

# PRIVATE EQUITY – FINANCING WITH ANTICRISIS ODOUR

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**Abstract:** *Within the context of overcoming consequences of the current financial and economic crisis has been paid attention to other form of financing than debt financing, it is (external) equity financing. The aim of this article is to point out features of so-called informal private equity financing especially, and its development in Europe; to accent some controversial aspects of this form of financing and its further possible development that has been also a subject of the explicit EU support, and that has had a connection with the Policy of the European Union towards small and medium-sized enterprises support.*

**Keywords:** Private Equity, Venture Capital, Business Angel Networks, Regional Policy, SMEs.

## 1. Introduction

Current global crisis started in the USA, which were going through the economic depression in the beginning of this century, and that's why the Federal Reserve System lowered interest rates, for recovery of economy. Money had become cheaper and interest in bank debt service increased consequently. With a certain simplification can be added: the fundamental problem in the USA became „inconspicuous“ mortgages for households which haven't been paid back because of high mobility of inhabitants and which have been transferred to other actors instead. Moreover, American banks issued CDSs<sup>1</sup>, proportion of their equity often didn't reach to demanded 8 % in agreement with Basel I or Basel II Accords issued by the Basel Committee on Banking Supervision. It cannot be discussed a propiarte circumspection of American banks, vice-versa may be applied economic terminus technicus “moral hazard” on them which essence is connected with reliance on the fact that consequences of their own irresponsible acting are transferred to someone else; making use of information dominance detrimental other subject. The biggest problem of the crisis, which had a tag “financial” first, is a way and size of its pouover into the real economy.

Quickly broadening crisis symptoms all over the globalized world called up a reaction. There have been worked up some programms for reduction of crisis impacts and for assuring of development goals in the European Union, the way of disposable financial resources utilisation has been changing too, for example [16], [20].

The aim of this article is to compare informal (business angels) and formal (venture capital funds) features in context of the principle of private equity financing and to focus on possible consequences of business angels' activities across the EU above all – and in the Czech Republic concretely – in the current economic reality and with emphasis on EU institutional and financial support and focusing on relation of business angels' activities to small and medium-sized enterprises (below just „SMEs“). Interest in persisting barriers of this form of financing's

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<sup>1</sup> CDS (credit default swap) = an option to compensate a loan, which would turn up irrevocable, in agreed proportion. A condition for utilisation is that a bank selling CDS will not get into financial insolvency. (Unfortunately, Lehman Brothers will not pay anything to anyone for its CDS.)

development doesn't stand aside in context of accent to development of innovations, competitiveness and employment across the European economic space.

## **2. Private equity financing with a view to business angels**

Basically, there are two possibilities how to raise additional capital for realization of business projects – equity funding (external, connected with ownership relations, or internal which is based on reinvesting of economic results) and debt financing. Utilisation of either forms of financing is characterized by a certain persistence of its historically based tradition, the American economy differs from the European ones by its financial and capital markets' focus.

Private equity financing represents just investing of external private resources (i.e. non-public) into companies which are not listed. It includes venture capital and buy-out investments. Venture capital is sometimes specified as formal equity, which is realized by venture capital funds and banks. Beside them, there is so-called informal equity provided by business angels acting as individual investors or as investors associated in business angel networks. „Business angels usually provide finance in return for an equity stake in the business, but may also provide other long-term finance. This capital can complement the venture capital industry by providing smaller amounts of finance (generally under €150 000) at an earlier stage than most venture capital firms are able to invest.“ [10]

According to both theoretical resources and current real practices, a business angel can be defined as: „an individual investor who provides with equity businesses with huge growth potential at varied stages – mostly at seed, start-up or expansive stage. In return for an investment gets business angel an equity stake in the business, mostly the minority one. The investment is supposed to appreciate during a period that is defined in advance and a form of exit happens then. Business angel provides a company with not only capital in the form of money but also with knowledge capital, it is expert knowledge, orientation in a field of his or her activity and information (contacts) about some strategic partners.“ [17]

Attention paid to private equity nowadays is understandable because – how is it mentioned in [11] – loan finance is usually a less flexible, more expensive and less secure alternative than risk capital and frequently available only under favourable economic conditions. The collateral required by banks usually poses a particular problem for SMEs and loan finance is particularly inappropriate for high-tech start-ups, where cash flow in the early stage is either negative or very limited.

