

**UNIVERSITAT
JAUME·I**

Venture Capital: an alternative financing for SMEs

Author: Jénifer Ribelles Recatalá

e-mail: al239981@uji.es

Tutor: Luisa Nieto Soria

Degree Final Project Finance and Accounting

ABSTRACT

Although venture capital is still a discreet figure of importance in the Spanish market of venture financing in the United States, it represents about 70% of corporate finance.

After the period of global economic recession, venture capital is presented as an alternative to bank financing at the present difficulty for SMEs in accessing credit.

This method based on the contribution of funds by an investor or a management company for conducting business projects with high potential for future benefits acts as a growth driver for the company and a stimulator of the economic development of a country. Finally, the investor is balanced for the risk taken in the investment through the profitability provided by these new companies after its IPO, in most cases.

INDEX

1. Introduction	1-3
2. Definition of Venture Capital	
a) First-stage financing	4
b) Expansion financing	5
c) Acquisition and Leveraged Management Buy Out	5
3. A short history of Venture Capital	6
4. Determinants of Venture Capital	7-9
5. Impact of macroeconomic variables in Venture Capital	
a) GDP growth	9
b) Interest rate	10
c) Unemployment rate	10
d) Research and Development	10
e) Total Entrepreneurial Activity Index	11
f) Initial Public Offering	11
g) Market to book Ratio	11
h) Market capitalization growth	12
6. Research and Development through Venture Capital	
a) The role of innovation in the economic growth	13
a.1) <i>Innovation improves productivity</i>	13
a.2) <i>Innovation improves competitiveness</i>	14
b) Venture Capital as a source of innovation	15-16
7. Regulatory aspects that influence the development of Venture Capital	
a) Influence of the political conditions in the VC	17
b) Effects of legal systems in the VC	18
c) Taxation of Venture Capital in Spain	18

<i>c.1) Direct taxation of "SCR"</i>	<i>19</i>
<i>c.2) Indirect taxation of "SCR"</i>	<i>19</i>
<i>c.3) Taxation of investment partners of the "SCR"</i>	<i>19</i>
8. Current situation of Venture Capital in Spain	20-24
9. Structural characteristics of Spanish SMEs.	25-26
10. Conclusion.	27-29
11. List of References.	30-33

**Venture Capital: an
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1. Introduction

Historically, the bank has been involved in over 80% of corporate finance in Spain, while in countries like France and Germany, the percentage varies between 50 and 60% and in the United States only represents less than one third of funding. (*ABC / Economy 2013*)

With the arrival of the economic crisis around 177.336 enterprises have gone bankrupt since 2008, being most of them SMEs, according to the Report of the Business School (ESADE¹). This data evidences a greater or lesser extent, with some exceptions, the problems of the Spanish companies facing tight credit and financing.

The paradigm shift caused by the long crisis which we live, the problems that the banking is facing, bailouts, mergers of institutions, the fall in domestic demand, difficulties to cope with the debt refinancing, etc. They have made that financial institutions operating in our country cannot cover either the financing needs of many customers.

This access to finance for the bulk of Spanish SMEs is currently expensive and difficult, especially when it comes to working. However, it is beginning to produce a phenomenon that we might refer to as “desbancarizacion process²” of corporate finance, mainly due to the search for new solutions to try to solve this serious credit crunch. Consequently, other systems or alternative non-bank financing began to appear, such as venture capital.

Traditionally, venture capital has focused on corporate finance start-ups or expansion, which have few internal funds and are characterized by a high degree of uncertainty about the future development of their business, making it difficult to access to alternative sources. Thus, venture capital investors play an important role in the economy, as they are to finance new companies that are growing and therefore, have high levels of risk. Thus, this activity encourages the development and renewal of the economies of the countries. Gompers and Lerner (2001)

¹ ESADE (Business School): is an independent non-profit university institution, founded in 1958 in Barcelona when a group of entrepreneurs and the Society of Jesus members joined forces, Since 1995, it has formed part of the Ramon Llull University.

² “Desbancarizacion process”: is the name that receive the process which involves reducing dependence of the banking business for funding

The acquisitions carried out by the private equity firms are temporary, and that, after a certain period, sales of the purchased shares are held. However, the medium-term maintenance of investments normally tends to be rather lengthy.

In the last phase, the investor will seek his departure from the company to realize the yields and reverse the flow of funds to suppliers. The main exit strategies proposed are selling to a strategic investor, the initial public offering (IPO) of shares in the company or the repurchase by the company.

The importance of venture capital lies in its ability to support the development of innovative and high-growth companies, so that they are able to reach their potential and create jobs and growth. According to a study developed by Martí Pellón (2007), the presence of a venture capital investor in the equity of a company generates a positive effect on the same (in terms of employment, turnover, results, asset investment and tax collection, among others), resulting in a growth of the company and, therefore, an economic impact on the area where the activity takes place.

Venture capital has been developed as an important intermediary in financing markets, providing capital to businesses that might otherwise have difficulty attracting funding. These companies tend to be small and young, which have high levels of uncertainty and large differences between the information that entrepreneurs and investors have. Moreover, these companies often have few tangible assets and operate in technological markets that change very quickly.

Over the last 50 years in the United States, venture capital has provided initial funding to companies like Microsoft, Apple, Intel, Lotus, Sun Microsystems or Federal Express, which currently have a presence in all developed economies. Furthermore, this type of financing has been established as the engine for innovative entrepreneurial companies. The success of many innovations backed by venture capital has generated huge yields for investors who focus their funds on these American companies.

In Europe, although the venture capital market started much later (in the 80s), the impact that has had the overall economy, has also been remarkable. The Private Equity and Venture Capital Association on a European study of companies backed by venture capital, reports that 94.5% of these companies said they could not exist if they had not received this alternative financing, while 89.7% of them said they had increased the number of employees after the investment in venture capital.

In line with what has been discussed before, the aims of this project are specified in thorough the knowledge of the non-bank finance risk-based capital in the different stages of development as well as in the evolution that has taken place since its inception.

Secondly, those determinants of this type of financing will be studied, as well as the impact that the main macroeconomic variables (GDP growth, interest rates, unemployment, etc.) have in the demand for risk capital.

Moreover, the importance of R & D spending in the growth of enterprises, and collectively, in the development of the economy through venture capital will be analyzed. Besides the effects of different economic policies that countries in which such capital is present and the legal framework of each country that regulates it will be observed.

