other private equity firms or financial institutions, buyback by managers or owners, repayment of preference shares/loans and write-off.

Generally, sale to another private equity firm and trade buyers are the most common forms of divestment, constituting 56% and 65% of the total aggregate divestment value for Europe and CEE, respectively (Figure 62). Croatia is no exception, with these two forms of exits accounting for 60% of all divestments. Specifically, the sale to another private equity firm represents almost 40% of the total exit value. Notably, sale to financial institutions is also an important form of exit, representing 25% of the total divestments. Importantly, there has never been a divestment carried out as a public offering in Croatia.

Figure 62. Distribution of divestment volumes by exit forms (2007-2019)



Source: Invest Europe / EDC.

REFERENCES

Adriala (2020), “Covid-19 Comparative Legal Guide: Online shareholders' meetings / online participation and voting in shareholders' meetings”, https://adriala.com/Adriala-Covid-19-Comparative.pdf.

Aldasoro I. and R. Unger (2017), “External financing and economic activity in the euro area – why are bank loans special?”, BIS Working Paper Series, No: 622, March 2017, www.bis.org/publ/work622.pdf.

Antolín, P., S. Payet, E. Whitehouse and J. Yermo (2011), “The Role of Guarantees in Defined Contribution Pensions”, OECD Working Papers on Finance, Insurance and Private Pensions, No. 11, OECD Publishing, http://dx.doi.org/10.1787/5kg52k5b0v9s-en.

Banerjee, R. and B. Hofmann (2018), “The rise of zombie firms: causes and consequences”, BIS Quarterly Review September, www.bis.org/publ/qtrpdf/r_qt1809g.pdf.

Branzoli, N. and A. Caiumi (2018), “How effective is an incremental ACE in addressing the debt bias? Evidence from corporate tax returns”, Taxation Papers, Working paper N. 71-2018, European Commission, https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation-paper-72-ace.pdf.

Broz, T. and T. Ridzak (2017), “Lending activity and credit supply in Croatia during the crisis”, *Journal of Policy Modeling*, *39*(6), Pg. 1102-1116, https://doi.org/10.1016/j.jpolmod.2017.08.004.

Corporate Governance Code (2020), Corporate Governance Code, HANFA and Zagreb Stock Exchange, www.hanfa.hr/media/4097/zse_kodeks_eng.pdf

De La Cruz, A., A. Medina and Y. Tang (2019), “Owners of the World’s Listed Companies”, OECD Capital Market Series, Paris, www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm.

Deloite (2017), “Taxation and Investment in Czech Republic 2017”, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-czechrepublicguide-2017.pdf

Domikulić, M. (2019), “Analiza Stanja Crowdfundinga u Hrvatskoj”, Thesis, University of Split, School of Economics, https://repozitorij.efst.unist.hr/islandora/object/efst%3A2799/datastream/PDF/view.

EBC (2012), “Working Group on NPLs in Central, Eastern and South-eastern Europe”, European Banking Coordination-Vienna Initiative, March 2012, www.imf.org/external/region/eur/pdf/2012/030112.pdf.

EBRD (2018), “Croatia, Corporate sector background paper - Strengthening private sector productivity to support long-term growth”, https://www.ebrd.com/documents/financial-institutions/croatia-corporate-productivity.pdf.

EBRD (2016), “Croatia legislative framework”, www.ebrd.com/documents/ogc/insolvency-profile-croatia.pdf?blobnocache=true.

EC (2021), “European Economic Forecast – Winter 2021 (Interim)”, https://ec.europa.eu/info/sites/info/files/economy-finance/ip144_en_1.pdf.

EC (2020a), “Country Report Croatia 2020”, https://eur-lex.europa.eu/legal-content/EN.

EC (2020b), “European Innovation Scoreboard 2020”, https:ec.europa.eu/docsroom/documents/41941.

EC (2020c), “European Economic Forecast-Summer 2020”, Institutional Paper No: 132 – July 2020, https://ec.europa.eu/info/sites/default/files/economy-finance/ip132_en.pdf.

EC (2020d), “Convergence Report – 2020”, Institutional Papers, No: 129, June 2020, www.ecb.europa.eu/pub/convergence/html/index.en.html.

EC (2017a), “Improving European Corporate Bond Markets”, https://ec.europa.eu/info/sites/info/files/171120-corporate-bonds-report_en.pdf.

EC (2017b), “Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups”, https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_69_vc-ba.pdf.

EU (2016/97), Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast), European Parliament, http://data.europa.eu/eli/dir/2016/97/oj.

