

FINANCING THE COMPANY WITH PRIVATE EQUITY/VENTURE CAPITAL FUNDS

Agnieszka Mazurek-Czarnecka¹

Abstract

The following paper is concerned with the sources of funding companies that finance on their own thanks to the involvement of some external shares from venture capital funds. The aim of the paper is to present private equity/venture capital funds in financing the company.

Keywords: *financing the company, private equity, venture capital, venture capital funds.*

1. Introduction

The main goal of every enterprise is to provide its owners with biggest profits possible. Such a goal can be achieved only when a proper strategy for the development of the company has been developed. This strategy should determine improvement of company's selling potential and strengthen its position on the market. While carrying out the adopted strategy, the enterprise can use various sources of financing. In order to maintain and strengthen its position, the company constantly has implement more and more innovative projects. Their implementation requires high costs as well as taking the risk. Enterprises at early stages of development have the greatest difficulty in gaining capital. Lack of creditworthiness prevents them from getting a loan from the bank. Thus, micro- and small enterprises have to tackle with a financial gap which can be filled by private equity/venture capital funds, which in turn belong to company's external capital.

I attempt in this article to present the subject of financing the company with private equity/venture capital funds, and my field of research is private equity/venture capital market in Poland in 2007-2014. The size and structure of capital invested by private equity/venture capital funds have been analyzed. The article depicts sources of financing the companies. The essence of private equity/venture capital financing has been explained, and the development of private equity/venture capital market in Poland has been analyzed. The desk research method has been used. It consists of gathering, analyzing, verifying

¹ M.A., Ph.D. Student, Department of Industrial Policy and Ecology, Cracow University of Economics, ul. Rakowicka 27, 31-510 Cracow, e-mail: agnieszkamazurekczarnecka@gmail.com.

and consolidating data that come from various sources, such as the literature on this subject, academic magazines, the Internet, other scientific works and finally, statistical data compilations.

2. Sources of financing companies

Proper functioning and development of every undertaking depend on its financial resources as well as on its ability to obtain new ones from external sources. Discussions on this subject should probably begin with the division of financing according to balance sheet law, which classifies capital into one's own and the outside one (Directive from 1994).

Companies can use either internal or external sources of financing. Availability and type of sources of financing that are used by the company depend on its size, the aim of financing, the stage of its development and finally, on risk connected with running it (Sokół, 2015, pp. 125-126). Potential financing capacity is big and has been presented in Figure 1.

Nevertheless, one should take into consideration the fact that not all sources of financing are equally available and within reach of every company. The choice of a source of financing depends e.g. on macroeconomic factors (inflation, tax system, the level of interest rates) as well as on microeconomic ones (costs of capital using, time needed to obtain profit, financial risk, company's viability). All these factors have the influence on the decision which sources of financing to choose (Skowronek-Mielczarek, 2015, p. 153).

Because of high risk, access to external sources of funding is limited, especially for the enterprises at early stages of development. The stage of company's development has a direct influence on its potential and credibility in the eyes of prospective capital givers. When a company enters the next phase of development, its ability to obtain external capital grows. (Sokół, 2015, p. 127).

Sources of funding an enterprise can be divided according to how easily accessible they are (Lewicki, 2009, p. 4):

- **easily accessible:** own funds, credit guarantees, trade liabilities, budget allocations, EU funds, loans from family and friends,
- **harder to access:** loans and short- term bank credits, factoring, leasing, OTC issues,
- **difficult to access:** long- term bank credits, issue of bonds and shares, private equity/venture capital funds, franchising.