Finally, the current situation of venture capital in Spain will be discussed, as well as the structural features that Spanish companies have and due to this fact this prevent them easy access to this market.

2. Definition of Venture Capital

The most widespread definition of risk capital is a subset of capital, which is defined as the provision of funds from financial investors in the medium to long term businesses with high growth potential.

This concept refers mainly to the US, since it is the country where this form of financing is more widespread, which is approximately 70% (NVCA³). This alternative non-bank financing takes into account the stage of development of the company. In addition, it is common that the investor accompanies the company at different stages from its development to its IPO.

As Pratt⁴ noted (1989) "today venture capital funds all stages of development that occur in a company":

- Early-Stage Financing
- Expansion financing
- Acquisition and Leveraged Management Buy Out

Each stage of development of the company and the corresponding funds can be analyzed as follows:

a) **First-stage financing**

The first stage is a relatively low sum of money given to an inventor or an entrepreneur to allow a new idea or to develop a prototype. This process is called seed-financing. Then it analyzes the future success of the idea or prototype and starts providing funds for developing the product and the implementation of the marketing plan. In general, a company at the beginning is still being organized or its existence is quite short (less than one year in operation). However, you must have been prepared a business plan, some market studies and obviously good management.

Consequently, the first stage is an intermediate stage between the beginning and expansion. At this point, the company has spent the initially invested capital and their needs focus on raising funds for the development of their trade policies.

³ NVCA (National Venture Capital Association): political association that fosters innovation and serves as the definitive resource for venture capitalists.

⁴ Pratt (1989): guide is the reference source to actively invest in private venture firms that operate worldwide capital.

b) Expansion financing

At this stage of development, the company produces and sells, even though not making any profits but has considerable inventory and accounts receivables. Importantly, it must have sufficient background operations to fund its operating cycle. Then, it takes place a stage in which the activity of the company begins to generate profits, i.e., breakeven is reached. However, the company needs additional funds to be used to increase the level of sales, strengthen capital funds, and perhaps, to improve the new product.

In the last stage of this level, funding consolidation occurs, which take companies to the introduction in the financial market over the next six or twelve months. At this point, major changes may occur in the capital structure, as some shareholders may want to retire liquidating the parts provided. From this point, the company may resort to means of traditional financing (bank loans), or likewise, interest in venture capital investors wishing to diversify their portfolios to minimize risk and keep control of the company.

c) Acquisition and Leveraged Management Buy Out

In the acquisition of financing funds will be provided to a company that let you finance the purchase of another company.

On the other hand, in the financing of resale or one of its divisions for their executives, funds are provided at the time of the acquisition of a division or a company by its own managers. They join venture capitalists to build the capital of a holding company that completes its means of intervention, borrowing. Through industrial activity, the company will create profits and dividends to poor holding companies which will be able to repay their loans.

3. A short history of Venture Capital

The first manifestations of venture capital activity appeared at the beginning of the 1940s. At this time, the work of venture capital investor was exercised by some great American families such as Rockefeller Brothers and Witney and Co. The institutionalization of this model US funding began with the creation in 1946 of the company "American Research and Development Corporation" (ARD) by the general George Doriot⁵. In 1958, the decree of the Small Business Investment Act, allowed the creation of Small Business Investment Companies, which now account for long-term for American SMEs the only source of funds for financing.

Between 1960 and 1970, the venture capital industry experienced an exceptional development with the creation of a large number of private companies. During this period, investors contributed in no small measure to the development of electronic and computer industries especially in the regions of Massachusetts and San Francisco.

Europe, meanwhile, had fallen behind the US. The reasons for the slowed growth, range from business problems inherent underdeveloped and fragmented to cultural economic obstacles and political landscape of predominantly socialist governments that created difficulties for entrepreneurs and businessmen to relatively markets.

It was not until Margaret Thatcher ⁶came to power in 1979, when the UK industry really started to take some permanence. In the early 1980s, there were several changes that helped to bring down the barriers that had been insurmountable some years ago. These changes represented a fundamental transformation of both market dynamics as well as the ability and willingness of investors and entrepreneurs to use venture capital as a funding source. After the evolution of this process, US investors began to show great interest in Europe.

However, at present, the US remains by far the largest on Europe venture capital market in the world capturing 61% of new resources provided and 62% of the volume of buyout transactions. Another difference is the average amount of investment and the American continent, the latter near the 6 million euros, compared to 0.9 million in Europe. (NVCA 2014)

⁵ George Doriot (1899-1987): he is considered the father of venture capital. In 1957 he founded INSEAD graduate school of global business.

⁶ Margaret Thatcher (1925-2013): British politics who served as prime minister 1979-1990, the first woman to have held this position.

4. Determinants of Venture Capital

Some research shows that companies backed by venture capital outperform their counterparts in several categories such as employment growth, sales, wages, exports, and increased R & D. In this section, through demand and the supply of venture capital will be studied this impact.

The demand for risk capital comes from entrepreneurs who need funds to finance innovative companies, while the supply of venture capital corresponds to the amount provided by private investors, pension funds and banks, ultimately.

Demand for venture capital depends both on factors influencing in the decision to create or expand an innovative company, and those that contribute to determining how in the way of its financial structure. These two variables must be taken into account and that will help to predict the impact that the demand for funds has.

The decision to create a new company depends on the innovation potential of the economy, which is important because it affects the number of new ideas that can be developed, and those factors affecting incentives genius idea to become an entrepreneur.

Authors like Cumming (2008) use the proportion of the capital stock relative to gross domestic product, from now on GDP as an indicator that measures the development of the market. This relationship shows a part of the national production and therefore must reflect the liquidity that has the economy. Economists such as Barry (1990) argue that a high value of this ratio may indicate good economic prospects of a country and an improvement of its financial structure, and therefore can identify opportunities for venture capital investors.

On the one hand, the potential for innovation and the technological opportunities of the economy are determined by variables such as the rate of growth of R & D, the capital invested in R & D and staff for research and development. The study Sahlman (1994) interprets the R & D as a measure of innovation capacity and measuring the resources it uses a nation to achieve a technological change in the future. Gompers and Lerner (1999) and Da Rin (2005) recognized the role of R & D spending in developing innovative industries by venture capital in the US.

