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PROPOSALS FOR LEGISLATIVE CHANGES AS FUNDING TO SUPPORT THE DEVELOPMENT OF PRIVATE EQUITY AND VENTURE CAPITAL IN THE CZECH REPUBLIC

Jaroslava Rajchlova [1], **Michaela Baranykova** [2]

Brno University of Technology, Kolejní 2906/4, CZ – 612 00 Brno, Czech Republic
Email: [1]rajchlova@fbm.vutbr.cz;[2]baranykova@fbm.vutbr.cz

Abstract. The essence of the paper is the formulation of draft amendments to the legislative and institutional conditions necessary for the development of private equity financing and venture capital in the Czech Republic. Changes in these areas were defined based on conclusions drawn from the foreign studies, the analysis conclusions of legislation in selected European countries (UK, Netherlands, Ireland, Poland), which belong among the PE / VC market leaders in Europe, and on other numerous information sources. In connection with fulfilment of the targets it is possible to formulate changes that may lead to improved conditions for the financing by PE / VC in the Czech Republic: full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003 to allow the investment of pension funds and insurance companies in private equity and venture capital. Public support for funding by PE / VC, for example in the form of tax deductible expenses generated investment losses. Establishment of a public-state fund to support emerging and developing businesses, which would operate on the basis of a "fund of funds", the Fund's PE /VC.

Keywords: private equity, venture capital, legislative conditions, barriers, financing of business development.

Jel classification: G24

1. Introduction

Finding various ways of how to finance the development is a current issue of businesses (Režňáková, Nývltová. 2007; Koráb *et al.* 2008). One of the alternatives for financing the development of businesses is the use of private equity and venture capital (hereinafter referred to also as PE/VC). According to Zinecker (2008), this means financing through equity, namely paying up of the increased registered capital on the part of new owners. (Režňáková 2007), like (Valach 2001; Schefzyk 2006), etc., perceive PE/VC as such a type of capital that is inserted into the registered capital of a company, basically not-publicly marketable enterprises, intended for the financing of initial activities of the company and especially for the financing of projects of an innovation and development nature bearing a high risk. The capital deposits are carried out on the part of private investors, known as Business Angels, or on the part of institutional investors - PE/VC funds. There are, however, not any PE/VC funds in the Czech Republic, which means that such investments are implemented through the so-called managerial companies. The specification whether the matter concerns a private equity type or venture capital depends on the development phase of the entity accepting such investments. This form of financing is used frequently in other European countries. In the central and eastern Europe it is not used as frequently but the situation is improving according to (Zinecker, Rajchlová 2010).

Due to the fact that this topic is highly current, major attention was paid to formulation of draft measures whose implementation can lead to the development of PE/VC funding in the Czech Republic. The research task was divided into two parts: the aim of the first part could be seen in the identification of impacts for the use of PE/VC in national economy, in the highlighting of opportunities and in the revealing of possible barriers for this form of funding in the Czech Republic. The aim of the second part consisted in the designing of particular legislative and institutional measures whose implementation can lead to the development of the PE/VC financing in the Czech Republic.

2. The first part

The aim of the first part of the research task is perceived by the authors in identification of impacts of the use of PE/VC in the national economy, in the highlighting of opportunities and in revealing the barriers for this form of funding.

2.1. Methods used

The objectives set out were achieved by means of an analysis of conclusions resulting from the results of the benchmarking study of the development of PE/VC funding in the Czech Republic. The background material for the analysis was formed by the data and information sources EVCA[1], CVCA[2], BVK[3] of a secondary nature, followed by the analysis of the development of use of PE/VC in the Czech Republic and in the context of PE/VC financing in selected European countries and in the countries of Central and Eastern Europe (hereinafter referred to as CEE), identification of the rate of use of this type of funding in the Czech Republic. With the use of the analysis of conclusions resulting from the benchmarking study and on the basis of an analysis of conclusions resulting from foreign studies it was possible to identify impacts on the national economy, to specify opportunities and mainly the barriers for this form of financing in the Czech Republic. The data were processed with the use of standard methods of scientific work, namely analyses, descriptions, induction, deduction, mathematical and statistical methods. Besides this, there were used charts increasing the descriptive capacity of individual results achieved.

