

EQUITY FINANCING OF GROWING AND INNOVATIVE BUSINESSES IN SLOVENIA

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Abstract

The article discusses alternative sources for SME financing in order to fill in the gap in financing different growth stages of innovative enterprises. It focuses primarily on venture capital, both formal and informal. Formal venture capital in Slovenia has not had a long tradition. The first venture capital funds were established in the 1990's and there are still only a few operating in Slovenia nowadays. Informal venture capital, also known, as business angels are somewhat older, but it is only recently that there have been efforts to join them under the framework of Business angel network. Thus we believe it is time to shed a little light on these pioneer efforts in developing formal and informal venture capital, thus filling the gap in equity financing of innovative enterprises in Slovenia. The recommendations in the end of the article can probably also be applied in other transition economies, where a certain degree of government involvement is expected to support and encourage the on-going process of equity financing which has already become a normal part of developed economies.

1. Introduction

Joseph Schumpeter, one of the earliest theorists of entrepreneurship defined the entrepreneurial process as an innovation and called the entrepreneur an innovator who creates destruction of existing market equilibrium and positions that equilibrium to some other point. Entrepreneurship is therefore not only about research and development of new products and procedures, production, manufacturing, marketing and finance but it also deals with exploiting changes created by entrepreneurs.

Speaking about innovation and entrepreneurship it seems necessary to emphasize the difference between the two usually not exactly diversified terms: invention and innovations. It looks quite often that people inventing different things usually find their satisfaction in making their prototype operating with no market confirmation that some real demand for it exists out there.

Of course there is a certain gap to pass before an invention becomes innovation in an entrepreneurial sense. Two main obstacles are foreseen in this gap: first, the lack of entrepreneurial/managerial knowledge to run and grow a business and, second, the lack of capital.

One of the main elements of innovation and entrepreneurship friendly environment are by all means developed capital markets. Having said that, we bring in mind especially availability of different sources of capital, both for young innovative businesses and more mature growing businesses. The objectives of the paper is therefore to discuss trends and possibilities of

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financing small and medium sized enterprises (SMEs) which can be in the environment of Slovenia but also other transitional countries regarded as non traditional sources of finance. One of the considerations is also devoted to the possible role of government in supporting this process.

2. Equity financing

Equity is a long-term form of financing a business. It simply enters and stays in the business to finance different stages of particular company's life cycle: seed capital, early stage capital, growth capital, spin-off and merging capital, turn around capital form companies which are in troubles etc.

There is one basic difference between equity and debt finance: the debtor has its legal right to have its loan and agreed interest repaid and it does not matter if the company has been successful using this loan or not. On the other side equity means a stake in the company in good and bad times. The returns of investors are therefore exclusively dependant on profitability of the invested company. Failure of such a company means loss for the investors. Equity finance is therefore a story of taking a certain degree of risk and expecting higher profits as a reward.

Apart, from entrepreneurs who establish their companies with their own savings, we generally speak about two forms of venture capital: venture capital funds and private investors (business angels). While there is no real difference between the two of them if they are watched through a viewpoint of a company's balance sheet, there is a basic difference in the form of how they are organized.

Venture capital funds normally collect money from private and public investors and spread it into different investments (projects) in order to minimize risk and maximize profits. Venture capital funds are therefore intermediates between investors and target companies. They charge a commission for their expertise. On the other side, business angels are much less formal. They invest directly in the companies. They usually are organized in certain clubs and networks but the purpose of this organizing is more networking, information exchange and investing the possibilities of syndicate investments, rather than formal collecting and investing money.