Elsewhere, the elements involved in the incentive to become an entrepreneur have to do with the expectations that the economy has, in the interest rate, in the legal framework of societies and labor market rigidities that exist. A set of good economic expectations are associated with an increased production of the expected benefits Acs

and Audretsch (1994), however, an economy with high interest rates increases the cost of capital of the company and consequently decreases the business. In addition, a high percentage of corporation tax reduced the net benefits of the employer, and therefore it becomes less attractive to carry out his innovative idea. Poterba (1989)

The second aspect that determines the demand for equity financing is the way to acquire the company. The decision for funding of an innovative company depends on the relative costs of the various forms of financing, as well as the relative benefits associated with them.

It should be highlighted that venture capitalists not only provide capital but they also actively involved in the joint venture and monitor their performance. Given the monitoring and the role of these investors, venture capital financing is particularly attractive when there is a high degree of information asymmetry⁷. Gompers (1995)

Other cause that may affect the choice of venture capital funding is related to the opportunities that subsequently the employer will have to regain control of their company.

The supply of venture capital depends on how the risk-return ratio will be compared with those obtainable in other alternative investments. The portfolio theory of Markowitz⁸ suggests that venture capital should be part of a diversified portfolio, but the relative amount invested in venture capital is influenced by other factors, such as the yield on alternative investments, taxation, regulation of pension funds and ease the firm to have its IPO in the last stage. In addition, since venture capitalists have a fraction of the company, all variables that influence the expected benefit, so will in offering the same way as happens in demand.

An active IPO market, whose initials are IPO, is an important determinant of the existence of a well-developed industry venture capital. Divestment strategies of these innovative companies, investors and entrepreneurs consider an IPO as the ideal mechanism because it reduces the cost of capital Jeng and Wells (2000), and optimize the capital structure Gompers and Lerner (1999a) as well as enhancing the reputation and gives the employer of choice to regain control. This option also allows venture capitalists to get a high return on the investment made in compensation for the acquired high risk.

⁷ Information asymmetry: It refers to the fact that one party may be better informed than their counter-part.

⁸ Markowitz Portfolio Theory (1952): investment is a theory that studies how to maximize profitability and minimize risk, by appropriate choice of assets comprising the portfolio.

According to a study done by Cumming (2006), an investment of 1 \$ in a firm that goes public offers an average yield of 1.95 US dollars on the original investment by an average holding period of 4.2 years. Meanwhile, a 1 \$ investment in a company that is not listed on a stock exchange only has an effective yield of only 0.40 dollar for an average stay of 3.7 years.

5. Impact of macroeconomic variables in Venture Capital

The economy is constantly changing, and now even more because of the existence of globalized economies. There are many factors involved in the ups and downs that occur, however, they deserve special attention to those whose variations have a direct impact on the economic development of a country.

As various changes in certain variables affect the normal course of the economy, they will also have an impact on the supply and demand of risk capital, since this type of financing is directly correlated with the economic development of a country, as it is considered a source of innovation and business growth.

Considering a study by Gomes and Azzim (2011), the effect that several macroeconomic variables have in the in the demand and supply of venture capital will be described in the following sections:

a) GDP growth

GDP is the monetary value of final goods and services produced by an economy in a given period. It is a representative indicator that helps to measure the increase or decrease of the production of goods and services of the companies in each country, only within its territory. This value reflects the competitiveness of enterprises.

When the economy is expanding, the opportunities for giving rise to a greater number of business enterprises are naturally more attractive. Thus, an increase in GDP of a country leads to an increasing demand for risk capital. This conclusion is the same noted by the authors Acs and Audretsch (1994), when analyzing the effect of fluctuations of macroeconomic policies in the emergence of new businesses. Analyzing the supply side of risk capital, economic expansions are also related in periods of high profitability as a result of divestments of these companies. Kortum and Lerner (2002)

b) Interest rate

The high interest rates affect the financing of companies, since investments are less profitable and this affects the bottom line. In the case that interest rates are very low, there may be a risk that companies face excessive debt and future interest rate have financial problems. Along these lines, when the interest rate of a country increases, it becomes attractive for a country to invest in bonds becoming a favorite alternative for European investors from investing in venture capital, as this activity is not as developed in our continent as in USA.

The effect of interest rates on demand for venture capital is ambiguous. On the one hand, higher interest rates affect the creation and expansion of businesses negatively, as the projects are economically less viable. Moreover, these high rates increase the attractiveness of venture capital funding compared to financing through bank loans.

c) Unemployment rate

The unemployment rate may affect the demand for risk capital in several ways. On the one hand, the unemployment rate influences expectations for the economy. A higher unemployment rate is likely to be associated with lower growth of the economy and therefore with lower business activity. But the unemployment rate may influence the incentive to become an entrepreneur. In this respect, it should be reflected whether the individual is employed or unemployed. An individual employee who is thinking of starting a business compares your current income with the expected return on new business. To a higher unemployment rate, future expected profitability decreases because it is likely that the business does not work, and spend a long time standing up to the individual to get a new job. By contrast, for an unemployed person the opportunity cost is reduced to start an activity, in most cases, due to incentive programs offered by many governments to become an entrepreneur⁹.

d) Research and Development

If the R & D rises, it means that the number of potential entrepreneurs with promising ideas often increases. Gompers and Lerner (1999b) Thus, spending on R & D has a positive impact on the demand for risk capital.

⁹ Entrepreneur: It means taking advantage of a business opportunity and organize the necessary resources to carry it out. After the financial crisis, the Spanish government has earmarked various programs to stimulate the economy.

Gompers and Lerner (1999a) show that spending on research and development activity is associated with risk capital. For them, the growth of funds available for investment by venture capital in the 90s, in the US, was due to increased technological opportunities.

Moreover, since research activities are expensive and involve a high level of risk, traditional sources of financing are not appropriate. In fact, venture capital is extremely important in the financing of this expenditure and the creation of innovative enterprises. In later sections of this study the relevance of such spending in the management of venture capital will be expanded.

e) Total Entrepreneurial Activity Index

Entrepreneurship and venture capital market are related. Gompers (1995) argues that increased business activity, the greater the amount of risk capital in the market is.

The Global Entrepreneurship Monitor (GEM) is dedicated to observe, analyze and make recommendations for business in some countries, allowing international comparisons that were not possible years ago. The GEM index calculates the Total Entrepreneurial Activity (TEA), which is a number ranging from 1 to 20, and takes into account the number of new entrepreneurs and new companies.

