

## **SMEs PERSPECTIVE ON VENTURE CAPITAL INVESTMENT CRITERIA - A STUDY OF CROATIAN SMEs**

*Marija Šimić Šarić\**

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*The importance of small and medium sized enterprises (SMEs) for the economy is indisputable. However, SMEs worldwide, including Croatian ones, have difficulties in accessing financing sources, primarily the alternative ones like venture capital. Seeking venture capital for entrepreneurs is a big challenge because of the absence of unique venture capital investment criteria and investment process. Less than 3% of the entrepreneurs succeed in attracting venture capital. In order to increase the chances of obtaining venture capital in the first phase, this study seeks to explain the required venture capital investment criteria from the perspective of SMEs. To the author's best knowledge, no studies have to date been undertaken specifically on venture capital investment criteria in Croatia. Final results suggest that the SME manager/owner (manager/owner of SMEs) who seeks to attract venture capital is a male, aged between 35-44, has an BSc academic degree and the company is privately owned. Regarding the profile characteristics, the results show that, looking from the point of the SME manager/owner, goal orientation and hard work are the most important factors for seeking venture capital in the first phase, followed by innovation and reasonable risk-taking.*

*Keywords:* Venture capital, SMEs, Croatia

### **1. INTRODUCTION**

Thousands of entrepreneurs every year try to obtain the necessary capital for their companies from venture capitalists (Petty and Gruber, 2009). Submitting their business proposals, they hope to meet the venture capital requirements. However, about 60% of the proposals are rejected in the first phase and only less than 3% of the entrepreneurs succeed to attract venture

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\* Marija Šimić Šarić, PhD, Senior assistant, University of Split, Faculty of Economics, Cvite Fiskovića 5, 21 000 Split, Croatia, E-mail: msimic@efst.hr

capital (Norton, 1995, Hudson and Evans, 2005, Albers, 2006, Metrick and Yasuda, 2011, Visagie, 2011). Some of the reasons for that include the absence of a distinctly defined venture capitalists decision-making process (Hudson and Evans, 2005), venture capitalists not fully understanding their own decision-making process (Hudson and Evans, 2005, Zacharakis and Meyer, 1998), venture capitalists and entrepreneurs having different opinions on the investment readiness of companies for financing through venture capital (Proimos and Murray, 2006), subjective nature of the decision-making process (Cope et al. 2004), and the absence of uniquely defined investment criteria (Khanin et al., 2008). Consequently, the method of selecting companies for financing remains a difficult process both for entrepreneurs and business owners (Capasso et al., 2014).

According to Martel (2006), there is a considerable amount of research done on investment criteria: Wells (1974), Poindexter (1976), Ruby (1984), Tyebjee & Bruno (1984), MacMillan et al. (1985), MacMillan et al. (1987), Siskos & Zopouididis (1987), Robinson (1987), Timmons et al. (1987), Hisrich & Jankowicz (1990), Roure & Keeley (1990), Dixon (1991), Hall & Hoffer (1993), Rah et al. (1994), Fried & Hisrich (1994), Muzyka et al. (1996), Boocock & Woods (1997), Zacharakis & Meyer (2000), Boehm (2002), Beim (2004), Kaplan & Stromberg (2004) and Martel (2006), but not one of those studies has produced a unique solution. Furthermore, Khanin et al. (2008), Jell et al. (2010), Kollmann and Kuckertz (2010), Visagie (2011) Narayansamy et al. (2012) and Capasso et al. (2014) also raised the questions concerning the nature and importance of the investment criteria set by venture capitalists.

Although considerable research on venture capitalists' investment criteria have been undertaken, to the best of the author's knowledge, research focused on the profile characteristics of SMEs attracting venture capital in the first phase, does not exist. The purpose of this research is to identify these characteristics.

## **2. SMEs - THEORETICAL REVIEW**

Academic researchers, governments and practitioners considered large companies crucial for economic growth till 1970s. It was thought that they were the key, the foundation of economic growth and the main source of job creation. However, in 1979, Birch with his work entitled "The Job Generation Process" directed the focus of scientists and governments from large enterprises to SMEs, because the report stressed the higher contribution of SMEs to job creation compared to large enterprises (Kingombe et al., 2010). Despite vast

research on SMEs in the last twenty years, it is evident that the research is still in its infancy (Mac an Bhaird, 2010).