Awareness of business angels' importance and their investments is also expressed by representatives of the European Business Angel Network<sup>2</sup> in context of necessity of innovations' support in European economies: „Great innovations are at risk. The financial and economic crisis is severely undermining the growth potential of innovative companies. Business angels and early stage investors are needed now more than ever!“ [7] There could be registered some ideas of necessity of creating some conditions for taking advantage of business angels' investments for economic development's support on the 9th annual EBAN congress held in Madrid in 2009: “It is even more important and relevant than ever before for early-stage investors across Europe as we all need to learn from each other how to adapt to both the

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<sup>2</sup> EBAN = the European trade association for business angels and early stage investors, an independent and non-profit association representing the interests of business angel networks (BANs), early stage venture capital funds and other entities involved in bridging the equity gap in Europe. It currently federates 90 organisations in 25 countries. [www.eban.org](http://www.eban.org)

challenges and the opportunities presented by the present exceptional economic conditions.... No one person or group has all the answers, but by sharing with each other we will all be more effective in our investing. .... It was astonishing to see how many organizations do exist and try to encourage and overcome the equity gap." [8]

### 2.1 The principle of private equity financing

The principle of private equity financing is investing in a business at a specific stage of development: seed-up, start-up, early stage or expansion stage. Besides buy-out investments it's a matter of venture private equity realized by either hands-on or hands-off approach. The ending of such an investment is exit realized as IPO, trade sale, refinancing, buy-back, write-off. The principle of this venture financing shows following picture 1.