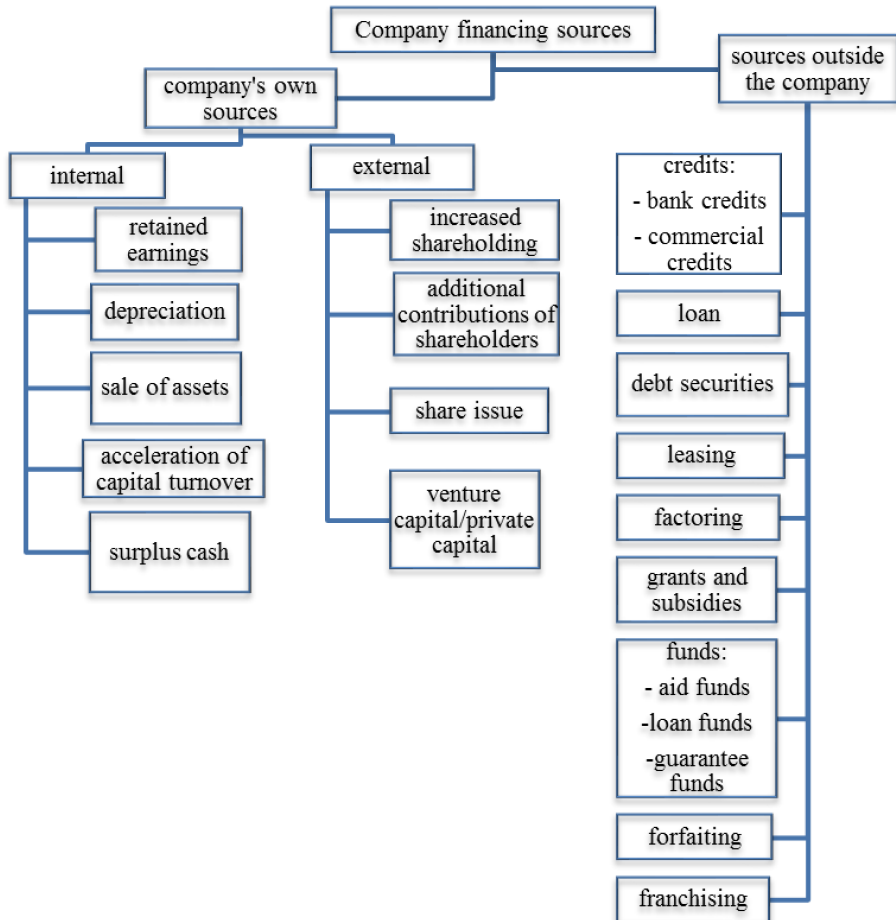


Figure 1. Sources of company's financing

Source: Own study based on Grzywacz. (2013); Dulnicc, (2011); Rębilas, (2014); Skowronek-Mielczarek (2002).

As the company develops, lack of capital becomes more and more noticeable and becomes the company's top priority. According to the so-called **theory of financing sources hierarchy**, entrepreneurs firstly use retained earnings. Thus, they use their own capital in the first place and after that, they resort to external sources of funding, i.e. outside capital. External own sources are used as the last ones (Chojnacka, 2012, p. 66).

The funding of innovative enterprises is a capital- intensive process which requires the inclusion of external funding sources. The increase of company's own capital with the use of external financing can be achieved

through an increase in shares, another issue of shares or, finally, through the use of resources from venture capital market participants. To the last group belong private equity/venture capital funds (Krawczyk, 2012, p. 126).

Company's own external funding depends on its organizational and legal form which is strictly defined by law. Operations of the company that contributes to the increase or decrease of capital value are also strictly defined. Company's own capital can be increased thanks to their owner's donations, share issue, business angels, private equity/venture capital funds (Kołosowska, 2013, p. 55).

Summing up, financing the company with private equity/venture capital funds belongs to company's own external sources of funding that are hard to access. For small enterprises, the greatest burden of obtaining such financing is organizational- law form. I will develop this thought in paragraph 3.

3. The essence of private equity/venture capital financing

There are many definitions of private equity/venture capital funds in the literature. P. Gompers and J. Lerner define venture capital as a free resource of accumulated funds that enables supporting investments of companies characterized by the above-average potential for growth. Accumulated capital is managed by funds created especially for this purpose. (Gompers, 1999, p. 344). J. Ostrowski, in turn, defines this type of funds as an external source of company's medium- and long-term capital source that at the same time has financial-advisory functions that are characterized by high financial risk (Ostaszewski, 2003, p. 180). The definition acknowledged in Europe is the one by European Private Equity and Venture Capital Association (EVCA), which describes venture capital as a subset of private equity. According to this definition, venture capital is a part of private equity which comprises capital investments supporting seed (commencement of activity), start-up (early stage of development) and early stage (enterprise's expansion) (Annual Survey of Pan-European Private Equity & Venture Capital Activity 2005, p. 349).

