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ScienceDirect

Procedia - Social and Behavioral Sciences 150 (2014) 97 – 106

Procedia
Social and Behavioral Sciences

10th International Strategic Management Conference

Venture capital in Latvia: the peculiarities, contradictions, and accessibility for SMEs

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Abstract

The authors of this article pay particular attention to the study of the nature of venture capital as a multi-meaning concept. It is evident that venture capital is one of the main sources of financing innovation entrepreneurship and small business. On the other hand venture capital represents an independent sector of market economy of a certain country. At the same time venture capital operation mechanism requires a definite system of public relations in risky business, which is based on economic interests of investors, entrepreneurs, government and society. The *purpose* of this research is, on the basis of the investigation, analysis and synthesis of contemporary publications on the topic of venture capital and opinions of Latvian venture investors, to make an attempt to evaluate the role of venture capital in the development of entrepreneurship and small businesses in Latvia, identifying the peculiarities and contradictions of its functioning in the conditions of entrepreneurial environment in the context of globalization.

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Peer-review under responsibility of the International Strategic Management Conference.

Keywords: venture capital, investors, venture capital funds, small business financing

1. Introduction

Despite the fact that in Latvia the number of publications and research papers on the topic of venture capital investments has increased over the last years, the phenomenon of venture capital and its operation mechanism have not been sufficiently scrutinized yet. The European Venture Capital Association

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(EVCA) keeps records only of the whole Baltic region. It is understandable as most of the funds focus their investments on all three Baltic countries or even more widely on the CEE and Russian region according to the research “Venture capital in Latvia revisited”. According to this study, in 2007-2008 venture capital investments in Latvia accounted for only 0.29% of GDP, whereas venture capital investments per capita were 30 euro (Vanags, Staševska and Paalzow, 2011). The data that has been presented by the Latvian researchers from Stockholm School of Economics in Riga shows that total amount of venture capital invested in Latvia equal to 215.2 mEur (Krits, Strenga, and Paalzow, 2013). Venture capital as a research object has been receiving increasing attention from modern scientists, academics, and practitioners. This phenomenon is multifaceted and unique. On the one hand, it represents the type of economic activity, which embodies intellectual entrepreneurship; on the other hand, it is one of investment forms characterised by high risk and high return on investment. In addition, during the venture capital investment implementation process a certain system of relations occurs, which involves investors, entrepreneurs, managers, society and state. Therefore a study of the peculiarities of this system operation as the factor that determines the success of venture capital investments may also become an independent piece of research.

There are also practical aspects that enhance the relevance of the topic. Many Latvian investors, who call themselves venture investors, are complaining about the lack of interesting innovative projects and point out the inertia among Latvian entrepreneurs. At the same time, entrepreneurs, who have unconventional innovative ideas, are complaining that they cannot get through to venture capitalists. It is clear that Latvia has not yet developed a system of effective venture capital investment; and this area of research remains a topic for debate and discussions. The result of this paper is a list of recommendations aimed at creating an effective mechanism for the venture capital investment operation as a vital funding source for innovative SMEs in Latvia. These recommendations are primarily designed for public institutions, as the authors attach critical importance to the position of the state in this matter.

2. Literature Review

Peculiarities of venture capital in Latvia were studied by Lace and Laizans (2007), the problems of management innovation activity were outlined by Denins and Zakovics (2008); Kopitov (2004) explored the possibilities of attracting venture capital to the transport sector; innovative business financing questions were presented in the paper by Jakusonoka and Prohorovs (2011); the impact of corporate tax on innovations was researched by Zelgalvis and Joppe (2011). An attempt to examine the size and scope of the venture capital sector in Latvia was undertaken by Vanags, Staševska, and Paalzow in “Venture Capital in Latvia Revisited” (2010). In order to draw attention to the venture capital industry, some venture capitalists publish their own materials in the Internet (Tamužs V., Sosars V., Riksis M., Prohorovs A., and Berzins A. working most actively in this field). In general terms the mechanism of venture financing is presented by the Directorate of the European Commission in the form of “The Guide to Risk Capital Financing in Regional Policy” (2004) and is available in the Internet.