EU (596/2014), Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0596

FESE (2020), “European IPO Report 2020”, Federation of European Securities Exchanges, https://fese.eu/app/uploads/2020/03/European-IPO-Report-2020.pdf.

FINA (2021), Financial Agency, agency website, (accesed January 2021), https://www.fina.hr/en/creditworthiness.

Gambacorta, L., J. Yang and K. Tsatsaronis, (2014), “Financial structure and growth “, BIS Quarterly Review, March 2014, https://www.bis.org/publ/qtrpdf/r_qt1403e.htm.

Górzyñski, M., K. Stanchev, G. Stoev, J. Pañków and M. A. Walewski (2000), “Fiscal Effects from Privatization: Case of Bulgaria and Poland”, Centre for Social and Economic Research, Case Reports No. 37, https://core.ac.uk/download/pdf/6704167.pdf.

Grubišić Šeba, M. (2017), “20 Years of the Croatian Capital Market, Zagreb”, *International Review of Economics & Business*, Vol. 20, Special Conference Issue, pp. 41-58, 2017.

HANFA (2018), “Annual Report 2018”, Croatian Financial Services Supervisory Agency, https://www.hanfa.hr/media/4249/annual-report-for-2018.pdf.

HM Revenue and Customs (2020), “Enterprise Investment Scheme, Seed Enterprise Investment Scheme and Social Investment Tax Relief”, https://assets.publishing.service.gov.uk/.

IMF (2020), “Staff Report for the 2019 Article IV Consultation for Republic of Croatia”, www.imf.org/en/Republic-of-Croatia-2019-Article-IV.

IMF (2017), “Economic Recovery and Credit Growth: the Case of Croatia“, www.imf.org/~/media/Files/Publications/WP/2017/wp17256.ashx.

IMF (2016a), “Global Financial Stability Report, October 2016: Fostering Stability in a Low-Growth, Low-Rate Era “, Chapter 3 Corporate Governance, Investor Protection and Financial Stability in Emerging Markets, https://doi.org/10.5089/9781513559582.082.

IMF (2016b), “Stock Market Liquidity in Chile“, IMF Working Paper Series, WP/16/223, www.imf.org/en/Publications/WP/Issues/2016/12/31/Stock-Market-Liquidity-in-Chile-44405.

IMF (2006), “Allowances for Corporate Equity in Practice“, IMF Working Paper Series, WP/06/259, www.imf.org/external/pubs/ft/wp/2006/wp06259.pdf.

IOPS (2019), “Country Profile: Croatia”, www.iopsweb.org/resources/39487277.pdf.

Kovač, J., F. Šesnić and J. Krišto (2018), “Perspectives of SME Financing Through Capital Markets: the Case of Croatia”, Governance Research and Development Centre (CIRU), http://hdl.handle.net/10419/180013.

Lin, C., Y. Ma, P. Malatesta and Y. Xuan (2011), "Ownership structure and the cost of corporate borrowing", *Journal of Financial Economics*, Volume 100, Issue 1, April 2011, Pages 1-23.

Matek, P. and M. Galic (2017), "The Impact of Minimum Return Guarantees on Management of Mandatory Pension Funds in Croatia", *Czech Journal of Economics and Finance*, Volume 67 (4), pages 342-369, August.

McKinsey (2020), "A new decade for private markets", McKinsey Global Private Markets Review 2020, February 2020, www.mckinsey.com/.

MAS (2021a), "Global-Asia Bond Grant Scheme (G-ABGS)", www.mas.gov.sg/schemes-and-initiatives/Asian-Bond-Grant-Scheme (accessed 18 March 2021).

MAS (2021b), "Sustainable Bond Grant Scheme", www.mas.gov.sg/schemes-and-initiatives/sustainable-bond-grant-scheme (accessed 18 March 2021).

OECD (2021), "Using digital technologies to strengthen shareholder participation", CGC Contribution to OECD GOING DIGITAL II, https://one.oecd.org/document/DAF/CA/CG(2021)2/en/pdf.

OECD (2020a), "Pension Funds in Figures", www.oecd.org/daf/fin/private-pensions/Pension-Funds-in-Figures-2020.pdf.

OECD (2020b), "The COVID-19 crisis in Croatia", dated 29 June 2020, https://www.oecd.org/south-east-europe/COVID-19-Crisis-in-Croatia-archive.pdf.

OECD (2019a), "OECD Corporate Governance Factbook 2019" OECD Publishing, Paris, www.oecd.org/corporate/corporate-governance-factbook.htm.