Since the supply of venture capital is more oriented towards innovative projects to other funding, it is obvious that a high TEA rate, increases the supply of risk capital. You can find a high TEA rate due to self-employment and entrepreneurship driven by the creation of new businesses rather than necessity. For a given innovation potential in an economy, an increase in business activity may imply that investors have to spend a larger fraction of their time selecting projects therefore; these capitalists will not be able to handle such detail monitoring activity.

f) Initial Public Offering

For investors IPOs are important for good yields as well as certify their quality managers of venture capital funds. This fact is related to the existence of markets consolidated Black and Gilson (1998) values and, moreover, they are the vehicle output which allows higher yields Barry (1990). A recent study by Smith (2010) shows that mergers and acquisitions are also important to explain the yield of US funds.

g) Market to book Ratio

This indicator shows the true market value of the company and not what it should be, through the following mathematical expression:

$$\text{MB Ratio} = \frac{\text{Market value of common shareholders' equity}}{\text{Book value of common shareholders' equity}}$$

One of the aspects that characterize the relationship between the employer and the company financed by venture capital is the control exercised by the investor on this. Gompers (1995) argues that the value of that control is higher when there is a high degree of asymmetry of information, which is measured through the market to book ratio. A high value of this ratio is associated industries that have strong growth opportunities, yet, are subject to greater agency costs¹⁰.

h) Market Capitalization Growth

Some authors like Kolari and Velez-Pareja (2012) argue that the interpretation of growth of market capitalization is very similar to GDP growth. Although this indicator associated with the stock market reflects investor expectations about the economy.

An increase in market capitalization corresponds to an increase of funds available for venture capital investment. In addition, as investors and businessmen have high expectations for economic development, the demand for equity increase. This increase also produces another effect as well, measures the capital gains that the stock market provides, so it is an indicator of profitability that the company can give. When you increase the return on equity, venture capital investment becomes less attractive to invest in equities. This produces a supply reduction in risk capital.

¹⁰ Agency costs: They are those produced by deviations that may arise in the two subjects, and the main agent. In business, the agent is who runs the company and the main one that provides the resources.

6. Research and Development through Venture Capital

The venture capital funds, channel large sums of money into new businesses at high risk and high profitability, by providing a new generation of entrepreneurs, a sufficient amount of money to meet existing companies. This makes a major venture capital to finance innovation since channeled much of the funds invested in new companies in sectors such as machinery software, telecommunications, internet, biotechnology, nanotechnology and renewable energy.

In the current economic climate, knowledge has positioned itself as a key factor for the development of competitive companies. Consequently, having an efficient national system of innovation ¹¹is becoming an increasingly crucial for the economic growth of a country element. The strategic objective pursued by the economies is to ensure the social and economic sustainable and balanced development, based on productivity and international competitiveness.

a) The role of innovation in the economic growth

The discovery of new technologies or improvements in processes or services is a key driver of economic growth. In the advanced economies, where the growth opportunities from capital accumulation are more difficult to exploit, innovation plays a crucial role in promoting economic development. This is because innovation improves productivity and competitiveness, and also increases economic growth.

a.1) Innovation improves productivity

New processes and improvements allow companies to extract more out of their activities and also increase productivity. These benefits are not limited just to the innovative company, but allow others to adopt technological advances and build on them their own benefit. Thus, investment in innovation improves productivity in the overall economy.

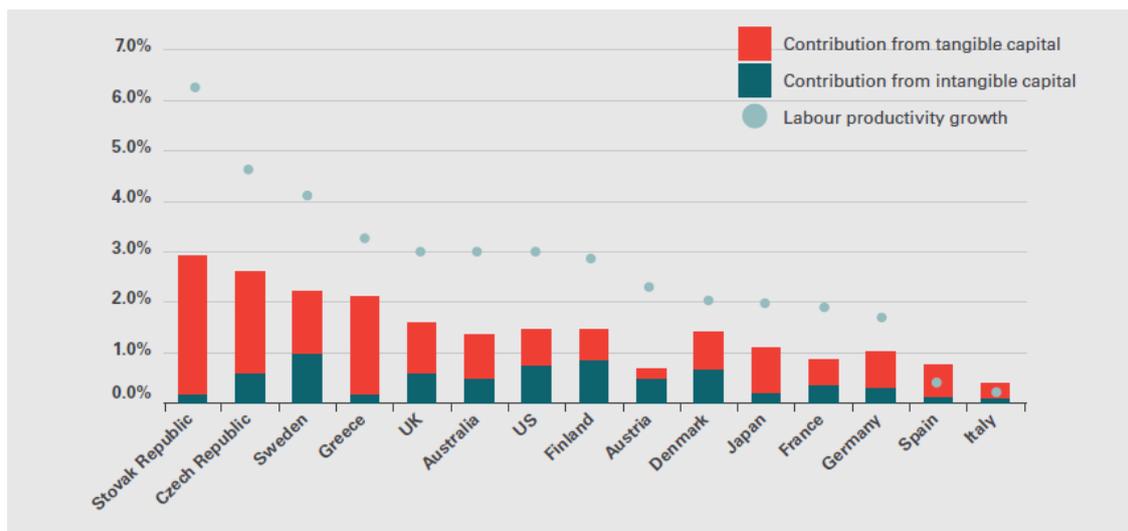
Currently, the estimations of several OECD ¹²countries show that companies invest both related to innovation (R & D, software, skills, expertise and brand of the

¹¹ National System of Innovation: set of institutions that individually and collectively contribute to the development and dissemination of new technologies and which provides a framework with which governments define and implement policies to influence the innovation process

¹² OECD (Organization for Economic Co-operation and Development): brings together 34 member countries and its mission is to promote policies to improve the economic and social welfare.

organization) as they do in the traditional capital assets, as is machinery, equipment and buildings. Such investment in intangible assets accounted for up to one percentage point, or about a quarter, growth in labor productivity in countries such as Austria, Finland, Sweden, United Kingdom and the United States between 1995 and 2006, as shown in the following chart.