3. Venture capital funds in Slovenia

3.1. Overview of venture capital history in Slovenia

The first privately owned venture capital fund in Slovenia was established in 1994 by Austria-Netherlands based company Horizonte Venture Management. Mainly, cash was provided by foreign banks, insurance companies and pension funds, but also some Slovene financial institutions contributed smaller stakes. Their investments have grown considerably since they entered their portfolio companies. So far they have invested in 12 companies. Approximately one half of their investments were in high-tech, especially in biotechnology (three investments), and electronics. Other investments were made in more traditional (old economy) industries, but they proved to have significant advantage over their competitors (patent rights, dominant market position, brand name...). Among those was also their first big exit in 2000 through trade sale, when they sold off one of their portfolio companies (Bofex – Big Bang, retail chain of consumer electronic goods) to a large Slovenian wholesale and retail firm Merkur. This was also first (and until now only) completed success story for venture

capital backed companies in Slovenia. Other companies from their portfolio are gradually preparing themselves for trade sale, which is currently most likely exit mechanism for venture capital funds all over the world.

Current value of Horizonte's portfolio is 16 million EUR, based on EVCA² valuation measures, which means they nearly tripled their investment. Furthermore, in 2002 they completed first closing (20 million EUR) on a new much larger fund. Horizonte is investing in SMEs with high growth potential or need funds for restructuring. They are active investors and owners (30 to 50 % of the company), which means they participate in strategic decisions through formal or informal board of directors (supervisory boards). They also provide help to their portfolio companies at raising additional funds, penetrating new markets, exercising patent protection, finding key people, closing deals with major clients and establishing business connections throughout the world.

Next in 1995 another private venture fund was founded. Slovenian Fund Management (SFM) was established to provide fresh long-term capital to Slovene private sector. Funds were raised mainly from foreign banking sector, but one third was raised from Slovene banks. Their investment strategy is somehow different. They tend to hold minority stake and are more passive investors. Since their investments are mainly in medium and large companies, control is exercised through supervisory boards (board of directors). They agree with management and owners on exit strategy prior entering into investment. Therefore they do not expect many difficulties with getting out of their portfolio companies. They generate deal-flow³ themselves or through banks and chambers of commerce and other professional associations. It too has successfully invested all of its available funds and is currently in the process of raising new fund.

Prophetes was established at the end of 1999 and is funded exclusively by Slovene private sector. It is the smallest fund regarding volume, but its strategy is to only invest in projects with very high knowledge input and high added value. They bet on so called "smartness of money". They provide total support for innovative entrepreneurs. They are developing their concept of partnership shareholder's company.

Aktiva Group incorporated its venture fund (Aktiva Ventures) in 2000, but made its first investment in Slovenia at the end of year 2001. Their focus is primarily targeted in telecommunications, software development and biotech projects. They intend to finance their portfolio companies through growth stages and through the internationalization phase. They plan to exit through IPO on major international stock exchange or trade sale to strategic partner.

In 2002 there have been plans to establish another government owned venture fund by the Ministry of Economic Affairs. Kmečka družba also plans to incorporate its own venture fund, for they have already made some investments, one of them is Seaway, yacht design and construction firm, being the most publicly spoken about.

Table 1 shows incremental increases in the volume of formal venture capital financing in Slovenia expected in the near future. This trend would certainly look stronger and more optimistic if the regulatory body of Slovenia would dismiss the restrictions faced by certain long-term institutional investors, such as pension funds and insurance companies, in their investment policy regulation. Alongside this, the main obstacle to venture capital flourishing development is also very rigid Slovene taxation policy regarding long-term capital gains tax for venture capital funds, as well as double taxation for their investors in Slovenia. This is the reason that most private venture capital funds operating in Slovenia have its capital located outside Slovenia (The Netherlands, Channel Islands, and other investor friendly locations).

² European Venture Capital Association

³ Deal-flow is the inflow of interesting projects possible for investments

In addition to the system obstacles mentioned above, currently most burning red tape obstacle is the court register regulation. This regulation forbids any new incorporation or equity enlargement procedures to firms that have unpaid debts to tax or other government authority. For venture capital funds that means that in order to invest in new project or put in new round of financing for existing portfolio company, all of the funds portfolio companies must have “clean record with the state and tax authorities”. Regarding the theory of venture capital investing, which acknowledges the 2-6-2 rule⁴, this is virtually impossible (Penca and Vadjal, 2002).