The problem of defining SMEs has existed since the first studies related to them. Today there is no general, global SME definition (Ata et al., 2013, Smit and Watkins, 2012, Mahembe, 2011, Ganbold, 2008, Fan, 2003, Tonge, 2001). Definitions slightly different from one country to the next, and they are primarily dependent on laws/acts of individual countries.

In the European union, a new definition of SMEs was implemented on 1 January 2005 (European Commission, 2006) and it reads as follows: “The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro“.

In Croatia, SMEs are defined according to the Accounting Law (Official Gazette, 109/07) and the Law on Small Business Encouragement (Official Gazette, 29/02, 63/07, 53/12, 56/13). SMEs are classified according to annual turnover, assets (balance sheet) and average number of employees. The classification for Croatia and European Union is given in Table 1.

Table 1. SMEs in Croatia and European Union

	Croatia			European Union		
	Micro	Small	Medium	Micro	Small	Medium
<b>Annual Work Unit (AWU)</b>	< 10	< 50	< 250	< 10	< 50	< 250
<b>Annual turnover (million)</b>	< €2	≤ € 10	≤ € 50	≤ €2	≤ €10	≤ €50
<b>Annual balance sheet total (million)</b>	<€ 2	≤ €10	≤ €43	≤ €2	≤ €10	≤ €43

Source: Author’s compilation based on European Commission (2006) and the Law on Small Business Encouragement (Official Gazette, 29/02, 63/07, 53/12, 56/13).

It is common knowledge that SMEs are confronted with a wide range of problems. Figure 1 shows the obstacles for European Union and Croatia. Croatian SMEs are faced with a larger number of different barriers compared to EU SMEs. Those barriers include ineffectiveness of the legal system, deficiency of educational programs for entrepreneurship, underdevelopment of financial

markets for the satisfaction of SME sector needs, corruption, uncoordinated government policies in creating a favorable business climate etc. A highly-ranked barrier both in the EU and in Croatia is access to finance. For Croatian SMEs additional problem is the underdevelopment of informal forms of financing like business angels or venture capital. It has often been pointed out that entrepreneurs in Croatia are not familiar with informal forms of financing and they do not know what the advantages and disadvantages are of these kinds of financing.

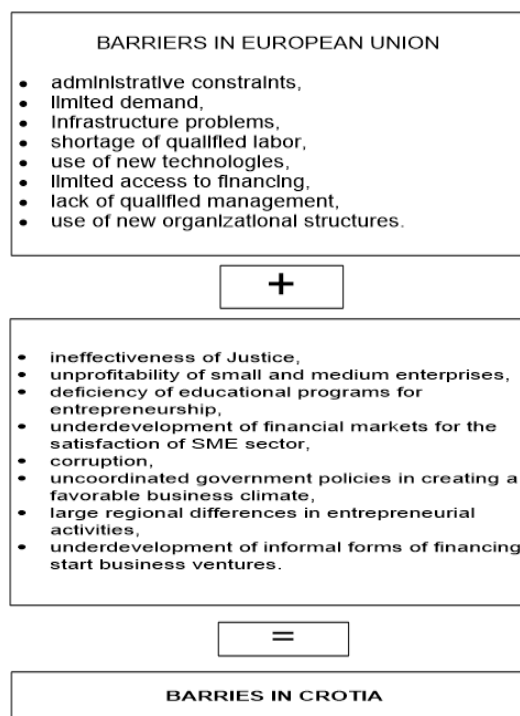


Figure 1. SMEs barriers in the EU and Croatia

Source: Author, according to Bistričić, Agatić and Kuzman (2011), Singet et al. (CEPOR, 2011), Kersan-Škabić and Banković (2008).

### 3. VENTURE CAPITAL INVESTMENT CRITERIA - THEORETICAL BACKGROUND

From the first research about venture capital in 1970s, investment criteria are in the focus of researchers worldwide. One question that remains in the focus of many researchers is this: What are the most important criteria that venture capitalists (VCs) take into account while making investment decisions?

The literature concerning venture capital investment criteria can be divided into two groups. One group are those who consider management characteristics as most important, while the other believe that the product/market are key for VCs decision making (Khanin et al., 2008). According to them some authors in different studies came to disparate opinions.