Figure 1. Intangible capital accounts for a large share of labour productivity growth (1995-2006)



Source: OECD (2011) based on COINVEST¹³ and national studies

Moreover, growth in multifactor productivity, that is, the combined productivity of capital and labor, improves the results of innovation and efficiency. Overall, the estimates made by the OECD show that investment in intangible assets such as patents, R & D, or software and multifactor productivity represented growth between two thirds and three quarters of the labor productivity in developed countries Europe. This means that innovation and productivity growth are the two main factors of economic growth in Europe.

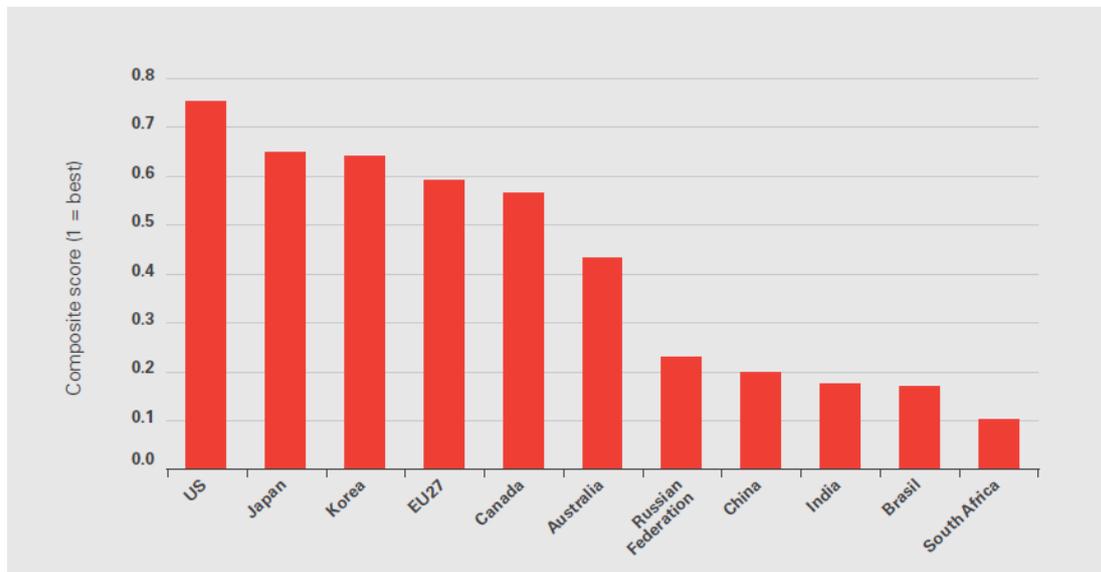
a.2) Innovation improves competitiveness

The innovative activity varies significantly between countries and regions. Half R & D OECD area is performed in ten percent of countries. As detailed in the following image, European innovation performance lags behind that of the United States, Japan and Korea, with significant variation between Member States. These disparities in levels of

¹³ COINVEST: is a platform connecting regional high-tech projects with emerging innovative ecosystem. With its activities it aims to develop an ecosystem to help prospective project obtain necessary assets: capital, access to market, managerial skills.

innovation among countries and regions have an impact on productivity between countries. This, in turn, has an impact on international competitiveness, so that investment in development and innovation in Europe is vital to improve the international competitiveness of the continent.

Figure 2. EU 27 Innovation performance compared to main competitors



Source: Innovation Union Scoreboard, European Commission (2011)

b) Venture Capital as a source of innovation

Venture capital emerged in the second half of the twentieth century playing a decisive role in financing young entrepreneurs and dynamic enterprises. According to Gompers (1995), some of the most innovative American recognized high technology, such as Apple, Cisco Systems, Genentech, Microsoft and Sun Microsystems, have been developed with the help of this type of funding, and therefore, the role played after the success of these companies is indisputable.

Large companies have the advantage over their smaller counterparts due to capital market imperfections, information asymmetries and its ability to finance projects, whether independent R & D, or own resources.

However, the emergence of venture capital markets in modern economies has provided some support for dynamic entrepreneurs considered a source of economic innovation. Due to the lack of guarantees, small innovative companies, mostly individual entrepreneurs, have limited access to capital markets to finance their projects access and, therefore, venture capital is the main alternative. Venture capitalists and investment

fund managers come to market to fill this funding gap, providing capital to these small dynamic and innovative companies, which have high growth potential, and in turn, they become co-owners of the projects in which they participate.

These venture capital firms and patents foster innovation success directly by allocating more funds for research and development of new products and processes in the investee companies, and indirectly through support for the implementation of the young companies. These activities lead to a significant rise in European innovation as the following data contained in the 2014 annual report published by the EVCA¹⁴:

- Estimates show that in some sectors, 1 € equity is nine times more effective in producing patents than 1 € of bank financing.
- The patents granted to European companies financed with venture capital totaling a value of 350 billion euros, or what is the same, twice the total amount of venture capital investment.
- The estimation of these companies supported by these funds represents 12% of all patents of the 12 most developed countries of Europe. In addition the average economic value of a patent is about 3 millions of euros.

¹⁴ EVCA (European private equity and Venture Capital Association): this organization covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions.

7. Regulatory aspects that influence the development of Venture Capital

Venture capital is recognized as an important source of funding for entrepreneurs Kortum and Lerner (2000) and a major engine for economic development and innovation. However, there are huge differences between countries concerned to the level of equity that is collected and invested. The high degree of these international variations are due to the risk assumed by investors not only has to do with the characteristics of the project being financed, but the political and legal aspects of the country where the company is located, are of particular relevance in the decision to invest.

a) Influence of the political conditions in Venture Capital

Firstly, Black and Gilson (1998) define the political risk from a business point of view, as the likelihood that project outcomes are affected because of changes that occur in the political environment. In this way, the political risk occurs when governments governing the rules for doing business, such as product regulations and prices, the nationalization of assets or resources, currency inconvertibility, as well, taxation may change quickly and the company cannot act with the same speed to protect themselves.

Next, empirical studies by Howell (1992) show the political risk as a structural characteristic of countries, which prevents conduct business, and as a result, leads to economic development to stagnate. Therefore, most companies tend to avoid investing in countries such as uncertainty is significant.

