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BOŽENA KADEŘÁBKOVÁ

Faculty of Civil Engineering, Czech Technical University, Czech Republic

ONDŘEJ PTÁČEK

Faculty of Economics, University of Economics in Prague, Czech Republic

BARRIERS OF FDI INFLOW IN VENTURE CAPITAL AND PRIVATE EQUITY IN THE CZECH REPUBLIC

Abstract:

The barriers that negatively affect the PE and VC investment activity in the Czech Republic include the following aspects. Few sources for funds from traditional fund raisers such as pension funds or insurance companies, which is caused mainly by legislative restrictions. Insufficient project quality causes high proportion of transaction cost to investment amount ratio. Insufficient project quality, lack of projects due to little interest from the potential investee companies caused by imperfect information all mean higher risk for investors causing their risk aversion to concentrate mainly on larger projects. Insufficient fundraising conditions lead also to few opportunities for exits. These are the main reasons of the Czech Republic's little PE and VC market activity, which is limited to 10-20 investments per year in total.

Keywords:

venture capital, asset management, private equity, financial markets, market failure, government failure

JEL Classification: G24

1. Introduction

This paper aims at description of relation between foreign direct investment and private equity and venture capital on case study of the Czech Republic. The basic hypothesis is that the paper should identify the barriers of foreign direct investment inflow in venture capital and private equity in the Czech Republic.

Theoretical background focuses on the decision-making principles connected with venture capital and private equity investing. Then, barriers of foreign direct investment in private equity and venture capital are analysed.

2. Theoretical background of venture capital and private equity

2.1. Functioning of venture capital: an alternative source of borrowing for start-up companies

The economic principle of venture capital (VC) and private equity (PE) is based on lender/borrower model. A financial investor typically wishes to hold the shares of an investee company through an investment vehicle¹ only over a certain period of time and then sell them and realise profit from the transaction. The only difference is that in case of venture capital and private equity financing, the cost of capital is realised by the borrower (founder) only implicitly as a part of profits (dividends, or part of by sell) that he or she has to forsake in favour of the investor by its exit.

In this article, we are interested in capital in the form of investment into a firm's equity, which is then transformed by the firm into physical capital by purchase of machinery, equipment or else. Later on, the firm realises flow of capital services $k_t = H(K_t)$ from a capital stock of size K_t , where $t \in \{0; 1\}$.²

In reality, lenders delegate their decision-making to financial market agents (banks, pension funds, insurance companies etc.) who are limited in the risk they may retain in their portfolios by law. Therefore the firms at the beginning of the life cycle have limited access to finance due to high risk connected with no entrepreneurial history of the founders and poor cash flow in compare to large firms in later stages, which find sources of capital for new investment much easier using also other instruments as public offering of stocks, corporate bonds or may use their own retained profits from the past periods.

Generally, a PE or VC investee company may be described as a shareholder-owned firm, as there are at least two shareholders: the founder and the investor. Each of them has its own preferences and risk aversion rates, however they must be generally consistent in the decision-making as the investor would otherwise leave the company. At least, the founder must comply with the requirement of investor to prefer the future dividend D_1 to the present dividend D_0 . On the other hand, as the companies that find themselves in the *Death Valley* (early stage of business life cycle) do not typically generate sufficient cash flow to cover their cost, it is a reasonable requirement as the profit of a firm in the first years of its existence is usually negative, zero or close to zero (i.e. below the company's break-even point).

¹ PE or VC fund structure, which may be using other financial market instruments, such as bank leverage, securitisation, funds of funds etc.

² Gravelle, Rees (2004)

2.2. Capital market and decision-making of a start-up firm and venture capital investor

Though we will now concentrate on an example of decision-making of a start-up firm and venture capital investor, the results are applicable also to private equity investment in later stages.