OECD (2019b), "Pension Markets in Focus", www.oecd.org/daf/fin/private-pensions/pensionmarketsinfocus.htm.

OECD (2019c), "Annual Survey of Investment Regulation of Pension Funds", www.oecd.org/daf/fin/private-pensions/2019-Survey-Investment-Regulation-Pension-Funds.pdf.

OECD (2019d), "OECD Investment Policy Reviews: Croatia 2019, OECD Investment Policy Reviews", OECD Publishing, Paris, https://doi.org/10.1787/2bf079ba-en.

OECD (2018), "OECD Equity Market Review of Asia 2018", www.oecd.org/corporate/OECD-Asia-Equity-Market-Review-2018.pdf.

OECD (2017a), "Business and Finance Outlook 2017", Chapter 2 Globalisation and the Level Playing Field", OECD Publishing, Paris, Pg. 77-81, http://dx.doi.org/10.9789264274891-en.

OECD (2017b), "Resilience in a time of high debt", Chapter 2 - OECD Economic Outlook, Volume 2017 Issue 2, https://doi.org/10.1787/eco_outlook-v2017-2-en.

OECD (2016), "Changing business models of stock exchanges and stock market fragmentation", Chapter 4 OECD Business and Finance Outlook 2016, www.oecd.org/daf/ca/BFO-2016-Ch4-Stock-Exchanges.pdf.

OECD (2015), "OECD Guidelines on Corporate Governance of SOEs", 2015 Edition, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264244160-en.

OECD (2007), "Fundamental Reform of Corporate Income Tax – No. 16", ISBN 978-92-64-03811-0, https://www.oecd.org/tax/tax-policy/39672005.pdf.

Official Gazette, No. 17/2020, Amendments to the Capital Market Act, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2020_02_17_402.html.

Official Gazette, No. 115/2018, Law on Amendments to the Law on Mandatory Pension Funds, The Croatian Parliament, https://narodne-novine.nn.hr/eli/sluzbeni/2018/115/2237.

Official Gazette, No. 127/2017, Audit Act, The Croatian Parliament, https://zse.hr/UserDocsImages/docs/legal/rules/2019-12-09%20-%20ZSE%20Rules.pdf.

Official Gazette, No. 115/2016, Income Tax Act, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2016_12_115_2525.html.

Official Gazette, No. 71/2015, Bankruptcy Act, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2015_06_71_1365.html.

Official Gazette, No. 21/2010, Regulation for the participation of the Croatian Government in the establishment of the Economic Cooperation Funds, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2010_02_21_531.html.

Official Gazette, No. 150/2005, Law on Investment Funds, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2005_12_150_2897.html.

Official Gazette, No. 84/2002, Securities Market Act, The Croatian Parliament, https://narodne-novine.nn.hr/clanci/sluzbeni/2002_07_84_1390.html.

Oliver Wyman and WFE (2016). “Enhancing Liquidity in Emerging Market Exchanges”, www.oliverwyman.com/Liquidity-in-Emerging-Markets-Exchanges-.pdf

Prag, A., D. Röttgers and I. Scherrer (2018), “State-Owned Enterprises and the Low-Carbon Transition”, OECD Environment Working Papers, No. 129, OECD Publishing, Paris. https://doi.org/10.1787/06ff826b-en

PWC (2020), Worldwide Tax Summaries, Accessed 06/09/2020, www.taxsummaries.pwc.com/croatia/.

Republic of Croatia (2020), “Annual State Property Management Plan for 2020”, www.narodne-novine.nn.hr.

Regulation (EU) 2017/1129, The Prospectus Regulation, *Official Journal of the European Union*, www.eur-lex.europa.eu/legal-content.

Sanderson, P., D. Seidl, J. Roberts and B. Krieger (2010), “Flexible or not? The comply-or-explain Principle in UK and German Corporate Governance”, Centre for Business Research, University of Cambridge, Working paper No. 407, www.cbr.cam.ac.uk/working-papers/wp407.pdf.

Storz, M., M. Koetter, R. Setzer and A. Westphal (2017), “Do we want these two to tango? On zombie firms and stressed banks in Europe”, European Central Bank, Working Paper Series, No 2104 / October 2017, www.econstor.eu/handle/10419/175728.

Tapking, J. and J. Yang (2006), “Horizontal and Vertical Integration in Securities Trading and Settlement”, *Journal of Money*, Credit, and Banking, Vol. 38, No. 7, https://www.jstor.org/stable/3838965.