Table 1: Volume of funds under management (only private equity) in million EUR

Fund name	Current fund	Future fund (2002-2003)
Horizonte	7	20-60
SFM	20	50
Aktiva Ventures	15	
Prophetes	0,6	
Kmečka družba		15
TOTAL	42,6	85-125

Source: Penca, Slavnič; Finance, December 2001.

3.2. Global trends in venture capital with regards to Slovenia

Table 2: Venture capital investments in Europe

	1997 (EUR millions)	1998 (EUR millions)
United Kingdom	4428	7105
Germany	1326	1948
France	1248	1777
Netherlands	760	1058
Italy	603	933
Spain	262	363
Belgium	179	259
Switzerland	55	215
Sweden	351	203
Finland	113	189
Norway	170	165
Ireland	36	64
Austria	19	50
Portugal	63	50
Denmark	22	40
Iceland	5	22
Greece	16	20

Source: EVCA, URL: <http://www.evca.com>, 2000.

Investors in venture capital funds must be long-term oriented, because investments are made in long-term projects (5-10 years) and since they are dealing with equity stakes, profit usually comes only from realized capital gains when they exit from their investments. Thus investing

⁴ 2-6-2 rule says that out of 10 investee companies 2 will fail and go bankrupt, 6 will be mediocre (probably with some unpaid tax and other liabilities) and 2 will do extraordinary well.

activity and reward reaping can be quite far apart in time. Historical studies show that USA are far ahead but Europe is following in the recent years with investments in UK much exceeding investment in other countries (**table 2**) Studies show that predominant investors in venture capital funds throughout the world are pension funds and insurance companies. **Table 3** shows the distribution among venture capital fund investors in USA and Europe for the year 1999.

Table 3: Typical investors to venture capital funds in USA and Europe in year 1999.

Sources of funds	USA	Europe
Corporations	12 %	9,5 %
Banks	10 %	29,1 %
Insurance companies		13,2 %
Pension funds	60 %	18,7 %
Foreign investors	1 %	
Private individuals	11 %	6,2 %
Mutual funds	6 %	
State agencies		4,7 %
Reinvested capital gains		7,3 %
Other		11,3 %
TOTAL	100 %	100 %

Source: NVCA [URL:http://www.nvca.org](http://www.nvca.org) in EVCA [URL:http://www.evca.com](http://www.evca.com), 2000.

In **table 3** we can see that in the USA where venture capital market is more mature than in Europe, predominate investors are pension funds that have the longest investment horizon from all of the above investors. Stunning is that corporations are putting in second largest amount of money. This is a separate trend that many companies outsource their R&D taskforce that way, but through money still control the new knowledge development. On the other hand in Europe the predominant investors in venture capital funds are banks followed by pension funds and insurance corporations. The reason lies in delayed pension reform and other regulatory restrictions that still exist in Europe (Penca and Vadjal, 2002).

4. Business Angels

Business angels have been now for years a well known part of entrepreneurial environment in the United States and it often looks like a common sense that an entrepreneur who needs more capital than he/she is able to raise from the three Fs⁵, will go out to seek some equity financing, because he/she is also often not to borrow a sufficient amount of money from the bank. When we say equity in the sense of start up or even seed capital we often have in mind business angels rather than venture capital and we understand business angels financing as an introduction course in the equity financing school.

There is one major strength in equity financing: the cash flow of the company is not jeopardized, like it is the case in debt type of finance where installments have to be repaid regularly although the company needs that cash to finance its growth and development. The weakness of equity financing on the other side is that it is actually the most expensive source of finance: the trade off for certain amount of equity finance is a share in the company that an entrepreneurs has to give off. The entrepreneur must make himself very clear about his/her expectations: a substantial growth has to be planned if the company is to be attractive for

⁵ The “three Fs” are known as: family, friends and fools

formal or informal venture capital and the income to the entrepreneur would be (in absolute sense) much bigger when venture capital is involved in the company.