The functioning of capital market in the mainstream economics is based on principle of choice of household between consumption M_0 and consumption M_1 , where time $t = 0$ is present and time $t = 1$ is future. We presume that the capital market in our model is perfectly competitive and the given price for lending and borrowing is expressed as an interest rate r . Since the capital market is perfect, all borrowers and lenders regard themselves as being able to borrow or lend as much as they like at the going rate of interest r .³ We assume that the economic agents decide under certainty.

For the purpose of this article, we suppose that consumption of a household can be also swapped in a capital market model for a firm's expenditure on inputs (total cost) due to analogy of their nature (consumption and cost both take form of expenditure), and then M_t may also stand for firm's expenditure on inputs where time $t \in \{0;1\}$. As we also suppose that the quantity of labour used by a firm at any period is fixed at $L^+ = L^*$, thence it follows that $M_t = wL_t^* + (1 + r)K_t$, where w is wage per unit of labour, L_t^* and K_t stand for quantity of labour and capital used by the firm for production over a period of time t . We assume the formula of production function $y_t = f(L_t^*, K_t)$.

Let's suppose there are only two shareholders in a firm: a founder α and an investor β . The founder α establishes a firm in time $t = 0$ and invests its own capital $K_{\alpha/0}$ in the firm alongside the investor, which invests its capital $K_{\beta/0}$ and also becomes a shareholder of a firm. We abstract from quasi-equity forms of investment from investors as shareholders (junior debts and others). We suppose that $K_{\beta/0} \gg K_{\alpha/0}$. It is then the intention of the founder α to attract much higher quantity of capital from the investor β . The founder α is furthermore ready to allocate own free time to labour $L_{\alpha/1}$ for the firm in the period $\langle 0;1 \rangle$. To the contrary, the investor β is wishing to invest only its capital $K_{\beta/0}$. Because there is a written deed (*term sheet* and *contract*) between the founder α and the investor β upon these conditions of their cooperation made at $t = 0$, thence it follows that

$$K_{\alpha/0} + wL_{\alpha/1} \geq K_{\beta/0} \quad (1)$$

because the founder α and the investor β typically conclude in the term sheet at $t = 0$ that the founder α will own at least 50 % of shares of the firm whilst contributing both $K_{\alpha/0}$ and $wL_{\alpha/1}$ to the firm⁴, as described in chapter.

We assume that the opportunity cost of own capital of a firm equals $(1 + r)K_w$ and explicit cost of borrowed capital equals $(1 + r)K_b$, where K_w is quantity of own capital and K_b is quantity of borrowed capital. Own capital means capital raised by shareholders or retained firm's profits from previous periods (endowment). Because we are at the beginning of the start-up firm's existence, we assume that there are no

³ Gravelle, Rees (2004)

⁴ We suppose that the founder α works (almost) for his start-up firm free of charge, so implicitly, he or she contributes $L_{\alpha/1}$ of own labour to the firm, which lowers its cost by $wL_{\alpha/1}$ in period $t = 1$.

retained firm's profits from previous periods in $t = 0$. Thence it follows that $K_{w/0} = K_{\alpha/0} + K_{\beta/0}$.

In time $t = 0$, the quantity of capital of a firm is

$$K_0 = K_{\alpha/0} + K_{\beta/0} \quad (2)$$

There is no borrowed capital K_b at $t = 0$, because the risk aversion of other lenders is higher than of the investor β and the risk profile of the start-up firm does not allow them to offer any capital to the start-up firm given that r remains unchanged. Then, we can finally conclude that $K_0 = K_w$ in a start-up firm.

At time $t = 1$, we suppose that the start-up firm has moved to the next stage of its business cycle⁵. The quantity of capital used by the firm in $t = 1$ has changed in compare to $t = 0$. We do not suppose any rise in shareholder's capital in the meantime⁶, so $K_{w/0} = K_{w/1}$.