The seminal study by MacMillan et al. (1985) proposes six categories important to venture capitalists: the entrepreneur's personality, the entrepreneur's experience, characteristics of the product or service, characteristics of the market, financial consideration and the venture team. It also considers 27 investment criteria (Table 2). Five out of ten most important investment criteria are related to the experience or personality of the entrepreneurs. *“There is no question that irrespective of the horse (product), horse race (market), or odds (financial criteria), it is the jockey (entrepreneur) who fundamentally determines whether the venture capitalist will place a bet at all”.*

Visagie (2011) concluded that „decision making criteria employed by venture capitalists have been a source of fascination to many: entrepreneurs seeking funding, VCs seeking comparability and academics seeking wisdom“. Kollmann and Kuckertz (2010) pointed out how different empirical studies emphasize the most important characteristics of the entrepreneur and the entrepreneurial team. Those authors state the following: “The influence of a management team's quality on venture performance is not merely a cliché popular with venture capitalists“. Except for company's ability to fulfill the requirements of PE, so called equity- worthiness, for the successful finishing of the investment, company has to be motivated to accept an outside equity investor, demonstrating a, so called, equity – willingness (Capasso et al., 2014).

Table 2. Venture capital investment criteria

<b>I. The entrepreneur's personality</b>	1. Capable of sustained intense effort
	2. Able to evaluate and react to risk well
	3. Articulate in discussing venture
	4. Attends to detail
	5. Has a personality compatible with mine
<b>II. The entrepreneur's experience</b>	6. Thoroughly familiar with the market targeted by venture
	7. Demonstrated leadership ability in past
	8. Has a track record relevant to venture
	9. The entrepreneur was referred to me by a trustworthy source
<b>III. Characteristics of the product or service</b>	10. I am already familiar with the entrepreneur's reputation
	11. The product is proprietary or can otherwise be protected
	12. The product enjoys demonstrated market acceptance.
	13. The product has been developed to the point of a functioning prototype
<b>IV. Characteristics of the market</b>	14. The product may be described as "high tech"
	15. The target market enjoys a significant growth rate.
	16. The venture will stimulate an existing market.
	17. The venture is an industry with which I am familiar.
	18. There is little threat of competition during the first three years.
<b>V. Financial considerations</b>	19. The venture will create a new market.
	20. I require a return equal to at least 10 times my investment within 5-10 years.
	21. I require an investment that can be easily made liquid (e.g., taken public or acquired).
	22. I require a return equal to at least 10 times my investment within at least 5 years
	23. I will not be expected to make subsequent investments.
<b>VI. The venture team</b>	24. I will not participate in latter rounds of investment (requires my participation in the initial round of investment).
	25. The venture is initiated by one person with the relevant experience to his idea.
	26. The venture is initiated by more than one individual, each having similar relevant experience.
	27. The venture is initiated by more than one individual, the individuals constituting a functionally balanced management team.
	28. None of the above is essential for the venture to go forward.

Source: MacMillan et al. (1985)

According to Martel (2006) most studies about venture capital investment criteria were conducted in developed equity markets (Wells 1974, Poindexter 1976, Tyebjee and Bruno 1981, Tyebjee and Bruno 1984, MacMillan et al., 1985, MacMillan et al. 1987, Khan 1987, Sandberg et al. in 1988, Riquelme and Rikards 1992, Hall and Hofer 1993, Fried and Hisrich 1994, Boocock and Woods 1997, Zacharakis and Mayer 1998 and Shepherd 1999).

For emerging equity markets, small equity markets and economies in transition the number of studies is minor - only three studies (Martel, 2006). In those studies, the most common method of data collection is a questionnaire.

#### 4. ENTREPRENEURIAL CHARACTERISTICS

While there is no single definition of entrepreneurs, we can define them as persons taking the initiative, patient and persistent, dedicated to their work, having exceptional organizational skills, ability to inspire people, to guide and control the business, committed to the attempt that all activities are performed following their unique vision. An entrepreneur can also be defined as a person who creates a business or product, manages resources, and takes the risk in order to make a profit, i.e. a person who organizes, manages, and assumes the risk of doing business in order to make profit (Siropolis, 1995, Buble and Kružić, 2006).

According to Hustedde and Pulver (1992), the success of attracting equity capital by entrepreneurs is associated with four universal variables:

- Characteristics of the entrepreneurs - education, experience and age;
- Characteristics of the enterprise – stage, industry type, and location;
- Characteristics of the request – amount, business plan, and prospective capital source;
- Source of advice – including technology, preparation of the business plan and a place to seek funds.