4.1. Business Angels Financing

Business angels are typically wealthy individuals who are willing to invest a part of their cash savings into prosperous ventures, which are innovative and ambitious enough to “promise” good capital gains after a certain amount of time. Business angels invest so called smart money which means that they do not just inject cash into the company but they also advise in gaining new customers and markets, finding new (debt or equity) sources of finance. In most cases business angels are recruited among entrepreneurs and managers. There are not many business angels who have not had any business experience.

Business angels usually fill in so called equity gap. They typically enter the company in the moment when the company is not able to get more debt funding on the other side its need for capital is too small to be interesting for venture capital. A typical business angel investment in Europe is between 10.000 and 250.000 Euros. Beyond this point, amounts are already interesting for the venture capital funds. It may be useful to stress why venture capital funds are not interested for smaller investments. They usually have very formalized decision-making process (due diligence). An investment process is much more time, people and money consuming, the cost of evaluating a particular business idea is therefore very high. It is what we call fixed or even sunk cost which do not depend on certain business decision. It seems very obvious that a venture capital fund will not go into evaluating process where there is no chance to get a positive financial outcome. Business angels are therefore willing to invest smaller amounts of money while their investment process is simplified, faster and also cheaper.

If there are similar market rules (demand and supply) applied in the formal venture capital market we cannot say that for the business angels market. Mason and Harrison (2000) argue that business angels capital market is so called invisible market. Business angels in most cases do not want to reveal their identity. Their records are not published and they are not able to use established marketing tools like promotion. Taking this into account there is a need for an intermediate. The main task of the intermediate is to collect data about demand and supply for the capital and to make matches between the two of them. In the other words, somebody has to put together a business angel and an entrepreneur according to their preferences about the investment. This is the main function of so called business angels in Europe. These networks typically just do the initial matchmaking and do not get involved in the further negotiations between two parties. A lot of matching is done through informal channels (word of mouth) as well but the number of them is not more than a blind guess rather than a serious estimation.

4.2. Business angels in Europe

There is an interesting comparison among financing growing businesses between Europe and US (O'Rourke, 2000): the average debt to equity ratio in US is one 1 to 2, while in Europe is 2 to 1. That means that Europe is much more debt than equity culture if we believe that equity in US is not just 3F money but also a lot of business angels and venture capital fund finance. As already said it is very difficult to obtain reliable data on business angel activities. To get the impression about these activities it may be useful to look at the data about business angel networks in Europe. As one can see in **table 4** the number of business angel networks almost doubled in two years. The fastest growth was recorded in France while United Kingdom has

obviously been ahead of Europe regarding this type of financing businesses. It is also common to all network apart from those in United Kingdom that they are all entirely or partly financed by local, regional or national governments.

In US equity financing can be in most cases found in the industries where a dramatic growth can be established: internet businesses, biotech, electronics are areas where a good shot can provide a real wealth to those who may have invested in the project only a few thousand dollars. But to be realistic: on the other side there are many failures, bankruptcies and personal tragedies. Europe is much more conservative about financing and equity financing can be found also in more traditional industries where such a dramatic growth may not be possible but profits are still good enough to be attractive for private investors.

Table 4: Business angels networks in Europe

Country	Year 2000	Year 1998
Austria	1	1
Belgium	5	2
Denmark	1	1
Finland	1	1
France	24	3
Germany	23	1
Ireland	1	1
Israel	1	0
Italy	5	0
Monaco	1	
Netherlands	2	1
Sweden	2	1
Switzerland	3	1
United Kingdom	49	49
TOTAL	119	62

Source: EBAN, 2001

4.3. Business Angels in Slovenia

Findings about characteristics of equity financing in Slovenia can be to a certain degree also applied for Slovenia. If we suppose that a vast majority of small businesses in Slovenia are family businesses one can find interesting or even concerning the following finding: 80 % of family businesses declared that they are in no circumstances ready to accept a non-family member to invest in their company.