Urionabarrenetxea, S., L. San-Jose and J.L. Retolaza (2016), “Negative equity companies in Europe: theory and evidence”, *Business: Theory and Practice*, 17(4), Pg. 307-316, doi.org/10.3846/btp.17.11125.

Velandia A. and R. Cabral (2018), “Why are more sovereigns issuing in Euros? Choosing between USD and EUR-denominated bonds”, Policy Research Working Paper; No. 8324, World Bank, Washington, DC, http://hdl.handle.net/10986/29289.

Zagreb Stock Exchange (2020), Ownership structure on July 31th 2020, https://zse.hr/en/ownership-structure/.

Zagreb Stock Exchange (2019), Exchange Rules, Zagreb, November 2019, https://zse.hr/rules.

ANNEX – CONSULTATION PROCESS AND METHODOLOGY FOR DATA COLLECTION

A. Consultation process

During the course of the project the OECD team travelled on fact-finding missions to Zagreb to held bilateral meetings with the following stakeholders:

- Croatian Central Depository and Clearing Company
- Croatian Banking Association
- Croatian Chamber of Economy
- Croatian Financial Services Supervisory Agency
- InterCapital Securities
- Ministry of Finance
- Ministry of Foreign and European Affairs
- Podravska Banka
- Privredna Banka Zagreb
- Zagreb Stock Exchange

The purpose of these meetings was to understand the focus and priorities of different stakeholders in Croatia and the feedbacks received in these meetings have been incorporated in the report.

The draft report and recommendations were first circulated for comments to the Ministry of Finance. The Ministry of Finance collected inputs from the Croatian Financial Services Supervisory Agency. After receiving their feedback, a revised version of the report was circulated for further comments to the following stakeholders:

- Association of Croatian Pension Funds Management Companies and Pension Insurance Companies
- Croatian Banking Association
- Croatian Central Depository and Clearing Company
- Croatian Chamber of Economy
- Croatian National Bank
- Zagreb Stock Exchange

B. Company financial and ownership information

The information presented in Chapter I of Part II is mainly based on the OECD-ORBIS Corporate Finance database. The extract of information presented in Chapter I includes financial statement and ownership information for non-financial companies between 2006 and 2017.

Company categories construction

Chapter I in Part II shows the following four non-financial firm categories: Category 1 “*Listed companies*”, Category 2 “*Large unlisted companies*”, Category 3 “*Small and mid-sized companies part of a group*”, and Category 4 “*Independent small and mid-sized companies*”. The construction of the company categories is based on the ownership, industry, legal information and financial information tables.

The procedure starts by identifying all listed and unlisted companies with assets over USD 100 million in the entire ORBIS universe. Non-financial listed companies are classified immediately as Category 1 and large unlisted non-financial companies as Category 2. For these groups, the consolidated financial statements are used, if available.

The following steps identify the countries of interest and use their ownership-country-year tables to identify companies in Category 3 and Category 4. ORBIS provides many records of owners at different points in time from different sources. Two criteria are used to clean the ownership information and to be left out with only one record for each owner-firm-year observation: the largest owner is kept and the latest information is prioritised. The largest owner can be either the global ultimate owner at 50%, the global ultimate owner at 25%, or the largest direct owner with over 25% holdings. Once the sample has a unique owner-firm-year record, owners are classified as corporations or natural persons.

Using the ownership records generated in the previous step, the routine starts by identifying the subsidiaries of the listed and large unlisted companies. Three types of companies are identified: 1) domestic subsidiaries with a local parent, 2) domestic subsidiaries with a foreign parent, and 3) companies controlled by a person. Some companies that are classified as subsidiaries in this step were already identified as large unlisted companies at the beginning. In these cases, since the subsidiary was already consolidated, its data were not used to avoid duplications. The domestic subsidiaries with a local parent in Category 1 or 2, or with foreign parents Category 1 or 2 are classified as Category 3. Please note that this category includes the non-financial domestic subsidiaries of financial domestic parent and foreign parents as these parents are excluded as they do not meet the industry requirement or because they are not incorporated in the domestic market under analysis. The companies where the largest owner is a person (over 25% ownership) are classified as Category 4.

Economy-wide calculations take into account the ownership structure of companies and avoid considering companies that are already consolidated in the accounts of domestic non-financial parent companies. Thus, economy wide calculations include companies from Category 1, Category 2, Category 4, companies without ownership information, and companies from Category 3 that had a foreign parent or a financial domestic parent.