According to Cubico et al. (2010), entrepreneurial potential can be explained by following these factors:

- Factor 1: Goal orientation – tendencies towards creativity and innovation, degree of determination in reaching goals and personal perception as to overall handling of work situations.
- Factor 2: Leadership – aptitude for management and leadership.
- Factor 3: Adaptability – ability to perceive environmental change and adaptability.

- Factor 4: Need for achievement – the desire for fame, success and social affirmation, as well as respect from others.
- Factor 5: Need for self-empowerment – the desire to realize oneself through one's job, which, apart from any economic goals, must be enjoyable, satisfying and interesting.
- Factor 6: Innovation – curiosity for what is new.
- Factor 7: Flexibility – tendency to reorient one's goals according to external situation.
  
- Factor 8: Autonomy – necessity of having one's own independent space to make decisions and choices.

According to Siropolis (1994), Buble and Kružić (2006), and Buble and Buble (2014), a successful entrepreneur should have the following traits:

- Innovation - innovative people are those who have a strong desire and willingness to tackle the unknown, want to do familiar things in new and unexpected ways, and offer good practical solutions;
- Reasonable risk-taking - possessing a "sixth sense" for risks and extreme courage and willingness to tackle those if and when they occur;
- Confidence - faith that they are better than others in their field, not reconciling with the existing state of things but trying to change;
- Hard work – person is a workaholic, but if the situation does not provide a challenge, they will tend to walk away from it;
- Goal orientation and responsibility - time and again setting new, higher goals and striving towards constant progress and development.

## **5. STRUCTURE OF THE STUDY**

As stated previously, investment criteria set by venture capitalist are still an enigma, not just for the entrepreneurs, but also for the venture capitalists. Based on previous research about entrepreneurs' characteristics needed for attracting venture capital (MacMillan et al, 1985, Hustedde and Pulver, 1992, Siropolis, 1994, Buble and Kružić, 2006, Cubico et al., 2010, Buble and Buble, 2014), four characteristics of a potential successful entrepreneurs profile were selected as variables: innovation, reasonable risk-taking, hard work and goal orientation.

In the questionnaire designed for this research, five questions were related to the characteristics of the respondents and 16 questions referred to the characteristics of the profile of SMEs manager/owner (four questions for each variable). Most of the questions were close-ended questions and formulated



according to the Likert-type scale with five degrees of intensity. The empirical research was based on data, collected by using a postal questionnaires, addressed to managers/owners of 58 small and medium sized Croatian companies, funded by venture capital. The sample list was collected personally, from a variety of secondary sources, as there is no database of companies financed by venture capital in Croatia.

A total of 29 usable questionnaires were received, which leads to the response rate of 50%. This can seem quite a small sample, but, given the specificity of the research field, which is characterized by confidentiality of data, the return rate of 50% of the survey represents above-average return rate. Thus, it was decided that the reached response rate was adequate for conducting statistical analyses.

Collected data were processed by using Microsoft Excel and SPSS 17.0 - Statistical Package for the Social Sciences (version 17.0) software. This processing resulted in: descriptive statistical analysis of the data collected, which included calculation of the mean values such as the mean, median, and mode, and the measures of dispersion around the mean values, i.e. standard deviation.

## 6. RESEARCH RESULTS

### 6.1. General characteristics of respondents

The company's size in this study is measured according to the criteria of the Law on Small Business Encouragement (Official Gazette, 29/02, 63/07, 53/12, 56/13). According to the guidelines set by this Law, entrepreneurs are classified as micro, small and medium subjects of SMEs according to these criteria: average number of employees, revenues and assets during the year. In the sample of 29 SMEs, 4 (13.8%) are micro enterprises, 11 (37.9%) are small and 14 (48.3%) are medium size (Table 3).

*Table 3. Profile of respondents*

Size of company	Micro	Small	Medium	Total (% of total)
<b>Total</b>	4 (13.8%)	11 (37.9%)	14 (48.3%)	29 (100%)

Source: Research results.

Descriptive statistics for demographic characteristics of the company managers/owners (age, gender, academic degree and type of ownership) is shown below (Table 4). None of the managers/owners is under 24, or over 59, while the majority of the managers/owners are aged between 35 and 44 (48.3%), which shows that the age structure of managers/owners can be considered as appropriate. Out of the total number of respondents 86.5% were male and 13.8% female; this is comparable to the Croatian entrepreneurship, being dominated by male entrepreneurs. In terms of the level of education, 82.6% of respondents have a university degree while 17.2% have high school education. Minor number of respondents have a PhD and MSc degree (just 3.4%). Higher education degree does not seem critical for attracting venture capital. Out of the total number of respondents, the majority have a privately-owned company (86.2%) while there is no state, county and city-owned companies. Knowing how venture capital is always looking for dynamic companies, presented results are consistent with theoretical assumptions.