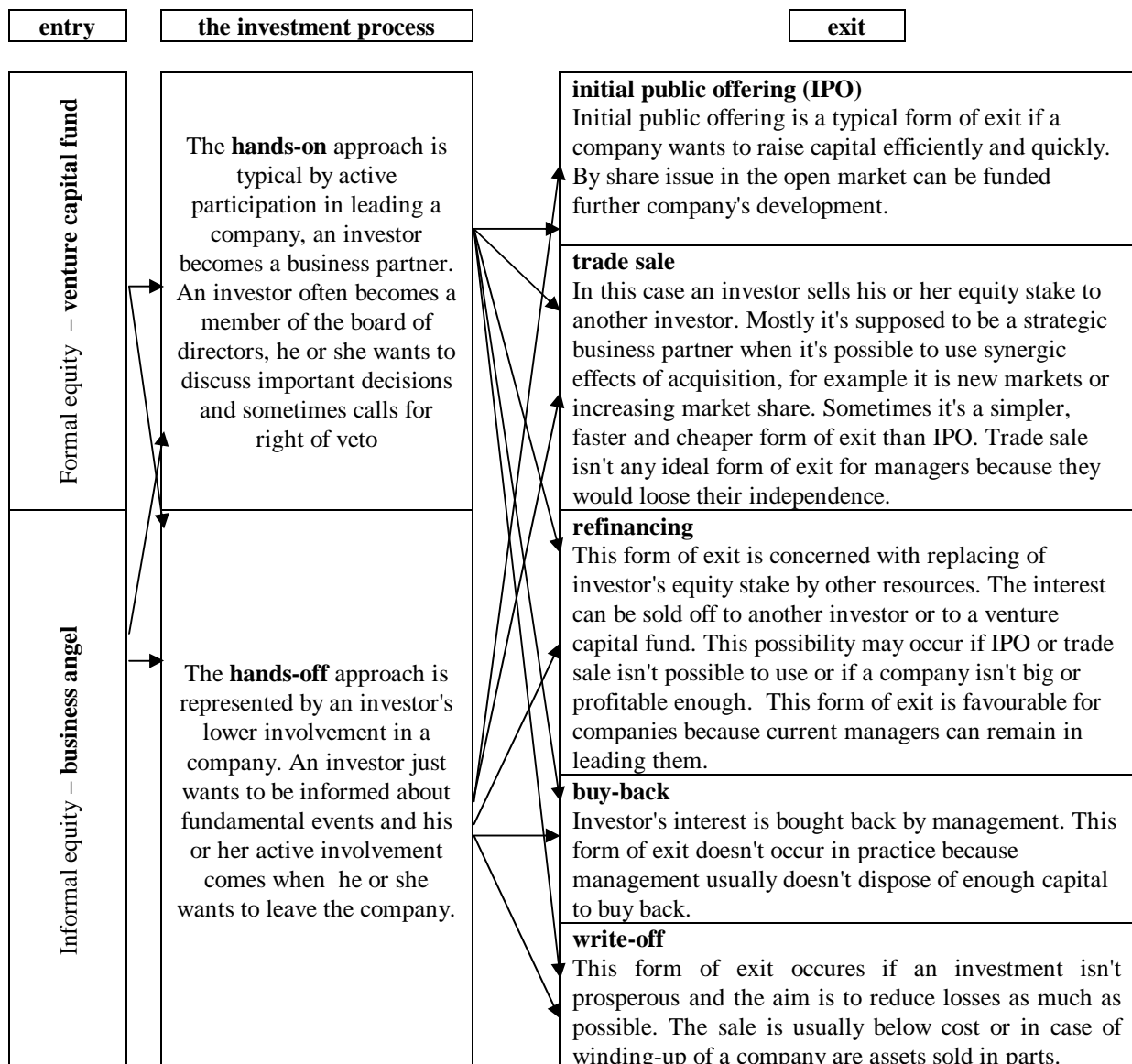


Figure 1: The principle of private equity financing (based on [17])

The purpose is to appreciate invested resources with respect for relations among three tops of the „investment triangle“: profitability, risk and liquidity [14]. The fact that it's a matter of venture investments prove data collected through a questionnaire dealing with situation of

companies, which business angel investments flew into, filled by members of EBAN: „Out of 25 networks answering the question about companies that have received financing through the network since their inception: 165 companies gone bankrupt; 88 companies have been divested as a loss; 128 companies have been divested as a profit“ [6]. On the other hand, bankrupts of business angels represent „just“ 10 % of all exits. [6]

## ***2.2 Comparison of business angels worldwide***

Business angels are associated with the USA traditionally, where venture investments began to broaden worldwide from. In recent years, there have been some leading economies in the business angel investments' market such the USA, Europe or Israel are, whereas in Africa and Latin America are business angel investments still undeveloped. But new markets have been developing very dynamically and have huge growth potential for the future. There can be expected increasing activity of business angels of the BRIC<sup>3</sup> countries in the future.

It is China that has been becoming very attractive country in the venture capital market, venture capital investments' volume reached \$ 1.9 billion [9] in 2007. China is the most frequent receiver of venture capital after the USA. In India, there got venture capital investments' volume near to \$ 1 billion and further growth is expected. The fundamental problem for business angels is lack of exits for having certainty to profit from their investments.

Business angel investments began to increase at the turn of the 20th and the 21st century. Whereas in the USA, there bursted the technology bubble which meant the end of the former successful period in 2000. Suddenly, the boom in trendy investments in internet, where most of business angels put their capital into, was over.

Globalization has been followed by increasing number of international transactions, for example there were realized 19 % [9] venture capital investments among continents in the period 2005 – 2006, it is a growth about 250 % [9] in comparison with previous five years.