Venture capital definitions offered by a number of venture capital associations and some researchers are provided below. Venture capital is: *Long-term investment* in the company’s equity with the purpose to promote the value of the company by financing its rapid growth and development (LVCA); *Subset of private equity* which is broadly defined as the provision of equity-oriented financing to enterprises that are not listed on a stock market (EVCA); *Specific type of finance* well suited to the requirements of new

technology based firms (Chistofidis and Debande, 2001); *The industry* that drives U.S. job creation and economic growth by helping entrepreneurs turn innovative ideas and scientific advances into products and services that change the way we live and work (Leach and Melicher, 2011); *Fund* made available for start-up firms and small businesses with exceptional growth potential. Managerial and technical expertise is often also provided (Kelly, 2010); *Equity support* to fund new concepts that involve a high risk and at the same time, have high growth and profits potential (Mohanty, 2005); *Investment of long-term equity* finance where venture capitalist earns his returns primarily in the form of a capital gain (Tripathy, 2004); *Professional asset management activity* that invests funds raised from institutional investors, or wealthy individuals, into promising new ventures with a high growth potential (DaRin, Hellmann, and Puri, 2011). From the summary it can be concluded that:

- The concept of venture capital is defined and explained starting from money to industry. The observed differences are regional – in Europe it is more viewed as an investment in a company, whereas in the USA it is taken more broadly as an industry that drives economic growth.
- There is no agreement in the terms and the concept. As emphasized by other researchers - recently some investors have been referring to venture investment and buyout investing as „private equity investing” (Mohanty, 2005).
- With the variety of venture capital definitions, most authors explain venture capital as long-term financial investments in new or fast-growing innovative companies, emphasizing the high degree of risk investors have to accept.

Despite the fact that the term *venture capital* has become firmly entrenched in the scientific vocabulary, this concept means different things to different people, which can obviously be explained by the difference in viewpoints and pursued objectives. The main research questions that have been addressed in this article are as follows:

RQ1: Venture capital investor in Latvia – who is he?

RQ2: What are the typical characteristics of venture capital activity in Latvia?

RQ3: What factors hinder the development of the venture capital investments for SMEs?

3. Methodology

3.1. Research Goal

The goal of this research is, on the basis of the investigation, analysis and synthesis of contemporary publications on the topic of venture capital and opinions of Latvian venture investors, to make an attempt to evaluate the role of venture capital in the development of small businesses in Latvia.

3.2. Sample and Data Collection

The authors proceeded with a study of the nature of venture capital based on Western publications, which resulted in the authors' attempt to give their own interpretation of this term. In order to portray the Latvian venture capitalist, identify the features of the Latvian venture capital business and the environment in which venture capital investment operates in, as well as to clarify the state's role in this process a standard personal interview was designed. Within the framework of this research project, a systematic survey of twelve Latvian investors was carried out; with the permission of the participants two sets of data were audio-recorded. Each interview lasted between 90 and 180 minutes. The selection of the

respondents for the interview was guided by the following principles. The degree of investor's activeness was determined by the number of times he had invested in innovative projects and the amount of funds invested. The survey involved the most recognizable and most active investors, one of them being the President of the Latvian Venture Capital Association (LVCA). There was one more important factor that determined the selection of the respondents - all the people surveyed are Latvian entrepreneurs.

The questions in the first part of the questionnaire were designed to portray the Latvian average venture capital investor: Who is he? Only Latvian respondents participated in the survey; this was done deliberately in order to determine the Latvian potential. The results of the survey led to the conclusion that there is no single standard "image" of a venture capitalist; based on the criteria developed the authors concluded that there are three groups of venture capital investors: business angels, investors and co-owners of venture capital funds, and investment companies. The respondents' answers to the questions in the second part of the questionnaire revealed investment features and approaches for each group of investors (How does he do that?) and form an idea about the essence of venture financing. Each survey question was formulated to reflect a certain criterion (e.g., industry, investment size, business development stage, investor's requirements, risks, and so on), which later could become the basis for the development of a system of indicators for controlling the investment process. The main purpose of the interviews was to try to establish a pattern between the type of investor and his behaviour (approach to investments). As a result it was found that *the nature of ownership and participation in venture capital determines the investor's motivation and requirements*. Any assessment of quantitative and qualitative relationships between the type of investor and peculiarities of his behaviour, as well as the development of venture financing model, which takes into account the type of investor, could be a topic for *further research*.