In this context, capital inflows and the development of a sound financial system are prerequisites for excellence for active risk capital industry, which in turn are influenced by political conditions. In these lines it is reasonable to argue that the level and quality of the political conditions of a country strongly determine the development of the venture capital business. This effect is evident when it comes to high-risk countries where instability and lack of developed financial and commercial markets are detrimental to any investment activity. Cumming (2008)

According to Lerner's words in an interview, a problem that usually occurs is the creation of programs by governments that ignore the dictates of the market, that is, the realities of the entrepreneurial process. Too often, government officials have encouraged finance industries or geographic regions where the private interest simply did not exist. Whether these decisions were driven by political considerations or arrogance, the result has been the squandering of resources and neglect venture capital initiatives. (*Martin and Garcia, Sintetia 2013*)

b) Effects of legal systems in the Venture Capital

Venture capital investments are characterized by a high level of risk that investors try to minimize being maintained in the selection of the company, and through, active surveillance in the company. In carrying out these tasks, an effective and efficient legal system is very important. Howell (1992)

Armour and Cumming (2008) analyzed the effects of the US bankruptcy laws in the development of VC activity, using a form to different law firms. In this country, the bankruptcy procedures of companies are crucial for investment as an inefficient mechanism for the reversal of insolvent enterprises, which significantly impede the progress of financial activity. In particular, they have found in the study that when the bankruptcy laws are imposed, the consequences for employers are severe, since the probability of business deals is reduced in most cases, and as a result, the demand for risk capital decreases. However, bankruptcy laws are themselves a byproduct of their own legal system and as such are highly correlated with the level of system efficiency, which in turn provides a more or less favorable investment environment.

On the other hand, in a classic work, Poterba (1989) argued that reducing tax rates on capital income could increase the attractiveness of becoming an entrepreneur, precisely because labor employees would be attracted to create businesses by lower tax rates. He argued that increasing the differential between the tax rates on capital revenue encourages the creation of new businesses, thus increasing the need for venture capital.

c) Taxation of Venture Capital in Spain

In Spain, the laws governing venture capital companies have suffered in the last years several modifications. The last one is reflected in the Law 22/2014 of 24 November 2014. The benefits of this tax regime are contained in Articles 55 and following of the Corporation Tax Act, and are characterized: (BOE¹⁵, number 275)

c.1) Direct Taxation of "SCR"¹⁶

- Capital gains exemption for income derived from the transmission of values in which these companies 99% involved, whenever from the second year of holding units until the fifteenth.

¹⁵ BOE: It is the official journal of the Spanish State dedicated to the publication of certain laws, regulations and acts of obligatory insertion.

¹⁶ SCR: acronym that receive the societies of Venture Capital in Spain

- Deduction for dividends.

c.2) Tributación indirecta de la SCR

- VAT¹⁷-exempt operations management and custody of these entities managed by management companies licensed and registered in the Special Administrative Records.
- They are exempt from ITP-AJD ¹⁸constitution operations and capital increase of the SCR.

c.3) Tributación de los socios inversores de la SCR

- Spanish investors' legal persons under the special regime of holding companies. Capital gains taxed at 40% if one year have elapsed since its acquisition and subsequent transmission, and 15% in all other cases.
- Non-resident investors without permanent establishment in Spain, will not be subject to taxation in Spain on dividends and capital gains from the investment.

¹⁷ VAT: Added tax value of the Spanish State

¹⁸ ITP-AJD: Transfer Tax stamp duty applied in Spain under current legislation.

8. Current situation of Venture Capital in Spain

In Spain the development of venture capital is limited, especially in the ways that invest in the initial phases of the life of a company. Therefore, all governments try to encourage progress, but certainly very limited results. The various Spanish institutions responsible for promoting venture capital activity are:

- The Spanish Association of Venture Capital (ASCRI) is a non-profit organization that represents the industry's Venture Capital & Private Equity in Spain with the authorities, government institutions, investors, entrepreneurs and media communications issues and it provides regularly updated statistics and the evolution of fiscal and legal framework, and also organizes a number of activities in order to promote and reinforce the contribution of venture capital for the economy and growth of SMEs in Spain information.
- The Center for Industrial Technological Development (CDTI) is a public corporation under the Ministry of Economy and Competitiveness, which promotes innovation and technological development of Spanish companies. It is the organization that channels funding applications and support for the R + D of Spanish companies in the national and international levels.
- ENISA is a public company under the Ministry of Industry, Energy and Tourism, through the Directorate General of Industry and Small and Medium Enterprises that actively participates in the financing of viable and innovative business projects and in energizing the market venture capital.

CDTI and Enisa are two of the funders of companies with more history in Spain. Along the way, they have gone from having a very marginal intensely energize entrepreneurship through granting numerous loans and soft loans participatory activity. Similarly, the work of these entities has allowed to position them as a very necessary for the activity of Venture Capital funds in their task of funding projects in early stages with innovative profile supplement. In 2013, both entities granted loans worth 97.6 million euros (- 3% compared to 2012) in a total of 720 operations (+ 9.6% vs. 2012). Most of the operations are directed to projects in seed stage startup and other early stages (62.5%) and the rest to the expansion phase. Most of the loans were below 250.000 euros.

The Risk Capital continuously gaining weight in Spain because with the onset of the crisis and with it the limited access to bank credit, companies have begun to see it as a good source of alternative financing. So, to get an idea of the volume of operations,

annual data of the last two periods that facilitates ASCRI in their annual reports have been observed.

First, total venture capital funding for ERC¹⁹s nationals in 2013 amounted to 273 million euros, i.e. 43% of total national collection. This volume of budget made possible by the "INNVIERTE" ²⁰program promoted by the CDTI. It notes that the increased activity of foreign venture capital funds has been made in start appearing. Specifically, they were 14 of the 20 international funds that have decided to bet on start-up. Another highlight is the dynamism of the divestment, since in 2013 several outputs have been realized through sale to foreign investors. However, in 2013 the volume of transactions in the early stages has fallen slightly compared to 2012 due to the lower volume led to follow-ons ²¹by domestic investors. Specifically, the volume of venture capital investment (seed, startup and other early stages) in Spain, reached 291 million euros, representing a fall of 1.5 percentage points compared to 2012 (296 million euros).

In second place, focusing the analysis on the activity carried out by the 117 venture capital funds, both domestic and international operating in the Spanish market in 2013 invested 208.5 million euros spread over 377 transactions, representing a fall of 5.6% in volume and 7.6% in number of transactions. Regarding the volume, it was the second worst record in recent years, after the year 2009 that just 193 millions of euros invested were exceeded. This trend could change from 2014, considering the number of new operators appearing almost daily in the Spanish venture capital scene many of them international.