The activity of business angels was increasing in 2006 and 2007, venture capital investments as a whole reached \$ 35.2 billion in the USA, Europe, Israel and China in 2006 [9]. There was an increase both of numbers of deals and of volume of capital, the highest increase was reached in China that has expanded abroad.

An average payback period was prolonged to more than 6 [9] years. Moreover, companies enter global markets sooner and make business angels to invest more capital into them this way.

Global climate change, high oil prices, fears for energy sources' safety and their limited reserves are the main causes of increasing global demand for green technologies. Green technologies, biofuels and bioenergy can become the most frequented sector into which could flow foreign investments and within the frame of them also business angel investments. That's the reason why countries from Latin America and Asia have huge growth potential in this sector, there are grown many agricultural plants in these countries.

Another investors' favorite sector are companies concerning with IT. Business angels have been revealing African potential too. African markets aren't so integrated with international markets as for example the American ones or the European ones are, that's why African markets are more isolated from the global crisis. Moreover, for Africa is typicall huge raw

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<sup>3</sup> Brasil, Russia, India, China

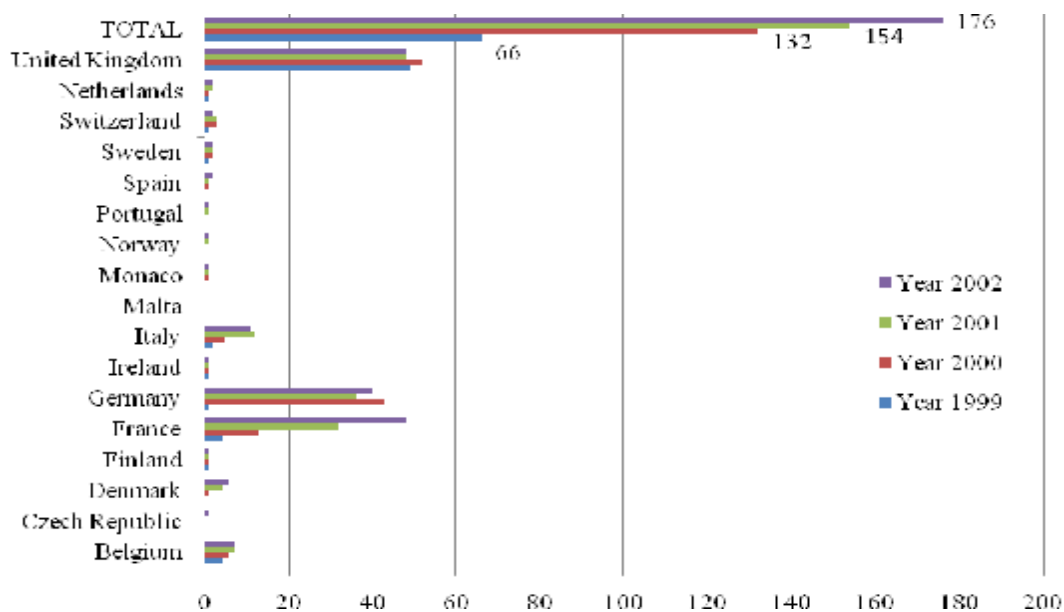
wealth that has become boom in recent years. There may be expected a big amount of business angel investments which are supposed to flow into companies concerning with extractive industry in Africa by reason of depletion of non-renewable energy sources for the future. For now, African venture capital market generally is connected with telecommunications, in this sector was Africa the second fastest growing market in 2008.

Although the whole world has been fighting lack of resources available for investments, and business angels invest less, huge volume of available capital may be found in Arabic countries. Such investors come especially from countries extracting oil as Kuwait, Katar, the United Arab Emirates or Saudi Arabia are. Arabic investors affirm there are still many opportunities to growth and success, there is just necessity of being much more creative. (fully in [17]).