The respondents' answers to the questions in the third section of the questionnaire allowed to identify the factors that affect venture capital investment process as well as to assess the role of the state. The results of the study gave an idea about the reasons why Western venture investment methods are not working in the Latvian environment. Based on the results of the interviews, analysis of statistical data and scientific publications, the authors used SWOT analysis tool and tried to evaluate the role of venture investment in small business development in Latvia.

The authors' opinion about venture capital is formulated on the basis of the views of all twelve respondents who participated in the research project; however, the opinions of the three interviewed respondents are summarized. The choice of these particular respondents can be justified as follows: all three respondents have an extensive experience and are the key persons in the Latvian venture capital sector; all three are the most active investors and are willing to share their experience (the first respondent is the President of the LVCA and has rich technical and managerial skills; the second is the most ambitious and aggressive; he works with JIC business incubator companies, while acting as a venture capital fund manager and a business angel; the third respondent participated in the creation Riga Stock Exchange, he was a venture capital fund manager.

3.3. Analysis and Results

To portray a venture capitalist in Latvia, the authors carried out structured in-depth interviews. The respondents represent a significant part of the Latvian venture capital market because all the respondents have managed venture capital fund assets in Latvia. The analysis of the results shows similar patterns in

motivation for becoming a venture capitalist – it is desire to do something new, make something new, and prove themselves because the main motivator is the desire for self-realization. The characteristics common to all the respondents are: passion in their work (this was especially marked in case of the second investor), possession of technical and management skills, commitment to innovation; without any doubt these are progressive people who are 'looking for talented and very intelligent people'.

Table 1. Venture capitalist phenomenon in Latvia

Indicator	Respondent 1	Respondent 2	Respondent 3
Experience about venture capital	Runs a venture capital fund	Ran a venture capital fund, currently is an active private investor	Used to run a venture capital fund
Occupation before becoming a venture capitalist	Management of manufacturing companies	Management of multinational company, branch in Latvia, business consulting	Financial sphere and business consulting
Motivation to become a venture capitalist	If I can run one company, I can several	A desire to make something new, avoid collective responsibility, working with mission impossible	A desire to do something new in Latvia
Main motivators	Desire for self-realization	Desire for self-realization and money	Desire for self-realization
Main keys to success (priority)	Professional skill; intuition; ability to form a team	Ability to form a team; Professional skills; "right" financial resources	Professional skill; ability to form a team; intuition
Attitude to failure	Accept failures as they are	Tolerant	Accept failures as they are
What is a venture capitalist? (self-assessment)	Businessman	An investor (in specific combination also an industry professional and a businessman)	Entrepreneurial investor

Despite the variety of venture capital definitions, that have been discovered in theoretical part of the research and taking into consideration the opinion of Latvian investors, a number of common features can be identified for a person who provides venture funding. This fact has allowed the authors of this paper to develop a model of venture capitalist (see Fig.1). The model developed by the authors is based on the main characteristics of venture capitalists and major attributes of each of these characteristics.