Another positive data is that a significant number of transactions are being closed, totaling 377 operations, of which 69.4% are venture capital, with 209 to 168 new investments and reinvestments. Almost 85% of the operations were less than one million euros and, in particular, more than half (58% of invested enterprises) received amounts less than 0.25 million euros. Therefore, very small operations are the protagonists of this market, as only 57 transactions representing more than one million euros. Investment in this segment most of the activity is geared to small SMEs (60.2% of the operations were performed in companies with less than 9 employees).

¹⁹ ERC: acronym that receive the entities of Venture Capital in Spain

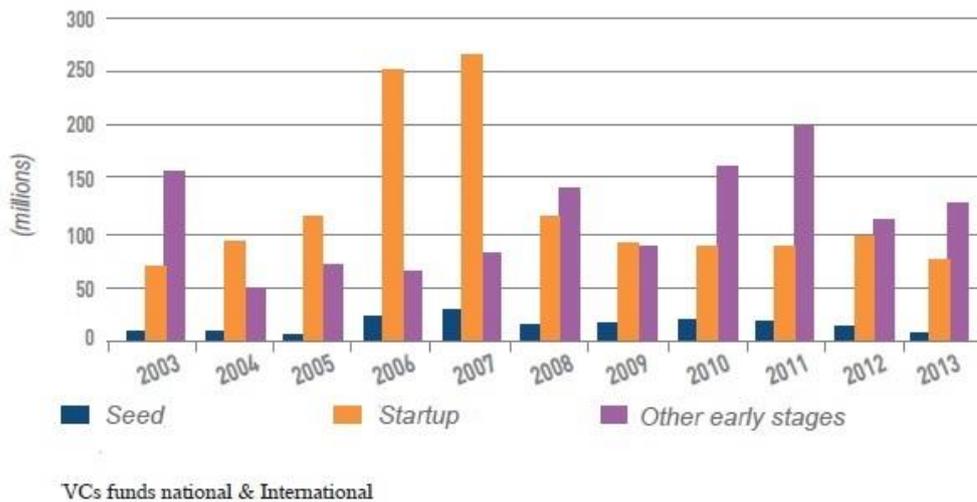
²⁰ INNVIERTE: program is part of the Spanish Strategy for Science, Technology and Innovation 2013-2020, approved by Agreement of the Council of Ministers on February 1st 2013.

²¹ Follow-ons: It is an issue of shares after the initial public offering of the company.

On the other hand, from the point of view of investor type, the activity is mainly involved by the private investors; 85% of the amount invested in venture capital was conducted by private entities (122 million euros in 285 operations) compared to 15% of public investors (31.4 million euros invested in 62 transactions).

Then, regarding the venture capital investment as the development phase, all categories have fallen compared to 2012 except for investment in "other early stages" or expansion has increased from 110 million euros in 2012 to 125.5 in 2013, a total of 190 operations. The seed stage companies received only 8 million investment in 48 operations, while starting capital reached an investment volume of 74.8 million euros in 139 operations. The following chart shows this decline.

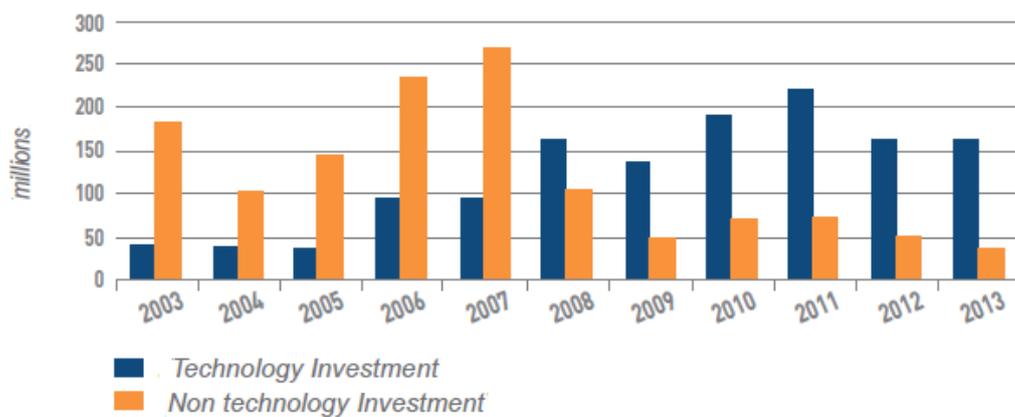
Figure 3. Stage distribution of VC investments



Fuente: ASCRI/ webcapitalriesgo

In addition, since 2005, the technology investment continues to stand in the Spanish venture capital market; in 2013 accounts for 81.5% of invested versus traditional investment companies (18.5%) volume. In total 170 million euros were invested in technology companies, a figure slightly lower than the historical peak in 2011 when it invested 225. The figure below details these figures.

Figure 4. VC investments in technology companies



VC funds national & International

Fuente: ASCRI/ webcapitalriesgo

9. Structural characteristics of Spanish SMEs

To apply the concept of SME to a Spanish company, you must meet the requirements outlined in the following chart according to the recommendation of the Commission of the European Union, published in the Official Journal of the European Union on 9th August 2008 (L.214).

	MICROENTERPRISE	SHORT	MEDIUM
EMPLOYEES	Less than 10	10 to 50	50 to 250
REVENUES	Until 2 million €	2 to 10 million €	10 to 50 million of €
ASSET	Until 2 million €	2 to 10 million €	10 a 43 million of €.

Sourced: Based on data of the Recommendation of the European Union

Following the parameters of the table above and according to the Central Companies Directory (CCD), on 1st January 2014 in Spain there are 3.114.361 companies, of which 3.110.522 (99.88%) are SMEs (between 0 and 249 employees). Compared with the EU, micro (0 to 9 employees) in Spain accounted for 95.8% of all enterprises, 3.4 points above the available for the entire EU in 2013 (92 estimate, 4%). There is also a significant difference in the representation of small Spanish companies (3.5%), 2.9 points lower than the estimate for the whole EU (6.4%).

SMEs in our country have very specific structural characteristics that differ from other foreign companies. These issues do not have a competitive advantage that creates differentiation and attract investors interested in business models set. These features are:

First, ownership of SMEs is characterized by being concentrated in one or a few people with expertise, leadership and good relations with customers. In addition, this category of companies does not usually have protocols of succession to ensure continuity. Also, managers often lack training in finance, production, management control, marketing and international trade. Finally, the people who make the management often lack the capacity to manage skillfully the growth of the company.