Table 4. Demographic statistics of respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Age	25-34	6	20,7	20,7	20,7
	35-44	14	48,3	48,3	69
	45-59	9	31	31	100
	<b>Total</b>	<b>29</b>	<b>100</b>	<b>100</b>	
Gender	Male	25	86,2	86,2	86,2
	Female	4	13,8	13,8	100
	<b>Total</b>	<b>29</b>	<b>100</b>	<b>100</b>	
Academic degree	High school	5	17,2	17,2	17,2
	College	3	10,3	10,3	27,6
	BSc	19	65,5	65,5	93,1
	MSc	1	3,4	3,4	96,6
	PhD	1	3,4	3,4	100
	<b>Total</b>	<b>29</b>	<b>100</b>	<b>100</b>	
Ownership	Private	25	86,2	89,3	89,3
	State	0	0	0	0
	County	0	0	0	0
	City	0	0	0	0
	Others	3	10,3	10,7	100
	<b>Total</b>	<b>28</b>	<b>96,6</b>	<b>100</b>	

Source: Research results.

## 6.2. Respondents' profiles

Innovative people are those who have a strong desire and willingness to tackle the unknown, want to do familiar things in new and unexpected ways, they are interested in new things, and offer good practical solutions (Siropolis, 1994, Buble and Kružić, 2006, Cubico et al., 2010, Buble and Buble, 2014).

The respondents were asked to indicate their degree of agreement or disagreement with the closed – ended question on a five-point Likert-type scale ranging from 1 (strongly disagree) to 5 (strongly agree). Four closed – ended questions measure this variable. The value of the variable innovation is obtained as the average value of the average of the four questions. The descriptive statistics are presented in Table 5.

Table 5. Descriptive statistic for innovation

		Innovation
N	Valid	29
	Missing	0
Mean		4.0776
Median		4.0000
Std. Deviation		0.72919
Minimum		2.25
Maximum		5.00

Source: Research results.

Table 2 indicates that innovation is highly evaluated by managers/owners who attract venture capital. The value of median is 4, compared to the maximum of 5.

According to Siropolis (1994), Buble and Kružić (2006), Buble and Buble, (2014), reasonable risk-taking means owning a "sixth sense" for risks and extreme courage and willingness to tackle them if and when they occur. The respondents were asked to indicate their degree of agreement or disagreement with the closed – ended question on a five-point Likert-type scale ranging from 1 (strongly disagree) to 5 (strongly agree). Four closed – ended questions measure this variable. The value of the variable 'reasonable risk-taking' is obtained as the average value of the average of the four questions. The descriptive statistic for reasonable risk-taking is shown in Table 6. The obtained results show that the characteristic 'reasonable risk-taking' is less important for

seeking venture capital in the first phase. Value of median is 3.5 (as compared to the scale maximum of 5).

Table 6. Descriptive statistic for reasonable risk-taking

		Reasonable risk-taking
N	Valid	29
	Missing	0
Mean		3.6866
Median		3.5000
Std. Deviation		0.76636
Minimum		1.50
Maximum		5.00

Source: Research results.

Hard work might be described in terms of ‘workaholism’, but if the situation does not provide a challenge, it is not pursued (Siropolis, 1994, Buble and Kružić, 2006, Cubico et al., 2010, Buble and Buble, 2014). The respondents were asked to indicate their degree of agreement or disagreement with the closed – ended question on a five-point Likert-type scale, ranging from 1 (strongly disagree) to 5 (strongly agree). Four closed – ended questions measure this variable. The value of the variable ‘hard work’ is obtained as the average value of the average of the four questions. From Table 7, it is evident that hard work, as a characteristics of the manager/owner, is extremely important.

Table 7. Descriptive statistic for reasonable risk-taking

		Reasonable risk taking
N	Valid	29
	Missing	0
Mean		4.1724
Median		4.2500
Std. Deviation		0.68499
Minimum		3.00
Maximum		5.00

Source: Research results.