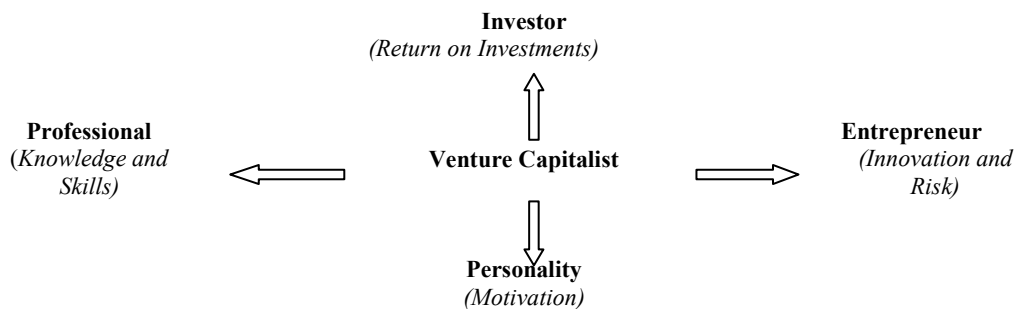


Fig.1. Model of Venture Capitalist (designed by the authors)

The collective image of the venture capitalist can be presented in four dimensions (features). First of all, this is a person who has a number of personal characteristics that define his character, behaviour and

motivation. Venture capitalist behaviour is distinguished by the innovative component and success factor. His behaviour is innovation focused; he lives in an innovative environment. The distribution of the investor, entrepreneur and professional roles in each case depends on various factors, primarily on the type of investor. In this model, one more feature is not mentioned intentionally - a manager's role, which is typical for venture capital fund managers. In some cases enterprising inventors, idea authors also become venture capitalists. Based on the study of Western publications about the nature of venture capital, the authors tried to give their own interpretation of this term. In our opinion,

Venture capital is a special kind of intellectual entrepreneurship, which is based on the innovative model of high profit and high-risk oriented economic behaviour.

The analysis of the respondents' answers are presented in Table 2, has helped the authors identify the main types of venture capitalists and identify factors that influence the nature of their behaviour and motivation, as well as to identify the main features of venture capital as a form of entrepreneurial activity.

Table 2. Venture capital investments as business type/industry

Indicator	Respondent 1	Respondent 2	Respondent 3
What is VC activity in Latvia?	Lifestyle	A type of economic activity	A profession
Typical venture capital investment modules in Latvia	VC funds with state participation; private direct investments; VC of commercial banks;	Venture capital funds with state participation and private direct investments in projects	VC funds, which receive public (EU and Latvia) support and private direct investments
Form of activity	Limited partnership	Limited partnership	Limited partnership
The experience and extent of team	Permanently 10 and fewer people, invite specialists needed for a specific project	Basically only one participates in project evaluation process but tries to organize a team of high level managers in financial sector	Basically bank financial specialist and invited experts in specific industries
Sources of innovative projects in Latvia	Regularly followed the information published in the press	Technology community (it is not very widely spread in Latvia), business incubators	Communication with mass media; state agencies; conferences; forums
Criteria for risk investment of the project	Must be viable and investors must be convinced	The team; importance of scope the problem to be solved; sustainable competitive advantage	People and team
Average number of projects under consideration	10 out of 100 projects are supported	1-2 out of 100 projects	3 out of 100 (including ideas)
Key aspects of potential project	Projects viability and investor belief in the project	Team, importance of the problem	Team, product; must see how the investor is going to earn
Investment	Restructuring of an existing company, rarely in a new company	Start-up	Idea; Restructuring of an existing company
Capital return in percentage	At least 25% per year	Approx. 40% annually (expected return in 5 to 7 years: 10-15 times; 1 out of 5 projects is successful)	The overall aim-30% annually.
Term of venture	4 – 5 years	4 – 7 years	Up to 10 years for start-ups

capital presence			
Main causes of invested projects failures (priorities)	Project management, lack of coordination with partners, high ambitions of participants	Insufficient aggression, the problem overvalue, Inability to attract competence (lack of global ambitions)	Little experience in VC. There is no natural selection, the lack of projects, inability to specialize in the industry
Project exit ways	Sale of his share (usually 50%), to other shareholders, other funds or stock exchange.	Sale to a strategic investor or trade sale; next round or the next stage investor	Most commonly trade-sale or sale to a financial or strategic investor

The analysis of the Latvian venture capital market as well as the views shared by the respondents show that the most common form of venture investment is the venture capital funds with state participation established as limited partnerships. The second most common type of venture investments is private direct investments in the project. Thus, innovative (venture capital) projects are funded by two categories of investors: venture capital funds with the participation of state capital, and private investors who refer to themselves as business angels. The nature of ownership and its participation in venture capital determines the motivation and requirements of the investor. For business angels money is the strongest motivator; this type of investors is the most aggressive, they take independent decisions and greater risk, but are tolerant to failures.