Second, the size of SMEs is an inverse indicator of the lack of transparency and poor quality of financial reporting. This is facilitated by the fact that most SMEs are not required to be audited, which entails a loss of credibility of the information reflected in their accounts for any investor, and thus a lack of security on the market.

Moreover, SMEs find it really difficult to balance their financial structure, because of the high risk of insolvency and serious asymmetries of information, which occur as a result of its shortcomings, the patent facing a credit crunch and forces them to accept a hardened price and delivery conditions. In these terms, the payment in Spain do not guarantee the payment, since the issuance of promissory notes by the suppliers at 90 or 120 days, give no assurance that these funds hold. With the advent of the crisis, the government wanted to regularize this situation, as it was one of the major causes that made bankrupt companies because their profit margin was pretty sparse. Thus on 7th July 2010 came into force the Law 15/2010 of payments, which reduced the maximum terms of payment standing after the last change, within 60 days.

However, the biggest problem arises when these companies negotiating with credit institutions does not yield a price conditions that protect the business result, or could reasonably accommodate maturity periods of economic and financial amortization, or beyond, impossible to get enough bank financing. Precisely in these cases, the SME compromised the implementation of its growth plan. To overcome this difficulty, the different policies to support SMEs, aware of the weight that these companies in the economy and credit constraints they face, have promoted a series of instruments to finance, in particular its growth plans through alternative funding sources.

Also, venture capital is primarily directed in particular to finance technology-based SMEs and, in general, to support companies whose economic risk excludes them from the interest of credit institutions. These companies with high growth potential and investment in R & D reached a figure of 11.213 companies by Juan Mulet ²²the end of 2014. However, more than half of these companies have about 9 employees, which indicates a high business innovation intensity, and therefore capture a segment for venture capital and suitable for the development of the Spanish economy.

In short, SMEs at maturity is characterized by very basic organizational structures prevailing in the figure of the manager-owner and an address without striking curriculum. Its smaller size and the qualitative characteristics that derive from it justify the poor reputation they have these companies in the market. These features are the main problems that must be overcome to become competitive in the market, and provided them access to finance and establish security at investors who see growth potential in their business.

²² Juan Mulet: director of the Foundation for Technological Innovation (COTEC)

10. Conclusion

Venture capital is a subset of capital, which is defined as the provision of funds from financial investors in the medium or long term businesses with high growth potential. The importance of venture capital lies in its ability to support the development of innovative and high-growth companies, so that they are able to reach their potential and create jobs and growth.

On the one hand, this method is presented as an alternative financing for small and medium enterprises, as market access is limited because of the risk they have. Thus, equity investors play a key role as they stimulate and assist the development of the economy of a country.

On the other hand, venture capital emerged in the United States experiencing an exceptional development of electronic and computer industries. However, this type of financing was not set in Europe till the 90s due to the fragmentation of markets and various economic, political and cultural obstacles.

As it has been seen, the demand for equity depends both on factors influencing the decision to create or expand an innovative company, and those that contribute to determine the way of its financial structure. However, the supply of venture capital depends on how the risk-return relationship with other alternative investments is.

On one side, when the economy of a country is in expansion, its GDP will increase and this increase will be shown in new opportunities for innovative companies that will increase the demand for risk capital. However, at high interest rates the effect it will have on the risk capital will be ambiguous. First, investment in bonds will be more attractive as it will offer big payoffs for the risks assumed, and secondly, companies at this rate hike will have greater difficulties in accessing and face bank loans, making the risk capital good alternative. In addition, unemployment rates will also affect, as large percentages of this index will be indicative of bad expectations and little incentive to become an entrepreneur.

Moreover, venture capital firms and patents foster innovation success directly by allocating more funds for research and the development of new products and processes in the investee companies, and indirectly through support for the start-up of young companies. These activities lead to significant innovation elevation of a state that is manifested by the degree of knowledge of human capital, the development of projects based on technological sectors and infrastructure quality. The increase in industries with these types of features creates competitive advantages based on differentiation, which

strengthens the growth of the economy of a country. Some examples of global reference of the importance of venture capital in the development of R & D are Apple, Microsoft and Sun Microsystems, among others.

In addition, the political conditions of a country are a mechanism that influences capital inflows and the development of a previous solid and transparent financial system, aspects to be taken to the progress of an active venture capital industry. In addition, a tax system with high tax rates will be harmful to the development of companies, as its net profit will be reduced, and therefore the activity of venture capital will also be reduced.

In Spain the development of venture capital is still very limited compared to the main member countries, especially in the ways that invest in the initial phases of the life of a company. With the onset of the crisis and with the limited access to bank loans, the two major funders of companies in Spain are CDTI and ENISA. In their careers, they have gone from having a very marginal intensely energize entrepreneurship through grant funding activity. At the same time, these governments have managed to attract foreign investors who have set their investment in newly emerging companies.

As for the Spanish SMEs, it would be the idea owner-manager exchange, as their accounts are audited to have greater credibility with investors. Another drawback that need improvement are the low profit margins and increase productivity through differentiating projects. These are some of the problems that small Spanish companies must overcome to make the venture capital industry is consolidated in our country and dependence on bank credit that currently exists, is reduced.

During the preparation of this work, I have had various limitations regarding the information there. In the United States there is considerable literature that exists about the functioning and figures representing venture capital, however, Europe is an alternative funding came rather later on the United States, with the very different financial markets, as well, political and legal systems. These differences in development between the two continents, I have hampered the comparison between the two.

Finally, I consider financing through venture capital as a source of innovation and progress of a country, which must show their ability to get to consolidate this industry. There are many barriers to overcome Spain to someday have this alternative as developed as in the United States, or at least, placing it at levels as the UK or Germany. The main problem I see in our country, it is difficult to change the mentality rooted small businesses and get them to adapt to new forms and facilities presenting the economy. I do not know if it's a matter of time, or a financial break for these entrepreneurs do not see the banks as the only instrument to take their businesses forward recur. However, I

am sure of that if governments foster good programs to entrepreneurial companies and facilitate SME access to public or private institutions willing to provide funds, alternative sources of financing such as venture capital could eventually revolutionize the Spanish economy and get strengthened.

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