According to Siropolis (1994), Buble and Kružić (2006), Cubico et al. (2010), and Buble and Buble (2014), goal orientation and responsibility stand

for constantly striving to set higher goals, i.e., achieving constant progress and development, and personal perception as to overall handling of work situations. The respondents were asked to indicate their degree of agreement or disagreement with the closed – ended question on a five-point Likert-type scale ranging from 1 (strongly disagree) to 5 (strongly agree). Four closed – ended question measure this variable. The value of the variable ‘goal orientation’ is obtained as the average value of the average of the four questions and the median totals 4.25, on the scale, with the maximum of 5.

Table 8. Descriptive statistic for goal orientation

		Goal orientation
N	Valid	29
	Missing	0
Mean		4.2903
Median		4.2500
Std. Deviation		0.50680
Minimum		3.00
Maximum		5.00

Source: Research results.

According to research results, managers/owners of small and medium enterprises which attracted venture capital in Croatia considered goal orientation and hard work as the most important characteristics for seeking venture capital in the first phase. These characteristics are followed by innovation and reasonable risk taking.

## 7. CONCLUSION

Small and medium enterprises (SMEs) are confronted with a range of barriers when doing business. Croatian SMEs are faced with a larger number of different barriers compared to EU SMEs including ineffectiveness of the legal system, deficiency of educational programs for entrepreneurship, underdevelopment of financial markets for the satisfaction of SME sector needs, corruption, uncoordinated government policies in creating a favourable business climate etc. A commonly stressed and highly ranked barrier in the EU and Croatia is access to finance.

SMEs, especially in the early stages of development, have difficulties accessing necessary financial sources. As one option for filling this financial gap there is venture capital as an alternative source of finance. However, a

common problem which occurs when SMEs attempt to seek venture capital is that about 60% of the business proposals are rejected in the first phase and only less than 3% of the entrepreneurs succeed in attracting venture capital. One of the most stated reasons for such a small percentage of investment is related to the fact that SMEs often do not satisfy the required investment criteria in the first phase.

Therefore, the aim of this research was to identify the SME manager/owner profile characteristics necessary to reach venture capital in the first phase. The results of the conducted research indicate that the SME manager/owner who attracts venture capital is a male, aged between 35-44, has an BSc degree and his company is privately owned. Regarding the profile characteristics, the results show that, looking from the point of view of the SME manager/owner, goal orientation and hard work are the most important characteristics, followed by innovation and reasonable risk-taking.

Not involving companies that failed to attract venture capital can be highlighted as a potential limitation of this study. This is a challenge for further research, as there is no publicly available data. Secondly, the data are collected using survey data and, thus, are subject to the usual limitations associated with such data. Despite the potential limitations of the study, the fact remains that this is the first empirical study conducted on companies that attract venture capital in Croatia.

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#### KRITERIJI ZA INVESTICIJU RIZIČNOG KAPITALA IZ PERSPEKTIVE MALIH I SREDNJIH PODUZEĆA (MSP) – ISTRAŽIVANJE HRVATSKIH MSP

##### Sažetak

Važnost malih i srednjih poduzeća (MSP) za gospodarstvo je neupitna. Međutim, MSP širom svijeta, uključujući i hrvatska, imaju poteškoća u pristupu adekvatnim izvorima financiranja, prvenstveno alternativnim izvorima poput rizičnog kapitala. Pristup rizičnom kapitalu za mnoge poduzetnike je veliki izazov zbog nepostojanja jedinstveno definiranih investicijskih kriterija rizičnog kapitala, kao ni investicijskog procesa. Tek nešto manje od 3% poduzetnika ostvare financiranje putem rizičnog kapitala. S ciljem povećanja mogućnosti privlačenja rizičnog kapitala u prvoj fazi, ovo istraživanje nastoji objasniti investicijske kriterije rizičnog kapitala potrebne za privlačenje rizičnog kapitala od strane MSP-a. Konačni rezultati pokazuju kako menadžer/vlasnik MSP-a koji je uspio privući rizični kapital ima između 35 i 44 godine, muškog je spola, fakultetski je obrazovan, a poduzeće je u privatnom vlasništvu. Vezano uz karakteristike profila, rezultati pokazuju da su, gledajući s aspekta menadžera/vlasnika MSP-a, postavljanje ciljeva i uporan rad najvažnije karakteristike, a slijede inovativnost i razumno preuzimanje rizika.

**Ključne riječi:** rizični kapital, MSP, Hrvatska