The summary of venture financing investment volumes shows that venture capital investments are not developed in Latvia as a type of business and type of financing. The authors gathered the opinions of the respondents which explain the reasons of slow development of venture financing; around them:

- The lack of deal flow and low quality projects;
- Mutual lack of experience in venture capital investments;
- Understanding of business is often limited to „buy-sell” – lack of understanding of the role of SMEs;
- Start-ups are not „aggressive” enough. In Latvia start-ups use modest, unaggressive brand building and overall strategies;
- Overvaluing the problem – taking yourself as an example in humanity problems is a mistake;
- Ambitions of shareholders – difficult to coordinate the operation of a fun;
- Lack of global ambitions (fear of talking to experienced investors, competent partners);
- Natural selection of getting the investment does not work because of subsidized funds; Everything is more violent under „normal” market conditions;
- Few active (initiative) and intelligent entrepreneurs;
- State as a fund participant is afraid to invest the money received from taxpayers in the private capital;
- As noted by one of the respondents: "The problem is not the lack of money, the problem is there is nothing invests in".

It's very interesting position of Latvian researcher Prohorovs A. (Prohorovs, 2013), who discovered the main factors affecting the attraction of capital into venture capital funds in Latvia, based on the opinion of venture capitalists: investors have no confidence in the funds' management team because of the lack of positive experience and previous achievements; the funds face difficulties to find good projects; and investors in funds understand that Latvia is a small market, ect.

In the concluding part of the research, the authors came across different views about the shortcomings of the existing venture financing system and opportunities for its further development. Therefore we offer the authors' conducted SWOT analysis of venture financing situation and perspectives in Latvia, which summarises the answers of the respondents in the Table 3. Evaluating opinions of the respondents, it can be concluded that in some aspects opinions are completely different. For example, several studies indicate that Latvia, compared to other countries, has a favourable tax policy, to which neither local researchers (Zelgalvis, Joppa, 2012), nor the respondents agree. They also point out that assistance is necessary, but in some Latvian cases it did not help to make rational investment decisions. The situation, when a project in which an investment has been made, is considered to be successful (main financial indicators, society's opinion), but is not successful from the investors view, because there is no one to implement the investments (respondents' overall view); this is a problem that impedes development of venture financing in Latvia.

Table 3. Evaluations of current situation and perspectives of VC investments in Latvia

Strengths	Weaknesses
<ul style="list-style-type: none"> • Access to subsidized resources, money for investment is sufficient; • Public support for venture capital is transferred to the private sector; • There is venture capital and venture investors; • There is practical experience in managing funds, failures (which are not big), but it is possible to learn from them. 	<ul style="list-style-type: none"> • Lack of knowledge about venture capital as a type of financing; • Lack of active entrepreneurs (initiative); • Lack of <i>matchmaking</i> - pairing, monitoring in technological incubation terms; • There is no information, analytical data; • We are at the earlier stage of VC market; • Lack of developed financial and stock markets.
Opportunities	Threats
<ul style="list-style-type: none"> • The whole venture financing eco system is in its early stage, problems can be solved relatively quickly; • Geographical location; • Developed business infrastructure, well-developed banking system; • The industries that have elaboration forerun - chemical, pharmaceutical, IT industry, spin-off from existing systems. 	<ul style="list-style-type: none"> • Investors' unwillingness to invest in small-scale projects (which are the majority in Latvia), too high costs and risks; • Improper use of the subsidized funds (now investments in business incubation are focused on regional development, not innovative business, decisions on public participation in investments are not always rational); • Unstable system of taxation; • The wrong choice of the economic development model.

