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Venture Capital, Private Equity and Foreign Direct Investment: Case Study of the Czech Republic

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Abstract

The paper analyses influence of venture capital (VC) and private equity (PE) investing on FDI inflow in the Czech Republic. There exist barriers in the Czech Republic, such as high investment thresholds, imperfect information or legislative barriers that negatively affect the PE and VC investment activity and prevent foreign investors from investing in Czech PE and VC. This is the main reason of the Czech Republic's little PE and VC market activity. Data on foreign direct investment (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.

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Keywords: venture capital; asset management; private equity; financial markets; market failure; government failure

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.

Theoretical background focuses on the decision-making principles and definitions connected with venture capital and private equity investing. Results describe the main features of the Czech private equity and venture capital market in relation to the European benchmark. Then, the influence of venture capital and private equity investing on foreign direct investment is analysed.

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2. Theoretical background of venture capital and private equity

Despite its relative importance in terms of ability to help start-ups develop in multinational companies and specific differences from other sources of capital, there is still insufficient background of theoretical economics in the field of venture capital. Despite there have been many attempts to describe the processes of venture capital, the terminology is still not unified.

The researched literature always considers Venture Capital as an asset class, mainly as a *subset* of Private Equity*. But, sometimes is Venture Capital perceived also as a *synonym* to Private Equity. Generally, the literature shows that there exist at least two stages of venture capital – early stage investments in start-up businesses and later stage investments in developing companies.

Private equity means generally investing capital in unquoted businesses†, unlisted on public markets. However private equity refers to the source of equity funds being on private markets, private equity may be used to invest also in listed shares, including to take over publicly listed companies, and delist them.‡

The term Risk Capital is often used as homonym to Venture Capital, but not always. For instance, Merton and Perold (1993) define risk capital as "the smallest amount that can be invested to insure the value of the firm's net assets against a loss in value relative to the risk-free investment of those net assets" (p. 17). This definition is very different and is related to risk management in financial institutions.

Typical is investment in shares of newly established businesses with high-growth potential (*start-ups, start-up firms*), often commercialising an innovation, but also with high risk of default. Risk-aversed rational investors would invest under these conditions if the investment promises high yields in future by exit.§ Private equity investors, mostly institutional, typically do not acquire businesses to realise take-overs, as strategic investors mostly do, but invest as financial investors and realise yields not in the form of regular dividends, but by exiting the investment in a period of usually 3-6 years. The stages with typical investment durations and investment amounts are depicted in Table 1.

Table 1: Private equity stages

Private equity stage	**Duration of investment (years)**	**Investment amount (EUR millions)**	**Expected yield (% p.a.)**	**Share of investors offering the respective type of investment**
Pre-seed, seed (venture capital)	7-12	Up to 0,2	Up to 100 %	1-2 %
Early stage, start-up (venture capital)	5-10	0,2 - 0,8, but may be also up to 7,5	35-50 %	5 %
Later-stage (venture capital)	4-7	0,4 - 1,5	30 %	10 %
Replacement, Growth	2-5	0,75 - 3,0	25 %	50 %
Buyouts	2-4	7,5 - 40 +	20-25 %	almost 100 %

Source: Dvořák, Procházka (1998)

We will operate with terminology brought up by the European Private Equity and Venture Capital Association (EVCA), as the paper is oriented mainly on European venture capital markets and EVCA is the most important association in this field on the old continent. Another important player in this field in Europe is the European Commission, which has presented its own definitions in the EC (2006). The Commission definitions for the purpose

* EVCA (2007)
† EVCA (2007)
‡ IMF (2009)
§ Dvořák, Procházka (1998)