We presume that the start-up firm has already some stable cash flow from its first customers (consumers), which allows it to borrow its first capital from a bank at $t = 1$, so it may be that $K_{b/1} > 0$. But, we also suppose that in case of *upside* scenario, the start-up firm realises profit $\pi_1 > 0$, which may then be transformed into dividend D_1 of the shareholders, so $\pi_1 = D_1$. Nevertheless, the stock of capital of a start-up firm at $t = 1$ equals:

$$K_1 = K_0 + \pi_1 = K_{\alpha/0} + K_{\beta/0} + \pi_1 \quad (3)$$

We suppose that the present dividend of a firm D_0 equals zero.

In contrary, the dividend D_1 differs from zero. Either the start-up firm is promising and $D_1 > 0$ as it realises positive profits and the firm is in *black numbers*, or the start-up firm is declining and therefore $D_1 < 0$ ⁷.

We assume under these conditions that dividend D_1 expected by a rational shareholder i in time $t = 0$ is at least the same as the opportunity cost of capital invested in the firm, so $D_{i/1} \geq (1 + r)K_{wi0}$, where K_{wi0} is a quantity of capital invested by a shareholder i in a firm in time $t = 0$.

In the end, we find out that the investor's capital is actually *lent* to the firm by the investor because we suppose that the investor takes part in the firm only to realise dividend

$$D_{\beta/1} \geq (1 + r)K_{\beta/0} \quad (4)$$

⁵ Or an end of its existence as it has still not gone through the whole period of the so called *Valley of Death*.

⁶ Although in reality, the investor β would actually only commit to invest $K_{\beta/0}$ at $t = 0$ and would transfer its capital in tranches following fulfillment of certain milestones set at $t = 0$ in the *term sheet*. Possible next rounds of financing from investor β or other investors would take place after $t = 1$.

⁷ The start-up firm may also find itself under the closure point in the short term (marginal revenue being below average variable cost, or $MR < AVC$) which may turn finally into the shareholders' decision to leave the start-up firm for a better opportunity in the long term.

and exit the firm⁸.

2.3. Venture capital, private equity and the Balance of Payments accounting principles

As regards the *Balance of Payments*, which shows data on *foreign direct investment* (inward direct investment, FDI) within the *financial account* statistics, venture capital and private equity investments may be included in several categories according to the International Monetary Fund (IMF) methodology.

The private equity and venture capital funds are regarded for the purpose of balance of payments accounting principles among other financial intermediaries, except insurance corporations and pension funds, which consist of financial corporations and quasi-corporations that are engaged in providing financial services by incurring liabilities, in forms other than currency, deposits, or close substitutes for deposits, on their own account for the purpose of acquiring financial assets by engaging in financial transactions on the market, and that are not included in another subsector. It is a feature of a financial intermediary that operations for both sides of the balance sheet are carried out in open markets.⁹ This category includes both investment banks, who themselves may invest their own funds in private equity or in hedge funds dedicated to venture capital, and venture capital and development (growth, buyouts) capital firms, who manage private equity and venture capital funds.¹⁰

As venture capital and private equity use equity based financial instruments, we have to find out, how equity is defined for the purpose of the financial account of the Balance of Payments. Equity is defined for the purpose of the Balance of Payments among other financial assets and liabilities as following: it consists of all instruments and records that acknowledge claims on the residual value of a corporation or quasi-corporation, after the claims of all creditors have been met. Equity is treated as a liability of the issuing institutional unit (a corporation or other unit). Equity may be split on a supplementary basis into:

- listed shares,
- unlisted shares, and
- other equity.

Both listed and unlisted shares are equity securities. Listed shares are those listed on an exchange and may sometimes be referred to as quoted shares. Unlisted shares can be referred to as private equity including venture capital. Other equity is equity that is not in the form of securities.¹¹

As we can see in the Table 4, unlisted shares may be further regarded as Direct Investment, Portfolio Investment, or Reserve Assets.

⁸ Or decides to participate in the next financing round.

⁹ IMF (2009)

¹⁰ These are regarded in IMF (2009), as specialized financial corporations that assist other corporations in raising funds in equity and debt markets and provide strategic advisory services for mergers, acquisitions, and other types of financial transactions.