Local researchers and policy makers point out a problem which is also admitted by venture capitalists - early-stage venture capital financing in Latvia is almost non-existent, as the existing venture capital funds focus on larger expansion projects. An essential obstacle hindering the development of the venture capital industry is the lack of investors willing to provide equity finance for small innovative firms (*Vanags et al, 2010*). Thus, it cannot be said that the Latvian VC industry yet represents classic model of venture financing that is seen as particularly supportive of innovative start-up businesses.

Venture capital investors have different opinions regarding future development perspectives for venture capital and Latvian business development in general. There are opinions that the future of the Latvian economy will be determined by large companies only. "How many small businesses there can be if there is no export?" This attitude explains the obvious fact that Latvian venture capital investors prefer to invest in existing fast-growing businesses rather than in new and innovative start-ups. This fact is a distinctive feature of the Latvian venture capital. Thus, the results of our research indicate that the Latvian venture

capital investment mechanism is not sufficiently developed; there is no consensus about the nature and purpose of venture capital, which indicates that the venture capital industry is in its infancy phase.

4. Conclusion and recommendations

The results of the research show that there is some relationship between the reality and the assessment of the future perspectives of venture capital, which can be explained by the peculiarities of the market, position of venture capital investors, susceptibility of the Latvian companies to innovations, and involvement of the state in the process. Exploring the cycle of venture capital investment, the authors have tried to "fit" into Kondratiev's 'long-waves cycle of economic conjuncture', since according to the predictions of this prominent Russian economist, a modern economy is in such a stage of development, where the decisive importance is attached to the investment policy of the state in the basic technology and innovation. This means that venture capital plays *the key role in the development of entrepreneurship and small businesses in Latvia*, whereas the state's position is of paramount importance in this matter.

Based on the results of the study, the authors believe that the *recommendations* presented below could contribute to maintaining venture capital investment potential in Latvia, improving the mechanism of venture capital financing and development of the venture capital industry in future.

1. The state has a neutral position in the question of venture capital (as in fact in the question of entrepreneurship development): the state neither interferes, nor supports its development either. To solve the problem "Where to invest?" and "Where to get the money?," one of the three Latvian ministries (Ministry of Economics, Ministry of Finance, Ministry of Regional Development), following the national interests must take the initiative in order to create a single national database (a single portal) of investors' resources and ideas of entrepreneurs. Only the transparency of information can provide the interaction between entrepreneurs (companies) and venture capitalist and relationship between venture capital firms.
2. The state involvement is necessary in the development of innovative strategy implementation mechanism, which would include a set of measures to stimulate companies' innovation in the high priority areas of economy and strengthen venture capital investments in the form of special tax incentives and conditions enabling companies to reduce the cost of capital employed and reduce the risk for the investors.
3. The question of obtaining statistical information about the scope of venture capital and its use remains relevant. It is necessary to introduce a new code of economic activity into the state NACE classificatory called "Venture capital investments" and keep a record of the size, sources and uses of venture capital. This recommendation is addressed to the Central Statistical Office and Commercial Register of Latvia.
4. Latvia has a developed but inefficient system of education in terms of the knowledge transfer to practical field. It is necessary to establish a new body, it may be a council on the state level, bringing together representatives of all higher education institutions in Latvia, which would accumulate the most valuable ideas presented as business plans developed by students and entrepreneurs. In order not to overburden the work of the council, all business plans must go through the preliminary selection process by the boards (committees) organised in each institution. The council could conduct business plan competitions on a regular basis, the best ideas could be forwarded to the Latvian Venture Capital Association. It should be noted that although some large banks organise business idea contests on their own initiative, participation of the Ministry of Education and Science in the promotion of such a council would be appropriate.

5. Venture capitalists themselves should be more active, clear and open to discussions with entrepreneurs. Every venture capital fund and business angels have their web sites; the problem is that they are separated. Creation of a single social network would facilitate the process of finding common interests among venture capitalists and entrepreneurs following the interest of the society. By the way, the idea of a unified social network could become an object of venture capital investing...

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