2.2. Results of the research, discussion

The analysis of the development of PE/VC financing in the Czech Republic was drawn up on the basis of relevant data for the period of 1997 to 2010, especially within the meaning of the development of the number of enterprises that were financed this way, volume of the means invested into the enterprises and subsequently distribution of the volume of investments according to the development phases of an enterprise and the development of the number of divestments, in relation with the associated volume of financial means during implementation of such divestments. This was followed by assessment of the rate of use of this form of financing in the Czech Republic in comparison with other European countries, through the indicator measuring the ratio of PE/VC investments to the gross domestic product of the country in question. Within the framework of this benchmarking, also a comparison of the rate of use of PE/VC in the Czech Republic was made with an exclusive focus on the countries of Central and Eastern Europe. Concerning such a comparison with other European countries, the Czech Republic states an average level (Table 1).

Table 1. Ratio of PE/VC investments to GDP in selected European countries (v %) (Source: adopted from (Rajchlová *et al.* 2011a))

Country	2010	2009	2008	2007	2006	2005	Aver. ratio
SW	0.78	0.37	0.67	1.2	1.44	0.86	0.87
UK	0.75	0.3	0.74	1.03	1.26	0.66	0.76
NL	0.33	0.14	0.45	1.03	1.05	0.6	0.61
FR	0.33	0.16	0.47	0.64	0.61	0.45	0.43
Fi	0.33	0.4	0.4	0.61	0.23	0.47	0.38
Nor	0.61	0.25	0.35	0.54	0.26	0.24	0.36
Hu	0.07	0.22	0.42	0.49	0.88	0.17	0.34
Be	0.27	0.34	0.2	0.64	0.45	0.16	0.33
Sp	0.28	0.1	0.21	0.4	0.37	0.48	0.3
CZ	0.13	1.02	0.3	0.13	0.32	0.11	0.29
Ge	0.19	0.11	0.37	0.44	0.31	0.25	0.27
Ir	0.5	0.32	0.16	0.3	0.39	0.08	0.27
La	0.05	0.01	0.27	0.79	0.07	0.07	0.2
It	0.1	0.13	0.34	0.21	0.33	0.02	0.18
Ro	0.1	0.19	0.2	0.39	0.12	0.09	0.16
Po	0.11	0.19	0.22	0.1	0.12	0.18	0.15
At	0.25	0.07	0.12	0.31	0.1	0.08	0.14
Pl	0.05	0	0	0.57	0.08	0.07	0.11
Gr	0.19	0.09	0.17	0.22	0.12	0.05	0.13
Est	0.01	0.07	0.13	0.19	0.03	0.22	0.09
Slo	0.05	0.03	0.09	0.33	0.03	0	0.08

In the context of comparison with the countries of Central and Eastern Europe, the Czech Republic was on the second place for the period from 2004 to 2010. In this context it is, however, necessary to point out the exceptional situation in 2009, when within the framework of 22 investments in the year in question one of them reached almost EUR 1 billion and therefore significantly affected the entire result for the period monitored.

Possible reasons for the average state of use of this method of financing were seen, on the basis of preliminary investigation, in legislative and institutional obstacles.

The low level of use of private equity and venture capital in the Czech Republic, according to (Dvořák 1998; Režňáková, Nývltová 2007), can be perceived also as a consequence of non-understanding and lack of knowledge of this form of funding, inability of the company management to draw up a business plan and to draw attention of potential investors this way, together with concerns of entrepreneurs due to administrative burdens resulting from the entry of such investors, and finally also as a consequence of a rather problematic valuation of the investment, given the fact that e.g. a public subscription of shares making it

[1] European Private Equity and Venture Capital Association

[2] Czech Private Equity and Venture Capital Association

[3] German Private Equity and Venture Capital Association

possible to achieve a high valuation is little used in the Czech Republic.

Another reason for the low use of PE/VC is the absence of a public, institutional support of this form of financing. There are so-called seed funds (Schefczyk 2006) in European countries, which are focused on financial support of emerging innovative businesses. In the Czech Republic, this need of arising of a seed fund was discussed at the level of the Ministry of Industry and Trade and at the level of banks; in November 2011 the Prime Minister of the Government of the Czech Republic declared establishment of such a fund in 2012.