¹¹ IMF (2009)

Table 1: Link between Financial Assets Classification and Functional Categories within the Balance of Payments, source: IMF

2008 SNA Financial Assets and Liabilities Classification	Functional categories				
	DI	PI	FD	OI	RA
AF1 Monetary gold and SDRs					
AF11 Monetary gold					
Gold bullion					X
Unallocated gold accounts					X
AF12 Special drawing rights				X ¹	X ¹
AF2 Currency and deposits					
AF21 Currency				X	X
AF221 Interbank positions				X	X
AF229 Other transferable deposits	X			X	X
AF29 Other deposits	X			X	X
AF3 Debt securities	X	X			X
AF4 Loans	X			X	X
AF5 Equity and investment fund shares					
AF51 Equity					
AF511 Listed shares	X	X			X
AF512 Unlisted shares	X	X			X ²
AF519 Other equity	X			x	
AF52 Investment fund shares/units					
AF521 Money market fund shares/units	x	X			X
AF522 Other investment fund shares/units	x	X		x	X
AF6 Insurance, pension, and stand. guarantee schemes					
AF61 Nonlife insurance technical reserves	x			X	
AF62 Life insurance and annuity entitlements	x			X	
AF63 Pension entitlements				X	
AF64 Claims of pension funds on pension managers	X			X	
AF65 Entitlements to nonpension benefits				X	
AF66 Provisions for calls under standardized guarantees	X			X	
AF7 Financial derivatives and employee stock options					
AF71 Financial derivatives					
AF711 Forward-type contracts			X		X
AF712 Options			X		X
AF72 Employee stock options			X		
AF8 Other accounts receivable/payable					
AF81 Trade credit and advances	X			X	
AF89 Other accounts receivable/payable	X			X	

Note: DI—direct investment; PI—portfolio investment; FD—financial derivatives (other than reserves) and employee stock options; OI—other investment; RA—reserve assets. X shows applicable functional categories (x shows cases considered to be relatively uncommon) for the most detailed instrument categories.

¹SDRs: Assets = Reserve assets; Liabilities = Other Investment.

²Unlisted shares must be liquid, as stated in paragraph 6.87.

To become Reserve Assets, the unlisted shares must be liquid. Venture capital investments are not liquid, as venture capital invests in early stages of business life-cycle. The start-up firms may become liquid later and make initial public offering, but not in the stage of venture capital. Growth and Buyout stages of private equity are more liquid than venture capital backed companies and some of them may be nearly as liquid as publicly traded shares. But we do not suppose the central banks to hold such shares. In reality, unlisted private equity shares are not typical sort of reserve assets for monetary authorities and can be omitted.

Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy.¹² *Immediate direct investment* relationships arise when a direct investor directly owns equity that entitles it to 10 % or more of the voting power in the direct investment enterprise. *Control* is determined to exist if the direct investor owns more than 50 % of the voting power in the direct investment enterprise. A *significant degree of influence* is determined to exist if the direct investor owns from 10 to 50 % of the voting power in the direct investment enterprise.¹³

As regards *portfolio investments*, they are defined as crossborder transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets. Acquisition of shares in hedge funds, private equity funds, and venture capital are examples of portfolio investment that occurs in less public and more lightly regulated markets. However, shares in these funds are included in direct investment when the holdings reach the 10 % threshold, and in other equity in other investment when investment is not in the form of a security and not included in direct investment or reserve assets.¹⁴

Typically, cross-border private equity or venture capital investment would be regarded as direct investment, as the private equity and venture capital funds mainly invest in equity shares ranging 25-50 %¹⁵ and the presented definition of direct investment assumes that at least 10 % of the company in the host economy.¹⁶

There is always a matter of valuation in case of private equity and venture capital international investment, as the equity shares are unlisted and therefore there may be no observable market prices for positions in equity not listed on a stock exchange. When actual market values are not available, an estimate is required. Alternative methods of approximating market value of shareholders' equity in a direct investment enterprise include the following:

- Recent transaction price;
- Net asset value;
- Present value and price-to-earnings ratios;
- Market capitalization method;
- Own funds at book value;
- All types of reserves identified as equity in the enterprise's balance sheet;
- Apportioning global value;

¹² OECD (2008)

¹³ IMF (2009)

¹⁴ IMF (2009)

¹⁵ Dvořák, Procházka (1998), s. 104, 136. On page 137, we find example of a private equity fund investment in 8 % of equity shares, but we have to bear in mind that the presented example was a syndicated investment of three private equity funds and this share referred to only one of them.