The Polish Private Equity Association (PSIK) which is an institution composed of the biggest private equity funds that are on the Polish market, provides a similar definition of venture capital saying it is a form of private equity. According to PSIK, venture capital funds are invested in early stages of the firm's development, and thanks to them new units can be opened or expanded. Subjects which offer solutions like these expect a return from invested money that is as high as the risk they have taken offering this type of solution (www.psiik.org.pl). Moreover, the author of the article claims that venture capital funds are a subset of private equity funds. This is why the term

private equity/venture capital funds are used when venture capital funds are mentioned.

It is worth pointing out that the investor is not only the giver of the capital but also cooperates with the enterprise in 4 basic areas (Rębilas, 2014, p. 167):

- private equity/venture capital fund monitors the current progress of investments (also, it monitors financial results of an enterprise),
- he participates in the management of the company (he participates in making strategic decisions),
- he cooperates on an ongoing basis in the field of enterprise development (provides know-how, establishes business contacts, subsidizes extra activities);
- he motivates the management staff.

Polish firms still do not make use of private equity/venture capital funds too often. This form of financing is popular with well-developed markets. Private equity/venture capital belongs to medium- and long-term commitment which later becomes of ownership nature. These funds most often exist on the private market and enable to gain above the average returns in time set by the investor (Sobańska & Sieradzan, 2004, p. 13). Private equity/venture capital funds (and, more precisely, unquoted equities and shares) managed professionally invest collected capital in securities of ownership nature. Shares are resold when the value of an enterprise increases as it guarantees profits from the capital invested. (Misiólek, 2011, p. 366).

External possibilities to gain company's own capital are not available for all enterprises, though. Companies of SME sector have limited access to such kind of funding. Limited-liability companies are in turn in an advantageous position when it comes to obtaining private equity/venture capital funds. Theoretically, it is possible to support civil-law partnerships with private equity/venture capital funds, yet, in practice it does not happen very often. It is because of the fact that a substantial number of SME companies are self-employment companies or partnerships. (Grzywacz, 2013, p. 24).

Private equity/venture capital funds function as (Kornasiewicz, 2004, p. 91-92; Górski, 2009, p. 271):

- independent enterprises which are not part of any holding company (enterprises like these manage one or a couple of funds),
- enterprises that manage resources from the public sector,
- enterprises that depend on insurance or pension companies,
- funds in the form of bank's subsidiaries and lending institutions;
- industrial corporations (often their main aim is to revise modern technologies).

As mentioned before, in the private literature equity tends to be identified with venture capital. Though, no matter how many similarities there are between these two investments, one should acknowledge that there is a clear distinction

between them. While private equity funds invest their capital in enterprises at different stages of development, venture capital funds are a part of private equity capital. Venture capital funds donate their resources to investments at early stages of development and expansion stages (Gabryelczyk, 2009, p. 197). Entrepreneurs who use high-risk funds, (and to those belong private equity/venture capital funds), are supported not only by capital, but also they benefit from consulting as regards the following: law, administration, and marketing (Johan, Schweizer & Zhan, 2014, p. 145).

Financing the company with private equity/venture capital funds can be done, as already mentioned, at different stages of company's development. The earlier the stage of company's development is, the higher risk entailed. In terms of stages of development of the firm, one can include the following examples of private equity/venture capital financing: (Wrzesiński, 2006, pp. 132-139; Sobańska & Sieradzan, 2004, pp. 202-243):

Early-stage-financing

- ***seed capital (seed stage financing)*** – is the capital at an early stage of a firm's development. Financial resources are intended to cover the cost of research and development process, and they finance activities until the assumptions of services and products are prepared. Resources at this stage are not substantial, but the chance of obtaining profit is big. The resources are usually invested for 7-12 years, and they mainly come from venture capital funds.
- ***start-up capital (start-up-financing)*** – concerns initial stage of investment and covers the expenses of the investing process- mainly those of preparation of production. Companies use this type of capital to implement the main stages of investments which require most financial resources. This type of funding concerns mostly newly-emerged enterprises and innovative ideas. Most often private equity/venture capital funds become engaged at this stage of company's development. Resources of this type are usually invested for 5-10 years.
- ***first-stage financing*** – is the financing of an early stage of an enterprise, mainly of bringing the product and services to the market, so firms focus mostly on building a strong position on the market that would enable them to expand further. Private equity/venture capital is involved for 2-5 years. It is also worth mentioning that at this stage the company has much easier access to other sources of financing. The demand for private equity/venture capital decreases.
- ***second- stage financing*** – is the financing of the enterprise's expansion on the market. The increase in production and sales on the local market, as well as activities aimed at gaining new selling places, are financed. Companies strive to increase their share on the