### ***2.3 Development of business angels and their networks in Europe***

History of business angels in Europe was initiated in 1997 by publishing a study regarding the potential for business angel investments and networks in Europe which was connected with the Third Multiannual Programme for SMEs (1997 – 2000). This program was focused on business angel networks' support in order to increase investments of informal private investors in entrepreneurial firms among others. A result was setting up the European Business Angel Network (EBAN).

The period 1999 – 2002 was connected with very dynamic increase in the number of business angel networks in Europe, which illustrates following graph 1. There had been nearly 300% increase from 66 up to 176 and this expansion continued. Most of business angel networks operated in the United Kingdom and in Germany, the most dynamic progress was in France. In the Czech Republic, there have been operating two business angel networks, according to the latest available EBAN's compendium: the Angel Investor Association and the Hidalgo Partners [6]. According to the CzechInvest, the investment and business development agency of the Czech Republic, there have been operating four business angel networks in the Czech Republic: the Angel Investor Association, the Central Europe Angel Club, the Business Angels Czech and the Business Angels Network [2].



Graph 1: The development of business angel networks in Europe in the period 1999 – 2002 (Source: based on [4])

In comparison with venture capital funds, business angel investments are characterized by a higher number of contracts (it's getting close to two-thirds of total private equity financing), the amounts of investments oscillate about 50 %, nevertheless, the average amounts of investments are dramatically smaller. Concrete data from the period 2005 – 2007 shows following table 1.

Table 1: Evolution of the amount invested in the seed stage by recorded venture capital funds (EVCA) and business angel networks (EBAN)

European seed industry	2005			2006			2007		
	EBAN	EVCA	% EBAN	EBAN	EVCA	% EBAN	EBAN	EVCA	% EBAN
Number of deals	653	409	61	843	477	64	1 111	699	61
Amount invested (in thousands of EUR)	130 717	96 497	58	149 474	197 704	43	184 203	184 693	50
Average amount of the deal (in EUR)	200 178	235 934	46	177 311	414 473	30	165 649	264 224	39

Source: based on [6]

### 3. Potential of business angels in current economic situation

Above mentioned lack of capital available for business activities' funding vary between € 0.5 million and € 3 million in European countries, according to EBAN.[7] There is usually business angels' engagement in SMEs for which is typical high innovation rate and high sales rate, mainly for companies from so-called high tech sectors [12], these ones are sometimes called „gazelles“. This is the way these companies fulfil two of the development's and economic growth's EU priorities – innovations and competitiveness. The third priority is the immanent feature of SMEs as a whole. (Fully in [13]). That is because they represent a stabilizing element of economy in term of employment. For example, there is constantly maintained a proportion of total employment just above 60 % with a gentle tendency to increase in the Czech Republic. [15]

#### 3.1 The European Union support of business angels

For Europe is typical institutional and financial support of business angels' activities. This question is discussed in a number of EU documents, often in relation to SMEs support. [7]

It cannot be left out of consideration that large support to private equity financing has been devoting also in the USA<sup>4</sup>. Legislative regulation had an immediate impact on economy at the same time: there was invested \$ 460 billion by 225 venture capital holders in 375 companies in 1979 and nearly \$ 4 billion by 700 venture capital holders in 1 729 businesses by end of 1987. [19]

In the European Union it had been the Community Multiannual Programme for Enterprise and Entrepreneurship for the period 2001 – 2005 which was followed by the Community Support Programme for Entrepreneurship and Enterprise Competitiveness for the period 2006 – 2007. The Guide to Risk Capital Financing in Regional Policy of 2002 is focused on improvement of SMEs' access to finance through using different kinds of venture capital tools. The issues of importance of venture capital are also mentioned in the Green Paper on Entrepreneurship and in related document the Action Plan on Entrepreneurship which was published in February 2004.