From the different interviews with entrepreneurs it can be suspected that some angel financing has already been done in Slovenia. This is often the case in the real estate projects where entrepreneur finds investors for the project (for instance: building and selling a block of flats) and when the project is finished the investors share the profits in accordance to their input. This type of financing projects is not a real equity financing for two reasons: first, the company itself often dies after the project is completed and second, in that type of projects there can be a certain degree of guarantee (collateral on land) secured, so we cannot talk anymore about sharing risks.

Slovenian business angels network has been from the beginning a joint project of Podjetnik (entrepreneur) magazine and Small Business Development Centre. A certain amount of funding was secured through the budget of Slovenian government. In its first year of activity the network was focused mainly on promotion of the concept. A web page was designed to

start gathering first information about supply (business angels) and demand (entrepreneurial projects) for capital. The network has been making efforts to organize as many meetings as possible for the angel – entrepreneur combinations which were evaluated that may be prosperous. These were all introduction meetings because the policy of the network is to not get involved into negotiations between the two parties. Some results of the work in the year 2001 have been collected in **table 5**. Among 12 business angels 9 of them have been entrepreneurs themselves. One of the angels inherited a large amount of money while two of them did not want to reveal details about origin of their capital but they both assured that it was earned legally.

Table 5: Business angel network activities in Slovenia in 2001

Number of business angels	12
Average investment amount	26.000 EUR (range: 15.000 to 50.000 EUR)
Number of applications for funding	50
Average application for funding	85.000 EUR (range: 25.000 to 500.000 Eur)
Number of meetings organized	14
Number of deals closed	2 (negotiations on three investments are to be closed)

Source: Business Angels Network Slovenia, SBDC, 2001

Table 6: Business angels networks and number of deals closed in Europe

Country	Number of business angels networks 2000	Number of deal closed 2000
Belgium	5	1
Denmark	1	0
Germany	13	21
Spain	1	0
France	14	76
Ireland	1	1
Italy	5	0
Luxemburg	1	0
Netherlands	2	51
Austria	1	3
Portugal	0	0
Finland	1	10
Sweden	2	3
United Kingdom	48	234
European Union	99	400
EU without UK	51	166

Source: Equitylink, EBAN Kongres 2001

One of the closed deals was not really a result of the network activities. The network was more involved as a consultant and meeting facilitator to both parties. The second deal closed was a real estate project, again not a typical angel type of financing. If we take the number of deals closed as a measure of success, than we have to find a reference for benchmarking. Deals closed by business angel networks all over Europe are gathered in **table 6**. The networks in Europe closed in average 4 deals in 2000 but a great deal has been contributed from activities in United Kingdom, which can be explained with longer tradition and culture of equity financing. On the other side, government sponsorship of networks in other countries may be the reason of lower efficiency of networks in these countries (Goossens, 2001).

Some findings from the meetings organized by Slovenian business angel network are gathered in **table 7**. The interesting point is, that after a year of promotion the concept there is still a certain degree of misunderstanding evident.

*Table 7: Types of projects applying for finance
In Business Angels network in year 2001*

Type of project	Number	%
Information technology	7	14
Building and constructing	11	22
New inventions	12	24
Tourism and restaurants	7	14
Arts and crafts	1	2
Food industry	4	8
Other services	6	12
Wholesale trade	2	4
TOTAL	50	100

Source: Business Angels Network, SBDC, 2001

If we look at the data in **table 7** it can be found out that real estate projects were the most numerous among all types. It has already been mentioned that this quasi angel type of financing has had a certain tradition in Slovenia. One may expect the information technology share to be higher (14 %) on the other side a large share of tourism and restaurants is a little bit of surprise.