¹⁶ However the limited partnership legal structures typically used for private equity and venture capital funds, often in off-shore countries, may make it more complicated to find the direct relations between an investor in the economy of origin of the investment and the company invested in the host economy.

- In cases in which none of the above methods are feasible, less suitable data may need to be used as data inputs. For example, cumulated flows or a previous balance sheet adjusted by subsequent flows may be the only sources available;
- If the current market price is not directly observable, the decision about the methods to adopt should take into account the availability of information as well as judgments as to which available method best approximates market values;
- The value of a direct investment enterprise's non-equity liabilities may exceed its assets – this situation can occur most commonly in the early or final stages of its existence.¹⁷

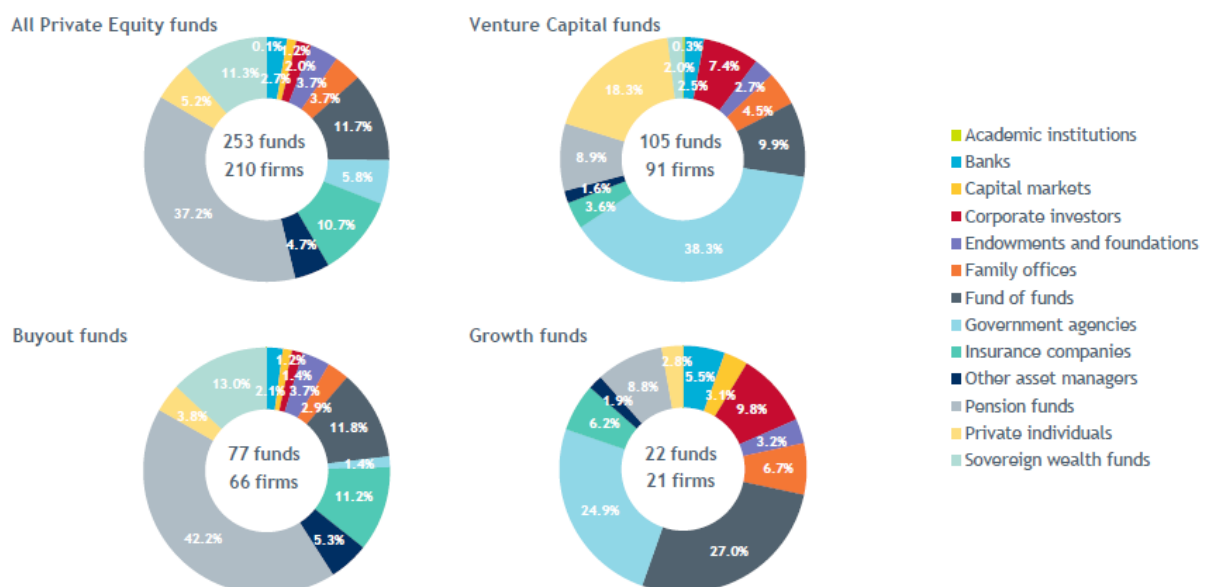
3. Discussion: Barriers of FDI inflow in Venture Capital and Private Equity in the Czech Republic

Investors in PE and VC funds include in particular pension funds, insurance companies, banks, funds of funds, government agencies and private investors.