At present, PE/VC for SME in the Czech Republic is a part of the Operational Programme - Enterprise and Innovation for 2007 – 2013, which cannot, however, be used because there is no fund from which the support of entrepreneurship would be paid.

Through venture capital and private equity it was possible to support the establishment and development of such companies as Facebook, Cisco, Fedex, Microsoft, Skype, Apple, Home Depot, Intel, Ebay, Google, Amazon, Starbucks, Twitter, Staples, Amgen, Zipcar, Zynga and others (source: NVCA). The potential for funding through venture capital and private equity for the Czech Republic therefore consists in the funding of such projects that are extraordinarily for-growth, feature a high added value and are often connected with innovations of both products and services within the meaning of patent registration (Rolling 2001; Schefcyk 2006). The financing through PE/VC means is therefore an opportunity for emerging Czech enterprises with a strong innovation potential as well as for the companies trying to expand.

Economic impacts of the PE/VC financing can be observed also in stimulation of entrepreneurial environment according to (Režňáková, Nývltová 2007), in establishment of new companies, higher competitiveness of business, according to (Roling 2001; Haessler et al. 2009; Schertler, Tykvova 2009), and as stated by (Engel 2001), (EVCA, 2002) in creation of new jobs. Positive impacts on development of businesses, especially in relation to a better economic development of businesses financed through PE/VC in comparison with those financed in another way, are documented by numerous foreign studies implemented e.g. by (AVCO4 2006; EVCA5 2002; BVCA 2002; Manigart and Van Hyfte 1999; Kortum, Lerner 2000; Amess 2003; Engel 2002; Engel, Keilbach 2002; Bygrave, Lange, Kotha, Stock 2001; Frederiksen 1997; Brophy 1988). An increase in PE/VC investments in the Czech Republic can therefore mean both an increase in the number of new innovative businesses and an expansion of the existing ones. According to the study (Belke, Fehn and Foster 2003), it is possible to connect the increase in the PE/VC investments with a drop of unemployment. Developed economies (Table 1) state the rate of the use of PE/VC as much as 2.5 times higher than the Czech Republic, and this form of financing is already well established there, and according to the above mentioned studies it is possible to state that the PE/VC funding contributes to the growth of the national economy. There should be made such changes in the Czech Republic, in particular in the field of legislation that would enable an increase in the use of this form of financing. It is also necessary to support educational activities, to draw enterprise owners' attention to advantages of this financing, it is necessary to formulate draft measures aimed at elimination of the barriers for PE/VC development in the Czech Republic. The proposals can contribute to the subsequent development of funding of PE/VC and in the context therewith also to implications of the above stated economic influences of private equity and venture capital on the national economy.

3. The second part

The aim of the second part was the draft of such legislative and institutional conditions for PE/VC funding in the Czech Republic whose implementation can lead to improvement of the situation on the PE/VC market in the Czech Republic and to an increase in investments of this type.

3.1. Methods used

The authors presuppose that the objectives of the second part can be achieved on the basis of conclusions of an analysis of legal standards, as well as of conclusions of an analysis of public aid in selected countries and in the Czech Republic. The grounds are formed of the analyses of law regulations of the Czech Republic, Poland, the United Kingdom, Ireland and the Netherlands, as well as the analyses of public aid of private equity and venture capital financing in the above mentioned countries. For achievement of the specified objective the authors follow scientific work methods, namely analysis, synthesis, induction, deduction and comparison.

[4] Austrian Private Equity and Venture Capital Organisation

3.2. Results of the research, discussion

The following areas were monitored as a criterion evaluating conditions suitable on a long-term basis for the PE/VC financing in individual countries: existing overall situation of the country, conditions for funds of investment companies investing on a PE/VC basis, pension funds, structure of funds, tax and legal conditions for investment companies and tax and legal conditions for PE/VC beneficiaries – enterprises. Each of the above mentioned conditions was assessed by a mark from 1 to 3 when 1 meant the best level and 3 meant an unsatisfactory level.

According to (Table 2) it is possible to state that the United Kingdom, Ireland, Greece, Belgium, feature, on a long-term and stable basis, good conditions for PE/VC financing. Lithuania is not included in the selection because only the conditions in 2008 were assessed in that country. Concerning the CEE countries, good evaluations were assigned to Hungary, Latvia, Estonia and Poland, but only Hungary together with Poland are assessed three times of the four periods. The Czech Republic was assessed in 2008 as the country with the worst conditions for PE/VC financing in Europe.