market and obtain leadership in the sales of goods and services. New sales networks are built, mergers and acquisitions take place. It is rare at this stage that a new private equity investor enters and most often the investor makes a decision to exit the investment. Nevertheless, if the decision to continue financing the expansion of the company is made, the capital is invested for 3-5 years.

- ***the exit of the investor from financial commitment-*** – this is the last stage of collaboration between private equity/venture capital and the enterprise. Exit from the investment can happen at every stage of investing and depends on others on investment assumptions, the enterprise's financial situation and the general situation on the market.

Also, it is worth pointing out that the divestment process depends mainly on the investment agreement. The investor can exit the investment in a few ways (Sobańska & Sieradzan, p. 122):

- purchase of shares by the owner,
- listing on the stock exchange,
- management buy out,
- sales of shares to chosen investors,
- liquidation of the undertaking.

Poor absorption of capital by SME sector, especially by the smallest companies, has become the most vital premise to use private equity/venture capital funds to finance the company's investments. Small undertakings do not have enough credit history check that would enable them to obtain credit from the bank. Their market position is often weak, too. Their demand for capital is, in turn, disproportionate to the size of their business, especially at its early stages (Bojańczyk, 2006, p. 72).

The shareholding character of support that is offered by private equity/venture capital funds raises concern and anxiety in its potential beneficiaries. One- man undertakings, especially those of commercial or service nature, will not make use of this sort of financing because of its organizational and legal form.

4. Private equity/venture capital market in Poland

The analysis of experiences of well-developed countries allows to draw conclusions that this method of financing the undertaking contributes to the acceleration of economic growth. Companies that used private equity/venture capital funds have reached significantly better financial results than their rivals which used traditional forms of support (Mikołajczyk, 2014, p. 48). None of the latter supports the company in such a complex way. It is also worth noticing that enterprises which use private equity/venture capital funds are

much less prone to turbulences on the market. Additionally, they go bankrupt very rarely which was proved during the last crisis. (Thomas, 2010).

The EU, after it has seen the equity gap, has taken measures to encourage governments of its member countries to create and develop private equity/venture capital funds which support SME sector (Waniak-Michalak, 2015, p. 92). The EU policy that backs up financially private equity/venture capital funds has contributed to increased interest of entrepreneurs in this form of investment. According to data from Central and Eastern Europe Statistics, in 2013 in East and Central Europe venture capital funds obtained 48,3% subsidies from public funds. In 2014, in turn, they got 41,9% of their overall value (*Central and Eastern Europe Statistics*, 2015, p. 7).

In Poland, there were 39 private equity/venture capital fund managers in 2014 that are members of Polish Private Equity Association (PSIK). Both managers and funds used various legal forms of businesses, e.g. joint-stock company, limited liability company, limited joint-stock partnership and closed-end investment fund.

Private equity/venture capital investment market is relatively young in Poland (it began in 1990). It is also a small one, thus changes happening in a year do not reflect the activity of a fund in a long period of time because of the fact that those changes might be the result of single transactions.

A substantial fall in investments of private equity funds in domestic undertakings was noted in 2013. Their value decreased by 786 mln PLN in comparison to 2012. Also, in 2014 there was a drop in private equity funds' investments, although it was not as rapid as in the previous year as it amounted to 66 mln PLN. Table 1 presents the value of investments financed with private equity/venture capital funds in Poland in 2007-2014 as well as the number of undertakings which obtained financial support from domestic private equity/venture capital funds.