EVCA data showed in 1997 that banks were the most important investors with 26.8% share on fundraising followed by pension funds (25.0%) and insurance companies (16.4%), whereas government agencies were at the rear with 2.2%.¹⁸

We can see from EVCA 2013 data in Chart 7 that the situation has changed in the meanwhile in fundraising – the largest investor in 253 existing European PE and VC funds managed by 210 PE and VC firms has become pension funds with 37.2% share on total fundraising followed by funds of funds (11.7%), sovereign wealth funds (11.3%) and insurance companies (10.7%). Within venture capital segment, government agencies became the largest investors with 36.3% share on total fundraising, second largest being sources from capital markets (18.3%)

Chart 1: Funds raised in PE and VC funds in Europe by investor type, 2013, source: EVCA (2014)



¹⁷ IMF (2009)

¹⁸ Dvořák, Procházka (1998)

In the Czech Republic, the situation is very different and shows that important potential PE and VC investors are discouraged by local market and legal conditions. Primarily, we can see that local investors raised only EUR 165 million over the period of 2007-2013. Pension funds, the most important investors in such funds in Europe, are missing, so are insurance companies or government agencies in case of venture capital. The fundraising activity is limited almost only to corporate investors, private individuals and banks.

Table 2: Funds raised in PE and VC funds in the Czech Republic by type of investor, 2007-2013 totals, data source: CVCA

Investor type	2007-2013	
	Funds raised	% share
Academic institutions	0	0,0%
Banks	25 000	15,1%
Capital markets	0	0,0%
Corporate investors	30 000	18,1%
Endowments and foundations	0	0,0%
Family offices	0	0,0%
Fund of funds	10 000	6,0%
Government agencies	0	0,0%
Insurance companies	0	0,0%
Other asset managers	4 460	2,7%
Pension funds	0	0,0%
Private individuals	18 300	11,1%
Sovereign wealth funds	0	0,0%
Unclassified	21 750	13,1%
New funds raised	165 510	100,0%

If the Czech Republic pursues reaching the European average as benchmark, it has to fill-in a yearly gap in PE and VC investment of 0.077% GDP according to 2007-2013 average figures, or EUR 113.2 million. VC investment gap 0.022 % GDP represents EUR 32.9 million yearly. As regards other PE stages (mainly growth and buyout), the yearly gap to the European benchmark would be 0.054% GDP or EUR 80.3 million.

The Czech financial market is not able to allocate resources effectively and attract local and foreign direct investment through PE and VC funds mainly due to the following barriers¹⁹:

- Unsufficient number of investor ready projects;
- Unsufficient fundraising conditions;
- Lack of opportunities for exits;
- Risk aversion on the supply side leading to high minimum investment threshold;
- Imperfect information on the demand side (investee companies).

¹⁹ Pazour, Marek (2011) and Ptáček (2014)

Mainly, the participation of pension funds and insurance companies in PE and VC funds is significantly restricted by law in the Czech Republic, which may be perceived as government failure.²⁰ Domestic sources for PE and VC funds are thus lacking. This is a problem throughout the Central and Eastern European region, though, as only 4% fundraising comes from domestic private investors.²¹ But, whereas in the rest of the region, government agencies became very active after 2009 and belong to the most important fundraisers (mainly in venture capital),²² this is not the case of the Czech Republic. This seems to be crucial for the growing differences between the Czech Republic and some other neighbouring countries, mainly as regards early stage venture capital investments, which are still almost invisible in the Czech Republic. Due to lack of domestic fundraising is Czech venture capital very limited to a few funds and several high net worth individuals (HNWIs), who cannot cover a variety of possible investee companies, whereas the foreign venture capital funds target rather larger investments.²³

Furthermore, the future impact of current development in the financial markets on the Czech PE and VC may not be very positive. The recent regulatory measures tend to influence negatively the capital available from the funds' investors. Less new money in the global PE market should influence even the Czech capital market, as most of the PE investors in Czech companies are represented by foreign PE and VC funds.²⁴

Another reason lies in legal barriers of establishing PE and VC funds within the Czech Republic. The PE and VC funds operate in the Czech Republic mainly from off-shore destinations. Off-shoring has been very much used to lower the operating costs of enterprises²⁵ or for tax optimisation purposes, which is the case.