Table 2. Evaluation of selected countries (Source: Authors' own conclusions inspired by (EVCA & KPMG, 2008, EVCA, 2006; 2007; 2008; 2009))

Country	Average value	2008	2006	2004	2003
United King.	1.34	1.45	1.46	1.26	1.2
Ireland	1.43	1.32	1.27	1.53	1.58
France	1.64	1.23	1.36	1.89	2.09
Greece	1.68	1.46	1.55	1.75	1.96
Belgium	1.69	1.33	1.51	1.82	2.08
Netherlands	1.70	1.63	1.6	1.76	1.79
Lithuania	1.75	1.75	x	x	x
Spain	1.81	1.58	1.52	1.96	2.17
Hungary	1.84	1.84	1.83	1.86	x
Portugal	1.87	1.63	1.71	1.81	2.32
Italy	1.88	1.96	1.72	1.86	1.96
Latvia	2.00	1.88	2.12	x	x
Norway	2.05	2.03	2.08	2.04	x
Sweden	2.07	2.02	2.12	2.05	2.09
Estonia	2.07	2.06	2.08	x	x
Poland	2.08	1.95	2.16	2.13	x
Finland	2.10	1.92	1.91	2.3	2.25
Austria	2.14	1.87	1.74	2.42	2.53
Czech Rep.	2.24	2.4	2.21	2.12	x
Germany	2.28	2.18	2.15	2.37	2.41
Rumania	2.31	2.27	2.35	x	x

The selection of countries suitable for an analysis of legal standards and public aid will be made with the use of the results obtained from the data stated in (Tables 1, Tables 2). The United Kingdom, Ireland and the Netherlands steadily state excellent conditions for the use of private equity and venture capital, Poland is assessed positively in the context of the CEE countries, together with Hungary. With regard to the difficulties caused by the financial and economic crisis in Hungary, it is Poland that will be analysed as a representative of the CEE countries. Tables 3, Tables 4 provide for results of the analysis of legal standards and public aid in selected countries.

It implies from (Tables 3, Tables 4) that developed countries and at the same time the countries with good conditions for PE/VC financing together with a high share of PE/VC investments to GDP feature a sophisticated system of support of alternative financing of development, an example of which private equity and venture capital is. A reduced corporate tax rate for emerging SME is used in the United Kingdom, in the Netherlands and in Ireland. Besides this, tax incentives for PE/VC investors are quite common; an entire group of conditions was drawn up in Ireland – Business Expansion Scheme – just for PE/VC investors. Funds of funds, i.e. funds of the so-called venture capital exist without exception for all countries except for the Czech Republic, but such a fund should be founded, on the basis of approval of the amendment to the Collective Financing Act, amending the Act no. 189/2004 Coll., on collective investment, as amended, and some other Acts. The amendment implements the changes at the European level into the Czech law regulation system. The Draft Act is mostly of an implementation nature and it reflects adoption of the new Directive of the European Parliament and of the Council 2009/65/EC, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (known as "UCITS IV"), and 4 European Legislative Acts, implementing UCITS IV. The draft text provides for a new definition of the so-called eligible investors and of the fund of eligible investors. Another area monitored was public aid in the form of Seed funds, or public funds for the support of development of business activities when the government lends financial means for the launching and development to innovative and technologically focused enterprises, and this process is described in all the countries, except for the Czech Republic and Poland. Nevertheless, as it has already been mentioned above, the seed fund should be founded in 2012, as implied from the speech of the Government Prime Minister in November 2011. A positive assessment was obtained by the Czech Republic only in the case of the corporate tax rate which is one of the lowest rates in Europe, together with the tax rate in Ireland.