According to data from Analysis of the National Bank of Poland (NBP) entitled – *Rozwój systemu finansowania w Polsce w 2014 (The Development of Financing System in Poland in 2014)*, in 2011-2014 the value of financial resources obtained by the enterprises through the share issue on the markets organized via GPW- Główny Rynek GPW (Warsaw Stock Exchange) and NewConnect exceeded 25%. Domestic private equity funds that specialize in buy-outs gathered more than a half of collected resources. The remaining resources were gathered by the so- called venture capital balanced funds which invest in seed and start-up phases.

Table 1. Value of investments and financial resources obtained by private equity/venture capital funds in Poland in 2007-2014 (in mln PLN)

Items	2007	2008	2009	2010	2011	2012	2013	2014
Value of domestic investments of private equity funds	2162	2549	2079	2015	2837	2262	1476	1410
– on domestic market	1742	1778	1154	1661	2584	1082	1276	955
– on foreign markets	420	771	925	354	253	460	200	455
Value of foreign investments of private equity funds in Poland	1082	448	1731	962	220	177	319	95
Value of financial resources obtained from domestic private equity funds	2158	2614	583	458	1823	2032	1097	45
Number of undertakings which obtained domestic private equity funds	50	67	29	52	63	72	94	76
Number of undertakings which obtained domestic venture capital funds	23	43	7	12	26	29	62	47

Source: own study based on: Rozwój systemu finansowania w Polsce w 2007 2011 i 2014 (The development of financing system in Poland in 2007, 2011 and 2014).

As it has been mentioned before, financing the investment at its early stages is characteristic for private equity/venture capital funds. Data in figure 2 confirm that in the period considered, over a half of enterprises which obtain venture capital support was at early stages of development and was financed by venture capital funds. In 2014, among 76 undertakings supported by private equity funds, 46 were financed by venture capital funds. Figure 2 depicts the structure of private equity/venture capital investments according to stages of an undertaking's development. In 2013, companies which received venture capital financing amounted to 66% of all companies financed with private equity. The situation was similar in 2014- enterprises using venture capital funds reached 62% of all enterprises supported by private equity resources. In both years analyzed, when one takes into consideration the stage of the undertaking's development, one has to notice that private equity/venture capital funds finance activities of enterprises being at the same stage of development.

As already mentioned, the market for private equity/venture capital investments in Poland is a small one and its changes within a year do not reflect on the tendencies in financing e.g. of its particular sectors. In years 2007-2014, analyzed in the article, one can observe some tendencies in 2013-2014, when there can be visible some minor similarities in the same sector. Investments in private equity/venture capital funds in Poland, according to sectors are presented in Figure 3.

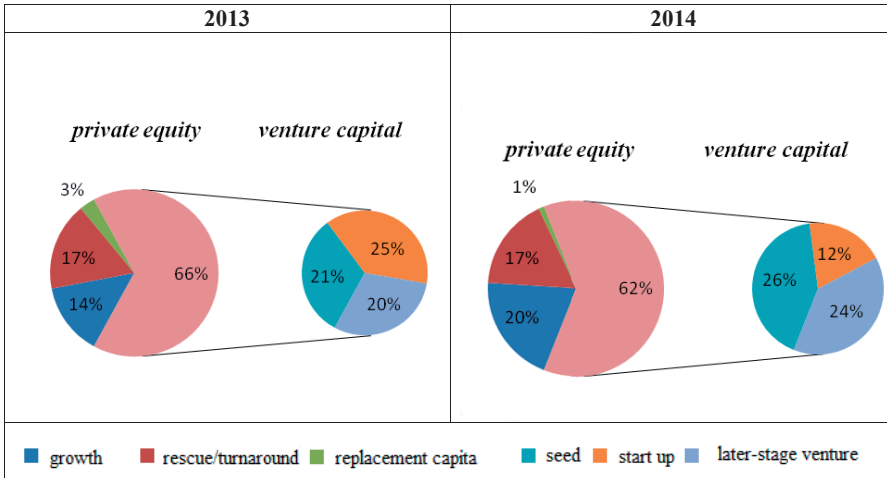


Figure 2. The structure of private equity investments specifying venture capital in Poland in 2014 according to the stage of company’s development

Source: Own study based on Rynek private equity/venture capital w Polsce w 2014 roku.