As regards PE and VC investments, the FDI could flow in the Czech Republic mainly through foreign funds of funds managing capital from pension funds and other investors. Corporate foreign direct investors could then extend the possibilities of exits, using network enterprising or creating alliances and acquisitions as modern forms of business integration.²⁶ Promotion of venture capital by appropriate government action, as well as measures for deepening of financial markets and increase of financial discipline, would enrich supply of equity capital.²⁷

One of the main reasons is that the investment criteria applied by the VC funds operating in the Czech Republic actually exclude investments in the seed and start up stages of SME development.²⁸ Even investments through the later stage are limited given the minimum investment size of ca. EUR 1 million for most funds. Consequently, the majority of realized transactions are management buyouts or buy-ins and replacement or secondary purchase transactions.

²⁰ For instance Art. 100 (2) of Law No. 427/2011 Sb., on supplementary pension savings stipulates that as regards investment securities, the pension funds in the Czech Republic may invest only in securities listed in public markets.

²¹ EVCA (2013)

²² EVCA (2014)

²³ Rejšek (2008)

²⁴ Compare with The McKinsey Global Institute (2011) and Di Carlo (2010).

²⁵ Vilamová, Janovská, Kozel, Vozňáková, (2011)

²⁶ Vilamová, Janovská, Kozel, Vozňáková, Švecová (2012)

²⁷ Vidučić, Vidučić, Boras, Šušak (2014)

²⁸ For instance due to higher expected IRR etc., Zinecker, Rajchlová (2010)

There also occurs imperfect information on the demand side, as the entrepreneurs are lacking practical knowledge on PE and VC (including its indirect positive effects on business) and are usually not willing to share equity with external investors.²⁹

According to CVCA findings³⁰, PE and VC investing has not yet become a common investment method in the Czech Republic. Such funds are still regarded as alternative financing sources that entrepreneurs seek out only after they are rejected at a bank. One of the reasons for this is insufficiency of domestic sources of investment funds, upon which especially smaller venture capital funds throughout Europe depend.

The reluctance towards capital-based instruments may stem from the pursuit of a high level of autonomy by the businesses. Both entrepreneurial candidates and representatives of companies in further phases of development indicated the need for independence as one of the main reasons for starting or having started their businesses according to a survey in Poland.³¹ Businesses also stress the lack of the competences of financial institutions and simplistic, underdeveloped and inappropriate approach to new business ventures' assessment in certain knowledge intensive industries, such as biotechnology.³²

4. Conclusion

There exist barriers in the Czech Republic that negatively affect the PE and VC investment activity and prevent foreign investors from FDI in Czech PE and VC:

- 1) Few sources for funds from traditional fund raisers such as pension funds or insurance companies, which is caused mainly by legislative restrictions.
- 2) Insufficient project quality causes high proportion of transaction cost to investment amount ratio.
- 3) Insufficient project quality, lack of projects due to little interest from the potential investee companies caused by imperfect information all mean higher risk for investors causing their risk aversion to concentrate mainly on larger projects.
- 4) Insufficient fundraising conditions lead also to few opportunities for exits.

These are the main reasons of the Czech Republic's little PE and VC market activity, which is limited to 10-20 investments per year in total. FDI takes 77% share on total PE and VC investment in the Czech Republic over 2007-2013. Data on FDI in PE and VC is distorted, though, as main foreign investors are investment funds with Czech managers who invest through vehicles established outside the EU for tax reasons. The solution that would contribute to dismantling the barriers of FDI inflow in PE and VC would be to create more favourable conditions for investing in the Czech Republic.

If the Czech Republic pursues reaching the European average as benchmark, it has to fill-in a yearly gap in PE and VC investment of 0.077% GDP, or EUR 113.2 million, according to 2007-2013 average figures.

The paper has identified the barriers of FDI inflow in venture capital and private equity in the Czech Republic.

²⁹ Zinecker, Rajchlová (2010)

³⁰ CVCA (2010)

³¹ Matejun (2013)

³² Martin (2013)

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