The EU support for business angels is not only conceptually declarative but there are also some financial resources available from EU Structural Funds and special European programmes. [18]

The European Regional Development Fund offered the possibility to finance business angel networks' activities after year 2000. This support was used in their projects by the United Kingdom (the LINC Scotland and the Xenox projects) and by Poland (the Lewiatan Business

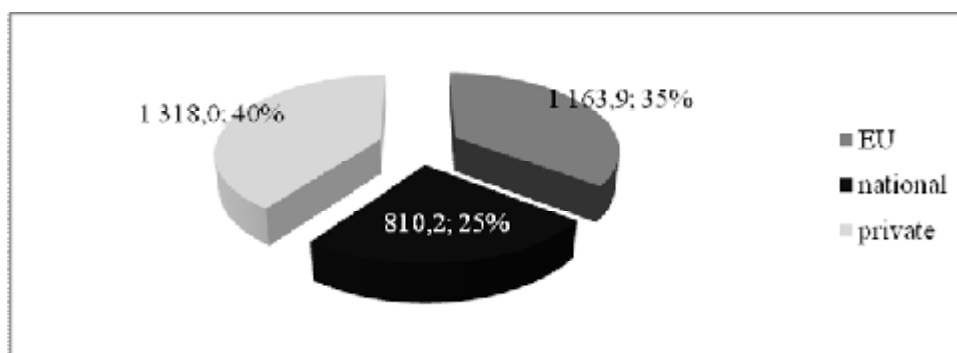
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<sup>4</sup> This fact show for example regularization elements from the end of 70th and 80th from the last century: [19]

- § The Revenue Act (1978): provided capital gains tax incentive for equity investments. Capital committed increased by \$556mn from the previous year.
- § ERISA's "prudent man" rule (1979): clarified investment guidelines for pension investors to allow for higher risk investments.
- § The Small Business Investment Incentive Act (1980): redefined venture firms as business development companies, eliminating the need for registering as an investment advisor.
- § ERISA's "safe harbor" regulation (1980): stated that venture managers would not be considered fiduciaries of plan assets.
- § The Economic Recovery Tax Act (1981): lowered capital gains rate. Capital commitments doubled to \$1.3 bn in 1981.
- § The Tax Reform Act (1986): reduced incentive for long-term capital gains.

Angels). There operates the INTERREG initiative as a part of ERDF with the aim of the support of cross-border cooperation which was used for example in the EUBAN project by Germany, by the Netherlands or by Belgium; in the WABAN project by Belgium and by France. The European Social Fund provides opportunities to improve training courses provided at regional level; Sweden (KISTA) and Spain (ABANT) have taken an advantage of them. Then are used – to strengthening the knowledge-based business angel networks above all – European programmes as the Leonardo (the I-CUBED project), the Cluster programme (the AFIBIO project), the PAXIS programme – the Sun&Sup project (Finnish project the Sitra; British project the Exemplas, German project the Netzwerk Nordbayern) or the INNOCOACH programme. Currently is a specific part of financial resources connected with the JEREMIE project.

Volume (in mil. EUR) and proportion in expenditure on risk capital financing divided into separated resources in EU 15 in the period 2000 – 2006 illustrates following graph 2.



*Graph 2: Estimated Expenditure on Risk Capital Financing in Structural Funds Programmes (based on [10])*

The ERDF cofinancing planned on Risk Capital Financing has doubled from the estimated € 570 million during 1994 – 1999 to approximately € 1200 million in the current programme period. Total expenditure during 2000 – 2006 is approximately €3300 million.

For the period 2007 – 2013 is one of the most important programmes involved with business angels the so-called CIP (the Competitiveness and Innovation Framework Programme), completely new set of instruments which provides over €1 billion to support SMEs' access to finance, a substantial amount of it channelled via the EIB Group. [20]

Awareness of importance of support for SMEs' access to financial resources, to venture capital above all, shows also the recommendation of the European Commission in the part VI “Small Business Act” for Europe [20]: “The EU and Member States should facilitate SMEs' access to finance, in particular to risk capital, micro-credit and mezzanine finance and develop a legal and business environment supportive to timely payment in commercial transactions.” There will be provided about €27 billion for SMEs' support in terms of fulfilling the EU cohesion policy and within this amount more than €3 billion through venture capital by end of 2013.