Financial information cleaning

The company category classification described in the previous section also incorporates different types of financial reporting (consolidated and unconsolidated reports). Large companies in the universe commonly report consolidated financial statements as well as unconsolidated financial statements. For the listed and large unlisted non-financial company categories, consolidated accounts are considered, if available. For the remaining categories, unconsolidated financial statements are used.

The raw financial dataset contains several firm-year observations when a company has multiple consolidation codes or it reports for different purposes. To construct a panel with a unique firm-year observation, the following steps are applied:

1. Financial companies are excluded.
2. The fiscal year corresponds to the previous calendar year of the closing date whenever the closing date of the financial statement is before June 30th.
3. Financial statements covering a 12-month period are used, preferably.
4. When multiple observations within the same year exist, accounts with closing dates closer to year-end are preferred to accounts with older closing dates.
5. Published annual reports are preferred to local registry filings. Local Registry filings are preferred to unknown filing types.
6. Accounts using IFRS are preferred to those using GAAP, accounts using GAAP are preferred to those using unknown accounting practices.
7. For companies with multiple consolidation codes, the following criteria apply: for companies that release consolidated financial statements, C1 is preferred when both C1 and C2 exist; for companies that release unconsolidated statements the observation from annual reports are preferred over others.
8. Financial information is adjusted by annual EUR Consumer Price Index changes and information is reported in 2018 constant million EUR.
9. Companies with at least one observation showing negative assets or negative fixed assets are dropped from the sample.

10. Companies with equal or less than 10 employees are dropped from the sample. When employee number is not available companies with total assets below EUR 35 000 are dropped from the sample.
11. Financial statement information is winsorized at 1% for both tails within companies' categories.

Industry classification

The OECD-ORBIS Corporate Finance uses the 1-digit SIC industry classification.

Standard Industrial Classification (SIC)
Agriculture, Forestry and Fishing
Mining
Construction
Manufacturing
Transportation, Communications, Electric, Gas and Sanitary service
Wholesale Trade
Retail Trade
Finance, Insurance and Real Estate
Services
Public Administration

C. Public equity data

The information on initial public offering (IPOs) and secondary public offerings (SPOs) presented in Chapter of Part II is based on transaction and/or firm-level data gathered from several financial databases, such as Thomson Reuters Eikon, FactSet and Bloomberg.

Considerable resources have been committed to ensuring the consistency and quality of the dataset. Different data sources are checked against each other and, whenever necessary, the information is also controlled against original sources, including regulator, stock exchange and company websites and financial statements.

Country coverage and classification

The dataset includes information about all initial public offerings (IPOs) and secondary public offerings (SPOs or follow-on offerings) by financial and non-financial companies for 5 European economies (Croatia, Czech Republic, Hungary, Poland and Slovak Republic) for the period from January 1995 to December 2019.

All public equity listings following an IPO, including the first time listings on an exchange other than the primary exchange, are classified as a SPO. If a company is listed on more than one exchange within 180 days, those transactions are consolidated under one IPO. The country breakdown is carried out based on the domicile country of the issuer. In the dataset, the country of issue classification is also made based on the stock exchange location of the issuer.

It is possible that a company becomes listed in more than one country when going public. The financial databases record a dual listing as multiple transactions for each country where the company is listed. However, there is also a significant number of cases where dual listings are reported as one transaction only based on the primary market of the listing. For this reason, the country breakdown based on the stock exchange is currently carried out based on the primary market of the issuer. Going forward, the objective is to allocate proceeds from an IPO to respective markets where the issuance is listed at the same time.

Currency conversion and inflation adjustment

The IPO and SPO data, and related financial statement data, such as total assets before the offering, are collected on a deal basis via commercial databases in current USD values. The information is aggregated at the annual frequency and, in some tables, presented at the year-industry level. Issuance amounts initially collected in USD were adjusted by US Consumer Price Index (CPI) and finally converted to 2019 EUR using the average exchange rate EUR/USD for 2019.