Table 3. Conditions for PE/VC financing in selected countries (Source: Authors' own work inspired by Rajchlová et al. 2011c))

Condition	CZ	Pl	UK
Corporate tax rate	19%	Progressive	Progressive
Reduced corporate tax rate for emerging SME	x	x	Deductibility of R&D expenses up to 175% of expenses on initial investment
Investments into risk bearing assets – insurance funds	Not possible	Maximum 10% of assets; geographic restrictions	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003[6]
Investments into risk bearing assets – pension funds	Not possible	Maximum 10% of assets; geographic restrictions	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003
Seed fund	Founded in 2012	Not described	Yes
Tax incentives for PE/VC investors	x	Investments exceeding EUR 100,000, possibility of subsequently writing off 50% of eligible expenses	Managerial fees connected with PE/VC investments are not subject to VAT; Venture Capital Trust[7]
Fund of funds	Amend ment to the Act approved on 16 February 2011	Yes	Yes
Income tax rate for pension funds, unit trusts and investment funds	5%	19%	20%

Endo of table 3

Table 4. Conditions for PE/VC financing in selected countries (Source: Authors' own work inspired by (Rajchlová et al. 2011b, c))

Condition	Netherlands	Ireland
Corporate tax rate	Progressive	12.5%
Reduced corporate tax rate for emerging SME	Reduction of taxes on wages at initial investments	Seed Capital Relief[8]
Investments into risk bearing assets – insurance funds	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003
Investments into risk bearing assets – pension funds	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003	Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003
Seed fund	Yes	Yes
Tax incentives for PE/VC investors	Fully tax-recognisable losses connected with investments into PE/VC funds	Business Expansion Scheme[9]
Fund of funds	Yes	Yes
Income tax rate for pension funds, unit trusts and investment funds	Taxation depending on the amount of shareholding in the enterprise	20%

[6] Full wording of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision

[7] If a private investor invests an amount up to GBP 200,000 with the help of the so-called "Venture Capital Trust", an entitlement for income tax discount arises at a level of 30% of the investment, if such an investment lasts for at least five years

[8] It serves for motivation of employees, encouraging them to launch entrepreneurial activities. If employees who are residents of Ireland leave their employment for the purpose of setting up their own business, they are entitled to reimbursement of tax on their previous income, if they use it as starting funds for their new business activities. This way it is possible to obtain aid up to an amount of EUR 190,500.

[9] Group of conditions for support of investments in PE/VC

Nevertheless, a key condition for development of PE/VC financing is a possibility of investments on the part of insurance and investment funds as it is the case of the United Kingdom, the Netherlands and Ireland. The funds of insurance companies and pension funds are, according to (EVCA, KPMG, 2008), the most important providers of financial means in the so-called fundraising process. This possibility is limited in Poland to 10% of the investment of total assets of the funds, however, within the framework of the OECD countries only. There is no possibility of such a type in the Czech Republic. Investments in venture assets are enabled by the plan of implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

From the above mentioned analysis of legislative standards and institutional environment of the selected countries it implies that the development of PE/VC investments in the Czech Republic necessarily requires a full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, possibility of tax advantages for PE/VC investors, and as one can see in the case of the countries except for Poland and the Czech Republic, an application of tax advantages for emerging SME is implemented.

In connection with fulfilment of the objectives set out it is possible to formulate changes which can lead to improvement of conditions for financing by way of PE/VC in the Czech Republic:

- Full implementation of the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003, for a possibility of investments by pension funds and insurance company funds into private equity and venture capital.
- Public aid of financing by way of PE/VC, e.g. in a form of tax-recognisable expenses from a loss incurred during investments.
- Establishment of a public – state-owned fund for support of emerging and development enterprises which would operates on the basis of the so-called “fund of funds”, i.e. a PE/VC fund.

4. Conclusions

The aim of the research objective was, on the basis of an analysis of development of financing in the Czech Republic, to identify the rate of use of this way of financing and to formulate such conditions that can lead to development of this alternative.

In connection with the objectives set out within the framework of the paper and on the basis of conclusions of analyses and conclusions resulting from analyses of professional foreign studies it is possible to sum up the conclusions derived from individual parts as follows: the Czech Republic belongs among the countries where the standard of financing can be assessed at an average level, it is necessary to adopt such measures that can increase this level, and then it is possible to expect implication of the above mentioned economic influences on the national economy.

It is necessary to transpose the Directive of the European Parliament and of the Council 2003/41/EC of 3 June 2003, for a possibility of investments by pension funds and insurance company funds into private equity and venture capital, as well as to launch a real support for the launching and development of innovative and technologically oriented enterprises, it is suitable to make tax incentives for investors supporting just the development of the above mentioned enterprises. And last but not least it is also important to increase education activities among entrepreneurs, regarding the form of PE/VC financing.

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