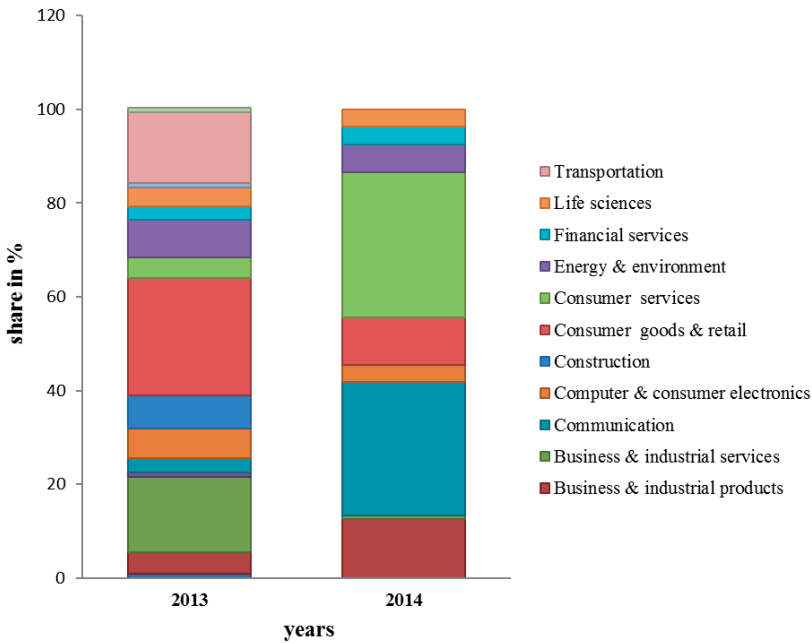


Figure 3. Investments in private equity/venture capital funds in Poland according to sectors in 2013 and 2014 (%)

Source: Own study based on: Rynek private equity/venture capital w Polsce w 2014 roku.

On the basis of existing data, no sound assessment of tendencies in financing enterprises from particular sectors is possible. In the following years, the discrepancy between them is even bigger, and it is mostly the result of single transactions.

5. Conclusions

A company which strives for development and strengthening its position on the market has to possess an adequate number of funds. When it does not, it can use debt financing. SME encounter a number of obstacles that prevent them from obtaining capital. As a consequence, it is a vital barrier for a company to develop and expand on the market. An effective, though still unpopular way of solving problems with capital is the use of private equity/venture capital funds. Funds of this kind are of a shareholding character, and the use of them does not cause the decrease in company's liquidity. It is worth noticing that companies which decide to use this kind of help do not only obtain capital, but also they get access to knowledge about new technologies, know-how, contacts databases, sales techniques, etc.

I have depicted in this paper private equity/venture capital market in Poland. Also, the value of domestic private equity/venture capital funds' investments has been analyzed in terms of their number and structure as well as sectors that received financing. The conclusion of this research is that private equity/venture capital market in Poland is relatively small, and the changes in this market do not represent the activity of these funds, especially in a long run. Private equity/venture capital funds constitute an alternative source of financing the company. Yet, they are classified as company's own, external sources of financing that are hard to access. The greatest obstacle to obtaining this kind of funding is its shareholding character, especially for sole traders. In 2014 only 76 enterprises received private equity funding which proves that this form of financing the company is still quite uncommon. However, it is worth pointing out that undertakings which use private equity/venture capital funds are less vulnerable to market turbulences, and the risk of their bankruptcy is very low. Further research of this subject will focus on financing the company's activities, especially at early stages of its development. Also, I will make an attempt to determine factors that help companies that use venture capital funds at early stages stay longer on the market.

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Biographical note

Agnieszka Mazurek-Czarnecka is a Ph.D. Student of the Cracow University of Economics, the Faculty of Finances. She completed her Master of Science degree in Finance Management and postgraduate studies in Lean Sigma Academy in School of Management and Banking in Cracow. During her studies, she was a chief editor of a cultural student magazine,

Multis Multum for four years. She received a Scholarship Sapera Auso for outstanding achievements in science as well as three Minister's Scholarships for outstanding academic achievements. Her master thesis was awarded the second prize. After graduation the faculty of Finance Management, she started working as a manager doing a project called „Time for business!“. She also worked on other projects co-financed by the European Social Fund where she was: an expert in monitoring economic activity, a specialist for the promotion and recruitment and an assistant for administrative matters.