### ***3.2 Business angels and their behaviour in times of crisis***

It is understandable that business angels don't stand apart from economic processes and their consequences connected with the financial and economic crisis. Contrariwise, some of them feel the impacts of crisis a lot, they suffered a loss of their investments. On the other hand, the ones whose financial resources are sufficient have much more opportunities today and these opportunities are very attractive. Besides, demand for their investments appreciate also



business angels' engagement in terms of sharing their managerial and entrepreneurial experience. It's a generally true fact that price decline belongs to one of the economic crisis' symptoms. On the one hand it means inaptitude for exits, on the other hand it may stimulate investments characterized by lower volume of capital and by higher profit rate. Moreover, economic recovery calls for investments and with a view to inelasticity of banks, their focus on providing small and easily enforceable credits to their solvent clients and necessity to document clients' business history for receiving a credit, private equity financing appears to be a solution.

There was launched a new business angels' initiative in the Czech Republic, investors are setting up „an angel bank“ the Credo Ventures with planned deposit of 0.5 billion CZK [3]. It's a clear evidence of the fact the investors are convinced of investments' potential even on such level which calls for innovation in the area of private equity financing's instruments. Purely informal venture capital has been turning into formal venture capital in a certain manner. The fund should consist of both private and institutional resources; shareholders would be involved as silent partners or actively. The Credo Ventures should not offer only finance but also consultancy, mentoring, intermediation of contacts, it is operating as standard business angels.

The fact there isn't lack of projects on the demand side illustrates a brief overview in table 2.

*Table 2 An overview of offered projects for business angel investments in the Czech Republic till 29.9.2009*

<b>Industry</b>	<b>Specify</b>	<b>Investment size (EUR)</b>	<b>Share proposal</b>	<b>Turnover (EUR)</b>	<b>EBIT/I</b>	<b>Years in Business</b>
Real estate	e-commerce	25 000	50 %	90 000	n.a.	15
Health	fitness	150 000	50 %	1 100 000	20 %	15
Bookstore	e-commerce	100 000	40-60 %	300 000	15-20 %	15
Internet	web-games	80 000	33 %	400 000	65 %	15
Construction	new material	50 000	60 %	400 000	n.a.	15
Entertainment	video on demand	1 000 000	50 %	500 000	20 %	5
Ceramics	Hand deco-rated ceramics	300 000	40-50 %	500 000	15-20 %	15
Wood	parquet	220 000	34 %	n.a.	n.a.	n.a.
Construction	construction material	200 000	30 %	n.a.	n.a.	n.a.

*Source: based on [1]*

The table shows that demand for investments is related to industries which usually are connected with business angel investments (more specified in [17]) – IT, materials, health. The applicants' history is 15 years in most cases. Demanded investment size is usually the amount from € 25 000 to € 300 000 in the Czech Republic (an exception is an investment in the amount of € 1 million but even this one isn't beside European dimension – see above),

proposed share is from 30 % to 60 %. The EBIT rate (if it's featured) is usually between 15 % and 20 %, an except is a project focused on internet games with its 65 % appreciation.

### ***3.3 Barriers to development of business angels' activities and their removing***

Although private equity financing appears to be an useful and effective form of investing and a way to ensure capital sufficiency then, informal capital as business angel investments are above all, there still remain some barriers which obstruct further development of private equity financing although there are many declared supporting measures both at the EU level and in individual countries, including the Czech Republic.

The Risk Capital Action Plan [5] has identified six categories of barriers that hinder the development of risk capital markets in Europe. These categories are:

- § market fragmentation,
- § institutions and regulations,
- § taxation,
- § paucity of high-tech SMEs,
- § human resources,
- § culture.

The aim of the Risk Capital Action Plan is to remove these barriers to allow the development of a true Europe-wide risk capital market.