Industry classification

Initial public offering and secondary offerings statistics are presented in this report using the Thomson Reuters Business Classification (TRBC). The economic sectors used in the analysis are the followings:

Thomson Reuters Economic Sector
Basic Materials
Cyclical Consumer Goods / Services
Energy
Financials
Healthcare
Industrials
Non-Cyclical Consumer Goods / Services
Technology
Telecommunications Services
Utilities

Exclusion criteria

With the aim of excluding IPOs and SPOs by trusts, funds and special purpose acquisition companies the following industry categories are excluded:

- Financial companies that conduct trust, fiduciary and custody activities
- Asset management companies such as health and welfare funds, pension funds and their third-party administration, as well as other financial vehicles
- Companies that are open-end investment funds
- Companies that are other financial vehicles
- Companies that are grant-making foundations
- Asset management companies that deal with trusts, estates and agency accounts
- Special Purpose Acquisition Companies (SPACs)
- Closed-end funds
- Listings on an over-the-counter (OTC) market
- Security types classified as “units” and “trust”
- Real Estate Investment Trusts
- Transactions with missing or zero proceeds

D. Ownership data

The main source of information is FactSet Ownership database. This dataset covers companies with a market capitalisation of more than USD 50 million and accounts for all positions equal to or larger than 0.1% of the issued shares. Data is collected as of end of 2019 in current USD, thus no currency nor inflation adjustment is needed.

The data is complemented and verified using Thomson Reuters Eikon and Bloomberg. Market information for each company is collected from Thomson Reuters Eikon. The information presented in Chapter II of Part II for each of the following five economies (Croatia, Czech Republic, Hungary, Poland

and Slovak Republic) is based on the available records of owners collected from the above mentioned sources for listed companies in those markets.

Next, the information for all the owners reported as of the end of 2019 is collected for each company. Some companies can have up to 5 000 records in their list of owners. Each record contains the name of the institution, the percentage of outstanding shares owned, the investor type classification, the origin country of the investor, the ultimate parent name, among others. Each owner record is re-classified into the following investor classes: Private corporations, Public sector, Strategic individuals, Institutional investors and Other free-float. When the ultimate parent was recognised as a Government, the investor record is, by default, classified as Public sector. For example, public pension funds that are regulated under public sector law are classified as government, and sovereign wealth funds are also included in that same category.

E. Corporate bond data

Data shown on corporate bond issuances in Chapter III of Part II is based on original OECD calculations using data obtained from Thomson Reuters Eikon that provides international deal-level data on new issues of corporate bonds. Corporate bond data from Croatia, Hungary, Poland, Slovak Republic and Czech Republic also includes the non-underwritten ones retrieved through Thomson Reuters Eikon’s Bond Search application. Data for the global trends includes only bonds which were underwritten by an investment bank. The database provides a detailed set of information for each corporate bond issue, including the identity, nationality and sector of the issuer; the type, interest rate structure, maturity date and rating category of the bond, the amount of and use of proceeds obtained from the issue.

The initial dataset covers observations in the period from 1 January 2000 to 31 December 2019. From this initial set, convertible bonds, deals that were registered but not consummated, preferred shares, sukuk bonds, bonds with an original maturity less than 1 year or an issue size less than USD 1 million are excluded.

The country breakdown is carried out based on the domicile country of the issuer. Issuance amounts initially collected in USD were adjusted by US Consumer Price Index (CPI) and finally converted to 2019 EUR using the average exchange rate EUR/USD for 2019.

F. Private Equity data

The main source of information for the private equity data presented in Chapter IV of Part II is Invest Europe / EDC. The information provided by Invest Europe is made up of firms managing investment vehicles or pools of capital (Funds) and primarily investing equity capital in enterprises not quoted on a stock market. Firms are included in the analysis as long as at least one of the funds they manage qualifies to the inclusion conditions; however, only the activity of the qualifying funds is taken into consideration.

The countries included when referring to Europe statistics are: Austria, Baltic countries (Estonia, Latvia, Lithuania), Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Norway, Other CEE (Bosnia-Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia, Slovenia, Slovak Republic), Poland, Portugal, Romania, Spain, Sweden, Switzerland, Ukraine, United Kingdom.

The fundraising activities are classified according to the country that corresponds to the location of the advisory team of the fund. The amount reported under investments includes equity, quasi-equity, mezzanine, unsecured debt and secured debt. Secured debts amounts within all investments packages are removed, unless the debt originates from private equity funds. Investment activities are recorded according to the location of the portfolio company. Divestment amounts are recorded at cost (i.e. the total amount divested is equal to the total amount invested previously). Private equity statistics are collected in current Euros. Amounts are then adjusted by using Euro CPI to express them in constant 2019 EUR.

The categories of private equity entities that are excluded from the Invest Europe Universe are: Fund of Funds, Hedge Funds, Real Estate, Project Financing/ Infrastructure, Secondary Funds, Distress Debt, Venture Credit, Participative Loans, Incubators, Accelerators, Business Angels and Holding companies.

www.oecd.org/corporate/capital-markets

Co-funded by
the European Union