When we discuss business-angels networks, two types of customers have to be taken into consideration: business angels and entrepreneurs. They both approach business angel network with different expectations, which often depend on degree of their understanding the concept. Some observations about understanding issues and expectations are collected in **table 8**.

Table 8: Some viewpoints on business angels concept

Entrepreneurs	<ul style="list-style-type: none"> • They do not want investor to get involved in daily operations
Business angels	<ul style="list-style-type: none"> • Some of them expect some sort of collateral • In most cases they are quickly ready to get in touch with entrepreneurs. • They want their privacy secured. • They want a personal contact with an intermediate

Source: Business Angels Network, SBDC, 2001

5. Final conclusions about venture capital in Slovenia

There will be six venture capital funds with the total amount more than 60 millions Euros in 2002. The supply of venture capital has been completed with the business angel capital on the informal side. But, it can be easily calculated that this potential is beyond the venture capital potential, which is available in so called developed countries, where the amounts are normally about 1 % of the gross domestic product, which makes this ratio about three times bigger than in Slovenia.

This can be explained particularly with the lack of equity financing culture in Slovenia because even fastest growing businesses finance their growth mainly with debt (Pšeničny, 2001). The lack of culture goes hand in hand with the lack of knowledge in this area.

The venture capital market is also specific for being small and will remain small on both sides: there is smaller number of entrepreneurial projects and there are smaller amounts of venture capital available. The amounts of money that may fill some new venture capital fund are under question mark. Another problem is seen as a lack of exit possibilities for investors. There is no market of shares in the companies and there have only been a few IPOs since the Stock Exchange in has been established. Therefore harvesting strategies are very limited. Legislation is another emerging problem regarding venture capital in Slovenia. There is no attractive tax incentive for investors on the other side legislation puts very rigid limitations about investment to banks, insurance companies and pension funds. The process of establishing a new venture in Slovenia is unfortunately still quite complicated and expensive. The Slovenian government itself has been considering of playing more active role in venture capital market. A certain amount of funds is planned for investments in new hi-tech start-ups. A certain procedures have been started to diminish formal barriers (legislative) but no discussion has been started yet on proposed tax incentives.

6. Recommendations

The question of encouraging and supporting equity financing activities seems to be a matter of concern throughout Europe in the recent few years. Recommendations that can be implemented also in Slovenia and other transition economies generally go into three directions (1) support of further development of entrepreneurial culture, (2) venture capital favorable legislation with emphasis on tax incentives and (3) diminished barriers for further investment of different financial institutions like pension funds and insurance companies. Further development of venture capital markets is also expected through final integration of European market with eliminated barriers for free flow of capital, human force and projects.

European commission has been very precise about its own advice regarding equity financing. The advised measures shall be dedicated to environment becoming supportive for creation and development of new and innovative businesses. That should be achieved through a set of structural and horizontal measures rather than direct investments in the sense of venture capital. Governments should only intervene with direct investments to override market failures that cannot be achieved through market supply and demand of venture capital.

Venture capital is in its nature an economic activity. Budget funded venture funds would become an unfair competition to commercial funds because of the probably limited expectations about the returns on investments. The equity finance gap should therefore not be filled in with direct investments of the budget funds. Rather than that governments should consider ways to mobilize more private equity for investments in venture capital funds and for direct investments in the companies (business angels).

Proposed measures to support venture capital financing follow three directions: (1) support measures for investors (2) support measures for intermediates (venture capital funds and business angels networks) and (3) support for target companies for investments. The support measures can be divided into two groups: (1) direct financial support and (2) other types of non-financial support. Special consideration should be given to ideas about guarantee schemes for investments. These guarantees can be governmental, commercial, mutual or combined. Direct financial support can be in a form of subsidized or secured loans and/or grant schemes to cover certain sunk costs of investment.

When discussing other types of non-financial support we have in mind consulting, training and informing which can be organized and/or financed by government. Thus will accomplish its role to encourage the demand and supply of equity finance and therefore fill in the equity finance gap.

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