As the worst barriers to development of Czech venture capital investments are considered [3] for example: impossibility of adapting the internal relations of joint stock companies and private limited companies for needs of investors; investors can be separated into categories by hands-on and hands-off approach only partly and with difficulty, institutional investors are considerably limited in venture investments. There is huge lack of tax incentives for venture capital - with a view both of income tax and value added tax. The SMEs' development is insufficient whereas such enterprises are the most frequent objects of business angels' activity; there isn't any systematic subvention which would have a form of taxation or fiscal incentives for young and perspective companies, any subvention for their innovation potential, for example it could be a possibility of tax-deductible costs of transfer of technologies for developing enterprises.

In this respect, the White Paper, published by EBAN [5], is very inspiring, this book arranges four categories and four levels of measures in a matrix way. The categories include supply issues, demand issues, environment issues and taxation issues; the levels are differed for the EU level, national/regional authorities, business angel networks' level and EBAN level. In a matrix way, there are elaborated 9 fields of measures then:

- § leveraging untapped investment potential and activating virgin angels,
- § growing the informal venture capital marketplace,
- § addressing the constant need to raise stake value,
- § improving investment readiness,
- § strengthening the dialogue between business angels and venture capitalists,
- § improving the partnership among regional stakeholders of support for entrepreneurship,
- § visibility,
- § regulation,
- § amending tax regulations applying to investment by business angels and other private investors.

For example, there are measures for the national/regional level on the supply side focused on tax privilege for business angel investments, on financial support of business angel networks' setting up and on administrative demands' simplification. For the demand side is recommended to develop and to deliver investment "readiness" training to entrepreneurs looking for any form of equity above all.

In light of SMEs environment, there is needed benchmarking of importance and effectiveness of SMEs as funded subjects. In the category taxation, there's the most emphatic demand for audit of tax treatment of investments by private individuals in unlisted start-ups. At the same time, the Ministries of Finance of the EU Member States should endeavour: „... to raise public awareness of the economic role of business angels in order to provide political justifications for such tax incentives.“[5]

#### **4. Conclusion**

Private equity financing has an irreplaceable role in economic recovery today but its importance has even in economy boom. Private equity are resources intended for appreciation, they're supposed to bring money to their holders. It represents a priori very efficient form of financing which evaluates and accepts an optimal risk ratio, profitability ratio and liquidity ratio individually. Its efficiency arises from a simple premise among others: capital owner decides about his or her resources for his or her benefit. Providing that economic behaviour is rational, it's the most efficient decision situation.

With this characteristics of private equity, with business angel investments concretely, agrees a relatively dynamic development all over the world, including also the Czech Republic, which hasn't been affected by consequences of current financial and economic crisis. On the contrary, there can be mentioned some chances and new opportunities in many respects.

But what remains the controversial issue is institutional and financial public support of private equity financing. The sense of government's intervention (or supra-state interventions within the meaning of the EU level) is elimination of market failure. Each intervention influences sensibly acting economic subjects. With regard to the principle of private equity financing and business angel investments can be submitted that direct support appears to be redundant. It would be a mistake to let it become and remain in being some weak economic elements and sub-optimal efficient solutions. But what has the highest importance is to remove barriers occurring in the area of taxation and legislative regulation which obstruct higher involvement of this form of financing and capital sufficiency insurance.

Another question is volume of support for the target objects of venture capital, i. e. SMEs. Regarding the role of small and medium-sized enterprises in national economy, there may be evaluated their institutional support, focusing on technological progress and on innovative entrepreneurship, as desired today – especially on conditions of globalization and in term of market structures. Still has to be applied institutional support's tools circumspectly in such a way to not break economic competition and to not create inefficiency in economy.

## Acknowledgement:

This article was worked out in context of solving the research project 402/08/0848 „The Model of stimulating regional growth proceedings“ in support of the Grant Agency of the Academy of Sciences of the Czech Republic.

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